Risk Management (R)

Regulation R – 1: Capital Adequacy Framework

Microfinance Banks (MFBs) are required to comply with the following two capital standards:

i. Minimum Capital Requirement (MCR):

Microfinance Banks (MFBs) shall maintain a minimum paid up capital (net of losses) as per following arrangement:

- One billion rupees if licensed to operate at national level.
- Five hundred million rupees if licensed to operate in a specified province;
- Four hundred million rupees if licensed to operate in a specified region; and
- Three hundred million rupees if licensed to operate in a specified district;

The MCR standard includes the following items:

- ✓ Fully Paid-up Common Shares
- ✓ Balance in Share Premium Account
- ✓ Reserve for issue of Bonus Shares
- ✓ Any other type of instrument approved by the SBP

Less

- ✓ Accumulated losses/ Discount allowed on the issuance of shares
- ✓ Negative General Reserves

ii. Capital Adequacy Ratio (CAR)

MFBs shall also maintain Capital Adequacy Ratio (CAR) equivalent to at least 15% of their risk weighted assets. The CAR is calculated by taking the Eligible Regulatory Capital as numerator and the Total Risk Weighted Assets (T-RWA) as denominator.

$$CAR = \frac{Total\ Eligible\ Capital}{Total\ Risk\ Weighted\ Assets}$$

Instructions on calculation of CAR are given in **Annexure - A**.

Instructions on Calculation of Capital Adequacy Ratio (CAR)

Every MFB shall maintain a minimum capital adequacy ratio (CAR) which shall not be less than fifteen percent (15%) of its total risk weighted assets (TRWA). The CAR shall be calculated as

$$CAR = \frac{Total\ Eligible\ Capital}{Total\ Risk\ Weighted\ Assets}$$

A.1 Total Eligible Capital (Numerator of the ratio)

The Eligible Capital refers to the capital that is arrived at after making the applicable deductions. For the purpose of calculating Capital Adequacy Ratio (CAR), the Total Eligible Capital will be the sum of the following:

1. Tier 1 Capital (going-concern capital or core capital)
   i. Common Equity Tier 1 (CET1)
   ii. Additional Tier 1 (AT1)
2. Tier 2 Capital (gone-concern capital or supplementary capital)

A.1.1. Common Equity Tier 1 (CET1)

CET1 shall be the sum of the following items:

i. Fully paid up (common shares) 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. Un-appropriated profits

Less

a. Un-appropriated losses
b. Intangible assets/ goodwill (net of any associated deferred tax liability)
c. Shortfall in provisions required against classified assets
d. Deficit on account of revaluation
e. Deferred Tax Assets (net of deferred tax liabilities) subject to transitional arrangements.
f. Significant Investment (more than 10% of the issued shares of the entity) in the capital of financial or commercial entities

A.1.2. Additional Tier 1 Capital (AT1):

Additional Tier 1 capital (e.g. perpetual non-cumulative preference shares) shall include instruments issued by the MFBs that meet the qualifying criteria as specified at Annexure-2 and Annexure-5 of SBP Basel III instructions issued under BPRD circular # 6 of 2013.

The inclusion of AT1 capital for CAR purposes shall be capped at 25 percent of the CET1 capital (after all deductions mentioned at CET1 level).

A.1.3. Tier 2 Capital (T2):

The total of Tier-2 capital shall be eligible up to a maximum of 41.67 percent of the CET1 capital (after all deductions mentioned at CET1) for inclusion in the capital base. The Tier 2 capital shall include the following elements.

i. **Subordinated debt:**

The subordinated debt shall qualify for inclusion in the Tier-2 capital subject to fulfillment of the eligibility criteria as specified at Annexure-3 and Annexure-5 of SBP Basel III instructions issued under BPRD circular # 6 of 2013. Notably, MFBs can raise subordinated debt from any person or entity, preferably from the sponsors.

ii. **Revaluation Reserves** (net of deficits, if any):

Revaluation reserves shall be the reserves created by revaluation of fixed assets and AFS securities held by the MFB. The assets and investments must be prudently valued fully taking into account the possibility of price fluctuations and forced sale value. Revaluation reserves (net of taxes) reflecting the difference between the book value and the market value will be eligible up to 100% for inclusion under Tier-2 Capital subject to the condition that the reasonableness of the revalued amount of fixed assets is duly certified by the external auditors of the MFB.

iii. **General Provisions or General Reserves for loan losses, Depositors' Protection Fund[1]:**

These reserves shall include only such provisions which are not created against identified losses and are as such freely available to meet unidentified losses. These provisions or reserves will be limited to a maximum of 1.25% of the total risk weighted assets.

A.1.4. Regulatory Deductions from CET1:

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

i. Intangible Assets/ Goodwill:

The book value of goodwill and other intangible assets like software, brand value etc., will be deducted net of any associated deferred tax liabilities.

ii. Shortfall in provisions required against classified assets:

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

iii. 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. The net surplus/ (deficit) on Available for Sale securities

[1] In the absence of a separate entity of deposit insurance, the Depositors' Protection Fund held by MFB will be considered as supplementary capital till further instructions.

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.

iv. Deferred tax assets (DTA):

All DTAs will be deducted in full net of deferred tax liabilities (DTLs). The DTLs permitted to be netted against DTAs will exclude the amounts that have been netted against the deduction of goodwill and intangibles.

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 sovereign risk weighting of 0%.

Transitional Arrangements:
The regulatory capital adjustment pertaining to net DTAs shall start in a phased manner starting from December 31, 2015 @ 25 percent per annum with full deduction from CET1 with effect from December 31, 2018. During the transition period, the part of DTAs which is not deducted from CET1 will attract a 100% risk weight.

v. Significant Investment in the capital of financial or commercial entities:

All significant investments (where an MFB owns more than 10% of the issued common share capital of the issuing entity or where the entity is an affiliate[2] of the bank) will be fully deducted from CET1. The equity investment which is equal to or below 10% of paid-up capital of such investee entities will attract 100% risk weight.

For the purpose of this rule, the Investments include all holdings i.e. direct, indirect, synthetic holdings of capital instruments (e.g. MFB will look through holdings of mutual fund/ index securities to determine their underlying holdings of capital).

A.2 Calculating Total Risk Weighted Assets (Denominator of Ratio)

The CAR standard uses the concept of risk weighted assets for determining a bank's capital requirements. The risk weighting varies according to each asset's inherent potential for default and what the likely losses would be in case of default.

The risk weighted amount of an on-balance sheet asset is 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. The **Table-B** below provides applicable risk weights for various classes of on-balance sheet assets and off balance sheet exposures.

[2] An affiliate of a MFB is defined as a company that controls, or is controlled by, or is under common control with, the MFB. 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.

Notes:

1. The risk weighting process shall cover all on-balance sheet and off-b alance sheet exposures except those (assets/ investments) which are deducted from CET1 capital. In order to avoid double impact, if any asset is deducted from capital then the same will not be counted for risk weighting purposes and zero risk weight will be applied to such exposures.
2. The risk weighting of 0% will apply only to that portion of a claim which is covered by a cash or cash equivalent (Govt. securities including National prize bonds, certificates of deposits or comparable instruments). For example, if a loan is partly secured by a cash deposit or cash equivalents, only the part of loan which is secured by cash equivalent will be risk weighted at 0%.
3. Similarly, guarantees must be direct, explicit, irrevocable and unconditional. Where a claim (in PKR) is partially guaranteed by Govt. of Pakistan or SBP, only the part of the claim which is fully guaranteed shall attract 0% risk weight.
4. All documentation used for collateralized transaction must be binding on all parties and legally enforceable. MFBs must take reasonable steps to ensure that the custody of collaterals is segregated from its own assets.
5. Securities/ collaterals shall be marked to market on periodic basis with appropriate margins to be maintained at all times.
6. For the calculation of operational risk weighted assets, average positive Gross Income of the bank over the past three years is to be used. Figures for any year in which gross income is negative or zero should be excluded from both numerator and denominator when calculating average.

   Gross Income (GI) is defined as the sum of net interest income and net non-interest income and shall be arrived at before accounting for: (i) provisions (including those for credit impairment), (ii) operating expenses (including fee in respect of outsourced activities), (iii) realized profits/ losses from the sale of securities, (iv) extra ordinary items/ windfalls, and (v) income from insurance.

   MFBs shall only use the figures of Gross Income as per the latest available (three years) audited accounts.

   Special Case: Where gross income of all three years is negative, in such case, the operational risk capital charge shall be determined by State Bank of Pakistan on a case to case basis.

A.3. Reporting Requirements

MFBs are required to submit CAR return as per the reporting formats attached as **Table-A** and **Table-B** within prescribed timelines.

Currently, MFBs are required to submit quarterly CAR statement within 14 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.

A.4. Notification Requirements

MFBs shall inform SBP immediately of:

i. Any breach of the minimum capital requirement or capital adequacy 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 or CAR along with proposed measures to address these concerns.

A.5. Reductions in Capital

Any MFB that intends to reduce its paid-up capital, it must obtain SBP's prior written consent.

A.6. Penalty for Non-Compliance

Any MFB that fails to meet the above mentioned regulatory capital requirements 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. Cancellation of the MFB license if SBP believes that the bank is not in a position to meet the MCR or CAR requirements.

NAME OF MICROFINANCE BANK

CAPITAL ADEQUACY RATIO AS OF XX.XX.XXXX

#	ITEMS		Amount
1	**Common Equity Tier-1 (CET1)**		
	1.1	Fully Paid-up Capital	xxx
	1.2	Balance in Share Premium Account	xxx
	1.3	Discount on issue of shares (insert negative amount)	
	1.4	Reserve for issuance of Bonus Shares	xxx
	1.5	General/ Statutory Reserves as disclosed in the Balance Sheet	xxx
	1.6	Un-appropriated Profit/(Loss)	xxx
	1.7	**Sub-Total (1.1 to 1.6)**	xxxxxx
	Less:		
	1.8	Intangible Assets/ Goodwill (net of any associated deferred tax liability)	xxx
	1.9	Shortfall in Provisions required against Classified Assets	xxx
	1.10	Deficit on account of revaluation	xxx
	1.11	Deferred Tax Assets (net of deferred tax liabilities) – subject to transitional arrangements	xxx
	1.12	Significant Investment (more than 10% of the issued shares of the entity) in the capital of financial or commercial entities	xxx
	1.13	**Sub-Total (1.8 to 1.12)**	(xxxx)
	1.14	**CET1 Capital (1.7 - 1.13)**	**xxxxxx**
2	**Additional Tier – 1 Capital (AT1)**		
	2.1	AT1 capital held	xxx
	2.2	AT1 capital recognized for CAR (max. up to 25% CET1 as calculated at item 1.14)	xxx
	2.3	**Tier-1 Capital (1.14 + 2.2)**	**xxxx**
3	**Tier-2 Capital**		
	3.1	Freely available General Provisions or reserves for loan losses – up to maximum 1.25% of Risk Weighted Assets	xxx
	3.2	Depositors' Protection Fund	xxx
	3.3	Revaluation reserves (net of taxes)	xxx
	3.4	Subordinated debt	xxx
	3.5	**Tier-2 capital Held (sub-total 3.1 to 3.4)**	**xxxx**
	3.6	**Tier-2 capital recognized for CAR** (max. up to 41.67% of CET1 as calculated at item 1.14)	**xxxxxx**
4	**Total Capital (2.3 + 3.6)**		
5	**Capital Adequacy Ratio**		
	5.1	Risk Weighted Assets (as per Table B)	xxxx
	5.2	Minimum Capital Requirement (15% of Total Risk Weighted Assets as per item 5.1 above)	xxx
	5.3	Total Capital Held [As per Item 4 above]	xxx
	5.4	Capital Surplus/(Shortfall) – (5.3 - 5.2)	xxx
	5.5	Capital Adequacy Ratio (5.3 / 5.1 x 100)	xxx

Risk Weighted Assets (as of ____________________)

S.No.	ITEMS	Book Value	Risk Weight	Adjusted Value
1	**Cash**		0%	
2	**Balances with Central Banks:** 2.1 With State Bank of Pakistan 2.2 With NBP (only for such functions where NBP performs similar role as SBP)		 0% 0%	
3	**Balances with Banks** 3.1 With Scheduled Banks in Pakistan		 20%	
4	**Investments in:** 4.1 Treasury Bills 4.2 Federal / Pakistan Investment Bonds 4.3 Other securities of Federal Government 4.4 Debentures, TFCs etc. of enterprises owned/ controlled by Govt. (a) Guaranteed by Federal Govt./SBP (b) Not guaranteed by Federal Govt./SBP 4.5 Debentures, TFCs etc. of private sector enterprises 4.6 Marketable Securities (Shares / Mutual Funds) 4.7 Other Investments (TDRs of Banks/MFBs)		 0% 0% 0% 0% 50% 100% 100% 20%	
5	**Loans & Advances** (Less Cash Margin and Govt. Securities held) 5.1 Loans guaranteed by Federal Govt./ SBP 5.2 Loans secured by deposits duly pledged 5.3 Loan secured by Gold 5.2 Microcredit 5.3 Loans fully secured by mortgage of residential or commercial property 5.4 Staff loans 5.5 Others (please specify)		 0% 0% 20% 100% 50% 0% 100%	
6	**Fixed Assets (net of accumulated depreciation)**		100%	
7	**Other Assets** 7.1 Advance tax 7.2 Deposits & prepayments 7.3 Accrued income on Advances 7.4 Accrued income on deposits accounts 7.5 Accrued income on investments - PIBs/T-Bills 7.6 Accrued income on investments – Others 7.7 Other receivable		 0% 100% 100% 100% 0% 100% 100%	

8	**Off-Balance Sheet items** 8.1 Direct credit substitute (financial guarantees, general standby LC, Acceptances etc.) 8.2 Transaction related contingent liabilities (performance bonds, bid bonds, SBLC related to particular transaction etc.) 8.3 Other short term off-balance sheet items or contingent liabilities (maturity less than one year) 8.4 Other long-term off-balance items or contingent liabilities (maturity greater than one year)		100% 50% 20% 50%	
9	**Operational Risk** 9.1 Average Gross Income over the previous three years (as per the latest available audited accounts)		20%	
	TOTAL			