Capital Adequacy Framework

2015

1. INTRODUCTION

1.1 BACKGROUND:

Prior to 1988, there was no uniform international regulatory standard for setting bank capital requirements. In 1988, the Basel Committee on Banking Supervision (BCBS)[1] developed the Capital Accord, which is known as Basel I, to align the capital adequacy requirements applicable especially to banks in G-10 countries. Basel I introduced two key concepts. First, it defined what banks could hold as capital, as well as designating capital as Tier 1 or Tier 2 according to its loss-absorbing or creditor-protecting characteristics. The second key concept introduced in Basel I was that capital should be held by banks in relation to the risks that they face. The major risks faced by banks relate to the assets held on balance sheet. Thus, Basel I calculated banks' minimum capital requirements as a percentage of assets, which are adjusted in accordance with their riskiness and assigning risk weights to assets. Higher weights are assigned to riskier assets such as corporate loans, and lower weights are assigned to less risky assets, such as exposures to government.

The BCBS released the "International Convergence of Capital Measurements and Capital Standards: Revised Framework", popularly known as Basel II, on June 26, 2004. This framework was updated in November 2005 and a comprehensive version of the framework was issued in June 2006. Basel II builds significantly on Basel I by increasing the sensitivity of capital to key bank risks. In addition, Basel II recognizes that banks can face a multitude of risks, ranging from the traditional risks associated with financial intermediation to the day-to-day risks of operating a business as well as the risks associated with the ups and downs of the local and international economies. As a result, the framework more explicitly associates capital requirements with the particular categories of major risks that banks face.

The Basel II capital framework also recognizes that large, usually internationally active banks have already put in place sophisticated approaches to risk measurement and management based on statistical inference rather than judgment alone. Thus, the framework allows banks, under certain conditions, to use their own 'internal' models and techniques to measure the key risks that they face, the probability of loss, and the capital required to meet those losses. In developing the new framework, the Basel Committee incorporated many elements that help to promote a sound and efficient financial system over and above the setting of minimum capital requirements. Keeping this in mind, the Basel II framework incorporates three complementary 'pillars' that draw on the range of approaches to help ensure that banks are adequately capitalized in commensurate with their risk profile.

Again, the Basel Committee on Banking Supervision (BCBS) released a comprehensive reform package entitled "Basel III: A global regulatory framework for more resilient banks and banking systems" (known as Basel III capital regulations) in December 2010. Basel III reforms are the response of the Basel Committee on Banking Supervision (BCBS) to improve the banking sector's ability to absorb shocks arising from financial and economic stress, whatever the source, thus reducing the risk of spill over from the financial sector to the real economy. Basel III reforms strengthen the bank-level i.e. micro prudential regulation, with the intention to raise the resilience of individual banking institutions in periods of stress. Besides, the reforms have a macro prudential focus also, addressing system wide risks, which can build up across the banking sector, as well as the procyclical amplification of these risks over time. These new global regulatory and supervisory standards mainly seek to raise the quality and level of capital (Pillar 1) to ensure that banks are better able to absorb losses on both a going concern and a gone concern basis, increase the risk coverage of the capital framework, introduce leverage ratio to serve as a backstop to the risk-based capital measure, raise the standards for the supervisory review process (Pillar 2) and public disclosures (Pillar 3) etc. The macro prudential aspects of Basel III are largely enshrined in the capital

[1] The Basel Committee on Banking Supervision is a committee of banking supervisory authorities that was established by the central bank governors of the Group of Ten countries in 1975. It consists of senior representatives of bank supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom, and the United States. It usually meets at the Bank for International Settlements in Basel, Switzerland where its permanent Secretariat is located.

buffers. Both the buffers i.e. the capital conservation buffer and the countercyclical buffer are intended to protect the banking sector from periods of excess credit growth.

The Basel Committees on Banking Supervision's (BCBS) recommendations on capital accord are important guiding frameworks for the regulatory capital requirement to the banking industry all over the world and Nepal is no exception. Realizing the significance of capital for ensuring the safety and soundness of the banks and the banking system, at large, Nepal Rastra Bank (NRB) has developed and enforced capital adequacy requirement based on international practices with an appropriate level of customization based on domestic state of market developments.

With a view of adopting the international best practices, NRB has already issued the Basel III implementation action plan and expressed its intention to adopt the Basel III framework, albeit in a simplified form. In line with the international development and thorough discussion with the stakeholders, evaluation and assessment of impact studies at various phases, this framework has been drafted. This framework provides the guidelines for the implementation of Basel III framework in Nepal. The Basel III capital regulations continue to be based on three-mutually reinforcing Pillars, viz. minimum capital requirements, supervisory review of capital adequacy, and market discipline of the Basel II capital adequacy framework.

1.2 OBJECTIVE:

The main objective of this framework is to develop safe and sound financial system by way of sufficient amount of qualitative capital and risk management practices. This framework is intended to ensure that each banks maintain a level of capital which,

(i) is adequate to protect its depositors and creditors.

(ii) is commensurate with the risk associated activities and profile of the banks.

(iii) promotes public confidence in the banking system.

1.3 PRE-REQUISITES:

The effective implementation of this framework is dependent on various factors. Some such pre-requisites are:

(i) Implementation of Basel Core Principles for effective Banking Supervision

(ii) Adoption of the sound practices for the management of Operational Risk

(iii) Formulation and adoption of comprehensive risk management policy

(iv) Adherence to high degree of corporate governance

1.4 RESPONSIBILITY:

The board of directors of each bank shall be responsible for establishing and maintaining, at all times, an adequate level of capital. The capital standards herein are the minimum that is acceptable for banks that are fundamentally sound, well managed, and which have no material financial or operational weaknesses. Thus, the banks are generally expected to operate above the limits prescribed by this framework.

1.5 SCOPE OF APPLICATION:

This framework shall be applicable to all "A" Class financial institutions[2] licensed to conduct banking business in Nepal under the Bank and Financial Institution Act, 2063.

This capital adequacy framework shall be applicable uniformly to all "A" class financial institutions on a stand-alone basis and as well as on a consolidated basis, where the bank is member of a

[2] "A" class financial institutions refers to "Commercial Banks"

consolidated banking group. For the purpose of capital adequacy, the consolidated bank means a group of financial entities, parent or holding company of which a bank is a subsidiary. All banking and other relevant financial activities (both regulated and unregulated) conducted within a group including a bank shall be captured through consolidation. Thus, majority owned or controlled financial entities should be fully consolidated. If any majority owned subsidiaries institutions 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 for capital adequacy purposes.

1.6 APPROACHES TO IMPLEMENTATION:

"International Convergence for Capital Measurements and Capital Standards: Revised Framework" alias Basel II under Pillar 1, provides three distinct approaches for computing capital requirements for credit risk and three other approaches for computing capital requirements for operational risk. These approaches for credit and operational risks are based on increasing risk sensitivity and allow banks to select an approach that is most appropriate to the stage of development of banks' operations.

The product and services offered by the Nepalese Banks are still largely primitive and conventional, in comparison with other economies. This coupled with the various inherent limitations of our system like the limitation of credit rating practices makes the advanced approaches like Internal Ratings Based Approach or even Standardized Approach impractical and unfeasible. Thus, at this juncture, this framework prescribes Simplified Standardized Approach (SSA) to measure credit risk while Basic Indicator Approach and an indigenous Net Open Position Approach for measurement of Operational Risk and Market Risk respectively.

1.7 IMPLEMENTATION OF ADVANCED APPROACHES:

This framework prescribes the simplest of the available approaches at the initial phase with a vision to move onto more complex and risk sensitive approaches as the market gradually gains maturity. However, banks willing to adopt advanced approaches, even for internal purposes, should obtain prior written approval from Nepal Rastra Bank on providing evidences that they have the resource and the capability to adopt the proposed approaches.

A bank will not be allowed to choose to revert to a simpler approach once it has been approved for a more advanced approach without supervisory approval. However, if a supervisor determines that a bank using a more advanced approach no longer meets the qualifying criteria for an advanced approach, it may allow the bank to revert to a simpler approach for some or all of its operations, until it meets the conditions specified by the supervisor for returning to a more advanced approach.

1.8 TRANSITIONAL ARRANGEMENTS

In order to ensure smooth migration to Basel III without aggravating any near term stress, appropriate transitional arrangements have been made. The transitional arrangements for capital ratios will begin from Mid July, 2016 (Shrawan 2073). Capital ratios and deductions from Common Equity will be fully phased-in and implemented as on Mid July, 2019. The phase-in arrangements for banks are indicated in the following Table:

BASEL III in Nepal					
Transition Period					
(Mid July)					
	2015	2016	2017	2018	2019
Minimum Common Equity Capital Ratio	4.00%	4.50%	4.50%	4.50%	4.50%
Capital Conservation Buffer	1.00%	1.25%	1.50%	2.00%	2.50%
Minimum common equity plus capital conservation buffer	5.00%	5.75%	6.00%	6.50%	7.00%
Minimum Tier 1 Capital (Excluding conservation buffer)	6.00%	6.00%	6.00%	6.00%	6.00%
Minimum Total Capital Excluding conservation buffer)	10.00%	9.75%	9.50%	9.00%	8.50%
Minimum Total Capital (including conservation buffer)	11.00%	11.00%	11.00%	11.00%	11.00%
Counter Cyclical Buffers	Introduce minimum standard	0-2.5%	0-2.5%	0-2.5%	0-2.5%
Leverage Ratio	Introduce minimum standard	Offsite Monitoring 4.00%			Migration to Pillar 1
Liquidity coverage ratio	Review Existing Framework		LCR 100%	LCR 100%	LCR 100%
Net stable funding ratio	Observation and Parallel Run		Introduce minimum standard	Implemented	
SIFI Measures	NRB shall issue the regulation.				

1.9 EFFECTIVE DATE:

All banks within the scope of this framework should adopt the prescribed approaches from Mid July 2016 (Fiscal Year 2073/74). In order to ensure smooth transition to new approach prescribed by this framework, a parallel run from Mid January 2016 (Poush End, 2072) to Mid July 2016 (Asar End, 2073) will be conducted. The banks are required to submit their capital adequacy report to the Bank Supervision Department on a monthly basis. Based on the findings of the parallel run, further amendments and modification will be incorporated in the framework wherever deemed necessary.

2. REQUIREMENTS FOR CAPITAL FUNDS

2.1 DEFINITION OF CAPITAL:

The qualifying regulatory capital shall consist of the sum of the following components:

I. Tier 1 Capital (Core Capital)

   A. Common Equity Tier 1 (CET1)

   B. Additional Tier 1 (AT1)

II. Tier 2 Capital (Supplementary Capital)

The detailed description of the components of regulatory capital and their elements are as follows:

I. Tier 1 Capital (Core Capital)

The key element of capital on which the main emphasis should be placed is the Tier 1 (core) capital, which comprises of equity capital and disclosed reserves. This key element of capital is the basis on which most market judgments of capital adequacy are made; and it has a crucial bearing on profit margins and a bank's ability to compete.

The BCBS has therefore concluded that capital, for supervisory purposes, should be defined in two tiers in a way, which will have the effect of requiring at least 50% of a bank's capital base to consist of a core element comprised of equity capital and published reserves from post-tax retained earnings.

In order to rank as Tier 1, capital must be fully paid up, have no fixed servicing or dividend costs attached to it and be freely available to absorb losses ahead of general creditors. Capital also needs to have a very high degree of permanence if it is to be treated as Tier 1.

Tier 1 Capital shall consist of Common Equity Tier 1 Capital and Additional Tier 1 Capital and the sum of these two capital shall be total Tier 1 Capital.

A. <u>Common Equity Tier 1Capital</u>

Common Equity is recognized as the highest quality component of capital and is the primary form of funding which ensures that a bank remains solvent. Common Equity Tier 1 Capital consists of the sum of the following elements:

(i) Common shares issued by the bank that meet the criteria for classification as common shares for regulatory purposes;

(ii) Stock surplus (share premium) resulting from the issue of instruments included in Common Equity Tier 1;

(iii) Statutory General Reserve;

(iv) Retained Earnings available for distribution to shareholders;

(v) Un-audited current year cumulative profit, after all provisions including staff bonus and taxes. Where such provisions are not made, this amount shall not qualify as Common Equity Tier 1 capital,

(vi) Capital Redemption Reserves created in lieu of redeemable instruments

(vii) Capital Adjustment reserves created in respect of increasing the capital base of the bank

(viii) Dividend Equalization Reserves;

(ix) Other free reserves if any

(x) Any other type of instruments notified by NRB from time to time for inclusion in Common Equity Tier 1 capital; and

(xi) Less: Regulatory adjustments / deductions applied in the calculation of Common Equity Tier 1 capital.

Criteria for common shares issued by the bank for inclusion in Common Equity:

Common shares must meet the following criteria to be included in Common Equity Tier 1 Capital:

1. All common shares should be the voting shares.
2. Represents the most subordinated claim in liquidation of the bank.
3. Entitled to a claim on the residual assets which is proportional to its share of paid up capital, after all senior claims have been repaid in liquidation (i.e. has an unlimited and variable claim, not a fixed or capped claim).
4. Principal is perpetual and never repaid outside of liquidation (except discretionary repurchases / buy backs or other means of effectively reducing capital in a discretionary manner with the prior approval of NRB which is allowable under relevant law as well as guidelines, if any, issued by NRB in the matter).
5. The bank does nothing to create an expectation at issuance that the instrument will be bought back, redeemed or cancelled nor do the statutory or contractual terms provide any feature which might give rise to such an expectation.
6. Distributions are paid out of distributable items. The level of distributions is not in any way tied or linked to the amount paid up at issuance and is not subject to a contractual cap (except to the extent that a bank is unable to pay distributions that exceed the level of distributable items). As regards 'distributable items', it is clarified that the dividend on common shares will be paid out of the current year's profit and retained earnings only.
7. There are no circumstances under which the distributions are obligatory. Non-payment is therefore not an event of default.
8. Distributions are paid only after all legal and contractual obligations have been met and payments on more senior capital instruments have been made. This means that there are no preferential distributions, including in respect of other elements classified as the highest quality issued capital.
9. It is the paid up capital that takes the first and proportionately greatest share of any losses as they occur. Within the highest quality capital, each instrument absorbs losses on a going concern basis proportionately and *pari passu* with all the others.
10. The paid up amount is classified as equity capital (i.e. not recognised as a liability) for determining balance sheet insolvency.
11. The paid up amount is classified as equity under the relevant accounting standards.
12. It is directly issued and paid up and the bank cannot directly or indirectly have funded the purchase of the instrument. Banks should also not extend loans against their own shares.
13. The paid up amount is neither secured nor covered by a guarantee of the issuer or related entity nor subject to any other arrangement that legally or economically enhances the seniority of the claim.
14. Paid up capital is only issued with the approval of the owners of the issuing bank, either given directly by the owners or, if permitted by applicable law, given by the Board of Directors or by other persons duly authorized by the owners.
15. Paid up capital is clearly and separately disclosed in the bank's balance sheet.

B. Additional Tier 1Capital

Additional Tier 1 Capital mainly include the instruments either classified as equity under relevant accounting standards but are not the common equity share and hence not includible in common equity tier 1 or the instrument which are classified as liabilities under relevent accounting standards, however it is includible in additional tier 1 capital. Under Basel III non-common equity elements to be included in Tier 1 capital should absorb losses while the bank

remains a going concern. Towards this end, one of the important criteria for Additional Tier 1 instruments is that these instruments should have principal loss absorption through either (i) conversion into 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. Banks should not issue Additional Tier 1 capital instruments to the retail investors.

Additional Tier 1 capital consists of the sum of the following elements:

(i) Perpetual Non Cumulative Preference Share (PNCPS) and Perpetual Debt Instruments (PDI) issued by the bank that meet the criteria for inclusion in Additional Tier 1 capital;

(ii) Stock surplus (share premium) resulting from the issue of PNCPS instruments included in Additional Tier 1 capital; and

(iii) Less: Regulatory adjustments / deductions applied in the calculation of Additional Tier 1 capital.

Criteria for Instruments issued by the bank for inclusion in Additional Tier 1:

Perpetual Non Cumulative Preference Share (PNCPS) and Perpetual Debt Instruments (PDI) issued by the bank must meet the following criteria to be included in Additional Tier 1 Capital:

1. The instruments should be issued by the Bank (i.e. not by any 'Special Purpose Vehicle' etc. set up by the bank for this purpose) and fully paid up.
2. The claim of investors of the instruments shall be:
   (A) In case of Perpetual Non Convertible Preference Share:
      (i) Superior to the claims of investors in equity shares; and
      (ii) Subordinated to the claims of PDIs, all Tier 2 regulatory capital instruments, depositors and general creditors of the bank.
   (B) In case of Perpetual Debt Instruments:
      (i) Superior to the claims of investors in equity shares and perpetual non-cumulative preference shares;
      (ii) Subordinated to the claims of depositors, general creditors and subordinated debt of the bank;
3. The instruments should be neither secured nor covered by a guarantee of the issuer or related entity or other arrangement that legally or economically enhances the seniority of the claim vis-à-vis bank creditors
4. The instruments should be perpetual, ie there is no maturity date and there are no step-ups or other incentives to redeem
5. The Instruments may be callable at the initiative of the issuer. This means that the instruments shall not be issued with "Put Option". However, banks may issue instruments with a "Call Option" at a particular date subject to following conditions:
   a)The call option on the instrument is permissible after ten years of issuance;
   b) To exercise a call option a bank must receive prior approval of NRB; and
   c)A bank must not do anything which creates an expectation that the call will be exercised.; and
   d) Banks must not exercise a call unless:
      i. The bank replaces the called instrument with capital of the same or better quality and the replacement of this capital is done at conditions which are sustainable for the income capacity of the bank; or
      ii. The bank demonstrates that its capital position is well above the minimum

capital requirements after the call option is exercised.

6. Any repayment of principal (eg through repurchase, buy-back or redemption) must be with prior approval of NRB and banks should not assume or create market expectations that supervisory approval will be given. Banks may repurchase / buy-back / redeem the instruments only if:

   (a) The bank replaces such instrument with capital of the same or better quality and the replacement of this capital is done at conditions which are sustainable for the income capacity of the bank; or

   (b) The bank demonstrates that its capital position is well above the minimum capital requirements after the repurchase / buy-back / redemption.

7. Dividend/coupon discretion:

   a. the bank must have full discretion at all times to cancel distributions/payments

   b. cancellation of discretionary payments must not be an event of default

   c. banks must have full access to cancelled payments to meet obligations as they fall due

   d. cancellation of distributions/payments must not impose restrictions on the bank except in relation to distributions to common stockholders.

8. Dividends/coupons must be paid out of 'distributable items':

   As regards 'distributable items', it is clarified that the dividend on perpetual non-cumulative preference shares (PNCPS) will be paid out of current year's profit only.

   In case of coupon on perpetual debt instruments (PDI), it is clarified that if the payment of coupons on perpetual debt instrument (PDI) is likely to result in losses in the current year, their declaration should be precluded to that extent.

   Dividend on PNCPS and coupons on PDI should not be paid out of retained earnings / reserves. In other words, payment of dividend/coupons should not have the effect of reducing retained earnings / reserves.

9. The instrument cannot have a credit sensitive dividend/coupon feature, that is a dividend/coupon that is reset periodically based in whole or in part on the banking organization's credit standing.

10. The dividend/coupon shall not be cumulative. i.e., dividend/coupon missed in a year will not be paid in future years, even if adequate profit is available and the level of CAR conforms to the regulatory minimum. When dividend/coupon is paid at a rate lesser than the prescribed rate, the unpaid amount will not be paid in future years, even if adequate profit is available and the level of CAR conforms to the regulatory minimum.

11. The instrument cannot contribute to liabilities exceeding assets if such a balance sheet test forms part of requirement to prove insolvency by any law or otherwise.

12. Instruments classified as liabilities for accounting purposes 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 will have the following effects:

    a. Reduce the claim of the instrument in liquidation;

    b. Reduce the amount re-paid when a call is exercised; and

    c. Partially or fully reduce coupon/dividend payments on the instrument.

13. Neither the bank nor a related party over which the bank exercises control or significant influence (as defined under relevant Nepal Financial Reporting Standards) can have purchased the instrument, nor can the bank directly or indirectly have funded the purchase of the instrument

14. The instrument cannot 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.

II. Tier 2 (Supplementary) Capital

The Supplementary (Tier 2) Capital includes reserves which have been passed through the profit and loss account and all other capital instruments eligible and acceptable for capital purposes. Elements of the Tier 2 capital will be reckoned as capital funds up to a maximum of 100 percent of Tier 1 capital arrived at, after making regulatory adjustments/deductions. In case, where the Tier 1 capital of a bank is negative, the Tier 2 capital for regulatory purposes shall be considered as zero and hence the capital fund, in such cases, shall be equal to the core capital.

The Tier 2 Capital consists of the sum of the following elements:

(i) Preference Share Capital Instruments [Perpetual Cumulative Preference Shares (PCPS) / Redeemable Non-Cumulative Preference Shares (RNCPS) / Redeemable Cumulative Preference Shares (RCPS)] issued by the bank with the maturity of 5 years or above;

(ii) Subordinated term debt fully paid up with a maturity of 5 years or above; unsecured and subordinated to the claim of other creditors, free of restrictive clauses and not redeemable before maturity. Since, subordinated term debt is not normally available to participate in the losses; the amount eligible for inclusion in the capital adequacy calculations is limited to 50% of core capital. Moreover, to reflect the diminishing value of these instruments as a continuing source of strength, a cumulative discount (amortization) factor of 20% per annum shall be applied for capital adequacy computations, during the last 5 years to maturity.

(iii) Hybrid capital instruments combine certain characteristics of debt and certain characteristics of equity. Each such instrument has a particular feature, which can be considered to affect its quality as capital. Where these instruments have close similarities to equity, in particular when they are able to support losses on an ongoing basis without triggering liquidation, they may be included in Tier 2 capital with approval from Nepal Rastra Bank.

(iv) Stock surplus (share premium) resulting from the issue of instruments included in Tier 2 capital;

(v) General loan loss provision limited to a maximum of 1.25% of total Credit Risk Weighted Exposures. General loan loss provision refers to provisions or loan- loss reserves held against future, presently unidentified losses are freely available to meet losses which subsequently materialize and therefore the provisions created in respect of Performing Loans only qualify for inclusion in Tier 2 Capital. Provisions ascribed to identified deterioration of particular assets or loan liabilities, whether individual or grouped, should be excluded. Accordingly, for instances provision on rescheduled/restructured and classified loans, both an individual account and portfolio level shall be excluded. The additional loan loss provisions created in respect of Personal Guarantee loans and loans in excess of Single Obligor Limits are specific provisions and hence cannot be included under this category. Such provisions however can be deducted from the gross exposures while calculating risk weighted exposures for credit risk.

However, provisions created in excess of the regulatory requirements or provisions which is not attributable to identifiable losses in any specific loans shall be allowed to be included in the General Loan Loss Provision.

(vi) Exchange equalization reserves created by banks as a cushion for unexpected losses arising out of adverse movements in foreign currencies.

(vii) Investment adjustment reserves created as a cushion for adverse price movements in banks' investments falling under "Available for Sale" category.

(viii) Revaluation reserves often serve as a cushion against unexpected losses but may not be fully available to absorb unexpected losses due to the subsequent deterioration in market values and tax consequences of revaluation. Therefore, revaluation reserves will be eligible up to 50% for treatment as Tier 2 capital and limited to a maximum of 2% of total Tier 2 capital subject to the condition that the reasonableness of the revalued amount is duly certified by the internal auditor of the bank.

(ix) Any other type of instruments notified by NRB from time to time for inclusion in Tier 2 capital

(x) Less: Regulatory adjustments / deductions applied in the calculation of Tier 2 capital .

Criteria for Instruments issued by the bank for inclusion in Tier 2 Capital:

Preference Share Capital Instruments [Perpetual Cumulative Preference Shares (PCPS) / Redeemable Non-Cumulative Preference Shares (RNCPS) / Redeemable Cumulative Preference Shares (RCPS)], Subordinated Term Debt and Hybrid Capital Instrument issued by the bank must meet the following criteria to be included in Tier 2 Capital:

1. The instruments should be issued by the Bank (i.e. not by any 'Special Purpose Vehicle' etc. set up by the bank for this purpose) and fully paid up.
2. These instruments could be either perpetual or dated with a maturity period of minimum 5 years or more and there should be no step-ups or other incentives to redeem. The perpetual instruments shall be cumulative. The dated instruments could be cumulative or non-cumulative.
3. The dated instruments (both cumulative and non-cumulative) shall be subjected to a progressive discount for capital adequacy purposes over the last five years of their tenor, as they approach maturity as indicated in the table below for being eligible for inclusion in Tier 2 capital.

Remaining Maturity of Instruments	**Rate of Discount (%)**
Less than one year	100
One year and more but less than two years	80
Two years and more but less than three years	60
Three years and more but less than four years	40
Four years and more but less than five years	20

4. Dividend/Coupon/Rate of Interest

   (i) The dividend/coupon payable to the investors may be either at a fixed rate or at a floating rate referenced to a market determined rupee interest benchmark rate.

   (ii) The instrument cannot have a credit sensitive coupon feature, i.e. a coupon that is reset periodically based in whole or in part on the banks' credit standing.

5. The claims of the investors in instruments shall be:

   (i) senior to the claims of investors in instruments eligible for inclusion in Tier 1 capital;

   (ii) subordinate to the claims of all depositors and general creditors of the bank; and

   (iii) Neither secured nor covered by a guarantee of the issuer or related entity or other arrangement that legally or economically enhances the seniority of the claim vis-à-vis bank creditors.

6. The instruments shall not be issued with "Put Option". However, the Instruments may be callable at the initiative of the issuer. Banks may issue instruments with a "Call Option" at a particular date subject to the following conditions:

   (i) The call option on the instrument is permissible after five years of issuance;

   (ii) To exercise a call option a bank must receive prior approval of NRB; and

   (iii) A bank must not do anything which creates an expectation that the call will be exercised; and

   (iv) Banks must not exercise a call unless:

(a) The bank replaces the called instrument with capital of the same or better quality and the replacement of this capital is done on conditions which are sustainable for the income capacity of the bank; or

(b) The bank demonstrates that its capital position is well above the minimum capital requirements after the call option is exercised.

7. Treatment in Bankruptcy / Liquidation

   The investor must have no rights to accelerate the repayment of future scheduled payments (coupon or principal) except in bankruptcy and liquidation

8. Prohibition on Purchase / Funding of Instruments

   Neither the bank nor a related party over which the bank exercises control or significant influence (as defined under relevant Nepal Financial Reporting Standards) should purchase the instrument, nor can the bank directly or indirectly should fund the purchase of the instrument. Banks should also not grant advances against the security of the debt instruments issued by them.

2.2 LOSS ABSORPTION OF ADDITIONAL TIER 1 INSTRUMENTS (AT1) AT THE PRE-SPECIFIED TRIGGER

I. Level of Pre-specified Trigger and Amount of Equity to be Created by Conversion / Write-down

1. As a bank's capital conservation buffer falls to 0.625% of RWE, it will be subject to 100% profit retention requirements. One of the important objectives of capital conservation buffer is to ensure that a bank always operates above minimum Common Equity Tier 1 (CET1) level. Therefore, a pre-specified trigger for loss absorption through conversion / write-down of the level of Additional Tier 1 (AT1) instruments (PNCPS and PDI) at CET1 of 5.125% of RWEs (minimum CET1 of 4.5% + 25% of capital conservation buffer of 2.5% i.e. 0.625%) has been fixed.

2. The write-down / conversion must generate CET1 under applicable Nepal Financial Reporting Standards equal to the written-down / converted amount net of tax, if any.

3. The aggregate amount to be written-down / converted for all such instruments on breaching the trigger level must be at least the amount needed to immediately return the bank's CET1 ratio to the trigger level or, if this is not sufficient, the full principal value of the instruments. Further, the issuer should have full discretion to determine the amount of AT1 instruments to be converted/written-down subject to the amount of conversion/write-down not exceeding the amount which would be required to bring the total Common Equity ratio to 7% of RWEs (minimum CET1 of 4.5% + capital conservation buffer of 2.5%).

4. The conversion / write-down of AT1 instruments are primarily intended to replenish the equity in the event it is depleted by losses. Therefore, banks should not use conversion / write-down of AT1 instruments to support expansion of balance sheet by incurring further obligations / booking assets. Accordingly, a bank whose total Common Equity ratio slips below 7% due to losses and is still above 5.125% i.e. trigger point, should seek to expand its balance sheet further only by raising fresh equity from its existing shareholders or market and the internal accruals. However, fresh exposures can be taken to the extent of amortization of the existing ones. If any expansion in exposures, such as due to drawdown of sanctioned borrowing limits, is inevitable, this should be compensated within the shortest possible time by reducing other exposures. The bank should maintain proper records to facilitate verification of these transactions by its internal auditors, statutory auditors and supervisors.

II. Types of Loss Absorption Features

5. Banks may issue AT1 instruments with conversion / write-down features. Further, banks may issue single AT1 instrument having both conversion and write-down features with the option for conversion or write-down to be exercised by the bank. However, whichever option is exercised, it should be exercised across all investors of a particular issue.

6. When a bank breaches the pre-specified trigger of loss absorbency of AT1 and the equity is replenished either through conversion or write-down, such replenished amount of equity will be excluded from the common equity tier 1 of the bank for the purpose of determining the proportion of earnings to be paid out as dividend in terms of rules laid down for maintaining capital conservation buffer. However, once the bank has attained a total Common Equity ratio of 7% without counting the replenished equity capital, that point onwards, the bank may include the replenished equity capital for all purposes.

7. The conversion / write-down may be allowed more than once in case a bank hits the pre-specified trigger level subsequent to the first conversion / write-down which was partial.

III. Treatment of AT1 Instruments in the event of Liquidation, Merger, Acquisition of the Bank

8. If a bank goes into liquidation before the AT1 instruments have been written-down/ converted, these instruments will absorb losses in accordance with the order of seniority indicated in the offer document, and legal provisions governing priority of charges. The order of seniority indicated in the offer document should be in compliance with the provision of Banking Act.

9. If a bank goes into liquidation after the AT1 instruments have been written-down, the holders of these instruments will have no claim on the proceeds of liquidation.

10. If a bank is merged with/acquired by any other bank before the AT1 instruments have been written-down/converted, these instruments will become part of the corresponding categories of regulatory capital of the new bank emerging after the merger/acquisition.

11. If a bank is merged with any other bank after the non-equity regulatory capital instruments have been written-down, these cannot be written-up by the merged entity.

IV. Fixation of Conversion Price, Capping of Number of Shares / Voting Rights

12. Banks may issue AT1 instruments with conversion features either based on price fixed at the time of issuance or based on the market price prevailing at the time of conversion.

13. There will be a possibility of the debt holders receiving a large number of shares in the event the share price is very low at the time of conversion. Thus, debt holders will end up holding the number of shares and attached voting rights exceeding the legally permissible limits. Banks should therefore, always keep sufficient headroom to accommodate the additional equity due to conversion without breaching any of the statutory / regulatory ceilings especially that for maximum shareholdings and maximum voting rights per investors / group of related investors. In order to achieve this, banks should cap the number of shares and / or voting rights in accordance with relevant laws and regulations on Ownership and Governance of banks. Banks should adequately incorporate these features in the terms and conditions of the instruments in the offer document.

V. Order of Conversion / Write-down of Various Types of AT1 Instruments

14. The instruments should be converted / written-down in order in which they would absorb losses in a gone concern situation. Banks should indicate in the offer document clearly the order of conversion / write-down of the instrument in question vis-à-vis other capital instruments which the bank has already issued or may issue in future.

2.3 DEDUCTIONS FROM CORE (TIER 1) CAPITAL:

Banks shall be required to deduct the following from the Common Equity Tier 1 capital for capital adequacy purposes. The claims that have been deducted from Common Equity Tier 1 capital shall be exempt from risk weights for the measurement of credit risk.

a. Book value of goodwill and all other intangible assets.

   Goodwill and all other intangible assets should be deducted from Common Equity Tier 1 capital including any goodwill included in the valuation of significant investments in the capital of banking, financial and insurance entities which are outside the scope of regulatory consolidation.

   The full amount of the intangible assets is to be a deducted net of any associated deferred tax liabilities which would be extinguished if the intangible assets become impaired or derecognized under the relevant accounting standards. For this purpose, the definition of intangible assets would be in accordance with the Nepal Financial Reporting Standards.

b. Deferred Tax Assets

   Deferred Tax Assets computed as under should be deducted from Common Equity Tier 1

   (i) Deferred Tax Assets associated with the accumulated tax losses

   (ii) Deferred Tax Assets other than associated with the accumulated tax losses, net of Deferred Tax Liabilities, if any. Where the Deferred Tax Liabilities is in excess of the Deferred Tax Assets (excluding Deferred Tax Assets associated with accumulated losses), the excess shall neither be adjusted against item (i) nor added to Common Equity Tier 1 capital.

c. Miscellaneous expenditure to the extent not written off. e.g. VRS expense, preliminary expense, share issue expense, deferred revenue expenditure, etc.

d. Investment in Securities of financial institutions licensed by Nepal Rastra Bank[3].

e. All Investments in equity of institutions with financial interest.

f. Investments in equity of institutions in excess of the prescribed limits.

g. Investments arising out of underwriting commitments that have not been disposed within a year from the date of commitment.

h. Reciprocal crossholdings of bank capital artificially designed to inflate the capital position of the bank.

i. Cash Flow Hedge Reserve

   The amount of the cash flow hedge reserve which relates to the hedging of items that are not fair valued on the balance sheet (including projected cash flows) should be derecognized in the calculation of Common Equity Tier 1. This means that positive amounts should be deducted and negative amounts should be added back. This treatment specifically identifies the element of the cash flow hedge reserve that is to be derecognized for prudential purposes. It removes the element that gives rise to artificial volatility in Common Equity, as in this case the reserve only reflects one half of the picture (the fair value of the derivative, but not the changes in fair value of the hedged future cash flow).

j. Defined Benefit Pension Fund Assets and Liabilities

   Defined benefit pension fund liabilities, as included on the balance sheet, must be fully recognized in the calculation of Common Equity Tier 1 capital (i.e. Common Equity Tier 1 capital cannot be increased through derecognizing or unrecognition of these liabilities). For each defined benefit pension fund that is an asset on the balance sheet, the asset should be

[3] Investment in shares of institutions, where the waiver has been explicitly provided by NRB are subject to risk weight of 100% and shall not be deducted from Tier 1 capital.

deducted in the calculation of Common Equity Tier 1 net of any associated deferred tax liability which would be extinguished if the asset should become impaired or derecognized under the relevant accounting standards.

k. Any other instruments as stipulated by Nepal Rastra Bank, from time to time.

2.4 CAPITAL FUNDS:

The capital fund is the summation of Tier 1 and Tier 2 capital and Tier 1 capital is the total of common equity Tier 1 and additional Tier 1 capital. A bank should compute capital ratios in the following manner:

$$\text{Common Equity tier 1 capital ratio} = \frac{\text{Common equity tier 1 Capital}}{\text{Total Risk Weighted Exposure*}}$$

$$\text{Tier 1 capital ratio} = \frac{\text{Eligible tier 1 Capital}}{\text{Total Risk Weighted Exposure}}$$

$$\text{Total Capital (CAR}^{\#}\text{)} = \frac{\text{Eligible Total Capital}}{\text{Total Risk Weighted Exposure}}$$

*Total Risk Weighted Exposure = Credit Risk RWE¥+Market Risk RWE+ Operational Risk RWE + Supervisory Adjustment under Pillar II

¥ RWE= Risk weighted Exposure;
Capital Adequacy Ratio

(i) Banks shall maintain a minimum total capital (MTC) of 8.5% of total risk weighted assets (RWAs) i.e. capital to risk weighted assets (CRAR).

(ii) Common Equity Tier 1 (CET1) capital must be at least 4.5% of risk-weighted assets (RWAs) i.e. for credit risk + market risk + operational risk on an ongoing basis.

(iii) Tier 1 capital must be at least 6% of RWAs on an ongoing basis. Thus, within the minimum Tier 1 capital, Additional Tier 1 capital can be admitted maximum at 1.5% of RWAs.

(iv) Total Capital (Tier 1 Capital plus Tier 2 Capital) must be at least 8.5% of RWAs on an ongoing basis. The sum total of the different components of the tier 2 capitals will be limited to the sum total of the various components of the Tier 1 capital net of deductions as specified in paragraph 2.3. In case the Tier 1 capital is negative, Tier 2 capital shall be considered to be "Nil" for regulatory capital adequacy purposes and hence, in such a situation, the capital fund shall be equal to the Tier 1 capital.

(v) If a bank has complied with the minimum Common Equity Tier 1 and Tier 1 capital ratios, then the excess Additional Tier 1 capital can be admitted for compliance with the minimum CRAR of 8.5% of RWAs.

(vi) In addition to the minimum Common Equity Tier 1 capital of 4.5% of RWAs, banks are also required to maintain a capital conservation buffer (CCB) of 2.5% of RWAs in the form of Common Equity Tier 1 capital.

Thus, with full implementation of capital ratios and CCB the capital requirements are summarized as follows:

	Regulatory Capital	**As % to RWAs**
(i)	Minimum Common Equity Tier 1 Ratio	4.5
(ii)	Capital Conservation Buffer (Comprised of Common Equity)	2.5
(iii)	Minimum Common Equity Tier 1 Ratio plus Capital Conservation Buffer [(i)+(ii)]	7.0
(iv)	Minimum Tier 1 Capital Ratio	6.0
(v)	Minimum Total Capital Ratio (MTC)	8.5
(vi)	Minimum Total Capital Ratio plus Capital Conservation Buffer	11.0

For the purpose of all prudential exposure limits linked to capital funds, the 'capital funds' will exclude the applicable capital conservation buffer and countercyclical capital buffer as and when activated, but include Additional Tier 1 capital and Tier 2 capital. It may be noted that the term 'Common Equity Tier 1 capital' does not include capital conservation buffer and countercyclical capital buffer.

2.5 CAPITAL CONSERVATION BUFFER

A. Objective

1. The capital conservation buffer (CCB) is designed to ensure that banks build up capital buffers during normal times (i.e. outside periods of stress) which can be drawn down as losses are incurred during a stressed period. The requirement is based on simple capital conservation rules designed to avoid breaches of minimum capital requirements.

2. Outside the period of stress, banks should hold buffers of capital above the regulatory minimum. When buffers have been drawn down, one way banks should look to rebuild them is through reducing discretionary distributions of earnings. Banks may also choose to raise new capital from the market as an alternative to conserving internally generated capital. However, if a bank decides to make payments in excess of the constraints imposed as explained above, the bank, with the prior approval of NRB, would have to use the option of raising capital from the market equal to the amount above the constraint which it wishes to distribute.

3. The capital conservation buffer can be drawn down only when a bank faces a systemic or idiosyncratic stress. A bank should not choose in normal times to operate in the buffer range simply to compete with other banks and win market share. This aspect would be specifically looked into by NRB during the Supervisory Review and Evaluation Process. If, at any time, a bank is found to have allowed its capital conservation buffer to fall in normal times, particularly by increasing its risk weighted assets without a commensurate increase in the Common Equity Tier 1 Ratio (although adhering to the restrictions on distributions), this would be viewed seriously. In addition, such a bank will be required to bring the buffer to the desired level within a time limit prescribed by NRB. The banks which draw down their capital conservation buffer during a stressed period should also have a definite plan to replenish the buffer as part of its Internal Capital Adequacy Assessment Process and strive to bring the buffer to the desired level within a time limit agreed to with NRB during the Supervisory Review and Evaluation Process.

4. The framework of capital conservation buffer will strengthen the ability of banks to withstand adverse economic environment conditions, will help increase banking sector resilience both going into a downturn, and provide the mechanism for rebuilding capital during the early stages of economic recovery. Thus, by retaining a greater proportion of earnings during a downturn, banks will be able to help ensure that capital remains available to support the ongoing business operations / lending activities during the period of stress. Therefore, this framework is expected to help reduce pro-cyclicality.

B. The Framework

5. Banks are required to maintain a capital conservation buffer of 2.5%, comprised of Common Equity Tier 1 capital, above the regulatory minimum capital requirement of 8.50%. Banks should not distribute capital (i.e. pay dividends or bonuses in any form) in case capital level falls within this range. However, they will be able to conduct business as normal when their capital levels fall into the conservation range as they experience losses. Therefore, the constraints imposed are related to the distributions only and are not related to the operations of banks. 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 Common Equity Tier 1 capital ratios.

Minimum capital conservation standards for individual bank	
Common Equity Tier 1 Ratio	Minimum Capital Conservation Ratios (expressed as a percentage of earnings)
4.5% - 5.125%	100%
>5.125% - 5.75%	80%
>5.75% - 6.375%	60%
>6.375% - 7.0%	40%
>7.0%	0%

For example, a bank with a Common Equity Tier 1 capital ratio in the range of 5.125% to 5.75% is required to conserve 80% of its earnings in the subsequent financial year (i.e. payout no more than 20%).

6. The capital conservation buffer will be phased in between mid July 2016 and becoming fully effective on mid July 2019. It will begin at 1% of RWEs on mid July 2016 and increase each subsequent year by an additional 0.50 percentage points, to reach its final level of 2.5% of RWAs on mid July 2019.The minimum capital conservation standards apply with reference to the applicable minimum CET1 capital and applicable CCB. Therefore, during the transition period, banks may refer to the following Table for meeting the minimum capital conservation ratios at various levels of the Common Equity Tier 1 capital ratios:

Minimum capital conservation standards for individual bank			
Common Equity Tier 1 Ratio after including the current periods retained earnings			Minimum Capital Conservation Ratios (expressed as % of earnings)
Mid July, 2016	Mid July, 2017	Mid July, 2018	
4.50% - 4.75%	4.5% - 4.875%	4.5% - 5.00%	100%
>4.75% - 5.00%	>4.875% - 5.25%	>5.00% - 5.50%	80%
>5.00% - 5.25%	>5.25% - 5.625%	>5.50% - 6.00%	60%
>5.25% - 5.50%	>5.625% - 6.00%	>6.00% - 6.50%	40%
>5.50%	>6.00%	>6.50%	0%

Banks that already meet the minimum ratio requirement during the transition period but remain below the 7% Common Equity Tier 1 target (minimum of 4.5% plus conservation buffer of 2.5%) should maintain prudent earnings retention policies with a view to meeting the conservation buffer as soon as reasonably possible. However, NRB may consider accelerating the build-up of the capital conservation buffer and shorten the transition periods, if the situation warrants so.

7. The Common Equity Tier 1 ratio includes amounts used to meet the minimum Common Equity Tier 1 capital requirement of 4.5%, but excludes any additional Common Equity Tier 1 needed to meet the 7% Tier 1 and 8.5% Total Capital requirements. For example, a bank maintains Common Equity Tier 1 capital of 8.5% and has no Additional Tier 1 or Tier 2 capital. Therefore, the bank would meet all minimum capital requirements, but would have a zero conservation buffer and therefore, the bank would be subjected to 100% constraint on distributions of capital by way of dividends, share-buybacks and discretionary bonuses.

8. The following represents other key aspects of the capital conservation buffer requirements:

   (i) Elements subject to the restriction on distributions: Dividends and share buybacks, discretionary payments on other Tier 1 capital instruments and discretionary bonus

payments to staff would constitute items considered to be distributions. Payments which do not result in depletion of Common Equity Tier 1 capital, (for example includes certain scrip dividend) are not considered distributions.

(ii) Definition of earnings: Earnings are defined as distributable profits before the deduction of elements subject to the restriction on distributions mentioned at (i) above. 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. If a bank does not have positive earnings and has a Common Equity Tier 1 ratio less than 7%, it should not make positive net distributions.

(iii) Additional supervisory discretion: Supervisors have the additional discretion to impose time limits on banks operating within the buffer range on a case-by-case basis. In any case, supervisors should ensure that the capital plans of banks seek to rebuild buffers over an appropriate timeframe.

2.6 COUNTERCYCLICAL BUFFER

A. Introduction

1. Losses incurred in the banking sector can be extremely large when a downturn is preceded by a period of excess credit growth. These losses can destabilise the banking sector and spark a vicious circle, whereby problems in the financial system can contribute to a downturn in the real economy that then feeds back on to the banking sector. These interactions highlight the particular importance of the banking sector building up additional capital defences in periods where the risks of system-wide stress are growing markedly.

2. The countercyclical buffer aims to ensure that banking sector capital requirements take account of the macro-financial environment in which banks operate. The primary aim of the countercyclical capital buffer requirement is to use a buffer of capital to achieve the broader macroprudential goal of protecting the banking sector from periods of excess aggregate credit growth that have often been associated with the build up of system-wide risk. Protecting the banking sector in this context is not simply ensuring that individual banks remain solvent through a period of stress, as the minimum capital requirement and capital conservation buffer are together designed to fulfill this objective. Rather, the aim is to ensure that the banking sector in aggregate has the capital on hand to help maintain the flow of credit in the economy without its solvency being questioned, when the broader financial system experiences stress after a period of excess credit growth. Therefore, excess aggregate credit growth is judged to be associated with a build-up of system-wide risk to ensure the banking system has a buffer of capital to protect it against future potential losses.

3. The countercyclical buffer regime consists of the following elements:

   a) Nepal Rastra Bank will monitor credit growth and other indicators that may signal a buildup of system-wide risk and make assessments of whether credit growth is excessive and is leading to the buildup of system-wide risk. Based on this assessment Nepal Rastra Bank will put in place a countercyclical buffer requirement when circumstances warrant. This requirement will be released when system-wide risk crystallises or dissipates.

   b) The countercyclical buffer requirement to which a bank is subject will extend the size of the capital conservation buffer. Banks will be subject to restrictions on distributions if they do not meet the requirement.

B. Countercyclical buffer requirements

Nepal Rastra Bank has adopted the Credit to GDP ratio, macro-economic vairable, as guide for reference point for taking buffer decisions. Nepal Rastra Bank will monitor Credit to GDP ratio at least annually and calculate Credit to GDP gap, i.e. the gap between Credit to GDP ratio and its Trend. The intensity of Credit to GDP gap shall be the indication of the extent of the buildup of system-wide risk i.e. If the credit-to-GDP ratio is significantly above its trend (ie there is a large positive gap) then this is an indication that credit may have grown to excessive levels relative to GDP. The Credit to GDP gap shall be calculated as follows:

$$\text{Credit to GDP Gap}_{(t)} = \text{Credit to GDP Ratio}_{(t)} - \text{Trend}_{(t)}$$

The countercyclical buffer requirement will vary between zero and 2.5% of risk weighted assets, depending on the extent of the build up of system-wide risk. The credit to GDP gap of 5 points shall be taken as cut off points of excess credit growth level. The increase by additional 1 point of credit to GDP gap in excess of 5 point shall require buffer requirement of 0.5% i.e. each increase in every one points in credit to GDP gap in excess of 5 points shall require to raise the buffer requirement by each 0.5%. For this purpose trend is defined as average of credit to GDP ratio of past 10 years. The following table shows the countercyclical buffer requirement in case of excess credit growth:

Countercyclical Buffer Requirement	
Credit to GDP Gap	Buffer Requirement in Terms of CET 1
Up to 5 points	0%
5 to 6 points	0.5%
6 to 7 points	1.0%
7 to 8 points	1.5%
8 to 9 points	2.0%
above 9 points	2.5%

The banks are required to raise level of the buffer by up to 12 months, but shall be allowed to decrease the level of the buffer with immediate effect. The bank, not being able to maintain the countercyclical buffer requirement, shall not be allowed to distribute its earning.

2.7 LEVERAGE RATIO

A. Rationale and Objective

One of the underlying features of the crisis was the build-up of excessive on- and off-balance sheet leverage in the banking system. In many cases, banks built up excessive leverage while still showing strong risk based capital ratios. During the most severe part of the crisis, the banking sector was forced by the market to reduce its leverage in a manner that amplified downward pressure on asset prices, further exacerbating the positive feedback loop between losses, declines in bank capital, and contraction in credit availability. Therefore, under Basel III, a simple, transparent, non-risk based leverage ratio has been introduced. The leverage ratio is calibrated to act as a credible supplementary measure to the risk based capital requirements. The leverage ratio is intended to achieve the following objectives:

a) constrain the build-up of leverage in the banking sector, helping avoid destabilising deleveraging processes which can damage the broader financial system and the economy; and

b) reinforce the risk based requirements with a simple, non-risk based "backstop" measure.

B. Definition and Calculation of the Leverage Ratio

a) The provisions relating to leverage ratio are intended to serve as the basis for testing the leverage ratio during the parallel run period. Banks are required to maintain minimum Tier 1 leverage ratio of 4% during the parallel run period from Mid July, 2016 to mid July, 2018. After the parallel run final leverage ratio requirement might be revised by NRB after taking into account the prescriptions given by the Basel Committee.

b) The leverage ratio shall be maintained on a quarterly basis. The Leverage Ratio shall be calculated as:

$$\textbf{Leverage Ratio} = \frac{\textbf{Capital Measure}}{\textbf{Exposure Measure}}$$

I. Capital Measure

a) The capital measure for the leverage ratio should be based on the definition of Tier 1 capital as set out in paragraph 2.1

b) Items that are deducted completely from capital do not contribute to leverage, and should therefore also be deducted from the measure of exposure.

II. Exposure Measure

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

a) on-balance sheet, non-derivative exposures will be net of specific provisions and valuation adjustments (e.g. prudent valuation adjustments for Available For Sale (AFS) and Held For Trading (HFT) positions, credit valuation adjustments);

b) physical or financial collateral, guarantees or credit risk mitigation purchased is not allowed to reduce on-balance sheet exposures; and

c) netting of loans and deposits is not allowed.

Component of Exposure Measure

(i) **On-Balance Sheet Items**

Banks should include all items of assets reported in their accounting balance sheet for the purposes of calculation of the leverage ratio. In addition, the exposure measure should include the following treatments for Securities Financing Transactions (e.g. repo and reverse repo agreements, CBLO) and derivatives.

(ii) Repurchase agreements and securities finance

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

(a) the accounting measure of exposure; and

(b) without netting various long and short positions with the same counterparty.

(iii) Derivatives

Derivatives create two types of exposure: an "on-balance sheet" present value reflecting the fair value of the contract (often zero at 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 should calculate exposure in respect of derivatives, including where a bank sells protection using a credit derivative, for the purposes of the leverage ratio by applying:

(a) the accounting measure of exposure (positive Marked to Market (MTM) value) plus an add-on for Potential Future Exposure (PFE) calculated according to the Current Exposure Method; and

(b) without netting the MTM values and PFEs in respect of various long and short positions with the same counterparty.

(iv) Other Off-Balance Sheet Items

Banks should calculate the off balance sheet items . These include commitments (including liquidity facilities), unconditionally cancellable commitments, direct credit substitutes, acceptances, standby letters of credit, trade letters of credit, failed transactions and unsettled securities. The off balance sheet items are source of the potentially significant leverage. Therefore, bank should calculate the above off balance sheet items for the purposes of the leverage ratio by applying a uniform 100% credit conversion factor (CCF).

3. CREDIT RISK

3.1 GENERAL:

Credit risk is the major risk that banks are exposed to during the normal course of lending and credit underwriting. There are two approaches for credit risk measurement: the standardized approach and the internal ratings based (IRB) approach. Due to various inherent constraints of the Nepalese banking system, the standardized approach in its simplified form, Simplified Standardized Approach (SSA), has been prescribed in the initial phase.

3.2 SIMPLIFIED STANDARDIZED APPROACH (SSA):

In comparison to Basel I, SSA aligns regulatory capital requirements more closely with the key elements of banking risk by introducing a wider differentiation of risk weights and a wider recognition of credit risk mitigation techniques. The advantage of implementing this approach is twofold. This approach allows transitional advantage for countries like us by avoiding excessive complexities associated with the advanced approaches of Basel II while at the same time it will produce capital ratios more in line with the actual economic risks that banks are facing, compared to the present Accord.

Under this approach commercial banks are required to assign a risk weight to their balance sheet and off-balance sheet exposures. These risk weights are based on a fixed weight that is broadly aligned with the likelihood of a counterparty default. As a general rule, the claims that have already been deducted from the core capital shall be exempt from risk weights for the measurement of credit risk.

Claims on foreign government, their central banks as well as foreign corporates shall be generally risk-weighed on the basis of the consensus country risk scores of export credit agencies (ECA)[4]. Wherever there are claims relating to unrated countries, they shall generally be risk weighed at 100 percent. However, these claims shall be subject to supervisory review and higher risk weight shall be assigned where the review process is deemed appropriate.

All kinds of claims including loans & advances as well as investments shall be a risk weighed net of specific provisions. Generally provision related to any receivable or investment is not defined as general or specific. In such a situation, the total provision against any claim/exposure (other than the loans and advances) shall be regarded as specific provision. However, provisions eligible for the supplementary capital shall not be allowed for netting while calculating risk weighted exposures.

In case of loans, advances and bills purchased the provisions created in lieu of Pass loans only are classified as General loan loss provision. All other provisions are components of specific loan loss provision. Hence, general loan loss provision doesn't comprise provisions created in respect of rescheduled/restructured and non performing loans. It also doesn't include additional provisions created for personal guarantee loans or lending in excess of Single Obligor Limits. However, provisions created in excess of the regulatory requirements and not attributable to identifiable losses in any specific loans shall be allowed to be included in the General Loan Loss Provision.

In order to be consistent with the Basel framework, the credit risk for the regulatory capital purpose shall be computed by segregating the exposure in the following 11 categories.

a) Claims on government & central bank

b) Claims on other official entities

c) Claims on banks

d) Claims on corporate & securities firms

e) Claims on regulatory retail portfolio

f) Claims secured by residential properties

g) Claims secured by commercial real state

4 The consensus country risk classification is available on the OECD's website (http://www.oecd.org) in the Export Credit Arrangement web page of the Trade Directorate. Each bank while computing the risk weight in any claim should use the updated risk score.

h) Past due claims

i) High risk claims

j) Other assets

k) Off balance sheet items

3.3 RISK MEASUREMENT AND RISK WEIGHTS:

a. Claims on government & central bank

1. All claims on Government of Nepal and Nepal Rastra Bank shall be risk weighed at 0 %.

2. Claims on foreign government and their central banks shall be risk-weighted on the basis of the consensus country risk scores as follows:

ECA risk scores	0-1	2	3	4 to 6	7
Risk weights	0%	20%	50%	100%	150%

b. Claims on other official entities

1. Claims on the Bank for International Settlements, the International Monetary Fund, the European Central Bank and the European Community will receive a 0% risk weight.

2. Following Multilateral Development Banks (MDBs) will be eligible for a 0% risk weight.

- World Bank Group, comprised of the International Bank for Reconstruction and Development (IBRD) and the International Finance Corporation (IFC),
- Asian Development Bank (ADB),
- African Development Bank (AfDB),
- European Bank for Reconstruction and Development (EBRD),
- Inter-American Development Bank (IADB),
- European Investment Bank (EIB),
- European Investment Fund (EIF),
- Nordic Investment Bank (NIB),
- Caribbean Development Bank (CDB),
- Islamic Development Bank (IDB), and
- Council of Europe Development Bank (CEDB).

3. The standard risk weight for claims on other Multilateral Development Banks will be 100%.

4. Claims on public sector entities (PSEs)[5]

i. Claims on domestic public sector entities:

The risk weight for claims on domestic pubic sector entitiesw will be 100%.

ii. Claims on foreign public sector entities will be risk-weighed as per the ECA country risk scores.

ECA risk scores	0-1	2	3 to 6	7
Risk weights	20%	50%	100%	150%

c. Claims on banks

[5] Public sector entity (PSE) is one, which is owned or controlled by government or any other entity categorized as PSE by NRB.

1. All claims, irrespective of currency, excluding investment in equity shares and other instruments eligible for capital funds, on domestic banks/financial institutions that fulfill Capital Adequacy Requirements will be risk weighed at 20% while for the rest, it will be 100%.

   Banks should make use of the publicly available information of the immediately preceding quarter of the respective banks to gauge their status on capital adequacy.

2. Claims on a foreign bank excluding investment in equity shares and other instruments eligible for capital funds shall be risk weighed as per the ECA Country risk score subject to the floor of 20%. The primary basis for applying the ECA Country Risk score shall be the country of incorporation of the bank. Where the bank is a branch office, the ECA score of the country where the corporate office is located shall be used while in the case of a subsidiary the basis shall be the country where the subsidiary is incorporated.

ECA risk scores	0-1	2	3 to 6	7
Risk weights	20%	50%	100%	150%

   However, the claims on foreign banks incorporated in the SAARC region and which operate with a buffer of 1% above their respective regulatory minimum capital requirements may be risk weighed at 20%. The banks shall be responsible to submit the latest capital adequacy position of such banks and demonstrate that they fulfill the eligibility requirements. Such capital adequacy position submitted by the banks should not be prior to one financial year. Moreover, such claims shall be subject to a supervisory review and supervisors may require the bank to risk-weigh the claims on ECA country risk scores where the review process is deemed necessary.

d. Claims on corporate & securities firms

1. The risk weight for claims on domestic corporate, including claims on insurance companies and securities firm will be 100%. The domestic corporate includes all firms and companies incorporated in Nepal as per prevailing Acts and regulations.

2. The claims on foreign corporate shall be risk weighed as per the ECA Country risk score subject to the floor of 20% as follows:

ECA risk scores	0-1	2	3 to 6	7
Risk weights	20%	50%	100%	150%

e. Claims on regulatory retail portfolio

1. Claims[6] that qualify all criteria listed below may be considered as regulatory retail portfolio and risk weighed at 75%, except for past due loans. Such claims however, have to be in strict compliance with the Product paper developed by the bank and approved by their respective board of directors

   Criteria:

   - *Orientation criteria* :- exposure is to an individual person or persons or to a small business. Bank should obtain written declaration from the borrower to the effect that their indebtedness is within the threshold across all banks and FIs..
   - *Product criteria* :- The exposure takes the form of any of the following:
     - Revolving credits and lines of credit, (including overdraft, hypothecation etc.)
     - Term loans and leases (e.g. hire purchase, auto loans and leases, student and educational loans[7]) and,

[6] Lending against securities (such as equities and bonds) whether listed or not, are specifically excluded from this category. Likewise credit card receivables are excluded from this category. However, lending against personal guarantee and fully backed by guaranteed cash flow such as pension etc. that has negligible risk of failure can be included in this category.

[7] Personal finance includes overseas employment loan, home loan (to the extent they do not qualify for treatment as claims secured by residential property), direct deprived sector loan.

- Small business facilities and commitments,
- Deprived sector loans up to a threshold of Rs.10 million (Ten Million only)

- *Granularity criteria*:- NRB must be satisfied that the regulatory retail portfolio is sufficiently diversified to a degree that reduces the risks in the portfolio, warranting the 75% risk weight. No aggregate exposure[8] to one counterpart can exceed 0.5 % of the overall regulatory retail portfolio.
- *Low value individual criteria* :- The total aggregated exposure to one counterpart[9] cannot exceed an absolute threshold of Rs.10 million (Nepalese Rupees Ten Million only)

2. Banks which have claims that fulfill all criterion except for granularity may risk weigh those claims at 100%

f. Claims secured by residential properties

1. Lending to individuals meant for acquiring or developing residential property which are fully secured by mortgages on residential property, that is or will be occupied by the borrower or that is rented, will be risk-weighted at 60%. However, banks should ensure the existence of adequate margin of security over the amount of loan based on strict valuation rules.

   Banks have to develop product paper and get it approved from the board of directors to regulate this kind of lending. The claims in order to be eligible for this category have to be in strict compliance with this product paper

2. Where the loan is not fully secured, such claims have to risk weighed at 150%
3. When claims secured by residential properties are or have been past due[10] at any point of time during the last two years, they shall be risk-weighted at 100%, net of specific provisions.

g. Claims secured by commercial real estate

1. Claims secured by mortgages on commercial real estate, except past due, shall be risk-weighed at 100%. Commercial real estate hereby refers to mortgage of Office buildings, retail space, multi-purpose commercial premises, multi-family residential buildings, multi-tenanted commercial premises, industrial or warehouse space, hotels, land acquisition, development and construction etc.

h. Past due claims

1. Any loan, except for claim secured by residential property, which is or has been past due at any point of time during the last two years, will be risk-weighted at 150% net of specific provision.

i. High risk claims

1. 150% risk weight shall be applied for venture capital and private equity investments.
2. Exposures on Personal loan in excess of the threshold of regulatory retail portfolio and lending against securities (bonds and shares) shall attract a risk weight of 150%. Similarly, exposures on credit card shall also warrant a risk weight of 150%.
3. Investments in the equity and other capital instruments of institutions, which are not listed in the stock exchange and have not been deducted from Tier 1 capital, shall be risk weighed at 150% net of provisions.
4. Investments in the equity and other capital instruments of institutions, which are listed in the stock exchange and have not been deducted from Tier 1 capital, shall be risk

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8 Aggregated exposure means gross amount (i.e. not taking any credit risk mitigation into account) of all forms of credit exposures availed from the bank .

9 Counterpart refers to one or a group of borrowers defined by the NRB directives as a single obligor.

10 An exposure is past due if it falls into any other category other than Performing loan as per provisions of NRB directive on Loan classification.

weighed at 100% net of provisions. Investments in mutual fund shall also be risk weighted at 100%.

5. The claims which are not fully secured or are only backed up by personal guarantee shall attract 150% risk weight.

6. Where loan cannot be segregated/or identified as regulatory retail portfolio or qualifying residential mortgage loan or under other categories, it shall be risk weighed at 150%.

j. Other assets

1. With regard to other assets, following provisions have been made;

- Interest receivable/claim on government securities will be risk-weighed at 0%.
- Staff loan given as per Employee By-laws and secured by residential property, that is or will be occupied by the staff or that is rented, will be risk-weighed at 60%. However, banks should ensure the existence of adequate margin of security over the amount of loan based on strict valuation rules.
- Investments in equity or regulatory capital instruments issued by securities firms will be risk-weighed at 100%.
- Cash in transit and other cash items in the process of collection will be risk-weighed at 20%. For this purpose, cash items shall include Cheque, Draft, and Travellers Cheques.
- Fictitious assets that have not been deducted from Tier 1 capital shall be risk weighed at 100%.
- All Other assets will be risk-weighed at 100% net of specific provision.

k. Off balance sheet items

1. Off-balance sheet items under the simplified standardized approach will be converted into equivalent risk weight exposure using risk weight as follows:

Off Balance Sheet Exposure	Risk Weight
Any commitments those are unconditionally cancelable at any time by the bank without prior notice, or that effectively provide for automatic cancellation due to deterioration in a borrower's creditworthiness (for example bills under collection)	0%
Forward exchange contracts.	10%
Short Term Trade-related contingencies Contingent liabilities arising from trade-related obligations, which are secured against an underlying shipment of goods for both issuing and confirming bank and are short term in nature. This includes documentary letters of credit, shipping guarantees issued and any other trade-related contingencies with an original maturity up to six months.	20%
Undertaking to provide a commitment on an off-balance sheet items	20%
Unsettled[11] securities and foreign exchange transactions between bank to bank and between bank and customer	20%
Long Term Trade-related contingencies Contingent liabilities arising from trade-related obligations, which are secured against an underlying shipment of goods for both issuing and confirming bank and are long term in nature. This includes documentary letters of credit, shipping guarantees issued and any other trade-related contingencies with an original maturity of over six months.	50%

[11] An unsettled transaction is one where delivery of the instrument is due to take place against receipt of cash, but which remain unsettled five business days after the due settlement date.

In case the usance letter of credit is discounted, the risk weight shall be calculated on net basis.	
Performance-related contingencies Contingent liabilities, which involve an irrevocable obligation to pay a third party in the event that counterparty fails to fulfill or perform a contractual non-monetary obligation, such as delivery of goods by a specified date etc. This includes issue of performance bonds, bid bonds, warranties, indemnities, underwriting commitments and standby letters of credit in relation to a non-monetary obligation of counterparty under a particular transaction.	50%
Long term irrevocable Credit Commitments Any un-drawn portion of committed credit lines sanctioned for a period of more than 1 year. This shall include all unutilized limits in respect of revolving working capital loans e.g. overdraft, cash credit, working capital loan etc. except for trade finance exposures.	50%
Short term irrevocable Credit Commitments Any un-drawn portion of committed credit lines sanctioned for a period of upto 1 year. This shall include all unutilized limits in respect of revolving working capital loans e.g. overdraft, cash credit, working capital loan etc. except for trade finance exposures.	20%
Repurchase agreements, securities lending, securities borrowing, reverse repurchase agreements and equivalent transactions This includes sale and repurchase agreements and asset sales with recourse, where the credit risk remains with the purchasing bank.	100%
Direct credit substitutes Any irrevocable off-balance sheet obligations which carry the same credit risk as a direct extension of credit, such as an undertaking to make a payment to a third party in the event that a counterparty fails to meet a financial obligation or an undertaking to a counterparty to acquire a potential claim on another party in the event of default by that party, constitutes a direct credit substitute. This includes potential credit exposures arising from the issue of financial guarantees and credit derivatives, confirmation of letters of credit (acceptances and endorsements), issue of standby letters of credit serving as financial guarantees for loans, securities and any other financial liabilities, and bills endorsed under bill endorsement lines (but which are not accepted by, or have the prior endorsement of, another bank).	100%
Unpaid portion of partly paid shares and securities	100%
Unpaid Guarantee Claim	200%
Other Contingent Liabilities	100%

3.4 CREDIT RISK MITIGATION:

Banks may use a number of techniques to mitigate the risks to which they are exposed. The prime objective of this provision is to encourage the banks to manage credit risk in a prudent and effective manner. As such, credit risks exposures may be collateralized[12] in whole or in part with cash or securities, or a loan exposure may be guaranteed by a third party. Where these various techniques meet the minimum conditions mentioned below, banks which take eligible financial collateral are allowed to reduce their credit exposure to counterparty when calculating their capital requirements to take account of the risk mitigating effect of the collateral. However, credit risk mitigation is allowed only on an account by account basis, even within regulatory retail portfolio.

[12] A collateralized transaction is one in which: a) banks have a credit exposure or potential credit exposure; and b) that credit exposures or potential credit exposure is hedged in whole or in part by collateral posted by the counter party or by a third party on behalf of the counter party.

As a general rule, no secured claim should receive a higher capital requirement than an otherwise identical claim on which there is no collateral. Similarly, the effects of the CRM shall not be double counted and capital requirement will be applied to banks on either side of the collateralized transaction: for example, both repos and reverse repos will be subject to capital requirements.

Those portions of claims collateralized by the market value of recognized collateral receive the risk weight applicable to the collateral instrument. The remainder of the claim should be assigned the risk weight appropriate to the counter party.

Where the same security has been pledged for both the funded and non funded facilities, banks should clearly demarcate the value of security held for funded and non funded facilities. In cases where the bank has obtained the same security for various forms of facilities; banks are eligible to claim the CRM benefit across all such exposures upto the eligible value of CRM.

a. Minimum conditions for eligibility:

In order to obtain capital relief towards credit risk mitigation, there are certain basic conditions that need to be fulfilled. Supervisors will monitor the extent to which banks satisfy these conditions, both at the outset of a collateralized transaction and on an on-going basis.

1. *Legal certainty:-* Collateral is effective only if the legal mechanism by which collateral given is robust and ensures that the lender has clear rights over the collateral to liquidate or retain it in the event of default. Thus, banks must take all necessary steps to fulfill local contractual requirements in respect of the enforceability of security interest. The collateral arrangements must be properly documented, with a clear and robust procedure for the timely liquidation of collateral. A bank's procedures should ensure that any legal conditions required for declaring the default of the customer and liquidating the collateral are observed. Where the collateral is held by a custodian, the bank must seek to ensure that the custodian ensures adequate segregation of the collateral instruments and the custodian's own assets. Besides that, banks must obtain legal opinions confirming the enforceability of the collateral arrangements in all relevant jurisdictions.

2. *Low correlation with exposure:-* In order for collateral to provide protection, the credit quality of the obligor and the value of the collateral must not have a material positive correlation. For example, securities issued by the collateral provider - or by any related group entity - would provide little protection and so would be ineligible.

3. *Maturity Mismatch:-* The maturity of the underlying exposure and the maturity of the hedge should both be defined conservatively. The effective maturity of the underlying should be gauged as the longest possible remaining time before the obligor is scheduled to fulfill its obligation. The collateral must be pledged for at least the life of the exposure. In case of mismatches in the maturity of the underlying exposure and the collateral, it shall not be eligible for CRM benefits.

4. *Currency Mismatch:-* Ideally the currency of the underlying exposure and the collateral should be the same. Where the credit exposure is denominated in a currency that differs from that in which the underlying exposure is denominated, there is a currency mismatch. Where mismatches occur, it shall be subject to supervisory haircut of 10%.

5. *Risk Management:-* While CRM reduces credit risk, it simultaneously may increase other risks to which a bank is exposed, such as legal, operational, liquidity and market risks. Therefore, it is imperative that banks employ robust procedures and processes to control these risks, including strategy; consideration of the underlying credit; valuation; policies and procedures; systems; control of roll-off risks; and management of concentration risk arising from the bank's use of CRM techniques and its effect with the bank's overall credit profile. In case where these requirements are not fulfilled, NRB may not recognize the benefit of CRM techniques.

6. *Qualifying criteria for guarantee:-* A guarantee (counter guarantee) to be eligible must represent a direct claim on the protection provider and must be explicitly referenced to specific exposures or a pool of exposures, so that the extent of the cover is clearly defined and irrefutable. Other than non-payment by a protection purchaser of money due in respect of the credit protection contract it must be irrevocable in that there must

be no clause in the contract that would increase the effective cost of cover as a result of deteriorating credit quality in the hedged exposure. It must also be unconditional in that there should be no clause in the protection contract outside the control of the bank that could prevent the protection provider from being obliged to pay out in a timely manner in the event that the original counter party fails to make the payments due.

On the qualifying default or non-payment of the counter party, the bank may in a timely manner pursue the guarantor for any monies outstanding under the documentation governing the transaction. The guarantor may make one lump sum payment of all monies under such documentation to the bank, or the guarantor may assume the future payment obligations of the counter party covered by the guarantee. The bank must have the right to receive any such payments from the guarantor without first having to take legal actions in order to pursue the counter party payment.

b. Eligible Collaterals:

1. Cash deposit (as well as certificates of deposit or fixed deposits or other deposits) with the bank. The banks may only claim these as CRM only if it has specific authority to recover the amount from this source in case of default.
2. Fixed Deposit Receipts/Certificates of deposits/other deposits of other Banks and FIs, who fulfill the capital adequacy requirements, subject to a 20% supervisory haircut.
3. Gold.
4. Securities issued by the Government of Nepal and Nepal Rastra Bank.
5. Guarantee of the Government of Nepal
6. Financial guarantee/counter guarantee of domestic banks and FIs who meet the minimum capital adequacy requirements subject to a haircut of 20%.
7. Securities/Financial guarantee/Counter guarantee issued by sovereigns.
8. Securities/Financial guarantee/Counter guarantee issued by MDBs in the list specified in 3.3 b (3 & 4)
9. Securities/Financial guarantee/Counter guarantee issued by banks with ECA rating 2 or better. The supervisory haircut shall be 20% and 50% for the banks with ECA rating of 0-1 and 2 respectively.

c. Methodology for using CRM

Step 1: Identify the accounts eligible for capital relief under credit risk mitigation.

Step 2: Assess the value of the exposure and the eligible collateral.

Step 3: Adjust the value of the eligible collateral in respect of the supervisory haircut in terms of currency mismatch and other eligibility requirements.

Step 4: Compare the adjusted value of the collateral with the outstanding exposure.

Step 5: The value of the eligible CRM is the lower of the adjusted value of the collateral and the outstanding exposure.

Step 6: Plot the eligible CRM in the appropriate category of credit risk.

The sum total of net amount of eligible CRM as per "Form No.4 Exhibit of claims with eligible credit risk mitigants" shall be consistent with the "Form No.3 Eligible Credit Risk Mitigants" prescribed in this framework.

4. OPERATIONAL RISK

4.1 GENERAL:

Operational risk is the risk of loss resulting from inadequate internal processes, people, and systems, or from external events. Operational risk itself is not a new concept, and well run banks have been addressing it in their internal controls and corporate governance structures. However, applying an explicit regulatory capital charge against operational risk is a relatively new and

evolving idea. Basel II requires banks to hold capital against the risk of unexpected loss that could arise from the failure of operational systems.

The most important types of operational risk involve breakdowns in internal controls and corporate governance. Such breakdowns can lead to financial losses through error, fraud, or failure to perform in a timely manner or cause the interests of the bank to be compromised in some other way, for example, by its dealers, lending officers or other staff exceeding their authority or conducting business in an unethical or risky manner. Other aspects of operational risk include major failure of information technology systems or events such as major fires or other disasters.

4.2 BASIC INDICATOR APPROACH:

Under the basic indicator approach, banks must hold capital for operational risk equal to the average over the previous three years of a fixed percentage (denoted alpha) of positive annual gross income.

The capital charge for operational risk may be expressed as follows:

$K_{BIA} = [\sum(GI_{1..n} \times \alpha)]/N$

where:

K_{BIA} = capital charge under the Basic Indicator Approach

GI = annual gross income, where positive, over the previous three years

N = number of the previous three years for which gross income is positive

α = 15 percent.

NRB shall review the capital requirement produced by this approach for general credibility, especially in relation to a bank's peers and in the event that credibility is lacking, appropriate supervisory action under Review Process shall be considered.

Figures for the year, in which annual gross income is negative or zero, should be excluded from both the numerator and denominator while calculating the average. In case where the gross income for all of the last three years is negative, 5% of total credit and investments net of specific provisions shall be considered as the capital charge for operational risk. For this purpose investments shall comprise of money at call, placements, investment in government securities and other investments irrespective of currency.

Similarly, in case of new banks who have not completed a year of operation and hence whose average gross income cannot be measured reliably, they shall also be required to compute their capital charge for operational risk vide the same approach as prescribed for banks with negative gross income. These banks may use the gross income approach from the second year onwards. But, based on the reasonableness of the so computed capital charge for Operation Risk, during the first three years of operation, review process may require additional proportion of capital charge if deemed necessary.

4.3 GROSS INCOME:

Gross income is defined as "net Interest Income" plus "non interest income". It is intended that this measure should:

a. be gross of any provisions (e.g. for unpaid interest) and write-offs made during the year;

b. be gross of operating expenses, exclude reversal during the year in respect of provisions and write-offs made during the previous year(s);

c. exclude income/gain recognized from the disposal of items of movable and immovable property;

d. exclude realized profits/losses from the sale of securities in the *"held to maturity" category*;

e. exclude other extraordinary or irregular items of income and expenditure

Thus, for the purpose of capital adequacy requirements, gross income shall be summation of:

a. Total operating income as disclosed in Profit and Loss account prepared as per NRB directive no.4. The total operating income comprises of:

1. Net Interest Income
2. Commission and Discount Income
3. Other Operating Income
4. Exchange Fluctuation Income

b. Addition/deduction in the Interest Suspense during the period.

Banks shall use the annual audited financials of the last three years for the computation of gross income under this approach. Hence, the capital requirement for operational risk for a whole financial year shall remain constant. Until the accounts are finalized for the financial year, banks shall use the provisional figures for the period, which should be validated by the internal auditor of the bank.

4.4 COMPUTATION OF RISK WEIGHT:

Operational risk-weighted assets are determined by multiplying the operational risk capital charge by 10 and adding together with the risk weighted exposures for credit risk.

5. MARKET RISK

5.1 DEFINITION OF MARKET RISK:

Market risk is defined as the risk of losses in on-balance sheet and off-balance sheet positions arising from adverse movements in market prices. The major constituents of market risks are:

a. The risks pertaining to interest rate related instruments;

b. Foreign exchange risk (including gold positions) throughout the bank; and

c. The risks pertaining to investment in equities and commodities.

5.2 SEGREGATION OF INVESTMENT PORTFOLIO:

Banks will have to segregate their investment portfolio into any of following three categories:

a. Held for Trading:

An investment that is made for the purpose of generating a profit from short term fluctuations in price should be classified under this category. An asset should be classified as held for trading even if it is a part of a portfolio of similar assets for which there is a pattern of trading for the purpose of generating a profit from short term fluctuations in price. These investments should be marked to market on a daily basis and differences reflected in the profit and loss account.

b. Held to Maturity:

The investments made with positive intent and ability of the bank to hold till maturity should be classified as held to maturity investments. The bank does not have the positive intent to hold an investment to maturity, if any of the following conditions are met:

1. Bank has the intent and the ability to hold the asset for only an undefined period; or
2. Bank stands ready to sell the asset (other than if a situation arises that is non-recurring and could not have been reasonably anticipated) in response to changes in market interest rates or risks, liquidity needs, changes in the availability of and the yield on alternative investments, changes in financing sources and terms, or changes in foreign currency risk.

The held to maturity investments should be valued at amortised cost i.e. the cost price less any impairments (if applicable). The impairments should be included in the profit and loss accounts for the period.

c. Available for Sale:

All other investments that are neither "held for trading" nor "held to maturity" should be classified under this category. These investments should be marked to market on a regular basis and the difference to be adjusted through reserves. Banks are required to maintain Investment Adjustment Reserve (eligible as Tier 2 capital) to the extent of 2% of available for sale portfolio.

The share investment on intitutions specified under Directives no. 8 shall be exempted for maitaining Investment Adjustment Reserve .

5.3 NET OPEN POSITION APPROACH:

Out of the various components of market risk, foreign exchange risk is the predominant risk in our country. The effects of other forms of market risk are minimal. Thus, a net open position approach has been devised to measure the capital requirement for market risk. As evidenced by its name, this approach only addresses the risk of loss arising out of adverse movements in exchange rates. This approach will be consolidated over time to incorporate other forms of market risks as they start to gain prominence.

The designated Net Open Position approach requires banks to allocate a fixed proportion of capital in terms of its net open position. The banks should allocate 5 percentage of their net open positions as capital charge for market risk.

5.4 NET OPEN POSITION:

Net open position is the difference between the assets and the liability in a currency. In other words, it is the uncovered volume of asset or liability which is exposed to the changes in the exchange rates of currencies. For capital adequacy requirements the net open position includes both net spot positions as well as net forward positions.

For capital adequacy purposes, banks should calculate their net open position in the following manner:

a. Calculate the net open position in each of the foreign currencies.

b. Convert the net open positions in each currency to NPR as per prevalent exchange rates.

c. Aggregate the converted net open positions of all currencies, without paying attention to long or short positions.

d. This aggregate shall be the net open position of the bank.

5.5 COMPUTATION OF RISK WEIGHT:

Risk-weighted assets in respect of market risk are determined by multiplying the capital charges by 10 and adding together with the risk weighted exposures for credit risk.

6. REVIEW PROCESS

6.1 GENERAL:

The supervisory review process of the framework is intended not only to ensure that banks have adequate capital to support all the risks in their business, but also to encourage banks to develop and use better risk management techniques in monitoring and managing their risks. It is the responsibility of the bank management in developing an internal capital assessment process and setting capital targets that are commensurate with the bank's risk profile and control environment beyond the core minimum requirements.

Nepal Rastra Bank recognizes the significance of the relationship between the amount of capital held by the bank against its risks and the strength and effectiveness of the bank's risk management and internal control processes. However, increased capital should not be viewed as the only option for addressing increased risks confronting the bank. Other means for addressing risk, such as strengthening risk management, applying internal limits, strengthening the level of provisions and reserves, and improving internal controls, must also be considered. Furthermore, capital should not be regarded as a substitute for addressing fundamentally inadequate control or risk management processes.

There are three main areas that is particularly suited to treatment under this process: risks considered under minimum capital requirements which are not fully captured it (e.g. credit concentration risk); those factors not taken into account by the minimum capital requirements (e.g. business and strategic risk); and factors external to the bank (e.g. business cycle effects).

In order to achieve the objectives of the supervisory review process, this process has been broadly divided into three parts:

a. Internal Capital Adequacy Assessment Process (ICAAP)

b. Supervisory Review

c. Supervisory Response

6.2 INTERNAL CAPITAL ADEQUACY ASSESSMENT PROCESS:

The internal capital adequacy assessment process (ICAAP) is a comprehensive process which requires board and senior management oversight, monitoring, reporting and internal control reviews at regular intervals to ensure the alignment of regulatory capital requirement with the true risk profile of the bank and thus ensure long-term safety and soundness of the bank. The key components of an effective ICAAP are discussed below.

a. <u>Board and senior management oversight</u>

Bank management is responsible for understanding the nature and level of risk being taken by the bank and how this risk relates to adequate capital levels. It is also responsible for ensuring that the formality and sophistication of the risk management processes is commensurate with the complexity of its operations. A sound risk management process, thus, is the foundation for an effective assessment of the adequacy of a bank's capital position.

The board of directors of the bank are responsible for setting the bank's tolerance for risks. The board should also ensure that management establishes a mechanism for assessing various risks; develops a system to relate these risks to the bank's capital level and sets up a method for monitoring compliance with internal policies. It is equally important that the board instills strong internal controls and thereby an effective control environment through adoption of written policies and procedures and ensures that the policies and procedures are effectively communicated throughout the bank.

The analysis of a bank's current and future capital requirements in relation to its strategic objectives is a vital element of the strategic planning process. The strategic plan should clearly outline the bank's capital needs, anticipated capital expenditures, desirable capital level, and external capital sources. Senior management and the board should view capital planning as a crucial element in being able to achieve its desired strategic objectives.

b. Sound capital assessment

Another crucial component of an effective ICAAP is the assessment of capital. In order to be able to make a sound capital assessment the bank should, at minimum, have the following:

- Policies and procedures designed to ensure that the bank identifies, measures, and reports all material risks;
- A process that relates capital to the level of risk;
- A process that states capital adequacy goals with respect to risk, taking account of the bank's strategic focus and business plan; and
- A process of internal control, reviews and audit to ensure the integrity of the overall management process.

c. Comprehensive assessment of risks

All material risks faced by the bank should be addressed in the capital assessment process. Nepal Rastra Bank recognizes that not all risks can be measured precisely. However, bank should develop a process to estimate risks with reasonable certainties. In order to make a comprehensive assessment of risks, the process should, at minimum, address the following forms of risk.

1. Credit risk: Banks should have methodologies that enable them to assess the credit risk involved in exposures to individual borrowers or counterparties as well as at the portfolio level. The credit review assessment of capital adequacy, at a minimum, should cover risk rating systems, portfolio analysis/aggregation, large exposures and risk concentrations.

   Internal risk ratings are an important tool in monitoring credit risk. Internal risk ratings should be adequate to support the identification and measurement of risk from all credit exposures, and should be integrated into an institution's overall analysis of credit risk and capital adequacy. The ratings system should provide detailed ratings for all assets, not only for problem assets.

2. Credit concentration risk: Risk concentrations are arguably the single most important cause of major problems in banks. A risk concentration is any single exposure or group of exposures with the potential to produce losses large enough (relative to a bank's capital, total assets, or overall risk level) to threaten a bank's health or ability to maintain its core operations.

   Lending being the primary activity of most banks, credit risk concentrations are often the most material risk concentrations within a bank. However, risk concentrations can arise in a bank's assets, liabilities, or off-balance sheet items, through the execution or processing of transactions (either product or service), or through a combination of exposures across these broad categories. Credit risk concentrations are based on common or correlated risk factors, which, in times of stress, have an adverse effect on the creditworthiness of each of the individual counterparties making up the concentration.

   Such credit concentrations are not addressed in the minimum capital requirements for credit risk. Thus, Banks should have in place effective internal policies, systems and controls to identify, measure, monitor, and control their credit risk concentrations. Banks should explicitly consider the extent of their credit risk concentrations in their assessment of capital adequacy under review processes. These policies should cover the different forms of credit risk concentrations to which a bank may be exposed to. Such concentrations include but are not limited to:

   - Significant exposures to an individual counterparty or group of related counterparty. Banks might also establish an aggregate limit for the management and control of all of its large exposures as a group;
   - Credit exposures to counterparties in the same economic sector or geographic region;

- Credit exposures to counterparties whose financial performance is dependent on the same activity or commodity; and
- Indirect credit exposures arising from a bank's CRM activities (e.g. exposure to a similar type of collateral or credit protection provided by a single counterparty or same collateral in cases of multiple banking).

A bank's framework for managing credit risk concentrations should be clearly documented and should include a definition of the credit risk concentrations relevant to the bank and how these concentrations and their corresponding limits are calculated. Limits should be defined in relation to a bank's capital, total assets or, where adequate measures exist, its overall risk level. A bank's management should conduct periodic stress tests of its major credit risk concentrations and review the results of those tests to identify and respond to potential changes in market conditions that could adversely impact the bank's performance.

3. Operational risk: The failure to properly manage operational risk can result in a misstatement of an institution's risk/return profile and expose the institution to significant losses. Gross income, used in the Basic Indicator Approach is only a proxy for the scale of operational risk exposure of a bank and can in some cases underestimate the need for capital. Thus, Banks should develop a framework for managing operational risk and evaluate the adequacy of capital as prescribed by this framework. The framework should cover the bank's appetite and tolerance for operational risk, as specified through the policies for managing this risk, including the extent and manner in which operational risk is transferred outside the bank. It should also include policies outlining the bank's approach to identifying, assessing, monitoring and controlling/mitigating the risk.

4. Market risk: The prescribed approach for the computation of capital charge for market risk is very simple and thus may not be directly aligned with the magnitude of risk. Likewise, the approach only incorporates risks arising out of adverse movements in exchange rates while ignoring other forms of risks like interest rate risk and equity risks. Thus, banks should develop a framework that addresses these various forms of risk and at the same time perform stress tests to evaluate the adequacy of capital.

   The use of internal models by the bank for the measurement of market risk is highly encouraged. Wherever bank's make use of internal models for computation of capital charge for market risks, the bank management should ensure the adequacy and completeness of the system regardless of the type and level of complexity of the measurement system as the quality and reliability of the measurement system is largely dependent on the quality of the data and various assumptions used in the model.

5. Liquidity risk: Liquidity is crucial to the ongoing viability of any financial institution. The capital positions can have a telling effect on institution's ability to obtain liquidity, especially in a crisis. Each bank must have adequate systems for measuring, monitoring and controlling liquidity risk. Banks should evaluate the adequacy of capital given their own liquidity profile and the liquidity of the markets in which they operate. Banks are also encouraged to make use of stress testing to determine their liquidity needs and the adequacy of capital.

6. Other risks: Although the 'other' risks, such as reputational and strategic risk, are not easily measurable, banks are expected to take these into consideration as well while deciding on the level of capital.

d. Monitoring and reporting

The bank should establish an adequate system for monitoring and reporting risk exposures and assessing how the bank's changing risk profile affects the need for capital. The bank's senior management or board of directors should, on a regular basis, receive reports on the bank's risk profile and capital needs. These reports should allow senior management to:

- Evaluate the level and trend of material risks and their effect on capital levels;

- Evaluate the sensitivity and reasonableness of key assumptions used in the capital assessment measurement system;
- Determine that the bank holds sufficient capital against the various risks and is in compliance with established capital adequacy goals; and
- Assess its future capital requirements based on the bank's reported risk profile and make necessary adjustments to the bank's strategic plan accordingly.

e. Internal control review

The bank's internal control structure is essential to a sound capital assessment process. Effective control of the capital assessment process includes an independent review and, where appropriate, the involvement of internal or external audits. The bank's board of directors has a responsibility to ensure that management establishes a system for assessing the various risks, develops a system to relate risk to the bank's capital level, and establishes a method for monitoring compliance with internal policies. The board should regularly verify whether its system of internal controls is adequate to ensure well-ordered and prudent conduct of business.

The bank should conduct periodic reviews of its risk management process to ensure its integrity, accuracy, and reasonableness. Key areas that should be reviewed include:

- Appropriateness of the bank's capital assessment process given the nature, scope and complexity of its activities;
- Identification of large exposures and risk concentrations;
- Accuracy and completeness of data inputs into the bank's assessment process;
- Reasonableness and validity of scenarios used in the assessment process; and
- Stress testing and analysis of assumptions and inputs.

6.3 SUPERVISORY REVIEW:

Nepal Rastra Bank shall regularly review the process by which a bank assesses its capital adequacy, risk positions, resulting capital levels, and quality of capital held by a bank. Supervisors shall also evaluate the degree to which a bank has in place a sound internal process to assess capital adequacy. The emphasis of the review should be on the quality of the bank's risk management and controls and should not result in supervisors functioning as bank management. The periodic review can involve any or a combination of:

- On-site examinations or inspections;
- Off-site review;
- Discussions with bank management;
- Review of work done by external auditors (provided it is adequately focused on the necessary capital issues); and
- Periodic reporting.

Some of the key areas which will be reviewed during the supervisory review process are discussed hereunder

a. Review of adequacy of risk assessment

NRB shall assess the degree to which internal targets and processes incorporate the full range of material risks faced by the bank. Supervisors shall also review the adequacy of risk measures used in assessing internal capital adequacy and the extent to which these risk measures are also used operationally in setting limits, evaluating business line performance, and evaluating and controlling risks more generally. Supervisors shall consider the results of sensitivity analyses and stress tests conducted by the institution and how these results relate to capital plans.

b. Assessment of capital adequacy

NRB shall review the bank's processes to determine that:

- Target levels of capital chosen are comprehensive and relevant to the current operating environment;
- These levels are properly monitored and reviewed by senior management; and
- The composition of capital is appropriate for the nature and scale of the bank's business.

NRB shall also consider the extent to which the bank has provided for unexpected events in setting its capital levels. This analysis should cover a wide range of external conditions and scenarios, and the sophistication of techniques and stress tests used should be commensurate with the bank's activities.

c. Assessment of the control environment

NRB shall consider the quality of the bank's management information reporting and systems, the manner in which business risks and activities are aggregated, and management's record in responding to emerging or changing risks. In all instances, the capital level at an individual bank should be determined according to the bank's risk profile and adequacy of its risk management process and internal controls. External factors such as business cycle effects and the macroeconomic environment should also be considered.

d. Supervisory review of compliance with minimum standards

In order to obtain relief as per this framework banks are required to observe a number of requirements, including risk management standards and disclosures. In particular, banks will be required to disclose features of their internal methodologies used in calculating minimum capital requirements. As part of the supervisory review process, supervisors must ensure that these conditions are being met on an ongoing basis. Likewise, the supervisors must ensure that qualifying criteria as specified in the framework are continuously being met as these criteria are developed as benchmarks that are aligned with bank management expectations for effective risk management and capital allocation.

e. Significance of risk transfer

Securitization or credit sale agreements with recourse may be carried out for purposes other than credit risk transfer (e.g. funding). Where this is the case, there might still be a limited transfer of credit risk. However, for an originating bank to achieve reductions in capital requirements, the risk transfer arising from a securitization or credit sale has to be deemed significant by the NRB. If the risk transfer is considered to be insufficient or non existent, NRB can require the application of a higher capital requirement or, alternatively, may deny a bank from obtaining any capital relief from the securitization or transfer agreements. Therefore, the capital relief that can be achieved will correspond to the amount of credit risk that is effectively transferred.

f. Credit Risk Mitigants

In case when the eligibility requirements are not fulfilled, NRB will not consider Credit Risk Mitigants in allocating capital. Similarly, CRM may give rise to residual risks, which may render the overall risk reduction less effective. Where, these risks are not adequately controlled by the bank, NRB may impose additional capital charges or take other appropriate supervisory actions.

g. Operational risk and Market Risk

The framework prescribes simple approaches for allocating capital for operational and market risk which may not be directly aligned with the volume and complexity of risk. Thus, the supervisor shall consider whether the capital requirements generated by the prescribed approaches gives a consistent picture of the individual bank's risk exposure in comparison with the peer group and the banking industry at large. Where NRB is convinced such is not the case, appropriate supervisory response is warranted.

h. Market Discipline

The framework requires banks to disclose various key informations about their business on a periodic basis. It is imperative that the banks discharge their obligations under the disclosure requirements in order to be eligible to claim benefits of CRM. In line with the utmost significance of this requirement, the supervisor shall review the adequacy of the disclosures.

As a part of this process itself, the supervisor shall regularly review the website of the banks and review the contents of the site. Wherever the review process identifies any shortcomings or non-compliances, appropriate supervisory response shall be initiated.

6.4 SUPERVISORY RESPONSE:

Nepal Rastra Bank expects banks to operate above the minimum regulatory capital ratios. Wherever, NRB is not convinced about the risk management practices and the control environment, it has the authority to require banks to hold capital in excess of the minimum.

a. Supervisory adjustments in risk weighted assets and capital

Having carried out the review process as described above, supervisors should take appropriate action if they are not satisfied with the results of the bank's own risk assessment and capital allocation. In such a scenario, NRB shall be empowered to undertake any or combination of the following adjustments in the banks risk weighted assets and regulatory capital computations.

1. Shortfall in provisions made by the bank against adversely classified assets shall be deducted from the Tier 1 capital.
2. The loans and facilities extended to Directors, Employees (other than loans given under Employee rules), Shareholders holding more than 1% percent shares and related parties as well as loans, advances and facilities restricted by the prevailing rules and regulations shall be deducted from Tier 1 capital.
3. In case the bank has provided loans and facilities in excess of its Single Obligor Limits, 10% of all such excess exposures shall be added to the risk weighted exposure for credit risk.
4. Where the bank has been involved in the sale of credit with recourse facility, 1% of the contract (sale) value shall be added to the risk weight for credit risk.
5. Where the banks do not have satisfactory Assets Liability Management policies and practices to effectively manage the market risks, an additional risk weight of 1% of Net Interest Income of the immediate previous financial year shall be added to the risk weight for market risk.
6. Where the bank's net liquid asset to total deposit ratio is less than 20%, a risk weight of 1% (as given in the table below) of total deposit, for each percent or portion of percent shortfall in such ratio, is added to total of the Risk Weighted Exposures.

Net liquid asset to total deposit ratio	A risk weight to be added to the Risk Weighted Exposures
19% - less than 20%	1% of total deposit
18% - less than 19%	2% of total deposit
17% - less than 18%	3% of total deposit
16% - less than 17%	4% of total deposit
15% - less than 16%	5% of total deposit and so on.

For this purpose, liquid assets include cash and bank balances, money at call & short notice, placement up to 90 days and investment in government securities. Borrowings repayable up to 90 days is deducted from liquid assets to obtain net liquid assets.

7. Where the banks do not adopt sound practices for the management of operational risk, an additional capital charge of 2% to 5% of Gross Income of Immediate previous financial year shall be levied for operational risks.
8. Where the Gross Income determined for computation of capital charge of Operational Risk for all of the last three years is negative and where the banks themselves have not addressed the capital charge for operational risk, 5% of the total credit and investments net of specific provisions shall be the capital charge for operational risk.

New banks who have not completed a year of operation and hence whose gross income cannot be measured reliably and where the banks themselves have not addressed the capital charge for operational risk, shall also be required to compute their capital charge for operational risk vide the same approach as prescribed for banks with negative gross income. These banks may use the gross income approach from the second year onwards. But, based on the reasonableness of the so- computed capital charge for Operation Risk, during the first three years of operation, review process may require additional proportion of capital charge.

9. During the course of review, where the supervisor is not satisfied with the overall risk management policies and procedures of the bank, the total risk weighted exposures of the bank shall be increased up to 5%.

10. In case the bank has not achieved the desired level of disclosure requirements, the total risk weighted exposures of the bank shall be increased up to 3%.

11. Banks that do not meet the eligibility requirements to claim the benefit under credit risk mitigation techniques shall not be allowed the benefit of CRM.

b. Corrective Actions for Non-Compliances

1. The failure on part of the banks to meet the provisions of this framework shall be considered as a violation of the NRB directives and shall attract stipulated actions. The nature of the enforcement action largely depends on degree of the capital adequacy of the bank. The trigger points and the prescribed action in case of non-compliance shall be as per the provisions of Prompt Corrective Action Byelaw 2064 propounded by Nepal Rastra Bank.

7. DISCLOSURE

7.1 GENERAL:

The purpose of disclosure requirements is to complement the minimum capital requirements and the review process by developing a set of disclosure requirements which will allow market participants to assess key pieces of information on the scope of application, capital, risk exposures, risk assessment processes, and hence the capital adequacy of the bank. It is believed that providing disclosures that are based on a common framework is an effective means of informing the market about a bank's exposure to those risks and provides a consistent and comprehensive disclosure framework that enhances comparability. The importance of disclosure is more pronounced in cases of banks that rely on internal methodologies in assessing capital requirements.

7.2 DISCLOSURE PRINCIPLES:

Banks should have a formal disclosure policy approved by the Board of directors that addresses the bank's approach for determining what disclosures it will make and the internal controls over the disclosure process. In addition, banks should implement a process for assessing the appropriateness of their disclosures, including validation and frequency. While deciding on the disclosure policy, the board should pay due attention to strike a balance between materiality and proprietary and confidential information.

a. Materiality

Besides the minimum prescribed disclosure requirements, a bank should decide which additional disclosures are relevant for it based on the materiality concept. Information would be regarded as material if its omission or misstatement could change or influence the assessment or decision of a user relying on that information for the purpose of making economic decisions.

b. Proprietary and confidential information

Proprietary information encompasses information (for example on products or systems), that if shared with competitors would render a bank's investment in these products/systems less valuable, and hence would undermine its competitive position. Information about customers is often confidential, in that it is provided under the terms of a legal agreement or counterparty relationship. This has an impact on what banks should reveal in terms of

information about their customer base, as well as details on their internal arrangements, for instance methodologies used, parameter estimates, data etc. The disclosure requirements set out below by NRB aims to strike an appropriate balance between the need for meaningful disclosure and the protection of proprietary and confidential information.

7.3 VALIDATION:

The disclosures of the bank should be subjected to adequate validation. In addition, supplementary material (such as Management's Discussion and Analysis) that is published should also be subjected to sufficient scrutiny (e.g. internal control assessments, etc.) to satisfy the validation issue. If material is not published under a validation regime, for instance in a stand alone report or as a section on a website, then management should ensure that appropriate verification of the information takes place, in accordance with the general disclosure principles.

7.4 DISCLOSURE REQUIREMENTS:

Banks should at minimum, disclose the following information at the stipulated time intervals. At the same time, banks shall be free to disclose any other information they consider important for its stakeholders as and when they consider necessary, beyond the prescribed requirements.

a. Banks should provide the following disclosures as at the end of each financial year along with the annual financial statements.

1. Capital structure and capital adequacy

- Tier 1 capital and a breakdown of its components;
- Tier 2 capital and a breakdown of its components;
- Detailed information about the Subordinated Term Debts with information on the outstanding amount, maturity, amount raised during the year and amount eligible to be reckoned as capital funds.
- Deductions from capital;
- Total qualifying capital;
- Capital adequacy ratio;
- Summary of the bank's internal approach to assess the adequacy of its capital to support current and future activities, if applicable; and
- Summary of the terms, conditions and main features of all capital instruments, especially in case of subordinated term debts including hybrid capital instruments.

2. Risk exposures

- Risk weighted exposures for Credit Risk, Market Risk and Operational Risk;
- Risk Weighted Exposures under each of 11 categories of Credit Risk;
- Total risk weighted exposure calculation table;
- Amount of NPAs (both Gross and Net)
  - Restructure/Reschedule Loan
  - Substandard Loan
  - Doubtful Loan
  - Loss Loan
- NPA ratios
  - Gross NPA to gross advances
  - Net NPA to net advances
- Movement of Non Performing Assets
- Write off of Loans and Interest Suspense

- Movements in Loan Loss Provisions and Interest Suspense
- Details of additional Loan Loss Provisions
- Segregation of investment portfolio into Held for trading, Held to maturity and Available for sale category

3. Risk Management Function

- For each separate risk area (Credit, Market and Operational risk), banks must describe their risk management objectives and policies, including:
  - Strategies and processes;
  - The structure and organization of the relevant risk management function;
  - The scope and nature of risk reporting and/or measurement systems; and
  - Policies for hedging and/or mitigating risk and strategies, and processes for monitoring the continuing effectiveness of hedges/mitigants.
- Types of eligible credit risk mitigants used and the benefits availed under CRM.

b. All commercial banks should make following disclosures on a quarterly basis on their respective websites.

- Tier 1 capital and a breakdown of its components;
- Tier 2 capital and a breakdown of its components;
- Detailed information about the Subordinated Term Debts with information on the outstanding amount, maturity, amount raised during the year and amount eligible to be reckoned as capital funds.
- Deductions from capital;
- Total qualifying capital;
- Capital adequacy ratio;
- Risk weighted exposures for Credit Risk, Market Risk and Operational Risk;
- Risk Weighted Exposures under each of 11 categories of Credit Risk;
- Total risk weighted exposure calculation table;
- Amount of NPAs (both Gross and Net)
  - Restructure/Reschedule Loan
  - Substandard Loan
  - Doubtful Loan
  - Loss Loan
- NPA ratios
  - Gross NPA to gross advances
  - Net NPA to net advances
- Movement of Non Performing Assets
- Write off of Loans and Interest Suspense
- Movements in Loan Loss Provisions and Interest Suspense
- Details of Additional Loan Loss Provisions
- Segregation of investment portfolio into Held for trading, Held to maturity and Available for sale category
- Summary of the bank's internal approach to assess the adequacy of its capital to support current and future activities, if applicable; and

- Summary of the terms, conditions and main features of all capital instruments, especially in case of subordinated term debts including hybrid capital instruments.

c. Disclosure requirements under this framework should also be published in the respective websites of the banks. Such disclosures of the banks should also be updated to reflect the capital adequacy position of the banks after the supervisory adjustments under the review process. Banks that do not host a website yet are required to make the necessary arrangements to host a website immediately.

d. Banks are required to report to NRB their capital adequacy computations, according to the format as specified in Annexure of this framework on a monthly basis within one month after the end of the month or as required by NRB from time to time. All such returns has to be validated by the internal auditor of the bank. If the monthly internal audit couldnot be carried out, it should be disclosed on the monthly returns. But, such returns at the end of the quarter must be submitted with the validation from the internal auditor of the bank.

   Besides the returns specified above, a bank must inform NRB within 30 days of:

   1. Any breach of the minimum capital adequacy requirements set out in this framework together with an explanation of the reasons for the breach and the remedial measures it has taken to address those breaches.
   2. Any concerns it has about its capital adequacy, along with proposed measures to address these concerns.

e. Full compliance of these disclosure requirements is a pre-requisite before banks can obtain any capital relief (i.e., adjustments in the risk weights of collateralized or guaranteed exposures) in respect of any credit risk mitigation techniques.

FORM NO. 1 CAPITAL ADEQUACY TABLE (Summary)

(Rs.In …..)

Particulars	Current Period	Previous Period
Common Equity Tier 1 Capital		
Tier 1 Capital		
Tier 2 Capital		
Total Capital		
Risk-Weighted Exposures		
Regulatory Ratios	Current Period	Previous Period
Leverage Ratio		
Common Equity Tier 1 to Risk Weighted Exposure Ratio		
Tier 1 to Risk Weighted Exposure Ratio		
Total Capital to Risk Weighted Exposure Ratio		

FORM NO. 1A CAPITAL ADEQUACY TABLE

(Rs.In …..)

1. 1 Risk Weighted Exposures		Current Period	Previous Period
a	Risk Weighted Exposure for Credit Risk		
b	Risk Weighted Exposure for Operational Risk		
c	Risk Weighted Exposure for Market Risk		
Adjustments under Pillar II			
	Add: 3% of the total RWE due to non compliance to Disclosure Requirement (6.4 a 10)		
	Add: ….% of the total deposit due to insufficient Liquid Assets(6.4 a 6)		
Total Risk Weighted Exposures (After Bank's adjustments of Pillar II)			
1.2 CAPITAL		Current Period	Previous Period
Tier 1 Capital (Core Capital) (CET1 +AT1)		0	0
Common Equity Tier 1 (CET 1)		0	0
a	Paid up Equity Share Capital		
b	Equity Share Premium		
c	Proposed Bonus Equity Shares		
d	Statutory General Reserves		
e	Retained Earnings		
f	Un-audited current year cumulative profit/(Loss)		
g	Capital Redemption Reserve		
h	Capital Adjustment Reserve		

i	Dividend Equalization Reserves		
j	Other Free Reserve		
k	Less: Goodwill		
l	Less: Intangible Assets		
m	Less: Deferred Tax Assets		
n	Less: Fictitious Assets		
o	Less: Investment in equity in licensed Financial Institutions		
p	Less: Investment in equity of institutions with financial interests		
q	Less: Investment in equity of institutions in excess of limits		
r	Less: Investments arising out of underwriting commitments		
s	Less: Reciprocal crossholdings		
t	Less: Purchase of land & building in excess of limit & unutilized		
u	Less: Cash Flow Hedge		
v	Less: Defined Benefit Pension Assets		
w	Less: Un recognized Defined Benefit Pension Liabilities		
x	Less: Other Deductions		
Adjustments under Pillar II			
	Less: Shortfall in Provision (6.4 a 1)		
	Less: Loans and Facilities extended to Related Parties and Restricted lending (6.4 a 2)		
Additional Tier 1 (AT1)			
a	Perpetual Non Cumulative Preference Share Capital		
b	Perpetual Debt Instruments		
c	Stock Premium		
Supplementary Capital (Tier II)		0	0
a	Cumulative and/or Redeemable Preference Share		
b	Subordinated Term Debt		
c	Hybrid Capital Instruments		
d	Stock Premium		
e	General loan loss provision		
f	Exchange Equalization Reserve		
g	Investment Adjustment Reserve		
h	Assets Revaluation Reserve		
i	Other Reserves		
Total Capital Fund (Tier I and Tier II)		0	0
1.3 CAPITAL ADEQUACY RATIOS		Current Period	Previous Period
Common Equity Tier 1 Capital to Total Risk Weighted Exposures (After Bank's adjustments of Pillar II)			

Tier 1 Capital to Total Risk Weighted Exposures (After Bank's adjustments of Pillar II)		
Tier 1 and Tier 2 Capital to Total Risk Weighted Exposures(After Bank's adjustments of Pillar II)		

FORM NO. 2: RISK WEIGHTED EXPOSURE FOR CREDIT RISK

(Rs.In .....)

A. Balance Sheet Exposures	Book Value	Specific Provision	Eligible CRM	Net Value	Risk Weight	Risk Weighted Exposures
	a	b	c	d=a-b-c	e	f=d*e
Cash Balance	0	0		0	0%	0
Balance With Nepal Rastra Bank	0	0		0	0%	0
Gold	0	0		0	0%	0
Investment in Nepalese Government Securities	0	0		0	0%	0
All Claims on Government of Nepal	0	0		0	0%	0
Investment in Nepal Rastra Bank securities	0	0		0	0%	0
All claims on Nepal Rastra Bank	0	0		0	0%	0
Claims on Foreign Government and Central Bank (ECA 0-1)	0	0		0	0%	0
Claims on Foreign Government and Central Bank (ECA -2)	0	0	0	0	20%	0
Claims on Foreign Government and Central Bank (ECA -3)	0	0	0	0	50%	0
Claims on Foreign Government and Central Bank (ECA-4-6)	0	0	0	0	100%	0
Claims on Foreign Government and Central Bank (ECA -7)	0	0	0	0	150%	0
Claims On BIS, IMF, ECB, EC and on Multilateral Development Banks (MDB's) recognized by the framework	0	0		0	0%	0
Claims on Other Multilateral Development Banks	0	0	0	0	100%	0
Claims on Public Sector Entity (ECA 0-1)	0	0	0	0	20%	0
Claims on Public Sector Entity (ECA 2)	0	0	0	0	50%	0
Claims on Public Sector Entity (ECA 3-6)	0	0	0	0	100%	0
Claims on Public Sector Entity (ECA 7)	0	0	0	0	150%	0
Claims on domestic banks that meet capital adequacy requirements	0	0	0	0	20%	0
Claims on domestic banks that do not meet capital adequacy requirements	0	0	0	0	100%	0
Claims on foreign bank (ECA Rating 0-1)	0	0	0	0	20%	0
Claims on foreign bank (ECA Rating 2)	0	0	0	0	50%	0
Claims on foreign bank (ECA Rating 3-6)	0	0	0	0	100%	0
Claims on foreign bank (ECA Rating 7)	0	0	0	0	150%	0
Claims on foreign bank incorporated in SAARC region operating with a buffer of 1% above their respective regulatory capital	0	0	0	0	20%	0

Claims on Domestic Corporates	0	0	0	0	100%	0
Claims on Foreign Corporates (ECA 0-1)	0	0	0	0	20%	0
Claims on Foreign Corporates (ECA 2)	0	0	0	0	50%	0
Claims on Foreign Corporates (ECA 3-6)	0	0	0	0	100%	0
Claims on Foreign Corporates (ECA 7)	0	0	0	0	150%	0
Regulatory Retail Portfolio (Not Overdue)	0	0	0	0	75%	0
Claims fulfilling all criterion of regulatory retail except granularity	0	0	0	0	100%	0
Claims secured by residential properties	0	0	0	0	60%	0
Claims not fully secured by residential properties	0	0	0	0	150%	0
Claims secured by residential properties (Overdue)	0	0	0	0	100%	0
Claims secured by Commercial real estate	0	0	0	0	100%	0
Past due claims (except for claim secured by residential properties)	0	0	0	0	150%	0
High Risk claims	0	0	0	0	150%	0
Investments in equity and other capital instruments of institutions listed in the stock exchange	0	0	0	0	100%	0
Investments in equity and other capital instruments of institutions not listed in the stock exchange	0	0	0	0	150%	0
Staff loan secured by residential property	0	0	0	0	60%	0
Interest Receivable/claim on government securities	0	0	0	0	0%	0
Cash in transit and other cash items in the process of collection	0	0	0	0	20%	0
Other Assets (as per attachment)	0	0	0	0	100%	0
TOTAL	0	0	0	0		0

B. Off Balance Sheet Exposures	Gross Book Value	Specific Provision	Eligible CRM	Net Value	Risk Weight	Risk Weighted Exposures
	a	b	c	d=a-b-c	e	f=d*e
Revocable Commitments	0	0		0	0%	0
Bills Under Collection	0	0		0	0%	0
Forward Exchange Contract Liabilities	0	0	0	0	10%	0
LC Commitments With Original Maturity Upto 6 months	0	0	0	0	20%	0
domestic counterparty						
foreign counterparty (ECA Rating 0-1)	0	0	0	0	20%	0
foreign counterparty (ECA Rating 2)	0	0	0	0	50%	0
foreign counterparty (ECA Rating 3-6)	0	0	0	0	100%	0
foreign counterparty (ECA Rating 7)	0	0	0	0	150%	0
LC Commitments With Original Maturity Over 6 months	0	0	0	0	50%	0
domestic counterparty						
foreign counterparty (ECA Rating 0-1)	0	0	0	0	20%	0

foreign counterparty (ECA Rating 2)	0	0	0	0	50%	0
foreign counterparty (ECA Rating 3-6)	0	0	0	0	100%	0
foreign counterparty (ECA Rating 7)	0	0	0	0	150%	0
Bid Bond, Performance Bond and Counter guarantee	0	0	0	0	50%	0
domestic counterparty						
foreign counterparty (ECA Rating 0-1)	0	0	0	0	20%	0
foreign counterparty (ECA Rating 2)	0	0	0	0	50%	0
foreign counterparty (ECA Rating 3-6)	0	0	0	0	100%	0
foreign counterparty (ECA Rating 7)	0	0	0	0	150%	0
Underwriting commitments	0	0	0	0	50%	0
Lending of Bank's Securities or Posting of Securities as collateral	0	0	0	0	100%	0
Repurchase Agreements, Assets sale with recourse	0	0	0	0	100%	0
Advance Payment Guarantee	0	0	0	0	100%	0
Financial Guarantee	0	0	0	0	100%	0
Acceptances and Endorsements	0	0	0	0	100%	0
Unpaid portion of Partly paid shares and Securities	0	0	0	0	100%	0
Irrevocable Credit commitments (short term)	0	0	0	0	20%	0
Irrevocable Credit commitments (long term)	0	0	0	0	50%	0
Claims on foreign bank incorporated in SAARC region operating with a buffer of 1% above their respective regulatory capital requirement	0	0	0	0	20%	0
Other Contingent Liabilities	0	0	0	0	100%	0
Unpaid Guarantee Claims	0	0	0	0	200%	0
TOTAL	0	0	0	0		0
Total RWE for credit Risk Before Adjustment (A) +(B)	0	0	0	0		0
Adjustments under Pillar II						
Add: 10% of the loan and facilities in excess of Single Obligor Limits(6.4 a 3)						0
Add: 1% of the contract(sale) value in case of the sale of credit with recourse (6.4 a 4)						
Total RWE for credit Risk (After Bank's adjustments of Pillar II)						

FORM NO.3 ELIGIBLE CREDIT RISK MITIGANTS

Credit exposures	Deposits with Bank	Deposits with other banks/FI	Gold	Govt. & NRB Securities	G'tee of Govt. of Nepal	Sec/ G'tee of Other Sovereigns	G'tee of domestic banks	G'tee of MDBs	Sec/ G'tee of Foreign Banks	Total
	(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)	
Balance Sheet Exposures										
Claims on Foreign government and Central Bank (ECA -2)										0
Claims on Foreign government and Central Bank (ECA -3)										0
Claims on Foreign government and Central Bank (ECA-4-6)										0
Claims on Foreign government and Central Bank (ECA -7)										0
Claims on Other Multilateral Development Banks										0
Claims on Public Sector Entity (ECA 0-1)										0
Claims on Public Sector Entity (ECA 2)										0
Claims on Public Sector Entity (ECA 3-6)										0
Claims on Public Sector Entity (ECA 7)										0
Claims on domestic banks that meet capital adequacy requirements										0
Claims on domestic banks that do not meet capital adequacy requirements										0
Claims on foreign bank (ECA Rating 0-1)										0
Claims on foreign bank (ECA Rating 2)										0
Claims on foreign bank (ECA Rating 3-6)										0
Claims on foreign bank (ECA Rating 7)										0
Claims on foreign bank incorporated in SAARC region operating with a buffer of 1% above their respective regulatory capital requirement										
Claims on Domestic Corporates										0
Claims on Foreign Corporates (ECA 0-1)										0
Claims on Foreign Corporates (ECA 2)										0
Claims on Foreign Corporates (ECA 3-6)										0
Claims on Foreign Corporates (ECA 7)										0
Regulatory Retail Portfolio (Not Overdue)										0
Claims fulfilling all criterion of regulatory retail except granularity										0
Claims secured by residential properties										0
Claims not fully secured by residential										0

Credit exposures	Deposits with Bank	Deposits with other banks/FI	Gold	Govt. & NRB Securities	G'tee of Govt. of Nepal	Sec/ G'tee of Other Sovereigns	G'tee of domestic banks	G'tee of MDBs	Sec/ G'tee of Foreign Banks	Total
	(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)	
properties										
Claims secured by residential properties (Overdue)										0
Claims secured by Commercial real estate										0
Past due claims (except for claim secured by residential properties)										0
High Risk claims										0
Investments in equity and other capital instruments of institutions listed in the stock exchange										0
Investments in equity and other capital instruments of institutions not listed in the stock exchange										0
Other Assets (as per attachment)										
Total										0
Off Balance Sheet Exposures										
Forward Exchange Contract Liabilities										
LC Commitments With Original Maturity Upto 6 months domestic counterparty										0
foreign counterparty (ECA Rating 0-1)										0
foreign counterparty (ECA Rating 2)										0
foreign counterparty (ECA Rating 3-6)										0
foreign counterparty (ECA Rating 7)										0
LC Commitments With Original Maturity Over 6 months domestic counterparty										0
foreign counterparty (ECA Rating 0-1)										0
foreign counterparty (ECA Rating 2)										0
foreign counterparty (ECA Rating 3-6)										0
foreign counterparty (ECA Rating 7)										0
Bid Bond, Performance Bond and Counter guarantee domestic counterparty										0
foreign counterparty (ECA Rating 0-1)										0
foreign counterparty (ECA Rating 2)										0
foreign counterparty (ECA Rating 3-6)										0

Credit exposures	Deposits with Bank	Deposits with other banks/FI	Gold	Govt. & NRB Securities	G'tee of Govt. of Nepal	Sec/ G'tee of Other Sovereigns	G'tee of domestic banks	G'tee of MDBs	Sec/ G'tee of Foreign Banks	Total
	(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)	
foreign counterparty (ECA Rating 7)										0
Underwriting commitments										0
Lending of Bank's Securities or Posting of Securities as collateral										0
Repurchase Agreements, Assets sale with recourse										0
Advance Payment Guarantee										0
Financial Guarantee										0
Acceptances and Endorsements										0
Unpaid portion of Partly paid shares and Securities										0
Irrevocable Credit commitments (Short Term)										0
Irrevocable Credit commitments (Long Term)										
Other Contingent Liabilities										0
Total										
Grand Total										

FORM NO.4 EXHIBIT OF CLAIMS WITH CREDIT RISK MITIGANTS

(Rs.In …….)

S.N.	Counterparty	Category	Facility	Outstanding	Eligible CRM			
					Nature	Gross Amount	Haircut	Net Amount

FORM NO.5 OTHER ASSETS

S.No.	Assets	Gross Amount	Specific Provision	Net Balance
1	Cash and Cash Items in Transit			0
2	Miscellaneous Expenditure not written off			0
3	Fixed Assets			0
4	Interest Receivable on Other Investment			0
5	Interest Receivable on Loan			0

6	Non Banking Assets			0
7	Reconciliation Account			0
8	Draft Paid Without Notice			0
9	Sundry Debtors			0
10	Advance payment and Deposits			0
11	Staff Loan and Advance			0
12	Stationery			0
13	Other			0
TOTAL		0	0	0

FORM NO. 6: RISK WEIGHTED EXPOSURE FOR OPERATIONAL RISK

Particulars	FY	FY	FY .....
Net Interest Income			
Commission and Discount Income			
Other Operating Income			
Exchange Fluctuation Income			
Addition/Deduction in Interest Suspense during the period			
Gross income (a)			
Alfa (b)	15%	15%	15%
Fixed Percentage of Gross Income [c=(a×b)]			
Capital Requirement for operational risk (d) (average of c)			
Risk Weight (reciprocal of capital requirement of 10%) in times (e)			10
Equivalent Risk Weight Exposure [f=(d×e)]			
PILLAR-II ADJUSTMENTS			
If Gross Income for all the last three years is negative(6.4 a 8)			
Total Credit and Investment (net of Specific Provision)			
Capital Requirement for operational risk (5%)			
Risk Weight (reciprocal of capital requirement of 10%) in times			10
Equivalent Risk Weight Exposure [g]			
Equivalent Risk Weight Exposure [h=f or g)			

FORM NO.7 RISK WEIGHTED EXPOSURE FOR MARKET RISK

S.No.	Currency	Open Position (FCY)	Open Position (NPR)	Relevant Open Position
1	INR			
2	USD			
3	GBP			
4	EURO			
5	THB			
6	CHF			
7	.....			
8	.....			
9	.....			
Total Open Position (a)				
Fixed Percentage (b)				5%
Capital Charge for Market Risk [c=(a×b)]				
Risk Weight (reciprocal of capital requirement of 10%) in times (d)				
Equivalent Risk Weight Exposure [e=(c×d)]				

FORM NO. 8 NET LIQUID ASSETS TO TOTAL DEPOSIT RATIO

(Rs. In …..)

Particulars	Amount
Total Deposit and Borrowing (A)	
Total Deposit(as per NRB Ni.Fa. 9.1)	
Total Borrowing(as per NRB Ni.Fa. 9.1)	
Liquid Assets (B)	
Cash(9.1)	
Bank Balance(9.1)	
Money at call and short notice (9.1)	
Investment in government Securities(9.1)	
Placement upto 90 days	
Borrowings payable upto 90 days (C)	
Net Liquid Assets (D)=(B-C)	
Net Liquid Assets to Total Deposit	
Shortfall in Ratio	
Amount to be added to Risk Weighted Exposures	

FORM NO.: 9 Leverage Ratio

(Rs.In …..)

	Particulars	Amount
A	**Exposure Measure**	-
	1. On balance sheet Assets(net of specific provisioning)	
	2. Repurchase agreements and securities finance	
	3. Derivatives	
	4. Off balance sheet exposure	
B	**Capital Measure**	-
	1. Common Equity Tier 1 Capital (After regulatory Adjustment)	
	2. Additional Tier 1 Capital	
		%
C	***Leverage Ratio***	
Note (if any):		