CHAPTER  8

CORPORATE DEBT RESTRUCTURING AND CAPITAL ADEQUACY NORMS (BASEL 2)
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A) PRUDENTIAL GUIDELINES

Background

8.1 The guidelines issued by the Reserve Bank of India on restructuring of advances (other than those restructured under a separate set of guidelines issued by the Rural Planning and Credit Department (RPCD) of the RBI on restructuring of advances on account of natural calamities) are divided into the following four categories:

(i) Guidelines on restructuring of advances extended to industrial units.

(ii) Guidelines on restructuring of advances extended to industrial units under the Corporate Debt Restructuring (CDR) Mechanism

(iii) Guidelines on restructuring of advances extended to Small and Medium Enterprises (SME)

(iv) Guidelines on restructuring of all other advances.

In these four sets of guidelines on restructuring of advances, the differentiation has been broadly made based on whether a borrower is engaged in an industrial activity or a non-industrial activity. In addition an elaborate institutional mechanism has been laid down for accounts restructured under CDR Mechanism. The major difference in the prudential regulations lies in the stipulation that subject to certain conditions, the accounts of borrowers engaged in industrial activities (under CDR Mechanism, SME Debt Restructuring Mechanism and outside these mechanisms) continue to be classified in the existing asset
classification category upon restructuring. This benefit of retention of asset classification on restructuring is not available to the accounts of borrowers engaged in non-industrial activities except to SME borrowers. Another difference is that the prudential regulations covering the CDR Mechanism and restructuring of advances extended to SMEs are more detailed and comprehensive than that covering the restructuring of the rest of the advances including the advances extended to the industrial units, outside CDR Mechanism. Further, the CDR Mechanism is available only to the borrowers engaged in industrial activities.

8.2 Since the principles underlying the restructuring of all advances were identical, the prudential regulations needed to be aligned in all cases. Accordingly, the prudential norms across all categories of debt restructuring mechanisms, other than those restructured on account of natural calamities which will continue to be covered by the extant guidelines issued by the RPCD were harmonized in August 2008. These prudential norms applicable to all restructurings including those under CDR Mechanism are laid down in para 7.5.

It may be noted that while the general principles laid down in para 7.5 inter-alia stipulate that 'standard' advances should be re-classified as 'sub-standard' immediately on restructuring, all borrowers, with the exception of the borrowal categories (i.e. consumer and personal advances, advances classified as capital market and real estate exposures), will be entitled to retain the asset classification upon restructuring.

8.3 The CDR Mechanism will also be available to the corporates engaged in non-industrial activities, if they are otherwise eligible for restructuring as per the criteria laid down for this purpose. Further, banks are also encouraged to strengthen the co-ordination among themselves in the matter of restructuring of consortium / multiple banking accounts, which are not covered under the CDR Mechanism.

8.4. General Principles and Prudential Norms for Restructured Advances

The principles and prudential norms laid down in this paragraph are applicable to all advances including the borrowers, who are eligible for special regulatory treatment for asset classification.
8.5 Eligibility criteria for restructuring of advances

8.5.1 Banks may restructure the accounts classified under 'standard', 'sub-standard' and 'doubtful' categories.

8.5.2 Banks cannot reschedule / restructure / renegotiate borrower accounts with retrospective effect. While a restructuring proposal is under consideration, the usual asset classification norms would continue to apply. The process of re-classification of an asset should not stop merely because restructuring proposal is under consideration. The asset classification status as on the date of approval of the restructured package by the competent authority would be relevant to decide the asset classification status of the account after restructuring/rescheduling/renegotiation. In case there is undue delay in sanctioning a restructuring package and in the meantime the asset classification status of the account undergoes deterioration, it would be a matter of supervisory concern.

8.5.3 Normally, restructuring cannot take place unless alteration / changes in the original loan agreement are made with the formal consent / application of the debtor. However, the process of restructuring can be initiated by the bank in deserving cases subject to customer agreeing to the terms and conditions.

8.5.4 No account will be taken up for restructuring by the banks unless the financial viability is established and there is a reasonable certainty of repayment from the borrower, as per the terms of restructuring package. The viability should be determined by the banks based on the acceptable viability benchmarks determined by them, which may be applied on a case-by-case basis, depending on merits of each case. Illustratively, the parameters may include the Return on Capital Employed, Debt Service Coverage Ratio, Gap between the Internal Rate of Return and Cost of Funds and the amount of provision required in lieu of the diminution in the fair value of the restructured advance. The accounts not considered viable should not be restructured and banks should accelerate the recovery measures in respect of such accounts. Any restructuring done without looking into cash flows of the borrower and assessing the viability of the projects / activity financed by banks would be treated as an attempt at ever greening a weak credit facility and would invite supervisory concerns / action.
8.5.5 While the borrowers indulging in frauds and malfeasance will continue to remain ineligible for restructuring, banks may review the reasons for classification of the borrowers as willful defaulters specially in old cases where the manner of classification of a borrower as a willful defaulter was not transparent and satisfy itself that the borrower is in a position to rectify the willful default. The restructuring of such cases may be done with Board's approval, while for such accounts the restructuring under the CDR Mechanism may be carried out with the approval of the Core Group only.

8.5.6 BIFR cases are not eligible for restructuring without their express approval. CDR Core Group in the case of advances restructured under CDR Mechanism / the lead bank in the case of SME Debt Restructuring Mechanism and the individual banks in other cases, may consider the proposals for restructuring in such cases, after ensuring that all the formalities in seeking the approval from BIFR are completed before implementing the package.

8.6 Asset classification norms

8.6.1 Restructuring of advances could take place in the following stages:

(a) Before commencement of commercial production / operation;

(b) After commencement of commercial production / operation but before the asset has been classified as 'sub-standard';

(c) After commencement of commercial production / operation and the asset has been classified as 'sub-standard' or 'doubtful'.

8.6.2 The accounts classified as 'standard assets' should be immediately re-classified as 'sub-standard assets' upon restructuring. The non-performing assets, upon restructuring, would continue to have the same asset classification as prior to restructuring and slip into further lower asset classification categories as per extant asset classification norms with reference to the pre-restructuring repayment schedule.

8.6.3 All restructured accounts which have been classified as non-performing assets upon restructuring, would be eligible for up-gradation to the 'standard' category after observation of 'satisfactory performance' during the 'specified period'. In case, however, satisfactory
performance after the specified period is not evidenced, the asset classification of the restructured account would be governed as per the applicable prudential norms with reference to the pre-restructuring payment schedule.

8.6.4 Any additional finance may be treated as 'standard asset', up to a period of one year after the first interest / principal payment, whichever is earlier, falls due under the approved restructuring package. However, in the case of accounts where the prerestructuring facilities were classified as 'sub-standard' and 'doubtful', interest income on the additional finance should be recognised only on cash basis. If the restructured asset does not qualify for up gradation at the end of the above specified one year period, the additional finance shall be placed in the same asset classification category as the restructured debt.

8.6.5 In case a restructured asset, which is a standard asset on restructuring, is subjected to restructuring on a subsequent occasion, it should be classified as substandard. If the restructured asset is a sub-standard or a doubtful asset and is subjected to restructuring, on a subsequent occasion, its asset classification will be reckoned from the date when it became NPA on the first occasion. However, such advances restructured on second or more occasions may be allowed to be upgraded to standard category after one year from the date of first payment of interest or repayment of principal whichever falls due earlier in terms of the current restructuring package subject to satisfactory performance.

8.7 Income recognition norms

Interest income in respect of restructured accounts classified as 'standard assets' will be recognized on accrual basis and that in respect of the accounts classified as 'non-performing assets' will be recognized on cash basis.

8.8 Provisioning norms

8.8.1 Normal provisions

Banks will hold provision against the restructured advances as per the existing provisioning norms.
8.8.2 Provision for diminution in the fair value of restructured advances

8.8.2.(i) Reduction in the rate of interest and/or re-schedulement of the repayment of principal amount, as part of the restructuring, will result in diminution in the fair value of the advance. Such diminution in value is an economic loss for the bank and will have impact on the bank's market value of equity. It is, therefore, necessary for banks to measure such diminution in the fair value of the advance and make provisions for it by debit to Profit & Loss Account. Such provision should be held in addition to the provisions as per existing provisioning norms and in an account distinct from that for normal provisions.

For this purpose, the erosion in the fair value of the advance should be computed as the difference between the fair value of the loan before and after restructuring. Fair value of the loan before restructuring will be computed as the present value of cash flows representing the interest at the existing rate charged on the advance before restructuring and the principal, discounted at a rate equal to the bank's BPLR as on the date of restructuring plus the appropriate term premium and credit risk premium for the borrower category on the date of restructuring. Fair value of the loan after restructuring will be computed as the present value of cash flows representing the interest at the rate charged on the advance on restructuring and the principal, discounted at a rate equal to the bank's BPLR as on the date of restructuring plus the appropriate term premium and credit risk premium for the borrower category on the date of restructuring.

The above formula moderates the swing in the diminution of present value of loans with the interest rate cycle and will have to follow consistently by banks in future. Further, it is reiterated that the provisions required as above arise due to the action of the banks resulting in change in contractual terms of the loan upon restructuring which are in the nature of financial concessions. These provisions are distinct from the provisions which are linked to the asset classification of the account classified as NPA and reflect the impairment due to deterioration in the credit quality of the loan. Thus, the two types of the provisions are not substitute for each other.

8.8.2.(ii) In the case of working capital facilities, the diminution in the fair value of the cash credit/overdraft component may be computed as indicated in para (i) above, reckoning the
higher of the outstanding amount or the limit sanctioned as the principal amount and taking the tenor of the advance as one year. The term premium in the discount factor would be as applicable for one year. The fair value of the term loan components (Working Capital Term Loan and Funded Interest Term Loan) would be computed as per actual cash flows and taking the term premium in the discount factor as applicable for the maturity of the respective term loan components.

8.8.2.(iii) In the event any security is taken in lieu of the diminution in the fair value of the advance, it should be valued at Re.1/- till maturity of the security. This will ensure that the effect of charging off the economic sacrifice to the Profit & Loss account is not negated.

8.8.2.(iv) The diminution in the fair value may be re-computed on each balance sheet date till satisfactory completion of all repayment obligations and full repayment of the outstanding in the account, so as to capture the changes in the fair value on account of changes in BPLR, term premium and the credit category of the borrower. Consequently, banks may provide for the shortfall in provision or reverse the amount of excess provision held in the distinct account.

8.8.2.(v) If due to lack of expertise / appropriate infrastructure, a bank finds it difficult to ensure computation of diminution in the fair value of advances extended by small / rural branches, as an alternative to the methodology prescribed above for computing the amount of diminution in the fair value, banks will have the option of notionally computing the amount of diminution in the fair value and providing therefor, at five percent of the total exposure, in respect of all restructured accounts where the total dues to bank(s) are less than rupees one crore till the financial year ending March 2011. The position would be reviewed thereafter.

The total provisions required against an account (normal provisions plus provisions in lieu of diminution in the fair value of the advance) are capped at 100% of the outstanding debt amount.
B) BASEL 2 NORMS

8.9 Capital Adequacy Ratio of Public Sector Banks: The capital adequacy ratio reveals the health of a bank. The public sector banks are required to attain the stipulated nine percent capital adequacy ratio. The capital adequacy ratio is defined as the ratio between the total banks capital and its risk-weighted assets. As a part of the financial sector reforms the RBI has introduced the capital adequacy norms in April 1992 to encourage banks to be more risk sensitive and adjust both on and off balance sheet exposures. Under the prevailing system except the government generated loans, most of the advances carry 100 percent risk weightages. According to the norms all claims on banks are assigned a risk weight age of 20 percent. ‘With regard to off balance sheet items guarantees issued by the banks against the counter guarantee of other banks and discounting of documentary bills accepted by other banks are to the treated as claims on banks and carry a risk weight of 20 percent. But the commercial banks are striving for 9 percent capital adequacy ratio. Basel II is a New Standard for the Measurement of Risks in Banks, and for the Allocation of Capital to cover those risks. Basel II aims to encourage the use of modern risk management techniques; and to encourage banks to ensure that their risk management capabilities are commensurate with the risks of their business. A risk weight refers to the the level of risk in an asset (advance or investment). But, how much capital is to be maintained to cover the risks.

The rationale behind capital is

- Capital is a key factor to assess the safety and soundness of a bank
- Adequate capital serves as safety net for likely loss due to risks
- Capital absorbs possible losses - gives depositors confidence in a bank
- Capital determines the maximum level of assets (loans and investments) of a bank

8.10 RISK CATEGORIES:

- **Credit risk**: the risk that a borrower or counterparty might not honour its contractual obligations - Very relevant to operating staff
- **Market risk**: the risk of adverse price movements such as exchange rates, the value of securities, and interest rates - Less relevant to operating staff
• **Operational risk** - the risk of loss resulting from inadequate or failed internal policies

### 8.11 The Working of Basel 2:

![Basel II - the Three Pillars](image)

(An Introduction to Basel 2)- STC, Hyderabad

Previously, regulators' main focus was on credit risk and market risk. Basel II takes a more sophisticated approach to credit risk, in that it allows banks to make use of internal ratings based Approach - or 'IRB Approach' as they have become known - to calculate their capital requirement for credit risk. It also introduces, in addition to the market risk capital charge, an explicit capital charge for operational risk. Together, these three risks - credit, market, and operational risk - are the so-called 'Pillar 1' risks.

Banks' risk management functions need to look at a much wider range of risks than this - interest rate risk in the banking book, foreign exchange risk, liquidity risk, business cycle risk, reputation risk, strategic risk. The risk management role of helping identify, evaluate, monitor, manage and control or mitigate these risks has become a crucial role in modern-day banking. Indeed, it is probably not exaggerating the importance of this to say that the quality of a bank's risk management has become one of the key determinants of a success of a bank.
The policy approach to Basel II in India is to conform to best international standards and in the process emphasis is on harmonization with the international best practices. Commercial banks in India have started implementing Basel II with effect from March 31, 2007. Though the Basel II framework provides various options for implementation, special attention was given to the differences in degrees of sophistication and development of the banking system while considering these options and it was decided that banks in India would initially adopt the Standardised Approach (SA) for credit risk and the Basic Indicator Approach (BIA) for operational risk. The prime considerations while deciding on the likely approach included the cost of implementation and the cost of compliance.

Overall capital is what makes financial systems stable. In general, expected losses are to be covered by earnings and provision and hence the need to price risk appropriately. Unexpected losses or losses beyond the normal range of expectations need have to be met by capital.

8.12 The steps taken for implementation of Basel II and the emerging issues.

- The RBI had announced in its annual policy statement in May 2004 that banks in India should examine in depth the options available under Basel II, and it drew a road-map by end-December 2004 for migration to Basel II and reviewed the progress made at quarterly intervals.
- The Reserve Bank organized a two-day seminar in July 2004 mainly to sensitise the Chief Executive Officers of banks to the opportunities and challenges emerging from the Basel II norms.
- Soon thereafter all banks were advised in August 2004 to undertake a self-assessment of the various risk management systems in place, with specific reference to the three major risks covered under the Basel II and initiate necessary remedial measures to update the systems to match up to the minimum standards prescribed under the New Framework.
- Banks were also advised to formulate and operationalise the Capital Adequacy Assessment Process (CAAP) as required under Pillar II of the New Framework.
• Reserve Bank issued a Guidance Note on operational risk management in November 2005, which served as a benchmark for banks to establish a scientific operational risk management framework.

• Banks were advised to have suitable risk management framework oriented towards their requirements dictated by the size and complexity of business, risk philosophy, market perceptions and the expected level of capital.

• Risk Based Supervision (RBS) in 23 banks had been introduced on a pilot basis.

• As per normal practice, and with a view to ensuring migration to Basel II in a non-disruptive manner, a consultative and participative approach had been adopted for both designing and implementing Basel II. A Steering Committee comprising senior officials from 14 banks (public, private and foreign) had been constituted wherein representation from the Indian Banks’ Association and the RBI was ensured. The Steering Committee had formed sub-groups to address specific issues. On the basis of recommendations of the Steering Committee, draft guidelines to the banks on implementation of the New Capital Adequacy Framework had been issued.

• The Reserve Bank had constituted a sub group of the Steering Committee for making recommendations on the guidelines that may be required to be issued to banks with regard to the Pillar 2 aspects. The guidelines with regard to Pillar 2 aspects covered the bank level initiatives that were required under Pillar 2.

The underlying philosophy while prescribing the Basel II principles for the Indian banking sector was that this must not result in further segmentation of the sector. Accordingly, it was decided that all scheduled commercial banks in India, both big and small, shall implement the standardised approach for credit risk and the basic indicator approach for operational risk with effect from March 31, 2007. (The following figure 8.2 would explain the working of Basel 2 matter)
By opting to migrate to Basel II at the basic level, the Reserve Bank has considerably reduced the Basel II compliance costs for the system. In a way, the elementary approaches which have been identified for the Indian banking system are very similar to the Basel I methodology. For instance,

a. there is no change in the methodology for computing capital charge for market risks between Basel I and Basel II;

b. the computation of capital charge for operational risk under the BIA is very simple and will not involve any compliance cost;

c. the computation of capital charge for credit risk will involve compilation of information in a marginally more granular level, which is expected to be achieved with a slight re-orientation of the existing MIS.

In the above circumstances, it might not be an entirely correct assessment that implementation of the elementary levels of Basel II significantly increases the cost of regulatory compliance. No doubt some additional capital would be required, but the
cushion available in the system, which at present has a Capital to Risk Assets Ratio (CRAR) of over 12 per cent, provides for some comfort. The banks have also started exploring various avenues for meeting the capital requirements. The Reserve Bank has, for its part, issued policy guidelines enabling issuance of several instruments by the banks viz., innovative perpetual debt instruments, perpetual non-cumulative preference shares, redeemable cumulative preference shares and hybrid debt instruments so as to enhance their capital raising options.

With a view to have an objective assessment of the true cost of implementation of Basel II, banks were advised to institute an internal study to make a true assessment of the costs involved – exclusively for the elementary approaches.

8.13 Operational Risk

Operational risk was one area which was expected to increase capital requirement for the banks. The Reserve Bank had announced in July 2004 that banks in India will be adopting the Basic Indicator Approach for operational risk. This was followed up with the draft guidelines for the Basel II framework in February 2005 where the methodology for computing the capital requirement under the Basic Indicator Approach was explained to banks. Even at the system level the CRAR of banks were well over 12 per cent. This reflects adequate cushion in the system to meet the capital requirement for operational risks, without breaching the minimum CRAR.

Since the loans and advances portfolios of Indian banks largely cover unrated entities that are assigned a risk weight of 100 per cent, the impact of the lower risk weights assigned to higher rated corporates would not be significant. However, given the investments into higher rated corporates in the bonds and debentures portfolio of the banks, the risk weighted corporate assets measured using the standardized approach may be subject to marginally lower risk weights as compared with the 100 percent risk weights assigned under Basel I (ICRA 2005).

In the case of retail exposure, which is the growth segment in the asset structure of most Indian banks post-liberalization, the RBI has gone with the lower 75 percent risk weight
prescribed under Basel II norms, as against the currently applicable risk weights of 125 percent and 100 percent for personal/credit card loans and other retail loans respectively. This is likely to accentuate the current tendency to diversify out of productive lending characterizing Indian banks.

The other benefit that Indian banks can exploit is the fact that they have a large short-term portfolio in the form of cash credit, overdraft and working capital demand loans, which are currently unrated, and carry a risk weight of 100 percent. They also have short-term investments in commercial papers in their investment portfolio, which also currently carry a 100 percent risk weight. The RBI's draft capital adequacy guidelines provide for lower risk weights for short term exposures, if these are rated. Thus would allow banks to benefit from their investments in commercial paper (which are typically rated in A1+/A1 category) and give them the potential to exploit the proposed short-term credit risk weights by obtaining short-term ratings for exposures in the form of cash credit, overdraft and working capital loans.

**An Illustration**

A typical bank portfolio has an exposure to retail loans, mortgage loans, personal/credit card loans, corporate loans, cash credit, working capital demand loans, corporate bonds and commercial papers. For illustration, we have considered a bank with exposures to these loans segments and applied the Basel I and new risk weights (under Basel II). Typically, a bank's corporate loan portfolio including cash credit and working capital demand loans has mostly unrated exposures. External ratings are used more in the investment portfolio, for investing in debentures, bonds, and commercial paper (typically A1+/A1), lowering the proportion of unrated exposures. The exposures and risk weight calculations for the hypothetical bank in the illustration is as follows
Table 8.1 - Difference between Basel 1 and 2 Risk weights

<table>
<thead>
<tr>
<th>Share of advances</th>
<th>Basel 1</th>
<th>Basel II risk</th>
<th>Basel II Risk</th>
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<tbody>
<tr>
<td></td>
<td>Weighted assets</td>
<td>weights</td>
<td>weights</td>
</tr>
<tr>
<td>Personal credit 2.00%</td>
<td>125%</td>
<td>2.50%</td>
<td>75%</td>
</tr>
<tr>
<td>Mortgage 12.00%</td>
<td>75%</td>
<td>9.00%</td>
<td>100%</td>
</tr>
<tr>
<td>Other retail loans 8.00%</td>
<td>100%</td>
<td>8.00%</td>
<td>75%</td>
</tr>
<tr>
<td>Corporate Loans 28.00%</td>
<td>100%</td>
<td>28.00%</td>
<td>100.90%</td>
</tr>
<tr>
<td>Cash Credit &amp; 40.00%</td>
<td>100%</td>
<td>40.00%</td>
<td>100.00%</td>
</tr>
<tr>
<td>Corporate Bonds 9.00%</td>
<td>100%</td>
<td>9.00%</td>
<td>72.70%</td>
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<tr>
<td>Corporate CPs 1.00%</td>
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<td>20.60%</td>
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<tr>
<td>Total 100.00%</td>
<td>97.50%</td>
<td>94.50%</td>
<td></td>
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</table>

Long term ratings

<table>
<thead>
<tr>
<th>Long term ratings</th>
<th>corporate</th>
<th>Weighted assets (Basel1)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Basel 2 Risk wghts</td>
<td>Basel II</td>
</tr>
<tr>
<td>LAAA 20%</td>
<td>2.00%</td>
<td>0.40%</td>
</tr>
<tr>
<td>LAA 50%</td>
<td>5.00%</td>
<td>2.50%</td>
</tr>
<tr>
<td>LA 100%</td>
<td>15.00%</td>
<td>15.00%</td>
</tr>
<tr>
<td>LBBB &amp; below 150%</td>
<td>10.00%</td>
<td>15.00%</td>
</tr>
<tr>
<td>Unrated 100%</td>
<td>68.00%</td>
<td>68.00%</td>
</tr>
<tr>
<td>Total</td>
<td>100.00%</td>
<td>100.90</td>
</tr>
</tbody>
</table>
The net result is that the implementation of Basel II does provide Indian banks the opportunity to significantly reduce their credit risk weights and reduce their required regulatory capital, if they suitably adjust their portfolio by lending to rated but strong corporates, increase their retail lending and provide mortgage under loans with higher margins. This would, of course, change the proportion of lending in their portfolio and the direction of their lending. But, even if they do not resort to that change, ICRA estimates that the implementation of Basel II would result in marginally lower credit risk weights and a marginal release in regulatory capital needed for credit risk.

However, the same does not hold for operational risk. The Basic Indicator approach specifies that banks should hold capital charge for operational risk equal to the average of the 15 per cent of annual positive gross income over the past three years, excluding any year when the gross income was negative. Gross income is defined as net interest income and non-interest income, grossed for any provisions, unpaid interest and operating expenses (such as fees paid for outsourced services). It should only exclude treasury gains/losses from banking book and other extraordinary and irregular income (such as income from insurance).

Besides this, the exact amount of capital that banks would need would depend on the legacy of bad debt or non-performing assets they carry. Much of the discussion on Basel II is based on the presumption that the problem of bad debt has been substantially dealt with. In the recent past, banks have been able to reduce their provisioning needs by adjusting their non-performing assets. The proportion of total NPAs to total advances declined from 23.2 per cent in March, 1993 to 7.8 per cent in March, 2004.

Among the many routes that were pursued to deal with the accumulating bad debt legacy, there were some that received special attention. The first and most obvious route was to set aside potential profits as provisions for bad assets. Banks have gone part of the way in this direction. The cumulative provisions against loan losses of the public sector banks worked out to 42.5 per cent of the gross NPAs for the year that ended on 31 March 2002 while international norms are as high as 140 per cent. Subsequently, the scheduled commercial banks (SCBs) raised provisions towards NPAs by as much as 40 per cent in 2003-
By the end of 2003-04, cumulative provisions of SCBs accounted for 56.6 per cent of gross NPAs.

The second was infusion of capital by the government into the public sector banks. It is estimated that the government had injected a massive Rs 20,446 crore towards recapitalization of public sector banks (PSBs) till end-March 1999 to help them fulfil the new capital adequacy norms. Subsequently, the S.P. Talwar and Verma committees set up by the finance ministry had recommended a two-stage capitalization for three weak banks (Indian Bank, United Bank of India and United Commercial Bank) involving infusion of a total of Rs 2,300 crore for shoring up their capital adequacy ratios. Similar infusion arrangements have been underway in the case of financial institutions like the IDBI and IFCI and in bailing out UTI, involving large sums of tax-payers’ money.

Finally, there are efforts to retrieve as much of these assets as possible from defaulting clients, either by directly attaching the borrowers' assets and liquidating them to recover dues or by transferring NPAs to specialized asset reconstruction or asset management companies. The government tried to facilitate recovery through the ordinance issued in June 2002, which was subsequently replaced by the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Bill passed in November 2002.

It should be obvious that of the above ways to deal with the legacy of NPAs, the first two are means that involves putting good money in to adjust for bad money, preempting the additional resources that the banks and the government can put into the system. It was only the third, involving a change in the legal framework governing the relations between lenders and borrowers, which involved penalties on the defaulting borrowers. However, it is here that the progress has been slow.
7.13 Rating agencies

In terms of Basel II requirements, national supervisors are responsible in determining whether the rating agencies meet the eligibility criteria. The criteria specified are objectivity in assessment methodology, independence from pressures, transparency, adequate disclosures, sufficient resources for high quality credit assessments and credibility.

India has four rating agencies of which three are owned partly/wholly by international rating agencies. Compared to developing countries, the extent of rating penetration has been increasing every year and a large number of capital issues of companies has been rated. However, since rating is of issues and not of issuers, it is likely to result, in effect, in application of only Basel I standards for credit risks in respect of non-retail exposures. While Basel II provides some scope to extend the rating of issues to issuers, this would only be an approximation and it would be necessary for the system to move to rating of issuers. Encouraging rating of issuers would be essential in this regard.

The borrowers were expected to approach the rating agencies for getting themselves rated, failing which banks would be constrained to assign 100% risk weight at the minimum for unrated borrowers.

The Reserve Bank had invited all the four rating agencies to make a presentation on the eligibility criteria and a self assessment with regard to these criteria. The rating agencies have since made their presentations and their ratings can be used by banks for risk weighting purposes.

7.14 Migration to advanced approaches

As a well established risk management system is a pre-requisite for implementation of advanced approaches under the New Capital Adequacy Framework, banks were required to examine the various options available under the Framework and lay a road-map for migration to Basel II. [The minimum requirements to be met by banks for adopting the advanced approach relate to (a) internal rating system design, (b) risk rating system operations, (c) corporate governance and oversight, (d) use of internal ratings, (e) risk quantification, (f) validation of internal estimates, (g) requirements for recognition of
leasing, (h) calculation of capital charges for equity exposures and (i) disclosure requirements. Hence, it is necessary that banks desirous of adopting the advanced approaches do a stringent assessment of their compliance with the minimum requirements before they shift gears to migrate to these approaches. In this context, current non-availability of acceptable and qualitative historical data relevant to ratings, along with the related costs involved in building up and maintaining the requisite database, does influence the pace of migration to the advanced approaches available under Basel II.

Banks which were internationally active should look to significantly improve their risk management systems and migrate to the advanced approaches under Basel II since they will be required to compete with the international banks which are adopting the advanced approaches. This strategy would also be relevant to other banks which are looking at adoption of the advanced approaches. Adoption of the advanced approaches will require adoption of superior technology and information systems which aid the banks in better data collection, support high quality data and provide scope for detailed technical analysis - which are essential for the advanced approaches. Hence, banks aiming at maintaining lower capital by adopting the advanced approaches would also have to be prepared to meet the higher information needs.

- Implementation of advanced approaches under Basel II will not be mandatory for small banks which are undertaking traditional banking business and have a regional or limited presence.
- Implementation of advanced approaches under Basel II should not be considered as fashionable and implementation of elementary approaches should not be considered as inferior.
- Any decision to migrate to the advanced approaches should be a well deliberated, conscious decision of the bank’s Board, after taking into account, not only their capacity to compute the capital requirement under those approaches but also their capacities to sustain the bank’s risk profile and the consequent capital levels under various scenarios, especially stress scenarios.
- The preconditions for migration to the advanced approaches would include (a) well established, efficient and independent risk management framework; (b) supported
by well established, efficient IT and MIS infrastructure; (c) cost benefit analysis of adoption of advanced approaches; (d) availability of appropriate skills and capacity to retain / attract such skills at all points in time; and (e) a well established, effective and independent internal control mechanism for supplementing the risk management systems (Figure 8.3 who are involved?) (8.4- Comparison of Basel accord and 8.5- Changed Capital requirements are from STC Presentations)
(Introduction to Basel Two- presentations of STC, SBI, Hyderabad)

From the above, it's clear that Basel two norms score over Basel 1 and is more comprehensive in its approach and assures a solid capital base in proportion to its risk. As per the latest norms, public sector banks and old private Sector banks should have a CAR ratio of 8%, New private Sector banks need to have a CAR of 9%. Insurance Companies and foreign banks to have capital adequacy of 10%.