CHAPTER 1

1.1 INTRODUCTION

The Indian Banking system plays a major role in the country’s economy. It is one of the catalysts for catapulting India as a major economic force in the world. The real GDP growth has averaged 8 percent over the past 3 years, and services, and manufacturing and exports sectors are booming. India’s Banking Industry grew more than fivefold during the last decade. However, from the international perspective, the Indian Banking system remained very small when compared to the size of the economy. The Banking system today intermediates a surprisingly small amount of assets relative to the size of the economy. As per Mr. K.C. Chakrabarty, Deputy governor, RBI nearly half the country is unbanked, only one-twelfth of our 600,000 villages have access to finance and upto 145 million households are excluded from banking. Consequently, much of the Indian Household Savings which is estimated to be roughly around 25-28% of GDP goes outside India’s formal Banking system. Only half of this savings is invested in Bank deposits and other financial assets. Hence there is a need to expand the Banking system orienting it to capture a substantial portion of the savings of the community. It is in this context that a well regulated and supervised Banking System becomes imperative for India. Consolidation, Competition and Risk Management are critical to the future of Banking(1)
The most recent crisis in the history of Banking was the Sub-Prime fiasco which resulted in the Global Financial Crisis and destabilised the economies of many countries. The global economic outlook suddenly deteriorated and in fact the Global GDP shrunk during years 2008-2009. The United States, Europe and Japan have gone into recession and the contagion effect has spread to most other countries (Duvvuri Subba Rao, RBI Governor). This is by far the worst crisis since the 1970’s.\(^{(2)}\) There were many Banking crisis since the 1990’s for example the Norwegian Banking crisis in 1990-91, the Japanese Banking crisis during 1991-92, the Mexican crisis in 1995, the Asian crises during 1997-98, and the Russian, Argentinian and Turkish Banking crises in 2000. In comparison, the Indian Banking Sector remained unscathed barring sporadic instances of Bank failures such as the Global Trust Bank, where too thanks to the urgent initiatives of the RBI and the Finance Ministry there was no contagion effect and things were sorted out efficiently. The role of the RBI in setting Governance and compliance standards in the Banking Sector is laudable. The way in which it responded to the challenges of the recent Global Financial Crisis and its effect on India has demonstrated once again that the Indian Banking system is robust and resilient. The soundness of the financial system in general and the Banking system in particular can be attributed to the regulatory and supervisory role of the RBI\(^{(3)}\).
1.2 BANKING SUPERVISION: HISTORICAL PERSPECTIVE

Banking supervision has assumed great significance in modern times throughout the world and it has become particularly important in developing economies such as India, as a sound Banking System is a sine-quo-non for the orderly growth of any economy. Banking regulation and supervision evolved over a period of time since the development of Commercial Banking in India which can be traced back to the 18th Century. The earliest Banks in India were Bank of Hindustan by M/s. Alexander and Company of Calcutta in 1770 and Bank of Calcutta which was established in 1806. The next major development in Commercial Banking was the establishment of Bank of Madras in 1843 by amalgamating four smaller Banks viz., Madras Bank, Carnatic Bank, Bank of Madras and the Asiatic Bank. The British also set up Bank of Bombay in 1868. These Banks were called the Presidency Banks and were amalgamated during 1921 to become the Imperial Bank of India. The Imperial Bank functioned as a Commercial Bank, a Banker’s Bank and Banker to the Government. The Imperial Bank was functioning as the Central Bank of the country till the formation of the RBI in 1935.

1.3 SUPERVISORY AND REGULATORY FRAME WORK

The regulatory and supervisory functions of the Banking system were not defined properly till the establishment of the RBI. The presidency Banks were regulated and governed by the Royal Charter and the Government of India. The Company legislation did not cover the
Banking Companies. The lack of proper regulatory and supervisory framework lead to major Bank failures undermining the confidence of the public. The first systematic study of the Banking regulation and supervision was conducted by the Central Banking Enquiry Committee (1929-31).\(^5\)

Important legislations covering the Banking Supervision aspects were the Banking Companies (Inspection) Ordinance 1946, Banking Companies (Restriction of Branches) Act 1946 and the Banking Companies Act 1949 applicable exclusively to the Banking Companies. This act later became the Banking Regulation Act from March 1966 onwards.\(^6\) By now the powers of the RBI became well defined. The Reserve Bank of India became the repository of all the regulatory and supervisory powers including the inspection of banks, liquidity of the banks, management of banks, amalgamation, reconstruction etc.

Thus the Banking Supervision in India evolved over a period of time once the Government started realising that a well regulated Banking system was necessary to safeguard the interests of the Depositors and to ensure the allocative efficiency of the financial system to fulfill growth objectives. During the pre reform period from 1970 to 1990 due to practices such as the administered rates of interest, govt. directed lending. RBI’s supervision was not very effective.\(^7\) It was only in the post reform period, the RBI became very innovative in evolving risk based methods and implemented them effectively.
Dr. Rakesh Mohan, Deputy Governor, RBI summarised the shortcomings of the Indian Banking System as under:

“Until the beginning of the 1990’s the state of the financial sector in India could be described as ‘a classic example of financial repression’ (Mac Kinnon 1973; Shaw 1973). The sector was characterised, inter alia, by administered interest rates, large pre-emption of resources by the authorities, extensive micro-regulations directing the flow of funds to and from financial intermediaries, relatively opaque accounting norms and limited disclosures, and dominant public ownership”(Financial Stability Review, Yale University 2007)

The other shortcomings may be summarized as under:

i) Strong entry barriers which thwarted competition

ii) Compartmentalization of activities of different types of financial intermediaries

iii) Low levels of efficiency and productivity

iv) Lack of commercial considerations in lending decisions and consequent rise in NPAs and

v) Erosion of capital due to high loan loss provisions and other losses

vi) Rigid foreign exchange market with inflexible and tight regulatory limits

vii) Low level of IT infrastructure in Indian Banks
Keeping in view the changing dynamics of Banking the world over and within the Country in terms of stupendous growth in the volumes of transactions, growth of innovative Banking products, growing use of Technology in the management of Banks, the complexities of market risks and exposures to various participants, the Reserve Bank has been proactively improving its supervisory techniques. However, the traditional macro approach was found to be less effective and so recourse has been taken to other Risk based supervisory methods in a phased manner. In this context a look at the growth in the volumes of transactions is very relevant. The situation as obtaining on the eve of Nationalisation of Banks in 1969, through 1991 when the Reform process began and the present status would give an idea of the stupendous growth of volumes. The number of Bank of Offices which was 8187 has increased to 61724 in 1991 and further to 87768 as on 31.03.2010. Deposits of Commercial Banks for these corresponding periods were Rs.4822 crores, Rs.200568 crores and Rs 4492826 crores respectively. (Source: Statistical Tables relating to Banks in India 2009-10)

The shift from traditional approaches of Banking supervision to the Risk Based methods has been gradual and through a consultative process. On all important aspects of Regulation and Supervision Work Groups were constituted or technical reports were prepared. Such Reports reviewed the international best practices, domestic imperatives and the options available for proper governance of Banks.
These reports were placed in a public domain and on the basis of the inputs from the Industry associations and self-regulatory organizations, final Reports were prepared keeping in view the feedback and suggestions. The most important reports in regard to Banking Regulation and Supervision are as follows:

i) Report of the Committee Financial System 1991 (Chairman: Mr. M. Narasimham)

ii) Report of the High Level Committee 1992 (Chairman: Dr. C. Rangarajan)

iii) Padmanabhan Committee on fine-tuning the Annual Financial Inspection of Banks

iv) Report of the Committee on Banking Sector Reforms 1998 (Chairman: Mr. M. Narasimham)

The constitution of the Technical Advisory Committee was intended to strengthen the consultative process on a continuing basis. The RBI has also constituted the Standing Technical Advisory Committee on Financial Regulation consisting of experts drawn from academia, financial markets, Banks, non-Banking Financial Institutions and Credit Rating agencies. The role of the committee was to examine the issues referred to it and advise the RBI on the desirable regulatory framework. Even the issuance of guidelines by the RBI was after draft versions were put in the public domain before finalisation of the same. For this purpose a Users’ Consultative Panel was constituted comprising representatives of Banks and market participants. The
initiatives of the RBI to relate the Indian Banking Regulatory framework with international best practices, at the same time keeping in view the developmental needs of the country has to be appreciated. With this end in view the RBI has constituted the Standing Committee on International Financial Standards and Codes. The recommendations of the Committee are placed on the website of the Reserve Bank. Of the Reports of the various Groups, two important reports which have relevance to the subject of the present study are the following:

i) Advisory group on Banking Supervision and  
ii) Advisory Group on Corporate Governance

A notable feature of the RBI's Supervisory initiatives is the continuous review of the regulatory measures in the Banking Sector to ensure that the system facilitates transactions by the common person and strengthen the credit delivery systems to fulfill the pressing needs of the society and the economy. The Annual policy statements affirm this. The regulatory measures aim to facilitate the ongoing shift from external regulation to internal systems of controls and Risk Management. The supervisory initiatives also aim to protect the integrity of the financial system by reducing the likelihood of Banking institutions becoming channels for money laundering, terrorist financing and other unlawful activities.
1.4 CONCEPTUAL FRAMEWORK RISK MANAGEMENT SYSTEMS

‘Risk’ is one of those terms generally understood intuitively. The Chambers 20th Century Dictionary defines ‘risk’ as a ‘hazard’, ‘chance of loss’ or ‘injury’. Risk is also distinguished from the term ‘uncertainty’. ‘Uncertainty’ refers to probabilities and to probabilities associated with decision alternatives having uncertain outcomes. Such outcomes may be favourable or unfavourable. Risk, on the other hand, has many interpretations. Its precise meaning and usage varies across individuals, disciplines and contexts (Fishburn 1984; Luce 1980). According to the Palgrave dictionary of Economics: “A situation is said to involve “Risk” if the randomness facing an economic agent can be expressed in terms of specific numeric probabilities. Risk increases as unfavourable outcomes become more probable or as probable unfavourable outcomes increase in adversity. According to Frank H.Knight, the practical difference between the two categories, risk and uncertainty, is that in the former the distribution of the outcome in a group of instances is known (either through calculation apriority or from statistics of past experience), while in the case of uncertainty, this is not true, the reason being in general it is impossible to form a group of instances, because the situation dealt with is to a high degree unique.

The development of modern Banking with sophisticated derivative products has its genesis in attempts to managing Risk. Theory of Risk suggests that as the financial system develops its ability to assess and
bear risks increases. The Palgrave dictionary of Economics suggest various uni-variate measures of risk viz., mean absolute deviation, inter-quartile range etc. The volatility of the cash flows is considered to reflect the riskiness of the activity. The mathematical definition of volatility is the standard deviation of cash flows. While standard deviation of cash flows serves as the basis, other measures like the covariance of return with the market which is also known as ‘beta’ measure also are used. Certain other measures such as ‘Gap’ in the foreign exchange where it indicates the difference between the assets and liabilities in a given currency or to find the difference between ‘rate sensitive assets’ and ‘rate sensitive liabilities’ are developed to capture the risk profile. However, the essence of all these measures can be related to the basic definition of risk i.e., standard deviation of cash flows.

Risk Management Systems in Indian Banks existed even during the pre-reform period, and predominantly covered the Assets-Liabilities Management (ALM) area. But they became more evolved during the 90’s. Guidelines for a comprehensive Risk Management System were first issued by the RBI on October 21, 1999. The guidelines broadly cover management of credit risk, market risk and operational risk. The existing ALM mechanism was already covering liquidity risk and interest rate risk. The guidelines emphasise the role of the Board of Directors in putting in place the methodologies for measuring and monitoring credit risk. The guidelines have placed the primary
responsibility of laying down risk parameters and establishing the risk management and control systems on the Board of Directors. The Reserve Bank has also advised that the Credit Policy Committee and the Assets and Liabilities committee should work in an integrated manner(12).

The investment committee should approve proposals for investment after subjecting them to the same degree of credit risk and analysis as if it were a loan proposal. RBI suggested that Banks follow prudential limits on inter-bank borrowings, call funding, core deposits, core assets etc. As per these guidelines Banks were asked to follow the value at risk (VaR) and duration approaches for measurement of interest rate risk.
1.5. RISK MANAGEMENT ARCHITECTURE FOLLOWED BY BANKS

At the apex level, there is the Supervisory Committee of Directors on Risk Management, which is a Board level Committee and oversees the Risk Management functioning of the Bank. Next come the Executive level Committees such as Asset Liability Management...
Committee (ALCO) for Market Risk, Credit Risk Management Committee for Credit Risk and Operational Risk Management Committee for Operational Risk function at the Bank. These Committees meet regularly to supervise and monitor the risks in various areas on an ongoing basis. Some Banks have appointed Consultants for advising and assisting the Management in implementing the Risk Management Systems and making the Bank Basel compliant.

The shift from transaction based supervision to Risk based Supervision was necessitated due to the complexity of modern times. The most important of the risks viz., Credit Risk, Market Risks (Interest Rate Risk, Foreign Exchange Risk and Liquidity Risk), Operational risk (People Risk, Control Risk, IT Risk, Legal/Regulatory Risk and Reputational Risk) need deft planning and careful handling by the Banks. The Supervisory mechanism too needs to upgrade their skills for prompt detection of the failure of the Risk Management systems. The Reserve Bank over a period of time has guided and insisted on setting up proper Risk Management Systems in Banks. \(^{(13)}\)

It is to the credit of the Indian Regulatory Agencies like the RBI, Securities Exchange Board of India(SEBI) and the Insurance Regulatory and Development Authority(IRDA) that the Indian Financial System remained comparatively unscathed despite the catastrophic failures of the financial systems elsewhere in the world.
The evolution of financial instruments and markets has enabled Banks to undertake varied risk exposures. In the context of these developments and the progressive deregulation and liberalisation of the Indian Financial Sector, having in place effective risk management and internal control systems has become crucial to the business of Banking. This is also significant in view of the introduction of the New Basel Capital Accord (14) under which capital maintained by a Bank will be more closely aligned to the risks undertaken. Further Internet Banking, E-Commerce, E-Money and other Information Technology related Innovations are adding new dimensions to Risks faced by the Banking Sector. Mergers and acquisitions as well as outsourcing of some non-core activities are undertaken by the Banks with some strategic objectives. They also enhance the Risks in Banking.

The objectives of Risk Management can be summarised as disaster prevention by setting Capital Adequacy Standards and prudential limits. This will lead to allocation of supervisory resources in accordance with the risk profile prepared by the Bank and focuses on areas exposed to greater risk. For the Bank supervised this may result in less supervisory intervention. As the focus would shift from transaction based audit and inspection to systems, Banks would be encouraged to develop systems and procedures and understand and perceive awareness of risks more accurately. Under the new approach the Audit methodology also will undergo a radical change. The Internal Audit of the Banks will now be Risk based so as to make it
more forward looking with emphasis on identification of potential risks if any with suggestions for risk mitigation.

1.6 **RISK MANAGEMENT IN THE CONTEXT OF BASEL ACCORDS**

The factors that contributed to the growth of Risk Management are:

i) Globalisation: The world has become a global village with the integration of financial systems through close cooperation between nations

ii) Deregulation: In the Indian context as in the case of many developing countries, the factors of deregulation both in interest rates, credit dispensation, exchange rates etc. have necessitated that Banks should manage their affairs and a proper Risk Management System in place is a sine-qua-non for the survival and growth of the organisation

iii) Development of sophisticated products: The evolution of modern Banking has seen the birth of many complex products and derivatives and unless these are monitored through proper Internal Controls and compliance, can lead to disastrous consequences

iv) Competition: With liberalisation came a new generation Private Sector Banks leading to stiff competition threatening the profitability and growth of the existing Banks. This called for a revamping of procedures and systems to keep pace with the new entrants.

v) International Best Practices and Basel requirements:
The current focus on Risk Management emerges from the requirements of the Basel Accords.

The Basel Committee on Banking Supervision (BCBS) is a Committee established by the Central Bank Governors of the Group of Ten (G-10) countries at the end of 1974. The members of the Committee came from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, United Kingdom and the United States. The Committee does not possess any formal authority and its recommendations are not mandatory. It only formulates broad supervisory standards and guidelines and recommendations. It is up to the regulatory authorities of the concerned countries to implement them or not. The Committee encourages that Banks worldwide achieve convergence towards common approaches and common standards.

The Governors of Central Banks of the G-10 countries established the Basel Committee as the Committee on Banking Regulations and Supervisory Practices at the end of 1974 in the aftermath of serious disturbances in international currency and Banking markets. Following the messy liquidation of a Frankfurt bank in 1974, on June 26th, a number of Banks had released Deutschmark to the Bank Herstatt in Frankfurt in exchange for dollar payments deliverable in New York.

On account of differences in the time zones, there was a lag in the dollar payment to the counter-party Banks, and during this gap, and
before the dollar payments could be effected in New York, the Bank Herstatt was liquidated by German Regulators. This incident prompted the G-10 nations to form BCBS under the aegis of the Bank for International Settlements (BIS). The Committee reports to the Committee of Central Bank Governors of the G-10 Countries, which meets Governors’ endorsement and commitment for its major initiatives.

The first meeting of the committee took place in February 1975 and since then meetings have been held regularly three or four times a year. The committee does not possess any formal transnational supervisory authority. Rather, it formulates broad supervisory standards and guidelines and recommends statements of best practices in the expectation that individual authorities will take steps to implement those which are best suited to their own national systems.

Basel I refers to a round of deliberations by Central Bankers from around the world. In 1988, BCBS published a set of minimal capital requirements for Banks. This is also known as the 1988 Basel Accord, and was enforced by law in the G-10 countries in 1992, with Japanese Banks permitted an extended transition period.

Basel I, that is, the 1988 Basel Accord, primarily focused on credit risk\textsuperscript{16}. Assets of Banks were classified and grouped in five categories according to credit risk, carrying risk weights of zero (for example home country sovereign debt), ten, twenty, fifty, and up to one
hundred percent. Banks with international presence are required to hold capital equal to 8% of the risk-weighted assets. The Basel I framework was designed to establish minimum levels of capital for internationally active Banks.(16)

However, its simplicity encouraged over 100 countries across the world to not only adopt the Basel I framework but also apply it across the entire banking segment without restricting it to the internationally active Banks. Thus, the voluntary adoption of Basel I framework by several countries has made it, de facto, a globally accepted standard, though not all countries are fully compliant with all the aspects.

The Capital measurement system was not intended to be static but to evolve over a period time. In November 1991, it was amended to give clarification of general provisions which could be included in capital. In April 1995, BIS issued an amendment to recognize the effects of bilateral netting of bank’s credit exposure in derivative products. Another task was to refine the framework to address risks other than credit risk, which was the focus of the 1988 accord. In January 1996, the market risks arising from bank’s open positions were incorporated.

In addition to the work on capital standards, particular supervisory questions which the Committee has addressed include the supervision of Banks’ foreign exchange positions, the management of Banks’ international lending (i.e. Country risk), the management of Banks’ off-balance-sheet exposures, the prevention of criminal use of the
banking system, the supervision of large exposures, risk management guidelines for derivatives and the management of interest rate risk. Other topics currently being addressed include the supervision of financial conglomerates, risk management issues relating to reporting, disclosure and accounting.

As the Basel I framework is seen as a “one-size-fits-all” model which measures risk broadly, it is necessary for the regulator to discriminate among Banks on the basis of their risk profiles. Therefore, it is now widely viewed as outmoded, and a more comprehensive set of guidelines, known as Basel II are in the process of being implemented by several countries. The introduction of Basel II over Basel I became fundamental for a number of reasons. Among these, Basel I envisages

- Permits limited differentiation among risk assets for capital requirements
- No capital requirement for operational risk
- A difficulty in considering new instruments and methods for managing credit
- The presence of capital arbitrage in some areas such as securitization with preference given to businesses for which regulatory capital requirements are low or do not exist

Basel II seeks to remedy the situation by modifying and adopting a more risk sensitive approach to capital requirements. It imposes
the provision of capital for operational risk also which was not covered under Basel I.

1.7 BASEL II ACCORD: THE THREE PILLAR APPROACH

The salient features of the Basel II guidelines are as under:

The edifice of Basel Accord rests on three pillars.

**Pillar I** Pillar prescribes capital requirements for credit risk, market risk and operational risk. For credit risk, which is by far the most important risk the Banks face, three approaches are stipulated:

a) Standardised approach: As per this approach, varied risk weights are to be assigned for different exposures based on the rating given by any of the approved external credit rating agencies. RBI has approved four such agencies viz., CARE (Credit Analysis and Research Ltd), CRISIL (Credit Rating Information Systems of India Ltd.), FITCH and ICRA (Investment Information and Credit Rating Agency of India). For external exposures RBI has approved FITCH, moody’s and Standard & Poor. It is also required that the rating should be solicited from these agencies by the Borrowers.

b) Internal Rating-based Approach (IRB approach): This is also known as the foundation approach as per which Banks themselves rate the borrowers. This presupposes that Banks put in place robust internal rating system. It is also necessary that the Rating Department is independent of business units
which take credit decisions. This is complex as Banks require past data at least for 3-5 years for computing the Probability of Default (PD).

c) IRB Advanced Approach: This is more sophisticated approach requiring 5-7 years data for computing the Loss Given Default (LGD).

The above requirements are applicable to Corporate exposures above Rs.5 crores. Exposures below Rs.5 crores are classified under Retail category and for this purpose risk weights have been prescribed by the RBI.

OPERATIONAL RISK: Three approaches have been prescribed for Operational Risk as under:

A) Basic Indicator Approach (BIA): As per BIA a highly simplified method of computing capital is given, requiring not much of past data. 15% of Gross average income (positive) for the last three years is to be provided.

B) The Standardised Approach (TSA): This is a little cumbersome method as the gross income has to be mapped for various business lines. Capital has to be computed on the basis of ‘beta’ factors provided by the RBI.

C) Advanced Measurement Approach (AMA): Under this approach capital charge is based on average ‘loss’ due to operational risk in the last five years added with the expected loss for the next year.
3. Market Risk: Two approaches are prescribed namely,

A) Standard duration approach which is to be initially followed by all Banks. Capital charge under this method is computed on the basis of duration of the investment;

B) Model Approach: As per this approach Banks have to develop Internal Risk Management Models. This is a more sophisticated approach and Indian Banks will take more time to develop these models.

**PILLAR II AND RISK MANAGEMENT SYSTEM**

As per the requirements of this Pillar, Banks are required to establish robust risk management system. Such a system is subject to supervisory review and if the regulator is not satisfied with the Risk Profile of the Bank and its Risk Management System, the RBI has the prerogative to prescribe additional requirements. Banks are also required to prepare Internal Capital Adequacy Assessment Procedure (ICAAP) policy. The Board of the Bank has to approve the ICAAP policy. ICAAP should capture risk categories other than those covered under Pillar I such as Legal Risk, Concentration Risk and Reputation Risk. These risks captured will have to be incorporated under ICAAP policy and will be outside the capital requirements under Pillar I. The Board has to also approve a stress testing policy to carry out stress testing and scenario testing. Pillar II also requires that the ratings of credit exposures based on internal rating models are independently
validated. Under operational Risk, Banks are required to put in place a Risk Management System based on self-assessment of operational risk by Branches. The Board has to also approve a risk mitigation plan based on self-assessment.

**Pillar III** Pillar III deals with disclosure requirements.

It stipulates that periodical disclosures are made to various agencies like the Regulator, the Board of the Bank and market participants about various parameters which indicate the Risk Profile of the Bank. To ensure market discipline Banks are required to put such disclosures on their respective Websites also.

**THE EFFICACY OF BASEL II**

Banking Supervisors and Analysts worldwide feel even Basel II will soon become outmoded as it suffers from many shortcomings. It is argued that the sophisticated risk measures give the larger Banks an unfair advantage as they are able to implement them with ease due to their skills and IT systems. But Banks in the developing countries would find it an uphill task to implement these sophisticated models. The capital requirements for these Banks will be generally more in comparison and to that extent result in restricting their access to credit or by making it more expensive. More risk sensitive measures are required for the larger, more sophisticated Banks, whereas the less sophisticated measures that are simpler to calculate, due to their lower risk sensitivity may be adequate for smaller Banks.
The second shortcoming of the Accord is that better credit risks will be advantageous as Banks move towards true pricing for risk. Experience with these systems in the United States and the United Kingdom, however, shows that the improved risk sensitivity means that Banks are more willing to lend to higher risk borrowers, just with higher prices. Borrowers previously 'locked out' of the banking system have a chance to establish a good credit history.

A more serious criticism is that the operation of Basel II will lead to a more pronounced business cycle. This criticism arises because the credit models used for Pillar 1 compliance typically use a one year time horizon. This would mean that, during a downturn in the business cycle, Banks would need to reduce lending as their models forecast increased losses, increasing the magnitude of the downturn. Regulators should be aware of this risk and can be expected to include it in their assessment of the bank models used.

Basel II Framework is basically a Risk Management Exercise and does not seek to change the business models of the Banks. Instead, it requires the Banks to have a holistic view of their risk profiles and fine-tune/update their Risk Management practices and formulate an Internal Capital Adequacy Assessment Process robust enough to capture all possible risks the Banks are facing or are likely to face. It expects Banks to initiate adequate and appropriate Risk Mitigation measures through effective Systems and Procedures.
Capital Management is only an off-shoot of the exercise, intended to graduate from Capital Adequacy (or Capital Sufficiency) to Capital Efficiency. It is aimed at minimizing the possible losses and optimizing the revenues. Further, Banks are expected to assess their own risk profile and provide appropriate capital, consistent with the risks. Providing excess capital is no insulation from the risks the Banks are facing. In fact, at times, excess capital leads to inefficient use of capital. May be, with this objective in mind, Basel II envisages under Pillar II, that Banks develop a realistic Internal Capital Adequacy Assessment Process (ICAAP) consistent with the risks profile and provide appropriate capital, which eventually leads to the concept of Economic Capital.

Banking Industry, primarily deals with financial services and faces with many financial risks. Hence, it is imperative that Banks have to identify and measure various risks faced by them and initiate suitable remedial measures to prevent or mitigate them. Hence, any Economic System to achieve a robust growth and sustain the same, needs to encourage and ensure a sound Banking System. Banking being one of the important barometers of the stability of the Economic System, the Regulators across the globe have been defining and re-defining the regulatory interventions, so as to ensure a sound Banking System in particular and stable Economic System in general.

With ever-growing and multi-dimensional banking business models, invariably, there appears to be an opaque area that always hides the
risks even from the sharp and trained vision of the risk managers. Robust Risk Management practices will help Banks to identify, measure and mitigate the unexpected losses (apart from the expected losses, which the Banks in any case take care of, as a normal business practice) and eventually will lead to lesser losses.

Banks have to develop appropriate Risk Management Practices that can identify the risks, measure them as far as possible and initiate appropriate remedial measures to mitigate them, without compromising the business objectives and growth plans. In fact, the Banks ought to put in place robust Risk Management Practices not only to insulate them from the possible losses but also to be internationally competitive.

Risk Assessment should form an integral part of the Banks’ Management and Decision Making Process, across all levels of decision-making, day-in and day-out. A self-assessment of Banks’ risk-profile is desirable, to gauge their preparedness and stability in case of sudden unforeseen shocks. This would facilitate better business sense.

Indian Banks, on their own, in their interest, have migrated to Basel II Framework. The Banks have to put in place robust Risk Management practices, fine-tune/update the systems, procedures and processes, enabling them to capture all the possible risks that the Banks are facing or likely to face and develop mechanisms to measure them as far as possible and initiate suitable remedial measures to mitigate them, which evidently are the key elements for business and growth of the Banks and to make them globally competitive.
Basel Committee on Banking Supervision has formulated 25 Core Principles to strengthen the Supervisory Regime. Core Principle XIII deals with Risk Management Process. It states: ‘Banking Supervisors must be satisfied that Banks have in place a comprehensive Risk Management process (including appropriate Board and Senior Management oversight) to identify measures, monitor and control all other material risks and where appropriate to hold capital against these risks.’

The Reserve Bank has issued detailed guidelines to Banks for putting in place Asset Liability Management (ALM) system with effect from April 1, 1999. (18) The ALM Committee has to be headed by the Chief Executive Officer/Chairman and Managing Director or the Executive Director of the Bank. Banks are required to lay down policy on identification, measurement, monitoring and control of various kinds of risks such as liquidity risk, interest rate risk and currency risk. These policies are to be reviewed from time to time so as to modify the same to suit any changes in business environment as perceived by the top management.

BASEL III

The US sub-prime crisis brought to the fore that things can go wrong despite the capital adequacy requirements as per Basel II, which is supposed to be a more sophisticated Risk Management tool. The US Banks have all affirmed that they are Basel compliant, and just before it fell in September 2008, Lehman Brothers stated that they had Tier
1 capital of 11 per cent as against the requirement of only 4 per cent. This lead the Basel Committee on Banking Supervision to have a relook at the capital requirements prescribed for Banks, and so Basel III is in the offing. The proposals under Basel III have two main objectives viz., i) strengthening the regulations regarding capital base and liquidity of Banks and ii) to improve the banking sector’s ability to absorb shocks arising from financial and economic stress. The measures suggested by Basel III Accord are as under:

A) Increase the total capital adequacy ratio from 8 per cent to 10.5%;

B) Introduction of leverage ratio as a proportion of Tier I capital to Banks total exposures

C) Introduction of liquidity and funding ratios.

1.8 RISK MANAGEMENT AND THE FINANCIAL STABILITY FORUM

The RBI appointed Financial Stability Forum (FSF). The Forum has since submitted its Report (April 2008). The committee has undertaken a thorough study of the causes which lead to the collapse of the international financial markets. The Forum has recommended several measures for strengthening prudential oversight of capital, liquidity and Risk Management of the Banks. It underlined the need to attain international standards to enhance transparency, valuation, changing the role and uses of credit ratings etc. It called for strengthening the Regulator’s role to respond promptly to any risk faced by individual institutions and to put in place robust mechanism
to deal with stress in financial system. The Reserve Bank has issued guidelines covering these recommendations.

**PRUDENTIAL OVERSIGHT OF CAPITAL, LIQUIDITY RISK MANAGEMENT**

RBI has taken steps for phased implementation of Basel II norms and the same are constantly monitored on a continuous basis. In fact RBI has prescribed capital levels at higher levels as compared to the Basel II norm of 8 per cent. RBI has also issued guidelines as regards the off-balance sheet vehicles in the form of Special Purpose Vehicles (SPVs). These SPVs were major incentives for transferring sub-standard credit risks in the West and this was the major cause for the sub-prime lending and the consequent catastrophic failure of the financial system there, as these were kept beyond the reach of the Regulators. Realising the importance of the area of SPVs, Reserve Bank has issued extensive guidelines prescribing capital charge for liquidity facilities to such SPVs. RBI has also required that such SPVs should be subjected to stress testing for various risk factors.

RBI has also prescribed strict credit conversion factors, risk weights and provisioning requirements for specific off-balance sheet items including derivatives at an enhanced level. RBI has also issued guidelines prohibiting complex structures like synthetic securitisation.
The Reserve Bank has put in place broad guidelines on asset-liability management. Banks have been left free to devise their own Risk Management Strategies under the Board approved policies.

Reserve Bank has also placed restrictions on borrowing and lending in the call money market to 100 per cent of capital funds (Tier I and Tier II Capital) on a fortnightly average basis. RBI has also restricted inter-bank liabilities (IBLS) to 200 per cent of the Banks net worth. Banks with Capital to Risk Weighted Assets Ratio above 11.25 per cent are permitted such cap up to 300 per cent. To secure enhanced transparency and valuation, the valuation norms and market discipline in respect of complex financial products, RBI has issued detailed guidelines on the valuation of various instruments including derivatives.

In terms of the Recommendations of the FSF Report, Reserve Bank has issued guidelines regarding the incorporation of Risk Management and Corporate Governance aspects, prudential norms relating to derivatives, specific transparency and valuation standards etc. FSF recommended a set of disclosure requirements to allow the market participants to assess key pieces of information on capital adequacy, risk exposure, risk assessment processes and key business parameters.
**FSF and Role of Credit Rating Agencies**

As recommended by the FSA, RBI has issued detailed guidelines prescribing norms relating to the selection of credit rating agencies by Banks. The facility of ‘cherry picking’ of assessments provided by different credit rating agencies has been prohibited. The names of the credit rating agencies, the risk weights associated with the particular rating grades and aggregated risk weighted assets are required to be disclosed.

The aspect of formulating a framework for cross-border supervision and supervisory cooperation with overseas regulators has also been examined by the FSF, which recommended that a system be put in place for this purpose. RBI has set up a working group to lay down a road map for adoption of a suitable framework for this purpose.

The further measures taken by the RBI on the report of the FSF include the following:

a) Institutional arrangement has been put in place to oversee the functioning of the financial markets on a daily basis

b) Institutional arrangements have been put in place for liquidity management facilities, including the liquidity adjustment facility (LAF), open market operations (OMOS) and market stabilisation scheme (MSS) besides standing facilities such as export credit refinance (ECR). The Reserve Bank has been empowered under the existing legal framework to deal with the resolution of weak
and failing Banks. Enabling provisions exist in the Banking Regulation Act for voluntary amalgamation and compulsory merger of Banks under sections 44A and 45 respectively.

c) The deposit insurance cover is offered by the Deposit Insurance and Credit Guarantee Corporation of India (DICGC). (FSF REPORT 2008)

1.9 RISK MANAGEMENT AND MONEY LAUNDERING

An important feature of a Bank’s Risk Management and control procedures is the ‘know your customer (KYC)’ mechanism whereby the Bank identifies its customers, keeps the information updated and uses it to understand when and whether transactions through a customer’s account are suspicious. Lack of adequate KYC safeguards can expose Banks to various risks such as reputational risk, operational risk, legal risk and concentration risk (Basel Committee’s Customer Due Diligence for Banks. (www.bis.org). The magnitude of the risks can be appreciated if one understands that huge sums of money that are involved in the money laundering activity, in the absence of proper system of following KYC guidelines. According to the estimate of the IMF ‘dirty money’ placed in the world financial system each year is in the range of USD 590 billion to USD 1.5 trillion (2 to 5 per cent of global GDP). Banks should protect themselves by means of continuous vigilance through an effective Know Your Customer programme. Operational risk relates to weaknesses in the implementation of Bank’s programmes, ineffective control procedures,
and failure to practice due diligence. Laxity in implementing the guidelines might cause Banks to be involved in lawsuits and result in legal risk. Keeping in view the importance of the subject the Basel Committee and the Financial Action Task Force (FATF) have laid down detailed guidelines on Accounting Opening and Customer Identification and Consolidated KYC Risk Management. The FATF in its efforts to deal with money laundering has formulated forty recommendations which provide the framework to prevent the use of the financial system for laundering proceeds of criminal activities. These recommendations are revised from time to time. These are akin to the principles of Basel Core Principles for Banking Supervision.

The Prevention of Money Laundering Act, 2002 (PMLA) lays down rigorous obligations on financial institutions and Banks to verify and maintain records of the identity of the customers in the prescribed manner. They also stipulate maintenance of records of transactions above a threshold limit and reporting of the details to the designated authority. PMLA lists certain crimes in the Schedule under the Indian Penal Code, The Narcotic Drugs and Psychotropic Substances Act, 1985, The Arms Act, 1959, The Wild Life Protection Act, 1972, The Immoral Traffic (Prevention) Act 1956, The Prevention of Corruption Act, 1988 etc. In the light of heavy penalties involved, it is necessary that the Banks have a proper Risk Management system incorporating the compliance requirements of PMLA.
The Reserve Bank of India has issued guidelines on know your customer (KYC) in November 2004. The provisions of the Prevention of Money Laundering Act (PMLA), 2002 came into effect from July 1, 2005. Consequently the Financial Intelligence Unit – India (FIU-IND) was set up to collect, compile, collate and analyse the cash and suspicious transactions reported by banks and financial institutions. India and its financial sector were evaluated by the Asia Pacific Group on Money Laundering (APGML) in 2005 and India secured the status of ‘Observer’ in the FATF.

1.10 RISK MANAGEMENT AND CORPORATE GOVERNANCE

Corporate Governance system to be embedded into the overall Risk Management architecture of a Bank assumes great importance in the light of the risks involved if there is lack of proper governance standards in the organisation. Milton Friedman, a Nobel Laurate defined Corporate Governance as “Corporate Governance is to conduct the business in accordance with owners’ or shareholders’ desires, which generally will be to make as much money as possible, while conforming to the basic rules of the society embodied in law and local customs”. In the present times, this definition is not acceptable as it is narrow in scope laying more emphasis on making money for the owners. Over a period of time the definition of Corporate Governance has widened. It is now required to include the interests of many stakeholders apart from the Shareholders. As per J.Wolfensohn, President, World Bank “Corporate Governance is about promoting
Corporate fairness, transparency and accountability”. The OECD principles define corporate governance as involving “a set of relationships between a company’s management, its board, its shareholders, and other stakeholders”.

In the case of Indian Banks, we are yet to have a sound system of Corporate Governance in place as is evident from the happenings of the last few years. The requirements of corporate governance framework differ depending on the ownership structure of the Banks. In India we have Public Sector Banks which are largely owned by the Government. The majority holding in State Bank of India is held by the RBI. State Bank of India holds majority shareholding in the subsidiary Banks, which are being divested gradually. The Private Sector Banks are owned and managed by financial institutions and major Corporates and public at large. Foreign Banks are essentially owned by overseas entities.

The Public Sector Banks with Government ownership control almost over 80 per cent of banking business in India and this complicates the role of the Reserve Bank of India as the regulator of the financial system. The role of the Government performing simultaneously multiple functions such as the manager, owner, quasi-regulator and sometimes even as super-regulator presents difficulties in the matter. Unless there is clarity in the role of the Government, and unless Boards of the banks are given the desired level of autonomy, it will be difficult to set up healthy governance standards in the Banks. Some
efforts are made in this direction. The Consultative Group of Directors of Banks/Financial Institutions (FIs) under the Chairmanship of Dr. A.S. Ganguly, member of the Board for Financial Supervision has made certain recommendations to strengthen the supervisory role of the Boards of Banks. Consequently to acceptance of the Committee’s recommendations, the Corporate Governance framework in the Banks has been strengthened through supervision, regulation and through interaction with the management of Banks. These measures encompass the responsibilities of the Boards of Banks, shareholder and stakeholder rights, disclosure and transparency requirements etc. The other Committees of the RBI which dealt with the subject are the Dr. R.H. Patil Committee and M.S. Verma Committee on Banking Supervision. As a part of the CAMELS rating supervisory process takes into account the working of the board and its committees. ‘M’ which is a part of CAMELS refers to the quality of Management. The effectiveness of the Management in ensuring regulatory compliance and exercising of adequate internal control and compliance, proper functioning of Audit Committees etc. is taken into account, while rating the Management function.

Basel Committee on Banking Supervision has formulated Principles of Corporate Governance and has revised them from time to time. The revised principles of BCBS were published in 2006 and provided a reference point for promoting the adoption of sound corporate governance practices by banking organizations. They cover the
Boards involvement in the bank’s strategy, setting clear lines of responsibility throughout the organisation, drawing up proper compensation policies consistent with the Bank’s long term objectives etc. Ironically after these principles were published there were a number of corporate governance failures and lapses, many of which came to the fore during the financial crisis that began in 2007. Some of these failures are on account of insufficient board oversight of senior management, inadequate risk management and unduly complex or opaque bank organisational structures and activities. In the light of these developments BCBS felt the need to revise these principles yet again, and released a consultative document on Principles for Enhancing Corporate Governance during June 2010. The important areas that need greater focus as per BCBS are Risk Management, Board practices, senior management, Internal Controls, compensation, complex or opaque corporate structures, disclosure and transparency requirements etc.