

BASEL III IN FUNCTION OF INCREASING THE SHAREHOLDERS CAPITAL

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Abstract

The purpose of this study is to present how the Basel III capital agreement standards are fulfilled by the Macedonian commercial banks, according to the banking regulation. This study made analysis of the three biggest banks in the Macedonian banking system, how they cover the obligation about an adequate level of capital necessary for covering the credit risk, the currency risk and the market risks.

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Introduction

The Macedonian banking system in the first half of 2017 with a capital adequacy ratio of two digits ranges from 12.6% to 20% and fully meets the Basel III capital agreement standards. The main goal of the new capital agreement is introducing reforms in order to increase the level and quality of the bank's own assets.

More than a decade ago, or more precisely in 1998, the US Federal Reserve Authority and representatives of other leading countries in the world made an agreement on the new standards of the banking capital. Actually, this agreement is called the **Basel Accords**, as a landmark of the city of Basel, in Switzerland where the agreement is signed. Starting from that moment, the new Basel standards are applied as unified in all banking institutions of the signatory countries, including our country. According to that, the original Basel standards in function of the bank capital today are known as **Basel I**, and the same impose the need for its diversification according to the sources. In addition, contrary to Basel I, when the same risk weight rate for each category in the assets of the balance sheet was applied, with the application of **Basel II**, when calculating the risk-weighted assets according to the degree of risk, elements ranking is performed, more precisely, loans are ranked according to their rating, where different weights are applied for each different category of loans.

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Basel III in function

As we know, today, in order to make a proper assessment of the capital adequacy, banks are obliged to quantify the risks in the structure of assets, and especially the credit risk. Therefore, we say that the bank is obliged to have an adequate level of capital necessary for covering the credit risk, the currency risk and the market risks. According to the banking regulation, the capital needed for covering the risks is required to be equal or higher than 8% of the risk weighted assets. On the contrary, the regulation says that the risk weighted assets have to be equal or higher than 12.5% from the capital needed for risk coverage.

The audited financial statements of the three largest commercial banks in the Macedonian banking system show the following two things:

(1) the participation of the capital in relation to the assets is significantly higher than the minimum required capital adequacy ratio, which the bank is obliged to satisfactorily maintain on at least 8%;

(2) show mutual differences regarding their share of capital in relation to the assets (capital adequacy);

Table 1: Capital adequacy ratio in the three largest banks from the banking system of the Republic of Macedonia for 2010.

“Komercijana banka”	Capital Adequacy Ratio (in%)	Period
“Stopanska banka” JSC Skopje	17,81%	31.12.2010
“NLB Tutunska banka” JSC Skopje	13,20%	31.12.2010
“Komercijalna banka” JSC Skopje	11,05%	31.12.2010

Source: Audited Financial Statements for 2010, (www.stb.com.mk; www.nlbtd.com.mk; www.kb.com.mk, June 30, 2011.)

In relation to such data from the table, the following questions arise:

- What is the significance of the capital in the banking overall?
- What is the structure of the sources of the banking capital?
- How is the rate of capital adequacy calculated?

As we know, the capital is one of the necessary resources for the functioning of an organizations. The absence of a sufficient amount of capital is a limiting factor for the banking activities, and therefore, limited capital represents a brake for greater profitability i.e. maximizing the market value of the bank. Hence, it can be said that the efficient functioning and the stability of a bank are in direct dependence on the size and suitability of its capital.

When talking about the capital, we need to make a clear distinction between the banking capital and the capital in the non-banking institutions. Unlike other non-banking organizations in the society, where the need for capital is significantly higher, in the case of the banks and other financial institutions related to financial services, the capital need is significantly low. As a matter of fact, the reason for this, should be found in the fact that the

banks have a low leverage which indicates that the share of capital in the total assets of the bank is very low. This is supported by point 3 of the National Bank of Republic of Macedonia (NBRM) Decision^{*}, which reads: **"The bank is obliged to continuously maintain a capital adequacy ratio that can not be lower than 8%."** (Official Gazette of RM no. 159/2007, p.18) In other words, the share of capital in the total assets of the bank should not be lower than 8%.

1. IMPROVEMENT THE QUALITY OF THE CORE CAPITAL, THE GOAL OF THE NEW BASELICAL STANDARDS

The new Basel Capital Accord aims to reform the capital framework in the banks by imposing higher standards in the function of the quality of the banks' own funds structure by increasing the level and participation of the core elements of Tier 1 capital (core capital). Actually, with this proposed reform of the meeting of the Central Bank Governors Group and managers of supervisory bodies held on September 12, 2010 in Basel, the most significant changes can be divided into two groups of activities as the following: increasing the required level of capital from one side, and the introduction of an international liquidity standard, on the other side.

One thing is clear: the new capital agreement strengthens the standards of capital adequacy. According to this, it can be concluded that the Macedonian banking system in the first half of 2014, with a capital adequacy ratio of 16.9%, fully meets the Basel III capital adequacy standards. In the context of this analysis, the NBRM says: "the Macedonian legislation monitors the changes and according to this the principles of Basel III will be implemented in the banking regulation". Furthermore, the National Bank adds that the changes in the international regulatory framework that were translated into the Basel III concept, which has the strengthening of the resilience of the banking system, through a higher regulatory capital adequacy ratio and regulatory certain coefficients of liquidity, will cause changes in the banking environment in our country.

Macedonian banks, both before and after the crisis, show a constant capital adequacy ratio greater than the one prescribed by Basel III. The capital adequacy ratio at the level of the entire banking system of the Republic of Macedonia, according to the NBRM data in 2008, before the beginning of the financial crisis equals 16.2%, while after the crisis in 2013, it is slightly more or 16.8% . Such continuity in maintaining a high capital adequacy ratio (well above 8% in accordance with the prescribed NBRM regulation) remains in the first half of the current year and equals 16.9%.

2. SMALL BANKS WITH THE LARGEST FALL OF CAPITAL ADEQUACY RATE

Actually, if the analysis goes even further, it will be concluded that the small banks have the largest fall in the percentage of the capital adequacy. Such a fall in the percentage moves with accelerated dynamics from too high 61.9% in 2008 to 14.9% in the first half of 2014, so it is expected that the same percentage of the first half of the year (maybe a little reduced) to end the current year . The situation with the large banks remained unchanged, practically they showed a positive continuity of the rate of 13.4% before the crisis to 16.0% in the first half of

2014, indicating that they are immune to the big cyclical changes in the financial markets and of course, it is a good indicator of the whole banking system. The medium-size banks show the most satisfactory results in terms of the capital adequacy ratio. Practically, they have the best percentage of 19.1% in the current year, which can certainly be like this due to the larger entry of foreign capital through the purchase of some medium-sized banks by major international banking brands.

Group	31.12.2008	31.12.2009	31.12.2010	31.12.2011	31.12.2012	31.12.2013	30.6.2014
Large banks	13.4%	13.8%	14.1%	15.0%	15.3%	15.8%	16.0%
Medium-size banks	16.7%	17.4%	17.0%	17.2%	22.2%	18.8%	19.1%
Small banks	61.9%	48.1%	54.7%	38.6%	18.8%	17.6%	14.9%
Bank system	16.2%	16.4%	16.1%	16.8%	17.1%	16.8%	16.9%

Source: NBRM, from

http://www.nbrm.mk/podatotsi_i_pokazатели_za_bankarskiot_sistiem_na_riepublika_makiedonija.nsp

Therefore, as a common feature of the banking system as a whole, it can be said that it is resistant to cyclical market flows from one side, and shows a capital adequacy ratio that can respond to the new capital regulations prescribed by the new Basel III capital agreement. This is so, if we take into consideration the fact that the fundamental goal of the reform of the new capital framework integrated in Basel III is to put a greater focus on equity, i.e. ordinary shares and retained earnings, rather than on the instruments with debt characteristics and lower quality. Essentially, this means that with the new Basel III rules, in the future, the minimum relation between the equity and risk weighted assets increases from the current 2% to 4.5%. Furthermore, the increase in this ratio will be followed by an increase in the core capital ratio (Tier 1) from 4% to 6%, while the total capital adequacy ratio will remain the same or 8%.

$\text{CAR} = \frac{\text{Core capital} + (\text{Additional capital I} + \text{Additional capital II})}{\text{Risk weighted assets}}$
<p>CAR - capital adequacy ratio Tier 1 capital - core capital Tier 2 capital - additional capital I and additional capital II</p>

3. GOOD "IMAGE" ON STABILITY DAMAGE

In addition, the new regulations foreseen with the implementation of Basel III include **additional amounts of required capital**, which represent an exceptional importance for mentioning. In fact, such additional amounts are comprised only of equity capital, which is tied in Tier 1, and the requirements of Basel are exactly this equity capital to be at least 2.5%

of the risk weighted assets. According to the members of the Basel Committee for Banking Supervision, this additional amount of capital is introduced as a result of the weaknesses in the banks' operations determined during the financial crisis. Such a statement of the committee is right, if it is known that during the crisis, certain commercial banks, which have achieved rates of adequacy far above the prescribed minimum, instead of retaining the profits that would achieve an increase in their capital, they continued to pay dividends, in order to leave a stronger impression on the public. But what has been achieved with it? Good "image" but stability damage?

The second type of additional capital according to the Basel Committee is called **countercyclical**. Actually, it can range from 0 to 2.5% depending on the conditions in the Macedonian Banking System, for which NBRM decides about its amount or inclusion as a percentage of the risk weighted assets. In this context, it is important to emphasize that this type of equity is not mandatory and the banks will not be obliged to allocate this type of additional capital throughout the entire economic cycle (as is the case with the previous one). This means the inclusion of a macro-prudential dimension in the capital framework, so that the banks will be able to use it in case of crisis i.e. in those conditions, the national supervisor abolishes the obligation to fulfill the required level of countercyclical capital.

4. CROATIAN BANKS UNDER HUGE ATTACK

Basel is a regulation that has began to apply in the European countries from January 1st, 2014. Croatia's experience shows that with its application, banks are under great pressure in their operation and can feel the changes. Therefore, good preparation and the ability to respond to changes are necessary. The regulation is applied for less than six months, it is sure that it will bring about a new tightening of the banking regulation. Prof. PhD. Ivan Shverko, from Croatian Bank "Croatia banka", said: "that it would mean demanding a higher level of capital, with higher operational costs. "Actually, the thing that will happen to the banking sector is that it will be more burdened, there will be less profit than now and the thing, unfortunately, about which our komittents should be aware of, is that loans to individuals and legal entities, will increase in price, "(personal communication, 2014). It is important to say that in the European Commission, just because the European crisis has not ended yet, they are trying to postpone it. They are trying to get a regulation that will be countercyclic rather than pro-cyclical, i.e. this regulation to come into force on the date we get out of the economic crisis. But it is uncertain whether it will succeed in doing so. According to the estimations of Croatian bankers, what is good for Macedonia is that currently, our country, is not a member of the European Union, so this regulation should not be applied. "But it would be a huge impact. What is happening now in Croatia is a huge impact to the operation of the banks and growth in the prices of the loans. In your country, this will happen later. Honestly, it may be better now to enjoy the times until that happens, "Shverko notes"(personal communication, 2014).

CONCLUDING OBSERVATIONS

1. Capital adequacy ratio from a minimum of 10.5% to a maximum of 13% The core capital (Tier 1) increases from 4% to 6%, so that with the new standards, its minimum will be 6%, so now when the additional amount for capital saving will be added to that from 2.5%,

it will reach it up to **8.5%**. As a matter of fact, its maximum can reach up to **11%**, if the NBRM implements the request for the allocation of the countercyclical capital.

2. The share capital, according to Basel III standards, should be at least 7% in relation to risk weighted assets, and mostly **9.5%** if the NBRM implements the maximum amount of countercyclical capital in the future.

3. Total equity (own funds) according to the new regulations should reach at least **10.5%** of the risk weighted assets.

4. The capital adequacy ratio, although it is not changed by the reforms at the beginning (remaining at least 8%), however, with the introduction of additional amounts of required capital, this rate is increased by at least 2.5%, and mostly for 5%.

The regional banking experiences show that Basel III brings changes in banking, which make the banking operations more difficult. According to the Croatian experiences, this regulation is a huge impact to the banking sector. Bearing in mind the fact that banks are still facing the consequences of the crisis, with bad placements and slow payment of the requests. These experiences can really help the Macedonian banking sector, to be prepared for the changes and all implications that may arise. In the context of such claims of the regional banking authorities, in our country, the NBRM will point out: "Macedonian legislation is constantly following the world practices and compliance with the international regulatory framework, and therefore the changes caused by Basel III will be incorporated into the domestic regulations, too. Sure, the process will go gradually. "

TIMETABLE FOR INTRODUCING THE REFORMS

The process of applying the new requirements for the amount of its own assets were launched at the beginning of 2013, until each Basel Committee member was to make appropriate changes of the national legal framework. The increase in the level of required share capital and the required core capital will be implemented gradually in several phases that will be completed by the beginning of 2015. The introduction of the additional amount for the preservation of the capital will begin in 2016 and will end on January 1st, 2019, where it is anticipated to increase this amount by 0.625% every year. With the gradual increase in this type of capital, the total amount of the required capital will increase from 8% to 10.5%. In the period of ten years, starting from 01.01.2013, the instruments that can not be part of all other elements of their own assets, with the exception of the share capital, will be gradually excluded.

The supervisory bodies of the NBRM have the right to predict shorter deadlines for applying the new standards if they deem it necessary taking into account the movements in our banking and financial system. As a matter of fact, according to the supervisors, only the banks that fulfill the requirements for the minimum capital adequacy ratio are obliged to follow the dynamics, but they are below the minimum of 7% for the share capital and the additional amount for the preservation of the capital.

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