

BASEL II (PILLAR 3) Disclosures

1. Scope of Application

Pillar 3 disclosures apply to Kotak Mahindra Bank Limited (KMBL) and its consolidated entities for regulatory purposes, wherein KMBL is the controlling entity in the group.

Basis of Consolidation for capital adequacy

The consolidated capital adequacy is based on consolidated financial statements of Kotak Mahindra Bank and its subsidiaries, prepared in accordance with guidelines for consolidated accounting and other quantitative methods vide circular DBOD.No.BP.BC.72/21.04.018/2001-02 dated 25th February, 2003 issued by Reserve Bank of India (RBI). The capital charge is computed as per RBI guidelines for implementation of the New Capital Adequacy Framework (Basel II) released in April 2007.

In accordance with the guidelines issued by RBI, the insurance subsidiary has been excluded from consolidation for the purpose of capital adequacy. The entities which carry on activities of financial nature are considered for consolidation for capital adequacy purpose as stated in the scope for preparing consolidated prudential reports laid down in RBI guidelines. The Bank consolidates all subsidiaries as defined in Accounting Standard (AS) -21 *Consolidated Financial Statements* on a line by line basis by adding together like items of assets, liabilities, income and expenses. Further, Bank's investments in Associates are consolidated using the equity method of accounting as defined by AS – 23 *Accounting for Investments in Associates in Consolidated Financial Statements*. Kotak Mahindra Bank Limited (KMBL) and its subsidiaries/ associates which have been consolidated, constitute the "Group". The list of subsidiaries/ associates consolidated as per AS 21 alongwith their treatment in consolidated capital adequacy computation is as under:

Name of the Subsidiary	Country of Origin	Activity	Status of consolidation
Kotak Mahindra Prime Limited	India	Non Banking Finance Company	Fully consolidated
Kotak Securities Limited	India	Securities Broking	Fully consolidated
Kotak Mahindra Capital Company Limited	India	Investment Banking	Fully consolidated
Kotak Mahindra Old Mutual Life Insurance Limited	India	Life Insurance	Fully consolidated for financial reporting but not for capital adequacy. Investment deducted from regulatory capital for capital adequacy
Kotak Mahindra Investments Limited	India	Non Banking Finance Company	Fully consolidated
Kotak Mahindra Asset Management Company Limited	India	Asset Management Company – Mutual Funds	Fully consolidated
Kotak Mahindra Trustee Company Limited	India	Trustee of mutual funds	Fully consolidated
Kotak Mahindra (International) Limited	Mauritius	Brokerage and advisory services	Fully consolidated
Kotak Mahindra (UK) Limited	U.K	Brokerage and advisory services	Fully consolidated
Kotak Mahindra, Inc.	USA	Brokerage and advisory services	Fully consolidated
Global Investments Opportunities Fund Limited (GIOFL)*	Mauritius	Investment company	Fully consolidated
Kotak Investment Advisors Limited	India	Asset manager of venture capital, private equity and similar funds	Fully consolidated
Kotak Mahindra Trusteeship Services Limited	India	Trustee of venture capital, private equity and similar funds	Fully consolidated
Kotak Forex Brokerage Limited	India	Foreign exchange brokerage services	Fully consolidated
Kotak Mahindra Pension Fund Limited	India	Pension fund management	Fully consolidated
Kotak Mahindra Financial Services Limited	Dubai	Advising on financial products for Middle East	Fully consolidated

Name of the Subsidiary	Country of Origin	Activity	Status of consolidation
Business Standard Limited **	India	Publishing	Consolidated by equity method for financial reporting but not for capital adequacy purpose
Business Standard Digital Limited **	India	Publishing	Consolidated by equity method for financial reporting but not for capital adequacy purpose
Infina Finance Private Limited	India	Non Banking Finance Company	Consolidated by equity method
Kotak Mahindra Asset Reconstruction Company Limited	India	Not operational	The company is not operational and Other than temporary diminution is provided for
Phoenix ARC Private Limited	India	Securitisation and asset Reconstruction	Consolidated by equity method
Ahmedabad Commodity Exchange Limited	India	Commodity Exchange	Consolidated by equity method
Regency Hospital Limited §	India	Hospital	Consolidated by equity method for financial reporting but not for capital adequacy purpose
Matrix Business Services India Private Limited	India	Business service provider	Consolidated by equity method for financial reporting but not for capital adequacy purpose

* GIOFL is a collective investment scheme set up as a fund in Mauritius with the status of a limited company under the Mauritius Companies Act. GIOFL has a class structure wherein there are different classes of redeemable participating shares. Each class of participating shares has its own Balance Sheet and Profit and Loss account. The Profit and Loss of each such class belongs to the participating shareholders of that class. The management shareholder is not entitled to any beneficial interest in the profit and loss of various classes nor is required to make good any shortfall. In substance there are no direct or indirect economic benefits received by the management shareholders. The substance over form must prevail. Accordingly, GIOFL is consolidated in respect of management shares of the entity having regard to substance over form of the entity.

** On 17th June, 2010, the Group substantially sold its stake in Business Standard Limited. Consequently Business Standard Limited and Business Standard Digital Limited ceased to be associates.

§ On 30th March, 2010, the Group sold its entire stake in Regency Hospitals Limited. Consequently the company has ceased to be an associate.

a. Capital Deficiencies

As at 31st March, 2010 there is no deficiency of capital in any of the subsidiaries of the Bank. The Bank maintains an oversight over its subsidiaries through their respective Boards and the Management Committee of the Bank is regularly updated.

b. Investment in insurance subsidiary

The Group's investment in insurance subsidiary is deducted from regulatory capital for capital adequacy purpose under Basel II as given below:

Rs. in crores

Name of the Entity	% shareholding of the Group	Investment value
Kotak Mahindra Old Mutual Life Insurance Limited	74%	377.62

The quantitative impact on regulatory capital of using risk weights investments versus using the deduction method is given below:

Rs. in crores

Method	Quantitative Impact
Deduction method	377.62
Capital at 10% based on risk weighted assets	37.76

2. Capital Structure

The capital adequacy norms issued by RBI classify capital funds into Tier-1 and Tier-2 capital. Tier-1 capital includes paid-up equity capital, statutory reserves, other disclosed free reserves, capital reserves and Elements of Tier-2 capital include investment reserve, general provision and loss reserve, eligible upper Tier-2 instruments and subordinated debt instruments (lower Tier -2 bonds). Group has issued debt instruments that form part of Tier-2 capital. The terms and conditions that are applicable for these instruments comply with the stipulated regulatory requirements.

Details of Upper Tier 2 and Lower Tier 2 Capital

Kotak Bank has issued debt instruments that form a part of Tier-2 capital. The terms and conditions that are applicable for these instruments comply with the stipulated regulatory requirements. The upper Tier-2 bonds are cumulative and have an original maturity of 15 years with call option after 10 years. The interest on upper Tier-2 bonds is payable either annually or semi-annually. Some of the upper Tier-2 debt instruments have a step-up clause on interest payment ranging up to 50 bps. The lower Tier-2 Subordinated bonds issued by Bank are cumulative and have an original maturity between 5 to 15 years. The lower Tier-2 Subordinated bonds issued by a subsidiary have an original maturity between 6 to 10 years and interest on these lower Tier-2 capital instruments is payable annually.

a. Amount of Tier I and Tier II Capital

Rs. in crores

	Amount
(a) Tier I Capital	
Paid-up share capital	348.14
Reserves and Surplus excluding translation and investment reserve	7,662.07
Deductions:	
Investment in paid-up capital of subsidiaries/ associates (50%)	190.64
Intangible assets other than Goodwill	325.70
Goodwill	3.42
Net Tier I Capital	7,490.45
(b) Total eligible Tier II Capital	823.81
(c) Debt instruments eligible for inclusion in Upper Tier II Capital	
Total amount outstanding	338.05
Of which raised during the current financial year	—
Amount eligible to be reckoned as capital	338.05
(d) Subordinated debt eligible for inclusion in Tier II capital	
Total amount outstanding	554.80
Of which raised during the current financial year	—
Amount eligible to be reckoned as capital	485.76
(e) General Provisions and loss reserves	176.95
(f) Investment reserve	42.89
Deductions:	
Investment in paid-up capital of subsidiaries/ associates (50%)	190.64
Net Tier II Capital	853.01

b. Total eligible capital as at 31st March, 2010

Rs. in crores

	Amount
Tier I Capital	7,490.45
Tier II Capital	853.01
Total eligible Capital	8,343.46

3. Capital Adequacy

The Group has made considerable progress in capturing data and implementing systems with regards to computing capital adequacy as per the standardised approach of Basel II for credit risk. Efforts are on to automate the process of capital computation as per Basel II and application system is being implemented to that effect.

In line with the guidelines of the Reserve Bank of India, the Group has adopted standardised approach for credit risk, basic indicator approach for operational risk and standardised duration approach for market risk for computing capital adequacy.

Approach to Capital Adequacy Assessment to support business activities

The diversified business activities require the Group to identify, measure, aggregate and manage risks effectively and to allocate capital among its businesses appropriately. The risk management framework lays emphasis on the Group's risk philosophy, proper organisational structure, risk and reward balance and is supported by dedicated monitoring and risk measuring mechanism.

Basic principles and risk and capital management

The Board is involved in defining risk appetite and capital at risk for the Bank, at an integrated level, covering all activities of the Bank. Development of the risk strategy and risk appetite is an ongoing process and is based on past experience and future plans. The risk strategy is consistent with the Board's overall risk tolerance, management's expertise in each business unit and the total financial amount that the Bank is prepared to place at risk of loss (capital at risk).

The Management Committee provides overall risk management supervision for the consolidated Group as a whole. Various risk committees, namely Asset Liability Management Committee (ALCO), Credit Committee, First Tier Audit Committee, Risk Management Committee, Information Security Committee etc, review specific risk areas and supervise the activities of enterprise wide risk management.

Other capital adequacy assessment aspects:

- Capital adequacy ratio (CAR) of the Bank is maintained at levels well over the 10% required in accordance with the license conditions.
- The Bank has put in place the ICAAP Policy and the same is being reviewed on a yearly basis which enables the Bank to maintain capital in line with the risks undertaken.

CAR has been worked out based on Basel-I and Basel-II guidelines (parallel run) and CAR is above the regulatory minimum level of 10%.

Capital requirements for various risk categories as at 31st March, 2010

Rs. in crores

Items	Amount
(a) Capital requirements for credit risk	
Portfolios subject to standardised approach	3,410.21
Securitisation exposures	5.33
(b) Capital requirements for market risk	
Using standardised duration approach	
Interest rate risk	193.96
Foreign exchange risk (including gold)	20.00
Equity position risk	118.54
(c) Capital requirements for operational risk	
Measured using basic indicator approach	578.73
Total capital required at 10%	4,326.77
Total capital funds of the Group	8,343.46
Total risk weighted assets	43,267.65
Capital adequacy ratio	19.28%

Computed as per Basel II guidelines

4. Credit Risk

Credit Risk is defined as the possibility of losses associated with diminution in the credit quality of borrowers or counterparties. In a bank's portfolio, losses stem from outright default due to inability or unwillingness of a customer or counterparty to meet commitments in relation to lending, trading, settlement and other financial transactions. Credit risk is managed through a framework which sets out policies and procedures covering the measurement and management of credit risk.

The Bank's credit policies and process notes articulate the credit risk strategy of the Bank and thereby the approach for credit origination, approval and maintenance. These policies define the Bank's overall credit sanction criteria, including the general terms and conditions. The policies / processes generally address such areas as target markets / customer segmentation, qualitative-quantitative assessment parameters, portfolio mix, prudential exposure ceilings, concentration limits, structure of limits, approval authorities, exception reporting system, prudential accounting and provisioning norms, etc. They take cognisance of prudent and prevalent banking practices, relevant regulatory requirements, nature and complexity of the Bank's activities, market dynamics, etc.

The Bank's credit exposure is primarily categorised into retail and wholesale borrowers. Retail exposure is mostly term loans and asset backed other than personal loans. Wholesale borrowers are internally categorized into emerging corporate, corporate and financial institutional group. While retail credit lending is largely based on predefined parameters and is mostly decentralised, credit appraisal is undertaken by an independent dedicated credit risk team for wholesale exposure.

Credit risk management processes

The Bank has made risk management a part of the management and governance of the bank with a greater focus on risks and how those relate to the capital the bank is holding. The Bank expects to achieve its earnings objectives and to satisfy its customers' needs while maintaining a sound portfolio. Credit exposures are managed through target market identification, appropriate credit approval processes, post-disbursement monitoring and remedial management procedures. Proactive managing of risks on its portfolio has helped the Bank foresee and restrict the impact of the global turmoil on its credit operations. Periodic portfolio review, clear identification of early warning signals and prompt action on the legal and recovery front ensure that defaults are minimal. Timely and in-depth research on industries and sectors ensure that funds are directed to positive outlook sectors. Adverse developments in sectors are tracked to facilitate timely decisions to exit Companies in negative outlook sectors. The above processes ensure that the Bank maintains a well diversified portfolio mitigating any risks on account of sector, region or borrower concentration.

During the year, the bank has also put in place rating based approval matrix for sanctioning wholesale bank loans.

Nature of reporting and measurement systems

The Bank has an internal rating model which is an integral part of every lending decision and is capable of rating large and emerging corporates, traders, brokers, NBFCs and services. The rating model is being further enhanced to give required inputs to estimate Probability of Default (PDs) and Loss Given Default (LGDs) based on the Bank's own experience. On the retail side, the bank has initiated implementation of a comprehensive internal credit rating model for the risk assessment of retail loan exposures. Application scorecards for major businesses in retail loans are ready. The parameters used for these scorecards and their individual weight-ages have been decided based on past experience of the bank. These parameters are both qualitative and quantitative in nature. Credit rating frameworks using these application scorecards are at different stages of implementation in different businesses in retail loans. The final output of the rating will help the bank to assess the expected probable loss number attached to each rating category. The internal rating systems are being further developed and validated as part of the Bank's endeavor to move towards advanced approaches of Basel II.

During the year the Bank has also implemented its stress testing framework for the Corporate as well as Retail portfolio. During the year, the bank has also used scenario analysis for stress testing. Loss analysis and expected loss forecasting on a static pool basis is continuously being refined to meet the demand of the current volatile market.

The bank complies with the norms on exposure stipulated by RBI for both single borrower as well as borrower group at the consolidated level. Limits have been set by the risk management group as a percentage of the Bank's consolidated capital funds and are regularly monitored.

The Bank monitors the level of credit risk (Low/Moderate/High/Very High) and direction of change in credit risk (increasing /decreasing/stable) at the portfolio level on the basis of the following parameters which also indicate level of concentration risk the portfolio might be exposed to:

- Exposure to Top 20 accounts as a percentage of Credit Risk Exposure (CRE).
- Percentage of term loans with residual maturity more than 3 years to total loans and advance.
- Percentage of unsecured loans to total loan and advances.
- Number of single borrower exposures exceeding 15% of capital funds.

- Number of group exposures exceeding 40% of capital funds.
- Percentage of credit in low risk grades to total credit exposure.
- Rating wise distribution of borrowers and
- Exposure migrating from investment grade to non-investment grade.

During the year, the Bank maintained a well diversified portfolio.

As part of the ICAAP, the Bank periodically reports the ICAAP outcomes in terms of the risk appetite statements and assessment of credit concentration risk and underestimation of credit risk under the standardized approach to the Board.

Credit Risk Management Principles

The Bank measures and manages its credit risk based on the following principles:

- The extension and renewal of any credit facility to a particular borrower requires credit approval at the appropriate authority level. The rating tool, which is already in place, not only indicates the concerned sanctioning authorities but also helps the authorities in such decisions.
- The approval of all limits to counterparties should be in line with the corporate credit policy and collateral risk management policy of the bank. Such approval should generally be within the Bank's portfolio guidelines and credit strategies.
- The credit worthiness of borrowers is regularly reviewed and monitored. Customers with emerging credit problems are identified early and classified accordingly. Remedial action is initiated promptly to minimize the potential loss to the bank.

Definition and classification of non-performing assets (NPA)

The Bank classifies its advances into performing and non-performing advances in accordance with extant RBI guidelines.

A NPA is defined as a loan or an advance where;

- interest and / or installment of principal remain overdue for a period of more than 90 days in respect of a term loan;
- the account remains 'out of order' – in respect of an overdraft/cash credit (OD/CC); and
- the bill remains overdue for a period of more than 90 days in the case of bills purchased and discounted.

Out of Order

An account should be treated as 'out of order' if the outstanding balance remains continuously in excess of the sanctioned limit/drawing power for a continuous period of 90 Days. In cases where the outstanding balance in the principal operating account is less than the sanctioned limit/ drawing power, but there are no credits continuously for 90 days as on the date of balance sheet or credits are not enough to cover the interest debited during the same period, these accounts should be treated as 'out of order'.

Overdue

Any amount due to the bank under any credit facility is 'overdue' if it is not paid on the due date fixed by the bank.

Further, NPAs are classified into sub-standard, doubtful and loss assets based on the criteria stipulated by RBI. A sub-standard asset is one, which has remained NPA for a period less than or equal to 12 months. An asset is classified as doubtful if it has remained in the sub-standard category for a period exceeding 12 months. A loss asset is one where loss has been identified by the Bank or internal or external auditors or during RBI inspection but the amount has not been written off fully.

The loans of subsidiaries have been classified as non-performing in accordance with the guidelines prescribed by their respective regulators.

Total credit risk exposures as at 31st March, 2010

Rs. in crores

Overall credit exposure	Fund based	Non-fund based	Total
Total gross credit exposures	30,190.90	4,521.72	34,712.62

Includes all entities considered for Basel II capital adequacy computation

Credit exposure include term loans, working capital facilities (i.e. funded facilities like cash credit, demand loans, temporary limits and non-funded facilities like letter of credits, acceptances and guarantees).

Geographic distribution of exposures as at 31st March, 2010

Rs. in crores

Exposures	Fund based	Non-fund based	Total
Domestic	30,190.90	4,405.49	34,596.39
Overseas	—	116.23	116.23
Total	30,190.90	4,521.72	34,712.62

Includes all entities considered for Basel II capital adequacy computation
Industry-wise distribution of exposures

Rs. in crores

Industry	Fund based	Non-fund based	Total
Auto loans	11,877.12	—	11,877.12
Personal loans	3,488.73	—	3,488.73
Home loans/Loan against property	4,456.71	—	4,456.71
Credit cards	240.06	—	240.06
Other retails loans	1,608.11	—	1,608.11
Iron and steel	238.16	175.78	413.94
Engineering	274.81	271.81	546.62
Chemical, dyes, paints etc	405.82	234.05	639.87
Construction	1,288.12	—	1,288.12
Automobiles	739.09	149.37	888.46
Infrastructure	944.41	1,082.59	2,027.00
NBFC's	513.52	198.03	711.55
Other industries (i)	4,116.24	2,410.09	6,526.33
Total	30,190.90	4,521.72	34,712.62

Includes all entities considered for Basel II capital adequacy computation

- (i) Other industries include entities from sectors such as cotton textiles, sugar, food processing, vegetable oils and vanaspati, paper and paper products, rubber and rubber products, cement, IT-related, gems and jewellery, capital markets, media publication etc.

Residual contractual maturity break-down of assets as at 31st March, 2010

Rs. in crores

Maturity Pattern	Cash and balances with monetary authority	Balances with other banks	Investments	Advances	Fixed Assets	Other Assets
0 to 14 days	919.18	201.94	4,574.30	1,567.42	—	320.40
15 to 28 days	69.04	—	329.52	1,402.12	—	104.01
29 days to 3 months	200.39	—	1,184.16	3,201.84	—	245.34
Over 3 months & upto 6 months	200.11	—	967.73	3,532.24	—	58.88
Over 6 months & upto 1 year	207.60	—	1,027.76	4,388.66	—	1.21
Over 1 year & upto 3 years	401.19	55.40	3,228.04	9,957.38	—	75.44
Over 3 years & upto 5 years	24.45	—	195.47	2,486.64	—	—
Over 5 years	65.08	—	1,157.21	3,182.18	456.38	791.96
Total	2,087.04	257.34	12,664.19	29,718.48	456.38	1,597.24

Consolidated figures for Kotak Mahindra Bank Limited, Kotak Mahindra Prime Limited and Kotak Mahindra Investments Limited

Amount of non-performing loans as at 31st March, 2010 including NPAs acquired from other banks and NBFCs

Rs. in crores

Items	Amount	
	Gross NPA	Net NPA
Substandard	562.25	342.97
Doubtful 1	175.10	84.39
Doubtful 2	121.23	10.30
Doubtful 3	2.70	—
Loss	55.39	3.18
Total	916.67	440.84
NPA Ratio (%)	3.04	1.48
Movement of NPAs		
Opening balance as at 1st April, 2009	790.59	454.31
Additions	724.95	156.15
Reductions	(598.87)	(169.62)
Closing balance as at 31st March, 2010	916.67	440.84

Includes all entities considered for Basel II capital adequacy computation

Gross NPA ratio is computed as a ratio of gross non-performing loans to gross advances

Net NPA ratio is computed as a ratio of net non-performing loans to net advances

Movement of provisions for NPAs

Rs. in crores

	Amount
Opening balance as at 1st April, 2009	336.29
Provisions made during the year	569.25
Write-off / Write back of excess provisions	(429.71)
Closing balance as at 31st March, 2010	475.83

Amount of non-performing loans as at 31st March, 2010 excluding NPAs acquired from other banks and NBFCs

Rs. in crores

Items	Amount	
	Gross NPA	Net NPA
Substandard	511.23	301.96
Doubtful 1	77.79	32.27
Doubtful 2	2.40	0.42
Doubtful 3	—	—
Loss	55.39	3.18
Total	646.81	337.83
NPA Ratio (%)	2.16	1.14
Movement of NPAs (gross)		
Opening balance as at 1st April, 2009	506.01	262.14
Additions	662.59	209.47
Reductions	(521.79)	(133.78)
Closing balance as at 31st March, 2010	646.81	337.83

Gross NPA ratio is computed as a ratio of gross non-performing loans to gross advances Net NPA ratio is computed as a ratio of net non-performing loans to net advances

Movement of provisions for NPAs

Rs. in crores

	Amount
Opening balance as at 1st April, 2009	243.88
Provisions made during the year	453.12
Write-off / write back of excess provisions	(388.02)
Closing balance as at 31st March, 2010	308.98

Amount of Non-performing investments (NPI)

Rs. in crores

	Amount
Gross NPI as at 31st March, 2010	6.29
Amount of provisions held for NPI	6.29
Net NPI as at 31st March, 2010	—

Movement of provisions for depreciation on investments

Rs. in crores

	Amount
Opening balance as at 1st April, 2009	6.30
Write off / Write back of provisions during the year*	(0.01)
Closing balance as at 31st March, 2010	6.29

*After considering appreciation in investments

5. Credit risk – portfolios subject to the standardised approach

External Ratings

In accordance with RBI Basel II guidelines, the Bank has identified the following External Credit Assessment Agencies (ECAI's) as approved rating agencies:

- a. Domestic credit rating agencies: CRISIL, ICRA, CARE and FITCH India
- b. International rating agencies: S&P, FITCH and Moody's

The Bank uses the external credit ratings to calculate risk weights for exposures on corporates. The issue/issuer ratings of the ECAI's are considered for the borrowers and the risk weights are then derived on a case by case basis based on a variety of factors (Seniority, Maturity of rating, etc) based on RBI's New Capital Adequacy Framework.

Credit exposures by risk weights

Rs. in crores

Exposure category	Fund based	Non-fund based	Total
Below 100% risk weight	12,063.43	1,938.36	14,001.79
100% risk weight	9,669.19	2,371.99	12,041.18
More than 100% risk weight	8,308.10	164.72	8,472.82
Total	30,040.72	4,475.07	34,515.79

Includes all entities considered for Basel II capital adequacy computation

6. Credit Risk Mitigation

The bank has put in place a comprehensive credit risk mitigation policy. The policy lists possible credit risk mitigation techniques and associated haircuts as envisaged in RBI guidelines. The objective of this Policy is to enable classification and valuation of credit risk mitigants in a manner that allows regulatory capital adjustment to reflect them. The Policy adopts the Comprehensive Approach, which allows full offset of collateral (after appropriate haircuts), wherever applicable against exposures, by effectively reducing the exposure amount by the value ascribed to the collateral. In the standardized capital computation process, the bank has taken Rs. 196.83 crores of collateral benefit.

7. Securitisation

a. Securitisation objectives and policies

Securitisation of assets is undertaken with the following objectives:

- **Meeting credit needs of borrowers** – Due to various constraints such as single party and group exposure norms, paucity of capital, internal sectoral exposure norms, etc, at times the Bank is unable to meet the entire credit requirements of the borrowers. Securitisation helps the Bank to overcome such constraints and meet customer's credit needs.
- **Assistance in management of asset-liability mismatches** – With traditional on balance sheet borrowing and lending, the maturity of assets tends to be much longer than that of the liabilities. Securitisation effectively makes Bank's assets more liquid providing scope to more flexibly manage maturity mismatches.
- **Reduction of credit risk, interest rate and liquidity risk** – Through Securitisation, the Bank can transfer credit, interest rate and liquidity risks to third parties.
- **Freeing up of capital and Improvement in return on capital** – Securitisation removes assets from the Bank's balance sheet and hence frees up capital for other uses. It also improves return on capital.
- **Contingency plan** – Securitisation of retail asset portfolio is considered as an important element of the contingency funding plan of the Bank.

Role played by the Group in the securitisation process:

- **Structurer:** The Bank scans the market to identify potential investors and structures the transaction to meet their requirements in compliance with the extant guidelines.
- **Collection and paying agent:** The SPV may appoint the concerned entity in the Bank as the collection and paying Agent. In such cases, the Bank collects the amounts due from the underlying obligors on the due dates and remits the same into the account of the SPV.

b. Summary of Bank's accounting policies for securitisation activities

In terms of RBI guidelines Bank sells assets to SPV only on cash basis and the sale consideration is received not later than the transfer of the asset to the SPV. Hence, any loss arising on account of the sale is accounted accordingly and reflected in the profit and loss account for the period during which the sale is effected and any profit/premium arising on account of sale is amortised over the life of the securities issued or to be issued by the SPV.

- (I) In case the securitised assets qualify for derecognition from the books of the Bank, the entire expenses incurred on the transaction e.g. legal fees, etc., is expensed at the time of the transaction and is not deferred.
- (II) Where the securitised assets do not qualify for derecognition the sale consideration received is treated as a secured borrowing.

c. Rating of the securitisation transactions:

The Bank uses the ratings provided by external credit rating agencies viz. CRISIL, FITCH (India), ICRA and CARE for the securitization of corporate loans and retail pools.

d. Breakup of the exposure securitised by the Bank during the year and subject to securitisation framework:

A. Banking Book

Rs. in crores

Sr. No.	Exposure type	Amount
1.	Total amount of exposures securitised	
	Corporate Loans	1,100.00
	Auto Loans (Car and commercial vehicles)	557.54
	Total	1,657.54
2.	Loss recognized during the period on securitisation	—
3.	Amount of assets intended to be securitised within a year	—
	Of which	
	— Amount of assets originated within a year before securitisation	—
4.	Unrecognised gain on securitisation	
	Corporate Loans	5.58
	Auto Loans (Car and commercial vehicles)	1.63

Includes all entities considered for Basel II capital adequacy computation

e. Aggregate amount of securitisation exposures retained or purchased and outstanding as on 31st March, 2010 is given below:

Rs. in crores

Sr. No.	Exposure type	On Balance Sheet Amount	Off Balance Sheet Amount
1.	Total amount of exposures retained	—	—
2.	Securities purchased	—	—
3.	Liquidity facility	—	—
4.	Credit commitments (cash collateral)	—	—
5.	Other commitments	—	—

f. Risk-weight wise and bucket wise details of the securitisation exposures on the basis of book value

Rs. in crores

Exposure type	Amount	Capital charge
Below 100% risk weight	—	—
100% risk weight	—	—
More than 100% risk weight	—	—
Deductions		
— Entirely from Tier I capital	—	—
— Credit enhancing I/Os deducted from total capital	—	—
— Credit enhancement (cash collateral)	—	—

B. Trading Book

Breakup of the exposure securitised by the Bank during the year and subject to securitisation framework:

Sr. No.	Type of Securitisation	Amount
1.	Aggregate amount of exposures securitised by the bank for which the Bank has retained some exposures and which is subject to the market risk approach	NIL

g. Aggregate amount of securitisation exposures retained or purchased and outstanding as on 31st March, 2010 is given below:

Rs. in crores

Sr. No.	Exposure type	On Balance Sheet Amount	Off Balance Sheet Amount
1.	Total amount of exposures retained	—	—
2.	Securities purchased		
	Auto Loans (Car and commercial vehicles)	185.97	—
3.	Liquidity facility	—	—
4.	Credit commitments (cash collateral)	—	—
5.	Other commitments	—	—

h. Risk-weight wise and bucket wise details of the securitization exposures on the basis of book value

Rs. in crores

Exposure type	Amount	Capital charge
Below 100% risk weight	185.97	5.33
100% risk weight	—	—
More than 100% risk weight	—	—
Deductions		
— Entirely from Tier I capital	—	—
— Credit enhancing I/Os deducted from total capital	—	—
— Credit enhancement (cash collateral)	—	—

Includes all entities considered for Basel II capital adequacy computation

8. Market Risk in Trading Book:

Market risk management policy

Market risk is the loss arising from changes in market prices or rates. The Bank's risks are managed through a framework that related the Bank's integrated risk management policy and structure of risk management to the Bank's strategy and objectives. The risk management framework lays emphasis on the groups risk philosophy, proper organizational structure, risk and reward balance and is supported by dedicated monitoring and risk measurement mechanism. The market risk for the Bank and each of its major subsidiaries is managed in accordance with the investment policy, which is approved by the respective Boards. These policies ensure that transactions in capital and foreign exchange markets and derivatives are conducted in accordance with sound and acceptable business practices and are as per the extant regulatory guidelines, laws governing transactions in financial markets and the financial environment. The policies are reviewed regularly to incorporate changes in regulatory guidelines and business and economic environment. The Bank's portfolio is exposed to interest rate risk, price risk and changes in currency prices. These risks arise due to Bank's position in various cash, derivative products and capital markets. The objective of the risk management function is risk identification, measurement and reporting them to the management.

Risk management objectives

The Bank manages its risk with the objectives listed below:

- Achieving risk return balance
- Managing and optimizing interest rate risk in banking and trading book
- Ensuring that mismatches between rate sensitive assets and liabilities is kept within limits
- Managing and optimizing currency and liquidity risk
- Proper recognition, classification, measurement and accounting of investments
- Compliance with regulatory guidelines
- Oversight over the operation and execution of market transactions

Structure and organization of the market risk management function

The Bank's risk management architecture is overseen by the Board of Directors and appropriate policies to manage risks are approved by the Board. The Board is involved in defining risk appetite and capital at risk for the Bank, at an integrated level, covering all activities of the Bank. Development of the risk strategy and risk appetite is an ongoing process and is based on past experience and future plans. The risk strategy is consistent with the Board's overall risk tolerance, management's expertise in each business unit and the total financial amount that the Bank is prepared to place at risk of loss (Capital at risk). The Management Committee provides overall risk management supervision for group. Various risk committees, namely Asset Liability Committee (ALCO), Credit Committee, First Tier Audit Committee, Risk Management Committee, Information Security Committee etc, review specific risk areas and supervise the activities of enterprise wide risk management. The main bodies in charge of management of Interest Rate Risk in the Banking Book in the Bank are the Asset Liability Management Committee (ALCO) and the Balance Sheet Management Unit (BMU).

The Bank uses a comprehensive range of quantitative tools and metrics for monitoring and managing risks. Some of these tools are common to a number of risk categories whereas the others are tailored to address the particular features of specific risk categories. Both with a view to bringing in risk sensitivity through policies and to duly meet the regulatory requirements, the Bank continually assesses the appropriateness and the reliability of the quantitative tools and metrics in the light of the changing risk environment.

Value at Risk

The Bank is computing the market risk capital charge for the trading book as per the standardized approach as per the regulator's guidelines. To complement this, Bank also calculates value at risk on its portfolio. Value at risk is computed for each type of market risk i.e. interest rate, foreign currency, equity etc taking into effect the various correlations between the risk factors. The internal model is also capable of undertaking stress testing and back-testing. The Bank intends to use this value at risk number for maintaining capital as per internal model approach when permitted by the regulator.

Stress Testing

Losses beyond the set confidence level are not captured by the value at risk calculation. The Bank periodically stresses the portfolio to highlight the potential risks that may arise due to events that are rare but plausible. The Bank conducts various tests like the impact of shock to one risk factor, extreme events that may change various risk factors simultaneously and worst case scenario that captures the potential damaging shift in various market risk factors.

The Liquidity Risk Management approach starts at the intraday level. Further to the intra day management, the Bank's Contingency Liquidity Plan (CLP) is a key element of its liquidity measurement and management framework. The CLP is intended to forewarn / mitigate adverse liquidity impacts. It is designed to address liquidity stresses posed by Bank-Specific Factors and Market-Specific Factors. The CLP defines several Early Warning Indicators (EWIs).

Hedging and risk mitigation

The Bank has defined limits on the positions that can be taken and all the business groups are required to adhere to the same. The hedging transactions are periodically assessed for hedged effectiveness in accordance with the applicable guidelines.

Market risk capital charge

Rs. in crores

Risk category	Capital charge
Interest rate risk	193.96
Equity position risk	118.54
Foreign exchange risk	20.00
Total capital required	332.50

Includes all entities considered for Basel II capital adequacy computation

9. Operational Risk Management (ORM)

The Bank and the group subsidiaries have well defined operational risk management objectives, strategies and governance structures. The Bank has a comprehensive ORM Framework that covers all activities and governance structure that enables the Bank to manage operational risk effectively. Independent operational risk management department reports its findings to the risk management committee. The Bank and the major subsidiaries have an operational risk management policy duly approved by the board that outlines the ORM governance structure, key risk assessment, risk monitoring and risk mitigating activities. The policy applies to all business lines within the Bank.

Most Group entities, including the Bank, have Risk Management Committees and to manage operational risks. Separate sub committees also exist in a few entities to screen all potential new mandates for profitability and to ensure that compliance, legal and reputational issues are addressed before accepting any mandate. Hence, depending upon the size of the group entity, the operational risk governance structure is adequate to manage material operational risks.

Senior Management in all group entities is actively involved in the management of operational risk and implementation of the respective ORM Frameworks / policies. Some group entities have separate operational risk management department. Remaining entities manage operational risk through internal control departments that vary in sophistication depending upon the business needs.

The internal control framework ensures that process related operational risks are minimized by way of regular monitoring and audits. The Group internal audit team, following RBI's risk based audit methodology, and the group compliance department provide sound platform for operational risk management along with risk management unit.

The following are some of the key techniques applied by bank and / or group companies to manage operational risks –

- Products and process notes need review by all concerned departments including compliance, risk management and legal. All concerned departments coordinate and discuss key operational risk issues involving people, process, technology, external factors, etc. so as to minimize them or ensure adequate controls over them. In subsidiaries, internal controls unit reviews the product notes in consultation with the respective departments, including compliance and legal.
- Unusual event reporting and creation of loss database have been institutionalized as a stepping stone towards measurement of operational risk. Analysis of unusual events assists identifying sources of operational risks and taking adequate risk mitigating measures to minimize those risks.
- Bank has rolled out its 'Risks and Controls Self Assessment' program for formally assessing the operational risks and related controls to mitigate these risks. Few group companies use control self assessment and risk assessment tools to identify operational risks.
- The Bank is taking various steps to increase the overall level of operational risk awareness amongst staff at all levels using various tools like trainings, workshops, risk assessment exercise and process related compliance certification / testing, etc. The Bank believes that a strong risk management culture and increased level of risk awareness amongst work force facilitate strengthening risk management systems.
- The Group level IT Security Committee provides direction for mitigating the operational risk in IT security.
- Disaster recovery and Business Continuity Plans (BCP) have been established for significant businesses. These plans are periodically tested and reviewed to ensure their effectiveness to mitigate unforeseen risks arising out of disruptions.
- In the larger group entities, in order to control customer fraud in the lending business, a Risk Containment Unit has been setup for Retail lending, which identifies document related fraud submitted by customers. Also, customers Central Bureau (CIBIL) scores are examined before executing any financial transaction with the borrower.

Approaches for computation of operational risk capital

In accordance with the guidelines issued by RBI, the Bank has adopted the "Basic Indicator Approach" for calculation of operational risk capital for capital adequacy purposes. As per these guidelines, the capital for operational risk is equal to 15% of average positive annual gross income of the previous three years. The bank's operational risk capital charge using basic indicator approach is Rs. 578.73 crores as at 31st March, 2010.

10. Interest Rate Risk in the Banking Book (IRRBB):

The exposure of the Bank's financial condition to adverse movements in interest rates is referred to as interest rate risk. The impact of market risk (including Interest Rate Risk) on the Bank's trading book is actively measured through a variety of risk metrics like PV01, option greeks and VaR. The bank's tolerance with respect to its exposure to market risk in the trading book is articulated through various risk limits and monitored through different MIS reports. The Bank also provides for capital for exposure to market risk in the trading book.

In the context of banking book, interest rate risk is interpreted as the current or prospective risk to both the earnings and capital of the bank arising from adverse movements in interest rates, which affect the Bank's banking book. Changes in interest rates affect a bank's earnings by altering interest-sensitive income and expenses, and the underlying value of a bank's assets, liabilities, and off-balance sheet instruments because the present value of future cash flows changes when interest rates change.

Although, the very nature of the financial intermediation business makes the Bank susceptible to interest rate risk, excessive risk could potentially pose a significant threat to the Bank's earnings and capital.

The main bodies in charge of management of interest rate risk in the banking book in the Bank are the Asset Liability Management Committee (ALCO) and the Balance Sheet Management Unit (BMU). BMU is part of the Bank's treasury.

The Bank's ALCO is broadly responsible for the financial management of the balance sheet. The ALCO sets the overall policy and limit framework within which the BMU operates. The responsibility of controlling of Interest Rate Risk in the banking book is vested with the BMU.

Various asset and liability divisions in the Bank disburse assets and mobilise liabilities of varying tenors, yields (or costs) and nature. These divisions may be net users of fund or net providers of fund to the Bank. Individually and together, these assets and liabilities lead to the creation of Interest rate risk on the banking book. Through the Funds Transfer Pricing (FTP) mechanism, the management of interest rate risk is taken out of the hands of individual asset and liability divisions and entrusted to a competent interest rate risk management body i.e. the BMU. The BMU analyses the risks inherent in the Balance sheet, determines appropriate hedging strategies in consultation with the ALCO and executes these strategies.

The Bank views Interest Rate Risk from two different but complementary perspectives, namely the Earnings Perspective and the Economic Value Perspective.

- The Bank uses gap analysis to determine the interest rate risk on the banking book from the earnings perspective. The statement of interest rate sensitivity is used as the base for gap analysis. In the statement of interest rate sensitivity, assets and liabilities are bucketed in defined tranches based on their maturity/repricing dates.
- The duration gap approach is used by the Bank to determine the sensitivity of the Economic Value of Equity (EVE) of the Bank to changes in interest rates. Modified duration is computed on an account-wise basis for the interest rate sensitive assets and liabilities of the Bank. A 100 bps shock is applied on the Leveraged MDuration Gap to arrive at the EVE impact due to on-balance sheet items. The impact of 100 bps shock on off-balance sheet items is also incorporated. Through constant monitoring, risk limits, FTP, and hedging, management has constantly strived to keep the level of IRR in the Bank within acceptable levels.
- Details of increase (decline) in earnings and economic value for upward and downward rate shocks based on balance sheet as on 31st March, 2010 are given below:
 - Earnings Perspective
Impact on earnings of 100 bps parallel shift in yield curve Rs. 29.11 crores
 - Economic Value of Equity

Impact on MVE of 100 bps adverse parallel shift in yield curve	Rs. 151.04 crores
Impact as a percentage of Tier1 + Tier2 Capital	1.81%

- **Funds transfer pricing mechanism:**

FTP is effectively used by the ALCO to achieve balance sheet management objectives. TP rates are reviewed by the ALCO in its meetings periodically and calibrated to encourage the mobilisation of desirable deposits and the disbursement of favorable assets (w.r.t duration and yields/costs).

- If the directional movement or volatility of interest rate is determined to be potentially adverse, the BMU may decide to hedge the risk using derivative products like IRS/CIRS and FX Options. A properly constructed hedge would insulate the EVE from dissipating to a great extent. Depending on its view, management may also decide not to hedge certain exposures to permit to continue increasing EVE. Management may decide to hedge individual positions or the IRR emanating from the entire book.