عمومی بانکی

Da Afghanistan Bank
Financial Supervision Department

مدیریت عمومی نظارت امور مالی — د مالی چارو د نظارت لوی مدیریت

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To,
Chief Executive Officers of licensed commercial banks & General Managers of permitted branches of foreign banks

Subject: - "Financing commercial real estate and construction loans"

As you know, Afghanistan, and particularly Kabul, is experiencing an unprecedented construction boom. This activity is a necessary component of rebuilding our shattered economy and infrastructure, and of providing decent housing for our growing population. Banking organizations, both full-fledged banks and branches of foreign banks, are participating in this construction boom by financing commercial real estate and construction loans, and residential mortgage loans to individuals. As of 31 May 2010, these loans amounted to AFN 15.1 billion, or 22 percent of total outstanding loans.

Although this lending is a desirable and profitable activity in which Afghanistan's banks may be involved, Da Afghanistan Bank (DAB, the central bank) reminds all bankers that such activity carries with it major risks, if not done properly or if the bank concentrates its lending activity excessively in this (or any other) sector. Poor judgment in granting individual loans, exceeding the large exposures limitation, or devoting more than 40 percent of a bank's capital to a single economic sector could result in large losses to the bank.

Da Afghanistan Bank draws your attention specifically to its regulation "**Asset risk diversification and limitations on large exposures of banking organizations**," that states that

> ***"An asset concentration exists when extensions of credit or other bank assets posing similar risk characteristics to a bank aggregate 40% or more of a bank's primary [read: Tier 1] capital. For domestic branches of foreign banks, the concentration threshold is 12% of total assets." (6.1.2.A)***

Every bank should calculate its loan, investment, and other exposure (including letters of credit and guarantees) to each sector and, where such exposure is more than 40% of Tier 1 capital, take steps to reduce it. DAB examiners will be looking for evidence that the bank has done these calculations at upcoming on-site examinations. The Board of Supervisors, for its part, also has responsibility in limiting these sectoral concentrations.

Again, quoting the regulation,

> ***"...the bank's Board of Supervisors is responsible for establishing appropriate risk parameters or limits on asset concentrations and for monitoring exposure, as well as for evaluating the methods used by management to administer, control, and stress-test asset concentration risk. Asset concentrations that involve excessive or undue risks require close scrutiny by the bank and should be reduced over a reasonable period of time." (6.2.1.A)***

For construction lending specifically, DAB urges banks to conduct complete analyses of the financial condition and past performance of both the real estate developer and the general contractor, and maintain appropriate documentation. Such documentation should indicate that the developer, contractor, and subcontractors have demonstrated the capacity to successfully complete the type of project to be undertaken. You must also ascertain that the real estate developer has obtained proper title to the land and there are no outstanding issues, such as community complaints, view blockage, road access blockage, or anything else, that could slow down or stop construction.

Some banks may be tempted to provide ***both*** construction loans to the developer ***and*** individual mortgage loans to households or businesses to purchase space in the completed development, either for residential purposes (such as single-family apartments) or commercial purposes (such as offices or shops). From DAB's standpoint, this is a very risky activity. Instead of providing the financing yourself to these buyers (so-called *permanent* mortgage loans, as distinguished from *construction* mortgage loans), you should require that the developer work with other banks to provide the loans. In many other countries, the combination of construction and permanent loans on the same project has spelled disaster for many banks, when the construction is completed poorly or late, when the project does not sell well and early buyers face declining property values, or other common problems.

You will all agree that avoiding loan concentration and, in particular, ensuring that large construction lending projects are undertaken with utmost care and due diligence, will not impose an undue burden or hardship on any financial institution. Quite the contrary, these safeguards will have the great benefit of building and maintaining trust and confidence in the Afghan financial sector, whose development over the last seven years has been astounding, and whose contribution to economic growth and the rebuilding of our nation has been immeasurable.

Very truly yours,

Abdul Qadeer Fitrat

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Governor
Da Afghanistan Bank