MANAGING FINANCIAL CAPITAL

Capital plays multiple roles in a bank. It helps a bank to acquire property, plant and equipment to establish and perpetuate business, protect uninsured depositors, act as a buffer to absorb unanticipated losses and also serves as a regulatory restraint on unjustified asset expansion. It is perhaps the last two roles that prompted regulators to prescribe higher capital, both in terms of quality and quantity, depending on the level of sophistication of a bank's operations.

As a result, banking has become a capital intensive business and capital is becoming the "limiting factor" inhibiting the growth of the banking industry in the face of tightening regulatory requirements and reporting standards. Both Basel III and SLFRS 9 promise to have a profound impact on the emerging banking landscape. Banks will require more capital and liquidity in future and would be forced to take less risk, all leading to higher costs and lower returns.

In the circumstances, the Bank accords the highest importance to pro-actively managing the capital at its disposal to remain solvent. Through the Internal Capital Adequacy Assessment Process (ICAAP) as well as the annual strategic planning and budgeting exercise, the Bank assesses its capital requirements. The Bank deploys tools such as prudent capital allocation, balancing risk-weighted assets, timely pricing, dividend policy, products and services portfolio and capital instruments for managing capital which has become a scarce resource.

Capital management objectives

Objectives of the Bank's Capital Management efforts include;

- Compliance with the regulatory requirements
- Maintaining internal capital targets which are more stringent than the regulatory requirements
- Optimum capital usage for maximum profitability thereby meeting the expectations of investors
- Supporting future business expansion
- Supporting desired credit rating
- Satisfying Basel III capital requirements while bearing the impact of SLFRS 9 due to additional provisions under expected credit loss model which requires provisions on off balance sheets exposures too in additions to current provisions made on balance sheet exposures.

Factors affecting capital

Restrictive capital definitions, difficulty in raising fresh capital given the poor market conditions, higher risk-weighted assets, additional capital buffers and higher capital adequacy ratios required under Basel III regulations are already in place pressuring capital requirements of banks. In addition, higher impairment provisioning anticipated based on the expected credit loss model under SLFRS 9 as opposed to the current incurred loss model under LKAS 39 which will make the provisions better aligned with the higher revenues from riskier loans, too will have implications on capital. In addition, the Debt Repayment Levy proposed in the Government budget 2018 which is to be borne by the financial institutions and the removal of most of the tax concessions currently available which will increase the tax payments are also expected to have a significant impact on the amount of capital that banks can internally generate.

During the year risk-free interest rates averaged over 9.5% and as a result, shareholders expect a risk premium in the return on their investments given the risks associated with investments in shares in the Bank. Raising Common Equity Tier 1 (CET 1) capital is relatively expensive compared to Basel III compliant Tier 2 capital due to the perpetual nature of such funds. Tier 2 capital with convertible options to be compliant with Basel III are saddled with additional risk premium but is tax friendly with the interest expense being tax deductible and whereas the cost of CET 1 capital is not. Increase in CET 1 capital results in a higher dividend payout resulting in less profit being ploughed back to the Bank. In order to address this issue, the Bank is currently evaluating the optimum mix of CET 1 and Tier 2 capital.

Progress in 2017

Despite the above pressures, by properly aligning capital planning with the corporate strategy, the Bank was able to successfully manage its capital which remained at comfortable levels throughout the year and as at the year end, leaving sufficient leeway for future business expansion. The primary contributors were the rights issue of shares in June 2017 infusing Rs. 10 Bn. and the relatively low levels of gearing that the Bank is currently operating at both in terms of on balance sheet gearing [10.68 times] as well as gearing in terms of risk-weighted assets [6.35 times]. The Bank also maintained a substantial portfolio of assets in Government securities which required no capital allocation. However, these too will attract a capital charge going forward.

During the year, the Bank assessed its capital requirements under the ICAAP using standardised approach for credit and market risk and basic indicator approach for operational risk, taking into account a broader range of risks and the Bank's risk and capital management capabilities. It revealed the need for a capital infusion to support the growth trajectory of the Bank for next two years, prompting the Bank to venture in to a rights issue. The ICAAP also assisted the Bank in realigning business processes to optimise capital utilisation. In addition, the Bank reviewed its Risk Control Self Assessment processes twice during the year to ensure the adequacy of processes to identify, record and assess potential risks and related risk management controls and implemented necessary actions to fill identified gaps.

The Bank also focused on generating tradeable loan assets to be able to dispose of such assets as and when required to reallocate funds for more capital efficient projects which also helped the Bank to increase its fee based income.

Capital Adequacy ratios and profitability ratios over the past 5 years are given on page 10 under Financial goals and achievements.

Total RWA for Credit Risk and Market Risk have increased to Rs. 725.5 Bn. and Rs. 6.3 Bn. respectively during 2017 from Rs. 602.9 Bn. and Rs. 3.6 Bn. during 2016. The RWA for Operation Risk meanwhile has increased to Rs. 57.9 Bn. during 2017 compared to Rs. 51.3 Bn. in 2016. The overall increase in RWA during 2017 was Rs. 131.8 Bn. which has been mainly contributed by the growth in loan book.

The CET 1 Capital stood at 12.11% as against the regulatory requirement of minimum 6.25%. The total capital ratio had improved to 15.75% in 2017 compared to 14.87% in 2016 which was well above the regulatory requirement of 11.75% Basel Work Group of the Bank met on a half-yearly basis to assess the capital adequacy and other capital related issues and to formulate and escalate its suggestions for implementation by way of strategies.

While the Bank has been historically generating significant amounts of capital through retained earnings, as evident from the issues of equity and debt instruments in the past, the Bank has a loyal shareholder base who takes a long-term view of their investment in the Bank and is ever willing to support the Bank at favourable terms whenever additional capital is required for business expansion.

2018 and beyond

Implementation of SLFRS 9 and Basel III would demand key changes in the way banks govern and report the asset side of their balance sheets, and could have a material impact on regulatory capital requirements. The capital planning therefore has become a critical exercise for all banks.

In line with the regulatory roadmap for additional capital requirement under Basel III guidelines the Bank also aligned its strategies to optimize the level of capital.

Having identified the need for expanding the capital base and after a careful analysis of the prevailing market conditions, the Bank has decided to issue 50 Mn. listed, rated, redeemable, subordinated Basel III compliant debentures with a non-viability conversion feature to raise Rs. 5.0 Bn., with the option of going upto Rs.10.0 Bn. to improve the Tier 2 capital requirements.

The Bank has sought approval from the Regulator to adopt Alternative Standardized Approach (ASA) in computation of risk weighted amount for operational risk as against the Basic Indicator Approach (BIA) which too is expected to give a substantial improvement in CAR.

The implementation of the SLFRS 9 impairment model puts extra pressure on the already dwindling NIM of banks and eventually the ability to plough back profits as capital for future expansion purposes, with the shift to the expected credit loss model. This has over emphasized, the need to move for rating based calculation on expected loss compared to the days past due (DPD) method. During 2018 the Bank will be undertaking a validation of its rating models by an independent party, which is a pre-requisite for relying on the rating based expected loss calculation as it can provide much improved loan loss provision figures thus easing the pressure on the scarce capital. In addition, a number of initiatives are in progress with regard to automation of certain back office functions which will bring about cost advantages to the Bank leading to improvement of profits that could end up as capital through retention.

Selection of sources of funding while having an understanding of regulatory controls in place as well as business requirements to grow in a sustainable manner, the Bank will rebalance its portfolios not only from a liquidity perspective but also from a profitability perspective to create better shareholder value.

Applying risk based pricing too is likely to be a universal approach to be adopted by all contenders in the banking environment in order to improve the NIM and will be pursued vigorously by the Bank as well. The bank feels that the need to adopt more robust risk based pricing techniques will be adopted across the industry in line with some of the developments facilitating a level playing field for such adoption. Revisiting the attractiveness of certain products in terms of utilization levels especially, the revolving limits to reduce the impact on provision requirement on the unutilised committed credit lines with the adoption of SLFRS 9 will push all banks in this direction.

Meanwhile the Bank will upgrade risk profile of its asset portfolio by continuously striving to maintain a high quality asset book through careful and strict risk assessments at the time of on-boarding new counterparties.

While the borrowings in the past have primarily been from a funding and liquidity perspective, going forward the Bank will explore borrowings from a capital perspective by going for convertible structures. The Bank will explore options available to adopt a scientific approach to capital allocation as well.

The current Funds Transfer Pricing (FTP) system is mostly based on duration rather than risk associated with the loans granted. The Bank is currently evaluating a FTP mechanism which will also capture the cost of capital through a revised yield curve, so that the cost of additional capital to be consumed will be recovered from the end user.