2. RBI Revises Capital Adequacy Norms Aligning with Basel Standards - Economy

1. Why in News

1. Reserve Bank of India (RBI) revised capital adequacy norms
2. Simplify Common Equity Tier 1 (CET1) calculations
3. Align counterparty credit risk rules with global Basel standards
4. Strengthens banking resilience and risk management
5. Improves transparency in measuring counterparty credit risk
6. Moderate impact on banks' risk-weighted assets

2. Key Changes in Capital Adequacy Ratio (CAR)

Simplified CET1 Inclusion

1. RBI removed earlier condition linking quarterly profits inclusion in CET1 capital with NPA provisioning pattern deviations
2. Streamlines capital calculation process
3. Reduces complexity in reporting
4. Allows more straightforward recognition of earnings in core capital

Revised Counterparty Risk Norms

1. Banks must now include trading-partner exposures of all consolidated entities
2. While calculating capital adequacy at group level
3. Comprehensive view of group-wide exposures
4. Prevents regulatory arbitrage through subsidiaries
5. Enhanced risk capture across banking group

Updated Add-on Percentages

1. RBI revised "add-on" factors for estimating future exposure
2. Arising from off-balance-sheet transactions such as derivatives
3. Reflects current market conditions and volatility
4. More accurate potential future exposure calculation
5. Better alignment with international practices

Risk Weight for Cleared Trades

1. Trades cleared through regulated central counterparties attract lower 2% risk weight
2. Reduces additional capital burden on banks
3. Incentivizes use of central clearing for derivatives
4. Promotes financial system stability through centralized risk management
5. Lowers capital costs for compliant banks

3. What is Capital Adequacy Ratio (CAR)?

Definition

1. Also known as Capital-to-Risk Weighted Assets Ratio (CRAR)
2. Measures bank's capital as percentage of risk-weighted assets
3. Key prudential regulation indicator
4. Ensures banks maintain adequate capital cushion

Components

Tier 1 Capital (Core Capital):

1. Equity capital and disclosed reserves
2. Retained earnings
3. Capable of absorbing losses without stopping banking operations
4. Going-concern capital
5. Highest quality capital

Tier 2 Capital (Supplementary Capital):

1. Supplementary reserves
2. Subordinated debt (maturity >5 years)
3. Revaluation reserves
4. Available to absorb losses during liquidation or financial stress
5. Gone-concern capital

Risk-Weighted Assets (RWA):

1. Bank assets adjusted according to risk profile
2. Riskier loans require higher capital backing
3. Corporate loans typically 100% risk weight
4. Government securities 0% risk weight
5. Retail mortgages lower risk weights
6. Derivatives and off-balance-sheet items included

Calculation Formula: CAR = (Tier 1 Capital + Tier 2 Capital) / Risk-Weighted Assets × 100

Consequences of Non-Compliance

Banks failing to maintain prescribed CAR face regulatory actions:

1. Restrictions on providing loans and credit to customers
2. Limitations on dividend payments to shareholders
3. Curbs on business expansion and new investment activities
4. Closer regulatory supervision
5. Potential recapitalization requirements

4. Significance of CAR

Depositor Protection

1. Higher CAR provides financial cushion to absorb unexpected losses
2. Protects depositor funds during crises
3. Public confidence in banking system
4. Reduces need for deposit insurance payouts

Financial Stability

1. Reduces possibility of bank failures spreading across financial system
2. Strengthens macroeconomic stability
3. Prevents systemic contagion
4. Banking sector resilience during economic downturns

Prudent Lending

1. Banks discouraged from excessive risky lending
2. Higher-risk assets increased risk-weighted assets and capital requirements
3. Promotes responsible credit allocation
4. Risk-return balance in lending decisions

Investor Confidence

1. Strong CAR levels improve investor confidence
2. Lower funding costs for well-capitalized banks
3. Reduces probability of panic-driven bank runs
4. Market discipline and pricing reflects capital strength

5. Limitations of Capital Adequacy Ratio

Liquidity Risk Not Captured

1. CAR does not account for liquidity risk
2. Possibility of sudden runs on bank not addressed
3. Separate liquidity coverage ratio needed

Accounting Manipulation

1. Ratio can be influenced by accounting practices
2. Potentially understating risk exposure
3. Window-dressing possibilities at reporting dates

Limited Scope

1. Measures capital adequacy but not profitability
2. Does not directly indicate operational efficiency
3. Static snapshot, not forward-looking measure
4. Cannot capture all types of risks (operational, reputational)

6.Basel III Norms

Global Regulatory Framework

1. International banking regulatory framework developed after 2008 global financial crisis
2. Strengthen banking resilience and risk management
3. Coordinated global standards

Minimum Capital Requirements

1. Minimum total CAR: 8% of risk-weighted assets globally
2. Common Equity Tier 1 (CET1) ratio: Minimum 4.5% under Basel III
3. Tier 1 capital: Minimum 6%

Capital Conservation Buffer

1. Additional Capital Conservation Buffer: 2.5% CET1
2. Effective minimum requirement: 10.5% total capital for Indian banks
3. Buffer to be drawn down during stress, rebuilt during normal times
4. Restrictions on distributions if buffer breached

RBI's Stricter Norms

1. RBI mandates scheduled commercial banks maintain minimum CAR of 9%
2. Higher than global Basel standards (8%)
3. Additional prudence for Indian banking system
4. Reflects emerging market risks

Other Basel III Elements

1. Leverage ratio: Limits absolute leverage
2. Liquidity Coverage Ratio (LCR): Short-term liquidity buffer
3. Net Stable Funding Ratio (NSFR): Long-term funding stability
4. Countercyclical capital buffer: Additional buffer during credit booms

7. Impact of Revised CAR Framework

Limited Impact on CET1

1. Most domestic banks unlikely to face major CET1 ratio reductions
2. Derivative trades largely cleared through regulated counterparties
3. Already benefit from lower risk weights
4. Minimal capital erosion expected

Moderate Rise in RWAs

1. Inclusion of consolidated entities' exposures may slightly increase risk-weighted assets
2. For some banks with significant group structures
3. Overall impact manageable
4. Well within existing capital buffers

Improved Risk Management

1. Revised framework strengthens transparency in counterparty credit risk measurement
2. Standardization across banks improves comparability
3. Better capture of trading activities' risks
4. Enhanced supervisory oversight

Alignment with Global Standards

1. Brings India closer to full Basel III compliance
2. Facilitates international banking operations
3. Level playing field with global peers
4. Enhances credibility of Indian banking regulation

8. Conclusion

RBI's revised CAR framework strengthens banking resilience through simplified CET1 calculations, comprehensive counterparty risk capture at group level, updated derivative exposure factors, and lower risk weights for centrally cleared trades. Aligns India's banking regulations with international Basel standards while maintaining RBI's stricter 9% minimum CAR. Limited impact on CET1 ratios, moderate RWA increase, and improved risk management transparency position Indian banks for enhanced stability and global competitiveness.

Source: https://www.newsonair.gov.in/rbi-eases-norms-for-inclusion-of-quarterly-profits-in-cet1-capital-calculation-by-banks/