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Author: Dr. Bhavik Swadia

S.M. Patel Institute of commerce, GLS University, India

CAPITAL ADEQUACY: A FINANCIAL SOUNDNESS INDICATOR FOR LENDING ACTIVITY OF SELECTED PUBLIC SECTOR BANKS OF INDIA

Dr. Bhavik Swadia

S.M.Patel Institute of commerce,

GLS University, India

bhavik_uswadia@yahoo.co.in

ABSTRACT

Along with profitability and safety, banks also have to focus on solvency, solvency refers to the situation where assets are equal to or more than liabilities. A Bank should select its assets in such a way that the shareholders and depositors' interest are protected. Capital acts as a buffer in times of crisis or poor performance by a bank. Sufficiency of capital also instils depositors' confidence. As such, adequacy of capital is one of the pre-conditions for licensing of a new bank as well as its continuance in business.

INTRODUCTION

The traditional approach to sufficiency of capital does not capture the risk elements in various types of assets in the balance sheet as well as in the off-balance sheet business and compare the capital to the level of the assets. The Basel Committee* on Banking Supervision had published the first Basel Capital Accord (popularly called as Basel I framework) in July, 1988 prescribing minimum capital adequacy requirements in banks for maintaining the soundness and stability of the International Banking System and to diminish existing source of competitive inequality among international banks. The basic features of the Capital Accord of 1988 are as under:

(i) Minimum Capital Requirement of 8% by end of 1992.

(ii) Tier approach to capital:

Core Capital: Equity, Disclosed Reserves

Supplementary Capital: General Loan Loss Reserves, Other Hidden Reserves, Revaluation Reserves, Hybrid Capital Instruments and Subordinate Debts

50% of the capital to be reckoned as core capital.

(iii) Risk Weights for different categories of exposure of banks ranging from 0% to 127.5% depending upon the riskiness of the assets as indicated in Annex 1. While commercial loan assets had a risk weight of 100%, inter-bank assets were assigned 20% risk weight; sovereign paper carried 0 % risk weight. In 2002, maintenance of capital

funds as a percentage of risk weighted assets was extended to all UCBs. Since 2005, the minimum Capital to Risk Assets Ratio that is expected to be maintained is 9 percent. Further, vide 1996 amendment to the original Basel Accord, capital charge was prescribed for market related exposures.

CAPITAL ADEQUACY RATIO

A bank's capital ratio is the ratio of qualifying capital to risk adjusted (or weighted) assets. The RBI has set the minimum capital adequacy ratio at 9% for all banks. A ratio below the minimum indicates that the bank is not adequately capitalized to expand its operations. The ratio ensures that the bank do not expand their business without having adequate capital.

CAR = Tier I capital + Tier II capital / Risk weighted assets

It must be noted that it would be difficult for an investor to calculate this ratio as banks do not disclose the details required for calculating the denominator (risk weighted average) of this ratio in detail. As such, banks provide their CAR from time to time.

Tier I Capital funds include paid-up equity capital, statutory and capital reserves, and perpetual debt instruments eligible for inclusion in Tier I capital.

Tier II Capital is the secondary bank capital which includes items such as undisclosed reserves, general loss reserves, and subordinated term debt, amongst others.

SBI, Canara Bank, PNB, BOI, and BOB has selected from public sector as a sample for the present study.

TOOLS & TECHNIQUES

For the present study, Ratio-Analysis in percentage as an Accounting tools and F-Test - ONE WAY ANOVA is used as tools of Statistics.

Capital Adequacy Ratio (CAR)

Tier II Capital includes loan loss reserve or undisclosed capital reserves, preferred stocks with maturity of at least 20 years, certain revaluation reserves and general loan provisions, subordinated debt with an original maturity of at least 7 years. For the present Study researcher has studied on Capital Adequacy Ratio (Tier II) as Tier II is based on loans and advances.

OBJECTIVE OF THE STUDY

To study the financial soundness indicator for lending activity of selected public sector banks of India as a capital adequacy norms

PERIOD OF STUDY

The study period is to be converted 5 years; from 2011-12 to 2014-15.

NO. OF SAMPLE

PRIORITY SECTOR ADVANCES TO TOTAL ADVANCES RATIO

Table 1 Ratio of Priority Sector Advances To Total Advances						
Name of Bank	Year					Average
	2011	2012	2013	2014	2015	
SBI	4.21	4.07	3.43	2.72	2.40	4.21
CANARA	4.51	3.41	2.63	2.95	2.54	3.61
PNB	3.98	3.35	2.96	2.65	2.91	3.00
BOI	3.84	3.36	2.82	2.73	2.56	2.81
BOB	4.53	3.84	3.17	3.00	2.74	2.63
Formula : (Priority Sector Advances/Total Advances) x 100						
Source: rbi.gov.in						

Analysis for calculated ratio for selected Public Sector Banks of India

From the above table it is clear that Average Capital Adequacy Ratio (Tier II) for selected public sector banks is showing between 2.8% to 4.20% during research period As Tier II shows loan loss reserve or undisclosed capital reserve or certain revaluation

reserve and general loss provision all this has concern with NPA and proportion of Tier II with weighted Average Capital is considered for Capital Adequacy Ratio (Tier II).

STATISTICAL ANALYSIS

H_0: All the selected Public Sector of India have equal norm with respect to Capital Adequacy Ratio (Tier II).

H_1: All the selected Public Sector of India have unequal norm with respect to Capital Adequacy Ratio (Tier II).

Table 2					
"F"-Test One Way ANOVA for Ratio of Priority Sector Advances to Total Advances for Selected Public Sector Banks of India					
Source of Variation	Sum of Square	Degree of Freedom	Mean Sum of Square	F_c	F_t
B.S.S.	8.477536	4	2.119384	29.16209	2.866081
W.S.S.	1.45352	20	0.072676		
T.S.S.	9.931056	24			

From the "F" test one way ANOVA Table as calculated above it shows that Calculated value of F_c = 29.16209 while tabular value of F_t = 2.866081 which show that calculated value F_c is greater than tabular value F_t, $F_c > F_t$ Hence Null Hypothesis is rejected and Alternative Hypothesis is accepted that All the selected Public Sector Banks of India have unequal norm with respect to Capital Adequacy Norms (Tier II) during research period.

GRAPHICAL ANALYSIS

Chart 1
Average Capital Adequacy Ratio (Tier II)
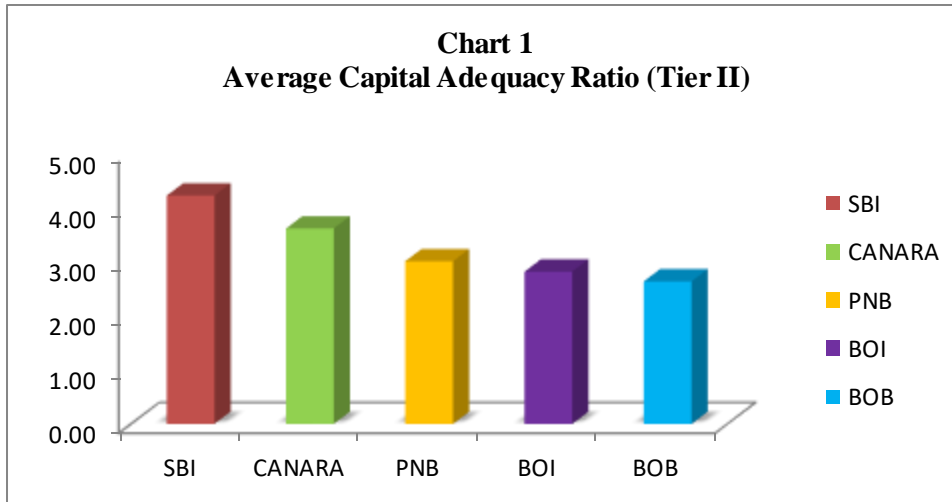
By observation of the graph of selected Public sector banks of India it shows overall fluctuation 2.8 % to 4.2% ranging during the research period for the Capital Adequacy Ratio (Tier II) during research period by research units.

CONCLUSION

Accordingly to the analysis, it shows that financial soundness indicator for lending activity as capital adequacy norms Tier II for the entire selected research units are showing overall fluctuation 2.8 % to 4.2% ranging during the research period for the Capital Adequacy Ratio (Tier II) during research period by research units during the research period.

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