Chapter 7

BASEL III IMPLEMENTATION: CHALLENGES AND OPPORTUNITIES IN MYANMAR

By
Cho Cho Lwin¹

1. Introduction

1.1 Objectives and Scope of Study

The aim of this study is to examine how the Myanmar financial system can comply with the Basel I, II and III accords in the financial sector and how the banks can protect depositors and underline the role of qualified capital as collateral for deposits.

The following are objectives of this study which purposes to:

- Study the soundness of the banking system in Myanmar;
- Identify the issues in banking sector development in general and assess the need for Myanmar banks to be in compliance with the Basel Accord requirements;
- Highlight the opportunities and challenges in implementing Basel I, II and III; and
- Assess the impact of implementing Basel on economic development.

Reviewing Myanmar’s financial system over the past 60 years, the main players in the country’s centrally planned economic system, established in 1962, have the state-owned banks and semi-government banks. The financial system contributed to the development of the national economy guided by government-planned targets. The Central Bank of Myanmar (CBM) - the monetary authority, controls the monetary system, such as interest policy,

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reserves, capital adequacy measurement and liquidity ratio, to facilitate the smooth functioning of the financial system.

Although Basel I was intended to be implemented in the emerging economies, its application in these economies was made under the pressure of international institutions and the policy-originating countries which created unforeseen distortions within the banking sectors of these emerging economies. However, in response to the banking crisis of the 1990s and the criticisms of Basel I, the Basel Committee adopted the Basel II. It is known as “A Revised Framework on International Convergence of Capital Measurement and Capital standards.” Under Basel II, the minimum capital requirement under the Basel I is expanded. Basel II provides banks with risk-weighted assets and tries to eliminate the loopholes in Basel I that allow banks to take on additional risk. Its first mandate is to broaden the scope of regulation to include assets of the holding company of an internationally active bank. This is done to avoid the risk that a bank will hide risk-taking by transferring its assets to other subsidiaries, and to incorporate the financial health of the entire firm in the calculation of capital requirements for its subsidiary bank.

The recent global financial crisis has revealed weakness in the risk management process of Basel II. Because Basel II did not adequately anticipate such as a collapse in market liquidity, investor confidence disappeared and banks faced severe losses in the market value of securities held by them. The Basel Committee adopted Basel III in late 2010. It is imperative for Myanmar to adopt the Basel accords step by step in line with the Myanmar financial system.

This paper focuses on the Basel Accords I, II and III implemented by the banks in Myanmar in accordance with the Bank for International Settlement (BIS)’s adopted schedule. As Myanmar is not yet integrated into the global financial and business community, it is not much affected by the world financial crises. The financial institutions and banks are practicing partially the requirements of Basel I in their daily operation. If the financial sector implements Basel II and III, the financial institutions are expected to face opportunities and challenges.

1.2 Outline of Paper

This concept paper outlines the proposal to strengthen the capital adequacy standards of the banking institutions in Myanmar, in line with the
requirements set under the Basel Accord, focusing to raise the quality, consistency and transparency of regulatory capital.

Many countries initiated financial reforms to develop the banking sector. In the context of Myanmar, its economic system was changed to a market-oriented system in 1988 and the Central Bank of Myanmar Law, the Union of Myanmar Foreign Investment Law and a host of other rules and regulations were promulgated in line with the market requirements.

The government allowed the private sector to establish and operate domestic and foreign banking business with the enactment of the Central Bank of Myanmar Law 1990 and Financial Institutions of Myanmar Law 1990. The private banks played an important and substantial role in the development of the banking sector by facilitating the intermediation of funds in the economy and contributing also to regional economic development. These private banks provide a full range of commercial banking services while expanding their branch network and offering additional services such as underwriting and trade financing facilities.

The CBM introduced Basel I to Myanmar banks in 1990 and the Capital Adequacy Ratio requirement of 10 percent. Banks are required to comply with the Liquidity Ratio, Reserve Ratio, and Loans to Deposit Ratio. The CBM closely monitors the banks by analysing their daily returns and financial positions in addition to on-site examination and off-site monitoring. The financial sector in Myanmar, particularly the banking sector, is currently in a stable position and has gained much progress. In order to establish a sound and efficient financial system functioning in harmony in the market economy, various financial reform measures have been undertaken to lay down the foundation of a modern financial system in Myanmar.

Therefore, the CBM has to review the existing regulations to minimise the possibility of regulatory arbitrage and assess the need for additional prudential regulations in implementing Basel II. Moreover, Myanmar needs to have sufficient human resource skills and technology. In order to improve and optimise the quantity and qualification of its human resources, a capacity-building programme is essential.

The paper is organised in six sections. Section 1 provides the introduction and the scope of study. Section 2 describes the overview of the financial system in Myanmar. Section 3 provides an assessment of the impact in the
implementation of the Basel standards. Section 4 presents the issues and challenges of implementing the Basel Standards in the context of the current national economic goals. Section 5 points the way forward and outlines the strategic options available covering capital and liquidity management. Finally, Section 6 concludes with some suggestions.

2. Overview of Financial System and Risk Assessment

2.1 General Overview of the Financial System

2.1.1 The Financial System in Myanmar

The relevant new laws and regulations were promulgated in 1990 to facilitate the intermediation of funds in the market economic system. The financial system of Myanmar consists of the banking sector and the non-banking sector. The banking sector includes the CBM, 4 state-owned banks, 19 private banks and 23 representative offices of foreign banks. The non-banking sector includes insurance corporation, Securities Exchange Centre, small loans enterprise and a financing company. The private banks and state-owned banks hold 62 percent and 38 percent, respectively, of the total assets of the banking sector.

Chart 1

Composition of Assets (2011-2012)

<table>
<thead>
<tr>
<th></th>
<th>State Owned Banks</th>
<th>Private Banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Percentage</td>
<td>62%</td>
<td>38%</td>
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</table>
2.1.2 Regulatory Regime in Myanmar

The government of Myanmar promulgated the following laws to liberalise the financial system:

- The Foreign Investment Law, 1988;
- The Central Bank of Myanmar Law, 1990;
- The Financial Institutions of Myanmar Law, 1990;
- The Myanma Agricultural and Rural Development Bank Law, 1990;
- The New Savings Bank Law, 1993; and

The draft of the new Central Bank of Myanmar law has been submitted to the Hluttaw for approval, and the Foreign Exchange Management Law has been enacted on 10 August 2012.

Under the Central Bank of Myanmar Law, 1990, the CBM is empowered to carry out the following functions:

- Advising the government on economic development policies and plans and on the state budget;
- Sole issuance of local currencies and notes;
- Licensing, inspection and supervision of the financial institutions;
- Regulating the financial system;
- Formulating and implementing monetary policy;
- Implementing exchange rate policy and controlling foreign exchange transactions; and
- Managing the international reserves.
The CBM needs to take the necessary actions to assure the soundness of the banking system and to regulate domestic and foreign banking operations systematically by applying the laws, rules and regulations which are in line with the international standard.

The CBM’s role in promoting economic development is regulating the operations of the banks to create a financial environment conducive towards the achievement of balanced and sustainable economic development. At present, the banks are complying with the rules and regulations adopted by the CBM in accordance with the Basel I Accord.

2.2 Risk Oversight Assessment and Vulnerabilities

The banking system in Myanmar faces minimal risk as Myanmar has yet to conduct foreign banking business. Only four banks are engaged in remittance business with Malaysia, Singapore and Thailand. However, Myanmar banks will be conducting foreign banking business in the near future. With the development of the banking sector and implementation of foreign banking business, banks are envisaged to face more risks, such as operational risk, credit risk and liquidity risk.

2.2.1 Credit Risk

Credit risk is one of the major problems of the banks. The CBM issued instructions on assets classification. Banks advance loans against security. In Myanmar, all banks are required to set aside a general provision of 2 percent of the total amount of loans and maintain a provision of 50 percent for doubtful loans and 100 percent provision for bad loans in accordance with Instruction No. (6) of the Internal Audit and Bank Supervision Department. Almost loans of the banks are collateralised. Moreover, banks are not permitted to lend more than 20 percent of their capital plus reserves to a single individual, an enterprise or an economic group.
Chart 3 below shows the types of loans and advances of the private banks as at 30 June 2012. Short-term loans of duration not more than a year, are predominant, followed by mortgage loans.

Chart 3

Source: Central Bank of Myanmar.
2.2.2 Liquidity Risk

In Myanmar, the banking sector faced a liquidity crisis in 2003. It was triggered by rumors and caused loss of public confidence in the banks. It prompted people to withdraw their deposits from the banks. The CBM injected the needed funds by obtaining government treasury bonds and securities and accepting banks’ mortgages. Banks’ poor liquidity management in maintaining inadequate liquidity was one of the major causal factors.

The chart below shows the profile of liquidity risk. Although loans and deposits of the private banks increased yearly, the loans-to-deposits ratio does not increase yearly because the banks are afraid of generating non-performing loans. The result was that the loan growth rate fell below the deposit growth rate. The increase in total assets yearly, as shown in the graph, was due to the operation of four new banks. However, the liquid assets held by banks are very low, decreasing by about 18 percent over the last two years. The decline in the liquidity ratio from 49 percent to 21 percent is not a good sign although it is still within the prescribed limit at 20 percent.

![Chart 4](image)

Source: Central Bank of Myanmar.
Regarding the composition of private bank deposits, depositors prefer to operate saving accounts which attract interest, while business enterprises are required to open current accounts. The last two years saw the rapid growth of saving deposits but the current account deposits only expanded marginally. As the political situation becomes more stable, there will be more foreign investment in the country. Banks will extend more loans and advances to the business sector for investment purposes. They will need to increase their time deposit base where the funds can be rolled as they are placed under fixed maturity periods. Although the banks do not have market risks and operational risk, facing external uncertainties, they need to prepare for all types of risks.

2.3 Status of Application of Basel Capital Adequacy Framework

There are two types of capital, Tier 1 and Tier 2, in Basel I. Tier 1 capital consists of two types of funds—disclosed cash reserves and other capital paid for the sale of bank equity, i.e. stock and preferred shares. Tier 2 Capital includes reserves created to cover potential loan losses, holdings of subordinated debt, hybrid debt/equity instrument holdings, and potential gains from the sale of assets purchased through the sale of bank stock. To follow the Basel Accord, banks must hold the same quantity of Tier 1 and Tier 2 capital.
In Myanmar, the banks, operating under the Central Bank of Myanmar Law and Financial Institutions of Myanmar Law, 1990, have adopted Basel I since 1992. However, the banks cannot fully comply with the requirements of Basel I because the banks’ total capital includes Tier 1 Capital and general provision of the total loans, which is one of the components of Tier 2 Capital.

The banks calculate the risk-weighted assets as follows:

- Mortgage Loans = 50 percent
- Secured Loans (machinery, gold, etc.) = 50 percent
- Unsecured Loans = 100 percent
- Due from Banks (excluding the state-owned banks) = 20 percent
- Internal Drafts, Cheque Purchase and Debit Note Issues = 20 percent
- Fixed Assets = 20 percent
- Other Assets = 100 percent

The Banks for International Settlement (BIS) and the Basel Committee prescribed the Capital Adequacy Ratio (CAR) of minimum 8 percent. But the CBM imposed a minimum CAR of 10 percent for the banks. All the banks maintain their paid-up capital of not less than 10 times their risk-weighted assets. The lenders are sufficiently well capitalised to protect depositors and the financial system.

3. Assessment of Impact of the Basel Standards

3.1 Assessment of Impact on Current Capital Ratios

Financial institutions have the responsibilities to the depositors. They need to hold sufficient capital because they accept deposits from the savers and lend to the borrowers. As lenders, banks face the risk that some borrowers would be unable to repay their loans. It is therefore essential for the financial institutions to have sufficient capital in order to protect their depositors from the risk of losing their money.
In Myanmar, there are four state-owned banks and 19 private banks under the CBM’s control. The 19 private banks submit their monthly statements reporting their CAR to the Financial Institutions Supervision Department (FISD) of the CBM.

Chart 6

![Chart showing trend in capital adequacy ratio](source: Central Bank of Myanmar)

In 2008, there were 15 private banks in Myanmar. Four new banks were established bringing the total to 19 private banks in 2010. The above chart shows the capital adequacy position of the private banks from 2008 to 2012. Although their core capital increased year by year, their risk-weighted assets increased more rapidly than their core capital. Therefore, their CARs declined from 40 percent to 25 percent from 2008 to 2012, which is still above the prescribed limit of 20 percent.

3.1.1 Description of New Capital Rules

According to the Basel Core Principle No (6), “Banking supervisors must set prudential and appropriate minimum capital requirement for all banks. Such requirements should reflect the risks that the banks undertake, and must define the components of capital, bearing in mind their ability to absorb losses. At least for internationally active banks, these requirements must not be less than those established in the Basel Capital Accord and its amendments.” In the Basel 1 Accord, lenders must hold Total Capital equal to at least 8 percent of risk-weighted assets and Tier 1 Capital of at least 4 percent of risk-weighted assets.
The Basel Committee has set a minimum capital adequacy ratio of 8 percent for banks to observe. The banks in Myanmar are mandated by the CBM to maintain their total capital at 10 percent of their risk-weighted assets. Banks are required to calculate their capital position at every month-end. The risk-weighted assets of a bank shall not exceed 10 times the combined total of its Capital and Reserves.

The following new rules in relation to liquidity were issued by the Bank Supervision Committee in 2003:

- Banks are to maintain 50 percent of their fully paid-up capital as free capital; and
- Provide the appropriate provision for reserve for both bad debts and contingencies.

### 3.1.2 Status of Current Level and Adequacy of Capital of Individual Banks or Banking Groups in Terms of Key Performance Indicators for Capital

The first Basel Accord was adopted in 1988. It is credited with providing stability to the international banking system, by prescribing consistent safety and soundness standards and by promoting better coordination among the regulators and financial supervisors in the participating countries. To raise the quality, consistency and transparency of regulatory capital, the Basel Committee stipulated that Tier 1 Capital shall consist of common equity and retained earnings.

Consequently, banks can hold strong Tier 1 Capital containing a limited amount of tangible common equity. The financial crisis demonstrated that the resources that served to cushion against the credit losses and write-offs came out of retained earnings, which is part of a bank’s tangible equity base.

In the Myanmar banking sector, all the financial institutions are required to comply with the requirement of Section 31 of the Financial Institution of Myanmar Law: “The relation between the risk weighted assets and the capital and reserves of a financial institution shall not exceed (10) times”. The banks have no holdings of subordinated debt, hybrid/equity instruments, and holdings of potential gains from the sale of assets purchased through the sale of bank
The two private banks issue shares to the public. The subscription volumes are low because the majority of the public do not invest in bank shares due to their low return.

The Basel Accord prescribed 8 percent for the CAR while the CBM imposed a minimum CAR of 10 percent. The private banks maintain CARs above the mandated level. Myanmar presently does not have a capital market. Most of the resources held by bank are not for investment purpose. Its means the capital available exceed the market requirement. Banks got less profit from the actual market.

Table 1
Current Level and Adequacy of Capital as at 31 March 2012

<table>
<thead>
<tr>
<th></th>
<th>Tier I Capital Ratio (%)</th>
<th>Total Capital Ratio (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basel Requirement</td>
<td>4</td>
<td>8</td>
</tr>
<tr>
<td>Country Requirement</td>
<td>5</td>
<td>10</td>
</tr>
<tr>
<td>(If differs from Basel requirement)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Actual (Private Banks)</td>
<td>25.51%</td>
<td>27.94%</td>
</tr>
</tbody>
</table>

Source: Central Bank of Myanmar.

3.1.3 Assessment of Capital Levels in Terms of Enhanced Capital Requirements under Different Capital Components and Qualification of Future Capital Requirement

Chart 7 shows the composition of Tier 1 Capital. The paid-up capital of the banks increased yearly because of their business profitability, so did their reserve provisions.
In Myanmar, the total capital in the banking sector increased yearly. This is due to opening of new branches and banks venturing into the international banking business. As the profits of private banks increased, their reserves and retained profits provisioning also increased.
3.2 Assessment of Current Level of Leverage

Source: Central Bank of Myanmar.
From the chart above, it is evident that the increase in Tier 1 Capital is not as fast as the growth of bank total assets. Consequently, the leverage ratio declined from 23 percent in 2008 to 18 percent in 2012.

3.3 Assessment of Liquidity in Terms of New Liquidity Ratios

3.3.1 Description of New Liquidity Rules

In the Myanmar banking system, the CBM imposes a minimum liquidity ratio for financial institutions at 20 percent of their eligible liabilities. To date, two banks are unable to meet this requirement. Banks failing to comply are required to pay a penalty for their liquidity shortfall.

In accordance with Sections 58 and Section 59 of the Central Bank of Myanmar Law, the CBM may impose on and collect from any bank or financial institution which fails to maintain required reserves or specified liquid assets in the appropriate ratio determined, a levy, not exceeding one-fifth of one per centum per day on the shortfall of liquid assets or required reserves in such bank or financial institution, as the case may be, until the shortfall is corrected.

The new liquidity rules issued by the Bank Supervision Committee (BSC) in 2003 are as follows:

- Banks’ deposits should not be more than 10 times the amount of their paid-up capital;
- Inter-bank borrowing among banks is prohibited; and
- Loans-to-deposits ratio must be between 70 percent and 80 percent.

At present, Myanmar banks do not have much difficulty meeting their liquidity requirements. The CBM may revise its liquidity requirement in the near future as the economy is liberalised and opened for the banks to engage in the international banking business, and when the banks are required to increase their capital in line with the Basel Accord.
3.3.2 Current Level and Adequacy of Liquidity of Individual Banks or Banking Groups in Terms of Key Performance Indicators for Liquidity

In Myanmar, 19 private banks submit their weekly statements of liquidity ratio to the FISD of the CBM. According to the statement of liquidity position, all banks are to maintain a minimum liquidity ratio of 20 percent. The eligible liabilities of the banks are more than 2, 3 or 4 times the value of their liquidity assets. The liquidity ratio of the banks ranges from more than 20 percent to nearly 50 percent.

Currently, banks’ liquid assets are classified as follows:

- Cash + Balance with CBM
- Gold (but not yet determined)
- Cheques, drafts and all receivables
- Bills, discounted with maturities up to 3 months
- Government securities
- Due from domestic banks (on net basis)
- Due from bank abroad

However, borrowing using the above assets as collateral is deducted from their liquidity holding when the banks borrow treasury bonds from the Central Bank.

In Myanmar, the eligible liabilities of the banks are as follows:

- Cheque bills and payables
- Due to domestic banks on net basis
- Due to bank abroad
- Deposits
- Demand Deposits
- Time Deposits
The liquidity position of the private banks in Myanmar is shown in the chart below:

**Chart 10**

The above chart shows the liquidity position of the private banks from 2008 to 2012. Liquid assets have been increasing steadily year by year, with eligible liabilities increasing at a faster rate than liquid assets, causing the liquidity ratios to decline. Including the liquid assets in total assets, although total assets have been increasing rapidly year by year, the growth of liquid assets is slower from 2008 to 2012.

The low liquid asset holding of banks is primarily due to their preference in investing mostly in safe and secure assets. The banks expect low risk and high return for their investments.

### 3.3.3 Quantification of LCR and NSFR and Assessment of Future Liquidity Requirements

The banks currently fulfill the minimum liquidity ratio of 20 percent. When they banks are permitted to conduct foreign banking operations, they will be required to meet the new liquidity requirements, such as LCR and NSFR, to comply with the international standards in accordance with the Basel Accords.
3.4 Impact on Different Peer Groups and the Banking System

The impact on different peer groups and the banking system in Myanmar are as follows:

- Liquidity standards and liquid assets can increase.
- New capital and new types of financial instruments can increase.
- The quality, consistency and transparency of the capital can increase.
- The banking sector can be protected from risks, such as liquidity risk and credit risk.

Banks in Myanmar are allowed to operate foreign banking business and, in the near future, foreign banks will be allowed to operate in Myanmar. The banking sector will be much larger and the banks need to raise additional capital to meet the liquidity requirements under the Basel Standards. If the banks have adequate additional capital and more liquid assets, they can be protected from all types of risks and from financial crises in the banking sector. Moreover, not only can the banks contribute to the development of the banking sector, but they can also stimulate the development of the economy and help achieve sustainable growth and stability.

4. Issues and Challenges in Implementing the Basel Standards

4.1 Regulatory Constraints

Most of the country exercises use the macro-prudential analysis which focuses on the health and stability of the financial system, whereas micro-prudential analysis deals with the condition of individual financial institutions. This analysis is based in the context of the Financial Soundness Assessment Programme (FASP) and the related Financial System Stability Assessments (FSSAs) which are adopted by the International Monetary Fund (IMF). In this regard, the health of the banking sector is analysed by looking at the levels and trends in the selected Financial Soundness Indicators (FSIs), typically consisting of capital adequacy, asset quality, profitability, liquidity and exposure to market risks and the linkage between these indicators and changes in the macroeconomic environment. This framework is also known as the CAMELS - capital adequacy, asset quality, management soundness, earnings, liquidity and sensitivity to the market risk - analysis.
From time to time, the IMF and the Bank for International Settlement (BIS) adopted policy guidelines for financial sector stability and strengthened the framework of measures to safeguard the use of the financial resources of member countries. Pursuant to the basic aim of a central bank to achieve and maintain a country’s monetary stability, the CBM keeps track of the banking sector development and regulates banks in the financial system so that they may not deviate from the path of financial stability.

The CBN regulates the domestic and foreign banking operations systematically by applying the laws, rules and regulations which are in line with international standard. It is necessary for the CBM to address the following key regulatory and supervisory issues to strengthen and assure the soundness of the banking system:

- Define a clear set of rules and penalties to enforce the regulation on the new capital and liquidity requirements;
- Ensure adequate legal and management authority and capacity to enforce the existing rules and regulations;
- Develop the operational system for intervening and resolving the weak banks;
- Analyse the possible impact of weak banks on the banking system and the whole economy;
- Set appropriate governance system and requirements for the bank-owners, board members and management authority;
- Enforce compliance with the Basel Accord on capital adequacy and liquidity;
- Define clearly the loans classification and plan for better provision;
- Develop the internal governance structure, including the wider functions of the internal auditing process;
- Identify the banks which are in a risky position and monitor them closely;
- Regulate and supervise the foreign exchange activities, including money laundering;
- Develop the bond market and trading activities in line with the market needs;
Establish regulatory and supervisory framework for foreign banks, if they are allowed to operate in Myanmar; and

Issue the necessary laws and instructions for the adoption of Basel II.

4.2 Capital Augmentation and Related Issues

According to Basel II, the Minimum Capital Requirement is expanded further than under Basel I. Basel II creates a bank’s risk-weighted assets and tries to eliminate the loopholes in Basel I that allow banks to take on additional risk. Its first mandate is to broaden the scope of regulation to include assets of the holding company of an internationally active bank. This is done to avoid the risk that a bank will hide risk-taking by transferring its assets to the other subsidiaries, and also to incorporate the financial health of the entire firm in the calculation of the capital requirements for its subsidiary bank.

The recent global financial crisis has revealed weakness in the risk management process of Basel II. Because Basel II did not adequately anticipate a collapse in market liquidity, investor confidence disappeared and the market value of securities held by banks suffered drastic losses. The Basel Committee subsequently adopted Basel III in 2010. The Basel accord needs to be carefully implemented step-by-step for it to be in line with the Myanmar financial system.

The Myanmar Securities Exchange Centre (MSEC) was established in 1996 to sell government treasury bonds to public. However, the Centre failed to take off due to low return. Today the country is without a capital market. It is a major challenge for raising Myanmar’s capital level.

4.3 Review of Assets and Liability Management Strategies

Based on the latest banking statistics, the major assets of the banks are composed of loans and advances 38 percent, followed by cash holdings 29 percent, and investments in government securities 24 percent. Banks’ cash holdings is the second largest component of their assets which means that the banks have cash reserves and are able to overcome liquidity squeeze to meet the liquidity needs of their customers. If the banks can manage and adopt effective asset management strategies in combination with the marketing of the latest products and services, they can generate maximum income with minimum risk.
Liabilities management is one of the important factors for financial institutions. For gain trust and confidence with the customers and stakeholders, banks must fulfill their obligations. Most banks’ liabilities are deposits which make up 83 percent of the total liabilities. The management of liabilities needs to be conducted carefully as mismanagement can cause bank runs. For instance, if a bank is faced with a case of money laundering, the bank’s reputation, public trust and legal status will be ruined, causing the bank to fail. It is thus vital for the top management and the Board of Directors to be aware of the bank condition and the bank business environment, domestically and internationally.
4.4 Implications on Cost and Profitability

In Myanmar, banks are free to acquire assets or open new branches and can offer other services to satisfy their customers. Therefore, the owners, board of directors and management committee ought to exercise due diligence in the introduction of new banking products and instruments, undertaking of short-term vs. long-term funding in the management of cost and profitability, and be mindful of the impact of their decisions on pricing, lending and margins.

The gap between private banks’ return on equity and assets has been increasing. In 2008, the return on equity was 18.68 percent while the return on asset was 2.23 percent. In 2012, these were 18.50 percent and 1.72 percent, respectively, indicating that although there were fluctuations during these years, in general it was more beneficial buying banks’ share instead of investing.
The private banks’ income and expenditure depend on the strategic management of their assets and liabilities. As shown above, the chart indicates that interest income increased and non-interest income increased every year in an upward trend, accompanied by proportionate increase in interest expenditure and non-interest payments. The Myanmar banks are doing good banking business. They are systematically controlled and comply with the international best practices and guidelines adopted by the CBM.
4.5 Implications for the Financial Markets/Economy

In Myanmar, the economic system was changed from a centrally planned economy to a market economy in 1989. Since then, the government implemented annual economic plans, four-year short-term plans, and also 20-year long-term plan for national economic development. The government is taking step to promote the development of a market-based economy and is initiating reforms in many sectors consistent with the political and economic climate. The financial sector is also included in the reform process for it to be competitive in the global marketplace.

4.6 Infrastructure Issues

In Myanmar, lack of business information, such as Balance Sheet, Profit and Loss Account and Income Statement, is one of the problems that hinder commerce. Market players do not have much access to information for them to obtain a true and accurate picture of firms in the marketplace. These two factors are to be considered for the development of the banking industry:

- Bankers have limited information on borrowers, their creditworthiness, investment opportunities, and return on investment.
- If a bank should select a risky project with a high probability of default, it will be costly for the bank to supervise and monitor the project closely to track the performance of the project.

4.7 Human Resource Constraints

Human resource management has become more important and essential for the acquisition of technical know-how on new products, software system and settlement procedures. In this regard, to fill the resource gap, the banking authorities have to make plans to not only conduct the appropriate training for their staff, but also to update the existing IT hardware and software system to accommodate Basel.

The management of banks are generally aware of the need for capacity building and staff development. The banks conduct seminars and training programmes to equip their staff with the latest technical know-how, new product knowledge and customer service skills to satisfy their customer needs.
Moreover, as the banking industry develops, foreign institutions in Myanmar are providing technical assistance and collaborating for the future development besides negotiations for joint-venture banks.

In addition, the Myanmar Banks Association (MBA) contributes to the development of the banking sector by conducting full-time and part-time Diploma in Banking (DB) and Master of Banking and Finance (MBF) programmes, and by raising the awareness of the public on the banking products and instruments.

The CBM, the main controller of the Myanmar financial and banking system, has conducted numerous training seminars and programmes for the officials of the private banks in subject areas such as the Basel Accords, Money Laundering, Trade Financing facilities, foreign exchange business, and other topics. The attendees, in turn, are expected to disseminate the knowledge gained to their own bank staff through in-house training.

4.8 Impact on Cross-border Supervision

At present only the state-owned bank, Myanmar Economic Bank (MEB), can conduct transactions and settlement with foreign banks overseas. Some private banks are licensed to operate international banking business, such as foreign exchange trading and inward remittance. They have recently been allowed to engage in trade financing. Therefore, issues relating to cross-border transactions have not yet surfaced for attention. However, Myanmar private banks which operate branches near the border of China, India, and Thailand have to prepare the cross-border supervision procedures with the neighbouring countries for challenges issues such as payment and settlement systems. Myanmar banks would also need to meet other challenges on cross-border supervision such as trade and settlement transactions in preparation for foreign banking business in the near future.

5. The Way Forward and Strategic Options

5.1 Strengthening the Regulatory Framework

In line with the market economy, the CBM allowed the private banks to adopt modern banking systems for domestic and international banking operations. The reform factors in the banking system are as follows:
• Banks to set their own interest rates (loan = 13 percent, deposit = 8 percent);
• Foreign banking business opened to banks (Inward remittance);
• Introduction of Hire Purchase operation, ATM, Myanmar Payment Union (MPU) card operation;
• Banks allowed to open new branches;
• Collateral for loans to include not only land and buildings, but also deposits, gold, and exportable commodities;
• Revision of the foreign exchange law and regulations
• Protection of depositors and introduction of deposit insurance;
• Operation of Foreign Exchange Auction to issue reference rate from the CBM.

5.2 Capital and Liquidity Management Strategies of Banks

Effective prudential regulation and supervision of banks are essential for financial stability. The task of the regulation and supervision is to ensure that banks operate in a prudent manner and hold sufficient capital and reserves to support their business. The Bank Supervisory Committee (BSC) closely monitors the daily financial statements of the banks. The CBM controls the banking industry by applying the following prudential regulations to the banks.

5.2.1 Credit Management

Credit risk management is very important. Banks are required to maintain operating ratios in line with the prudential regulations of the CBM. The banks are mandated by law to set aside for general provision 2 percent of their total loans and maintain 50 percent provision for doubtful debts and 100 percent provision for bad loans. Loans of the banks which have collaterals are categorised as quality loans. Banks have low non-performing loans. Their on-performing loan ratio is under 2 percent. The banks are required to comply with the prescribed ruling that “Bank shall not lend more than 20 percent of their Capital plus Reserves to a single individual, an enterprise or an economic group.
5.2.2 **Liquidity Management**

In order to prevent liquidity and systemic crises, the CBM closely supervises the operation of the banks and has established the BSC to assure the smooth and sound operation of the banking system.

5.2.3 **Liquidity Ratio**

Banks are required to maintain a liquidity level of not less than 20 percent of their eligible liabilities. If the banks fall short of the requirement, the penalty is 1/5 of 1 percent of the shortfall.

5.2.4 **Reserve Ratio**

According to prudential regulations of the Central Bank of Myanmar, 10 per cent of total deposits are required to be maintained by each bank as the minimum reserve requirement. It means each bank has to deposit 75 per cent of the required reserve at the Central Bank of Myanmar and 25 per cent of the reserve may be maintained in the form of cash at the bank. The required reserve for a bank to be maintained with the Central Bank of Myanmar must not exceed 35 per cent of the total liabilities of the bank. However, in the event of serious inflationary pressure, the Central Bank of Myanmar may increase the 35 per cent ceiling requirement.

Overall Reserve Ratio = Cash in hand + Account with CBM / Total Deposit= 21.77 percent

These statements are submitted by banks to the CBM:

- Weekly - Reserve Position, Liquidity Ratio
- Monthly - Balance sheet, Income and Expenditure Statement, Capital Adequacy Ratio
- Quarterly - Non-performing Loan Statement
- Annually - Annual Report

The FISD monitors the banks’ operations from their submissions and takes actions, where necessary, to enforce compliance by banks with the applicable laws, rules and regulations in their banking operation. The measures include conduct of on-site examination. All the financial institutions observe
the prescribed regulations which are imposed for preserving financial stability, and banks perform their banking functions in an orderly manner.

The CBM is empowered to implement the banking sector development strategy and approaches the implementation in three phases:

**Phase I**
(a) Promoting institutional development
(b) Promoting skills and efficiency among the domestic banks in the medium term, while allowing foreign banks to establish representative offices in Myanmar. The foreign banks are initially allowed to open representative offices serving only as liaison offices of their corporate headquarters;

**Phase II** Permitting selected domestic banks to establish joint-venture banks with foreign banks; and

**Phase III** Permitting foreign banks to open bank branches and conduct banking business in Myanmar.

The CBM is organised in 12 departments. One of these departments, the FISD, is responsible for the examination and supervision of the financial institutions and is tasked with four main objectives:

- Protection of Depositors;
- Maintenance of Monetary Stability;
- Efficiency of the Financial Institutions; and
- Progress of the national economy.

The FISD has two approaches; on-site examination and off-site monitoring. On-site examination assists in the monitoring of the financial institutions through inspection of banking operations and contact. Off-site supervision examines the financial statements for compliance by banks with the prescribed rules, regulations, guidelines, the CBM Law and the Financial Institution of Myanmar Law. The examiners of the FISD visit the various private banks and interview the Chairman and Management Committee to collect information and analyse the data. The performance of the bank is compared with other banks in the peer group. The criteria for evaluation include profit trends and strategies, balance sheet management, divestments
and wind-downs, redesign of the business development models and portfolios focus, capital and liquidity management strategies, training and development plan for staff, modifications to IT infrastructure in line with the market needs, and assessment of readiness for implementation of Basel at desired level or time plan.

5.3 Development of Capital Market Instruments

At present Myanmar’s financial market instruments consists of bank loans, equity shares, and treasury bonds issued by the CBM. While Myanmar’s banking sector is relatively small compared with other ASEAN countries, bank loans are still important in contributing to national economic development. The CBM has issued three types of government Treasury Bonds: two-year treasury bonds, three-year treasury bonds and five-year treasury bonds, in denominations of Kyat 10,000/, Kyat 100,000/, and Kyat 1,000,000/, with effect from 1993 and 2010. The interest rates of these treasury bonds are presently at 8.75 percent, 9 percent, 9.5 percent, respectively. Because of the low rate of return, these bonds are not tradable in the market and the large amount of government bonds are mostly held by the private banks.

At present, Myanmar is without a capital market. To launch the capital market, the MSEC was established in 1996 with 50-50 percent joint venture between the MEB, one of the state-owned banks, and the Daiwa Institute of Research Ltd., Japan (DIR).

The MSEC’s objectives are to:

- Plan the development of a securities market in Myanmar;
- Support the privatisation and internationalisation of the Myanmar economy.

The MSEC also purposes to provide the following services:

- Assisting companies to become public companies;
- Brokering, dealing, and underwriting securities;
- Publishing investment information;
- Providing investment consultancy services;
Managing venture capital funds and acting as an agent for joint ventures;

- Selling government treasury bonds as an agent of the CBM; and

- Selling shares of listed companies in Myanmar as an agent of those companies.

### 5.3.1 Legal Framework

The drafting of the Securities and Exchange law was started in 1996 but it is not promulgated until now for several reasons. The final draft law was passed by Amyotha Hluttaw on 22 August 2012. It is subject to approval by Pyithu Hluttaw in the next session of Hluttaw probably in October/November of this year. It is envisaged that the Law will be in place by the end of this year. The by-laws, rules and regulations are to be formulated in the next two years. The other related laws, rules and regulations also need to be revised, amended or supplemented to meet the needs of the market.

### 5.3.2 Bond Market

A new two-year Treasury Bond was issued on 1 January 2010 adding to the existing three-year and five-year Bonds issued since 1993 with a view of promoting the Treasury Bond market. A new Treasury Bond selling system was introduced appointing the MSEC and MEB as Selling Agents. The MSEC and MEB were allowed as trading floor for the secondary market. The interest rates were reformed in 1 September 2011 and 1 January 2012. Treasury Bonds are allowed as mortgage in taking loans up to 80 percent of its value from the commercial banks. The proposal to allow Inter-bank Bond Trading is in the final stage of deliberation.

### 5.3.3 Equity (Share) Market

Two public companies were listed in the MSEC, one in 1996 and other in 2005. Share market trading is rather active, with demand exceeding short supply. Even though there are more than 22 public listed companies, only a few of them are thought to be qualified in share trading. The emergence of qualified public companies is a real challenge.

### 5.3.4 Others

Educational programmes like training, seminars and workshops have been continuously provided. Technical assistance for development of bond market...
was provided by AESAN Secretariat funded by JAFTA (Japan-ASEAN Finance Technical Assistance) and undertaken by DIR. A Memorandum of Understanding (MOU) was signed on 29 May 2012 between the CBM and DIR and the Tokyo Stock Exchange with a view to assisting the development of the Yangon Stock Exchange by 2015. Another MOU was signed on 14 August 2012 between the CBM and the Policy Research Institute of the Ministry of Finance, Japan, for assistance in the development of the Securities and Exchange Law and Rules and Regulations of Myanmar.

5.3.5 Weaknesses

Weaknesses include the following:

- Education, particularly low financial literacy,
- Infrastructure (electricity, communication, information technology),
- Lack of knowledge in the securities business at all levels,
- Weakness in corporate culture and corporate governance,
- Comprehensive legal framework is lacking far behind
- Poor infrastructure for the development of the securities market.

5.4 Development of Infrastructure and Addressing of Related Issues

The MPU was established by the CBM comprising members from the state-owned and private banks. It is an interbank network service provider which provides shared ATM network service for the customers of its member banks to conveniently access their funds anywhere from any of the participating banks’ ATMs; and provides a payment system for the member banks to do interbank settlements for their customers’ ATM transactions. This system is centralised, maintained and controlled by the CBM.

The private banks which are licensed to engage in the international banking business are eligible to apply to join the Society for Worldwide Interbank Financial Telecommunication (SWIFT), a network service that enables financial institutions worldwide to send and receive payment orders in a secure and reliable environment. In this regard, the private banks are presently in the process of upgrading their IT hardware and software systems to comply with the international standards for the transmission of payment instructions and settlement. The international organisations and non-
governmental organisations are currently working out the needs of IT infrastructure, software applications and computer equipment for the banking sector.

5.5 Capacity Building for Staff of Regulator and Banks

Human capital and skills are important for the development of a modern financial sector. Personnel in the banks and services industry, to be service oriented, must be aware of the concept of internal and external customers. The financial institutions should train and upgrade the banking knowledge and skills of their staff to raise their professionalism and competence. The CBM staff are expected to be familiar with all the banking policy instruments and methods for them to perform. It is also incumbent on them to be well equipped if they are to impart their knowledge and experience to the banking sector. Much training is needed for the regulators of the CBM. Myanmar has decided to approach the implementation of Basel II step-by-step to facilitate the financial sector’s transition to the international standard.

5.6 Road Map for Implementation of Basel III

The CBM is responsible for the financial stability and soundness of the banks. Bank supervision, prevention of bank failures and enforcement of the Basel standards for the banking sector to comply with the Basel Accord are some of the CBM’s core duties. Given the rapid transformation of the economy and the modernisation of the banking sector in Myanmar, the CBM should replace or substitute direct control with prudential supervision and risk management, and advocate the introduction of sound banking practices, raising the bar for banks to practise risk-based capital requirement and liquidity control in accordance with the standards of Basel II and III. The officials of the CBM are currently taking steps to provide education and training for the staff of all the financial institutions with the view of assisting the institutions to comply fully with Basel I and to gear up the organisations for the adoption of Basel II and III. The time frame for the adoption of Basel II is not yet been finalised. The officials of the CBM are discussing with international organisations to draw up an appropriate implementation plan for the Myanmar financial system.

6. Conclusion

The banking industry plays a key role in financial sector development and economic development with the adoption of the market economy.
Financial sector stability is crucial for sustained economic growth and cannot be achieved without a strong financial system. A stable financial system commands strong public confidence in the financial institutions and is efficient in financial intermediation, mobilising funds from savers (depositors) and channeling the same to investors (borrowers).

In Myanmar, macroeconomic stability and political stability have still plenty of room to improvement for financial system development. The reform measures on the banking and economic system must be in line with the international best practices. These financial reforms should be put in place to prepare Myanmar for the ASEAN Free Trade Area and other similar initiatives. In this regard, the financial sector needs to mobilise and channel available financial resources for national economic development and provide the best banking services and instruments to stimulate trade and business development.

To develop the banking sector, the following major weaknesses need to be addressed:

6.1 Capital Deposit Ratio

The equity-to-deposit ratio regulation, promulgated by the BSC, restricts the volume of deposits to be not more than ten times the paid-up capital. This causes a contraction of the bank deposits. International practices like deposit insurance system which is more effective than equity-to-deposit ratio should be introduced to prevent bank-runs.

6.2 Unattractive Interest Rates

The interest rates are lower than the inflation rate of the country and discourage people from the saving. Even though the per capita income of Myanmar is low, the incentive to save and invest would be increased if there are high rates of return. Therefore, international method of inflation targeting should be exercised as the monetary policy instrument.

6.2 Lack of Banking Services

As compared with the trading partner countries’ banking services, the banking products and services in Myanmar do not meet the requirement of markets and customers. Myanmar has an estimated population of sixty million, but only people living in urban centres have access to banking services.
People in the rural sector have limited or no access to banking services because of poor coverage of the banking network in the interior.

6.3 Narrow Range of Banking Products

Apart from the traditional banking products and services, such as deposits, loans and advances, banks can provide credit card, debit card, ATM services, hire purchase, remittance, and many other financial products and services. Banks should extend banking facilities to include foreign exchange and international trade financing facilities to service the growing needs of the economy. When private banks are allowed to participate in the banking system, business competition will spur improvement and innovation in financial products and services and will raise standards in the banking sector.

6.4 Delay to Establish Capital Market

In order to ensure that banks can raise funds effectively in the market, it is necessary to establish a capital market without further delay. Banks hold Treasury Bonds in the absence of financial market instruments. The money market, equity market, bond and security market are not developed leaving bankers with no choice but to hold treasury bonds to cover for the interest payment for deposits. To increase financial resources, the financial system has to encourage not only indirect financing through the banks but also direct financing from the financial markets.

In conclusion, the banking and financial sector reforms should be approached step by step. The CBM should replace or substitute direct controls with prudential supervision and market-based instruments. A sound financial system can facilitate the mobilisation of financial resources and the channeling of these resources to the productive sectors efficiently. Strengthening the supervision of the banking sector calls for the intensification of training and development for the staff and regulators of the CBM, investment in computer and telecommunication infrastructure, enforcement of new capital and new liquidity requirements, and formulation of a time frame for the implementation of Basel II.
References


Basel Committee on Banking Supervision, (2009), Enhancements to the Basel II Framework, July.


Moody’s Analytics, “Basel III New Capital and Liquidity Standards - FAQs,” Also Available at <www.moodysanalytics.com>


U Soe Thein, Myanmar Securities Market.
# Appendix 1

## Key Information Sheet (2007-2008 to 2011-2012)

<table>
<thead>
<tr>
<th>Macro Economic Data</th>
<th>2008</th>
<th>2009</th>
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<th>2011</th>
<th>2012</th>
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<td>47.71</td>
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<td>Total capital Ratio</td>
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<td>Liquid Assets/Eligible Liabilities Ratio</td>
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<td>49.88</td>
<td>49.29</td>
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## Appendix 2

### Kyats Bn

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<td>Cash in hand + A/c with CBK</td>
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<td>164.47</td>
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<td>Cheque drafts &amp; all receivable</td>
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<td>Bill discounted with maturities up to 3 months</td>
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<td>Current Accounts</td>
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<td><strong>Composition of Borrowings</strong></td>
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<td>Short term Borrowings</td>
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<td>Other</td>
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<td><strong>Composition of Tier I capital</strong></td>
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<td>Paid up capital</td>
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