UNCOMPLICATE

Be it a seasoned banking whiz or a business head at any bank large or small, the pressure to get to grips with the changing times is growing at an ever-increasing pace. To begin with, the challenges posed by multiple delivery channels, disintermediation, dynamic business models, compliance with global and local regulatory changes, among others, are having profound implications on banks today.

At Tata Consultancy Services, we believe that the need of the hour is to Uncomplicate.

To cut through these perplexing and all-encompassing demands with a time-tested, market-ready and move-as-you-grow solution, TCS BaNCSat any time and any place. With the right mix of interactive, intuitive and instantaneous technologies that deliver flexibility, agility and greater operational control, this universal financial services platform can help your bank drive customer growth, reduce Total Cost of Ownership and enhance new product development all together. How can we make such a promise? Some of our success stories will tell you how.

TCS BaNCS enabled a leading bank in India with a network of over 18,400 branches, 25,000 ATMs and over 261 million customer accounts, with a unified technology platform to create one of the largest homogeneous banking networks in the world. On the other hand, TCS BaNCS re-engineered a Taiwanese Bank with a network of 101 branches to run 24x7 with 99.9% up-time, bringing down its Total Cost of Ownership by a staggering 58%. TCS BaNCS has scored leadership consistently in industry analyst reports.

Now, don't you think it is time to uncomplicate?
INTRODUCTION

The subprime crisis brought in its wake the kind of financial crisis not seen since the Great Depression. Like a merciless hurricane it brought down many a hallowed institution once considered invincible – institutions like Lehman Brothers, Bear Stearns and Northern Rock – devastating economies and causing human suffering. More than anything else, it exposed the weaknesses in supervision. Supervisors had not anticipated the deadly risks associated with subprime assets and banks’ exposure to them in various forms. By the time realisation sank in, most of Europe had been swept by the contagion.

The Great Financial Crisis left the Indian financial system largely unaffected due to its relatively lower level of sophistication, lesser integration with overseas financial markets and tighter regulation and supervision. The Reserve Bank of India (RBI) has come in for accolades on its regulation and supervision, for leaning against the wind to stem growth in sensitive sectors like real estate, among other steps. However, while these were reassuring circumstances in the past, the same cannot hold good for all time. Financial markets the world over are like rivers – ever changing and ever flowing where nothing can remain constant. With the blurring of market boundaries no country can remain smug and unaffected by events in other countries. No country is entire in itself and its fortunes are intertwined with those of the rest of the world and the death knell of institutions elsewhere should strike concerns in other countries, for the bell tolls for them too. Regulators and supervisors in countries affected by the crisis have done some soul searching in the aftermath of the crisis, on the systemic weakness and are working on changes in institutional structure, policies and processes to ensure that such crises do not recur. Supervisors, India included, can learn valuable lessons on strengthening their own supervisory philosophy, strategy and systems.

SUPERVISION OF THE INDIAN BANKING SYSTEM

The RBI is responsible for supervision of banks under its statutory powers under the Banking Regulation Act 1949 and the RBI Act 1934, State Bank of India Act 1955, State Bank of India (Subsidiary Banks ’Act 1959 and the Banking Companies (Acquisition and Transfer of Undertakings ) Acts of 1970 and 1980. As supervisor, its methodology of supervision has been through a combination of onsite Annual Financial Inspection (AFI) and offsite monitoring from data submitted by banks through prescribed returns. The AFIs assess the banks’ financial position, its ability to pay its present or future depositors and compliance with licensing conditions besides statutory and regulatory guidelines. The assessments are on parameters of CAMELS (Capital Adequacy, Asset Quality, Management, Earnings, Capital Adequacy, Liquidity and Systems and Controls) and for foreign banks on CALCS (Capital Adequacy, Asset Quality, Liquidity, Compliance and Systems and Controls). The methodology of the AFI involves detailed examination of the bank’s books, assessment based on these findings, offsite data/ other information. It relies on detailed transaction testing and is more compliance oriented. Besides, AFIs have been, till recently, non-discriminatory in their approach, with every bank being taken up for inspection annually irrespective of its risk profile. Based on the findings, banks are rated on a ten point scale from A+ to D in ascending order. A Monitorable Action Plan may be drawn up by the supervisor to address key concerns thrown up by the AFI which has to be complied with by banks within a specified time frame.

The system has served the Indian financial system well so far. Yet there can be no room for being smug. One of the lessons of the financial crisis has been that institutions which
failed were apparently well capitalized as per reported data and had been assessed as well capitalized and liquid by supervisors. This indicates that there were inadequate assessments of risks both present and emerging by both the supervisor and supervised, which led to weaknesses and under capitalisation. There is therefore the need for supervisors to have a more realistic assessment of risks that banks can run and a willingness to act and take swift action when dangers loom. The need is therefore to move from a transaction based broad brush, compliance-oriented approach, towards a more risk-based approach to banking supervision with the authority and willingness to take decisive enforceable action on its outcomes.

The Basel Committee on Banking Supervision defines Risk-based Supervision as a ‘forward looking’ approach where the supervisor assesses the various business areas of the financial institution and the associated quality of management and internal controls to identify the areas of greatest risk and concern and directs supervisory focus to these areas. The 14th International Conference of Banking supervisors was of the view that the essence of RBS was based on the supervisors’ explicit assessment of risk and its key distinguishing feature is that supervisory resources are allocated where they are needed most. RBS therefore provides definite advantages to supervisors in understanding the risks in a bank and in their business. It helps assess the systemic risks that a bank may pose the possibility of contagion. It provides a forward looking assessment, indicating the direction of risk and provides supervisors with the inputs enabling them to take appropriate measures. Further, it helps optimise supervisory resources by greater focus on banks according to their risk profile.

Risk-based supervision has been adopted by supervisors in various countries with varying degrees of success.

INTERNATIONAL MODELS OF RISK-BASED SUPERVISION

The developed countries in the Western hemisphere and in Malaysia, Singapore and Hong Kong have evolved their models of risk-based supervision. In Australia, the Australian Prudential and Regulatory Authority (APRA) supervises banks, building societies and credit unions (authorized deposit-taking institutions), life and general insurance and reinsurance companies, friendly societies and superannuation funds (excluding self-managed funds). APRA promotes financial stability by requiring these institutions to manage risk prudently so as to minimize the likelihood of financial losses to depositors, policy holders and superannuation fund members. It supervises banks and financial institutions through a combination of onsite and offsite examinations. APRA relies on the PAIRS model (Probability and Impact Rating System) and SOARS (Supervisory Oversight and Response System). It assesses the regulated institutions risk, based through offsite and onsite examination. It examines and measures the inherent risks in the bank against the management and controls in place and assigns a PAIRS rating. The PAIRS model contains a framework for probability and impact of failure. The framework for probability of failure contains two aspects – the probability rating – a descriptive assessment of the likelihood that the regulated entity could fail (low, lower medium, upper medium, high and extreme) and the probability index (a quantitative measure of the approximate relative likelihood that a regulated entity could fail). Based on the probability and impact rating (the impact rating is a descriptive assessment of the potential adverse consequences that could ensue from the failure of a regulated entity and consists of four ratings – Low, Medium, High and Extreme), the APRA takes one of four supervisory stances viz. Normal, Oversight, Mandated Improvement, or
Restructure. APRA plans its onsite examinations based on the SOARS stance with the frequency being determined by its risk perception. APRA has in place a framework which ensures quality and consistency which include predictive analysis – analytical tools with a forward looking capacity, hindsight review and assessment to evaluate the effectiveness and outcomes of current supervision practice and make changes where necessary. This level consists of peer group benchmarking sessions and peer reviews. A combination of these tools leads to better risk assessments, planning of supervisory action and improvement in supervisory judgements of APRA.

In Brazil, the Banco Central Do Brazil (BACEN) is responsible for supervision of banks. The Annual Supervision Programming strategy is to focus on the size of the institution and its complexity, and the inspection would depend on the Risk and Control Assessment System (SRC) and Special Verification. The SRC identifies and assesses the most relevant risks in an institution and the quality of its internal control and management systems. The supervisory exercise assesses the key risks in a bank on parameters. The SRC assigns a risk rating to an institution based on quantitative and qualitative parameters. The quantitative rating is based on capital adequacy, asset quality, liquidity and profitability, while the qualitative rating parameters are business risks and controls (credit, legal, operational, market, liquidity and contagion risks, corporate functions and controls, strategic, information technology, reputation, money laundering and operational risk). The assessment is based on both onsite and offsite data. The bank is assigned a rating from 1–4 and the rating would determine the frequency of examination.

Canada has adopted a risk–based model of supervision way back in 1999. Canada with its background of strong regulation and supervision and conservative lending practices and strongly capitalized banks, emerged virtually unscathed from the financial crisis. At the heart of the Canadian supervisory system is the OSFI which supervises all deposit–taking institutions. In its model, for each inherent risk of each significant activity OSFI examines the quality of risk management and arrives at the net risk. The net risk of all the activities is combined to arrive at the overall net risk of the bank. The assessment also examines banks capital, earnings and liquidity at both present and prospective levels. This is captured in a risk matrix and the Composite Risk Rating (CRR) arrived at after assessing the bank’s risk profile and its capital and earnings vis–a–vis its overall net risks from its significant activities and its liquidity. The CRR is arrived at as low, moderate, above average or high, and is aligned with the intervention ratings for taking supervisory action. OSFI also conducts a Supervisory Review Process (SRP) to assess adequacy of the bank’s capital vis–a–vis its risk profile.

In the United Kingdom, the Financial Services Authority had been vested with the powers of supervision of investment business insurance and banking. Following the crisis, a new Financial Policy Committee at the Bank of England and a new Prudential Regulation Authority (PRA) as a subsidiary of the Bank of England have been constituted for better supervision in a twin peaks model. On April 1, 2013 the PRA became responsible for the Prudential Regulation and Supervision of banks, building societies, credit unions, insurers and major investment firms. It is responsible for ensuring that the business of the firms it supervises is carried on in a way that avoids any adverse effect on the stability of the UK financial system and seeks to minimise the adverse effect which the failure of a supervised firm could have on the financial system, besides protecting depositors’ interests. The PRA regulates around 900 financial groups containing deposit takers, which include 240 banks, 50 building societies and 600 credit unions, as well as
a small number of designated investment firms that have the potential to present significant risk to the stability of the financial system. It is not the PRA’s mandate to ensure that no firm fails. It is thus a key principle in PRA’s approach that it does not seek to operate a zero-failure regime. Considering the impact of firm failure, and acting pre-emptively to ensure either recovery or orderly closure, is a core aspect of the PRA’s approach. PRA stipulates that the firms it supervised should satisfy certain minimum threshold conditions. The threshold conditions require firms to have an appropriate amount and quality of capital and liquidity, have appropriate resources to measure, monitor and manage risk, be fit and proper, and conduct their business prudently and must be capable of being effectively supervised by the PRA. The PRA’s supervisory approach relies significantly on judgements. The judgement relates to the risks that a supervised firm poses to the system, its ability to comply with the threshold conditions and how to address any problem if identified, the supervisor’s judgement of which risks are the most material and must be pursued. A judgement-based approach is necessary in a forward looking regime and the growing complexities in banking business. The PRA’s supervisory judgements are based on evidence and analysis. The PRA’s risk framework consists of three key elements i.e.

- the potential impact that a firm could have on financial stability both by the way it carries on its business and in the event of failure;
- the risk content i.e. how the external context in which the firm operates and the business risks it faces might affect the viability of the firm;
- mitigating factors, including a firm’s management and governance and its risk management and controls (operational mitigation), its financial strength, specifically capital and liquidity (financial mitigation), and its resolvability (structural mitigation).

The PRA’s assessment would determine the intensity of supervision for a firm and the supervisory strategy. The potential for a firm to affect economic stability would depend on the services it provides like payment settlement, clearing, retail, corporate banking custodial services. The scale of its potential impact would be determined by the size and complexity of its business operations and its interconnectedness with the rest of the financial system. Based on this criteria, PRA has categorised the firms it supervises into five categories based on quantitative and qualitative analysis including the business model of the firm, the external content in which it operates etc. Its supervisory activity would involve regular engagement with staff at all levels of seniority, information gathering and analysis, detailed onsite testing or inspections in a particular area, drawing on work of external auditors, commissioning special audits etc. The degree of intensity of supervision would depend on the risk categorisation of the firms. It has a proactive intervention approach where the PRA identifies varying degrees of a firm’s proximity to failure and takes appropriate action. In each of its supervisory communications the PRA focuses on outcomes of its directions.

**CHALLENGES FOR INDIAN BANK SUPERVISION**

The Indian banking system has grown exponentially in the last decade with the balance sheet of Indian banks standing at Rs 82994 billion as on March 31, 2012. The growth however has been lower in 2011–12 than in previous years due to the global financial crisis, the fragile recovery in global markets and the growing stress in the power and aviation sector. Indian banks were well–capitalised with CRAR of 14.24% in 2012 under
Basel II (well above the regulatory minimum of 9%) which had increased from 14.19% in 2011. The core capital of scheduled commercial banks stood at 10.4% as against regulatory minimum of 6%. A disturbing feature was the growth in non-performing assets (NPA), with gross NPAs up from 2.5% in 2011 to 3.1% in 2012, while net NPAs stood at 1.4% (1.1% in 2011). Indian banks have subsidiaries and branches, both domestic and overseas, and in a world where economic boundaries have blurred, the risk of contagion, lurking black swans in complex financial products and potential for regulatory arbitrage, call for closer supervision and innovative methods of risk analysis. The growth in the Indian banking system with increased complexity in banking business has made it imperative for RBI to review the entire supervisory process, particularly in the light of the global financial crisis and move towards a risk-based approach.

As early as August 2001, the RBI initiated steps to nudge banks to move towards a more risk-focused approach. It had engaged the services of an international consulting firm to examine the entire supervisory framework and prepare a blueprint for transition to a more sophisticated system of risk-based supervision by incorporating international best practices. The discussion paper on 'Move Towards Risk-based Supervision' released by RBI in August 2001, envisaged that it would focus its supervisory attention on banks in accordance with the risk each bank poses to itself as well as to the system. The risk profile of each bank would determine the supervisory program comprising offsite surveillance, targeted onsite inspections, structured meetings with banks, commissioned external audits, specific supervisory directions and new policy notices in conjunction with close monitoring through a Monitorable Action Plan (MAP) followed by enforcement action, as warranted. It was emphasized that the successful implementation of the process of risk-based supervision would require adequate preparation both on the part of the regulator and the commercial banks.

The introduction of risk-based supervision required the banks to reorient their organizational set up and put in place an efficient risk management architecture, adopt risk focused internal audit, strengthen the management information system, and set up compliance units. The banks would also be required to address human resource issues like manpower planning, selection and deployment of staff and their training in risk management and risk-based audit. Change management is a key element in risk-based supervision and the banks should have clearly defined standards of corporate governance, well-documented policies and efficient practices in place so as to clearly demarcate the lines of responsibility and accountability so that they align themselves to meet the requirements of risk-based supervision. The objective was to supervise institutions and allocate supervisory resources based on the risk profile of the institution and the systemic risk they pose. Risk-based supervision proposed to build on and refine the CAMELS approach of onsite inspection and offsite monitoring. It would involve a more forward looking approach rather than a point-in-time assessment. Risk-based supervision would therefore require integrity of data in banks, soundness of systems and technology, appropriateness of risk control mechanism, and supporting human resources and organizational structure.

The cornerstone of risk-based supervision is an accurate risk profiling of each bank. The risk profile would capture the risks faced by the institution from its various activities. Under risk-based supervision, the efficacy of the bank's organization management and controls would be examined. Risk-based supervision would also identify outlier banks based on new activities, balance sheet growth and profitability on the basis of a two tailed test (too good or too bad) which would determine the frequency

continued on page 10....
How will banks' approach to risk management change with the advent of risk-based supervision guidelines?

Risk-based supervision's (RBS) main purpose is to develop a risk profiling of commercial banks in India. Post the recent global economic crisis, there has been a shift towards RBS, and away from the erstwhile CAMELS (Capital adequacy, Asset quality, Management, Earnings appraisal, Liquidity and Systems & controls) approach, which was more of a transaction testing model. The supervisory stance of RBS will extend to an analysis of a bank's propensity for failure and its likely impact on the financial system. With banks moving into this uniform methodology of supervision, India will now be at par with best practices around the world.

RBS can be termed forward looking as it seeks to assess risk buildup by examining whether the supervised entity/bank follows regulatory prescriptions, and if its internal risk management practices are aligned with regulatory expectations. In short, it's goals are to help banks optimize the utilization of supervisory resources and minimize the impact of crises scenarios in the financial system.

RBS can be termed forward looking as it seeks to assess risk buildup by examining whether the supervised entity/bank follows regulatory prescriptions, and if its internal risk management practices are aligned with regulatory expectations. In short, it's goals are to help banks optimize the utilization of supervisory resources and minimize the impact of crises scenarios in the financial system.

Banks play a transformative role and are subject to the financial market dynamics, while at the same time, increased competition; new business models and new entrants into the banking sector are challenging this dynamic today. This exposes banks to a variety of risks, and over the past three decades managing risks has become nothing short of a challenge for any bank across the globe. This can also be attributed to several developments in the financial industry such as the deregulation of financial markets and banks' diversifying into newer business lines such as providing custodial services.

On one side there is the challenge of risk identification and mitigation, and on the other, a failure to enforce regulations and rely on the efficient market hypothesis. No amount of regulation or supervision can save a financial institution if its top management is not sensitive to what is good for their bank. They are the first line of defense and effective risk supervision from their side in the form of their ability to identify, manage and mitigate risks is critical. This, in turn, would translate to the permeation of this risk assessing culture across the bank's internal auditors, and eventually to the external supervisors or the central bank for RBS to make any meaningful progress in India.

If RBS has to be successful, a bank would have to be oriented towards identifying and pricing each of these risks appropriately. Further, a thorough income analysis involving assessment of products, services, activities, profitable lines of businesses alongside the identification of hidden and new or peripheral risks is imperative.

Accountability for profits with a disposition of measuring returns along with the risks involved and inculcating a discipline of good governance within the bank is the first step towards the RBS transition. For instance, when an asset is priced in line with the risk rating of the customer, it does not mean that a lower rated customer gets a better price than a higher rated one.

Yes, RBS enforces more guidelines on the supervisory role rather than the bank, wherein the supervisor has to ensure that banks comply. By asking the right questions to banks and also intervening wherever necessary.

Banks will now have to seek accurate clarification and enforce internal mechanisms to execute on the Board's mandate and direction. What this signifies is a need for being alert within and outside the institution and re-evaluating risk profiles often through extensive probing or discussions resulting in logical conclusions. In short, RBS should result in operational independence, accountability and healthy relationships between banks and the regulatory bodies.

Banks need to bear in mind though, that despite enhanced supervision, the primary responsibility of managing risk effectively and efficiently still rests with them.
What role will technology play in the successful implementation of this new approach to risk management?

With core banking solutions being implemented across all banks in India, this had led to enhanced availability, quality and consistency of data. Basel II and other regulatory drivers, including competitive market forces, compelled banks to invest in improving their risk management capabilities. This has led to bankers becoming more conscious about the risks involved in their institutions.

RBS will assess the quality of a bank’s procedures for evaluating, monitoring and managing risk and its internal models for determining economic capital. But as RBS supervision is dependent on the inputs provided by a bank’s risk management system, it can only be as effective as a bank’s risk management system. For a risk management system to be effective, it needs to have a rigorous method of internal controls and governance, with the top management of the bank playing a critical role in its enforcement.

A robust offsite surveillance system eliminating the need for manual intervention in the flow and integrity of data being submitted from banks to RBI will define the success of RBS.

Are there any global best practices that banks in India should consider in the area of risk-based supervision?

The adoption of the CAMELS approach to supervisory risk assessments and rating has closely aligned the Indian banking system to international best practices. The need to preserve the soundness of the international banking system highlighted effective risk management, adequate capital provision, sound supervision and regulation, transparency of operations, independent and quality internal controls and governance as prime.

RBI has played the role of the central bank in India. Post liberalization in 1992, and the advent of Basel regulations changed the supervisory role played by RBI in India. RBI now simultaneously discharges various roles such supervisor, monitor, liquidity controller and policy maker.

Though Basel I sets the criteria of maintaining 8% capital adequacy ratio, RBI had instructed all Indian banks to maintain at least 9% capital adequacy ratio for a while now. With the successful implementation of the BASEL III norms, banks have to now maintain at least 11.5% capital adequacy ratio in the form of Tier1 capital. The successful implementation of Basel III will provide a common platform or a common level playing field for all banking players both in the national as well as international level in future.

Alongside the evolution or risk practices worldwide, changing banking group structures and increasing product complexity demands that supervisors identify those institutions that pose the biggest risks and whose failure can have a maximum impact on financial stability. If we have to ensure that global risk practices and benchmarks are established and maintained, it is imperative that supervisors are able to assess and zero in on the real sources of risk, conduct proactive assessments of risks and track them based on their impact. Majority of Indian banks have successfully implemented Basel II norms and they are also developing their own internal credit rating framework in India. Basel III necessitates the maintenance of a certain amount of capital adequacy ratio to hedge against liquidity risks but extremely high capital adequacy ratio reduces the credit creating capacity of a bank, with an adverse impact on profit margins.

What benefits will accrue to the Indian banking industry on a systemic level with the move to risk-based supervision?

A risk-based approach for supervision of commercial banks in India will help identify and address—incipient risks at the institution and systemic level in a proactive manner. The need to keep tabs on risks in exacerbated by the fact that banks use public funds, receive protection for depositor guarantees and liquidity support. Identifying and mitigating risks from the perspective of safety and soundness of each bank and also from a systemic stability perspective can be achieved only in the form of continuous supervision.

Banks that come with low levels of technology, lesser evolved risk management practices and inadequate human resources could result in entity-specific supervision wherein the intensity of monitoring is proportional to the risk levels at the bank. Having said that, the RBS framework is extremely dependent on the supervisor’s assessment and judgment, which means that the outcome of supervision would be subject to how objectively these assessments are made for each firm.

To sum up, it is in a bank’s own interest to ensure the success of the risk-based supervision process as it not only helps them identify incipient risks and prepare mitigation plans while it also reduces their supervisory and compliance burden.
and degree of their examination. Accordingly, a scheme of incentives and disincentives was envisaged. Banks with a better compliance record and a good risk management and control system could be entitled to an incentive package which could be in the form of longer supervisory cycle and lesser supervisory intervention. The banks, which fail to show improvement in response to the MAP, would be subjected to a disincentive package such as, more frequent supervisory examination and higher supervisory intervention including directions, sanctions and penalties. The mandatory and discretionary actions as enshrined in the Prompt Corrective Action (PCA) framework would be a part of the supervisory enforcement action. Risk-based supervision was also expected to leverage on the work of specialist third parties like external auditors, to avoid duplication of efforts. At the bank level, the move towards RBS would require a review of their risk management architecture and bridge the gaps.

As a prerequisite, banks were advised to move towards a risk focused internal audit. RBI had issued a guidance note on risk-based internal audit in December 2002 to banks for enabling a smooth transition to risk-based supervision. While the precise scope of work of internal auditing must be determined by each bank, at a minimum they must review and report upon the control environment as a whole, the process by which risks are identified, analyzed and managed, the line of controls over key processes, the reliability and integrity of corporate management function, safeguarding of assets and compliance with rules and regulations.

To achieve these objectives, banks would have to gradually move towards risk focused auditing, in addition to the system of selective transaction-based auditing. The implementation of risk-based auditing would mean that greater emphasis is placed on the internal auditor’s role of mitigating risks. By focusing on effective risk management the internal auditor would not only offer remedies for current trouble areas but also anticipate problems and play an important role in protecting the bank from risk hazards. The risk based auditing would not only cover assessment of risks at the branch level but would also cover, as an independent assessing authority, assessment of risks at the corporate level and the overall process in place to identify, measure, monitor and control the risks. In order to focus attention on areas of greater risk to the bank, a location-wise and activity-wise risk assessment should be performed in advance of onsite risk-based auditing. This would allow identification of high risk areas which would enable prioritizing the activities and locations for risk-based audit. The high-risk areas need to be looked into more frequently than the low risk areas.

Risk-based audit would be an aid to the ongoing risk management by banks, as it would provide checks and balances in the system. The banks could form a small committee of executives and entrust them with the responsibility to chalk out an action plan, implement and monitor the progress in adoption of risk management systems and risk focused audit and report to the top management and board of directors periodically.

The success of risk-based supervision bank-wide would depend on the authenticity and integrity of data. Banks were there advised to have efficient management information systems and put in place systems for storage and retrieval of data. The success or failure of any scheme also depends heavily on the people factor. Hence RBI had emphasized the need for a supporting training program to equip bank staff with the necessary skill set. Besides, a compliance department headed by an official not below
the rank of General Manager was required to be set up to ensure the timeliness, accuracy and sustainability of the compliance to the deficiencies pointed out by the risk-based supervision. The move towards risk-based supervision was to begin in 2002–03. RBI had subjected select banks to RBS in a pilot project in 2004, 2005 and 2006 along with the AFIs based on the CAMELS approach. The findings from the study indicated that as some banks were not yet on core banking systems, they were not yet ready for the transition to a risk-based approach and would require further time to strengthen their risk management systems and operationalize risk-based internal audit. This delayed the transition to risk-based supervision. However, given the dynamic changes in the financial world, the growth in the balance sheets of Indian banks, the growing complexity of business and the lessons from the global financial crisis, the transition to a risk-based approach in supervision had become imperative.

THE ROAD TOWARDS RISK-BASED SUPERVISION

The RBI had constituted a High-Level Steering Committee (HLSC) chaired by Deputy Governor Dr. K.C. Chakrabarty, to improve the quality of its supervisory processes/techniques and benchmark them with global best practices.

The HLSC, which submitted its report on June 11, 2012, recommended measures to transform the extant supervisory approach of examining past performance through a transaction-testing based (CAMELS) framework to a risk-based approach using trend analysis to find risk drivers and predict the path and passage of risks in the banks’ books. It is a forward-looking approach for analysing risks and assessing the probability and impact of bank failure. It would entail providing a structured methodology for identifying and assessing different types of risk. Risk-based supervision is a more objective supervisory process which also involves continuous engagement with banks. In essence, the supervisor would have to get under the skin of the bank, understand its business, the products which drive income and the risk they pose. On the other hand, the risk management architecture of the bank, the commitment of its board and top management, and the quality of its controls and risk mitigants need to be weighed vis-a-vis the risk.

This would mark a move from the 'one size fits all approach' of Annual Financial Inspection of banks and is intended to be replaced with a continuous supervision approach that is based on the risks posed by the bank to the supervisory objectives. The risk assessment involves obtaining and updating bank-related information from various sources including onsite inspection and analyzing the material risk and concerns arising out of the bank's operations. The bank's profile would be created from this data. The risk assessment would identify the activities of the bank that may create potential hazards to detriment of supervisory objectives and goals, the severity and impact of the risks and the effectiveness of risk management which would need supervisory action, taking corrective action and monitoring the bank's compliance. In the risk assessment matrix the inherent prudential risks and prudential risk controls in place in each risk group would be taken into account. The net risk for all component groups would be rated on a continuous scale (0–4) and would be aggregated into a single score by using appropriate weights to each component in the matrix and the aggregate net risk of the bank arrived at. The composite risk score, which is a determinant of the probability of bank failure, would be used to produce a risk index which together with the impact index would then be used to determine the intensity of the supervision.
The supervisory stance of the RBI based on the position of the bank in the risk matrix could be one of four – Baseline Monitoring, Close Monitoring, Active Oversight or Corrective Action – and would comprise specific supervisory actions to be initiated by the supervisor during the supervisory cycle. The risk assessment and the supervisory actions are intended to enable identification of risks and effective intervention at an early stage so as to minimise losses/ potential disruptions to the banking system. As part of the supervisory process, the bank could be subjected to an onsite examination based on the Supervisory Action Plan. Risk-based supervision would also rely on thematic reviews/ targeted reviews, say across peer banks to assess critically the risk and quality of controls in specific products, lines of business etc. It would also involve assessment of the adequacy of the bank’s capital under the Supervisory Review and Evaluation Process (SREP). SREP is the Pillar 2 process of the Basel II framework to ensure that banks have a process for assessing their capital adequacy in relation to their risk profile and a strategy for maintaining their capital levels. Supervisors have to review and evaluate the bank’s internal capital adequacy assessments (ICAAP) and strategy to maintain capital and take appropriate supervisory action. Risk-based supervision would also draw on inputs from external audit for its risk assessment.

A supervisory risk rating exercise capturing the risk in the bank would be carried out as part of the annual supervisory process, which would measure the net risk in a bank. The proposed supervisory risk rating under risk-based supervision is a shift from the CAMELS rating, to focus more on the key risk areas and the net risk arrived at by adjusting the respective risk mitigants against the inherent risk. The risk of bank failure can be determined by adjusting the net risk of the bank against its available capital. Risk-based supervision would help optimise scarce supervisory resources.

The committee's recommendations were to encourage banks to adopt a risk-based business conduct within an indicative timeframe through a system of incentives and disincentives. The RBI has taken steps to operationalize the recommendations of the committee. As a first step, banks have been advised of the decision to make the transition to a risk-based approach to supervision from the next supervisory cycle (2013–14). They have been advised to assess the status of their risk management architecture, culture, practices and related processes against certain essential requirements identified for the introduction of risk based supervision.

**CHALLENGES FOR BANKS UNDER RISK-BASED SUPERVISION**

Risk-based supervision would involve a change in the mindset of banks in the way they do business. It would require mechanisms for assessing and pricing risk and efficient capital allocation. While most banks are on core banking systems, the quality of management information systems and the integrity of data are vital. Besides, the supervisor would need more granular financial/ risk data, policies, documents like risk reports to board/ top management, and minutes of board meetings, internal audit reports, minutes of various committees etc. from the banks to assess the risk appetite of the bank and the governance framework. Banks also need to analyze the risks associated with various lines of business, their key drivers of growth in income and examine the adequacy of risk mitigants by way of controls in place. The effectiveness of a robust risk management architecture needs to be challenged by stress tests/ reverse stress tests. The outcomes of the stress tests need to be factored into the business and capital planning exercise. Above all, effective understanding and appreciation of risk needs to be built into a bank’s DNA. This would require leading from
the top by the bank’s board and top management in creating an effective risk management culture in their respective banks.

**CHALLENGES FOR THE SUPERVISOR**

The risk-based supervision process would require the supervisor to closely monitor banks, have an understanding of the business they do, complexities of products offered, risk management architecture and strategies. Besides strengthening of market intelligence, an ability to sniff the wind, identify and co-relate significant changes in banks’ balance sheets, market behaviour, the macroeconomic environment in which banks operate, should be part of the supervisor’s tool kit. They need to examine and assess whether the risk management systems and processes ensure sound banking and that the business is within a bank’s risk appetite and defined by sound banking practices and adequate capital. The human resource challenges for both the supervisor and the banks would be skill upgradation for sharper analytical skills required under risk-based supervision, change management, capacity building and retention of talent.

**THE WAY FORWARD**

Risk-based supervision is a journey and not an end in itself. The efficacy of the risk-based systems and processes will depend on how it is implemented and need to be constantly reinvented. It must be recalled that the banking systems of many countries which had adopted risk-based supervision were affected by the global financial crisis. The build up to the crisis was characterised by the almost child-like belief that markets were self-correcting and the regulatory mantra was ‘light touch’. As Alan Greenspan has noted – “All of the sophisticated mathematics and computer wizardry essentially rested on one central premise: that enlightened self interest of owners and managers of financial institutions would lead them to maintain a sufficient buffer against insolvency by actively monitoring and managing their firms’ capital and risk positions”. This premise was shattered by the subprime crisis.

The failure of institutions like Northern Rock was due to inadequate assessment of the risk that it posed. Its business model differed from most banks whose resources come from stable customer deposits. Northern Rock, however, raised money primarily by participating in the wholesale market and by securitizing mortgages. To securitize mortgages, it packaged multiple mortgage loans into bonds that were sold to investors. By doing so, Northern Rock was able to raise money quicker and more cheaply than its rivals, allowing the bank to grow continuously for more than a decade. Unfortunately, Northern Rock’s business plan also exposed it to more risk because it was giving out loans faster than it could raise the money to back them. The tripartite regulatory authority of Bank of England, Treasury and FSA failed to identify the risk in such a business model. As Adair Turner, Chairman, FSA put it in the Economist’s Inaugural City Lecture in January 2009 – "The far bigger failure – shared by bankers, regulators, central banks, finance ministers and academics across the world – was the failure to identify that the whole system was fraught with market-wide, systemic risk. The key problem was not that the supervision of Northern Rock was insufficient, but that we failed to piece together the jigsaw puzzle of a large UK current account deficit, rapid credit extension and house price rises, the purchase of UK mortgage-backed securities by institutions in the US performing a new form of maturity transformation, and the potential for irrational exuberance in the market price of credit. We failed to realize that there was an increase in total system risk to which financial regulators overall –
authorities, central banks and fiscal authorities – needed to respond”.

The lessons of the crisis are that systems alone are not enough. Supervisors need to correlate patterns of behaviour and trends in banks’ balance sheets. They need to understand the risk appetite of the institution, risk management architecture, corporate governance and organizational culture, and the policy on incentives and disincentives. Supervisors would have to enhance their knowledge of the business model of an institution, its risk appetite and key income drivers. The global financial crisis was created in part by regulators' unwillingness to play spoilsport when the party was in full swing and a naive belief in the self correcting power of markets. Institutions need to know that they are under watchful eyes of the supervisor, a belief reinforced by frequent interactions with them. Besides, supervisors should show the capacity and willingness to intervene, take decisive actions when deficiencies/ violations are brought out in supervisory reviews.

While the watchful eye of the supervisor would be on large systemically important banks, smaller banks which have the potential to become systemic through the business they do, exposure to other banks or changes in the financial environment, need to be subject to a certain minimum level of monitoring. The FSB in its paper on Improving Effectiveness of SIFI (Systemically Important Financial Institution) Supervision in November 2010, observed that supervisors tend to focus in their risk assessments more on processes and characteristics than outcomes. This includes spending a majority of their supervisory effort looking at the governance frameworks and processes in areas such as risk management, credit risk approvals, board oversight, and capital adequacy assessments, without enough analysis to confirm that the outputs of the processes in terms of the resulting risk profile and exposures were consistent with supervisory expectations. This was due to the fact that prior to the crisis many SIFI’s risk management processes had been assessed by supervisors to be acceptable. However, the risk management systems did not take cognizance of falling underwriting standards, poor risk/ reward decisions and increasing complexity. There was insufficient analysis by supervisors of whether the processes were likely to produce outcomes that were within the banks’ risk appetite, and even if they were, whether the risk appetite was acceptable for a regulated institution. Therefore, supervisors need to evaluate the risk management systems in the context of the bank's business and its risk appetite.

Risk–based supervision calls for a change in the way both supervisors and the supervised do business. Therefore, supervisors need to ‘stay hungry and stay foolish’ to achieve the objective of financial stability in testing times.

References


About the Author

Theresa Karunakaran

Theresa Karunakaran was General Manager with Reserve Bank of India (RBI). Joining the RBI as an Officer in 1976, she has worked in all the major areas of central banking, with the major part of her career spent in the area of regulation and supervision of banks.

She has been a member of various working committees of the RBI and was nominated by RBI and Government of India to be part of a three-member international team with representation from Treasury Government of Australia and BaFin constituted by Financial Stability Board and IMF which carried out the assessment of Bank of Mauritius compliance with Basel Core Principles.

Presently she is working as a Consultant with Axis Bank. She holds an MA in Economics from University of Kerala and post graduate Diploma in Management.