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India: Financial Sector Assessment Program—Detailed Assessments Report on Basel Core Principles for Effective Banking Supervision

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FINANCIAL SECTOR ASSESSMENT PROGRAM

INDIA

BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION

DETAILED ASSESSMENT

AUGUST 2013

INTERNATIONAL MONETARY FUND
MONETARY AND CAPITAL MARKETS DEPARTMENT

THE WORLD BANK
FINANCIAL AND PRIVATE SECTOR DEVELOPMENT
VICE PRESIDENCY
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GLOSSARY

AASB	Auditing and Assurance Standards Board
AFC	Asset financing companies
AFI	Annual financial inspection
ALCO	Asset and Liability Committee
AML/CFT	Anti-money laundering/ combating of financing of terrorism
ANBC	Adjusted net bank credit
APG	Asia Pacific Group
BCPs	Basel Core Principles
CPC	Credit Policy Committee
CPs	Core principles
CRAR	Capital to risk-weighted assets ratio
CRM	Country risk management
CRR	Cash reserve ratio
CTR	Currency transaction report
DBOD	Department of Banking Operations and Development
DBS	Department of Banking Supervision
DICGC	Deposit Insurance and Credit Guarantee Corporation
DRT	Debt Recovery Tribunals
ELA	Emergency liquidity assistance
FATF	Financial Action Task Force
FIU	Financial Intelligence Unit
FMC	Forward Markets Commission
FSAP	Financial Sector Assessment Program
FSDC	Financial Stability and Development Council
FSLRC	Financial Sector Legislative Reforms Commission
IASB	International Accounting Standards Board
ICAAP	Internal Capital Adequacy Assessment Program
ICAI	Institute of Chartered Accountants of India
IFC	Infrastructure Finance Companies
IFRS	International Financial Reporting Standards
IRB	Internal rating based
IRDA	Insurance Regulatory and Development Authority
IRR	Interest rate risk
IRRBB	Interest rate risk in the banking book
KYC	Know your Customer
LoLR	Lender of last resort
MC	Master Circular
MoU	Memorandum of Understanding
MVE	Market value of equity
NABARD	National Bank for Agriculture and Rural Development

NBFC	Nonbank financial companies
NPA	Nonperforming assets
NPLs	Nonperforming loans
NRV	Net realizable value
PCA	Prompt corrective action
PEP	Politically exposed persons
PFRDA	Pension Fund Regulatory and Development Authority
PMLA	Prevention of Money Laundering Act
PSS	Payment and Settlements Systems
RBI	Reserve Bank of India
ROA	Return on assets
ROSC	Report on Observance of Standards and Codes
RTGS	Real time gross settlement system
SEBI	Securities and Exchange Board of India
SIDBI	Small Industries Development Bank of India
SLR	Statutory liquidity ratio
SREP	Supervisory review and evaluation process
STR	Suspicious transaction report
UTs	Union Territories

I. SUMMARY, KEY FINDINGS AND RECOMMENDATIONS

A. Summary

1. **The Reserve Bank of India (RBI) is to be commended for its tightly controlled regulatory and supervisory regime, consisting of higher than minimum capital requirements, frequent, hands-on and comprehensive onsite inspections, a conservative liquidity risk policy and restrictions on banks' capacity to take on more volatile exposures.** The Indian banking system remained largely stable during the global financial crisis. Since then, the government of India and RBI have taken additional measures to enhance the soundness and resilience of the banking system, such as the establishment of a Financial Stability and Development Council (FSDC), the implementation of a countercyclical provisioning regime, and the development of a roadmap for the introduction of a holding company structure.

2. **Despite this strong performance, several gaps and constraints in the implementation of the regulatory and supervision framework remain.** The most significant gaps are in the area of international and, to a lesser extent, domestic supervisory information sharing and cooperation. In addition, some previously observed weaknesses in the financial architecture, particularly with regard to the independence of RBI and the inherent conflict of interest when supervising state owned banks, remain. Also, the assessors identified a number of opportunities to better align current supervisory policies and procedures to international best practice. These include suggestions for improved coordination between the central office and the regional offices, increased interaction with auditors and private sector banks, more focused attention to banks' internal risk-management models, a gradual move to more risk-based supervision and a revision of the RBI rotation policy to foster stronger supervisory expertise.

3. **Indian banks have established significant overseas operations in more than 45 jurisdictions, but RBI has Memoranda of Understanding (MOUs) with only 2 jurisdictions and limited informal arrangements with several others, leading to material gaps in the flow of information.** Although RBI has made some progress since the 2009 self-assessment, a significant informational gap remains—a gap that has not been filled through other means such as conducting its own overseas inspections (none since 2008). Importantly, Indian banks operate in a number of countries in unstable regions where it cannot be assumed that strong supervisory practices are in place. The assessors also noted gaps in the licensing process, as it was not clear that there was a systematic analysis of the quality of host-country supervision in reviewing overseas expansion proposals, nor a rigorous and consistent review of whether the home countries of foreign banks seeking to open offices in India practice consolidated supervision. As a home supervisor, it would also be good practice to establish and host supervisory colleges for the Indian banks that are internationally active.

4. **The authorities have identified 12 financial conglomerates that are subject to a supplementary monitoring framework, but some areas for strengthening consolidated supervision practices remain.** For instance, RBI cannot order inspections of other subsidiaries it does not regulate, carry out transaction testing at such subsidiaries, or obtain copies of inspection reports directly from their regulators. A proposed amendment to the BR Act would, if enacted, address this deficiency. In the immediate term, the assessors believe that RBI should look for ways to ensure it receives inspection reports directly from its peer supervisory agencies to reduce any delays in receipt. The current practice is to obtain such reports from the parent bank at the time of the inspection. Other opportunities for enhanced consolidated supervision include limiting the participation at a segment of interagency meetings to regulators only, thus creating a forum for frank and candid conversation without bank representatives present. Finally, the methodology for rating banking companies should be reconsidered so that the rating methodology explicitly provides for a mechanism to reflect contagion risk from nonbanking subsidiaries in a systematic way.

5. **Although no instances of *de facto* government interference were observed, several legal provisions in the RBI Act and the BR Act limit the *de jure* independence of RBI.** Some legal provisions in the BR Act and RBI Act allow the central government to give directions to RBI, to require it to perform an inspection, to overrule its decisions, and to supersede the Central Board of RBI. While, in practice, these have never been used, the removal of these provisions would provide greater legal certainty regarding the independence of RBI. Also, the formal grounding of RBI independence in the RBI Act would further strengthen its autonomy. Finally, the reasons for the removal of the head of the supervisory agency during his/her term are not specified in law.

6. **With regard to state-owned banks, an employee of RBI still acts as a nominee director on each of their Boards.** RBI's remedial powers are also more limited. After the 2006 amendment to the Banking Companies (Acquisition and Transfer of Undertakings) Act 1970/1980, central government, on the recommendation of RBI, nominates a person possessing necessary expertise and experience in regulation or supervision of commercial banks, as a director of a nationalized bank. The provision does not mandate that such person should be an employee of RBI. In practice, however, the nominee director is a current employee from RBI from a department other than bank supervision. From the assessors' discussion with banks, it appears that this director takes a rather active role in the Board's discussions and is sometimes implicitly relied upon to ensure regulatory compliance. This blurs the lines between the supervisory role of RBI and its assumed role as the Board's compliance guardian. The authorities should consider providing greater clarity to the limitations of the nominee director's role in order to avoid the appearance of RBI becoming involved in a bank's internal control processes. As the statutes constituting public banks empower them to do banking business, there is no provision empowering RBI to disempower such banks from carrying on banking business. RBI can also not remove officers/directors of a public bank, except directors appointed by shareholders other than the central government. Furthermore, as a more general observation, there remains considerable discretion in the

Prompt Corrective Action (PCA) regime to allow a bank to continue to operate for, potentially, in excess of a year, with extremely low capital; given the capital to risk-weighted asset ratio (CRAR) is a total capital concept, a 3 percent total capital level could involve very little (common) equity. If such discretion were exercised regarding a public bank, the government would presumably take action at some point.

7. **RBI has a large number of regional offices, each in charge of supervising its assigned banking population, leading to coordination challenges.** That the off-site monitoring function (at central office) is largely separated from the on-site supervision function at the regional offices presents some challenges that RBI acknowledges. We also believe that it should build on the current program of interaction among the regional office inspectors as a group and the central office by establishing a regular forum for inspectors to go through findings, insights, and questions, particularly when new supervisory approaches or regulations are being introduced. Doing this in a structured and consistent way would not only support strengthened supervisory judgments made by RBI examiners, but also the capacity to develop a broader horizontal perspective on bank's risk-management practices. More generally, increasing the focus in the annual financial inspection (AFI) process on critically assessing risk-management practices is encouraged, including a stronger focus on assessing the quantity of people and skill level of people in risk management and control functions.

8. **Indian banks are increasing their risk-management sophistication and RBI has announced its timetable for the move toward the implementation of the Basel II advanced approaches.** Comprehensive and robust internal supervisory guidance for the assessment of the Internal Capital Adequacy Assessment Process (ICAAP) was developed and banks have submitted their ICAAPs. That said, discussions with banks reveal that many challenges remain for migration to the Basel II advanced approaches. Most relate to constraints on data, tools, and methodologies, and the required skills for the quantification and modeling of risks as well as the validation of these models. The RBI will have to consider how to address a range of practical implementation issues consistently. Going forward, it will also have to reflect if, and how, current supervisory policies and practices have to be strengthened for effective supervision of banks applying the Basel II advanced models on an ongoing basis.

9. **With the increased use of risk modeling, there is a need to devote more supervisory attention to risk models that are used for risk-management purposes, even if they are not generating inputs for the regulatory capital calculation.** A formal regulatory requirement for banks to develop and implement a sound model validation policy would be a first step in that direction. RBI examiners should then also develop a system of periodic validation and independent testing of models in banks.

10. **RBI is looking to take various action steps that could address a number of the concerns outlined above:**

- RBI has proposed changes in the banking law. These changes would provide it access to information from banking companies about their associated enterprises (including nonbank financial companies) on a more timely and certain basis, and give it an ability to order inspections of nonbank subsidiaries of banking companies, that would address many of the domestic coordination challenges**.**

- RBI is moving ahead on putting in place more MOUs to address some of the concerns on home/host coordination.

- RBI has taken initial steps toward a more risk-based supervision approach. Risk-based supervision attempts to vary the scope and intensity of supervision according to the level of risk individual institutions pose. In the medium term, risk-based supervision can optimize supervisory resources. The assessors recommend RBI continue its phased approach toward implementation by gradually integrating more forward-looking elements in the supervisory process and focusing attention beyond the rectification of deficiencies observed during the onsite inspection.

11. **RBI has launched an initiative to consider modifications of elements of the supervisory process for the largest banking groups.** We have been advised that a steering group, led by a deputy governor, began a year-long review process in April 2011 to consider a range of potential changes. As the review began, the Department of Banking Supervision (DBS) announced some restructuring of its operations to move the off-site monitoring process closer to the on-site inspection process. We were also advised orally (although we have not seen documentation to this effect) that the DBS will establish a new supervisory regime for the largest (12) banking companies, which have been designated as systemically important in India, involving such elements as (a) supervisory responsibility being moved from the regional offices (including from the Mumbai regional office) to the central office; and (b) the central office planning to shift away from the current once a year approach to a supervisory approach that is more continuous, with targeted reviews conducted of an individual banking company or a cross-section of firms, focusing on areas of potential concern that have been seen through the monitoring process. We believe such a program, if it is well developed and well implemented, has the potential to improve a number of our areas of concern such as increasing the risk focus of supervision, linking monitoring and on-site inspections more effectively, enhancing the consistency and effectiveness of the supervision of systemically important firms, and helping to develop specialized expertise that will be increasingly necessary as Basel II and III are adopted.

12. **Further steps to enhance the specialized expertise of supervisory personnel should also be taken—specifically, to review the current rotation policy for supervisory staff, which limits the build-up of expertise in banking supervision and regulation.** In

view of the intensity of changes in financial regulation (particularly Basel II and Basel III), as well as the increased complexity and globalization of supervised entities, the assessors are of the opinion that RBI's rotation policy is outdated and should be revised. This could be achieved in a phased manner; for example by narrowing rotation areas for supervisors to similar areas of expertise, i.e., limited to DBS, Department of Banking Operation And Development (DBOD) and other departments involved in the supervision of NBFIs. To address concerns of regulatory capture, rotations of supervisors assigned to specific supervised entities should be implemented.

13. **Finally, and very broadly, with RBI now represented on the G-20, the FSB, and the Basel Committee on Banking Supervision, it has the opportunity to influence the direction of the global policy debate.** The capacity to do that would be enhanced with some structural changes within RBI to prepare representatives at the various meetings more effectively, through better coordination and focus between Departments within RBI.

B. Information and Methodology Used for the Assessment

14. **This assessment of the current state of compliance with the BCPs in India has been undertaken as part of the joint IMF-World Bank Financial Sector Assessment Program (FSAP).**[1] The assessment was conducted from June 15 till July 1, 2011. It reflects the banking supervision practices of RBI as of the end of May 2011 and covers only commercial banks.

15. **The assessment is based on several sources:** (i) a complete self-assessment prepared by the RBI in 2011 as well as in 2009;[2] (ii) detailed interviews with the RBI staff at the head office as well as the regional office in Delhi; (iii) a review of laws, regulations, and other documentation on the supervisory framework and on the structure and development of the Indian financial sector; (iv) a review of a number of on-site and off-site examination reports and correspondence with banking companies and auditors; and (v) meetings with the Ministry of Finance, state-owned banks, private sector banks, foreign banks, and an external auditor, as well as the banking association.

16. **The assessment was performed in accordance with the guidelines set out in the Core Principles (CPs) Methodology.**[3] It assessed compliance with both the "essential" and the "additional" criteria, but the ratings assigned were based on compliance with the "essential" criteria only. The methodology requires that the assessment be based on the legal

[1] The assessment was conducted by William Rutledge (external expert) and Katia D'Hulster (World Bank staff).

[2] The Government of India, in consultation with the RBI, decided to undertake a comprehensive self-assessment of the financial sector and for that purpose constituted the Committee on Financial Sector Assessment (CFSA) in September 2006. A comprehensive BCP assessment was finalized, peer reviewed and published in 2009.

[3] Issued by the Basel Committee on Banking Supervision, October 2006.

and other documentary evidence in combination with the work of the supervisory authority as well as its implementation in the banking sector. The assessment of compliance with the CPs is not, and is not intended to be, an exact science. Banking systems differ from one country to the next, as do their domestic circumstances. Furthermore, banking activities are changing rapidly around the world, and theories, policies, and best practices of supervision are swiftly evolving. Nevertheless, it is internationally acknowledged that the CPs set minimum standards.

17. **This assessment is based solely on the laws, supervisory requirements, and practices that were in place at the time it was conducted.** However, where applicable the assessors made note of regulatory and supervisory initiatives which have yet to be completed or implemented. The assessment team enjoyed excellent cooperation with its counterparts and, within the time available to perform their work, reviewed all the information provided. The assessors thank the authorities for their openness and active involvement in the process.

C. Institutional and Macroprudential Setting, Market Structure Overview

18. **India has recovered strongly from the fallout from the global financial crisis.** GDP grew by 8¼ percent in 2010 and is forecast to grow at 7¾ percent in 2011, driven by domestic demand. A number of reforms related to infrastructure finance have been successful, but progress on the broader structural agenda, including in the financial sector, has been slow. Inflation remains a key concern, with headline inflation above 8 percent annually since mid-2008. While the RBI has gradually lifted policy rates over the past year, real interest rates remain negative and markets are increasingly worried about inflation. Continued inflation and higher policy rates could affect growth prospects and ultimately have an impact on financial stability. With foreign direct investment and equity flows falling, concerns about excessive inflows and rupee appreciation have diminished, and recent strong export performance has helped contain the current account deficit. On the other hand, a trend toward short-term capital inflows raises concerns about sustainability. Going forward, high oil prices, inflation, and weaknesses in governance represent risks to the balance of payments and could impact financial stability.

19. **The financial sector is diversified, highly interconnected, and expanding rapidly.** It comprises commercial banks, cooperative banks, nonbanking financial institutions, insurance companies, and mutual funds, with overall assets of about 150 percent of GDP. Commercial banks are the largest group, comprising nearly 60 percent of total financial assets. Financial firms are interconnected through ownership and funding relationships. Major banks own insurance companies, fund management companies, and securities firms. Banks, nonbank financial companies (NBFCs), and mutual funds are linked through the wholesale funding market.[4] Industrial companies are not allowed to own banks, but the

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[4] Mutual funds invest 70 percent of assets in short-term instruments, the bulk of which are bank certificates of deposits (CDs). NBFCs borrow from banks and mutual funds. Banks invest in, and borrow from, mutual funds. Bank CDs issued to mutual funds account for 8 percent of total deposits in 2011, up from 3 percent in 2007.

authorities are looking at new norms for bank licensing and proposals for a holding company structure that would permit mixed conglomerates.

20. **Public banks dominate the banking sector, and the government plays an active role in banks' asset allocation.** Majority government-owned banks account for nearly three-fourths of total banking assets. The government's share in the capital of public sector banks is now close to the 51 percent statutory minimum, limiting the banks' ability to raise additional private equity (unless the government purchases additional shares). A sizable portion of banking assets is held in government securities under a 24 percent minimum statutory liquidity requirement. Banks are an important conduit for lending to priority sectors—such as agriculture, small-scale industries, and exports—with lending targets to priority sectors at 40 percent of total loans and advances for domestic banks and 32 percent for foreign banks. Lending to infrastructure and real estate has grown rapidly in recent years, the former actively promoted by the authorities, including through a relaxation of prudential standards.

21. **Increasing access to finance in a prudent, sustainable, and responsible manner is a key priority for the authorities.** A large section of India's population has little or no access to financial services. Measures to promote access to banking services include 'no frills' accounts; simplified know-your-customer rules for small accounts; incentives for banks to open bank branches in under-served areas; business correspondent/agent models; and mobile phone banking. There is a large institutional framework to promote financial inclusion, which includes rural cooperative banks; specialized regional rural banks sponsored jointly by public sector banks and the government; and a number of development finance institutions such as the National Bank for Agriculture and Rural Development (NABARD) and the Small Industries Development Bank of India (SIDBI).

22. **There is a strong institutional framework for financial oversight.** The RBI regulates banks and some nonbank financial companies (NBFCs). The Insurance Regulatory and Development Authority (IRDA) regulates insurance. The Securities and Exchange Board of India (SEBI) regulates the spot and derivatives markets of various financial instruments, and the Forward Markets Commission (FMC) regulates the commodity futures market. The Pension Fund Regulatory and Development Authority (PFRDA) is meant to regulate the nascent pension fund industry, though its enabling legislation is yet to be approved. In rural finance, NABARD is both a credit provider and a supervisor of cooperative banks (other than primary cooperative banks) and regional rural banks. Jurisdiction of the major regulators is generally well demarcated, but there remain gaps and areas of overlap. The government has recently established a Financial Stability and Development Council (FSDC), comprising the financial regulators and chaired by the Union Finance Minister.

D. Preconditions for Effective Banking Supervision

23. **RBI is tasked with the regulatory oversight of the payment and settlement systems in the country.** The smooth functioning of the payment and settlement systems is a prerequisite for the stability of the financial system. The legal framework for the oversight role of RBI is provided by the Payment and Settlement Systems (PSS) Act, 2007 and the Payment and Settlement System Regulations. Following this Act, RBI has been provided a sound and well-founded legal basis for regulation and oversight of payment and settlement systems. The Act clearly defines settlement finality and provides an explicit legal basis for multilateral netting. The findings of the 2009 CPSS Core Principles self-assessment are that the existing payment system operates cheaply and efficiently, with minimal systemic risk.

24. **Nevertheless, a number of measures have been suggested to further strengthen the efficiency of payment and settlement systems.** These include (i) shifting high-value transactions to a more secure electronic payment system, like real time gross settlement system (RTGS); (ii) combating credit card fraud; and (iii) steps to optimize the utilization of the electronic payments infrastructure and reduce the charges for such transactions. The current low utilization of the electronic payments infrastructure can be increased with the use of technology to make the facilities more accessible to customers, thus optimizing the use of this infrastructure and achieving greater financial inclusion.

25. **Despite numerous recent legislative changes, significant weaknesses in the insolvency framework remain.** Insolvency is governed by a multiplicity of laws in India and the process of registering security interests remains difficult. For creditors seeking to recover debts from borrowers, the primary tools are the Debt Recovery Tribunals (DRT) and the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act (SARFAESI, 2002), both of which present significant limitations. Both tools result in relatively low returns for creditors and long time periods needed for liquidation. Delay in the recovery proceedings result in a slow-down of credit growth and the drying up of funding for creditworthy borrowers, which prevents its proper utilization and recycling.

26. **The accounting profession appears to be well established and convergence with IFRS is planned for 2013.** The India Institute of Chartered Accountants of India (ICAI) sets the accounting standards, but RBI can, in agreement with the ICAI, require specific carve-outs or modifications for commercial banks. This has been done in the area of provisioning and disclosure. RBI is in the process of preparing prudential guidelines for alignment of Indian accounting standards with international accounting standards by 2013. Convergence with IFRS is even more important, given that a number of Indian banks are expanding globally. That said, more awareness should be created about international finance reporting standards (IFRSs) among auditors and all others who are involved in the process, as well as to ensure that they are able to put in place systems and procedures to comply with IFRS.

27. **India is one of the earliest countries to have adopted International Standards on Auditing, but it needs to take some proactive steps in implementing them more effectively.** This can be achieved by issuing more technical guidance and other literature to help small and medium practitioners to understand standards. The functioning of the Quality Review Board should start at the earliest, and steps need to be taken to accelerate the process of making the Board of Discipline and Disciplinary Committee functional. The Quality Review Board also needs to play a more proactive role as an independent oversight body for the auditing profession in India. The principal auditor of the company should have access to the working papers of auditors. Finally, there is a need to give functional independence to Auditing and Assurance Standards Board (AASB).

28. **The legislative framework for AML/CFT has been set out in the Prevention of Money Laundering Act (PMLA) 2002.** The respective regulators have issued guidelines for entities regulated by them. A number of initiatives have been taken by various regulators in the financial sector, such as issuance of guidelines for submission of Currency Transaction Report (CTR)/ Suspicious Transaction Report (STR) to the Financial Intelligence Unit (FIU), and preservation of records as well as guidelines on wire transfers to banks. Major areas where action needs to be taken to further strengthen the AML/CFT practices and align them with international standards are the effective implementation of record-keeping requirements and a robust regime for submission of STRs.

Effective market discipline

29. **Listed companies are subject to a modern continuous disclosure regime, and banks are subject to specific disclosure requirements, which include publication of their annual reports.** RBI prescribes key elements to be disclosed, including the entities' governance and risk-management arrangements, as well as audited financial statements. The RBI also publishes financial statement information on the industry. There is a need for strengthening the disclosure mechanism to bring about greater transparency in ownership structures, and stringent penal action needs to be taken where nontransparent practices are unearthed. The implementation of IFRS in India is generally expected to further reinforce effective market discipline.

Mechanisms for providing an appropriate level of systemic protection (or public safety net)

30. **RBI has broad and strong lender-of-last-resort (LoLR) powers, but they are under review to assess international lessons learnt during the global financial crisis.** Under section 17 and 18 of the RBI Act ('war-time' powers), RBI has wide discretion to lend to economic agents in support of its policy goals. In this respect, RBI has enormous powers and a wide variety of instruments to meet crisis situations. That said, given the increasing integration of global markets, the global financial crisis has necessitated the need for a re-look at the conventional role of LoLR. Accordingly, RBI has constituted a working group to look into issues relating to liquidity with a specific mandate to examine (i) the powers

available as per the provisions with RBI as regards its role of LoLR; (ii) the scope for putting in place a mechanism whereby the same can be activated at the shortest possible notice; and (iii) the scope for expanding the instruments that can be permitted for providing liquidity.

31. **The existing instruments are considered adequate and RBI does not encourage a system of providing, ex-ante, any assurance about its emergency support.** An ex ante assurance would be a source of moral hazard. RBI's interventions depend on specific circumstances and judgment about contagion and systemic stability. Furthermore, RBI has at present the choice of using conventional and unconventional measures as needed. Any blueprint for LoLR has the potential to constrain RBI from using unconventional measures in times of extreme market distress, as many central banks did to bail out afflicted firms in the current crisis.

32. **A deposit insurance system is in place.** The Deposit Insurance and Credit Guarantee Corporation (DICGC) is a wholly owned subsidiary of the RBI. Deposit insurance extended by DICGC covers all commercial banks, including local area banks, regional rural banks, and urban cooperative banks in all the states and union territories (UTs).

33. **The governance arrangements for domestic crisis management are being strengthened.** Even as RBI has implicitly been the systemic regulator in India, other financial sector regulators, too, have important responsibilities. Beyond the regulators, the global crisis has demonstrated the importance of the coordinating role the government has to play, especially in times of stress. The post-crisis focus on establishing an institutional mechanism for coordination among regulators and the government has culminated in the establishment, in December 2010, of the Financial Stability and Development Council (FSDC) to be chaired by the Union Finance Minister. The FSDC is to be assisted by a sub-committee to be chaired by the governor of RBI. This structure attempts to strike a balance between the sovereign's objective of ensuring financial stability to reduce the probability of a crisis and the operative arrangements involving the central bank and the other regulators. While the sub- committee is expected to evolve as a more active, hands-on body for financial stability in normal times, the FSDC would have broad oversight and would assume a central role in crisis times.

34. **Steps to reinforce contingency planning and coordination among regulations in times of stress remain.** While the governance structure has been agreed upon, contingency plans and action plans are not yet established. It is essential that extensive cross-sectoral cooperation takes place to identify threats to the stability of the Indian financial sector and to test contingency plans and structures to mitigate such threats. Also, responses in the resolution of potential financial crises should be coordinated among participating authorities.

E. Main Findings

Objectives, Independence, Powers, Transparency and Cooperation (CP 1)

35. **The independence of the RBI is not enshrined in the law and there are some legal provisions that could seriously undermine the independence from the government.** In practice, however, the assessors have not come across evidence of government or industry interference. Legal provisions in the Banking Regulation Law and the Reserve Bank of India Act allow the central government to give directions to RBI to require it to perform inspections, to overrule decisions, and to supersede the RBI Board. Although these provisions have never been used in practice, it would be beneficial to remove them from the law so as to provide greater legal certainty. Finally, RBI does not have the power to disempower a public bank to carry on banking activities. The reasons for the removal of the governor of RBI are not specified in the law, although there have been no instances where the governor has been dismissed without a valid reason and the rules of natural justice apply, the explicit specification of the reasons for dismissal in the law would be better aligned with good international practice. The governor is also not appointed for a minimum term but for a maximum term, with the possibility of reappointment.

36. **In public sector banks, which make up a major part of the financial system, an RBI representative still acts as a Director on the Board.** In practice, this representative is a current employee from RBI from a department other than banking supervision. It appears that this person takes on an active role in the Board discussions and is sometimes implicitly relied upon to ensure regulatory compliance. This provision has the potential to blur the distinction between RBI's legal powers as a banking supervisor and its involvement in actively managing a bank. Hence, at a minimum, greater clarity should be provided to the banks as to the limitations of the role.

37. **Legal protection for bank supervisors is in place and, as a matter of practice, the employees costs of defending actions made while discharging their duties in good faith are borne by RBI.** Some enhancements could be made to the current arrangements. Ideally, the Act should specifically state that the legal protection provided to RBI employees is not limited in time (i.e., provides protection beyond the termination of appointment or employment). Also, at a minimum, it is necessary that protection against incurring the costs of defending the actions of supervisors is stated clearly and explicitly (at least at the level of internal procedures), including the financing of any expenses since the start of the legal proceedings.

38. **RBI has entered into MOUs with other foreign supervisory authorities and has received approval from the central government for this purpose.** It does, however, lack extensive formal or informal supervisory information-sharing arrangements. Given the large and growing dimension of overseas activities of Indian banks in many foreign jurisdictions, including some unstable and high-risk countries, the absence of arrangements for supervisory

information sharing should be addressed as soon as possible. RBI also does not have direct access to call for information for any entity in the banking group. The proposed amendment to Section 29A of the BR Act under the Banking Law Amendment Bill 2011 is expected to remedy this gap in the future.

Licensing and Structure (CPs 2–5)

39. **India has a sound framework for granting banking licenses and overseeing prospective ownership changes, and intended expansion of banks.** There is a clear line of demarcation between bank and nonbanks, and a well-defined set of activities that banks can engage in directly or indirectly. Improvement opportunities exist in aspects of controlling foreign bank entry and Indian bank expansion overseas, as well as ensuring in the licensing process that strong risk-management programs will be implemented by new banks.

Prudential Regulation and Requirements (CPs 6–18)

40. **RBI has set prudent and appropriate minimum capital adequacy requirements and has defined components of capital in accordance with internationally agreed guidelines.** That said, many challenges remain for migration to the Basel II advanced approaches. Most relate to constraints on data, tools, and methodologies, and the required skills for the quantification and modeling of risks, as well as the validation of these models. RBI will also have to consider how to address a range of practical implementation issues consistently, and how supervisory policies and practices may have to be enhanced for effective supervision of banks applying the Basel II advanced models on an ongoing basis.

41. **The assessors identified several other areas for strengthening of prudential regulation.** One relates to the establishment of a requirement for periodic and rigorous risk model review and validation by banks, even for risk models that are not used as input for regulatory capital purposes. There is also a need to ensure that prudential guidance is issued and applied to the consolidated banking group rather than just to the bank.

42. **The prudential framework in India is characterized by concentration limits that are significantly higher than international best practice and a too-general definition of connected counterparties.** The default of a borrower or a group of connected borrowers can cause a serious loss to a banking group. The current large exposure limit is a maximum of 55 percent of a banking groups' capital. The assessors also recommend that more guidance and more frequent and detailed onsite verification of the criteria for the determination of "connected exposures" is required. This could take the form of a broadening of the guiding principles; for example, by including cross-guarantees between entities or financial interdependency that result in the entities becoming one single risk.

43. **Some other areas for strengthening the prudential framework were identified.** These include the definition of related parties as well the requirements for arm's-length transactions. Furthermore, a formal legal or regulatory requirement to inform RBI

immediately of any adverse developments in operational risk should be introduced. The internal control framework in banks can be enhanced by ensuring that updates on developments affecting the fit-and-proper test for existing directors are received, as well as ensuring a stronger focus in the AFI process on assessing the quantity of people and skill of people in risk management and control functions.

Methods of ongoing banking supervision (CPs 19–21)

44. **RBI supervises the direct activities of banks with a well-defined set of on-site supervisory practices, extensive regulatory reporting, and improvement of off-site monitoring techniques.** Emerging global practices are being introduced, although more structured interaction between the in-house regulatory areas and field inspectors would enhance the rigor and consistency of new procedures being introduced. RBI largely defers to functional supervisors of nonbank affiliates domestically, and to foreign supervisors of overseas offices and subsidiaries, for hands-on supervision of operations subject to their jurisdiction, although regulatory reports to RBI do cover such operations. There are also challenges in ensuring that appropriately specialized supervisory expertise is developed and maintained, particularly in light of RBI-wide rotational policies.

Accounting and disclosure (CP 22)

45. **There is room for improvement in the frequency and intensity of interaction between RBI and external auditors and the access rights to the external auditor's working papers.** Although RBI does not have direct authority to rescind the appointment of the external auditor, it can, and has in the past, withdrawn the approval of the appointment of the external auditor.

Corrective and remedial powers of supervisors (CP 23)

46. **RBI has broad discretion in the range of remedial actions it can take to address problem situations, a prompt corrective action regime, and a set of tools to use in problem bank resolution.** This architecture is sound in relation to private sector banks, but is not generally applicable in practice to dealing with problems in public sector banks, which make up the largest percentage of the Indian banking market.

Consolidated and cross-border banking supervision (CPs 24–25)

47. **RBI has begun efforts to improve its focus on consolidated supervision on cross-border banking supervision.** It has established more structured forums for interaction with domestic functional regulators and beginning the process of improved information flow and coordination with foreign supervisors through executing MOUs. RBI could broaden its supervisory focus domestically through changing its practices for obtaining information from firms, using a more appropriate construct for evaluating consolidated firms, and interacting

more effectively with functional regulators; a proposed statutory amendment would also improve consolidated information access by the RBI.

Table 1. India: Summary of Compliance with the Basel Core Principles

Core Principle	Grading	Comments
1. Objectives, independence, powers, transparency, and cooperation		
1.1 Responsibilities and objectives	C	
1.2 Independence, accountability and transparency	MNC	The reasons for the removal of the head of the supervisory agency during his/her term are not specified in Law. RBI's Legal Department states that the government would not be able to remove the governor unless there are valid reasons and the rules of natural justice are complied with. The assessors take note of this position, but confirm that in accordance with essential criterion 1 of this core principle, the specification of the reasons in the law as well as the requirement to disclose them is required. Legal provisions in the BR Law and RBI Act allow the central government to give directions to RBI, to require it to perform an inspection, to overrule decisions, and to supersede the Central Board of RBI. While in practice these have never been used, it would provide greater certainty regarding the independence of RBI if these provisions were removed and the independence of RBI were formally grounded in the RBI Act. In practice, however, the assessors have not come across evidence of central government interference which would seriously compromise the independence of RBI. With regard to independence of RBI from the industry, the role of the nominee director in the public sector banks blurs the distinction between the legal powers of RBI as a banking supervisor and an active role of RBI appointed staff in the management or compliance function of a bank. Considering that public sector banks represent more than 70 percent of the Indian banking market, the authorities should abolish the role of the nominee director. As a second best or intermediary solution, they should at least consider providing greater clarity to the limitations of the role in order to avoid the appearance of RBI becoming involved in a bank's management. The Banking Regulation Act should allow RBI to enter into MOUs without the agreement of the central government. Strictly speaking, the governor is not appointed for a minimum term but for a maximum term (with the possibility of reappointment). The assessors believe that with the growing complexity and intensity of changes in financial regulation (particularly Basel II and Basel III) as well as the increased complexity and globalization of supervised entities, RBI

Core Principle	Grading	Comments
		may wish to reconsider its strict rotation policies so as to ensure its staff can build up expertise in banking supervision and regulation. For example, rotation areas for supervisors could be narrowed to similar areas of expertise, i.e., limited to the Department of Banking Supervision, the Department of Banking Operations and Development, and other departments involved in the supervision of NBFIs. To address concerns of regulatory capture, rotations of supervisors assigned to specific supervised entities should be implemented. Given the future demands that will be placed on banking supervision staff for the Basel II and Basel III process and the movement to more continuous supervision of the largest banking companies (see also CP 20), staffing levels should be reviewed to ensure the appropriate quantity and quality of staff in these areas.
1.3 Legal framework	C	
1.4 Legal powers	LC	For the most part, RBI has the requisite authority to address compliance with the banking law through appropriate access to information and staff of banks, and the capacity to address instances of non-compliance by taking of a range of enforcement actions. However, it lacks the authority to disempower a public sector bank to carry on banking activity.
1.5 Legal protection	C	It is recommended that the protection for the costs of defending the actions of supervisors should be stated more clearly (preferably in the law and, in the meantime, at least at the level of internal procedures), including the financing of any expenses from the start of the legal proceedings.
1.6 Cooperation	MNC	Given the large and growing overseas activities of Indian banks in numerous foreign jurisdictions (including some unstable or high-risk jurisdictions), the absence of formal, or even extensive informal, arrangements for receiving information from host supervisors is a serious problem that should be addressed through the acceleration of the process of entering into formal MOUs or other means. (See CP 25.) The flow of regular information from the domestic nonbank supervisors also raises issues, although the issue is somewhat lessened by the capacity of RBI to obtain copies of inspection reports from the banks, by the reporting mechanisms RBI has imposed, and by the meeting structure it has created with the other regulators. Moreover, the creation of the FSDC and its subcommittee may help address that over time, especially if the FSDC focuses on improving information exchange between the regulators—ensuring that: 1. Mechanisms are found for written material (including inspection reports) to be regularly shared on a timely basis; 2. Escalation protocols are appropriately broad (covering IRDA as well as SEBI directly) and fully operational to promptly alert other relevant supervisors about concerns that a supervisor is developing; and

		3. The semi-annual meetings on major banking companies (i.e., the designated bank-led financial conglomerates, as well as other systemically important banks not considered financial conglomerates, provided they engage in appreciable insurance or securities activities) take place on a fully regular basis, involving representatives of the supervised firm, but also allowing the opportunity for a regulators-only discussion of issues regarding that banking company. There is a proposed change to Section 29A of the Banking Regulation Act that would allow RBI to call for information from any entity in the banking group. Direct access by RBI to information on subsidiaries and associated companies would be improved with the passage of this proposed amendment.
2. Permissible activities	C	Banking is well defined in Indian banking law, with a clear line of demarcation from nonbanking companies. Activities that a banking company can engage in are clearly specified.
3. Licensing criteria	LC	RBI has a clear licensing process, with the ability to develop necessary information and apply discretionary judgment in its decision-making, although no domestic licenses have been granted for a number of years. There are some areas that should be strengthened, such as: • Putting in place a closer *ex ante* review of the intended risk management and control systems of a proposed new bank and/or ensuring that it be examined at a very early stage of its operations (within the first 6 to 12 months); • Requiring more clearly that a foreign bank applicant is subject to overall consolidated supervision in its home country; and • Considering the inclusion of a requirement for ongoing information exchange with the home country supervisor as a condition for licensing an office of a foreign bank.
4. Transfer of significant ownership	C	RBI has the legal authority and operating procedures to review changes in the ownership of shares of banking companies. The definition of substantial interest is focused on beneficial ownership, avoiding issues that could otherwise crop up with shares being held by nominees. However, there is a prospect of control being exercised through means other than shareholdings, suggesting that it would be appropriate to find a means to incorporate a more judgmental test of controlling interest. There is also the possibility of there being a change in ownership of an existing shareholder that would not be subject to review.
5. Major acquisitions	LC	The structured approach for reviewing prospective investments in subsidiaries has the key elements needed to ensure that the banking company focuses on banking activities and to provide effective oversight by RBI on expansion.

		Areas to address include the following: 1. The capacity of RBI to monitor the risks of a nonbank subsidiary, and to take action to address on a very timely basis circumstances where problems surface, is limited, such as by the potential time-lags in getting information concerning entities regulated by other agencies and the lack of legal authority to request information about unregulated entities; and 2. A more systematic approach to critical review of host country supervisory arrangements should be developed and implemented.
6. Capital adequacy	C	RBI has set prudent and appropriate minimum capital adequacy requirements for banks that reflect the risks that the bank undertakes. It has defined the components of capital in accordance with internationally agreed guidelines and has the legal power to require higher capital ratios for individual banks. RBIs requirements are stricter than those established in the applicable Basel requirements. RBI will move to Basel III on the internationally agreed timeline. The assessors recommend that RBI issue guidelines requiring adequate distribution of capital among different entities of the banking group. Discussions with banks indicate that many challenges remain for migration to the Basel II advanced approaches. Most relate to constraints on data, tools, and methodologies, and the required skills for the quantification and modeling of risks as well as the validation these models. RBI will have to consider how to address a range of practical implementation issues consistently. Going forward, it will also have to reflect if supervisory policies and practices may have to be enhanced for effective supervision of banks applying the Basel II advanced models on an ongoing basis.
7. Risk management process	LC	RBI has issued guidance on most of the key elements of risk management structure and operations, and the annual financial inspection process is used to access compliance with that guidance. The areas of improvement opportunity identified include: 1. Establishing a requirement for periodic and rigorous model review and validation by banks, even of internal risk models not currently used for regulatory capital purposes; and 2. Ensuring that risk guidance is issued to, and applied strongly in practice to, the consolidated banking company rather than just the bank.
8. Credit risk	C	Although Paragraph 3 of the 1999 Risk Management Guidelines state that banks should have a multi-tier credit approving system, there is no explicit RBI requirement that major credit risk exposures exceeding a certain amount or percentage of capital, or exposures that are especially risky or otherwise not in line with the mainstream of bank activity, are to be decided by the bank’s senior management.

		There is no specific requirement in the regulations that potential future exposure be included in the credit management strategies or policies. With the increased use of credit risk models for internal risk management purposes, RBI should consider requiring banks to have a comprehensive model validation policy approved by the Board (see also CP 7). Although this requirement would of course be evident for banks intending to apply the advanced approaches under Basel II, the banks on the standardized approach should also be subject to validation requirements in case they use models that do not directly generate inputs to the regulatory capital calculation (for example, for an internal model used by a standardized bank for pricing).
9. Problem assets, provisions, and reserves	C	
10. Large exposure limits	MNC	More detailed requirements and more guidance on the criteria for the determination of "connected exposures" is required. This could take the form of a broadening of the guiding principles, for example by including cross-guarantees between entities or financial interdependency that result in the entities becoming one single risk. Likewise, RBI examiners should include the verification of the definition of connected parties in more depth during the annual financial inspection. The large exposure limit of 40 percent—which can exceptionally be brought to 50 percent for infrastructure exposures—for a group borrower is significantly higher than the large exposure limits of 25 percent that is considered good international practice. The assessors are cognizant of the fact that this is an additional criterion, however, they believe that this limit has the potential to allow the default of one particular consolidated borrower to cause a serious loss of capital in a banking company. While the assessors also appreciate the need for a balanced approach between financial development and financial stability objectives, they believe that the aggregate limit for large exposures is significantly out of line with international good practice.
11. Exposure to related parties	LC	Elements of the current legal and regulatory structure are reasonably conservative—such as the general prohibition on lending to directors and the need for transactions with affiliates to be on an arm's length basis. However, there are several significant areas to address: 1. The failure of the definition of related parties to include shareholders or promoters is a gap that should be remedied. 2. Regulatory approaches should be developed for excluding any such lending from capital or for taking other adjustment steps. 3. A law change is being proposed that would require by explicit provision in law that loans to subsidiaries and joint ventures be on an arm's length basis. A regulatory provision to ensure such an arm's length relationship with some subsidiaries currently is in place.

12. Country and transfer risks	C	
13. Market risks	C	
14. Liquidity risk	C	RBI has put in place a very conservative framework for liquidity risk management, which is critically reviewed as part of the annual financial inspection process, as confirmed by an inspection report review. The reviews include critical reviews of the bank's duration gap analysis and a review of the integrity of data systems that support liquidity metrics.
15. Operational risk	LC	There is no legal or regulatory requirement for banks to inform RBI of any adverse developments in operational risk. However in practice, the quarterly meetings with banks ensure that RBI is kept informed of any material adverse developments within maximum three months after the facts. RBI set up in 2010 a Working Group on Information Security, Electronic Banking, Technology Risk Management, and Cyber Frauds. The group examined various issues arising out of the use of information technology (IT) in banks and made recommendations in nine broad areas: IT governance, information security, information security audit, IT operations, IT services outsourcing, cyber fraud, business continuity planning, customer awareness programs, and legal aspects. Some banks may have already implemented or may be in the process of implementing some or many of the requirements of the circular. Therefore RBI required banks to conduct a formal gap analysis between their current status and the new stipulations as laid out in the circular and to establish a time-bound action plan to address the gaps. However, banks need to ensure implementation of basic organizational framework and put in place policies and procedures which do not require extensive budgetary approvals, or infrastructural or technology changes, by October 31, 2011. The rest of the guidelines need to be implemented by April 2012, unless a longer timeframe is indicated in the circular. There are also a few provisions that are recommendatory in nature, implementations of which are left to the discretion of banks. The requirements in this circular are not in place at the assessment date but their implementation is expected to strengthen operational risk management in the commercial banks.
16. Interest rate risk in the banking book	C	
17. Internal control and audit	LC	RBI has put in place a good framework for internal controls. Its annual financial inspections critically evaluate a range of internal control issues such as the bank's internal audit governance and processes, their sanctions authorities, and their compliance approach and effectiveness. There are several recognized areas of possible improvement: 1. Ensuring updates on developments affecting the fit and proper test for existing directors are received, and

		2. Ensuring a strong focus in the annual financial inspection process on assessing the quantity and skill level of people in risk management and control functions.
18. Abuse of financial services	LC	The issues raised in FATF Mutual Assessment Report on AML/CFT that were within the responsibility of RBI have been addressed. The RBI regulatory framework for AML generally complies with the essential criteria of this Core Principle. Nevertheless, the inspection reports reviewed by the assessors did mention many critical weaknesses in the areas of AML/Know your Customer. From their review, the assessors conclude that Know your Customer/AML inspections have only started recently and hence no full level of compliance is to be expected at this stage.
19. Supervisory approach	LC	RBI has in place an extensive system of onsite inspections and offsite monitoring of financial returns to allow it to stay abreast of the risk profiles of its supervised institutions. As of 2011, 645 people work in the Department of Banking Supervision (from 729 two years ago). Given the demands that will be placed on the Department of Banking Supervision and the Department of Banking Operations and Development from the Basel process and the movement to more continuous supervision for twelve of the largest banking companies (see CP 20), the assessors believe that staffing should be reviewed to ensure the appropriate quantity and quality of staff in these areas (see also CP 1.2). The general practice of rotating people across the departments of RBI should also be reassessed given the need to develop specialized expertise within supervision. While the assessors recognize that some rotation could be beneficial, having the bulk of the supervisory/regulatory (i.e., Department of Banking Supervision and Department of Banking Operations and Development) staff be people who spend the vast majority of their career in bank supervision/regulation and related areas (e.g., nonbank supervision) would improve the level of expertise of that area (see also CP 1.2.) The focus on the consolidated risks of the banking group should be increased; RBI should consider its methodology for rating banking companies, to provide explicitly for a way to reflect systematically the issues that may arise at nonbank subsidiaries. Clearer guidance should be issued on the need for banking groups to provide updates on developments and changes between annual financial inspections. RBI should ensure the review and validation of models used for internal risk management, even if not yet used for regulatory capital purposes, is consistently done.

Core Principle	Grading	Comments
20. Supervisory techniques	LC	RBI utilizes onsite supervision and offsite monitoring to carry out its supervisory program. The principal improvement needs (some of which are also discussed under various other Core Principles) include: 1. Building on the current program of interaction among the regional office inspectors as a group and the central office, by providing a regular forum for the inspectors to go through findings, insights, and questions particularly when new supervisory approaches are being introduced. Adding this additional element would also improve the capacity to develop more of a horizontal perspective on how banks are engaging in a particular business area or how they are carrying out an element of risk management practice. 2. More intensive reviewing of nonbank subsidiaries. 3. Improved monitoring of foreign operations through better information flow from overseas supervisors and/or more overseas inspections. 4. Ensuring critical review and validation of risk management models that are not yet used for regulatory capital purposes. 5. Developing more structured interaction throughout the year with directors of private sector banking companies that could improve the knowledge of banking companies and facilitate dealing with problem situations when they arise. 6. The assessors have also been advised that an initiative to consider modifications of elements of the supervisory process for the largest banking groups has begun. A Steering Group, led by a deputy governor, began a year-long review process in April 2011 to consider a range of potential changes. As the review began, the Department of Banking Supervision announced some restructuring of its operations to move the offsite monitoring process closer to the onsite inspection process. The assessors were also advised orally that the Department of Banking Supervision will establish a new supervisory regime for the largest (12) banking companies, which have been designated as systemically important in India, involving such elements as (i) supervisory responsibility being moved from the regional offices (including from the Mumbai regional office) to the central office; and (ii) the central office planning to shift away from the current once a year approach to a supervisory approach that is more continuous, with targeted reviews conducted of an individual banking company or a cross-section of firms, focusing on areas of potential concern that have been seen through the monitoring process. The assessors believe such a program, if it is well developed and well implemented, has the potential to improve a number of our areas of concern.
21. Supervisory reporting	LC	RBI does not have the power to require information from affiliated but unregulated entities of a banking group. It has however proposed a legal amendment to address this concern.

22. Accounting and disclosure	LC	RBI does not have the direct authority to rescind the appointment of a statutory auditor. The authorities state, however, that in the past they have withdrawn this approval when serious deficiencies in the working of the external auditors have come to RBI's attention. The financial statements are based on accounting standards prescribed by ICAI. These are not accounting standards and auditing practices that are internationally and widely accepted. Convergence with IFRS for banks is scheduled to commence from April 2013 onwards. In India, the standards on financial instruments (AS 30, 31, and 32) have not been notified and are therefore not binding. In order to fill the gap, RBI has been issuing prudential guidelines on investment classification and valuation, and income recognition, asset classification, and provisioning. RBI does not have access to external auditors' working papers. It is recommended RBI increase its interaction with external auditors.
23. Corrective and remedial powers of supervisors	LC	RBI has broad discretion in the range of remedial actions it can take to address problem situations, a prompt corrective action regime, and a set of tools to use in problem bank resolution. There are some gaps, particularly related to the applicability of the approaches to public banks: 1. The RBI cannot disempower a public bank to carry on banking activity and Even within the capital piece of the Prompt Corrective Action regime, there is considerable discretion to allow a bank to continue to operate for potentially in excess of a year, with extremely low capital; given the CRAR is a total 2. capital concept, a 3 percent total capital level could involve very little (common) equity. 3. RBI can appoint the chief executive officer or additional directors for a problem bank. As these persons are not granted additional powers, they may give the appearance of RBI becoming involved in the management of a problem bank. RBI should provide greater clarity to these roles.
24. Consolidated supervision	LC	RBI has taken steps to broaden its supervisory focus to include a stronger focus on the consolidated group. Through the establishment of the FSDC and subcommittee structure, through regular inter-agency meetings, through implementation increasingly of norms for the consolidated organization, and from supplemental consolidated returns, RBI now has a number of elements of strong consolidated oversight, but gaps remain: 1. RBI cannot order inspections of, or require reports from, domestic nonbank subsidiaries it does not regulate; a proposed amendment to the banking law (a new Section 29 (A) of the Banking Regulation Act, Power in Respect of Associated Enterprises) would, if enacted, address this consolidated supervision deficiency. RBI also is not able to undertake transaction testing at such subsidiaries. 2. RBI does not receive inspection reports directly from nonbank supervisory agencies; the timeliness and regularity of receipt should

		be improved as compared to the current practice of obtaining such reports from the parent bank at the time of the annual financial inspection. 3. There are opportunities to improve the process of inter-agency meetings: a. by ensuring that they take place on a fully regular schedule (for both designated conglomerates and other banking companies with substantial nonbanking operations); and b. by providing for the opportunity for candid conversation that would arise from portions of the meetings being regulators-only. 4. RBI should consider its methodology for rating banking companies, to provide explicitly for a way to reflect systematically the issues that may arise at nonbank subsidiaries. 5. There are major gaps in home/host information sharing arrangements as detailed in CP 25. a. RBI has not used its powers to conduct overseas inspections since 2008.
25. Home-host relationships	MNC	The significant and growing overseas operations of Indian banks and the extent of foreign bank presence in India necessitate that RBI significantly strengthen their channels of communication and coordination with overseas supervisors. 1. With Indian banks having overseas operations in more than 45 jurisdictions, but RBI having MOUs with only two, and informal information sharing arrangements to varying degrees with only a few others, there are material gaps in the flow of information. 2. RBI has not filled those gaps through other means such as by doing overseas inspections; it has not done any overseas inspections since one was done in May 2008. 3. RBI has also not reached out to the host jurisdictions through the hosting of any supervisory colleges. 4. Given that the jurisdictions in which Indian banks operate include a number of countries in unstable regions and/or where it cannot be assumed that strong local supervisory practices have always taken strong hold, reaching out to the range of host supervisors for increased supervisory dialogue seems most appropriate. 5. RBI also does not clearly assess during the licensing process whether the home countries of foreign banks seeking to open offices, practice consolidated supervision; neither does it carry out the analysis of the quality of host country supervision through a rigorous and consistent analytical process.

Core Principle	Grading	Comments
		With RBI now represented on the G-20, the FSB, and the Basel Committee on Banking Supervision, the opportunity exists to influence the direction of global policy. The capacity to do that would be enhanced with some structural changes within RBI to prepare representatives at the various meetings through better coordination and focus between the various Departments within RBI.
Aggregate: Compliant (C) – #, Largely compliant (LC) – #, Materially noncompliant (MNC) – #, Noncompliant (NC) – #, Not applicable (N/A) – #		

Table 2. India: Recommended Action Plan to Improve Compliance with the Basel Core Principles

Core Principle	Recommended action
Objectives, Independence, Powers, Transparency and Cooperation (CP 1)	Provide greater certainty regarding the independence of RBI by removing impeding provisions from related acts. Provide greater clarity regarding the role of the nominee director in the public banks, which can blur the distinction between the legal powers of RBI as a banking supervisor and an active role of RBI appointed staff in the management or compliance function of a bank. Clearly specify in law the reasons for the removal of the head of the supervisory agency during his/her term. Reconsider the strict rotation policies, so as to ensure staff can build up expertise in banking supervision and regulation. Enshrine in law that the protection for the costs of defending the actions of supervisors including the financing of any expenses from the start of the legal proceedings will be borne by RBI. Address the limited flow of regular information from the domestic nonbank supervisors by: • Developing mechanisms for written material (including inspection reports) to be regularly shared on a timely basis; • Broadening and strengthening escalation protocols to promptly alert other relevant supervisors about concerns that a supervisor is developing; and • Regularly holding the semi-annual meetings on major banking companies, but also allowing the opportunity for a regulators-only discussion of issues regarding that banking company.
Licensing Criteria (CP 3)	Put in place a closer *ex ante* review of the intended risk management and control systems of a proposed new bank. Require more clearly that a foreign bank applicant is subject to overall consolidated supervision in its home country. Consider the inclusion of a requirement for ongoing information exchange with the home country supervisor as a condition for licensing an office of a foreign bank.
Transfer of Significant Ownership (CP 4)	Incorporate a more judgmental test of “controlling interest.”
Major Acquisitions (CP 5)	Enhance RBI’s ability to monitor the risks of nonbank subsidiaries, and seek legal authority to request information for unregulated entities. Develop and implement a more systematic approach to critical review of host country supervisory arrangements.

Core Principle	Recommended action
Capital Adequacy (CP 6)	Issue regulatory guidelines explicitly requiring adequate distribution of capital among different entities of the banking group. Address the various practical challenges resulting from Basel II advanced model implementation. Consider enhancement of supervisory policies and practices for effective supervision of banks applying the Basel II advanced models on an ongoing basis.
Risk Management Process (CP 7)	Establish a requirement for periodic and rigorous model review and validation by banks (recognizing the importance of internal risk models although not currently used for regulatory capital purposes). Ensure that risk guidance is issued to, and applied strongly in practice to, the consolidated banking company rather than just the bank.
Credit Risk (CP 8)	Introduce a regulatory requirement that major credit risk exposures exceeding a certain amount or percentage of capital, or exposures that are especially risky or otherwise not in line with the mainstream of bank activity, are to be decided by the bank's senior management. Introduce a regulatory requirement that potential future exposure be included in the credit management strategies or policies.
Large Exposures (CP 10)	Establish more detailed requirements and more guidance on the criteria for the determination of "connected exposures." Allocate more time and resources for the assessment of the definition of "connected exposures" during the annual financial review. Lower the 40 percent consolidated borrower large exposure limit, which can be raised to 50 percent in exceptional circumstances, to bring it in line with good practice.
Related Parties (CP 11)	Include shareholders and promoters in the definition of related parties. Require by explicit provision in law that loans to subsidiaries and joint ventures be on an arm's length basis.
Operational Risk (CP 15)	Introduce a legal or regulatory requirement for banks to inform RBI of any adverse developments in operational risk.
Internal Control/Audit (CP 17)	Ensure that updates on developments affecting the fit and proper test for existing directors are received. Ensure a strong focus in the annual financial inspection process on assessing the quantity and skill level of people in risk management and control functions.
Supervisory Approach (CP 19)	Review staffing to ensure the appropriate quantity and quality of staff to meet the demands from the Basel process and the movement to more continuous supervision for the largest banking companies. Reassess the general practice of rotating people across the departments of RBI given the need to develop specialized expertise within supervision. Increase the extent of the focus on the consolidated risks of the banking group; re-consider the methodology for rating banking companies, to provide explicitly for a way to reflect systematically the issues that may arise at nonbank subsidiaries. Issue clearer guidance on the need of banking groups to provide updates on developments and changes between annual financial inspections.

Core Principle	Recommended action
Supervisory Techniques (CP 20)	Introduce into the current programs of interaction among the regional office inspectors as a group and the central office a specific forum for going through findings, insights, and questions, particularly when new supervisory approaches are being introduced. Perform more intensive reviews of nonbank subsidiaries. Improve the monitoring of foreign operations through better information flow from overseas supervisors and/or more overseas inspections. Ensure critical review and validation of risk management models that are not yet used for regulatory capital purposes. Develop more structured interaction throughout the year with directors of private banking companies.
Supervisory Reporting (CP 21)	Introduce the power to require information from affiliated but unregulated entities of a banking group.
Accounting/Disclosure (CP 22)	Obtain access to the external auditors' working papers. Increase interaction with external auditors as part of good supervisory practice.
Supervisors' Corrective and Remedial Powers (CP 23)	Consider the applicability of the remedial powers to public banks.
Consolidated Supervision (CP 24)	Empower RBI to require inspections of, or require reports from, domestic subsidiaries that it does not regulate; and to receive inspection reports directly from nonbank supervisory agencies. Improve the process of inter-agency meetings by: • Ensuring that they take place on a fully regular schedule (for both designated conglomerates and other banking companies with substantial nonbanking operations); and • Providing for the opportunity for candid conversation that would arise from portions of the meetings being regulators-only. Conduct overseas inspections on a considerably more regular basis.
Home-Host relationships (CP 25)	Promptly address material gaps in the flow of information through the execution of MOUs or other means with overseas hosts. Consider hosting supervisory colleges for Indian banks with major international presence. More clearly assess during the licensing process whether the home countries of foreign banks seeking to open offices practice consolidated supervision and do so through a rigorous and consistent framework of analysis. Consider changes to prepare representatives for participation in the various international forums and working groups in which RBI participates through better coordination and focus between the various departments within RBI.

F. Authorities' Response

48. **RBI welcomes the comprehensive review of banking regulation and supervision in India by the joint IMF-World Bank team.** The deliberations leading to this assessment have been quite extensive, comprehensive and productive. The assessment has been with respect to the highest international standards and we welcome the opportunity to comment on it.

49. **The assessment recognizes that the Indian banking system remained largely stable on account of tightly controlled regulatory and supervisory regime by RBI.** Notwithstanding our strong performance in the recent past, the assessment identifies several gaps and constraints in the implementation of regulatory and supervisory framework. The most significant gaps identified are in the area of international, and to a lesser extent, domestic supervisory information sharing and cooperation. Consolidated supervision of financial conglomerates, and some limits on the *de jure* independence of RBI are the other major gaps identified in the assessment. Nevertheless, the assessment also recognizes that RBI has been striving to address these gaps and, while RBI lacks de jure independence, there has been no *de facto* interference from the government.

50. **As regards these observations, we recognize that there is no room for complacency, even as India has emerged relatively unscathed from the crisis.** As a member of Financial Stability Board, Basel Committee on Banking Supervision, and IMF, India is actively participating in post crisis reforms of the international regulatory and supervisory framework under the aegis of G-20. India remains committed to adoption of international standards and best practices, wherever necessary, and in a phased manner and calibrated to local conditions to suit our best interests. However, it is our intention not only to implement the international standards and best practices, but also be ahead of the minimum requirements. We have taken several steps in the past to address systemic risk issues which are now becoming the international norms.

51. **With regard to the recommendation regarding the supervisory information sharing and cooperation, efforts are vigorously on to establish information sharing mechanisms with various jurisdictions where Indian banks are operating.** We have information sharing arrangements with four jurisdictions and MOUs with another 12 jurisdictions are expected to be reached shortly. Further, RBI also has informal arrangements with major jurisdictions for information sharing. Nevertheless, we recognize the importance of establishing information sharing arrangements with other jurisdictions. However, this is a time consuming process and we hope to establish appropriate information sharing networks as quickly as possible. Efforts are also on to establish supervisory colleges, so as to increase the efficacy of supervision.

52. **RBI recognizes the importance of addressing the interconnectedness issue posed by financial conglomerates.** RBI has taken several steps toward their effective supervision.

Some of the important steps are: (i) prudential limits have been put in place on aggregate interbank liabilities as a proportion of their net worth; (ii) access to uncollateralized funding market is restricted to banks and primary dealers and there are caps on both lending as well as borrowing by these entities; (iii) investment in the capital instruments of other banks and financial institutions is restricted to 10 percent of investing banks' capital funds, in addition to the stipulation that a bank cannot hold more than 5 percent of other bank's equity; (iv) banks' exposure to NBFCs is subject to tight limits and NBFCs have been increasingly subjected to more stringent prudential regulation; and (v) we have also put restrictions on exposures to complex activities and products and have a system for intensive monitoring of financial conglomerates and for common exposures in sensitive sectors.

53. **Regarding the appointment of an RBI officer as a nominee director on the Board of banks, RBI recognizes the moral hazard issues posed by this practice.** However, this system has served us well and ensured more effective compliance of RBI regulations from the banks' side. Nevertheless, keeping the moral hazard issue in mind, sometime back, the respective Acts were amended to provide for appointment of one director possessing necessary expertise and experience in matters relating to regulation and supervision and regulation of commercial banks, by the central government on recommendation of RBI. This gave RBI latitude for not putting its serving officers on Boards of banks. The serving officers were replaced by retired RBI officers. However, as this transition was not particularly satisfactory, currently serving officers are being nominated. Nevertheless, RBI is sensitive to the issue and this has since been taken up with Government of India for amendment of the enabling provisions of the Act under which RBI nominee directors are appointed.

54. **We reiterate that in India the regulations are completely ownership neutral and that same level of scrutiny is applied to both public and private sector banks.** Even the foreign banks, unlike in many other countries, have the same amount of freedom as the domestic banks have (except regarding expansion) and are treated exactly on par with the domestic banks for prudential purposes. When we impose penalty on a public sector bank, we do not consult the government and we place penalty imposed in public domain just as we do for the private sector banks.

55. **With regard to the issue of large exposure limits, RBI does recognize that the group borrower limit is different from the single borrower limit and is significantly larger than the international norms.** However, this deviation is on account of our needs to meet the development needs of the country. Some of the major corporate groups, which are also the drivers of growth in Indian economy, have grown very rapidly compared to banks. Keeping the group borrower limit at the level of single borrower limit would severely constrain the availability of bank finance, which is major source of finance in India, to these corporate groups. A reduction in lending to these groups would hamper the growth of the economy. Moreover, banks would be left with surplus lendable resources which may result in adverse selection. Thus, while RBI is aware of the deviation of Indian practice from the currently accepted international norms, this deviation is more on account of credit needs to

due to compulsions of robust growth, investment needs of infrastructure and the demand ushered in by increasing financial inclusion.

56. **Finally, while RBI may have some differences of opinion, RBI recognizes the importance of the FSAP in promoting financial stability and serving Indian interests.** As stated earlier, RBI is committed to meet the best international practices that are appropriate for us. RBI wishes to express its strong support for the role FSAP plays in promoting the soundness of global financial system and looks forward to a continuing dialogue with the IMF/World Bank and other global counter parts in seeking to improve the stability and effective supervision of global financial system.

II. Detailed Assessment

Principle 1	**Objectives, autonomy, powers, and resources.** An effective system of banking supervision will have clear responsibilities and objectives for each authority involved in the supervision of banks. Each such authority should possess operational independence, transparent processes, sound governance, and adequate resources and be accountable for the discharge of its duties. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorization of banking establishments and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.
Principle 1(1)	**Responsibilities and objectives.** An effective system of banking supervision will have clear responsibilities and objectives for each authority involved in the supervision of banks.
Description	**EC 1** The Reserve Bank of India (RBI) is an autonomous body created under the Reserve Bank of India Act 1934. It is entrusted, inter alia, with the sole responsibility for the regulation and supervision of banks under the Banking Regulation Act 1949. The responsibilities of the RBI and the objectives of supervision of the RBI are defined in various articles of the Banking Regulation Act, particularly Section 22 and Section 35A. These objectives focus on the safety and soundness of the banking system. Laws and regulations that provide the framework of minimum prudential standards which banks are required to meet are in place. The Securities and Exchange Board of India (SEBI) is responsible, under the SEBI Act, for the licensing and supervision of the stock exchanges, market intermediaries (such as stock brokers, underwriters, portfolio managers and investment advisers), depositories and custodians, and collective investment schemes. The SEBI's primary focus is to ensure investor protection, market stability and to counter market manipulation. The Insurance Regulatory and Development Authority (IRDA) was set up in 2000 to regulate, promote and ensure orderly growth of the insurance business and re-insurance business. The legislative framework for this sector is contained in the Insurance Act, 1938 and the IRDA Act, 1999. The IRDA regulates and supervises insurance companies, insurance intermediaries and other organizations connected with the insurance business.

	The Financial Intelligence Unit-India (FIU-IND) was set up by the government of India in 2004 and became operational in March 2006. The FIU-IND has been designated as the central national agency for receiving, processing, analyzing and disseminating information relating to suspect financial transactions as well as large cash transactions. In addition, the FIU-IND is responsible for coordinating and strengthening efforts of national and international intelligence, investigating and enforcement agencies in pursuing the global efforts against money laundering, terrorist financing and other related crimes. The Pension Fund Regulatory and Development Authority (PFRDA) was established by Government of India in 2003. The government has, through an executive order mandated PFRDA to act as a regulator for the pension sector. The mandate of PFRDA is development and regulation of pension sector in India. **EC2:** The RBI Act clearly defines the mandate of the RBI. In particular, Section 17 lists the business in which the RBI can transact. The RBI Act also entrusts other functions to the RBI such as the regulation of nonbank financial institutions, management of foreign exchange reserves, management of sovereign debt and regulation of forex, money, and government securities markets, and their derivatives. More broadly, Article 15A of Section 17 grants the RBI the authority to exercise powers and functions and the performance of duties entrusted to the Bank under the Act or under any other law for the time being in force. In this respect, the Banking Regulation Act (BR Act) provides the basic prudential framework including licensing, business activity, capital, liquidity management, governance, penal provisions, winding up and liquidation of nonviable banks. The Foreign Exchange Management Act 1999 empowers the RBI to regulate the foreign exchange market. The Payment and Settlement Systems Act mandates the RBI to regulate and supervise the payment and settlement systems. The RBI is also vested with broad powers in Section 35A and Section 36 of the BR Act to issue guidelines to banking companies in general or to any banking company in particular on any issue relating to the functioning of banks if it is satisfied that these are required. The RBI has laid out mandatory prudential guidelines and norms for sound management of banks, liquidity management, capital adequacy, income recognition, asset classification and provisioning, connected lending, large exposures, securitization, derivatives and risk management. The powers in the BR Act ensure the RBI can enforce compliance with the provisions of the Act. **EC 3** The banking laws are reviewed and updated from time to time considering the changing needs of the banking industry and economy. The BR Act was last amended in 2007. The Banking Laws (Amendment) Bill, 2011 has been introduced in the parliament on March 22, 2011, for the amendment of the Banking Regulation Act, 1949 and the Banking Companies (Acquisition & Transfer of Undertakings) Act, 1970 and 1980 keeping in view of the changes in the banking sector. As announced in the Union Budget for 2010–2011, the government of India has constituted a Financial Sector Legislative Reforms Commission (FSLRC) under the chairmanship of Justice (Retd), B.N. Srikrishna on March 24, 2011 to examine, inter alia, architecture of the Legislative and Regulatory System governing the financial sector in India. **EC 4** The RBI publishes fortnightly a consolidated statement containing aggregate liabilities and assets of all the scheduled commercial banks as per Section 43 of the RBI Act. The RBI brings out certain publications at regular intervals on the financial strength and performance of banking industry and state of the economy. The

	publications include Banking Statistics, Report on Currency and Finance, Report on Trends and Progress of Banking in India (Section 36(2) of the BR Act), Credit Information Review, and monthly RBI bulletin containing statistics on selective economic and banking indicators and weekly statistical supplements. Additionally, (a) listed banks are also required to publish their quarterly unaudited financial statements as per the listing requirements with Stock Exchanges as per SEBI requirements, (b) all banks are required to publish limited financial data (similar to details disclosed by listed banks) at half yearly intervals and (c) publish their annual audited financial statements along with all the schedules. Disclosures under Pillar III of Basel II are also required to be published along with the annual financial statements by all banks. **AC1** As outlined in CP 20, the RBI takes into account the risks posed and the different approaches to mitigate those risks by individual banks and banking groups in setting its supervisory program and allocating resources.
Assessment	Compliant
Comments	
Principle 1(2)	**Independence, accountability, and transparency.** Each such authority should possess operational independence, transparent processes, sound governance, and adequate resources and be accountable for the discharge of its duties.
Description	**EC 1** The RBI is solely responsible for the regulation and supervision of all commercial banks. The primary objective is to undertake consolidated supervision of the financial sector comprising commercial banks, financial institutions and nonbanking finance companies. As described in Section 8 of the RBI Act the management of the RBI rests with the Central Board of Directors. The governor and a deputy governor are appointed by the central government for a term not exceeding five years and are eligible for reappointment (Section 8 (4) of the RBI Act). They are part of a Central Board of 20 members, representing different constituents but appointed by the central government. The members of the Board of Directors consist of the governor, four deputy governors, 14 directors and one government official nominated by the central government. There is no history of the central government making frequent changes to the composition or membership of the Central Board. The reasons for the removal of the head of the supervisory agency during his term are not specified in law. The government consults with the RBI on potential Board candidates that have to be eminent individuals chosen for their professional qualifications, background and experience. Current directors on the Central Board represent broad spectrum of interests *inter alia* academia and experience in industry and agriculture. The arrangements governing the functioning of the Board require a director to raise any conflict of interest before the issue is discussed. He/she would then not participate in the discussions or decisions. There is no explicit legal source to ensure the independence of the RBI in the Act. Also, a number of provisions in the RBI Act and the BR Act appear to undermine its independence from the central government with regard to banking supervision. *Inter alia*, these are: Section 7 of the RBI Act allows the central government to give directions from time to time to the (Reserve) Bank as it may, after consultation with the governor, consider necessary in the public interest;

	Section 35 (1) and (4) state that the central government can direct the RBI to cause an inspection to be made. In 35 (4), the central government is given the power to defer the passing, cancel or modify specific orders of the RBI under the terms and conditions it may think fit to impose; Section 22 (5) allows any banking company aggrieved by the decision of the RBI to cancel a license to appeal with the central government within 30 days. The decision of the central government shall be final (Section 22 (6)); The BR Act does not empower the RBI to enter in Memoranda of Understanding (MOU) with other jurisdictions, but needs the approval of the central government; Section 11 of the RBI Act allows the central government to remove the governor or the deputy governor from office during their term. The Law does not place any obligation on the government to publicly disclose the reasons for the removal; and Section 30 of the RBI Act allows the central government to supersede the Central Board if the RBI fails to carry out any of the obligations imposed on it under the RBI Act. In that case, the central government may entrust the general superintendence and direction of the affairs of the RBI to the agency as the central government determines. When this action is taken, the central government needs to outline the circumstances leading to such action in a full report to parliament at its earliest opportunity and in any case within three months. In practice, however, the authorities confirmed that the provisions under (a), (b), (e) and (f) have never been used. Provision (c) has been used only once for a NBFI but the RBI had it successfully overturned in Court. With regard to (d), with the approval of the central government, the RBI has also concluded a number of MOUs with two jurisdictions and has a significant number of MOUs in the pipeline. Additionally, there are some provisions in the BR Act, which may compromise the independence of the RBI toward the banking sector. For example, a representative of the RBI acts as a nominee director on the Board of public sector banks. This is, generally speaking, a current employee from the RBI from a department other than bank supervision. From the assessors' discussion with banks, the assessors where given evidence that this director takes an active role in the Board discussions and is sometimes implicitly relied upon to ensure regulatory compliance. This provision thus blurs the distinction between the RBI's legal powers as a banking supervisor and its involvement in actively managing a bank. Within the RBI, there is a separate Board for Financial Supervision (BFS), a committee of the Bank's Central Board of Directors, specifically entrusted with the responsibilities of financial supervision, including banking supervision. BFS has been constituted by the Bank's Central Board's Regulation 1994 as part of delegated legislation as per regulation under subsection (i) of Section 58 of the RBI Act 1934. The governor is the Chairman of BFS. The Board is constituted by co-opting four directors from the Central Board as members for a term of two years and is chaired by the governor. The deputy governors of the Reserve Bank are ex-officio members. One deputy governor, usually, the deputy governor in charge of banking regulation and supervision, is nominated as the Vice-Chairman of the Board. The BFS meets generally once a month and provides direction on a continuous basis on regulatory policies including governance issues and regulatory practices. It considers inspection reports and other supervisory issues placed before it by the supervisory departments. BFS through the Audit Sub-Committee also aims at upgrading the quality of the statutory audit and internal audit functions in banks and financial institutions. The audit sub-

	committee includes deputy governor as the chairman and two directors of the Central Board as members. The BFS oversees the functioning of Department of Banking Supervision (DBS), Department of Nonbanking Supervision (DNBS) and Financial Institutions Division (FID) and gives directions on the regulatory and supervisory issues. **EC 2** The RBI's objectives as a supervisory agency are set out in the RBI Act and the BR Act. An annual report on the working of the RBI with detailed analysis of its annual accounts and an assessment of the Indian economy is submitted to the central government under Section 53 (2) of the RBI Act. The annual report contains a detailed chapter on regulation and supervision. The RBI, through the Ministry of Finance of the government of India, is also accountable to various parliamentary Committees for the discharge of its duties. **EC 3** The RBI has focused considerable resources in the appointment and training of its staff through relevant training provided internally or by external agencies/experts. Industry participants confirmed the RBI and its staff have established their credibility based on professionalism and integrity. The RBI applies a strict rotation policy among its staff, ensuring that staff rotate to other positions after three to four years. As of 2011, 645 people work in the Department of Banking Supervision including the regional offices; the number of people in the Department has declined from 729 two years ago. **EC 4** The RBI is financed through its resources and does not receive financial support from the central government nor from the industry. Major sources of income for the RBI are from (i) the deployment of foreign currency assets and gold and (ii) interest on domestic securities and market operations. The budget for banking supervision is sufficient to hire outside experts, to travel to onsite inspection locations and to invest in information technology. The RBI equips its officers with the latest techniques of supervision through ongoing training programs organized at its own staff colleges viz. Reserve Bank Staff College, Chennai; College of Agricultural Banking, Pune; and Institute for Development and Research of Banking Technology, Hyderabad. Besides, the RBI regularly sends its officers to training programs, seminars and conferences conducted by international bodies, Central Banks of other countries and international organizations like Bank for International Settlements and the International Financial Institutions. The officers of RBI are also seconded to commercial banks on a selective and reciprocal basis in order to expose them to the functioning of commercial banks. **AC 1** The governor of the RBI is not appointed for a minimum term but he/she is appointed for a maximum term not exceeding five years and is eligible for reappointment.
Assessment	Materially noncompliant
Comments	The reasons for the removal of the head of the supervisory agency during his term are not specified in Law. The RBI's legal department states that the government would not be able to remove the governor unless there are valid reasons and the rules of natural justice are complied with. The assessors take note of this position, but confirm that in accordance with essential criterion 1 of this core principle, the specification of the reasons in the Law as well as the requirement to disclose them is required. Legal provisions in the BR Law allow the central government to give directions to the RBI, to require it to perform an inspection, to overrule decisions and to supersede the Central Board of the RBI. While in practice these have never been used, it would provide greater certainty regarding the independence of the RBI if these provisions were removed and the

	independence of the RBI were formally grounded in the RBI Act. In practice, however, the assessors have not come across evidence of central government interference which would seriously compromise the independence of the RBI. With regard to independence of the RBI from the industry, the role of the nominee director in the public sector banks blurs the distinction between the legal powers of the RBI as a banking supervisor and an active role of RBI appointed staff in the management or compliance function of a bank. Considering the public sector banks represent more than 70 percent of the Indian banking market, the authorities should abolish the role of the nominee director. As a second best or intermediary solution, they should at least consider providing greater clarity to the limitations of the role in order to avoid the appearance of the RBI becoming involved in a bank's management. The BR Act should allow the RBI to enter into MOUs without the agreement of the central government. Strictly speaking, the governor is not appointed for a minimum term but for a maximum term (with the possibility of reappointment). The assessors believe that with the growing complexity and intensity of changes in financial regulation (particularly Basel II and Basel III) as well as the increased complexity and globalization of supervised entities, the RBI may wish to reconsider its strict rotation policies so as to ensure its staff can build up expertise in banking supervision and regulation. For example, rotation areas for supervisors could be narrowed to similar areas of expertise i.e., limited to DBS, DBOD and other departments involved in the supervision of NBFIs. To address concerns of regulatory capture, rotations of supervisors assigned to specific supervised entities should be implemented. Given the future demands that will be placed on banking supervision staff for the Basel II and Basel III process and the movement to more continuous supervision the largest banking companies (see also CP 20), staffing levels should be reviewed to ensure the appropriate quantity and quality of staff in these areas.
Principle 1(3)	**Legal framework.** A suitable legal framework for banking supervision is also necessary, including provisions relating to authorization of banking establishments and their ongoing supervision.
Description	**EC 1** The powers to issue a license to a company for commencing and carrying on the business of banking (Section 22(1) of the BR Act) and the powers to revoke license (Section 22(4) of the BR Act) are vested with RBI. That said, as referred to in CP 1.4, the RBI does not license state owned banks as these are set up by separate Acts and hence, it cannot disempower a state owned bank to carry on banking activity. . **EC2** The RBI has the power to set mandatory prudential rules by issuing directions or guidelines on any aspect of banking (Section 35A and 36 of the BR Act). The RBI has also issued a relatively small number of guidance notes. In strict legal terms, guidance notes reflect supervisory expectations. Nevertheless, the authorities confirmed to the assessors that they have the same level of enforcement as the guidelines. Guidelines and guidance notes are issued to banks in the form of Circulars. At the end of June of every year, circulars are bundled by topic and grouped into Master Circulars (a suite of individual circulars on the same or similar topic) and published on the RBIs website. The RBI consults with the industry and other stakeholders by placing proposals on its website before issuing guidelines. Industry participants confirmed that suitable time is given for comments or feedback.

	EC 3 Section 27 (1) of the BR Act states that every banking company shall submit to the RBI a monthly prudential return. Section 27 (2) allows the RBI to request any information from banking companies in the form and frequency it deems necessary. Section 35 (2) of the BR Act also states that it shall be the duty of every director or officer of a banking company to produce to any RBI officer making an inspection all books, accounts, and other documents in his custody and to furnish him with any statements and information relating to the affairs of the banking company as the said officer may require of him within such time as the said officer may specify. The authorities have not encountered situations where their access to the books or the personnel of a bank was challenged.
Assessment	Compliant
Comments	
Principle 1(4)	**Legal powers.** A suitable legal framework for banking supervision is also necessary, including powers to address compliance with laws as well as safety and soundness concerns.
Description	EC1: Under Section 35A of the BR Act, the RBI has the authority to exercise discretionary judgment in issuing directives to banking companies that 1) are in the public interest; 2) are in the interest of banking policy; 3) prevent the affairs of a banking company from being conducted in a manner detrimental to the interests of the depositors, or 4) secure the proper management of a banking company. EC2: Section 27 of the BR Act, in authorizing the RBI to obtain information from banking companies, and Sections 35 and 22, in providing access to records/staff of banking companies, provide for appropriate access on the part of the RBI to information in order to review compliance with internal rules and limits, as well as with external laws and regulations. More specifically, Section 35 (2) of the BR Law gives the RBI access to every director, office or employee of a banking company and requires these persons to provide the RBI with any statements or information the RBI examiners may require. EC3: The RBI has the power under Section 35A of the BR Act to issue directives to banking companies. The BR Act in Sections 46 and 47 authorizes the RBI to take action against banking companies that fail to comply with the provisions of the BR Act, including the imposition of monetary penalties and the potential for criminal liability. Section 22(4) authorizes the RBI to cancel the license of a banking company. It does not have similar authority for public banks, which account for more than 70 percent of the Indian banking market.
Assessment	Largely Compliant
Comments	For the most part, the RBI has the requisite authority to address compliance with the banking law through appropriate access to information and staff of banking companies, and the capacity to address instances of non-compliance through the taking of a range of enforcement actions. However, it lacks the authority to cancel the licenses of a public bank.
Principle 1(5)	**Legal protection.** A suitable legal framework for banking supervision is also necessary, including legal protection for supervisors.
Description	**EC 1** The BR Act provides for explicit protection to the supervisors under Section 54. No suit or other legal proceeding shall lie against RBI or any of its officers for anything or any damage caused or likely to be caused by anything done in good faith or intended to be done in pursuance of the BR Act.

	The Legal Department of the RBI confirmed that this protection extends to: • The Board of the RBI; and • The employees beyond their termination of employment or appointment. **EC 2** The assessors were informed that, as a matter of practice, the employee's costs of defending actions and/or omissions made while discharging their duties in good faith are borne by the RBI. The Legal Department informed the assessors that this practice had been applied in a particular instance in the past.
Assessment	Compliant
Comments	It is recommended that the protection for the costs of defending the actions of supervisors should be stated more clearly (preferably in the law and, in the mean time, at least at the level of internal procedures), including the financing of any expenses from the start of the legal proceedings.
Principle 1(6)	**Cooperation.** Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.
Description	EC1: No formal arrangement exists for exchanging written information between the domestic regulators, as there are no MOUs or other comparable formal mechanisms in place. Accordingly, the RBI does not get copies of inspection reports directly from the other domestic regulators it can obtain copies of such reports from the banks, although there is often a time lag. We have been advised of a program (Integrated System of Alerts) providing for the regulated entities of SEBI (such as stock exchanges) sending alerts to the RBI. There are semi-annual and quarterly meetings between RBI, SEBI, and IRDA, at which some information is exchanged. The semi-annual meetings, covering the Financial Conglomerates, take place at a senior level and involve senior people from a supervised institution. From a review of minutes of a meeting, at times issues are being raised by other regulators that lead to the RBI issuing appropriate guidance to the bank to address the issues. The quarterly meetings take place at a more operational level, and do not include representatives of the supervised institution. Importantly, a new Financial Stability and Development Council ("FSDC") was set up in December 2010 under the Chairmanship of the Union Finance Minister, with members from the RBI, SEBI, IRDA, PFRDA, and the government, that deals with financial stability issues as well as inter-regulatory coordination. A Sub-Committee under the FSDC was also set up, with the governor of the RBI as Chairman. EC2: The RBI has a significant gap in its information-exchange arrangements with foreign authorities. It has begun to address the gap by entering into MOUs with two foreign supervisory authorities. However, with Indian banks operating in over forty-five jurisdictions through branches, subsidiaries, and joint ventures, and with informal arrangements also limited (involving only several additional overseas supervisors), the issue remains a serious problem. EC3: In practice, the information received from other supervisors is used only for supervisory purposes and is treated as confidential, although this is not required explicitly by any provision of law. EC4: Under Section 45E of the RBI Act, no court can require or any other authority can compel the RBI to disclose information obtained by it under Section 45C of the RBI Act or furnished by a banking company under Section 45D of the RBI Act. In addition under

	Section 28 of the BR Act, the RBI is only allowed to disclose information obtained under the BR Act in aggregated form.
Assessment	Materially non-compliant
Comments	Given the large and growing dimension of overseas activities of Indian banks in numerous foreign jurisdictions (including some unstable or high risk jurisdictions), the absence of formal, or even extensive informal, arrangements for receiving information from host supervisors is a serious problem that should be addressed through the acceleration of the process of entering into formal MOUs or other means. (See CP 25.) The flow of regular information from the domestic nonbank supervisors also raises issues, although the issue is somewhat lessened by the capacity of the RBI to obtain copies of inspection reports from the banks, by the reporting mechanisms the RBI has imposed, and by the meeting structure it has created with the other regulators. Moreover, the creation of the FSDC and its important Committee may help address that over time, especially if the FSDC focuses on improving information exchange between the regulators – ensuring that: 1. mechanisms are found for written material (including inspection reports) to be regularly shared on a timely basis; 2. escalation protocols are appropriately broad (covering IRDA as well as SEBI directly) and fully operational to promptly alert other relevant supervisors about concerns that a supervisor is developing; and 3. the semi-annual meetings on major banking companies (i.e., the designated bank-led financial conglomerates, as well as other of the SIFIs not considered financial conglomerates, provided they engage in appreciable insurance or securities activities) on a fully regular basis, involving representatives of the supervised firm, but also allowing the opportunity for a regulators-only discussion of issues regarding that banking company. There is a proposal to insert a new Section 29 (A) in the BR Act that would allow the RBI to call for information from any entity in the banking group. Direct access by the RBI to information on subsidiaries and associated companies would be improved with the passage of this proposed amendment.
Principle 2	**Permissible activities.** The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined, and the use of the word “bank” in names should be controlled as far as possible.
Description	EC1: The term “bank” is clearly defined in Section 5 of the BR Act. EC2: The permissible activities of banking companies are enumerated in Section 6.1 of the BR Act, with Section 6.2 explicitly prohibiting a banking company from engaging in any other activities. Activities of subsidiaries of banking companies are limited to those permissible to the bank directly. While mutual fund and insurance activities are permissible activities under the law for banking companies, the RBI has limited engagement in them; they cannot be engaged in through a department of the banking company. Banks can set up subsidiaries engaged in some data processing and IT activities as well. EC3: Section 7 of the BR Act limits the use of terms such as “bank,” “banker,” and “banking” to licensed banking companies, and requires that such licensed banking companies incorporate “bank” in their names.

	EC4: There are several classes of nonbanking companies that can take deposits other than demand deposits: Development Financial Institutions and Nonbanking Financial Companies which are both subject to RBI supervision, and Corporations. The deposits are not covered by deposit insurance. EC5: The RBI maintains a current list of all authorized banking companies on its web-site; updates of the list are specifically made public through the issuance of a circular.
Assessment	Compliant
Comments	Banking is well defined in Indian Banking Law, with a clear line of demarcation from nonbanking companies. Activities that a banking company can engage in are clearly specified.
Principle 3	**Licensing criteria.** The licensing authority must have the power to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the ownership structure and governance of the bank and its wider group, including the fitness and propriety of Board members and senior management, its strategic and operating plan, internal controls and risk management, and its projected financial condition, including its capital base. Where the proposed owner or parent organization is a foreign bank, the prior consent of its home-country supervisor should be obtained.
Description	EC 1: The RBI is both the supervisory authority and the licensing authority. As is customary in other jurisdictions, licensing decisions can be appealed. In the case of India, the decisions can be appealed to the central government; if over-ruled by the central government, the RBI could itself petition the courts for review. The RBI has provided the assessors with documentation that this power was in fact used successfully by the RBI to have the courts over-rule a decision made by the central government that had over-ruled an RBI decision. (See also CP 1.2.) EC 2: In practice, there have been no approvals of domestic bank licenses for a number of years, following the finding of problems at some relatively recently established private banks. Legal authorities provide that the RBI issues licenses only after tests of entry specified in Section 22 (3) of the BR Act have been fulfilled. The RBI reviews capital to ensure it meets the minimum requirement and assesses the ownership structure, operating plans and controls, the ability to pay its present and future depositors in full, the quality of management, and whether the licensing would be in the public interest. EC 3: The criteria for issuing licenses are generally consistent with the criteria involved in ongoing supervision, although governance and risk management expectations are not explicitly built into the licensing provisions. EC 4: The RBI has the implicit authority to deny applications if the criteria are not met. In practical terms, the failure to approve constitutes an effective denial. EC 5: Under Section 22(3) (c) of the BR Act, the proposed management is evaluated to ensure that it will not be prejudicial to the public interest or the interests of present or future depositors. If the banking group is not widely held, not regulated, not publicly listed, or lacks transparency, the license could be denied. EC 6: The RBI reviews the ownership structure of proposed banks to assess the suitability of the promoters of a banking company. With a test of 5 percent ownership of shares, a reasonably low threshold for review and acknowledgement has been established by regulation.

EC 7: The BR Act in Section 22(d) requires the RBI to ensure the adequacy of the capital structure before granting a license. Pursuant to RBI Guidelines issued on January 3, 2001, the initial minimum capital of a new bank as Rs. 200 crore, which would be raised to Rs. 300 crore within three years of commencement of business EC 8: A Various elements of a fit-and-proper test are applied to the directors of a bank. Under the Companies Act, people with criminal convictions are ruled out of being directors. A more specific to banking requirement is that the chairman/managing director must have specified banking or financial qualifications under Section 10-B (4) of the BR Act. The qualifications of other directors are reviewed, largely to ensure that the range of preferred areas of expertise and experience specified in Section 10A of the BR Act is satisfied.

Subsequent changes in the Board are not approved ex ante, except that full-time directors (managing director (CEO) and executive directors) of private banks are reviewed before the fact by the RBI; for public banks, an Appointments Board, chaired by the governor of the RBI, develops a list of proposed nominees that is then confirmed by the Ministry of Finance and the central government.

Other changes in directors are required to be reported to the RBI under an Operating Circular. Moreover, as part of the Annual Financial Inspections ("AFI") process, the exercise of the authority of the nominating committee of the Board in selecting new directors, is reviewed.

EC 9: The RBI reviews the proposed strategic and operating plans of the bank to determine whether an appropriate system of corporate governance, risk management, and internal controls will be in place. However, it does not determine prior to authorization the proposed systems that will be used in practice; these will be covered in the annual inspection of the new bank, typically within 18-24 months of its establishment rather than more immediately (e.g., 6-12 months) after establishment.

EC 10: Under Rule 11 of the Banking Regulation (Companies) rules, 1949, applications must be filed in a prescribed form (Form III), which requires submission of a project report, covering the business potential and viability of the proposed bank. Pro forma financial statements and projections are included in the submissions. Financial information on the promoters of the bank, including information on their financial worth and on their business interests (including details on credit outstanding) is reviewed.

EC 11: The RBI obtains a non-objection letter from the home country supervisor, before granting a license from a foreign bank It also reviews the quality of supervision exercised by the home country supervisor, but does not explicitly consider whether it practices consolidated supervision overall, nor does it have a clear template for analysis of the overall quality of supervision. During the discussions, RBI representatives indicated that consolidated supervision is reviewed only in the context of the proposed office falling within the supervisor's responsibility, and the qualitative assessment of supervision is carried out with little apparent analytical structure.

EC 12: The RBI has the power under Section 22 (4) of the BR Act to cancel a license if it fails to comply with any of the conditions imposed. Implicitly, the authority would cover false statements made in the course of an application. The fact that strong penalties under Section 46 can be imposed for false statements more generally also works to limit the likelihood of false statements in licensing applications.

The RBI does not have the authority the disempower a state bank to carry on banking activity, as the state banks are not subject to Section 22 of the BR Act.

	EC 13: Section 10A(2) of the BR Act mandates that not less than 51 percent of the directors have special knowledge or practical experience in accountancy, agriculture, banking, co-operation, economics, finance, law, small scale industry etc. There are also fit and proper criteria established by the RBI to ensure that the directors understand the risk profile of a bank. AC 1: The assessment of the application includes an evaluation of the ability of the shareholders to supply additional capital support to the bank if needed. AC 2: New banks, as well as more long established banks, are subject to off-site supervision through the filing of a series of mandated prudential returns (See CP 21.). They are also subject to the AFI process, which for new banks, will include a focus on compliance with the licensing conditions.
Assessment	Largely Compliant
Comments	The RBI has a clear licensing process, with the ability to develop necessary information and apply discretionary judgment in its decision-making, although no domestic licenses have been granted for a number of years There are some areas that should be strengthened, such as: • Putting in placed a closer ex-ante review of the intended risk management and control systems of a proposed new bank and/or ensuring that it be examined at a very early stage of its operations (within the first six to twelve months); • Requiring more clearly that a foreign bank applicant is subject to overall consolidated supervision in its home country; an • Considering the inclusion of a requirement for on-going information exchange with the home country supervisor as a condition for licensing an office of a foreign bank.
Principle 4	**Transfer of significant ownership**. The supervisor has the power to review and reject any proposals to transfer significant ownership or controlling interests held directly or indirectly in existing banks to other parties.
Description	EC 1: While neither the banking law nor regulations specifically define significant ownership and controlling interest, the BR Act does in Section 5(ne) define the term, “substantial interest” as the beneficial ownership of the lesser of Rs 5 lakhs or 10 percent of the paid-up capital of the company. Moreover, Section 12 (2) of the BR Act restricts specific shareholders (such as could be the case with promoters) from voting more than 10 percent of the shares of a banking company, and under regulations issued by the RBI under Section 35A of the BR Act, a 5 percent shareholding requires an acknowledgement by the RBI. EC 2: Pursuant to Section 35A of the BR Act, any transfer of shares exceeding 5 percent of the paid-in capital of the bank requires acknowledgement by the RBI. EC 3: Under Section 35A of the BR Act, the RBI has the power to reject any proposal for a significant change in ownership or controlling interest in a bank. EC 4: The RBI is able to monitor shareholdings even below the 5 percent level through review of reports requested beginning in August, 2005, from private sector banks on details of share transfers that have resulted in changes in shareholdings of any individual entity of 0.5 percent.

	EC 5: The RBI has a prior approval process at the 5 percent level in place. In case transfers of this amount occur without approval, the RBI is empowered to direct the bank to reverse the transfer. AC 1: Neither the law nor regulations require banks to notify the RBI in the event they become aware of material information which could negatively affect the suitability of a major shareholder.
Assessment	Compliant
Comments	The RBI has the legal authority and operating procedures to review changes in the ownership of shares of banking companies. The definition of substantial interest is focused on beneficial ownership, avoiding issues that could otherwise crop up with shares being held by nominees. However, there is a prospect of control being exercised through means other than shareholdings, suggesting that it would be appropriate to find a means to incorporate a more judgmental test of controlling interest. There is also the possibility of there being a change in ownership of an existing shareholder that would not be subject to review.
Principle 5	**Major acquisitions.** The supervisor has the power to review major acquisitions or investments by a bank, against prescribed criteria, including the establishment of cross-border operations and confirmation that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.
Description	EC 1: Under Section 35A of the BR Act, banking companies can, with prior approval of the RBI, acquire more than 50 percent of the shares of a company engaged in activities that are permissible for a bank directly under Section 6 of the BR Act; in addition, two activities listed in Section 6 (insurance and mutual funds) cannot be engaged in through a department of the bank itself. Banking companies cannot acquire between 30 percent and 50 percent of the shares of any company, except with the concurrence of the central government, in addition to RBI approval. Under the law, banking companies can acquire less than 30 percent of the shares of any company regardless of the activities of such company. In any event, under Section 19 (2) of the BR Act, the aggregate equity investments made (as pledgee, mortgagee, or owner) by a banking company in the shares of other companies must be less than 30 percent of the bank's equity. Moreover, by RBI regulation, the amount of such investments is further limited to 10 percent of the banking company's own equity by individual investment and 20 percent in the aggregate. EC 2: The criteria for consideration of proposals include the review of activity and investment limits specified under EC 1. Other aspects have been spelled out in the Master Circular, "Para banking activities" issued on July 1, 2010. Acquisition proposals are also evaluated in terms of prospective effects on the financial condition of the banking company and whether they are otherwise desirable. EC 3: The potential for acquisitions to expose the investing bank to undue risk is limited by the fact that most of the companies that can be invested in are subject to the supervision and regulation of another Agency (e.g., SEBI, IRDA, National Housing Bank), although some nonregulated companies can also be acquired. Some unregulated subsidiaries can be established, but principally only in the area of information technology/ data processing.

	Under Section 19 of the BR Act, the RBI does review the prospective establishment of foreign branches or subsidiaries; it has discretion to deny an application if concerns, such as the presence of secrecy laws prohibiting free flow of information, exist. EC 4: All proposals for major acquisitions are evaluated from the point of view of the impact on the bank, and the ability of the acquirer to manage the investment/acquisition well. EC 5: Some acquisitions of shares can be made without RBI approval: shares held in the trading book and shares amounting to less than 30 percent of the shares of an investee (non-financial) company subject to the limits described above; there are no requirements that the companies invested in engage only in activities closely related to banking. EC 6: With the exception of the investments made under the 30 percent threshold, the RBI is made aware of the intended investments of a banking company before they occur. However, as discussed under CP 24, the capacity of the RBI to monitor the activities of subsidiaries to ensure they are not posing risks to a banking group is constrained. AC 1: Under Section 19 (1) of the BR Act, any prospective foreign operation of an Indian bank requires prior approval of the RBI. In the review of such filings, the RBI determines broadly that appropriate supervisory arrangements in that host country are in place, although the extent of the review appears limited. If requested, the RBI advises the host country that it is the supervisor and regulator of the banking company.
Assessment	Largely Compliant
Comments	The structured approach for reviewing prospective investments in subsidiaries has the key elements needed to ensure that the banking company focuses on banking activities and to provide effective oversight by the RBI on expansion. Areas to address include the following: 1. The capacity of the RBI to monitor the risks of a nonbank subsidiary, and to take action to address on a very timely basis circumstances where problems surface, is limited, such as by the potential time-lags in getting information concerning entities regulated by other Agencies and the lack of legal authority to request information for unregulated entities; and 2. A more systematic approach to critical review of host country supervisory arrangements should be developed and implemented.
Principle 6	**Capital adequacy.** Supervisors must set prudent and appropriate minimum capital adequacy requirements for banks that reflect the risks that the bank undertakes and must define the components of capital, bearing in mind its ability to absorb losses. At least for internationally active banks, these requirements must not be less than those established in the applicable Basel requirement.
Description	**EC 1 & EC2**. The capital adequacy requirements have been implemented through various prudential regulations, summarized in the Master circular “Prudential guidelines on Capital Adequacy and Market Discipline” (the MC) last updated on 1 July 2010. Banks on a solo and a consolidated basis are required to maintain a Capital Adequacy Ratio of at least 9 percent of their risk-weighted assets as per the Basel II methodology (standardized approach for credit as well as market risk and basic indicator approach for operational risk) covering both on and off-balance sheet items (paragraph 4.1 of the MC). Further, the minimum Tier 1 capital ratio is prescribed at 6 percent (paragraph 4.1.3 of the MC). At the time of the assessment, all banks met these minimum capital requirements. The system

	level capital ratio stood at 14.5 percent per cent at the end of March 2011, well above the regulatory minimum. The RBI has also implemented risk weights above the minimum Basel II risk weights in a number of areas, for example more granular risk weights for mortgage lending based on LTV ratios. Paragraph 4.2. of the MC also defines the components of Tier 1 and Tier 2. The eligible instruments, prudential limits and their loss absorbing capacity are in accordance with the limits prescribed under the Basel I Accord (1988) as well as the Sydney Press release from 1998. The deductions from capital are generally considered conservative. At the time of the assessment, around 85 percent of Tier 1 consisted of common equity. Capital requirements apply equally to all commercial banks. **EC 3** In section 35A of the BR Act, the RBI has the legal power to impose a specific capital charge and/ or limit on all material risk exposures. Going forward, the RBI will introduce a systematic assessment of the relevant risk factors and the internal capital adequacy assessments of each bank and set individual capital ratios. Accordingly, the RBI will consider prescribing a higher level of minimum capital ratio for each bank under the Pillar 2 framework on the basis of its respective risk profile and risk management system. The RBI has stated in paragraph 4.1 of the MC that banks are expected to operate at a level well above the minimum level. **EC 4** Although no individual capital ratios have been set, the supervisory expectation for banks to hold capital well above the regulatory minimum has been clearly articulated by the RBI. The calculation of the required capital ratio is aligned with, and in some instances stricter than, the Basel II methodology. Hence, it includes on and off balance sheet risks. **EC 5** The RBI has implemented a 9 percent capital adequacy ratio and a 6 percent Tier 1 ratio compared to respectively the 8 percent and 6 percent regulatory minima. **EC 6** In accordance with Section 35A of the BR Act, the RBI may issue a direction to a bank in the interest of the concerned bank, in the interest of the banking system or in the interest of its depositors. In practice the RBI is guided by its Prompt Corrective Action (PCA) framework. Under the PCA, supervisory responses are linked to three parameters i.e., net NPA ratio, capital adequacy ratio and return on assets. **EC 7** At present all banks in India are on the standardized approach for credit risk, the basic indicator approach for operational risk and the standardized approach for market risk. The RBI has published its timetable for adoption of the advanced approaches. **AC 1** All commercial banks are treated equally for capital purposes. **AC 2** In India, no banks are held by holding companies. Hence, capital adequacy requirements do not apply at the holding company level but they do apply on a consolidated basis. The capital adequacy requirements apply to all commercial banks, regardless of whether they are internationally active. **AC 3** The RBI has issued detailed Pillar 2 (ICAAP) guidelines. Banks are required to capture all material risks on a forward looking basis and plan capital accordingly. Their assessments are subject to a supervisory review and evaluation process (SREP). **AC 4** The RBI has not issued guidelines that require adequate distribution of capital among different entities of the group.
Assessment	Compliant
Comments	The RBI has set prudent and appropriate minimum capital adequacy requirements for banks that reflect the risks that the bank undertakes. It has defined the components of

	capital in accordance with internationally agreed guidelines and has the legal power to require higher capital ratios for individual banks. The RBIs requirements are stricter than those established in the applicable Basel requirements. The RBI will move to Basel III on the internationally agreed timeline. The assessors recommend the RBI issue guidelines requiring adequate distribution of capital among different entities of the banking group. Discussions with banks indicate that many challenges remain for migration to the Basel II advanced approaches. Most relate to constraints on data, tools and methodologies and the required skills for the quantification and modeling of risks as well as the validation these models. The RBI will have to consider how to address a range of practical implementation issues consistently. Going forward, it will also have to reflect if supervisory policies and practices may have to be enhanced for effective supervision of banks applying the Basel II advanced models on an ongoing basis.
Principle 7	**Risk management process.** Supervisors must be satisfied that banks and banking groups have in place a comprehensive risk management process (including Board and senior management oversight) to identify, evaluate, monitor, and control or mitigate all material risks and to assess their overall capital adequacy in relation to their risk profile. These processes should be commensurate with the size and complexity of the institution.
Description	EC 1: Through an October 27, 1999 Circular ("Risk Management Systems in Banks"), the RBI articulated expectations for the risk management structures of banking organizations. From a review of inspection reports, the governance structures around risk management and control are assessed, and critical evaluations are done across such risk management areas as credit risk, liquidity risk, and operational risk. EC 2: In that 1999 Circular, the RBI stated that the primary responsibility of laying down risk parameters and establishing the risk management and control system rests with the Board of Directors; this responsibility was extended more explicitly to senior management in 2010. The implementation of the integrated risk management system could be assigned to a Risk Management Committee or to a Committee of top executives reporting to the Board. EC 3: In the AFI, the RBI reviews corporate governance issues including how risk management approaches are updated and communicated across the bank. Limits and their exceptions are also reviewed at that time. EC 4: Efforts are made to ensure that the Board has the mix of skills needed to understand the nature and level of risk, and that the Board and senior management receives the necessary management information. EC 5: Banks have put in place internal capital adequacy assessment processes that are evaluated by the RBI under SREP. EC 6: There is no current rigorous validation and independent testing of models and systems in the banks, which is consistently required by, or conducted by, the RBI; these models are not currently used for regulatory capital purposes.. Banks apply some independent testing of models from Internal Audit or External Audit. EC 7: Banks are expected to have adequate information systems for measuring, assessing, and reporting on the size, composition, and quality of exposures. They are required to adhere to prudential norms in the MC on Income Recognition, Asset Classification, and Provisioning, and provide reports to senior management on performance in this regard. The RBI reviews these requirements during the AFIs.

	EC 8: Banks are required to appoint a senior officer as Compliance Officer, who has to ensure that new products intended to be offered by the bank are in line with regulatory guidelines. The new product approval process also involves typically the risk department. There is no legal or regulatory requirement for the Board of Directors to be involved, although the policies of some banking companies necessitate that new products are approved by the Board – thus, there is some potential for inconsistency. EC 9: The RBI has advised banks of the need to put in place robust risk management architecture, with segregation of duties between front and back office functions, and the recognition of the need for independence in the middle office function of risk management. However, as indicated in the 2009 Self Assessment and reconfirmed in discussions the assessors had with the RBI, the guidance has been issued only to the bank and not to the overall banking group. The extent of the focus on consolidated (vs. bank only) risk management in the RFI process appears limited. EC 10: The RBI has issued guidance in such areas as asset/liability management, liquidity risk, market risk, credit risk, and operational risk. AC 1: The RBI has advised banks that each of credit risk, market risk, and operational risk has to be managed within a separate function. AC 2: Detailed guidance on stress testing was issued on June 26, 2007. Banks were required to put in place appropriate stress test policies, and to ensure that they were operational as March 31, 2008. Compliance has been assessed through AFIs. AC 3: Through the ICAAP and SREP processes there is some review of reputational and strategic risk.
Assessment	Largely Compliant
Comments	The RBI has issued guidance on most of the key elements of risk management structure and operations, and the AFI process is used to access compliance with that guidance. The areas of improvement opportunity identified include 1. Establishing a requirement for periodic and rigorous model review and validation by banks, even of internal risk models not currently used for regulatory capital purposes, and 2. Ensuring that risk guidance is issued to, and applied strongly in practice to, the consolidated banking company rather than just the bank.
Principle 8	**Credit risk.** Supervisors must be satisfied that banks have a credit risk management process that takes into account the risk profile of the institution, with prudent policies and processes to identify, measure, monitor, and control credit risk (including counterparty risk). This would include the granting of loans and making of investments, the evaluation of the quality of such loans and investments, and the ongoing management of the loan and investment portfolios.
Description	**EC 1** The RBI has issued guidelines on Risk Management Systems in Banks in October 1999 and a detailed Guidance Note on credit risk in October 2002. The Risk Management guidelines require risk management policies be established by the Board which should be consistent with the broader business strategies, capital strength, management expertise and overall willingness to assume risk. Paragraph 3.1.5 of the Risk Management guidelines require that the credit risk management process to be articulated in the bank's Loan policy, and approved by the Board. In accordance with paragraph 2.1 of the 1999 Risk Management Systems in Banks circular, the Board should also set limits by

	assessing the bank's risk and risk bearing capacity. The RBI examiners confirm during the AFI that senior management implements the risk strategy and the Loan Policy approved by the Board and develops the policies and processes. Commercial banks in India are subject to directed lending thresholds imposed by the government. More specifically, they are required to direct 40 percent of their Adjusted Net Bank Credit (ANBC) or credit equivalent amount of Off-Balance Sheet Exposure, whichever is higher toward priority sectors in accordance with the MC "Lending to Priority Sectors." For foreign banks, the required amount is 32 percent. Priority sectors for domestic banks are agriculture, micro and small enterprise advances, and advances to weaker sections. For foreign banks, the priority sectors are micro small enterprise advances and export credit. Within those broad targets, various sub targets exist. The authorities state that banks are not allowed to differentiate in the application of prudential norms between priority sector and other lending. Banks are still expected to perform their usual due diligence procedures. Nevertheless, the June 2011 Financial Stability Report of the RBI indicates that the asset quality under priority sector lending, especially agriculture, deteriorated at a faster rate as compared to the overall asset quality. • Shortfalls in meeting the target are subject to a mandatory deposit of the shortfall: for Indian banks, the deposit is for 7 years, in the Rural Infrastructure Development Fund (which on-lends to the National Bank for Agriculture and Retail Development or NABARD). The deposit is remunerated at a rate inversely proportional to the shortfall, and may be just 2-3 percent. For foreign banks, the deposit is for 3 years, with the Small Industry Development Bank, which refinances other banks lending to the priority sectors. **EC 2** In terms of the guidelines mentioned under EC 1, the Board of Directors of each bank is responsible for putting in place an appropriate credit risk management framework, for approving and periodically reviewing the credit risk policy, strategy, procedures and processes. Banks are required to constitute a high-level Credit Policy Committee (CPC) to deal with issues pertaining to credit sanction, disbursement and follow-up procedures and to manage and control credit risk on a whole bank basis. Banks also have to set up an independent Credit Risk Management Department to enforce and monitor compliance of the risk parameters and prudential limits set by the Board. The 2002 Guidance note includes specific requirements with regard to the credit grading framework, portfolio surveillance and reporting, limit systems, portfolio review mechanisms and internal reporting. Compliance with these requirements is assessed during the AFI. The assessors reviewed the credit risk section of an inspection report to gain comfort on the depth and scope of the work. **EC 3** Section 20 of the BR Act explicitly prohibits banks from lending to connected parties namely members of the Boards of directors, the entities in which they are interested, and their relatives. It also requires that any individual involved in any such decision should disclose his interest and not participate in credit decisions involving those entities. These requirements are also included in regulations, particularly in the MC "Loans and advances – statutory and other restrictions." As regards transactions with the bank's related parties such as their subsidiaries, associates, joint ventures etc. these are required to be at arms' length basis and are specified as one of the licensing conditions. Whether or not banks are adhering to these regulations are looked into during the Annual Financial Inspections. (see also CP 11 "Related Parties").

	EC 4 Section 27(2) of the BR Act, allow the RB at any time to direct a banking company to provide it, within such time as may be specified by the Reserve Bank, with such statements and information relating to the business or affairs of the banking company (including any business or affairs with which such banking company is concerned) as the RBI may consider necessary or expedient. Further, Section 35 (2) of the BR Act states that it shall be the duty of every director or other officer or employee of the banking company to produce to any officer making an inspection under sub-section (1) or a scrutiny under sub-section (1-A) all such books, accounts and other documents in his custody or power and to furnish him with any statements and information relating to the affairs of the banking company as the said officer may require of him within such time as the said officer may specify. Notwithstanding the above, the RBI may convene a meeting of the specified officials of a bank to discuss any issue that it considers necessary. The authorities stated that they have yet to encounter specific problems in getting access to a banking company's books or systems. **AC 1** Although Paragraph 3 of the 1999 Risk Management Guidelines state that banks should have a multi tier credit approving system, there is no explicit RBI requirement that major credit risk exposures exceeding a certain amount or percentage of capital, or exposures that are especially risky or otherwise not in line with the mainstream of bank activity are to be decided by the bank's senior management. Nevertheless, the authorities advised that in practice most banks would have such a requirement as part of their credit policies. **AC 2** The RBI requires the inclusion of counterparty risk including potential future exposure for the calculation of regulatory capital. There is however no specific requirement in the regulations that counterparty risk and potential future exposure be included in the credit management framework. **AC 3** Banks are required to obtain the financial statements from borrowers as a matter of practice. The RBI has also a system of credit information sharing, which requires participating banks to verify exposures exceeding Rs 25 lakhs before granting loans.
Assessment	Compliant
Comments	Although Paragraph 3 of the 1999 Risk Management Guidelines state that banks should have a multi tier credit approving system, there is no explicit RBI requirement that major credit risk exposures exceeding a certain amount or percentage of capital, or exposures that are especially risky or otherwise not in line with the mainstream of bank activity are to be decided by the bank's senior management. There is no specific requirement in the regulations that potential future exposure be included in the credit management strategies or policies. With the increased use of credit risk models for internal risk management purposes, the RBI should consider requiring banks to have a comprehensive model validation policy approved by the Board (see also CP 7). Although this requirement would of course be evident for banks intending to apply the advanced approaches under Basel II, the banks on the standardized approach should also be subject to validation requirements in case they use models that do not directly generate inputs to the regulatory capital calculation (for example, for an internal model used by a standardized bank for pricing).

<table>
<tr><td>Principle 9</td><td>Problem assets, provisions, and reserves. Supervisors must be satisfied that banks establish and adhere to adequate policies and processes for managing problem assets and evaluating the adequacy of provisions and reserves.</td></tr>
<tr><td>Description</td><td>
EC 1 Banks are required to establish policies for the identification and management of nonperforming assets (NPA) as well as for provisioning. These policies should include regular review of NPAs and management reporting to the Board. Board approved policies for write offs are also required.
The RBI has issued two mandatory prudential guidelines for commercial banks.

Income recognition, asset classification and provisioning pertaining to the advances portfolio.
Classification & valuation of the investment portfolio.

All banks are required to classify their loan and investment assets as standard (performing) or nonperforming assets . Assets are classified as NPA when amounts are due for 90 days or more or, if in the view of the banks the recovery prospects are weak.
The RBI has set norms for the classification of NPAs as sub standard, doubtful and loss assets depending on the ageing of the assets. RBI norms specify the required specific provisions taking into account the potential threat to the recovery of the asset.
Moreover, standard or performing assets also require a provision between 0.40 percent and 2 percent to cover expected losses. When computing NPAs, the value of the collateral is not deducted from the balance outstanding.
The RBI norms are minimum requirements. Any bank may voluntary make specific provisions for advances or loans at higher rates to provide for estimated actual loss, provided these higher rates are approved by the Board of Directors and consistently applied from year to year.
On top of specific provisions for NPAs, banks' Boards should lay out approved policies regarding "floating provisions." The latter can only be used for contingencies under extraordinary circumstances for making specific provisions in impaired accounts after obtaining the Board's approval and with prior permission of the RBI. The Board is required to lay out an approved policy as to what circumstances will be considered extraordinary. At the time of the assessment, the vast majority of banks held provisions above the minimum requirements of the RBI.
The provisioning requirement outlined in the MC are as follows:
<table>
<tr><td>Standard assets</td><td>Substandard assets</td><td>Doubtful < 3 years</td><td>Doubtful > 3 years</td></tr>
<tr><td>0.40 percent - 2 percent of outstanding amount

Irrespective of the Net Realizible Value (NRV) of the security</td><td>15 percent - 25 percent of outstanding amount irrespective of the NRV of the security</td><td>100 percent of the unsecured portion plus 25 to 40 percent of the NRV of the tangible security</td><td>100 percent of the outstanding irrespective of the NRV of the tangible security</td></tr>
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	As outlined in paragraph 5.10 of the MC, banks are required to respect a Provisioning Coverage Ratio (PCR) of not less than 70 percent. The PCR is essentially the ratio of provisioning (specific and floating) to gross NPA and indicates the extent of funds a bank has kept aside to cover loan losses. The positive surplus resulting from the provisions under the 70 percent PCR as compared to the NPA provisions should be recorded and disclosed in an account "countercyclical provisioning buffer." This buffer will only be allowed to be used for making specific provisions for NPAs during periods of system-wide downturn, to be determined by the RBI. **EC 2** It is the primary responsibility of the bank's management to ensure that adequate provisions as per the prudential requirements are made. The bank's auditors certify the appropriateness of the asset classification and the adequacy of the provisions as per the RBI norms. The RBI receives the annual long form audit report to analyze the work carried out by the external auditors. During the AFI, the RBI examiners also assess the adequacy of the provisions. For this examination, a coverage ratio of 60 percent is targeted for the sample for private sector banks and foreign banks. For public sector banks, the target is set at 30 percent. In addition, examiners review the provisioning and write off procedures. In case of material adjustments to comply with the RBI's minimum standards, these are pursued with the bank for immediate rectification. The examiners also assess the systems and procedures for early identification of problem assets. This review covers the oversight and management of the portfolio (see also EC 5). The assessors have reviewed the problem assets section of an inspection report and have concluded that the scope and depth of the work performed by the onsite examiners is adequate. **EC 3** The RBI guidelines include specific provisioning requirements for derivatives exposures (paragraph 5.9.12 of Part A of the Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances). Moreover, the accounting standard AS 29 "Contingent Liabilities and Provisioning" which is mandatory for all commercial banks in India also requires recording of provisions for contingent liabilities that are likely to result in a loss to the entity. Hence, if a bank anticipates a loss on account of any off balance sheet commitment or exposure, it is required to provide for it. **EC 4** The realizable value of the security is to be assessed by an expert valuer when the security is above Rs 5 crore. Realizable values are subject to haircuts depending upon the period of delinquency (MC paragraph 5.3). Also, when the realizable value is less than 10 percent of the exposure, it has to be ignored (MC paragraph 4.2.9 ii). These requirements add additional conservatism in the assessment of the provisioning requirement. **EC 5** In accordance with the MC referred to in EC1, banks are required to designate a time limit for overdue accounts and to determine a threshold for active intervention, well before the account become NPA. All accounts are required to be put on a list for early follow up and time bound action to prevent slippage in NPA category. Also, banks must track migration of borrowers from one rating scale to another on an ongoing basis. **EC 6** In addition to the work carried out during the AFI (see EC 2), asset quality of banks is also monitored on a quarterly basis through the submission of prudential returns. As part of their annual financial statements, banks are also required to disclose movements in provisions and nonperforming assets. **EC 7** In accordance with Section 35A of the BR Act, the RBI can issue directions to all banks or to individual banks. These directions can include, *inter alia*, higher provisions. As

	an example of the use of this power, the assessors were informed of a number of specific instances where the authorities have asked for higher provisions. In general, the banks will make the adjustments on request without the need to issue a direction. **EC 8** As outlined above under EC 2, the examiners of the RBI assess the accuracy of the classification of NPAs and the adequacy of provisions for prudential purposes. The RBI has the power to require additional provisioning or higher capital (in accordance with the powers described in EC 3 of CP6) by issuing a direction to a particular bank or to banks in general in accordance with Section 35A of the BR Act. **EC 9** The MC includes some detailed requirements with regard to valuation of risk mitigants. Paragraph 5.3 of the MC requires that collateral such as immovable property must be valued once in three years by expert valuers appointed as per the guidelines of the Board of Directors of the Bank. The prudential guidelines recognize only tangible security and do not allow intangible security such as guarantees, comfort letters etc. As outlined in EC 4 of this CP a valuation by external agencies is required when the Rs 5 crore threshold is exceeded. **EC 10** The MC includes detailed guidelines for classification of assets as nonperforming based on the record of recovery. A NPA is a loan or advance where interest and/or installment of principal remain overdue for a period of more than 90 days (MC paragraph 2.1). With regard of an overdraft account, the account is treated as "out of order" if the outstanding balance remains continuously in excess of the sanctioned limit or drawing power (paragraph 2.2 of the MC). If, in the view of the bank, recovery prospects are weak, advances and/or investments should also be classified as NPA. Banks are also required to classify investments as nonperforming if any amounts due in respect of such investments have not been collected within 90 days after the due date. **EC 11** The RBI has issued a Circular on 10 June 2010 "Calendar of Reviews" which requires that a Position report, giving details of NPAs and recovery thereof must be placed on the Board's agenda at every meeting. In addition, banks are required to submit a review of all borrowers' accounts which are classified as substandard, doubtful or loss where the amount outstanding is Rs 1 crore and above. The report should be comprehensive and cover details on the deficiencies observed, systemic controls required for prevention of NPAs, etc. **EC 12** The guidelines on provisioning mentioned in EC 1 do not explicitly distinguish between the assessment and analysis of large accounts versus smaller accounts. That said, banks are encouraged to hold provisions above the regulatory minimum requirement. As stated under EC 11, specific requirements based on size are also in place for substandard, doubtful and loss accounts. The Guidelines on the management of Credit risk of October 12, 2002 also require banks to have in place loan a loan review/credit audit mechanism for large accounts within 3-6 months of sanctioning as on existing accounts. **AC 1** Loans are required to be classified as nonperforming where payments are contractually in arrears for 90 days. The RBI has also issued detailed requirements "Prudential Guidelines on Restructuring of Advances" for restructuring of loans and advances in Part B of the MC. The requirements state that any method of refinancing an existing loan which is on the verge of being classified as NPA will be viewed adversely and categorized as ever-greening. Additionally, restructuring of loans should not lead to improved classification. Banks may continue the asset classification status when appropriate provisions are made against the net present value of the loss in the account as a result of the restructuring.

Assessment	Compliant
Comments	
Principle 10	**Large exposure limits.** Supervisors must be satisfied that banks have policies and processes that enable management to identify and manage concentrations within the portfolio, and supervisors must set prudential limits to restrict bank exposures to single counterparties or groups of connected counterparties.
Description	**EC 1** The RBI requires banks to develop policies and procedures to define a "group of connected counterparties." In this respect, the notions of "effective control" and "communality of management" are guiding principles for banks in making this determination. The authorities state that Indian accounting standards have to be followed, but no reference to this could be found neither in the MC nor in the guidance to banks. From a review of a sample of inspection reports, the assessors concluded that the depth and scope of RBI examiners verifying the classification of connected counterparties during the annual financial inspection is too limited. The RBI has the power to challenge the definition of group of connected counterparties and impose additional limits on the exposure or require additional capital (see EC 3 of CP6) and has apparently only done so on one occasion in the past. **EC 2** In the circular "Risk Management in Bank" issued on 7 October 1999, the RBI has prescribed limits for large exposures at 15 percent of bank's capital for a single borrower and 40 percent of bank's capital for a group of borrowers respectively (paragraph 3.2.2.c). These limits apply at the solo and the consolidated banking group level. Both limits can be exceeded by 5 percent and 10 percent respectively for infrastructure projects. These are prudential ceilings; banks can set lower exposure norms with the approval of their Board of Directors. In exceptional and temporary circumstances, the Board of Directors can increase the large exposure limits, single as well as group, by an additional 5 percent, subject to the borrower consenting to the bank making additional disclosures regarding the counterparty in the Annual Report. At the time of the assessments, none of the banks had used this discretion. The circular also prescribes that the sum of the large exposure limit must be set below 800 percent of capital funds, With effect from 29 May 2008, the exposure limit in respect of a single borrower has been raised to 25 percent of the capital funds in respect of oil companies who have issued Oil bonds (which do not have Statutory Liquidity Ratio (SLR status)) by the government of India. In addition to this, banks may in exceptional circumstances consider enhancement of the exposure to the Oil Companies up to a further 5 percent of capital funds. Lower prudential limits have been sect with regard to bank's exposures to Nonbank Financial Companies. The exposure of a bank to a single NBFC / NBFC-AFC (Asset Financing Companies) should not exceed 10 percent and 15 percent respectively of the bank's capital funds. Banks may however assume exposures to single NBFC / NBFC-AFC up to 15 percent or 20 percent respectively of their capital funds provided the exposure in excess of 10 percent or 15 percent respectively, is on account of funds lent on by the NBFC/NBFC-AFC to the infrastructure sector. Exposures of banks to Infrastructure Finance Companies (IFC) should not exceed 15 percent of its capital funds as per its last audited balance sheet, with a provision to increase it to 20 percent if the same is on account of funds on lent by the IFCs to the infrastructure sector. All prudential thresholds mentioned in the EC are stated in in the Master Circular "Exposure Norms" , paragraph 2.1.1. "Prudential ceilings"

	These limits are monitored during the AFI as well as using the monthly offsite monitoring process of the prudential returns. Banks are also required to report their Top 20 exposures on a monthly basis. For the application of this CP, exposures include on balance sheet as well as off balance sheet exposure. For derivatives, exposures are calculated using the current exposure method. **EC 3** The examiners of the RBI analyze and assess the integrity of the management information systems aggregating the exposures to individual and group counterparties during the AFI. **EC 4 I**n accordance with the Circular "Risk Management in Banks" issued by the RBI on October 7, 1999 (paragraph 3.2.2.d) as well as paragraph 2.2. of the Master Circular "Exposure Norms', banks are required to establish internal limits for aggregate commitments to specific sectors. Moreover, the RBI has restricted the aggregate exposure of banks to the capital markets in all forms to 40 percent of net worth as of March 31 of the previous year of the bank. Within this ceiling, the bank's direct investment in shares, convertible bonds and debentures, units of equity oriented equity funds and all exposures to Venture Capital Funds (VCF) should not exceed 20 percent of its net worth. (for more details on the composition of the exposures to Capital Markets, see paragraph 2.3.1. of the Master Circular "Exposure Norms"). **EC 5** The RBI receives periodical offsite prudential returns reporting various sectoral and geographical concentrations. Any significant movement in risk concentration at the system level is used as input for policy responses and significant variations at the bank level are taken up with the respective banks. Under the ICAAP process for banks, credit concentration risk is also assessed by the RBIs examiners. The assessors reviewed the internal supervisory guidance and risk scoring templates under the SREP and concluded that these were comprehensive and consistent with the supervisory objectives. **AC 1** The group large exposure limit of 40 percent is significantly higher than the large exposure limit in this AC.
Assessment	Materially Noncompliant
Comments	More detailed requirements and more guidance on the criteria for the determination of "connected exposures" is required. This could take the form of a broadening of the guiding principles, for example by including cross-guarantees between entities or financial interdependency that result in the entities becoming one single risk. Likewise, RBI examiners should include the verification of the definition of connected parties in more depth during the AFI. The large exposure limit of 40 percent - which can exceptionally be brought to 50 percent for infrastructure exposures - for a group borrower, is significantly higher than the large exposure limits of 25 percent which is considered good international practice. The assessors are cognizant of the fact that this is an additional criterion, however, they believe that this limit has the potential to allow the default of one particular consolidated borrower to cause a serious loss of capital in a banking company. While the assessors also appreciate the need for a balanced approach between financial development and financial stability objectives, they believe that the aggregate limit for large exposures is significantly out of line with international good practice.

Principle 11	**Exposures to related parties.** In order to prevent abuses arising from exposures (both on balance sheet and off balance sheet) to related parties and to address conflicts of interest, supervisors must have in place requirements that banks extend exposures to related companies and individuals on an arm's length basis; these exposures are effectively monitored; appropriate steps are taken to control or mitigate the risks; and write-offs of such exposures are made according to standard policies and processes.
Description	EC 1: A definition of related parties exists, but fails to include shareholders and promoters within it. Officers of the bank are also excluded from the definition. EC 2: With a limited exception of loans for personal use as described in Paragraphs 2.1.2 and 2.2.1 of the Master Circular – Loans and Advances – Statutory and Other Restrictions, directors (or firms with which the director is interested as partner, manager, employee, or guarantor or in which he holds a substantial interest) are not allowed under Section 20(1) of the BR Act to obtain credit from their bank The term "director" is also defined broadly to include for example people on advisory Boards. While in most instances, promoters and other principal shareholders would have a director representation and be subject to prohibition on getting loans, but if not , there is no requirement that loans to them, or companies affiliated with them, be proscribed or subject to an explicit arms length review. By RBI regulation, loans to subsidiaries or joint ventures must be on an arms-length basis. EC 3: The requirement that the transactions with related parties and the write-off of related party exposures (beyond a specified level) be approved by the Board has limited applicability. Loans to related parties cannot be made, except to a limited extent (personal use in the case of directors). Loans to relatives of directors of banks are required to be reviewed by the Board if they exceed 2.5 million INR (with the director not participating in the sanction of such loan); loans below that level can be approved through the normal bank approval processes, but should then be reported to the Board. EC 4: The requirement that persons benefitting from an exposure (directly or through a relative) should not be party to the sanction process has limited applicability for the same reasons as described in EC 3—i.e., the limited extent to which loans can be granted to related parties (as defined) or their relatives. EC 5: The requirement that regulators have the capacity to deduct the exposures to related parties from capital or to require their collateralization has limited applicability for the same reasons as described in EC 3—i.e., the limited extent to which loans can be granted to related parties (as defined) or their relatives. EC 6: The requirement that the supervisor require banks to have policies and procedures to identify individual exposures to related parties as well as the total amount of such exposures, and to monitor and report on them through an independent credit review process has limited applicability for the same reasons as described in EC 3—i.e., the limited extent to which loans can be granted to related parties (as defined) or their relatives. EC 7: The requirement that the supervisor obtains and reviews information on aggregate exposures to third parties has limited applicability for the same reasons as described in EC 3—i.e., the limited extent to which loans can be granted to related parties (as defined) or their relatives.
Assessment	Largely Compliant
Comments	Elements of the current legal and regulatory structure are reasonably conservative—such as the general prohibition on lending to directors and the need for transactions with

	affiliates to be on an arms-length basis. However, there are several significant areas to address: The failure of the definition of related parties to include shareholders or promoters is a gap that should be remedied. Developing some of the regulatory approaches for excluding any such lending from capital or for taking other adjustment steps. A law change is being proposed that would require by explicit provision in law that loans to subsidiaries and joint ventures be on an arms-length basis. A regulatory provision to ensure such an arms-length relationship with some subsidiaries currently is in place.
Principle 12	**Country and transfer risks.** Supervisors must be satisfied that banks have adequate policies and processes for identifying, measuring, monitoring, and controlling country risk and transfer risk in their international lending and investment activities and for maintaining adequate provisions and reserves against such risks.
Description	**EC 1**: The RBI has issued the circular "Risk Management systems in Banks – Guidelines on country risk management" on 19 February 2003. The 2002 Guidance Note on Credit Risk (see CP 8) also includes a chapter dedicated to Country risk (Chapter 7) These regulations require banks to formulate well documented and clearly defined Country Risk Management (CRM) policies, approved by their Boards. The scope of the policies should extend cover over their domestic as well as foreign operations as well as direct and indirect country risk. For each country where the bank's net funded exposure is 2 per cent or more of its total assets, the bank is required to formulate the Country Risk Management Policy for dealing with country risk problems. These should include contingency plans and exit strategies in times of crisis. The circular also requires banks to implement systems and procedures approved by the Board, to handle situations involving significant changes in conditions in a country. **EC 2** As part of offsite monitoring, banks report exposures to all countries in excess of 1 percent of total assets. Banks are required to set country exposure limits as a percentage of regulatory capital (Tier 1 and Tier 2). The limit setting is the ultimate responsibility of the Board but limits should be reviewed periodically and in any case not less than once a year. During the AFI, the RBI examiners assess the information systems of the bank to ensure it tracks the exposures accurately and comprehensively. They also analyze the policies and procedures for the management of country risk. The assessors have reviewed an inspection report and were satisfied with the scope and depth of the work done by the bank examiners. At the assessment date, Indian banks had an average of 15 percent to 18 percent of foreign exposures, mainly to the United Kingdom, the Middle East, Europe, and the United States. **EC 3** The RBI has a prescribed provisioning requirement on the net funded country exposures on a graded scale ranging from 0.25 to hundred percent. The provision scale follows the seven grade risk classification followed by the Export Credit Guarantee Corporation of India (ECGC). These provisions are to be made when the bank's net funded exposure is two percent or more of its total assets. Banks provisioning levels may be lower in respect of short term exposures i.e., less than 180 days. The country risk provisions are in addition to the provisions required to be held according to the asset classification of the asset. **EC 4** As indicated in EC 2, the RBI receives information on country exposures through the off-site monitoring process. Banks are also required to review the country risk exposures on a quarterly basis.
Assessment	Compliant

Comments	
Principle 13	**Market risk.** Supervisors must be satisfied that banks have in place policies and processes that accurately identify, measure, monitor, and control market risks; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposures, if warranted.
Description	**EC 1** All Indian commercial banks have relatively limited trading books, on average less than 10 percent of total assets. The RBI has issued a guidance note on market risk management in October 2002. The guidance note requires that the Board clearly articulate market risk management policies, procedures, prudential risk limits, review mechanisms and reporting and auditing systems. The policies should address the bank's exposure on a consolidated basis and clearly articulate the risk measurement systems that capture all material sources of market risk and address the effects on the bank. The guidance note also outlines the organizational set up for Market Risk Management. **EC 2** The 2002 guidelines require the Board to articulate risk limits, review mechanisms and reporting and auditing systems in the area of market risk. Indian banks are not allowed to take positions in commodities (Section 6 of the BR Act) and gold positions are treated as FX in accordance with the Basel guidelines on market risk. Banks are required to manage their market risk by adopting both the traditional and duration gap analysis and to hold regulatory capital in accordance with the standardized approach. The adherence and adequacy to market risk limits set by the Board are assessed during the AFI by RBI specializing in market risk. The RBI has advised banks that it will allow the use of the Internal Models approach for regulatory capital purposes after a regulatory approval process. The IMA is more risk sensitive and aligns the capital charge for market risk more closely to the actual losses likely to be faced by banks due to movements in the market risk factors. **EC 3**: The entire investment portfolio is to be classified under three categories i.e., Held to maturity, Available for Sale and Held for Trading. The Held for Trading and Available for sale positions should be marked-to-market periodically. Where market risk is not measured daily, Risk taking units must have procedures that monitor activity to ensure that they remain within the approved limits all the time. The RBI guidelines do require the bank's valuation methods to appropriately capture concentrations, less liquid positions and stale positions which should be reflected in the provisions held by banks (see MC "Prudential Guidelines on Capital Adequacy" paragraph 8.7.1) **EC 4** The RBI has released detailed supervisory expectations with regard to stress testing and scenario analysis of market risk positions (Annexure V of the Guidance note referred to in EC 1) as well as in a separate set of guidelines to banks (Circular "Guidelines on stress testing" issued on June 26, 2007). During the AFI, RBI examiners assess if banks comply with the scenario analysis, stress testing, and contingency planning requirements in the guidance note. The assessors have reviewed and inspection report and have concluded that the depth and the scope of the market risk examination procedures are adequate. **AC 1** In accordance with the Circular mentioned under EC 1, all market rates used by the bank for marking risk exposures to market, used to revalue assets or for risk analysis models such as VaR analysis, must be sourced independently from the dealing room to provide an independent risk and performance assessment. If the bank has established an independent middle office function, the latter should take this responsibility.
Assessment	Compliant
Comments	

Principle 14	**Liquidity risk.** Supervisors must be satisfied that banks have a liquidity management strategy that takes into account the risk profile of the institution, with prudent policies and processes to identify, measure, monitor, and control liquidity risk and to manage liquidity on a day-to-day basis. Supervisors require banks to have contingency plans for handling liquidity problems.
Description	EC 1: The RBI has issued guidelines for liquidity risk management, and has updated them to reflect more sophisticated expectations. Refinements to the framework mandated in 1999 have been issued in 2007 and 2010. The RBI also monitors statutory reserve requirements – specifically, the cash reserve ratio and the statutory liquidity ratio EC 2: The RBI requires that Boards take overall responsibility for management of risks, decides the risk management policy of the bank, and set limits for liquidity risks. The Asset-Liability Committee consisting of senior management of the Board, including the CEO, is responsible for ensuring adherence to the limits set by the Board as well as for deciding on the business strategy of the bank, as it relates to assets and liabilities. The Management Committee of the Board (or other specific Committee) should oversee the implementation of the system and review how well it functioning. EC 3: The Asset and Liability Committee (ALCO) is responsible for balance sheet planning, including the strategic management of liquidity risks. There is discretion for each bank in deciding on the role of the ALCO. EC 4: Banks are required to undertake portfolio-wide liquidity stress tests and scenario analyses to assess funding requirements under varying assumptions and differing sets of assumed business conditions --- the differing business conditions include a normal situation, a bank-specific crisis, and a market-crisis scenario. The requirements were established in a Circular dated June 26, 2007. As part of the AFI process, inspectors review the diversification of funding sources, through the review of the top 10 or 20 sources of funding for each bank. EC 5: Banks are required to establish aggregate and individual gap limits for each currency, and to receive RBI approval for such limits. Banks are also required to manage liquidity and interest rate risk in their foreign currency by doing maturity and position analysis, and fixing net open positions which are approved by the RBI. EC 6: Banks are required to prepare Contingency Funding Plans, providing a blueprint for asset sales, market access (including options for alternative funding sources if existing sources are not available), and restructuring the maturity and composition of assets and liabilities. These are reviewed during the AFI process. As discussed in CP 20, ensuring consistent and rigorous reviews are carried out by inspectors as part of the AFI process would be improved with a concentrated effort to bring inspectors together with the central office to discuss findings and concerns; the review of contingency funding plans would be a good example of where this could be very beneficial. AC 1: Stress testing for foreign currency liquidity for large banks active in the foreign exchange market has been prescribed by the RBI.
Assessment	Compliant
Comments	The RBI has put in place a very conservative framework for liquidity risk management, which is critically reviewed as part of the AFI process, as confirmed by inspection report reviews. The reviews include critical reviews of the bank’s duration gap analysis and a review of the integrity of data systems that support liquidity metrics.

Principle 15	**Operational risk.** Supervisors must be satisfied that banks have in place risk management policies and processes to identify, assess, monitor, and control/mitigate operational risk. These policies and processes should be commensurate with the size and complexity of the bank.
Description	**EC 1** In 2005, the RBI issued a detailed guidance note on operational risk. The guidance note outlines the role of the Board and Senior management in operational risk management. It also detailed the requirements with respect to the policy and strategic approach to operational risk, the identification and assessment as well as the monitoring of operational risk. Independent evaluation by internal audit and capital allocation are also addressed. **EC 2** The Board of Directors of a bank is primarily responsible for ensuring effective management of operational risks. The Board would include a Committee of the Board to which the Board may delegate specific operational risk management responsibilities: • The Board of Directors should be aware of the major aspects of the bank's operational risks as a distinct risk category that should be managed, and it should approve an appropriate operational risk management framework for the bank and review it periodically. • The Board of Directors should provide senior management with clear guidance and direction. • The operational risk framework should be based on appropriate definition of operational risk which clearly articulates what constitutes operational risk in the bank and covers the bank's appetite and tolerance for operational risk. The framework should also articulate the key processes the bank needs to have in place to manage operational risk. The Board also reviews the framework regularly to ensure that the bank is managing the operational risks arising from external market changes and other environmental factors, as well as those operational risks associated with new products, activities or systems. **EC 3** The adequacy of the operational risk management framework is assessed during the onsite inspections. The RBI examiners also assess the strategy, policies and procedures and their implementation. The assessors have reviewed an inspection report and were satisfied with the scope and depth of the examination procedures in the area of operational risk. **EC 4** In accordance with the requirements in the Circular on Business Continuity plans issued on 15 April 2005, banks have in place contingency and business continuity plans to ensure their ability to operate on an ongoing basis and limit losses in the event of severe business disruption. These plans need to be stress tested annually and the plans may be revised to appropriately address any new or previously unaddressed parameters. The Circular requires that banks establish disaster recovery and business continuity plans that take into account different types of plausible scenarios to which the bank may be vulnerable, commensurate with the size and complexity of the bank's operations. Banks should periodically review their disaster recovery and business continuity plans so that they are consistent with the bank's current operations and business strategies. Moreover, these plans should be tested periodically to ensure that the bank would be able to execute the plans in the unlikely event of a severe business disruption. **EC 5** As outlined in the Guidance note referred to in EC 1, banks are required to have an appropriate information security function and system development. The RBI employs a

	number of examiners specializing in IT risks. Market participants confirmed the extent and depth of the IT risk component during the AFI by the RBI examiners. **EC 6** There is no legal or regulatory requirement for banks to inform the RBI of any adverse developments in operational risk. Only frauds amounting to more than Rs 1 lakh are to be reported to the RBI on a case by case basis in accordance with paragraph 3 of the Master Circular "Frauds – Classification and Reporting." Frauds of less than Rs 1 lakh are also due to be reported to the RBI in consolidated form, by category. The RBI has established a mechanism to monitor frauds in banks that allows it to identify outlier banks for further discussion. The authorities informed the assessors that any other adverse developments would generally be raised as part of the quarterly meetings with banks as outlined in CP 20. **EC 7** The guidance note of 2005 on operational risk includes legal risk into the operational risk definition. **EC 8** The RBI has issued comprehensive guidelines on outsourcing on 3 November 2006 ("Guidelines on Managing Risks and Code of Conduct in Outsourcing Financial Services by banks"). The guidelines require that a bank intending to outsource any of its financial activities has to put in place a comprehensive outsourcing policy, approved by its Board, which incorporates, *inter alia*, criteria for selection of such activities as well as service providers, parameters for defining material outsourcing based on the broad criteria, delegation of authority depending on risks and materiality and systems to monitor and review the operations of these activities. In considering or renewing an outsourcing arrangement, appropriate due diligence should be performed to assess the capability of the service provider to comply with the obligations in the outsourcing agreement. Due diligence should take into consideration qualitative and quantitative, financial, operational and reputational factors. Where possible, the bank should obtain independent reviews and market feedback on the service provider to supplement its own findings. For critical activities, the bank has to consider contingency plans, including the availability of alternative external parties and the costs and resources required to switch external parties, potentially on very short notice. During the AFI, the RBI examiners review the implementation of these guidelines to assess the quality of related risk management systems particularly in respect of material outsourcing. Material outsourcing arrangements are those, which if disrupted, have the potential to significantly impact the business operations, reputation or profitability. **AC 1** The scope of the 2005 guidance note on operational risk is at the level of the banking group (see paragraph 3 second bullet point of the guidance note referred to in EC 1). The Guidance Note recognizes that the approach for operational risk management will depend on the size and sophistication as well as the nature and complexity of its activities (paragraph 2.4 of the Guidance Note referred to in CP1). During the AFI, the RBI examiners assess the application of the operational risk management requirements across the banking group.
Assessment	Largely compliant
Comments	There is no legal or regulatory requirement for banks to inform the RBI of any adverse developments in operational risk. However in practice, the quarterly meetings with banks ensure that the RBI is kept informed of any material adverse developments within maximum three months after the facts.

	The RBI has set up a Working Group in 2010 on Information Security, Electronic Banking, Technology Risk Management and Cyber Frauds. The Group examined various issues arising out of the use of Information Technology in banks and made its recommendations in nine broad areas. These areas are: IT Governance, Information Security, IS Audit, IT Operations, IT Services Outsourcing, Cyber Fraud, Business Continuity Planning, Customer Awareness programs and Legal aspects. Some banks may have already implemented or may be in the process of implementing some or many of the requirements of the circular. Therefore the RBI required banks to conduct a formal gap analysis between their current status and the new stipulations as laid out in the circular and to establish a time-bound action plan to address the gaps. However, banks need to ensure implementation of basic organizational framework and put in place policies and procedures which do not require extensive budgetary approvals, infrastructural or technology changes, by October 31, 2011. The rest of the guidelines need to be implemented by April 2012 unless a longer time-frame is indicated in the circular. There are also a few provisions which are recommendatory in nature, implementations of which are left to the discretion of banks. The requirements in this Circular are not in place at the assessment date but their implementation is expected to strengthen operational risk management in the commercial banks.
Principle 16	**Interest rate risk in the banking book.** Supervisors must be satisfied that banks have effective systems in place to identify, measure, monitor, and control interest rate risk in the banking book, including a well-defined strategy that has been approved by the Board and implemented by senior management; these should be appropriate to the size and complexity of such risk.
Description	**EC 1** In accordance with the “Supervisory Review Process under the New Capital Adequacy Framework – Guidelines for Pillar II” issued on 26 March, 2008, banks are required to have an ICAAP which *inter-alia* covers management of interest rate risk in the banking book. Banks can decide, with the approval of the Board, on the appropriate level of interest rate risk in the banking book which want to carry keeping in view their capital level, interest rate management skills and the ability to re-balance the banking book portfolios quickly in case of adverse movement in the interest rates. In any case, a level of interest rate risk which generates a drop in the market value of equity (MVE) of more than 20 percent with an interest rate shock of 200 basis points, will be treated as excessive and such banks will be required by the RBI to hold additional capital against interest rate risk in the banking book (IRRBB) as determined during the SREP. The banks which have IRRBB exposure equivalent to less than 20 percent drop in the MVE may also be required to hold additional capital if the level of interest rate risk is considered, by the RBI, to be high in relation to their capital level or the quality of interest rate risk management framework obtaining in the bank. At the assessment date, however no banks were holding a capital surcharge imposed by the RBI for IRRBB. While the banks may decide to hold additional capital toward IRRBB keeping in view the potential drop in their MVE, the IRR management skills and the ability to re-balance the portfolios quickly in case of adverse movement in the interest rates, the amount of exact capital add-on, if considered necessary, will be decided by the RBI as part of the SREP. The implementation of the above policy measures are reviewed by IRRBB specialists of the RBI during the AFI. Banks confirmed to the assessors the comprehensive scope and adequate depth of the review by the RBI examiners. **EC 2** Banks were initially required to adopt a approach to interest rate risk measurement from the 'earnings perspective' using the Traditional Gap Analysis (TGA). However, in

	November 2010 banks were advised to adopt more sophisticated methods to measure the interest rate risk from Market Value of equity perspective using Duration Gap Analysis by April 2011 (see "Guidelines on Banks Asset and Liability Management Framework – Interest Rate Risk" issued on 4 November 2010). The guidelines include requirements with regard to model validation. Compliance with the requirements is assessed by RBI interest rate specialists during the AFI. The assessors reviewed an inspection report and concluded that the scope and depth of the examination procedures was adequate. **EC 3** The RBI guidelines also require that banks also identify the risks associated with the changing interest rates on its on-balance sheet and off-balance sheet exposures in the banking book from both, a short-term and long-term perspective. This includes the impact of changes due to parallel shocks, yield curve twists, yield curve inversions, changes in the relationships of rates (basis risk), and other relevant scenarios. In accordance with the regulatory requirements, banks have to demonstrate the validity of their assumptions about the behavioral characteristics of its non-maturity deposits and other assets and liabilities, especially those exposures characterized by embedded optionality to the RBI examiners. Given the uncertainty in such assumptions, stress testing and scenario analysis should be used in the analysis of interest rate risks. In practice, the authorities stated that most banks only assess the impact of parallel shifts in the yield curve. The RBI issued the Circular "Guidelines on Stress testing" on 26 June 2007. **AC 1** Banks submit a monthly prudential return on interest rate sensitivity for exposures in local currency as well as foreign currency to the RBI. The half yearly consolidated prudential returns also include measures on interest rate sensitivity. In accordance with Section 27.2 of the BR Act, the RBI has the power to request any information from banks. **AC 2** IRRBB is an essential component of the AFI and the RBI has specialized examiners who assess the management of IRRBB in banks. Banks confirmed the depth and scope of the reviews to the assessors. Assessors also reviewed an inspection report for this area. Also, the IRRBB is part of the ICAAP which banks have to submit on a yearly basis to the RBI in accordance with the guidelines in "Supervisory Review Process under the New Capital Adequacy Framework – Guidelines for Pillar 2" issued on 26 March 2008. From discussions with banks, the assessors were informed that an active dialogue between the bank and the RBI examiners as part of the SREP is not standard supervisory practice but is conducted in specific instances cases. **AC 3** The RBI issued the Circular "Guidelines on Stress testing" on 26 June 2007. The Circular requires that Board and senior management regularly review the results of scenario analyses and stress tests, including the major assumptions that underpin them. The guidelines include an example for the stress testing of IRRBB. **AC 4** The banks' Board has overall responsibility for the management of risks and should decide the risk management policy of the bank and set limits for liquidity, interest rate, foreign exchange and equity price risks. The Asset - Liability Committee (ALCO) consisting of the bank's senior management including CEO is responsible for ensuring adherence to the limits set by the Board as well as for deciding the business strategy of the bank (on the assets and liabilities sides) in line with the bank's risk tolerance. The 1999 Circular on Risk Management Systems in banks requires "a separate risk management framework independent of operational departments and with clear delineation of levels of responsibility for the management of risk" (Introduction, bullet vii).
Assessment	Compliant
Comments	

Principle 17	**Internal control and audit.** Supervisors must be satisfied that banks have in place internal controls that are adequate for the size and complexity of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding the bank's assets; and appropriate independent internal audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.
Description	EC 1: Section 10B of the BR Act established the responsibility of a full-time Chairman of the Board. The RBI established a Fit and Proper Test for directors as updated in a May 23, 2011 Circular. Corporate governance guidance was set out in a June 4, 2002 circular. The role of the Chairman and Managing director is combined in Public Sector banks as the CMD. In private sector banks, there is a Chairman and a Managing director/CEO, each fulltime. As indicated in the 2009 Self Assessment carried out by the Committee on Financial Sector Assessment, there continues to be no explicit requirement for the RBI to be notified of material developments concerning a fit and proper test for existing directors. EC 2: Through an 11/1/96 Circular on Internal Control and Inspection/Audit Systems of Banks, the RBI has established an expected internal control structure. Through a Circular issued in 1999 ("Risk Management in Banks"), guidelines for the delegation of powers to make loans were established. Authorization for large loans would have to be made by a Committee – with the large loan definition subject to definition by the bank. EC 3: Pursuant to the 2002 review by a consultative group, the functions of the Board have been set to include delegating powers appropriately and providing for the organizational structure and financial and other controls. EC 4: The BR Act in Section 36 AA provides the RBI with the authority to remove officers of a bank. The discretion is broad and has been used in practice (officers of private sector banks). This provision of law is not however applicable to public banks. EC 5: A Master Circular provides for clear functional separation of (1) trading; (2) settlement, monitoring, and control; and (3) accounting. This is monitored through the inspection process. Skills are looked at broadly in the Inspection process. Assessment of adequacy of resources comes into the overall assessment of Management in the CAMELS rating process; the AFI also looks to see if the functions like audit and compliance are done well and timely rather than focusing on the number of people per se. The RBI has indicated in the 2009 Self Assessment and in conversations with the assessors, that there is not a specific focus on reviewing the appropriate balance of skills and resources of the back office and control functions relative to those of the front office/business origination, although it is not ignored. The normal rotation of people across a banking company is expected to smooth out the degree of skills of people in different areas. The need for adequate staffing in Compliance is explicitly referenced in a 2006 Circular. EC 6: Guidelines for a Compliance function have been established in a Circular issued on April 20, 2007. Adherence to the guidelines is reviewed during inspections. The Chief Compliance Officer has to be sufficiently senior with a reporting line to senior management and the right of direct access to the Board of Directors. EC 7: A Guidance Note dated December 27, 2002 provides guidelines on ensuring that a risk-based internal audit function exists at banking companies. The effectiveness of Internal Audit is assessed as part of the AFI.

	EC 8: The Head of Internal Audit is a senior person (typically at the General Manager level) with a reporting line to the Board's Audit Committee. With respect to foreign banking organizations, the head of audit is expected to report to the head of the FBO's India office, and to have a dotted to the firm-wide head of internal audit. Circulars have been issued on December 11, 2008 and November 3, 2006, concerning outsourcing and guidance on using off-shore service providers. On the latter banking companies must ensure that the relevant off-shore supervisor would not object to RBI inspection visits or visits of the bank's internal or external auditors. Internal Audit can inspect the outsourcing entity (and for the RBI inspector) to review the books and records of the outsourcing entity – the RBI has done so within India. Core activities, such as internal audit, cannot be outsourced. However, assessors were informed of a particular bank has outsourced specific internal audit assignments that require specialized expertise (such as internal model validation). Back office operations where position taking is not involved can be outsourced (see also CP 15).
Assessment	Largely Compliant
Comments	The RBI has put in place a good framework for internal controls. Its AFIs review critically evaluates a range of internal controls issues such as the banks' internal audit governance and processes, their sanctions authorities, and their compliance approach and effectiveness. There are several recognized areas of possible improvement opportunity: Ensuring updates on developments affecting the fit and proper test for existing directors are received. Ensuring a strong focus in the AFI process on assessing the quantity of people and skill level of people in risk management and control functions.
Principle 18	**Abuse of financial services.** Supervisors must be satisfied that banks have adequate policies and processes in place, including strict "know-your-customer" rules, that promote high ethical and professional standards in the financial sector and prevent the bank from being used, intentionally or unintentionally, for criminal activities.
Description	**EC 1** The Prevention of Money Laundering Act 2002 (PMLA) is at the core of the legal framework put in place to combat money laundering in India. It defines the powers and responsibilities of the competent authorities in Section 54. Under the PMLA, Rules and regulatory guidelines, India has foreseen a specific role and powers for the regulatory authorities (RBI, SEBI and IRDA) and the Financial Intelligence Unit (FIU-IND) to explicitly monitor commercial banks' compliance with the AML/CFT obligations. The RBI has regulatory powers and supervisory capacity and now also includes ensuring compliance with the AML/CFT provisions as part of its inspection process. The RBI issued a Master Circular "Know your Customer (KYC) norms/ Anti Money Laundering (AML) standards / Combating of Financing of Terrorism (CFT) /Obligations of banks under PMLA" on 1 July 2010. This circular is the consolidation of the mandatory guidelines issued to banks by the RBI up to June 30, 2010 and has to be read in conjunction with Section 12 of the PMLA which details the obligations of banking companies. Under these guidelines and the PMLA, all commercial banks must have a policy framework on KYC. The guidelines require that banks have KYC policies in place covering customer acceptance policies, customer identification procedures, monitoring of transactions and risk management.

	EC 2 The RBI examiners ensure during the AFI that banks comply with the AML/KYC policies. When issues are identified, actions are taken.. The RBI carried out a survey in 2006 to check the position of bank's compliance with KYC/AML guidelines. At that time, the survey revealed that all banks had implemented the KYC/AML policies with the approval of their Boards and the guidelines were enforced at the branch level. Nevertheless, the inspection reports reviewed by the assessors did mention many critical weaknesses in the areas of AML/KYC. From their review, the assessors conclude that KYC/AML inspections have only started recently and hence no full level of compliance can be expected at this stage. **EC 3** The suspicious transactions are reported only to the Financial Intelligence Unit-IND (FIU). The RBI does of course have access to the suspicious transactions reports during its AFI. Frauds amounting to more than Rs 1 lakh are to be reported to the RBI on a case by case basis in accordance with paragraph 3 of the Master Circular "Frauds – Classification and Reporting." Frauds of less than Rs 1 lakh are also due to be reported to the RBI in consolidated form, by category. Banks are also required to report all cases of fraud to the concerned agencies immediately. RBI maintains a database of frauds and their modus operandi and this information is shared with banks to enable them to prevent occurrences of such frauds. **EC 4** As indicated under EC1, the RBI has issued detailed guidelines to implement. These guidelines include four sections namely, Bank's Customer Acceptance Policy, Customer Identification Procedures, Monitoring of transactions and Risk management. The first section on Customer Acceptance Policy (paragraph 2.3. of the Master Circular mentioned in EC 1 above) requires that banks do not open accounts in fictitious names. They also need to apply risk-based parameters to categorized accounts and the guidelines give broad guidelines for low risk customers. The second section on Customer Identification Procedures (paragraph 2.3. of the Master Circular mentioned in EC 1 above) spells out the procedures to be carried out at the different stages. The bank should take reasonable steps to identify the beneficial owners and accept clients only after that process has been completed. The mutual assessment report "Anti Money Laundering and Combating the Financing of Terrorism" by the FATF/Asia Pacific Group (APG) assessment team (the AML report) issued on 25 June 2010 reviewed the compliance of the Circular with the PMLA and with international best practices. Recommendation 5 on Client Identification Program is rated partially compliant. The FATF/APG assessors comment that the RBI circular is silent on the need to revisit the customer due diligence measures when there are suspicions of money laundering or terrorist financing. They also make some additional comments on the lack of guidance provided on how institutions are expected to implement the high level requirement in the PMLA rules to identify the ultimate beneficial owner. Additionally, they comment on the issue of client accounts opened by professional intermediaries and the potential conflicts with client confidentiality provisions that apply to lawyers, accountants and company secretaries who routinely open such accounts. This issue has now been address by an updated circular. The FATF/APG assessors also state that the circular does not require a specific override of the procedures for low risk customers when there are suspicions of money laundering or where factors suggest that the customer poses a higher risk. Finally, they suggest the authorities should require banks to consider filing a STR when the institution can no longer be satisfied that it knows the true identity of the customer.

	The specific requirements with regard to politically exposed persons (PEP) are detailed in paragraph 2.5 (v) of the Master Circular mentioned in EC1 above. The decision to enter into a relationship with PEPs has to be taken at senior level and intensive due diligence is to be applied. The scope of the guidelines extends to relatives and family members of PEPs. The third section on the Monitoring of transactions (paragraph 2.8 of the Master Circular mentioned in EC 1 above) requires banks to pay special attention to all complex, unusual large transactions and all unusual patterns; transactions that involve large amounts of cash inconsistent with the normal/expected activity of customers and very high turnover with the size of balance maintained. Banks should also exercise ongoing due diligence with respect to the business relationship with every client and closely monitor the transactions in order to ensure that they are consistent with their knowledge of the client, his business and risk profile and where necessary, the source of funds. The forth section on Risk Management (paragraph 2.10 of the Master Circular mentioned in EC1 above) details the responsibility of the Board in ensuring that effective KYC policies and procedures are drafted and implemented. It also outlines the roles of internal audit and compliance in evaluating and ensuring adhere to the KYC policies and procedures. **EC 5** Banks are required to gather information about correspondent banks (paragraph 2.15 of the Master Circular mention in EC 1 above). Information on the bank's management, major activities, level of AML/CFT compliance, purpose of opening accounts, identity of any third party entities that will use the correspondent banking services and regulatory/supervisory framework in the correspondent/respondent's country are required to be obtained. The AML Report has rated Recommendation 7 on Correspondent banking as largely compliant. Shell banks are not permitted to operate in India. Banks are advised in paragraph 2.15 (b) of the Master Circular mentioned above in EC 1 not to enter into a relationship with shell banks. Before establishing a correspondent relationship with a foreign institution, banks have to ensure themselves that the foreign institution does not permit its accounts to be used by shell banks. The AML Report has rated Recommendation 18 on Shell Banks in India as largely compliant. **EC 6** As stated under EC 2, the RBI examiners verify compliance with the KYC circular during the AFI. The requirements in paragraph 2.10 of the MC mentioned above in EC 1 outline the important roles of internal audit and compliance in evaluating and ensuring adherence to the KYC policies and procedures. Banks should ensure that their internal audit is staffed adequately with individuals who are well versed in such policies and procedures. Internal and concurrent auditors have to check and verify the application of KYC procedures at the branches and comment on the gaps observed. The Audit Committee has to be informed of compliance in this respect on a quarterly basis (paragraph 2.10 risk management of the MC mentioned in EC 1). Reports of these audits have to be made available to the RBI on request or during the inspection of banks. **EC 7** The KYC guidelines have been issued by the RBI under Section 35 A of the BR Act. Hence, the RBI has a range of extensive powers to address noncompliance (see also CP 23). **EC 8** As outlined in EC 6, internal auditors have to verify compliance with KYC guidelines. As per paragraph 2.18 of the MC mentioned above in EC1, banks should appoint a Principal Officer (PO) from Senior Management as the contact point for all AML issues.

	He is responsible for monitoring and reporting all transactions and sharing information as required under the law as well as liaison with enforcement agencies, banks and other institutions. The PO is also responsible for timely submission of CTR, STR and the reporting of counterfeit notes and all transactions involving receipt by nonprofit organizations of value more than Rs 10 lakh or its equivalent in foreign currency to FIU-IND. The PO does not need to be a full time role and the role is generally performed by the Compliance or the Legal officer. Banks are also required to put in place adequate screening mechanisms as an integral part of their recruitment processes (paragraph 2.12 c of the MC mentioned above in EC1). Banks have to implement an ongoing employee training program so that their staff are adequately trained in KYC procedures with different focus for frontline staff, compliance staff and staff dealing with new customers (paragraph 2.12 b for the MC mentioned above in EC1) **EC 9** The RBI analyses and assesses bank's MIS systems during the AFI. It also reviews the policies and procedures of banks in the AML area during this time, ensuring that banks processes and policies for staff to report any problems related to the abuse of the bank's financial services to management and/or the PO are in place. **EC 10** Section 14 of the PMLA 2002 states that banking companies or their officials would not be liable to any civil proceedings against them for furnishing any information to the appropriate authority under the Act. The AML report has rated India Largely Compliant on Recommendation 14 – Protection and no tipping off. **EC 11** There is no explicit prohibition on the RBI from sharing information relating to suspect and actual criminal activities with the relevant judicial authorities as well as with the FIU. The secrecy provisions in the BR Act do not apply in this particular case as Section 71 of the PMLA has an overriding effect in case of inconsistencies with other law for the time being in force. The RBI has not yet had to inform the FIU directly of any concerns. **EC 12** Section 56 (1b) of the PMLA 2002 states that the government of India may enter into an agreement with the government of a foreign country for exchange of information for prevention of any offence under the Act or under the corresponding law in force in that country or investigation of a case relating to any offence under the above Act. The RBI has entered into an MOU with China and Dubai but these MOUs do not contain specific provisions with regard to the abuse of the financial system. **AC 1** Not applicable as the this is done by the FIU-IND.
Assessment	Largely Compliant
Comments	The issues raised in the Mutual Assessment report "Anti Money Laundering and Combating the Financing of Terrorism that were within the responsibility of the RBI have been addressed. The RBI regulatory framework for AML generally complies with the essential criteria of this Core Principle. Nevertheless, the inspection reports reviewed by the assessors did mention many critical weaknesses in the areas of AML/KYC. From their review, the assessors conclude that KYC/AML inspections have only started recently and hence no full level of compliance is to be expected at this stage.

Principle 19	**Supervisory approach.** An effective banking supervisory system requires that supervisors develop and maintain a thorough understanding of the operations of individual banks and banking groups—and of the banking system as a whole—focusing on safety and soundness and the stability of the banking system.
Description	EC 1: The RBI has issued guidelines on risk management systems, and guidance notes on the management of credit, market, and operational risk. Moreover on a quarterly basis, a risk profile template is required to be completed and submitted to the RBI by the risk management area of a bank. As a major part of the AFI process, inspectors review the risks of the banking company and how they are managed. Monitoring activities take place throughout the year, some elements directed at determining which banking companies should get high priority and focus in the AFI process, others geared to determining the focus that should be placed within the individual AFI. EC 2: The RBI monitors trends and developments in the financial system through the compilation of macro-prudential indicators, which include both aggregated micro-prudential indicators of individual financial institution health and macro-economic indicators associated with financial system soundness. The RBI has periodic contact with the supervisors of nonbank financial companies, although as discussed in CP 24, opportunities for improvement exist in this dimension. EC 3: The RBI has in place a monitoring system (OSMOS) which analyzes on a quarterly basis the risks to which individual banks are exposed, reviewing the banks individually and in relation to their peers. Supervisory work is prioritized on the basis of inspection findings but also from the monitoring process. EC 4: Compliance of banking groups with prudential regulations and other legal requirements is evaluated in the course of the AFI of each firm. A review of an inspection report provided to the assessors confirmed that the RBI very carefully reviews key prudential regulations and legal requirements, and provides the inspected banking company with very detailed observations and findings. EC 5: The RBI expects notification from banking companies on substantive changes in their activities, structure, and overall condition. With respect to some categories of developments (frauds), there is clear guidance on the reporting requirements, but no such clear guidance exists for other categories of change (changes in business strategy, changes in directors and Senior Management (other than the CEO)), etc. The RBI expects that such updates will often be provided during the quarterly meetings. EC 6: The RBI has a well-developed information system for capturing, tracking, and reviewing important prudential information. AC 1: Some efforts to review risks in a more forward-looking way are done, such as through stress tests and review of concentrations. More could be done, through for example more consistently reviewing risk management models (even if they are not currently used for regulatory capital purposes).
Assessment	Largely Compliant
Comments	The RBI has in place an extensive system of on-site inspections and off-site monitoring of financial returns to allow it to stay abreast of the risk profiles of its supervised institutions. As of 2011, 645 people work in the Department of Banking Supervision; that the number of people in the Department has declined from 729 two years ago. Given the demands that

	will be placed on DBS and DBOD from the Basel process and the movement to more continuous supervision for twelve of the largest banking companies (see CP 20), we believe that staffing should be reviewed to ensure the appropriate quantity and quality of staff in these areas (See also CP 1.2); The general practice of rotating people across the Departments of the RBI should also be re-assessed given the need to develop specialized expertise within supervision. While we recognize that some rotation could be beneficial, having the bulk of the supervisory/regulatory (i.e., DBS and DBOD) staff be people who spend the vast majority of their career in bank supervision/regulation and related areas (e.g., nonbank supervision) would improve the level of expertise of that area (see also CP 1.2.) The extent of the focus on the consolidated risks of the banking group should be increased; the RBI should consider its methodology for rating banking companies, to provide explicitly for a way to reflect systematically the issues that may arise at nonbanking subsidiaries; Clearer guidance should be issued on the need of banking groups to provide updates on developments and changes between AFIs; and The RBI should ensure the review and validation of models used for internal risk management, even if not yet used for regulatory capital purposes, is consistently done.
Principle 20	**Supervisory techniques.** An effective banking supervisory system should consist of on-site and off-site supervision and regular contacts with bank management.
Description	EC 1: The RBI assesses the financial condition of banks through a combination of off-site monitoring and on-site inspections. The on-site inspections evaluate the quality of the Board of Directors and of top management and the effectiveness of their oversight. EC 2: Section 35 of the BR Act authorizes the RBI to carry out inspections. A planning process takes place prior to the AFI. Extensive information is requested of the bank, including recent audit reports, in advance of the AFIs. Teams of inspectors, whose expertise is generally well respected by the banks, carry out the extensive on-site reviews. The AFIs have been carried out by the regional offices of the RBI (including a regional office in Mumbai). With AFIs taking place through regional offices across the country (some with very few institutions) there is a real question of how consistency in inspector judgment can be ensured. Particularly, when new policy approaches are being rolled out, there is a need for structured interaction among the regional office inspectors as a group and with the central office to go through findings, insights, and questions; this does not appear to be happening. Doing this in a more structured and consistent way would also improve the capacity to develop more of a horizontal perspective on how banks are engaging in a particular business area or how they are carrying out an element of risk management practice. EC 3: The RBI carries out its AFIs in a very hands-on way with extensive review of individual credit files and through testing of automated systems and reporting processes. For private banks and foreign banks, 60 percent of the loan portfolio is to be reviewed this way; for public banks, the guideline level is 30 percent. They receive some information on operations of nonbank subsidiaries, but do not subject such companies to any of the transaction testing processes applicable to banks. The RBI does not require that models used for risk management purposes (but not as yet for regulatory capital purposes) are consistently reviewed and validated.

	Supervisory concerns are enumerated in great detail in the Inspection Report, with a follow-up process of senior management consultation used to establish greater clarity on the prioritization of supervisory concerns, and the setting of timeframes for addressing them. Where extensive changes are needed to address supervisory concerns, action plans are developed that are monitored by RBI staff. EC 4: The RBI has in place a monitoring system (OSMOS) which analyzes on a quarterly basis the risks to which individual banks are exposed, reviewing the banks individually and in relation to their peers. Supervisory work is prioritized on the basis of inspection findings but also from the monitoring process. There is structured interaction between the Inspection Officer (who will carry out the AFI) and the Relationship officer (who is responsible for ongoing interaction with the banking company), drawing on reports from OSMOS. Outlier banks are periodically determined and advisories shared with the Relationship Officer. EC 5: Quarterly discussions are held with the senior management of the banking companies to review with them concerns arising from the analysis of offsite data and to discuss progress in addressing the observations and concerns from the previous AFI. Similarly there is regular interaction with officials at other levels within the banking company. There is no similar regular interaction with directors. The RBI directors on Boards of public banks do provide a report to the RBI every two months. More frequent interaction with directors of private banks would provide another of information updates for a banking company, and would create a strong channel of communication that could be particularly useful in dealing with a future problem situation. Information flow from domestic nonbank supervisors and from overseas supervisors could be improved to provide other important sources of information between the AFIs. EC 6: The quality of management is assessed within the CAMELS construct, with M now accounting for 18 percent of the composite rating. During the AFI, the composition of the Board is examined as is the effectiveness of Board oversight and delegation and the overall quality of corporate governance and internal control. EC 7: The internal audit function of banks is reviewed during the AFI, where the scope, coverage, and effectiveness of internal audit, concurrent audit, and statutory audit programs are evaluated. The AFI also assesses the effectiveness of the Audit Committee of the Board. EC 8: An extensive report of inspection is provided to the bank. After discussions with senior management, a separate letter on major findings is sent, detailing time frames for addressing concerns that had been raised.
Assessment	Largely Compliant
Comments	The RBI utilizes on-site supervision and off-site monitoring to carry out its supervisory program The principal improvement needs (some of which are also discussed under various other Core Principles) include: Building on the current program of interaction among the regional office inspectors as a group and the central office, by providing a regular forum for the inspectors to go through findings, insights, and questions particularly when new supervisory approaches are being introduced. Adding this additional element would also improve the capacity to develop more of a horizontal perspective on how banks are engaging in a particular business area or how they are carrying out an element of risk management practice;

	More intensive reviewing of nonbank subsidiaries; Improved monitoring of foreign operations through better information flow from overseas supervisors and/or more overseas inspections; Ensuring critical review and validation of risk management models that are not yet used for regulatory capital purposes; and Developing more structured interaction throughout the year with directors of private sector banking companies, which could improve the knowledge of banking companies and facilitate dealing with problem situations when they arise. We also have been advised that an initiative to consider modifications of elements of the supervisory process for the largest banking groups has begun. A Steering Group, led by a deputy governor, began a year-long review process in April 2011 to consider a range of potential changes. As the review began, the Department of Banking Supervision announced some restructuring of its operations to move the off-site monitoring process closer to the on-site inspection process. We were also advised orally that the DBS will establish a new supervisory regime for the largest (12) banking companies, which have been designated as systemically important in India, involving such elements as a) supervisory responsibility being moved from the regional offices (including from the Mumbai regional office) to the central office; and b) the central office planning to shift away from the current once a year approach to a supervisory approach that is more continuous, with targeted reviews conducted of an individual banking company or a cross-section of firms, focusing on areas of potential concern that have been seen through the monitoring process. We believe such a program if it is well developed and well implemented has the potential to improve a number of our areas of concern.
Principle 21	**Supervisory reporting**. Supervisors must have a means of collecting, reviewing, and analyzing prudential reports and statistical returns from banks on both a solo and a consolidated basis and a means of independent verification of these reports, through either on-site examinations or the use of external experts.
Description	**EC 1** Section 27 of the BR Act states that every banking company must submit on a monthly basis to the RBI a return in the prescribed form showing its assets and liabilities. The RBI may also at any time direct a banking company to provide it with statements and information relating to the business or affairs of the banking company. The BSD's supervisory strategy includes an offsite monitoring process through the introduction of a set of fortnightly returns, monthly, quarterly and biannual returns. For banking companies on a solo basis there are 23 prudential returns submitted and the periodicity varies from fortnightly, monthly and quarterly to annual. Consolidated prudential returns are collected from banking companies on a 6 monthly basis. In addition, overseas banking subsidiaries have to submit separate quarterly returns to the RBI. Finally, financial conglomerates are subject to a quarterly prudential reporting requirement, focusing mainly on intra-group transactions. The RBI has identified 6 financial conglomerates with a banking company. **EC 2** Financial statements of banks are prepared using accounting standards prescribed by the Institute of Chartered Accountants of India (ICAI). Section 29 of the BR Act prescribes the format for preparation of the financial statements. The RBI has also issued detailed instructions on the disclosure of financial statements. Banks are mandated to disclose additional information as part of the annual financial statements such as the Capital adequacy ratio, Tier 1 ratio, the percentage of shareholdings in the nationalized banks, lending to sensitive sectors etc. In the preparation of the prudential returns, banking companies have to use the same accounting standards. Additionally, the RBI has

	issued detailed and elaborate guidance called "Offsite Surveillance Reports" to assist banks in the completion and submission of the prudential returns. **EC 3**: Where the RBI determines that gaps exist in the accounting framework, the it issues its own valuation rules. The prudential norms for classification, valuation and operation of the investment portfolio as well as the prudential norms on income recognition, asset classification and provisioning pertaining to advances are the most important areas where the RBI valuation rules complement the accounting standards. The RBI examiners verify adherence to the guidelines during onsite inspections. **EC 4** As stated under EC 1, the RBI analyses suite of prudential returns on a solo as well as well as on a consolidated (prudential scope of consolidation as well as financial conglomerates basis). The prudential returns are submitted on a fortnightly, monthly, quarterly and annual basis. **EC 5** The RBI performs an analysis of the prudential returns on an aggregate as well as on an individual bank/banking group basis. The aggregate or horizontal review consists of a number of reports including the "Monthly Banking Outlook" report and a quarterly "Review of the Macro Prudential Indicators" report. The assessors reviewed the most recent reports and concluded they were comprehensive and informative. The analysis at an institutional level includes a peer group analysis. For this purpose, four broad peer groups and a number of sub-peer groups have been identified. It is important to note that some additional offsite analysis can be performed at a regional office level. **EC 6** The BR Act allows the RBI to request and receive any relevant information from banks and other supervised entities belonging to the banking group (Section 27 of the BR Act). A quarterly meeting "Regulated Institutions meeting" is organized for banking groups, where institution specific concerns with respect to a banking group is shared among the various departments of the RBI that supervise the regulated entities of the banking group. The RBI, however, cannot request information from affiliated but unregulated entities (see also CP 24). **EC 7** The RBI has the power to issue directions under the BR Act (Section 35A) where necessary in the interest of banking policy, in the public interest or where the affairs of the banking company are being conducted in a manner detrimental to the interest of the depositors. Section 27 (2) of the BR Act also empowers the RBI to direct a banking company at any time to furnish it, within such time as the RBI may specify, with such statements or information it deems necessary. Section 35 (2) of the BR Act also gives the RBI access to every director, office or employee of a banking company and requires these persons to provide the RBI with any statements or information the RBI examiners may require. **EC 8** There are no regulations that assign specific senior management responsibilities for the accuracy of the returns. It is a supervisory expectation of the RBI that the prudential returns be signed off on by a member of Senior Management (generally the compliance officer). Submission of erroneous information to the RBI results in the imposition of penalties as specified in Section 46 (1) of the BR Act. **EC 9** The validity and integrity of the prudential returns are periodically verified upon submission. As indicated in EC8, the prudential returns have to be signed by a member of Senior Management. In case of inconsistencies or inaccuracies, the banking company is directed to correct the information (by Section 35A of the BR Act). In case of submission of incorrect or incomplete information, it is treated as nonsubmission of returns and leads to a penalty under Section 46 of the BR Act. Section 30 (1B) of the BR Act allows the RBI

	to direct a special audit of the banking company's account. The RBI may also appoint a person duly qualified under any other Law for the time being in force or direct the auditor of the banking company himself to conduct a special audit. In any case, the auditor shall comply with the directions of the RBI and make a report of the audit to the RBI. The expenses of such a special audit have to be borne by the banking company (Section 30 - 1C of the BR Act). The authorities stated that as a matter of supervisory practice, the special audit would usually not be performed by the statutory external auditor. **EC 10** The appointment letter of the external auditor clearly contains the roles and responsibilities including the scope of the work. The assessors reviewed the RBI's instructions to be included in the letter of appointment of external auditors and concluded these were sufficiently specific. The auditors also have to provide their findings to the RBI in accordance with Section 30 (3) f the BR Act. When the services of auditors are required for any special examinations, the specific scope of the audit is spelt out and monitored by the RBI. Any deficiencies observed are discussed with the external auditors and, if need be, referred to the Institute of Chartered Accountants of India, the oversight body for the external audit profession. **EC 11** The statutory auditors are required to highlight matters of material significance in the Long Form report to the annual accounts. In accordance with the RBI terms of appointment generally used for external auditors, they are also required to report directly to the RBI frauds of Rs 1 crore and above which have not been reported by banks as well as serious irregularities, if any, observed by them during the course of the audit.
Assessment	Largely Compliant
Comments	The RBI does not have the power to require information from affiliated but unregulated entities of a banking group. It has however proposed a legal amendment to address this concern.
Principle 22	**Accounting and Disclosure.** Supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with accounting policies and practices that are widely accepted internationally, and publishes, on a regular basis, information that fairly reflects its financial condition and profitability.
Description	**EC 1** The RBI has the authority to hold management of a bank accountable for ensuring that the financial record keeping system and the data they produce are reliable and to impose penalties or directions in accordance with respectively Section 47A and Section 35A of the BR Act. **EC 2** Section 30 (1A) makes it mandatory for all banks to get their annual accounts audited every year by an external auditor pre-approved by the RBI. The external auditor certifies that the financial statement represent a true and fair view of the affairs of the bank under section 30 (3) of the BR Act. **EC 3** Banks must use the valuation rules determined by the Institute of Chartered Accountants of India (ICAI), unless the RBI lays out rules that deviate from the Accounting Standards set by the ICAI. In this respect, the RBI has laid out asset classification and provisioning norms, as well as norms for the valuation of collateral. Banks are also required to set up provisions for standard loans amounting to 0.25 percent to 2 percent. The positive and negative replacement values of derivatives transactions do not have to be recorded on the balance sheet but the unrealized losses and profits arising from their variations are disclosed in the notes to the annual accounts. The RBI has also mandated additional disclosures in the notes to the annual accounts of banks.

	EC 4 The scope of the statutory audit is determined in Section 30 of the BR Act. Sec 30 (1-B) of the BR Act states that "where the RBI is of the opinion that it is necessary in the public interest or in the interests of the banking company or its depositors so to do it may, at any time, by order direct that a special audit of the banking company's accounts, for any such transaction or class of transactions or for such period or periods as may be specified in the order, shall be conducted and may by the same or a different order either appoint a person duly qualified under any law for the time being in force to be an auditor of companies or direct the auditor of the banking company himself to conduct such special audit] and the auditor shall comply with such directions and make a report of such audit to the Reserve Bank and forward a copy thereof to the company." In addition, the RBI outlines additional tasks to be performed by the external auditor of banks. These include certifications of a number of returns and disclosures. Hence, in practice the RBI has the power, and uses that power to vary the audit scope. **EC 5** In accordance with Section 30 (3) of the BR Act and the circulars of the RBI, the statutory auditors are required to complete a number of certifications for the bank and in some instances for each branch. These certificates covers aspects of internal control, balances with other banks, investment advances, premises, other assets and liabilities, reserves and provisions, compliance with statutory reserve requirements, treasury operations and adherence to income recognition, asset classification and provisioning norms. **EC 6** The banking company can only appoint a statutory auditor with the prior approval of the RBI (see Section 30 1-A of the BR Law). The RBI also has to approve the re-appointment and the removal of the external auditor. In case the RBI were to discover the external auditor had inadequate expertise or independence during the execution of his mandate, the authorities stated they would refer the case to the ICAI. Another option, exercised by the RBI in the past, would be to withdraw approval of the external auditor. **EC 7** The formats for preparation of financial statements are prescribed under Section 29 of The BR Act. The financial statements are prepared based on Indian accounting standards prescribed by the ICAI, except those that have been specifically modified by RBI in consultation with the ICAI keeping in view the nature of banking industry (mainly provisioning and disclosure requirements). The Indian banks will converge to IFRS as from April 2013 onwards. **EC 8** All commercial banks are listed and in accordance with listing requirements, they are required to publish unaudited quarterly results. Section 31 of the BR Act requires the publication of the audited balance sheet and profit and loss accounts together with the auditors' report. The RBI has determined that banks have to publish their annual accounts in a newspaper in circulation at the place where the bank has its principal office. Further, banks have to publish their annual accounts in abridged form in additional newspapers, journals, etc. to give wider coverage to banks' operations. Finally, in accordance with the Master Circular "Prudential guidelines on Capital Adequacy and Market Discipline, Part C Market Discipline" banks have to disclose the Pillar III disclosures of Basel II. **EC 9** The RBI has issued the MC "Disclosure in Financial Statements – Notes to accounts" which lists particular disclosures banks need to make to their annual financial accounts, in addition to the ICAI accounting standards. The most important areas of disclosure are listed below: Capital Adequacy Ratio; Tier I capital ratio; Tier II capital ratio; Percentage of shareholding of the government of India in nationalized banks; Net NPL ratio; Amount of provision made toward NPLs and provisions for income-tax for the year; Amount of

	Subordinated debt raised as Tier II capital (by way of explanatory notes / remarks in the balance sheet as well as in Schedule 5 relating to other liabilities and provision); Gross value of investments, provision for depreciation on investments and net value of investments separately for within India and outside India; Interest income as percentage to working funds; Non-interest income as a percentage to working fund; Operating profit as a percentage to working funds; Return on assets; Business (deposits and advances) per employee; Profit per employee; Maturity pattern of certain assets and liabilities; Movement in NPLs; Foreign currency assets and liabilities. Moreover, the Pillar III discloses referred to in EC 8 also include both qualitative and quantitative information. **EC 10** The RBI can issue a direction under Section 35 A of the BR Act in case a bank does not comply with the disclosure requirements. The disclosures are reviewed by the RBI. Examiners analyze the balance sheet, accounting policies, disclosures forming part of financial statements as well as Pillar III disclosures. The annual financial inspections also ensure compliance with the disclosure standards. **EC 11** RBI publishes a Weekly Statistical Supplement and fortnightly Scheduled Bank's statement of position indicating deposits, borrowings and advances at the aggregate level. The Report on Trend and Progress of Banking in India, an annual publication by RBI provides detailed analysis of the performance of all banks operating in India. **AC 1** RBI organizes periodical seminars for auditors. Senior member(s) of the audit profession are represented on the Central Board of RBI. Audit Committee of the BFS lays down and reviews policies concerning audit of banks and financial institutions. A Chartered Accountant from the Central Board and President of ICAI attend these meetings as invitees. Regular consultation with the audit profession also takes place through meetings of the Bank Audit Committee, which decides on the accounting standards and audit coverage. Discussions between an auditor and the assessors revealed that there is not much regular interaction between individual auditors and RBI examiners at an institutional level. **AC 2** Under the existing legal framework, there is no legal responsibility on the auditors to report directly to the RBI on matters of material significance observed by them in the audit of banks. Nevertheless, in the appointment letter the RBI requires auditors to report to them as soon as the audit work is completed, serious irregularities noticed in the bank's working. Similarly, there is a reporting requirement on statutory auditors in case of fraud above Rs. 100 lakhs. Statutory auditors also have the responsibility of highlighting matters of material significance in their report to the annual accounts as per Companies Act. These matters are then of course disclosed to the general public. **AC 3** As per RBI's internal procedure for the appointment of statutory auditors , a firm of Chartered Accountants (auditors) associated with any particular bank continuously for four years is required to be rested for a period of at least two years. During the rest period of two years, the concerned audit firm is not considered for a branch audit also by the bank. Branch auditor firms are also rested for a minimum period of 2 years after continuous association for 5 years. **AC 4** In accordance with paragraph 14.8 of the Master Circular "Prudential guidelines on Capital Adequacy and Market Discipline, Part C Market Discipline," banks have to have a disclosure policy. **AC 5** The RBI does not have explicit powers to have access to external auditors' working papers. That said, the authorities stated that they can request supporting material from the external auditor to support his judgment.

Assessment	Largely compliant
Comments	The RBI does not have the direct authority to rescind the appointment of a statutory auditor. The authorities state, however, that in the past they have withdrawn this approval when serious deficiencies in the working of the external auditors have come to the attention of the RBI. The financial statements are based on accounting standards prescribed by the ICAI.. These are not accounting standards and auditing practices that are internationally and widely accepted. Convergence with IFRS for banks is scheduled to commence from April 2013 onwards. In India, the standards on financial instruments-AS 30, 31 and 32 have not been notified and are therefore not binding. In order to fill the gap, RBI has been issuing prudential guidelines on investment classification and valuation, and income recognition , asset classification and provisioning. The RBI does not have access to external auditors' working papers. It is recommended the RBI increase its interaction with external auditors.
Principle 23	**Corrective and remedial powers of supervisors.** Supervisors must have at their disposal an adequate range of supervisory tools to bring about timely corrective actions. This includes the ability, where appropriate, to revoke the banking license or to recommend its revocation.
Description	EC 1: Supervisory letters highlighting major deficiencies are issued to the CEO of a banking company upon completion of an AFI by a regional office and after follow-up discussions of findings that takes place at a senior level. Those discussions of findings with senior executives of the bank takes place following review by the central office of the inspection report, and provides the bank with the opportunity to debate the findings. A general time frame for compliance is established by a May 29, 2002 circular, alluding to one- to three-month timeframes. In practice, though, timeframes are often determined after interaction with the banking company. In the sample letter provided, time frames for addressing the concerns were appreciably longer – six months or more. If action plans are required -- e.g., because of some ongoing changes in important processes -- progress is monitored by the Supervisory Relationship Officer for the bank; the relevant risk expert and the Principal Inspecting Officer may be invited to the monthly monitoring meetings but this is not likely to be always the case. EC 2: The RBI has powers to address the orderly resolution of a problem bank, including closure, or assisting in the restructuring or merger with a stronger organization. Certain resolution powers can also be invoked by the central government if it determines that the banking company is being managed to the detriment of depositor interests or interests of banking policy, or for more broadly if such action is needed for the better provision of credit generally or for a particular community or area (Section 36AE of the BR Act). The RBI can organize a voluntary amalgamation of banking companies under Section 44A of the BR Act, provided that the scheme of amalgamation is approved by the requisite majority of shareholders of both banking companies. A banking company may also be voluntarily wound down under Section 44 of the BR Act, provided that the RBI certifies that the company will be able to pay all of its debts to its creditors as they accrue. Under Section 45 of the BR Act, the RBI can apply to the central government for an order to suspend the business of a banking company (moratorium) to prepare a compulsory scheme of reconstitution or amalgamation. During the moratorium, limits will be placed on deposit withdrawals) and an acquirer will be identified. That decision is usually made over

	a week-end with the necessary logistical steps taken the following week, preparatory to the resumption of normal business as part of the acquire bank. No financial support will be provided, but some regulatory forbearance may be exercised in some circumstances. EC 3: Under Section 35A of the BR Act, the RBI has broad enough authority to be able to issue directives to a banking company to take necessary remedial action if the bank is not complying with laws and regulations or is engaged in unsafe and unsound banking practices, or where the interests of depositors are otherwise threatened. It has the authority to impose penalties on banks under Section 46 of the BR Act, and has done so (most recently on April 11, 2011 on 19 banks for violations of derivatives regulations) Under Section 46.5 of the BR Act, the RBI can also refer matters to the courts for action against individuals involved in violations. EC 4: Except for public banks, Section 22 (4) of the BR Act empowers the RBI to cancel a license if the company fails to comply with any of the conditions imposed upon various parts of Section 22 of the BR Act. Under Section 21 of the BR Act, the RBI can direct a banking company relating to 1) the purposes of advances it can make; 2) margins to be maintained; 3) maximum amount of advances to any entity; 4) maximum amount of guarantees to any entity; or 5) the rates or other terms applicable to advances and guarantees. Among the reasons in support of such actions are to prevent the banking company from conducting affairs in a manner detrimental to the interests of the depositors, or to secure the proper management of any banking company. Under Section 10 B of the BR Act, the RBI can appoint a new CEO of a problem private sector bank, and has built up a data base of people from which to choose. Under Section 36AB of the BR Act, the RBI can also add one or more additional directors to strengthen the Board of a private sector bank. EC 5: The RBI has a prompt corrective regime, involving not only capital triggers but also triggers tied to NPAs and ROAs. If the level of NPAs is beyond established levels, the RBI can issue directions to address them, for example, by upgrading underwriting policies or reducing or stopping lending in some sectors. If the level of ROA falls below established levels, the banking company can be directed not to take costly liabilities, to skip dividend payments, to avoid some businesses, or to develop ways to increase fee income. Accordingly, discretion is used in addressing both of these triggers. If the CRAR falls below 9 percent, the RBI will require a capital augmentation plan, restrict expansion of Risk-weighted Assets and require that dividend payments by reduced or skipped. If the CRR falls to 6 percent, the RBI will order recapitalization and may make changes in directors or Management; if the bank fails to submit/implement the recapitalization plan, the RBI may take steps to merge the bank. If the CRAR falls below 3 percent, the regime provides that the RBI will take steps to merge/amalgamate/ liquidate or impose moratorium on the bank, if its CRAR does not improve beyond 3 percent within one year or such extended period as may be established. Thus, even within the capital piece of the PCA regime, there is considerable discretion to allow a bank to continue to operate for potentially in excess of a year, with extremely low capital; given the CRAR is a total capital concept, a 3 percent total capital level could involve very little (common) equity. If such discretion were exercised regarding a public bank, the government would presumably take action at some point.

	EC 6: Under Sections 46 and 47 of the BR Act, the RBI has the power to apply penalties and sanctions to the banking company as well as to the company's management and to members of the Board.
Assessment	Largely Compliant
Comments	The RBI has broad discretion in the range of remedial actions it can take to address problem situations, a prompt corrective action regime, and a set of tools to use in problem bank resolution. There are some gaps, particularly related to the applicability of the approaches to public banks: 1. The RBI cannot disempower a public bank to withdraw from banking activities 2. Even within the capital piece of the PCA regime, there is considerable discretion to allow a bank to continue to operate for potentially in excess of a year, with extremely low capital; given the CRAR is a total capital concept, a 3 percent total capital level could involve very little (common) equity. If such discretion were exercised regarding a public bank, the government would presumably take action at some point. 3. The RBI can appoint the CEO or additional directors for a problem bank. As these persons are not granted additional powers, they may give the appearance of the RBI becoming involved in the management of a problem bank. The RBI should provide greater clarity to these roles.
Principle 24	**Consolidated supervision.** An essential element of banking supervision is that supervisors supervise the banking group on a consolidated basis, adequately monitoring and, as appropriate, applying prudential norms to all aspects of the business conducted by the group worldwide.
Description	EC 1: Through required reporting and the AFI process, the RBI does maintain a good understanding of the overall structure and operations of banking groups, domestic and cross-border. This has been verified by a review of an inspection report. EC 2: Under Section 35 of the BR Act the RBI has the power to inspect a banking company, including its foreign operations (although it has not used such authority to inspect foreign operations since a May 2008 inspection of a bank's subsidiary in the United Kingdom). However, the RBI does not have the authority to inspect a subsidiary of a banking company that it does not regulate; such subsidiaries are generally subject to the supervision and regulation of separate Agencies, such as SEBI and IRDA. The RBI has the authority to inspect the operations of foreign banks operating in India, under the same provisions applicable to domestic banks. EC 3: The RBI has made improvements in its capacity to evaluate the risks posed by nonbanking companies to its supervised banking companies, although improvement opportunities remain. The improvements are particularly important given the extent to which some banking companies engage in activities through subsidiaries (two with more than 40 percent of their total activities in subsidiaries and associated companies). The RBI has initiated a program of increased reporting and surveillance of Financial Conglomerates, with the designation based on the extent of their operations in multiple business lines. A total of 12 financial conglomerates have been so designated, with six of the twelve being bank-led conglomerates; the RBI is the designated lead supervisor of those six. On a quarterly basis, the six companies file a special Conglomerate Return,

	that provides consolidated financial information (including consolidated capital and exposure concentration information) , capsule financial information on the individual nonbanking subsidiaries, information on the nature and dimension of intra-group transactions, and updates on elements of governance (including the composition of the Boards of directors). Within the Department of Banking Supervision, a unit has been established with individuals designated for ongoing review of the six firms; the individuals are expected to share information and perspective with one another, and to interact with counterparts at SEBI and IRDA. There is no provision for the sharing of inspection results directly between the nonbanking supervisory authorities and the RBI, even regarding subsidiaries of bank-led Financial Conglomerates, although copies of the relevant reports could be obtained by the RBI from the parent bank incident to the AFI process. The Financial Conglomerate process does contemplate the holding of a semi-annual meeting of senior RBI people with counterparts from the relevant nonbanking supervisory authorities to discuss individual firms. The extent to which these meetings have been held on that schedule, and conducted in a way that would involve detailed discussion of concerns has not been established with the assessors; it was also confirmed that the meetings are carried out with representatives of the supervised institution, potentially limiting the candor with which views of the various agencies are exchanged. Some reporting of consolidated information is also required of firms that have not been designated as financial conglomerates, although the required information is not as detailed as for the financial conglomerates. Some such firms have operations in multiple financial sectors, but do not meet one or more of the quantitative criteria for designation. Currently there is no expectation of semi-annual meetings for such firms. (As discussed in CP 20, a separate list of systemically important banking groups has been established.) More recently a structure has been established at the most senior levels within India to focus on financial stability issues and to facilitate cooperation and coordination between the various supervisory agencies. The FSDC was set up in December 2010 under the Chairmanship of the Union Finance Minister, with members from the RBI, SEBI, IRDA, PFRDA, and the government, that deals with financial stability issues as well as inter-regulatory coordination. A Committee under the FSDC was also set up, with the governor the RBI as Chairman. EC 4: The RBI has established prudential norms on a consolidated basis regarding capital adequacy, exposure norms, liquidity ratios, mismatches of assets and liabilities, and exposures to related parties. The RBI collects consolidated financial information on banking companies, including balance sheet and profit and loss statement, supplementing the more extensive reporting required on a solo-bank basis. However, non-financial and insurance subsidiaries (as well as associates and joint ventures) are excluded from the consolidated reports and norms. The approach used to assigning supervisory ratings to a banking company is a bank-centric one, the CAMELS construct. There is no explicit way to reflect issues arising from nonbank subsidiaries in the composite rating, in a separate component rating, or within any of the existing component ratings. EC 5: There are no MOU's or other formal information sharing arrangements with SEBI and IRDA; any reports that are received by the RBI from those agencies are provided by the parent bank during the RFI. There is a semi-annual meeting with an opportunity for information exchange in a more informal way, although the meetings typically include

	senior officials of a supervised institution, potentially limiting candid communication. An Integrated System of Alerts was established in 2003, under which the regulated entities under SEBI (e.g., stock exchanges) send alerts to the RBI; we have not been advised of similar arrangements regarding SEBI directly or regarding IRDA. . EC 6: The RBI has the authority to control the activities of a banking company and its subsidiaries through an applications process and through the working of the banking law, which limits the activities of a subsidiary of a bank to what a bank can legally engage in directly. Locations are also controlled through the applications process, which includes the review of annual branch banking plans with a focus on ensuring appropriate serving of under-banked areas. EC 7: Based on a review of a sample inspection report, the RBI does an extensive view of the activities of overseas offices of the specific Indian bank as part of the AFI, including some assessment of the managerial strength at such locations. The capacity to determine in a rigorous way that the foreign operations are managed in a safe and sound manner, in compliance with supervisory and regulatory requirements, is limited by the shortcomings in home/host information sharing arrangements discussed in CP 25; in addition, the RBI has carried out very few on-site inspections of overseas operations --- one in 2008, and none since that time. EC 8: The RBI expects the parent banks to review its overseas operations on an ongoing basis, carrying out appropriate inspections and audits. (The bank is also required to report to the RBI on overseas violations.) The banking company's performance in this regard is assessed as part of the Group risk assessment made during the AFI process. Questions on foreign operations would be part of the quarterly and half-yearly discussions with the banking companies. EC 9: At least implicitly, the RBI has the authority to require closing a foreign office or subsidiary if it is posing excessive risk of various kinds to the parent bank. EC 10: The RBI factors in the degree of supervisory intensity in a host jurisdiction when considering an application. There is, however, no well laid-out set of indicators to assess supervisory intensity consistently across the jurisdictions. In the SREP (Pillar 2) reviews of banks with overseas offices/subsidiaries, the extent of risk at foreign offices is reviewed and supervisory discretion is used to counsel the bank if the trend of risk is increasing.
Assessment	Largely Compliant
Comments	The RBI has taken steps to broaden its supervisory focus to include a stronger focus on the consolidated group. Through the establishment of Council/Sub-Committee structure, through regular inter-Agency meetings, through implementation increasingly of norms for the consolidated organization, and from supplemental consolidated returns, the RBI now has a number of stronger elements of strong consolidated oversight. A number of gaps in consolidated supervision remain. 1. The RBI cannot order inspections of, or require reports from, domestic non-subsidiaries it does not regulate; a proposed amendment to the banking law (a new Section 29 (A) of the BR Act, Power in Respect of Associated Enterprises) would, if enacted, address this consolidated supervision deficiency. The RBI also is not able to undertake transaction testing at such subsidiaries.

	2. The RBI does not receive inspection reports directly from nonbank supervisory agencies, improving the timeliness and regularity of receipt as compared to the current practice of obtaining such reports from the parent bank at the time of the AFI; 3. There are opportunities to improve the process of inter-Agency meetings a. by ensuring that they take place on a fully regular schedule (for both designated Conglomerates and other banking companies with substantial nonbanking operations); and b. by providing for the opportunity for candid conversation, that would arise from portions of the meetings being regulators-only; 4. The RBI should consider its methodology for rating banking companies, to provide explicitly for a way to reflect systematically the issues that may arise at nonbanking subsidiaries. 5. There are major gaps in home/host information sharing arrangements as detailed in CP 25; and The RBI has not used its powers to conduct overseas inspections since 2008.
Principle 25	**Home-host relationships.** Cross-border consolidated supervision requires cooperation and information exchange between home supervisors and the various other supervisors involved, primarily host banking supervisors. Banking supervisors must require the local operations of foreign banks to be conducted to the same standards as those required of domestic institutions.
Description	EC 1: The information exchanged between home and host supervisors is less than what would be expected, particularly viewed in relation to the dimension of activities conducted by various Indian banks overseas and by the number of foreign banks operating in the Indian market. Indian banks have operations in more than 45 countries, through branches, subsidiaries or joint ventures. Thirty-seven foreign banks have branches in India. EC 2: Formal information exchange arrangements are very limited. MOUs have been signed with only two authorities (China Bank Regulatory Commission in 2010 and Dubai Financial Services Authority in 2011). Discussions are in various stages with about 20 other jurisdictions. Where MOUs are not in place, some information is exchanged from time to time as the need for it is recognized and/or based on reciprocal understandings with some supervisors. As indicated in the 2009 Self Assessment, there have been exchanges on “specific issues” with “a few” overseas supervisors. The RBI also advises that it has received copies of some reports conducted by supervisors in some of the jurisdictions in which Indian bank operations are relatively larger – specifically, from the UKFSA, the Federal Reserve, HKMA, and MAS since the beginning of 2010. . The RBI has not hosted any supervisory colleges. The RBI does participate in colleges organized by home country supervisors when invited, involving four banks over the past four years. EC 3: The RBI as home supervisor provides limited information to host supervisors. It has never hosted a supervisory college.

	EC 4: As host supervisor, the RBI provides limited information to home supervisors. It does encourage home supervisors to meet with the RBI, incident to any on-site reviews of operations of branches in India the home supervisor may do. EC 5: The RBI supervises offices of foreign banks in the same way as it supervises operations of local banks. The license granted to the foreign bank allows for the same array of activities as an Indian bank can conduct. EC 6: The RBI does ensure that the home country supervisor is aware of a proposed establishment of an office, and requests a letter of non-objection. However, there is no assessment of whether a home country practices consolidated supervision although some limited review of supervisory intensity on the part of the home supervisor is made. EC 7: Home country supervisors have been given access to the Indian offices of their banks to do on-site evaluations. EC 8: No shell banks are permitted in India. EC 9: While the situation described (i.e., the taking of consequential action on the basis of information received from another supervisor) apparently has not occurred, the RBI indicates it would consult with the other supervisor if the situation should arise in the future. AC 1: Communication strategies are not generally strongly formed, given the limited formal and informal channels of communication with overseas supervisors. The RBI has not hosted any supervisory colleges although it has participated in colleges for four institutions over the past three years.
Assessment	Materially noncompliant
Comments	The significant and growing overseas operations of Indian banks and the extent of foreign bank presence in India necessitates that the RBI significantly strengthen their channels of communication and coordination with overseas supervisors. 1. With Indian banks having overseas operations in more than 45 jurisdictions, but the RBI having MOUs with only two, and informal information sharing arrangements to varying degrees with only a few others, there are material gaps in the flow of information. 2. The RBI has not filled those gaps through other means such as by doing overseas inspections; it has not done any overseas inspections since one was done in May 2008. 3. The RBI has also not reached out to the host jurisdictions through the hosting of any supervisory colleges. 4. Given that the jurisdictions in which Indian banks operate include a number of countries in unstable regions and/or where it cannot be assumed that strong local supervisory practices have always taken strong hold, reaching out to the range of host supervisors for increased supervisory dialogue seems most appropriate. 5. The RBI also does not clearly assess during the licensing process whether the home countries of foreign banks, seeking to open offices, practice consolidated supervision, nor does it carry out the analysis of the quality of host country supervision through a rigorous, consistent, analytical process.

	With the RBI now represented on the G-20, the FSB, and the Basel Committee on Banking Supervision, the opportunity to influence the direction of global policy. The capacity to do that would be enhanced with some structural changes within the RBI to prepare representatives at the various meetings through better coordination and focus between the various Departments within the RBI.