The Royal Bank of Scotland N.V. – Indian Branches
(Incorporated in the Netherlands with limited liability)

BASEL II – PILLAR 3 DISCLOSURES

The Royal Bank of Scotland N.V. - Indian Branches ('the Bank') is subject to the Basel II framework with effect from March 31, 2008 as stipulated by the Reserve Bank of India (RBI). The Basel II framework consists of three-mutually reinforcing pillars:

(i) Pillar 1: Minimum capital requirements for credit risk, market risk and operational risk
(ii) Pillar 2: Supervisory review of capital adequacy
(iii) Pillar 3: Market discipline

Market discipline (Pillar 3) comprises set of disclosures on the capital adequacy and risk management framework of the Bank. These disclosures have been set out in the following sections.

I. SCOPE OF APPLICATION

The Pillar 3 disclosures apply to The Royal Bank of Scotland N.V. - Indian Branches which is operating in India as a branch of The Royal Bank of Scotland N.V. incorporated with limited liability in the Netherlands.

II. CAPITAL STRUCTURE

Summary information on main terms and conditions/features of capital instruments

As per the RBI capital adequacy norms, the Bank's regulatory capital is classified into Tier-I capital and Tier-II capital. Tier-I capital includes paid-up equity capital, statutory reserves, other disclosed free reserves, capital reserves and innovative perpetual debt instruments (Tier-I bonds) eligible for inclusion in Tier-I capital that comply with requirement specified by RBI. Tier-II capital includes general provision and loss reserve, investment reserve, Hybrid capital (upper Tier-II bonds) and subordinate debt instruments (lower Tier-II bonds) eligible for inclusion in Tier-II capital.

Tier-I bonds (Innovative Perpetual Debt Instruments) are perpetual in nature with a call option after the instrument has run for 10 years. Interest on Tier-I bonds is payable semi-annually. These Tier-I bonds have a step-up clause on interest rates ranging from 0 to 100 basis points.

The upper Tier-II bonds (Hybrid debt Capital) have an original maturity of 15 years with call option after 10 years. The interest on upper Tier-II bonds is payable semi-annually. The upper Tier-II debt instruments have a step-up clause on interest rates of 100 basis points. The lower Tier-II bonds (subordinated debt) have an original maturity of greater than 5 years. The interest on lower Tier-II capital instruments is payable semi-annually

The bank has not borrowed any Subordinate Debt/Innovative Perpetual Debt Instrument/Hybrid capital during the year ended 31 March 2012.

Capital Funds

(Rs. In crores)

		31 March 2012	31 March 2011
A	**Tier-I Capital**	**2,550.41**	**2,265.57**
	Of which		
	- Paid up share capital	169.02	169.02
	- Reserves and surplus	2,428.62	2,293.31
	- Innovative perpetual debt instrument (IPDI)	310.18	304.85
	- Amount deducted from Tier-I capital		
	- Deferred tax assets	(337.96)	(458.78)
	- Intangible assets	(3.13)	(4.04)
	- Others	(16.32)	(38.79)
B	**Tier-II Capital (net of deductions) (B.1+B.2+B.3-B.4)**	**838.91**	**904.16**
	Of which		
B.1	Debt capital instruments eligible for inclusion as upper Tier-II capital (Hybrid capital)	**566.39**	**508.08**
	- Total amount outstanding	715.70	715.70
	- Of which amount raised during the current year	Nil	Nil
	- Amount eligible as capital funds	566.39	508.08
B.2	Subordinated debt eligible for inclusion in Tier-II capital	**74.42**	**209.69**
	- Total amount outstanding	757.90	1,087.19
	- Of which amount raised during the current year	Nil	Nil
	- Amount eligible as capital funds	74.42	209.69
B.3	Other Tier-II Capital - Provision for Standard assets and Investment reserves.	**198.10**	**186.39**
B.4	Deductions from Tier-II capital	-	-
C	**Total Eligible Capital**	**3,389.32**	**3,169.73**

III. CAPITAL ADEQUACY

a. Capital Management

Objective
The Bank actively manages its capital to meet regulatory norms and current and future business needs considering taking cognizance of the strategic intent of the Bank, profitability of particular businesses and opportunities for growth. The proper mapping of credit, operational and market risks to this projected business growth enables assignment of capital that not only adequately covers the minimum regulatory capital requirement but also provides headroom for growth. The calibration of risk to business is enabled by a strong risk culture in the Bank aided by effective, technology based risk management systems

Organizational set-up
The capital management framework of the Bank is administered by the Asset Liability Committee (ALCO) and the Risk and Control Committee (RCC) under the supervision of the EXCO.

Regulatory capital
The Bank is subject to the capital adequacy norms stipulated by the RBI guidelines on Basel II. The RBI guidelines on Basel II require the Bank to maintain a minimum ratio of total capital to risk weighted assets of 9.0%, with a minimum Tier-I capital adequacy ratio of 6.0%. The total capital adequacy ratio of the Bank at March 31, 2012 as per the RBI guidelines on Basel II is 12.46% with a Tier-I capital adequacy ratio of 9.38%. Under Pillar 1 of the RBI guidelines on Basel II, the Bank follows the standardized approach for credit risk, Standardized Duration method for market risk and Basic Indicator approach for operational risk.

Internal assessment of capital
The Bank's capital management framework includes a comprehensive internal capital adequacy assessment process (ICAAP) conducted annually and which determines the adequate level of capitalization for the Bank to meet regulatory norms and current and future business needs, including under stress scenarios. The ICAAP encompasses capital planning for a four year time horizon, identification and measurement of material risks and the relationship between risk and capital.

The Bank's capital management framework is complemented by its risk management framework (detailed in the following sections), which includes a comprehensive assessment of material risks.

Stress testing which is a key aspect of the ICAAP and the risk management framework provides an insight on the impact of extreme but plausible scenarios on the Bank's risk profile and capital position. Based on the approved stress testing framework, the Bank conducts stress tests on its various portfolios and assesses the impact on its capital ratios and the adequacy of capital buffers for current and future periods. The Bank periodically assesses and refines its stress tests in an effort to ensure that the stress scenarios capture material risks as well as reflect possible extreme market moves that could arise as a result of market conditions.

Based on the ICAAP, the Bank determines its capital needs and the optimum level of capital.

Monitoring and reporting

The Management maintains an active oversight over the Bank's capital adequacy levels. On a quarterly basis an analysis of the capital adequacy position and the risk weighted assets and an assessment of the various aspects of Basel II on capital and risk management as stipulated by RBI, are reported to the EXCO. Further, the ICAAP which is an annual process also serves as a mechanism for the Board to assess and monitor the Bank's and the Bank's capital adequacy position over a four year time horizon.

b. Capital requirements for various risk areas

As required by RBI guidelines on Basel II, the Bank's capital requirements as at 31 March 2012 have been computed using the Standardized approach for credit risk, Standardized Duration method for market risk and Basic Indicator approach for operational risk. The minimum capital required to be held at 9.00% for credit, market and operational risks is given below:

(Rs. in crores)

		31 March 2012	**31 March 2011**
A	Capital requirements for Credit Risk	1,919.39	1,819.78
	- Portfolios subject to standardized approach	1,919.39	1,819.78
	- Securitization exposures	Nil	Nil
B	Capital requirements for Market Risk	196.96	274.51
	- Standardized duration approach		
	- Interest rate risk	142.96	238.51
	- Foreign exchange risk	54.00	36.00
	- Equity risk	Nil	Nil
C	Capital requirements for Operational risk	331.60	354.07
	- Basic indicator approach	331.60	354.07
D	Capital Adequacy Ratio of the Bank (%)	12.46%	11.65%
E	Tier-I CRAR (%)	9.38%	8.33%
F	Tier-II CRAR (%)	3.08%	3.32%

RISK MANAGEMENT FRAMEWORK:

As a financial intermediary, the Bank is exposed to various types of risks including credit, market, liquidity, operational, legal, compliance and reputation risks. The objective of the risk management framework at the Bank is to identify measure, control, monitor and manage as well as report risks in a clear manner and that the policies and procedures established to address these risks are strictly adhered to.

The important aspects of the Bank's risk management are a robust risk approval mechanism, well defined processes and guidelines and an elaborate internal control mechanism. The risk approval mechanism covers all the key areas of risk such as credit, market and operational risk and is involved in quantification of these risks wherever possible for effective and continuous monitoring.

Measurement of risks for capital adequacy purposes
Under Pillar 1 of the extant RBI guidelines on Basel II, the Bank currently follows the Standardized approach for credit risk and Standardized Duration approach for market risk and Basic Indicator approach for operational risk.

Objectives and Policies

The Bank's risk management processes are guided by well defined global as well as local policies appropriate for various risk categories. There is an independent risk team that oversees this function and oversight is by the regional as well as the global risk offices and also by periodic independent risk reviews / internal auditor reviews.

The risk appetite for the Bank in India is determined by the global risk committees based on inputs from the country management.

Besides the risk management and compliance departments of the Bank in India, there are several committees such as Asset-Liability Committee (ALCO), Risk and Control Committee (RCC), etc. that are involved in managing the concerned risks within the bank's guidelines as well as regulatory requirements.

The Bank has global policies for Stress Testing to measure impact of adverse stress scenarios on the adequacy of capital.

Structure and Organization

The Risk Management function reports to the Country Executive in India and has functional reporting to the Regional Head of Risk who is based in Singapore. Risk has three distinct teams - Credit Risk, Market Risk and Operational Risk and each of these teams are headed by experienced risk professionals. For credit risk, there is a Risk Management Committee which meets regularly to consider credit proposals for approval.

IV. CREDIT RISK

The Bank is exposed to credit risk in its lending operations. Credit risk is the risk of loss that may occur from the failure of any counterparty to abide by the terms and conditions of any financial contract with the Bank, principally the failure to make required payments as per the terms and conditions of the contracts.

Credit Risk Management Policy

Credit risk considers the ability of a borrower or counter-party to honor commitments under an agreement as any such failure has an adverse impact on the banks' financial performance. The Bank is exposed to credit risk through its various lending activities such as funded facilities, non-funded facilities as well as hedging facilities.

The Bank's credit risk management process is independent of the business so as to protect integrity of the risk assessment process and decision making. The global as well as local policies guide the credit risk team to make informed decisions.

Credit risk in respect of exposures on corporate as well as micro, small and medium enterprises (MSME) is measured and managed at both individual counterparty level as well as at a portfolio level. Some of the products extended by the bank are managed at the portfolio level, as the individual loans under product programs are guided by the product program

norms with built in triggers. Credit rating tools are an integral part of risk-assessment of the corporate borrowers and different rating models are used for each segment that has distinct risk characteristics such as Large Corporate, Small and Medium Corporate, financial companies, project finance etc.

The credit rating tools use a combination of quantitative inputs and qualitative inputs to arrive at a 'point-in-time' view of the rating of counterparty. Each internal rating grade corresponds to a distinct probability of default. Model validation is carried out periodically at a global level by objectively assessing the accuracy and stability of ratings.

All credit exposures, once approved, are monitored and reviewed periodically against the approved limits. Besides this there are monthly risk migration analysis and monthly watch list meetings.

The Bank's retail asset portfolio is managed to ensure stable risk adjusted earnings stream by maintaining customer defaults within acceptable levels. The Bank periodically carries out a comprehensive portfolio level analysis of retail asset portfolio with a risk-return perspective. Risk measurement for the retail exposures is done on basis of comprehensive credit assessment parameters.

Risk Review involves independent review of credit risk assessment, compliance with internal policies of the Bank and with the regulatory framework, compliance of sanction terms and conditions and effectiveness of loan administration.

Customers with emerging credit problems are identified early and classified accordingly. Remedial action is initiated promptly to minimize the potential loss to the Bank.

The Bank controls and limits concentration risk by means of appropriate structural limits and borrower limits based on creditworthiness. The exposures to individual clients or group are based on the internal rating of the borrower as well as group-wise borrowing limits and capped by the regulatory ceiling.

Industry analysis plays an important part in assessing the concentration risk within the loan portfolio. Particular attention is given to industry sectors where the Bank believes there is a high degree of risk or potential for volatility in the future. The Bank has fixed internal limits for aggregate commitments to different sectors so that the exposures are evenly spread over various sectors.

Definition and classification of non-performing assets (NPAs)
Advances are classified into performing and non-performing advances (NPAs) as per RBI guidelines. NPAs are further classified into sub-standard, doubtful and loss assets based on the criteria stipulated by RBI. A substandard asset is one, which has remained a 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 more than 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.
An asset, including a leased asset, becomes non-performing when it ceases to generate income for the Bank.

An NPA is defined as a loan or an advance where:
(i) Interest and/or installment of principal remain overdue for more than 90 days in respect of a term loan. 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;
(ii) if the interest due and charged during a quarter is not serviced fully within 90 days from the end of the quarter;

(iii) the account remains 'out of order' in respect of an overdraft/cash credit facility. An account is treated as 'out of order' if:
  a. the outstanding balance remains continuously in excess of the sanctioned limit/drawing power for 90 days; or
  b. 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 the balance sheet; or
  c. credits in the account are not enough to cover the interest debited during the accounting period; or
  d. drawings have been permitted in the account for a continuous period of 90 days based on drawing power computed on the basis of stock statements that are more than three months old even though the unit may be working or the borrower's financial position is satisfactory; or
  e. the regular ad hoc credit limits have not been reviewed/renewed within 180 days from the due date/date of adhoc sanction.

(iv) a bill purchase discounted by the Bank remains overdue for a period of more than 90 days;
(v) interest and or installment of principal in respect of an agricultural loan remains overdue for two crop seasons for short duration crops and one crop season for long duration crops;
(vi) In respect of a securitization transaction undertaken in terms of the RBI guidelines on securitization, the amount of liquidity facility remains outstanding for more than 90 days;
(vii) In respect of derivative transactions, if the overdue receivables representing positive mark-to-market value of a derivative contract, remain unpaid for a period of 90 days from the specified due date for payment.

Restructured assets

As per RBI guidelines, a fully secured standard loan can be restructured by rescheduling principal repayments and/ or the interest element, but must be separately disclosed as a restructured loan in the year of restructuring. Similar guidelines apply to restructuring of substandard and doubtful loans.

A sub-standard/doubtful asset, which has been restructured, will be upgraded to the standard category only after a satisfactory performance by the borrower over a period of time. The RBI has specified the period to be one year from date when the installment / interest falls due as per the restructuring scheme.

CREDIT RISK EXPOSURES

Total Gross Credit Risk Exposure Including Geographic Distribution of Exposure

(Rs. in crores)

	31 March 2012			31 March 2011		
	Domestic	**Overseas**	**Total**	**Domestic**	**Overseas**	**Total**
Fund based	23,185.48	Nil	23,185.48	19,987.69	Nil	19,987.69
Non fund based	12,437.69	Nil	12,437.69	18,004.20	Nil	18,004.20
Total	**35,623.17**	**Nil**	**35,623.17**	**37,991.89**	**Nil**	**37,991.89**

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Distribution of advances by industry sector

(Rs. in crores)

Sr. No.	Industry Classification	31 March 2012		31 March 2011	
		Funded	Non funded	Funded	Non funded
1	Mining	1.01	1.23	6.23	44.64
2	Iron and Steel	60.59	0.34	35.41	2.06
3	Other Metal and Metal Products	114.72	144.41	111.00	99.85
4	All Engineering	1,277.40	804.37	1,028.19	641.67
5	Electricity	125.30	280.36	121.65	212.25
6	Cotton Textiles	95.62	-	173.43	-
7	Food Processing	277.53	175.04	477.68	302.40
8	Paper and Paper Products	110.27	65.59	1.13	97.70
9	Rubber and Rubber Products	183.23	24.74	129.32	22.34
10	Chemicals, Dyes, Paints etc	525.84	36.92	584.08	47.02
11	Leather and Leather Products	24.54	8.41	23.46	4.83
12	Gems and Jewellery	3,750.72	26.90	3,211.36	48.21
13	Construction	155.85	207.10	163.56	451.68
14	Petroleum	3.89	28.02	3.10	140.90
15	Automobiles including trucks	765.19	0.09	513.84	0.06
16	Computer Software	77.23	254.82	127.91	321.22
17	Infrastructure	2,392.05	-	681.39	-
18	Banking	367.99	2,740.52	429.26	2,713.37
19	Other Industries	1,341.61	1,916.41	1,143.91	1,851.21
20	Residual exposures	883.92	3.04	1,584.96	-
	Total	**12,534.50**	**6,718.31**	**10,550.85**	**7,001.44**

Residual contractual maturity breakdown of Assets

(Rs. in crores)

Particulars	31 March 2012		31 March 2011	
	Advances	Investments	Advances	Investments
Upto 1 day	339.73	-	260.93	0.00
2 to 7 days	763.79	19.71	775.25	89.86
8 to 14 days	392.23	-	956.42	139.83
15 to 28 days	829.60	9.95	700.36	365.47
29 days to 3 months	6,715.46	1,866.10	2,098.22	1,923.58
Over 3 months & up to 6 months	1,026.94	231.66	758.93	1,509.00
Over 6 months & up to 1 year	187.05	474.32	460.83	1,556.97
Over 1 year & up to 3 years	1,911.53	1,205.99	3,995.62	1,119.64
Over 3 year & up to 5 years	64.06	1,919.61	137.88	1,096.85
Over 5 years	304.11	1,994.03	406.40	1,100.40
Total	**12,534.50**	**7,721.38**	**10,550.85**	**8,901.61**

Movement of NPAs and Provision for NPAs

(Rs. in crores)

	Particulars	**31 March 2012**	**31 March 2011**
A	Amount of NPAs (Gross)	345.61	614.48
B	Net NPAs	93.35	173.70
C	NPA Ratios		
	- Gross NPAs to gross advances (%)	2.71%	5.59%
	- Net NPAs to net advances (%)	0.74%	1.65%
D	Movement of NPAs (Gross)		
	- Opening balance	614.48	685.37
	- Additions during the year	145.74	548.23
	- Reductions during the year	(413.71)	(619.12)
	- Closing balance	346.51	614.48
E	Movement of Provision for NPAs		
	- Opening balance	440.77	424.46
	- Provision made during the year	55.59	197.50
	- Write offs / Write back of excess provision	(243.20)	(181.19)
	- Closing balance	253.16	440.77

Non Performing investments (NPIs) and Provision for depreciation on NPIs - NIL

V. Credit Risk: Use of rating Agency under the Standardized approach

The Bank has not applied any external ratings for its funded and non funded short-term and long-term instrument / bank facilities' and has taken a risk weight of 100% against each unrated exposure.

Details of Gross credit risk exposure (Fund based and Non-fund based) based on Risk Weight

(Rs. in crores)

	31 March 2012	**31 March 2011**
Below 100% risk weight	16,837.70	23,925.27
100% risk weight	18,125.31	13,373.09
More than 100% risk weight	660.15	693.54
Deductions		
- Investments in subsidiaries	Nil	Nil

VI. CREDIT RISK MITIGATION

The Bank uses various collaterals both financial as well as non-financial, guarantees and credit insurance as credit risk mitigants. The main financial collaterals include bank deposits, NSC, KVP, LIP, while main non-financial collaterals include land and building, plant and machinery, residential and commercial mortgages. The guarantees include guarantees given by corporate, bank and personal guarantees. This also includes loan and advances guaranteed by Export Credit & Guarantee Corporation Limited (ECGC).

The Bank reduces its credit exposure to counterparty with the value of eligible financial collateral to take account of the risk mitigating effect of the collateral. To account for the volatility in the value of collateral, haircut is applied based on the type, issuer, maturity, rating and re-margining/revaluation frequency of the collateral.

Detail of total credit exposure position as on 31 March 2012

(Rs. in crores)

	31 March 2012	**31 March 2011**
Covered by		
- financial collaterals	537.86	630.96
- Guarantees	3,717.41	1,337.00

VII. SECURITISATION

No financial assets were sold to Securitization / Reconstruction Company for Asset Reconstruction either during the current year or the previous year.

VIII. MARKET RISK IN TRADING BOOK

Market risk is the risk to the Bank's earnings and capital due to changes in the market level of interest rates or prices of securities and foreign exchange, as well as the volatilities of those changes. The Bank is exposed to market risk through its trading activities, which are carried out both for customers and on a proprietary basis. The Bank adopts a comprehensive approach to market risk management for its trading, investment and asset/liability portfolios. The policies ensure that operations in securities, foreign exchange 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 securities and the financial environment. The policies contain the limit structure that governs transactions in financial instruments. The policies are reviewed periodically to incorporate changed business requirements, economic environment and changes in regulations.

The Bank uses various risk metrics, both statistical and non-statistical, including:

- Non-statistical measures like position, gaps and sensitivities (duration, PVBP, option greeks)
- Value at risk (VaR)

The Bank has set in place Value at Risk (VaR) limits, which are based on the Historical Simulation Method to control and monitor market risk. The Bank has also in place PV01 limits (impact of 1 basis point shift in the yield curve) and basis limits to control the exposures. Daily reports are made available through the risk management systems for monitoring these exposures. In addition to these limits, stress and scenario analysis are undertaken to evaluate shock impacts.

The Bank periodically reports on the various investments and their related risk measures to the EXCO. The Bank also periodically submits the required reports to the regulator as per the regulatory reporting requirements.

Capital Requirement for Market Risk

(Rs. in crores)

	Amount of Capital required	
	31 March 2012	**31 March 2011**
- Interest rate risk	142.96	238.51
- Foreign exchange risk (including gold)	54.00	36.00
- Equity position risk	Nil	Nil

IX. OPERATIONAL RISK

Operational Risk is the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events, including. Operational risk includes legal risk but excludes strategic and reputation risk. Operational risk is an integral and unavoidable part of the RBS Group's business as it is inherent in the processes it operates to provide services to customers and generate profit for shareholders.

The objective of the Bank's operational risk management is to manage and control operational risks in a cost effective manner within targeted levels of operational risk consistent with the Bank's risk appetite as specified in the Operational Risk Management Policy (the Policy) approved by the EXCO. To ensure appropriate responsibility is allocated for the management, reporting and escalation of operational risk, the Group operates three lines of defense model which outlines principles for the roles, responsibilities and accountabilities for operational risk management.

Operational risk – three lines of defense model

1st line of defense
The Business: The Business is responsible for setting risk appetite, owns and manages its risks within the overall Group risk appetite, and is responsible for complying with all Group policies. The business must test and certify the adequacy and effectiveness of its controls in place to meet these responsibilities.

2nd line of defense
Risk Management: It is responsible for owning and developing the risk management framework and tools, which the business uses to discharge its responsibilities. The 2nd line of defence must provide oversight and challenge to the 1st line on management of its risks.

3rd line of defense
Group Internal Audit is the 3rd Line of Defense and provides independent assurance over the key risks to the organization, which includes an assessment of the entire control framework.

The Operational Risk Policy Standards provide the direction for delivering effective operational risk management. They comprise principles and processes that enable the consistent identification, assessment, management, monitoring and reporting of operational risk across the Group. The objectives of the standards are to protect the Group from financial loss or damage to its reputation, its customers or staff and to ensure that it meets all necessary regulatory and legal requirements.

The standards are supported by several key operational risk management techniques of which the Bank applies the following techniques:

- Risk assessments: business units identify and assess operational risks to ensure that they are effectively managed, prioritized, documented and aligned to risk appetite;

- Risk Event and Loss data management: each business unit's internal loss data management process captures all operational risk loss events above certain minimum thresholds. The data is used to enhance the adequacy and effectiveness of controls, identify emerging themes, enable formal loss event reporting and inform risk and control assessments and scenario analysis.
Escalation of individual events to senior management is determined by the seriousness of the event. Operational loss events are categorized under the following headings:

  - Clients, products and business practices;
  - Technology and infrastructure failures;
  - Employment practices and workplace safety;
  - Internal fraud;
  - External fraud;
  - Execution, delivery and process management;
  - Malicious damage; and
  - Disaster and public safety

- Risk Issues Management: This process is meant to ensure that operational risk issues are captured and classified consistently, and that there is robust governance over their closure and acceptance.

- New products approval process: this process ensures that all new products or significant variations to existing products are subject to a comprehensive risk assessment. Products are evaluated and approved by specialist areas and are subject to executive approval prior to launch; and

- Control Environment Certification: This requires to provide a bi-annual assessment and certification regarding, adequacy and effectiveness of the internal risk and control framework for which they are responsible; management of material risk within the business, within defined risk appetite and tolerance levels; and compliance with the Group Policy Framework and supporting policy standards .

Scope and nature of reporting and measurement systems

Reporting forms an integral part of operational risk management. The Group's risk management processes are designed to ensure that issues are identified, escalated and managed on a timely basis. Exposures for each division are reported through monthly risk issue reports, which provide detail on the risk issues and action plans.

Events that have a material, actual or potential impact on the branch's finances, reputation or customers, are escalated and reported to divisional and Group executive.

Policies for mitigating

The objective of operational risk management is not to remove operational risk altogether, but to manage the risk to an acceptable level, taking into account the cost of minimizing the risk with the resultant reduction in exposure. Strategies to manage operational risk include avoidance, transfer, acceptance and mitigation by controls.

Each business unit must manage its operational risk exposure within an acceptable level, testing the adequacy and effectiveness of controls and other risk mitigants regularly and documenting the results. Where unacceptable control weaknesses are identified, action plans must be produced and tracked to completion.

Approach for Operational Risk Capital Assessment

As per the RBI guidelines on Basel II, the Bank has adopted Basic Indicator approach for computing capital charge for operational risk. The capital required for operational risk at March 31, 2012 was Rs. 331.60 crores.

X. INTEREST RATE RISK IN THE BANKING BOOK (IRRBB)

a. Risk Management Framework for IRRBB

Interest Rate Risk in the Banking Book (IRRBB) refers to the potential adverse financial impact on the Bank's potential variability in earnings and capital value resulting from changes in market interest rates. Interest rate risk is the risk of IRRBB refers to the risk of deterioration in the positions held on the banking book of an institution due to movement in interest rates over time. The Bank holds assets, liabilities and off balance sheet items with different maturity or re-pricing dates and linked to different benchmark rates, thus creating exposure to unexpected changes in the level of interest rates.

Organizational set-up

The Bank's Asset Liability Management Committee (ALCO) is responsible for evolving appropriate systems and procedures for identification and analysis of various balance sheet risks including IRRBB and laying down parameters for efficient management of these risks. The ALCO focuses on setting interest rate risk appetite through imposing limits on relevant indicators, which positively contributes to optimising the balance sheet structure and Net Interest Income (NII) over time, while limiting the susceptibility to interest changes. ALCO periodically monitors risk positions of the Bank, ensures compliance with regulatory requirements and internal limits and provides strategic guidance for management of the IRRBB.

Risk measurement and reporting framework

Presently the Bank uses the following tools for managing interest rate risk:

- Gap analysis: The interest rate gap or mismatch risk is measured by calculating gaps over different time intervals as at a given date. This static analysis measures mismatches between rate sensitive liabilities (RSL) and rate sensitive assets (RSA). The report is prepared monthly by grouping rate sensitive liabilities, assets and off-balance sheet positions into time buckets according to residual maturity or next re-pricing period, whichever is earlier. The difference between RSA and RSL for each time bucket signifies the gap in that time bucket. The direction of the gap indicates whether net interest income is positively or negatively impacted by a change in interest rates and the magnitude of the gap helps in finding out the change in net interest income for any given interest rate shift. The Bank has internal limits for the local currency interest rate risk gap statements.
- Earnings at risk (EaR): The interest rate gap reports mentioned above indicate whether the Bank is in a position to benefit from rising interest rates by having a positive gap (RSA > RSL) or whether it is in a position to benefit from declining interest rates by having a negative gap (RSL > RSA). EaR measures the change in NII over a one year time horizon for various levels of parallel shift in interest rates.
- Economic value: Change in the interest rates have a long-term impact on the capital position of the Bank, as the economic value of the Bank's assets, liabilities and off-balance sheet positions get affected by these rate changes. The Bank applies modified duration approach and monitors impact of various levels of parallel shift in interest rate curves on the capital position. This report is periodically presented before ALCO.
- PV01: PV01 measures the impact on economic value of a 1 basis point (0.01%) change in interest rates. The Bank monitors and manages the interest rate risk on its banking book through PV01 limits.

Details of increase (decline) in earnings and economic value for upward and downward rate shocks, assuming parallel shift in the interest rate curves, based on the local currency positions as are given below:

Earnings perspective:

	31-Mar-12		31-Mar-11	
Amounts in Rs. Crores	**-200**	**200**	**-200**	**200**
INR	(72.8)	72.8	(12.1)	12.1
USD	(19.2)	19.2	(50.2)	50.2
GBP	0.2	(0.2)	0.1	(0.1)
EUR	(3.0)	3.0	0.7	(0.7)
JPY	32.9	(32.9)	36.5	(36.5)
RES	(0.1)	0.1	(0.1)	0.1
Total	**(62.0)**	**62.0**	**(25.1)**	**25.1**

Economic value perspective:

	31-Mar-12		31-Mar-11	
Amounts in Rs. Crores	**-200**	**200**	**-200**	**200**
INR	74.2	(74.2)	72.3	(72.3)
USD	(9.7)	9.7	(3.9)	3.9
GBP	(2.7)	2.7	(2.2)	2.2
EUR	(8.2)	8.2	(20.3)	20.3
JPY	(38.6)	38.6	(8.1)	8.1
RES	(0.5)	0.5	(0.1)	0.1
Total	**14.5**	**(14.5)**	**37.8**	**(37.8)**

12. LIQUIDITY RISK

Liquidity risk is the risk that a bank will be unable to meet its obligations, including financing commitments as they fall due.

Liquidity problems are usually caused through the crystallization of another risk. For example:

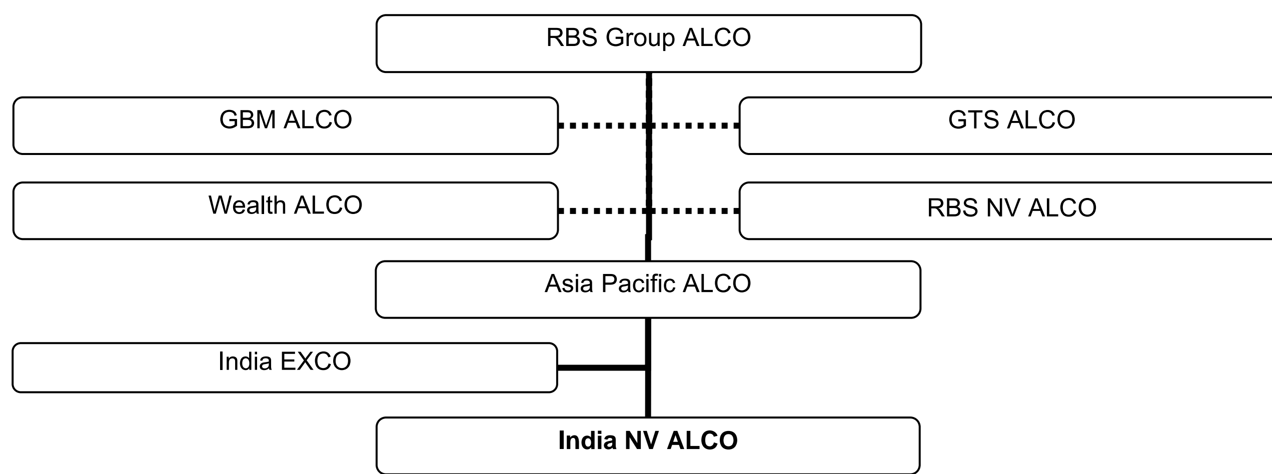
- a market event may limit the ability to liquidate assets at short notice, which may lead to the bank having to raise funds from elsewhere
- loss of confidence for a variety of reasons may lead customers to withdraw deposits and the bank will need to liquidate assets to meet this demand
- an operational problem (e.g. system outage) may impact the banks ability to make payments triggering a market wide liquidity problem

The Bank has liquidity and funding policy which acts as the principal document that sets guidelines for management of Liquidity Risk. The objectives of this policy are summarized below:

- Ensure effective and prudent management of liquidity and funding, which is fundamental to the continuing financial strength and soundness of the Bank.
- Ensure that actual and potential financial obligations can be met as and when they fall due.
- Ensure that all regulatory and internal requirements related to management of liquidity and funding are met on a continual basis.
- Ensure that regular liquidity stress testing is performed and that adequate contingency funding plans are in place.
- Ensure that a robust control environment is maintained for the reporting of liquidity risk and the resolution of limit breaches.
- To ensure that effective balance sheet planning is undertaken in order to facilitate the management of liquidity risk and the funding profile.
- Set out various risk mitigation tools that the Bank will use to measure, monitor and to effectively manage liquidity and funding risk.

Organisational set-up
India Asset & Liability Committee (ALCO) is responsible for Liquidity risk management. India ALCO consists of senior management of the Bank and meets periodically (minimum ten times in year). The committee oversees the funding and liquidity position of the Bank and provides structural guidance and oversight. The committee is responsible to oversee and ensure compliance with regulatory and internal requirements related to Liquidity risk management.

The ALCO governance framework is depicted in the following chart:



Liquidity risk appetite and limits of the Bank is set in line with the groups strategic plan, Liquidity policy and is set such that the regulatory requirements related to liquidity and funding stipulated by Reserve Bank of India are met at all times. The liquidity risk appetite is proposed by India ALCO and approved by APAC ALCO through limits and targets on various liquidity metrics.

ALCO also approves liquidity stress testing procedures, scenarios and assumptions and reviews stress test results and initiate actions to adjust the risk profile if required. ALCO also reviews and approves the Contingency funding plan which aims to minimize the repercussions of a liquidity crisis such that trust of the market in RBS NV India is quickly restored and the bank continues to be able to meet its obligations.
ALCO has delegated the execution of day-to-day funding and cash management activities to the Money Market Desk within Markets & International Banking Division. The Money Market Desk ensures that under normal circumstances the Bank:

- Has sufficient liquidity on a daily (and intraday) basis
- Optimizes the return on short term cash balances while meeting internal and regulatory Liquidity Risk limits
- Maintains the cash reserve requirement (CRR) and Statutory Liquidity reserve (SLR) requirement.
- Maintains an optimal level of collateral with the central bank for funding and payment purposes

Risk measurement and reporting framework
RBS NV India employs various liquidity metrics to proactively monitor and manage Liquidity Risk in the Balance sheet. These liquidity metrics can be categorized in following categories
Regulatory requirements: These liquidity metrics have been prescribed by Reserve Bank of India and have to be complied at all times.

- Statement of structural liquidity: The Bank prepares the Statement of structural liquidity on daily basis, covering assets and liabilities denominated in INR in accordance with the guidelines issued by the Reserve Bank of India (RBI). The assets and liabilities are placed as per their contractual or behavioral maturity in the time buckets specified by RBI. The behavioral assumptions are reviewed periodically and approved by ALCO. The mismatch positions are monitored against regulatory and internal limits. Any excess against these limits are reported to ALCO.
- Foreign currency Maturity and position (MAP) report: The Bank also prepares gap statements for assets denominated in major foreign currencies. These statements will be prepared on monthly basis.
- Short term dynamic liquidity statement: A statement covering expected cash flow position for next 90 days is prepared on fortnightly basis on the basis of projected balance sheets. These reports are circulated amongst the senior management of the Bank and are also periodically presented in ALCO meetings.
- **Concentration on liabilities:** The Bank also monitors prudential limits stipulated by RBI on Inter Bank Liability, Call/notice money market lending and borrowing limits and overseas borrowing limits.

Internal Limits: These are hard limits and have to be complied with at all times.

- Operational liquidity limits (OLLs): This cash flow metric sets the short term liquidity risk appetite of the Bank and aims to ensure that the Bank has adequate assets to meet expected maturing liabilities within a specified time band. OLLs have been set for 7 days and 28 days mismatches in INR and the position is monitored on daily basis.

Internal targets: India ALCO sets targets for following metrics and reviews them at least annually. Performances vs. targets are monitored closely and are considered while creating funding plans. However, since performances vs. targets are strongly influenced by external factors, deviations from the set targets are permitted if actions are considered to address any shortfall.

- Loan to deposit ratio: The Bank monitors Customer loans to customer deposits ratio on monthly basis. The guiding principle behind this ratio is that the client loans should be sufficiently funded by client deposits. ALCO sets a target for this metric and reviews it at least annually.
- Matched funding percentages: These are targets set on cumulative assets over cumulative liabilities. Assets and liabilities are grouped by maturities, and for each bucket the cumulative assets/liabilities are calculated by summing up all the assets/liabilities from the longest time band (>3 years) down to the time period of that bucket. The guiding principle behind this measure is to encourage funding behavior where assets in a particular time bucket or longer buckets are funded by liabilities in that bucket or longer buckets. ALCO sets targets for this metric and reviews these on at least an annual basis. ALCO monitors the matched funding position on a monthly basis.
- Concentration risk: Concentration risk is a measure of the reliance on a few key depositors for funding purposes. The share of top 5 depositors in the total deposit base is considered for calculating concentration risk. ALCO sets a target for this metric and reviews it at least annually. ALCO monitors the ratio on a monthly basis.

- Undrawn commitments: The level of irrevocable undrawn commitment is monitored to gauge the potential liquidity risk. If the level of irrevocable undrawn commitment reaches the trigger level India ALCO considers the situation and provides appropriate guidance based on the funding position and liquidity conditions at that point of time. The position is monitored monthly and reported to ALCO.
- Stress test survival horizons (all currency): Minimum Survival Horizons are set to ensure that the branch has adequate short term liquidity to cover the potential cash outflows for a set period of time under the most stressed scenario. These are monitored on quarterly basis.

Internal guidelines: These are reflective of best practice in liquidity risk management and likely future regulatory limits. Deviation from guidelines flag a potential future issue but no immediate action is required to address any shortfall.

- Net stable funding ratio: It is a Basel III measure. This is calculated as a ratio of available stable funding to different requirements of stable funding. The Bank will monitor the ratio on a monthly basis.
- Liquidity coverage ratio: Liquidity Coverage Ratio is a Basel III standard to measure the ability of a bank to cover the 30 days outflow by maintaining adequate high quality liquid assets. Calculation will be done taking guidance from the Basel liquidity risk guideline.
- Stress test survival horizons (Currency wise): Minimum Survival Horizons are set for INR and FCY. These are monitored on quarterly basis.

Liquidity stress testing

The Bank carries out liquidity stress testing on a quarterly basis. These tests aim to gauge the Bank's ability to meet all its obligations in various stress scenarios which include idiosyncratic stress, systemic market stress, combined idiosyncratic and market stress and economic downturn, with corresponding assumptions on deposit erosions, asset growth, haircuts on marketable assets, access to swap markets etc. Stress testing scenarios and corresponding assumptions are periodically reviewed and approved by ALCO. The committee also monitors the liquidity stress testing results and available lines of defence at quarterly intervals.

1.1.1 Contingency Funding Plan

The Bank maintains a Contingency Funding Plan (CFP) the purpose of which is to minimise the repercussions of a liquidity crisis such that trust of the market in RBS NV India is quickly restored and the bank continues to be able to meet its obligations. India ALCO reviews and approve the CFP at least on annual basis. The salient features of the Bank's CFP are summarised below:

- The CFP sets out the Bank's plan for the management of liquidity either when a potential problem is anticipated or in the event of an actual problem leading to a significant strain on the liquidity position.
- The CFP consists of two parts: (i) Liquidity Stress Testing and (ii) Liquidity Crisis Action Plan. Liquidity Stress Testing aim to gauge Bank's ability to meet all its obligations in various stress scenarios and are carried out at quarterly intervals. Liquidity Crisis Action Plan focuses on liquidity management plans during anticipated or actual period of liquidity stress.
- The CFP contains set of early warning indicators that are monitored to help in assessing any potential problem. It also details the process that needs to be followed for invoking CFP.

- The CFP lays down the membership, roles and responsibilities of Contingency Liquidity Team (CLT). India ALCO has delegated authority to the CLT to take any action necessary to meet funding and liquidity requirements once CFP has been invoked. The CFP sets out list of management actions that CLT can take in an liquidity event.
- Internal and External communications that should be considered in a liquidity event is also outlined in the CFP.
- The test the CFP once a year through a "dry run" in which occurrence of red liquidity event is tested. Post incident evaluation of the CFP is discussed in ALCO.

In summary, the Bank has in place robust governance structure, policy framework and review mechanism to ensure availability of adequate liquidity even under stressed market conditions.