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Study of capital adequacy and privatization: A challenging role of commercial banks in India

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Abstract
Inadequacy of capital relative to the scale of risk exposure was internationally acknowledged as a major concern all over the world. As a result, in 1988, the Basle Committee established a norm that capital of a bank must at least be equal to 8 percent of the risk weighted assets. It might be useful to recall that risk exposure became a major concern in the context of wide spread financial distress of the 1980s. In fact, many foreign and international banks consider an 8 percent capital adequacy norm as barely adequate. In the reforms package introduced in India, this minimum norm was accepted and was to be attained by 31st March, 1996. In view of the international agreement in this regard, the banks which have overseas branches (there are only eight such banks) were specially required to attain this requirement even earlier if they were to continue with their foreign operations. Other banks would also suffer by way of lower credit rating and difficulty in operating lines of credit from overseas banks if they fail to achieve the norm. Overseas suppliers may not honor letter of credit of such banks which will require them to route such business through other banks this will undoubtedly push up their costs.

Keywords: Capital, privatization, commercial banks

Introduction

The capital adequacy norm has been attained by most public sector banks in two ways: first, the Central Government has provided budgetary support and provided capital to the tune of about Rs. 11,000 crore to the nationalized banks in the form of non-marketable interest bearing securities. The second method is through mobilizing capital through debt or equity instruments from the market. This is indeed a complete change from 1969 when banks were nationalizing and some compensation was paid to the owners. Today, the banks are, in effect, being denationalized through partial privatization. This issue has not received serious attention in the discussion on financial sector reforms.

The objectives of partial privatization could be many. It could simply to raise capital but without losing control. Or, it could be to bring into the public sector banks new stake holders who would expect a different kind of accountability from bank managements. The current buzz words re-corporate governance. Entry of private equity holders is expected to bring in a change in corporate management and practices to make them more efficient.

Let us take the issue of raising capital for maintaining a reasonable capital adequacy. It is not clear at all whether the capital adequacy norm is relevant for all state owned banks. A bank's health is indicated not only by this ratio but also by other aspects such as its lending practices and the way it manages the risks associate with lending.

Furthermore, in the ultimate analysis that are taken are covered by the government. In any case, advances to public sector units that are guaranteed by the central or the state government are assigned a zero risk weight-age in determining the level of capital to risk weighted assets ratio (CRAR). Therefore if the banks is itself fully or more than 90 percent owned by the government does it not mean that the risks are also fully covered, not in the commercial sense, but in the sense of full government backing? The Indian Bank episode this year is adequate indication of this point. Even though the entire net worth of the Bank has been wiped out, there is no run on the bank. If the bank is losing deposits and business, it is because the public sector units had been directed, even before the losses were reported, not to keep their deposits in banks whose capital adequacy was less than 8 percent. Other than this, none of the depositors are particularly concerned about the huge losses.

Apart from several issues of a more technical nature regarding definition of assets for classification into different categories (e.g. Tier I and II) there is the entire issue of the role of capital adequacy norm in the Indian context. It is true that the norm helps as a check on the activities of the bank. The CRAR requires, as a minimum, that the bank generate retained earning sufficient for its capital base to grow at the same rate so that normal business expansion can take place. It is also a cushion against risk of advances going bad. Therefore, it is also a cushion against risk of advances going bad. Therefore, it is certainly an effective tool for self-regulation by the banks. But it is of no help as far as risk liability of a public sector bank is concerned in the sense that the liability will continue to be that of the government.
The issue of what is the risk liability and who bears it is relevant in determining the method to be adopted for achieving capital adequacy. Bank are trying to raise capital through bonds or through equity issues. The capital market route should really be termed as partial privatization. If the risk of a public sector bank has to be borne by the government, then capital is unimportant per se. If that be the case then the insistence on private equity can be justified by the second argument for privatization which is, that it will improve the functioning of the banks through better management. Through partial privatization better corporate governance is expected via the presence of new stake holder to whom bank managements will be accountable. But if this be the argument, then the well run banks do not have to be privatized. Only those that appear to have problems over a period of time should be privatized-not partially but completely through take over. Further if Government shareholding must remain a minimum of 51 per cent how are changes in corporate governance (particularly greater autonomy), come about? As long as majority ownership continues with the government, it is difficult to visualize a change in the basic approach of control through the ministry of Finance. In fact, at point we would like to mention that despite reforms, recommendations of the Narasimham Committee with respect to giving greater functional our autonomy and greater operational flexibility to banks have not been implemented. The appointment of the top management personnel (Chairman and Managing Director and Executive Director) continues to be done through what can only be described as a political process. In short, the government is not prepared to give up control.
If, on the other hand, private equity is to be raised in order to mobilize capital, then the hank will have to go into all the financial parameters including valuation of assets so that they are able to get a good premium in the market and not end up making distress sales to fulfill the capital adequacy norm. From this point of view there is justification only for the strong banks to raise equity from the market. Other would have to wait until they are able to show better financial result. In this case, government should get back its capital which it may use for capitalizing the weak banks. Present estimates indicate that the government will have to inject a minimum of Rs. 3,000 crore by March 1997 if all banks have to achieve the minimum 8 per cent norm. This implies that no bank be permitted to set off its write off against capital given to it. There is at least one case in which this has been permitted by the government without any fuss.
Privatization is concerned with creating property rights so that the stake holders in the enterprise are able to exercise control and influence policy making. If the government is prepared for allowing control to go into hands other than itself, another question arises. This is the question of whether it is necessary to prescribe limits or ceilings on holdings by specific categories of investors. The amended Banking Regulations Act puts a ceiling of 20 per cent on foreign holdings. On the other hand, the State Bank of India Act has yet been amended along similar lines even though the Bank has obtained domestic as well as foreign capital through equity and GDR issues. If equity is raised without any ceiling on shares for specific categories of equity holders. Then it does imply a change in the stake holders and therefore of control from the government to some other group (e.g. publicly owned financial institutions, or foreign institutional investors). They may be as undesirable as government control. The World Bank in its World Development Report of 1989 went into the entire issue of financial sector reform. Even this report did not accept the proposition that privatization can be a means for improving efficiency. Nor did it recommend unrestricted operation of foreign institutional investors as it might result in excessive disinermediation by local banks.
It seems that no one is particularly clear about the objectives of partial privatization of the baking sector. One can take the position that instead of partial privatization it might be worthwhile to consider complete privatization of at least some banks, rather than partial privatization of all banks.
The sustainability of capital adequacy is another important consideration. If, for example the government share is brought down to say 65 per cent after the first equity issue, further increases will be possible only if the government provides further funds to retain its majority share in equity as provided by law. If privatization is the result of the fact that government can no longer provide adequate funds to the banks, then the same is likely to hold in the foreseeable future. In that case sustaining capital adequacy in future would depend upon internal resource generation which can come about only through greater efficiency of operations.

Rural banking

An area in which nationalization of banks in 1969 succeeded has been the extension of the bank network in rural areas. Commercial bank’s share in total outstanding agricultural loans in March 1993 was 54 per cent compared to 39 per cent of co-operatives and 7 per cent of the Regional Rural Banks (RRBs). Notwithstanding the fact that the vast branch network of the rural credit delivery system has become its major strength, it also become one of the problem areas for the banks themselves. The quality of lending, the non-viability of institutions and the high level of over-dues are the recognized weaknesses of the system including that of the commercial banks. The banks are faced with the problem of low margins and high transaction costs. Opportunities for cross subsidization are nonexistent. In fact, one of the aspects of the reform agenda was to remove cross subsidization in priority sector lending. And this has been achieved except for the Differential Rate of Interest (DRI) of 4 per cent applicable to advances to the poorest of borrowers. Such advances must constitute a minimum of one per cent of all bank advances.
Government policies and the emphasis on fulfilling given targets have not only contributed to poor quality of lending but has reduced the banks to conduits of direct government subsidies. This has harmed the banking culture and brought in several undesirable features in managing credit. The

situation in which after giving credit, the bank manager has virtually no power to recover the moneys lent makes the situation of the bank manager unenviable. The traditional money lending systems have sustained themselves on all the grounds on which the institutional credit system is faltering. Their transaction costs are low; they know their clients and effectively practice price discrimination by lending at rates varying between zero to any other high level judged appropriate by them according to the credit risk involved; they are available at all times and for all purpose; and above all they know how to recover their money. All of these features are lacking in the commercial bank lending in rural areas. Were it not for specific directions and availability of refinance, banks, left to themselves, might never have extended rural credit in the manner in which they have done. Management of personal for rural postings and lack of staff motivation has become an irritant for good employer employee relations even though this may not be the most important. Owing to heavy over dues and the consequent provisioning requirements, banks are reluctant to lend. But they are under compulsion to lend. The utility of the Led Bank Scheme and the Service Area Approach has become questionable. Some of the parameters used in the past to judge to performance (such as district/ regional/rural credit-deposit ratios) are no longer as relevant now as they were in the past.
The Narasimham Committee had made two major recommendations. First, the prescribed 40 per cent of total credit to priority sectors, including 18 per cent to agriculture, should be permitted to form one or more subsidiaries to take over the branches of RRBs sponsored by it and also to transfer some of the rural branches to such a subsidiary. Differences on the issue of mandatory credit and concessional credit to agriculture are many and remain unresolved. The result is that both these recommendations have not been accepted by the government and the status quo continues.
The RRBs sponsored by the commercial banks have some inherent weaknesses that have been pointed out from time to time. At the end of 1992-93, 171 RRBs out of 196 were making losses. Certain alternatives have been put forward with regard to the RRBs. One suggestion is to merge them into an all India Bank. The second suggestion would like formation of such banks as local Area Banks state wise, by merging all RRBs in the concerned state. Another view is that the commercial banks should not be allowed to withdraw, even partially, from rural banking. The reasons given for this view are that the vast infrastructure created by the banks during the last three decades would become a wasteful investment. Furthermore, it would not be in the banks' interest to cut themselves off from a growing and a large segment of the Indian economy. Several countries in the region like Thailand, Malaysia, Indonesia and Bangladesh have succeeded in making commercial lending to agriculture. Strategic decisions in this respect are required. But as they raise complex issues from every point of view-political, economic and organizational retaining the status quo has been the easiest decision. Problems both for the banks and for agricultural credit remain unchanged. The reorganization of RRBs have been on the agenda of reform but very little has been achieved so far even though more than one committee has gone into the matter and made recommendations.

The next stage of reforms

The next stage of reforms has become a talking point. The discussion is not limited to the banking and financial sectors. At present the economy is showing signs of distress. Some of these signs may be related to the reform process. This is the decline in credit off take despite increased liquidity with the banks. This could be interpreted as a sign of recession or lack of demand in the system. But, if some of the operational aspects are taken into account we may discover other reasons. One such reason is the lack of credit discipline among the borrowers. The end use of funds has neither been effectively monitored not has diversion of funds been prevented. Borrowers now find that the borrowed funds are locked up in investments such as real estate and stock market. Therefore projects proposals are not forthcoming as investors are finding it difficult to raise their own share in equity. They are therefore, unable to from the banks.
At the same time the morale of the bankers is very low. This affects credit appraisal as well as delivery. Unfortunately, banking personal have become an unenviable lot. Doing business honestly and with social commitment is not a debatable issue. This should be not only first choice but, the first choice. If this is not possible, given the facilities of human nature and the imperfections of institutional arrangements, the second choice could, possibly, be to do business and not worry too much about high ethical and moral standards by taking action in specific cases. But what does one say when there is neither business nor adherence to ethical standards?
Unfortunately, it seems that the public sector banks might be falling into the last mode. Business is suffering because there is always the possibility that a bad account would become a vigilance case. The Ministry of Finance, the CBI and Vigilance involved. The internal management structures in which the Chief Vigilance Officer can investigate the decision of the Chairman and Managing Director or of the Executive Director, cannot be a framework which is conducive for healthy decision-making processes, with the courts also joining the fray and becoming more active, a fear psychosis has been generated. The result is pushing papers, creating records and shifting responsibilities from one level to the next. Credit off-take or business is suffering not only because of recession in the market but also because bankers have been put in a passive and defensive posture rather than in an aggressive business creating posture necessary in a completive setting. On account of competition from private banks and the non-banking financial companies, banks are losing some of their most profitable business. The share of the private banks in the total profits of the banking sector has gone up disproportionately their share in deposits and advances. Action that can be taken against misconduct at this level is again severely restricted by the procedures that have to be followed before action can be taken Orientation of banks, as in government departments, is towards procedures rather than towards results.
Promoters, on the other hand, are finding it difficult to raise money in the capital market because of the depressed conditions in the market. One reason for this sorry state is the fact that more than one thousand companies who raised an estimated Rs. 3,000 crore from the capital market have disappeared. There is not redress because the promoters have not even left an address. The losers are mostly small investors who entered the market directly or via the UTI and

the bank sponsored mutual funds. The supervisory authority has failed to distinguish between risky investment where prices may have crashed in the market and fraudulent dealings where the promoters cannot even be found. The point in the present context is that many of the capital issues of these companies were lead managed by the banks in their new avtar as merchant bankers. Has anyone done an audit of these appraisals to find out where mistakes have been made?
As far as banking itself is concerned, so far, the rules of the game have been rewritten and mandated. The banks have been able to adjust to the new situation with government help. But financial market reforms are not simply a matter or rewritten the rules of the game. It requires more fundamental changes in management and institutions in orders that the rules of the game get internalized so as to give greater productivity and greater efficiency in financial intermediation. The cost of and inefficient banking system has to be borne by the economy and the indicator is high interest cost. We have a long way to go yet.
One of the recommendations of the Narasimham Committee regarding the setting up of u and Asset Reconstruction Fund (ARF) to take over from banks their bad and doubtful debts at a discount deserves to be implemented. Management of fiascos like that of the Indian Bank may have been easier had an ARF existed. The proposal has not been accepted as the management of such a fund is not easy. It also raises the moral hazard problem. The proposal, however merits consideration as it might enable raising funds for further capitalization that will become necessary even after the 8 percent norm has been achieved by all banks within the stipulated time.
Other recommendations not implemented so far relate to the organization and management of the banking sector. The committee visualized two or three all India large sized banks with international presence; 8 to 10 all India banks with some regional bias and the rest. The idea in this approach is to encourage healthy competition and mutual inter-dependence for the benefit of all. The present approach requires all banks to follow the same approach and do everything. Re-organization will necessitate mergers and acquisitions. But this is a difficult matter especially in the context of the human factor involved. The merger of New Bank of India with the Punjab National Bank has not been to happy.
The complexity of dealing with the human factor also limit the speed of technological modernization. The public sector banks are losing profitable high value accounts to foreign and to Indian private banks because the public sector banks are unable to offer services through the more efficient modern technologies. In the context of globalization and overseas business, this factor will become a major handicap for Indian banks. This aspect certainly requires further speeding up.
Capital account convertibility has on the agenda of reform. The question is: this possible to achieve if the banking sector is unable to meet competition from international banks? What distinguishes the latter is that they operate profitably with a much smaller spread between interest earned and expended. Further, distress in the financial system accentuates in the event of large capital outflows. This has been the case in several countries. Examples are Indonesia, Brazil, Indonesia and Mexico, besides effective monetary policies for viable foreign exchange management, a resilient banking system is necessary to meet such an eventuality. The main ingredient of such a system is prudent and efficient operations. Risks incurred in lending including foreign exchange risks, are likely to increase. Banks require honing and increasing of their skills in this direction.
To ensure efficiency, there is need also for more effective supervision. The Bank of International Settlements in its analysis of the impact of banking sector reforms found that the impact depends upon the equality of bank supervision. Wherever such procedures were inadequate or had not been put in place, the impact was less favorable. This was the case in Indonesia where procedures for regulation were not introduced along with reforms and in Mexico where procedures for loan evaluation and screening of borrowers were inadequate. The RBI has constituted a Board for Financial Supervision within the Department of Supervision of the Bank itself. This is not according to the Narasimaham Committee recommendations according to which the Board was to be an autonomous Board. The effectiveness and the quality of supervision has to be further improved. The Department may need strengthening for at least one function *viz.* monitoring and analysis of the returns sent by the banks. The number of circulars and the guidelines issued by the RBI is indeed alarming. Effectiveness should not become inversely proportional to the number of circulars issued.
Management of personnel in the public sector banks is an area of major concern. Centralization of decision whatever may have been their utility earlier. Scant attention is paid to planning and nurturing the leadership role. Promotions are by seniority and the grade structure are rigidly prescribed. Enough is known about the pathetic state of the process of identifying top personnel for the banks. There is no need to add to this information except to highlight and important area in which public sector management, in general, and of the banks in particular needs improvements.

Challenging role of commercial banks

Loan is just like a sword whose two sided are sharp. If it is precisely used it would be proved helpful in development and production. And if it is misused it is made a burden. The loanee falls in grip of debts and becomes poorer.
Role of banks is not only urgently important but also it is extremely needful in the precise conduct of the programmes proposed by the Government so that it may change in the facility of loans from time to time along with their views and behaviour also to the people of weaker sections of society. In order to change the social and economic structure of the country, banks shall have to work together and will take active role in achieving the objectives of different programmes introduced by the Government.
In present context serious challenges have been cropped up before Indian Banks. Most of banks are going on in loss, however, foreign banks provide attractive interest and other facilities are attracting more customers towards themselves. But with the advent of computers, the sword of unemployment and retrenchment on large scale is hanging before Indian Banks.
Today Indian Commercial Banks are standing at such crossroad where they shall to take a firm decision for adopting the modernization. Having brought transparency and skillfulness in their business, they can regain the falling faith of customers so finish them off by following the old tract.
Adopting practical approaches with prompt transparency, Indian Commercial Banks, therefore, shall have to boost up

themselves. A concerted with renewed confidence and strength. So commercial banks are required to revise their policies that will be meeting the unsatisfied credit needs of agro and allied agro activities in a more effective manner.

Conclusion

On the whole, it can be conducted that in comparison to the depth of poverty, under-employment of the masses and vast credit requirement of the rural needy, the Commercial Banks have mounted up to certain distance but the distinction it has to reach on the long but thorny road is far-far away. Following crystal analysis reveals the observations for policy recommendations for the development of Public Sector Commercial Banks:–

- General trend of commercial banks has been in favour and rich and influential people instead of the real needy. So effective efforts should be made to reserve the process at an earliest.
- Financing by commercial banks in rural areas hardly reach to the poor mass. So the poor rural mass have ultimately to depend, upon the non-institutional agency for financing their needs which is a simple exploitation of not only the poor but in a broad way our democratic economic set-up. Hence, it has to be thoroughly screened to ensure that the real help has gone to the real needy.
- To minimize the danger of multiple financing to a person must not only be co-ordination among the different financial institutions but also their jurisdiction be earmarked area-wise.
- The banks should not sanction loans in the name of imaginary persons.
- The amount deposited in the banks of rural areas should not be diverted for development of other areas.
- A special team consisting of representatives of central and state Governments and public workers be made to evaluate the whole process from time to time not only to remove the corrupt practices but also to cater the government policies in right direction. This evaluation must not be made simply a paper work but the team should approach the beneficiaries at their door step.

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