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TECHNICAL ASSISTANCE REPORT – FSSR FOLLOW UP TECHNICAL ASSISTANCE—IMPLEMENTATION OF THE BASEL II/III CAPITAL FRAMEWORK

October 2023

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TECHNICAL ASSISTANCE REPORT

ZIMBABWE

FSSR Follow Up Technical Assistance—Implementation of the Basel II/III Capital Framework

August 2023

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GLOSSARY

AFRITAC	Africa Regional Technical Assistance Center
AMA	Advanced Measurement Approaches
ASA	Alternative Standardised Approach
BI	Business Indicator
BSD	Banking Supervision Division
CEM	Current Exposure Method
CET1	Common Equity Tier 1
CRM	Credit Risk Mitigation
ECAI	External Credit Assessment Institution
FC	Financial Component
FSSR	Financial Sector Stability Review
FX risk	Foreign Exchange risk
IDLC	Interest, Leases and Dividend Component
IMM	Internal Model Method
ILM	Internal Loss Multiplier
IMF	International Monetary Fund
LEG	IMF's Legal Department
MCM	IMF's Monetary and Capital Markets Department
NPL	Nonperforming Loan
P&L	Profits and Losses
QIS	Quantitative Impact Study
RBZ	Reserve Bank of Zimbabwe

RW	Risk Weight
RWA	Risk Weight Asset
SC	Services Component
SCRA	Standardized Credit Risk Assessment Approach
SFT	Securities Financing Transactions
SME	Small and Medium Enterprises
SRS	Supervisory Rating Scale
SSA	Simplified Alternative Standardized Approach
TA	Technical Assistance
TB-BB	Trading Book – Banking Book

PREFACE

At the request of the Reserve Bank of Zimbabwe (RBZ), the Monetary and Capital Markets (MCM) Department conducted a virtual mission from May 8 to 19, 2023 to assist the RBZ on implementing Basel II/III capital framework. The focus of this TA was to assist the RBZ banking supervisors on updating the capital framework with particular focus on standardised approaches for credit, operational and market risks, capital definition, leverage ratio, large exposures, and capital conservation buffer.

The mission had virtual meetings with Mr. Philip Madamombe, Director of the RBZ Banking Supervision Division (BSD); Mr. Ruzayi Chiviri; Mrs. Norah Mukura; Mrs. Rachel Mushosho; Mrs. Susan Kabungaidze; Mrs. Violet Ndoro (all the RBZ Deputy Directors of the BSD); and supervisors responsible for the implementation of Basel III capital framework.

The mission team would like to express its gratitude to the RBZ and its staff, particularly to Mr. Philip Madamombe, Mr. Ruzayi Chiviri, Ms. Norah Mukura, and Dr. Jeremiah Borerwe, for the excellent arrangements made to facilitate the work, as well as for their openness, productive discussions, and excellent cooperation.

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 remote TA mission supported the RBZ on updating regulations to the Basel III capital framework. The mission reviewed Zimbabwe's capital framework (laws, guidelines, and templates of prudential returns), identified areas to update capital requirements, discussed these areas with the management of the RBZ, and provided recommendations for drafting amendments in line with the Basel II/III framework approaches assessed as the most suitable to the Zimbabwean financial market characteristics.

The RBZ should update its current capital regulations in line with the Basel II/III framework. Some of the areas which require updates are the capital definition; the standardised approaches for credit, operational, and market risks; as well as the reviews of large exposures and leverage ratio frameworks. It was agreed with the RBZ that next TA mission (around November 2023) will review draft regulations, support the RBZ in elaborating a questionnaire for an impact study, and develop the supervisory reporting templates under the new regulatory framework,

Currently, all banks use standardised approaches for calculating risk-based capital requirements in Zimbabwe. Zimbabwe's capital framework (2011)[1] provides guidance for the use of standardised and internal model approaches for the calculation of credit, operational, and market risks, conditioning the use of internal model approaches to supervisory approval. However, there are no banks using internal models to calculate capital requirements in Zimbabwe.

The increased granularity and risk-sensitivity introduced in the Standardised Approach of Basel III could be a useful approach for calculating capital requirements for credit risk in Zimbabwe. Zimbabwe has been calculating Risk Weighted Asset (RWA) for credit risk based on Basel I requirements. Since 2012, the RBZ has been conducting a parallel run of banks' capital calculations based on a modified Basel II standardised approach for credit risk. Due to the absence of external credit rating agencies to cover credit exposure, the RBZ has implemented a modified standardised approach based on a Supervisory Rating Scale (SRS), which is a proxy for external credit ratings and guides the risk weight (RW) allocation for some exposures. In view of the increased granularity and risk-sensitivity now available in the Basel III Capital Framework, as well as the removal of mechanistic dependence on external ratings, the RBZ should consider implementing the standardised approach for credit risk.

The implementation of the Basel III Standardised Approach for the calculation of capital requirement for operational risk requires some adjustments in banks' data collection process. Currently, the RBZ regulation follows the Basel II Alternative Standardised Approach (ASA), which segregates retail and commercial banking based on the gross loans and the other business lines based on the adjusted gross income approach. Under the new Basel III

[1] Guideline No: 1-2011/BSD Technical Guidance on the Implementation of the Revised Capital Adequacy Framework in Zimbabwe.

Standardised Approach, the business lines were replaced by a Business Indicator (BI). The data to be captured for the calculation of the BI components may require some system and process changes at banks to ensure appropriate data collection for the calculation of capital requirements for operational risk.

In order to implement Basel III capital requirements for market risk, the RBZ should focus on improvement of the trading book identification criteria and a few updates necessary to move to the Simplified Alternative Standardized Approach (SSA). The RBZ regulation for the calculation of capital requirements for market risk follows the Basel 2.5 Standardised Approach (2009). The Basel III capital requirement for market risk allows the use of a SSA, an updated version of Basel 2.5 Standardised Approach, for banks with smaller or simpler trading books.[2] Additionally, Basel III has established new specifications and enhancements to limit regulatory arbitrage in the definition of the boundary between trading and banking books.

The RBZ's regulation on Large Exposures assesses the exposures in relation to total capital. The RBZ regulation established limits of 25 percent and 75 percent for single and group exposures, respectively, in relation to total capital base. It is recommended that he RBZ utilize Tier 1 capital as the reference parameter and set large exposure limits in line with the Basel III large exposure framework.

The leverage ratio requirement in Zimbabwe is designed similarly to Basel III. Exposures (ratio's denominator) comprise total assets and include off-balance sheet items. However, the ratio's numerator (Tier 1 Capital) is aligned with capital definition of Basel II and the prudential adjustments applied to it does not impact the denominator (exposures). This conservative approach can become a relevant issue when Basel III capital definition is implemented, depending on the significance of the prudential adjustments. Additionally, there is no special treatment for derivative and securities financing transactions (SFT) exposures as proposed by Basel III, although these elements can be irrelevant for the financial system.

The RBZ should conduct impact studies to facilitate assessment of the transition to Basel III capital requirements. This will further help BSD to identify eventual calibration needs, and to establish implementation timelines as well. Subsequently, the RBZ should develop the final supervisory reporting templates under the new regulatory framework.

[2] In Zimbabwe, the highest market risk concentration is in FX risk (banks' foreign currency holdings). Securities trading markets are not developed and banks are not ordinarily allowed to hold exposures in equities and commodities.

Table 1. Zimbabwe: Key Recommendations

Key Recommendations		Priority	Timeline[1]
1. Capital Calculation, Definition and Capital Buffers	1.1 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
2. Capital Requirement for Credit Risk	2.1 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
3. Capital Requirement for Operational Risk	3.1 Draft new regulation on the capital requirement for operational risk in line with the Basel III Standardised Approach	Medium	ST
4. Capital Requirement for Market Risk	4.1 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
	4.2 Draft updates in the definition of trading book and banking book in line with the Basel III requirements	High	ST
5. Large Exposures	5.1 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
6. Leverage Ratio	6.1 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	Medium	ST
7. Reporting Templates	7.1 Review the BSD1 prudential reporting template structure to incorporate all changes from the updated capital regulatory framework	High	MT
8. Impact Studies	8.1 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[3]

[1] I - immediate, up to 6 months; ST, short-term, 6 to 12 months; MT, medium-term, 12 to 24 months

[3] The timeline for the elaboration of impact studies should follow the priority recommended to each drafted topic.

I. Introduction

1. MCM conducted a virtual mission from May 8 to 19, 2023 to assist the RBZ in reviewing and updating its regulations to the Basel II/III capital framework. The mission held numerous virtual meetings with management and supervisors of the BSD. The mission presented an overview of Basel II/III capital framework to all supervisors of the RBZ BSD.

2. The FSSR, which was conducted in November 2018, identified areas requiring improvement and TA in Zimbabwe's banking supervision, resolution, and crisis-management arrangements. In the specific area of prudential regulation and supervision, the main gaps were in: (i) the legislative framework; (ii) risk-based supervision; (iii) Basel II/III implementation; and (iv) consolidated supervision. A FSSR follow up TA roadmap was agreed with the authorities to address the areas of priority. Subsequently, in May 2019, the RBZ requested TA to support implementation of the required reforms.

3. As part of the initiatives to assist the authorities in eliminating gaps in the regulatory framework and strengthening of risk-based supervision, several TA missions have been undertaken. In 2019, the IMF provided joint LEG/MCM TA to assist the RBZ in the enhancement of the RBZ Act, Banking Act, etc. In 2019–20, the IMF provided two TAs on strengthening risk-based supervision. In 2020–22, three TA remote missions supported the RBZ in implementing Basel III liquidity standards and consolidated supervision. In 2021–22, Africa Regional TA Center (AFRITAC) South also delivered two virtual TAs on remote examination and off-site supervision. All these missions have taken into consideration the RBZ's priorities and needs against the background of the challenging macroeconomic circumstances.

4. The FSSR report highlighted the importance of strengthening capital framework in Zimbabwe. The RBZ is currently assessing banks' capital requirements against the Basel I credit regime and the Basel 2.5 market-risk amendment framework, with additional capital also being held for operational risk using the Basel II Framework methodology. Additionally, the RBZ has been conducting a parallel run of banks' capital calculations based on a modified Basel approach for credit risk since 2012. With the IMF support, the RBZ is planning to implement Basel II/III capital requirements considering Zimbabwe's particularities and using proportionality.

5. This report is divided into four sections. After this introductory section, Section II provides an overview of the banking sector, Section III presents the status of capital framework in Zimbabwe, and Section IV discusses the TA recommendations for updating and implementing the Basel II/III capital framework.

II. Banking Sector Overview

6. The banking sector consists of 14 commercial banks, 3 building societies, and 1 savings bank that, in total, account for 36 percent of GDP as of end- March 2023. Of the current 18 banking institutions, 8 have foreign control, with a market share of 57.5 percent.

Other banks are local, including banks in part of wholly state-owned (the structure of the banking sector and its indicators are presented in Appendices I and II).

7. The Zimbabwean banking sector engages in traditional banking activities of financial intermediation, deposit acceptance, and lending (Appendix II Figures 13–14). Banking sector assets are mainly in the form loans and advances, balances with the RBZ, and securities and investments. Derivatives such as swaps and futures are not a common feature of the market, and banks are not allowed to trade in equities and commodities in the normal course of business. Liabilities are largely comprised of deposits (54.1 percent), and capital and reserves (17.3 percent).

III. Capital Framework in Zimbabwe

A. Capital Definition and Capital Buffers

8. The Zimbabwe's capital definition is in line with Basel II requirements. According to section 3.2 of the Guideline No: 1-2011/BSD, total capital corresponds to the sum of Tier 1 and Tier 2 capital with necessary deductions (Appendix III).

9. Zimbabwe's scope of application of the prudential framework is on a consolidated basis and the RBZ is seeking to move forward with implementation of its regulations.[4] The Basel III and RBZ's frameworks[5] consider that relevant financial activities should be captured through consolidation, including securities firms (similar regulation), leasing, credit cards, portfolio management, investment advisory, custodial services, and ancillary activities to the business of banking.

10. Zimbabwe's minimum required capital ratios are higher than those prescribed by Basel II and include a capital buffer for domestic systemically important banking institutions (D-SIBs). In Zimbabwe, the Tier 1 and Total Capital ratios are 8 percent and 12 percent,[6] respectively, which are higher than the Basel II requirement of 4 percent and 8 percent.

[4] Zimbabwe: Technical Assistance Report—Financial Sector Stability Review Consolidated Supervision (2022). Paragraph 11: "…Although the Guidelines prescribe minimum prudential requirements (e.g., capital ratio, large exposures) on a consolidated basis, the consolidated ratios and exposures in the CS-1 report are not subject to analysis" (https://www.imf.org/en/Publications/CR/Issues/2022/12/19/Zimbabwe-Technical-Assistance-Report-Financial-Sector-Stability-Review-Consolidated-527110). Guideline n° 002-2007/BSD states that the consolidated supervision framework shall apply to every banking institution, bank holding company, financial conglomerate, mixed activity group. Additionally, it defines "financial conglomerate" any group of companies under common control whose exclusive or predominant activities consist of providing significant services in at least two financial services sectors. Financial services sector encompass the banking, insurance and securities sectors, including asset management companies and microfinance institutions.

[5] Sections SCO10 e SCO30 (https://www.bis.org/basel_framework/standard/SCO.htm).

[6] RBZ 2012 Mid-Term Monetary Policy Statemen, Section 6.4.

For D-SIBs, the additional capital buffer[7] of 1–3.5 percent of total RWA should be fulfilled with Tier 1.

B. Calculation of RWA for Credit Risk

11. The RBZ has developed a modified standardized approach for credit risk calculation,[8] in which the exposure classifications and definitions are broadly in line with Basel II Framework. The RBZ's asset classes and exposures definition follow the Basel II Framework definition, as well as credit risk mitigation (CRM). However, the risk-weights applied to the exposures for the calculation of capital requirements to credit risk are based on proxies of external credit ratings (Table 3) developed by the RBZ.[9] It's important to highlight that the RBZ's 'modified standardized approach' intended to bring consistency to the process, as all banks are required to use the same rating scale, as well as to enhance the risk-sensitiveness of the methodology, when compared to the Basel II unrated risk-weights. However, it has left to the bank's internal judgement the risk classification[10] of exposures, based on qualitative criteria (Table 2), which represents a relevant vulnerability of the metrics. The Basel II standardized approach seeks to avoid the use of the banks' internal judgement for this purpose, as it only recognizes risk classification from independent external agencies, besides the standardized risk-weights. The IRB approach, on its turn, recognizes qualitative criteria but also requires quantitative procedures and statistical models to calculate capital requirements for credit risk.

12. The mission noted that the CRM methodology is largely in line with Basel II and III. The set of mitigants and approaches (simple and comprehensive) are similar, and all the institutions apply the simple approach. However, the risk weighting methodology depends on banks' internal judgement instead of the standardized RWs. Basel III contains more granular and higher supervisory haircuts for collaterals in the comprehensive approach (CRE20.50) than in Zimbabwe (Guideline 001- 3.16.19) and Basel II (Part 2, II, D, §151).

[7] Prudential Standard No. 01-2020/BSD (https://www.rbz.co.zw/documents/BLSS/2020/Prudential-Standard-No.-01-2020-BSD.pdf).

[8] Although the official regulatory standardised approach for credit risk in Zimbabwe is calculated according to the Basel I methodology, the TA has assessed the implemented modified standardised approach for credit risk which is on parallel run since 2012, for the purposes of identifying gaps and proposing improvements in line with the Basel III Framework.

[9] The RBZ has developed the modified standardised approach to rate credit exposure, in case of the absence of ratings from external credit rating agencies. According to this approach, banks are required to develop internal rating procedures do classify unrated exposures using the Supervisory Rating Scale (SRS) presented in Table 2 and use the mapping rating scale of Table 3 to identify the external agency's equivalent rating of the exposure.

[10] Guideline 001, paragraph 3.9.6, "Banking institutions must document the criteria for mapping their internal ratings to the SRS".

Table 2. Supervisory Rating Scale

SRS Classification		Descriptive Classification	Risk Level	Five Tier Loan Classification
Rating	Sub-rating			
1	-	Prime Grade	Insignificant	Pass
2	2a	Strong	Modest	
	2b			
	2c			
3	3a	Satisfactory	Average	
	3b			
	3c			
4	4a	Moderate	Acceptable	Special Mention
	4b			
	4c			
5	5a	Fair	Acceptable with care	
	5b			
	5c			
6	6a	Speculative	Management Attention	
	6b			
	6c			
7	7a	Highly Speculative	Special Attention	
	7b			
	7c			
8		Substandard	Vulnerable	Substandard
9		Doubtful	High Default	Doubtful
10		Loss	Bankrupt	Loss

Source: Guideline Nº 1-2011/BSD - Technical Guidance on the Implementation of the Revised Capital Adequacy Framework in Zimbabwe

Table 3. Mapping of the RBZ Rating Scale

Nº	Reserve Bank Scale	Standard & Poors/Fitch/GCR	Moody's
1	1	AAA	Aaa
2	2a	AA+	Aa1
3	2b	AA	Aa2
4	2c	AA=	Aa3
5	3a	A+	A1
6	3b	A	A2
7	3c	A-	A3
8	4a	BBB+	Baa1
9	4b	BBB	Baa2
10	4c	BBB-	Baa3
11	5a	BB+	Ba1
12	5b	BB	Ba2
13	5c	BB-	Ba3
14	6a	B+	B1
15	6b	B	B2
16	6c	B-	B3
17	7a	CCC+	Caa1
18	7b	CCC	Caa2
19	7c	CCC-	Caa3
20	8	CC	Ca
21	9	C	C
22	10	D	D

Note: All ratings below 5- (in grey cells) are sub-investment.

Source: Guideline Nº 1-2011/BSD - Technical Guidance on the Implementation of the Revised Capital Adequacy Framework in Zimbabwe

13. The RBZ framework applies the Basel II Current Exposure Method (CEM) to treat derivative exposures. The Basel III counterparty credit risk methodology, which discontinued the Basel II CEM and updated the standardized approach (SA-CCR) and the internal model method (IMM), is characterized by extreme complexity. Both the SA-CCR and the IMM are highly detailed and may impose burdens on banks engaged in a non-complex activities. Against this background, the TA mission advises that the authorities maintain the CEM approach.

C. Calculation of RWA for Operational Risk

14. The RBZ's standardized approach for the calculation of capital requirement to cover exposures on operational risk follows Basel II ASA requirements. Basel II Standardized Approach segregates banks' activities into eight business lines. The capital charge for each business line is calculated by multiplying gross income by a factor (β).[11] ASA methodology allows loans and advances to replace the gross income, as the exposure indicator for retail and commercial banking business lines,[12] while the remaining six business lines keep calculation based on gross income. Jurisdictions that opt for the ASA have also national discretion to aggregate the other six business lines using β=18%. The RBZ applies the aggregation alternative to require capital for operational risk under the ASA.[13]

15. All 18 banks in Zimbabwe use the ASA for the calculation of capital requirement for operational risk. Findings of the 2016–2017 BSD onsite reviews revealed that 14 banks are already fully compliant with mapping the 8 business lines into the 3 business lines required by regulation.[14] The reviews have also observed that those banks were putting efforts towards the creation of an internal loss database,[15] although none of them had applied for the use of Advanced Measurement Approaches (AMA).

D. Calculation of RWA for Market Risk

16. RBZ criteria for the identification of Trading Book Exposures follows the Basel 2.5 Framework. According to Basel 2.5 (2009), the key determinant upon which application of the credit risk framework or the market risk framework to a given instrument is based on the bank's

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[11] Business line factors (β): corporate finance – 18%; trading & sales – 18%; retail banking – 12%; commercial banking – 15%; payment & settlement – 18%; agency services – 15%; asset management – 12%; and retail brokerage – 12%. Total capital charge results on the three-year average of the regulatory capital charges across each of the business lines in each year ($K_{BSA} = \{\sum_{years\ 1-3} max[\ \sum(GI_{1-8} \times \beta_{1-8}), 0]\}/3$, *where GI = Gross Income*).

[12] K_{ASA} = β x m x LA, where m = 0.035 and LA = loans and advances.

[13] $K_{SA} = \frac{\sum_{t=1}^{6}(0.12 \times m \times LAR_t)}{6} + \frac{\sum_{t=1}^{6}(0.15 \times m \times LAC_t)}{6} + \frac{\sum_{t=1}^{6}\max[(0.18 \times AGI_t), 0]}{3}$, where LAR = loans and advances from retail banking; LAC = loans and advances form commercial banking; and AGI = aggregated gross income from the other 6 business lines.

[14] Retail banking, commercial banking and the other 6 aggregated business lines (corporate, trading & sales, payment & settlement, agency services, asset management, and retail brokerage)

[15] Internal Data in Basel II Framework paragraphs 670-674 establish the criteria for the creation of an internal loss database (https://www.bis.org/publ/bcbs128.pdf).

intent to trade the instrument.[16] The Basel Revised Market Risk Framework of 2016 has maintained the boundary as the trading intent, but established additional specifications and enhancements to limit regulatory arbitrage between the capital requirements of the banking book and the trading book, where it was determined that lower capital requirements would apply in one or the other. Those improvements have been included in the Basel III Framework, as outlined in the document "RBC25 Basel III - Boundary between the banking book and the trading book".[17]

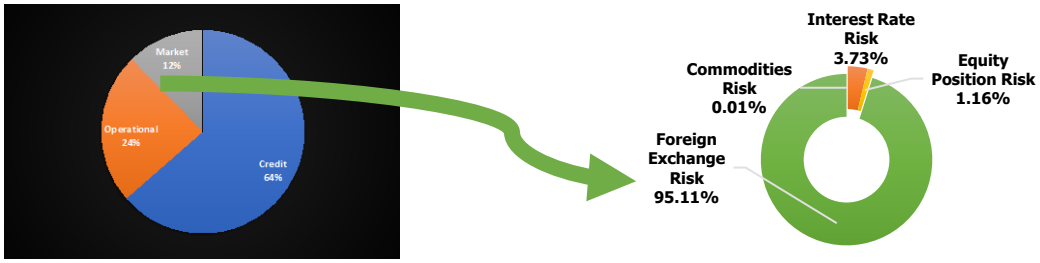
17. Exposure to market risk in Zimbabwe is highly concentrated in FX risk. Figure 1 presents the banks' RWA composition. According to RBZ information, the high market risk concentration in FX risk is due to the banks' foreign currency holdings. Securities trading markets are not yet developed, and banks are not ordinarily allowed to hold exposures in equities and commodities.[18] Nevertheless, currently, two banks are exceptionally holding those type of exposures.

[16] BCBS Explanatory note on the minimum capital requirements for market risk: "This inherently subjective criterion made the boundary between the application of the credit risk and market risk frameworks difficult to enforce in a consistent manner, and allowed for the possibility of banks to engage in regulatory arbitrage between the capital requirements of the banking book and the trading book where it was determined that lower capital requirements would apply in one or the other." (https://www.bis.org/bcbs/publ/d457_note.pdf).

[17] BCBS Explanatory note on the minimum capital requirements for market risk: "Those enhancements include: (i) Additional specification on the appropriate contents of the trading book: the revised boundary sets out a list of instruments that must be allocated to the trading book and a list of instruments that must be allocated to the banking book, and banks are not permitted to deviate from these lists. Additionally, the definition of the trading book is supplemented with a list of instruments "presumed" to be in the trading book. A bank must receive supervisory approval for any deviations from these presumptions; (ii) enhanced supervisory oversight: banks must make available to supervisors the reports that describe the rationale for including instruments in the trading book and compliance with the framework's scope of application; (iii) restrictions on the ability to arbitrage the boundary: the framework establishes a strict limit on the movement of instruments between the banking book and the trading book. If the capital requirement for an instrument is reduced as a result of moving the instrument from one book to the other, the difference in the capital requirement as measured at the time of the move is imposed as a fixed, additional Pillar 1 minimum capital requirement; (iv) clearer treatment of risk transfers across the boundary: banks may choose to hedge some of the risks in the banking book via instruments held in the trading book. The Basel 2.5 framework's boundary specified the treatment of such internal risk transfers of credit risk but was silent with respect to other risk classes, such as equity risk and interest rate risk. To promote consistency and comparability in regulatory practices across jurisdictions, the framework specifies the treatment of internal risk transfers of equity risk and interest rate risk from the banking book to the trading book." (https://www.bis.org/bcbs/publ/d457_note.pdf).

[18] Guideline Nº 1-2011/BSD - Technical Guidance on the Implementation of the Revised Capital Adequacy Framework in Zimbabwe – January 2011: "3.39.11 However, banking institutions in Zimbabwe are not ordinarily permitted to assume equities and commodities risk; as such this guidance is confined to interest rate risk and FER."

Figure 1. Banks' RWA Composition for Market Risk in Zimbabwe



Source: RBZ

18. All 18 banks in Zimbabwe use the Standardized Approach for the calculation of capital requirement for market risk. RBZ regulation for capital requirement on market risk allows the use of internal models under supervisory approval. However, no bank has applied for them yet. Regarding the standardized approach, RBZ regulation is in line with Basel 2.5 Standardized Approach,[19] in terms of the components for the calculation of capital requirement for interest rate risk and foreign exchange risk (FER). As banking institutions in Zimbabwe are not ordinarily permitted to assume equities and commodities risk, the components for the calculation of capital requirements for these risks were not included in the regulation.

19. RBZ applies the SRS[20] (Table 2), for the definition of RW factors to unrated trading securities, in the calculation of capital requirement to specific risk.[21] The calculation of capital requirement for interest rate risk under Basel III SSA is the sum of two amounts: specific risk and general market risk (Figure 8). As the specific risk reflects the risk of the issuer,[22] its calculation is based on the credit risk classification of the financial instrument. According to RBZ regulation, banks must grade the unrated financial instruments according to the SRS criteria and apply the mapping table (Table 3) to identify the equivalent bucket in terms of the grading scale of an External Credit Assessment Institution (ECAI). The capital charge bucket to be

[19] Capital requirement for market risk under the Basel 2.5 SA is given by the sum of capital requirement due to exposures in interest rate risk, FER, equity risk and commodities risk ($MRC_{SA} = CR_{IRR} + CR_{FX} + CR_{EQ} + CR_{COMM}$). See BCBS "Revisions to the Basel II market risk framework," 2011 (https://www.bis.org/publ/bcbs193.pdf).

[20] Guideline Nº 1-2011/BSD - Technical Guidance on the Implementation of the Revised Capital Adequacy Framework in Zimbabwe – January 2011: "3.9.1 …in the absence of External Credit Rating Agencies, the Reserve Bank of Zimbabwe has expanded the supervisory loan classification system from five classes (i.e., pass, special mention, substandard, doubtful and loss) to a new Supervisory Rating Scale (SRS) with ten main classes, along with several subclasses." In 3.10, the regulation maps the SRS to Rating Agency equivalent.

[21] The Basel Framework: "MAR40.4 The minimum capital requirement [to interest risk] is expressed in terms of two separately calculated amounts, one applying to the "specific risk" of each security, whether it is a short or a long position, and the other to the interest rate risk in the portfolio (termed "general market risk") where long and short positions in different securities or instruments can be offset." See https://www.bis.org/basel_framework/ for details.

[22] Basel III Framework: "MAR40.5 The capital requirement for specific risk is designed to protect against an adverse movement in the price of an individual security owing to factors related to the individual issuer." (https://www.bis.org/basel_framework/).

applied for the calculation of specific risk of an unrated financial instrument corresponds to its "ECAI equivalent" grade in the specific risk charge table (Table 4).

Table 4. Specific Risk Capital Charges in Zimbabwe

Categories	Supervisory Scale	External credit Assessment	Specific risk capital charge
Government	1 – 4	AAA to AA-	0%
		A+ to BBB-	0.25% (residual term to final maturity 6 months or less)
			1.00% (residual term to final maturity greater than 6 and up to and including 24 months)
		BB+ to B-	1.60% (residual term to final maturity exceeding 24 months)
		Bellow B-	8.00%
		Unrated	12.00%
			8.00%
Qualifying			0.25% (residual term to final maturity 6 months or less)
			1.00% (residual term to final maturity greater than 6 and up to and including 24 months)
			1.60% (residual term to final maturity exceeding 24 months)
Other		Similar to credit risk charges under the standardised approach of this Framework, e.g.:	
		BB+ to BB-	8.00%
		Bellow BB-	12.00%
		Unrated	8.00%

Source: Guideline Nº 1-2011/BSD - Technical Guidance on the Implementation of the Revised Capital Adequacy Framework in Zimbabwe – January 2011

E. Large Exposures

20. The RBZ should assess Large Exposures relative to Tier 1 Capital in line with the Basel III Framework. According to Basel III [LEX10.8], "the sum of all exposure values of a bank to a counterparty or to a group of connected counterparties must be defined as a large exposure if it is equal to or above 10 percent of the bank's Tier1 capital". The RBZ large exposures are evaluated over a broader base [23] (Capital Base instead of Tier 1 Capital), which

[23] Source: PART VI - PRUDENTIAL LENDING LIMITS of Banking Regulations.pdf.

raises the cap and may exclude counterparties that should be treated as large exposures according to Basel III Framework.

21. RBZ definition of "common enterprises" follows the Basel III Framework definition of "connected counterparties", but the regulation is brief in the clarification of connections due to economic interdependence. Basel III Framework establishes several criteria to the identification of connected counterparties due to control relationship [LEX10.13] and economic interdependence [LEX10.17].[24] While the criteria for the identification of control relationship are more objective, the identification of economic interdependence is based on qualitative criteria.[25] RBZ regulation is in line with the criteria established in Basel for the identification of control relationship. However, the concept of economic interdependence due to guarantees exchange or the counterparties' financial problems presented in Basel criteria 2, 5 and 6 are not explicitly mentioned in RBZ regulation.[26]

22. RBZ regulation establishes special limits for large exposures to corporate groups. RBZ regulation establishes the limit of 25 percent Capital Base to exposures from single persons and common enterprises and the limit of 75 percent Capital Base to exposures from corporate groups[27] (Figure 2), due to the high concentration of the credit market in wholesale operations.

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[24] Basel III Framework LEX10 Definitions and application. (https://www.bis.org/basel_framework/).

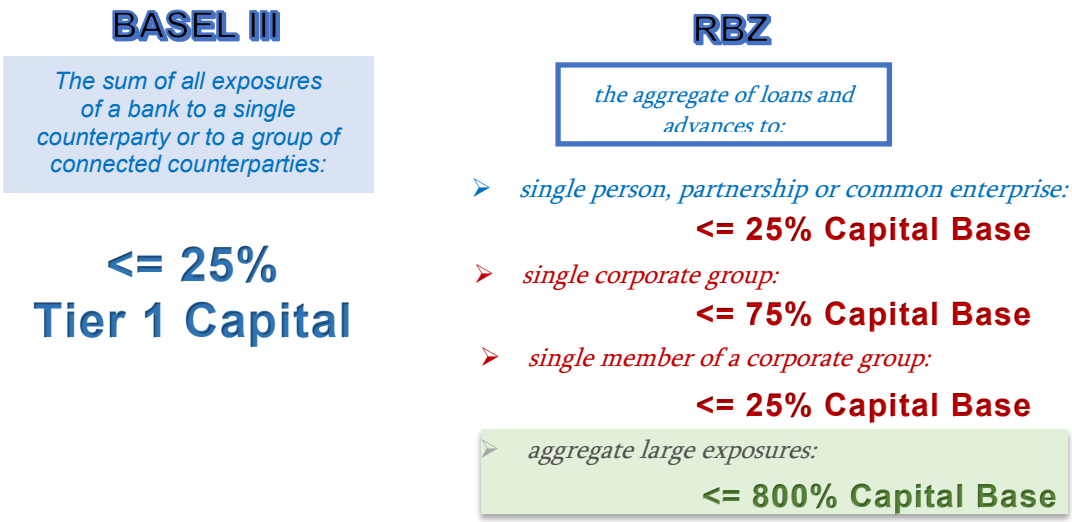
[25] Basel Framework "LEX10.16 In establishing connectedness based on economic interdependence, banks must consider, at a minimum, the following qualitative criteria: (1) Where 50% or more of one counterparty's gross receipts or gross expenditures (on an annual basis) is derived from transactions with the other counterparty (e.g. the owner of a residential/commercial property and the tenant who pays a significant part of the rent); (2) Where one counterparty has fully or partly guaranteed the exposure of the other counterparty, or is liable by other means, and the exposure is so significant that the guarantor is likely to default if a claim occurs; (3) Where a significant part of one counterparty's production/output is sold to another counterparty, which cannot easily be replaced by other customers; (4) When the expected source of funds to repay the loans of both counterparties is the same and neither counterparty has another independent source of income from which the loan may be serviced and fully repaid; (5) Where it is likely that the financial problems of one counterparty would cause difficulties for the other counterparties in terms of full and timely repayment of liabilities; (6) Where the insolvency or default of one counterparty is likely to be associated with the insolvency or default of the other(s); (7) When two or more counterparties rely on the same source for the majority of their funding and, in the event of the common provider's default, an alternative provider cannot be found – in this case, the funding problems of one counterparty are likely to spread to another due to a one-way or two-way dependence on the same main funding source." (https://www.bis.org/basel_framework/).

[26] The RBZ regulation defines as qualitative criteria to the identification of economic interdependence: "(a) the expected source of repayment of loans or advances for a pair or group of borrowers is the same for each or every borrower", which would meet Basel criterion 4 and, in some way, the criterion 7, and "(c) a pair or group of persons is engaged in businesses that are financially interdependent to a substantial degree", which would cover the concepts detailed in Basel criteria 1 and 3.

[27] Banking Regulations.pdf - PART VI - PRUDENTIAL LENDING LIMITS "(39-2) Subject to this paragraph and paragraph 40, the aggregate of loans and advances outstanding at any time to any single corporate group shall not exceed 75% of a banking institution's Capital Base for the whole group or 25% to any single member of a corporate group." "(38) A common enterprise shall be deemed to exist between persons when (a) the expected source of repayment of loans or advances for a pair or group of borrowers is the same for each or every borrower; or (b) loans or advances are made to a pair or group of persons who are related through common control, that is, where any one or more of them acting in concert (i) directly or indirectly own or control 20% or more of the voting stock of the

However, a limit of this magnitude may weaken the effectiveness of the measure as a backstop to risk-based capital requirements,[28] as already pointed out in the FSSR report[29] of 2019.

Figure 2. Basel III and RBZ Limits on Large Exposures



23. RBZ regulation exempts exposures from the large exposures calculation even if they represent CRM techniques and offsetting schemes. In the calculation of large exposures amount, Basel III Framework exempts a few operations and counterparties, and recognizes CRM techniques (also recognised for risk-based capital requirements purposes) [LEX 30.13], and offsetting schemes [LEX 30.22-30.30] for the exposures' calculation. RBZ regulation, instead, defines the operations that are exempted for the calculation of large exposures, even if the exemption represents a CRM or offsetting. This approach seems more conservative, as it only allows for the risk mitigation of exposures in full (taken as an exemption, in that case). Besides, an adequate classification of the deductions applied to the exposures' measurement due to CRM

other person or another person in the group; (ii) control in any manner the election of a majority of the directors, trustees or other office-bearers exercising similar functions of the other person or another person in the group; (iii) otherwise exercise a controlling influence over the management or policies of the other person or another person in the group; or (c) a pair or group of persons is engaged in businesses that are financially interdependent to a substantial degree. … "corporate group" means a holding company and all its subsidiaries."

[28] Basel III Framework "LEX10.2 …To serve as a backstop to risk-based capital requirements, the large exposures framework should be designed so that the maximum possible loss a bank could incur if a single counterparty or group of connected counterparties were to suddenly fail would not endanger the bank's survival as a going concern." (https://www.bis.org/basel_framework/).

[29] "13. The banking system shows many signs of fragility. Credit concentration is elevated reflecting the structure of the economy. Since lending to households is limited, most of the lending is directed to large firms servicing largely the export market. Credit concentration is also elevated both from the single borrower perspective to the group level. The reporting of large exposures masks the true extent of the risk as exposures from groups are not aggregated. Moreover, large exposure limit exceptions are granted for groups, of up to 75 percent of capital. A few banks have exercised these exceptions." Source: FSSR report - February/2019

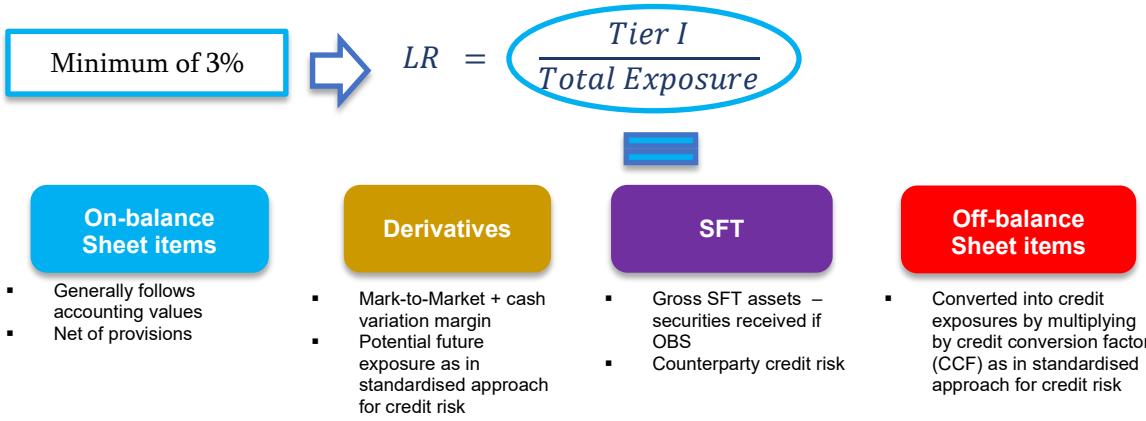
techniques, offsetting or exemptions is important for banks to comply with the Basel III requirements for the report of large exposures to supervisors.[30]

F. Leverage Ratio

24. Zimbabwe leverage ratio requirement is designed similarly to Basel III. Exposures comprise total assets and include the off-balance sheet items. However, the capital measure is aligned with the Tier 1 capital definition of Basel II. Besides, the prudential adjustments to Tier 1 are not deducted from the exposure measure, what can be conservative, depending on the number and severity of the adjustments. This procedure needs to be re-assessed as the authorities update the definition of capital in line with the Basel III capital framework.

25. RBZ regulation does not consider the special treatment (Figure 3) for derivatives and SFTs in the calculation of the Leverage Ratio. As informed during the mission, the Zimbabwean derivatives market is reduced, and the absence of the special treatment does not cause harm to the exposure measure.

Figure 3. Basel III Framework Leverage Ratio Requirement



Note: All prudential adjustments in Tier 1, related to assets, may be deducted from the exposure measure

IV. Recommendations for Updating and Implementing the Basel II/III Framework

26. The RBZ should consider updating its regulations to Basel II/III Framework. The areas for updating include capital definition and the standardized approaches for credit, operational and market risks, as well as the reviews of large exposures and leverage ratio frameworks. The updated drafts will facilitate the implementation of impact assessment. In

[30] Basel III Framework: "LEX20.4 Banks must report to the supervisor the exposure values before and after application of the CRM techniques. Banks must report to the supervisor: (1) all exposures equal to or above 10% of the bank's Tier 1 capital (2) all other exposures without the effect of CRM being taken into account equal to or above 10% of the bank's Tier 1 capital; (3) all the exempted exposures with values equal to or above 10% of the bank's Tier 1 capital; and (4) their largest 20 exposures to counterparties included in the scope of application, irrespective of the values of these exposures relative to the bank's Tier 1 capital." (https://www.bis.org/basel_framework/).

addition, there is need to review the prudential report (BSD1) and undertake impact studies for the implementation of the new framework.

A. Capital Definition and Capital Conservation Buffer

27. The goal of Basel III to enhance the quality of the capital bases was highlighted to the RBZ. The changes introduced in Basel III point to a sounder capital bases aiming at improving financial system resilience. The Basel III Total Capital is composed by Common Equity Tier 1 (CET1), Additional Tier 1 and Tier 2. According to Basel III framework CAP10[31], the CET1 should be composed by:

- issued common shares and similar instruments;
- stock surplus (share premium);
- retained earnings, including interim profit/loss;
- accumulated other comprehensive income and other disclosed reserves; and
- minority interest; and
- regulatory adjustments.

28. The capital structure envisages the predominance of stocks and retaining earnings alongside new characteristics for capital instruments to sustain the institution as a going concern. Regulatory capital is adjusted (Figure 4) to deduct assets not available to bear losses.

Figure 4. CET1 regulatory adjustments

Assets deducted in full:

NEW
- Gain on sale related to securitization transactions
- Goodwill and other intangibles
- Investments in the capital of financial institutions or in own shares
- Deferred tax assets related to operation losses
- Benefit pension fund assets with restricted access by the bank
- Minority interest held by third parties
- Cash Flow hedge reserve
- Shortfall of the stock of provisions to expected losses
- Cumulative gains/losses from changes in own credit risk on fair valued liabilities
- Non-significant investments in banking, financial and insurance entities not consolidated

Assets partially deducted ("basket" < 15% of the CET1):

NEW
- Significant investments in banking, financial and insurance entities not consolidated
- Deferred tax assets related to temporary differences
- Mortgage Servicing Rights (MSRs)

[31] Available at https://www.bis.org/basel_framework/index.htm?export=pdf.

29. The debt instruments in Basel III Framework should comply with new requirements to be eligible to the regulatory capital. Capital instruments should be able to suffer losses while the institution is functioning (Table 4). Additional Tier 1 and Tier 2 instruments should be subject to the possibility of write-off or conversion into shares in determined situations or if the point of non-viability is reached.

Table 5. Capital Instruments According to Basel II and III Frameworks

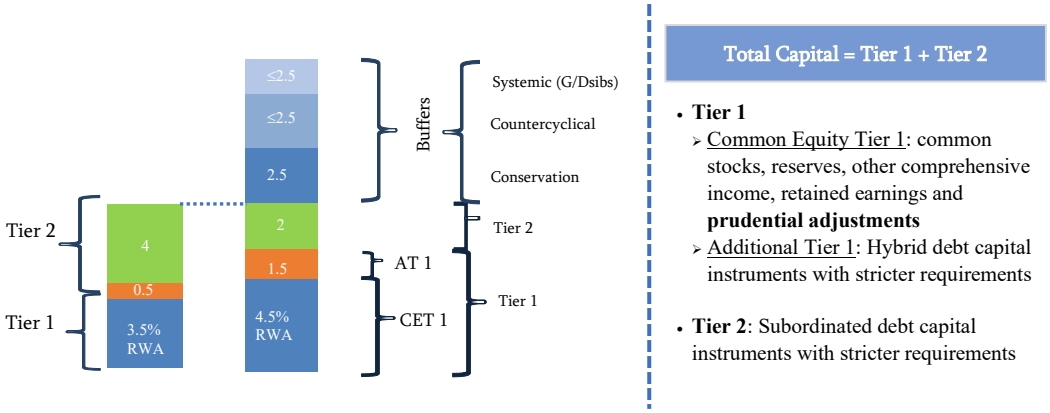
Elements of Regulatory Capital	Basel II	Basel III
Tier 1	Perpetual Most Subordinated Not guaranteed	• No step-up or other incentive to redeem • Should absorb losses through write-off of principal or conversion into shares as in a going concern situation (high-trigger → at least 5.125%) • Full discretion to cancel dividend/coupon • Cancelation is not an event of default
Tier 2	>5 years Subordinated Not guaranteed 20% reduction in maturity	• Not differentiated into upper and lower Tier 2 capital • Not step-up or other incentive to redeem • Should absorb losses through write-off of principal or conversion into shares as in a gone concern situation (low trigger → point of no viability)

30. The Basel III minimum capital requirements (Figure 5) enhance the quality and quantity of capital required when compared to Basel II, due to the preponderance of CET1 requirement and the introduction of buffer requirements (conservation, countercyclical and systemic). The CET1 should be used first to fulfill the minimum requirement and the remaining amount should contribute to the capital buffers requirements.[32] Zimbabwe already has the systemic buffer, although the requirement should be satisfied with Tier 1 capital. Considering the average of Tier 1 capital ratio of 27.9 percent and Total Capital of 41.1 percent in March 2023 (reported by banks), Zimbabwe presents a quite comfortable solvency situation, preparing the banks for stricter capital definition and requirements introduced in Basel III.

31. The capital conservation buffer, not yet implemented in Zimbabwe, comes to provide an additional layer of capital to improve financial institutions soundness. Capital distribution constraints will be imposed when capital levels fall within this range. Institutions will be able to conduct business as normal when their capital levels fall into the conservation range as they experience loss. The constraints imposed only relate to distributions, not the operation of the bank.

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

Figure 5. Capital Requirements in Basel II and Basel III Frameworks



32. The key recommendations for the improvement of capital definition in Zimbabwe consist of the following actions:

i. Review the capital composition in line with Basel III Framework: the stricter capital definition defined in Basel III Framework should be implemented, including the prudential adjustments, as well as the additional features for capital instruments, assessing the applicability of some capital deductions and possible simplifications; and

ii. Implement the requirement for the capital conservation buffer.[33]

33. Based on the new draft, BSD should conduct a quantitative impact study (QIS) to review the industry situation in face of the new capital concepts and requirements. The study should collect data regarding the gross capital components, the prudential adjustments, the capital instruments characteristics, and the RWA components, in order to assess the main factors in the transition to the Basel III framework.

B. Standardized Approach for Credit Risk

34. Basel III Framework for credit risk envisages to improve the risk-sensitiveness, to reduce the dependence on external ratings and ensure the suitability of the standardized approach (Table 5). To achieve these goals, an appropriate asset class expansion and RW recalibration was carried on improving granularity.

[33] The implementation of the countercyclical capital buffer is out of the scope of this TA.

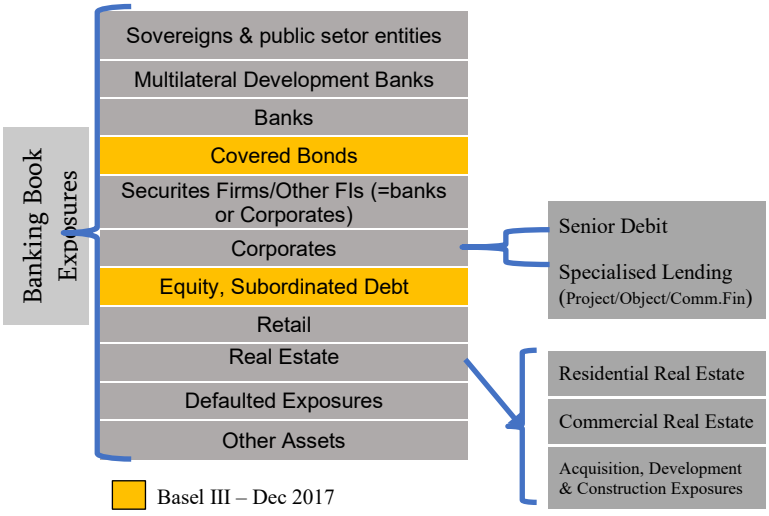
Table 6. Key Changes in the Standardised Approach for Credit Risk (Basel III Framework)

Exposure Category	Changes
Unrated exposures – banks & corporates	More granular approach
Banks – rated exposures	Some RW recalibrated, more granular treatment
Corporates	More granular, new categories – Corporate SME, Specialised Lending
Covered Bonds	New exposure category
Residential Real Estate	More risk-sensitive, RW according to LTV ratios
Retail	More granular, new "transactors" & "revolvers"
Commercial Real Estate	More risk-sensitive (flat 100% RW in Basel II)
Subordinated debt & equity	More granular RWs (100% RW in Basel II)
Off-B/S items	Positive CCFs (10%, Basel II- 0%) for unconditionally cancellable commitments (UCCs)
Defaulted exposures	New definition of default, aligns with IRB definition

35. New asset classes and concepts were introduced to better cover the risk incurred. Compared to the Basel II Standardized Approach, new assets classes emerged as the covered bonds, equity and subordinated debt, specialized lending and acquisition, development and construction exposures, as presented in Figure 6.

Figure 6. Exposure Classes in Basel II and III Standardised Approaches for Credit Risk

Basel II Std. Approach RWA	
Sovereigns/Central Banks	0% - 150%
PSEs (bank RWs)	20% - 150%
MDBs	0%, 20% - 150%
Banks	20% - 150%
Sec. firms (RWs of banks or corporates)	
Corporates	20% - 150%
Regulatory Retail	75%
Claims sec by res property	35%
Claims sec by CRE	100%
Past Due loans	100% - 150%
Other assets	100%



36. The RBZ should consider updating in the current capital requirement for credit risk in line with the Basel III Standardized Credit Risk Assessment (SCRA) approach. This includes the introduction of new asset classes and concepts, the review of the RWs applicable to

the different asset classes, specially SCRA to unrated credit exposures, as summarized in Table 8 of Appendix IV. The Basel III Framework has implemented several improvements[34] to increase granularity and the risk sensitivity of the standardized approach, among others:

i. residential and commercial real estate have more risk-weight granularity according to the loan-to-value (LTV) ratio and the dependence on cash flow of the property;

ii. retail exposures related to credit card and overdrafts can receive lower RW;

iii. the bank exposure has new RWs varying with the counterparty grades;

iv. new RWs have been introduced for corporate exposure, contemplating investment grade and small and medium enterprises (SME); and

v. exposure to funds that should be treated according the funds portfolios.

37. RBZ should consider maintaining the use of Basel II CEM to treat derivative exposures and the comprehensive approach from CRM for (SFTs), in order to avoid the CCR methodological complexity. Both the SA-CCR and the IMM methodologies demonstrate an elevated detailing and may be burdensome and unsuitable for the Zimbabwean context.

38. Updating the supervisory haircuts in the RBZ comprehensive approach for CRM is recommended, but not crucial. Zimbabwe CRM methodology contains less granular and lower supervisory haircuts for collaterals in the comprehensive approach (Guideline 001- 3.16.19), than in Basel III Framework (CRE20.50). Considering that the institutions in Zimbabwe only use simple approach, the supervisory haircuts update is recommended, although not crucial.

39. Based on the new draft, quantitative studies should be conducted in order to assess the impacts of the new concepts, asset classes and RWs available at the Basel III Standardized Approach. The data collection should encompass granular information about applicable treatment to each individual asset class, credit conversion factor (CCF), constituted provisions and the RWs available in Basel III Framework, together with the current treatment. The detailing of concepts, for example, the past due loans and defaulted exposures is important to better assess the impact of the new prudential framework.

C. Standardized Approach for Operational Risk

40. Basel III Framework capital requirement for operational risk has replaced the three former Basel II Framework approaches for one single Standardized Approach.[35] 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 BI component); and (ii) banks which have experienced greater operational risk losses historically are more likely

[34] The set of available RWs was enlarged and recalibrated to contemplate more granular risks contributing to reduce the dependence on external ratings and to improve the standardised approach suitability.

[35] OPE25 in the Basel III Framework (https://www.bis.org/publ/bcbs189.pdf).

to experience operational risk losses in the future (represented by the Internal Loss Multiplier - ILM-component). Figure 7 summarizes the main metrics for its calculation.

Figure 7. Methodology for the Calculation of Capital Requirement for Operational Risk under the Basel III Standardised Approach

$$ORC = BIC \times ILM$$

ORC = Operational Risk Capital Requirement
BIC = Business Indicator Component
ILM = Internal Loss Multiplier

$$BIC = BI \times \alpha$$

BI = Business Indicator
α = marginal coefficient

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

$$BI = ILDC + SC + FC$$

ILDC = interest, leases and dividend component
SC = services component
FC = financial component

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

LC = Loss Component: 15 times average annual operational risk losses incurred over the previous 10 years

Note: Calculated as the average over three years:
***ILDC** = min (abs (interest income – interest expense), 2.25% 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)*

41. The implementation of Basel III Standardized Approach to the calculation of capital requirement for operational risk would require an accompanying adjustment in the data collection process by banks. Prior simplifications allowed by Basel II ASA, such as calculating retail and commercial banking exposures by the accounting value instead of gross income, as well as the aggregation of the remaining six business lines into one single component, were discontinued in the new standardized approach. In Basel III Framework, the former eight business lines were reclassified in categories (interest, leases, dividends, fees, Profits and Losses -P&L- and other - Figure 7) and organized as three components of BI (ILDC: Interest, leases and dividend component; SC: services component; and FC: financial component – Figure 7). The calculation of each component requires the estimation of incomes and expenses (or P&L). The new approach to capture data for the calculation of the BI Component will require banks to review their systems responsible for data collection to the calculation of capital requirements to operational risk.

42. The calculation of the ILM component is required only for banks with BI > EUR 1 billion. According to Basel III Standardized Approach, if a bank falls into the lowest α bucket

(BI <= 1 billion euros), ILM would be set equal to 1.[36] In this case, the bank would not need to create and maintain the 10-years internal losses data base, currently only required to the use of AMA in the RBZ regulation. It's important to highlight, however, that an internal loss database is a relevant granular data source, very useful to support the banks' operational risk management and internal controls, as well as to improve supervisory processes.

43. The RBZ should consider adopting the new Basel III Standardized Approach[37] for operational risk to replace the current Basel II Alternative Standardized Approach in the RBZ regulation. The new regulation should establish ILM = 1 as well as update the requirements for public disclosure of quantitative data on operational risk exposures.

44. BSD should conduct a QIS to facilitate the eventual calibration of the Basel III Standardized Approach to the Zimbabwean financial environment. The RBZ should develop a questionnaire to collect data from all banks, in order to assess, among other issues:

i. the impact of the new methodology in the capital requirement level: the study should measure the impact in capital requirements due to the implementation of Basel III Standardized Approach, especially taking into consideration the recommendations in items iv and v below, as well estimate an adequate time period for its full implementation;

ii. the scope of BIs, which may be simplified in line with the existing financial activities in Zimbabwe, as well as those expected to be developed in the near future;

iii. banks' capacity to collect data for the calculation of BI components: the study should assess any challenges banks may have shifting to the calculation of BI components;

iv. the requirement for ILM calculation: if banks fall into the lowest α bucket, ILM would be equal to 1, which would avoid the need of a requirement for banks developing a 10-years internal losses data base. This scenario, which would simplify the implementation of Basel III Framework capital requirement for operational risk, should be assessed taking into consideration the efforts already put in place by banks to develop that data base. In the case where the data bases preparedness is already well developed in banks, the RBZ could consider implementing the ILM at least as a cap (not higher than 1), to encourage banks to conclude the construction of such data base. The ILM could initially be set as 1, in order to focus implementation on data collection for BI components calculation as a first step, and then consider the implementation of ILM calculation to a subsequent phase.

[36] Basel III Framework: "OPE25.11For banks in bucket 1 (i.e. with BI ≤ €1 billion), internal loss data does not affect the capital calculation. That is, the ILM is equal to 1, so that operational risk capital is equal to the BIC (=12% x BI)." (https://www.bis.org/publ/bcbs189.pdf).

[37] Basel III OPE25 (https://www.bis.org/basel_framework/).

v. eventual calibration[38] of the marginal coefficient (α): α buckets are calibrated to fit internationally active banks' parameters and may be overestimated to the Zimbabwean financial market, which would make all banks fall into the lower bucket (α = 12%). As the current regulation (ASA) applies a β factor of 12% (same as the α lower bucket) only to retail banking,[39] the RBZ may have room to assess the impact of an eventual recalibration of the α marginal coefficient. In this case, the considerations from item iv regarding the implementation of ILM would be more relevant.

D. Standardised Approach for Market Risk

45. The Basel III capital requirement for market risk allows the use of the SSA[40] for banks with smaller or simpler trading books, under supervisory approval. The BCBS Revised Market Risk Framework of 2016[41] has implemented several improvements in the Standardized Approach, mostly to enhance its risk sensitivity to financial instruments that feature optionality or subject to credit risk or other residual risks. Thus, concerns on the application of such methodology to financial environments with low complexity gained force during the framework's implementation phase. As a result, the Revised Basel Framework published in 2019 introduced a revised approach for the Basel 2.5 SA methodology as a simplified alternative (SSA) for banks with smaller or simpler trading book portfolios. Basically, the SSA methodology consists of applying scaling factors[42] to the former Basel 2.5 risk components,[43] as presented in Figure 8.

[38] Similar recalibration has been done by the RBZ in the definition of retail small and medium enterprises (SME). For Basel III, retail SME is defined as counterparties with total exposures to credit risk <= 1 billion euros. In Zimbabwe, the cap is US$100,000 as defined in the Basel II Technical Guideline.

[39] β = 15% to commercial banking, and β = 18% to the other 6 aggregated business lines.

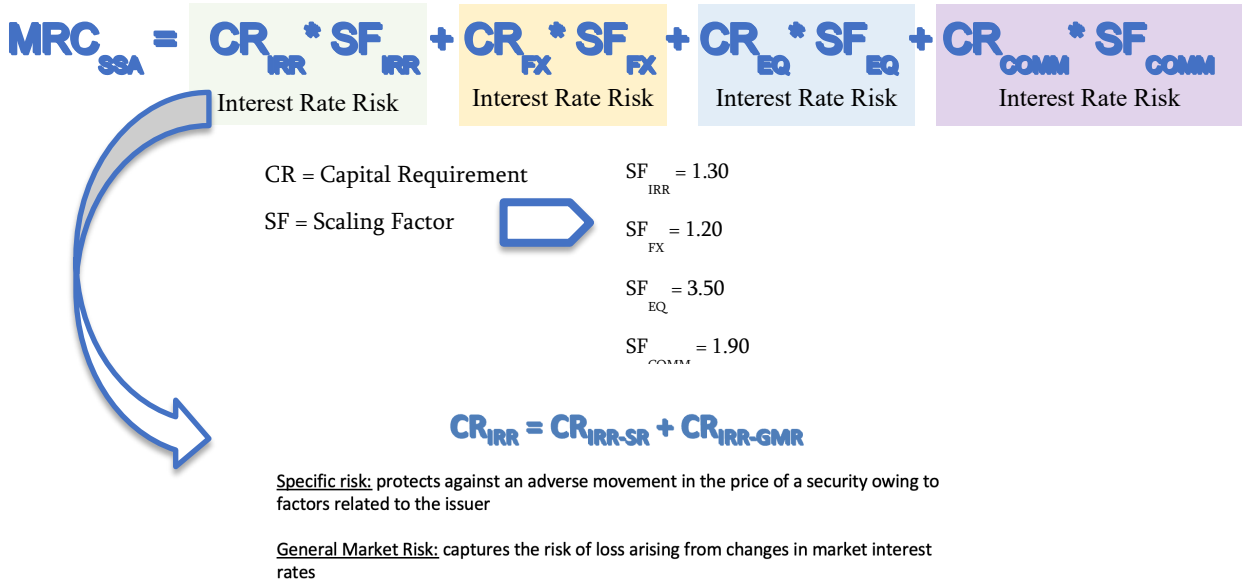
[40] Basel III Framework: "MAR11.7 In determining its market risk for regulatory capital requirements, a bank may choose between two broad methodologies: the standardised approach and internal models approach (IMA) for market risk... Supervisors may allow banks that maintain smaller or simpler trading books to use the simplified alternative to the standardised approach...". (https://www.bis.org/basel_framework/).

[41] The BCBS Revised Market Risk Framework of 2016 has also implemented more strict criteria for the identification of trading book and banking book portfolios. See "RBC25 - Boundary between the banking book and the trading book" in the BCBS "The Basel Framework" (https://www.bis.org/basel_framework/) for more details.

[42] RBZ may check the need for calibration of the scaling factors to domestic market by using a VAR approach to test if SSA approach compared to VAR calculations would create a significant difference.

[43] Basel III Framework: "MAR40.2 The capital requirement arising from the simplified standardised approach is the simple sum of the recalibrated capital requirements arising from each of the four risk classes – namely interest rate risk, equity risk, FX risk and commodity risk as detailed in the formula below… $MRC_{SSA} = CR_{IRR}*SF_{IRR} + CR_{FX}*SF_{FX} + CR_{EQ}*SF_{EQ} + CR_{COMM}*SF_{COMM}$." (https://www.bis.org/basel_framework/).

Figure 8. Main Components for the Calculation of Capital Requirement for Market Risk under the Basel III Simplified Alternative Standardised Approach



46. The RBZ should consider updating its Trading Book – Banking Book (TB-BB) definition requirements in line with the Basel III Framework [RBC25], mainly to:

i. Clarify "MUST" and "PRESUMED" requirements for TB-BB classification: regulation should incorporate the list of instruments that must be allocated to the trading book (RBC25.1-RBC25.6), and the list of instruments that must be allocated to the banking book (RBC25.7-RBC25.8). In addition, the definition of the trading book should include a list of instruments "presumed" to be in the trading book (RBC25.9), where supervisory approval would be required for any deviations from these presumptions;

ii. Supervisors should institute procedures for assessing presumed deviations and changes in the financial instrument classification (RBC 25.10, RBC 25.16). The regulations should require banks to make available to supervisors, reports that describe the rationale for including instruments in the trading book and compliance with the framework's scope of application (RBC25.11-RBC25.12);

iii. establish rules for TB-BB switching: Regulations should establish a strict limit on the movement of instruments between the banking book and the trading book by banks'own discretion (RBC25.14), highlighting that in case of a reduction on the capital requirement as a result of moving the instrument from one book to the other (only with supervisory approval), the difference in the capital requirement as measured at the time of the move should be required as a fixed, additional Pillar 1 capital requirement, until the maturity of the instrument (RBC25.15);

iv. enhance requirements for the treatment of Internal Risk transfer: Regulations should be updated to incorporate specifications for the treatment of internal risk transfer (RBC25.18-RBC25.27).

47. The RBZ's current Standardized Approach for the calculation of capital requirements for market risk should be updated and aligned to the Basel III SSA, in order to:

i. apply the scaling factors to the parcels, as illustrated in Figure 8;

ii. align the methodology for the calculation of capital requirement to specific risk with the methodology for the calculation of capital requirements for credit risk[44];

iii. assess the need to include parcels for the calculation of capital requirements for equity risk (MAR40.41- MAR40.52) and commodities risk (MAR40.63-MAR40.73), as a guidance for banks with exceptional exposures on these instruments.

48. BSD should conduct a QIS to assess the impact of Basel III SSA implementation in the capital requirement level. The RBZ should develop a questionnaire to collect data from all banks, in order to assess, among other impacts:

i. the application of the scaling factors to the SSA metrics' components;

ii. the inclusion of the parcels to calculate capital requirements for equity risk and commodities risk, as applicable;

iii. confirm adequacy of banks' systems in identifying TB-BB portfolios.

E. Large Exposures

49. The RBZ should continue to review and prime its monitoring system for the treatment of large exposures to corporate groups. Although large exposures are being closely monitored on weekly basis by the RBZ, as recommended in the FSSR report of 2019,[45] it is important to assess data on the distribution of large exposures in the banks' portfolio to promote compliance to counterparty limits, as well as to define a strategy for a transition period to move towards the adequacy of the current limits to Basel III standards.

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[44] As specified in the Basel III Framework MAR40.6 Table 1 – Specific risk capital requirements for issuer risk – Government and other categories (https://www.bis.org/basel_framework/).

[45] "**58. Monitoring of large exposures, exceptions to the large exposure limits granted for groups and lack of aggregation of large exposures as a percentage of regulatory capital calls into question the RBZ's operational independence and accountability for the increase in these exposures in the banking sector.** The RBZ needs to not only have a better line of sight on banks' concentrations to single and group large exposures as a percentage of regulatory capital, but to have the wherewithal to enforce remedial action by banks operating in breach of these requirements. These total exposures should be monitored and reported on to the BSSC to ensure a greater awareness and accountability of how banks are progressing against reducing such exposures. Many of these large problematic loans being reported by the banks, are either substandard, weak or non-performing, putting banks' capital at risk.

66. The RBZ should collect both single large exposures and group exposures as a percentage of regulatory capital on a per bank basis and take remedial action to have banks reduce such exposures to an acceptable prudential limit. Reporting this information to the Director of BSD and up to the BSSC will ensure line of sight on the potential exposures to banks' capital levels." Source: FSSR report - February/2019.

50. The RBZ should review the current regulation on large exposures' limits, mainly aiming to:

i. Replace the Capital Base by Tier 1 Capital for the identification of large exposures (>=10% Tier1 Capital) and the calculation of the large exposures limit (<= 25% Tier 1 Capital);

ii. Adjust large exposures limit requirements in line with Basel III Framework - LEX <= 25% Tier 1 Capital to each single or group of connected counterparties: the RBZ should consider planning a strategy for a transition period to align the requirements to corporate groups with Basel III standard.;

iii. Improve criteria for economic interdependence identification: as the identification of economic interdependence is based on qualitative criteria, it is important that regulation provides a thorough clarification of its concept. In practical terms, TA experts recommend the review of the current criteria in line with LEX10.17 of the Basel Framework;

iv. Revise the exemptions settled in paragraph 40 of the current the RBZ regulation in line with Basel III Framework recommendations for CRM techniques (LEX30.7-LEX30.21), offsetting schemes (LEX30.22-LEX30.30) and exemptions (LEX30.31-LEX30.36), assessing the possibility of eliminating those exemptions that do not comply with Basel III Framework requirements [e.g. 40(f)] in the current the RBZ regulation;

v. Require banks to immediately inform breaches on the limit to supervisors: paragraph 41 of the RBZ regulation requires banks to "promptly bring the loan or advance into conformance", however, it misses the requirement to immediately communicate the breach to supervisor, as recommended in LEX 20.3 of the Basel Framework[46].

51. Based on the new draft, BSD should conduct a QIS to assess the impact of the review on the RBZ's Large Exposures regulation in the banks' compliance to the limits. If necessary, the RBZ should collect additional data on large exposures from all banks, in order to assess:

i. the change in the metric's reference from Capital Base to Tier1 Capital;

ii. eventual adjustments in the composition of a group of connected counterparties due to more clarification on the criteria for the identification of connected counterparties due to economic interdependence;

iii. the strategy to align the requirements to corporate groups with Basel III standards.

[46] Basel III Framework: "LEX 20.3 Breaches of the limit, which must remain the exception, must be communicated immediately to the supervisor and must be rapidly rectified." (https://www.bis.org/basel_framework/).

F. Leverage Ratio

52. The capital definition and the exposure measure for the calculation of the Leverage Ratio should be updated in line with Basel III Framework. The exposure measure should be updated considering the prudential adjustments related to assets in Tier 1, to maintain consistency between numerator and denominator. The RBZ should assess if the special treatment to SFTs and derivatives is necessary. In case it becomes effective, the RBZ should consider the comprehensive approach for SFTs and Basel II CEM approach for derivatives.

G. Reporting Templates

53. The RBZ should review the current BSD1 prudential reporting templates to ensure the incorporation of all changes from the updated capital regulatory framework. The BSD1 framework consolidates the reporting templates that provide information to BSD conduct the assessment of compliance with prudential capital requirements and operational limits of supervised entities. As information reported to supervisors under Basel III should satisfy the granularity needed to conduct ongoing off-site supervision processes, it is expected that the changes in prudential regulation proposed in this TA will need to be reflected in some BSD1 worksheets.

APPENDIX I. STRUCTURE OF THE BANKING SECTOR AS OF MARCH 31, 2023

Table 7. Structure of the Banking Sector in Zimbabwe

No	BANK NAME	TOTAL ASSETS (ZW$)	MARKET SHARE (%)	CONTROL	COUNTRY OF HOME SUPERVISION	BANKS ARE INVOLVED IN CONSOLIDATED SUPERVISION (home/host)
1	**CBZ Bank**	1,130,050,234,770.55	19.91%	Mixed	Zimbabwe	+
2	**Stanbic Bank**	918,650,864,507.17	16.18%	Foreign	South Africa	+
3	**Ecobank**	739,198,108,189.91	13.02%	Foreign	Togo	+
4	**CABS**	442,191,703,712.68	7.79%	Foreign	Zimbabwe	+
5	**FBC Bank**	384,480,543,152.44	6.77%	Mixed	Zimbabwe	+
6	**ZB Bank**	280,932,959,100.53	4.95%	Local Private	Zimbabwe	+
7	**First Capital Bank**	232,342,278,025.32	4.09%	Foreign	Malawi	+
8	**BancABC**	485,447,943,743.94	8.55%	Foreign	Zimbabwe	+
9	**Standard Chartered Bank**	158,979,840,529.56	2.80%	Foreign	England	+
10	**Nedbank**	103,766,143,893.50	1.83%	Foreign	South Africa	+
11	**NMB Bank**	183,751,326,408.78	3.24%	Foreign	Zimbabwe	+
12	**Steward Bank**	140,020,529,948.00	2.47%	Local Private	Zimbabwe	+
13	**Metbank**	166,681,717,235.00	2.94%	Local Private	Zimbabwe	+
14	**AFC Commercial Bank**	124,208,300,016.33	2.19%	State	Zimbabwe	+
15	**POSB**	48,621,261,619.69	0.86%	State	Zimbabwe	
16	**FBC Building Society**	53,091,909,639.42	0.94%	Mixed	Zimbabwe	+
17	**National Building Society**	64,137,033,951.54	1.13%	State	Zimbabwe	
18	**ZB Building Society**	19,696,722,910.20	0.35%	Local Private	Zimbabwe	+
	Total	**5,676,249,421,354.56**	**100.00%**			

Source: The Reserve Bank of Zimbabwe

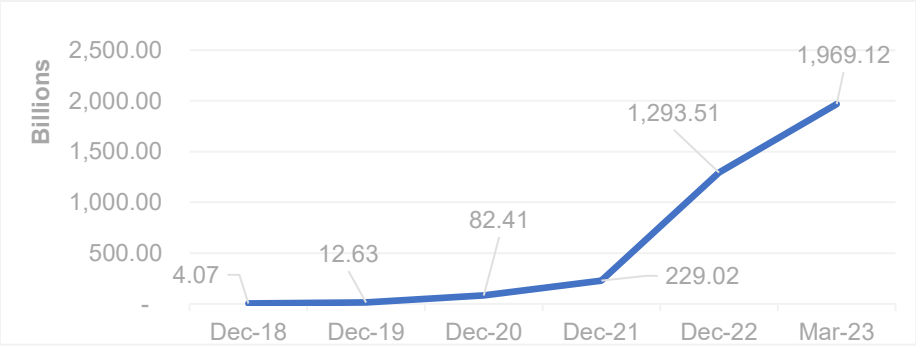
APPENDIX II. BANKING SECTOR INDICATORS

Table 8. Key Metrics for the Banking Sector

Key Indicators	Benchmark	Mar-22	June-22	Sept-22	Dec-22	Mar-23
Total Assets	-	$969.24bn (USD6.81bn)	$1.94tn (USD5.30bn)	$3.11tn (USD5.00bn)	$3.81tn (USD5.67bn)	$5.68tn (USD6.11bn)
Total Loans & Advances	-	$320.36bn (USD2.25bn)	$603.14bn (USD1.65bn)	$1.01tn (USD1.63bn)	$1.29tn (USD1.92bn)	$1.97tn (USD2.12bn)
Net Capital Base	-	$170.00bn (USD1.19bn)	$349.48bn (USD0.95bn)	$535.96bn (USD0.86bn)	$746.30bn (USD1.11bn)	$1.01tn (USD1.09bn)
Core Capital		$138.21bn (USD0.97bn)	$284.74bn (USD0.78bn)	$438.11bn (USD0.70bn)	$611.11bn (USD0.91bn)	$803.08bn (USD0.86bn)
Total Deposits	-	$582.26bn (USD4.09bn)	$1.12tn (USD3.06bn)	$1.91tn (USD3.07bn)	$2.29tn (USD3.11bn)	$3.17tn (USD3.41bn)
Net Profit	-	$27.05bn (USD0.19bn)	$181.25bn (USD0.49bn)	$342.28bn (USD0.55bn)	$503.13bn (USD0.75bn)	$207.25bn (USD0.22bn)
Return on Assets	-	3.39%	8.67%	16.48%	17.43%	4.92%[47]
Return on Equity	-	12.43%	31.60%	53.19%	54.33%	16.62%
Capital Adequacy Ratio	12%	35.16%	33.87%	35.45%	37.51%	41.05%
Tier 1 Ratio	8%	26.97%	18.84%	23.97%	26.92%	27.85%
Loans to Deposits Ratio	70%	55.02%	53.69%	52.83%	55.67%	62.09%
NPLs Ratio	5%	1.57%	1.50%	1.41%	1.58%	3.30%
Liquidity Ratio	30%	61.38%	60.78%	59.51%	59.50%	57.65%

Source: The Reserve Bank of Zimbabwe.

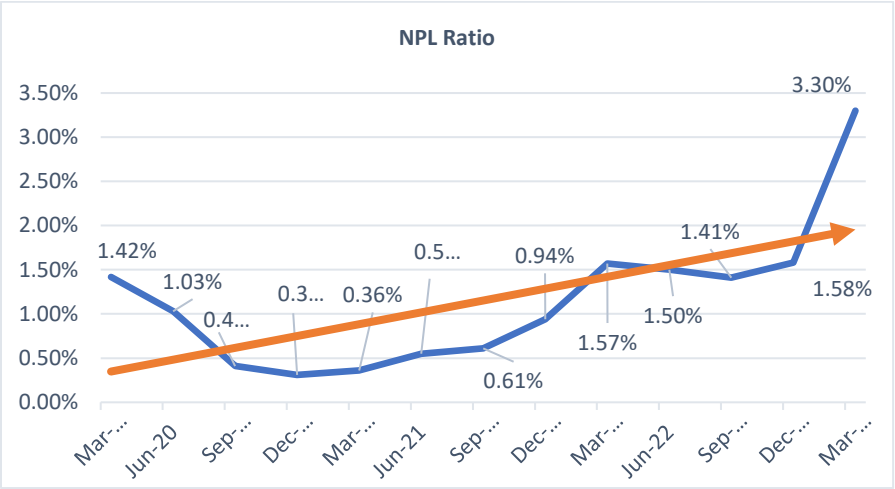
Figure 9. Banking Sector Loans and Advances – Total Loans



Source: The Reserve Bank of Zimbabwe

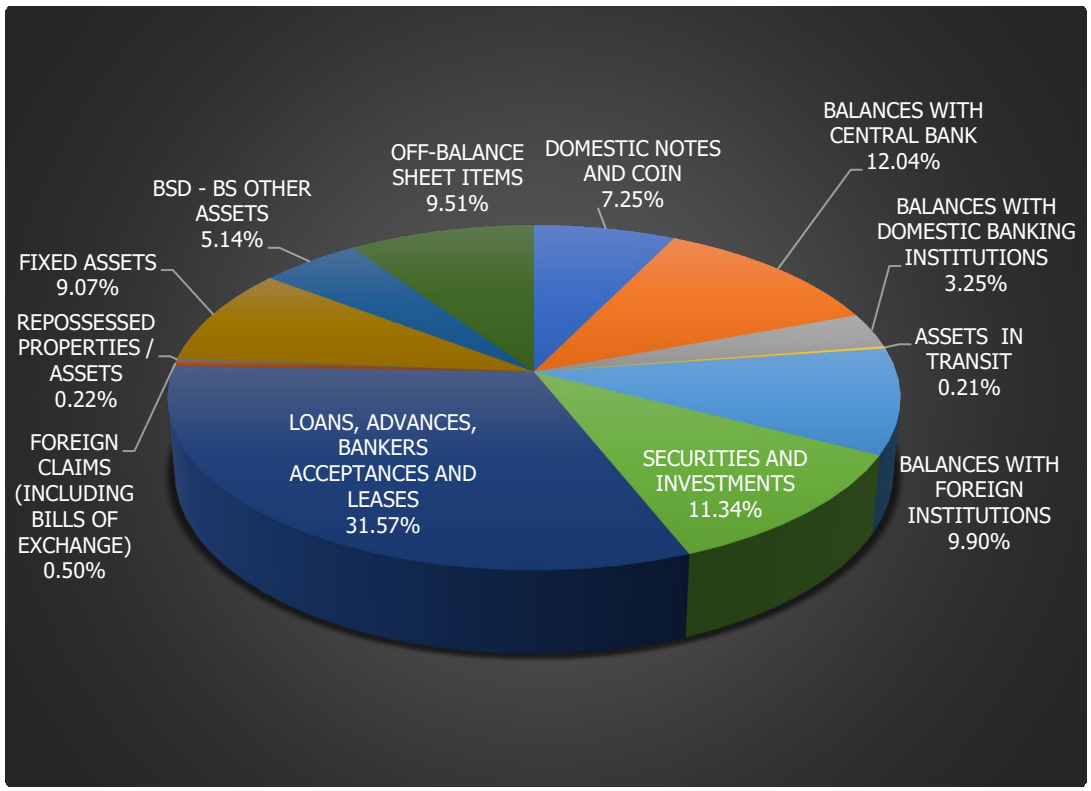
[47] Please note profitability indicators are based on cumulative earnings with December figures based on annual earnings and March, first quarter earnings.

Figure 10. Nonperforming Loans



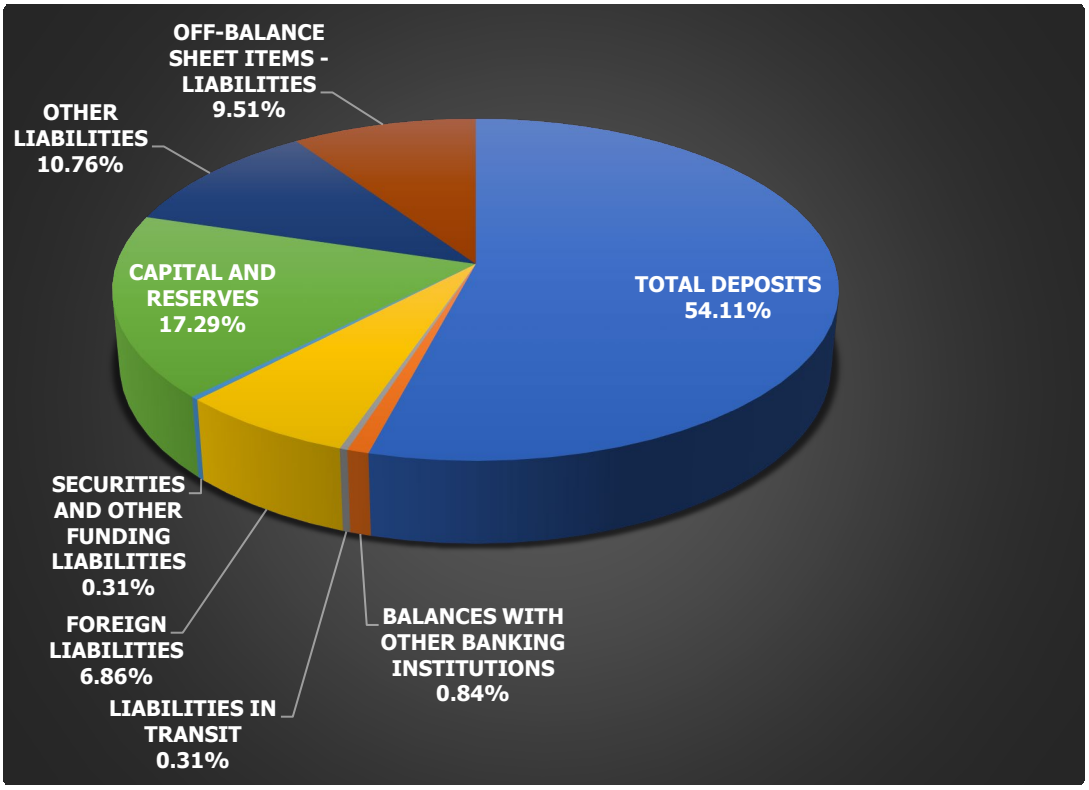
Source: The Reserve Bank of Zimbabwe.

Figure 11. Banking Sector Assets, as of March 2023



Source: The Reserve Bank of Zimbabwe.

Figure 12. Banking Sector Liabilities, as of March 2023



Source: The Reserve Bank of Zimbabwe.

APPENDIX III: CAPITAL COMPOSITION IN ZIMBABWE

Capital Tier 1 is composed by:

- issued and fully paid up ordinary shares or common stock;
- paid up non-cumulative irredeemable preference shares;
- reserves consisting of:
    a. non-repayable share premiums;
    b. disclosed reserves created by a charge to net income in the financial year immediately preceding the current one;
    c. published retained earnings for the current year, including interim earnings, where these have been verified by external auditors; and
- minority interests in subsidiaries arising on consolidation.

Capital Tier 2 is composed by:

- the current financial year's unpublished profits where provisions for taxation, dividends and bad debts have been made;
- the full extent of fixed assets revaluation reserves where they are carried through to the balance sheet;
- revaluation reserves arising from the holding of equity securities at historic cost and not at market values to the extent of 55% of the reserve;
- general bad debt provisions to the extent of 1,25% of total risk weighted assets;
- the full extent of any subordinated term debt (loan capital) whose remaining term to maturity is more than five years, and so much of any subordinated term debt whose remaining term to maturity is five years or less as is calculated by amortizing or discounting such debt by a cumulative factor of 20% per year of the remaining term to maturity, provided that this element will not be included to the extent that it exceeds 50% of the core capital of the banking institution;
- hybrid (debt/equity) capital instruments such as cumulative preference shares which are unsecured and fully paid up and are available to meet losses;
- equity funded through the capitalization of revaluation reserves;
- the full extent of any minority interests in cumulative redeemable preference shares; and
- such hidden reserves as the RBZmay agree to be included in supplementary capital.

The Zimbabwe Capital Base considers the following deductions:

- From the Tier 1:
    a. the current financial year's unpublished losses;
    b. goodwill;
    c. equity funded through the capitalization of revaluation reserves
- From gross capital:
    a. investments in or lending of a capital nature to subsidiaries engaged in banking and financial activities which are not consolidated

b. encumbered assets - funds acquired by using the bank's capital funds which have subsequently been pledged as collateral for borrowings or are encumbered by any caveats rendering them unavailable to meet losses arising from the institution's operations

APPENDIX IV. RISK WEIGHTS FOR CREDIT RISK

Table 9. Compared Risk Weights for Credit Risk: Basel II, Zimbabwe, and Basel III Frameworks

Asset class	Detail	Risk Weight			
		Basel II Part 2, II, A	Zimbabwe Guideline Nº 1-2011/BSD Section 3.14	Basel III CRE20	Observation
Domestic Sovereign		0% funded in same currency Rated 0-150% Unrated 100%	0%	0% funded in same currency Rated 0-150% Unrated 100%	The RBZ should consider the use of Basel III risk weights
Foreign Sovereign		0% funded in same currency Rated 0-150% Unrated 100%	0% funded in same currency Rated 0-150%	0% funded in same currency Rated 0-150% Unrated 100%	The RBZ should consider the use of Basel III risk-weights
Public Sector Entities	Based on Sovereign (National Discretion if there is revenue raising power)	0% funded in same currency Rated 0-150% Unrated 100%	Similar to corporates Rated 20 - 150%	Rated 20-150% Unrated 100%"	The RBZ should consider the use of Basel III risk-weights
	Based on Banks	Rated 20-150% Options 1 or 2 (Unrated 100 or 50%)		Rated 20-150% Unrated 50%	
Multilateral Development Banks		0% for highly rated Option 2 banks - 20-150% Unrated 50%	0% for highly rated	0% for highly rated Option 2 banks - 20-150% Unrated 50%	African Export-Import Bank is not present in Basel III list
Banks	Based on Sovereign (1 notch below) (National Discretion)	Rated 20-150% Option 1 - Unrated 100%	Rated 20-150% preferential treatment (< 3 months)	(ECRA) Rated 20 - 150% preferential treatment (<3 months) (SCRA) Grade A - C 30 - 150% preferential treatment (< 3 months) 20 - 75%	The RBZ should consider the use of SCRA methodology considering the sovereign risk floor for FX transactions
	Based on Banks	Rated 20-150% Option 2 - Unrated 50 or 20% (short term)			
Subordinated Debt, Equity		SD and capital - Deducted	Equity in Financials - Deducted	Speculative unlisted equity 400%	Risk weights should be updated

Asset class	Detail	Risk Weight			
		Basel II Part 2, II, A	Zimbabwe Guideline Nº 1-2011/BSD Section 3.14	Basel III CRE20	Observation
and Capital Instruments		Other equity 100% Commercial entities above threshold - deduction	Other equity 100%	Other equity 250% National programs (Equity) 100% Subordinated Debt 150% Commercial entities above threshold 1250% Significant financials (not deducted) 250%	
Securities Firms	Based on Banks	Rated 20-150% Option 1 - Unrated 100% Option 2 - Unrated 50% or 20% short term	Rated 20-150% Similar corporates	(ECRA) Rated 20 - 150% preferential treatment (<3 months) (SCRA) Grade A - C 30 - 150%) preferential treatment (< 3 months)	The RBZ should consider the use of the new Basel III risk-weights
	Based on Corporates	Rated 20-150% Unrated 100%		Rated 20-150% Unrated 100% Investment grade 65% Corporate SME 85%	
Corporates		Rated 20-150% Unrated 100%	Rated 20-150%	Rated 20-150% Unrated 100% Investment grade 65% Corporate SME 85%	The RBZ should consider the use of the new Basel III risk-weights
Regulatory Retail		75%	75%	Transactors 45% Retail 75% Household not retail 100%	The transactors risk weight should be included
Residential Real Estate		35%	35% - LTV < 80%	Not materially dependent - 20 - 30% LTV <80%; 40 – 70% LTV >80% Materially dependent –	The Basel III asset class definition and the new risk weights should be included

Asset class	Detail	Risk Weight			
		Basel II Part 2, II, A	Zimbabwe Guideline Nº 1-2011/BSD Section 3.14	Basel III CRE20	Observation
				30 - 45% LTV <80%; 60 – 105% LTV >80%	
Commercial Real Estate		100%	100%	Not materially dependent - Min (60%, RW of counterparty) LTV < 60%; RW of counterparty LTV > 60% Materially dependent - 70% LTV < 60%; 90% LTV 60% <> 80%; 110% LTV > 80%	The Basel III asset class definition and the new risk weights should be included
Other real estate		RW counterparty	RW counterparty	Not materially dependent - RW counterparty Materially dependent - 150% Land acquisition, development and construction - 100% Residential and 150% other	The Basel III asset class definition and the new risk weights should be included
Securitisation		Rated: Long term 20 - 150% B+ or lower - deduction Short term 20-100% Lower A3 - deduction Unrated - deduction senior - look through second loss - max(100%, high underlying) Liquidity facilities - high underlying	Rated: Long term 20 - 150% B+ or lower - deduction Short term 20-100% Lower A3 - deduction Unrated - deduction senior - look through second loss - max(100%, high underlying) Liquidity facilities - high underlying	CRE 40 -45 SEC SA 41	

Asset class	Detail	Risk Weight			
		Basel II Part 2, II, A	Zimbabwe Guideline Nº 1-2011/BSD Section 3.14	Basel III CRE20	Observation
Past Due		90 days delay Provision < 20% - 150% Provision < 50% - 100% Provision > 50% - 50% (Supervisory discretion)	90 days delay Provision < 20% - 150% Provision < 50% - 100% Provision > 50% - 50%	Defaulted exposures (90 days + problematic exposures) Provision < 20% - 150% Provision < 50% - 100% Provision > 50% - 50%	Update the asset class definition
Covered Bonds				Rated 20-100% Unrated 10-100% dependent on the issuing bank	Introduce the new asset class
Specialised Lending	In Basel II and Zimbabwe (Corporates) In Basel III - rating of the project, not the counterparty, following corporates	Rated 20-150% Unrated 100%	Rated 20-150%	Rated 20-150% Project Finance - 130% Pre-Operational Phase; 100% or 80% Operational Phase Object Finance - 100% Commodities Finance - 100%	Introduce the new asset class
Off Balance Sheet		Commitments 20% (<3 months) 50% (>3 months) Unconditionally Cancellable 0%	Commitments 20% (<3 months) 50% (>3 months) Unconditionally Cancellable 0%	Commitments 40% Unconditionally Cancellable 10%	Update the credit conversion factors