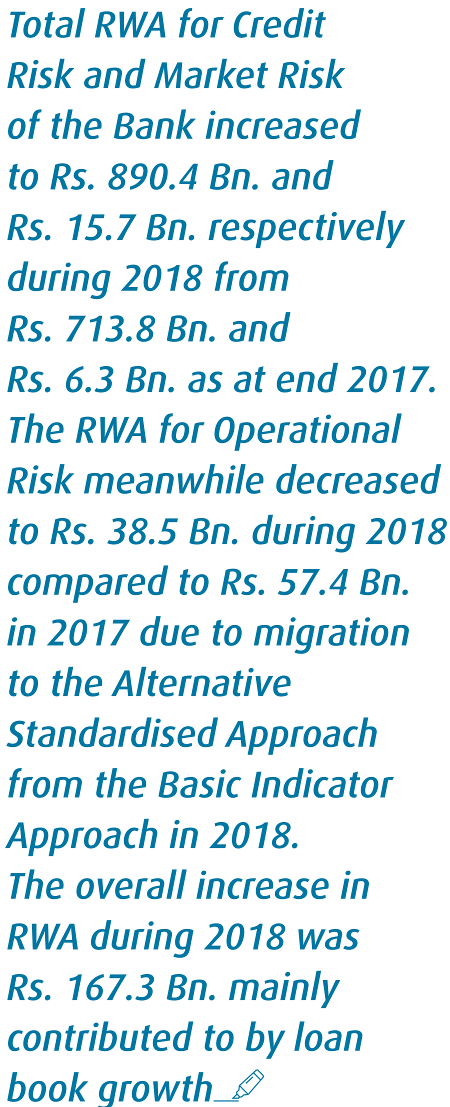
Managing Financial Capital



Capital acts as a buffer to absorb unanticipated losses and serves as a regulatory restraint on unjustified asset expansion. These are the probable reasons to have prompted regulators to prescribe higher capital, both in terms of quality and quantity. Capital also helps banks to acquire property and equipment to establish and perpetuate business, and protect itself against uninsured depositors.

The need to retain capital has resulted in certain limitations being imposed on banks, inhibiting the growth of the banking industry in the face of tightening regulatory requirements and reporting standards. Already, both Basel III and SLFRS 9, have had a profound impact on the emerging banking landscape. Required to hold on to more capital and liquidity, banks will be forced to take less risk, and bear the brunt of higher costs and lower returns.

Among others, restrictive capital definitions, difficulty in raising fresh capital due to lacklustre market conditions, higher risk-weighted assets, additional capital buffers and higher capital adequacy ratios (CARs) required under Basel III regulations, higher impairment provisioning under SLFRS 9, Debt Repayment Levy and removal of most tax concessions previously available are exerting pressure on capital management of banks.

To remain solvent in such a landscape, the Bank considers it a priority to pro-actively manage the capital at its disposal. The Bank assesses its capital requirements through the Internal Capital Adequacy Assessment Process (ICAAP) and the annual strategic planning and budgeting exercise. The tools it deploys include: prudent capital allocation, balancing risk-weighted assets, timely pricing, dividend policy, products and services portfolio and capital instruments for managing capital.

Capital management objectives

The 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 (which meets investor expectations)
- 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 the expected credit loss model which requires provisions on loan commitments/off balance sheet exposures and foreign currency denominated Government securities as well.

Progress in 2018

Despite the stressful environment that prevailed, the Bank was able to manage capital well during the year. As a result, the Bank's capital remained at a comfortable level throughout the year, allowing sufficient leeway for future business expansion. The primary contributors for this success included:

- Accurate alignment of capital planning with corporate strategy
- Expanding the Tier II capital base by Rs. 10 Bn. via an issue of listed, rated, redeemable, subordinated Basel III compliant debentures
- Relatively low levels of gearing that the Bank is currently operating at
- Investing in Government securities which do not attract capital charge

Given the recent developments ICAAP revealed the need for strengthening the corporate plan and budgeting exercise in 2019. This prompted the Bank to announce a Basel III compliant debenture issue in December 2018 which will be issued during the first half of 2019. The ICAAP also assisted the Bank in realigning business processes to optimise capital utilisation.

In addition, to ensure the adequacy of processes to identify, record, and assess potential risks and related risk management controls, the Bank reviewed its Risk Control Self Assessment processes twice during the year and implemented necessary actions to fill identified gaps.

In order to have disposable assets at hand which can be reallocated for more capital-efficient projects, the Bank focused on generating tradable loan assets. This move supported the Bank's CARs and profitability ratios over the past five years.

Total RWA for Credit Risk and Market Risk of the Bank increased to Rs. 890.4 Bn. and Rs. 15.7 Bn. respectively during 2018 from Rs. 713.8 Bn. and Rs. 6.3 Bn. as at end 2017. The RWA for Operational Risk meanwhile decreased to Rs. 38.5 Bn. during 2018 compared to Rs. 57.4 Bn. in 2017 due to migration to the Alternative Standardized Approach from the Basic Indicator Approach in 2018. The overall increase in RWA during 2018 was Rs. 167.3 Bn. mainly contributed to by loan book growth.

The CET 1 Capital ratio stood at 11.3% as against the minimum regulatory requirement of 7.375%.

Keeping well above the regulatory requirement of 12.875%, the total capital ratio stood at 15.6% at end of 2018.

The Bank's Basel Work Group met periodically to assess the capital adequacy and other capital related issues and to formulate and escalate its suggestions for implementation by way of strategies.

The Bank's strong reputation for managing capital prudently and effectively through retained earnings has borne fruit over the years. This is evident from its handling of past issues of equity and debt instruments. Thanks to a loyal shareholder base that takes a long-term view of their investment in the Bank, and especially one that is ever willing to be supportive at favourable terms, the Bank retains its strong position even in times when additional capital is required for business expansion.

2019 and beyond

The way banks manage and report the asset side of their balance sheets was heavily impacted by the implementation of SLFRS 9 and Basel III. For this reason, capital planning has become an essential exercise for all banks.

During the year, the Bank aligned its strategies to optimise the level of capital in line with regulatory prerequisites under Basel III guidelines.

The Bank has received approval from the regulator to adopt Alternative Standardised Approach (ASA) as against the Basic Indicator Approach (BIA), a move that is expected to improve CAR going forward.

The net interest income of banks are under pressure due to the implementation of the SLFRS 9 impairment model which restricts the Bank's ability to plough back profits as capital for future expansion purposes. This emphasises the need to move to a ratings-based calculation on expected loss compared to the days past due (DPD) method.

During 2018, the Bank validated its rating models through an independent party. This is a pre-requisite for relying on the rating based expected loss calculation as it can provide much improved loan loss provision figures and ease pressure on the scarce capital. In addition, a number of automation initiatives were implemented for back office functions with the aim of bringing about cost advantages to the Bank. In turn these are expected to lead to an improvement of profits that could end up as capital through retention.

To create better shareholder value, the Bank will rebalance its portfolios both from a liquidity perspective and a profitability perspective. This will be done in line with the Bank's comprehensive understanding of the regulatory controls in place and the business requirements for growing in a sustainable manner.

To improve NIMs, it is likely that all players in the banking environment will begin applying risk-based pricing, an approach that will be vigorously pursued by the Bank as well. The need to adopt more robust risk-based pricing techniques is more important than ever and is likely to be adopted across the industry, especially with developments to facilitate a level playing field for such adoption already in the pipeline.

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

While past borrowings 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 as was done in 2017 and 2018. It will also explore options for adopting a scientific approach to capital allocation.

The Bank's Funds Transfer Pricing (FTP) system is largely based on duration rather than risk associated with the loans granted. To recover the cost of additional capital to be consumed from the end user, the Bank is currently evaluating a FTP mechanism which will also capture the cost of capital through an appropriate yield curve.

Further details are given under "Disclosure 6 – Summary discussion on adequacy/meeting current and future capital requirements" on page 402.