



# **Instructions for Basel III Implementation in Pakistan**

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**Banking Policy & Regulations Department**

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## Preamble

State Bank of Pakistan issued instructions for the Implementation of Basel II capital accord under BSD Circular No. 8 of 2006. However, the existing instructions are being revised and updated in the light of recent developments on the capital requirement as published by the Basel Committee on Banking Supervision (BCBS) under the Basel III capital reforms and clarifications issued by SBP from 2006 onward while implementing capital related instructions.

These instructions will further strengthen the existing capital framework under which certain provisions of existing Basel II instructions will be amended and some new requirements will be introduced.

Keeping in view of the volume of instructions, SBP will issue these revisions in the following two parts;

- i. Reforms/ amendments mainly pertaining to regulatory capital and related deductions;
- ii. Revision of Basel II instructions to cover remaining aspects of Basel III reforms;

**These instructions address the first part mainly pertaining to eligible capital and related deductions.**

## **A. An Overview of Capital Instructions**

All banks/ DFIs are required to comply with the capital adequacy framework which comprises the following three capital standards:

**i. Minimum Capital Requirement (MCR):**

The MCR standard sets the nominal amount of capital banks/ DFIs are required to hold. No bank/ DFI shall commence and carry on its business in Pakistan unless it meets the nominal capital requirements prescribed by SBP from time to time.

**ii. Capital Adequacy Ratio:**

The Capital Adequacy Ratio (CAR) assesses the capital requirement based on the risks faced by the banks/ DFIs. The banks/ DFIs are required to comply with the minimum requirements as specified by the State Bank of Pakistan on standalone as well as consolidated basis.

**iii. Leverage Ratio:**

The Tier-1 Leverage Ratio of 3% is being introduced in response to the recently published Basel III Accord as the third capital standard (parallel run to commence from December 31, 2013) which is simple, transparent and independent measure of risk. Refer to Chapter-3 for details.



## **B. Minimum Capital Requirement (MCR)**

The Minimum Capital Requirement (MCR) standard sets the nominal amount of capital banks/DFIs are required to hold. This requirement is set by SBP as per national discretion. No Bank/DFI incorporated in Pakistan shall commence and carry on its business unless it has a minimum paid up capital (net of losses) as prescribed by SBP from time to time.

Similarly, no banking company incorporated outside Pakistan shall commence and carry on banking business in Pakistan unless it meets the minimum assigned capital<sup>1</sup> (net of losses) requirements as prescribed by SBP from time to time.

The current MCR instructions have been issued vide BSD Circular No. 19 of September 5, 2008 and BSD Circular No. 7 of April 15, 2009.

The MCR standard consists of sum of the following elements:

- Fully Paid-up Common Shares/ Cash deposited with SBP<sup>1</sup>
- Balance in Share Premium Account
- Reserve for issue of Bonus Shares
- Any other type of instrument approved by the SBP.

Less

- Accumulated Losses/ Discount offered on issue of shares
- Negative General Reserves

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<sup>1</sup> In the case of foreign banks operating in branch mode in Pakistan

## Chapter – 1: General instructions on Capital Adequacy Framework

### 1.1. Introduction:

The Capital Adequacy Ratio (CAR) is calculated by taking the Eligible Regulatory Capital as numerator and the total Risk Weighted Assets (RWA) as denominator.

$$CAR = \frac{\text{Total Eligible Capital}}{\text{Credit RWA} + \text{Market RWA} + \text{Operational RWA}}$$

Currently, banks/ DFIs are required to maintain a minimum CAR of 10 percent on an ongoing basis at both standalone and consolidated level which will gradually be increased in the light of these instructions.

For the purpose of capital adequacy, the consolidated bank means an entity that is the parent of a group of financial entities<sup>2</sup>, where the parent entity itself may either be a bank or a holding company. This consolidation is to ensure that risk of the whole banking group is captured.

The term ‘bank’, wherever used throughout the document, unless otherwise specified, means all the banks and Development Financial Institutions (DFIs) under the regulatory purview of the State Bank of Pakistan (SBP).

The details of various components of Eligible Capital instruments are described in [Chapter 2](#).

### 1.2. Measurement of Risk Weighted Assets

Banks are required to calculate Risk Weighted Assets (RWA) in respect of credit, market and operational risks. The methodologies to calculate RWA for each of these risk categories are described in detail in relevant chapters.

### 1.3. Scope of Application

The capital adequacy framework applies on all banks both at standalone as well as at consolidated level. As such, reporting bank shall comply with the capital requirements at two levels.

#### i. Standalone Level:

The standalone level capital adequacy ratio measures the capital adequacy of a reporting bank based on its standalone capital strength and risk profile; and

#### ii. Group/ Consolidated Level:

The consolidated (“Group”) level capital adequacy ratio measures the capital adequacy of a bank based on its capital strength and risk profile after consolidating the assets and

<sup>2</sup> Financial entities mean banks, DFIs, Exchange Companies, Investment banks, leasing companies, Modarabas, Discount houses, brokerage firms, Mutual funds & Asset Management Companies and Insurance but do not include Commercial entities.

liabilities of all its banking group entities, except the subsidiaries which are engaged in insurance and commercial business.

All banking and other relevant financial activities (both regulated and unregulated) conducted within a group containing a bank is to be captured through consolidation. Thus, majority-owned or controlled (defined under applicable accounting standard) financial entities will be fully consolidated.

If any majority-owned or controlled financial subsidiaries are not consolidated for capital purposes, all equity and other regulatory capital investments in those entities attributable to the group will be deducted, and the assets and liabilities, as well as third-party capital investments in the subsidiary will be removed from the bank's balance sheet.

Since insurance & commercial subsidiaries of the bank are not required to be consolidated, hence when measuring capital adequacy for banks, the equity and other regulatory capital investment shall be required to be deducted from common equity tier 1. Under this approach the bank will remove from its balance sheet assets and liabilities, as well as third party capital investments in an insurance/ commercial subsidiary. In case of any shortfall in the regulatory capital requirement of unconsolidated financial subsidiary (e.g. insurance), the shortfall shall be fully deducted from the Common Equity Tier 1 capital (at standalone as well as consolidated level).

All investments (which are outside the scope of regulatory consolidation) in the capital instruments issued by banking, financial and insurance entities are to be treated as per paragraph 2.4.9 of Chapter 2.

All significant equity investments in commercial entities (which exceeds 10% of the issued common share capital of the issuing entity) or where the entity is an unconsolidated affiliate<sup>3</sup> will receive a 1000% risk weight. The equity investment which is equal to or below 10% of paid-up capital of investee company will attract risk weight depending on the bank's classification in the banking book or trading book.

#### **1.4. Reporting Requirements**

Banks are required to submit CAR statements on the reporting formats provided by SBP within prescribed timelines. In addition to the periodic unaudited statements, banks/DFIs are also required to submit an annual CAR statement duly certified by the external auditors.

As per the timeframe specified by SBP, vide BSD circular letter No. 3 of February 6, 2010, banks/ DFIs are required to submit quarterly CAR statement within 18 working days from the end of each calendar quarter. Whereas the annual CAR statement, duly certified by the external auditor, is required to be submitted within three months from the close of the year as per BSD Circular No. 1 of January 6, 2009.

Further, to supplement risk based requirements, banks are required to calculate monthly Leverage Ratio on standalone as well as on consolidated level and report to SBP their quarterly

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<sup>3</sup> An affiliate of a bank is defined as a company that controls, or is controlled by, or is under common control with, the bank. Control of a company is defined as (1) ownership, control, or holding with power to vote 20% or more of a class of voting securities of the company; or (2) consolidation of the company for financial reporting purposes

ratio based on average of monthly calculated ratios as per timeline prescribed above. For further details, refer to [Chapter-3](#) on Leverage Ratio.

### **1.5. Notification Requirements**

A bank must inform SBP immediately of:

- i. Any breach of the minimum capital requirement, capital adequacy ratio or leverage ratio as set out in these instructions and the remedial measures it has taken to address those breaches.
- ii. Any concern it has about its MCR, CAR or leverage ratio, along with proposed measures to address these concerns.

### **1.6. Reductions in Capital**

Where a bank intends to reduce its paid-up/ assigned capital, it must obtain SBP's prior written consent.

### **1.7. Penalty for Non-Compliance**

Any bank that fails to meet the above mentioned regulatory capital requirement within the stipulated period shall render itself liable to the following actions:

- i. Imposition of penalties and/ or such restrictions on its business including restrictions on acceptance of deposits and lending as may be deemed fit by SBP.
- ii. De-scheduling of the bank, thereby converting it into a non-scheduled bank.
- iii. Cancellation of the banking license if SBP believes that the bank is not in a position to meet the MCR, CAR or Leverage Ratio requirements.

## Chapter – 2: Regulatory Capital

### 2.1 Components of Capital

For the purpose of calculating capital under capital adequacy framework, the capital of banks shall be classified into two tiers. The total regulatory capital will consist of sum of the following categories:

1. Tier 1 Capital (going-concern capital)
  - i. Common Equity Tier 1
  - ii. Additional Tier 1
2. Tier 2 Capital (gone-concern capital)

#### 2.1.1. Common Equity Tier 1 (CET1)

Common Equity Tier 1 shall consist of sum of the following items:

- i. Fully paid up (common shares) capital / assigned capital
- ii. Balance in share premium account
- iii. Reserve for Issue of Bonus Shares
- iv. General/ Statutory Reserves as disclosed on the balance-sheet
- v. Minority Interest (in case of CAR calculated on a consolidated basis) i.e. common shares issued by consolidated subsidiaries of the bank and held by third parties meeting eligibility criteria, as mentioned under paragraph A-1-1 of [Annexure-1](#).
- vi. Un-appropriated / un-remitted profits (net of accumulated losses, if any)
- vii. Less regulatory adjustments applicable on CET1 as mentioned in [paragraph 2.4](#).

#### 2.1.2. Additional Tier 1 Capital (AT1)

Additional Tier 1 capital shall consist of the following items:

- i. Instruments issued by the banks that meet the qualifying criteria for AT1 as specified at [Annexure-2](#).
- ii. Share premium resulting from the issuance of AT1 instruments.
- iii. Minority Interest i.e. AT1 issued by consolidated subsidiaries to third parties (for consolidated reporting only); Refer to paragraph A-1-2 of [Annexure-1](#) for further details.
- iv. Less regulatory adjustments applicable on AT1 Capital as mentioned in [paragraph 2.4](#).

#### 2.1.3. Tier 2 Capital (Gone Concern Capital or Supplementary Capital)

The Tier 2 capital (or gone concern capital) shall include the following elements:

- i. Subordinated debt/ Instruments (meeting eligibility criteria as specified in [Annexure-3](#)).
- ii. Share premium resulting from the issue of instruments included in Tier 2.

- iii. Minority Interest i.e. Tier-2 issued by consolidated subsidiaries to third parties as specified at A-1-3 [Annexure-1](#).
- iv. Revaluation Reserves (net of deficits, if any) – for details refer to point [2.3.1](#).
- v. General Provisions or General Reserves for loan losses – details at [2.3.2](#).
- vi. Foreign Exchange Translation Reserves.
- vii. Undisclosed Reserves – details at [2.3.3](#).
- viii. Less regulatory adjustments applicable on Tier-2 capital as mentioned at [paragraph 2.4](#).

## 2.2. Limits (Minima & Maxima)

These instructions/ rules will be adopted in a phased manner starting from the end year 2013, with full implementation of capital ratios by the year-end 2019, as per table 2.2.1 below. All banks will be required to maintain the following ratios on an ongoing basis:

- i. Common Equity Tier 1 of at least 6.0% of the total RWA.
- ii. Tier-1 capital will be at least 7.5% of the total RWA which means that Additional Tier 1 capital can be admitted maximum up to 1.5% of the total RWA.
- iii. Minimum Capital Adequacy Ratio (CAR) of 10% of the total RWA i.e. Tier 2 capital can be admitted maximum up to 2.5% of the total RWA.
- iv. Additionally, Capital Conservation Buffer (CCB) of 2.5% of the total RWA is being introduced which will be maintained in the form of CET1. Details regarding CCB framework and transitional arrangements are appended in [Annexure-4](#).
- v. The excess additional Tier 1 capital and Tier-2 capital can only be recognized if the bank has CET1 ratio in excess of the minimum requirement of 8.5% (i.e. 6.0% plus capital conservation buffer of 2.5%).
- vi. For the purpose of calculating Tier 1 capital and CAR, the bank can recognize excess Additional Tier 1 and Tier 2 provided the bank has excess CET1 over and above 8.5%. Further, any excess Additional Tier 1 and Tier 2 capital will be recognized in the same proportion as stipulated above i.e. the recognition of excess Additional Tier 1 (above 1.5%) is limited to the extent of 25% (1.5/6.0) of the CET1 in excess of 8.5% requirement. Similarly, the excess Tier 2 capital (above 2.5%) shall be recognized to the extent of 41.67% (2.5/6.0) of the CET1 in excess of 8.5% requirement.
- vii. SBP has prescribed CAR level higher than the BCBS requirements. A part of the cushion may be utilized for meeting the countercyclical capital buffer. Instructions on operational aspects for the implementation of the countercyclical capital buffer will be issued separately.

**2.2.1. Phase-in Arrangement and full implementation of the minimum capital requirements:**

		Year End						As of Dec 31
Sr. #	Ratio	2013	2014	2015	2016	2017	2018	2019
1.	CET1	5.0%	5.5%	6.0%	6.0%	6.0%	6.0%	6.0%
2.	ADT-1	1.5%	1.5%	1.5%	1.5%	1.5%	1.5%	1.5%
3.	Tier 1	6.5%	7.0%	7.5%	7.5%	7.5%	7.5%	7.5%
4.	Total Capital	10.0%	10.0%	10.0%	10.0%	10.0%	10.0%	10.0%
5.	CCB (Consisting of CET1 only)	-	-	0.25%	0.65%	1.275%	1.900%	2.5%
6.	Total Capital plus CCB	10.0%	10.0%	10.25%	10.65%	11.275%	11.90%	12.5%

**2.3. Eligibility Criteria – Other Elements of Capital****2.3.1 Revaluation Reserves**

Revaluation Reserves will form part of Tier-2 capital. Revaluation Reserves may be created by revaluation of fixed assets and available for sale (AFS) securities held by the bank. The assets and investments must be prudently valued fully taking into account the possibility of price fluctuations and forced sale value.

The net surplus / (deficit) on Available for Sale instruments and revaluation of fixed assets 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 CET1.

**2.3.2 General Provisions or General Reserves for Loan Losses**

General Provisions or General Reserves for loan losses will be limited up to 1.25 percent of the credit risk-weighted assets under standardized approach. Under IRB approach, where the total expected loss amount is less than the total provisions held, banks can recognize this difference in tier-2 capital up to maximum of 0.6% of the credit risk weighted assets.

### **2.3.3 Undisclosed Reserves**

Undisclosed Reserves may be included in Tier-2 despite being unpublished, provided they appear in the internal accounts of the bank. Only those reserves can be included that have been passed through the profit and loss account of the bank. The undisclosed reserves should satisfy the following:

- a. Undisclosed reserves should be set aside from the institution's earnings duly certified by the External Auditors. Undisclosed Reserves should not be encumbered by any provision or known liability and should be freely available to meet unforeseen losses.
- b. SBP will express in writing appropriateness of undisclosed reserves for inclusion in Tier-2 capital.

## **2.4. Regulatory Capital Deductions**

In order to arrive at the eligible regulatory capital for the purpose of calculating CAR, banks are required to make the following deductions from CET1.

### **2.4.1 Book value of Goodwill and all other Intangible Assets**

The book value of goodwill and other intangible assets like software, brand value etc., will be deducted net of any associated deferred tax liabilities which will be extinguished if the intangible assets become impaired or derecognized under the relevant accounting standards. This includes any goodwill in the valuation of significant investments in the capital of banking, financial and insurance entities that are outside the scope of regulatory consolidation<sup>4</sup>.

### **2.4.2 Shortfall in provisions required against classified assets**

Shortfall in provisions against classified assets will be deducted from CET1. Under IRB approach, shortfall in provisions from expected losses will also be deducted from CET1. The full shortfall amount will be deducted without considering/netting any tax effects that could be expected to occur if provisions were to rise.

### **2.4.3 Deficit on account of revaluation**

The net deficit (after tax) on account of revaluation (i.e. Available for Sale category and on fixed assets) shall be deducted from CET1. Refer to explanation provided in section 2.3.1 above.

### **2.4.4 Deferred tax assets (DTA)**

- Deferred tax assets (DTA), which rely on future profitability of the bank to be realized, will be deducted from CET1. DTAs may be netted with associated

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<sup>4</sup> Investments in entities that are outside of the scope of regulatory consolidation refers to investments in entities that have not been consolidated at all or have not been consolidated in such a way as to result in their assets being included in the calculation of consolidated risk-weighted assets of the group.



deferred tax liabilities (DTLs) if both relate to tax levied by the same taxation authority and offsetting is permitted by the relevant tax authority.

- For DTA pertaining to temporary differences (e.g. allowance for credit losses), the amount to be deducted is explained in the “threshold deductions” section [2.4.10](#) below.
- All other DTAs (e.g. assets relating to operating losses, such as the carry forward of unused tax losses, or unused tax credits) will be deducted in full net of DTL as described above.

The DTLs permitted to be netted against DTAs will exclude the amounts that have been netted against the deduction of goodwill, intangibles and defined benefit pension assets, and will be allocated on a pro rata basis between DTAs subject to the threshold deduction treatment and DTAs that will be deducted in full.

An over-installment of tax or any receivable from the local tax authority which is classified as current tax assets for accounting purposes and recovery of such receivable do not rely on the future profitability of the bank will be assigned the relevant sovereign risk weighting.

#### **2.4.5. Defined benefit pension fund assets**

Defined benefit pension fund liabilities, as included on the balance sheet, must be fully recognized in the calculation of CET1 (i.e. CET1 cannot be increased through derecognizing these liabilities). For each defined benefit pension fund that is an asset on the balance sheet, the asset will be deducted from CET1 net of any associated deferred tax liability which would extinguish if the asset becomes impaired or derecognized under the relevant accounting standards. However, where the bank has unrestricted/ free access to these assets of the fund, with supervisory approval, offset the deduction. Such offsetting assets will be given the risk weight as if they were owned directly by the bank.

#### **2.4.6 Gain on sale related to securitization transactions**

Bank will derecognize in the calculation of CET1, any increase in equity capital resulting from securitization transactions, such as that associated with expected future margin income resulting in a gain on sale.

#### **2.4.7 Cash flow hedge reserve**

The cash flow hedge reserve only reflects one half of the picture, the fair value of the derivative but not the changes in fair value of hedged future cash flow. Therefore the amount of cash flow hedge reserve that relates to the hedging of items that are not fair valued on the balance sheet (including projected cash flows), if positive will be deducted. However, negative amount under cash flow hedge will be added back to calculate CET1 (in case a bank adds gain to tier-2 capital then the tier-2 will be adjusted accordingly).

## 2.4.8 Investment in own shares

All of a bank's investment in its own common shares, held directly or indirectly will be deducted from CET1 to avoid the double counting of a bank's own capital. The treatment described will apply irrespective of the location of the exposure in the banking book or the trading book. Moreover, banks should look through holdings of index/ mutual fund securities to deduct exposures to own shares. Following the same approach, bank must deduct any investment in their own additional tier 1 or tier 2 instruments.

## 2.4.9 Investments in the Capital of Banking, Financial and Insurance Entities

### Corresponding Deduction Approach

Under the corresponding deduction approach, banks will deduct investments in the capital of other banks, financial institutions and insurance entities from the respective tier of their own capital. This means the deduction will be applied to the same component of capital for which the capital will qualify if it was issued by the bank itself.

If, under the corresponding deduction approach, a bank is required to make a deduction from a particular tier of capital and it does not have enough of that tier of capital to satisfy the deduction, the shortfall will be deducted from the next higher tier of capital (e.g. if a bank does not have enough additional tier-1 capital to satisfy the deduction, the shortfall will be deducted from CET1).

Banks will make the following corresponding deductions:

**2.4.9.1 Reciprocal crossholdings of capital** designed to artificially inflate the capital position of banks will be deducted. For this purpose, a holding is considered to be a reciprocal crossholding if the investee entity has also invested in any type of bank's capital instrument which may necessarily not be the same instrument as the bank is holding.

**2.4.9.2 Investments in the capital of Banking, Financial & Insurance Entities (outside the scope of regulatory consolidation): [where the bank does not own more than 10% of the issued common share capital of the entity]**

The regulatory adjustments described in this paragraph applies to investment in the capital of banking, financial and insurance entities that are outside the scope of regulatory consolidation and where the bank does not own more than 10% of the issued common share capital of the entity. In addition:

- a. Investments include all holdings i.e. direct, indirect, synthetic holdings of capital instruments (e.g. bank will look through holdings of mutual fund/ index securities to determine their underlying holdings of capital). Holdings in both the banking book and the trading book are to be included. Capital includes common stock and all other types of cash and synthetic capital instruments (e.g. subordinated debt). Moreover,

investments also include underwriting positions held for longer than three months (as stipulated in prudential regulations). SBP may consider requests to exclude temporarily certain investments where these investments are made in the context of resolving or providing support to a distressed institution.

- b. If the total of all holdings (mentioned at point-a) in aggregate exceed 10% of the bank's common equity (paid-up capital plus reserves mentioned under CET1 less all regulatory adjustments mentioned up to point 2.4.9.1 above) then the amount above 10% of a bank's common equity will be deducted under the corresponding deduction approach.
- c. The amount to be deducted from common equity will be calculated as the total of all holdings which in aggregate exceed 10% of a bank's common equity multiplied by the common equity holdings as a percentage of the total capital holdings. This would result in a common equity deduction which corresponds to the proportion of total capital holdings held in common equity. Similarly, the amount to be deducted from Additional Tier1 or Tier 2 capital will be calculated as the total of all holdings which in aggregate exceed 10% of the bank's common equity multiplied by the Additional Tier 1 or Tier 2 capital holdings as a percentage of the total capital holdings.
- d. Amounts below the threshold, which are not deducted, will continue to be risk weighted. Thus, instruments in the trading book will be treated as per the market risk rules and instruments in the banking book will be treated as per the standardized approach or internal ratings-based approach (as applicable). For the application of risk weighting the amount of the holdings will be allocated on a pro rata basis between those below and those above the threshold.
- e. Detailed illustration of paragraph 2.4.9.2 is provided at [Appendix-2](#).

### **2.4.9.3 Significant Investments in the capital of Banking, Financial & Insurance Entities (outside the scope of regulatory consolidation)**

The regulatory adjustments described in this paragraph applies to investment in the capital of banking, financial and insurance entities that are outside the scope of regulatory consolidation where the bank owns more than 10% of the issued common share capital of the issuing entity or where the entity is an affiliate of the bank. In addition:

- a. Investments include all holdings i.e. direct, indirect, synthetic holdings of capital instruments (e.g. bank will look through holdings of mutual fund<sup>5</sup>/ index securities to determine their underlying holdings of capital). Holdings in both the banking book and the trading book are to be included. Capital includes common stock and all other types of cash and

<sup>5</sup> Refer to chapter-4 for detailed instructions on bank's investment in the units of mutual funds.

synthetic capital instruments (e.g. subordinated debt). Moreover, investments also include underwriting positions held for longer than three months (as stipulated in prudential regulations). SBP may consider requests to exclude temporarily certain investments where these investments are made in the context of resolving or providing support to a distressed institution.

- b. All investments (mentioned at point-a) which are not common share (e.g. subordinated debt etc.) will be fully deducted following a corresponding deduction approach.
- c. Investments (mentioned at point-a) in common shares will be subject to “Threshold Deduction” treatment described in next paragraph.
- d. A detailed illustration of paragraph 2.4.9.3 is provided at [Appendix- 3](#).

#### 2.4.10 Threshold Deductions

Instead of full deduction, the following items may each receive limited recognition when calculating CET1, with recognition capped at 10% of the bank’s common equity {after application of all the regulatory adjustments mentioned up to 2.4.9.3 (b)}.

- Significant investments in the common shares of unconsolidated financial institutions (banks, insurance and other financial entities) as referred to in paragraph 2.4.9.3 (c).
- DTAs that arise from temporary differences (i.e. credit provisioning etc.)

Moreover, the amount of the above two items that remains recognized after the application of all the regulatory adjustments must not exceed 15% of CET1 calculated after all regulatory adjustments. Refer to [Appendix-4](#) for an illustration.

The amount of the two items which are not deducted in the calculation of CET1 will be risk weighted at 250% and are subject to full disclosure.

#### 2.4.11 Transitional Arrangements for Capital Deductions

In the light of Basel III proposals, SBP has harmonized deductions from capital which will mostly be applied at the level of common equity tier 1. The transitional arrangement for implementing the new standards are intended to ensure that banking sector can meet the higher capital standards through reasonable earnings retention and capital raising, while still supporting lending to the economy. In this regard, the following transitional arrangements are prescribed:

Phase-in of all deductions from CET1  (in percentage terms)	Year End						As of Dec 31
	2012	2013	2014	2015	2016	2017	2018
	-	-	20%	40%	60%	80%	100%

**Explanation:**

- The regulatory capital adjustment will start in a phased manner December 31, 2014 @ 20 percent per annum with full deduction from CET1 w.e.f. December, 2018. During the transition period, the part which is not deducted from CET1/ Additional Tier 1/ Tier 2 will attract existing treatment.
- In the year 2013, the banks will not apply the additional deductions proposed under the Basel III rules and will apply existing treatment. For example, DTA will not be deducted but risk weighted.
- The treatment for the year 2014 (w.e.f. December 31, 2014)
  - If an item is to be deducted under new Basel III rules and is currently risk weighted under the exiting regime then it will require 20% deduction from CET1 and rest of the 80% will be subject to risk weight as applicable under the existing rules.
  - If an item is required to be deducted under the existing framework (suppose from Tier 2) and Basel III rules prescribe deduction from CET1; in that case, 20% of the amount will be deducted from CET1 and the rest will be deducted from current tier of deduction (i.e. tier 2).
  - In case of Minority Interest, if such capital is not eligible for inclusion in CET1 but is included under the existing guidelines in Tier 1 then 20% of the amount will be deducted from the relevant component of capital (Tier 1).

**2.4.12 Phase out of Non Qualifying Capital Instruments:**

Capital instruments (e.g. subordinated debt/ TFCs) issued before January 1, 2013 which meets the Basel III criteria, except that they do not meet the loss absorbency clause requirements, will be considered non-qualifying capital instruments and will be subject to the following phase-out arrangement.

Reporting Period	Year End (Dec. 31)									
	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Cap { % of base amount that may be included in Tier-2 capital under phase out arrangements }	90%	80%	70%	60%	50%	40%	30%	20%	10%	0%

The amount of these transitional instruments that may be included in regulatory capital will be determined by reference to the base amount. The base amount will be fixed at the outstanding amount which is eligible to be included in the tier-2 capital under the existing framework (Basel II) applicable as on December 31, 2012. The recognition will be capped at 90% (of the base amount) from December 31, 2013, with the cap reducing by 10 percentage points in each subsequent year. Where a Tier-2 instrument is subject to regulatory amortization, the individual instrument eligible to be included in tier-2 capital will continue to be amortized at a rate of 20% per year during the transition period in addition to the aggregate cap reducing at a rate of 10% per annum. Capital instruments issued after January 1, 2013 must meet all of the Basel III criteria for regulatory capital (including the loss absorbency clause requirements) to qualify as regulatory capital.

## Chapter – 3:      Leverage Ratio

### 3.1 Introduction & Objective

In order to avoid building-up excessive on- and off-balance sheet leverage in the banking system, a simple, transparent and non-risk based Leverage Ratio is being introduced with the following objectives:

- constrain the build-up of leverage in the banking sector which can damage the broader financial system and the economy; and
- reinforce the risk based requirements with an easy to understand and a non-risk based measure.

### 3.2 Definition and Calculation

$$\text{Leverage Ratio} = \frac{\text{Tier 1 Capital (after related deductions)}}{\text{Total Exposure}}$$

- 3.2.1 A minimum Tier 1 leverage ratio of 3% is being prescribed both at solo and consolidated level.
- 3.2.2 The banks will maintain leverage ratio on quarterly basis. The calculation at the end of each calendar quarter will be submitted to SBP showing the average of the month end leverage ratios based on the following definition of capital and total exposure.

### 3.3 Capital Measure

- 3.3.1 The capital measure for the leverage ratio will be based on the new definition of Tier 1 capital as specified in Chapter 2, section [2.1](#).
- 3.3.2 Items which are deducted completely from capital do not contribute to leverage and will therefore also be deducted from the measure of exposure. This means that deductions from Tier 1 capital specified in section [2.4](#) (Chapter 2) will also be made from the exposure measure.
- 3.3.3 According to the treatment outlined in section 2.4.9.3, where a financial entity is included in the accounting consolidation but not in the regulatory consolidation, the investments in the capital of these entities will be deducted to the extent they exceed 10% of the bank's common equity (paid-up capital plus reserves). To ensure that the capital and exposure are measured consistently for the purposes of leverage ratio, the assets of such entities included in the accounting consolidation will be excluded from the exposure measure in proportion to the capital that is excluded under section 2.4.9.3.

### 3.4 Exposure Measure

#### 3.4.1 General Measurement Principles

The exposure measure for the leverage ratio will generally follow the accounting measure of exposure. In order to measure the exposure consistently with financial accounts, the following will be applied by the bank:

- i. On balance sheet, non-derivative exposures will be net of specific provisions and valuation adjustments (e.g. surplus/ deficit on AFS/ HFT positions).
- ii. Physical or financial collateral, guarantee or credit risk mitigation purchased is not allowed to reduce on-balance sheet exposure.
- iii. Netting of loans and deposits is not allowed.

#### 3.4.2 On-Balance Sheet Items

Banks will include items using their accounting balance sheet for the purposes of the leverage ratio. In addition, the exposure measure will include the following treatments for Securities Financing Transactions (e.g. repo, reverse repo etc.) and derivatives:

**i. Repurchase Agreements and Securities Financing:**

Securities Financing Transactions (SFT) are a form of secured funding and therefore an important source of balance sheet leverage that will be included in the leverage ratio. Therefore banks should calculate SFT for the purposes of leverage ratio by applying

- The accounting measure of exposure; and
- Without netting various long and short positions with the same counterparty

**ii. Derivatives:**

Derivatives create two types of exposures: an on-balance sheet present value reflecting the fair value of the contract (often zero at the outset but subsequently positive or negative depending on the performance of the contract), and a notional economic exposure representing the underlying economic interest of the contract. Banks will calculate derivatives exposure, including where a bank sells protection using a credit derivative, for the purposes of leverage ratio by applying:

- The accounting measure of exposure (positive mark to market value) plus an add-on for potential future exposure calculated according to the Current Exposure Method as per instructions prescribed in the Chapter for Credit Risk.
- Without netting the mark to market values and potential future exposure regarding long and short positions with the same counterparty.

#### 3.4.3 Off-Balance Sheet Items

Banks will calculate the off-balance sheet (OBS) items specified in Credit Risk chapter under the section of “Risk Weights Off-Balance Sheet Exposure” by applying a uniform

100% credit conversion factor (CCF). For any commitments that are unconditionally cancellable at any time by the bank without prior notice, a CCF of 10% will be applied.

### **3.5 Parallel Run Reporting**

The parallel run period for leverage ratio will commence from December 31, 2013 to December 31, 2017. During this period, the leverage ratio and its components will be tracked to assess whether the design and calibration of the minimum tier 1 leverage ratio of 3% is appropriate over a credit cycle and for different types of business models, including its behavior relative to the risk based requirements.

Bank level disclosure of the leverage ratio and its components will start from December 31, 2015. However, banks will report their Tier 1 leverage ratio to the State Bank on quarterly basis from December 31, 2013.

Based on the results of the parallel run period, any final adjustments to the definition and calibration of the leverage ratio will be made by SBP before the first half of 2017, with a view to set the leverage ratio requirements as a separate capital standard on December 31, 2018.



## Chapter – 4: Investment in the units of Mutual Fund/ Collective Investment Scheme

### 4.1 Introduction

This chapter provides various options/ approaches to determine capital requirement for banks' investment in the units of mutual funds/ collective investment schemes. The choice of option will depend on the availability of information on the underlying exposure of each/ individual mutual fund/ collective investment scheme at all times.

### 4.2 Look-through Approach

The look through treatment is designed to capture the risks of an indirect holding of the underlying assets of the investment fund.

Full look through	Where the bank is aware of the actual underlying investments of the mutual fund on daily basis, the bank may calculate the capital charge on its investment as if the underlying exposure/ asset class held by the mutual fund is held by the bank itself.
Modified look through	In case the bank is not aware of the underlying investment on a daily basis, the bank may determine capital charge by assuming that the mutual fund first invests to the maximum extent in the most risky asset class (i.e. which attracts highest risk weight under existing instructions) allowed under its offering document and then continues making investments in descending order (second highest risk weighted asset) until the total investment limit is reached.
Conservative Approach	If the bank is not in a position to implement the above approaches, the bank may calculate capital charge based on the most risky asset (i.e. assigning the highest risk weight) category applicable to any asset the mutual fund is authorized to hold as per its offering document.

### 4.3 Capital Treatment

Banks'/ DFIs' investments in the units of mutual funds will be subject to Market Risk and hence will be categorized in the Trading Book. The capital charge will be calculated in the following manner.

#### 4.3.1 Investment/ holding up to 30% in a single mutual fund:

If a bank's holding in a single fund does not exceed 30% then the bank may apply any of the approaches described in section 4.2 above:

#### 4.3.2 Investment/ holding in a single fund within the range from 30% to 50%:

For such investments, the capital charge will be the sum of (i) capital charge calculated based on look through approach for investment up to 30%, as described in point 4.3.1 above, and (ii) an additional capital charge of 20% on incremental investment beyond 30% benchmark.

**4.3.3 Investment/ holding in a single fund exceeding 50% or investment subject to lock-in clause:**

In case banks' holding/ investment in a single mutual fund exceeds 50%; then the investment up to 30% of a mutual fund will attract capital charge based on look through approaches whereas the incremental amount exceeding 30% threshold will be deducted from Tier-1 capital of the bank. Furthermore, where the banks' investment is subject to any lock-in clause (irrespective of its percentage holding) under which the bank cannot liquidate its position (e.g. seed capital), the entire investment will be deducted from Tier-1 for CAR.

**4.4 Significant investment in the capital of Asset Management Company (AMC):**

Asset Management Company (AMC) is considered as a financial entity for capital adequacy purposes and any significant minority and/or majority investments in the capital of AMC is subject to the same rules as described in the Scope of Application (chapter 1) and Investments in the Capital of Banking, Financial and Insurance Entities (section 2.4.9).

## **Annexure-1: Minority Interest (For Consolidated Reporting only)**

Banks should recognize minority interests that arise from consolidation of less than wholly owned banks, securities or other financial entities in CAR on consolidated basis to the extent specified below:

### **A-1-1: Common shares issued by consolidated subsidiaries.**

Minority interest arising from the issue of common shares by a fully consolidated subsidiary of a bank may receive recognition in CET1 only if: (1) the instrument giving rise to minority interest is common share, and (2) the subsidiary that issued the instrument is itself a bank<sup>6</sup>. The amount of minority interest recognized in CET1 capital will be calculated as follows:

- Total minority interest meeting the two criteria above minus the amount of the surplus CET1 of the subsidiary attributable to the minority shareholders.
  - i. Surplus CET1 of the subsidiary is calculated as the CET1 of the subsidiary minus the lower of:
    - a) The minimum CET1 requirement of the subsidiary plus the capital conservation buffer (i.e. 8.5% of risk weighted assets).
    - b) The portion of the consolidated minimum CET1 requirement plus the capital conservation buffer (i.e. 8.5% of consolidated risk weighted assets) that relates to the subsidiary.
  - ii. The amount of the surplus CET1 that is attributable to the minority shareholders is calculated by multiplying the surplus CET1 by the percentage of CET1 that is held by minority shareholders.

### **A-1-2 Tier 1 qualifying capital issued by consolidated subsidiaries**

Tier 1 capital instruments issued by a fully consolidated subsidiary of a bank to third party investors (including amounts under paragraph A-1-1) may receive recognition in Tier 1 capital only if the instruments, if issued by the bank, meet the criteria for classification as Tier 1 capital.

The amount of capital that will be recognized in Tier 1 capital will be calculated as follows:

- Total Tier 1 capital of the subsidiary issued to third parties minus the amount of surplus Tier 1 capital of the subsidiary attributable to the third party investors.
  - i. Surplus Tier 1 capital of the subsidiary is calculated as Tier 1 capital of the subsidiary minus lower of:
    - a) The minimum Tier 1 requirement of the subsidiary plus the capital conservation buffer (i.e. 10.0% of risk weighted assets)
    - b) The portion of consolidated minimum Tier 1 capital requirement plus the capital conservation buffer (i.e. 10.0% of consolidated risk weighted assets) that relates to the subsidiary.
  - ii. The amount of surplus Tier 1 capital that is attributable to third party investors is calculated by multiplying the surplus Tier 1 capital by the percentage of Tier 1 capital that is held by third party investors.

<sup>6</sup> Here the term “bank” means all financial institutions including NBFCs regulated by SBP & SECP

The amount of Tier 1 capital that will be recognized in Additional Tier 1 will exclude the amounts recognized in CET1 as mentioned in point A-1-1 above.

### **A-1-3 Tier 1 and Tier 2 qualifying capital issued by consolidated subsidiaries**

Total capital instruments (i.e. Tier 1 and Tier 2 capital instruments) issued by a fully consolidated subsidiary of the bank to third party investors (including amounts under paragraph A-1-1 and A-1-2) may receive recognition in Total Capital only if the instruments would, if issued by the bank, meet all of the criteria for classification as Tier 1 or Tier 2 capital.

The amount of this capital that will be recognized in consolidated Total Capital will be calculated as follows:

- Total capital instruments of the subsidiary issued to third parties minus the amount of the surplus Total Capital of the subsidiary attributable to the third party investors.
  - i. Surplus Total Capital of the subsidiary is calculated as the Total Capital of the subsidiary minus the lower of:
    - a) the minimum Total Capital requirement of the subsidiary plus the capital conservation buffer (i.e. 12.5% of risk weighted assets)
    - b) the portion of the consolidated minimum Total Capital requirement plus the capital conservation buffer (i.e. 12.5% of consolidated risk weighted assets) that relates to the subsidiary.
  - ii. The amount of the surplus Total Capital that is attributable to the third party investors is calculated by multiplying the surplus Total Capital by the percentage of Total Capital that is held by third party investors.

The amount of the Total Capital that will be recognized in Tier 2 will exclude amounts recognized in CET1 under paragraph A-1-1 and amounts recognized in Additional Tier under paragraph A-1-2 above.

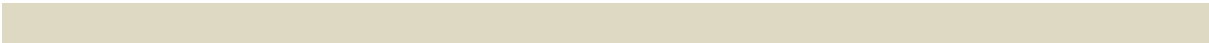
*Note: An illustrative example for calculation of minority interest and other capital issued out of consolidated subsidiaries that is held by third parties is furnished as Appendix-1*

## **Annexure-2: Criteria for Additional Tier-1 Capital Instrument**

The instruments (e.g. perpetual non-cumulative preference shares - PNCPS) meeting the following criteria will be considered for inclusion as Additional Tier-1 Capital.

- i. The instrument is issued, fully paid-up, perpetual, unsecured and permanently available to absorb losses.
- ii. The instrument should rank junior to all other claims except common shares.
- iii. Dividends/ Coupons:
  - a. Unpaid dividends/ coupons should be non-cumulative.
  - b. The issuer should have full discretion over the amount and timing of dividend/ coupon distribution i.e. the ability to waive any dividends/coupons and failure to pay should not constitute event of default.
  - c. No compensation should be available to preference shareholders other than the dividends/ coupons.
  - d. The dividend/ coupon rate or formulae should be known at the time of issuance of instruments and not linked to the credit standing of the issuer.
  - e. The rate can be fixed or floating (with reference to any benchmark rupee rate but spreads/margin cannot be changed during the life of instrument).
  - f. No step-up feature in instruments should be allowed.
  - g. The dividends/ coupons should only be paid from current year's earnings and will be subject to condition that any payment on such instruments should not result in breach of regulatory MCR and CAR requirements set by SBP from time to time.
  - h. All instances of non-payment of dividends/ coupons should be notified to the Banking Policy & Regulations Department.
- iv. Optionality:
  - a. No put option should be available to the holders of the instruments.
  - b. Issuer can exercise call option but after five years from issuance date with the prior approval from SBP. Bank should clearly indicate to the prospective investors that bank's right to exercise the option is subject to written approval of SBP. Banks shall not exercise a call unless they replace the called instrument with capital of same or better quality. Call premium (when issue is redeemed) is not allowed. Bank should also demonstrate that capital position is well above the minimum capital requirement after the call is exercised.
- v. Redemption/ Repurchase:
  - a. No redemption shall be allowed in first five years of issuance. Any repayment of principle must be with the approval of SBP and bank must not create market expectation that supervisory approval will be granted.
  - b. There should not be any sinking fund requirements on issuer for retirements of the instrument. Further terms and conditions of the issue should not be such as to force the issuer to redeem the instruments at any point in time.
- vi. Neither the bank nor a related party over which the bank exercise control or significant influence should purchase the instrument, nor should the bank directly or indirectly have funded the purchase of the instrument. Banks are not allowed to grant advances against the security of the capital instruments issued by them.

- vii. The instrument should not have any features that hinder recapitalization, such as provisions that require the issuer to compensate investors if a new instrument is issued at a lower price during a specified time frame.
- viii. The features of instrument should be transparent, easily understood and publicly disclosed.
- ix. For disclosure in the Balance Sheet, Perpetual Non-cumulative preference shares (PNCPS) will be classified as “Capital” under the heading of “Additional Tier 1” instrument subject to SBP approval, while perpetual cumulative preference shares/perpetual debt instruments will be classified as “Liabilities” in the Balance Sheet.
- x. Loss Absorption Features
  - a. The instrument should be able to absorb losses incurred by the issuer on a going concern and gone concern (point of non-viability) basis.
  - b. Instruments must have principal loss absorption through either
    - i. Conversion to common shares at an objective pre-specified trigger point, or
    - ii. A write-down mechanism which allocates losses to the instrument at a pre-specified trigger point. The write-down would reduce the claim of the instrument in liquidation, reduce the amount to be re-paid when a call is exercised and partially or fully reduce dividend payments on the instrument.
  - c. A detailed criteria for loss absorption are furnished in [Annexure-5](#). In order for an instrument issued by a bank to be included in Additional Tier 1, it must meet or exceed minimum requirements to ensure loss absorbency set out in the [Annexure-5](#).
- xi. Conversion of Instruments into Ordinary Shares
  - a. The instruments issued by the banks may contain conversion feature based either on a price fixed at the time of issuance or pricing formula applicable at the time of conversion. However, to quantify the maximum dilution and to ensure that prior shareholder approval for any future issue of the required number of shares is held, the maximum conversion ratio based on 20 percent of the ordinary share price at the time of issue is being prescribed. Adjustments may be made for subsequent share splits, bonus issues and similar transactions.
  - b. In case of unlisted banks, the conversion price may be determined based on the fair value of banks’ common shares which may be estimated as per mutually acceptable methodology
  - c. To avoid breach of any statutory ceilings, banks are required to keep all prior approvals such as sufficient room in their authorized capital for the conversion of additional tier 1 capital into common shares.
  - d. In case of convertible instruments, the conversion into ordinary shares will be allowed subject to approval of SBP and shareholders holding 5% or more of paid-up shares (ordinary or preferred) shall fulfill the fit and proper criteria of SBP.
- xii. Issuance of Additional Tier 1 Capital Instruments
  - a. Banks interested to issue these instruments should submit terms of the issue (in the light of this annexure) for the in-principle approval of SBP.

- b. The issuing bank should submit a report to SBP giving details of the instrument along with a copy of offering document within one month from the date of issue.
  - c. The proceeds of rupee denominated debt instruments offered/issued to non-residents will have to be repatriated to Pakistan and converted into rupees by the bank concerned and the Proceeds Realization Certificate will be furnished to SBP. The bank concerned will be allowed to remit the principal amount of debt instruments at maturity as well as the profit/interest thereon from the interbank market. Hedging will not be available on such instruments. Banks should comply with all the terms and conditions, if any set out by SECP, stock exchange or under any law in the country with regard to issue of the instruments.
- xiii. Bank's investment in Additional Tier 1 capital instruments issued by other banks/ financial institutions will be subject to following:
- a. Attract risk weight as per Section 2.4.8 and Credit Risk/ Market Risk Chapter of this document.
  - b. For the purpose of prudential regulation (R-6), investment in additional tier 1 capital instruments will be considered as exposure against shares.
  - c. Bank's investment in a single issue of such additional tier 1 capital of any other bank will not at any time exceed 15% of the total size of the issue.
- 

### **Annexure-3: Criteria for inclusion of Debt Instruments as Tier 2 Capital**

The subordinated debt instruments (e.g. TFCs etc.) issued by banks should meet the following terms and conditions to qualify for inclusion as Tier 2 Capital for capital adequacy purposes. Subordinated debt will also include rated and listed subordinated debt instruments i.e. TFCs etc. The terms of issue for these debt instruments are as under:

- i. Should be fully paid up, unsecured.
- ii. Subordinated to all other indebtedness of the bank including depositors, however, senior to the claims of investors in instruments eligible for inclusion in Tier 1 capital.
- iii. Should have a minimum original fixed term maturity of five years.
- iv. Recognition in regulatory capital (Tier-2) in the remaining five years before maturity will be amortized on a straight line basis.
- v. In case of staggered principal repayments, for inclusion as supplementary capital, the outstanding amount less any scheduled repayment must be discounted by 20% a year as indicated in the table below i.e. 20% of the original amount less any redemption) during the last five years to maturity.

Remaining Maturity of Instrument	Rate of Discount
Less than or equal to one year	100%
More than one year but less than or equal to two years	80%
More than two years but less than or equal to three years	60%
More than three years but less than or equal to four years	40%
More than four years but less than or equal to five years	20%

- vi. The instruments should be rated separately by a credit rating agency recognized by SBP – Minimum rating should be equivalent to ‘2’ as per SBP rating grid.
- vii. The instruments should be ‘vanilla’.
- viii. The issuer shall decide rate of profit. The rate of profit should be known at the time of issuance of subordinated debt instruments and not linked to the credit standing of the issuer.
- ix. The rate can be fixed or floating (with reference to any benchmark rupee rate), however, spreads/margin cannot be changed during the life of the instrument.
- x. All instances of non-payment of profits should be notified to the Banking Policy & Regulations Department.
- xi. Should not be redeemable before maturity without prior approval of SBP
- xii. Should be subject to a lock-in clause, stipulating that neither interest nor principal may be paid (even at maturity) if such payments will result in shortfall in bank’s MCR or CAR or increase any existing shortfall in MCR and CAR.
- xiii. No put option should be allowed to investor and there should not be any step-up feature in such instruments.
- xiv. The instrument may be callable at the initiative of the issuer after a minimum period of five years with prior approval of SBP.
- xv. Neither a bank nor a related party over which the bank exercise control or significant influence can purchase the instrument, nor can the bank directly or indirectly have funded the purchase of the instrument.



- xvi. The banks before issuing any subordinated debt instruments for inclusion in Tier-2 capital will be required to obtain prior approval of SBP.
- xvii. The issuing bank must clearly disclose in the offer documents that the instrument is unsecured, subordinated as to payment of principal and profit to all other indebtedness of the bank, including deposits and is not redeemable before maturity without prior approval of SBP. Moreover, the investors should be intimated that they have no right to accelerate the repayment of future scheduled payments (interest or principal) except in bankruptcy and liquidation.
- xviii. Banks should indicate the amount/details of subordinated debt raised as supplementary capital by way of explanatory notes in their annual audited accounts and quarterly Statement of Capital Adequacy Return, as submitted to SBP.
- xix. In order for an instrument issued by a bank to be included in Tier 2 capital, it must meet or exceed minimum requirements to ensure loss absorbency set out in the [Annexure-5](#).
- xx. Bank should not grant advances against the security of their own subordinated debt issue. While granting loans/advances against subordinated debt instruments of other banks, the margin requirement prescribed under Prudential Regulations shall be maintained, however, the bank's total financing against subordinated debt instruments issued by a bank should not exceed its total Tier-I capital less deductions. Further, the bank shall not provide any accommodation to finance purchase of its subordinated debt instrument.
- xxi. Bank's investment in a single issue of such TFCs of any other bank will not at any time exceed 5% of its own CET1 less deduction or 15% of the total size of the issue, whichever is less. Anything in excess of these thresholds will be deducted from CET1.
- xxii. Bank's investment in subordinated debt issued by other banks/ financial institutions
  - a. Will attract risk weight as per Section 2.4.8 and Credit Risk/ Market Risk Chapter of this document.
  - b. Will be treated as exposure against shares/ TFCs for the purpose of prudential regulation ceilings proposed in R-6.
- xxiii. The issuing bank should submit a report to SBP giving details of the subordinated debt, such as amount raised, maturity of the instrument, rate of profit etc. within one month from the date of issue.
- xxiv. The proceeds of rupee denominated debt instruments offered/issued to non-residents will have to be repatriated to Pakistan and converted into rupees by the bank concerned and the Proceeds Realization Certificate will be furnished to SBP. The bank concerned will be allowed to remit the principal amount of debt instruments at maturity as well as the profit/interest thereon from the interbank market. Hedging will not be available on such instruments. Banks should comply with all the terms and conditions, if any set out in any law in the country with regard to issue of such instruments.

## **Annexure-4: Capital Conservation Buffer**

### **A-4-1 Introduction & Objective**

- i. The banks shall buildup capital conservation buffer (CCB) in good/ normal times which can be used as losses are incurred during stressed period. The requirement is based on simple capital conservation rules designed to avoid breaches of minimum capital requirements.
- ii. Outside of periods of stress, banks should hold buffers of capital above the regulatory minimum.
- iii. When buffers have been drawn down, the banks shall limit discretionary distributions of earnings. This could include reducing dividend payments, share buy-backs and staff bonus payments. Banks may also choose to raise new capital from the existing or new sponsors/ investors as an alternative to conserving internally generated capital.
- iv. In the absence of raising capital from the private sector, the share of earnings retained by banks for the purpose of rebuilding their capital buffers should increase as their actual capital levels approach near the minimum capital requirement.
- v. The capital conservation framework reduces the discretion of banks which have depleted their capital buffers to further reduce them through generous distributions of earnings. In doing so, the framework will strengthen their ability to withstand adverse economic environments. Implementation of the framework will help increase sector resilience both going into a downturn, and provide the mechanism for rebuilding capital during the early stages of economic recovery. Retaining a greater proportion of earnings during a downturn will help ensure that capital remains available to support the ongoing business operations of banks through the period of stress. In this way the framework should help reduce procyclicality.

### **A-4-2 The Framework**

- i. Banks are required to maintain a capital conservation buffer of 2.5% comprising of CET1, above the regulatory minimum CAR requirement of 10%. Capital distribution constraints will be imposed on a bank when capital levels fall within this range (i.e. between 10% to 12.5%). Banks will be able to conduct business as normal when their capital levels fall into the conservation range as they experience losses. The constraints imposed only relate to distributions, not the operation of the bank.
- ii. The distribution constraints imposed on banks when their capital levels fall into the range increase as the banks' capital levels approach the minimum requirements. The table below shows the minimum capital conservation ratios a bank must meet at various levels of the CET1 capital ratios.

Capital conservation range above the minimum requirement	
CET1 (as a percentage of RWA)	Min. Capital Conservation Ratios (expressed as a percentage of earnings)
<6.0% - 6.5%	100%
>6.5% - 7.0%	80%
>7.0% - 7.5%	60%
>7.5% - 8.5%	40%
> 8.5%	0%

- iii. For example, a bank with a CET1 ratio in the range of 6.5% to 7.0% is required to retain 80% of its earnings in the subsequent financial year (i.e. payout no more than 20% in terms of dividends, share buybacks and discretionary bonus payments). The CET1 ratio includes amounts used to meet the 6.0% minimum CET1 requirement, but excludes any additional CET1 needed to meet the 7.5% Tier 1 and 10% Total Capital requirements. For example, a bank with 10% CET1 and no Additional Tier 1 or Tier 2 capital will meet all minimum capital requirements, but will have a zero conservation buffer and therefore will be subjected to 100% constraint on capital distributions by way of cash dividends, share-buybacks and discretionary bonuses.
- iv. Following are the other key aspects of the capital conservation buffer requirements:
  - a. **Elements subject to the restriction on distributions:** Cash dividends, share buybacks, discretionary payments on other Tier 1 capital instruments and discretionary bonus payments to staff are the items which will be considered as distributable. Payments that do not result in a depletion of CET1, which may for example include certain scrip dividends (bonus shares) are not considered distributions.
  - b. **Definition of earnings:** Earnings are defined as distributable profits calculated prior to the deduction of elements subject to the restriction on distributions. Earnings are calculated after the tax which would have been reported had none of the distributable items been paid. As such, any tax impact of making such distributions are reversed out. Where a bank does not have positive earnings and has a CET1 ratio less than 8.5%, it will be restricted from making positive net distributions.
  - c. **Standalone or consolidated application:** CCB is to be applicable both at standalone level as well as at the consolidated group level. Moreover, application of CCB will be made on the lower of the CET1 ratio arrived at on a standalone or consolidated basis.

### A-4-3 Transitional Arrangements

- i. The CCB will be phased in from December 31, 2015 to year end 2019.

- ii. Banks that already meet the minimum ratio requirement (6.0%+0.25%) from December 2015 (during the transition period) should maintain prudent earnings retention policies so as to meet the conservation buffer as soon as reasonably possible.

## **Annexure-5: Minimum Requirements to Ensure Loss Absorbency**

### **A-5-1 Introduction & Objective**

1. The terms and conditions<sup>7</sup> of all non-equity capital instruments (i.e. Additional Tier 1 and Tier 2) issued by banks will have provision that requires such instruments at the option of the supervisor to be either written-off<sup>8</sup> or converted into common equity upon occurrence of a certain trigger event.
2. In order for an instrument issued by a bank to be recognized in Additional Tier 1 or in Tier 2 capital, it must meet the criteria mentioned in the following paragraphs in addition to the criteria specified in Annexure 2 or 3.

### **A-5-2 Loss Absorption of Additional Tier-1 Instruments at a Pre-specified Trigger:**

- i. The additional Tier-1 capital instruments (classified as other than equity at issuance) must have loss absorption clause whereby these instruments will be permanently converted to common shares when the bank's CET1 ratio falls to or below 6.625% of RWA {i.e. minimum CET1 of 6.0% plus 25% of capital conservation buffer of 2.5% (0.625%)}. Moreover, the bank should immediately notify SBP upon reaching the trigger point.
- ii. A bank will have full discretion to determine the amount of Additional Tier-1 instruments to be converted into common shares subject to following conditions:
  - a. Where a bank's CET1 reaches the loss absorption trigger point, the aggregate amount of Additional Tier-1 capital to be converted must at least be the amount sufficient to immediately return the CET1 ratio to above 6.625% of total RWA (if possible).
  - b. The converted amount should not exceed the amount needed to bring the CET1 ratio to 8.5% of RWA (i.e. minimum CET1 of 6.0% plus capital conservation buffer of 2.5%).
- iii. The contractual terms and conditions of Additional Tier-1 instruments must also include a clause requiring full and permanent conversion of the instrument into common shares at the point of non-viability (mentioned below in Section A-5-3).
- iv. The conversion method will describe and follow the order (hierarchy of claims) in which they will absorb losses in liquidation/ gone concern basis. These terms must be clearly stated in the offer documents.
- v. In case, conversion of Additional Tier-1 capital instrument is not possible following the trigger event, the amount of the instrument must be written off in the accounts resulting in increase in CET1 of the bank.

<sup>7</sup> Under the Basel III rules (reference BIS press release dated January 13, 2011)

<sup>8</sup> The BCBS Basel III rules permit national discretion with respect to non-equity capital instruments to be written off or converted to common shares upon a trigger event. Accordingly, SBP will prefer the option of conversion to common shares.

- vi. Where the additional tier-1 capital instrument includes write-off provisions, the mechanism must state:
  - a. The claim of the instrument on liquidation of the issuer is reduced to (or below) the value of the written-off instrument.
  - b. The amount of the instrument to be paid in case of a call is reduced by the written-off amount of the instrument.
  - c. The distributions (dividends/ profit) payable on the instrument must be permanently reduced.

#### **A-5-3 Loss Absorbency of Non-Equity Capital Instruments at the Point of Non-Viability**

- i. The terms and conditions of all non-CET1 and Tier 2 instruments issued by banks must have a provision in their contractual terms and conditions that the instruments, at the option of the SBP, will either be fully and permanently converted into common share or immediately written off upon the occurrence of a non-viability trigger event called the Point of Non-Viability (PONV) as described below;
- ii. The PONV trigger event is the earlier of;
  - a. A decision made by SBP that a conversion or temporary/ permanent write-off is necessary without which the bank would become non-viable.
  - b. The decision to make a public sector injection of capital, or equivalent support, without which the bank would have become non-viable, as determined by SBP.
- iii. The issuance of any new shares as a result of the trigger event must occur prior to any public sector injection of capital so that the capital provided by the public sector is not diluted.
- iv. The amount of non-equity capital to be converted/ written-off will be determined by the SBP.
- v. Where an Additional Tier-1 capital instrument or Tier-2 capital instrument provides for conversion into ordinary shares, the terms of the instruments should include provision that upon a trigger event the investors holding 5% or more of paid-up shares (ordinary or preferred) will have to fulfill fit and proper criteria (FPT) of SBP.
- vi. The conversion terms of the instruments must contain pricing formula linked to the market value of common equity on or before the date of trigger event. However, to quantify the maximum dilution and to ensure that prior shareholder/ regulatory approvals for any future issue of the required number of shares is held, the conversion method must also include a cap on the maximum number of shares to be issued upon a trigger event.
- vii. The conversion method should describe and take into account the order (hierarchy of claims) in which the instruments will absorb losses in liquidation/ gone concern basis. These terms must be clearly stated in the offer documents. However, such hierarchy

should not impede the ability of the capital instrument to be immediately converted or to be written off.

- viii. There should be no impediments (legal or other) to the conversion i.e. the bank should have all prior authorizations (sufficient room in authorized capital etc.) including regulatory approvals to issue the common shares upon conversion.
- ix. The contractual terms of all Additional Tier 1 and Tier 2 capital instruments must state that SBP will have full discretion in deciding/ declaring a bank as a non-viable bank. SBP will, however, form its opinion based on financial and other difficulties by which the bank may no longer remain a going concern on its own unless appropriate measures are taken to revive its operations and thus, enable it to continue as a going concern. The difficulties faced by a bank should be such that these are likely to result in financial losses and raising the CET1/ MCR of the bank should be considered as the most appropriate way to prevent the bank from turning non-viable. Such measures will include complete write-off/ conversion of non-equity regulatory capital into common shares in combination with or without other measures as considered appropriate by the SBP.

#### **A-5-4 Group Treatment**

- i. As the capital adequacy is applicable both on standalone and consolidated levels, the minority interests in respect of (non-equity) capital instruments issued by subsidiaries of the banks including overseas subsidiaries can be included in the consolidated capital of the banking group only if these instruments have pre-specified triggers/loss absorbency at the PONV. In addition, where a bank wishes the instrument issued by its subsidiary to be included in the consolidated group's capital, the terms and conditions of that instrument must specify an additional trigger event. The additional trigger event is the earlier of:
  - a. A decision that a conversion or temporary/permanent write-off, without which the bank or the subsidiary would become non-viable, is necessary, as determined by the SBP; and
  - b. The decision to make a public sector injection of capital, or equivalent support, without which the bank or the subsidiary would have become nonviable, as determined by the SBP. Such a decision would invariably imply that the write-off or issuance of any new shares as a result of conversion or consequent upon the trigger event must occur prior to any public sector injection of capital so that the capital provided by the public sector is not diluted. The additional Tier 1 instruments with write-off clause will be permanently written-off when there is public sector injection of funds.
- ii. The subsidiaries need to obtain necessary approval/ NOC from their respective regulators for allowing the capital instrument to be converted/ written off at the additional trigger point referred above. Moreover, the instrument may also provide for conversion or write-off should the host authority of subsidiary determines a loss absorption event in respect of the subsidiary.

## Appendix 1: Minority Interest (illustration)

A banking group consists of two legal entities that are both banks. Bank P is the parent and Bank S is the subsidiary and their unconsolidated balance sheets are as given below.

Bank P Balance Sheet		Bank S Balance Sheet	
<b>Assets</b>		<b>Assets</b>	
Loan to Customers	100	Loan to Customers	150
Investment in CET1 of Bank S	7		
Investment in AT1 of Bank S	4		
Investment in the T2 of Bank S	2		
<b>Total</b>	<b>113</b>	<b>Total</b>	<b>150</b>
<b>Liabilities and Equity</b>		<b>Liabilities and Equity</b>	
Depositors	70	Depositors	127
Tier 2	10	Tier 2	8
Additional T 1	7	Additional T 1	5
Common Equity	26	Common Equity	10
<b>Total</b>	<b>113</b>	<b>Total</b>	<b>150</b>

The balance sheet of Bank P shows that in addition to loans to its customers, it owns 70% of the common shares of Bank S, 80% of the additional Tier 1 capital of Bank S and 25% of the Tier 2 capital of Bank S. The ownership of the capital of Bank S is therefore as follows:

Capital Issue by Bank S			
	Amount issued to Parent (Bank P)	Amount issued to third parties (Minority Interest)	Total
Common Equity	7	3	10
Additional Tier 1	4	1	5
<b>Tier 1</b>	<b>11</b>	<b>4</b>	<b>15</b>
Tier 2	2	6	8
<b>Total Capital</b>	<b>13</b>	<b>10</b>	<b>23</b>

Consolidated Balance Sheet	
<b>Assets</b>	
Loan to customers	250
<b>Liabilities and equity</b>	
Depositors	197
Tier 2 issued by subsidiary to third party	6
Tier 2 issued by parent	10
Additional Tier 1 issued by subsidiary to third party	1
Additional Tier 1 issued by parent	7
Common Equity issued by subsidiary to third party (i.e. minority interest)	3
Common equity issued by parent	26
	<b>250</b>



In consolidated accounts, the CET1 of Rs. 7, AT1 of Rs. 4 and Tier-2 of Rs. 2 of Bank S issued to Parent P netted against similar amount of investment reflected in the asset side of Parent Ps' balance sheet.

For illustrative purposes Bank S is assumed to have risk weighted assets of 100 against the assets valuing 150. In this example, the minimum capital requirements of Bank S and the subsidiary's contribution to the consolidated requirements are the same since Bank S does not have any loans to Bank P. This means that it is subject to the following minimum plus capital conservation buffer requirements and has the following surplus capital.

<b>Minimum and surplus capital of Bank S</b>			
	<b>Minimum plus capital conservation buffer</b>	<b>Capital available</b>	<b>Surplus</b> {Point 2a of annexure}
CET1 (6.0+2.5=8.5)	8.5 (=8.5% of 100)	10	1.5 (=10-8.5)
T1	10 (=10% of 100)	15 (= 10+5)	5 (=15-5)
Total capital	12.5 (= 12.5% of 100)	23 (=10+5+8)	10.5 (=23-12.5)

The following table illustrates how to calculate the amount of capital issued by the Bank S is to be included in consolidated capital, following the calculation procedure set out in [Annexure-1](#).

<b>Bank S: Amount of capital issued to third parties included in consolidated capital</b>					
	Total Amount issued (a)	Amount issued to third parties (b)	Surplus (c)	Surplus attributable to third parties (i.e. amount excluded from consolidated capital) $d=(c)*(b)/(a)$	Amount included in consolidated capital $e= (b) - (d)$
CET1	10	3	1.5	0.45	2.55
T1	15	4	5	1.33	2.67
TC	23	10	10.5	4.56	5.44

The following table summarizes the components of capital for the consolidated group based on the amounts calculated in the table above. Additional Tier 1 is calculated as the difference between CET1 and Tier 1, while Tier 2 is the difference between total capital and Tier 1.

	Total amount issued by parent (all of which is to be included in consolidated capital)	Amount issued by subsidiaries to third parties to be included in consolidated capital	Total issued amount (by parent and subsidiary) to be included in consolidated capital
CET1	26	2.55	28.55
Additional Tier 1	7	0.12	7.12
Tier 1	33	2.67	35.67
Tier 2	10	2.77	12.77
Total capital	43	5.44	48.44

## Appendix 2: Investment less than 10% (illustration)

**Investment in the capital of banking, financial and insurance entities (that are outside the scope of regulatory consolidation) where the bank does not own more than 10% of the issued common shares of the entity**

Suppose;

### A) Regulatory Capital Structure of a Bank (PKR in millions)

Paid-up equity	300
Eligible Reserves & Profit	200
<b>Total common equity</b>	<b>500</b>

Eligible Additional capital	15
<b>Total Tier 1 capital</b>	<b>515</b>

Eligible Tier 2 capital	100
<b>Total Eligible capital</b>	<b>615</b>

### B) Bank Investment in Entity A & B (where the bank does not own more than 10% of the issued common share capital of the entity.

Entity	Capital Structure of the Investee entity				Investment of bank in the entity			
	Common Equity	Additional Tier 1	Tier 2	Total	Common Equity	Additional Tier 1	Tier 2	Total Investment
A	300	10	0	310	15	10	0	25
B	400	0	50	450	25	0	10	35
					40	10	10	60

### Working:

Check-1: Bank's total holding of capital instruments is not more than 10% of the issued common share of the entity.

Entity A - total investment of 25 is less than 30 (10% of 300)

Entity B - total investment of 35 is less than 40 (10% of 400)

Check-2: The aggregate of the total investment is 60; which is more than 50 (10% of 500 - total common equity of the bank). Hence the excess amount from 10% of banks common equity i.e. 10 (60 minus 50) is required to be deducted.

In order to calculate proportional deductions, we need to calculate the following:

**i. Proportion of total capital holdings held in common equity, additional tier 1 and tier 2.**

The proportion of bank's investment in the common equity of these entities =  $40/60 = 0.666$

The deduction from common equity of bank =  $0.666 * 10 = 6.66$

Likewise,

The proportional deduction from Additional tier 1 =  $10/60 * 10 = 1.67$

The proportional deduction from tier 2 =  $10/60 * 10 = 1.67$

**ii. Proportion of investment held in the banking book and the trading book**

Supposing that the bank has kept its investment into the trading book and banking book in the following manner;

	<b>Common Equity</b>	<b>Additional Tier 1</b>	<b>Tier 2</b>	<b>Total</b>
Total investment in A & B held in the banking book	30	6	3	39
Total investment in A & B held in the trading book	10	4	7	21
<b>Total</b>	<b>40</b>	<b>10</b>	<b>10</b>	<b>60</b>

Common equity investments of the bank in A & B which are to be risk weighted =  $40 - 6.66 = 33.34$

Banking book exposure subject to risk weight =  $(30/40) * 33.34 = 25$

Trading book exposure to be risk weighted =  $(10/40) * 33.34 = 8.34$

Similarly Additional tier 1 and Tier 2 capital investments would be risk weighted, i.e.

For Additional Tier 1 investment to be risk weighted =  $10 - 1.67 = 8.33$

Banking book exposure subject to risk weight =  $(6/10) * 8.33 = 5.0$

Trading book exposure to be risk weighted =  $(4/10) * 8.33 = 3.33$

For Tier 2 investment to be risk weighted =  $10 - 1.67 = 8.33$

Banking book exposure subject to risk weight =  $(3/10) * 8.33 = 2.5$

Trading book exposure to be risk weighted =  $(7/10) * 8.33 = 5.83$

### Appendix 3: Significant Investment (illustration)

*where the bank owns more than 10% of the issued common share capital of the issuing entity or where the entity is an affiliate in the capital of banking, financial and insurance entities that are outside the scope of regulatory consolidation*

Suppose;

#### A) Regulatory Capital Structure of a Bank (PKR in millions)

Paid-up equity	300
Eligible Reserves & Profit	200
<b>Total common equity</b>	<b>500</b>

Eligible Additional capital	5
<b>Total Tier 1 capital</b>	<b>505</b>

Eligible Tier 2 capital	100
<b>Total Eligible capital</b>	<b>605</b>

#### B) Significant Investment in Entity A & B (where the bank owns more than 10% of the issued common share capital of the entity.

Entity	Capital Structure of the Investee entity				Investment of bank in the entity			
	Common Equity	Additional Tier 1	Tier 2	Total	Common Equity	Additional Tier 1	Tier 2	Total Investment
A	100	100	10	220	35	10	5	50
B	200	0	20	220	35	0	5	40
					70	10	10	90

#### Working:

Check-1: Bank's total holding of capital instruments is more than 10% of the issued common share of both the entities.

Entity A - total investment of 50 is more than 10 (10% of 100)

Entity B - total investment of 40 is more than 20 (10% of 200)

Deductions (other than common equity):

All investment in Additional Tier 1 (in A & B) to be deducted = 10

All investment in Tier 2 (in A & B) are to be deducted = 10

Since the bank does not have adequate additional tier 1, hence the shortfall ( $10 - 5 = 5$ ) will be deducted from the higher category of capital i.e. CET1.

After the above deductions, the Capital Structure of a Bank will show following position:

Total common equity	495	(less by 5, due to AT1 shortfall deduction)
Eligible Additional capital	0	(less by 5, due to AT1 deduction)
<b>Total Tier 1 capital</b>	<b>495</b>	
Eligible Tier 2 capital	90	(less by 10, due to T2 deduction)
<b>Total Eligible capital</b>	<b>585</b>	

Deduction for common equity:

Banks common equity = 495

10% of banks common equity =  $10\% * 495 = 49.5$

Hence the amount to be deducted from CET1 =  $70 - 49.5 = 20.5$

The exposure subject to risk weight of 250% = 49.5

(Irrespective of position held in the banking or trading book)

## **Appendix 4: The 15% of common equity limit on specified items**

This Annex is meant to clarify the calculation of the 15% limit on significant investments in the common shares of unconsolidated financial institutions (banks, insurance and other financial entities), and deferred tax assets arising from temporary differences (collectively referred to as specified items).

The recognition of these specified items will be limited to 15% of CET1, after application of all deductions. To determine the maximum amount of the specified items that can be recognized<sup>9</sup>, banks will multiply the amount of CET1<sup>10</sup> (after all deductions, including after the deduction of the specified items in full) by 17.65%. This number is derived from the proportion of 15% to 85% (i.e.  $15\%/85\% = 17.65\%$ ).

As an example, take a bank with PKR 85 of common equity (calculated net of all deductions, including after the deduction of the specified items in full).

The maximum amount of specified items that can be recognized by this bank in its calculation of CET1 capital is  $\text{PKR } 85 \times 17.65\% = \text{PKR } 15$ . Any excess above PKR 15 must be deducted from CET1. If the bank has specified items (excluding amounts deducted after applying the individual 10% limits) that in aggregate sum up to the 15% limit, CET1 after inclusion of the specified items, will amount to  $\text{PKR } 85 + \text{PKR } 15 = \text{PKR } 100$ . The percentage of specified items to total CET1 will equal 15%.

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<sup>9</sup> The actual amount that will be recognized may be lower than this maximum, either because the sum of the three specified items are below the 15% limit set out in this appendix, or due to the application of the 10% limit applied to each item.

<sup>10</sup> This is hypothetical amount of CET1 and is used only for the purposes of determining the deduction of the specified items.