Part I
FAQ On NRB
New Capital Adequacy Framework (NCAF)

Fundamental Concept and Background

1. What is Basel Capital Accord?

Basel Capital accord is a capital adequacy framework developed by the Basel committee. In 1988, the Basel Committee decided to introduce a capital measurement system commonly referred to as the Basel Capital Accord. This system provided for the implementation of a credit risk measurement framework with a minimum capital requirement of 8% on banks Risk Weighted Assets (RWA). The 1988 framework is also known as "**Basel – I"**. Since 1988, this framework has been progressively introduced not only in member countries but also virtually in all other countries.

2. What is Basel - II?

The " international convergence on capital measurement and capital standard -2004" is popularly known as Basel-II. It is a capital adequacy related standard framed by Basel committee. After the successful implementation of 1988 accord in more than 100 countries, the Basel Committee on Banking Supervision reached an agreement on a number of important issues for promoting best and uniform banking practices as well as setting standards and guidelines for supervisory function. Following extensive interaction with banks, industry groups and supervisory authorities that are not members of the Committee, the revised framework was issued on 26 June 2004, which is being regularly revised and updated.

The Basel-II aims to replace Basel I and to make the capital framework more risk sensitive. Basel II has recommended major revision on the international standard on bank's capital adequacy, which requires banks to implement risk management policies that closely align banks capital with its economic capital. The Basel II has been introduced basically for the protection of depositor's interest by preserving the integrity of capital in Banks.

3. What is Basel Committee?

The Basel committee on Banking Supervision (BCBS) is popularly referred as Basel Committee. It was established by the central bank Governors of the Group of Ten countries (G-10) at the end of 1974 and meets regularly four times a year. It has about twenty-five technical working groups and task forces, which also meet regularly.

Now the Committee's members come from Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States. Countries are represented by their central bank and also by the authority with formal responsibility for the supervision of banking business where this is not the central bank.

The Basel Committee provides a forum for regular cooperation on banking supervisory matters. Over recent years, it has developed increasingly into a standard-setting body on all aspects of banking supervision, including the Basel II regulatory capital framework.

The Committee encourages contacts and cooperation between its members and other banking supervisory authorities. It circulates to supervisors throughout the world both published and unpublished papers providing guidance on banking supervisory matters.

The Committee does not possess any formal supranational supervisory authority, and its conclusions do not, and were never intended to, have legal force. Rather, it formulates broad supervisory standards and guidelines and recommends statements of best practice in the expectation that individual authorities will take steps to implement them through detailed arrangements - statutory or otherwise - which are best suited to their own national systems. In this way, the Committee encourages convergence towards common approaches and common standards without attempting detailed harmonization of member countries' supervisory techniques.

4. Is Basel-II Mandatory?

Basel-II has been designed to provide options for banks and banking systems world-wide, the Basel Committee acknowledges that moving towards its adoption in the near future may not be the first priority for all central banks in all non-G10 countries in terms of what is needed to strengthen their supervision.

Basel II aims to build on a solid foundation of prudent capital regulation, supervision, and market discipline, and to enhance further risk management and financial stability. As such, the Committee encourages each national supervisor to consider carefully the benefits of the new Framework in the context of its own domestic banking system and in developing a timetable and approach to implementation. Given resource and other constraints, these plans may extend beyond the Committee's implementation dates. That said, supervisors should consider implementing key elements of the supervisory review and market discipline components of the new Framework even if the Basel II minimum capital requirements are not fully implemented by the implementation date. It is said that the national supervisors should also ensure that banks that do not implement Basel II are subject to prudent capital regulation and sound accounting and provisioning policies.

5. What are the approaches of Basel II?

A major innovation of the Basel II is the introduction of distinct options for the calculation of key types of banking risk. For credit, operational and market risk, there are different approaches of increasing risk sensitivity to allow banks and supervisors to select the approach or approaches that they believe are most appropriate to the stage of development of banks' operations and of the financial market infrastructure. The following table identifies primary approaches available by risk type.

SN	Credit Risk	Operational Risk	Market Risk
1	Standardized Approach	Basic Indicator Approach	Standardized Approach
2	Foundation IRB Approach	Standardized Approach	Internal Model Approach
3	Advanced IRB Approach	Advanced Measurement Approaches (AMA)	

6. What are the basic characteristics of Basel-II?

Basel-II captures the risk through its three pillar minimum capital requirement, Supervisory review process and market discipline. It addresses not only the credit & market risk but also the operational risk. The risk is computed based on the actual risk profile of the counter part. It is not ad hock or general. Hence the capital is truly risk based.

7. When advanced approaches will be adopted?

We understand that the new framework developed by the Basel committee is a product of long exercise in the globe. It is mainly the outcome of sophistication in to developed economy and complex product introduced in to the global market. The approach to Basel II in Nepal is to confirm to best international standards with local context. We plan to adopt advance approaches gradually as the market attains maturity and emerges as more sophisticated.

Those banks planning for the advance approaches are requested to collect loss data and also adhere to the sound practice for risk management. Banks will be encouraged to move along the advance approaches as they achieve increasing sophistication in their risk management systems and processes. However, banks must obtain prior approval of the Nepal Rastra Bank if they intend to use any one of the advanced approaches namely Standardized Approach, IRB Approach, Advanced Measurement Approach.

8. Is "New Capital Adequacy Framework (NCAF)" of Nepal different from Basel Capital Accord?

Nepal Rastra Bank has developed and enforced capital adequacy requirement based on international practices with appropriate level of customization based on domestic state of market developments. The existing regulatory capital is based on the Basel committee's 1988 recommendations.

The NCAF outlines the Nepal Rastra Bank's guidelines for domestic commercial banks, which is based on the simplest approaches of Basel II framework.

9. Is NCAF applicable to all financial Institutions?

No.

Only "A" Class financial institutions, licensed by Nepal Rastra Bank under the Bank and Financial Institution Act-2063 are subject to this new capital adequacy framework.

10.What are Tier I capital and Tier II capital?

Capital that is fully paid up and having no fixed servicing or dividend costs attached to it and freely available to absorb losses qualify as Tier-I capital. Tier I capital is also termed as core capital. Core Capital also needs to have a very high degree of permanence if it is to be treated as Tier 1.

Tier 2 Capital consists of general loan loss provision, revaluation reserve, exchange equalization reserve, investments adjustment reserves, and other reserves, redeemable preference share and subordinated term debt. Tier-II capitals shall be subject to the certain limitations and restrictions. Amount of tier-2 capital shall not exceed tier 1 capital

Sum of Tier I and Tier II capital is Total Capital.

11.What is Risk Weighted Exposure?

Risk weighted exposure is the maximum amount of risk attached to a portfolio or a transaction or underlying assets. It is the sum of risk weight for credit risk, market risk, operational risk and any supervisory adjustments on such risk weigh.

12. Is Basel-II practicable to our context?

The true Basel-II is almost impracticable for the numbers of years in our context. However the journey should be started and should keep in touch to the international developments and be prepared to capture the principle in full when the need is arises. It is encouraged by the different simplest options available in the framework. The simplest approaches are practicable and it has been enforced to the commercial banking industry. The destination to advance approaches is really a long one in our context.

13. Is there any commitment from the NRB for adoption?

No.

There is no any commitment for the adoption of Basel-II. The initiation towards the Basel- II is voluntary one and to follow the international best practice in time. NRB has decided to go for the Basel-II in a simplified way to be practicable in our circumstances. Based on that policy, NRB's intention and adoption plan is communicated to the FSI/BIS for their reference.

14. What are the challenges for the NCAF implementation?

The Basel-II is challengeable to supervisor as well as banking industry. The Supervisory capacity building, Market discipline, issue of poor governance in to the industry, poor governance in to the market, poor data base, lack of credit rating agencies, Re-capitalization of negative net worth bank and lack of adequate, accurate and reliable financial data are some of the challenges ahead for effective implementation of New capital adequacy framework.

Part II
FAQ
On NRB
New Capital Adequacy Framework (NCAF)

1. What is the minimum Capital Adequacy Requirements prescribed by Nepal Rastra Bank through its NCAF?

   Answer:
   The minimum Capital Adequacy Requirement (CAR) prescribed by Nepal Rastra Bank (NRB) as per its new capital adequacy framework is 10%, out of which 6% must be the core capital.

2. What approaches are selected to assess different types of risk?

   Answer:
   Under first Pillar following simplest approaches are selected to measure the main components of banking risks.
   - Credit risk: Simplified Standardize Approach
   - Operational risk: Basic Indicators approach
   - Market risk: Standardized approach (Net open position)

3. What types of additional provisioning can be included in Tier 2 capital?

   Answer:
   General loan loss provision (GLLP) created against the pass category of loan is eligible for supplementary capital, which is restricated to 1.25% of total Risk Weighted Exposure (RWE). At the same time, provision created in excess of the regulatory requirements and which is not attributable to identifiable losses shall be allowed to be included in tier II capital subject to maximum of 1.25% of total RWE. In this way provisioning which has been tied with any individual loan cannot be considered to be the component of Tier-II For example: If the bank categorized the loan of the xyz limited in pass categories and provides additional provisioning say 5% of total exposure. It is not allowed to include in tier II capital. If Banks provide additional 1% for whole particular product say hire purchase or auto loan that may eligible for Tier II capital.

4. What are the Criteria for assessing credit risk in NCAF?

Answer:
The NCAF follows the Simplified Standardize Approach (SSA) to assess the credit risk. There are 11 categories of credit risk portfolio under simplified standardized approach. Credit risk under balance sheet and off balance sheets items are segregated into 11 categories. Banks exposure in these categories is multiplied with given risk weight to get the Risk weighted exposure for credit risk. Under the simplified standardized approach the risk consensus country risk score generated by Export Credit Agency (ECA) has been taken as a basis for specific risk weights of any counter part.

5. What is ECA rating?

Answer:
ECA stands for export credit agency, an agency of OECD. The ECA generates consensus country risk score for any country in the world, which is useful to identify the country business environment and risk of cross border business with the particular country. Under the simplified standardized approach this country risk score is considered as basis for risk weight in new capital standard. In order to identify the exact country risk score banks are required to download updated version of country risk score available in the websites (http:/www.oecd.org).

6. Out of the 11 categories, which products are provided special priority for minimum risk weight?

Answer:
Under NCAF some of the credit products shall have incentives compare to others. Among the various loan products, the claim secured by residential mortgage shall receive special incentives, as it has to be risk weighted only at 60%. Other products are retail products with specified eligibility criteria that will be risk weighted at 75%.

7. Why Claims on Residential mortgage is gives minimum risk weight? What are the minimum criteria to be maintained in such product?

Answer:
Among the various types of security used in banking industry, the residential property is considered to be comparatively safe due to the sentimental attachment of borrower towards the residential property. At the same time the home loan product are more covered by reliable fixed source of income to repay the loan. In this way the claims secured by residential mortgage is risk weighted at a lower rate. In order to honor its low risk feature following conditions are laid down in the framework

- Separate product paper approved by BOD and notified to Nepal Rastra Bank,
- The property occupied (or rented) by Borrower.
- The loan having adequate margin of security.
- Security valued in strict criteria.

8. What are the minimum criteria for Claims on Regulatory Retail portfolio?

Answer:

Following criteria should be fulfilled for this category.

- Separate product paper approved by BOD and notified to Nepal Rastra Bank
- **Orientation criteria:** The loan should be granted to an individual or the small business enterprises. If a loan is provided to a member of group borrower or the member of corporate or to a big corporate, such loan shall not fulfill these orientation criteria. SME loan, cottage industry loan, personal loan not mentioned in negative list etc could be the example of orientation criteria.
- **Product criteria**: Identified products such as,
    - Revolving credit lines of credit
    - Term loans and leases
    - Small business facilities and commitments
    - Deprived sector loan up to threshold.
- **Granularity criteria**: No aggregate exposure to one counterpart can exceed 0.5% of the overall regulatory retail portfolio.
- **Low Value individual criteria**. The aggregated exposure to one counterpart (defined by NRB directives) can not exceeded an absolute threshold of unto Rs. 10 million.

Notes:

The total exposure of individual party including all other bank and FIs, should be monitored thorough self declaration of borrower. It can be observed by CIC report whether it is applicable.

9. What types of personal loans are not eligible for Regulatory Retail portfolio?

Answer:

Following types of personal loans are excluded from regulatory retail portfolio;

- Margin type lending which is basically collateralized by the stock and securities whether listed or not.
- Credit card receivables and

Other personal loan exceeding prescribed threshold (Rs 10 Million) limit

10. What would be the risk weight for claims on NGO?

Answer:
If it is licensed by NRB for financial services as FINGO, it comes under "claims on banks" otherwise it comes under "other assets".

11. Is the sanction limit of loan (unutilized portion of Sanction loan) is subject to risk weight?

Answer:
Yes.
It is an irrevocable credit commitment and treated as off balance sheet exposure of a bank that requires 20% risk weight for the capital allocation purpose. This includes any un-drawn portion of committed credit lines sanction for a period of up to 1 year. This shall include all unutilized limits in respect of revolving working capital loans except for trade finance exposure.

12. What is Credit Risk Mitigation (CRM) technique? What process should be completed to calculate the CRM benefits?

Answer:
Credit Risk Mitigation is a technique of minimizing credit risk through financial collateral used in particular loan. In other word, eligible financial collateral which are allowed to reduce their credit exposure to counterpart when calculating their capital requirement to take account of the risk mitigating effect of the collateral is known as CRM. Credit risk mitigation is allowed only on account basis, even within regulatory portfolio. The following process mention in to the framework needs to be followed to calculate the CRM benefits.

- **Step 1**: Identification of 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.

13.What types of security and collaterals are eligible to claim CRM ?

Answer:

- **Cash deposit** (as well as certificates of deposit or fixed deposits or other deposits) with the bank.
- **Fixed Deposit** Receipts/Certificates of deposits/other deposits of other Banks, who fulfill the capital adequacy requirements, subject to a 20% supervisory haircut.
- **Gold.**
- Securities issued by the Government of Nepal and Nepal Rastra Bank. Guarantee of the Government of Nepal
- **Financial guarantee/counter** guarantee of domestic banks who meet the minimum capital adequacy requirements subject to a haircut of 20%.
- **Securities/Financial guarantee**/Counter guarantee issued by sovereigns.
- **Securities/Financial guarantee/Counter guarantee** issued by MDBs in the list specified in 3.3 b (3 & 4, CAF)
- 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.

Notes:

- **CRM should be calculated on the basis of Individual loan file.**
- **Supervisory hair cut is properly executed. It is not taken as the part of supervisor. Bank must obey the rules mention in CAF.**

14. What does this supervisory haircuts mean?

Answer:

A supervisory adjustment on exposure or on collateral is referred as supervisory hair cuts.

15. What is operational risk? How it is measured under Basic Indicator Approaches?

Answer:

The operational risk is the risk of direct or indirect loss due to inadequate or failed internal processes, people, and systems, or from external events. NCAF selected the Basic Indicators approach for assessing Operational risk.

- Under this approach the capital charge is 15% of average gross annual income, where positive, over past three years.
- Gross income includes the net interest income and other income but does not include gain/loss from sale of Held To Maturity securities and extraordinary items.
- Net interest income mean gross of interest suspense.

16. Does the un-audited latest gross income could be considered for calculating operational risk?

Answer:
Generally Bank shall use the annual audited financial of the last three years for the computation of gross income under this approach. Where the latest figure are available which are subject to audit it shall be included as part of the gross income of the latest year. In other words, to comply with the spirits of the capital accord bank are encourage to include the provisional gross income of the latest period, which should be validated by the internal auditor of the bank.

17. How can we calculate operational risk, in case all of the last three years gross income is negative?

Answer:
Where the Gross Income determined for computation of capital charge of Operational Risk for all of the last three years is negative, 5% of the total credit and investments net of specific provisions shall be the capital charge for operational risk.

Note: Same approach is applied to newly established Bank who has not completed one year of operation and whose gross income cannot be measured reliably.

18. What is market risk?

Answer:
Market risk is defined as the risk of losses in on and off-balance sheet position arising from movements in market prices which includes:

- The risks pertaining to interest rate related instrument and equities in the trading book.
- Foreign exchange risk including gold position
- The risk pertaining to investment in equities and commodities.

19. What is the capital requirement for Market risk?

Answer:
The NCAF does not capture all types of market risk. For the initial stages it is initiated to capture currency risk components of the market risk, where by, 5 % of the net open position is required as capital charge as part of the market risk under NCAF. As an add0itional measure, banks are required to maintain an "Investment Fluctuation Reserve" (eligible as tier II capital) to the extent of 2% of trading investment portfolio.

20. What is Pillar II under the NCAF? What are the key areas of supervisory review?

Answer:

Pillar II of NCAF refers the Supervisory Review process which ensure that banks have adequate capital to support all the risks in their business and also encourage banks to develop and use better risk management technique in monitoring and managing their risk.

21. Is the Pillar II is only supervisory concern?

Answer:

No.

Banks senior management and board of the bank are primarily responsible for the risk management and capital allocation of the bank. In this way the senior management of the bank is consider as first tier supervisor of the banks operation. At the same time the regulator or the supervisory authority is responsible for the review and timely intervention on the capital issue. In this way the banks senior management and the supervisory authority both has concern on the Pillar -II of capital framework..

22. What should be treatment of claims that fulfill all criteria of claims on regulatory retail portfolio except granularity criteria?

Answer:

Entire amount of such exposures which fulfills all criteria of regulatory retail portfolio except granularity criteria should be categorized under 'Claims fulfilling all criterion of regulatory retail except granularity' providing 100% risk weight.

23. What does Liquid Asset consist of for determination of Liquid Asset to Total Deposit Ratio?

Answer:

Liquid Asset consists of cash, bank, money at call or short notice, investment in government securities and consist of placements upto 90 days net of borrowings upto 90 days with foreign banks (Ref. NRB Circular no.27/066-67 dated 66/10/2).

24. What should be the treatment for investment in equity of non-listed financial institutions licensed by Nepal Rastra Bank?

Answer:

Investment in equity of non-listed financial institutions licensed by Nepal Rastra Bank should be deducted from TIER 1 Capital. However, investment in shares of Rural Development Banks, Credit

Information Centre and other 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.

25. What should be the treatment of interest receivable on investment?

Answer:

Interest receivable on investment should be provided same risk weight as provided to the investment amount.

26. Can exposure on Trust Receipt Loan fulfilling granularity criteria and low value individual criteria of regulatory retail portfolio be categorized under claims on regulatory retail portfolio?

Answer:

Exposures on Trust Receipt Loan do not fulfill product criteria of regulatory retail portfolio. Therefore, such claims do not qualify as regulatory retail portfolio.

27. How much risk weight should be provided to exposure on margin lending?

Answer:

Lending against securities (bonds and shares) has been categorized under High Risk Claims. Such exposures shall attract a risk weight of 150%.

28. Can indirect institutional deprived sector lending exceeding Rs. 10 million be categorized as regulatory retail portfolio?

Answer

No.

Indirect deprived sector lending should be categorized based on claims with the institution through which investment has been made. For e.g. investment made through micro financial institutions should be categorized as claims on banks and financials institutions.

29. What should be the treatment when Personal loan aggregated with counterpart exceeds Rs. 10 million?

Answer:

Due to associated risks under such circumstances whole exposure of Personal loan that exceeds threshold i.e 10 million, should be categorized under high-risk claims.

30. Is there any discrimination in risk weight for Public Sector Entities (PSEs) having good financial indicator?

Answer

No.

Claims with any public sector entities (PSEs) should be categorized under claims with Public Sector Entity (ECA 7). However their financial strength could be reflected through CRM benefits.

31. Can securities/ financial guarantee/ Counter guarantee issued by foreign banks incorporated in the SAARC region with a buffer of 1% above their respective minimum capital requirements be eligible collateral for the purpose of Credit Risk Mitigants?

Answer

No.

This facility is provided only on claims. No CRM is allowed for securities/ financial guarantee/ Counter guarantee issued by foreign banks incorporated in the SAARC region with a 1% buffer capital.

32. How to create Investment adjustment reserve for Available for Sale portfolio?

Answer:

Investments that are neither "Held for trading" nor "Held to maturity" should be classified under Available for sale (AFS) category. These investments should be marked to market on a regular basis (periodical i.e. monthly for NRB monitoring purpose) and the difference should be adjusted to Investment adjustment reserve which consists of at least 2% of AFS portfolio in Regulatory reserve and excess in Adjustment reserve. Investment adjustment reserve shall be eligible for Tier II capital. An illustration for investment in listed company categorized as Available for sale portfolio in three different periods and treatment of Investment adjustment reserve corresponding to it has been presented below:

Period 1 :

Investments	**Cost Price (Rs.)**	**Book Value (Rs.)**
Held for trading	Nil	Nil
Held to maturity	1,100,000.00	1,100,000.00
Available for sale	1,500,000.00	1,700,000.00
		2,800,000.00
Investment Adjustment Reserve		
Regulatory Reserve		34,000.00
Adjustment Reserve		166,000.00
		200,000.00

Eligible for Tier 2 capital

Investment Adjustment Reserve 200,000.00

(Upward valuation of Rs. 34,000 and Rs. 166,000 credited to Regulatory Reserve and Adjustment Reserve respectively.)

Period 2 :

Investments	**Cost Price (Rs.)**	**Book Value (Rs.)**
Held for trading	Nil	Nil
Held to maturity	1,100,000.00	1,100,000.00
Available for sale	1,500,000.00	1,525,000.00
		2,625,000.00
Investment Adjustment Reserve		
Regulatory Reserve		30,500.00
Adjustment Reserve		-
		30,500.00

(BV decline of Rs. 175,000 adjusted from IAR; RR and AR Rs.3,500 and Rs.166,000 respectively and balance Rs. 5,500 charged to P/L account)

Eligible for Tier 2 capital

Investment Adjustment Reserve 30,500.00

Period 3 :

Investments	**Cost Price (Rs.)**	**Book Value (Rs.)**
Held for trading	Nil	Nil
Held to maturity	1,100,000.00	1,100,000.00
Available for sale	1,500,000.00	1,300,000.00
		2,400,000.00
Investment Adjustment Reserve		
Regulatory Reserve		26,000.00
Adjustment Reserve		-
		26,000.00

(BV decline of Rs. 225,000 adjusted from IAR; RR Rs.4,500 and balance Rs.220,500 charged to P/L account)

Eligible for Tier 2 capital

Investment Adjustment Reserve 26,000.00