



Islamic Republic of Afghanistan
Da Afghanistan Bank

Summary

Da Afghanistan Bank (DAB) is issuing a regulation on capital circulation of the regulation for comment is consistent with Article 3 of the Decree Law of Banking in Afghanistan (Banking Law), which requires that a regulation be published in the manner “best calculated to bring the regulation to the attention of the domestic banking industry.” If DAB determines that the delay in issuing a regulation that would be caused by circulating the regulation for public comment would be a “serious threat to the interests of the banking system” it may forego this requirement. In the case of this regulation, DAB chooses to circulate the regulation for public comment.

Purpose of rule

The purpose is to develop a regulation that makes 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 Principle 6 of the Basle Committee on Banking Supervision’s Core Principles Methodology.

Background and summary of rule

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.

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.



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Article Two: Capital

Part A — General.

§2.1.1. Authority

This regulation on the calculation of regulatory and core capital is pursuant to the authority granted to DAB by Article 35.3 of the Decree Law of Banking in Afghanistan.

§ 2.1.2. Definitions.

- a). *Assets* means the net book value of on-balance sheet assets and the credit equivalents of off-balance sheet items.
- b). *Conversion factors* are used to convert off balance sheet items into their credit equivalents. Credit conversion factors are multiplied by the nominal principal amounts to achieve their risk weighted credit equivalents.
- c). *Core (Tier 1) capital* means a bank's permissible permanent paid-in capital that may be comprised of any or all of the following:
 - i. common equity shares and their related surplus;
 - ii. non-cumulative, 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);
 - iii. such other instruments as may be approved by DAB as permissible permanent capital from time to time, by regulation or order; or
 - iv. retained profit/loss for previous years, legal reserves, other reserves set aside for after-tax profit and the cumulative foreign exchange transaction adjustment.

- d) *Credit equivalent* of an off-balance sheet item of a bank means the nominal value of that item adjusted for the respective credit weight.
- e) *Equity investments* are those ownership interests in another entity that a bank expects to produce income, appreciation in value or other economic benefits.
- f) *Financial capital* means the amount of capital, calculated according to International Accounting Standards, measured as the difference between total assets and total liabilities, with no adjustments.
- g) *Good-will* means the excess of the price paid by a bank for a collection of assets and liabilities over the net value of the assets and liabilities calculated separately
- h) *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.
- i) *Category A countries* means Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea, Luxembourg, Mexico, Netherlands, New Zealand, Norway, Poland, Portugal, Slovak Republic, Spain, Sweden, Switzerland, Turkey, United Kingdom and the United States.
- j) *Off-balance-sheet items* mean the contingent liabilities of a bank including direct credit substitutes issued by it such as guarantees of indebtedness, standby letters of credit, commercial letters of credit, loan commitments 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.
- k) *Regulatory (total) capital* means the sum of a bank's Core (Tier 1) capital and its Supplementary (Tier 2) capital. In the calculation of regulatory capital, supplementary capital is limited to 100 percent of core capital.
- l) *Risk-asset* means any monetary asset that is carried on the balance sheet of a bank, such as a loan, that entails any risk of loss in value to that bank.
- m) *Risk-weighted assets* of a bank means the assets of a bank adjusted for the respective risk weight corresponding to the degree of risk stipulated for individual types of assets.
- n). *Supplementary (Tier 2) capital* means capital that may be comprised of any or all of the following but only up to a total of 100 percent of core (Tier 1) capital:

- i. 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;
- ii. term preferred shares (shares whose holders have the right to redeem them and which have original terms of 5 years or more). These shares are subject to approval as capital from time to time throughout their terms. Term preferred shares are further classified into intermediate term preferred shares (ITPS—5 to 20 years) and long term preferred shares (LTPS—over 20 years). The amount of term preferred shares eligible to be included in Tier 2 capital will be reduced by 20% of their original amounts at the beginning of each of the last 5 years of their terms. The sum of ITPS and subordinated debt includable in supplementary capital is limited to 50 percent of core capital;
- iii. term debt instruments that 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 Supplementary (Tier 2) capital will be reduced by 20% of their original amounts at the beginning of each of the last 5 years of the instrument's life;
- iv. hybrid debt/equity instruments that satisfy the criteria stated in § 2.2.3.
- v. debt instruments which are mandated to be convertible into common shares and which are unsecured and fully paid-in; or
- vi. general reserves for loan losses up to a maximum of 1.25 percent of risk weighted assets at any one time, or such other percentage as may be established from time to time by DAB regulation or order.
- vii. revaluation reserves of fixed assets, available-for-sale investments, and cash flow hedges and other assets.

§ 2.1.3. Capital General.

- a) DAB requires all banks licensed in Afghanistan to maintain a 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. In determining the adequacy of a bank's capital, DAB will take into account a number of factors in assessing to ensure that the minimum capital adequacy ratio required is broadly proportional to the bank's risk profile. These factors include the bank's asset quality, adequacy of provisioning, credit risk concentrations, profitability, liquidity, off-balance sheet exposures, concentration of particular types of assets or liabilities,

operational risk and the effectiveness of the bank's management systems for monitoring and controlling risk.

- b) In assessing whether an instrument is eligible for inclusion in a bank's capital for capital adequacy purposes, DAB considers both the form and substance of the instrument. Banks must consult DAB in advance of issuing any capital instrument (whether to be issued by the bank itself or its subsidiary), except where the bank or its subsidiary has previously issued capital in the same form proposed.
- c) Capital adequacy is assessed in two tiers:
 - i. Tier 1 or core capital, consisting of the highest quality capital elements that fully meet all the essential characteristics of capital; and
 - ii. Tier 2, or supplementary capital, which includes other instruments which, to a varying degree, fall short of the quality of Tier 1 capital, but nonetheless contribute to the overall strength of a bank as a going concern.
- d) Capital in a subsidiary in excess of that needed to support the business of that subsidiary will not be eligible to be included in the bank's consolidated capital base, unless it can be clearly demonstrated that it is freely available to support the operations of other parts of the financial business group.

§ 2.1.4. Minimum financial capital requirement.

DAB requires that all banks licensed in Afghanistan at all times maintain financial capital of not less than AF 500 million.

§ 2.1.5. Minimum risk-adjusted asset capital ratio.

All banks shall maintain a minimum regulatory (total) capital to risk-weighted asset ratio of not less than 12 percent and a core (Tier 1) capital to risk-weighted asset ratio of 6 percent.

- a) A bank's risk adjusted capital ratio is obtained by dividing its capital base by its risk-weighted assets.
- b) The minimum ratio set forth above may be changed by DAB by regulation or order from time to time.

Minimum ratio of regulatory (total) capital to risk weighted assets shall be determined by the formula:

$$= \frac{C_{\text{tot}}}{\text{RA}}$$

C_{tot} – Total Capital (daily average) less prescribed deductions

RA – risk weighted assets (daily average).

Minimum ratio of core (Tier 1) capital to risk weighted assets shall be determined by the formula:

$$= \frac{C_{core}}{RA}$$

where,

C_{core} - core capital (average daily) less prescribed deductions

RA – risk weighted assets (daily average).

The standard percentages for institutions are applicable to banks that are well managed and operating in a sound manner. However, DAB may require higher percentages for those banks deteriorating in financial position or functioning in highly risky sectors or displaying weaknesses in management.

Part B — Prudential Regulations.

§ 2.2.1. Characteristics of Tier 1 Capital.

To be included as Tier 1 capital, capital instruments must satisfy the following criteria:

- a) The instrument should normally take the form of shares unless otherwise approved by DAB. It must be treated as equity under International Accounting Standards, and be reported as such in the bank's published financial statements, except where an alternative treatment has been agreed with DAB.
- b) The instrument must be unsecured and fully paid-up. The proceeds of the issue must be immediately available to the issuer/bank. Only the proceeds actually received from the issue are to be included.
- c) The instrument must be subordinated in terms of the right of repayment of principal and interest to all depositors and/or other creditors of the issuer/bank. Issue documentation must clearly indicate this to prospective holders, and must preclude the exercise of any contractual rights of set-off between the instrument and any claims by the issuer on the holders of the instrument. Issue documentation must also clearly indicate that the instrument does not represent a deposit liability of a bank.
- d) The instrument must have no maturity. It must not be redeemable at the initiative of the holder nor must it carry any other provision that requires future redemption by the issuer. The instrument may, however, be redeemable at the option of the issuing bank, with DAB's prior approval. In this event, issue documentation must give clear and

- prominent notice to prospective investors that the issuer's right to exercise any such option to redeem or purchase the instrument is subject to such prior DAB approval.
- e) The instrument (including any unpaid dividends or interest) must be available to absorb losses incurred by the issuer in the ordinary course of business.
 - f) Dividend (or interest) payments to the instrument must be non-cumulative. The issuer must be able to waive any dividend (or interest) payments on the instrument and alter the timing of payments. The instrument must not provide for payment of any form of compensation to investors other than by way of a distribution of profits.
 - g) The non-payment of a dividend (or interest) on the instrument must not trigger any restrictions on the issuer, other than the need to seek the holders' approval before paying dividends on other shares, or purchasing shares (outside normal trading operations), or retiring shares.
 - h) Dividend (or interest) obligations on the instrument must not be linked to the credit standing of the issuer. The rate of dividends (or interest), or the formulae for calculating dividend (or interest) payments, must be fixed at the time of issuing the instrument.
 - i) Where the instrument provides for a mandatory conversion or an option to the holders or the issuer to convert into another form of eligible Tier 1 capital instrument, it must not contain any conversion feature that effectively provides for a return of capital or compensation for unpaid dividends (or interest). The terms of conversion should be fixed at the time of issue in line with market terms and conditions.
 - j) The instrument must not contain any terms or restrictions that could adversely inhibit the issuer's ability to be managed in a sound and prudent manner (particularly in times of financial difficulty), or restrict DAB's ability to resolve any problems encountered by the issuer (e.g., clauses preventing further senior debt issues).
 - k) Any subsequent modification of the terms or conditions of the instrument, which impact on its eligibility to continue qualifying as Tier 1 capital, must be subject to DAB's prior consent.

A bank is required to provide DAB with copies of documentation associated with the issue of the instrument. Where the terms of an issue depart from established precedent, banks should consult DAB prior to issue.

§ 2.2.2. Deductions from capital.

Good-will, intangible assets and future tax benefits are to be deducted from a bank's Core (Tier 1) capital before the Supplementary (Tier 2) portion of the calculation is made.

Equity investments are to be deducted from a bank's regulatory (total) capital.

§ 2.2.3. Characteristics of Tier 2 Capital.

Hybrid debt/equity instruments must satisfy the following criteria to be eligible as Tier 2 capital:

- a) The instrument must be unsecured and fully paid-up. The proceeds of the issue must be immediately available to the issuer. Only the proceeds actually received from the issue are to be included.
- b) The instrument must be subordinated in right of repayment of principal and interest to all depositors and/or other creditors of the issuer, except those creditors (not depositors) expressed to rank equally with or behind the holders of the instrument. Issue documentation must clearly indicate this to prospective holders, and must preclude the exercise of any contractual rights of set-off between the instrument and any claims by the issuer on the holders of the instrument. Issue documentation must also clearly indicate that the instrument does not represent a deposit liability of a bank.
- c) The instrument must not be redeemable at the initiative of the holder nor must it carry any other provision that requires future redemption by the issuer. The instrument may, however, be redeemable at the option of the issuing bank with the prior approval of DAB. Where the instrument offers a redemption option to the issuer, issue documentation must give clear and prominent notice to prospective investors that the issuer's right to exercise any such option to repay, purchase or otherwise redeem the instrument is subject such prior DAB approval.
- d) The instrument (including any unpaid dividends or interest) must be available to participate in losses without the issuer being obliged to cease trading. This can be achieved either by conversion into ordinary shares or by treating the instrument as a class of share capital in the event that the issuer's retained earnings become negative. Where the instrument provides for an automatic conversion into ordinary shares (including any unpaid interest), the rate of conversion must be fixed at the time of subscription to the instrument. Alternatively, the instrument can provide for principal and unpaid interest to be treated as if it constituted a specific class of share capital of the bank. Issue documentation must disclose to prospective investors the manner by which the instrument is to be treated in a loss situation.
- e) The instrument must allow the issuer an option to defer servicing obligations where profitability does not justify a dividend or interest payment. Although any unpaid dividends or interest can be accumulated, they must not be compounded. The instrument must not provide for payment of any form of compensation to investors other than by way of a distribution of profits.
- f) Dividend (or interest) obligations on the instrument must not be linked to the credit standing of the issuer. The rate of dividends (or interest), or the formulae for calculating dividend (or interest) payments, must be fixed at the time of issuing the instrument.
- g) The instrument must not provide for the payment of a higher dividend or interest rate if dividend or interest payments are not made on time (nor a reduced rate of interest if interest payments are made on time).
- h) In the event that the issuer defaults under the terms of the instrument, remedies available to the holders should be limited to actions for specific performance, recovery of dividend or interest amounts currently outstanding, or the winding-up of the issuer.
- i) Where the instrument carries a right or obligation to convert into share capital of the issuer, the conversion provisions must not be structured to provide a redemption or

return of the original investment or any compensation for unpaid dividends or interest to the holders. The terms of conversion should be fixed at the time of issue in line with market terms and conditions.

- j) The instrument must not contain any terms, covenants or restrictions that could adversely inhibit the issuer's ability to be managed in a sound and prudent manner (particularly in times of financial difficulty), or restrict DAB's ability to resolve any problems encountered by the issuer (e.g. clauses preventing further senior debt issues).
- k) Any subsequent modification of the terms or conditions of the instrument, which impact on its eligibility to continue qualifying as Tier 2 capital, must be subject to DAB's prior consent.

A bank is required to provide DAB with copies of documentation associated with the issue of the instrument. Where the terms of an issue depart from established precedent, the bank should consult DAB prior to issue.

General reserves for loan losses must satisfy the following criteria to be eligible as Tier 2 capital:

- a) The amount of general reserves for loan losses to be included in Tier 2 capital should be net of any associated future income tax benefits on a gross basis, and is limited to a maximum of 1.25 per cent of total risk-weighted exposures.
- b) The amount of general reserves for loan losses included must be created against future, presently unidentified losses and must be freely available to meet any losses that may subsequently materialize. Any general reserves created against specific or identified losses and against identified deterioration in the value of particular assets, whether individual or grouped, foreign or domestic, are not eligible for inclusion in Tier 2 capital.

Reserves arising from the revaluation of fixed assets can be included in Tier 2 capital subject to the following conditions:

- a) the fixed assets must be owned by the bank or its subsidiaries;
- b) the reserves must be shown on the balance sheet or notes to the accounts without passing through the profit and loss accounts;
- c) the revaluations are subject to audit review consistent with International Accounting Standards and auditing practice;
- d) the amount of reserves to be included in Tier 2 capital must incorporate the full effect of any diminution in the values of fixed assets (i.e. net of any devaluations), and should be after allowance for expected realization costs and associated taxes; and
- e) the revaluation has been approved in advance by DAB. Normally revaluations of fixed assets are not allowed except in extraordinary circumstances.

Revaluation reserves of other assets can be included in Tier 2 capital subject to the following conditions:

- a) the reserves must be shown on the balance sheet or notes to the accounts without passing through the profit and loss accounts;
- b) the reserves must incorporate the amount of any diminution in the values of assets (i.e. net of devaluations); and
- c) only 45 per cent of the net revaluation surplus (net of devaluations) can be included in Tier 2 capital.

§ 2.2.4. Risk categories, risk weights for assets and off-balance sheet items.

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

- a). Category 1 - Zero (0) percent risk weight.
 - i. Cash in Afghanis and in foreign readily convertible currencies;
 - ii. Balances due from and claims on central banks of Category A countries subject to the prior approval of DAB. Direct claims on or claims unconditionally guaranteed by central governments of Category A countries, subject to the prior approval of DAB or their agencies or instrumentalities which explicitly carry the full faith and credit of such central governments subject to the prior approval of DAB;
 - iii. Precious metals and precious stones appraised at values approved by DAB 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;
 - iv. Current account at DAB;
 - v. Any other obligations of DAB, including time deposits, certificates of deposit, or other short-term financial instruments;
 - vi. Loans or the portions thereof supported by cash collateral in the form of Afghanis or other readily convertible currency maintained at current value, deposited with the bank and pledged and blocked for the purpose; and
 - vii. Any other assets as may be determined by DAB.
- b). Category 2 - Twenty (20) percent risk weight.
 - i. Loans or the portions thereof supported by collateral in the form of securities issued or unconditionally guaranteed by central banks or central governments of Category A countries, subject to the prior approval of DAB;

- ii. Direct claims on or claims unconditionally guaranteed by banks licensed and operating in Category A countries subject to the prior approval of DAB;
 - iii. Direct claims having maturities of one year or less on banks licensed and operating in non-Category A countries, subject to the prior approval of DAB or claims unconditionally guaranteed by such banks;
 - iv. Securities issued by or unconditionally guaranteed by central banks or central governments of Category A countries subject to the prior approval of DAB;
 - v. 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 DAB;
 - vi. Cash items in process of collection; and
 - vii. Any other assets as may be determined by DAB.
- c). Category 3 - Fifty (50) percent risk weight.
- i. Loans or the portions thereof supported by collateral in the form of first lien residential mortgages whose underlying indebtedness is not more than 30 days past due;
 - ii. 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; and
 - iii. Any other assets as may be determined by DAB.
- d). Category 4 - One Hundred (100) percent risk weight.
- i. All claims on and portions of loans to private debtors;
 - ii. 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, real estate held for investment; and
 - iii. Any other assets not already included in another risk-weight category as may be determined by DAB.

§ 2.2.5. Off-balance sheet items credit conversion factors.

The following values are assigned to off balance-sheet items to convert them into on-balance sheet equivalents, which are then placed in risk-weight categories according to the obligor:

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

Part C — Frequency of Assessment.

§ 2.3.1. Management Responsibility.

It is the responsibility of every administrator of the bank to notify DAB whenever any measure of capital is less than the minimum required.

§ 2.3.2. Frequency of DAB Assessment of Capital Adequacy.

DAB will assess each bank's capital adequacy at the end of each calendar quarter. If DAB finds a capital deficiency that has not precisely been reported to it by a bank administrator, DAB will formally notify the bank. After notification is received, the bank will have 60 days to remedy the deficiency. If the deficiency is not remedied within 60 days in a way that is demonstrable to DAB, DAB will apply enforcement action against the bank.