Relaxing capital norms can hit banks’ credibility: RBI official

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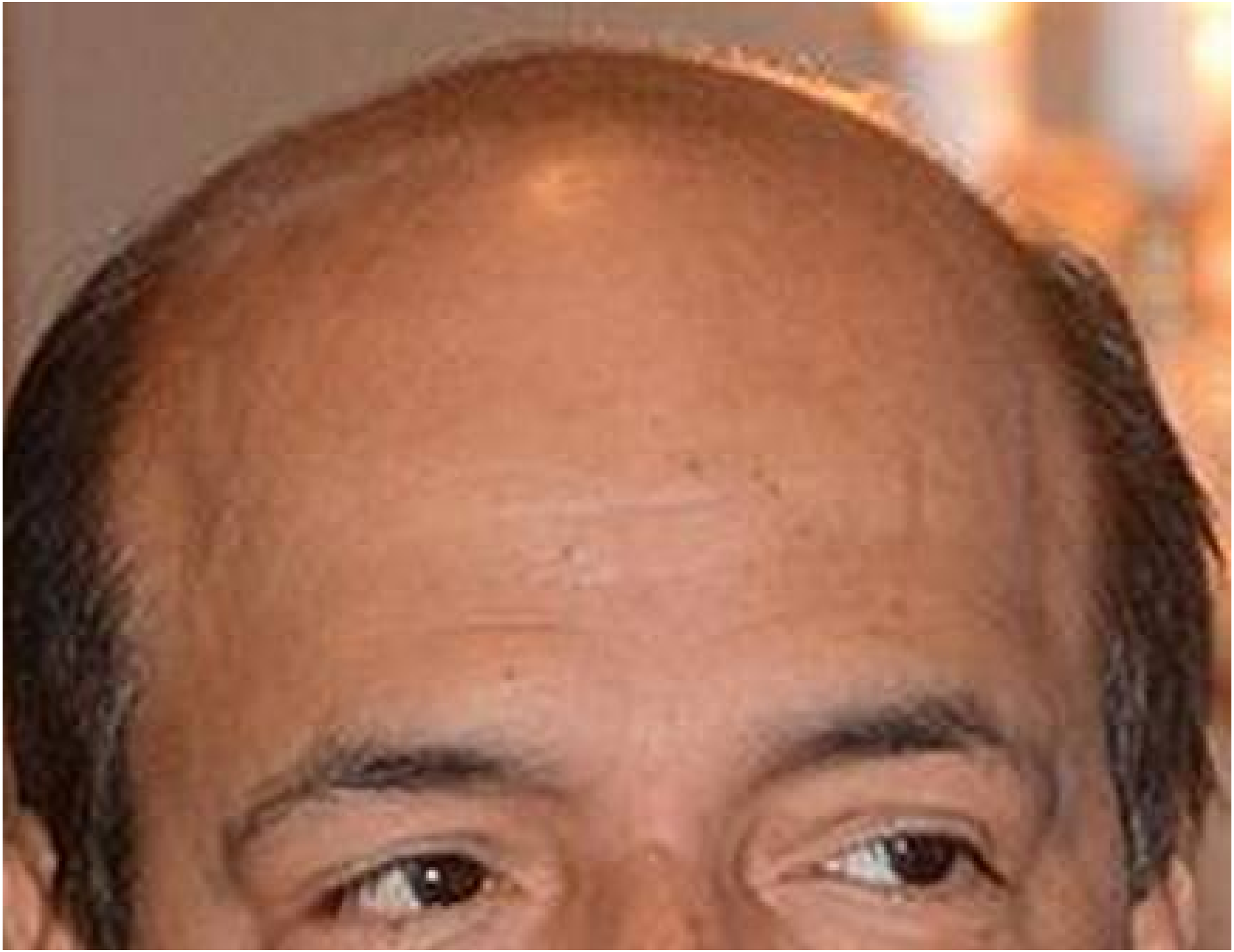

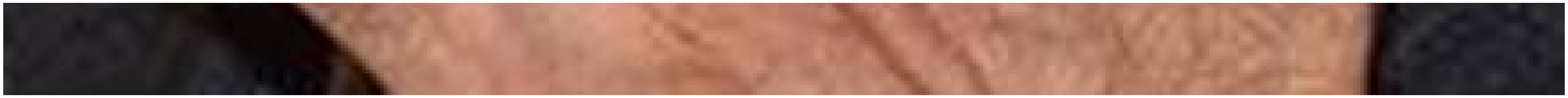

NS Vishwanathan, Deputy Governor, Reserve Bank of India

MUMBAI, NOVEMBER 2

Ruling out any relaxation in prudential capital regulations, RBI Deputy Governor NS Vishwanathan emphasised that these regulations enable banks to sustain unexpected losses without defaulting on their obligations, especially deposits, by maintaining adequate levels of capital.

He cautioned that any relaxation of these norms for public sector banks can result in a reset of their credibility/standing in international markets.

In India, an overall capital requirement of 9 per cent of risk weighted assets has been prescribed for banks, with the common equity tier-1 capital of 5.5 per cent as against 8 per cent and 4.5 per cent, respectively, required under Basel norms.

“Higher capital levels in banks also have a stabilising effect on a country’s macro-economy. Further, higher levels of capital increases the skin in the game for shareholders, thus potentially leading to better credit appraisal and screening.

“Raising capital does involve costs – there is no free lunch – but the costs to the economy are offset by the savings made in the form of potential losses avoided in averted banking crises,” said the Deputy Governor in a speech at XLRI on October 29.

As the equity component in a bank goes up, the leverage goes down, potentially making the bank safer, thus leading the investors in the bank equity to demand lower returns on equity, and the depositors too may be willing to accept a lower return in view of greater safety of their funds.

Pointing out that any slackening of the prudential norms can result in a reset of public sector bank’s credibility/standing in the international markets, Vishwanathan said such a reset could increase the cost and ease of doing business for their clients, who may need to migrate to other banks which are compliant with Basel standards.

Moreover, differential prudential regulation for banks based on ownership structure, when they operate in the same market, would be anti-competitive and could create systemic imbalances, which obviously are not desirable outcomes.

The Deputy Governor termed as fallacy the claim by the managements of defaulting borrowers that “the restructuring plan proposed by them will result in ‘zero haircut’ for banks; whereas, if banks file insolvency application, new investor would be willing to take over the defaulting entities only with ‘huge haircuts’ on debt.”

“What one needs to understand is that while the payments offered by the existing management are usually spread over a long period, the new investors mostly come up with upfront cash payments. The choice before banks is: ‘illusory future payments’ vs ‘upfront real cash’,” he said.

Banks need to arrive at the present value of ‘illusory future payments’ by discounting it for time value of money and more importantly for the uncertainty in receiving the payments taking into account the existing management’s past records.

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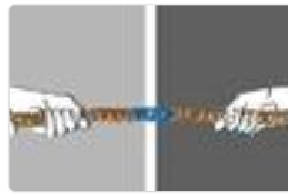

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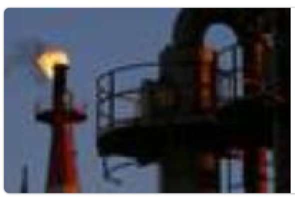

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