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Banking capital: It is the wizard's hand

We have to look at banking reforms afresh and review the processes as well as the accounts of all the banks.

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The deferred tax assets arising due to timing differences are permissible up to 10% of a bank's Tier-1 capital. (Photo: Reuters)



The financial sector is known for financial engineering and its success has been legendary. However, our banking system is no less engineered, and while the effects look good to begin with, the probability of conditions moving in the other direction can be high.

Let us look at the latest regulation regarding the calculation of regulatory capital for reckoning Tier-1 capital under the Basel III framework. Three changes have been made.

First, the revaluation reserves arising from change in carrying the amount of a bank's property consequent upon its revaluation would be considered as Tier-1 capital instead of Tier-2 capital at a discount of 55%.

Second, foreign currency translation reserves arising due to translation of financial statements of a bank's foreign operations to the reporting currency would also qualify at a discount of 25%.

Third, deferred tax assets arising due to timing differences are permissible up to 10% of a bank's Tier-1 capital.

There is nothing amiss in this concept as we are following the global practice when calculating capital. There are, however, some questions or issues which come up.

One, if this is a global concept, why was this not done earlier? The timing has a touch of irony as it comes when public sector banks (PSBs) have challenges with capital; and in one stroke of the regulatory pen, Rs 40,000 crore is released into the system which will justify lending of Rs 4 lakh crore, assuming a Capital Adequacy Ratio (CAR) of 10%. The market has cheered and the movement in stock indices seems to vindicate this move, bringing out the sun rays suddenly through the dark clouds.

Two, such reclassification while shoring up capital does not provide resources to lend as this would be more of an accounting entry. So, while the adherence to prudential norms looks better, the ability to lend will not change.

Three, can there be a perverse incentive that will develop where banks can, say, have assets revalued regularly at a higher level to meet the prudential norms? This can lead to caution being kept aside when operating loan books.

Four, are we just delaying the inevitable, which is that a tough call has to be taken on disinvestment or mergers of PSBs as the government has limited fiscal space to capitalise banks? Even if this is not the intention, it will help in procrastination.

The banking system has never been free from such controversy. The concept of restructured assets, it may be remembered, was often interpreted as a camouflage for ever-greening of bad assets. When this concept came into the banking lexicon, it was defended quite vociferously by all. The rationale was that large infra projects in particular ran into temporary problems because of extraneous reasons, which had to be reversed by more sympathetic treatment of these assets. The logic was warped as this justification can be used for any asset which turns bad, because except where there is wilful default or where companies are very badly governed, all NPAs would have had their genesis in the economic slowdown, policy paralysis (of the earlier government), etc.

Interestingly, we did not treat this issue with concern until the level went up to a very high 7-8%, when they were reckoned as part of the stressed assets and were repeated in all policies with a blend of disdain and awe. But the issue was well known and allowed to both germinate and proliferate as several companies took refuge under this umbrella, which provided protection in a progressive manner. And today, there is a major scare that the stressed assets have reached astronomical magnitudes, leading to disruption in bank balance sheets.

More recently, the issue of NPAs has again caught attention in terms of classification. Several banks had treated NPAs as performing, as long as their loans to companies were being serviced, while others which were not paid on time by the same companies classified them as performing. This anomaly had to be corrected, which took some tough talk to ensure that the books were cleaned up. This has dented the profit and loss (P&L) of several banks in Q3FY16, and it is anybody's guess as to how long it will take to clean

them up permanently, though most banks claim that March 2016 would be the terminal point. 

While it is true that one can always be wiser after the event, since if the dangers were known, the systems would have been tightened earlier, the larger question is why was this not done earlier? It is similar logic which comes to mind when the classification of capital has changed at a time when there is desperate need for capital which is not forthcoming that easily. The problem really is that with this additional comfort being provided, banks could just go slow on thinking of reforming their balance sheets. The owner of these banks, i.e. the government, would get breathing space to take further action, and the market demand for higher capitalisation has been addressed in a jiffy. We have definitely deferred the problem, though there is a possibility that there could be misuse of these definitions by some banks.

The message is that we have to look at banking reforms afresh and review processes as well as accounts of all the banks. Studying global practices sounds good, but the issue is that countries follow different rules and regulations, and it is always possible to borrow templates from systems which are convenient for us. This should be eschewed and a balanced view taken. An independent committee looking at various banking issues, especially in the areas of quality of assets and capital, can make the outcome more credible. We have come a long way with Narasimham and his two committees which brought about a lot of fairness in banking practices. Reviewing the system afresh is the way out. Knee-jerk reactions to prevalent circumstances may be tempting, but not a permanent solution.

The author is chief economist, CARE Ratings. Views are personal
