Straight away

Capital Adequacy Ratio Requirements for Locally Incorporated Merchant Banks

24 February 2011

What is new?

In September 2009, the Monetary Authority of Singapore ("MAS") issued a consultation paper on proposed changes to the merchant bank regulatory framework. The MAS has issued the response to feedback received in respect of the above consultation paper.

Responses by MAS

In its response, the MAS has stated the following intentions:

- Increasing minimum capital requirements of merchant banks to S$15 million.
- Imposing Basel II and Basel III capital requirements on locally incorporated merchant banks.

In addition, the MAS has cancelled Directive 9: Involvement in Trade with immediate effect.

The MAS will be conducting further consultations on imposing the Large Exposures Framework on merchant banks.

Capital adequacy ratio requirements for locally incorporated merchant banks

Locally incorporated merchant banks will be required to comply with Basel II risk-based capital requirements and Basel III revised capital standards.

Merchant banks will be required to adopt the Standardised Approaches under Pillar 1 of Basel II standards to compute their risk-weighted assets for credit, market and operational risks. The minimum capital adequacy ratio ("CAR") requirements will be:

- Tier 1 CAR of at least 6%; and
- Total CAR of at least 8%.

The revised capital standards under Basel III shall apply to the locally incorporated merchant banks as appropriate (in line with the transition timelines set out by the Basel Committee and as adopted by the MAS).

The MAS will be conducting a separate consultation on the draft rules and reporting schedules for the capital adequacy requirements for locally incorporated merchant banks.

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Am I affected?

The proposed minimum capital and capital adequacy ratio requirements apply to all locally incorporated merchant banks in Singapore.

The potential implication to capital can be significant as shown below:

Scenario: A merchant bank specialising in shipping loans, not previously subjected to CAR requirements*

Assuming the merchant bank only has a shipping loan portfolio of Singapore dollar equivalent of S$500 million, all booked under the Asian Currency Unit.

Based on existing capital requirements, a merchant bank not previously subjected to CAR will require a minimum of S$3 million of capital funds.

Under the proposal, the capital requirement of the merchant bank (assuming insignificant market risk) is assessed as follows:

	Amount	Risk Weight	Risk-Weighted Assets
Credit Risk			
Unrated shipping corporates	S$500 million	100%	S$500 million
Market Risk			
No market risk exposure	-		-
Operational Risk			
Commercial banking:			
- Year 1 gross income	S$60 million	15%	S$9 million
- Year 2 gross income	S$60 million	15%	S$9 million
- Year 3 gross income	S$40 million	15%	S$6 million
3-year average			S$8 million
		Total RWA:	S$508 million
Proposed capital requirements:			
Minimum amount of Capital Funds per proposed Directive 1			S$15 million
Minimum amount of Tier 1 Capital			S$30.5 million
Minimum amount of Total Capital			S$40.6 million
Existing Capital Funds			S$3 million
Shortfall			S$37.6 million

*Note: The above example has been simplified for illustration purpose only.

What do I need to do?

Locally incorporated merchant banks will be given a period of six months from the date of issuance of the capital adequacy rules to comply with the new requirements.

Merchant banks should immediately perform an impact analysis on their capital funds. This could be a diagnostic review. Management needs to be immediately aware in order to make further management decisions.

In addition, management needs to consider the implications on the merchant bank's systems and processes. For more complex businesses, management needs to assess the adequacy of system and processes to meet the new requirements. For instance, management needs to assess whether the merchant bank's existing systems and processes for acceptance of collaterals are sufficiently robust and adequate for the merchant bank to recognise the effects of credit risk mitigation under Basel II.

Merchant banks should also evaluate the current business model and legal vehicle (incorporated entity versus branch entity) under which the current activities are undertaken. Potential options include transferring the merchant bank business into an existing bank branch or converting the merchant bank into a branch entity. Factors that will need to be taken into account include:

- Differences in tax treatments, such as tax residency of the merchant bank.

- Flexibility in moving and raising capital.

Who can I approach?

Contact any of the following individuals to find out how PwC can assist you:

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