Queries on Basel 3 Implementation and SBP's responses

Q1 (a): Are banks' investments in associates/ subsidiaries require deduction from CET1 on standalone basis under Basel III?
Q1 (b): What is the treatment of CAP-2 (50:50) deductions during the transitory period?
Q1 (c): What figure needs to be incorporated in cell D40 & C40 of regulatory adjustment sheet (Gross holdings of Common Stock) of Excel Format for CAR Reporting?

Reply: As per Basel III instructions, a bank's investment of greater than 10% of an investee entity is considered significant and as such a banks' investment in associates/ subsidiaries (which are not consolidated) also falls under the definition of significant investments. The paragraphs 2.4.9.3 & 2.4.10 deal with such investments. Previously such investments were deducted @ 50% from Tier 1 and 50% from Tier 2. However, under Basel III instructions instead of full deduction, an amount up to 10% of a bank's CET1 (after apply threshold deduction) will be recognized i.e., not deducted whereas, most of the deductions under Basel III would be made from CET1 as such the treatment of CAP 2 deductions would be eliminated on the full implementation of Basel III.

The following treatment will be applied during the transitional arrangements (paragraph 2.4.11):

1. The banks will sum their significant investments as under:
   a. Where the bank's investment is more than 10% (of the investee company) but less than 20% (of the investee company); and
   b. Where the bank's investment is greater than 20% of the investee companies' capital (previously shown under CAP 2).
2. As of 31-12-2014, the banks would arrive at the gross holding figure (cell D40 of the regulatory adjustments sheet of B-III CAR reporting format) by adding the amount mentioned at point # 1(a) and 20% of the amount mentioned at 1(b) above, whereas, the remaining 80% of the CAP 2 amount as mentioned at point 1(b) will be deducted @ 50% from Tier 1 and 50% from Tier 2.

   Similarly, as of 31-12-2015, the banks would arrive at the gross holding figure (cell D40) by adding the amount mentioned at point # 1(a) and 40% of the investment under 1(b), whereas the remaining 60% of the 1(b) amount will be deducted @ 50% from Tier 1 and 50% from Tier 2 & so on till 31-12-2018 when the full amount of CAP 2 (point-1(b)) will be shifted to Cell D40.
3. The gross holding figure arrived at D40 as per above would be recognized to the extent of 10% of the applicable CET1 limit (after applying 15% threshold deduction limit) and would be risk weighted at 250%.
4. The gross amount exceeding the applicable limit of CET1 would attract the following treatment

- 20% of the amount would be deducted while the remaining amount would risk weighted @100% for the 1st year of deduction i.e., 31-12-2014.

5. As explained at point # 2 above, the remaining 80% of the CAP 2 {point-1(b)} amount will be deducted @ 50% from Tier 1 and 50% from Tier 2 for the 1st year of deduction i.e., 31-12-2014.

Treatment of CAP 2 deductions and significant investments in "C40" of the Regulatory Adjustment Sheet:

For every reporting period, banks will report full amount as calculated at point # 1 above (all investments greater than 10%) in Cell # "C40" on the "Regulatory Adjustment Sheet". In this regard, Cell # "C41 and C42" have also been opened to facilitate the banks for reporting of their significant investment based on the nature of capital instruments.

Q2. What would the mode of the first Basel III reporting be i.e. return in hard form or and electronic submission through DAP?

Q3. The circular states that "Banks/ DFIs are advised to submit their CAR returns based on the instructions contained in this circular in parallel run for 3rd quarter of 2013" whereas the enclosed instructions to the circular at page 15 section 2.4.11 state "In the year 2013, the Banks will not apply the additional deductions proposed under the Basel III rules and will apply existing treatment".
In view of the two conflicting time lines, which of these are Banks required to follow?

Reply to Q2 & Q3: Banks will continue reporting their Basel II returns on DAP and submit hard copies to the BPRD.
Additionally, banks will submit CAR return based on Basel III instructions in soft copy to email address ahsin.waqas@sbp.org.pk and shumaim.ilyas@sbp.org.pk and submit hard copies to the BPRD.
The disclosure requirements to be published in annual accounts has been circulated vide BPRD circular # 11 of 2014.

Q4. Section 2.4.9.1 states "Reciprocal crossholdings designed to artificially inflate the capital position of Banks will be deducted". Our question is, are there reciprocal cross holdings that do not artificially inflate capital or do all reciprocal cross holding inflate capital?

Reply: All reciprocal investments inflate capital therefore all needs to be deducted.

Q5. In case of reciprocal cross holdings, is the full amount invested by the Bank in Tier 1 and Tier 2 instruments of an investee required to be deducted? Or is the amount invested by that investee back into our Tier 1 and Tier 2 instruments required to be deducted?

Q6: Reciprocal Cross Holdings: 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.
As per the text of the circular it seems that the entire bank's investment in the investee entity is to be deducted. However as per our understanding, the reciprocal would mean the lower of Bank's investment in investee company or Investee company's investment in the bank. Please confirm whether the minimum of the of Bank's investment in investee company or Investee company's investment in the bank should be deducted.

Reply to Q5 & Q6: By definition reciprocal crossholdings mean minimum/ common amount of both entities' investments in the capital instruments (whether the investment was made in Tier-1 or tier-2). The bank should total its own investments in investee entity and investee entity's investment in the bank. The common/ minimum amount is the reciprocal crossholding which needs to be deducted. After determining the amount to be deducted (minimum of both), the bank will apply "corresponding deduction approach" and deduct the amount from the same component of capital for which the capital will qualify if it was issued by the bank itself. The left over amount (if any) will be deducted from the higher form of capital. In the table below, minimum common amount is 70. Bank A will deduct 50 from AD Tier 1, 10 from Tier 2. Moreover, the remaining Rs. 10 will be deducted from AD Tier 1 by Bank A.

	Bank A Capital	Bank A's investment in B	Bank B capital	Bank B's investment in A
AD Tier 1	2,000	100	1,000	50
Tier 2	100	10	100	20
		110		70

Q7. In case the situation is such that the Bank has both (1) a reciprocal cross holding and (2) investment in the capital of Banking, Financial and Insurance entities (outside the scope of regulatory consolidation), will the Bank make a full deduction as per treatment specified above in Q6 first?

Reply: Yes, reciprocal investments would be deducted first. The portion of reciprocal investments once deducted will not be counted again while determining any other limits. The same order of deduction is given in the reporting format.

Q8. Does a TFC have to be listed for it to be counted towards the Tier II capital requirements under Basel III?

Reply: No, TFCs does not have to be listed for consideration for Tier-2 capital.

Q9. With respect to section 2.4.10 Threshold Deductions; where it says "the amount of the above two items that remains recognized" is the recognized portion in here being referred to as the deduction?

Reply: The expression "the amount of the above two items that remains recognized" means the amount of the two items that are not deducted i.e. below the 10% of a bank's CET1 (of both items) after applying the check of 15% (threshold deduction). The recognized portion will attract risk weight of 250%.

Q10. With respect to examples illustrated in Appendix 2 and 3, it appears that the investments in Tier 1 and Tier 2 instruments are being taken at market value / balance sheet value when checking for their size against the 10% of the issued common equity of the entity (that is at par value). Are the two sides of this check to be taken at paid up value or market value? As per our understanding, number of shares held to number of shares outstanding needs to be considered while arriving at holding percentage.

Reply: For determination of bank's investment whether it is below 10% or above 10% of the investee entity. The limit will be calculated by the number of shares held to the number of shares outstanding. After determination of the investment limit (i.e. applicable section of Basel III 2.4.9.2 or 2.4.9.3) the rest of the instructions are applied on the carrying value on the balance sheet (which may be market value in case of HFT & AFS).

Illustration:
Consider a situation where a bank has invested in an entity which has 100 million shares of Rs. 10 each. There are following two ways to calculate the 10% limit:

1. Based on the number of shares, the 10% issued shares come to 10 million shares. Suppose the bank has invested in 9 million shares @ Rs. 15 per shares. Now if we take the limit of 10% based on number of shares then this investment will fall in the category of less than 10% investment as the bank has investment is 9% of the shares of the entity.
2. Whereas based on the amount of paid up capital, the 10% amount of paid up capital comes to Rs. 100 million. If we take the limit of 10% based on the amount of paid up capital then this investment will fall in the category of more than 10% as the bank's investment amount comes to Rs. 135 (9*15=135) million.

As such, follow the treatment given at point # 1 (above) for determining 10% limit.

Q11: With respect to Annexure-1 A-1-1(i b), are the RWAs of the subsidiary after excluding related party transactions?

Reply: Annexure-1 A-1-1(i b) pertains to consolidated risk weighted assets on which accounting consolidation rules are applicable which usually exclude transactions between parent and subsidiaries.

Q12: With reference to section 2.4.9, wherein instructions state that "Investments shall include all holdings i.e. direct, indirect, synthetic holdings of capital instruments". Do indirect holdings include exposure from Investments in Capital of Banking, Financial and Insurance Entities that the investee has invested in, as an example: AKBL invests into Admajee Insurance which further invests into capital of Bank-Alflalah. Will AKBL consider Adamjee's investment in capital of Bank Al falah as an indirect exposure?

Reply: No, if a bank has made investment in ABC entity's capital instruments directly and bank has also invested in the units of mutual funds and that mutual fund has invested in the capital instruments of ABC, then mutual funds investment would be considered indirect investment (for more details, see Q15 below).

Q13: Phase in arrangements for deductions pertaining to CET1 are illustrated in the Basel III guidelines (2.4.11), however for Tier II deductions (excluding subordinated debts) & benefits; gradual recognition criteria is not available. Therefore, we understand that all the deductions & benefits related to Tier II needs to be recognized immediately. As per the newly circulated formats of Basel III, benefit of Revaluation reserves have been restricted to 20% only; however there is no clarity regarding the future recognition schedule. This recognition criteria laid in the format is apparently not in line with the issued Basel III guidelines. Please confirm our understanding.

Reply: Those items which are currently deducted from tier-2 capital will gradually be shifted to CET1 as given at 1.1.24 @ 20% per annum starting from Dec 31, 2014. Similarly, the benefit of revaluation reserves (net of tax effect) would also be available in a phased manner @ 20% per annum for the remaining portion of 55%. However, till 30-09-2014, banks may follow the existing practice of taking 45% benefit of revaluation surplus without tax effect. Moreover, banks may avail 100% benefits of the revaluation reserves provided they make 100% deductions as well.

Q14: Quoting the extracts of point vi of para 2.2 (limits – minima & maxima), Quote "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."Unquote

Our understanding (based on the text of circular) is that if a bank is maintaining Tier 1 capital below 8.5% then it would not be able to avail benefit of Tier 2 capital in excess of 8.5%. Further the benefit of excess tier 2 shall always be 41.67% of CET1 in excess of 8.5% and this percentage would not vary. Please confirm our understanding as from the final Basel III excel format that was shared by SBP, this is not holding true and the benefit of Tier 2 might exceed the 41.67% limit. For 2013 the CET1 limit is 5% and the tier 2 limit is 3.5% therefore using the same concept the limit would be 70% instead of 41.67%. We are raising this query since this aspect has not been covered in the section for Transitional Arrangement for capital deductions (para 2.4.11).

Reply: The limits (minima/ maxima) prescribed in para 2.2 have been calculated on the basis of full implementation by 2019 (i.e. 2.5/6.0 = 41.67%). However, during the transition period, the proportion will be determined based on the CET1 requirements (e.g. as of 31-12-2014 limit of ADT1 1 would be 1.5/5.5 = 27.27% whereas limit for T2 would be 3.0/5.5 = 60%) prescribed in table 2.2.1. Next, the excess CET 1 will be determined by deducting CET1 of 5.5% (as required CET1+CCB as on 31-12-2014) from the CET1 held by the bank. The resulting excess amount will be multiplied by the proportion of ADT1 and T2 determined as above.
Moreover, in case a bank's CET1 is less than the required level of CET1+CCB as per table 2.2.1, then its Additional Tier 1 & Tier 2 limit will also be reduced accordingly. This is in line with the SBP Basel-2 instructions where recognition of tier-2 capital is limited to 100% of tier-1.

Q15: Significant Investments in the capital of Banking, Financial & Insurance Entities:

Investments falling under the captioned category would be attracting market risk & credit risk charge as well as capital deductions are also being applied. Logically one investment should attract either Credit or Market risk charge. Further the deduction from capital should be either from Credit Risk or market risk guidelines.
For example (as per the recently issued circular regarding investment in mutual funds) investment in mutual funds are now part of trading book & will be attracting a capital charge & a deduction thereof. However the same instrument is also qualifying as a significant investments >10% & will be attracting a credit charge & deduction as well. Please clarify that how this scenario can be dealt with. As logically, an investment can either be part of banking book or trading book.

Reply: As discussed with the concerned bank, the query is about investment in mutual funds which are to be categorized in the trading book. However, our Basel III instructions stipulate that if a bank has invested in the units of a mutual fund and that mutual fund has invested in the capital instruments of financial entities, then such indirect investments will also be included in the section of significant investment or insignificant investment as the case may be. The threshold section 2.4.10 will also be applicable and all recognized items (Significant Investment and DTA pertaining to provisioning) will be subject to 250% risk weight (in banking book). Once such investments are included in the significant/ insignificant investment potion, the same will not be counted in the bank's investment in mutual fund.

It is further clarified that any indirect holding (through mutual or other funds) are subject to following:

- If the amount of investment made by the mutual funds (and other funds) in the capital instruments of financial entities is **known**, the indirect investment of the bank in such entities is equal to bank's investment in mutual fund multiplied by the percent of investments of mutual funds in the financial entities' capital instruments.
- If the amount of investment made by the mutual funds (and other funds) in the capital instruments of financial entities is **not known**, but as per the offering document/ mandate of fund these funds are allowed to make such investments, the indirect investment of the bank is equal to bank's investment in mutual funds multiplied by the maximum permissible limit which these funds are authorized to invest in the financial entities' capital instruments.

Q16: Investment in TFCs of other Banks:
As per the Basel II guidelines investment in TFCs of other banks will be deducted from capital, if the investments exceed the following:
- **Investment in TFCs exceeding 10% of their equity**
- **Investment exceeding 5% of its own equity**
- **Investment exceeding 15% of the total size of the issue**

However, in Basel III guidelines (Annexure 3) the first condition is not mentioned. Please confirm whether the same would be applicable from Dec 2013 onwards.

Reply: The 1st condition has been excluded as the same will be covered under bank's investment sections 2.4.9.2 {Investments in the capital of Banking, Financial & Insurance

Entities} and 2.4.9.3 {Significant Investments in the capital of Banking, Financial & Insurance Entities}.

Q.17. Under CAP – 2 calculations, significant minority investments in banking & other financial entities are deducted. Please clarify the components which fall within the scope of this deduction.

Reply: The CAP-2 calculation under existing Basel II covers equity investment of more than 20% in a financial entity. As such, the CAP-2 amount arrived under Basel II & the CAP-2 portion as given in the Basel III "Regulatory Adjustment" sheet should tally (except the amount of significant investment in commercial entities subject to 1000% RW) till Dec 2014 when phased deductions will start.

Q.18. Please specify the requirements if the bank decides to opt for full Basel III deductions upfront in 2015 rather than the phased implementation up to Dec 31, 2018. How would the CCB be raised during transitory period? Moreover, is there any formal approval required in this regard?

Reply: The banks will inform SBP about their intention of opting for full Basel III implementation along with reasons/ justifications and impact on their CAR.

In this regard, banks will make 100% deductions (DTAs, defined benefit pension fund assets, investment/ significant investment in the capital of banking, financial and insurance entities etc.) and avail 100% benefits of items (revaluation reserves and significant minority & majority investments in financial entities) covered under Basel III instructions and maintain minimum ratios mentioned in the row (1) to (6) as per requirement as of December 31, 2019 which includes requirement to maintain CCB as well. Table 2.2.1 as contained in our instructions on Basel III highlights the regulatory requirements vis-à-vis maintenance of key ratios and has been reproduced below.

		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**	-	-	0.25%	0.65%	1.275%	1.900%	2.5%

	(Consisting of CET1 only)							
6.	**Total Capital plus CCB**	10.0%	10.0%	10.25%	10.65%	11.275%	11.90%	12.5%

Q.19. As per the format, all the reciprocal investments are deducting in full. However, as per our understanding; there might be no deduction in September quarter & then the phase in approach will follow.

Reply: Only the additional deductions required under Basel III are subject to transitional arrangements. Since the reciprocal investments were also subject to deduction under the Basel II instructions therefore no phased deduction would be allowed and the bank will to make full deduction.

Q.20. Please clarify that how to deal with the differential amount arising due to treatment of reciprocal nature of the investments. For example if XYZ has invested PKR 100 Mn in ABC bank & the ABC bank in turn has also invested in XYZ capital with an amount of PKR 20 Mn. As per the methodology, lower of the two investments is deducted. What is the treatment of remaining PKR 80 Mn? Shall we include the differential / remaining amount in investments of < 10% or > 10.

Reply: Yes – only the remaining amount of PKR 80 million will be accounted for as once a deduction is made it will not be counted again.

Q.21. In order to arrive at indirect holdings / investments, details of mutual funds investments are evaluated. If the mutual fund has invested in the entities where Bank has already invested, such indirect holdings are added in existing investments. After that, what fraction of investments needs to be deducted from investment in mutual funds?

Reply: As explained in FAQ # 15 (issued previously to determine the proportional indirect holding). The amount which will be transferred from the mutual funds to the existing investment (from indirect to direct holding) would reduce the amount of investment in mutual funds. The mutual fund rules would be applicable on the reduced amount depending on the holding in a single mutual fund.

Q.22. If the Bank has invested in AT1 & Tier 2 of another Bank. Please clarify whether this investment falls under the direct deduction or shall we follow the threshold deduction approach as given for Tier 1 investments.

Reply: It depends, if the investment falls under the definition of reciprocal investment then the direct deduction approach would require common amount of investment to be deducted. Whereas, the threshold deduction is allowed for investment greater than 10% as mentioned in section 2.4.9.3 of Basel III. If section 2.4.9.3 is applicable, all non-common equity investments (AT1 and Tier-2) would be deducted and only investment in common shares would follow the threshold deduction (section 2.4.10).

Q.23. Since public information by Banks and FIs is disseminated with a lag of almost one calendar month post quarter end, it would not practically be possible for us to assess the accurate impact while meeting the 18 working day deadline. In this regard, we would be unable to accurately assess impact from indirect holdings in the capital of Banks, Financial Institutions and Insurance companies through our investments in mutual funds. Similarly, when applying the 10% holding check, we would not be having the "issued common share capital" of these entities available. Although the KSE webpage does make this information available but the reporting date cannot be discerned. Similarly CET 1 elements of these entities such as retained earnings are not available until one month after the close of quarter.

Reply: On best effort basis, banks should use the latest financial numbers available at the time of submission of CAR returns. With regard to investment in entities, the latest available (unaudited) quarterly financial results may be used and if these are unavailable the bank may use the latest available annual audited accounts. However, in case of mutual funds, the bank should seek latest information from the asset management company managing the mutual funds based on which net asset value (NAV) is calculated. For further details on mutual funds refer to FAQ # 15.

Q.24. Reference to BPRD Circular No. 6 of August 2013, wherein Banks were required to calculate Leverage Ratio as a 3 month average. Due to operational constraints experienced by Banks in calculating the Leverage Ratio as a 3 month average we would like to seek your formal confirmation on whether Leverage Ratio standard has been revised as a last month of the quarter ended ratio starting Dec 2013.

Reply: Instead of calculating quarterly leverage ratio as 3 months' average, banks may calculate their quarterly leverage ratio by using:

- Average of 3 month-end figures of "Total Exposure" in the denominator, whereas;
- Quarter-end figure of "Tier 1 Capital" in the numerator instead of 3 month average figures till further instructions in this regard.

Q.25. What is the risk weight to be applied on the Deferred Tax Assets which are not deducted under the transitional arrangements?

Reply: The following treatment will be applicable on Deferred Tax Assets during the transitional period:

1. The DTAs that rely on future profitability (excluding temporary differences) will be subject to the following treatment:
    a. The amount of phased deduction @ 20% per annum will start from December 31, 2014 with full deduction in December 31, 2018 (e.g. 20% as on Dec 2014, 40% as on Dec 2015 & so on)
    b. The amount of non-deducted portion during the transition period (e.g. 80% as on Dec 2014, 60% as on Dec 2015 & so on) will be risk weighted at 100%.

2. The DTAs that arise from temporary difference will be subject to the following treatment:

a. The amount which is recognized {i.e. below the 10% of a bank's CET1 after apply the check of 15% of a bank's CET1 – under threshold deductions} will be subject to 250% risk weight.
b. The amount above the 10% of a bank's CET1 will be deducted in a phased manner @ 20% per annum (e.g. @ 20% w.e.f. Dec 2014, 40% w.e.f. Dec 2015 etc.) while the non-deducted portion of DTAs (e.g. 80% as of Dec 2014, 60% as of Dec 2015) will be risk weighted at 100% during the transition period.

Moreover, similar treatment will be applicable on "Significant Investments in the capital instruments issued by banking, financial and insurance entities that are outside the scope of regulatory consolidation, as given at serial No. 2 above.

Q.26. A bank has investments in two mutual funds, Fund A and Fund B. The bank is aware of the underlying investments of Fund A, but not Fund B, on a daily basis. Is it permissible in such a scenario for the bank to employ full look-through approach for Fund A and modified look-through / conservative approach for Fund B, or must the bank instead use the modified look-through / conservative approach for both funds?

Reply: The bank can opt for different approaches of look-through for different mutual funds. It is envisaged that information on some of the mutual funds would be easily available (e.g. funds managed by subsidiary AMC) while in other cases it would be difficult to get actual information on daily basis (or at least on monthly basis). Hence, bank may use full look-through approach for Fund A in which information is available on daily basis (or at least on monthly basis) while for the Fund B, the bank has the option to use either modified or conservative look through approaches, provided information is not available readily as in case of Fund A.

Q 27: The Basel III instructions on Mutual Fund investments prescribe that banks can use Full Look through approach provided they have the break-up of actual underlying assets of Mutual Fund investment on daily basis whereas the earlier issued BPRD circular # 04 of 2013 on the subject requires the details of underlying assets on monthly basis for the use of the Full Look Through approach. Please clarify which instructions to follow.

Reply: This is a typographical mistake made in the Basel III instructions. As such banks can use Full Look through approach provided they have the break-up of actual underlying assets of Mutual Fund investments on monthly **basis.**

Q.28: Regarding the circulated Basel III disclosures formats, it is our understanding that comparative figures of 2012 are only to be given under Note no. 44, Note 44.1 and Note 44.5 (of revised Basel III disclosure template). And under Note 44, the comparative numbers will be restricted till line/item no. 78 i.e. "Total Capital to RWA" as the information under item no 79 till 93 were not applicable in 2012, since Basel III was not enforced in the said period.

Further we would also like to confirm that previous year figures (i.e. of 2012) shall be on the basis of Basel II framework applicable as of December 31, 2012.

Reply: Your understanding about the comparative figures of 2012 is correct as comparative figures are to be disclosed under Note # 44, Note 44.1 and Note 44.5 of the Basel III disclosure template. However, it may be noted that SBP has not imposed any specific requirements for the

year end 2012 comparative reporting. As such, the bank may exercise its discretion and report comparative figure based either on Basel II framework or on Basel III comparative basis, both practices are acceptable. However, the approach adopted should be disclosed as a footnote.

Going forward, the comparative figures are to be reported on Basel III basis for year end 2014 onwards.

Q.29: In Note 44.3, what is required to be reported in regulatory consolidation column?

Reply: Since the banks are required to report their CAR on standalone as well as consolidated basis, therefore it is clarified that the same format of note 44.3 would be used for reporting of bank's standalone as well as consolidated reporting.

However, for consolidated reporting, the insurance & commercial subsidiaries of the bank are not required to be consolidated for capital adequacy purposes. Hence, for consolidated reporting requirement on a group basis, a difference may arise between the accounting balance sheet and regulatory consolidation for which separate columns have been provided in tables 44.3.1 and 44.3.2.

Banks having no insurance or commercial subsidiaries may report same amount under both the columns (Balance sheet as in published financial statement and Under Regulatory scope of consolidation) of table 44.3.1 OR properly disclose this fact.

Q.30: Where to show surplus on revaluation of fixed assets and AFS pertaining to the Minority Interest/ Non-Controlling Interest?

Reply: For consolidated reporting of CAR, the surplus on revaluation pertaining to subsidiaries should not be reported under Minority Interest rather the same is to be reported under Tier-2 capital as part of overall Revaluation Reserves pertaining to Property/ AFS.

Q.31: Will reciprocal cross holding of Tier II instrument be deducted from Tier II capital if the bank has not taken any benefit of Tier II capital instrument?

Reply: No, the bank is not required to deduct reciprocal cross holding if the bank has not taken any benefit of such capital for CAR purposes (e.g. TFC which is subject to 100% discount factor).

Q.32: If bank is not taking any benefit of TFCs because of applicable haircut, whether the bank to report the details of TFC in note # 44.3

Reply: No, details of only those capital instruments are to be provided in note # 44.3 which are eligible for inclusion in the regulatory Capital.

Q.33: Should we include indirect holding of the investee bank for the computation of Reciprocal cross holdings? For example, If ABC bank has invested in the shares of XYZ bank directly and XYZ bank has also invested in the shares of ABC bank indirectly (through investment in mutual funds). So should we consider the indirect investment of XYZ bank in ABC bank?

Reply: For the computation of reciprocal cross holdings of capital, generally all direct investments are considered. However, SBP may also consider including the indirect investments using the mutual funds structures if, based on SBP assessment, these structures are used to artificially inflate the capital positions of the bank.

Q.34: What is meant by Amount subject to Pre-Basel III deduction in Note 44?

Reply: In the SBP circulated Note 44, banks/ DFIs have to report the amounts in two columns namely (i) Amount and (ii) Amount subject to Pre-Basel III treatment – under which banks would disclose the amount which is being risk weighted and in future would be deducted from the capital after the full implementation of Basel III.

Q.35: Since banks are required to submit Audited CAR for December 2013 along with External Auditor Certificate. Please guide; should we have to submit Audited CAR on both Basel-II & Basel-III basis? Further, please also guide regarding External Auditor Certificate, Should it be certified on the basis of Basel-II or Basel-III?

Reply: Banks are required to submit Audited CAR based on Basel III basis only along with the External Auditor Certificate. Moreover, for Dec 2013 audited reporting only, banks are not required to upload/submit the audited CAR on DAP portal which is still based on Basel II format.

However, for on-going quarter end reporting, banks will continue reporting their Basel II returns on DAP and submit hard copies to the BPRD in addition to CAR return based on Basel III instructions whereby soft copy is to be sent to email address ahsin.waqas@sbp.org.pk and Shumaim.ilyas@sbp.org.pk along with the Basel III hard copies to the BPRD.

Q.36: Banks and DFIs have been instructed vide BPRD Circular No. 25 of 2014 to apply a risk weight of 125% effective from December 31, 2014, on all unrated private sector borrowers with aggregate outstanding exposure from financial institutions (both fund-based and non-fund based) of Rs. 3 billion or above, net of liquid assets. In this regard, how the amount of outstanding exposure of a borrower from the entire financial institutions be determined?

Reply:

The above SBP circular letter has been superseded vide BPRD circular letter # 02 of January 9, 2015 and such the threshold limit and risk shall be applied accordingly. Whereas the banks may determine the total outstanding exposure as under:

- The information regarding total net outstanding exposure may be collected from the customers and the same may be verified through e-CIB report or by using the Data-Pull functionality of e-CIB system which allows the bank to extract aggregate outstanding exposure being availed by each of its customer from the entire financial sector.
- For verification of information received from its customers, bank shall use the most recent e-CIB report or Data-Pull functionality of e-CIB system. However, to ensure that the bank use the most recent data for capital purposes it is recommended that the e-CIB report/ data pull extracted should be of the month preceding the quarter end (e.g. for Dec 31, 2014 reporting, eCIB data as of November 30, 2014 may be used).

- To ease out the operational burden, the banks may use the corporate database of eCIB system till further orders.

Moreover, the term 'liquid assets' have been defined in the prudential regulations and banks may use that definition. However, in circumstances where the bank is not able to ascertain the value of liquid assets (security), the bank shall consider total outstanding exposure of the customer for the purpose of determining aggregate net exposure.

Q.37: As per Basel-III document issued under BPRD circular # 06 dated August 15, 2013, the "Bank level disclosure of the leverage ratio and its components will start from December 31, 2015". In this regard, what will be the format of leverage ratio disclosure so that banks can include the disclosure in their financial accounts closing of December 31, 2015?

Reply:

All banks should include a qualitative disclosure for leverage ratio in their annual financials from December 31, 2015. The disclosure should clearly state the current year's leverage ratio (as percentage), Total Tier 1 capital (the numerator), total exposure measure (Denominator) and last year's ratio.

In case of any significant variation in the leverage ratio, the disclosure should also include an explanation for the shift.

The above disclosure may be made under the Note 44 "Capital Assessment & adequacy – Basel III specific".

Q.38: Para A-5-3 (viii) of Annexure 5 of Basel-III document issued under BPRD circular # 06 dated August 15, 2013, stipulates that "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". Do prior regulatory approvals include SECP approval?

Reply:

Banks & DFIs are not required to secure upfront approval from SECP for obtaining SBP's consent to issue non-equity ADT1 & Tier 2 capital instruments for CAR purposes. However, in this context, banks and DFIs will submit an undertaking that they have fulfilled all other pre-conditions (except SECP's approval) necessary for conversion of these instruments at the Point of Non-Viability (PONV) event. Accordingly, SECP approval shall be obtained on post facto basis.

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