CAPITAL ADEQUACY REGULATIONS

Handbook of Procedures

FINANCIAL INSTITUTIONS (PRUDENTIAL CRITERIA) REGULATIONS 1994
UNDER SECTION 38 OF THE FINANCIAL INSTITUTIONS ACT, 1993

March 1995

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HANDBOOK OF PROCEDURES

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1. OVERVIEW

The Financial Institutions (Prudential Criteria) Regulations, 1994 were passed in July 1994. Part II of the Regulations deals with minimum capital adequacy requirements for all institutions licensed under the Financial Institutions Act, 1993. Regulation 3(1) sets the ratio of a licensee's qualifying capital to its risk adjusted assets (the Capital Ratio) at 8%.

The Capital Adequacy Computation (CB100) form is to be completed by all licensed financial institutions at the end of each calendar quarter and submitted within ten (10) working days of the end of the period to which the return relates to:

The Inspector of Financial Institutions
Financial Institutions Supervision Department
Central Bank of Trinidad and Tobago

I. PURPOSE

In keeping with the move towards securing international convergence of supervisory regulations governing the capital adequacy of international banks, the Central Bank of Trinidad and Tobago has adopted a risk-based capital measure and has established a uniform standard for the measurement of capital adequacy.

This uniform standard provides for differences in the risk profiles among financial institutions and recognizes the inherent credit risk in off-balance sheet transactions. Capital is therefore assessed in relation to credit risk.

In the absence of substantial empirical evidence concerning the incidence, nature and volume of off-balance sheet interest rate and foreign exchange contracts in Trinidad and Tobago, the Regulations do not treat with these instruments. It is envisaged however, that at a later date, revisions will be made to deal with these instruments, developments in the financial system and other pertinent issues.

II. FRAMEWORK

The basic framework used here is that adopted by the Basle Committee on Banking Regulations and Supervisory Practices. However, those guidelines have been tailored to accommodate situations peculiar

to the Trinidad an Tobago financial system. The emphasis is on evaluating credit risk and therefore the framework does not address the other risks to which financial institutions are exposed.

III. MECHANICS IN BRIEF

(i) All assets recorded on the balance sheet of a licensee as well as the nominal principal amount of its off-balance sheet exposures, are assigned to broad risk categories.

(ii) The aggregate of both risk adjusted on-balance sheet and off-balance assets is measured against the licensee's qualifying capital.

(iii) The ratio of qualifying capital to risk adjusted assets should not be less than the minimum standard i.e. 8.0% [Regulation 3(1)].

The Capital Adequacy Regulations stipulate the minimum capital ratio. Those institutions wishing to undertake substantial expansions in their asset bases must aim at achieving capital levels in excess of the minimum requirements. Additionally, the Central Bank may require a licensee to maintain a Capital Ratio in excess of the minimum standard, having regard to the quality of its loan portfolio, its loan provisioning policies and the effectiveness of its operating policies and procedures.

2. QUALIFYING CAPITAL

Regulations 5, 6, 7

A bank's qualifying capital consists of its core and supplementary capital components, net of deductions, and subject to certain limits and restrictions.

I. CORE CAPITAL

This category comprises equity and disclosed reserves. These capital elements are considered core because they are either:

(i) Permanent in nature, or

(ii) Available to absorb losses while the institution remains a going concern.

Because of the fluctuations which may occur in a licensee's profit and loss account during any fiscal period, retained earnings will be eligible for inclusion as core capital only where such profits have been reviewed by the external auditors of the licensee.

(See Schedule 1(a) for components of core capital).

II. DEDUCTIONS FROM CORE CAPITAL

Although current year unaudited profits are not eligible for inclusion as core capital, current year realized losses (whether determined by external audit or not) are to be deducted from core capital. This is an application of the prudence concept.

Secondly, bonus shares funded by the capitalization of unrealized asset revaluation reserves are not to be considered as core capital because the underlying source of funding of such issues, unrealized asset revaluation reserves, is indeterminate. Bonus shares funded from the proceeds of the disposal of revalued assets, that is, from realized reserves, would be eligible for inclusion as core capital.

Thirdly, with respect to Goodwill and Intangible Assets, the economic value of these assets is usually indeterminate, and therefore predictions of the useful life and carrying values are often unreliable. The assets are therefore effectively written off for the purposes of supervisory capital measurement.

(See Schedule 1(b) for deductions made from core capital).

III. SUPPLEMENTARY CAPITAL

All components of a licensee's capital base other than those eligible for inclusion as core capital, constitute supplementary capital.

(See Schedule 1(c) for the components of supplementary capital).

IV. LIMITS AND RESTRICTIONS ON QUALIFYING CAPITAL

Limits and restrictions have been placed on qualifying capital to ensure that:

(i) Undue reliance is not placed on supplementary components which are not permanent in nature, that is, capital which is not available to absorb losses while the institution is a going concern

(ii) A licensee does not accumulate indefinitely, general provisions and reserves for losses on assets without creating specific provisions and reserves on identifiable losses, thereby boosting its capital base

(iii) No recognition is given to capital components which may have been funded by unrealized gains on assets due to the element of subjectivity inherent in property valuations

(iv) Limited life redeemable capital instruments and subordinated term debt are discounted as they approach maturity.

The actual values of core and supplementary capital used in the computation of the Capital Ratio are subject to the following limits and restrictions:-

(i) Core capital must not be less than fifty percent (50%) of qualifying capital i.e. supplementary capital must not exceed core capital.

(ii) The aggregate of limited life redeemable preference shares and subordinated term debt shall not exceed fifty percent (50%) of core capital

(iii) Limited life redeemable preference shares and subordinated term debt are to be discounted by twenty per cent (20%) of the original amount, less any redemptions in each year of the last five years before maturity.

(iv) General provisions and reserves for losses on assets referred to in regulation 6(h) are to be limited to a maximum of 1.25% of risk adjusted assets after specified deductions

(v) Asset revaluation reserves should not exceed twenty percent (20%) of core capital

(See Part 1 of the capital computation form CB100)

3. RISK ADJUSTED ASSETS

Regulations 8, 9, 10

I. CONVENTIONAL BALANCE SHEET ASSETS

A Risk adjusted assets reflect the values reported on a licensee's balance sheet (net of specific provisions) multiplied by the appropriate risk weights. These assets represent a 'claim on' an obligor or 'ownership' by the institution.

(See Schedule II for a summary of asset risk categories).

B Risk weights are percentages that are assigned to each category according to either:

(i) The principal obligor,

(ii) The guarantor, or

(iii) The nature of the collateral held

The Capital Adequacy Regulations recognize seven (7) main categories of principal obligors:

(i) Governments

(ii) Statutory authorities

(iii) Central Banks

(iv) State Owned Financial and Commercial Entities

(v) Financial Institutions

(vi) Private Sector Non-Financial Institutions

(vii) Individuals

Other categories recognized are:-

Government guarantees, loans fully secured by mortgages on residential properties that are occupied by the borrower of rented and claims collateralized by cash.

If a claim is only partially guaranteed by the government, that portion which is not covered by the guarantee is assigned to the risk category applicable to the principal obligor.

Where an asset qualifies for classification in more than one risk category, it is assigned to the category that has the lowest risk weight [Regulation 8(3)].

(See Schedule II for summary of risk weights).

C Procedures for adjusting balance sheet assets to take account of risk

(i) Assign the balance sheet value (net of specific provisions but before general provisions) of each asset to the appropriate risk category

(ii) Multiply the aggregate dollar value for each risk category by the risk weight associated with that category
(iii) Sum the resulting weighted values for each category

(See Part II of the computation form).

II. <u>OFF-BALANCE SHEET ASSETS</u>

A Off-balance sheet items are those financial transaction which are often fee based and which do not generally involve the acquisition of conventional balance sheet assets and the taking of deposits.

B An off-balance sheet item is included in the determination of the aggregate of risk adjusted assets only after it has been converted to a credit facility, equivalent to conventional balance sheet items.

C This credit conversion equivalent represents the nominal principal amount of the off-balance sheet item multiplied by the appropriate credit conversion factor.

D The <u>credit conversion factor</u> is a measurement which seeks to reflect the potential credit risk of a particular off-balance sheet engagement

The regulatory framework recognizes four major categories of potential risk:

(i) Commitments with original maturities of up to one (1) year and/or which can readily cancelled.
(ii) Short term self-liquidating trade-related contingencies
(iii) Transaction related contingencies where the commitment crystallizes only when the customer fails to honor an obligation
(iv) Direct credit substitutes

E <u>Off-balance sheet risk weights</u> are the percentages assigned to each off-balance sheet category according to the obligor.

(See Schedule III(a) and (b) for summaries of off-balance sheet items, conversion factors and risk weights).

F <u>Procedures for computing the risk adjusted credit equivalent of off-balance sheet items</u>

(i) Assign the nominal principal amount of the off-balance sheet item to the appropriate risk category

(ii) Calculate the credit equivalent amount by multiplying the nominal principal amount by the appropriate credit conversion factor
(iii) Aggregate the credit equivalent amounts for each risk category
(iv) Multiply the aggregate credit equivalent amount for each category by the risk weight associated with that category
(v) Sum the resulting weighted values of each category

(See Part III of the computation form).

III. DEDUCTIONS FROM RISK ADJUSTED ASSETS

A On-balance sheet assets, for the purpose of these regulations should be reported gross of any general provision included in the accumulated provision account.

Prudential Criteria Regulation 11(2) requires that where a licensee makes a specific provision for all or part of a credit facility, such credit facility shall be reported net of the specific provision. For the purposes of the capital adequacy computation, it is therefore expected that all assets will be reported on the CB100 worksheet net of provisions made for identifiable losses. This procedure will also be applicable to assets such as investments and notes receivable.

B Intangible assets, including goodwill, are not recognized as part of the asset base of an institution for the purpose of these guidelines. The value of these items is therefore deducted from the risk adjusted on-balance sheet assets.

C General reserves and provisions for losses in excess of 1.25% of risk adjusted assets (after the deductions referred to in A and B above), and therefore disallowed in the capital computation, are also deducted from risk adjusted assets.

(See part IV of the computation form).

4. SCHEDULES

Schedule I (a) - <u>Components of Core Capital</u>

[Regulation 5(i)]

Core capital comprises –

(a) Fully paid issued ordinary share capital and related surplus;

(b) Fully paid perpetual non-cumulative preference shares and related surplus;

(c) The statutory reserve fund of the licensee referred to in section 25(1) of the Act;

(d) Capital reserves excluding asset revaluation reserves;

(e) General reserves excluding those for losses on assets;

(f) Retained earnings as stated at the end of the last financial year in the audited financial statements of the licensee;

(g) Retained earnings as stated in audited interim financial statements of the licensee.

Schedule I (b)

Deductions made from Core Capital

[Regulation 5(2)]

The following deductions are made from core capital –

(a) Losses made by the licensee in its current year of operation whether audited or unaudited and whether or not publicly disclosed;

(b) Bonus shares that have been issued from capitalization of asset revaluation reserves subsequent to the commencement of the Act;

(c) Intangible assets, including goodwill arising from the acquisition of assets and capitalized preliminary expenses.

Schedule I (c)

Components of Supplementary Capital

[Regulation (6)]

Supplementary capital comprises –

(a) Fully paid issued perpetual cumulative preference shares in respect of which the issuer has no right to defer or eliminate preferred dividends;

(b) Limited life preference shares which are redeemable at the end of a stated period and the original maturity of which is not less than five years;

(c) Bonus shares issued from capitalization of asset revaluation reserves, being equity created from unrealized gains which resulted from the revaluation of real estate property or other fixed assets as stated in paragraph (f)(ii);

(d) Capital instruments which are essentially permanent in nature and consist of a combination of equity and debt;

(e) Term debt which is subordinated to general creditors and claims of depositors and which has an original maturity of no less than five years;

(f) Asset revaluation reserves arising from –

   (i) The formal restatement of the balance sheet, or

   (ii) The revaluation of real estate or other fixed assets ascertained as at a balance sheet date and supported by an independent professional valuation conducted within one year before or three months after that balance sheet date;

(g) Undivided profits of the current year that are unaudited, and whether or not publicly disclosed;

(h) General reserves or provisions for losses on assets, namely –

   (i) Reserves set aside for future unidentified losses on assets, which reserves are normally reported as part of shareholders' equity;

   (ii) General provisions that have been created for unidentified losses and form part of the accumulated provision account, but excluding specific reserves and provisions created against identified losses.

Schedule II

Summary of Risk Weights and Asset Risk Categories

Percentage Risk Weights and Balance Sheet Assets

(1) Zero Percent

(a) Cash, Trinidad and Tobago currency and foreign currency, owned and held by the licensee;

(b) Deposits held by the licensee at the Central Bank;

(c) Treasury bills and other government securities;

(d) Claims on Government and all Government guaranteed obligations, including securities

(e) Securities of and claims on local government

(f) Securities of and claims on statutory authorities

(g) Claims and obligations guaranteed by foreign central banks and foreign governments

(h) Claims collateralized by cash on deposit at the licensee.

(2) Ten percent

Claims on and obligations of State-owned financial and commercial entities excluding obligations expressly guaranteed by the state.

(3) Twenty Percent

Claims on licensees including items in the process of collection;

Claims on and obligations of other financial institutions, including foreign commercial banks and the Home Mortgage Bank;

Bankers' acceptances held as part of a licensee's investment portfolio.

(4) Fifty

Loans fully secured by mortgages on residential properties that are owner-occupied by the borrower or rented.

(5) One hundred

(a) Loans secured by commercial or agricultural properties;

(b) All other assets not specified in (1) to (4).

Schedule III (a)

Summary of Off-Balance Sheet Items and Percentage Conversion Factors

Conversion Factors and Credit Facilities

(1) Zero

(a) Unused portion of overdraft facilities;

(b) Unused portion of credit card facilities.

(2) Twenty

Short-term self-liquidating trade-related contingencies, including commercial letters of credit which arise from the movement of goods and which are collateralized by the underlying goods

(3) Fifty

(a) Performance bonds;

(b) Guarantees;

(c) Indemnities;

(d) Performance standby letters of credit;

(e) Loans managed on behalf of Home Mortgage Bank.

(4) One hundred

(a) Items which substitute for loans, including guarantees of indebtedness, bankers' acceptances and financial standby letters of credit;

(b) Legally binding arrangements that obligate the licensee to extend credit, including loans and lease commitments and undisbursed loan funds;

(c) Sale and repurchase agreements with recourse to the licensee where the credit risk remains with the licensee;

(d) Documentary letters of credit and bills of collections accepted by the licensee

Schedule III (b)

Summary of Percentage Risk Weights

Percentage Risk Weights on and Off Balance Sheet Items

(1) Zero

Credit facilities extended to Government, local government, statutory authorities, the Central Bank, foreign central banks and foreign governments

(2) Ten

Credit facilities extended to State-owned entities

(3) Twenty

Credit facilities extended to financial institutions not mentioned in (1) and (2)

(4) One Hundred

Credit facilities extended to private sector non-financial institutions and individuals.