



**FREQUENTLY ASKED QUESTIONS (FAQs)
ON BASEL II & MINIMUM CAPITAL
REQUIREMENTS (MCR)**

**BANKING POLICY & REGULATIONS DEPARTMENT
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INTRODUCTION:

These Frequently Asked Questions (FAQs) pertain to the instructions issued on “Minimum Capital Requirements- Implementation of Basel II” circulated vide BSD Circular # 8 of 2006 dated June 27, 2006 & “Implementation of Basel III Capital Instructions” circulated vide BPRD Circular # 6 of 2013 dated August 15, 2013 for the purpose of implementing revised capital adequacy requirements based on the framework promulgated by the Basel Committee on Banking Supervision (BCBS).

The FAQs intend to provide ready reference for the queries pertaining to Capital Structure under Basel, Minimum Capital Requirements (MCR), Credit Risk – Standardized Approach, Credit Risk Mitigation (CRM), Operational Risk & Market Risk etc. by providing answers to the relevant questions. However, it may be noted that these FAQs are to be read in conjunction with the above mentioned Circulars. The answers are general in their scope and do not take into account a particular circumstance of any individual institution. Exceptions or qualifications not covered in these FAQs, may still apply to particular institutions. As such, reading these FAQs is no substitute for reading the above mentioned Circulars themselves.

The FAQs by no way are a substitute for obtaining advice from State Bank of Pakistan. Should the need arise, Banks/ DFIs, in their own interest, are advised to consult State Bank of Pakistan particularly in case of any doubt in applicability of the answers provided.

The terms/ abbreviations/ acronyms used in the FAQs have the same meaning as in the above referred Circulars unless otherwise stated. Furthermore, the sections, tables, or other references imply references to those in the above referred Circulars.



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CAPITAL STRUCTURE UNDER BASEL & MCR

- 1) What will be the treatment of surplus/ (deficit) on revaluation of Available for sale (AFS) portfolio into revaluation reserves?**

Ans: The net surplus/ (deficit) on revaluation of Available for sale (AFS) instruments will be calculated on portfolio basis. If net amount (after tax) is surplus it will be included in Tier-2 capital, and if the net amount is deficit (after tax) it will be deducted from the CET-1.

- 2) Can General Reserves as disclosed on balance sheet be appropriated to offset losses?**

Ans: If the institution has sufficient resources to offset the losses, it can cover any shortfall in MCR by doing so under intimation to State Bank of Pakistan. However, efforts should be made to rebuild the General Reserves as soon as possible.

- 3) Whether discount factor based on term to maturity should be applied to only subordinated debt instruments or all subordinated term debt included in Tier-2 capital?**

Ans: The discount factor based on term to maturity should be applied on subordinated debt as well as subordinated debt instruments such as TFC/bonds etc.

- 4) How to increase assigned capital in case of banks incorporated outside Pakistan? What will be the procedure to be followed?**

Ans: As per Section 13(2) of Banking Companies Ordinance 1962, banks incorporated outside of Pakistan can maintain their assigned capital with SBP in any of the following forms:

- i) interest-free deposit in cash in Pakistan rupees;
- ii) interest-free deposit in a freely convertible approved foreign exchange within the meaning of the State Bank of Pakistan Act, 1956 (XXXIII of 1956), specified by the State Bank in respect of such banking company; and
- iii) deposit of un-encumbered approved securities.

Banks can increase their assigned capital by remitting funds directly to SBP Nostro Account. The bank may then approach the Finance Department of SBP for confirmation of the same.

- 5) Is it allowed to withdraw the capital assigned in excess of the required level of MCR?**

Ans: The request for withdrawal of excess capital is assessed on case-to-case basis keeping in view the financial health of the bank and its future capital needs.

- 6) What would be the process to withdraw the excess assigned capital?**



Ans: In case of withdrawal of excess assigned capital, the bank needs to obtain clearance from Banking Policy & Regulations Department & then have to submit the following documents to Exchange Policy Department:

- i) Audited Balance Sheet and Profit & Loss Account of its operation in Pakistan.
- ii) Tax provision made during the current and prior years along with its computations.
- iii) A Certificate from the auditors in Pakistan that tax provision made in the accounts is sufficient to meet all tax liabilities in Pakistan, or copies of final assessment orders and forms duly certified by the Income Tax Department.
- iv) Certificate from the auditors showing the liability for staff gratuity as at the close of accounts and provision made there-against. If no provision has been made, reasons thereof.
- v) Provision made in the current year for classified assets.
- vi) Confirmation to the effect that the amount provided for classified assets is not less than the amount required to be provided on the basis of the Prudential Regulations of the State Bank.

7) For foreign bank branches, is it permissible to maintain the capital partly in the form of interest free deposit in USD and partly in the form of investment in approved government securities?

Ans: Yes, it is permissible to maintain the capital partly in the form of interest free deposit in USD or any other currency approved by SBP and partly in the form of investment in approved government securities.

8) Which rate would be used for crediting equivalent PKR into the PKR account of the bank if the bank chooses to fully or partially convert the capital?

Ans: Assigned capital of the bank placed in USD will be converted into PKR at the exchange rate prevailing on the date of conversion.

9) Are there any restrictions on hedging the FCY risk if the bank chooses to fully or partially convert its USD denominated capital into PKR?

Ans: Under the existing regulations, hedging of capital is not allowed.

10) Would the payment of equivalent PKR be on delivery versus payment (DVP) basis once the bank surrenders equivalent amount of approved government securities with SBP?

Ans: As per current practice, for assigned capital kept in shape of Government securities, once the securities mature the bank has to replace the maturing securities with new securities. For replacement of securities, the bank will approach Banking Policy & Regulations Department at least a week before the maturity of pledged security with a request to replace the maturing securities with the new securities of same worth.



11) Would the SBP allow the bank to convert the capital back into the interest free USD deposit on or before the maturity of approved government securities?

Ans: SBP restricts the banks to change their options quickly.

12) What is the minimum tenor of the approved government securities, such as T-Bills and PIBs, that are eligible for maintaining the minimum capital requirements?

Ans: T-Bills and PIBs of any tenor are eligible for maintaining the minimum capital requirement.

13) Would there be any approval required for converting the capital from the interest free USD deposit to investment in approved government securities?

Ans: Yes, a formal request for the conversion of assigned capital from interest free USD deposit to investment in approved government securities is to be made to the Banking Policy & Regulations Department.

14) Is there any remuneration on assigned capital of the bank placed with SBP?

Ans: Under Section 13(2) of BCO 1962, the SBP does not pay any remuneration on assigned capital of the bank placed with SBP either in terms of PKR or approved foreign currencies.

15) Is it allowed to invest excess assigned capital of the bank placed with SBP in government securities and then remitting the same without prior approval of SBP?

Ans: The banks may withdraw their excess assigned capital placed with SBP subject to SBP approval and may invest them in government securities subsequently. Furthermore, the banks may remit it subject to SBP approval.

16) Is the assigned capital held with SBP allowed to be treated for Statutory Liquidity Requirement (SLR) purposes?

Ans: Capital placed under section 13(2) of BCO and FCY deposits placed by banks with SBP are allowed for SLR purposes.



CREDIT RISK - STANDARDIZED APPROACH

17) How many rating agencies can bank have for each type of claim?

Ans: Any SBP recognized rating agency may be used for the rating purpose. Currently, SBP has recognized two local credit rating agencies (PACRA and JCR-VIS) and three international rating agencies (Moody's, S&P and Fitch) for risk weighting purposes.

18) Whether bank can use rating solicited by third party for capital adequacy purposes?

Ans: Banks are required to use only solicited rating as explained in BSD Circular # 05 of 2010.

19) How old a rating may be used for capital adequacy purposes?

Ans: The ratings reviewed by recognized External Credit Assessment Institutions (ECAIs) in last 15 months may be used as advised in BSD Circular # 05 of 2010.

20) Can the banks apply 'Multiple Ratings'?

Ans: Section 2.3.4 i.e. 'Multiple Ratings' of SBP Basel II Guidelines applies when credit ratings are available from multiple ECAIs chosen by the banks. The bank should then use the criteria given in the section 2.3.4 of SBP Basel II Guidelines issued through BSD Circular No. 08 of 2006 dated June 27, 2006.

21) For Pakistani banks having exposures abroad, what ratings can they use?

Ans: Pakistani banks having exposures abroad may use the ratings assigned by the recognized ECAIs viz. Standard & Poors, Moody's, Fitch Ratings, PACRA and JCR-VIS. They may also use the ratings assigned by ECAIs recognized by the respective supervisors of the jurisdictions with reference to Section 2.3 of Basel II Guidelines. However, for the ratings issued by the ECAIs recognized by the respective supervisors, the risk weights will only be assigned after their mapping with SBP grades for which approval would be granted on case-to-case basis.

22) Can domestic ratings assigned by PACRA and JCR-VIS be used for foreign currency denominated loans?

Ans: Para 2.3.6 on Domestic Currency and Foreign Currency Assessments of BSD circular 8 of 2006 states that domestic currency ratings, if separate, would only be used to risk weight claims denominated in the domestic currency. PACRA and JCR-VIS ratings are local/ domestic ratings (if not explicitly stated otherwise) and should thus be used for determining risk weight of financing facilities denominated in domestic currency only as these do not take into account sovereign risk.

23) Can banks use credit rating of international parent entity to risk weight unrated local customers?



Ans: External credit ratings of international parent entities cannot be used for assigning risk weight to locally incorporated subsidiaries unless they are also separately rated. The parent company can act as protection provider through an explicitly stated, direct, irrevocable and unconditional financial guarantee which can be used for credit risk mitigation under para 2.6.4 on Guarantees of MCR Guidelines issued under BSD Circular # 08 of 2006.

24) What should be the risk weight of guarantees issued by bank on its own behalf?

Ans: Banks own ECAI rating will be considered as commitment with certain drawdown and such guarantees will be placed under 100% Credit Conversion Factor (CCF).

25) Under Standardized Approach, what will be the treatment for SMEs that do not have a rating from ECAI?

Ans: Under Standardized Approach, SMEs not fulfilling the conditions of the regulatory retail portfolio would be considered as unrated corporate entities.

26) Who would bear the cost of rating: Bank or obligor?

Ans: This is a matter to be decided between banks and obligors mutually but through a transparent policy of the bank.

27) Can international banks outside SBP purview be treated as banks for capital calculation?

Ans: Yes, the banks outside SBP purview may be treated as banks for capital calculation provided they are recognized as banks by their respective regulators.

28) What will be the treatment for exposures on banks owned by federal governments such as National Bank, IDBL, ZTBL etc. and Joint venture Development Finance Institutions (DFIs)?

Ans: These shall be treated as 'claims on banks'.

However, where NBP is performing the job of SBP as treasury bank (for clearing purposes as SBP agent) such claims are to be risk weighted at 0% like 'claims on SBP'. Benefit of government guarantee as eligible collateral is available under credit risk standardized approach against deposits in banks which are under the ambit of Banks Nationalization Act, 1974.

29) What is the treatment of investments marked as strategic?

Ans: The investments marked as strategic will form part of the banking book and not of trading book.

Inter-alia, a strategic investment will be deducted from the capital if the investment is made in the financial, insurance or securities company and it exceeds 10% of the CET1 capital of the bank (refer to SBP Basel III rules 2.4.9.3).



In case of commercial entities, investment exceeding 10% threshold would be subject to 1000% Risk Weight (refer to SBP Basel III – Scope of application).

30) Where can I get the List of Public Sector Entities (PSEs)?

Ans: The list of PSEs is maintained by the Statistics & DWH Department. This list is periodically updated. In this regard, the criterion for identification of an institution as PSE is as under:

“Resident corporations controlled by the government. Control may be exercised through ownership of more than half the voting shares (at least 51%), legislation, decree, or regulations that establish specific corporate policy or allow the government to appoint the directors. In cases where more than half voting shares are kept by the government but the management control has been handed over to other party (such as PTCL), the entity is treated as private sector party.”

31) Which Public sector entities (PSEs) operating in Pakistan can be treated as Sovereign?

Ans: Currently no PSE will be treated as Sovereign unless specified by SBP.

32) What will be the treatment of Shares of Khushhali Bank and Pakistan Export Finance Guarantee (PEFG)?

Ans: Equity shares in Khushhali Bank and PEFG may be treated as any other equity investments and there will be no preferential treatment for the purpose of assigning risk weights.

33) What is the treatment for SMEs under Basel II?

Ans: SMEs if not falling within the Retail portfolio will form part of the Corporate portfolio.

34) What is the treatment for Pre-IPO advance subscription amount of TFC for credit risk capital charge calculation?

Ans: Pre-IPO advance subscription amount would be treated like credit exposure on the counterparty till the time of the successful IPO of the TFC, after which the exposure will become the investment of the bank and will be treated accordingly.

35) Which exposures to “small business” may be classified as Retail Portfolio?

Ans: Loans meeting the eligibility criteria of the ‘Retail’ category issued under BSD Circular # 05 dated February 14, 2008 would be treated as Retail Portfolio.

36) Can listed, unlisted, public and private limited companies with an exposure less than Rs. 75 million be classified as retails?

Ans: Exposure against listed, unlisted and public limited companies will not be classified as retail, however, an exposure of less than Rs. 75 million against a private limited company may be classified as retail for CAR calculation purposes.



37) Can Government universities, hospitals be classified as PSE or do they come under GoP exposure?

Ans: No. Non-profit organizations such as universities, hospitals etc., in public sector are predominantly funded by public means through the central or provincial government. As per list maintained by Statistics & DWH dept., public sector universities, hospitals & local government units are included in the federal government/ provincial government institutions list. Therefore, government universities & hospitals come under GoP exposure.

38) Is City District Government Karachi a GoP exposure?

Ans: Yes, City District Government Karachi may be treated as exposure on government.

39) What will be the treatment for investment in premises, plant and equipment and all other fixed assets; and claims on all fixed assets under operating lease?

Ans: These will be assigned risk weight of 100% according to the relevant category as in Table 2.2 of SBP Basel II guidelines.

40) What will be the treatment of inter-company accounts?

Ans: Inter-company accounts with a parent entity and with other sub-entities of the parent entity may be risk weighted according to the appropriate exposure type based on class of counter-party (e.g. bank, corporate etc.) as provided in Table 2.2 of the SBP Basel II guidelines. For instance, if a bank has extended loan to a related corporate entity, the bank will treat the exposure as 'claim on corporate'.

41) What will be the treatment of Carry Forward Trade?

Ans: Exposure will be categorized as exposure on corporate and 100% risk weight will be applied. Furthermore, the equities involved in the transaction may be treated as collateral provided they satisfy the requirements under section 2.6.2 'Eligible Collateral'.

42) Can all retail and non-retail unutilized credit lines (except those where commitments are given for participation in syndicated loans) be treated as unconditionally cancelable i.e. without notice, and no credit conversion factor be applied to such unutilized limits?

Ans: No. The decision to treat the retail and non-retail unutilized credit lines (except those where commitments are given for participation in syndicated loans) as unconditionally cancelable should be based on the essence of the commitment i.e. the bank should not decide on the mere inclusion of clause for unconditionally cancelable. It should also consider the past experience/ practice whether it actually cancels such commitments or not.



43) Is the granularity limit for regulatory retail portfolio calculated based on the approved limits or the outstanding limits?

Ans: The granularity limit should be calculated by taking into account the approved limits of the borrowers falling in the retail category, instead of the outstanding balances (drawn amount). However, risk weights should be assigned to the outstanding balances.

44) What will be the treatment for an exposure classified as Past Due Loan?

Ans: The exposure that has been classified as Past Due Loan will be risk weighted as per item (n) 'Past Due Loans' of Table 2.2 of SBP Basel II Guidelines.

45) What will be the treatment for NIT units?

Ans: Banks' / DFIs' investments in the units of mutual funds (NIT) will be subject to market risk and hence will be categorized in the trading book (Ref: page no. 19 of SBP Basel III instructions).

46) Can National Prize Bonds issued by Government of Pakistan be treated as Cash Equivalent?

Ans: Yes, National Prize Bonds issued by Government of Pakistan can be considered as cash equivalent.

47) In case of investment, will the risk weight be assigned on book value or mark to market value?

Ans: Investments held in Banking Book will be treated as On-Balance Sheet credit exposure. The risk-weighted amount will be determined by multiplying its current book value (including accrued interest or revaluations, and net of any specific provision or associated depreciation) by the relevant risk-weight specified in Table 2.2 of SBP Basel II Guidelines (Ref: section 2.4 'Risk Weights - On-Balance Sheet Exposures'). Investments held in the Trading Book are to be marked to market as per section 5.1.2 i.e. 'Trading Book' of SBP Basel II Guidelines.

48) Whether accounts such as Income/Markup accrued and Surplus/Deficit should be added/subtracted to their respective exposures or in Other Assets Exposure title?

Ans: Income/markup accrued and surplus/deficit should be added/subtracted to the respective exposures (Ref: section 2.4 'Risk Weights - On Balance Sheet Exposures' of SBP Basel II Guidelines).

49) How capital charge will be determined on transactions where the bank has issued loan to customer against term deposit receipts (TDRs) issued by banks other than itself?

Ans: The exposure to the customer may be slotted into the appropriate exposure category as given in the SBP Basel II guidelines and the capital charge be determined accordingly.



However, only certificates of deposits or comparable instruments issued by lending bank itself may be treated as cash equivalent collateral.

50) What is the treatment in case of exposure against L/C bills duly accepted by a bank?

Ans: L/C bills unconditionally accepted by another bank are to be treated as exposure on banks.

51) Will staff loans attract a lower risk weight?

Ans: Staff housing finance qualifying as per definition 2.1.6 'Residential Mortgage Finance' of SBP Basel II Guidelines may be treated as residential mortgage. Other staff loans shall be treated as Retail or in other categories provided respective requirements are fulfilled. (BSD Circular # 05 of 2008)

52) What should be the risk weight of trade loan overdue where specific provisioning was less than 20%?

Ans: These loans will be moved to claim on past due loans with 150% risk weight.

53) Do loans against security of open land qualify as Residential Mortgage?

Ans: No, open land does not qualify as residential real estate. It may further be noted that loans secured by residential real estate for business purposes and loans secured against commercial real estate do not fall under Residential Mortgage loans.

54) If placements with contractual maturity of less than three months are continually rolled over, do they qualify for preferential risk weight?

Ans: Foot Note No 25 (Page 22) of original Basel International Convergence of Capital Measurement and Capital Standards (ICCMCS) comprehensive framework dated June 2006, states that supervisors should ensure that claims with (contractual) original maturity under 3 months that are expected to be rolled over (i.e. where the effective maturity is longer than 3 months) do not qualify for this preferential treatment for capital adequacy purposes.

55) Can Food departments of provincial governments be considered as govt. entities?

Ans: If the exposure to food departments is backed by sovereign guarantee and the entity has revenue generating powers, then the exposure mitigated to the extent of the guarantee will be given 0% risk weight. Remaining exposure will be treated on the basis of entity rating by ECAs as laid out in item (g) Table 2.2 of the SBP Basel II Guidelines.

56) What will be the treatment of advance payment against new software for CAR calculation?

Ans: Advance payment against software shall also be treated as intangibles and be deducted from the capital when arriving at eligible capital for CAR calculation.



57) Whether intangible assets and investments in subsidiaries that have been deducted from capital should also be excluded from the risk weighted assets or not?

Ans: The items that are deducted from the capital of a bank/DFI are to be excluded from its risk weighted assets.

58) Is capital charge required on expired portion of off-balance items?

Ans: Capital charge for credit risk is applicable on expired off-balance sheet exposures as long as these appear in the books of accounts. The very presence of such exposures in the account implies that the bank will oblige such off-balance sheet exposures even after their expiry. For instance, in case of LCs, bank gives extra time to the customers to whom it would oblige after expiry date. Similar obligation in case of guarantee is reversed only after receipt of original guarantee to avoid any legal risk. In case, the bank is fully satisfied that legally there would be no obligation, it may reverse such off-balance sheet exposures to avoid any capital charge.

59) What will be the treatment in terms of risk weights for cheques in transit/ clearing suspense account?

Ans: Cheques in transit / clearing suspense account shall be risk weighted as per the recording policy of the bank.

60) What should be the Credit Conversion Factor (CCF) of Financial Guarantees and Stand by Letter of Credit (SBLCs)?

Ans: Financial Guarantees and SBLCs serving as financial guarantee should be categorized in 100% CCF under BSD circular 8 of 2006 table 2.4.

61) What should be the CCF of Unutilized/ Undrawn Term Loan commitments?

Ans: Unutilized/Undrawn Term Loan commitments should be placed in 100% CCF under BSD circular 8 of 2006 table 2.4.

62) What will be the CCF for acceptance under usance L/Cs?

Ans: "Acceptance on Trade Bills" which are collateralized by the underlying shipment shall receive 20% Credit Conversion Factor. However, where the underlying shipment ceases to be collateral for the "Acceptance on Trade Bills" CCF of 100% shall be applied.

63) What will be the exposure against No Liability L/Cs?

Ans: 0% CCF shall be levied on No Liability L/Cs. However, it must be ensured that the particular L/C places no obligation/liability on the bank.

64) What CCF should be assigned to commitment in respect of acquisition of fixed assets and civil works?



Ans: Such non-cancelable commitments should be placed in 100% CCF under BSD circular 8 of 2006 table 2.4.

65) What will be the Credit Conversion Factor (CCF) for 'advance payment guarantees'? Will it be a part of 'direct credit substitute' category?

Ans: Generally 'advance payment guarantees' support certain performance obligations of a borrower related to a particular transaction. In such a case, 50% CCF may be applied by treating it transaction related contingent item.

However, if the contents/ terms and conditions of the guarantee makes the bank liable to general indebtedness (directly dependent on the creditworthiness) of the customer then 100% CCF is to be applied as per the Basel text by categorizing it as 'direct credit substitute'.

66) What is the treatment of guarantees issued in favor of utility corporations for CAR purposes?

Ans: Bank guarantees that are issued to guarantee payment of utility bills to utility suppliers on behalf of the customers of the bank should be included in 100% CCF. The nature of these guarantees is similar to that of financial guarantees as the bank is guaranteeing a financial obligation rather than a performance obligation.

67) In case of US \$ settlement account maintained with SBP whether 0% risk weight be assigned being an account maintained with SBP or else based on the rating of Govt. of Pakistan?

Ans: In such a case, the bank should assign risk weight based on the foreign currency (\$) rating of Govt. of Pakistan.

68) What will be the treatment of investment in US \$ bonds and credit link note (US \$) issued by GoP?

Ans: Claims on Govt. of Pakistan denominated in foreign currency (other than Pak rupee) will be risk weighted as per foreign currency rating/international rating of Pakistan conducted by international rating agencies.

69) What is the treatment for cash balance in foreign currency deposit account with SBP?

Ans: Cash balance in foreign currency deposit account with SBP may be treated either as "Foreign Currency claims on SBP arising out of statutory obligations of banks in Pakistan" or as "Claims on SBP denominated in currencies other than PKR", whichever applicable.

70) What will be the risk weight of Foreign Currency deposited with SBP in excess of statutory obligations?



Ans: Foreign Currency deposited with SBP in excess of statutory obligations should be placed under 'foreign currency claims on SBP arising out of Statutory Obligations of banks in Pakistan' with 0% risk weight. In this regard, full amount of assigned capital placed with SBP will be subject to 0% Risk Weight.



CREDIT RISK MITIGATION (CRM)

71) In case government security is used as collateral, what will be the value, book value or mark to market?

Ans: Under the Simple Approach, the mark to market value of the collateral is considered subject to appropriate discounting as per section 2.6.3.1 'Simple Approach' of the SBP Basel II Guidelines.

Under the Comprehensive Approach, the current value of the collateral will be taken into account subject to appropriate haircut as per section 2.6.3.2 'Comprehensive Approach' of the SBP Basel II Guidelines.

72) Can banks take the benefit of a Government Guarantee in CRM?

Ans: Banks can take the benefit of government guarantee provided that fulfill the criteria under subsection 2.6.4.8 'Sovereign guarantees and counter-guarantees' of section 2.6.4 'Guarantees' of the SBP Basel II Guidelines.

73) What will be the treatment of foreign currency denominated instruments issued by Government of Pakistan taken as collateral for local currency financing?

Ans: Foreign currency denominated instruments issued by Government of Pakistan may be treated as collateral against exposure in local currency as well as in foreign currency. However, the foreign currency rating of Government of Pakistan will be used for risk weighting purposes.

74) Whether government guarantees issued to secure commodity finance exposure are eligible for taking mitigation benefit in capital calculations e.g. guarantees provided by the Government of Pakistan to secure financing to GoP Food Departments like PASSCO?

Ans: Government Guarantees can be used for the purpose of CRM as specified in section 2.6.4.8 'Sovereign Guarantees and Counter-Guarantees' of the SBP Basel II Guidelines.

75) Can unrated government securities like PIBs, TBs, DSCs and SSCs be used for credit risk mitigation?

Ans: PIBs, TBs, DSCs and SSCs can be treated as Eligible Collateral under CRM Simple Approach. However, PIBs and TBs are Sovereign Securities and should be subject to discounting as in section 2.6.3 - 'Methodology' of the SBP Basel II Guidelines. Furthermore, the instructions regarding Maturity Mismatch provided in section 2.6.3 should be complied with meticulously.

76) Is maturity mismatch between the expiry of the exposure and expiry of the collateral allowed under Credit Risk Mitigation?

Ans: Under CRM Simple Approach, the collateral must be pledged for at least for the life of the exposure i.e. maturity mismatch will not be allowed.



If maturity mismatch occurs under CRM Comprehensive Approach and the CRM has an original maturity of less than one year, the CRM is not recognized for capital purposes. In other cases where there is a maturity mismatch, partial recognition is given to CRM for regulatory capital purposes as specified (Ref: section 2.6.3.2. (a) of SBP Basel II Guidelines).

77) Is benefit of government guarantee as eligible collateral available to banks under the standardized approach to credit risk against balances with nationalized banks?

Ans: Benefit of government guarantee as eligible collateral is available under credit risk standardized approach against deposits in banks which are under the ambit of Banks Nationalization Act, 1974.

78) Can gold be used as cash equivalent for credit risk mitigation?

Ans : Yes. Gold may be used for credit risk mitigation as mentioned in section 2.6.2.1 (ii) i.e. 'Eligible Collateral-Simple Approach' of the SBP Basel II Guidelines subject to minimum risk weight of 20%.

79) Which risk weight is given to equities (held as collateral in the form of shares) in CRM? Can we assign risk weight below 100% to shares held as collaterals?

Ans: According to section 'O' & 'P' of table number 2.2 of BSD circular number 8 of 2006, 100% risk weight is applied on listed equity investments and regulatory capital instruments issued by other banks (other than those deducted from capital) held in banking book, whereas 150% risk weight is applied on unlisted equity investments (other than those deducted from capital) held in banking book.

80) In case a financial institution is a subsidiary and its rating is not available, can the group rating be applied on it for eCIB and other regulatory reporting?

Ans: No. The banks are required to report their internal credit risk rating of the borrowers in eCIB, whereas for the purpose of calculation of capital charge against credit risk under standardized approach, the banks can use ratings assigned by rating agencies. Further as explained in para 2.3.7 of SBP Basel II instructions, external assessments for one entity within a corporate group cannot be used to risk weight other entities within the same group.

81) Is rating requirement applicable throughout the life of the TFC for CAR purposes?

Ans: Yes. The rating requirement is applicable throughout the life of the TFC. Therefore, as early as the rating of the instrument drops below the benchmark rating, the instrument will not be considered as Tier-II capital for capital adequacy ratio (CAR) purposes.

82) What will be treatment in case the rating of TFC drops below the benchmark rating?

Ans: In such a case the TFC would be like an unsecured borrowing by the issuing bank.



OPERATIONAL RISK

83) How will operational risk capital charge be calculated for banks not having the requisite three (3) years gross income data?

Ans: Banks not having the requisite three (3) years gross income data will adopt the following procedure:

- a) When the bank is in operation for less than one year the value of gross income, based on the published quarterly/ half yearly financial statements available at time of capital adequacy calculations, will be annualized.
- b) Once the annual audited accounts are available for full year, the available audited figures will be used for capital calculations.

84) What is the treatment of Gross Income for Pre merger/ acquisition years?

Ans: Gross Income based on audited accounts of all entities that existed before the point of merger/ acquisition should be included while calculating gross income in both Basic Indicator and Standardized Approaches.

85) What does 'Payments & Settlements' business line refer to?

Ans: 'Payments & Settlements' business line refers to all those activities undertaken by a bank relating to payments/ settlements, funds transfer, and clearing services to its wholesale customers whether Corporates, other financial institutions or government agencies.

86) Where the income arising on Govt. Bonds (T-Bills, PIBs which are part of banking book) and TFC should be classified?

Ans: As per supplementary business line mapping guidance at Page-160 of SBP Basel II Guidelines, net income (from coupons and dividends) on securities held in banking book is classified as gross income from commercial banking. Such income could have also been classified as Trading & Sales if the instruments are held for trading purpose (trading book). In short, banks should be consistent, if a bond has been categorized as part of the banking book then for operational risk the same categorization should be maintained.

87) Where the income derived from investment in subsidiaries and associates should be classified?

Ans: As per Appendix 6.1 of Basel II Guidelines, Proprietary Position (Equity activities) forms part of Trading & Sale business lines and are in mark to market book. However under Basel-II requirements and SBP guidelines investment in subsidiaries and associates form part of banking book and therefore this income derived from investment in subsidiaries and associates should become part of commercial banking activities.



88) Where the markup cost arising on Bank's own TFC should be classified?

Ans: The mapping guidance clearly suggests that weighted average cost of funding (from whatever source) should be subtracted from net interest income to calculate gross income for commercial banking. Hence cost of TFC may be classified under Commercial Banking.

89) What is the treatment of income derived from 'Bancassurance' for calculation of Operational Risk Capital Charge under Basic Indicator Approach (BIA)?

Ans: Income from 'Bancassurance' may be treated as part of Gross Income (GI) like other commission income and attracts operational risk capital charge under BIA.

90) What is the treatment of dividends received on non-trading equity/ investment in the calculation of gross income for Operational Risk capital charge purposes?

Ans: Dividends received on non-trading equity/ investment becomes part of non-interest income and therefore should be included in gross income for calculation of operational risk capital charge.

91) How will the gross income be arrived at for purpose of determining the operational risk charge at each quarter end? Will the annual gross income for the past three financial years be used or of the previous 36 months?

Ans: The gross income for each of the past three financial years as appearing in the annual audited accounts will be used when determining the operational risk charge.

92) Are there any Qualifying Criteria for Alternate Standardized Approach (ASA)?

Ans: The Qualifying Criteria for The Standardized Approach (TSA) and Alternate Standardized Approach (ASA) are the same and are detailed in BSD circular 8 of 2006 Section 6.3.

93) How do we reconcile gross income in The Standardized Approach?

Ans: Total Gross Income of all business line for each year should equal Gross Income calculated under Basic Indicator Approach.

94) If the gross income of all previous 3 years is negative, how would the operational risk capital charge be calculated?

Ans: In such cases, the operational risk capital charge will be determined by the SBP on case to case basis.



MARKET RISK

95) What is the definition of Trading Book?

Ans: Generally investments in Available for Sale (AFS), Held for Trading (HFT) and derivatives may form part of trading book. The word 'generally' suggests that most of the times the AFS securities would be held in the trading book (and not in the banking book) as they are exposed to market risk.

The exception is, however, available for bank's equity investment marked as "Strategic Investment". In short, securities being held with the trading intent should be placed as part of the trading book and would attract market risk capital charge.

96) If an instrument is classified as 'Available for Sale' but intention is not of short-term resale, will it be included in Market Risk Capital Charge or not?

Ans: Investments in AFS will be part of trading book & market risk capital charge will be applied.

97) Do we need to calculate General Market Risk on Forward Foreign Exchange Contracts?

Ans: The bank's measurement system should include all interest rate derivatives and off-balance sheet instruments in the trading book, which are interest rate sensitive. These include forward rate agreements, interest rate & cross currency swaps and forward foreign exchange contracts. The forward foreign exchange contracts are not subject to specific risk charge unless the underlying is a corporate debt security. However, General market risk applies to all derivatives products subject to exemption for fully or very closely-matched positions in identical instruments.

Yes, General market risk capital charge against forward foreign exchange contract is to be applied.

98) How do we define negligible foreign exchange business?

Ans: A bank doing negligible business in foreign currency is exempted from foreign exchange risk (As per Para 5.3.3 of Basel-II circular) provided that both:

- a) Greater of the sum of its gross long positions and sum of its gross short positions in all foreign currencies does not exceed 100% of eligible capital.
- b) Its net open position does not exceed 2% of its eligible capital.

99) Whether the determination of negligible business in foreign exchange business be made only at end of year or over extended period?

Ans: The determination of negligible business will be done as per positions on the date of statements (i.e. Quarterly).

100) Whether Sukuk held as AFS shall be reported banking book element or as trading book element for calculation of market risk capital charge?



Ans: As per SBP Basel-II guidelines, AFS portfolio is generally included in the trading book therefore, Sukuk held as AFS shall be treated as trading book element for calculation of market risk capital charge unless criteria mentioned in FAQ # 95 above is met.

101) What will be the treatment of investment in foreign branches/ subsidiaries for foreign exchange risk for CAR purposes?

Ans : For calculation of capital charge under Basel-II, exposures in relation to foreign branches/ subsidiaries would also be taken into account and the exposures in overseas branches should not be treated structural in terms of capital calculation. Attention is drawn to section 5.3.3.1(c) of SBP Basel-II instructions wherein the 'structural position' excluded does no more than protect the bank's capital adequacy ratio.

102) What is "structural" position?

Ans: Under Foreign Exchange Manual instructions, no foreign currency-denominated assets or liabilities can be termed as structural position unless it has been explicitly agreed with the supervisory authorities (not to include that item in FEEL calculations). According to section 5.3.3.1 (c) of SBP Basel II, "structural" position does no more than protect the bank's capital adequacy ratio.

103) What instruments, if any, in the banking book are subject to market risk?

Ans: On balance sheet assets held outside trading book and funded by another currency and un-hedged for foreign exchange risk will be subject to both credit and market risk capital requirement. Derivatives, unless they are contracted to hedge positions in the banking book will be considered part of trading book and will be subject to both credit and market risk capital requirement. Repurchase /reverse repurchase, securities lending held in trading book will be subject to both credit and market risk capital requirement. Furthermore, Interest Rate Risk in the Banking Book shall be covered under the Internal Capital Adequacy Assessment Process (ICAAP).

104) Do we need to calculate only market risk capital charge for Trading Book?

Ans: Capital charge on interest rate risk and equity risk is calculated on trading book only while capital charge on foreign exchange risk is calculated on positions throughout the bank's balance sheet.

Derivatives and repo of securities held in trading book will be subject to both credit and market risk capital charge. For details of interest rate derivatives requiring specific and general market risk refer to BSD circular # 08 of 2006 Table 5.4.



LEARNING EXAMPLES OF CREDIT RISK MITIGATION TREATMENT¹
(COMPREHENSIVE APPROACH)

Learning Example - 1:

Assuming any product such as CF or TF against AAA rated client with PKR 100 million exposure (Principal +markup) and PKR 110 million main index shares as eligible Basel II TSA security with no maturity and currency mismatch etc. How would we solve the equation for such transaction?

Answer: As per Table 2.7, supervisory haircut assume daily marked to market, daily remargining and 10 business day holding period. This transaction is a secured lending transaction which receives haircut with daily mark to market, no remargining clause and 20 days holding period, hence we will use Scaling Factor for adjustment for holding period.

	Supervisory Haircut	Scaling Factor	Adj. Haircut
H_e	0 – Cash Disbursed	-	0
H_c	0.15	$\sqrt{(N_R + (T_M - 1))}/10$ $\sqrt{(1 + (20 - 1))}/10 = 1.414$ (Note that $N_R = 1$ when bank is calculating collateral mark to market daily, if bank is revaluing on 60 days, than $N_R = 60$)	$0.15 \times 1.414 = 0.212$
H_{fx}	0	-	0

$$\begin{aligned}
 E^* &= \max \{0, [E \times (1 + H_e) - C \times (1 - H_c - H_{fx})]\} \\
 &= \max \{0, [100 \times (1 + 0) - 110 \times (1 - 0.212 - 0)]\} \\
 &= 13.32 \text{ PKR}
 \end{aligned}$$

$$RWA = E^* \times RW = 13.32 \times 0.2 = 2.664 \text{ PKR}$$

¹ The variables used in 'Learning Examples of Credit Risk Mitigation Treatment' have same meaning as defined in SBP Basel II instructions issued vide BSD Circular No. 08 of 2006.



Learning Example – 2:

Bank A repos out 1,000 PKR in BBB+ corporate bonds with remaining maturity of 3 years to Bank B (A rating). It receives as collateral main index equities denominated in a different currency worth 1,100 PKR. The equity collateral is revalued every 60 days.

Answer:

	Supervisory Haircut	Scaling Factor	Adj. Haircut
H_e	0.06 (Corporate bond is being lent)	$\sqrt{(N_R + (T_M - 1))}/10$ $\sqrt{(1 + (5 - 1))}/10 = 0.71$ $T_M = 5$ (Repo style transaction) $N_R = 1$ (Daily Remargining)	$0.06 \times 0.71 = 0.04$
H_c	0.15 (Collateral in Main Index Equity)	$\sqrt{(N_R + (T_M - 1))}/10$ $\sqrt{(60 + (5 - 1))}/10 = 2.53$ $N_R = 60$ (Revalued after 60 days)	$0.15 \times 2.53 = 0.38$
H_{fx}	0.08	$\sqrt{(N_R + (T_M - 1))}/10$ $\sqrt{(60 + (5 - 1))}/10 = 2.53$	$0.08 \times 2.53 = 0.20$

$$\begin{aligned}
 E^* &= \max \{0, [E \times (1 + H_e) - C \times (1 - H_c - H_{fx})]\} \\
 &= \max \{0, [1000 \times (1 + 0.04) - 1100 \times (1 - 0.38 - 0.20)]\} \\
 &= 578 \text{ PKR}
 \end{aligned}$$

$$RWA = E^* \times RW = 578 \times 0.5 \text{ (A rated bank)} = 289 \text{ PKR}$$



Learning Example -3:

Bank A lends cash of PKR 1,000 to Bank B (A rated) for a period of 5 years against 2 year deposit in US\$ in Bank A valuing PKR 850. The deposit is revalued every 180 days.

Answer:

	Supervisory Haircut	Scaling Factor	Adj. Haircut
H_e	0	-	0
H_c	0	-	0
H_{fx}	0.08	$\sqrt{(N_R + (T_M - 1))}/10$ $\sqrt{(180 + (20 - 1))}/10 = 4.46$ $T_M = 20$ (Secured lending transaction) $N_R = 180$ (Revalued every 180 days)	$0.08 * 4.46 = 0.36$

Collateral Adjustment for Maturity Mismatch:

$$\begin{aligned}
 C_a &= \{C \times (1 - H_c - H_{fx})\} \times ((t - 0.25)/(T - 0.25)) \\
 &= \{850 \times (1 - 0 - 0.36)\} \times 2 - 0.25 / 5 - 0.25 \\
 &= 544 * (1.75/4.75) \\
 &= 200.42
 \end{aligned}$$

$$\begin{aligned}
 E^* &= \max \{0, [E \times (1 + H_e) - C_a]\} \\
 &= \max \{0, [1000 \times (1 + 0) - 200.42] \\
 &= 799.58 \text{ PKR}
 \end{aligned}$$

$$RWA = E^* \times RW = 799.58 \times 0.5 = 399.79 \text{ PKR}$$



Learning Example -4:

Flat Repo with a bank counterparty (not satisfying the conditions for zero Haircut)
Bank A repo out PKR 1,000 (Market Value) of 10 year PIB maturing in 5 years to Bank B (risk weighted at 20%) and receive PKR 950. Revaluation/ remargining is conducted weekly. There is no currency and maturity mismatch.

Answer:

	Supervisory Haircut	Scaling Factor	Adj. Haircut
H_e	0.04	$\sqrt{(N_R + (T_M - 1))/10}$ $\sqrt{(7 + (5 - 1))/10} = 1.049$ $T_M = 5$ (Repo style transaction) $N_R = 7$ (Revalued weekly)	$0.04 * 1.049 = 0.042$
H_c	0(Cash)	-	0
H_{fx}	0	-	0

$$\begin{aligned}
 E^* &= \max \{0, [E \times (1 + H_e) - C \times (1 - H_c - H_{fx})]\} \\
 &= \max \{0, [1000 \times (1 + 0.042) - 950 \times (1 - 0 - 0)]\} \\
 &= 91.95 \text{ PKR}
 \end{aligned}$$

$$RWA = E^* \times RW = 91.95 \times 0.2 = 18.4 \text{ PKR}$$



Learning Example -5:

Flat reverse repo with a bank counterparty (not satisfying the conditions for zero Haircut)
Bank B receives collateral PKR 1,000 worth of 10 year PIB maturing in 5 years and provides PKR 950 to Bank A (risk weighted at 50%). Revaluation/ remargining are conducted weekly. There is no currency and maturity mismatch.

Answer:

	Supervisory Haircut	Scaling Factor	Adj. Haircut
H_e	0(Cash)	-	0
H_c	0.04	$\sqrt{(N_R + (T_M - 1))} / 10$ $\sqrt{(7 + (5 - 1))} / 10 = 1.049$ $T_M = 5$ (Repo style transaction) $N_R = 7$ (Revalued weekly)	$0.04 * 1.049 = 0.042$
H_{fx}	0	-	0

$$\begin{aligned}
 E^* &= \max \{0, [E \times (1 + H_e) - C \times (1 - H_c - H_{fx})]\} \\
 &= \max \{0, [950 \times (1 + 0) - 1000 \times (1 - 0.042 - 0)]\} \\
 &= 0 \\
 RWA &= E^* \times RW = 0 \times 0.5 = 0
 \end{aligned}$$



Learning Example - 6:

Repo & Reverse Repo are subject to both Credit & Market Risk Capital Requirements

Type of the Security	GOP security
Residual Maturity	5 years
Coupon	6 %
Current Market Value	PKR 1050
Cash borrowed	PKR 1000
Modified Duration of the security	4.5 years
Assumed frequency of margining	Daily
Minimum holding period	5 business days
Change in yield for computing the capital charge for general market risk	0.7 % (Zone in table 5.3 of the circular)

A. In the books of the borrower of funds

a. Capital charge for investment in Security (on balance sheet):

S. No	Items	Particulars	Amount in PKR
A	Capital for Credit/ market Risk of the security		
1	Capital for credit risk (if the security is held under HTM)	Credit Risk	Zero (Being Govt. security)
2	Capital for market risk (if the security is held under AFS/ HFT)	Specific Risk	Zero (Being Govt. security)
		General market risk (4.5 * 0.7 % * 1050) [Modified duration * assumed yield change (%) * market value of security]	33.07

**b. Capital Charge for repo transaction involving the security
(For the off-balance sheet exposure due to lending of the security
under repo)**

Off Balance Sheet Exposure = Market Value of Security = PKR 1050

Credit Conversion Factor = 100% (Table 2.4)

On Balance Sheet Equivalent Exposure = PKR 1050



	Supervisory Haircut	Scaling Factor	Adj. Haircut
H_e	0.02	$\sqrt{(N_R + (T_M - 1))}/10$ $\sqrt{(1 + (5 - 1))}/10 = 0.707$ $N_R = 1$ (Remargining daily) $T_M = 5$ (Repo style transaction)	$0.02 \times 0.707 = 0.014$
H_c	0 - cash	-	0
H_{fx}	0	-	0

$$\begin{aligned}
 E^* &= \max \{0, [E \times (1 + H_e) - C \times (1 - H_c - H_{fx})]\} \\
 &= \max \{0, [1050 \times (1 + 0.014) - 1000 \times (1 - 0 - 0)]\} \\
 &= 64.7 \\
 RWA &= E^* \times RW = 64.7 \times 0.2 \text{ (AAA rated)} = \text{PKR } 12.94
 \end{aligned}$$

B. In the books of the lender of funds

a. Capital Charge for investment in Security: Not Applicable

a	Capital for Credit/ market Risk of the security		
11	Capital for credit risk (if the security is held under HTM)	Credit Risk	Not applicable, as it is maintained by the borrower of funds
12	Capital for market risk (if the security is held under AFS/ HFT)	Specific Risk	Not applicable, as it is maintained by the borrower of funds
		General market risk	Not applicable, as it is maintained by the borrower of funds

b. Capital Charge for repo transaction involving the security

(In this case, the cash lent is the exposure and the security borrowed is collateral)

Exposure = PKR 1000



	Supervisory Haircut	Scaling Factor	Adj. Haircut
H_e	0 – cash	-	0
H_c	0.02	$\sqrt{(N_R + (T_M - 1))} / 10$ $\sqrt{(1 + (5 - 1))} / 10 = 0.707$ $N_R = 1$ (Remargining daily) $T_M = 5$ (Repo style transaction)	$0.02 \times 0.707 = 0.014$
H_{fx}	0	-	0

$$\begin{aligned}
 E^* &= \max \{0, [E \times (1 + H_e) - C \times (1 - H_c - H_{fx})]\} \\
 &= \max \{0, [1000 \times (1 + 0) - 1050 \times (1 - 0.014 - 0)]\} \\
 &= 0 \\
 RWA &= E^* \times RW = 0 \times 0.2 \text{ (AAA rated)} = \text{PKR } 0
 \end{aligned}$$
