CHAPTER 2

2.1 INTRODUCTION TO RISK BASED SUPERVISION

INTRODUCTION OF CAMELS AND CALCS

The traditional method of supervision during the 80’s was the system of Annual Appraisal of Banks which was purely based on-site Inspections. During the 90’s the system of group-wide supervisory oversight was adopted. The system of off-site monitoring of banks was introduced in 1995. Gradually supervisory rating models such as the CAMELS AND CALCS were also developed by the Reserve Bank to provide a risk based summary view of the overall health of individual Banks. Certain important parameters were selected for rating the Banks and Grades were awarded on the basis of these supervisory ratings. Capital Adequacy, Asset Quality, Management, Earnings, Liquidity and Supervision were the parameters.

2.2 PROMPT CORRECTIVE ACTION\(^{(23)}\)

Another important milestone in the Risk Based approach to Banking supervision was the introduction of Prompt Corrective Action (PCA) Frame Work. The PCA framework enables timely intervention of the RBI when soundness parameters such as the Capital Adequacy, Asset Quality and the Return on Assets deteriorate. The financial crisis that began in Asia in the 80’s has brought the importance of the PCA framework to the fore. The crisis clearly demonstrated the importance of robust and efficient domestic financial systems. Weak banking
systems and poorly developed capital markets contributed to misallocation of resources that eventually led to the crisis. The key to strengthening the domestic financial system is the implementation of sound practices for regulation, supervision, settlement, and accounting and disclosure standards. The implementation of sound practices depends on incentives to do so. These can be in the form of market-based incentives, either alone or in combination with official or regulatory incentives. These have been emphasised in the Report of the Working Group on Strengthening Financial Systems (of BIS / IMF / OECD / World Bank).

Under the PCA framework, Trigger points have been set up under three parameters, i.e. Capital to Risk Weighted Assets Ratio (CRAR), Net NPAs and ROA. Composite Rating, being the supervisor’s assessment of the overall condition of a bank, has not been taken as a trigger point. Composite Rating is a combined assessment based on the rating given on each component of CAMELS, viz. Capital adequacy, asset quality, management, earnings, liquidity and systems and controls. Supervisory ratings and actions taken based on such ratings are not made public. The triggers based on CRAR, Net NPAs and ROA take care of a bank’s performance in three critical areas which are quantifiable and form an integral part of the rating framework.

For every trigger point a set of mandatory and discretionary steps have been laid down. The steps are designed to pre-empt any
deterioration in the soundness of banks. Any actions, without duly recognising the diverse profile and factors contributing to the problems in banks, however, may not achieve the desired effect. The PCA should, therefore, encompass certain actions, which should bring immediate improvements, while some action points would be initiated in alignment with the severity of the problem. Thus, a set of **Mandatory** and **Discretionary** action points, in conformity with the magnitude of problems should be in place to bring about improvement in the functioning of banks. The rationale for classifying the rule based action points into Mandatory and Discretionary is that some of the actions are essential to restore the financial health of banks while other actions will be taken at the discretion of the Central Bank depending upon the profile of each bank. In cases where banks do not show improvement, despite taking mandatory actions, some of the discretionary actions will get converted into mandatory actions. However, in exceptional cases, the Central Bank may have the right to waive mandatory provisions.

**Recommended Trigger Points:**

**CRAR**

Three trigger points have been proposed:

(i) CRAR less than 8%, but equal to or more than 6%

(ii) CRAR less than 6%, but equal to or more than 3%

(iii) CRAR less than 3%
**NON PERFORMING ASSETS:**

Two trigger points have been suggested as under:

(i) Net NPAs over 10% but less than 15%

(ii) Net NPAs 15% and above

**ROA**

Internationally 1% ROA is considered as a benchmark. However, in view of the varying experience of domestic and foreign banks in developing countries a trigger point of below 0.25% has been proposed.

The PCA mechanism helped the RBI to monitor the health of the Banks more effectively.

**2.3 OFFSITE SURVEILLANCE AND MONITORING SYSTEM (OSMOS)**

Another notable tool in the armory of the Reserve Bank of India in Risk Based Supervision is the technique of Offsite monitoring and Surveillance (OSMOS) which was introduced in March 1996. OSMOS returns require quarterly reporting on assets, liabilities and off balance sheet exposures, CRAR, operating results for the quarter, asset quality and large credit exposures with respect to domestic operations by banks in India.

A data base providing information has been created dealing with information on managerial and staff productivity, in addition to
providing information on important ratios on financial growth and supervisory aspects of the Bank's functioning.

This information is subjected to computerised analysis and reviews are prepared for submission before the Board for Financial Supervision for its review and monitoring. During the year 1999, the returns have been revised and a second tranche of returns covering liquidity and interest rate risk were introduced.

OSMOS helps RBI to compute trend analysis reports on important parameters covering macro level growth/various performance indicators for placing before the Board for Financial Supervision. Such reports are prepared on quarterly, half-yearly and yearly basis.

Indian Banks having overseas presence are required to report information on assets and liabilities, problem credits, maturity mismatches, large exposures etc. on a quarterly basis. They are also required to report country exposures and operating results on an annual basis. During 2000, a revised system covering Banks with overseas presence was introduced. The revised off-site returns are intended to provide information relating to the quality and performance of investment and credit portfolio, implementation of risk management processes etc.

OSMOS is an information system used by the RBI to aid in continuous supervision between two on-site inspections. The important component of the OSMOS system consists of a set of
structured returns designed to capture critical information concerning
the financial health of the supervised entities at frequent intervals.
The system is highly computer driven. The set of 21 returns include
monthly, quarterly, half-yearly and annual returns covering Capital
Adequacy, Asset Quality, Operating Results, Structural Liquidity,
Interest Rate Sensitivity etc.

2.4 BOARD FOR FINANCIAL SUPERVISION(25)

The problem of conflict of interest faced at the RBI functioning as a
Central Bank and as Supervisor of the Banking System remained
unresolved. This was drawing criticism both nationally and
internationally, with critics arguing that the Supervisory function was
being compromised. The Committee on Financial System set up by
the Government of India has gone into this aspect in detail. The
Committee suggested that the supervisory functions of the RBI should
be separate from the more traditional central banking functions. They
suggested the formation of a separate agency which would be devoted
wholly to the supervisory function of Banks. Based on this
recommendation the Board for financial Supervision was constituted
on November 16, 1994. BSF functions under the RBI (BFS)
Regulations, 1994. The Board functions under the Chairmanship of
the Governor of the RBI co-opting four non-official Directors from the
Central Board as Members for a term of two years. The Deputy
Governors of the Reserve Bank function as ex-officio Members. The
Department of Banking Supervision provides all the secretarial
support to the BFS. The BFS played a very important role in securing the orderly supervisory oversight of Banks.

The Board is required to meet at least once a month. The quorum for the meeting requires the attendance of the Chairman or the Vice-Chairman (one of the Deputy Governors) and two other members.

BFS receives the advice of an Advisory Council which was constituted on November 16, 1994. The council consists of five members drawn from the fields of Banking, Law, Finance, Accountancy and Law. The Committee meets once a quarter. Another important tool of the BSF is the Audit Sub Committee constituted by the BSF in January 1995. The Committee is chaired by the Vice Chairman of BSF and two non-official members of the BSF as other members. The Representatives of the Institute of Chartered Accountants are sometimes invited to attend the meetings of the Audit Sub Committee depending on the agenda of the meeting. The main function of the Committee is to achieve improvement in the quality of the statutory audit and concurrent audit/internal audit of the banks. Aspects such as fixing of remuneration, approval of the panel of statutory auditors and branch auditors are referred to this Committee.

The decision of the BFS to implement an off-site surveillance function to provide for in-house monitoring of Banks and other credit institutions is a step forward in introducing Risk Based Supervisory frame work. The market intelligence and surveillance unit (MISU) on
all supervised institutions has proved very effective as a part of prudential supervisory reporting framework.

Introduction of the Macro Prudential Indicators (MPIs) Review marked another landmark in the Risk Based Supervisory approach of the RBI since the year 2000. Aggregated Macro Prudential Indicators (AMPIs) help the Regulator to ascertain by exception the soundness of a Bank’s operations through the Capital Adequacy, Asset Quality and Return on Assets, Management Soundness, Liquidity, and Sensitivity to Market Risk etc.

Introduction of the International best practices and norms on Risk weighted capital adequacy requirement as per the Basel I Accord, and later as per the Basel II Accord, Accounting, Income Recognition, Provisioning and Exposure in a phased manner marked the beginning of the transformation from Micro to Macro Prudential and Risk based Regime. Measures specifically aimed at strengthening Risk Management through recognition of different components of risk, assignment of risk-weights to various asset classes, norms on connected lending, risk concentration, application of marked-to-market principle for investment portfolio and limits on deployment of funds in sensitive activities are among the important.
3.5 MICRO-REGULATION VS. MACRO REGULATION

Micro regulation is intended to deal with individual Banks to identify issues specifically faced by them while Macro regulation deals with identifying factors that affect the Banking system in general. The most important aspect in micro-regulation is Credit Risk Management. Micro regulation prescribes rules relating to credit pricing, servicing, capital adequacy and asset quality norms. Credit Risk management is an upcoming and highly debated topic in the design of modern regulatory framework such as Basel II (BCBS 2006). Micro regulation plays a very important part in Credit Risk Management. Similarly in the case of Market Risk and Operational Risk too Micro regulation is important. Apart from Micro regulation, the Regulatory oversight should be broad based to deal with factors affecting the system as a whole. The recent financial crisis behoves on the Regulators to deal with the buildup of systemic risk affecting the whole Banking system. What has been started to be studied as bank runs, as chief destabilizing force of banking stability (Dowd, 1992) is now studied as an all encompassing force starting with the liquidity crunch, which translates into solvency issues for otherwise healthy institutions and which may further translate as contagion across the banking sector (Brunnermier and Pedersen, 2009)

The focus of designing a prudent macro-regulation necessarily concerns three aspects related to systemic risk in a system:
a) To analyze rising correlations across banks and the destabilizing vulnerabilities they can pose to the system.

b) To discover the macroeconomic determinant of systemic stability using aggregate data.

c) To estimate the systemic risk through the modelling approaches which has been used in credit risk measurement for a risky portfolio