



Summary of Recommendations

5.1 The Committee reviewed the literature on international practices about designing and operating the differential premium systems as also the models in use. While deliberating on the development of an appropriate design for differentiating banks, the Committee also placed reliance on the guidance available from the IADI through its various papers and publications. The Committee held elaborate discussions and identified the important considerations, which were needed to be kept in view while designing and instituting the differential premium system. Taking these into account, the Committee has made certain recommendations in Chapters 3 and 4 for developing a Differential Premium System for banks in India. Summary of these recommendations is presented in the following paragraphs.

Recommendation 1

5.2 The Committee debated upon the magnitude of task likely to devolve on the Corporation in finalising the rating process and the heterogeneity in the different classes of banks in the context of their adaptive capabilities. Having regard to these aspects, the Committee recommends a simple and easy to understand, but a robust rating model capturing key risk parameters should be put in place. ***(Paragraph 3.5)***

Recommendation 2

5.3 Placing reliance on international practices, IADI guidance and also the merits of retaining visible distinction among the rating categories, the Committee recommends that number of categories for assigning premium rates should be limited to four or five. ***(Paragraph 3.7)***

Recommendation 3

5.4 Due to qualitative inputs not being readily available and the Corporation's own difficulties in collecting such inputs across the entire universe of banks, the Committee came to the view that the input variables could be designed based on the annual audited/published data of the individual banks for a large part, say, weighing upto 90% in the overall score. Other information like conduct of a member in dealings with the Corporation, eligibility for access to Reserve Bank's liquidity window, regulatory penalties, adoption of IT and other soft information may constitute remaining 10%. ***(Paragraph 3.8)***

Recommendation 4

5.5 Committee was of the view that any model to be used for rating should have predictive power of the risk of insured banks, at least for the near future which is feasible only through forward looking assessments like risk based supervisory assessments. The Committee, taking note of the practice of quite a few jurisdictions (Canada, Malaysia, Turkey, US) in which supervisor's rating is an important input, recommends that the Corporation may consider initiating a dialogue with the Supervisors for entering into a formal arrangement under which the supervisors could share their ratings with the Corporation under appropriate safeguards of confidentiality and usage, in due course of time by which the supervisors would have subjected all the banks to the forward looking risk assessment. At that stage, Corporation can refine the rating model further and use supervisory rating as an additional input in the rating process. ***(Paragraph 3.9)***

Recommendation 5

5.6 For operationalization of the rating system, the Committee realised that supervisory information sources, particularly in respect of cooperative banking sector have not yet stabilised. The Committee therefore recommends that the Corporation institutes its own appropriate MIS for the member banks for collecting model related data. ***(Paragraph 3.10)***

Recommendation 6

5.7 For the sample validation of data submitted by the banks in connection with rating process, the Committee recommends that the supervisors, on the lines of verification of returns currently submitted by the banks to the Corporation, could extend their checking to the information submitted by the banks in the context of rating also, during the course of their inspections as and when taken up, and furnish a feedback to the Corporation. **(Paragraph 3.11)**

Recommendation 7

5.8 The Corporation should also utilise the supplementary information available from sources easily accessible, to upgrade its market intelligence about general wellbeing of the member banks and also to use this information to validate the Corporation's assessment of banks. For example, the peer reviews on commercial banks and scheduled UCBs being prepared by regulatory/supervisory departments would provide a good indication about banks' current state and the likely path of future. The Committee also suggests obtaining appropriate inputs from NABARD in respect of RRBs, State and District Central Cooperative Banks. **(Paragraph 3.12)**

Recommendation 8

5.9 In order to promote the sanctity of the Differential Premium System, the Committee recommends that there should not be any forbearance for non-receipt or late receipt of model related information from a bank and any such default should earn the bank a straight downgrade of rating by a notch and accordingly premium be charged at the corresponding rate. **(Paragraph 3.13)**

Recommendation 9

5.10 For a bank which has just started its operations, the Committee recommends that such a bank may be assigned a premium category corresponding to 'base premium rate' till it produces its first annual financial accounts. It is assumed that a new bank would produce its financial accounts at the first annual financial accounting date (currently 31 March), after the commencement of its operations. **(Paragraph 3.14)**

Recommendation 10

5.11 To handle a merger situation, the Committee recommends that merging entity will pay premium till the date of its deregistration by the Corporation, at the rates applicable to it, while post merger, the bank taking over will pay the premium applicable to it from the date of deregistration of merged entity till the next rating reset. ***(Paragraph 3.15)***

Recommendation 11

5.12 For providing incentives in favour of better rating and dis-incentivising a low rating, the Committee recommends that the premium rates should move along the ratings ladder in geometric/curvilinear progression rather than arithmetic/linear progression. ***(Paragraph 3.16)***

Recommendation 12

5.13 The Committee recommends rating discovery on annual basis, based on the annual audited data of the banks on March 31 and accordingly annual reset of the premium rates. ***(Paragraph 3.20)***

Recommendation 13

5.24 Having regard to the steps involved in the exercise, rating arrived as of March 31, should apply for the following October –September insurance period. ***(Paragraph 3.21)***

Recommendation 14

5.15 Though the Committee decided that rating calculation and premium reset could be an annual exercise, the Committee was not averse to obtaining information for the model's inputs from the banks on a half yearly basis, to take advantage of the benefits accruing from tracking a bank's performance in the context of a possible unexpected deterioration in its performance, particularly in respect of the banks in the lowest or second lowest rating category in the latest available rating and the need for consequent remedial action. ***(Paragraph 3.22)***

Recommendation 15

5.16 Committee examined the desirability of bringing in the pro-cyclicality in premium rates reset with the intention of collecting higher premium during the periods of good performance for faster build up the Reserve Fund, or a lower premium during periods of stress, but did not find it either feasible or desirable. **(Paragraph 3.23)**

Recommendation 16

5.17 The Committee, in the interest of transparency, recommends the key characteristics of the rating model be published in public domain. **(Paragraph 3.26)**

Recommendation 17

5.18 The rating process and results, within the Corporation, should be managed with due care of confidentiality. In the world outside the Corporation, only the rated bank should know its rating. The Committee observed that the confidentiality safeguards adopted by Reserve Bank with regard to their rating system could be looked at for instituting the confidentiality and usage requirements within the Corporation. **(Paragraph 3.27)**

Recommendation 18

5.19 The Committee also recommends that within a rated bank, rating should be known only to key/important personnel and should not be disclosed or used by the bank for any other purpose like canvassing of business, or any type of capital funding, etc. **(paragraph 3.28)**

Recommendation 19

5.20 Introduction of Differential Premium System is a major systemic change for the insured banks. The Committee therefore recommends that transition be managed with due care. Appropriate consultations may be held with stakeholders like representative bodies of insured banks, supervisors, regulators and the government and a clear transition path is laid down. **(Paragraph 3.29)**

Recommendation 20

5.21 New classes of banks viz. Payment Banks and Small Finance Banks may start operating in due course. The Corporation would need to revisit the proposed rating model for examining the format and applicability to these classes of banks as and when these banks start operating. **(Paragraph 3.30)**

Recommendation 21

5.22 As the financial landscape and regulatory and supervisory norms are continuously evolving, Committee recommends that all the aspects of the rating system and premium collection be reviewed periodically, at a minimum of once in three years so that the rating system and methodology remain current and relevant. **(Paragraph 3.31)**

Recommendation 22

5.23 While keeping the model simple but with capability of capturing all-important risks on the balance sheet of a bank, Committee recommends a rating model adapted to CAMELS approach with following ingredients:

- (a) Capital Adequacy and quality of its composition (weight 25%),
- (b) Asset Quality (weight 25%),
- (c) Profitability (weight 20%)
- (d) Liquidity (weight 20%), and
- (e) Other information (weight 10%)

(Paragraph 4.9)

Recommendation 23

5.24 The Committee recommends capturing risks through various sub-ingredients incorporated in the model so as to exhibit a higher objectivity.

(Paragraph 4.12)

Recommendation 24

5.25 The Committee recommends transparent rules for assigning Reward Points (RPs) for each sub-ingredient. **(Paragraph 4.13)**

Recommendation 25

5.26 The Committee recommends that the Corporation should institute a system of rating review to provide an opportunity to members if any of them desires and appeals for the rating calculation to be rechecked. Notwithstanding the appeal, the requesting bank must pay the premium on or before the due date for the relevant insurance period. **(Paragraph 4.15)**

Recommendation 26

5.27 The Committee examined two methods of classification of objects among different risk groups – percentile method and benchmark method. In the interest of the model capturing the risks and classifying the banks equally well in the varying economic conditions, Committee recommends a benchmark-based approach for classification. **(Paragraph 4.19)**

Recommendation 27

5.28 Keeping in view the earlier recommendation that restricting the number of risk categories to 4 or 5, the Committee recommends classification of banks in 4 risk categories as under:

- (i) Low Risk (LR) banks - banks with total RPs 80 and above;
- (ii) Moderate Risk (MoR) banks - banks with total RPs 65 and above but below 80;
- (iii) Medium Risk (MeR) banks - banks with total RPs 50 and above but below 65;
- (iv) High Risk (HR) banks - banks with total RPs below 50;

(Paragraph 4.20)

Recommendation 28

5.29 Based on the results of a simulation conducted across 87 commercial banks and 50 scheduled urban cooperative banks, together capturing 92% of assessable deposits and ensuring that the premium collection is not adversely affected, the Committee recommends following premium rate structure:

Rating	Base PremiumRate (paise % pa)	Multiplicative Factor	Effective Premium Rate	Step Up
(1)	(2)	(3)	(4)=(2)*(3)	
LR	10	0.95	9.5	-
MoR	10	1	10	0.5
MeR	10	1.1	11	1
HR	10	1.25	12.5	1.5

(Paragraph 4.23)

Recommendation 29

5.30 For placing the banks on a transition path and enabling them an opportunity to improve their financials before the proposed classification rules set in, the Committee recommends application of relaxed classification rules for first year, as under:

- (i) Low Risk (LR) banks - banks with total RPs 75 and above;
- (ii) Moderate Risk (MoR) banks - banks with total RPs 60 and above but below 75;
- (iii) Medium Risk (MeR) banks - banks with total RPs 45 and above but below 60;
- (iv) High Risk (HR) banks - banks with total RPs below 45;

(Paragraph 4.25)

Recommendation 30

5.31 The Corporation has not yet set up a formal Reserve Ratio Target though it is working towards attaining an informally set level of 2.5%. The Committee recommends that the Corporation set up a Reserve Ratio Target on a scientific basis and strive to achieve the same. The Target Ratio should also be subjected to periodic review so that it remains updated for evolving banking conditions. **(Paragraph 4.27)**

Recommendation 31

5.32 Once the Target is reached, the Corporation may revise the premium rates downward without compromising on continuous maintenance of the target and may also raise the rates in case the Reserve Ratio falls below the target due to some event so as to restore it back to the target. (***Paragraph 4.28***)