BASEL - II - BANKERS' PERSPECTIVE

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1. Introduction

As bankers we need to realize that :

a) Basel II will become a **new regulatory requirement** with effect from 01st January 2008, whether one likes it or not.

b) By 01st January 2008, a significant number of countries may have implemented Basel II, with some countries adopting the advanced approaches.

c) After about 5-7 years, Sri Lanka too would be compelled by circumstances to move into these advanced approaches, when the rest of the world is moving in this direction.

d) Individual banks in Sri Lanka too will be compelled to move into advanced approaches, when they realize that other banks are moving in this direction.

Hence, it is necessary to formulate and agree on a clear Road Map for implementing the different stages of Basel II, which will be a long "journey" for bankers. Such a Road Map has been designed by the Central Bank , with the following mile-stones.

Period up to 31st December 2007 will be the pre-implementation period and the task during this period should be to:

* Prepare the **test calculations accurately,** on the capital charge under the Basel II for the credit, market and operational risks and submit quarterly returns to the Central Bank on time, in addition to the returns to be submitted on the regulatory capital charge, under the Basel I. However, it is felt that these Test Calculations are still not being done properly, due to several unresolved issues, remaining outstanding.

* Acquire a clear knowledge on the rationale & advantages of Basel II and realize that this is not only a mere regulatory requirement, but also a value adding exercise, if implemented properly. Hence, banks need to identify the benefits accruing to them under Basel II and implement it in a proper manner, to reap these benefits. Then only will they be able to justify the cost and involvement, in implementing Basel II.

* Educate the staff on the different capital calculation methods to be adopted under different approaches. In this connection, bankers will have an up-hill task of educating the staff on the complex Basel II, as the staff may not be adequately conversant even with the simple Basel I, due to the limited staff involvement in it.

* Identify IT related issues involved in the test calculation process and explore the possibility of providing IT backed solutions as much as possible, to minimize the manual work.

* Identify and implement the operational changes that are needed for proper implementation of Basel II such as establishment of proper Risk Management Departments.

* Endeavor to promote a new credit culture in which credit rating becomes a standard practice and the customers improve their financials and data quality, facilitating realistic credit ratings possible in this market.

* Assess the capital requirements of the respective banks, based on the outcome of their test calculations and take appropriate capital raising measures, if necessary.

* Appoint a Task Force at each bank to co-ordinate and implement action plan.

* Get the involvement of the top managements of banks for implementation of Basel II, in addition to the staff education referred to above.

* Make necessary budgetary allocations, as banks may have to acquire/ develop necessary software support for effective implementation of Basel II.

Period after 01st January 2008. (post- implementation period)

* Fulfill all requirements under the Three Pillars of Basel II.

    - Comply with **Pillar I** requirements of Basel II, by maintaining the regulatory capital of banks under the prescribed Approach.

        - Credit Risk- Standardized Approach.
        - Market Risk-Standardized Measurement Approach.
        - Operational Risk- Basic Indicator Approach.

    - Improve credit quality and overall risk management practices to reap the full benefits of Basel II.

    - Try to introduce **risk-adjusted pricing,** based on the risk profile of the customers and the capital charge thereon.

- Take the necessary **capacity building measures**, required for migrating to the Advanced Approaches, at the appropriate time.

- In particular, develop the IT capabilities to handle **internal credit rating** and **risk weighting functions** of customers internally, under the **Internal Ratings Based (**IRB) Approaches.

Migration to the Internal Ratings Based (IRB) Approaches

No time frame has been fixed. However, Banks need to fulfill two fundamental requirements to move into the IRB Approaches; namely

i. They need to have a proper internal rating system to credit rate the customers internally.

ii. They also need to have a proper data base developed on the loss data, to determine the risk weights to be applied. Unlike in the **Standardized Approach (S/A)**, no standard set of risk weights are made available in the IRB Approaches. Hence, these are to be determined by each Bank on the basis of its own data history. Development of such a data base will require 5-7 years of data history.

Hence, Sri Lankan Banks are very likely to take at least 5 years to move into the IRB Approaches even if they start the process now.

2. Identification of issues and finding solutions under the Standardized Approach on credit risk.

All Banks operating in Sri Lanka have already commenced test calculations under the **S/A**, as per the **draft guidelines** issued by the Central Bank. Hence, even Foreign Banks operating in Sri Lanka will have to adopt the **S/A** for their regulatory purposes during this initial period, even if they are in a position to adopt the IRB Approach for their internal / group purposes.

There is no change in the capital charge of 10%, despite two more risks being factored into the capital adequacy framework and only the **Risk Weighting** process has undergone major changes, as detailed below.

- Additional risk groups for customers /advances have been introduced in Basel II

- Additional risk weights too have been introduced.

Table 1.

Basel I	Basel II
i. Domestic Sovereign / Central Banks ii. Foreign Sovereigns / CentralBanks. iii. Commercial / Development Banks. iv. Residential Mortgage Loans. v. Advances secured by certain guarantees. vi. Other Advances	i. Domestic Sovereign / Central Banks ii. Foreign Sovereigns / Central Banks. iii. **Non Govt. Public Sector Entities** iv. **MDBs, BIS and IMF** v. Commercial / Development Banks. vi. **Stockbrokers, Primary Dealers, Finance Companies, Leasing Companies, Merchant Banks and Investment Banks.** vii. **Corporates.** viii. **Insurance Companies.** ix. **SMEs.** x. **Regulatory Retail Portfolio.** xi. Residential Mortgage Loans .xii. **Commercial Real Estate.** xiii. **Non –Performing Loans.**

Note : Highlighted are the new risk groups.

Hence, banks are required to classify all their products / advances according to these new risk groups, adopting the prescribed definitions.

* The risk group, called "**corporate**" above, has no specific definition in Basel II and hence all customers who **do not fall** into any of the other defined categories will have to be classified as "corporate".

* This may clash with the normal "corporate" definition, currently adopted by banks.

* As NPLs have been categorized as a separate risk group, only the performing products / advances could be included in the other risk groups, referred to above..

Table 2.

Basel I	Basel II
0%	0%
10%	10%
20%	20%
50%	35%
100%	50%
	75%
	100%
	150%

Note : Highlighted are the new risk weights

Certain risk groups have been assigned with multiple risk-weights:

Unlike in Basel I, some risk groups (referred to in i-viii above) are assigned with **multiple risk weights, (**ranging from 0% -150%), to be assigned to different customers within the same risk group, whereas the other risk groups have been assigned with a single risk-weight.

3. Credit Rating related issues.

Assigning different risk weights to different customers in the risk group is to be done on the basis of their individual credit risk, measured in terms of their **credit rating;** an entirely new exercise introduced into the capital adequacy framework Basel II. Hence, Basel II has attempted to convert the Capital Adequacy Framework into a ratings based one.

Nevertheless, banks are not expected under the **S/A,** to undertake **internally** any credit rating of their customers. (This will be required only under the IRB Approaches). This exercise has been assigned entirely to the External Credit Rating Agencies (ECRA), approved by the Central Bank and banks are expected to go by their ratings.

Once the credit rating is given by an ECRA to a particular customer, banks are required under the Standardized Approach to pick the appropriate risk weight given in Basel II and assign same to the customer. (Under the IRB Approach, the risk weight too has to be determined internally by banks , in addition to the credit rating). Hence, internal credit ratings at banks, even if available, should not be used for this purpose, under the S/A. This is the way Basel II has attempted to capture credit risk of advances in risk weighting them; a factor completely omitted in Basel I.

Though the Standardized Approach is **comparatively easier** than the IRB Approach to this extent, there are several external credit rating related issues to be dealt with by Banks, under the S/A.

a) Credit rating is something new for our markets. Even some of the best corporate customers are not yet rated.

b) Only two credit rating agencies in the country.

c) This is a costly exercise.

d) Even if customers are willing / persuaded to obtain credit ratings, the quality of their financials may pose a serious problem for proper credit rating.

- Only a few companies may have audited accounts.
- Some may not have any formal financial statements.
- Most of the financials available may have been prepared for tax purposes.
- If these financials are submitted, they may not get proper credit ratings.
- A customer may be able to get a loan from a credit officer, without having proper financials. However, he may not get a credit rating from an ECRA, in the same manner.
- Option in Basel II to remain un-rated and be risk weighted at 100% may be preferred by some customers, rather than taking the risk of being risk weighted at 150%.
- Hence, a large number of customers in market like ours may fall into the unrated category and continue to be risk weighted at 100%, which is as same as in Basel I.

4. Risk groups with a single and concessionary risk weight being assigned:

Under the S/A, the remaining risk groups referred to in (a) (b) and (c) below, are assigned with a **single risk weight** to be applied to **all** the customers, within the risk group irrespective of their individual credit quality. Hence, banks may apply this single risk weight on the total of the respective risk groups.

4.1 Regulatory SME Portfolio

a. Regulatory Retail Portfolio is the main such risk group in Basel II, with a **single** and a **preferential** risk weight of 75% being assigned with, as against 100% risk weight in Basel I.

b. However, this single risk weight of 75% is available only on the **performing** SME advances, as NPLs are to be dealt with separately

c. As the risk weight is common for all advances, no individual credit rating for customers in the risk group is necessary.

d. However, **proper identification** of these customers may be a **problem,** as the prescribed definition is different.

- Assets value not exceeding Rs.35 million, excluding land and buildings.
- **Aggregate exposure** to one customer not exceeding Rs.35 million.
- Annual turnover limit is yet to be determined (the Basel II Sub-Committee of the SLBA is to make recommendations to the Central Bank).
- Product criteria confined to revolving credit lines including overdrafts, term loans and leases.

e. Core-banking software systems of most banks may not have some of these criteria such as assets size; annual turnover etc. to identify these SME advances.

f. Hence, most banks are still evaluating the following options to identify them.

- Effect suitable software modifications or Acquire new software.
- Handle the task manually

Basel II Sub- Committee of the SLBA is looking into these issues to make appropriate recommendations to the Central Bank. Hence, the Test Calculations done by banks in this area may still not be entirely accurate.

g. In addition, there is also the **Granularity Criterion** on SMEs. (aggregate exposure to one customer without Credit Risk Mitigation (CRM), should not exceed 0.2% of the total **Regulatory SME portfolio.)**

Table 3. Banks with large SME portfolios will be at an advantage, under this criterion.

Total SME	**Bank A Rs.17.5 Bn.**	**Bank B Rs.10 Bn.**	**Bank C Rs.5 Bn.**	**Bank D Rs.1 Bn.**
Single customer Limit @ 0.2%	Rs.35 Mn.	Rs.20 Mn.	Rs.10 Mn.	Rs.2 Mn.

- As shown for Bank "A" above, any bank needs to have a base of Rs. 17.5 Bn. to accommodate a customer up to Rs.35 Mn., in their SME portfolio.
- Bank "B" cannot accommodate the same customer in their SME portfolio, due to their lower base.
- Hence, small banks have requested the Central Bank to give them some relief on this issue.
- Banks also cannot apply the granularity criterion, until the definitions are finalized.

h. Banks run the risk of being compelled to treat these SME advances as "corporate" and risk weight them at 100%, in the event they fail to identify them properly, according to the prescribed criteria.

i. Though, a single risk weight of 75% could be applied on the total of SMEs, the individual SME advances will have to be adjusted o/a of eligible collateral given by the customers, if any , under the CRM process of Basel II.

4.2 Regulatory Retail Portfolio

a. A single and concessionary risk weight of 75% could be applied on Regulatory Retail Advances, as against 100% risk weight applied in Basel I. However, this too is confined to the performing Regulatory Advances, as the NPLs are to be dealt with separately.

b. No individual credit rating is necessary and the single risk weight could be applied on the total.

c. However, a different definition has been prescribed, in identifying them.

- Only small **non-business** loans granted to **individuals,** that fulfills the following criteria could be included.

    - Product type: Personal loans, such as vehicles loans, educational loans, consumer durable loans, credit cards, personal overdrafts and personal leases.

    - Aggregate loan size (including all loans and overdrafts to the customer : Rs.10.0 Mn. or 0.2% of the capital funds of the bank, whichever is lower).

    - Single customer exposure not to exceed the Granularity Criterion of 0.2% of the total Regulatory Retail Portfolio of the respective banks.
- Identification of these retail advances on the core banking IT systems of banks may be a problem. Hence, banks may have to make suitable arrangements / modifications in their IT systems to identify these advances. Hence, the test calculations in this area too cannot be still accurate

- Under this criterion too, banks with a large base of Regulatory Retail Advances and /or Capital Funds would stand to benefit.
- As shown above, a bank needs to have a base of Rs. 5.0 Bn. on Regulatory Retail

Advances and Capital Funds of Rs.5.0 Bn. to accommodate a customer up to Rs.10 Mn., in their SME portfolio. Bank "B" cannot accommodate the same customer in their SME portfolio, due to their lower base on these two.

- Small banks with a low base in Retail Portfolio and new banks with a low capital base may be at a disadvantageous position. Hence, these banks have requested the Central Bank to give them some relief on this issue.

Table 4.

Total Retail / Capital Funds	Bank A Rs..5. 0 Bn.	Bank B Rs.2..5 Bn.	Bank C Rs.1.0 Bn.	Bank D Rs.0. 5 Bn.
Single customer limit @ 0.2%	Rs.10 Mn.	Rs.5.0 Mn.	Rs.1.0 Mn.	Rs.1.0 Mn.

d. Banks run the risk of being compelled to treat these retail advances as "corporate" and risk weight them at 100%, in the event they fail to identify them properly according to the prescribed criteria.

e. Though, a single risk weight of 75% could be applied on the total, the individual Regulatory Retail advances too will have to be adjusted o/a of eligible collateral given by the customers, if any, under the CRM process of Basel II.

4.3 Residential Mortgage Loans

a. A single risk weight of 35% could be applied on Residential Mortgage Loans, as against 50% risk weight applied in Basel I (Subject to local regulatory validation). Once again the NPLs should not be included, as they are to be dealt with separately.

b. No individual credit ratings are necessary for the individual advances and hence the risk weight of 35% could be applied on the total.

c. However, the loans should be strictly for residential purposes and hence loans for commercial buildings are excluded. The following may be included
   - Loans for owner-occupied or will be occupied properties
   - Loans for rented or to be rented properties
   - Loans for condominium properties

d. No upper limits on loans have been fixed, but loan size should not exceed 75% of the valuation of property, at the time of granting the loans. Hence, banks need to refer to the original loan documentation to make this verification.

e. If the loan has been granted for both land and buildings, valuation of property will be done as follows :
   - Land ; according to professional valuation
   - Building ; as per the BOQ

f. Loan amount in excess of 75% of the valuation, if any, may be risk weighted at 100%.

g. Banks need to identify these loans properly, to be entitled to apply the concessionary risk weight of 35%.

4.4 Duty of banks with regard SME, Retail and Residential Mortgage advances.

a. The preferential risk weights assigned to these categories are incentives to promote these advances, which are considered priority products in developing countries like ours. Hence, banks are expected to sort out the identification and other IT issues and apply as much as possible on them, the preferential risk weights made available in Basel II.

b. Failure to do so, may result in these advances being risk weighted at 100%. This would be a burden both on the bank and the customer, as the bank has to provide additional capital on the advance and the customer may have to pay for it, by way of higher pricing.

c. Such banks may not be able to pass down any price benefit to the customers and hence they may lose the competitive advantage in the market.

4.5 Non –Performing Advances.

a. NPLs in all risk groups are to be tackled as a separate category in Basel II. In the case of overdrafts, interest in suspense should be netted before any risk weighting. (as in Basel I)

b. There are two sub-categories of NPLs and their risk weights depend on the extent of specific provisions available.

Table 5: Non-Performing Residential Mortgage Loans.

	Extent of the loan, covered by specific provisions	Balance amount of the loan
Specific provisions < 20% of the outstanding amount of the loan	Set-off the provision against the loan	Risk weight at 100%
Specific provisions > 20% of the outstanding amount of the loan	- do -	Risk weight at 100%

Table 6: Other Non-Performing loans (except residential mortgage loans) & overdrafts

	Extent of the loan, covered by specific provisions	Balance amount of the loan
Specific provisions < 20% of the outstanding amount of the loan	Set-off the provision against the loan	Risk weight at 150%
Specific provisions > 20% of the outstanding amount of the loan	- do -	Risk weight at 100%

- Hence, all NPLs will be individually risk weighted, depending on the extent of provision cover, against them. However, no individual credit rating will be needed.

- Consequent to the above, non-performing loans between 90-180 days, will require a very high capital charge. They may have not have any loan loss provisions to be deducted during this period and hence the full loan will have to be risk weighted at 150%. However, when they cross the 180 days period and are provided at least up to 20%, the risk weight comes down to 100%, to be applied only on the un-provided portion of the loan.

- Banks need to have customer-wise balances of Interest in Suspense (against overdrafts) and loan loss provisions, on their IT systems to handle this risk weighting of NPLs on the IT systems. The necessary fields will have to be up dated, if available in the IT systems to accommodate these particulars. If not available, banks will have decide whether it is possible to create such fields, without compromising too much on the computer security or to purchase a suitable software, catering to Basel II.

- If there are eligible collateral, the value of those should also be adjusted appropriately, before the un-provided portion of the loan / overdraft is risk-weighted.

5. Credit Risk Mitigation in Basel II, based on eligible Collateral

5.1 Eligible collateral

a) Even Basel I recognized following collateral, the value of which could be set off against the advances, in the process of risk weighting them.

   i) Cash deposits with the lending bank, with a legal right to set-off against the advance.
   ii) Gold or jewellery, provided as collateral against the advance.
   iii) Guarantees of the Government/ Central Bank, against which advances have been granted.
   iv) Central Bank / Government Securities, against which advances have been granted.
   v) Provident fund balances of the staff against which advances have been granted.
   vi) Bank guarantees, against which advances have been granted.

b) All these collateral (except the **provident fund balances** referred to above) have been recognized so far as "eligible collateral" in the draft guidelines issued by the Central Bank, for Basel II purposes.

c) In addition to the above , Basel II recognizes the following too as eligible collateral, for the purposes of credit risk mitigation.

   (i) Rated Debt securities :

- With at least BB- when issued by sovereigns or Public Sector Entities (PSEs), treated as sovereign by the national supervisor.

It should be noted that on clarification, the Central Bank stated that the above should strictly apply to the **sovereign debt of other countries** and the **sovereign debt of Sri Lanka** should be given the zero risk weight.

- With at least BBB- when issued by other entities (including banks, securities firms and PSEs not treated as sovereign).

- With at least A-3 / P-3 for short term debt instruments.

- **Unrated debt securities :**

  - Issued by a bank, listed on a recognized stock exchange and classified as a **senior debt** are eligible. Hence **subordinated debt securities such as debentures and deposits** of banks may not be eligible. These instruments may be very rare in markets like ours.

  - These too are subject to a discount of 25% of the market value.

- **Equities (including convertible bond) of companies:**

  - Should be listed and included in a **main index.** (may be Milanka, but yet to be clarified) and subject to a discount of 25% of the market value.

d) Only the above collateral are considered "**eligible collateral**" in Basel II and hence other collateral such as land & buildings, stocks etc **are not eligible** for credit risk mitigation. However, banks can continue to accept them as collateral for loans and even adjust the value in provisioning.

e) Value of these **"eligible collaterals"** should be considered across the loan book, before the loans in any risk category (corporate, retail, non-performing loans etc) are risk weighted.

f) Collateral such as cash deposits, gold etc which are considered risk free could be set off against the advances, up to 100% of the value of the collateral. Hence, in these instances, only the balance portion of the loan, un-covered by such collateral, if any, is to be risk weighted.

g) Government / Central Bank guarantees and Government / Central Bank securities referred to above too could be set off against the advance up to 100% of the value, provided that:

- the advance and the collateral are designated in the same currency and
- value of the instrument is adjusted o/a the prescribed discounts, if any.

h) In the case **other eligible collateral** referred to above, namely **bank guarantees**, **debt instruments** of all non-sovereign entities including banks and **equities** of companies, the CRM approach is different, as detailed below.

- As the collateral is associated with **some degree of risk,** the value of same cannot be set off 100% against the advances. Hence, Banks have to first determine the **value** of the collateral, after adjusting for the prescribed discounts, if any.

- Then they have to ascertain the risk weight of the collateral by reference to its credit rating, if any.

- Thereafter, they need to compute the risk weighted value of the collateral, by applying the risk weight on the value of the collateral and

- Then substitute the risk weighted value of the collateral as computed above, on the value of the collateralized portion of the advance, provided the risk weighted value of the collateral is lower. If the risk weighted value of the collateral is higher than that of the customer, the collateral should be ignored.

i) Though the IT systems of some banks may have the necessary fields to accommodate different collateral against the advances, these fields may not have been fully used by them. Hence, such banks need to update these fields in respect of all **existing** loans and overdrafts and also for the **new** facilities to be granted in future, with proper collateral codes to be assigned.

j) Further, banks may have to modify the IT systems to accommodate additional information on collateral, such as their credit ratings, risk weights etc. Banks also need to find out as to how the risk weights applicable on different collateral be substituted in the IT system, with those of the respective customers. Hence, they need to seriously consider whether their core-banking systems can be modified to handle these functions or they will have to either develop or purchase suitable software system.

k) In the event banks deciding to acquire new software, they need to ensure that :
- The software is capable of catering to all evolutionary stages of Basel II.
- Regulatory validation is obtained.
- Cost of justifiable.

l) In view of these issues, it is felt that the banks are still not handling these additional collateral properly, in their Test Calculations.

6. Assessment of Impact on the Regulatory Capital of Banks, under Basel II

This is the other important task for banks during the pre-implementation period**.** However, this cannot be done properly, until the above issues are properly resolved and hence only a broad assessment can be made as follows.

6.1 On different risk groups.

a. Domestic Sovereign and Central Bank- No change in capital charge, as there is no change in the risk weight.

b. Foreign Sovereigns and Central Banks.
   - Risk weighted at 10% - 20% in Basel II.
   - Risk weighting varies from 0% -150% under Basel II.
   - Some may move into higher risk weights.
   - Hence, the capital charge may rise, but these claims are very limited in our markets.

c. Claims on Non-Central Government Public Sector Entities
   - All were risk weighted at 100% under Basel I.
   - Most of them **may not be having** any credit rating.
   - Hence, they would fall in to the unrated category and continue to be risk weighted at 100%, under the Basel II.
   - Consequently, the capital charge may **remain unchanged**.

d. Claims on banks.
   - Mainly foreign currency placements, nostro debit balances and inter- bank loans come under this category.
   - Under Basel I, all these claims were risk weighted at 20%, which is the minimum under Basel II.
   - Most banks do have credit ratings and risk weights vary from 20%- 150%.
   - Consequently, some banks may move into the higher risk brackets under Basel II, depending on their credit ratings and consequently, the capital charge may **go up** marginally.

e. Claims on Primary Dealers, Stock Brokers, Finance Companies, Leasing Companies, Merchant Banks and Investment Banks.

   - All were risk weighted at 100% under Basel I
   - Most of them may be having credit ratings and risk weights vary from 20%- 150%.
   - Some may move in to lower risk weight categories under Basel II. and hence, the capital charge may **drop** marginally.

f. Claims on Corporates

- All un-classified exposures fall in to this category and hence, the volumes may be substantial.
- All were risk weighted at 100% under Basel I
- Most of them may not be having any credit rating.
- Hence, most of them are likely to remain at 100% under Basel II, which is as same as Basel I. Consequently, the capital charge may **remain almost unchanged**.

g. Non-performing Loans

- Capital charge may go up **substantially,** in the case of NPLs between 90-180 days, as explained above.

h. SME, Retail and Residential Mortgages

- **Significant drop** is possible, irrespective of the credit quality, depending on the volumes in the advances-mix, provided the advances are identified properly.

6.2. Impact on the overall capital of banks under Basel II.

6.2.1 Credit Risk

- Under the Basel I, capital charge on credit risk depended mainly on the **asset-mix** and **volume-growth** in the risk-assets portfolio of banks.
- Asset-mix and volume growth will continue to affect on the capital charge under Basel II.
- In addition, the **advances-mix** will have a major impact on the capital charge under the Standardized Approach of Basel II, with several new risk groups being introduced, with low risk weights.
- However, the extent of drop in capital charge will depend on the advances volumes falling into these risk groups and the accuracy in identification of them.
- Credit quality had only a very little impact on capital charge under Basel I. However, Basel II. attempts to capture credit quality into the capital charge, through different risk weights being assigned to different credit ratings..
- Hence, movements in credit quality of customers within risk groups, (having multiple risk weights) should **theoretically** have an impact on the capital charge, against the respective risk groups. Nevertheless, in actual practice this will depend on the extent of proper credit rating being used, with in the respective risk groups.
- Credit rating is still not an essential part of our credit culture and hence the impact may be very marginal.

- The new CRM too may have only a little impact initially, as availability of corporate debts and equities to be used as CRM is limited in our markets
- Hence, any significant drop in capital charge against credit risk is **unlikely**

6.2.2 Market Risk

- A marginal increase is expected

6.2.3 Operational Risk

- A significant increase is expected under the Basic Indicator Approach.

Hence, regulatory capital of most banks under the Standardized Approach may rise initially, irrespective of their credit quality. This is only a provisional estimate, that could be made by an outside third party and only the Central Bank can make a proper assessment on this .

7. Challenges for banks in raising Regulatory Capital

7.1 Tier I- Retained Profits

a. Increased taxes is a real challenge, with the Corporate Tax increased from 30% to 35%. In addition, Special VAT (on profits + staff costs), has been increased from 15% to 20%, and this is not permitted to be deducted for corporate tax purposes. Hence, total effective tax rate of banks is well above 55%.

b. Consequently, the industry average on Return on Assets (after tax) of banks, may be even below 1% and the Return on Assets after dividends may be even lower than this.

c. For capital adequacy purposes, what is relevant is the Return on Risk Weighted Assets and Contingencies (after tax and after dividends), and the industry average of this may be even below 0.9%, with the increased taxes.

d. This will result in a huge gap between the capital requirement of 10%, which is the common rate against most of the risk weighted assets in our markets and their low rates returns. Hence, this gap has to be raised by banks from other sources.

e. **Some Consideration for Banks to maximize retained profits.**

- Improve contribution from fee-based income
- Improve overall profitability through cost efficiency and tax planning.

- Improve credit quality to reduce :
    - Interest in suspense
    - Loan loss provisions
    - Capital charge against loans
- Promote credit ratings culture to reap the benefits of improved credit quality. It is only credit ratings that can translate credit quality in to lower risk weights of Basel II. In the absence of credit ratings, improved credit quality will have little or no impact either on the risk weight or capital charge.
- Adopt Risk Adjusted Pricing to maximize returns.
- Manage dividends pay out ratio and profit repatriation.
- Improve Operational and Market Risk management.
- Make proper awareness in the market about the low returns actually prevailing in the banking industry, despite high profits, which are attributable to high business volumes of banks.

7.2. Tier I- capital infusion

***a.* Preference Shares**

Not permitted for capital adequacy purposes and also not worth in issuing them due to the current tax implications.

b. Ordinary shares.

Under the Listing Rules of the CSE, any new share issue has to be approved by the existing shareholders. Hence, Banks have to obtain their concurrence in all new equity issues.

7.3 Tier II- Corporate Debt

a. There are market limitations in raising funds through these instruments. They are also generally high cost (at least 2%-3% risk premium is payable over T.B. rates).

b. Maximum permitted for Capital Adequacy purposes is limited to 50% of Tier I.

c. These are subject to annual discounting even before maturity.

Hence, raising capital to the extent required under Basel II, will remain a great challenge for Banks.