The New Basel Capital Accord

Regulatory Capital and Leveraging Capacity

It is not understood how lower regulatory capital in Banks could be interpreted as “Rewards for stronger and more accurate risk management.” Well-managed banks should have no difficulty in raising equity capital from the market.

The efficiency of the Banking System is mainly dependent upon “Fit and Proper Management” so as to ensure that the accumulated wealth of the community is utilised for increasing human productivity, production of goods and services at affordable prices and generation of employment with emphasis upon distributive justice. In fact no enterprise should suffer for want of capital from the banking system whether by way of loan or equity support!

In fact, the correct measure of growth, efficiency and profitability of a bank should be its ability to influence its existing and prospective shareholders to contribute to its growing needs for equity to cater to its projected growth. The real reward for shareholders of a bank comes from enhancement of share value and increase in dividend payouts and not by increasing the bank'' leveraging capacity.

No doubt, by their very nature, Banking Establishments have been historically ‘highly leveraged’- acceptance of deposits for the purpose of lending or investment being the essence of their business. However, the past 25 years have seen the shift from deposits/ loans to Equity culture. It is high time that the difference between rewards for equity providers and depositors of banks should now go in favour of those who contribute to the risk capital so that reliance on leveraging reduces. Therefore, the cost of capital whether paid by way of interest or dividend on shares should be regarded as a necessary charge on the profits of a bank, before determining its tax liability. In order to ensure that these charges are reasonable, the Central Bank of the country may prescribe the maximum admissible rate of interest and dividend, which will be permitted as a deduction from, profits before charging tax on profits. Also both interest income and dividend income in the hands of the investors should be treated alike for tax purposes.

Three Pillars of the New Accord

- First pillar: minimum capital requirement
- Second pillar: supervisory review process
- Third pillar: Market discipline

Knowledge gained from the failures of the banks/financial institutions during the latter half of the twentieth century whether it was First Continental Bank of Chicago or Bank Ambroisini or BCCI or Barings or Sumitomo or any Savings and Loan Association etc; leads one to the conclusion that these failed banks/institutions had successfully hood - winked the Regulators/Supervisors, the Auditors and the Rating Agencies. In fact some

of these failed establishments were the darling of this Trio who once commended their growth and innovations for other market players to emulate. It is also observed that the Regulators and the Rating Agencies raise the Alarm much after the horses have bolted. Other banks/ financial institutions also fail to observe or check the machinations of the manipulators.

Moreover, quite often The Regulatory Agencies, the Rating Agencies and the Auditors add a note of General disclaimer in all such situations by stating that their advice and guidance is advisory in nature and the ultimate responsibility lies with the management of the concerned banks. Thus unless it is specifically provided that the regulators and the rating agencies shall be held jointly and severally responsible for the efficient control over the designated banks chosen for special treatment the above will not remain the three pillars of strength but will degenerate into three layers of control without accountability. The supervisors and regulatory agencies are increasingly moving away from Micro management despite the criticism that they are abondoning their post and abdicating their responsibility. Under the " three pillar concept', it would be difficult to fix and enforce accountability for a failed bank/financial institution.

Hence, there is no justification to alter the concept of objectivity in the present universal formula for fixing regulatory capital. There is no need to make the formula subjective allowing for exceptions for each bank and each class of customer. The broad customer classification is relevant and should be continued. All the banks work in a specified socio-political and legal milieu and there should be no discrimination among banks working in similar situations as explained below.

The Neglected Domain

Hardly does a day pass when one Central bank or the other does not comment upon the threat of Debt Bomb! The greatest danger to the banking system world wide is posed by the mounting bad loans and long delays in courts in deciding suits filed by the banks, for recovery of their overdues. Decrees are hard to obtain and harder still are the enforcement of decrees and recovery of decreed debts. Many non-challant borrowers are able to hide their true financial position by continuing to obtain loans/overdrafts from the banking system in the names of their associates and other entities. There are instances where advances granted to some entities have been classified as non-performing and provided for by some banks while other banks treat loans granted to the same entity or its associates and subsidiaries as fully performing requiring no provisioning. Thus an otherwise insolent person or bankrupt group is able to hide behind the shroud of secrecy and take shelter of separate independent corporate structure.

The matter of long delays in disposal of suits filed by banks against defaulting borrowers in courts of law and execution of decrees through the court process is a great moral hazard; this has encouraged many a wilful defaulter and insolvent individuals to live off bank loans.

This is a crucial matter which needs the urgent attention of the Basel Committee, the Central Banks of the world and the Judicial system all the world over.