



A Study of Capital Adequacy Requirements of SSI Regarding Commercial Banks in India

Raavi Jain

Department of Commerce, S.D. College of Commerce, Muzaffarnagar (U.P.) India
Email Id: raavijain76@rediffmail.com

Abstract

Banking system occupies an important role in the economy of a nation. In fact, banking system of any country is the lifeblood of an economy. A banking institution is indispensable in the modern society. It plays a pivotal role in the economic development of a country and forms the core of the money market for the country. The Capital Adequacy framework of the Basel Committee on Banking Supervision (BCBS) which was adopted by the G 10 countries in 1990 and by the rest of the world thereafter, has been the single most successful attempt in the move towards convergence of international standards in banking, enabling cross-country assessments and comparisons of internationally active banks. Every industry needs capital to run the business activities. Particularly in SSI, the enterprise is going to collapse without adequate supply of capital. With the introduction of economic liberalization, privatization and globalization the whole scene of Indian financial market has changed. Similarly, the role of banking sector has changed dramatically. The banking sector performs three primary functions in an economy; first, the operation of the payment system, second, the mobilization of savings and finally, the allocation of savings to investment projects. The banking system which constitutes the core of the financial sector plays a critical role in transmitting monetary policy impulses to the entire economic system. An efficient banking structure can promote greater amount of investment which can further help to achieve a faster growth rate of economy. Worldwide experience confirms that countries with well developed and market oriented free banking system grow faster and more consistently.

Keywords: Banking system, Capital Adequacy Framework, Basel Committee on Banking Supervision, SSI, Economic System.

PAPER/ARTICLE INFO

RECEIVED ON: 17/08/2017

ACCEPTED ON: 11/10/2017

Reference to this paper should be made as follows:

Raavi Jain (2017), "A Study of Capital Adequacy Requirements of SSI Regarding Commercial Banks in India", *Int. J. of Trade and Commerce-IIARTC*, Vol. 6, No. 2, pp. 595-602

1. INTRODUCTION

With the introduction of economic liberalization, privatization and globalization the whole scene of Indian financial market has changed. Similarly, the role of banking sector has changed dramatically. Risk management has become part and parcel of the strategic planning process of bankers. Risk is the potentiality that both the expected and unexpected events may have an adverse impact on the bank's capital and earnings. While the expected losses are generally taken care of by suitable pricing methodology, the unexpected losses, both on account of individual exposure and the whole portfolio in entirety, is to be borne by the bank itself and hence is to be taken care of by the requisite capital. Hence, the need for suitable capital structure and sufficient Capital Adequacy requirements is felt.

Over the past decade, the macro economic consequences of asset quality of banking institutions have been the subject matter of much attention of policy makers. Added to this, the worldwide trend towards deregulation of financial sectors and the widespread banking problems of many countries arising largely in consequence of this trend have raised a host of questions relating to the linkages between de-regulation, risk behaviour of banks and banking crises. Consequently, the banking sector, or for that matter, the financial sector in general, in most emerging economies are passing through challenging yet exciting times. Banking crises in LDCs and NICs can have costly repercussions for industrial economies as well. About a quarter to a third of industrial country exports are absorbed by the developing countries. Such crises can reduce absorption by developing countries, disrupt the payments mechanism and curtail portfolio investment flows into developing countries, reducing overall growth¹. An understanding of bank responses to capital regulation may be helpful in designing regulations that better satisfy regulators' objectives. One traditional objective of capital regulation has been to reduce bank failures and promote banking stability. Another objective has been to reduce losses to depositors and the deposit insurer when the bank fails. Regulators are especially sensitive to deposit insurance losses because the government not only often provides insurance through formal programs, but also, in the absence of de jure coverage, has historically been the insurer of last resort.

2. OBJECTIVES OF THE STUDY

- To study the capital adequacy requirements in Small-Scale Industries regarding commercial banks.
- To study the capital adequacy standard in India.

3. REVIEW OF LITERATURE

Akkihah (1984) study of 94 small-scale industries in Hubli Dharwad Municipal Corporation (HDMC) in the state of Karnataka revealed that the management of working capital in sample industries was found to be highly unplanned. The study concentrated on the ratios like current ratio, inventory turnover ratio, fixed assets turnover ratio, total assets turnover ratio, earnings power and gross profit margin. The application of ratio analysis has revealed that the mismanagement of working capital had adverse effect on the performance of the industries.

Amandeep (1991) attempted to estimate profit and profitability of Indian Nationalized banks and to study the impact of priority sector lending, credit policies, geographical expansion, industrial

sickness, competition, deposit composition, establishment expenses, on bank profitability. For this purpose trend analysis, ratio analysis and regression analysis were used.

Diamond (2000), Banks capital creates liquidity for the bank due to the fact that deposits are most fragile and prone to bank runs. Moreover, greater bank capital reduces the chance of distress.

Gangadhar (1981) study examined the statistical trends in working capital position among medium, large and small public, private limited companies in the Indian corporate sector during 1961-76. The application of second parabola revealed that the current assets formed relatively higher proportion of total net assets in private limited companies than that of public limited companies. This study also revealed that in case of medium and large scale public limited companies there appeared to be a lead - lag relationship between gross fixed assets and current assets over the study period.

Ghosh (1983) study proves into the existing practice of working capital in crane manufacturing industry in India. The study findings indicate that the management of individual components of working capital was erratic. The collection mechanism followed by the sample companies was very unplanned and the companies took more time that allowed in collecting the cash from the customers. The study also revealed that payable to the suppliers were equally delayed keeping highest portion of payable pending for more than allowed period. The study recommended the immediate need for streamlining the working capital management practices.

Jain (1988) in his study among ten manufacturing trading and services industries in the state of Rajasthan, brought out various working capital management practices followed by the selected companies. The study found out that the companies had both over investment and under investment problems. The study strongly recommended for the release of excess funds in working capital and to invest the same in short - term or long term assets. On the other hand, the study recommended that the companies should avoid under investment in working capital if they wanted higher profit margins.

Khandelwal (1985) carried on half-complete empirical research initiated by late N.M Agarwal, among forty small-scale industries in Jodhpur industrial estate. The study attempted to investigate in to working capital management process and practices among the selected units between the years 1975 - 1980. The study revealed that the sample firms held more investments in inventories than required and management of receivables constituted as much as 50% of total current assets. Highlighting the sickness in Jodhpur Industrial estate the study attributed the main reason to inefficient management of working capital. Based on findings the study suggested that the entrepreneurs need to be educated about the basic concepts and efficient way of working capital management.

Mukerjee (1986) in his study on "management of working capital in public Enterprises" in respect of central government industrial undertakings, and covering a period from 1974 - 75 to 1978-79 has found that, the current assets increased due to the accumulation of inventories and current liabilities increased due to increase in financing through payables, the Overall Size of the workings capital had been significantly influenced by the overall size of sales and output, the working capital requirement of the units were not ascertained based on the considerations as suggested for prudent financial management, there was a significant negative correlations between overall profitability and size of working capital, there was an over investment in

structural determinants and huge size of working capital and due to faulty financial policies adopted by the units, the liquidity and profitability has a very significant negative correlations.

Sahajwala and Bergh, (2000). Basel Committee on Banking Supervision also stipulates the CAMELS components. As regards the capital adequacy, they grouped the factors like : a) size of the bank, b) volume of inferior quality assets, c) bank's growth experience, plans and prospects, d) quality of capital, e) retained earnings, f) access to capital markets, and g) non-ledger assets and sound values not shown on books (real property at nominal values, charge-offs with firm recovery values, tax adjustments).

Sangmi and Nazir, 2010 Capital adequacy ratio shows the internal strength of the bank to withstand losses during crisis. Capital adequacy ratio is directly proportional to the resilience of the bank to crisis situations. It has also a direct effect on the profitability of banks by determining its expansion to risky but profitable ventures or areas.

Ved Pal and Malik (2007) in their empirical paper examined the difference in financial characteristics of public, private and foreign sector banks based on factors such as profitability, liquidity, risk and efficiency. Sample of 74 Indian commercial banks consisting of 24 public sector, 24 private sector and 23 foreign banks were taken for the period of 2000-2005. Multi-nomial regression analysis was used and results revealed that foreign banks proved to be high performer in generating with a given level of resources and they are better equipped with managerial practices and in terms of skills and technology. Foreign banks were more consistent with market system as reflected in terms of net interest margin. The public banks emerged as the 80 next best performance after foreign banks. There were giving a higher return on equity in comparison to foreign and private banks. It was high performance from expense rate and efficiency ratio. The private banks emerged with a better use of resources as compared to PSBs.

4. THE CAPITAL ADEQUACY REQUIREMENTS IN SMALL-SCALE INDUSTRIES REGARDING COMMERCIAL BANKS

Small-scale industry (SSI) plays an important role in the economy of India. In spite of all the odds, the SSI sector has emerged as India's engine of growth in the new millennium. The Capital Adequacy framework of the Basel Committee on Banking Supervision (BCBS) which was adopted by the G 10 countries in 1990 and by the rest of the world thereafter, has been the single most successful attempt in the move towards convergence of international standards in banking, enabling cross-country assessments and comparisons of internationally active banks. The results of a 1996 survey conducted by the BCBS indicated that 92 percent of the 140 participating countries had put in place a risk-weighted framework along the lines of Basel approach. Yet, despite being acknowledged as a valuable framework for comparing risk associated with assets and allocating capital accordingly, it has been criticized for, among others, the broad-brush approach and its failure to provide disincentives for riskier exposures within the same broad asset class. Every industry needs working capital to run the day-to-day business activities. Particularly in SSI, the enterprise is going to collapse without adequate supply of working capital.

Banking sector being one of the most highly leveraged sectors of any economy, face high risks. The ability to gauge risk and take appropriate action is the key to success for any bank. In the wake of the introduction of prudential regulation as an integral part of financial sector reforms in India, there has been a growing debate as to whether capital adequacy requirements are the best

means to regulate the banking system. Capital is essential and critical to the perpetual continuity of a bank as a going concern. On the recommendations of the Narasimhan Committee (1992), RBI introduced the internationally accepted Capital to Risk-Weighted Assets Ratio (CRAR), also called Capital Adequacy Ratio (CAR) system as a Capital Adequacy measure to be achieved in a phased manner by the Scheduled Commercial banks operating in India.

The capital adequacy ratio (CAR) is a measure of a bank's capital. It is expressed as a percentage of a bank's risk weighted credit exposures. Also known as capital-to-risk weighted assets ratio (CRAR), it is used to protect depositors and promote the stability and efficiency of financial systems around the world. Two types of capital are measured: tier one capital, which can absorb losses without a bank being required to cease trading, and tier two capital, which can absorb losses in the event of a winding-up and so provides a lesser degree of protection to depositors.

Capital Adequacy Ratio (CAR) = Tier one Capital+ Tier two Capital/ Risk Weighted Assets
--

The reason why minimum capital adequacy ratios are critical is to make sure that banks have enough cushion to absorb a reasonable amount of losses before they become insolvent and consequently lose depositors' funds. Capital adequacy ratios ensure the efficiency and stability of a nation's financial system by lowering the risk of banks becoming insolvent. If a bank is declared insolvent, this shakes the confidence in the financial system and unsettles the entire financial market system. During the process of winding-up, funds belonging to depositors are given a higher priority than the bank's capital, so depositors can only lose their savings if a bank registers a loss exceeding the amount of capital it possesses. Thus, the higher the bank's capital adequacy ratio, the higher the degree of protection of depositor's monies.

5. TIER ONE AND TIER TWO CAPITAL

Tier one capital is the capital that is permanently and easily available to cushion losses suffered by a bank without it being required to stop operating. A good example of a bank's tier one capital is its ordinary share capital.

Tier two capital is the one that cushions losses in case the bank is winding up, so it provides a lesser degree of protection to depositors and creditors. It is used to absorb losses if a bank loses all its tier one capital.

Total capital to risk weighted exposures ratio for Small Bank Inc. using the following information:

Particulars	Exposure	Risk Weight
Government Treasury held as asset	1,500,000	0%
Loans to Corporates	15,000,000	10%
Loans to Small Businesses	8,000,000	20%
Guarantees and other non-balance sheet exposures	6,000,000	10%

The bank's Tier 1 Capital and Tier 2 Capital are \$200,000 and \$300,000 respectively.

Banks total capital = \$200,000 + \$300,000 = \$500,000

Risk-weighted exposures = \$1.5×0% + \$15×10% + \$8×20% + \$6×10% = \$3.7 million

Capital Adequacy Ratio = \$0.5 million/\$3.7 million = 14%

When measuring credit exposures, adjustments are made to the value of assets listed on a lender's balance sheet. All the loans the bank has issued are weighted, based on their degree of risk. For



example, loans issued to the government are weighted at 0 percent, while those given to individuals are assigned a weighted score of 100 percent.

6. CAPITAL ADEQUACY STANDARD IN INDIA

In India, at present, there is a 'three track' approach for Basel compliance – the commercial banks are Basel I compliance with respect to credit and market risks; the urban cooperative banks maintain capital for credit risk as per Basel I and market risk through surrogate charges; and the rural banks have capital adequacy norms that are not on par with the Basel norms. The three track approach is justified by the necessity to maintain varying degree of stringency across different types of banks in India reflecting different levels of operational complexity and risk appetite.

The three track approach is also justified in order to ensure greater financial inclusion and for an efficient credit delivery mechanism. India adopted Basel I norms for scheduled commercial banks in April 1992, and its implementation was spread over the next three years. It was stipulated that foreign banks operating in India should achieve a CRAR of 8 per cent by March 1993 while Indian banks with branches abroad should achieve the 8 per cent norm by March 1995. All other banks were to achieve a capital adequacy norm of 4 per cent by March 1993 and the 8 per cent norm by March 1996.

The RBI responded to the market risk amendment of Basel I in 1996 by initially prescribing various surrogate capital charges such as investment fluctuation reserve of 5 per cent of the bank's portfolio and a 2.5 per cent risk weight on the entire portfolio for these risks between 2000 and 2002. These were later replaced with VaR-based capital charges, as required by the market risk amendments, which became effective from March 2005. India has gone a step ahead of Basel I in that the banks in India are required to maintain capital charges for market risk on their 'available for sale' portfolios as well as on their 'held for trading portfolios' from March 2006 while Basel I requires market risk charges for trading portfolios only.

The RBI has announced the implementation of Basel II norms in India for internationally active banks from March 2008 and for the domestic commercial banks from March 2009.

Basel III reforms are the response of Basel Committee on Banking Supervision (BCBS) to improve the banking sector's ability to absorb shocks arising from financial and economic stress, whatever the source, thus, reducing the risk of spill over from the financial sector to the real economy. During Pittsburgh Summit in September 2009, the G20 leaders committed to strengthen the regulatory system for banks and other financial firms and also act together to raise capital standards, to implement strong international compensation standards aimed at ending practices that lead to excessive risk-taking, to improve the over-the-counter derivatives market and to create more powerful tools to hold large global firms to account for the risks they take. For all these reforms, the leaders set for themselves strict and precise timetables. Consequently, the Basel Committee on Banking Supervision (BCBS) released comprehensive reform package entitled "Basel III: A global regulatory framework for more resilient banks and banking systems" (known as Basel III capital regulations) in December 2010.

Common Equity Tier 1 capital ratio = Common Equity Tier 1 Capital/ Credit Risk RWA + Market Risk RWA + Operational Risk RWA

Tier 1 capital ratio = Eligible Tier 1 Capital/ Credit Risk RWA + Market Risk RWA + Operational Risk RWA

Total Capital (CRAR) = Eligible Total Capital/Credit Risk RWA + Market Risk RWA + Operational Risk RWA

RWA = Risk weighted Assets

Capital to Risk Weighted Asset Ratio

Reserve Bank issued Guidelines based on the Basel III reforms on capital regulation on May 2, 2012, to the extent applicable to banks operating in India. The Basel III capital regulation has been implemented from April 1, 2013 in India in phases and it will be fully implemented as on March 31, 2019. Accordingly, banks were advised to undertake an internal assessment of their preparedness for migration to advanced approaches and take a decision with the approval of their Boards, whether they would like to migrate to any of the advanced approaches.

7. CONCLUSION

Small-scale industry (SSI) plays an important role in the economy of India. In spite of all the odds, the SSI sector has emerged as India's engine of growth in the new millennium. The Capital Adequacy framework of the Basel Committee on Banking Supervision (BCBS) which was adopted by the G 10 countries in 1990 and by the rest of the world thereafter, has been the single most successful attempt in the move towards convergence of international standards in banking, enabling cross-country assessments and comparisons of internationally active banks. The role of banking sector has changed dramatically. The banking sector performs three primary functions in an economy; first, the operation of the payment system, second, the mobilization of savings and finally, the allocation of savings to investment projects. The banking system which constitutes the core of the financial sector plays a critical role in transmitting monetary policy impulses to the entire economic system. An efficient banking structure can promote greater amount of investment which can further help to achieve a faster growth rate of economy. The capital adequacy ratio (CAR) is a measure of a bank's capital. It is expressed as a percentage of a bank's risk weighted credit exposures. Also known as capital-to-risk weighted assets ratio (CRAR), it is used to protect depositors and promote the stability and efficiency of financial systems around the world. Two types of capital are measured: tier one capital, which can absorb losses without a bank being required to cease trading, and tier two capital, which can absorb losses in the event of a winding-up and so provides a lesser degree of protection to depositors.

REFERENCES

- [1]. Athanasoglou, P.P., Sophocles, N.B., Matthaïos, D.D. (2005), Bank-Specific, Industry-Specific and Macroeconomic Determinants of Bank Profitability, Working paper, Bank of Greece, 1(1), 3-4.
- [2]. Babar, H.Z., and Zeb, G. (2011), Camels Rating System for Banking Industry in Pakistan, Master Thesis, Umea School of Business.
- [3]. Bakshi, S. (2004), Basel Norms- challenges In India, The Chartered Accountant, 426-432.
- [4]. Banerjee, S. (2012), Basel I and Basel II Compliance: Issues for Banks in India, Working Paper 68/2012, Madras School of Economics.

- [5]. **Chen, J.(2003)**, Capital adequacy of Chinese banks: Evaluation and enhancement, *Journal of International Banking Regulation*, 4 (4), 320-327.
- [6]. **Dang, U. (2011)**, The CAMEL Rating System in Banking Supervision: a Case Study, *International Business Degree Thesis*, Arcada University of Applied Sciences.
- [7]. **Diamond, D.W., Raghuram, A. (2000)**, A Theory of Bank Capital, *The Journal of Finance*, 52(6), 12-23.
- [8]. **Fatima, N. (2014)**, Capital Adequacy: A Financial Soundness Indicator for Banks, *Global Journal of Finance and Management*, 6 (8), 771-776.
- [9]. **Honohan (1997)** has estimated that since 1980, the resolution costs of banking crises in all developing and transition economies have approached a quarter of a trillion dollars.
- [10]. **Nathwani, N. (2004)**, The Study of Financial Performance of Banking Sector of India, *Doctoral Dissertation*, Saurashtra University.
- [11]. **Ongore, V.O. and Kusa, G.B. (2013)**, Determinants of Financial Performance of Commercial Banks in Kenya, *International Journal of Economics and Financial Issues*, 3(1), 237-252.
- [12]. **Pasha, M.A. & Swamy, T.S. (2012)**, Basel II norms with special emphasis on capital adequacy ratio of Indian Banks, *A Journal of M P Birla Institute of Management*, 6(1), 23-40.
- [13]. **Roy, D.G., Kohli, B. and Khatkale, S. (2013)**, Basel I to Basel II to Basel III: A risk Management Journey of Indian Banks, *AIMA journal of Management & Research*, 7(2/4).
- [14]. **Sahajwala, R. and Bergh, P.V.D. (2000)**, Supervisory Risk Assessment and Early Warning Systems. *Basel Committee on Banking Supervision, Working Papers No. 4*, Bank for International Settlements (BIS), Basel, Switzerland, December.
- [15]. **Sangmi, M., Tabassum, N. (2010)**, Analyzing Financial Performance of Commercial Banks in India: Application of CAMEL Model, *Pakistan Journal Commercial Social Sciences*, 4(1), 40-55.
- [16]. **Singh, M. and Vyas, R.K. (2009)**, Capital Adequacy and Scheduled Commercial Banks in India, *Bauddhik*, I (1).
- [17]. **Sundarajan,V. and Errico, L. (2002)**, Islamic Financial Institutions and Products in the Global Financial System: Key Issues in Risk Management and Challenges Ahead, *IMF Working Paper No. WP/02/192*, November.
- [18]. <http://www.allbankingsolutions.com/Banking-Tutor/Basel-iii-implementation-guidelines-RBI.htm>
- [19]. www.rbi.org.in