



Indian Banks' Association



From Compliance to Internal Assessment

- Is risk management by Indian banks driven from within?

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1. BACKGROUND

The deadline for the first phase of Basel II compliance by banks operating in India and having an international footprint is just over. Remaining banks still have another year to become compliant. To begin with, The Indian regulator has mandated only the elementary approaches to credit and operational risk, keeping in view the data requirements for advanced approaches, and also the risk management skills available in these banks.

In the rush to meet the deadline, most banks have focused their attention to raise capital to meet the regulatory capital requirements. A few days before the deadline of March 31st, 2008, Reserve Bank of India (RBI) released the Supervisory Review Process under the New Capital Adequacy Framework - Guidelines for Pillar 2. Among other things, the supervisory review seeks to address the residual risks not captured under Pillar 1 to ensure that banks have put in place robust internal risk assessment and control infrastructure.

Anand Sinha, executive director, RBI, while speaking at a conference in beginning of 2007 had remarked that 'Basel II is not a goal, but a journey'. Basel II is to be considered as architecture for governance of banks, and not just capital adequacy, he observed. It is a wholesome package and the numbers for capital charge are just a consequence. Supervisory oversight can complement but not replace the self-governance by banks themselves. Basel II simply exhorts the banks to function in a manner as to safeguard their own interests and those of their various stakeholders. It attempts to align regulatory capital with economic capital. Basel II accord has deliberately created a regulatory arbitrage for those banks which have better and robust risk management frameworks.

Structure of the Survey

Against this backdrop, the present survey seeks to assess the current status of risk infrastructure in major Indian banks, in terms of skill sets, processes, technology and data. It also attempts to assess the degree to which their risk management is driven by internal assessment and not just regulatory compliance.

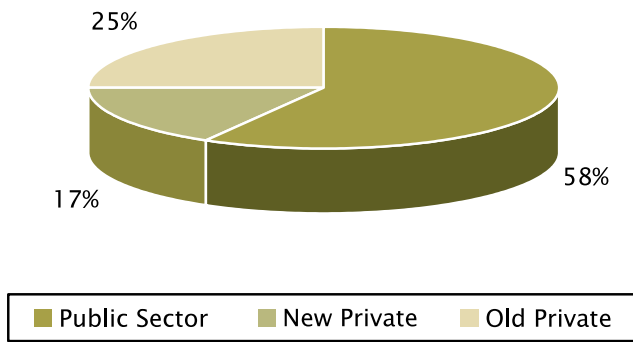
The survey has its focus on domestic banks, which can be classified into government owned (public sector) and private. The sample consists of 14 public sector banks and 10 private sector banks, of which 4 are new generation private banks and 6 are old generation private banks. The sample contains 9 banks which were required to become Basel II compliant as of March 31st 2008.

A questionnaire containing 21 questions (with some sub questions) was sent to the chairman and managing director (CMD)/executive director (ED) and head of risk management of selected banks. Based on the information submitted by respondent banks, face-to-face interviews were conducted with CMDs and risk management teams of major banks. In these interviews, attempts were made to moderate both under-reporting and over-reporting in responses to the questionnaire, and to supplement the questionnaire to elicit bank-specific details. All the respondents have been very cooperative in the interviews, and participated with such intensity as to raise the level of the interview to serious topical discussion and debate.

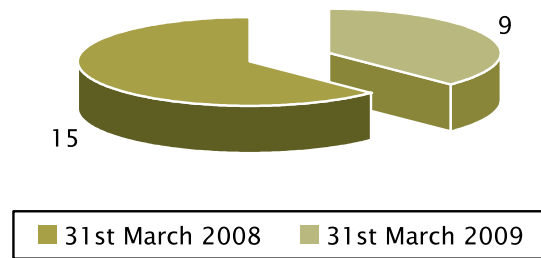
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Sample Composition

By Sector



By Compliance Date



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2. COMPLIANCE V/S RISK MANAGEMENT

One of the primary objectives of this survey was to examine the extent to which risk management process and infrastructure in Indian banks was driven by regulatory pressures to become Basel II compliant.

Was the March 2008 deadline too stiff?

The question was posed to 9 banks that were mandated to become compliant by March 2008, on account of their having international operations. Seven out of 9 banks held that **'there was no need for RBI to extend the deadline to enable us to put in place systems and processes for deriving greater benefit from improved risk management'**. Only two banks responded that the deadline could have been extended by another 12 months.

Challenges faced

Based on the responses from these nine banks, the following were the major challenges faced by them in meeting the March 2008 deadline:

- Creating awareness among staff on asset categorisation and data capture
- Data accuracy and completeness
- Getting borrowers to get themselves externally rated
- Definition of undrawn commitments
- Fine-tuning of technology solution
- Segregating all credit exposures to various categories for assigning risk weights
- Defining regulatory retail (average turnover for the last three years)
- Creating awareness at auditors' level for Basel II returns
- Putting in place all the required policies under Basel II framework relating to Internal Capital Adequacy Assessment Process (ICAAP), Disclosure, Stress Testing, Credit, Market and Operational Risk Management, Collateral Management etc

All the nine banks have been grappling with compliance issues and the deadline. All of these have faced similar challenges. But a few among these have their systems and processes in place, and have definite plans to move on to internal assessment approaches.

An interesting observation is that banks that were early adapters of core banking solution are by and large ahead of the pack in risk management also. One reason for this could be attributed to data related issues. The frontrunners have realised the importance of data centralisation and risk data warehouse.

The two banks which have indicated that an extension of compliance deadline by 12 months would have helped them are only being candid, while the majority appears to have exercised prudent restraint. One bank among the two exceptions, is in fact ahead on the risk management curve of some of the banks that have sounded confident about the deadline. Details on the challenges faced by these banks would be highlighted at appropriate places in this report.

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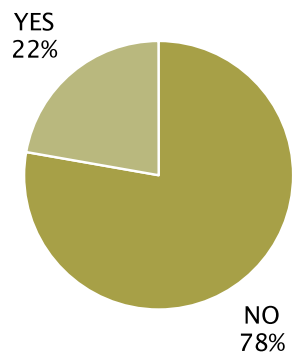
Opinion of banks which have March 2009 as deadline

Most private banks and a few public sector banks fall in this category. All the public sector banks who have to become Basel II compliant by March 31st 2009 echo their March 2008 counterparts' views that 'no extension of the deadline is needed'. All new generation private banks except one also exude the same confidence. **Some of the banks in new private and public sector have capability to become compliant ahead of the deadline.**

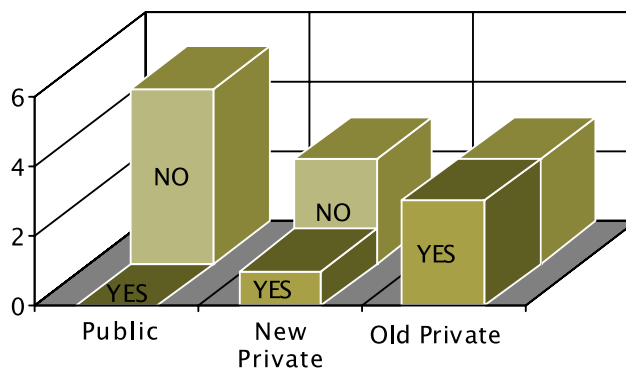
Old generation private sector banks, however, are evenly divided on this issue. Half of them want the deadline to be extended, whereas the other half does not hold this view. One private bank has sent two responses (by different functionaries) which are also divided on this issue!

Regardless of whether the deadline is March 2008 or 2009, the extra time sought by banks which favour extension, is 12 months. The opinions are graphically presented below.

March 2008 Deadline Should Have Been Extended



March 2009 Deadline Should Be Extended



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Challenges being tackled

- Data Integrity and availability
- Putting in place required systems and processes
- Data Collection
- Undrawn Limits
- Development of ICAAP & Disclosure policies
- Getting borrowers rated
- Acquiring software of capital calculation and data capture

Some of the old private banks and public sector banks are still grappling with data availability and are in the process of putting in place the required risk management infrastructure and developing policies under Pillar 2 and 3.

To what extent have Basel II compliance efforts resulted in improving risk management?

Responses to this question were on predictable lines. One-third of the respondents said 'to a limited extent' while the two-third majority claimed that the improvement has been 'substantial'. Not a single bank chose 'negligible' or 'very little' or 'to a great extent'.

But, during discussions an entirely new insight was gained. Three of the banks which maintained that improvements in risk management have been only 'to a limited extent' were in fact quite advanced in their risk management practices and implementation. It is an encouraging sign that some banks have started separating internal risk assessment from compliance efforts.

In a sharp contrast, it was also revealed that some banks which are yet to put in place robust risk management framework, have responded 'substantially'. Clearly, large differences in perception have clustered the responses slightly to the right side of the average.

The next question attempted to elicit a little more detailed response.

Possible benefits in the next two years, on account of Basel II compliance efforts

Banks were asked to rate the possibility of various benefits on a scale of 0 to 9, where 0 meant no possibility and 9 meant definitely. The responses have been depicted on the next page. Responses of two banks were outliers and hence not included in the analysis.

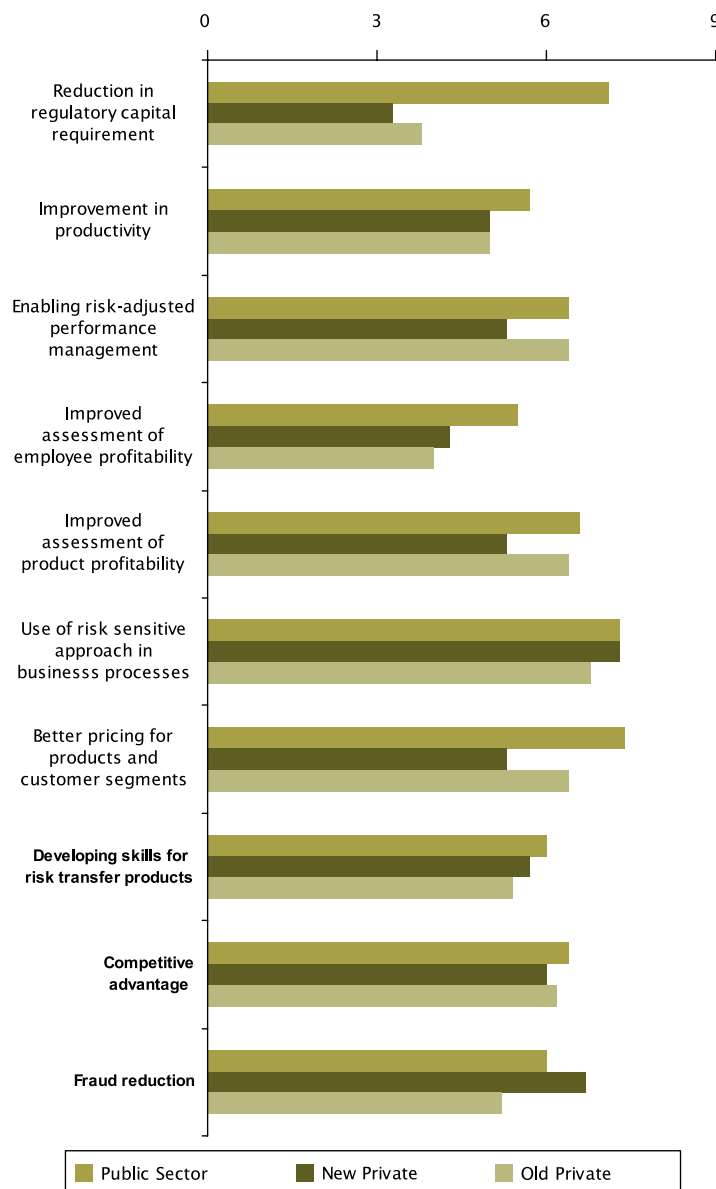
It is difficult to understand how public sector banks consider '**reduction in regulatory capital requirement**' as a benefit accruing to them in the next two years. While it is likely that the capital charge on account of credit risk may come down after all their good corporate accounts are externally rated, collateral management is complete, and issues arising out of unutilised limits are taken care of. Improvement in credit approval and monitoring process may also result in reduction of capital charge on account of credit risk. But no reduction in capital

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charge can be expected in the next two years. In fact it will increase as revenue increases. It is highly unlikely that the RBI will allow Indian banks to adopt 'Advanced Measurement Approach' for operational risk in the next two years. Also, banks do not have sufficient data to adopt this approach.

Public sector banks seem to be quite optimistic about the possibility of various benefits, with the sole exception of 'Fraud Reduction'. It is difficult to find any plausible explanation other than that this optimism results from a general tendency not to rate below average

'Use of risk sensitive approach in business processes', 'Improvement in productivity' and 'Competitive advantage' are the three benefits which have been rated almost equally by all the three categories.



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3. RISK MANAGEMENT INFRASTRUCTURE

A. Committees

All the banks under survey have an integrated risk management committee at the Board level. A few banks specifically add asset liability management (ALM) function to this committee.

At executive level, Credit Risk Management Committee (CRMC), Operational Risk Management Committee (ORMC) and Asset Liability Committee (ALCO) are functioning in almost all the banks.

Some public sector banks and old private banks have reported Credit Policy Committee and Market Risk Management Committee under risk management infrastructure, and a few banks have reported a multi-disciplinary Committee for Basel II implementation. Some banks have a Risk Management Committee at executive level which looks after credit, market, and operational risk.

Some committees are bank-specific such as:

- Business Continuity Plan (BCP) Steering Committee
- Rating Committee
- Task Force for Risk-based Supervision (RBS) and Risk-based Internal Assessment (RBIA)
- Risk Management Review Committee for Risk Governance
- Credit Risk Evaluation Committee (CREC)
- Task Force of Operational Risk Managers (functional departments) and Operational Risk Management Specialists (support departments)
- Risk management cells at zonal offices, regional offices etc

A few public sector banks have risk management cells/officers at regional/zonal centres. These banks have been able to move ahead in data collection not only for elementary approaches presently prescribed by the RBI, but have also made considerable progress in loss data collection and identification of key risk indicators (KRIs) for operational risk and data on credit default for calculating probability of default (PD).

The board level and executive level committees owe their existence in most banks to regulatory prescriptions. This is also seen to be a major reason for similarity in risk management committees in all the banks.

It is the operational level task forces, committees, or dedicated functionaries in some progressive banks that set them apart from the rest, and also indicate a development which is driven by internal decisions rather than compliance.

B. Dedicated Staff

Wide variation in the number of dedicated officers and executives for risk management function and Basel II implementation has been observed from the responses received. As the banks in the sample have large differences in size, level

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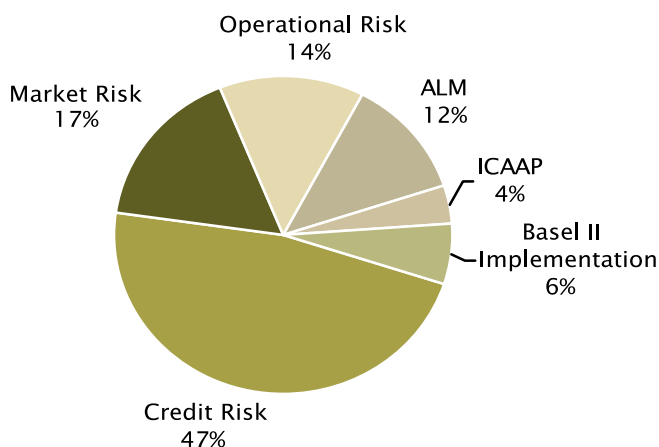
of risk management activities and in some cases even in functions performed by dedicated risk management staff; it is not possible to draw any conclusion from the numbers. For instance, one bank has the largest number of staff for credit risk -43 to be precise- but their activities also include recovery of non-performing assets (NPA).

Old private banks have people dedicated to risk management ranging from 5 to 10. Generally, the size of the risk management department appears to have a correlation with the progress made in risk management, though one or two cases of overstaffing of risk management department have been noticed.

Banks that have taken a lead in operational risk management, notably HDFC Bank and IDBI Bank, have a larger number of dedicated personnel looking after operational risk. Smaller banks do not have clear cut segregation of duties in their integrated risk management department, but for the purposes of reporting they have bifurcated the staff strength in risk management.

The following chart summarises the distribution of the dedicated staff among various risks and functions:

Distribution of Dedicated Staff



The above distribution does not take into account staff at regional/zonal/field offices.

C. Managing Skill Set

‘Does your bank have sufficient skill-set for driving risk management? If yes, how did you achieve this; and if no, what initiatives are being formulated to tackle this problem?’

Surprisingly, two public sector banks have been bold enough to say NO. Two other public sector banks have responded with a moderate ‘to some extent’. Three of the old private banks have avoided the question with responses such as ‘yes we have posted trained personnel for risk management’, ‘steps are being taken to develop

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sufficient skills by imparting knowledge to staff members of all cadre’, and ‘postings to the risk department are done considering the skill level of the staff’.

During face-to-face discussions, quite a few public sector banks have admitted that recruiting and retaining skilled staff for risk management at the current compensation levels is a challenging task. One large public sector bank which has done pioneering work in credit risk management, informed that it has lost its skilled manpower to other banks and solution vendors.

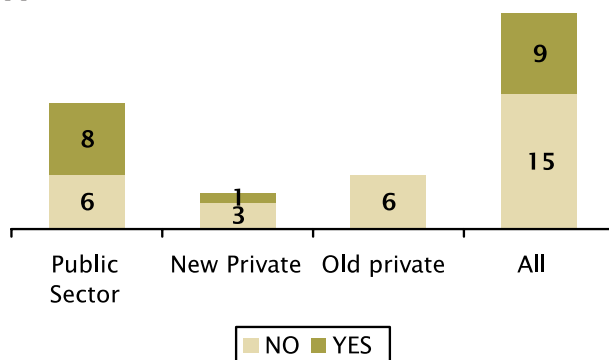
Some banks have resorted to recruiting skilled manpower from the market at both entry level and at higher levels. Providing training to internal staff through internal training facilities and also at external institutes like National Institute of Bank Management (NIBM), Professional Risk Managers’ International Association (PRMIA), Institute of Insurance and Risk Management (IIRM), Bankers Training College (BTC) etc, is another approach that the banks are following.

Bold statements notwithstanding, the responses betray a serious shortage of skilled manpower for risk management function in banks, which is more acute for smaller banks. The shortage gets aggravated due to attrition and transfers, especially in public sector banks. Banks where senior executives have been working in the risk management function for a longer period, have been found to have made more progress.

D. Appointing Consultants

Nine banks appointed consultants for Basel II implementation and establishing risk management framework. Eight of these banks are public sector banks, while only one is a new private bank. None of the old private sector banks have appointed a consultant.

Appointed A Consultant?



But the picture becomes clearer when we analyse hiring of a consultant by the two categories of banks - those which were to become compliant by March 2008 and those who were to do so by March 2009. The break-up is depicted in the chart below.

Public sector banks constituted a large share of the banks that were to become compliant by march 2008. More than half of these banks have gone for a

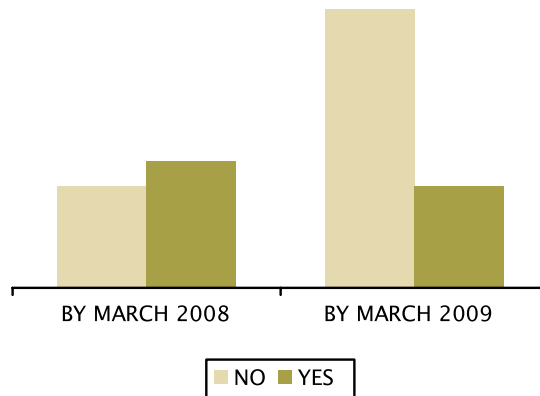
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consultant. In fact, one public sector bank had hired three consultants-PriceWaterhouseCoopers (PWC) in 2001 for ‘diagnostic study to ascertain the areas that needed improvement in respect of the risk management function’, IBM and Boston Consultancy Group in 2005 for ‘gap study post PWC report for Basel II framework and to define standardised data requirements and process document’, and finally Ernst & Young in 2007 to do audit and gap analysis of comprehensive data and system architecture on credit risk management, and of software solution for Basel II implementation.

The other consultants who were appointed by banks include:

- Deloitte Touche Tohmatsu
- Crisil
- IMaCS (ICRA)

Consultant Appointed by Different Categories



It must also be noted that many banks which have selected a rating solution or a capital calculation engine, have contracted for some amount of consultancy by the supplier (for instance, Crisil).

E. Risk Data Warehouse

The status of implementation of risk data warehouse in the banks under survey is depicted in Table 1.

Table 1

STATUS	PUBLIC SECTOR	NEW PRIVATE	OLD PRIVATE	TOTAL
No action	-	1	2	3
Process initiated	4	2	3	9
Consultant appointed	1	-	-	1
Data requirements defined	1	-	1	2
Vendor Selected	1	-	-	1
Implementation in process	7	-	-	7
Fully Implemented	-	1	-	1

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4. PILLAR 1 RISKS

Part of the survey questionnaire focused on current status of Basel II compliance in respect of specific risks such as credit risk, market risk, operational risk, under pillar 1; and other steps taken for management of residual risks like interest rate risk, liquidity risk, concentration risk etc under pillar 2.

A. Credit Risk

Tasks completed

In response to the question on the activities completed in respect of credit risk capital charge calculation under Basel II, almost all the banks reported that they have been able to segregate their entire credit portfolio (wholesale and retail) into different risk-weight classes.

Ten out of 14 public sector banks reported having completed the task of **'obtaining external ratings on eligible wholesale exposures'**, two of these reported that 'it is being done' and the rest two are yet to begin. All old private sector banks except one have not responded to the question.

During discussions, all public sector banks informed that they are using all the four external credit rating agencies viz CRISIL, ICRA, FITCH, and CARE that have been approved by the RBI. It also came to light that there is resistance from the corporate borrowers in getting themselves rated. While big corporate borrowers (above INR 50 crores) pose fewer problems, smaller corporate borrowers are seen to be a problem.

But if these unrated borrowers get themselves rated, it would release capital for the bank, and the benefits could be passed on in the form of interest rate concessions to motivate these borrowers to get themselves rated. 'There is no leeway available to us to grant further concessions in interest rates,' observes one public sector banker, and adds that 'we may think of penalising them if they do not get rated'. Most of these banks are hopeful of getting 80 to 90 percent of their corporate borrowers rated by March 2009.

In addition to the resistance from the borrowers, capacity of rating agencies is another issue. Most bankers agree that all the four rating agencies combined cannot scale up to the task. 'Rating agencies are under pressure' observe the banks.

'Defining eligible financial collaterals and establishing a management system for them' is a task which all public sector banks and most private banks claim to have completed. During discussions, it appeared to be a tall claim by most of the banks.

Except two public sector and two old private banks all banks have reported that they have either internally developed or bought a capital calculation solution and a rating solution.

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Preparing for IRB and permissible risk mitigation techniques

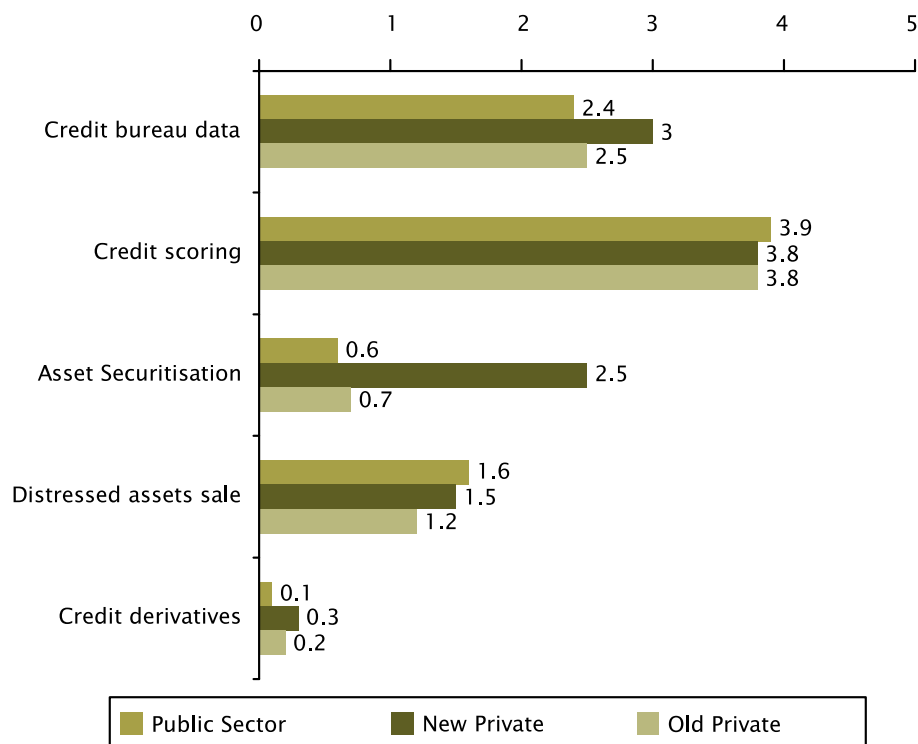
Nine public sector banks have reported that they have completed ascertaining data requirements for Internal Ratings Based (IRB) approach for credit risk and done data gap analysis and data quality assessment. Six out of these nine banks are those which have already become compliant in March 2008. Only one new private sector bank joins these nine public sector banks, while another claims that efforts are on in this direction. All other new private and old private banks are yet to begin this process.

Similarly, the task of deciding policies on permissible risk mitigation techniques like credit derivatives or on-balance sheet netting has been reported to have been completed by six public sector banks, two new private sector banks and also by three old private banks.

Managing credit risk at origination and through risk transfer mechanisms

Banks were asked to rank five such mechanisms on a scale of 1 to 5 based on their current use in credit risk management (The higher the rank, the more is the use). The responses are displayed in the chart below:

Extent of Use of Certain Mechanisms



Credit scoring is being used by all the banks to a great extent. However, during discussions it was revealed that most of the scorecards are judgment-based and do not use statistical techniques. Use of credit bureau data comes next. Here new

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private banks are seen to be using it a shade more than public sector and old private banks.

New private banks rely a lot on asset securitisation as a risk transfer tool. Its use by public sector and old private banks is negligible. Public sector banks lead in selling distressed assets, though the difference is a marginal one vis-à-vis their private counterparts. But this mechanism is yet to gather momentum.

Lack of market for credit derivatives, and regulatory constraints are cited as the reasons for dismal use of this mechanism.

B. Operational Risk

Responses for tasks completed for operational risk have to be taken with a pinch of salt. The level of understanding of this risk and various activities related to its measurement and management appears to be the major reason for flatness of responses received. Barring two public sector and one old private bank, all other respondents have confirmed setting up of a separate operational risk department. Some banks have one officer in this department, while the others have only two. This is clearly a case of compliance-centric reporting. A similar if not better response has been received on the task of **'operational risk policy formulation and adoption', 'Business continuity (BC) and disaster recovery (DR) policies are in place', and 'Outsourcing policy and controls are documented'**.

Seven of the fourteen public sector banks have claimed to have completed **'self risk assessment'** for operational risk; but only one new private bank has claimed it. Surprisingly, all but one of the old private banks have claimed to have completed it.

Only two public sector banks have claimed to have **'Key Risk Indicators (KRIs) identified by all business units'**. Again, while only two new private sector banks have claimed to have completed it, four of the old private banks have claimed to have done it. There appears to be a substantial qualitative and perception difference in the definition of these tasks by different banks. Hence, their responses cannot be compared.

A few banks which have undertaken identification of KRIs in true spirit are now in the process of narrowing them down. These banks have realised that tracking a large number of KRIs is not a practical solution.

Loss data collection methodology

Majority of banks have claimed to have put in place the loss data collection process in respect of operational loss events in place. Yet, as one public sector bank puts it succinctly: 'There have been instances of consistent nil reporting'. The problem of under-reporting by branches, especially of near-miss events, poses a great problem in collecting loss data. Some banks are relying on internal audit to address this issue, while some others are using the risk officers posted in field offices to ensure proper reporting.

Banks are keenly awaiting operationalisation of Indian Banks' Association's

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initiative of creating shared loss database for credit and operational risk (Cordex).

Only four banks in the sample have reported having acquired an operational risk solution. These constitute one public sector bank, two new private, and one old private bank.

C. Market Risk

Most banks are using their old systems for treasury. These include KVAR+, Kondor Global Limits, market risk solutions from Credence Analytics and 3i Infotech, and eTreasury of Tata Consultancy Services (TCS). Excel spreadsheets are also being used. New private banks are using Summit FT from Misys, Numerix, Murex and SunGard solutions, which have support for structured derivative product pricing, among other functionalities. One public sector bank is implementing Opics Plus from Misys.

Quite a few banks are looking for improvements in their existing software solutions.

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5. PILLAR 2 AND 3: POLICIES AND OPINIONS

The supervisory review process specified under Pillar 2 of Basel II Accord, among other things, attempts to capture those risks which have not been addressed under Pillar 1 completely. Interest rate risk in the banking book is one such risk.

Interest Rate Risk

Almost all the banks have reported that they have implemented 'modified duration gap' approach for interest rate risk. Some banks have implemented it across the bank while some have done it for investments only. Most banks use Excel spreadsheets and apply the approach at the group level, only one or two banks are using (Oracle Financial Services Application (OFSA) to implement this approach at item level. One bank is implementing BALM from Surya Software, while three banks use Pinnacle (Kastle ALM) from 3i infotech.

Some banks are treating corporate accounts at item level and retail accounts at group level. Some others are treating investments at item level and others at group level. Three banks have reported that it is yet to be implemented.

Quite a few banks which do not have a proper software solution, are planning to acquire/ upgrade the existing one to move on to item level implementation.

Disclosure Policy under Pillar 3

Only five banks in the sample are yet to adopt the disclosure policy. The accounts (or finance, as some banks call it), and risk management department are the two departments which collaborate to implement this policy. One or two banks have a disclosure committee and a compliance officer who is responsible for implementation of the policy.

Stress Testing, ICAAP and related issues

Most banks have claimed that they have a board approved ICAAP in place, while some are in the process of formulating it as per the guidelines issued by the RBI in March 2008. We are intentionally not mentioning the numbers since during discussions many banks have admitted that ICAAP is being formulated / approved /modified.

Liquidity risk, Credit concentration risk, interest rate risk in the banking book, and reputation risk have been mentioned as the residual risks that most banks want to address in their ICAAP.

Stress testing policy has also been reported by quite a few banks to be in place and is primarily being used for asset liability management (ALM) and interest rate risk.

Most of these policies have been formulated under regulatory pressure. Implementation is yet to start, and only when it starts, the new challenges and issues will emerge. As of now, these represent only the good intentions.

Question on 'benefits of Economic Capital Methodology' evoked only academic responses which have been dropped from this report.

As of now, no bank is considering '**measuring correlations between various risks**'.

Opinions

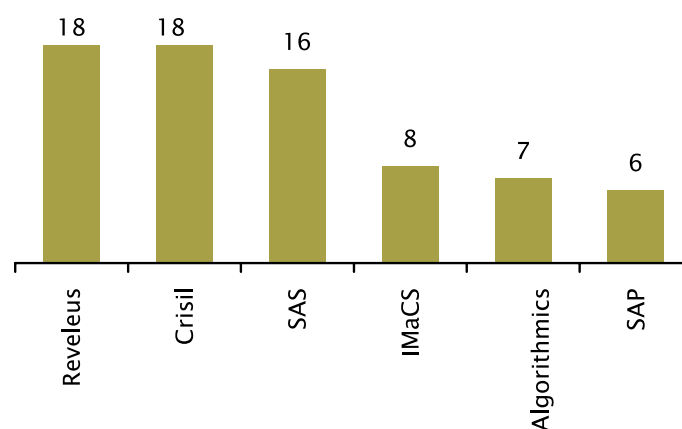
Banks in the sample were almost unanimous that they want to '**migrate from standardised approach for credit risk to advanced IRB via foundation IRB**'. Only one old private bank wants to jump straight to advanced IRB from standardised approach. Major public sector banks, most of the new private banks and a few old private banks have already begun preparations to collect data for foundation IRB (FIRB). The general expectation is that domestic banks will be able to migrate to FIRB earliest by 2010 or 2011, if permitted by the RBI.

In case of operational risk, 16 banks want to '**migrate finally to Advanced Measurement Approach (AMA) via Standardised Approach**'. These include three new private banks, two old private banks, and 11 public sector banks. One old private bank wants to remain at basic Indicator Approach, while the other wants to migrate only to Standardised Approach. Five banks, which include three public sector and two old private banks want to jump to AMA.

During discussions, there were many converts from the group of 16 to those who wanted to jump to AMA. These banks were asked what benefits they will get by moving to Standardised Approach. The cost of segregating revenues across eight business lines will not be worth the nominal reduction offered by Standardised Approach, most of them conceded. Only Union Bank of India and Punjab National Bank maintained their position.

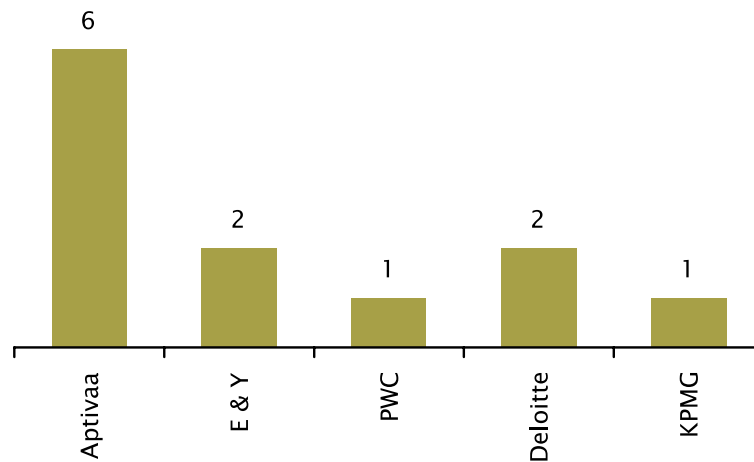
Top Six Risk Solution Suppliers

Banks in the sample were asked to name six risk solution suppliers they knew well. The chart below captures their responses.



Respondents had mixed up consultants, solution suppliers, and system integrators. The position of consultants is depicted below:

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Crisil, Reveleus, and SAS lead the risk solutions market in India. IMaCS, Algorithmics, SAP, SunGard and OFSA of Oracle are also well-known. Lesser known are Fermat, Misys, Riskraft, Kalypto and RiskMetrics.

Among consultants, Aptivaa leads, followed by Ernst & Young and Deloitte. TCS is the preferred system integrator, followed by Wipro.

There is no doubt that most of the risk management efforts of domestic banks in India at this point of time have been motivated by regulatory compliance. But, some banks have started thinking beyond compliance and are looking at risk management as a strategic business tool. Based on the survey responses and personal interviews, banks in the sample can be broadly classified under three categories as in Table 2. We have included only the typical examples.

Table 2.

Category	Example Banks
Leaders	State Bank of India, Punjab National Bank, Union Bank of India, Bank of India, HDFC Bank
Catching up	Bank of Baroda, Syndicate Bank, Vijaya Bank, Karnataka Bank, ING Vysya, Indian Bank
Beginners	Allahabad Bank, Dena Bank

Size, skill set, and motivation of the top management are the three critical factors that separate these categories. The journey from compliance to internal assessment by domestic banks has just begun, but the momentum forward is clearly visible.

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Indian Banks' Association

Indian Banks' Association, formed in 1946, is an advisory service organisation of banks in India. It serves as a co-ordinating agency and a forum for its 156 member banks to interact in matters concerning the banking industry. IBA members comprise of Public Sector banks, Private Sector banks, Foreign Banks having offices in India, and Urban Co-operative banks. IBA's vision is "to work proactively for the growth of a healthy, professional and forward looking, banking and financial services industry, in a manner consistent with public good".

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