REGULATION ON CAPITAL ADEQUACY

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Approved by DAB Governor:	Date	DAB Board Secretary ....

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ISLAMIC REPUBLIC OF AFGHANISTAN
DA AFGHANISTAN BANK, REGULATION ON CAPITAL ADEQUACY FOR ISLAMIC BANKING AND FINANCIAL INSTITUTIONS

PART A: PREAMBLE

1. Background

1.1 This Regulation on Capital Adequacy (hereinafter referred to as "the Regulation") is issued *by the* Da Afghanistan Bank (hereinafter referred to as "DAB") which shall be adopted and become the regulation for Islamic Financial Institutions, Financial Institutions operating with an Islamic Window and Financial Institutions operating with an Islamic Unit (collectively referred to as "the Banks") in the Islamic Republic of Afghanistan offering Islamic financial products.

1.2 Capital is the cornerstone of a bank's strength. It provides a buffer to absorb unanticipated losses from a bank's activities, and in the event of problems, allows the bank to keep operating while those problems are addressed and resolved. The maintenance of adequate capital reserves by a bank can foster confidence in the financial soundness and stability of the bank by providing continued assurance that the bank will continue to meet its obligations to its depositors and other creditors. Thus, DAB requires all banks licensed in Afghanistan to maintain a minimum amount of financial capital, as well as a minimum capital ratio that is adequate for the types of activities that it undertakes. To this end, DAB uses a risk-based approach to the measurement of a bank's capital adequacy. It must be stressed that the minimum capital amounts and ratios are absolute minimums only. They do not necessarily indicate that a bank's capital is adequate. DAB expects banks to normally operate with capital well in excess of minimum required amounts.

1.3 The regulation defines core (Tier 1) capital, which is made up of the highest quality capital elements; supplementary (Tier 2) capital, which includes other instruments which fall short of the quality of Tier 1 capital, but which contribute to the capital strength of the bank; and regulatory (total) capital. It also sets the minimum capital ratios for Tier 1 and Total Capital. The regulation also details the primary criteria by which DAB will judge the inclusion of instruments or sources of capital into Tier 1 and Tier 2, the risk weights assigned to various asset categories, and the conversion factors applied to off- balance sheet items to properly reflect them in the capital calculations.

2. Purpose

2.1 The purpose is to make clear to banks precisely how the capital adequacy of their institution will be assessed for regulatory purposes. The regulation provides for the different regulatory tiers of capital, based on the quality and permanence of the issued instrument or source of capital. This capital regulation is generally in keeping with the Islamic Financial Service Board's Capital Adequacy Standard.

3. Scope of the Regulation

3.1 This Regulation is issued pursuant to Article 2.2 of the Afghanistan Bank Law gazetted on 12/17/2003 (corresponding to 30/10/1382) in relation to the powers of DAB to regulate and supervise Banks in the Islamic Republic of Afghanistan and any amendments thereto.

3.2 The scope of this Regulation is to provide a banking products and services in safe and sound manner that supports the Bank's compliance. Bank is required to comply with the Regulation both on an entity and consolidated basis which is required to include the positions undertaken by subsidiary entities and overseas financial subsidiaries.

3.4 Minority interests that arise from consolidating less than wholly-owned subsidiaries may be included in the consolidated capital to the extent that such minority interests are readily available to other group entities. Investment in regulatory capital, other than ordinary shares of banking or any other financial entity shall be treated as an investment with the regulatory capital treatment depending on whether the instrument is held in the banking book or the trading book. Meanwhile, investment in equity of banking shall be subject to the appropriate treatment associated with the investment classification that is either held in the banking book or trading book.

PART B: CAPITAL ADEQUACY FRAMEWORK

4. Definition

4.1 Capital Adequacy Framework (CAF) is a framework issued by DAB for Islamic Banks to specify the risk measurement methodologies of calculating a minimum capital requirement against credit risk, market risk and operational risk.

4.2 CAF, which was the derived based on the Islamic Financial Services Board (IFSB), together with the revised framework from the Basel Committee on Banking Supervision's Documents (Basel II), specified the standardized approach for capital computations as follows:-.

a. Standardised Approach for Credit Risk;
b. Standardised Approach for Market Risk
c. Basic Indicator Approach for Operational Risk.

The above standardized approach for capital computation will be outlined and circulated in the specific framework of capital adequacy requirements.

4.3 These approaches shall form the basis for the computation of the risk weighted capital ratio (RWCR) for the Bank. During the development of CAF, DAB adopted a more collaborative and consultative effort in engaging industry players and stakeholders for the purpose of ensuring greater clarity in terms of the appropriate level of capital charges, as well as the supervisory expectations in promoting a smooth transition from the traditional Basel I to the more risk-sensitive framework. Basel I was transformed to Basel II to make it more comprehensive.

5. Type of Pillars

CAF consists of three pillars as follows:-

a) Minimum capital requirements
b) Supervisory review process
c) Market discipline.

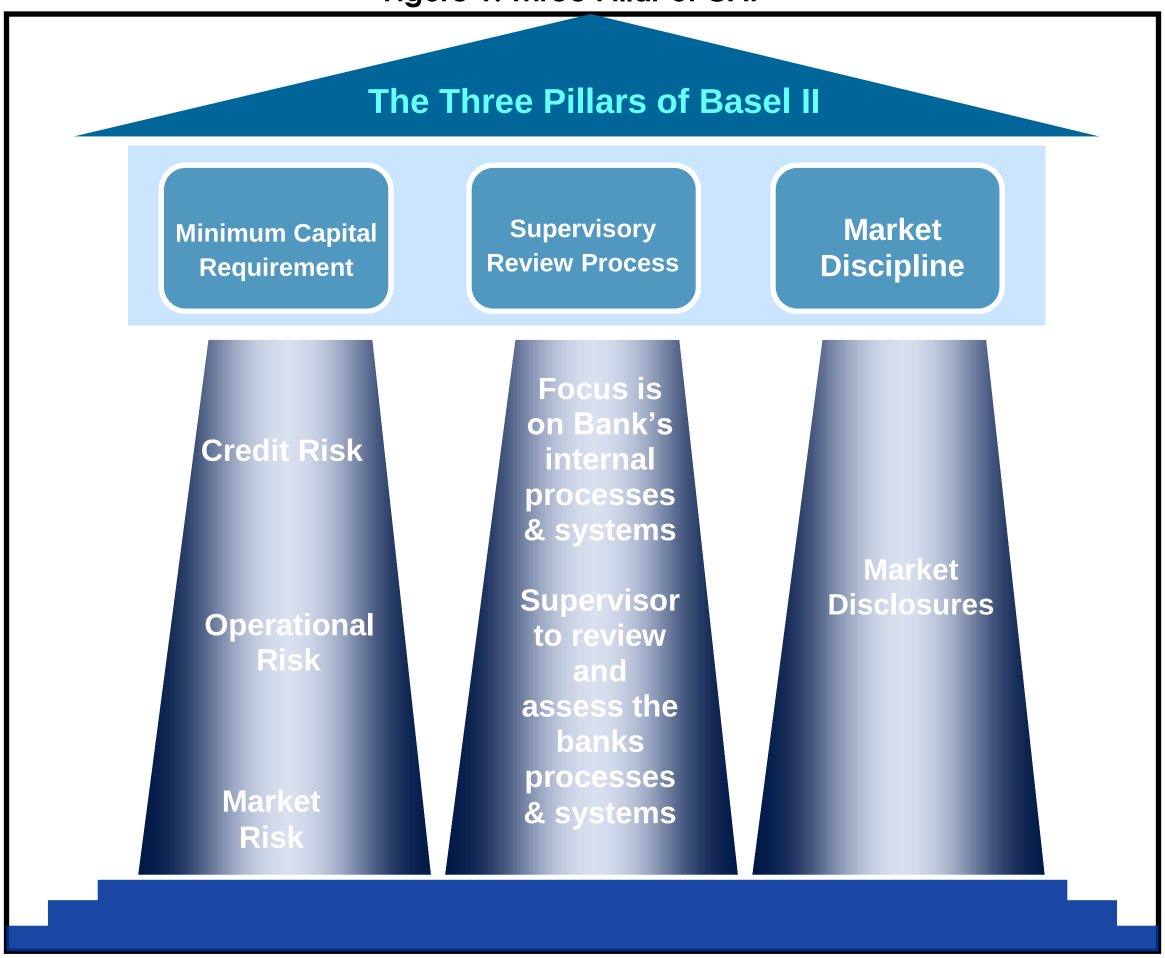
5.1 Pillar 1: Minimum Capital Requirements

Pillar 1 covers regulatory requirements for credit, market and operational risk. The capital adequacy is measured by using the following formula:-

$$\frac{\text{Total Capital}}{\text{Credit Risk} + \text{Market Risk} + \text{Operational Risk}} = \text{The bank's capital ratio (minimum 8\%)}$$

Under CAF (Basel II), the denominator of the minimum capital total capital ratio will consist of three parts: the sum of all risk-weighted assets for credit risk, plus 12.5 times the sum of the capital charges for market and operational risk.

Figure 1: Three Pillar of CAF



5.2 Pillar 2: Supervisory Review Process

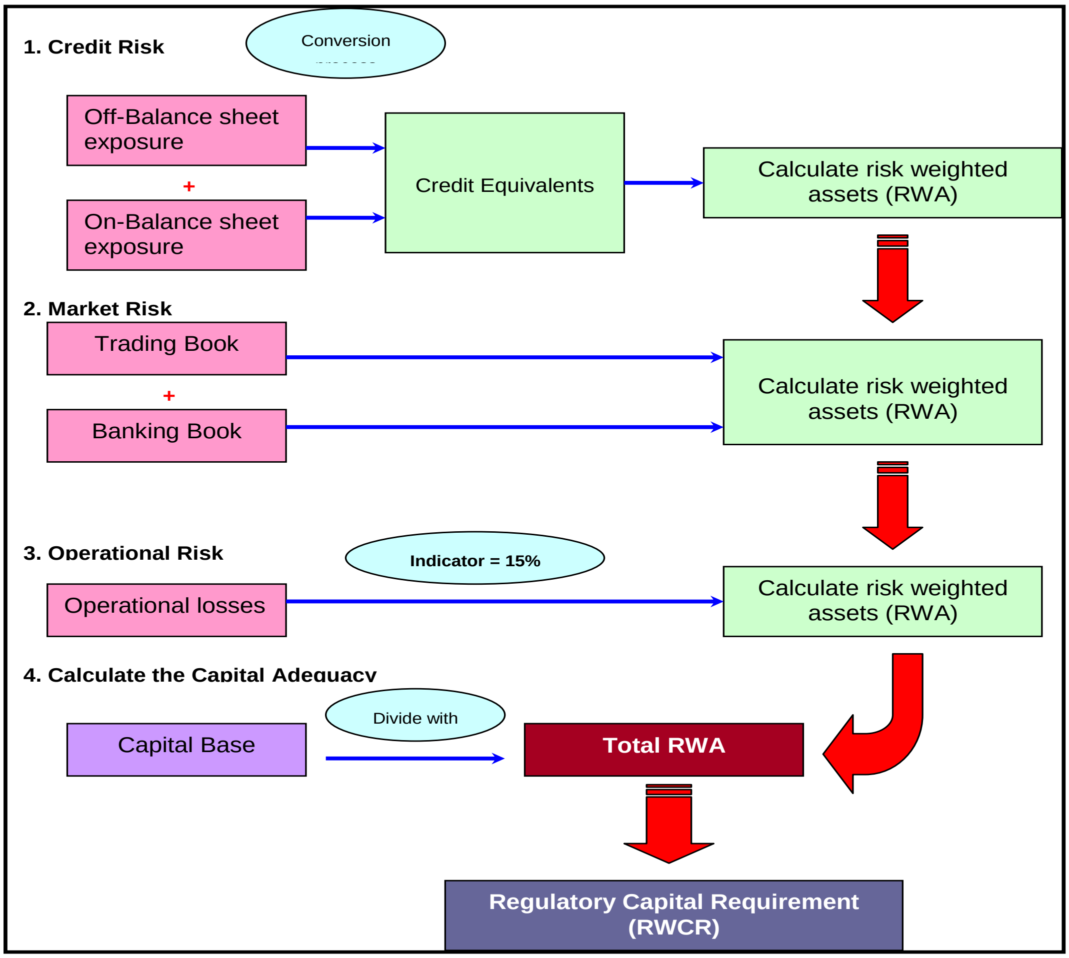
Pillar II defines the process for supervisory (DAB) review of an institution's risk management framework and its capital adequacy. It sets out specific oversight responsibilities for the board and senior management, thus reinforcing principles of internal control and other corporate governance practices established by DAB. According to the Basel Committee, "The [New Accord] stresses the importance of bank management developing an internal capital assessment process and setting targets for capital that are commensurate with the bank's particular risk profile and control environment. DAB would be responsible for evaluating how well the Banks are assessing their capital adequacy needs relative to their risks. This internal process would then be subject to DAB review and intervention, where appropriate.

5.2 Pillar 3: Market Discipline

Pillar III aims to bolster market discipline through enhanced disclosure by banks. It sets out disclosure requirements and recommendations in several areas, including the way a bank calculates its capital adequacy and its risk assessment methods. Enhanced comparability and transparency are the intended results. At the same time, the Basel Committee has sought to ensure that the Basel II disclosure framework aligns with national accounting standards and, in fact, does not conflict with broader accounting disclosure standards, of which banks must comply.

5.4 Calculation of Minimum Capital Requirements

FIGURE 2



5.5 Capital Base

5.5.1 Figure 2 above presents the calculation of the total minimum capital requirements for credit, market and operational risk. The capital ratio is calculated using the definition of regulatory capital and risk-weighted assets. The total capital ratio must be no lower than 8%.

5.5.2 For supervisory purposes, should be defined in two tiers in a way which will have the effect of requiring at least 50% of a bank's capital base to consist of a core element comprised of equity capital and published reserves from post-tax retained earnings (Tier 1). The other elements of capital (supplementary capital) will be admitted into the Tier 2, which is limited to 100% of Tier 1.

5.5.3 As such, in defining the constituents of capital funds, a two-tier system is adopted as follows:

Capital Elements	Current Period
Tier 1 Capital	
Paid Up Ordinary Share Capital	
Paid Up Non Cumulative Perpetual Preference Shares	
Share Premium	
Retained Profit/(Loss)	
Surplus after Tax Arising from The Sale of Fixed and Long Term Investments	
Current unadjusted net profits on a half-yearly basis	
Innovative Tier 1 Capital	
Tier 1 Minority Interest	
Other Reserves	
less:	
Goodwill	
Deferred Tax Assets/(Liabilities)	
Others (please specify)	
Total Tier 1 Capital (Core Capital)	-
Tier 2 Capital	
Property Revaluation Reserve	
Ordinary Shares Capitalised from Property Revaluation Reserve	
Cummulative Perpetual Preference Shares	
Minority Interest in Cumulative Perpetual Preference Shares of Non Wholly Owned Subsidiaries	
Approved Hybrid Debt Capital Securities Issued	
General Allowance for Bad and Doubtful Debts and Financing Maximum Allowable Subordinated Debt/*Sukuk* Capital	
Total Tier 2 Capital	-
Total Eligible Tier 2 Capital	
less:	
Investment in Subsidiaries	
Investment in Insurance Companies	
Holdings of Other Banking Institution's Capital Instruments	
Investment in Property funded by Shareholders' Fund*	
Other Deductions	
Capital Base	-

5.6 Risk-Weighted Assets

a) Total risk-weighted assets are determined by multiplying the capital requirements for market risk and operational risk by 12.5 and adding the resulting figures to the sum of risk-weighted assets for credit risk.

b) For on-balance sheet and off-balance sheet in credit risk, they are assigned to the relevant Risk Weight Assets (RWA) bucket and multiplied by the appropriate risk-weight; 0%, 20%, 50%, 100% and 150%.

c) Unlike the credit risk (RWA) calculation, the market and operational risk calculation results directly in a capital requirement. It can be converted to RWA calculations by multiplying with 12.5, (inverse of 8%).

5.7 The Standardised Approach for Credit Risk

The capital requirements under the Standardised Approach for Credit Risk is determined based on an approach that link predefined sets of exposures or classes of assets to predefined risk weights.

In principal a risk weights for the exposures of Islamic banks shall be determined based on recognized rating of an external credit assessment institution (ECAI), preferential risk weight for the regulatory retail and residential real estate portfolios, or specific rating prescribed by DAB for specifically identified exposures. In addition, this Framework also recognizes wider range of credit risk mitigation techniques.

5.8 The Standardised Approach for Market Risk

Market risk is defined as the risk of losses in on- and off-balance sheet positions arising from movements in market prices. The standardised approach for market risk shall address the following:

a) Benchmark rate risk and equity risk pertaining to financial instruments in the trading book;
b) Foreign exchange risk and commodities risk in the trading and banking books;
c) Inventory risk arising from Islamic banks’ business activities; and
d) Treatment of options.

5.9 The Basic Indicator Approach for Operational Risk

The measurement of the capital for operational risk is based on the Islamic Financial Services Board (IFSB) in Basic Indicator Approach.

a) Under Basic Indicator Approach the Operational Risk capital charge shall hold capital for operational risk equal to the average over the previous three years of a fixed percentage (denoted alpha) of positive annual gross income.

b) Gross Income Figures for any year in which annual gross income is negative or zero should be excluded from both the numerator and denominator when calculating the average.

c) The Bank need to keep 15% of its Gross Revenue in receives to cover all it financing out.

d) In the basic indicator approach the measure is a Bank's average annual gross income over the previous three years. The average is multiplied by a factor 0.15 is set by Basel Committee to produce the capital requirement.

5.10 The three standardized approaches for capital computation will be formulated and the detailed frameworks will be circulated in the specific guidelines of capital adequacy requirements.

6. Custodian of the Regulation on Capital Adequacy

6.1 This Regulation shall be under the safe custody of the Legal and Regulatory Section ("LRS") of DAB. Any changes to this Regulation shall be made by the LRS, as reviewed by the DAB Executive Board and upon approval by DAB Supreme Council. A copy of the amended Regulation shall be made available to all stakeholders for reference and implementation.

6.2 Banks may further refine the Regulation to suit their particular structure and policies. Such amendments shall be approved by the Bank's Risk Management Committee at the Board level. The Bank's Risk Management Division will have custody over the Regulation on Capital Adequacy.

7. Effective Date of the Document

The Effective date of this Regulation is the ______ day of ______________ 20___