Implementation of Basel III accord: The present state and future challenges in the Sri Lankan Banking Sector

K. A. D. S. M. Kodithuwakku[*] and Chandana Aluthge
Department of Economics, University of Colombo, Sri Lanka
[*]Corresponding author: shehani.minonshika@gmail.com

Introduction

The Bank for International Settlements (BIS) – Central Banker's Bank, located in Basel, Switzerland produced new set of banking regulations to avoid – at least minimize – the danger of another financial and economic crisis. The Basel Committee on Banking Supervision (BCBS) has collectively reached an agreement to reform to strengthen global capital and liquidity rules with the goals of promoting a more resilient banking sector which is being referred to as "Basel III". After financial crisis, Basel committee has revised Basel II and introduced Basel III with the intention of strengthening the global capital framework, capital conservation buffer, countercyclical buffer, leverage ratio, global liquidity standards and risk coverage.

"Basel III" is a comprehensive set of reform measures, developed by the BCBS, to strengthen the regulation, supervision and risk management of the banking sector. (Bank for International Settlements, 2015). BIS emphasized that the credit losses and write downs come out from retained earnings, which is a part of bank's tangible common equity base, inconsistency in the definition of capital across economies and lack of disclosure were main roots in the crisis situation made worse due to lack of quality and quantity of capital base (Bank of International Settlements, 2015).

Therefore, the BCBS clearly presents the definitions for the total regulatory capital through Basel III accords as Tier I capital: Going-concern capital and Tier II Capital: Gone-concern capital. To improve market discipline, the transparency of the capital base will be improved, with all elements of capital required to be disclosed along with a detailed reconciliation to the reported accounts. In this context it is very important to get to know how far Sri Lankan banks could be able to implement Basel II and the success they achieved in implementing Basel III accords especially on the capital adequacy criteria.

This research aims to analyze Basel III implementation to understand the present state and to identify the challenges faced by the local banking industry. The evidence is useful to assess the level of readiness of the local banking sector to face financial instability.

Methodology

This study compares the three most important Capital Ratios of banks. These ratios are Total Capital Ratio, Tier I Capital or Core Capital Ratio and Common Equity Capital Ratio. The study gathers these information from 2011 to 2016 and examine timely changes within the period in question. The Basel III accord started its implementation process in Sri Lanka in 2011 and that justifies the selection of time period. The sample of banks includes Bank of Ceylon, Peoples' Bank, Sampath Bank, Commercial Bank, Hatton National Bank and Seylan Bank. These six banks are considered the Systemically Important Banks (SIBs) in the Sri Lankan banking industry because they represent 75 per cent of the total commercial bank assets, 63 per cent of the banking sector assets, and 36 per cent of the entire financial system's assets (CBSL, 2013). An extended analysis done through the calculation of industry bench mark where the all SIBs of Sri Lanka has been included in the sample. To calculate the three ratios introduced above, information given in the annual reports of respective banks for the period from 2011 to 2016 were used.

Results and discussion

Total Capital ratio indicates relationship between total capital base and the risk weighted assets of the bank. According to Basel III, the minimum required level of total capital ratio is 8 percent. The highest average level of total capital ratio, 14.52 percent, for the banking industry was recorded in 2014. But it has declined to 13.65 percent in the end of 2016. However, the industry bench mark is still above the minimum required level.

Table1 Total Capital Ratio

Name of the Bank	2011	2012	2013	2014	2015	2016
Bank of Ceylon	10.88	11.45	12.10	13.55	13.07	12.34
Peoples' Bank	14.82	14.00	14.98	14.30	12.60	12.09
Commercial Bank	13.01	13.84	16.93	16.22	14.28	15.89
Hatton National Bank	14.51	16.60	16.62	14.83	12.70	15.27
Sampath Bank	11.45	13.61	14.22	13.62	12.26	12.87
Seylan Bank	14.57	14.37	15.75	14.73	12.87	13.18
Industry Bench Mark	12.92	13.66	14.52	14.52	13.03	13.65
Basel III Threshold	8.00	8.00	8.00	8.00	8.00	8.00

Source: Author's calculations

Tier I capital ratio provides the association between Tier I capital to risk weighted assets of the bank. The minimum level of the ratio expected by the Basel III ranges from 4.50 percent to 6 percent. Even though the industry bench mark is above the minimum required level, the Tier I capital ratio has declined to 10.02 percent in 2016. It was the lowest value reported during the period in question. The industry bench mark of tier I capital ratio was around 11percent but shows a slight decrease at the end of the period. Seylan Bank, Hatton National Bank and Commercial Bank were above the industry bench mark while two state banks along with Sampath bank were below the industry bench mark.

Table 2: Tier I Capital Ratio

Name of the Bank	2011	2012	2013	2014	2015	2016
Bank of Ceylon	7.75	8.26	8.40	9.50	9.10	8.70
Peoples' Bank	9.62	9.75	10.39	10.90	9.90	9.80
Commercial Bank	12.11	12.63	13.30	13.07	11.55	11.56
Hatton National Bank	12.76	13.90	12.95	12.15	10.53	11.20
Sampath Bank	10.24	11.80	10.08	8.83	7.90	8.31
Seylan Bank	14.22	14.36	14.58	13.75	12.24	10.74
Industry Bench Mark	10.64	11.16	11.12	11.33	10.02	10.02
Basel III Threshold	0.00	0.00	4.50	5.50	6.00	6.00

Source: Author's calculations

Common Equity Ratio provides the fraction between common equity to risk weighted assets. The ratio has reported a sharp decline to 10.61 percent in 2015 from 13.61 percent in 2013. It was revealed that many banks were failed to compile and record their common equity capital.

It is evident that all systematically important banks in Sri Lanka have achieved the minimum capital requirements imposed by the Basel III accords.

Challenges: Calculation of common capital by banks are at unsatisfactory level. Hence, banks should be guided to compile and record them continuously.

Conclusion

Sri Lankan commercial banks successfully fulfilled the Basel III capital adequacy requirements in terms of the total capital ratio, common equity ratio and the tier one capital ratio. After 2014 the industry bench marks of the capital ratios recorded a slight decline. Bank of Ceylon, Peoples' Bank and Sampath Bank recorded their average of capital ratios below the industry bench mark during the period in question. Commercial Bank, Hatton National Bank and Seylan Bank recorded their averages higher than the industry bench marks during the same period. The capital adequacy of the banking sector matters when managing sudden financial shock. This analysis confirms that the SIBs of the Sri Lankan banking sector could able to manage the Basel III capital adequacy requirements at the end of year 2016.

Keywords: *Basel III accords, capital adequacy, economic and financial crisis, financial regulations.*

References

Bank for International Settlements. (2015). *International Regulatory Framework for Banks (Basel III).* Retrieved February 3, 2016, from www.bis.org: http://www.bis.org/bcbs/basel3.htm

Central Bank of Sri Lanka. (2011-2015). *Central Bank Annual Reports.* Retrieved March 2016