Mr Talwar considers emerging trends in supervision in India

Speech by Mr S P Talwar, a Deputy Governor of the Reserve Bank of India, at the meeting of SAARC Supervisors in Pune (India) on 27-30/1/99.

At the outset, on behalf of the Governor of the Reserve Bank of India and Government of India, I extend a hearty welcome to all the Central Bankers of the SAARC Region on their visit to India and particularly to the Reserve Bank's College of Agricultural Banking. I also feel honoured for the privilege bestowed on me to inaugurate the Meeting of the Bank Supervisors to discuss 'Emerging Trends in Supervision' today.

It is in fitness of things that the Meeting is being held in this city, which is known as the 'City of learning' in and around which great Indian philosophers and educationalists held sway for centuries. The scenic surroundings of the College of Agricultural Banking and salubrious climate of Pune, I am sure, will provide the necessary ambience for sharing the inherent supervisory skills and learning about each other's country experiences.

The theme of discussions of such inter central bank meets used to centre around core economic or monetary policy issues. However, in the context of the South East Asian financial crisis and its contagion effect on the financial system of some of the even well established global economies, regulation and supervision of financial vehicles has emerged as the foremost topic of concerns in any international conference. Central banks around the world have also started working towards strengthening prudential norms and enforcing transparency in financial reporting by financial institutions to avert any future international financial crisis.

The regulatory and supervisory frameworks for banks and other institutions in India have also undergone significant changes, keeping pace with the reforms introduced in the financial sector. The details of these changes will be presented in greater detail by my colleagues from the RBI in the coming sessions. I would like to highlight some of the more important ones to serve as a backdrop for the fruitful discussions that are slated to follow this inaugural session.

Prudential Norms

The focus of the statutory regulation of commercial banks in India until the early 1990s was mainly on licensing, administration of minimum capital requirements, pricing of services including administration of interest rates on deposits as well as credit, reserves and liquid asset requirements. In these circumstances, the supervision had to focus essentially on solvency issues.

After the evolution of the BIS prudential norms in 1988, the RBI took a series of measures to realign its supervisory and regulatory standards almost on a par with international best practices. At the same time, it also took care to keep in view the socio-economic conditions of the country, the business practices, payment systems prevalent in the country and the predominantly agrarian nature of the economy, and ensured that the prudential norms were applied over the period and across different segments of the financial sector in a phased manner. The Indian banking system is at present subjected to the following prudential norms:

Exposure Norms

- Exposure to a single borrower should not exceed 25% of the bank's capital funds (i.e. paid up capital and free reserves).

- Group exposure should not exceed 50% of the capital funds of the bank. An additional 10% is allowed in respect of exposure to infrastructure projects (power, telecom, roads & ports).

Connected Lending

- Section 20 of the Banking Regulation Act prohibits loans to directors or to any firm or company in which directors hold an interest.

- The banks should maintain an arms-length relationship in respect of own subsidiaries or joint ventures; all loans to such companies have to be made at commercial rates and are subject to limits which apply to similar companies.

- There is an aggregate ceiling fixed for loans related to owned funds of the subsidiary.

Capital Adequacy Norms

- Under the risk-weighted asset approach for the purpose of capital adequacy standards, the minimum CRAR has been prescribed at 8% and will be further raised, to 9% (which is already applicable to banks permitted to trade in gold), with effect from 31 March 2000.

Income Recognition Norms

- Under the Income Recognition Norms, income from non-performing assets cannot be taken as part of the profits of banks unless the income has been realised.

Asset Classification Standards

- The definition of 'past due' for a period of any two quarters in a financial year in respect of interest or instalment of principal under a credit facility has been adopted as part of the Asset Classification Norms to identify NPAs.

- Based on the status of an asset as an NPA, it is required to be classified as standard, substandard, doubtful and loss assets and appropriate provisions made.

- Banks are required to make a general provision of 10% of the total outstanding under substandard assets.

- A doubtful asset has been defined as one which has remained as an NPA for a period exceeding 2 years and provisions are required at 100% of the unsecured portion and 20 to 50% in respect of the secured portion over a period of 3 years. The period for reckoning an NPA as doubtful will be further shortened, to 18 months, by 31 March 2001.

- Banks are required to write off the entire loss assets or make 100% provision therefor.

- Banks are required to create provisions on government guaranteed NPAs from 1 April 2000.

- A general provision of 0.25% on standard assets has to be made for the year ending 31 March 2000.

Marking Investments to Market

- Banks are required to bifurcate their investments in approved securities (govt. or govt. guaranteed securities and bonds) into "permanent" and "current" investments. The ratio of permanent investment to total investment has been reduced from a high of 70% in 1992-93 to 30% in 1998-99 and the intention to mark 100% of bank's investments to market (as current investments) over the next 3 years has already been announced. While appreciation in the value of securities is ignored, depreciation has to be fully provided for.

The aforesaid prudential standards compare favourably with some of the international best practices already in vogue in developed economies.

New Supervisory Initiatives

The entire supervisory mechanism has been realigned since 1994 under the directions of a newly constituted Board for Financial Supervision (BFS), which functions under the aegis of the RBI, to suit the demanding needs of a strong and stable financial system. The supervisory jurisdiction of the BFS now extends to the entire financial system barring the capital market institutions and the insurance sector.

The periodical on-site inspections, and also the targeted appraisals by the Reserve Bank, are now supplemented by off-site surveillance which particularly focuses on the risk profile of the supervised institution. A process of rating of banks on the basis of CAMELS in respect of Indian banks and CACS (Capital, Asset Quality, Compliance and Systems & Control) in respect of foreign banks has been put in place from this year.

The Off-site Monitoring and Surveillance System (OSMOS) was introduced in 1995 as an additional tool for supervision of commercial banks to supplement the on-site examinations. The system consists of 12 returns (called DSB returns) focussing on supervisory concerns such as capital adequacy, asset quality, large credits and concentrations, connected lending, earnings and risk exposures (viz. currency, liquidity and interest rate risks). As part of the first tranche, 7 returns have so far been operationalised and the second tranche of returns on risk management aspects and consolidated supervision is expected to be introduced by next year.

The supervisory intervention by the RBI is normally triggered by the deterioration in the level of capital adequacy, NPAs, credit concentration, lower earnings, and larger incidence of frauds which reflect the quality of control.

Internal Control Systems

Like the central banks in developed supervisory regimes, the RBI also has started placing an increasing reliance on professional accountants in the assessment of internal control systems of the banks and non-bank financial institutions. Over the period, the responsibilities of auditors have been delineated not only to make the audit more detailed but also to make them accountable. The methodology and processes used to generate available data as certified by the audit profession would improve the reliability of financial statements as regards their conformity with national accounting and disclosure standards.

Another area of crucial importance is the strengthening of internal control systems in banks. The Reserve Bank has, over the years, emphasised the need for having an effective internal control system in banks. Banks have also been advised to introduce the system of concurrent audit in major and specialized branches. As a result, all commercial banks have introduced concurrent audit since 1993 by using external auditors as a major resource. The banks are now required to set up audit committees to follow up on the reports of the statutory auditors and inspection by the RBI. Similarly, immediate action is warranted on reconciliation of inter branch accounts which, if left unreconciled, are fraught with grave risks. Substantial progress has been made by banks in reconciliation of the outstanding entries, and the BFS reviews progress in this area at quarterly intervals.

Operational Strength of the Indian Banking System

It is now commonly acknowledged that the Indian banking sector has, as a result of the ongoing reforms, emerged strong and resilient. The public sector banks which suffered losses of Rs.3,293 crore in 1992-93 and Rs.4,349 crore in 1993-94, i.e. in the initial years of introduction of prudential norms, have ended the year 1997-98 with a net profit of Rs.5027 crore. Net NPAs of public sector banks formed 8.2% of the net advances and 3.3% of the total assets as at the end of March 1998.

Evolution of the Risk Management System

Financial institutions carry a wide range of risks, including credit, interest rate, foreign exchange, liquidity, operational and reputational risks. These risks are highly interdependent and events (whether expected or unanticipated) that affect one area of risk can have ramifications on other risk categories. In the context of deregulation of interest rates in India, market risk has now emerged as an area requiring immediate attention on the asset side of the balance sheet. In recognition of this, the RBI has issued to the banks draft guidelines (with the final guidelines becoming operational from 1 April 1999) for a broad framework for asset-liability management, taking into account the variance in the business profile of banks in the public sector and private sector as well as the data/information base available to banks in India.

Transparency and Disclosure Standards

Another area where the RBI has moved ahead is to impart greater transparency to the balance sheets of banks. This was a logical step after the adoption of prudential norms, with the banks in India coming under greater international scrutiny. During the last couple of years, the range and extent of disclosures has been gradually increasing so as to provide a clearer picture to informed readers of balance sheets. The banks are now required to disclose the break-up of the provisions made towards NPAs, depreciation of investments and other purposes besides, the capital adequacy ratio and the level of net non-performing assets.

With effect from 1997-98, banks are required to disclose accounting ratios relating to income heads like operating profit, return on assets, business per employee and profit per employee. From the year ending 31 March 2000, the following information, among others, should also be disclosed by the banks operating in India in the published accounts:

- Maturity pattern of loans and advances, investment securities, deposits & borrowings,
- Foreign currency assets and liabilities,
- Movements in NPAs & provisions,
- Lending to sensitive sectors as defined by the RBI from time to time.

The primary objective of any supervisory regime has to be prudential, viz., to protect the safety and soundness of domestic banking systems. Its application can at the same time provide an incentive for other countries to improve the quality of their prudential supervision. If banks want to operate in other markets where these core principles are strictly applied, they will have to convince the authorities in the host countries that the quality of supervision in their home country is adequate. This can create powerful new incentives for improvements in supervision. Recently, I had the privilege of associating myself with the Willard Group of the Bank for International Settlements (BIS) constituted by G 10 countries to look into these aspects. The Group has come out with recommendations which call for close coordination amongst central banks and governments of the world, as well as the international financial institutions like the IMF and World Bank, in promoting stability, accountability and transparency in the financial systems.

Adoption of Core Principles and Uniform Accounting Standards

The Core Principles for Effective Banking Supervision (1997) evolved by the Basle Committee on Banking Supervision (BCBS) have been accepted for adoption by the RBI. The Core Principles seek to promote and enhance the standards of supervision. Incidentally, I may add that the International Accounting Standards Committee (IASC) is also working closely with the BCBS on reducing differences in supervisory approaches to loan valuation and credit loss provisioning. In many areas of banking supervision and securities regulation, international consensus has been reached and principles or standards have been established. In other areas there still is a need to define best practices and develop standards. The lack of international consensus on sound practices for loan valuation, loan-loss provisioning and credit risk disclosure seriously impairs the ability of market analysts as well as regulators to understand and assess the risk inherent in a financial institution’s activities.

Supervision of Non Bank Financial Institutions

I would like to specifically mention the far-reaching supervisory initiatives on the part of the RBI which has now brought all Indian development finance institutions and non banking financial companies under an intensive supervisory framework through both on-site inspection and off-site monitoring procedures.

Development Finance Institutions

The RBI set up an exclusive Supervisory Division in August 1990 for monitoring the operations of select all Indian development financial institutions (FIs). Currently, 12 such FIs are being monitored. Of them, the term lending and refinance institutions, viz. Industrial Development Bank of India (IDBI), Industrial Credit & Investment Corporation of India Ltd. (ICICI), Industrial Finance Corporation of India Ltd. (IFCI), Industrial Investment Bank of India Ltd. (IIBI), EXIM Bank, Tourism Finance Corporation of India Ltd. (TFCI), National Bank for Agriculture and Rural Development (NABARD), National Housing Bank (NHB) and Small Industries Development Bank of India (SIDBI) are also subject to the on-site supervision process of the RBI.

Prudential norms relating to income recognition, asset classification, provisioning and capital adequacy have also been prescribed, for IDBI, ICICI, IIBI and EXIM Bank in March 1994 and for SIDBI , NABARD and NHB in March 1996.

Supervision of NBFCs

The RBI has been regulating the NBFCs, which numbered around 40000 companies, for over 3 decades since 1963. The regulatory role up to 1997 was confined to deposit acceptance activities of NBFCs and did not cover the asset quality and liquidity mismatch aspects.

In the context of the increasing functional diversity and expanding intermediation role of this sector, the RBI, through enabling legislation to its regulatory powers, has taken a series of steps for compulsory registration and liquidation of recalcitrant and defaulting companies in repayment of public deposits. An entry norm of minimum net owned funds of Rs.25 lakhs was prescribed for the purpose of registration.

A registration process to cover as many as 7689 companies was initiated in July 1997 and was completed by December 1998. Simultaneously, prudential guidelines have been put in place to govern the various aspects of their functioning besides bringing them under more intensive on-site supervision based on the CAMELS pattern. More detailed presentation on some of the innovative supervisory practices and extensive use of technology for data compilation and analysis is slated to follow during the last session of this Meeting.

Millennium (Year 2000) Issues

I would like draw your attention to one of the current IT related issues, viz. the Y2K problem, which is pursued by the RBI more as a business continuity risk than a technology problem. The initiation of supervisory measures by the RBI is in synchronisation with the standards set by the BIS. The RBI has an enlarged role of monitoring and enforcing compliance by the entire financial sector and co-ordinates its efforts with the National Level Task Force set up by the Prime Minister of India.

Major policy initiatives taken in this regard focus on promoting increased awareness, establishing targets and benchmarks for industry, industry-wide status assessment and maintaining pro-active supervisory pressures. The RBI issued circulars in September 1997 to commercial banks explaining the Y2K problems and possible solutions. Targetted on-site appraisals have been commissioned by the RBI to verify the compliance efforts on the part of banks.

A target date of 31 December 1998 was fixed for ensuring Y2K compliance and banks may be subject to penal measures in case of persisting non-compliance beyond March 1999. Institutions have also been advised to put in place appropriate contingency plans to take care of possible system failures. A high-powered Working Group in the RBI, under the chairmanship of the Deputy Governor and with representatives drawn also from the banking industry, reviews the progress made in compliance at regular intervals.

As you would have observed from the foregoing, the Indian supervisory system has already made much headway in realigning itself to the emerging needs, particularly addressing the risks inherent in the liberalisation and globalisation of the Indian economy after the advent of financial sector reforms. The prudential norms adopted by Indian banks in the area of marking the investments to market conform to the international standards. The disclosure norms already prescribed for Indian banks as part of accounting standards do conform to the global best practices besides ensuring transparency in published accounts. The only area where the BIS standards are yet to be implemented in full are those relating to asset classification, particularly in respect of re-defining NPAs as those past due for a quarter (instead of 2 quarters as at present) and the reduction in the period for classifying such accounts as doubtful from 24 months to 12 months. We are however making earnest efforts in this direction to make our banking system more transparent and vibrant.

The banking system had acquired, at the time of introduction of prudential norms for the first time in 1992-93, a large quantum of non-performing credit which can be termed as legacy NPAs. It is worth mentioning that the incremental NPAs in subsequent years have been at much lower levels. The level of NPAs in the Indian banking sector is being commented upon as an alarming one by various international and domestic analysts/groups. At the same time, these agencies have rather chosen to ignore the high level of NPAs which have totally eroded the banking systems in the East Asian countries, with many banking institutions folding up as a consequence. In this background, it has to be mentioned that the NPAs of the Indian banking system have already been provided for more than 50 per cent, which is often ignored by the international agencies when evaluating the NPA status of the Indian system. Further, Indian banks secure their loans to a very large extent by collateral. The banks in India do not normally prefer to write off loans covered by collateral during the pendency of cases in law courts. Looking into the delays in realisation of collateral, it is of paramount need to focus our attention on expediting legal reforms recommended by the Committee on Banking Sector Reforms (Narasimham Committee II). The banks also have to activate the procedures of compromise settlements and their recovery machinery towards faster recovery.

Another factor which contributed to the build-up of NPAs in the past was the lack of focussed attention on the end use of funds by the borrowers. The borrowers in many instances went for projects and purposes other than those included or prioritised in the original schemes sanctioned by the banks. To avoid such a situation, the banks have already started paying a lot of attention to the end use of credit. The RBI expects the banks to set up an efficient and appropriate loan review mechanism for this purpose.

As you would have observed from the foregoing, we have covered a lot of ground in strengthening our prudential regulation and supervision system for the financial system over the last few years. I can proudly claim that the efforts of the central bank in this direction have helped in sustaining the health of the Indian banking system, enabling it to withstand the contagion effect of the East Asian syndrome.

There is a lot of pressure to reduce the asset classification norm to one quarter in respect of past due loans and a lot of discussions have taken place in this regard at various international fora. However, we have taken a view that the international practices should not be merely mimicked but should be carefully evaluated and applied to a country's specific situation, keeping in view the support systems. In countries like India and even in some well developed countries, the trade and commerce cycle combined with payment and settlement systems extends beyond a quarter. Unless the underlying commercial and payment systems move towards faster settlement of trade transactions, we do not see any immediate compulsion to shift to a norm for asset classification of one quarter in respect of past dues.

I should stress at this point that it is easy to introduce stricter norms but it requires lot of discipline to resist leeways sought by banks at the implementation stage. We are not in favour of such leniencies. We strongly believe that once the norms are laid by the central bank, they should be complied with in letter and spirit by the constituent institutions. Though it has taken some time for us to introduce the prudential norms, I am sure that the banks in India follow these norms as a gospel.

I would like to conclude with a request to the participating financial supervisors to focus their deliberations and try to arrive at possible ways of addressing emerging areas of supervisory concern which are not just regional but universal, owing to the interdependency of financial systems across the globe. I shall particularly like the supervisors' discussions to centre around the assessment of supervised institutions' capabilities in the management of NPAs, installing appropriate business and operational risk management systems, enhancing transparency in disclosure standards and earnestness in the introduction of an effective internal control mechanism.

I would like to record my appreciation for the excellent arrangements made by the College of Agricultural Banking and untiring efforts on the part of its Principal, Mr S K Newlay, and his colleagues in hosting the Meeting. I am sure that no efforts will be spared by the team in looking after the comforts of the visiting dignitaries from other central banks during their stay.

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