Capital Adequacy: A Financial Soundness Indicator for Banks

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Abstract
A strong banking infrastructure plays a major role in supporting economic activity and meeting the financial needs of all the sections of society and thus contributed in the overall growth of the country. For the smooth flow of credit in an economy, it is essential that banks should be financially sound so as to meet the various requirements of other fields. Capital adequacy ratio (CAR) is one of the measures which ensure the financial soundness of banks in absorbing a reasonable amount of loss. Capital adequacy requirements have existed for a long time, but the two most important are those specified by the Basel committee of the Bank for International Settlements. This study highlights the various components of regulatory capital and outlines the basics of Basel’s norms in respect to minimum capital requirements for banks. Moreover, the study analyzed the trend in CAR values for top 10 scheduled commercial banks in India. The study found out that ICICI bank maintained the highest CAR while Bank of India accounted the least position.

Keywords: Capital adequacy ratio, Basel norms, Tier capital.

1. Introduction
Banks encounter various types of risks while carrying the business of financial intermediation as it is the highly leveraged sector of an economy. Risk and uncertainties, therefore, form an integral part and parcel of banking. Thus, risk management is the core to any banking service and hence the need for sufficient Capital Adequacy Ratio is felt. Regulation of capital assumes significant importance so as to reduce bank failures, to promote stability, safety and soundness of the banking
system, to prevent systemic disaster and to ultimately reduce losses to the bank depositors.

The Basel Committee on Banking Supervision (BCBS) is a committee of banking supervisory authorities which published the Basel Accords i.e., rules regarding capital requirements. BCBS is a comprehensive set of reform measures to strengthen the regulation, supervision and risk management of the banking sector. In 1988, BCBS introduced the capital measurement system commonly referred to as Basel I. In 2004, BCBS published Basel II guidelines which were the refined, reformed and more complex version of Basel I. While Basel I focus only on credit risk, Basel II includes market and operational risks besides credit risks. Basel III released in December, 2010 which lay more focus on quality, consistency and transparency of the capital base. India adopted Basel I guidelines in 1999 while Basel II guidelines were implemented in phases by 2009. The Basel III capital regulation has been implemented in India from April 1, 2013 in phases and will be fully implemented as on March 31, 2018.

2. **The Need for Minimum Capital Requirement**
   The capital which banks hold with themselves as required by financial regulator is known as minimum capital requirement. Banks exposed to various types of risks while granting loans and advances to various sectors. In order to absorb any losses which banks face from its business, it is imperative that banks should have sufficient capital. If banks have adequate capital, then it can protect its depositors from unforeseen contingencies as well promotes the stability and efficiency of financial systems.

3. **Components of Capital**
   **Tier I Capital:** The elements of Tier I capital includes paid-up capital (ordinary shares), statutory reserves, disclosed free reserves, Perpetual Non-cumulative Preference Shares (PNCPS) subject to laws in force from time to time, Innovative Perpetual Debt Instruments (IPDI) and capital reserves representing surplus arising out of sale proceeds of asset. It is generally referred as the core capital which absorbs losses without a bank required to cease trading and thus provides more of protection to its depositors.

   **Tier II Capital:** The elements of Tier II capital include undisclosed reserves, revaluation reserves, general provisions and loss reserves, hybrid capital instruments, subordinated debt and investment reserve account. It is the supplementary capital which absorbs losses in the event of winding up and thus provides lesser degree of protection to its depositors. Tier II items qualify as regulatory capital to the extent that they absorb losses arising from bank’s activities.

   **Tier III Capital:** This is arranged to meet part of market risk, viz. changes in interest rate, exchange rate, equity prices, commodity prices, etc. To quantify as Tier III capital, assets must be limited to 250% of a bank’s Tier I capital, be unsecured subordinated and have a minimum maturity of 2 years.
4. **Capital Adequacy Ratio (Car)**

Capital adequacy ratio is the ratio which protects banks against excess leverage, insolvency and keeps them out of difficulty. It is defined as the ratio of banks capital in relation to its current liabilities and risk weighted assets. Risk weighted assets is a measure of amount of banks assets, adjusted for risks. An appropriate level of capital adequacy ensures that the bank has sufficient capital to expand its business, while at the same time its net worth is enough to absorb any financial downturns without becoming insolvent. It is the ratio which determines banks capacity to meet the time liabilities and other risks such as credit risk, market risk, operational risk etc. As per RBI norms, Indian SCBs should have a CAR of 9% i.e., 1% more than stipulated Basel norms while public sector banks are emphasized to keep this ratio at 12%. Capital adequacy ratio is defined as:

\[
\text{CAR} = \frac{\text{Tier I + Tier II + Tier III capital (capital funds)}}{\text{Risk Weighted Assets (RWA)}}
\]

5. **Objectives of Study**

- To examine the various aspects of regulatory capital.
- To analyze the trend in CAR values of the SCBs in India as per Basel norms I and II.

6. **Research Methodology**

The study is conducted for a period of 5 years, i.e., from 2008-09 to 2012-13. For the purpose of study 10 banks were identified as sample based on their business mix. The study is based on secondary data where a major portion of data is extracted from ‘A Profile of Banks 2012-13, RBI’. Further, various articles, reports and research papers relating to capital adequacy published in different business journals, magazines, newspaper, periodicals and data available on internet is also concerned. The study used average, standard deviation, ratio and percentage analysis to analyze and interpret the data.

<table>
<thead>
<tr>
<th>S. No</th>
<th>SCBs</th>
<th>Business Mix (Amt in million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>SBI</td>
<td>22,483,562</td>
</tr>
<tr>
<td>2</td>
<td>Bank of Baroda</td>
<td>8,020,691</td>
</tr>
<tr>
<td>3</td>
<td>Punjab National Bank</td>
<td>7,002,853</td>
</tr>
<tr>
<td>4</td>
<td>Bank of India</td>
<td>6,712,071</td>
</tr>
<tr>
<td>5</td>
<td>Canara Bank</td>
<td>5,980,326</td>
</tr>
<tr>
<td>---</td>
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</tr>
<tr>
<td>6</td>
<td>ICICI Bank</td>
<td>15.53</td>
</tr>
<tr>
<td>7</td>
<td>HDFC Bank</td>
<td>15.69</td>
</tr>
<tr>
<td>8</td>
<td>Union Bank of India</td>
<td>13.27</td>
</tr>
<tr>
<td>9</td>
<td>Axis Bank</td>
<td>13.69</td>
</tr>
<tr>
<td>10</td>
<td>IDBI Bank</td>
<td>11.57</td>
</tr>
</tbody>
</table>

Table 2 shows that all the SCBs have maintained CAR above the stipulated requirement i.e., 9%. The CAR value was highest in ICICI bank followed by Axis bank and HDFC banks for the year 2013. It is evident from the table that the average CAR and standard deviation was also highest in ICICI bank. The lowest CAR was accounted to Bank of India followed by Union Bank of India and IDBI Bank.

8. Conclusion
Capital adequacy is an important parameter for judging the strength and soundness of banking system. Banks with reasonable CRAR can absorb the unexpected losses easily and their cost of funding is also reduced which ultimately improve the profitability of banks. The given study revealed that top Indian banks are maintaining adequate level of CRAR. It has been found out that ICICI bank has maintained highest level of CAR.
followed by HDFC and Axis bank while Bank of India has the lowest. This made us conclude that private sector banks are in good position as compare to public banks in maintaining higher capital adequacy ratio. On an average basis all the banks have CAR between 12.22% to 18.35%, which is an indicator that even implementation of Basel III norms will not pose much difficulty for Indian banks at least initially. Financial crisis in the world has increased the importance of capital adequacy requirements. In India, the impact of financial crises was low due to strong capital structure regulatory environment.

References


