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Prudential Norms on Capital Adequacy – Primary (Urban) Co-operative Banks (UCBs)

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Working Paper
(WP15/2022)

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INDIA
April 2022

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Citation Guideline:
Bandyopadhyay, Arindam (2022), “Prudential Norms on Capital Adequacy – Primary (Urban) Co-operative Banks (UCBs)”. NIBM Working Paper Series: Policy Research Notes WP15/April.

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ABSTRACT

Ensuring the financial soundness of the Urban Cooperative Banks (UCBs) is crucial for protecting the interests of its depositors and other stakeholders. The capital adequacy ratio is considered an internationally recognized benchmark for measuring bank solvency. This has been popularized by the Basel Committee for Banking Supervision. The regulatory framework including the recent amendments has been designed with commercial bank operations in mind. In order to establish global standards in the capital structure of UCBs, India's central bank has recently issued prudential norms on capital adequacy to safeguard the interest of major stakeholders including the depositors. It has delineated a structured approach for defining the capital instruments and giving thrust on keeping core capital to absorb unexpected business losses. This article provides a comprehensible description of the new norms for capital recognition and risk weights estimation, its essence, and policy implications for the Banking and Financial Services sector. The new prudential standard is expected to encourage UCBs to strengthen their financials and enhance solvency positions.

Keywords: Capital Adequacy Norm, Risk Management, UCBs

JEL Classification Number: G20, G21

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1. Background

Indian Cooperative Banks play an important role in the credit dissemination process. Their objective is to promote thrift, self-help, and cooperation among the members, provision of credit to members and persons with limited means, and extension of banking services to the customers. Capital is considered a critical fuel for growth. Due to increased risk in the business, capital erosion takes place which may threaten the solvency position of these lending entities. Effective management of risk and capital by an institution protects the interest of the depositors and prevents bank runs and thereby minimizes the socio-economic costs. The Urban Cooperative Banks (UCBs) follow the mission of working together for a common purpose or mutual interest. The UCBs initially lent to small borrowers and businesses within their community and locality. However, over the years, their scope of operations has widened considerably and some of these banks have grown in size and area of operations. In the recent past, there is a rising concern about the deterioration in asset quality and solvency position of UCBs (both Gross NPAs and Provisions increased significantly). Mobilization and management of scarce capital in cooperatives have been a challenge due to the lack of market access and the refundable nature of cooperative capital (Srivastava, Upadhyay, and Saxena, 2021). As a regulator, RBI prescribes prudential norms in various areas like capital adequacy, income recognition, asset classification and provisioning, exposure norms as well as liquidity requirements. Recently, the Reserve Bank of India on April 1, 2022, has come out with a master circular on setting prudential norms on capital adequacy for Urban Cooperative Banks in India. The RBI follows the Basel capital standards and often these are more stringent than what the Basel norms require to ensure financial stability. The basic intention of the Central Bank is to impose prudent capital management discipline in UCBs and improve governance. Using the regression analysis, Heiko and Cihak (2007) empirically found that a higher share of cooperative banks increases the stability (measured by z-score) of an average bank in the same banking system. This article is an attempt to briefly discuss the RBI master circular of prudential capital adequacy norms and its policy implications for Indian banking operations.

2. Summary of the Circular

The circular clearly delineates the method for estimating capital adequacy ratio in line with the Basel norms for Primary Urban Cooperative Banks. As per the norm, they shall maintain a minimum of 9% Capital to Risk weighted Assets (CRAR). The CRAR is the minimum capital adequacy ratio expressed as the proportion of regulatory permissible available capital to risk-weighted assets (RWA). It is stipulated at 9 percent on an ongoing basis. The capital funds for capital adequacy purposes consist of the core component as tier I and borrowed component in the form of tier II. The entity can bifurcate equally 50% for tier I and 50% for tier II in maximum. In fact, more thrust has been given to tier I capital in comparison to Tier II since Tier Ihas greater loss absorption power. The purpose is to strengthen the capital adequacy, risk management, and disclosure requirements of UCBs. Bank assets carry a degree of risk with them. This majorly includes

credit risk and operational risk due to lending and to a certain extent market risk due to investment portfolio. More risky is the asset, higher risk weight is assigned by the Basel Committee which increases the risk weightage and lowers its asset value. Based on the regulatory capital and risk-weighted assets, the (CRAR) of a bank is computed.

The regulatory capital funds of banks as defined in the standard have tier I and tier II versions of capital. Tier I capital comprises mainly of equity capital, retained earnings, and reserves. It is deemed to be of the highest quality because it has the full loss absorption capacity. Share premium resulting from the issue of equity capital is also considered as tier I capital of a bank. Hence it is termed as core capital of a bank. The circular clearly states that Revaluation reserves, general or floating provisions, and specific provisions made for loan losses and other asset losses or diminution in the value of any assets will not be reckoned as tier I capital funds for UCBs. However, these can be incorporated in tier 2 capital funds. Tier II capital is known as supplementary capital which consists of certain reserves, and specific types of subordinated debt. It also qualifies as regulatory capital to the extent that it can be used to absorb losses arising from a bank's business activities (lending, investment, commission services, etc.).

The risk weights for different instruments for estimating CRAR have been specified in the Circular. This has been done for both investment assets as well as loans and advances. For example, the risk weight for Central Government and State Government guaranteed loans are zero percent in view of minimal credit risk. However, loans granted to PSUs of the Government of India, Commercial Real Estate Loans, Cooperative, and Group Housing Societies are 100 percent. For Residential Real Estate, it has been made more risk-sensitive since it is aligned with Loan to Value Ratio (LTV) and exposure size. For exposures up to Rs. 30 lakh and LTV<75%, Risk Weight(RW) is 50%, but for more than Rs. 30 lakh with the same LTV ratio it is made 75% and for higher LTV ratio above 75%, risk weight will be 100%. This way, it has added more risk sensitivity to the capital adequacy assessment process.

3. Newer Elements in Current Policy

The new circular has clearly given direction to keep capital against market risk. UCBs are exposed to the risk of losses in, on balance sheet as well as off balance sheet positions arising from adverse movement in market prices of instruments. These risks pertain to volatility in interest rate linked instruments and equity prices in the trading book. The market risk capital charge has been prescribed for foreign exchange related risks in both banking and trading books. Earlier, UCBs were advised to assign an additional risk weight of 2.5 percent on investments besides risk weights prescribed for credit risk in respect of investment portfolio.

As per the new norm, UCBs will be permitted to raise share capital as part of tier I capital requirements. They can also issue Perpetual Non-Cumulative Preference Shares (PNCPS) that comply with the regulatory requirements. The prudential capital standard also recognizes Perpetual Debt Instruments (PDI) which will be eligible to be included in tier I capital. Both PNCPS and PDIs are commonly referred to as additional tier IInstruments (ATI). Further, UCBs can issue Perpetual Cumulative Preference Shares (PCPS), Redeemable Non-Cumulative Preference Shares (RNCPS), and Redeemable Cumulative Preference Shares (RCPS) to augment their tier II capital. Long Term Subordinated Bonds (LTSB) are recognized as tier II capital. All these will improve the solvency position of UCBs and will provide more market confidence. It is important to

note that the PDI issuance shall not exceed 35 percent of the total tier I capital at any point in time. Similarly, PNCPS issued in excess of the overall ceiling of 35 percent, shall be eligible for inclusion under the upper tier II capital of the bank. The payment of dividend by the bank can be made if the overall CRAR is above the minimum regulatory requirements specified by RBI.

Clear guidelines on reporting format for statement of capital funds, risk assets exposures, and risk asset ratio have also been given in annexure IV(Annexure IV-Proforma of Returns). This will enable the top management of UCBs as well as regulator and the market participants to clearly understand their capital, portfolio risk as well as solvency positions. The master circular also provides a consolidated reference of all the instructions and guidelines about capital, risk weights, provisioning norms, and accounting aspects related to UCBs. This is expected to bring more transparency in the disclosure process of UCBs and the market will operate more efficiently.

4. Implications for the BFSI Sector

The new prudential guidelines of RBI are expected to improve the financial performance and solvency of the UCBs through better management of risk and capital. Though the CRAR framework mentions about Basel I, an attempt has been made to provide greater thrust on quality capital to absorb the business shocks. In terms of the numerator, it provides a solid background for graduating towards more sophisticated Basel III capital standards even for larger UCBs.

Capital acts as a safety cushion against unexpected loss due to its loss of absorption power. In this context, the quality of capital becomes paramount to ensure the financial viability of banks. This has been emphasized by many researchers as well as regulators worldwide. Tier I capital and instruments are considered to be the going concern capital. The reason is that it allows a bank to continue its activities and maintain solvency. The highest quality component hinges on tier I capital since it is the most junior claim in the capital structure and comprises of retained earnings, reserves, and equity capital. Tier II capital is considered to be gone concern capital. Since CRAR includes all tier I capital and it truly represents the actual level of solvency of a bank in terms of core capital. In the RBI circular, it is quite evident that emphasis has been given on quality capital (mainly Tier 1) to ensure greater solvency and loss absorption power of capital.

By permitting UCBs to augment quality capital through the issuance of equity shares, preference shares, Perpetual Non-Cumulative Preference Shares (PNCPS), and Perpetual Debt Instruments (PDIs), the Central Bank is trying to ensure greater financial stability and market efficiency of UCBs. In terms of risk-weighted assets for standard loans and also non-performing assets, the framework hints at moving towards more risk sensitive but simpler approaches. This will enable the UCBs to go for better capital planning after duly considering portfolio risk assessment.

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