



Pursuant to Article 23, paragraph 1, and Article 35, paragraph 1, subparagraph 1.1, of Law No. 03/L-209 on Central Bank of the Republic of Kosovo (Official Gazette of the Republic of Kosovo, No. 77 / 16 August 2010), and Articles 15, 16 and 85, paragraph 1, of Law No. 04/L-093 on Banks, Microfinance Institutions and Non-Bank Financial Institutions (Official Gazette of the Republic of Kosovo, No. 11 / 11 May 2012), the Board of the Central Bank of the Republic of Kosovo at the meeting held on 22 December 2015 approved the following:

REGULATION ON BANK CAPITAL ADEQUACY

Article 1 Purpose and scope

1. The purpose of this Regulation is to ensure that banks hold capital sufficient to cover the risks involved in their business, to maintain the minimum capital level and also a capital adequacy ratio which reflects the risk exposures of the bank both on- and off-balance sheet.
2. This Regulation shall apply to all banks that are licensed by the CBK to operate in the Republic of Kosovo, excluding branches of foreign banks.

Article 2 Definitions

1. All terms used in this Regulation are as defined in Article 3 of the Law No.04/L-093 on Banks, Microfinance Institutions and Non-Bank Financial Institutions and/or as further defined herein for the purpose of this Regulation:

- a) *Bank* – means a shareholder company engaged in the business of banking, including a subsidiary, licensed by the CBK;
- b) *Branch of a foreign bank* – means a person that is organized, has its head office and holds a license to engage in the business of banking in a jurisdiction other than Kosovo.
- c) *Common Equity Tier 1 capital* – means a bank’s permissible permanent paid-in capital which may be comprised of any or all of the following:
 - i. Common equity shares and their related surplus;
 - ii. Earnings which have not been distributed.

Additional Tier 1 capital – means:

- i. perpetual preferred shares (being those which, in the event of liquidation of the bank, are not paid any amounts until all depositors and other creditors have been fully addressed, but are paid in full, (preferred) before any common shareholder is paid and which have rights to agreed dividend payments but which have no maturities or options of their holders to redeem);
- ii. such other instruments as may be approved by the CBK as permissible permanent capital from time to time by rule or order.

Deductions from Tier 1 Capital:

- i. Goodwill and intangible assets are to be deducted from a bank's Tier 1 capital before the Tier 2 capital portion of the calculation is made;
- ii. Investments in equity of banks or other financial institutions that comprise above ten per cent (10%) of their capital (this percentage shall include also the subordinated rights), or investments in amounts less than 10% of their capital, but with a significant influence in decision making of these financial institutions. Investments in equity of banks and other financial institutions (including here also the subordinated rights) that comprise less than 10% of the bank's equity before deductions, where the amount above the 10% threshold shall be deducted.;
- iii. Deferred tax assets;
- iv. Lending to a Bank-Related Person, except lending covered with cash.

d) *Tier 2 capital includes a bank's:*

- i. Reserves for loan losses up to a maximum of 1.25 % (one point twenty-five percent) of its risk weighted assets at any one time or such other percentage as may be established by the CBK from time to time by rule or order;
- ii. Ordinary preferred shares (being preferred shares which have maturities or are redeemable at the option of their holders and which are cumulative (have the right to payment of past dividends missed) if the bank has the option to defer payment of dividends;
- iii. Term preferred shares (shares whose holders have the right to redeem them and which have terms of 5 years or more). These shares are subject to approval as capital from time to time throughout their terms by the CBK. The amount of long-term preferred shares (shares with maturities in excess of ten (10) years eligible to be included in Tier 2 capital will be reduced by 20 % (twenty percent) of their original amounts at the beginning of each of the last 5 years of their terms;
- iv. Term debt instruments which are fully subordinated to the rights of depositors (those which, in the event of liquidation of the bank, are not paid any amounts until all depositors have been paid). The amount of long-term subordinated debt instruments (those with maturities in excess of ten years) eligible to be included in Tier 2 capital will be reduced by 20% (twenty

percent) of their original amounts at the beginning of each of the last five (5) years of the instrument's life;

v. Debt instruments which are mandatory convertible into common shares and which are unsecured and fully paid-in;

vi. Subordinated term debt are liabilities, but if subordinated term debt was issued with an original term to maturity of over five years, then it may be included as Tier 2 capital to a maximum of 50% (fifty percent) of Tier 1 capital; and

vii. Tier 2 capital cannot be higher than 100% (one hundred percent) of Tier 1 capital.

- e) *Total capital* – means the sum of a bank's Tier 1 capital and its Tier 2 capital.
- f) *Risk-asset* – means any monetary asset which is carried on the balance sheet of a bank such as a loan which entails any risk of loss in value to that bank.
- g) *Off-balance sheet items* – means the contingent liabilities of a bank including direct credit substitutes issued by it such as guarantees of indebtedness, standby letters of credit and other contingencies which must be disclosed as footnotes on its balance sheet but for which no definite risk value is available for purposes of inclusion in the principle part of its balance sheet.
- h) *Goodwill* – means the excess of the current value of a bank asset over the value at which it is carried on the bank's books as more fully defined under international accounting standards.
- i) *Intangible asset* – means the identifiable non-monetary assets of a bank, which have no physical substance, which are carried and controlled by it as a result of past events and from which future economic benefits are expected to flow as more fully defined under international accounting standards.
- j) *A direct credit substitute* – means any arrangement in which a bank assumes risk of credit-related losses from assets or other claims that it has not transferred, when the risk of credit loss exceeds the banks pro rata share of the assets or other claims.
- k) *Trade-related letters of credit* – means short-term self-liquidating instruments used to finance the movement of goods and are collateralized by the underlying goods.
- l) *Operational risk* – means the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This definition includes legal risk, but excludes strategic and reputation risk.
- m) *Loan-to-value ratio (LTV)* – is or means defined as the outstanding principal balance on the loan amount divided by the current estimated market value of the residence.

Article 3

Minimum Capital

1. According to paragraph 1 of Article 15 of the Law No. 04/L-093 on Banks, Microfinance Institutions and Non-Bank Financial Institutions should have at least seven (7) million Euros of paid-in capital, subject to the restrictions in paragraph 2 of Article 15 of the Law on Banks, at all times.
2. The requirement from the paragraph 1 of this Article must be satisfied within 6 months of the Law No. 04/L-093 on Banks, Microfinance Institutions and Non-Bank Financial Institutions coming into force.

Article 4

Capital Adequacy Ratio

1. Banks are required to maintain a minimum ratio of 12% (twelve percent) of risk assets and other risks, in total capital and 8% (eight percent) in Tier 1 capital. This minimum applies to all banks. Under its powers in paragraph 2 of Article 16 of the Law No. 04/L-093 on Banks, Microfinance Institutions and Non-Bank Financial Institutions, the CBK may require individual banks to maintain higher ratios.
2. CBK also applies a minimum leverage ratio provided with Article 9 of this Regulation.

Article 5

Risk Weighted Assets and Off-balance Sheet Claims

1. The following are the risk weights assigned to risk assets of banks to measure banks' compliance with this Regulation:

Category 1 - 0 % (Zero Percent) Risk Weight

- (a) Cash in Euro and in foreign readily convertible currencies.
- (b) Balances due from the CBK, and claims on Central Banks of countries rated from the Rating Agencies, as described in **Annex I**.
- (c) Holding of securities issued by the Government and Municipalities of the Republic of Kosovo.
- (d) Direct claims on or claims unconditionally guaranteed by central governments of countries rated the Rating Agencies, as described in **Annex I**.
- (e) Precious metals and precious stones appraised at values approved by the CBK on a case by case basis held in a bank's own vault or if in the vaults of a depository, clearly appropriated to such bank.
- (f) Loans or the portions thereof supported by cash collateral in the form of Euro or other readily convertible currency maintained at current value, deposited with the bank and pledged and blocked for the purpose.
- (g) Claims for the funds which are fully established by one or more central governments, central banks, multilateral development banks , or entities of public sector rated assigned as risk-

weighted according to the jurisdiction where established, to which shall be applied 0% risk weight as per the requirements of this regulation. The only source of these funds shall be the payment funds from the abovementioned institutions in form of participation, excluding any other fund financed through debts.

- (h) Claims to the International Monetary Fund (IMF), the Bank for International Settlements (BIS), the European Central Bank (ECB) and the European Community.
- (i) Claims to multilateral development banks such as the International Bank for Reconstruction and Development; the International Finance Corporation; the Inter-American Development Bank; the Asian Development Bank; the African Development Bank; the Council of Europe Development Bank; the Nordic Investment Bank; the Caribbean Development Bank; the European Bank for Reconstruction and Development; the European Investment Bank; the European Investment Fund; the Multilateral Investment Guarantee Agency; the International Finance Facility for Immunisation; and the Islamic Development Bank.

Category 2 - 20 % (twenty percent) Risk Weight

- (a) Direct claims on or claims unconditionally guaranteed by banks with short-term credit ratings from the Rating Agencies, as described in **Annex I**.
- b) Loans or the portions thereof supported by collateral in the form of securities issued or unconditionally guaranteed by Central Banks or central governments of countries rated the Rating Agencies, as described in **Annex I**.
- c) Securities issued by or unconditionally guaranteed by Central Banks or Central Governments of countries rated the Rating Agencies, as described in **Annex I**.
- d) Loans or the portions thereof supported by collateral issued by or guaranteed by multilateral lending institutions or global or regional development institutions subject to the prior approval of the CBK.
- e) Claims from banks, with residual maturity of up to one year and claims with residual maturity of up to one year, covered by irrevocable, unconditional guarantees and securities issued by these banks, licensed by CBK. Claims on banks shall not include bank's claims serving as collateral in other banks, claims included as a component of the own funds of those banks, as well as claims on banks in court procedure.
- f) Cash items in process of collections.

Category 3 - 35 % (thirty-five percent) Risk Weight

- (a) Qualifying residential mortgage loans – Category A (QRML-A) according to the CBK Regulation on Mortgage Residential Loans.

Category 4 – 50 % (fifty percent) Risk Weight

- (a) Direct claims having maturities of one year or less or claims unconditionally guaranteed by banks, subject to prior approval of the CBK, that has short-term credit ratings from the Rating Agencies, as described in **Annex I**.
- (b) Direct claims from or claims unconditionally guaranteed by the central governments of states, classified by the Classification Agencies as described in **Annex 1**.
- (c) Qualifying residential mortgage loans – Category B (QRML-B) according to the CBK Regulation on Mortgage Residential Loans.

Category 5 – Seventy-five Percent (75 %) Risk Weight

- (a) Loans or the portions thereof supported by collateral in the form of first priority residential mortgage with default exceeding 30 days (when a loan is in default of over 30 days, where the unpaid amount does not exceed 30 days of default (when a loan is overdue for over 30 days, the entire exposure of that creditor should be weighed as the loan, with the exception of cash loans and if the source of the payment for the other exposure is different from that of the loan) which is subject to the following conditions:
 - (i) The ownership of the residential property must be verified and documented;
 - (ii) The maximum loan-to-value (LTV) ratio shall not exceed sixty-five percent (65%); and
 - (iii) The real estate market value must be supported by an independent appraiser, which may be in the form of a valuation by a qualified and licensed real estate appraiser or from the immovable property tax base compiled by municipalities in accordance with the Law on Taxes on Immovable Property in Kosovo.
- (b) Loans to builders to finance real estate construction where the property to be financed has been pre-sold or pre-leased pursuant to a legally enforceable contract with the sales proceeds or rentals unconditionally assigned to the bank.

Category 6 – One Hundred Percent (100 %) Risk Weight

- (a) Direct claims having maturities of one year or less or claims unconditionally guaranteed by banks, subject to prior approval of the CBK, which are not rated.
- (b) All other claims to debtors that do not qualify for a Category 1-4 risk weight.
- (c) Premises, plant and equipment, other fixed assets and other real estate owned as a result of foreclosures or other takings of land or buildings as a result of defaults.
- (d) Qualifying residential mortgage loans with default over 90 days after the deduction of specific provisions.

Category 7 – One Hundred and Fifty Percent (150 %) Risk Weight

- (a) Direct claims having maturities of one year or less or claims unconditionally guaranteed by banks, subject to prior approval of the CBK, that has short-term credit rating, as described in Annex I.

2. Off-Balance-Sheet Items Conversion Factors

The following values are assigned to off balance-sheet items:

- a) Unused portions of commitments with original maturities of 1 (one) year or less and unused portions of commitments which are unconditionally cancellable at any time, regardless of maturity, will be assigned 0% of their face value for risk weighting purposes.
- b) Short-term self-liquidating trade related contingencies; including commercial letters of credit and bid guarantees will be assigned 20% of their face values for risk weighting purposes.
- c) Direct credit substitutes including guarantees of payment and standby letters of credit will be assigned 100% of their face values for risk-weighting purposes.
- d) Any other item not included in (b) and (c) will be assigned 100% of their face values for conversion to on balance-sheet equivalents.

Article 6 Operational Risk

1. Banks shall apply the basic indicator approach (BIA) under the Basel II capital framework.

- a) The BIA requires a capital charge of 15 % (fifteen percent) of gross income be added to the risk weighted assets of the bank in calculating the risk-asset ratio. Gross income is defined as net interest income plus net non-interest income. It is intended that this measure should:
 - i. be gross of any provisions (e.g. for unpaid interest);
 - ii. be gross of operating expenses, including fees paid to outsourcing service providers;
 - iii. exclude realized profits/losses from the sale of securities; and
 - iv. exclude extraordinary or irregular items as well as income derived from insurance.
- b) For newly established banks with less than three years data, the new bank shall use any actual gross income earned to date for purposes of deriving the average gross income, while leaving the gross income for any remaining quarters as zero.

2. Subject to the CBK's prior approval, banks may use SA to calculate its operational risk capital charges. Under the SA the capital requirement for operational risk is the average over three years of the risk-weighted relevant indicators calculated each year across the business lines (in accordance with Annex II and Annex III). In each year, a negative capital requirement in one business line, resulting from a negative

relevant indicator may be imputed to the whole. However, where the aggregate capital charge across all business lines within a given year is negative, then the input to the average for that year shall be zero. The three-year average is calculated on the basis of the last three twelve-monthly observations at the end of the financial year. When audited figures are not available, business estimates may be used.

Article 7

Market Risk

If the CBK assesses that a bank is highly exposed to the market risk it may require additional capital to the bank.

Article 8

Capital Planning

The CBK requires banks to develop an internal process for capital adequacy planning in relation to their risk profiles, which continuously presents the adequate level of capital, estimated by the bank. The bank's internal process for planning the adequacy level of capital will be subject to CBK assessment.

Article 9

Leverage Ratio

1. Under paragraph 2 of Article 16 of the Law No. 04/L-093 on Banks, Microfinance Institutions and Non-Bank Financial Institutions, the CBK has the authority to establish a minimum leverage ratio.
2. Banks are required to maintain a minimum 7 percent leverage ratio. (Leverage ratio equals total equity / total assets).

Article 10

Enforcement, Remedial Measures and Civil Penalties

Any violation of this Regulation shall be subject to the remedial measures and penalties provided for in the Law No. 03/L-209 on Central Bank and the Law No. 04/L-093 on Banks, Microfinance Institutions and Non-Bank Financial Institutions.

Article 11

Abrogation

Upon the entry into force, this Regulation shall abrogate the Regulation on Bank Capital Adequacy issued by the CBK Board on December 26 April 2013 and the Regulation on Bank Capital Adequacy issued by the CBK Board on 26 February 2016, and any other provisions that may be in conflict with this Regulation.

Article 12
Annexes

Annex I, Annex II and Annex III are integral parts of this Regulation.

Article 13
Entry into force

This Regulation shall enter into force on 1 January 2016.

The Chairman of the Board of Central Bank of the Republic of Kosovo

Prof. Dr. Bedri Peci

ANNEX I

<u>Claims on Central Banks and Sovereigns</u>						
Rating	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to B-	Below B-	Unrated
Risk Weight	0%	20%	50%	100%	150%	100%
<u>Claims on Banks</u>						
Rating	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to B-	Below B-	Unrated
Risk Weights for Claims with Maturity above Three (3) Months	20%	50%	100%	100%	150%	100%
Risk Weights for Claims with Maturity up to Three (3) Months	20%	20%	20%	50%	150%	100%

Interpretation	Moody's		S&P		Fitch	
	Long-term	Short-term	Long-term	Short-term	Long-term	Short-term
Investment-grade ratings	Rating	Rating	Rating	Rating	Rating	Rating
Highest credit quality	Aaa	P-1	AAA	A1+	AAA	F1+
High credit quality	Aa1		AA+		AA+	
	Aa2		AA		AA	
	Aa3		AA-		AA-	
Strong payment capacity	A1	P-2	A+	A1	A+	F1
	A2		A		A	
	A3		A-		A-	
Adequate payment capacity	Baa1	P-3	BBB+	A-2	BBB+	F2
	Baa2		BBB		BBB	
	Last rating in investment-grade		Baa3	BBB-	A-3	BBB-
Speculative-grade ratings						
Speculative	Ba1		BB+	B	BB+	B
Credit risk developing due to economic changes	Ba2		BB		BB	
	Ba3		BB-		BB-	
Highly speculative	B1		B+		B+	
credit risk present,	B2		B		B	

with limited margin safety	B3	Not prime	B-		B-	
High default risk,	Caa1		CCC+	C	CC+	C
capacity depending on sustained,	Caa2		CCC		CCC	
favorable conditions	Caa3		CCC-, CC		CCC-, CC	
Default,	Ca, C		C, D	D	C, D	D
Although prospect of partial recovery						

ANNEX II

Formula for calculating the operational risk capital charge under BIA is:

$$KBIA = \{\sum(GI1 \dots n \times \alpha)\}/n$$

Where

KBIA = capital charge under BIA

GI = annual gross income of the banks, where positive, over the preceding

three years n = number of the preceding three years where annual gross

income is positive

$$\alpha = 15\%$$

The formula for calculating the operational risk capital charge under SA:

$$KSA = \{\sum_{\text{years 1-3}} \max[\sum(GI1-8 \times \beta1-8), 0]\}/3$$

Where

KSA = capital charge under SA

GI1-8 = annual gross income in a given year for each of the eight business lines

B1-8 = a fixed beta factor (as defined in Annex III).

ANNEX III

Business line	List of activities	Percentage
Corporate finance	<p>Underwriting of financial instruments and/or placing of financial instruments on a firm commitment basis</p> <p>Services related to underwriting</p> <p>Investment advice</p> <p>Advice to undertakings on capital structure, industrial strategy and related matters and advice and services relating to the mergers and the purchase of undertakings</p> <p>Investment research and financial analysis and other forms of general recommendation relating to transactions in financial instruments</p>	18%
Trading and sales	<p>Dealing on own account</p> <p>Money broking</p> <p>Reception and transmission of orders in relation to one or more financial instruments</p> <p>Execution of orders on behalf of clients</p> <p>Placing of financial instruments without a firm commitment basis</p> <p>Operation of Multilateral Trading Facilities</p>	18%
Retail brokerage (Activities with a individual physical persons or with small and medium sized entities)	<p>Reception and transmission of orders in relation to one or more financial instruments</p> <p>Execution of orders on behalf of clients</p> <p>Placing of financial instruments without a firm commitment basis</p>	12%
Commercial banking	<p>Acceptance of deposits and other repayable funds</p> <p>Lending</p> <p>Financial leasing</p> <p>Guarantees and commitments</p>	15%
Retail banking (Activities with a individual	<p>Acceptance of deposits and other repayable funds</p> <p>Lending</p>	

physical persons or with small and medium sized entities meeting the criteria set out in Article 79 for the retail exposure class)	Financial leasing Guarantees and commitments	12%
Payment and settlement	Money transmission services, Issuing and administering means of payment	18%
Agency services	Safekeeping and administration of financial instruments for the account of clients, including custodianship and related services such as cash/collateral management	15%
Asset management	Portfolio management Managing of UCITS Other forms of asset management	12%