

**CAPITAL ADEQUACY NORMS
FOR
PRIMARY (URBAN) COOPERATIVE
BANKS**

CAPITAL ADEQUACY

The term Capital Adequacy

Captures :

- **Overall Soundness of the individual bank**
- **Risk Exposure of the individual bank**

Reflects the idea of the bank

- **Bank capital as a cushion or buffer to absorb losses**

CAPITAL ADEQUACY

Reflects

The Optimum amount of capital that it would require to ensure the confidence of all stakeholders – investors, depositors, creditors and regulators

BASEL CAPITAL ACCORD - I

Basel Committee on Banking Supervision (BCBS) is a Committee of Supervisory authorities of G 10 countries

BCBS aims to improve supervisory understanding and the quality of supervision worldwide

Early 1980s – Fast growth of assets of international banks but slow growth of capital

Need for strengthening capital base to ensure stability of financial system and to avoid bank failures

BCBS issued the Capital Accord in 1988 prescribing minimum capital ratio of 8% to be achieved by end 1992

BASEL CAPITAL ACCORD - I

Major Objectives:

- ❖ **Strengthening of the International Banking System**
- ❖ **Promoting convergence of national capital standards**
- ❖ **Ironing out competitive inequalities among banks across countries**
- ❖ **Adequate Capitalization of banks, especially those engaged in international business**

BASEL CAPITAL ACCORD - I

Main features of the Accord :

Primarily addressed to Internationally active banks

Sought to establish a minimum capital ratio, leaving it to the national regulatory authorities to prescribe higher ratios

Intended to apply to banks on a consolidated basis (including subsidiaries, branches, etc.)

Stress on the fact that Capital Adequacy is only one of the several dimensions of financial soundness of a bank

CAPITAL ADEQUACY IN INDIA

- **INTRODUCED IN 1992 – 93 AND MADE APPLICABLE TO COMMERCIAL BANKS**
- **FOREIGN BANKS OPERATING IN INDIA WERE REQUIRED TO ACHIEVE CRAR OF 8% BY 31-3-93**
- **ALL INDIAN BANKS WERE REQUIRED TO ACHIEVE CRAR OF 4% BY 31-3-1993**
- **INDIAN BANKS HAVING BRANCHES ABROAD WERE REQUIRED TO ACHIEVE CRAR OF 8% BY 31-3-1995**
- **INDIAN BANKS NOT HAVING BRANCHES ABROAD WERE REQUIRED TO ACHIEVE CRAR OF 8% BY 31-3-1996**

**FROM THE YEAR ENDED 31 MARCH 2000
ONWARDS THE CRAR WAS RAISED TO 9%**

CRAR REQUIREMENT FOR NBFCs

10 % BY MARCH 31, 1998

12 % BY MARCH 31, 1999

HIGH POWER COMMITTEE ON UCBs

- **UCBs ALSO PERFORM SAME FUNCTIONS AS COMM. BANKS AND EXPOSED TO SIMILAR RISKS**
- **TO ACHIEVE STABILITY OF THE BANKING SYSTEM**
- **CRAR NORMS TO BE APPLICABLE TO UCBs**
- **RECOMMENDED VARIOUS MEASURES TO AUGMENT CAPITAL BASE OF UCBs**

STATUTORY REQUIREMENT

IN TERMS OF SECTION 11 OF BR ACT 1949 BANKS REQUIRE CERTAIN AMOUNT OF CAPITAL & RESERVE FOR CARRYING ON THEIR OPERATIONS IN INDIA

THE AMOUNT OF CAPITAL DEPENDS ON

- COUNTRY OF INCORPORATION
- AREA OF OPERATION (STATES ,UTs)
- GEOGRAPHICAL SPREAD OF BRANCHES (IN METROPOLITAN CITIES - MUMBAI / KOLKATA OR OTHER CITIES) ETC.

CAPITAL REQUIREMENT OF COOPERATIVE BANKS

**AS PER SECTION 11 OF BR ACT
(AS APPLICABLE TO COOPERATIVE BANKS)**

**NO COOPERATIVE BANK SHALL
COMMENCE OR CARRY ON THE BUSINESS
OF BANKING IN INDIA UNLESS THE
AGGREGATE VALUE (REAL OR
EXCHANGEABLE) OF ITS PAID UP CAPITAL
AND RESERVES IS NOT LESS THAN RS. 1
LAKH**

CONTD ...

THE NEW GENERATION PRIVATE SECTOR BANKS WERE REQUIRED TO HAVE INITIAL CAPITAL OF RS.100 CRORE,

AS A CONDITION FOR BANK LICENCING UNDER SECTION 22 OF BR ACT, 1949

THESE ARE MINIMUM CAPITAL REQUIREMENT

ADEQUATE CAPITAL

AS BUSINESS GROWS ,THE MINIMUM CAPITAL BECOMES INADEQUATE

IMPERATIVE NEED ARISES FOR HAVING CAPITAL WHICH IS SUFFICIENT TO BEAR ALL POSSIBLE LOSSES

THIS IS CALLED ADEQUATE CAPITAL

CONTD ..

NORM EVOLVED IS THAT CAPITAL
TO RISK WEIGHTED ASSETS RATIO
(**CRAR**) SHOULD BE ATLEAST 9%

$$\frac{\text{CAPITAL FUNDS}}{\text{RISK WEIGHTED ASSETS}} \times 100 = 9$$

OBJECTIVES OF CAPITAL ADEQUACY POLICY

**SAFETY, STABILITY AND SOUNDNESS
OF INDIVIDUAL BANKS AND BANKING
SYSTEM**

&

**FAIR AND CONSISTENT IN APPLICATION
TO BANKS ; COMPETITIVE LEVEL
PLAYING FIELDS FOR BANKS**

CAPITAL ADEQUACY IN UCBs

INTRODUCED WEF 31-3-2002 AS UNDER

AS ON	SCHEDULED UCBs	NON-SCHEDULED UCBs
31-3-2002	8 %	6 %
31-3-2003	9 %	7 %
31-3-2004	AS APPLICABLE TO COMMERCIAL BANKS	9 %
31-3-2005	AS APPLICABLE TO COMMERCIAL BANKS	AS APPLICABLE TO COMMERCIAL BANKS

QUANTIFICATION OF ADEQUATE CAPITAL

- ADEQUATE CAPITAL AS A PERCENTAGE OF THE ASSETS BASED ON THE RISK PERCEPTION
- THE PERCEIVED RISK ATTACHED TO EACH OF THE FUNDED ASSETS IS AGGREGATED
- THE NON FUNDED ITEMS (CONTINGENT LIABILITIES) ARE FIRST BROUGHT ON PAR WITH FUNDED ASSETS THROUGH CREDIT CONVERSION FACTORS AND THEN RISK WEIGHTED VALUES ARE COMPUTED

METHODOLOGY FOR COMPUTATION OF RISK WEIGHTED ASSETS

“ON-BALANCE SHEET ASSETS” (OBSAs)

RISK WEIGHTS (RW) ARE ASSIGNED TO VARIOUS OBSAs based on relative riskiness

RISK WEIGHTED VALUES (RWV) OF NOMINAL VALUE (NV) OF OBSAs ARE CALCULATED AS UNDER

$$\text{NV OF OBSA} \times \text{RW}$$

(NV is Book value net of cash margins and provisions)⁸

ASSIGNMENT OF RISK WEIGHTS

0%	Cash, Balance with RBI, Investment in Govt. and approved securities, advances guaranteed by Govt., other dues from RBI/GOI, adv tax paid/TDS, etc
20%	All claims from other banks/PFIs, investments in Govt. securities not forming part of approved market borrowings, staff loans
50%	Advances covered by guarantee of DICGC/ECGC
100%	All other advances, investments and other assets
2.5%	All investments (towards market risk)

Some Specific Instructions

- Govt Securities not guaranteed (22.5%)
- Govt securities which are not approved market borrowings (22.5%)
- Investments in PFIs (127.5%)
- Consumer Credit (125%)
- Loans to PSUs (100%)
- Loans to SSIs under CGFT (0%)
- Loans against commercial property (125%)

AN ILLUSTRATION

ASSET	NV	RW %	RWV
CASH	100	0	0
BANK BALANCE	150	20	30
INVESTMENTS	200	50	100
ADVANCES	400	100	400
FIXED ASSETS	100	100	100
OTHER ASSETS	100	20	20
TOTAL (X)	1,050	-----	650

OFF-BALANCE SHEET ITEMS (OBSI)

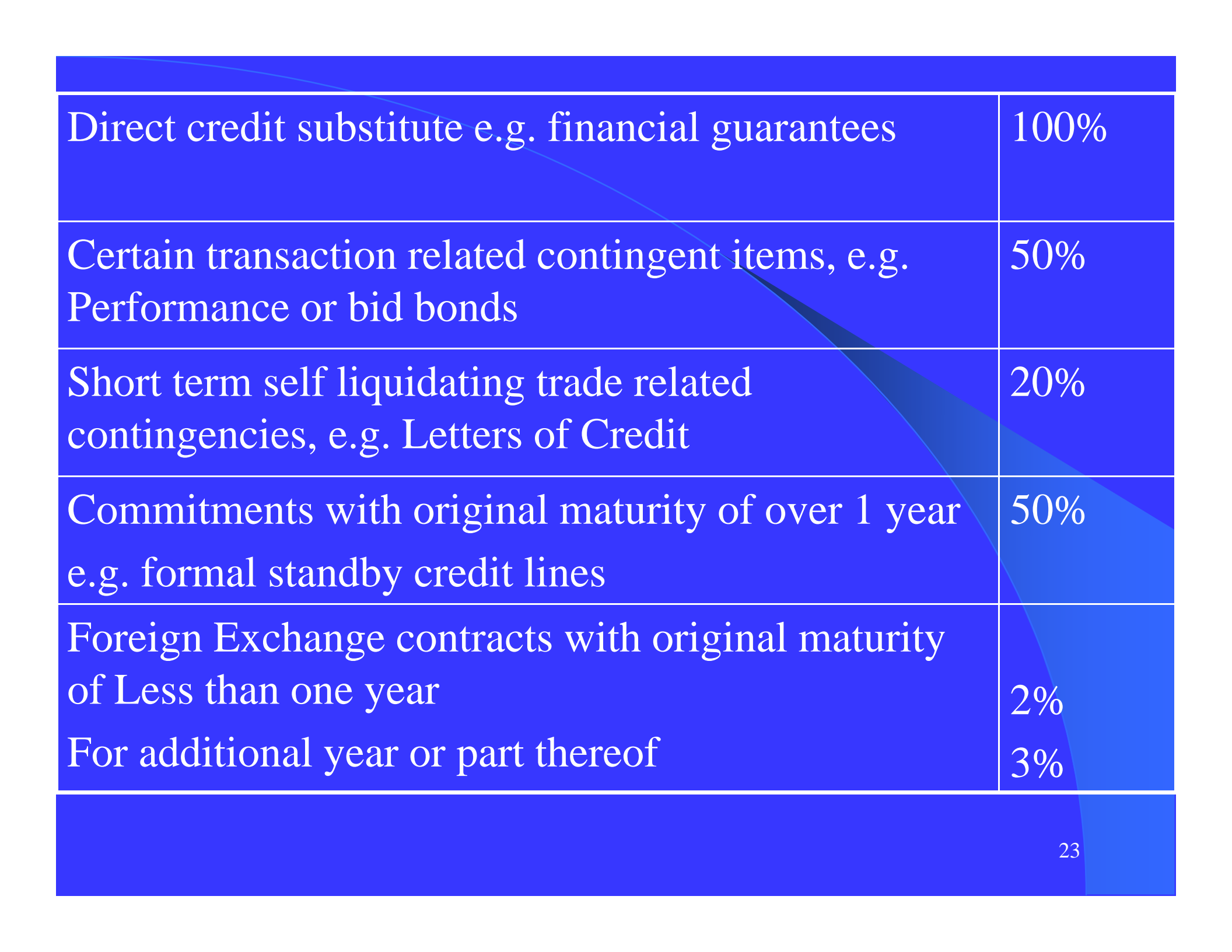
CONTINGENT LIABILITIES SUCH AS GUARANTEES, LETTERS OF CREDIT ETC ARE ASSIGNED CREDIT CONVERSION FACTORS (**CCF**)

CREDIT EQUIVALENTS (**CE**) OF OBSIs ARE COMPUTED AS UNDER

$$\text{NV OF OBSI} \times \text{CCF}$$

RWV OF OBSI IS COMPUTED AS UNDER

$$\text{CE OF OBSI} \times \text{RW}$$



Direct credit substitute e.g. financial guarantees	100%
Certain transaction related contingent items, e.g. Performance or bid bonds	50%
Short term self liquidating trade related contingencies, e.g. Letters of Credit	20%
Commitments with original maturity of over 1 year e.g. formal standby credit lines	50%
Foreign Exchange contracts with original maturity of Less than one year	2%
For additional year or part thereof	3%

AN ILLUSTRATION

ITEM	NV	CCF (%)	CE	RW	RWV
GUARANTEES	200	50	100	100	100
LETTERS OF CREDIT	500	20	100	50	50
TOTAL (Y)	700	---	200	---	150

COMPUTATION OF TOTAL RISK WEIGHTED VALUE (TRWV)

$$= (\text{RWV OF OBSA}) + (\text{RWV OF OBSI})$$

$$= (X + Y)$$

$$= (650 + 150)$$

$$= 800$$

COMPUTATION OF CAPITAL FUNDS

IF CRAR IS 9 %

CAPITAL FUNDS REQUIRED WOULD BE

9 % OF TRWV ie 9 % OF 800 = 72

DIVIDED INTO

TIER - I (CORE) CAPITAL &

TIER – II (SUPPLEMENTARY) CAPITAL

TIER I CAPITAL

PAID UP CAPITAL : COLLECTED FROM REGULAR MEMBERS OF THE BANK HAVING VOTING POWERS

FREE RESERVES

CAPITAL RESERVES : SURPLUS ARISING OUT OF SALE PROCEEDS OF ASSETS

SURPLUS IN P/L A/C: BALANCE AFTER APPROPRIATION TOWARDS DIVIDEND, ETC.,

COMPONENTS OF TIER-I CAPITAL

- ORDINARY PAID UP CAPITAL
- CAPITAL RESERVES
- FREE RESERVES (incl Building Fund)
- SURPLUS

SUB TOTAL

(A)

LESS

- INTANGIBLE ASSETS
- DEFICIT IN NPA PROVISIONS
- INCOME ON NPAs WRONGLY RECOGNISED
- PROVISION REQUIRED ON DEVOLVED LIABILITY
- ACCUMULATED LOSSES

SUB TOTAL

(B)

TIER-I CAPITAL (A - B)

(C)

**CO-OPERATIVE SOCIETIES ACTS OF STATES
PRESCRIBE QUANTITATIVE CEILING ON SHARE
CAPITAL THAT CAN BE HELD BY INDIVIDUAL
MEMBERS**

THIS LIMITS UCBs TO ENLARGE THEIR CAPITAL BASE

**THE ISSUE IS BEING TAKEN UP WITH REGISTRARS OF
CO-OPERATIVE SOCIETIES OF STATES**

**TILL THE CEILING IS REMOVED, UCBs WHICH ARE
UNABLE TO ACHIEVE CRAR**

**SHOULD APPROPRIATE ATLEAST 50% OF NET PROFIT
TO STATUTORY RESERVE / RESERVE FUND / GENERAL
RESERVE**

&

SHOULD NOT DECLARE DIVIDEND @ MORE THAN ²⁹20 %

COMPONENTS OF TIER-II CAPITAL

- **UNDISCLOSED RESERVES** (accumulation of post tax profits)
- **REVALUATION RESERVES** (AT 55 % DISCOUNT)
- **PROVISION ON STANDARD ASSETS**
- **GENERAL / EXCESS PROVISION** (ON OTHER THAN STD ASSETS) – MAXIMUM OF 1.25 % OF TRWAs
- **INVESTMENT FLUCTUATION RESERVE** (excess provision held towards depreciation in investments)
- **HYBRID DEBT CAPITAL** (INSTRUMENTS HAVING CHARACTERISTICS OF DEBT AND EQUITY) *
- **SUBORDINATED DEBT** (FULLY PAID UP, UNSECURED, FREE OF RESTRICTIVE CLAUSES, NO REDEMPTION WITHOUT BANK'S CONSENT)*
- **TOTAL (D)**

* **NO BAR IN ISSUING, SUBJECT TO PROVISIONS OF STATE COOPERATIVE ACTS / MULTI STATE CO-OPERATIVE ACT**

- TIER-I + TIER-II = TOTAL CAPITAL FUNDS

$$(C) + (D) = (E)$$

- (E) SHOULD BE ATLEAST = 9 % OF TRWA
(IN THIS EXAMPLE 9% OF 800 = 72)

&

- (C) SHOULD BE ATLEAST 50 % OF (E)
(IN THIS EXAMPLE 50 % OF 72 = 36)

- IF (C) IS < 50% OF (E) & (D) IS MORE THAN (C),
THEN (D) WILL BE RESTRICTED TO
EQUIVALENT OF (C) FOR COMPUTING (E)

CRAR – ACTUAL vs PRUDENTIAL

	POSITION (ACTUAL)				PRUDENTIAL POSITION (IN CASE OF POSITION D) @
	A	B	C	D	
TIER-I	36	40	36	33	33
TIER-II	36	32	39	39	33
TCF	72	72	75	72	66
STATUS	OK	OK	OK	NOT OK	NOT OK

A- MINIMUM CONDITIONS ARE FULFILLED

B- BETTER THAN THE MINIMUM SINCE TIER-I IS > REQUIRED

C- ENTIRE TIER-II CAN BE GIVEN BENEFIT SINCE MIN TIER-I IS ACHIEVED

D- THOUGH TCF = MIN REQUIRED, TIER-I IS < MINIMUM REQUIRED

@- TIER-II IS RESTRICTED TO EQUIVALENT OF TIER-I

CURRENT CAPITAL ADEQUACY ACCORD

DRAWBACKS :

Exclusive Focus on Credit Risk and exclusion of other forms of risk

No differentiation between sound and weak banks and uses the same basis for all

THE NEW BASEL ACCORD - II SALIENT FEATURES

BCBS's new consultative document in January 2001

Detailed framework to replace the existing accord

Three mutually reinforcing pillars, viz.,

Minimum Capital Requirement

Supervisory Review Process

Market Discipline

THE NEW BASEL ACCORD - II SALIENT FEATURES

Change in approach to credit risk

Inclusion of explicit capital requirements for operational risk

Range of risk sensitive options for assessing risks

Standardized Approach

Foundation Approach

Internal Ratings Based Approach

THE NEW BASEL ACCORD - II

SALIENT FEATURES

EXISTING ACCORD	NEW ACCORD
Focus on a single risk measure	More emphasis on bank's own internal methodologies, supervisory review and market discipline
One size fits all	Flexibility, menu of approaches, incentive for better risk management
Broad brush structure	More risk sensitivity

Thanks