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PRUDENTIAL AND SUPERVISORY NORMS AND STABILITY OF THE INDIAN BANKING SYSTEM

Dr. Meera Mehta[1] & Dr. Harish Handa[2]

[1].Assistant Professor, Department of Commerce, Shaheed Bhagat Singh College, Delhi University, New Delhi- 110017

[2].Associate Professor & Formerly Lecturer Massey University, New Zealand Department of Commerce, Shaheed Bhagat Singh College, Delhi University, New Delhi- 110017

ABSTRACT

Deregulation in the financial sector had enlarged the item run in the created business sector. A percentage of the new items presented are Mastercards, housing finance, subordinates and different balance sheet things. In this way new vistas have made numerous hotspots for banks to create higher benefits than the customary fiscal intermediation. All the while they have opened new areas of risks additionally. Amid the previous decade, the Indian banking industry kept on reacting to the developmental difficulties of rivalry, dangers and vulnerabilities. Risks start in the manifestations of client default, financing a crevice or antagonistic developments of business sectors. Measuring and evaluating risks in not simple or instinctive. Our controllers have made some genuine endeavors to bring prudential and supervisory standards fitting in with global bank rehearses with a plan to fortify the steadiness of the keeping money framework. This paper endeavors to study the quantitative part of Capital Adequacy Norms under the Basel Accords.

KEY WORDS:Risk Management, Tier-I, Tier-II, Risk Weighted Assets.

INTRODUCTION

The international banking scene has lately seen solid patterns towards globalization and solidification of the budgetary framework. Dependability of the monetary framework has turned into the focal test to bank controllers and administrators all through the world. The Indian banking scene has seen dynamic deregulation, foundation of prudential standards and an assessment of universal supervisory best practices. M/s. Price Waterhouse Coopers, London, were chosen by RBI to embrace an audit of the flow, administrative and supervisory methods of the RBI with a perspective to support in the presentation of risk based regulation and supervision of Indian Banks.

RISK MANAGEMENT SYSTEM

Risk management is quickly developing as a science and taking a bigger and unmistakable space, in the field of bank management. Risk or the management of the same is not another idea. Risk Management until now has been through instinct, hunch and recognition. An organized methodology for Risk Management has been slippery to the Banks for a respectably long time. The first step towards an organized Risk Management arose through Basel initiatives. The advent of Basel II has certainly brought to focus the pressure on Capital through differential risk weights.

REVIEW OF LITERATURE

Daniel Tabbush, Head of CLSA Banking Research (2008) in his report stated "Mortgage-loan risk weightings drop from 50% to 35% under Basel II, making them much more profitable in terms of regulatory capital required, while small and medium-sized enterprise (SME) lending can move from 100% to 75%".

Anand Wadadekar (2008) in his study "Basel Norms & Indian Banking System" revealed that Basel II Norms offer a variety of options in addition to the standard approach to measuring risk. Paves the way for financial institutions to proactively control risk in their own interest and keep capital requirement low.

Niall S.K. Booker, chief executive officer, HSBC India and chairman of the IBA Committee of Basel II states "There is the possibility that in international market access may be easier and costs less for banks adopting a more sophisticated approach....however in a market like India it seems likely that the large domestic players will continue to play a very significant role regardless of the model used".

Mandira Sharma & Yuko Nikaido (2007) in their study on"Capital Adequacy Regime in India" examined issues and challenges with regard to the implementation of CRAR norms under Basel II regime in India. They also tried to identify limitations, gaps and inadequacies in the Indian banking system which may hamper the realization of the potential benefits of the new regime.

Ernst & Young in their survey in (2008) revealed that Basel II has changed the competitive landscape for banking. Those organizations with better risk systems are expected to benefit at the expense of those which have been slower to absorb change due to increased use of risk transfer instruments. It also concluded that portfolio risk management would become more active, driven by the availability of better and more timely risk information as well as the differential capital requirements resulting from Basel II. This could improve the profitability of some banks relative to others, and encourage the trend towards consolidation in the sector.

Vyas, et. al (2007) studied the impact of Capital regulation norms like Basel II on credit growth of Indian banks. The study concluded that capital requirements regulations do not seem to affect credit growth in spite of the growing concerns about the banking stability.

Singla (2008) studied the financial performance of banks in India in view of increasing globalization and increased competition in the banking industry. He concluded that the financial positions of banks is reasonable, debt-equity ratio is maintained at an adequate level and NPAs also witnessed a decline during the study period.

CAPITAL ADEQUACY NORMS

The Basel I framework defined two minimum standards for acceptable capital adequacy requirements viz., Risk Based Capital Ratio & Asset to Capital Multiple. As a sequel to this, Reserve Bank of India introduced capital adequacy norms for banks in April 1992. Under this system, assets (loans & investments) on and off the balance sheet are assigned definite risk weights (0%, 20%, 50% and100%). Banks are expected to maintain capital funds, which ensure a minimum capital ratio (Capital to risk weighted assets) of 9% on an ongoing basis. The financial subsidiaries and associates of a Bank should individually meet their respective regulatory capital requirements. In case of any shortfall the Bank shall make good such amount by deducting from its capital funds at 50% from Tier I and 50% from Tier II.

The risk based capital ratio is defined as the ratio of capital to risk weighted assets. Assets mean both on balance sheet items (Loans, advances and investments etc) and off balance sheet exposures(Guarantees and Letters of credit etc). As per the accord Banks had to hold a minimum capital of 8% over the risk weighted assets. Out of the minimum capital to be held, at least 4% of it should be in the form of Tier I capital. The asset to capital multiple was set at 12.5. Tier II capital is limited to 100% of Tier I capital.

Hence,

Capital Adequacy Ratio (CAR) = Capital / Credit Risk

Capital = Tier I Capital + Tier II Capital

Capital ratio Minimum 8% as per Basel and 9% as per RBI

Credit Risk = sum of Risk Weighted Assets (RWA)

Risk Weighted Assets = Exposure X Supervisor determined risk weights.

In India as a result of Basel I Accord, we saw the introduction of prudential norms such as asset classification, income recognition and capital adequacy. Basel I met the following objectives:

- Strengthened the capital base of Banks
- Created clear and uniform guidelines for all Banks world over
- Reduced competitive distortion among banks.

However, it had many deficiencies like applying uniform risk weight to a pool of assets irrespective of their risk profile, ignoring the importance of operational risk and following a one size fits all approach. Basel Committee on Banking Supervision (BCBS) came up with revised norms in 1999 by plugging the defects of their earlier accord.

The Basel II norms are uniformly applicable to all Scheduled Commercial Banks with the exception of Regional Rural Banks at the consolidated level. The financial institutions recognized for implementing Basel II are: 1)Banks 2) Insurance Companies 3) Mutual

Funds 4) Primary Dealers 5) Housing Finance companies 6) Non-Banking Financial Companies and 7) Merchant Banking Companies.

CAPITAL FUNDS

Capital funds for capital adequacy purpose are classified into Tier I and Tier II Capital. Under Tier I again the elements to be included are specified separately for Indian Banks and Foreign Banks. In respect of Indian Banks the elements eligible for treatment as Tier I Capital are

- Paid up capital
- Statutory Reserves
- Other disclosed free Reserves
- Capital Reserves representing surplus arising out of sale proceeds of Assets

The components of Tier II Capital for capital adequacy purpose are:

- **Undisclosed Reserves** (provided they represent accumulations of post-tax profits and not routinely used for absorbing normal or operating losses)
- **Cumulative perpetual preference shares (**should be fully paid up and do not contain any clauses which permit redemption by the holder)
- **Revaluation Reserves** (discounted at 55% while determining their value for inclusion under Tier II capital)
- **General Provision and Loss Reserves** (Admitted as Tier II capital to a maximum of 1.25% of Total Risk Weighted Assets)
- **Hybrid debt capital instruments** (treat only such instruments as Tier II which have close similarity to equity and are able to support losses on an ongoing basis without triggering liquidation)
- **Subordinated debts** (treated as Tier II) subject to the following
  - Should be fully paid-up and unsecured
  - Should be subordinated to the claims of other creditors
  - Should be free of restrictive clauses
  - Should not be redeemable at the initiative of holder or without the consent of Reserve Bank
  - Should be subject to progressive discount as they approach maturity
  - Should have an initial maturity of not less than 5 years or remaining maturity of not less than 1 year.
  - Shall be reckoned as Tier II only to the extent of 50% of Tier I capital
  - Should be subject to progressive discount as they approach maturity
  - Should have an initial maturity of not less than 5 years or remaining maturity of not less than 1 year.
  - Shall be reckoned as Tier II only to the extent of 50% of Tier I capital
- **Investment fluctuation Reserve** (5% of Total Investments held as reserve for Market risk)
- **Investment in financial subsidiaries and associates** – For capital adequacy purposes following treatment is given
- If investments of the bank upto 30% of the paid up equity of subsidiary 100% risk weight shall be assigned to such invested amount
- If investment of the Bank in paid up equity of subsidiary is more that 30% then such invested amount shall be deducted from the Bank's capital funds at 50% from Tier I and 50% from Tier II

The other Adjustments to Capital Funds are

- ☆ Intangible assets & losses (both current & brought forward from previous periods) to be deducted from Tier I
- ☆ Deferred Tax Assets being an intangible asset to be deducted from Tier I
- ☆ Banks investment in instruments (Equity shares, subordinated debt instruments, Hybrid debt capital instruments or any other instrument of capital character) in excess of 10% of investing Bank's capital funds should be deducted at 50% from Tier I and 50% from Tier II Capital.
- ☆ Banks should not acquire any fresh stake in a Bank's equity shares, which will result in Bank's holding exceeding 5% of the investee Bank's equity capital.
- ☆ The elements of Tier I and Tier II should not include foreign currency loans granted to Indian parties.

To study the impact of Asset quality on Capital let us take three scenarios having the same total asset exposure of Rs 100 crores but with different asset quality. For the purpose of simplicity in assessing asset quality we have taken the assets as falling under three risk categories namely Low, Medium and High risk.

Scenario I

Risk level	Exposure (in crores)	Risk weight	Risk weighted Asset (in crores)
Low	20	20%	4
Medium	30	50%	15
High	50	150%	75
	Total Risk Weighted	Asset	94

CAR = Capital / Total Risk Weighted Asset

Capital = CAR X Total Risk Weighted Asset

Capital = (9/100) X94 **= 8.46 crores**

Scenario II

Level of risk	Exposure (in crores)	Risk Weight	Risk Weighted Asset (in crores)
Low	35	20%	7
Medium	30	50%	15
High	35	150%	52.5
	Total Risk Weighted	Asset	74.5

Capital Required = Total Risk Weighted Asset x CAR

= 74.5X (9 / 100) = **6.70 crores**

Scenario III

Level of risk	Exposure (in crores)	Risk Weight	Risk Weighted Asset (in crores)
Low	50	20%	10
Medium	30	50%	15
High	20	150%	30
	Total Risk Weighted	Asset	55

Capital Required = 55 X (9 / 100) = 4.95 crores

Low composition of low risk exposures and high composition of high-risk exposures in the asset portfolio in Scenario I indicate a poor asset quality and warrant a capital of Rs 8.46 crores.

Equal composition of Low, Medium and High-risk exposures in Asset portfolio in Scenario II indicate a Medium Asset quality warranting a capital of Rs 6.70 crores.

High composition of low risk Assets and low composition of High risk assets in credit portfolio in Scenario III indicate high quality assets and require capital of Rs 4.95 crores.

CONCLUSION

- Better the asset quality lower is the capital required to be held.
- Hence improving the asset quality helps banks in managing the credit risk in loan book by holding less capital.

- While quantitative tools help in knowing the asset quality of credit portfolio, qualitative tools help in improving the asset quality.
- Hence both qualitative and quantitative tools are required for effectively managing credit risks and thereby the capital to be held.

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