Diluting Capital Adequacy Norms

What is the issue?

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- Union government will reportedly hold discussions with RBI in an attempt to persuade it to dilute the capital requirements for Indian banks.
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- While this is to ease the financial burden on the government with regard to recapitalisation, the move is imprudent.
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What is the government seeking to do?

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- Ratio of common stock and reserves of a bank divided by its risk-weighted assets (expressed in percentage) is called Common Equity Tier - I (CET-I).
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- Currently, Indian banks are required to hold at least 5.5% of such capital in reserve, which the government is seeking to reduce.
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- As RBI is the regulator in the financial sector and "CET-I" is its independent prerogative, the government will have persuade the RBI board to this end.
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- Notably, the international Basel-III standards are less stringent, and require banks to keep only 4.5% in hand.
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Why?

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- Bad loans within banks (particularly PSU banks) have ballooned in recent times – which have increased bank's "capital adequacy needs".
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- Notably, six public banks are close to breaching RBI's capital adequacy mandate of "5.5% for CET-I and another 2.5% for capital conservation buffer".
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- Significantly, Punjab National Bank (PNB), which is the country's second-largest public sector lender, is also among those 6 banks.
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- Considering this, the government is staring at the possibility of paying huge sums from its budget to aid failing banks meet their capital needs.
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- In this context, the government is already under pressure due to its budgetary obligations and is seeking to ease the demands from the banking sector.
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Is the move rational?

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- This would be an imprudent course that is based either on a lack of knowledge of the Indian banking sector or a lack of care.
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- There is a very good reason why Indian capital adequacy ratios are higher than those recommended by the international Basel-III norms.
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- This is because the health of the banking sector in India requires greater attention, given the problems of regulation.
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- Notably, Indian banking is prone to judgemental errors in capital adequacy, misclassification of asset quality, and wrong application of standards.
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- Such problems are common with developing countries and in fact, many countries have set even higher capital adequacy rations than India.
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What is the way ahead?

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- The basic logic of the Basel-III requirements is for greater capital to be built up at times of growth and is run down at times of weakness.
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- It is not for the regulations themselves to be altered at precisely the time when they are needed to preserve the health of the banking sector.
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- The government's bank recapitalisation plan to secure the health of the Indian banking system cannot be secured by reducing the required cost.
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- Just because the budgetary package is falling short in terms of size does not mean that other essential regulatory requirements should be diluted.
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Source: Business Standard

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