RBI's Supervision over a Bank

Why in news?

The Reserve Bank of India (RBI) has placed Dhanlaxmi Bank under tight monitoring with the bank's financial position coming under greater public scrutiny.

What is the reason for placing the bank under tight scrutiny?

- Inadequate financial disclosures
- Rising expenses
- General mismanagement of the business
- Deteriorating capital adequacy situation of the bank

How did the bank get to this situation?

- Under Basel-III norms, banks are supposed to maintain their capital to risk weighted assets ratio (CRAR) at 9% or above.
- Dhanlaxmi Bank's CRAR dropped to around 13% during March 2022 from 14.5% in 2021, prompting the RBI to take stock of the financial health of the bank.
- Dhanlaxmi Bank's capital adequacy has dropped below the stipulated standards in the past and it has even been placed under the prompt corrective action framework (PCA) by the RBI.
- Under the PCA, the RBI places restrictions on lending by troubled banks and keeps a close eye on them until their financial position improves sufficiently.

What is the significance of capital adequacy for a bank?

> *The CRAR is a ratio that compares the value of a bank's capital (or net worth) against the value of its various assets weighted according to how risky each asset is.*

- The riskier a type of asset held in a bank's balance sheet, the higher the weightage given to the value of the asset while calculating the bank's capital adequacy ratio.
- This causes the capital adequacy ratio of the bank to drop, thus signalling a higher risk of insolvency during crises.
- It is an indicator of the ability of a bank to survive as a going business entity in case it suffers significant losses on its loan book.
- A bank cannot continue to operate if the total value of its assets drops below the total value of its liabilities as it would wipe out its capital and render the bank insolvent.

What happens next?

- In the case of Dhanlaxmi Bank, the write-down and reclassification of tier-2 bonds in the next few months is expected to adversely affect the bank's capital adequacy ratio.
- Dhanlaxmi Bank has been trying to issue additional shares in the open market through a rights issue to raise more equity capital from existing shareholders.
- The additional capital could help in raising the bank's CRAR which serve as a buffer absorbing any losses incurred by the bank on its loan book in the case of any crisis in the future.
- But, the rights issue has been delayed by the ongoing court battle with minority shareholders and the bank's non-compliance with rules regarding the composition and strength of the management board.
- The RBI is likely to keep a close eye on Dhanlaxmi Bank and may even intervene if the delay of the rights issue threatens the bank's ability to meet the capital adequacy norms.
- The bank could even become an acquisition target if it is unable to raise the required capital.

References

1. The Hindu | When does RBI step in to monitor a bank?
2. Investopedia | Basel III Norms
3. BIS | Basel III framework for banks

Quick facts

Basel-III norms

- Basel III is an internationally agreed set of measures developed by the Basel Committee on Banking Supervision (a consortium of central banks from 28 countries, based in Basel, Switzerland) in response to the financial crisis of 2007-09.
- The measures aim to strengthen the regulation, supervision and risk management of banks.
- The guidelines aim to promote a more resilient banking system by focusing on four vital banking parameters
    - Capital
    - Leverage
    - Funding
    - Liquidity
- As of 2022, it is still in the process of implementation.

Tier 1 capital

- Tier 1 refers to a bank's core capital, equity, and the disclosed reserves that appear on the bank's financial statements.

- If a bank experiences significant losses, Tier 1 capital provides a cushion that can allow it to weather stress and maintain a continuity of operations.

Tier 2 capital

- Tier 2 refers to a bank's supplementary capital, such as undisclosed reserves and unsecured subordinated debt instruments.
- Tier 1 capital is more liquid and considered more secure than Tier 2 capital.

