TECHNICAL ASSISTANCE REPORT

ZIMBABWE

Financial Sector Stability Review Follow Up Technical Assistance on the Implementation of the Basel III Capital Framework

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Glossary

AFRITAC	Africa Regional Technical Assistance Center
AMA	Advanced Measurement Approaches
AML	Anti-Money Laundering
ASA	Alternative Standardized Approach
BCBS	Basel Committee on Banking Supervision
BI	Business Indicator
BIC	Business Indicator Component
BSSFSD	Banking Supervision, Surveillance, & Financial Stability Division
CAR	Capital Adequacy Ratio
CEM	Current Exposure Method
CET1	Common Equity Tier 1
CFT	Combating the Financing of Terrorism
COMM	Commodity [Risk]
CPF	Countering Proliferation Financing
CRC	Capital Requirement to Credit Risk
CRM	Credit Risk Mitigation
D-SIB	Domestic Systemically Important Bank
ECAI	External Credit Assessment Institution
EQ	Equity [Risk]
FC	Financial Component
FSSR	Financial Sector Stability Review
FX	Foreign Exchange [Risk]
GDP	Gross Domestic Product
HQLA	High Quality Liquid Assets
ICAAP	Internal Capital Adequacy Assessment Process
IDLC	Interest, Leases and Dividend Component
ILM	Internal Loss Multiplier
IMF	International Monetary Fund
IRR	Interest Rate Risk
LC	Loss Component
LCR	Liquidity Coverage Ratio
LEG	IMF's Legal Department
LEX	Large Exposures

LR	Leverage Ratio
MCM	IMF's Monetary and Capital Markets Department
MDB	Multilateral Development Banks
MIS	Management Information System
MRC	Capital Requirement to Market Risk
NPL	Nonperforming Loan
NSFR	Net Stable Funding Ratio
ORC	Capital Requirement to Operational Risk
P&L	Profits and Losses
QIS	Quantitative Impact Study
RBZ	Reserve Bank of Zimbabwe
RW	Risk Weight
RWA	Risk Weight Asset
SA	Standardised Approach
SACCO	Savings and Credit Cooperative Organizations
SC	Services Component
SCRA	Standardized Credit Risk Assessment Approach
SF	Scaling Factor
SFT	Securities Financing Transactions
SME	Small and Medium-Sized Enterprises
SRS	Supervisory Rating Scale
SSA	Simplified Alternative Standardized Approach
TA	Technical Assistance
TB-BB	Trading Book – Banking Book
ZiG	Zimbabwe Gold

Preface

At the request of the Reserve Bank of Zimbabwe (RBZ), the Monetary and Capital Markets Department (MCM) conducted a hybrid mission: a virtual mission from November 25 to 29, 2024, and an in-person visit to Harare, Zimbabwe, from March 17 to 21, 2025, to assist the RBZ in finalizing the updated capital regulations based on the Basel III Capital Framework.

The mission met with Mr. Philip Madamombe, Director of the RBZ Bank Supervision, Surveillance and Financial Stability Division (BSSFSD), Mrs. Norah Mukura (Deputy Director), Dr. Jeremiah Borerwe (Chief Bank Examiner) and other supervisors, responsible for the implementation of Basel III capital standards, and representatives of Zimbabwe's banks.

The mission wishes to express its gratitude to the RBZ and its management, particularly to Mr. Philip Madamombe, Mrs. Norah Mukura and Dr. Jeremiah Borerwe, for their excellent cooperation, productive discussions, and their hospitality.

As a follow-up to the Financial Sector Stability Review (FSSR), the Technical Assistance (TA) was financed by the Financial Sector Stability Fund.

Executive Summary

As a follow-up to the 2019 FSSR, a hybrid TA mission supported the RBZ in finalizing the updated capital regulations based on Basel III Capital Framework. The mission reviewed the RBZ drafts of updated capital regulatory framework, which were prepared in response to previous TA mission's recommendations, with particular focus on standardized approaches for credit, operational and market risks; capital definition; leverage ratio; large exposures; and capital conservation buffer. The TA mission discussed with the RBZ the identified areas for improvement and provided recommendations for their enhancement and next steps.

As recommended by the FSSR and previous TA missions, advancing the capital framework in Zimbabwe is a high priority. Under Zimbabwe's current capital framework (2011), banks calculate capital for credit risk using the Basel I regime, and for market and operational risk, they use Basel II standardized approaches. Since 2012, the RBZ has been conducting a parallel run of banks' capital calculations based on a modified Basel II approach for credit risk. With IMF support, the RBZ has been implementing certain elements of Basel III capital requirements, considering Zimbabwe's particularities and using proportionality.

Currently, the capital definition in the RBZ draft regulation is mostly aligned with Basel III. For Additional Tier 1 instruments, the RBZ should review the trigger point of the write-down mechanism in case of a recalibration of the minimum capital requirements. The RBZ is encouraged to maintain a conservative approach to the revaluation of land and buildings (properties). Finally, it was recommended that many regulatory adjustments be included in the draft to ensure closer alignment with Basel III.

The RBZ draft regulation for capital calculation for credit risk requires minor adjustments. The draft regulation follows the Standardized Credit Risk Assessment (SCRA) approach, which reduces dependence on external ratings. Among the recommendations to enhance the regulation, it was highlighted that the RBZ should assess the adequacy of lower risk weights (RW) for retail and general corporate exposures; include the definition for Small and Medium-Sized Enterprises (SME) in the draft; and include a Credit Risk Mitigation (CRM) section in the regulation.

The RBZ draft regulation for capital calculation for operational risk is in line with the Basel III Framework, as recommended in the March 2023 TA mission. This TA recommended that the RBZ set the Internal Loss Multiplier (ILM) component equal to 1 for all banks or exclude it from the metrics for simplification purposes. It is expected that neutralizing the ILM in the metrics would not impact the results of capital calculation for operational risk in Zimbabwe[1]. However, the RBZ should consider keeping the

[1] According to Basel III methodology, for banks where the sum of all Business Indicator (BI) components, which represent the total exposure to operational risk, is less than 1 billion dollars, the Internal Loss Multiplier (ILM) component of the metrics should be set equal to 1. Banks in Zimbabwe are not expected to exceed this cap.

requirement for all banks to develop and manage an operational risk loss database, despite it being required for the calculation of the ILM, independent of the use of ILM component in the metrics[2].

The RBZ draft regulation for capital calculation for market risk is in line with the Simplified Alternative Standardised Approach (SSA) of the Basel III Framework. Currently, banks in Zimbabwe calculate capital for market risk by applying the Basel II.5 Standardized Approach (SA) for the calculation of two market risk components: interest rate risk and foreign exchange risk. The components to estimate equity risk and commodity risk are not required in the RBZ current regulation, as banks were not ordinarily allowed to hold exposures in equities and commodities. The RBZ draft regulation has incorporated the full SSA methodology[3], including the scaling factors and capital requirements for equity and commodity risks, as recommended in the March 2023 TA mission. Besides, the criteria for the identification of trading book exposures already existing in the current regulation were improved to align with Basel III framework.

RBZ should assess the impacts of recalibrating parameters in the calculation of RWA equivalent for market and operational risks to ensure that the consequences of recalibration match the regulator's intentions. To achieve the goal of requiring capital ratios higher than the Basel minimum requirement, in 2012 the RBZ raised the Total Capital ratio to 12 percent and the Tier 1 capital ratio to 8 percent[4]. Therefore, the parameters applied to exposures in equity and foreign exchange risks were recalibrated to 12 percent, and the multipliers used to estimate RWA equivalents were adjusted to 8.33 (1/12 percent) for both market and operational risks. It is important to highlight, however, that changing the RWA multiplier without proportionally recalibrating the respective capital risk component (MRC, ORC) will neutralize the expected increase in capital for that particular risk and provoke a reduction in capital for those requirements whose ratios remained unchanged or increased less than the change applied to the calculation of the RWA equivalent. To avoid unintended consequences in recalibrating parameters, objectives and strategies to recalibrate Basel III parameters were discussed with the RBZ team during the mission, in line with the notes presented in Annex IV.

The draft regulation is implementing the capital conservation buffer, in addition to the existing Domestic Systemically Important Bank (D-SIB) buffer, and leverage ratio. Currently, the regulation requires D-SIBs to fulfill the requirement with Tier 1 capital, but the Basel III framework requires CET1. The capital conservation buffer will provide an additional fixed layer of capital for all banks. Both buffers can be used during times of stress. However, whenever capital levels fall within this range, distribution constraints will be imposed on the bank. The capital measure of the Leverage Ratio (LR) was updated considering Basel III, only the exposure measure of the LR should be revised.

The RBZ draft regulation on large exposures aligns with Basel Framework and prudential limits. Following recommendations from the March 2023 TA mission, the draft regulation has been reviewed to

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[2] An internal loss database in line with Basel III framework is a relevant granular data source, very useful to support the banks' operational risk management and internal controls. For supervisory purposes, it is an important data source for identifying banks' fragilities and to monitor the adequacy of capital requirement for operational risk, as well as to permit eventual future adjustments in the metrics.

[3] Capital requirement for market risk under the Basel III SSA is given by the sum of capital requirement due to exposures in interest rate risk, foreign exchange risk, equity risk and commodities risk using Basel II 2.5 SA methodology, each of them multiplied by its respective scaling factor ($MRC_{SSA} = SF_{RR}*CR_{IRR} + SF_{FX}*CR_{FX} + SF_{EQ}*CR_{EQ} + SF_{COMM}*CR_{COMM}$).

[4] According to Basel III Framework, the minimum ratio of 8% is required to total capital and 6% to Tier 1 capital.

incorporate several improvements. These include using Tier 1 capital instead of total capital for calculating large exposure limits, excluding the 75 percent total capital limit for single members of a corporate group, providing more detailed criteria for identifying economic interdependence, specifying the information to be reported to supervisors, and requiring banks to immediately inform supervisors of any breaches of the limit.

BSSFSD should gather information from the banking industry to estimate the impact of implementing the Basel III Capital Framework in Zimbabwe. This TA strongly reinforced the recommendation of the March 2023 TA mission to conduct a Quantitative Impact Study (QIS) exercise and a public consultation of the draft regulation prior to its approval. The RBZ draft regulation introduces many changes to the calculation and compliance with Basel III minimum capital requirements and prudential limits. Therefore, the impacts on banks' capacity to comply with the new standards, as well as the challenges of operationalizing implementation, need to be identified, assessed, and discussed with banks.

The in-person mission focused on capacity building of the RBZ's supervisory team and participated in an event with the Bankers Association of Zimbabwe on raising awareness about the Basel III capital framework. About 30 supervisors from the BSSFSD participated in a two-day targeted training on Basel III capital framework. During the event with banking institutions, IMF experts gave a presentation on the Pillar 1 capital requirements and prudential limits to raise awareness and obtain the banking industry's perspective on the benefits and challenges of aligning capital requirements in Zimbabwe more closely with the Basel III capital framework.

Developing prudential reporting templates were left to a later stage. Basel III concepts and metrics need to be well understood, and a final version of the draft regulation is a prerequisite for the development of reporting templates. During this mission, TA experts intensively discussed with the BSSFSD team the concepts and methodologies needed to align more closely capital requirements in Zimbabwe with the Basel III framework. Further TA mission is recommended to assist the RBZ with the assessment of the results of public consultation and QIS as well as updating prudential reporting templates used by the BSSFSD to collect information on capital minimum requirements and prudential limits.

BSSFSD should review its resources to ensure effective supervision of updated capital framework. It is important to assure adequate headcount and skills to conduct the Basel III implementation project and to properly encompass all the changes in supervisory activities that the new framework requires.

The FSSR Follow-up project was extended up to August 31st, 2026[5], to continue the banking regulatory and supervisory reforms that were initiated. The RBZ has committed to finalizing these reforms, although additional technical assistance is needed, particularly in areas such as Basel III framework, consolidated supervision and corporate governance.

[5] Before being extended, the FSSR Follow-up Project was designed to finish on December 31, 2024.

Recommendations

Table 1. Key Recommendations

Recommendations	Priority	Timeframe 1/
1. Finalize the draft regulation on updating capital requirements and prudential limits more closely with Basel III standards by incorporating the recommendations of this TA and submit the draft for public consultation.	High	I
2. Conduct a QIS with the banks' support to estimate the impact on the banking system of updating capital requirements and prudential limits more closely with Basel III standards, including the following topics: a. Capital definition and capital conservation buffer; b. Capital requirement for credit risk; c. Capital requirement for market risk; d. Capital requirement for operational risk; e. Large exposures; f. Leverage ratio.	High	ST
3. Approve the new regulation on capital requirements and prudential limits.	High	ST
4. Update the BSSFSD prudential reporting templates that provide supervisors with information on capital requirements and prudential limits, in line with the updated regulation framework.	Medium	MT
5. Review BSSFSD's resources to ensure effective supervision of updated capital framework, including adequate headcount and skills to conduct the Basel III implementation project and to properly encompass all the changes in supervisory activities that the new framework requires.	Medium	I

1/ Immediate: <6 months; Short term: with results from 6 to 12 months; Medium term: with results from 12 to 18 months.

I. Introduction

1. MCM conducted a hybrid mission from November 25, 2024 to March 21, 2025 to assist the RBZ in finalizing the updated capital regulations based on the Basel III Capital Framework. From November 25 to 29, 2024, the mission held numerous virtual meetings with middle management and supervisors of the BSSFSD. The in-person mission from March 17 to 21, 2025 comprised of technical meetings with the BSSFSD, targeted training sessions to banking supervisors on the implementation of Basel III capital standards, and participation as guest speakers in RBZ's capital standards awareness event with the Bankers Association of Zimbabwe covering requirements of international standards.

2. In the 2019 FSSR follow-up TA roadmap, it was agreed with the authorities to address identified weaknesses in Zimbabwe's banking supervision, resolution, and crisis-management arrangements. Subsequently, the RBZ requested TA to support implementation of the reforms outlined in the TA Roadmap and Project Plan. It was expected that this TA would support the RBZ's efforts to safeguard financial stability by strengthening its regulatory and supervisory framework, institutional capacity, as well as the technical capacity of its staff.

3. To address gaps in the legislative framework and strengthening risk-based supervision, crisis management and resolution methodologies, several TA missions have been conducted. In 2019, the IMF provided joint LEG/MCM TA aimed at assisting the RBZ in enhancing the RBZ Act, the Banking Act, and the Deposit Protection Corporation Act. In 2019-2020, the IMF conducted two TAs on strengthening risk-based supervision. Subsequently, from 2021 to 2024, five TA missions supported the RBZ in implementing consolidated supervision, Basel III liquidity and capital standards. Additionally, AFRITAC South delivered three TA missions aimed at enhancing banking supervision. More recently, MCM provided TA on strengthening of the bank resolution and crisis management frameworks. Throughout these missions, careful consideration has been given to the RBZ's priorities and needs.

4. The TA mission was the second mission dedicated to the implementation of Basel capital standards. The RBZ is currently assessing banks' capital requirements against the Basel I credit regime and the 1996 market-risk amendment framework, with additional capital also being held for operational risk using the Basel II methodology. The current official capital adequacy ratios of the Zimbabwean banks are based on these frameworks. However, the RBZ has been conducting a parallel run of banks' capital calculations based on a modified Basel approach for credit risk since 2012. The TA mission, conducted in May 8-19, 2023, reviewed Zimbabwe's capital regulatory framework and provided support and training to the RBZ in preparing drafting amendments. Currently, the TA mission reviewed the RBZ's drafts of updated capital framework and provided advice on remaining issues and next steps.

5. The mission participated in an awareness session for banking institutions to present the Basel III capital standards. The event, organized by the RBZ, with 30 participants from the banking industry was held during the TA mission. During the event, the RBZ presented the reform related to the implementation of Basel III capital standards. IMF experts made a presentation on the international standards to raise awareness and obtain the banking industry's perspective on the benefits and challenges in implementing these requirements.

6. The mission also included two days of training to bank supervisors. About 30 supervisors from the BSSFSD participated in the training. The first day focused on capital definition, capital buffers and the standardized approach for credit risk. Training on the standardized approaches for market and operational risks, as well as the Leverage Ratio (LR) and Large Exposures (LEX) was performed on the second day.

7. This report is divided into three sections. After this introductory section, Section II provides an overview of the banking sector, and section III discusses the implementation of Basel III capital standards.

II. Banking Sector Overview

8. The banking sector of Zimbabwe consists of 14 commercial banks, 4 building societies, and 1 savings bank that, in total, account for ZiG161.39 billion[6] in assets, which correspond to 18 percent of GDP (December 31, 2024). Of the 19 banks, 7 banks have foreign shareholding, with a market share of over 51 percent. Other banks are local, or state owned, in part or whole (Annex I).

9. The RBZ stated[7] that the banking sector continues to demonstrate resilience and adequate capitalization. It was pointed out that banking institutions are taking measures to strengthen their financial and operational resilience in response to the dynamic operating environment. Based on data from banks' prudential returns, all banks were compliant with the minimum capital adequacy requirements on December 31, 2024. The banking sector average capital adequacy and Tier 1 ratios of 34.91 percent and 31.69 percent were well above the regulatory minimum of 12 percent and 8 percent, respectively. Banking sector core capital continues its gradual growth mainly due to revaluation gains from foreign exchange denominated assets and investment properties. Banking sector indicators are presented in Annex II.

10. Banking sector continues reporting a low nonperforming loans (NPLs) to total loans ratio. On December 31, 2024, the NPLs ratio was 3.37 percent, a deterioration from 2.09 percent reported as of 31 December 2023. Despite the deterioration in the ratio, the sector's average NPL ratio remained within the internationally acceptable threshold of 5 percent. It is important, however, to continue enhancing supervisory monitoring and ensure that banks timely identify NPLs and accurately reflect asset classification and provisioning in their balance sheets.

11. Banks started to calculate and report LCR to the RBZ in June 2023. The implementation of Basel III liquidity standards and other liquidity monitoring tools improved the capacity of RBZ's supervisors in the identification of liquidity vulnerabilities in the banking system and the assessment of the banks' liquidity risk. The LCR data reported by banks align with BSSFSD's expectation on large amounts of High-Quality Liquid Assets (HQLA) buffers[8], when compared with banks' liquidity needs under the stress scenario defined by the LCR metrics. BSSFSD's September 2024 data revealed 82 percent of bank deposits were in foreign currency, mainly USD.

12. On April 5, 2024, Zimbabwe introduced a new currency - Zimbabwe Gold (ZiG), which is anchored by a composite basket of foreign currency and precious minerals (mainly gold) held as reserves for this purpose by the RBZ. The new currency was established by an amendment to the RBZ Act. The RBZ also made changes to its exchange rate and monetary policies with the aim to achieve a stable national currency. When the new currency was introduced, the banking sector converted the ZW$ balances into ZiG balances.

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[6] Exchange rate 1 USD=25.7985 ZiG (December 31, 2024; Reserve Bank of Zimbabwe); the nominal GDP was USD 35.224 billion (December 31, 2024; IMF).

[7] Banking Sector Report for the Quarter Ended December 31, 2024, RBZ Quarterly Reports - Banking Sector.

[8] Coins, banknotes, and reserves at the RBZ are the main components of HQLA buffer of most banks.

III. The Implementation of Basel III Capital Standards

A. Capital Definition and Capital Conservation Buffer

13. The capital definition in the RBZ draft regulation is mostly aligned with Basel III. The Basel framework aims to enhance the quality of the capital. The definitions of CET1, Tier 1 and Tier 2 require minor adjustments. Regarding the Additional Tier 1 instruments, it is important to update the trigger point of the write-down mechanism in case of a recalibration of the minimum capital requirements. With regards to the treatment for revaluation gains from investment properties, two options are available: considering them as CET1 or as Tier 2. The RBZ is encouraged to evaluate the implementation of a conservative treatment for revaluation of land and buildings (properties)[9] through the quantitative impact studies. In view of the ongoing operationalization of the Consolidated Supervision Framework[10], provisions that recognize instruments issued by consolidated subsidiaries of the bank and held by third parties that meet the criteria for inclusion in CET1, Tier 1 or Tier 2 as regulatory capital could be included in the regulation.

14. Regulatory adjustments applied in the calculation of capital require updates. The adjustments in the calculation of regulatory capital have the objective to exclude amounts related to balance sheet items with uncertain capacity to absorb losses and avoid double leveraging of capital. This is an important step in the calculation of regulatory capital to guarantee its quality. While some of these adjustments could be suppressed considering the low materially in the local financial system[11], the RBZ should consider amending the regulation to include the following: cumulative gains and losses due to changes in own credit risk on fair valued liabilities; defined benefit pension fund assets and liabilities; investments in own shares (treasury stock), own other capital instruments; reciprocal cross-holdings in the capital of banking, financial and insurance entities; and investments in the capital of banking, financial and insurance entities that are outside the scope of regulatory consolidation.

15. The draft regulation is implementing the capital conservation buffer in addition to the existing Domestic Systemically Important Bank (D-SIB) buffer[12]. RBZ issued a prudential framework

[9] In the current RBZ regulation, the revaluation gains from investment properties, which are fair valued and considered part of retained earnings according to accounting standard IAS40, are recognized as core capital, while revaluation gains on owner occupied properties are treated as Tier 2 subject to a 55% discount. This approach provides two different treatments for an item which has – from a prudential perspective - the same nature. In the calculation of the capital base, Basel III standard would allow property revaluation to be recognized in CET1(i.e. revaluation gains from investment properties within retained earnings and revaluation gains on owner occupied properties within Other Comprehensive Income). However, the amount of revaluation gains arising from properties in the banking system is relevant and this would require supervisors to ensure that the fair value of a revalued asset can be measured reliably (in accordance with the accounting rule) and impose additional conditions from a supervisory perspective, as necessary, to avoid artificially inflated assets. After all, the supervisor assesses whether the valuation used for regulatory purposes is reliable and prudent. Therefore, recognizing unrealised gains on property revaluation in Tier 2 subject to a 55% haircut (as it is the current draft regulation) is – from a regulatory perspective – a more prudent measure.

[10] Details related to the TA on Consolidated Supervision Framework are available in the IMF Country Report No. 22/379 and Zimbabwe: Technical Assistance Report—Financial Sector Stability Review Consolidated Supervision.

[11] For example, adjustments on cash flow hedge reserve and on gains related to securitisation transactions.

[12] The countercyclical capital buffer was not in the scope of this TA mission, and it is recommended that it be included in a future TA.

in 2020[13] to deal with D-SIB, which includes the requirement of a buffer. Currently, the regulation requires D-SIBs to fulfill the requirement with Tier 1 capital. Considering the implementation of Basel III framework, this should be updated to CET1. The capital conservation buffer will provide an additional fixed layer of capital for all banks. Both buffers could be used during times of stress. However, whenever capital levels fall within this range, distribution[14] constraints will be imposed to the bank.

B. Standardized Approach for Credit Risk

16. The draft regulation follows the Standardized Credit Risk Assessment (SCRA) approach to the calculation of capital requirements for credit risk. Consistent with Basel III, authorities implement the approaches, which do not require the use of external ratings for banks and corporations. The use of the SCRA increases the risk sensitivity and reduces dependence on external ratings. This is particularly important for jurisdictions whose banks and corporates do not have long-term global external ratings. At the same time, the increased granularity achieved by introducing new asset classes and RW provides a more risk- sensitive methodology.

17. RBZ should assess the adequacy of lower RW for retail and general corporate exposures. Basel III allows the use of lower RW for retail exposures arising from transactors[15]. This category assumes the customer has a lower risk of default and due to that a lower RW can be applied[16]. In this sense, the RBZ should evaluate the appropriateness of applying such lower RW based on the analysis of data on credit operations. Additionally, the international standard allows the use of lower RW for corporates identified as “investment grade”[17]. Since the RW rules for corporates rely on the approach not using external ratings and the definition of investment grade is purely qualitative, the RBZ should carefully evaluate which local corporates would fall into this category.

18. The regulation should include the definition for Small and Medium-Sized Enterprises (SME). According to Basel Framework, SMEs are defined as corporate exposures where the reported annual sales for the consolidated group of which the corporate counterparty is a part are less than or equal to €50 million. In addition to clearly defining, it in the regulation, the RBZ should assess the appropriate annual sales considering the local economic environment.

19. BSSFSD should conduct a QIS. The new concepts, asset classes and RW can significantly change the RWA of an institution. Therefore, the QIS should gather granular information from banks to assess the impact of the new methodology.

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[13] Prudential standard 01-2020/BSD

[14] Distributions include dividends and share buybacks, discretionary payments on other Tier 1 capital instruments and discretionary bonus payments to staff.

[15] Transactors” are obligors in relation to facilities such as credit cards and charge cards where the balance has been repaid in full at each scheduled repayment date for the previous 12 months. Obligors in relation to overdraft facilities can also be considered as transactors if there has been no drawdown over the previous 12 months

[16] RW of 45%.

[17] An "investment grade" corporate is a corporate entity that has adequate capacity to meet its financial commitments in a timely manner and its ability to do so is assessed to be robust against adverse changes in the economic cycle and business conditions.

20. Other recommendations to enhance the regulation are[18]:

- Assess the need to include a risk weight mapping table for foreign sovereigns based on external ratings; otherwise, such exposures will receive a RW of 100 percent;
- Decide the most convenient way to set the rules for exposures to multilateral development banks (MDB). For example, the norm can provide the criteria for identifying highly rated MDBs[19] or explicitly list them in the regulation;
- Include a provision for subordinated debt exposures, which shall be risk-weighted at 150 percent;
- Evaluate the inclusion of a specific provision for speculative unlisted equity exposures, which shall be risk-weighted at 400 percent;
- Exclude the asset class "covered bonds" due to their non-existence in the local market;
- Adding a general rule for exposures not assigned to any specific asset's classes. Other exposures shall be risk-weighted at 100 percent;
- Include a Credit Risk Mitigation (CRM) section in the regulation. The provisions from the existing guideline[20] should be included in the norm. Additionally, updates to the supervisory haircuts are recommended[21].

C. Standardized Approach for Operational Risk

21. RBZ draft regulation for capital calculation for operational risk is in line with the Basel III Framework. Conceptually, the new methodology assumes that: (i) operational risk increases at an increasing rate with a bank's income (represented by a marginal coefficient α applied to the Business Indicator component); and (ii) banks that have historically experienced greater operational risk losses are more likely to experience operational risk losses in the future (represented by the Internal Loss Multiplier component). Figure 1 summarizes the main metrics for its calculation.

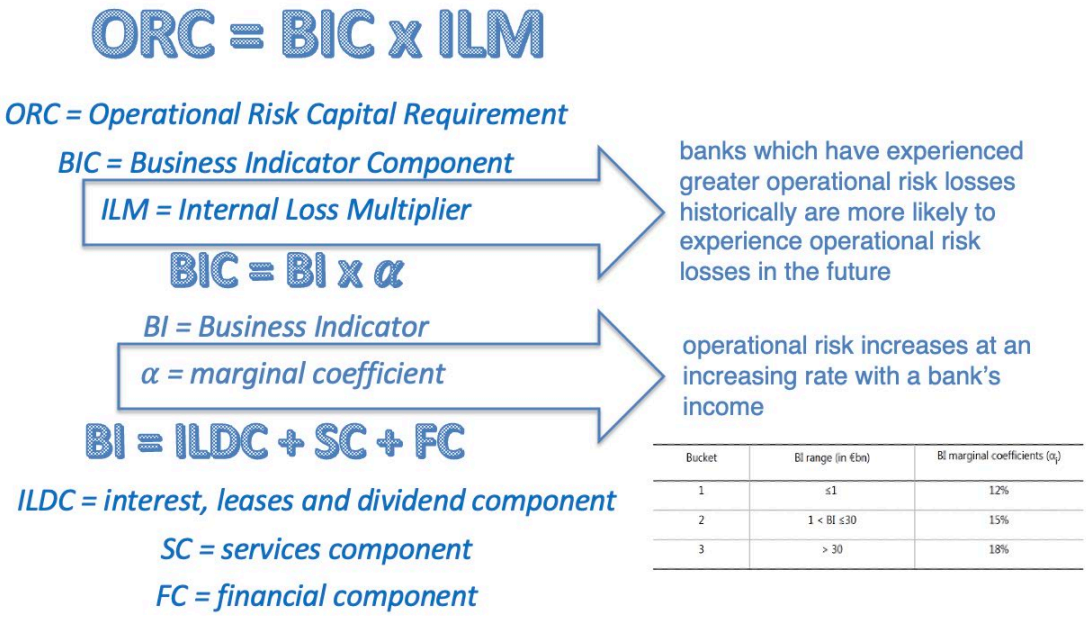
[18] These topics were discussed and agreed with RBZ team during the on-site mission. Some of them are not in the regulation draft while others need to be reviewed.

[19] Highly rated MDB are eligible for a 0% RW.

[20] Guideline No: 1-2011/BSD

[21] Basel III supervisory haircuts are defined in chapter CRE22.50 of the consolidated Basel framework, available at https://www.bis.org/basel_framework/chapter/CRE/22.htm

Figure 1. Methodology for the Calculation of Capital Requirement for Operational Risk under the Basel III Standardised Approach



Bucket	BI range (in €bn)	BI marginal coefficients (α_i)
1	≤1	12%
2	1 < BI ≤30	15%
3	> 30	18%

Note: Calculated as the average over three years:
***ILDC** = min (abs (interest income – interest expense), 2.25 percent x interest earning assets) + dividend income*
***SC** = max (other operating income, other operating expense) + max (fee income, fee expense)*
***FC** = abs (net P&L trading book) + abs (net P&L banking book)*

$$ILM = \ln\left[\exp(1) - 1 + (LC/BIC)^{0.8}\right]$$, where:

LC = Loss Component, equal to *15 times average annual operational risk losses incurred over the previous 10 years.*

22. The RBZ should consider establishing the ILM equal to 1 or excluding the component from the metrics for capital calculation for operational risk. For the calculation of the ILM, banks are required to structure and maintain a high quality 10-year operational losses database[22]. Low-quality loss databases that do not reflect the totality of operational losses of a bank may estimate an ILM <1, and, and consequently, a lower requirement of capital for operational risk[23]. Besides, according to the draft regulation, if a bank falls into the lowest α bucket (Business Indicator (BI) <= 1 billion dollars), which is expected to happen to all Zimbabwean banks, the ILM should be set equal to 1. Thus, setting the ILM equal to 1 or excluding it from the metrics for simplification purposes would not impact the results[24].

[22] Supervisors need to be very comfortable with the quality of the banks' data losses, to avoid unintended decrease in capital requirement for operational risk.

[23] Loss databases that do not reflect the totality of operation losses of a bank may estimate a LC component lower than the BIC (see ILM metrics in Figure 1), which would imply an ILM <1, and, consequently, a lower requirement of capital for operational risk.

[24] Postponing the need of loss databases for the calculation of the ORC (by neutralizing the ILM component), would give time to banks to develop sound loss databases and supervisors to be comfortable with data quality.

23. The RBZ should consider keeping the requirement of an operational risk loss database to all banks, independent of the use of the ILM component in the metrics. An eventual need in the future for the activation of the ILM component (if banks fall in α buckets 2 or 3) or the intent of recalibrating α ranges would require data from loss databases for its assessment. Besides, an internal loss database in line with Basel III framework is a relevant granular data source, very useful to support the banks' operational risk management and internal controls. For supervisory purposes, it is an important data source for identifying banks' fragilities and monitoring the adequacy of capital requirement for operational risk. This TA recommended that the eventual decision to exclude the ILM component from the metrics or establish ILM = 1 for all banks does not impact the requirement of creating and maintaining a loss database in line with the Basel III Framework established in the draft.

24. The RBZ should assess the impacts of recalibrating the RWA equivalent multiplier for operational risk to ensure that the consequences match the regulator's intentions. To achieve the intention of requiring capital ratios higher than Basel III minimum requirements (12 percent for total capital and 8 percent for Tier 1 capital), a multiplier of 8.33 (1/12 percent) instead of 12.5 (1/8 percent) was defined to calculate the equivalent RWA for operational risk. Changing the RWA multiplier[25] without proportionally recalibrating the operational risk metrics neutralizes the expected increase of capital for operational risk in the calculation of total capital, which ratio had been raised in 50 percent (from 8 percent to 12 percent total capital), and provokes a reduction of capital for those requirements whose ratios remained unchanged or had increased less than 50 percent (CET1, Tier 1 and the buffers, in this case). Thus, this TA recommended the RBZ to revise its strategies for recalibration to ensure that the consequences to be achieved match the objectives. See notes for clarification on the recalibration of Basel III parameters presented in Annex IV for more details.

25. BSSFSD should conduct a QIS to estimate the impact of implementing the Basel III Standardized Approach for operational risk in Zimbabwe. The RBZ should develop a questionnaire to collect data from all banks to assess, among other issues:

- The impact of the new methodology on capital requirement level: the study should measure the impact on capital requirements due to the implementation of the Basel III Standardized Approach, as well as estimate the need for a phase-in period for its full implementation;
- The scope of Business Indicators, which might be simplified by excluding those referring to financial activities not existent in Zimbabwe and not expected to be developed in the near future;
- Banks' capacity to collect data for the calculation of Business Indicator components: the study should assess any challenges banks may face when shifting to the calculation of Business Indicator components;
- The need for an ILM component in the metrics: if banks fall into the lowest α bucket, the ILM would be equal to 1, which could postpone eventual supervisory concerns about the quality of banks' loss

[25] The importance of using the correct RWA multiplier has been discussed in many Regulatory Consistency Assessment Programmes (RCAPs); for example, in the Assessment of Basel III risk-based capital regulations – India https://www.bis.org/bcbs/publ/d320.pdf

databases to a later stage and focus on the implementation of the Business Indicator components as a first step.

D. Simplified Alternative Standardized Approach for Market Risk

26. The RBZ draft regulation for capital calculation for market risk is in line with the Simplified Alternative Standardised Approach (SSA) of the Basel III Framework. Currently, banks in Zimbabwe calculate capital for market risk by applying Basel II.5 Standardized Approach (SA) for the calculation of two market risk components: interest rate risk and foreign exchange risk[26]. Basel III SSA methodology uses the same Basel II.5 metrics, with the application of scaling factors to each component of the metrics[27]. The RBZ draft regulation follows the March TA mission recommendations, as it has incorporated the full SSA methodology, including the scaling factors and capital requirement for equity and commodity risks, as well. Additionally, the criteria for identifying trading book exposures already existing in the current regulation were improved to align with the Basel III framework.

27. The RBZ should assess the impacts of recalibrating parameters in the calculation of capital for market risk to ensure that the consequences match the regulator's intentions. To achieve the intention of requiring capital ratios higher than the Basel III minimum requirement (12 percent for total capital and 8 percent for Tier 1), the parameters equal to 8 percent applied to exposures in equity and foreign exchange risks were raised to 12 percent while those applied to other risk components were kept unchanged[28]. Besides, a multiplier of 8.33 (1/12 percent) instead of 12.5 (1/8 percent) was used to calculate the equivalent RWA for market risk[29], to avoid double recalibration. This TA recommended that the RBZ revises its strategies for recalibration to ensure that the consequences achieved match the regulator's objectives. See notes for clarification on the recalibration of Basel III parameters presented in Annex IV for more details.

28. BSSFSD should conduct a QIS to estimate the impact of implementing the Basel III Simplified Alternative Standardized Approach for market risk in Zimbabwe. The RBZ should develop a questionnaire to collect data from all banks to assess the impact of the introduction of the scaling factors, as well as capital requirement for equity and commodity risks. The study should measure

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[26] Capital requirement for market risk under the Basel II.5 SA is given by the sum of capital requirement due to exposures in interest rate risk (IRR), foreign exchange risk (FX), equity risk (EQ) and commodities risk (COMM). However, the components to estimate equity risk and commodity risk are not required in the RBZ current regulation, as banks were not ordinarily allowed to hold exposures in equities and commodities.

[27] Capital requirement for market risk under the Basel III SSA is given by the sum of capital requirement due to exposures in interest rate risk, foreign exchange risk, equity risk and commodities risk using Basel II 2.5 SA methodology, each of them multiplied by its respective scaling factor ($MRC_{SSA} = SF_{RR}*CR_{IRR} + SF_{FX}*CR_{FX} + SF_{EQ}*CR_{EQ} + SF_{COMM}*CR_{COMM}$).

[28] The recalibration criterion was not based on the need to require more capital specifically to equity and foreign exchange risks, but to raise to 12% the parameters equal to 8% in the Basel III calibration, which, in that case, were those applied to equity and foreign exchange risks.

[29] Changing the RWA multiplier and not proportionally recalibrating the market risk metrics neutralizes the expected increase of capital to market risk in the calculation of total capital, which ratio had been raised in 50% (from 8% to 12% total capital), and provokes a reduction of capital to those requirements which ratios remained unchanged or had increased less than 50% (CET1, Tier 1 and the buffers, in this case). In the RBZ draft regulation, the recalibration was targeted to equity and foreign exchange risks (see footnote 12). Annex IV presents a few notes for clarification on the impacts of recalibrating capital requirements under Basel III methodology.

the impact on capital requirements due to the implementation of Basel III SSA, which is expected to be at least 20 percent[30], and assess the need for a phase-in period for its implementation.

29. A few requirements for the calculation of commodities risk and interest rate risk are missing in the draft regulation[31]. For commodities risk, it is necessary to require 3 percent of the bank's gross positions in commodities [32]. For interest rate risk, guidance on the treatment of derivatives needs to be provided, and the table that presents the parameters for the calculation of horizontal disallowance is missing on the text. Additionally, this TA recommended establishing a cap to quantify [currencies with] "minor operations" in the FX metrics, to harmonize the application of this requirement among banks[33].

30. Other minor recommendations[34] to enhance the clarification of the draft's capital calculation rules to market risk under the SSA comprehend:

- Excluding from the draft any paragraph that refers to other approaches (not SSA) used to calculate capital for market risk;
- Creating a specific section in the document, preferably just after capital definition, to outline the criteria for the identification of trading and banking books exposures, which are currently drafted dispersedly along the market risk section; and
- Arranging the metrics of MRC components along the text in the same order they appear in the formula.

E. Large Exposures

31. The RBZ draft regulation on large exposures is in line with the Basel Framework. The RBZ has reviewed the regulation on large exposures' limits as recommended in the March/2023 TA mission[35] to align it with the Basel Framework. The RBZ has incorporated in the draft the following improvements:

- The use of Tier 1 capital (instead of total capital) for the calculation of LEX limits;
- The exclusion of the 75 percent total capital limit to single members of a corporate group;
- More details on the criteria for identifying economic interdependence;
- More details on the information to be reported to supervisors;

[30] According to the RBZ information, market risk is highly concentrated in FX risk is due to the banks' foreign currency holdings. Securities trading markets are not yet developed, and banks are not ordinarily allowed to hold exposures in equities and commodities. Nevertheless, banks may hold those type of exposures in limited circumstances. Due to those market characteristics and the application of a 1.20 scaling factor to capital requirement to foreign exchange risk, a minimum of 20% increase in capital requirement to market risk is expected.

[31] The missing requirements presented in this paragraph were discussed with the RBZ team during the in person meetings and agreed to be incorporated in the draft.

[32] Aiming to protect the banks against basis risk, interest rate risk and forward gap risk under the simplified approach, the capital requirement for each commodity shall be subject to an additional capital requirement equivalent to 3% of the bank's gross positions, long plus short, in each commodity.

[33] The 5% cap of total currencies exposures, already used in the LCR methodology, would be adequate.

[34] Those minor recommendations were discussed with the RBZ team during the in-person meetings and agreed to be incorporated in the draft.

[35] For more details, see Zimbabwe: Technical Assistance Report—FSSR Follow up Technical Assistance—Implementation of the Basel II/III Capital Framework (https://www.imf.org/en/Publications/CR/Issues/2023/10/19/Zimbabwe-Technical-Assistance-Report-FSSR-Follow-up-Technical-Assistance-Implementation-of-540727).

- A requirement for banks to immediately inform supervisors of breaches on the limit.

32. The RBZ should conduct a QIS to assess the impact of the reviewed Large Exposures regulation on banks' compliance with the limits. If necessary, the RBZ should collect additional data on large exposures from all banks to assess:

- The impact of changing the metric's reference from Capital Base to Tier 1 Capital;
- Banks' capacity to identify economic interdependency among counterparties;
- The need for a phase-in period for its full implementation.

F. Leverage Ratio

33. The capital measure of the Leverage Ratio (LR) was updated considering Basel III. The current technical guidance on the implementation of the revised capital adequacy framework in Zimbabwe[36] defines the leverage capital ratio as the ratio of core capital to total assets. The capital measure of the LR (numerator of the formula) is Tier 1, as defined in the rules to calculate the minimum capital requirements, and this is reflected in the updated regulation.

34. The exposure measure of the LR should be revised. The exposure measure (denominator of the formula) should comprise not only the total assets (on-balance sheet items) but also off-balance sheet items. In addition, the draft regulation includes rules for derivatives and Securities Financing Transactions (SFT), as prescribed by Basel III. In this sense, the RBZ should assess if the regulation should allow bilateral netting agreements to be recognized in the calculation of derivatives and SFT. If positive, the provisions related to the eligibility of netting agreements and net calculations must be included in the regulation. If not, the regulation should only include provisions related to the calculation on a transaction-by-transaction basis. The RBZ should also confirm the existence and/or materiality of triparty repo in the market to adjust the regulation accordingly[37].

35. The QIS should also consider the LR. The LR is a non-risk-based "backstop" measure to the risk-weighted capital requirement. In this sense, it is important to assess if this requirement may become a binding constraint for any of the banks. This can happen in banks with a large share of low risk-weighted assets on their balance sheets.

G. Reporting Templates

36. Developing prudential reporting templates were left for a later stage. Having well-understood Basel III concepts and metrics, along with a finalized version of the draft regulation, is a prerequisite for developing reporting templates. During this mission, TA experts intensively discussed with the BSSFSD team the concepts and methodologies needed to align more closely capital requirements in Zimbabwe with the Basel III Framework. This work occupied the entire agenda. Further TA mission is recommended

[36] Guideline 1-2011/BSD

[37] In a triparty repo collateral, selection, settlement, custody and management during the life of the transaction is outsourced by the parties to a third-party agent.

to assist the RBZ with updating prudential reporting templates used by the BSSFSD to collect information on capital minimum requirements and prudential limits.

H. Supervisory Resources

37. BSSFSD is concerned about its capacity to absorb increasing demand and complexity with the implementation of Basel III framework. The enhancements to the regulatory framework will inevitably raise efforts on supervisory activities, due to the new metrics for the calculation of prudential standards and increased amount of reported data. BSSFSD is already struggling with constraints on staff number to conduct all tasks under its responsibilities (see Annex V). Currently, the implementation of Basel standards – liquidity and capital frameworks – are under the Financial Stability, Policy Research and Resolution unit[38] with a headcount of only 4 people. Thus, this TA recommends a review of the BSSFSD resources to ensure effective supervision of updated capital framework, including to assure adequate headcount and skills to conduct the Basel III implementation project and to properly encompass all the changes in supervisory activities that the new framework requires.

[38] As this unit is also responsible for financial stability and resolution, it would be ideal for these functions to be housed in separate structural units outside of the BSSFSD.

Annex I. Structure of the Banking Sector as of December 31, 2024

No	BANK NAME	TOTAL ASSETS (ZiG)	MARKET SHARE (percent)	CONTROL	COUNTRY OF HOME SUPERVISION	BANKS ARE INVOLVED IN CONSOLIDATED SUPERVISION (home/host)
1	CBZ	28,746,597,282.47	17.82	Mixed	Zimbabwe	+
2	STANBIC BANK	24,220,388,856.44	15.01	Foreign	South Africa	+
3	ECOBANK	23,685,686,220.99	14.68	Foreign	Togo	+
4	FBC	13,111,499,994.40	8.13	Local Private	Zimbabwe	+
5	CABS	12,958,063,617.98	8.03	Mixed	Zimbabwe	+
6	ZB BANK	9,783,127,820.21	6.06	Local Private	Zimbabwe	+
7	FIRST CAPITAL BANK	8,583,632,414.63	5.32	Foreign	Malawi	+
8	NMB BANK	7,057,584,319.22	4.37	Foreign	Zimbabwe	+
9	BANC ABC	5,324,377,778.58	3.30	Foreign	South Africa	+
10	NEDBANK	5,150,344,030.72	3.19	Foreign	Zimbabwe	+
11	STEWARD BANK	4,068,123,304.88	2.52	Local Private	Zimbabwe	+
12	NBS	3,685,238,180.32	2.28	Local Private	Zimbabwe	+
13	FBC CROWN	3,599,896,707.83	2.23	Local Private	Zimbabwe	+
14	AFC	3,042,350,240.78	1.89	State	Zimbabwe	+
15	METBANK	2,578,522,698.16	1.60	State	Zimbabwe	
16	POSB	2,478,558,304.51	1.54	State	Zimbabwe	
17	FBC BS	2,280,278,865.34	1.41	Mixed	Zimbabwe	+
18	ZB BS	791,037,529.06	0.49	Local Private	Zimbabwe	+
19	TIME BANK	188,172,648.03	0.12	Local Private	Zimbabwe	
	TOTAL	161,333,480,814.54	100.00			

Source: The Reserve Bank of Zimbabwe.

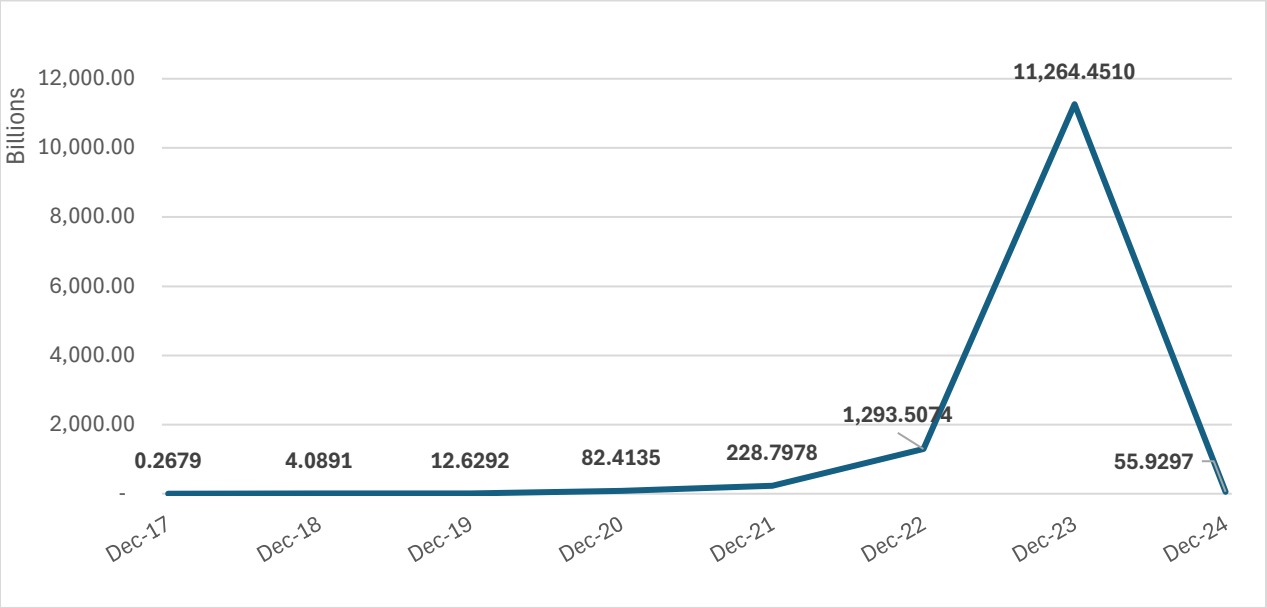
Annex II. Banking Sector Indicators

Table 2. Banking Sector Key indicators

KEY INDICATORS	BENCHMARK	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24
		ZW$	ZW$	ZW$	ZW$	ZW$	ZW$	ZiG	ZiG	ZiG
Total Assets (Billion)	-	3,814.43	5,676.25	27,284.88	28,355.17	34,412.23	106,782.6	77.554	139.195	161.582
Total Loans (Billion)	-	1,293.51	1,969.12	10,190.14	9,699.42	11,264.45	40,052.00	27.452	51.411	55.930
Net Capital Base (Billion)	-	746.30	1,013.18	5,948.89	6,316.68	7,657.91	24,608.14	16.447	33.468	38.424
Total Deposits (Billion)	-	2,323.51	3,171.31	14,776.75	16,075.83	19,469.49	60,629.76	43.600	76.102	89.066
Net Profit (Billion)	-	503.13	207.25	4,553.21	4,671.78	5,768.05	14,771.46	10.419	20.565	26.751
Return On Assets	-	17.43%	4.92%	26.11%	23.69%	23.97%	22.83%	13.37%	20.84%	23.52%
Return On Equity	-	54.33%	16.62%	74.60%	55.63%	68.99%	61.53%	35.74%	55.87%	64.72%
Capital Adequacy Ratio	12	37.51%	41.05%	40.48%	43.15%	37.34%	36.99%	46.15%	37.25%	34.98%
Tier 1 Ratio	8	26.92%	27.85%	35.35%	27.28%	25.77%	30.39%	40.13%	32.64%	31.75%
Loans To Deposits	70	55.67%	62.09%	68.96%	60.34%	49.27%	55.98%	52.51%	58.70%	58.83%
Non-Performing Loans Ratio	5	1.58%	3.30%	3.63%	2.34%	2.09%	2.13%	2.02%	3.19%	3.38%
Liquidity Ratio	30	59.50%	57.65%	59.88%	61.74%	60.53%	61.97%	59.52%	57.53%	58.83%
Liquidity Coverage Ratio	100 %	X	X	174.12%	241.11%	307.72%	287.32%	315.80 %	282.66 %	267.19 %

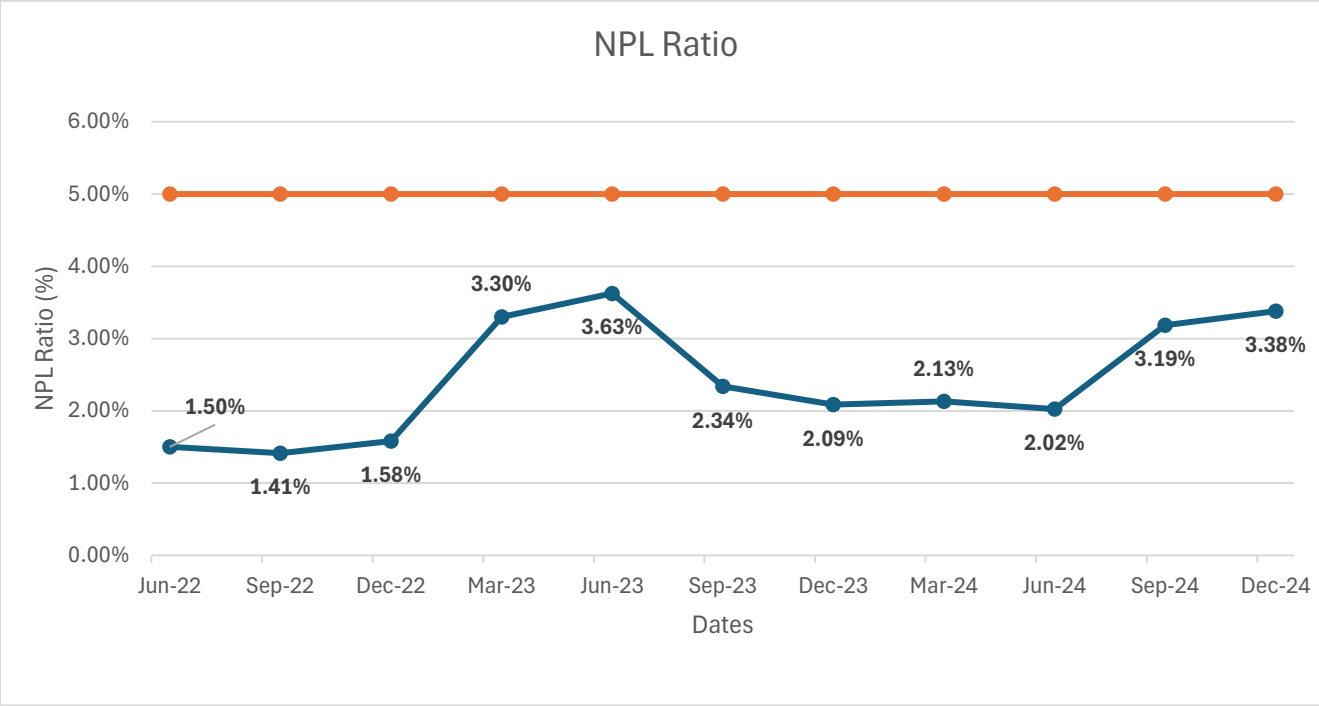
Source: The Reserve Bank of Zimbabwe.

Figure 2. Banking Sector Loans and Advances



Source: The Reserve Bank of Zimbabwe.

Figure 3. Nonperforming Loans Ratio (%)



Source: The Reserve Bank of Zimbabwe.

Annex III. Status of the Implementation of Key Recommendations

Key Recommendations	Priority	Timeline[1]	Status
1. The RBZ to finalize the draft LCR regulation: - Final revision to take into account the comments raised on the draft version of the LCR guidelines and the LCR report template; - Final revision of instructions for completing the LCR templates for public disclosure and prudential reporting to supervisors; - Additional data requirement for the implementation of the monitoring tools.	High	I	Implemented
2. The RBZ to approve new LCR regulation.	High	I	Implemented
3. The RBZ to require banks to prepare action plans to achieve compliance with new liquidity regulations and begin its implementation.	Medium	I	Implemented
4. The RBZ to monitor LCR implementation by banks, based on the steps established in their action plans.	Medium	ST	Implemented
5. The RBZ to ensure that banks report their LCR and information for the monitoring tools on regular basis.	High	ST	Implemented
6. The RBZ to ensure that banks disclose LCR and other liquidity risk information to the public.	High	MT	Regulation issued, but not yet in force
7. The RBZ to review the liquidity risk monitoring process using data from the LCR and the monitoring tools, with the following objectives: - Assure an adequate quality level on data used to monitor the banks' liquidity risk exposure. - Map the liquidity risk level of the supervised institutions, both in aggregate and by relevant currencies (domestic and US$), and monitor liquidity risk. - Identify any idiosyncratic liquidity issue in a specific bank that would lead to supervisory actions to address the problem. - Monitor the banks' liquidity level during stress periods and keep the RBZ board and relevant departments informed about the liquidity issues and vulnerabilities. - Monitor the banks' compliance with the LCR minimum requirement and take promptly actions when a bank reports a breach in the LCR. - Assess whether the LCR information banks are disclosing to the public is correct.	High	MT	Implementation in progress: (i) aggregate LCR and by currency are being monitored; (ii) validation process is implemented; (iii) plans are underway to fully implement the liquidity monitoring process

Key Recommendations	Priority	Timeline[1]	Status
8. The RBZ to approve new NSFR regulation, to ensure that banks compute and report their NSFR on regular basis, and to examine banks' compliance with established regulations.	High	MT	Advanced stage of implementation: NSFR Standard and Template are finalized and to be subjected to the RBZ Quality Assurance Process
9. Draft a new version of capital definition in line with the Basel III requirements by incorporating notable advancements in: - Prudential adjustments - Capital instruments loss-absorbing capacity (going concern) - Capital buffers	High	I	Drafted
10. Draft updates in the current capital requirement for credit risk in line with the Basel III Standardised Approach by incorporating changes in: - asset classes - concepts - risk weights	High	ST	Drafted
11. Draft new regulation on the capital requirement for operational risk in line with the Basel III Standardised Approach	Medium	ST	Drafted
12. Draft updates to the current Standardised Approach (Basel 2.5 SA) to comply with the Basel III Simplified Alternative Standardised Approach (SSA), mainly aiming to: - apply scaling factors to the risk components - prepare to incorporate capital requirements for equity and commodity risks	Medium	ST	Drafted
13. Draft updates in the definition of trading book and banking book in line with the Basel III requirements	High	ST	Drafted
14. Draft updates to the current regulation on Large Exposures, mainly aiming to: - use Tier I Capital for setting the large exposure limits - adjust the large exposures' limit requirements in line with the Basel III Framework - improve criteria for economic interdependence identification - revise the exemptions list in line with Basel III treatment for CRM Techniques and offsetting schemes	High	I	Drafted

Key Recommendations	Priority	Timeline[1]	Status
15. Draft updates to the current regulation, mainly aiming to: - Update the capital definition in line with the Basel III Framework - consider the update of the exposure measure regarding the treatment of derivatives and Securities Financing Transactions (SFTs)	Medium	ST	Drafted
16. Review the Basel II prudential reporting template structure to incorporate all changes from the updated capital regulatory framework	High	MT	Not started
17. Based on the drafts, conduct impact studies to assess banks' capacity to implement and comply with the proposed changes in capital requirements and operational limits, in order to establish an appropriate implementation strategy	High	MT	Not started

1I, immediate, with results less than 6 months; ST, short-term, with results from 6 to 12 months; MT, medium term, with results from 12 to 24 months.

Annex IV. Recalibrating Capital Requirements under Basel III Methodology - Notes for Clarification

A. Introduction

According to the Basel III Framework, banks must meet the three following requirements on an ongoing basis:

(1) Common Equity Tier 1 must be at least 4.5 percent of RWA.

(2) Tier 1 capital must be at least 6 percent of RWA.

(3) Total capital must be at least 8.0 percent of RWA.

In addition, a Common Equity Tier 1 capital conservation buffer is set at 2.5 percent of RWA for all banks. Banks may also be subject to a countercyclical capital buffer or higher loss absorbency requirements for systemically important banks.

In jurisdictions that apply standardized approaches for calculating capital requirements for credit and market risks, the RWA represents the sum of the following three elements:

(a) RWA for credit risk;

(b) RWA for market risk; and

(c) RWA for operational risk.

The approach for the calculation of RWA for credit risk, however, differs from those to market and operational, as for credit risk, Basel methodology estimates the total RWA exposures, while for the other risks, the methodologies estimate the actual capital requirement. Thus, in order to calculate the sum of the three RWA components for the calculation of total capital requirement, the amounts estimated for market and operational risks must be divided by 8 percent, which is equivalent to be multiplied by 12.5, as follows:

$$MINIMUM\ CAPITAL\ REQUIREMENT\ \geq\ RWA_{CR} * 8\% + MRC + ORC$$

$$or\ 8\%\ \leq\ \frac{TOTAL\ CAPITAL}{RWA_{CR} + {MRC}/{8\%} + {ORC}/{8\%}}, \text{ where:}$$

MRC = capital requirement for market risk

ORC = capital requirement for operational risk

Thus:

$$RWA_{MR} = {MRC}/{8\%} = 12.5 * MRC \; and \; RWA_{OR} = {ORC}/{8\%} = 12.5 * ORC$$

The same 12.5 multiplier must be applied in the calculation of all capital requirement components.

B. Increasing Minimum Capital Requirement

At national discretion, jurisdictions may require higher minimum levels of capital. Up to the Basel II environment, this would solely mean to establish a higher Capital Adequacy Ratio (CAR), for example, 12 percent. Thus, banks would be required to comply with 50 percent higher capital than "Basel" on an ongoing basis.

Basel III, however, has increased not only the number of minimum requirements a bank should comply with[39], but also the type of requirement, when implemented the concept of capital buffers[40].

Thus, jurisdictions that intend to settle higher capital requirements under the Basel III framework should carefully assess the several options the new methodology allows for, to choose the one that better fits its purposes. Besides, it must be aware of the impacts of recalibration, to avoid unintended consequences in the quality and amount of required capital.

It is important to highlight that this annex has no intent of recommending any specific or general increase in the Basel III calibration. Its intent is solely to clarify which are the existing possibilities for each purpose, as well as to warn the RBZ on eventual undesirable impacts in capital quality due to changes in the metrics' parameters.

C. Increasing "hard" and/or "soft" Capital Requirement

The first step to jurisdictions that intend to require higher levels of capital is to be sure of its objectives:

i. Gone concern: to reinforce banks' capacity to absorb losses after closing its activities, in a resolution process. In this case, the recalibration should target the "hard" capital requirements for CET1, Tier 1 and/or Total Capital. More details on this recalibration are presented in Topic 4;
ii. Going concern: to reinforce banks' capacity to absorb losses during periods of stress, without closing its activities. In this case, the recalibration should target the "soft" capital requirements, i.e. the buffers, and banks would be allowed to use the increased amount in periods of stress. For example: increasing conservation buffer requirement would reinforce the capital level of all banks, on an ongoing basis. Banks would be able to use the buffer for idiosyncratic and systemic crisis and its use would imply in restrictions to the bank's dividend distribution;

[39] Minimum requirements for CET1, Tier1 and Total Capital.

[40] The capital buffers were designed to avoid breaches of minimum capital requirements, as banks are allowed to draw down the capital buffer as losses are incurred.

Jurisdictions do not have to choose just one of the options above to target its recalibration. In fact, all of them could be applied simultaneously. The choice of what to recalibrate and in how much should be increased would depend on the jurisdiction's purposes and needs.

In the previous example, where the jurisdiction intent was to raise the capital minimum requirement in 50 percent, which represents an increase of 4 percent capital in nominal amounts, the recalibration could be settled with infinite combinations. Table 3 exemplifies a few possible combinations, among "hard" and "soft" capital modalities:

Table 3. Recalibration Alternatives for an Increase of 4 percent in Capital Requirements

		Recalibration Alternatives for an increase of 4% in Capital Requierements		
Capital Requirement Components	Basel III Ratios	Total Capital (a)	Conservation Buffer (b)	Blended (c)
Total Capital	8%	**12%**	8%	**10%**
Conservation Buffer	2.50%	2.50%	**6.50%**	**4.50%**
Total Requirement	10.50%	**14.50%**	**14.50%**	**14.50%**

All alternatives represent an increase of 4 percent in total capital requirement. The consequences of each alternative, however, would vary as follows:

(a) The increased amount represents a 4 percent increase in the "hard" capital requirement, which must be complied by banks on an ongoing basis, with no possibility of using it in moments of stress;
(b) The increased amount represents a 4 percent increase in the "soft" capital requirement, which must be complied by banks on an ongoing basis, with the possibility of using it in moments of stress, with restrictions in dividends distribution;
(c) The 4 percent increased amount is distributed among the "hard" and "soft" requirements and the consequences described in (a) and (b) shall occur proportionally and simultaneously.

D. Impacts of Recalibration in the Quality of Capital Composition and in the Compliance with the Prudential Limits

For the assessment of the impact of recalibration in the quality of capital composition, this topic will explore the alternative (a) presented in Table 3, which represents a 4 percent increase in Total Capital.

Considering the three hard limits of capital minimum requirement proposed in Basel III Framework, a recalibration from 8 percent to 12 percent total capital can be settled in different ways, according to the intent of the jurisdiction, as presented in Table 4:

Table 4. Impacts of Recalibration in the Quality of Capital Composition

Capital Requirement	Basel III Ratios	Total Capital (a)	Total Tier 1 (b)	CET1 (c)	Blended (d)
CET1	4.5%	4.5%	4.5%	**8.5%**	**6.5%**
Additional Tier 1	1.5%	1.5%	5.5%	1.5%	2.5%
Total Tier 1	6.0%	**6.0%**	**10.0%**	**10.0%**	**9.0%**
Tier 2	2.0%	6.0%	2.0%	2.0%	3.0%
Total Capital	8.0%	**12.0%**	**12.0%**	**12.0%**	**12.0%**

A single 4 percent increase in the minimum requirement of total capital (option (a): minimum of 12 percent Total Capital) means that the jurisdiction allows banks to increase the amount of (lowest quality) Tier 2 capital in 4 percent. Should the increase be applied to the Tier 1 limit (option (b): minimum of 10 percent Tier 1), banks would be allowed to increase capital with Additional Tier 1 instruments and the Total Capital minimum requirement would have to be adjusted to 12 percent. An increase in the (highest quality) CET1 limit (option (c): minimum of 8.5 percent CET1) would require banks to raise capital with CET1 instruments and the other two limits would have to be adjusted (Tier1 = 10 percent and Total Capital = 12 percent). Recalibrating simultaneously the three ratios (Option (d)), would imply in the above-mentioned consequences simultaneous and proportionally, and the interdependence of the ratios should be respected (Total Capital ratio >= Tier 1 ratio >= CET1 ratio).

Thus, the decision of recalibrating the capital ratios should consider the capital quality composition that would be optimal and viable to the jurisdiction. It would depend on the capital instruments existing in the financial environment and which ones the regulator intends to encourage banks to hold as capital.

Finally, it is important to highlight that an increase in Tier 1 capital minimum requirement, as observed in alternatives (b), (c) and (d) of Table 4, eases banks compliance with the prudential limits. Both metrics (LEX and LR) use Tier 1 as capital reference. Thus, an increase in Tier 1 capital represents similar increase in those limits.

E. Impacts of Recalibrating RWA Components in the Capital Requirements

This topic will explore the impacts of recalibrating the RWA components in the capital requirements amounts. For this purpose, the same example of an intended increase in 12 percent Total Capital will be used.

The capital minimum requirements according to Basel III Framework can be written as:

$$(1) \qquad 4.5\% = \frac{CET1}{RWA_{CR}+RWA_{MR}+RWA_{OR}} = \frac{CET1}{RWA_{CR}+{}^{MRC}/_{8\%}+{}^{ORC}/_{8\%}}$$

$$(2) \qquad 6.0\% = \frac{Tier\ 1}{RWA_{CR}+RWA_{MR}+RWA_{OR}} = \frac{Tier\ 1}{RWA_{CR}+{}^{MRC}/_{8\%}+{}^{ORC}/_{8\%}}$$

$$(3) \qquad 8.0\% = \frac{Total\ Capital}{RWA_{CR}+RWA_{MR}+RWA_{OR}} = \frac{Total\ Capital}{RWA_{CR}+{}^{MRC}/_{8\%}+{}^{ORC}/_{8\%}}$$

The example in Table 5 considers the capital requirements to credit risk, market risk and operational risk equal to 100 each (which would be equivalent to a RWA_{CR} equal to 1250 according to Basel III

calibration, as CRC = RWA_{CR} * 8%). The total RWA equals 3750, which is equivalent to a total capital amount of 300:

Table 5. Total Capital Requirement Calculation – Basel III Calibration

	Basel III Ratio (CR/ Total RWA)	RWA	Capital Requirement (CR)	RWA or RWA Equivalent (CR/8%)
Credit Risk		1250		1250
Market Risk			100	1250
Operational Risk			100	1250
Total RWA				**3750**
Total Capital	8.0%			***300***
Tier 1	6.0%			225
CET1	4.5%			169
Conservation Buffer	2.5%			***94***
Total Capital Requirement (Total Capital + Conservation Buffer)				**394**

To recalibrate Total Capital to 12 percent, it would be expected the adjustments of RWA for market and operational risk accordingly, which would mean dividing the respective capital requirements by 12 percent. The rational for those adjustments is that MCR and OCR are already the capital requirements themselves and would need to be divided by the capital ratio in order to estimate the total RWA (the formula's denominator).

However, Table 5 shows the impact of those adjustments in the calculation of the other capital ratios, if the same adjusted total RWA were used to estimate them:

Table 6. Impact of Recalibration in the Capital Ratios

	Recalibrated Ratio (CR/ Total RWA)	RWA	Capital Requirement (CR)	(a) RWA or RWA Equivalent (CR/8%)		(b) RWA or RWA Equivalent (CR/12%)	
Credit Risk		1250		1250		1250	
Market Risk			100	1250		833	
Operational Risk			100	1250		833	
Total RWA				**3750**	**% Increase**	**2917**	**% Increase**
Total Capital	**12.0%**			***450***	50%	***350***	17%
Tier 1	6.0%			225	0%	175	-22%
CET1	4.5%			169	0%	131	-22%
Conservation Buffer	2.5%			***94***	0%	***73***	-22%
Total Capital Requirement (Total Capital + Conservation Buffer)				**544**	**38%**	**423**	**7%**

In alternative (a), the increase in total capital ratio of 12% does not impact the factor used to estimate RWA_{MR} and RWA_{OR}. Therefore, the increase in the amount of total capital (50 percent) equals to the increase settled in the ratio (50 percent). It is important to highlight that the other capital ratios (Tier 1, CET1 and conservation buffer), which have not been recalibrated, were not impacted and continued to require the same amount of capital as before.

Alternative (b), however, adjusts the factors applied for the calculation of MRC and ORC. Thus, RWA for those components reduce from 1250 to 833. Thus, the 50 percent increase in total capital affects only the component for credit risk, resulting in an amount of 350 capital (instead of 450 in alternative (a)), which, in this example, represents a real increase of 17 percent of total capital, not 50 percent as expected by the ratio's increase.

The main issue of the adjustment in MRC and ORC factors, however, is regarding its use in capital requirements where capital ratios were not recalibrated. In those cases, they will, in fact, provoke a reduction in the minimum requirement, proportional to the relevance of market and operational risks' components in the total RWA calculation[41]. In the example of alternative (b), where CRC, MRC and ORC are equivalent (each of them is equal to 100), a reduction of 22 percent is observed in Tier 1, CET1 and Conservation Buffer, when compared to the Basel III calibration of 8 percent total capital.

It is important to highlight that in both alternatives ((a) and (b)) of Table 5, no recalibration of the MRC or the ORC was considered. If that were the case, the RBZ should be aware of its impact in the calculation of all capital ratios and ensure that the results really reflect the regulator's intentions.

[41] The capital requirement reduction will be proportional to the relevance of MRC and ORC components in the calculation of total RWA. The more relevant they are, the higher will be the reduction in the requirement of non-calibrated ratios (same ratio as Basel III).

Annex V. Responsibilities of the RBZ's BSSFSD

BSSFSD staff is composed by 47 employees. Their responsibilities comprehend:

1. Supervision of Banks & Sustainable Finance
- Risk based on-site examinations and off-site surveillance of banks;
- Promotion of sustainable standards in the banking sector;
- Recommending corrective actions on distressed and/or non-compliant institutions.

2. Supervision of Banks & Financial Conglomerates
- Risk based on site examinations and off-site surveillance of banking institutions with a particular focus on banking groups;
- Cross border supervision;
- Recommending corrective actions on distressed and/or non-compliant institutions.

3. Financial Stability, Policy Research and Resolution (4 people)
- Financial stability assessments (quarterly- under auspices of Multidisciplinary Financial Stability Committee) and annual financial stability reports;
- Conduct banking sector stress tests, ICAAP assessments, model risk reviews;
- Development of prudential standards, frameworks, and guidelines;
- **Implementation of Basel standards – LCR, NSFR, Capital framework;**
- Resolution of distressed/unviable banks, as well as research on topical issues.

4. Financial Inclusion, Licensing & supervision of Microfinance Institutions, SACCOs & development Finance Institutions and Market Conduct Supervision
- Licensing and ongoing supervision of deposit taking (prudential) and credit only (no-prudential microfinance institutions, as well as development finance institutions;
- Driving national financial inclusion strategy, including financial literacy programs;
- Market conduct supervision including consumer protection issues.

5. MIS, Credit & Collateral Registries
- Management of divisional information management system to facilitate ongoing assessments of condition and performance of supervised entities;
- Management of credit and collateral registries to facilitate credit risk management enhancement and promotion of financial inclusion.

6. Legal, Compliance & Enforcement
- Development and Review of legal and regulatory frameworks;
- Enforcement of banking law and regulations.

7. AML/CFT Supervision
- AML/CFT/CPF supervision of banks and microfinance institutions;
- AML/CFT/CPF National Risk Assessment, development of AML/CFT framework.