

Basel III: Capital Adequacy Regulations and Domestic Banks in Sri Lanka: An Assessment of Current Implementation with Emerging Challenges

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Introduction

Financial stability is an important component in the global economy and plays a key role in maximizing real economic gains. This proves the continuous efforts taken by the international regulatory bodies to minimize the adverse effects due to the economic and financial crisis in 2007/2008. The Bank for International Settlements – Central Banker’s Bank, located in Basel, Switzerland produced new set of banking regulations to avoid – at least minimize – the danger of another financial and economic crisis. The Basel Committee on Banking Supervision (BCBS) is an international financial regulatory body which was established in 1974 to structure the global banking risks by formulating guidelines and regulations relating to credit, capital, markets and operations. As an operational practice to overcome the effects of financial crisis, the Basel Committee collectively discussed and came up with a set of agreements. Its first accord issued in 1988 which named as Basel I and an updated version was published in 2004 as Basel II (Buddhipala, 2017). Basel III introduced in 2011 by reforming Basel II regulations to strengthen the global capital and liquidity rules with the goals of promoting more resilient banking sector. Capital adequacy, Liquidity Management, Risk Management and Market Discipline are the four major components that has been

regulated in the Basel III. According to Bank of International Settlements, lack of quality and quantity of the capital base was one of the main influential factors for the financial crisis. This resulted, the credit losses come out from retained earnings (a part of bank's tangible common equity base), inconsistency in the definition of capital across economies and lack of disclosure (Bank of International Settlements, 2016). Therefore, Basel Committee on Banking Supervision clearly defined the "Total Regulatory Capital" through Basel III accords as Tier one capital: Going-concern capital and Tier two capital: Gone-concern capital.

International regulatory bodies introduced a concept of "Systematically Important Banks" to regulate financial bodies effectively with more control, which represents a financial institution whose unmanageable failure, because of its size, complexity and systemic interconnectedness, would lead significant disruption to the wider financial and economic system. Domestic and Global are the two types of systematically important banks where the banks which are limited their operations within the originated country called domestic while the banks which provide a wide range of international coverage through branches defined as global. Existing researches recognized the impact of implementing Basel III in developed economies such as USA, Japan and European Union, but cannot be satisfied with the assessments carried out on local banking system. This research considered the domestic systematically important banks since the global systematically important banks carry out operations here are not originated in Sri Lanka.

Objectives

Assess the capital adequacy measurements of Basel III within the domestic systematically important banks and to identify the emerging challenges in implementing Basel III capital adequacy regulations when moving further.

Methodology

The capital adequacy ratio consists of three main ratios namely, Tier one capital ratio (Core capital ratio), Total capital ratio and Common equity ratio, defined as follows.

$$\textit{Tier1 Capital Ratio} = \frac{\textit{Tier1 capital}}{\textit{Risk weighted assets}} * 100$$

$$\textit{Total Capital Ratio} = \frac{\textit{Total capital}}{\textit{Risk weighted assets}} * 100$$

$$\textit{Common Equity Ratio} = \frac{\textit{Common equity capital}}{\textit{Risk weighted assets}} * 100$$

A comparative ratio analysis of six Domestic Systematically Important Banks (DSIBs) been conducted using the secondary data from the respective annual reports for the period of 2011-2016. All six DSIBs in Sri Lanka namely Bank of Ceylon, Peoples' Bank, Sampath Bank, Commercial Bank, Hatton National Bank and Seylan Bank will be assessed in this empirical research. These six DSIBs represent 75 % of the commercial bank assets, 63 % of the banking sector assets and 36 % of the entire financial system's assets (Central Bank of Sri Lanka, 2013).

Results and Discussion

The Central Bank of Sri Lanka divided the banking sector by assigning an asset threshold of LKR 500 billion to regulate the financial intermediary system in a sophisticated manner. Table 1 illustrates the set targets which should be met in given time frames in order to satisfy Basel III capital adequacy regulations.

Table 1: Basel III Capital Adequacy Requirements (in Percentage)

| Components of Capital | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 |
|--|------|------|------|------|-------|-------|------|
| Banks with Assets Less Than LKR 500 billion | | | | | | | |
| Common Equity Tier One including Capital Conservation Buffer | 3.5 | 4 | 4.5 | 5.12 | 5.75 | 6.37 | 7 |
| Tier I including Capital Conservation Buffer | 4.5 | 5.5 | 6 | 6.62 | 7.25 | 7.87 | 8.5 |
| Total Capital Ratio including Capital Conservation Buffer | 8 | 8 | 8 | 8.62 | 11.25 | 12.87 | 12.5 |
| Banks with Assets More Than LKR 500 billion | | | | | | | |
| Common Equity Tier Including Capital Conservation Buffer and Capital Surcharge on Domestic Systemically Important Banks | 3.5 | 4 | 4.5 | 5.12 | 6.25 | 7.37 | 8.5 |
| Tier I including Capital Conservation Buffer and Capital Surcharge on Domestic systemically Important Banks | 4.5 | 5.5 | 6 | 6.62 | 7.75 | 8.87 | 10 |
| Total Capital Ratio including Capital Conservation Buffer and Capital Surcharge on Domestic Systemically Important Banks | 8 | 8 | 8 | 8.62 | 11.75 | 12.87 | 14 |

(a) Tier one capital ratio is the proportion of tier one capital to risk weighted assets of the bank which has Basel III threshold of 4.5 % to 6 % at the end of 2016. As shown in figure 1, all six domestic systematically important banks in Sri Lanka are in satisfactory level when meeting the core capital requirements of Basel III. Two state banks managed to continue stable capital ratio while Seylan, Sampath and Hatton National banks report slight decline in their capital ratio

over the considered time period. Commercial bank is maintaining fairly high and stable capital ratio comparing to its' competitors.

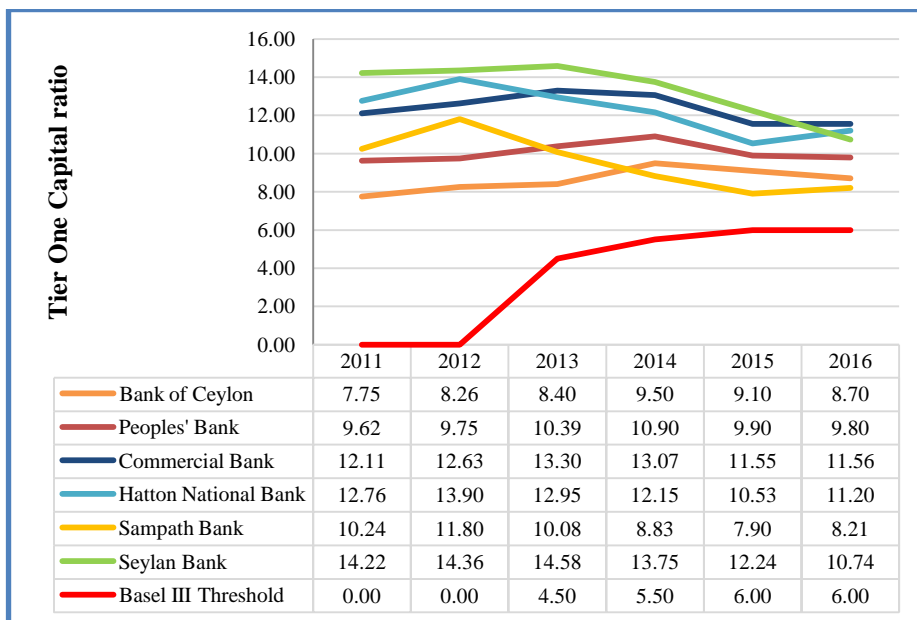


Figure 1: Tier One Core Capital Ratio of DSIBs in Sri Lanka

(b) Total Capital ratio, is the ratio between total capital base and the risk weighted assets of the bank which the minimum requirement of Basel III accords is 8 %. The total capital ratios of domestic systematically important banks in Sri Lanka are also reports a satisfactory level. Figure 2 illustrates the behavior of total capital ratios of considered DSIB's and there we can clearly see The Hatton National Bank has sudden incline in capital ratio after three years of downturn by reporting 15.3 % in 2016.

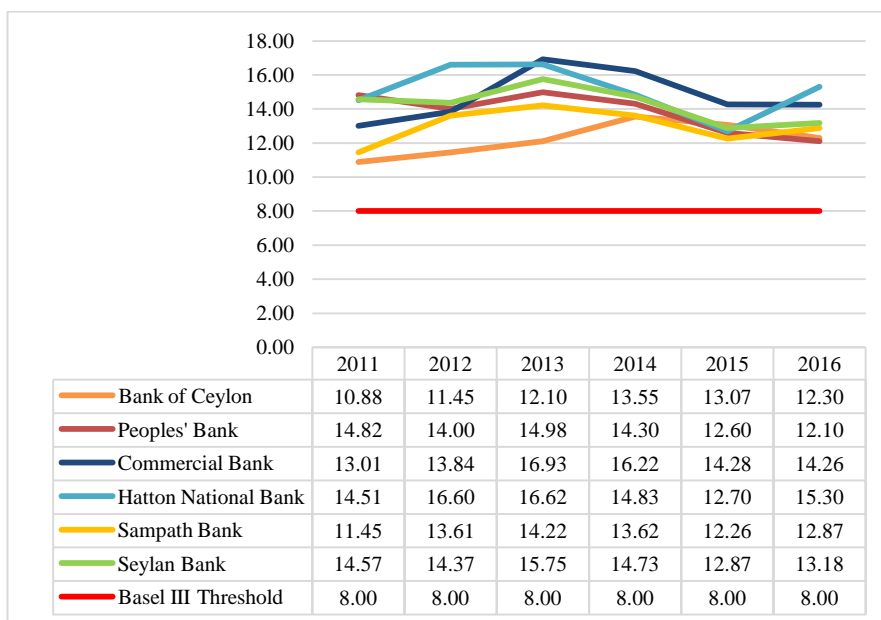


Figure 2: Total Capital Ratio of DSIBs in Sri Lanka

(c) Common capital ratio provides the fraction between common capital to risk weighted assets, but most of the banks did not clearly differentiate common equity from core capital in their calculations which they publish in annual reports. Even all domestic systematically important banks pay their attention to clearly publish tier one capital ratio and total capital ratio, lack of data on common equity ratio created a challenge in this data analysis. Basel III accords require minimum 5 % common equity ratio without capital conservation buffer in 2016. This must be increased up to 8.5 % by domestic systematically important banks by 1st January 2019.

Conclusion and Policy Implications

As per the evidences drawn from the research it can be conclude that all the domestic systematically important banks in Sri Lanka could manage to meet the international capital adequacy requirements drawn by Basel III accords, in terms of tier one (core) capital ratio and total capital ratio. Lack of proper disclosure created a challenge to assess the

level of implementation on common equity ratio. In addition to the findings drawn from the analysis, prevailing literature emphasizes several challenges emerged with new Basel III accords. Increased capital and liquidity requirements may limit the options to raise additional tier one capital with small equity market in Sri Lanka (25 % of GDP) comparing to other Asian economies such as India (70 % of GDP) and Thailand (88 % of GDP). Another challenge may arise is uncommon usage of convertible structures to claim additional tier one capital in future stages in Basel III implementation. Further investments on IT infrastructure and on data architecture will be needed in terms of fulfilling disclosing requirements assigned by Basel III and the local financial regulatory bodies and commercial banks should pay attention on these challenges when moving further.

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