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STUDENTS' ECONOMIC FORUM

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October 2013

Theme 263

INROADS

A monthly publication from South Indian Bank

22nd Year of Publication

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SIB STUDENTS' ECONOMIC FORUM

OCTOBER 2013

Theme No. 263 : INROADS

A well informed customer will make the policy makers as well as organisations which produce goods and services more responsive to the customer needs. This will also result in healthy competition among organisations and improve the quality of goods and services produced.

The "SIB Students' Economic Forum" is designed to kindle interest in economic affairs in the minds of our younger generation. We highlight one theme in every monthly meeting of the Forum. The Reserve Bank of India (RBI) has decided to change its system of monitoring and supervising banks. The new system "INROADS (Indian Risk-Oriented and Dynamic Rating System)" is expected to be more progressive. The changes have been suggested by a high-level steering committee chaired by Deputy Governor Shri K C Chakrabarty.

What is the rationale behind introduction of the new system?

The Reserve Bank of India (RBI) has decided to change the way it monitors and supervises banks in order to make the process more forward-looking. The move comes against the backdrop of the risks that have emerged after the global financial crisis of 2008, with lenders shifting from offering traditional products to more complex ones. According to RBI, the country's financial sector would now be evaluated under a dynamic risk-based mechanism, which the present CAMELS rating system lacked.

What according to the committee is the RBI's experience with Risk Based Supervision?

Reserve Bank of India has continuously aimed at improving the efficiency and efficacy of its supervisory processes in line with the changes in the operating environment. Realizing the need for a continuous monitoring of the banks through off-site analysis of critical data impacting their risk profiles, conducting targeted on-site inspections and making early supervisory interventions, Reserve Bank of India initiated a pilot program for supervision of select banks under the Risk-based approach during the supervisory cycle of 2003-04. The pilot studies were also continued during the succeeding supervisory cycles.

What were the major objectives of the various pilot studies?

- To assess the level and direction of various risks in the bank concerned and compare the position with the CAMELS based- AFI findings;
- To study the level of preparedness of the banks in regard to risk management practices;
- To build a pool of experienced inspecting officers well conversant with the Risk based approach of supervision; and

- To back-test the efficacy of the RBS framework.

Which are the essential features of an effective bank supervisory regime according to the committee?

- Assesses compliance with rules and regulations and adherence to safe and sound banking practices;
- Sensitive to evolving macro-economic and regulatory changes;
- Responsive to the emerging risks at individual banks;
- Clearly diagnoses the risk profile of each bank and ensure that banks have appropriate risk management systems with a strong internal control and external audit mechanism;
- Conducts supervision on a consolidated basis appropriately assessing the risks posed by all significant lines of business, including those subject to the primary supervision of another regulator and maintains effective coordination with the other regulators;
- Efficient use of available supervisory resources by allocating the greatest resources to the areas of highest risk; and
- Maintains an adequate pool of trained supervisory personnel with appropriate skill- sets.

Which were the major Terms of Reference for the high level steering committee?

1. To review the approach to supervision so as to make the process more effective and useful to the supervised entities as well.
2. To examine the extant onsite supervisory examination approach, methodology and processes / tools including review of the Supervisory Rating & Stress Testing Framework.
3. To examine the extant offsite supervisory methods including the efficacy of offsite surveillance system.
4. To review the adequacy of Prudential Supervisory guidelines and Supervisory Review Process under Pillar 2 and recommend measures for moving over to a forward looking Risk Based Supervision Framework.
5. To examine the extant methods for conducting Consolidated Supervision and recommend measures for enhancing the intensity and efficacy of supervision of Systemically Important banking groups (SIBs) / conglomerates on a continuous basis as also strengthening cooperation / coordination with domestic regulators.
6. To recommend measures of strengthening the extant cross-border supervisory cooperation processes including the provisions / coverage of the bilateral MoUs and outline an approach for establishing Supervisory Colleges for Indian banks.
7. To assess the adequacy of the institutional structure for carrying out supervisory function, especially human resources aspects (need for creating specialists with appropriate skill sets for examining specific risk areas viz. credit, market, liquidity etc.) use of technology vis-a-vis supervisory objectives and the extant complexity of banking products / processes.
8. To suggest a framework for feedback mechanism and review of supervisory processes and make recommendations to address the gaps identified in the extant supervisory process.
9. To consider / make recommendations on any other matters relating to or incidental to the above.

How does RBI propose to replace CAMELS?
A high-level steering committee for the review of supervisory processes for banks, set up by RBI under the chairmanship of Deputy Governor K C Chakrabarty, has suggested the changes in the supervisory approach. Most of the suggestions have been accepted by the central bank.

The committee identified several shortcomings of the current system and has recommended a phased move towards RBS. In India, banking supervision is done through off-site surveillance and monitoring system (OSMOS) and onsite supervision involving Annual Financial Inspection (AFI) which is presently modelled around the CAMELS framework for domestic banks and CALCS for foreign banks. RBI proposes to replace CAMELS with INROADS (Indian Risk-Oriented and Dynamic Rating System) from the next round of annual financial inspection, in 2013. At present, the central bank uses the CAMELS (Capital adequacy, Asset quality, Management, Earnings, Liquidity, and Systems and control) method, to assign ratings to Indian banks. CAMELS, which goes from A+ to D is assigned to a bank while finalising the Annual Financial Inspection (AFI) report. The new system, INROADS, is to capture the risks that may cause a bank to fail and is based on risk measures. The new system may be implemented from the next round of Annual Financial Inspection, in 2013. Annual Financial Inspection report will be fast-tracked with single-point contact at RBI to bridge regulatory gap and Information-sharing agreements with overseas regulators on cards.

Which are the supervisory methods /tools proposed by the committee?
In a risk-based supervisory framework, both onsite examination and off-site surveillance complement one another as they are mutually interdependent. RBS is, therefore, designed and implemented as a process encompassing both on-site examination and off-site surveillance of banks.

Off-site supervision: The Committee recommends that under the proposed risk-based framework, the off-site supervision should be substantially strengthened to provide inputs for the onsite visits. It is observed that the the quality and integrity of the data, submitted by the banks to the supervisors, is not generally reliable or is inconsistent and as such there is a need to eliminate any manual intervention involved in the flow of data from the banks to RBI. The Committee also recognises a pressing need for instilling some discipline in the banks to ensure data integrity. The offsite supervisory process includes preliminary risk assessment of the banks based on captured data flows pertaining to their business plan/strategies, group structure, financial statements, compliance and internal audit/plans and reports, observations of external auditors etc.

On-site examination: With the preliminary risk assessment of the banks being done off-site, under the RBS regime, the focus and orientation of the on-site visits would undergo a significant change from the present supervisory practice. The Committee is of the view that the level of risk rather than the volume of business should be the determinant of the periodicity of on-site examination and accordingly recommends that while the periodicity of the onsite supervisory examination /reviews for all large and risky banks could be annual, the on-site inspection of the smaller banks with a lower risk profile should be conducted only once in a 2 to 3 year cycle.

Thematic Reviews: Apart from the regular monitoring of banks, it is also necessary that supervisor undertakes thematic review of a particular product, market or practice using a specialised team to assess whether any risks are brewing within the sector or at system levels. Some indicative areas for such focused reviews may include observance of KYC compliance, management of money laundering risks, approaches for management of interest rate, exposure to sensitive sectors, investment and liquidity risk, NPA, pension liability, compensation practices etc.

Interactions with the Top management of banks: The present system of holding quarterly discussions with the Top Management of all banks as a matter of routine may be replaced with formal interactions, the periodicity of which is determined by the supervisor based on its risk assessment for a particular bank /banking group. In this context, a mechanism for periodic interaction of the supervisor with the Top Management of the banks at a common platform, for deliberating on issues affecting the banking sector as a whole, would mutually benefit the supervisor and the supervised entities.

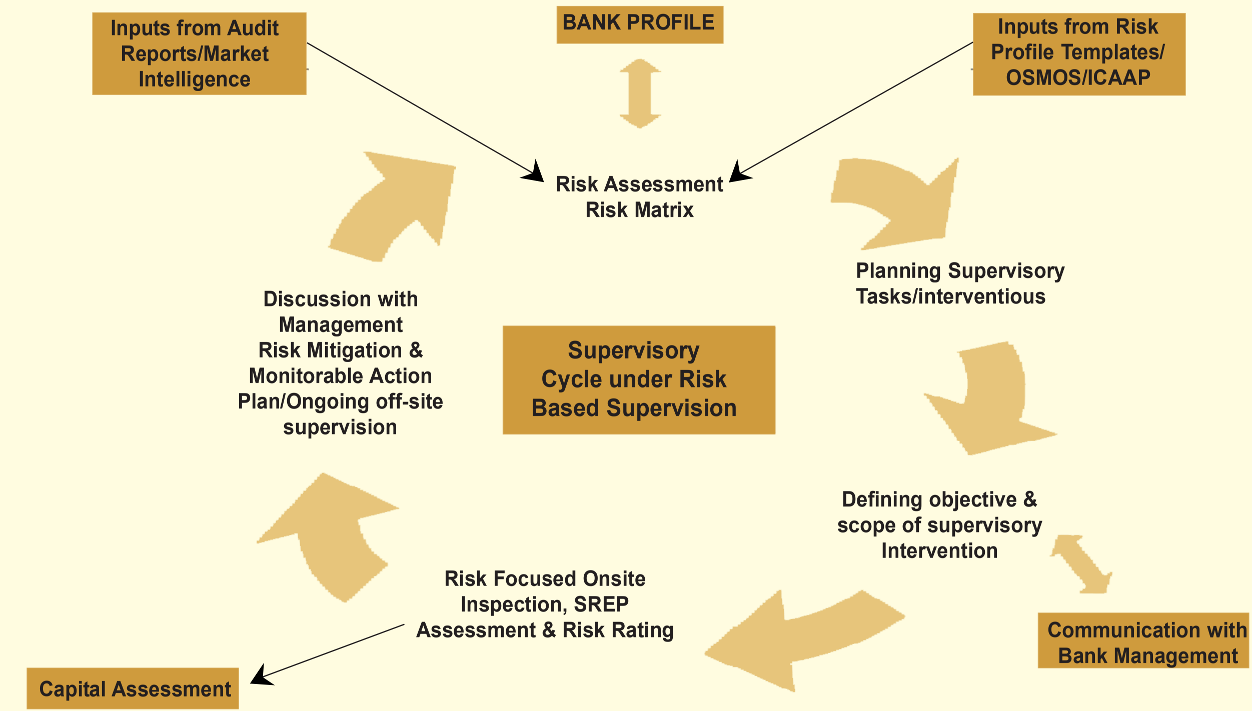
How does the new system work?
RBI has pointed out that the present form of rating captures only a few risk elements and represents a bank's past-year performance. Besides, RBI is of the view, the present rating does not capture the risks that could cause a bank to fail. According to the Central bank sources, some of the broader risks, such as credit risk, operational risk, and strategic and business group risk, increase the probability of a bank's failure.

How does the new system address the areas of concern in AFI?
The process of Annual Financial Inspection has been expedited and it is now proposed that banks should address the areas of concern mentioned in AFI during a particular year. In a given year, AFI is undertaken for the previous year, and significant delays were noticed last year.

How does the new system facilitate cooperation with regulators of other countries?
The banking regulator is also entering into mutual regulatory cooperation agreements with regulators of other countries to extract information about Indian banks operating overseas and vice versa. RBI has already signed an agreement with 14-15 countries and is in talks with the US – a country where a majority of Indian banks have presence. Sources said since the US had three federal banking supervisors, the process might take some time.

What is the plan to create a single-point contact?
The central bank is also planning to create a single-point contact for each bank in order to plug the regulatory lacuna. "It is quite often the case that information about a bank with one department of RBI is not known to other departments. So, a single-point contact will be created for each bank," a source said.

Supervisory Processes under RBS



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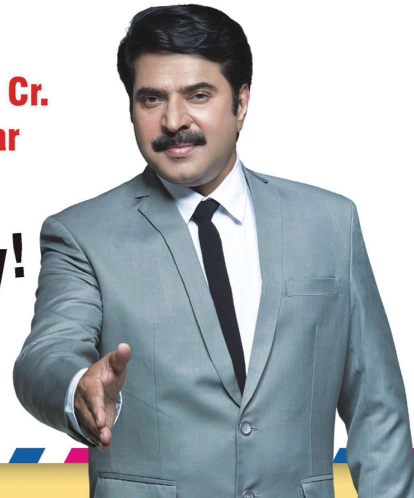

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