Capital Adequacy in Banks — Whither now?

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Basel II prescriptions have ushered in a transition from the traditional regulatory measure of capital adequacy to an evaluation of whether a bank has found the most efficient use of its capital to support its business i.e., a transition from capital adequacy to capital efficiency. In this transition, how effectively capital is used will determine return on equity and a consequent enhancement of shareholder value.

The Basel Committee on Banking Supervision decided to introduce a capital measurement system in banks in 1988, which was commonly referred to as the Basel Capital Framework or the Basel–I Accord. Since then, this framework has been progressively introduced by virtually every monetary authority in the world and covers most of the banking entities having international operations. This system provided for the implementation of a credit risk framework with a minimum capital standard. Weightages were assigned by the Committee for different categories of exposure of banks so that risky assets like unsecured commercial loans carried a risk weight of 100% whereas risk-free investment in sovereign paper carried zero per cent risk. The Basel-I framework was relatively simple to understand and implement and the mainstream banking institutions worldwide adopted the prescribed minimum capital adequacy standards. Though not free from its share of criticism, this imposed discipline has been acknowledged by many as a factor contributing to overall financial strength of the banking system. As far as our country is concerned, banks have complied with all elements of Basel-I with the introduction of capital charge for market risks effective from the year ended March 2005.

While the Basel Committee's initiatives to ensure adequate capital base of banks succeeded to a great extent, it was increasingly felt that the 1988 framework was ineffective to grapple with evolving innovative financial products offered by banks such as derivatives and securitised paper. Basel-I focused mainly on advances and investments and it simplistically prescribed same capital norms for all banks across the board. There was scope for manipulating the minimum capital computations. The major drawback of Basel-I was that it did not consider allocation of capital to take care of substantial and real operational risks of banks. A need was also felt to recognise modern risk management techniques developed and implemented by major banks during the past decade since the norms did not distinguish between high and low quality assets within the same class. Responding to the criticism and deficiencies experienced in implementation of the 1988 Accord, the Basel Committee issued a proposal in June 1999 for a new capital adequacy framework to replace the 1988 framework. Following extensive interaction with banks and industry groups worldwide, the proposal underwent a couple of revisions at its drafting stage and the final version - 'International Convergence of Capital Measurement and Capital Standards: A Revised Framework' was issued by the Basel Committee on Banking Supervision in June 2004. This framework (popularly known as Basel-II) is intended to serve as a basis for national rule-making and approval processes to continue, and for banks to complete their preparations for the new framework's implementation.

The revised Framework has been designed to provide options for banks for determining the capital requirements for credit risk and operational risk, and enables banks and their supervisors to select approaches that are most appropriate for their operations and financial markets. The Framework is expected to promote adoption of stronger risk management practices in banks. The revised framework builds on the current framework to link capital requirements more closely with inherent risks in banking and to provide banks and their supervisors with multiple choices for assessment of capital adequacy.

Much has been said and written about the 'three pillars' supporting the Basel-II framework. The 'three pillars' attempt to achieve a comprehensive coverage of risks, enhance risk sensitivity of capital requirements and provide tools for a refined measurement of required capital. The key objective of the new framework is to align regulatory capital to underlying risk and induce banks to strengthen their risk management capabilities. Implementation of Basel-II is seen as one of the significant challenges facing the banking sector in many jurisdictions. Commercial banks in India will start implementing Basel-II with effect from March 31, 2007. The roadmap drawn up by the RBI envisages banks to adopt initially the 'standardised approach' for credit risk and the 'basic indicator approach' for operational risk. After adequate skills are developed, both by the banks and also by the supervisors, some banks may be allowed to migrate to the Internal Rating Based (IRB) Approach. Implementation of Basel-II will require more capital for banks in India due to the fact that operational risk has not been captured under Basel-I, and the capital charge for market risk was not prescribed until recently. Today, the Indian banking system has a relatively healthy CRAR of 12%+. However, it is going to be a serious challenge both for banks and for the regulator to develop skills and techniques with regard to adoption of the advanced risk management approaches. The RBI has indicated that a consultative and participative approach will be adopted for designing and implementing Basel-II in the Indian banking system with a view to ensuring smooth migration from Basel-I. After detailed deliberations by a steering committee comprising experts and senior bankers, the RBI has issued draft guidelines to the banks on implementation of the new capital adequacy framework. In a recent talk, the Deputy Governor of the RBI recognised the daunting task ahead and said that supervisory capacity building measures have been initiated by the RBI to identify the gaps and to assess and quantify the extent of additional capital which may be required to be maintained by the banking system comprising about 90 scheduled commercial banks in India. In the same talk the Deputy Governor emphasised the need for improving risk management systems in banks in view of the increasing degree of deregulation and exposure of banks to a variety of new risks. At the initial stages of development of the risk management systems, banks were managing each risk in isolation.

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The current business environment demands a more integrated approach to risk management. It is no longer sufficient to manage each risk independently or in functional silos. Enterprises worldwide are, therefore, now putting in place an integrated framework for risk management, which is proactive, systematic and spans across the entire organisation.

Having ascertained the required optimum capital taking into account the regulatory minimum plus the amount needed to provide some cushion and to support business growth in the near-medium term, banks would have to decide the best way to go about raising the money. Looking at some of the exotic, complex instruments put out by enterprises of late, it seems that the old plain vanilla equity and debt paper is no longer in fashion. Of course, one has also to reckon the changed profile of the modern investor – he may be an NRI, foreigner, FII, foreign company etc. – and his specific investment objective and horizon. For banks, capital-raising involves consideration of not just the financial or commercial aspects but also of stringent regulatory

prescriptions by the RBI. In fact the RBI has recently permitted banks to issue certain 'innovative' instruments within the Basel framework of Tier 1 / 2 / 3 capital.

As we know, the Basel Capital Accord of 1988 classifies capital under three 'Tiers'. Briefly, the instruments used under these capital Tiers are the following:

Tier 1 Capital:

(a) Permanent shareholders' equity;

(b) Perpetual non-cumulative preference shares;

(c) Disclosed reserves;

(d) Innovative capital instruments

Tier 2 Capital:

(a) Undisclosed reserves;

(b) Revaluation reserves;

(c) General provisions/general loan-loss reserves;

(d) Hybrid debt capital instruments (a range of instruments which combine characteristics of equity capital and debt); and

(e) Subordinated term debt

Tier 3 Capital:

Short term subordinated debt for the sole purpose of meeting a proportion of the capital requirements for market risks.

It may be noted that banks may employ Tier 3 capital only at the discretion of their national monetary authority or the central bank. At present, banks in India are not allowed to raise Tier 3 capital.

The options for raising Tier 1 and Tier 2 capital funds as available to the banks in India in terms of the present RBI guidelines on capital adequacy which do not allow banks to raise capital funds through the issue of

(a) Preference shares – both cumulative and non cumulative;

(b) Innovative capital instruments for inclusion in Tier 1 capital; and

(c) Hybrid debt instruments for inclusion in Tier 2 capital.

Recently, the RBI examined the feasibility of allowing banks to raise capital funds through the above-mentioned instruments- (Notification Ref. RBI/2005-06/283 DBOD. No.BP.BC. 57 / 21.01.002 / 2005-2006 dated January 25, 2006). However, since Tier 3 capital is short term in nature and is an optional item of capital for meeting a portion of banks' exposures to market risks, this option has not been considered for the present.

The above notification states that with a view to provide banks in India additional options for raising capital funds to meet both the increasing business requirements as well as the Basel-II requirements within the existing legal framework, it has been decided that banks may augment their capital funds by issue of the following additional instruments:

(a) Innovative Perpetual Debt Instruments (IPDI) eligible for inclusion as Tier 1 capital;

(b) Debt capital instruments eligible for inclusion as Upper Tier 2 capital;

(c) Perpetual non-cumulative Preference shares eligible for inclusion as Tier 1 capital - subject to laws in force from time to time; and

(d) Redeemable cumulative Preference shares eligible for inclusion as Tier 2 capital - subject to laws in force from time to time.

Further, the RBI has also issued guidelines governing the instruments at (a) and (b) above, indicating the minimum regulatory requirements for issuance of Innovative Perpetual Debt Instruments eligible for Tier 1 and Debt Capital Instruments eligible for Tier 2. Detailed guidelines regarding issuance of preference shares are to follow separately in due course.

Terms and conditions applicable to Innovative Perpetual Debt Instruments (IPDI) indicate that the instrument could be in the form of a bond or debenture denominated in Indian rupees. The amount to be raised may be decided by the board but it shall not exceed 15% of Tier 1 capital. IPDIs shall be perpetual i.e. without any maturity and may carry either fixed or floating interest rates. These instruments cannot have 'put option. However, 'call option' may be provided after at least ten years. The issuing bank is not permitted to grant advances against the security of its innovative instruments. These innovative instruments shall have a lock-in clause whereby the issuing bank shall

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not be liable to pay interest if the bank's CRAR is below the regulatory minimum prescribed by the RBI. The claims of investors in IPDIs shall be superior to equity shareholders but subordinated to the claims of all other creditors. Further, investment in these instruments by FIIs and NRIs shall be within the overall limit of 49% and 24% of the issue respectively subject to the investment by each FII not exceeding 10% and by each NRI not exceeding 5% of the issue. As regards foreign banks operating in India, they may raise head-office borrowings in foreign currency for inclusion of Tier 1 capital subject to the same terms and conditions as applicable to Indian banks.

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Terms and conditions applicable to Debt Capital Instruments (DCI) to qualify for inclusion as Upper Tier 2 capital prescribed a minimum maturity period of 15 years. DCIs shall have a lock-in clause in terms of which the issuing bank shall not be liable to pay either interest or principal even at maturity if the bank's CRAR is below the regulatory minimum prescribed by RBI. The guidelines provide for a progressive discount for capital adequacy purposes, as in the case of long-term subordinated debt, over the last five years of DCI tenor. Further, DCIs may be redeemed only with the prior approval of the RBI. Investments in Upper Tier 2 instruments by FIIs shall be within the limits laid down in the policy for external commercial borrowings.

Today, all said and done, Basel-II implementation is being perceived by most banks as a compliance challenge. While it may be so, bank managements would do well to recognise that Basel-II, in fact, offers considerable opportunities to banks for refinement of risk management systems and improvement in capital efficiency.

Comprehensive Risk Management: Under Basel-I, banks were clued on to credit and market risks only. Basel-II has brought into focus a larger number of risks requiring banks to focus on a broader canvas. Besides the increase in the number of risks, banks are now beginning to focus on their inter-linkages with a view to achieve a more comprehensive risk management framework. Basel-II implementation, therefore, is being increasingly seen as a medium through which banks constantly endeavour to upgrade their risk management systems to address the changing environment. Further, in the initial stages, banks were managing each risk independently, in isolation, which is no longer adequate. Enterprises worldwide are, therefore, now putting in place an integrated framework for risk management, which is proactive, systematic and covers the entire organisation. Banks in India are also moving from the individual silo system to an enterprise-wide risk management system. This is placing greater demands on the risk management skills in banks and has brought to the fore the need for capacity building. While the first milestone would be risk integration across the entity, banks would do well to aggregate risk across the group both in the specific risk areas as also across the risks.

Capital Efficiency: Basel II prescriptions have ushered in a transition from the traditional regulatory measure of capital adequacy to an evaluation of whether a bank has found the most efficient use of its capital to support its business i.e., a transition from capital adequacy to capital efficiency. In this transition, how effectively capital is used will determine return on equity and a consequent enhancement of shareholder value. In effect, banks may adopt a more dynamic approach to use of capital, in which capital will flow quickly to its most efficient use. This revised efficiency approach is expected to guide the return-on-equity strategy and influence banks' business plans. With the extension of capital charge for market risks to the AFS portfolio this year and the coming into force of Basel II norms in March 2007, banks would need to shore up the capital levels not only for complying with these requirements but also for supporting the balance sheet growth. With a view to enhancing the options available to banks for augmenting their capital levels, the Reserve Bank of India has now permitted banks to issue new capital instruments, including perpetual instruments. Key features of such instruments have been already noted earlier and these are designed to help banks in not only managing their capital effectively but also efficiently.

It remains to be seen how our banks utilised the new window of innovative instruments now available to them. ❐