CAPITAL ADEQUACY REQUIREMENTS AND INDIAN COMMERCIAL BANKS

Dr. M.K. Dekate
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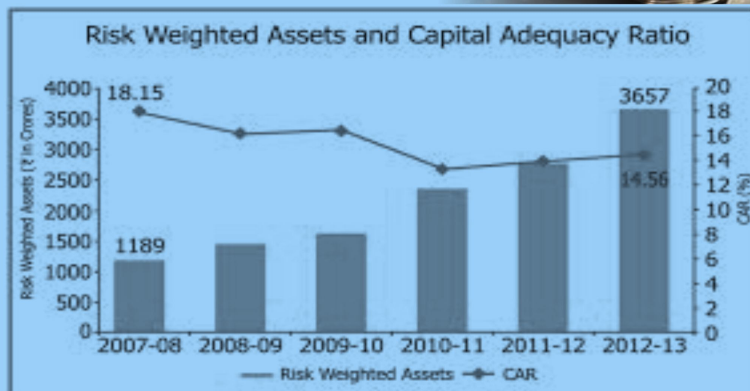

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Preface

In July 1988, 'International Convergence of Capital Measurement and Capital Standards' generally known as the Basel Capital Accord was created by the Basel Committee on Banking Supervision (BCBS), Basel, in Switzerland. The Basel I Accord, was designed to establish minimum levels of capital for internationally active banks. The committee's (BCBS) work on regulatory convergence had two fundamental objectives; Primarily, the framework should serve to strengthen the soundness and stability of the international banking system. Secondly, the framework should be fair and have high degree of consistency in its application to banks in different countries with a view to diminishing on existing source of competitive inequality among international banks. Initially, the capital accord recognized only credit risk. Subsequently, the market risk was also brought under the capital accord. Thus, Basel I focused on credit and market risks.

Following the East Asian Financial Crisis, the Credit Risk Management system was updated and new requirements to cover operational risk were created. A new framework known as the Basel II norms which refers to a document called 'International Convergence of Capital Measurement and Capital Standards: A Revised Framework' was released by the Basel Committee on Banking Supervision (BCBS) on June 26, 2004.

The Basel Committee's norms were initially addressed to international banks based in G-10 countries but over time the prudential regulators handed over to all kinds of banks irrespective of the domestic or international nature of their activities. The minimum Capital to Risk-weighted Assets Ratio (CRAR) has been specified at 8 per cent by the Basel Committee on Banking Supervision (BCBS) under both the Basel I and Basel II frameworks.

Basel III is the new international regulatory requirement resigned to correct the deficiencies in the system. It seeks higher capital adequacy ratio to meet any financial exigency. As per the new norms, banks were required to share up their capital at 7 per cent of risk-weighted assets. Although banks in India have higher capital requirement under Basel II, their Tier I or equity capital needs to be stored up to meet the norms. The Basel Committee has prescribed a retail roadmap for smooth transition to Basel III standards between January 1, 2003 and January 1, 2019.

The financial tsunami originated in United States in 2008 devastated economies of several countries. The epicenter was the reckless sub-prime lending of US investment banks. The root cause of 1991 South East Asia Crisis was also germinated in the faulty financial system. These incidents remind that weak and fragile policies in banking system can create disastrous and chaotic structure in national and international economies.

A sound and efficient banking system is *sine qua non* for maintaining financial stability. Therefore, considerable emphasis has been placed on strengthening the capital requirement in recent years.

Against this background, this book throw light on functioning of Indian commercial banks, the behaviour of capital infusion in attaining and maintaining CRAR. The trend and pattern of changes in risk weights of assets of commercial banks, the direction of bankers towards portfolio of assets after imposing risk weights, changes in the major banking indicators, operational and managerial constraints in implementing and maintaining capital adequacy requirements, etc.

We acknowledge the help from National Institute of Bank Management (NIBM), Pune; Reserve Bank of India, Central Office Mumbai; Indian Bank Association (IBA), Mumbai; Indian Institute of Technology (IIT), Mumbai and Jawaharlal Nehru Library, University of Mumbai. We are also grateful to Dr. Acharya and Dr. Jain, Yusuf Esmail College Mumbai. We are thankful to Himalaya Publishing House Pvt. Ltd., Mumbai, who has published this manuscript in a systematic manner. We hope that the book will be helpful to planners, practitioners, researchers and those who are associated with financial markets.

Dr. M.K. Dekate
Dr. Cromptom Anto T.

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List of Abbreviations

ADR	American Depository Receipt
AFS	Available for Sale
AIRB	Advanced Internal Rating Based Approach
ALM	Asset-Liability Management
AMA	Advanced Measurement Approach
AMC	Asset Management Company
ARC	Asset Reconstruction Company
ASCB	All Scheduled Commercial Banks
BCBS	Basel Committee on Banking Supervision
BFS	Board for Financial Supervision
BIA	Basic Indicator Approach
BIS	Bank for International Settlements
BR Act	Banking Regulation Act
BSSL	Banking Sector Support Loan
CACS	Capital Adequacy, Asset Quality, Compliance and Systems
CAGR	Compounded Annual Growth Rate
CAMELS	Capital Adequacy, Asset Quality, Management, Earnings, Liquidity and Systems
CAR	Capital Adequacy Ratio
CARE	Credit Analysis & Research Limited
CCB	Capital Conservation Buffer
CDO	Collateralised Debt Obligations
CFS	Committee on Financial Systems
CGTSI	Credit Guarantee Fund Trust for Small Industries
CRAR	Capital to Risk-weighted Assets Ratio
CRISIL	Credit Rating Information Services of India Limited
CRR	Cash Reserve Ratio
DA	Doubtful Assets
DFI	Development Financial Institutions
DICGC	Deposit Insurance and Credit Guarantee Corporation
DRT	Debt Recovery Tribunal
EAD	Exposure at Default
ECGC	Export Credit Guarantee Corporation
ECRA	External Credit Rating Agency
EXIM Bank	Export Import Bank of India
FCCB	Foreign Currency Convertible Bond

FI	Financial Institution
FIRB	Foundation Internal Rating Based
FSA	Financial Services Authority
G-10	Group of 10 Countries
G-20	Group of 20 Countries
GDP	Gross Domestic Product
GDR	Global Depository Receipt
GIC	General Insurance Corporation
HFC	Housing Finance Companies
HFT	Held for Trading
HTM	Held to Maturity
IBA	Indian Banks Association
IBRD	International Bank for Reconstruction and Development
ICRA Ltd.	Investment Information and Credit Rating Agency of India Limited
IDBI	Industrial Development Bank of India
IFCI	Industrial Financial Corporation of India
IFR	Investment Fluctuation Reserve
IMA	Internal Models Approach
IMF	International Monetary Fund
IPDI	Innovative Perpetual Debt Instruments
IPO	Initial Public Offering
IRB	Internal Rating Based Approach
IRDA	Insurance Regulatory and Development Agency
LAB	Local Area Banks
LAF	Liquidity Adjustment Fund
LGD	Loss Given Default
LIC	Life Insurance Corporation of India
LIBOR	London Inter-bank Offered Rate
LTV	Loan to Value
MIS	Management Information System
MTM	Marked to Market
NABARD	National Bank for Agriculture and Rural Development
NBFC	Non-banking Financial Company
NCAF	New Capital Adequacy Framework
NPA	Non-performing Assets
NPL	Non-performing Loans
NHB	National Housing Bank
NRI	Non-resident Indian

OBS	Off-balance Sheet
OECD	Organization for Economic Co-operation and Development
OSMOS	Off-site Monitoring and Surveillance System
PCA	Prompt Corrective Action
PD	Probability of Default
PD	Primary Dealer
PLR	Prime Lending Rate
PNCPS	Perpetual Non-cumulative Preference Shares
PSB	Public Sector Bank
PSE	Public Sector Entities
RBI	Reserve Bank of India
RoA	Return on Asset
RoE	Return on Equity
RRB	Regional Rural Bank
RWA	Risk-weighted Asset
SA	Standardized Approach
SARFAESI Act	Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act
SCB	Scheduled Commercial Bank
SDA	Standardized Duration Approach
SEBI	Securities Exchange Board of India
SFC	State Financial Corporation
SIDBI	Small Industries Development Bank of India
SLR	Statutory Liquidity Ratio
SME	Small and Medium Sized Enterprises
SMM	Standardized Measurement Method
S&P	Standard & Poor
SPSS	Statistical Package for Social Sciences
SSA	Sub-standard Assets
UCB	Urban Co-operative Bank

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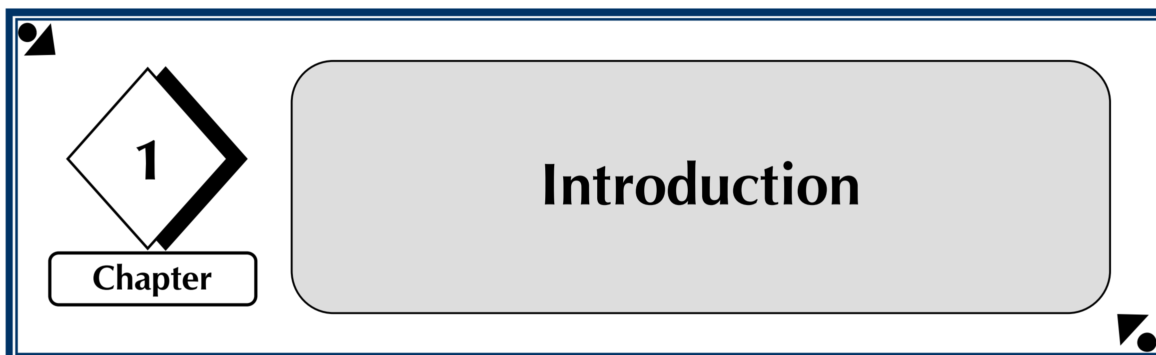

INTRODUCTION

Commercial banks are financial intermediaries, accepting deposits of money from the public for the purpose of lending and investments. Even though the traditional business of banking institutions has undergone changes, lending and investments continues to be the core business activity of commercial banks. The strength and stability of the banking institutions is a barometer of the economic stability of a country. Indian banking system has witnessed gradual and purposeful implementation of several reforms over the last two decades. Maintaining adequate capital commensurate with the risks was one among the reforms.

Money lending, the ancient form of banking in India, could be traced back to the Vedic period, i.e., 2000 to 1400 BC. Further, existence of professional banking in India could be traced back to the period 500 BC. *Kautilya's Arthashastra,*[1] dating back to the period 400 BC contained references to the terms such as creditors, lenders and lending rates. Banking was fairly varied and catered to the credit needs of the trade, commerce, agriculture as well as individuals in the economy.

The Royal Commission on Indian Currency and Finance set up in 1926, observed that a system of banking that was eminently suited to India's then requirements was in force in that country many centuries before the science of banking became an accomplished fact in England. The banking practices in India were vastly different from the European counterparts. During this period, money lending activity, the ancient form of banking worked on mutual trust, confidence and without securities and facilities that were considered essential by British bankers.[2]

The process of providing financial services is changing rapidly from traditional banking to a one-stop shop of varied financial service and the old institutional demarcations are getting increasingly blurred. In the challenging decades ahead, a healthy, competitive, market oriented, efficient and professionally managed financial system is imperative for the distinctive contribution to the growth of the economy. In the financial sector, banking system has the dominant role in mobilisation of savings and their economic as well as efficient allocation.

The episodes of financial instability often have adverse impact on wider sections of the community, including firms and households. The overall cost of such episodes could be enormous for an economic system, which often spills over cross borders. The East Asian crisis during the mid-1990s revealed implications of weaknesses in the financial sector on the economy in terms of severe economic and social consequences. Excessive volatility in financial markets can significantly raise the cost of capital for business investment and adversely affect expansion in output. The weak financial

sector may also impede the monetary transmission mechanism when the central bank attempts to stimulate the economy.[3] The global financial meltdown also underlined the importance of banking system.

In India, banking system by far, the most dominant segment of the financial sector, accounting as it does for over 80 per cent of the funds flowing through the financial sector and it is appropriate that reform in this sector has been receiving major emphasis. The faster growth of the banking sector in relation to the real economy pushed up the ratio of assets of scheduled commercial banks to GDP to 92.5 per cent at end March 2007.[4] In the pre-reform period, the Indian financial sector was a government dominated system with limited efficiency and too much stability through rigidity.

FINANCIAL REFORMS AND CAPITAL ADEQUACY REQUIREMENT

In the financial sector, especially in banking segment, wide ranging reforms have been undertaken since the early 1990s. The capital adequacy norms were implemented among the banks in India as per the recommendations of Committee on the Financial System (1991),[5] a high powered committee appointed by Government of India. The committee's recommendation on the capital adequacy was based on the standards prescribed by the Basel Committee on Banking Supervision (BCBS)[6] appointed by the Bank for International Settlements (BIS),[7] Basel in Switzerland. Globally, these norms were known as Basel norms on capital adequacy. Originally meant for implementation among globally active banks in G-10 countries, these norms were accepted and implemented by many countries as a measure for ensuring the strength and stability of the domestic banking system. Accordingly, the banks were required to maintain capital funds proportionate to the risk weight of assets.

Though Basel II is not a legal document, to synchronize with global trends and expectations of all stakeholders, RBI implemented capital adequacy norms in the country in a phased manner beginning from March 31, 1993.

SIGNIFICANCE OF CAPITAL ADEQUACY REQUIREMENT IN BANKING SECTOR

Capital adequacy is the requirement of adequate capital for meeting the unexpected losses which may occur in the course of banking business, basically in lending and investment activities. The adequacy of capital in commercial banking is measured and indicated by a ratio, Capital to Risk-weighted Assets Ratio (CRAR) or simply, Capital Adequacy Ratio (CAR). It is the ratio of capital funds to the aggregate risk-weighted assets. Risk-weighted assets means the quantum of assets based on the perception of risks. Book value of assets and the risk-weighted assets on the same properties may vary. For calculating the capital adequacy, the quantum of risk-weighted assets has to be ascertained rather than the book value or market value of assets. The percentage of risk weights are prescribed by RBI and revised according to the risk perception.

CRAR, the indicator of capital adequacy requirements was implemented among banks in India as part of the accepting the global standards in banking.

The capital adequacy requirement was introduced in various stages. In the beginning, capital adequacy norms were implemented among foreign banks in India w.e.f. March 31, 1993. For other banks, these norms were implemented in a phased manner. Reserve Bank of India made it mandatory for all other commercial banks w.e.f. March 1996. Excluding foreign banks, there are 47 commercial banks (26 public sector banks and 21 private sector banks) as on March 2011.

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1. The Arthashastra is an ancient Indian treatise on statecraft. economic, policy and military which identifies its author by the names 'Kautilya' and 'Vishnugupta', both names that are traditionally identified with Chanakya who was a scholar at Takshashila and the teacher and guardian of Emperor Chandragupta Maurya, the founder of Mauryan Empire (*Source:* Wikipedia).
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3. Reserve Bank of India (2007), 'Report on Trend and Progress of Banking in India 2006-07', Reserve Bank of India, Mumbai, pp. 196-197.
4. Reserve Bank of India (2007), 'Report on Trend and Progress of Banking in India 2006-07', Reserve Bank of India, Mumbai, p. 5.
5. Government of India (1991), Report of the Committee on the Financial System (Chairman – Shri M. Narasimham), Reserve Bank of India, Mumbai.
6. Basel Committee on Banking Supervision (BCBS) is a committee of banking supervisory authorities that was established by the central bank governors of the Group of Ten countries (France, Germany, Belgium, Italy, Japan, the Netherlands, Sweden, the United Kingdom, the United States, Canada and Switzerland.) BCBS has played a central role in establishing the Basel Capital Accords of 1988 and 2004.
7. Bank for International Settlements (BIS) is an international organization of central banks and serves as a bank for central banks. Presently, the Bank has 58 members, It usually meets at the Bank for International Settlements in Basel, where its permanent Secretariat is located.