CHAPTER VI

RECOMMENDATIONS & SUMMARY

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RECOMMENDATIONS & SUMMARY

1. TIER I AND TIER II CAPITAL

1. Banks carry out assessment of CRAR ratios generally every quarter but the researcher recommends in times of downturn the banks should undertake the assessment at least monthly or even fortnightly or weekly depending upon the severity of the downturn. Banks viz. State Bank of India which carry out assessments yearly seem to high ratios in terms of delinquency and non-performing loans thereby funds infused by the government in these banks seem to be at a high risk.

2. Banks can arise capital under Tier I as well as Tier II to meet the CRAR standards but higher the capital raised in the form of preference, subordinated debt or other debt instruments or even equity would require regular outflow of profits in the form of returns like interest, dividends to the stakeholders burdening the profits of the banks and making it difficult for them to survive, compete and expand in the market.

3. Regular revisions in the risk weights of asset/advances let out by the banks should coincide with the assessment and revision of the capital adequacy ratios.

4. Since the norms have also authorised the regulatory authority – RBI to allow banks to raise capitals through instruments approved by RBI. RBI should design such instruments which will lead to minimum outflow of profits from the bank and the stakeholders can benefit through capital accumulation and appreciation in the value of these instruments. Direct funding or borrowings from RBI on the lines of repurchase agreements can also be approved to meet the regulatory norms under Tier I and Tier II capital.

The above observations lead the research to the fact that banks operating in the country have maintained their capitals in accordance with the laid down regulations. The further chapters will highlight the areas where capital allocation is not the only solution to a stable financial institution and a stable economy but in the dynamic business environment and the complex risks which the banks are faced with, there is much beyond being conservative and limiting capital in a way limiting the profit earning capability of the bank.
2. PILLAR I – CREDIT RISK

1. With the advent of Basel III norms in India banks should scale up to advanced credit risk assessment approaches viz. Advanced Internal Ratings Based Model or Advanced Measurement Approach so as to apportionate risk in accordance to appropriate mitigation measures in the current complex and highly dynamic business environment. This is also recommended for smaller banks whose volume of credit risk may be negligible in comparison to larger and sophisticated banks but they too can cater to project financing and loan syndication which can turn smaller banks to systemically important banks.

2. Diversifying credit risk through hedging in credit default swaps along with on balance sheet netting seem to be effective mitigation measures only if the derivatives are rightly hedged and monitored and proper risk weights are assigned to borrowers in the course of netting. If not rightly used these techniques can multiply risk fourfold for credit risk.

3. Lessons learnt from US recession clearly indicate that banks should rely to the minimum on external credit rating agencies for rating borrowers and providing loans. Unless these external credit rating agencies are regulated and audited by SEBI or any authorised regulatory body. It is observed that large banks viz. SBI, HSBC completely rely on external credit rating agencies which can lead to a systemic crisis.

4. Stress testing exercise for credit risk is currently implemented by few banks as observed under research. The researcher strongly recommends stress testing (quarterly or half-yearly) for credit risk as this practise will highlight the areas where borrowers especially large corporate or MSME’s can default on account of highly uncertain business arena. Accordingly banks can mitigate credit risk reflected through regular stress testing either through credit derivates, collaterals or guarantees.

5. Model validation and risk audits are essential features not only to ensure that there is accurate measurement of credit risk along with credit concentration risk but also to upgrade the basic models inorder to make them more risk sensitive. Risk audit will help to evaluate the efficacy of the credit mitigation measures and also highlight the
requirement of any new department, committee or sub – committee within the credit risk management department for a more comprehensive risk assessment framework.

3. PILLAR I – MARKET RISK

Understanding the market risk management practices across banks under study, the researcher provides following recommendations for further enhancement of market risk management practices across banks:

1. Mitigation of market risks across forex, interest rates, commodities, equity through derivatives can multiply the risks and lead to unlimited losses if the bank does not have dedicated department with a well outlined policy with regular monitoring of markets with stop loss limits in place.

2. Banks under study have not shown keen interest to move to higher advanced approach – Internal Models approach under market risk as required by the accord. Internal Models Approach will pose a challenge to the banks to completely shift over to this approach as it requires huge amount of capital, infrastructure as well trained and qualified staff to assess each risk in the market with its retrospective model in place and upgrade the same as per need of the increasing risk appetite of the bank.

3. Market risk audits should be conducted by the top managerial personnel or the directorial board at least yearly to test the efficacy of market risk management practices implemented by the bank and to enhance the same.

4. In terms of VaR, stress testing, back testing, scenario analysis and sensitivity analysis it has been observed that banks under research are well conducting these above techniques and mitigating market risks as required by the RBI guidelines. The banks should keep these as sensitive as possible to reflect the minutest factor posing market risk and take aid of external credit rating agencies to enhance these techniques and increase sensitivity.

5. Banks should work with external credit rating agencies to develop customised models catering to risk profile, risk appetite, interest rates, forex, equity, commodity,
derivatives and other market risk components and migrate to Internals Models Approach for better market risk management.

Market sensitive models/ policies is the need of the hour in the banks under study catering to large amount of market risk and not mere allocation of capital or investments in the capital market which will reduce the risk taking ability of the bank and result in being conservative in terms of market risk despite its inherent potential.

4. PILLAR I – OPERATIONAL RISK
The researcher observes several shortcomings in the operational risk management across banks and thereby provides the following recommendations:

1. Majority of banks have not upgraded or neither are making efforts to allocate capital and provide required infrastructure to scale up to the advanced approaches. Since operational risk is very diverse and it sources from legal, reputational, IT and infrastructure related risks, strategic risks, organisational culture, ethics and fraud related matters which emphasizes the fact that modern day banks glocalising need to upgrade to **Advanced Measurement Approach** and the approach should be sensitive to assess the sources which will pose operational risk in the bank.

2. Since only 13 banks under survey have transferred operational risk to third party through Insurance it yet again shows weak operational risk management. Thus banks should transfer some portion of operational risk arising from infrastructure or IT related to insurance which is a basic mitigating measure.

3. Foreign banks have been observed to be weak in terms of operational risk management. Foreign banks expanding and setting up branches in India face large amount of uncertainty and challenges on account of RBI regulations. Therefore, firstly a dedicated operational risk management policy with special internal committees well acquainted with the RBI regulations is an essential pre requisite in every foreign bank expanding into India. The senior management as well the Board should be involved in the approval of products and services along with regular oversight of architecture for managing operational risk in the bank.
4. Stress testing and estimation of VaR for market risk is widely carried out by banks but it was observed that ICICI bank has adopted the Advanced Measurement Approach and resorts to VaR estimation for operational risk in the bank. This practise should be followed by other banks especially by larger and sophisticated banks and those identified as Systemically Important Banks under Basel III viz. State Bank of India.

5. Audit trails or risk audits should be conducted under the pursuit of operational risk to maintain ethical organisational conduct and minimise fraud and money laundering activities. It will also help to evaluate efficacy of operational risk mitigating measures implemented by the bank.

5. PILLAR II – SUPERVISORY REVIEW PROCESS

The researcher has drawn inferences that the banks under research have developed unique Internal Capital Adequacy Assessment Process (ICAAP) keeping in view their exposure to risks – credit, market, operational and other residual risks to identify, quantify and mitigate the risks. Few banks conduct sensitivity analysis on the capital adequacy ratio to ensure its estimation covers essential risks faced by the bank. While few banks viz. IDBI has also set up a Capital Assessment Model and a Risk Assessment Model for ICAAP. These practices should be widely adopted and implemented across all other banks for an effective and risk-sensitive ICAAP.

It has been observed that reporting under ICAAP is regularly done to RBI almost on a quarterly basis which ensures the banks maintain minimum CRAR thus accepting our first hypothesis. The disclosure also enables RBI or the concerned regulatory authority to take necessary action incase if the banks don’t comply with norms and keep financial stability intact. The researcher recommends RBI or any other concerned regulatory authority to conduct surprise audit checks to scrutinize internal risk management systems as reported by the banks and ensure these systems are upgraded with the expansion of the bank’s structure and operations. Therefore, in this case even the second hypothesis can be accepted that banks would not sick if there is a strong regulatory supervision over ICAAP and not merely maintaining minimum capital in relation to the risk exposure.
6. PILLAR III – MARKET DISCIPLINE

1. Firstly, banks need to categorize their interest rate risk exposure into basis risk, repricing risk, yield risk, risk with embedded optionality etc. Techniques viz. stress testing, estimation of VaR, scenario analysis, sensitivity analysis, gap analysis are widely implemented across banks under study which enables them to assess and monitor risks, but these techniques especially stress testing and VaR estimation needs to be conducted on a regular basis in the banks such as weekly, monthly, quarterly, half yearly depending upon bank’s risk exposure and risk appetite then only it will prove to be effective.

2. Primarily, it is the responsibility of monitoring IRBB has been assigned to the ALCO. If the bank’s risk appetite reflects higher risk from IRBB, a special policy – Interest rate risk management policy can be framed for it along with setting up a sub-department or a committee under the ALCO to manage the IRBB.

3. As for liquidity risk, stress testing, contingency funding plan or a contingency policy along with gap analysis, study of liquidity ratios, sensitivity statements etc have proven to be full proof for mitigating the liquidity risk. Banks should widely adopt liquidity contingency funding plan as an effective liquidity risk mitigation measure.

4. ALCO monitors liquidity risk in the banks along with IRBB. Some banks as observed have formulated special policy for liquidity risk which should be widely implemented across all banks. Banks should also set up Investment and Funds Committee to invest surplus funds into marketable securities and manage liquidity risk.

5. It has been observed that very few banks under study have actually identified any other risks under Pillar III. Internal Risk Management Department of each bank should closely observe the market for any strategic, reputational, compliance, legal, forex, equity, commodity risks which can certainly impact the financial position of the bank. An individual committee can be formed to manage these risks and apply measures to minimise risks and maximise the profits.

6. Residual risks such as mortgage risks, equity risks, commodity risks, issuer credit risks have been observed to mitigate using hedging against derivatives. These hedging practices can further multiply risks on account of market fluctuations and uncertainty as seen in the US recession mortgage backed securities and collateralised debt obligation with the triggers in the collapse of major financial institutions. Thereby
banks should rely on collaterals for minimising issuer credit risk and mortgage risks and fix stop loss limits for hedging and speculating to limit losses if any.

The researcher has observed that the banks under study have developed a risk identification mechanism under Pillar III to identify residual risks viz. liquidity risk, interest rate risk, foreign exchange risk, reputational risk etc. which can definitely prove to be an important measure in protecting banks against a crunch or even a major collapse as the regulatory authorities don’t require banks to hold capital against Pillar III risks. Thus in this case the second hypothesis would be rejected as the banks may comply with the norms and maintain capital but the underlying risk of failure will still overpower them as even these pillar III risks can prove to be extremely threatening to the survival on account of changes in economic cycles or any exceptional situation in the economy locally or globally.

The researcher recommends that the Basel norms should include a portion of the reserved capital towards exposure of the pillar III risks of the banks to ensure and maintain financial stability. Though under Basel III Net Stable Funding Ratio (NSFR) and Liquidity Coverage Ratio (LCR) have been introduced as a part of the regulatory capital solely for liquidity risk, the other risks also need to accounted for because if they pose a high risk for the banks and its existence in the market.

7. ASSET LIABILITY MANAGEMENT

Asset – Liability Management being the core of the bank structure requires efficacy in channelizing fund flow throughout the organisation. The research indicates that the banks under study have well developed ALM systems in terms of analysing financial statements and essentially managing advances and deposits. The Basel norms do not clearly lay down norms for structuring ALM systems in banks, but surely modern day banks have realised that the need to identify the existing risks as well as the risks under the wraps which would emerge in the near future and affect the financial stability of these banks. The overall health of the economy is equally responsible to worsening of the asset quality of banks. The ALCO should keep a close watch of the GDP movements, industrial growth, stock prices and inflation indices to adopt prudent provisioning, orderly sell and restructuring in case of those assets which can possibly show signs of non-performance in the long run.

The second hypothesis of the research would be rejected as banks despite following the norms can turn sick if they don’t read between the guidelines and formulate forensic approaches for the above which will certainly threaten their survival and profitability.
8. CORPORATE GOVERNANCE

Efficacy of corporate governance is most essential feature to ensure that these international norms are adhered to. RBI has laid down a well defined architecture for corporate governance internally as well as externally through auditing and public disclosure which has enabled an effective supervisory overview. The research indicates that maintaining minimum capital is not the only premise which ensures financial stability of the banks but ensuring an effective surveillance mechanism through the regulatory authorities which has been achieved to a large extent in India by RBI. Thus in this case the second hypothesis will be rejected that despite following the norms banks can turn sick on account of lack of effective corporate governance mechanism.

9. SUMMARY

“A Resilient Performance through Challenging Times” is the statement of the Chairman & Managing Director – Shri S S Mundra, Bank of Baroda who has clearly outlined that despite massive slowdown in industrial growth, impact of current account deficit, rising inflation, poor global demand, regulatory and environmental bottlenecks and sluggish investment activity their bank is well capitalised and has been able to maintain regulatory requirements under Basel. Bank of Baroda has yet again faced a year where deposits have grown at a rate slower than their credits with a return on assets ratio of only 0.9% and gross profits approximating to 27% for the financial year 2013-2014. The study reveals the banks under research have maintained required legal capital as well as followed the approaches of maintaining capital for each type of risk faced by the bank inspite of low profitability and deficiency of capital. The multiplier effect of all this capital lying unproductive is certainly impacting developing nations like India, where in addition to RBI regulations, the international guidelines are to be followed on a more conservative front and it is to be implemented across all scheduled commercial banks operating in India irrespective of their size, expansion strategy, customer base, nature of operations, deposits etc.

Banks firstly have to keep capital to meet regulatory norms along with statutory reserves of RBI and then invest further capital to set up models, internal ratings, scorecards, internal risk management departments, regular upgradation of IT and infrastructure, risk audits, regular training and development of employees etc. If Banks have to focus on building strong internal risk mitigating measures and techniques and spend crores of rupees for such factors
then what is the requirement of CRAR? As risk and capital are directly proportional as per the norms banks have to allocate higher amounts of capital during crisis, at a time when the market itself is deficient of funds and neither the Government nor the Qualified Institutional Buyers (QIBs), Mutual Funds, Broking Houses and retail investors would be willing or able to invest and enable banks to strengthen their core or subordinate capitals.

Majorly, keeping capital aside as contingency capital or capital in proportion to risk weighted assets have turned banks unprofitable and several cases have proven this right including the most recent case of Royal Bank of Scotland exiting Indian markets. Earlier, Royal Bank of Scotland had acquired ABN AMRO bank which too exited Indian market on being unprofitable.

Moving ahead to implication of Basel III norms a new segment of Tier III capital gets added in the core and supplementary capital including Net Stable Funding Ratio and Liquidity Coverage Ratio specifically defined for liquidity risk which was ignored under Basel II and several researchers highlighted that liquidity risk could emerge significant in leading a bank to a financial meltdown. Thus, more and more capital has to be churned into reserves and ratios putting immense pressure on the banking sector to maintain these ratios as well mobilise higher amount of savings to provide loans, expand businesses, conduct research and development of new financial products and further market these financial products, effective customer relationship management, recruit qualified personnel for regular operations of the bank as well as for risk management etc.

Thus the researcher points out that the Basel guidelines should focus on maintaining minimum capital in proportion to principle risks identified by banks which will enable banks to survive turbulent times. Regulatory authorities should not be conservative and force banks to maintain higher levels of capital in proportion to the risks unless the economic environment of the country demands it. The major focus of BIS should be on introducing techniques, models and approaches to assess and minimise these risks according to banks nature and complexity of banks operations, size and structure, existence in overseas markets. This can be brought up by BIS in consultation with regulatory bodies across the world as nature of business environment differs internationally and implementing standard norms and approaches make it more challenging for banks.

The key element of research as well as of the accord is the Internal Capital Adequacy Assessment Process (ICAAP) which can be divided into the following components:
1. **A valid capital analysis:** this analytical framework establishes a correlation between the risks the financial institution is exposed to and the required capital in proportion to these risks.

2. **Comprehensive risk analysis:** this framework identifies measures and quantifies the varied risks the bank is exposed to.

3. **Supervisory overview** by the Directorial Board and the senior managerial personnel.

4. **Monitoring and reporting:** a framework of regular reporting under supervision for the risk appetite and the capital position.

5. **Internal audit mechanism:** under the internal control system an independent review would be carried out.

The internal supervisory review process focuses mainly on the adequacy of the internal procedures, systems, methodologies for reviewing and assessing capital and its related risks. The quantum of capital can never serve to be an effective substitute for prudential norms therefore efficacy of the internal supervisory and control systems is an essential pre-requisite.

The ten principles laid down by the accord which serves as a guiding factor for banks to set their ICAAP in place for effective capital and risk assessment. These principles are explained as follows:

- **Principle 1 - Every institution must have a well defined methodology for assessment of capital adequacy and its related risks:** banks must establish adequate capital assessment procedures as well as measurement and quantification of risks. These procedures should include strategies and processes aiming to attain a capital base in order to sustain in relation to the business activities and risks. Examination of this principle should be done at the level of the bank as well as at the consolidated level of the financial institutions.
• **Principle 2 – ICAAP is the sole responsibility of the bank.**

Every institution is responsible for defining their objectives, setting their strategies, identifying risks and thereby setting an ICAAP consistent with the internal risk profile as well as the business environment.

The ICAAP should be customised according to the bank’s internal processes, needs, scenarios, resources etc. The ultimate responsibility of the ICAAP is of the institution itself despite outsourcing in relation to its specific risk position and internal control systems.

• **Principle 3 – specification of the ICAAP policy design is a must along with documentation of the bank’s capital policy with the allocation of the sole responsibility of the ICAAP to the Directorial Board and the top managerial personnel.**

The dual responsibility of the ICAAP both supervisory as well as managerial rests with the senior management. The supervisory function involves designing the ICAAP in line with the corporate objectives, scope and the methodology. The details of the technical concepts in the ICAAP too are the responsibility of the top management. The top management has to ensure the integration of the ICAAP into the systems and the processes of the institution. The ICAAP should be in total agreement with the bank’s overall framework for managing risk and culture. The outcomes of the ICAAP should be reported to regularly to the top management and if need arises revisions should be made in the ICAAP design by the senior management to suit the changing business environments and needs of the institution.

• **Principle 4 – The management culture as well as the decision making process of the institution should strongly integrate ICAAP into these systems.**

Continuous assessment of the ICAAP in relation to the material risks and activities of the organisation should be carried out at regular intervals and its feedback should be given to the designing authority. Allocation of capital to business lines, for expansion plans and for individual credit decision making process should be considered while designing the ICAAP. ICAAP is essential in small organisations too where it is integrated in the decision making process both for business and banking operations.
• **Principle 5 – an annual review of ICAAP is required in order to assess the appropriateness of the policy in line with business operations and systems.**

Any deviation observed can be immediately taken care of by fixing the gaps and keeping it in place with the objectives and internal processes of the systems. Annual review should also check whether all the risks posed to business are adequately covered and quantified under the ICAAP. The procedure for review should be subjected to independent internal and external review to ensure efficacy in the ICAAP policy. Any changes in the corporate objectives, methodologies, processes, needs, scenarios, strategies of the business having an impact on the ICAAP of the business should be incorporated in the policy retrospectively.

• **Principle 6 – ICAAP should be completely based on risks.**

The adequacy of the institution’s capital is a function of its risk profile. Targets for capital adequacy should be defined keeping in view with the exposure of risk and the internal business environment of the bank. Quantum of capital to be held, external ratings, market reputation, strategic goals should be considered in the policy. The institution should clearly define the different risks for which quantitative measurement is required and for those qualitative measurement is required, emphasis should also laid for risk management and use of risk mitigation tools. Unsophisticated banks who apply simpler and basic techniques for assessment of risks under Pillar I are also required to base their capital requirements and governance and supervisory overview over the ICAAP policy.

• **Principle 7 – ICAAP should be comprehensive.**

No standard categorisation of risks and definition of the concept of materiality the ICAAP should still capture all the possible risks the business is exposed to. Every institution can define their own terminology customised for their ICAAP framework along with the differences in the terminology and the techniques used for the capital calculation. The ICAAP framework cannot be partial or biased to include only certain risks while ignore the others for instance – ICAAP identifies operational risk thereby it should also define the source from operational originates as well as the technique or methodology for assessing and measuring the operation risk in business. ICAAP
should be comprehensive covering risks under Pillar I – credit, market and operational as well as Pillar III – interest rate risk in the banking book, liquidity risk, reputational risk etc.

**Principle 8 – ICAAP should be progressive and forward looking.**
Analysis of macroeconomic factors is required and its relation to the strategic objectives of the business for the formulation of the ICAAP design. Bank should develop an internal strategy for capital adequacy which can include factors viz. expected increase of borrowings, potential source of future capital increase, dividend policy and procyclical effects which can impact the assessment of risks under Pillar I. Bank should have an approved capital plan which clearly outlines the objectives of the institution and the stipulated time frame to achieve these objectives as well as the authority to achieve these objectives should be defined in the plan. This explicit plan should also include strategies for immediate action such as requirement of additional capital, use of risk mitigation techniques, redefining business strategies and objectives etc.

**Principle 9 – ICAAP should be based on adequate measurement and assessment process.**
Though there is no standard procedure for setting the ICAAP in place in any institution but it should totally depend upon the proportionality of business and risks. The institutions are not required to use and apply economic capital models in business but the supervisory authorities require banks to use sophisticated risk management models and techniques. Quantification of certain risk factors may be difficult therefore estimates can be accepted in such cases. Any risk factor difficult to estimate should not be excluded from the computation of capital adequacy requirement of business. Combination of qualitative as well as quantitative techniques should be used for the assessment of risks in relation with varied risks models and techniques.

**Principle 10 – ICAAP should produce a reasonable outcome.**
ICAAP should produce a reasonable outcome and hold true all assumptions made in the course of risk management. It is important that all the assumptions on which the ICAAP is based should be reasonable, sound and realistic. All similarities and
differences arising in the course of applying ICAAP to risk management should cover all material risks and regulatory capital requirement under Pillar I and II. In case any significant differences are detected in the due course of the imposition of the supervisory regulations and the capital estimations of the institution due justification should be given for it and accordingly the gap should be filled. In case if any model or technique fails to measure and completely identify a certain risk factor immediate measure needs to be taken for solving the problem.

Therefore the above principles clearly highlight the need and importance of the ICAAP in the risk management culture and internal business operation of any banking company. Drawbacks in the ICAAP design will significantly lead to failure of the entire risk management framework and architecture in the institution. This failure if not detected in the regular review by the Directorial Board and the top managerial personnel it will lead to collapse of the banking institution and render the entire Basel accord worthless. Such ICAAP failures in several systemically important banks in an economy can trigger a systemic crisis or large collapse of the financial backbone in any country. ICAAP is the core of the Basel concordat drawing attention to sophisticated and comprehensive internal models, ratings, techniques, mechanisms for qualitative and quantitative assessment of risks posed to the business. ICAAP should focus on CRAR and maintaining adequate capital in proportion to risks and inclusion of CRAR with the quarterly assessment under its framework. Unfortunately, the entire focus is only on keeping adequate capital under the CRAR ratio and framing effective techniques, models and mechanisms is largely ignored. This negligence is due to over emphasis on capital adequacy ratio and its public disclosure as well as of huge requirement of finance to set and define these processes in line with ICAAP. The revised guidelines should focus on the above difficulties and hurdles in fully imbibing the Basel guidelines in the regulatory culture of the banking company or it will just prove to be an additional burden on the banks rather proving effective to prevent any further systemic crisis or global meltdown.

10. Limitations of the study

1. The primary research data is collected by various modes (E-mail, telephonic conversation and face-face) and hence the responses are subject to the clarity, time availability and the seriousness shown by the respondents.
2. There is a possibility that the primary research conducted could include biased opinion of the respondents.

3. The secondary data collected from various sources can become outdated by the time the researcher completes the entire study on account of dynamic business environment in which banks operate today.

4. The study is primarily limited to the banks operating in Mumbai covering a broad spectrum of representative samples across the banking sector. The researcher has also taken efforts to collect data from few respondents particularly market participants in the metro cities – Delhi, Bengaluru and Pune in order to provide a more comprehensive outlook to the project.

11. Scope for further research

Certain countries world over have identified Islamic Banking as crisis resistant banking. Middle east countries, south east Asia (primarily Malaysia and Indonesia), Africa and Europe have adopted Islamic Banking over conventional banking. The rate of growth of Islamic Banking in these countries around 15-20% and have found it to lead to financially stable economies. Therefore, leaving the forum open for future researchers to diverge into Islamic Banking or Basel III norms and establish their relationship with financial stability.