INSTRUCTION CPO/B-2000/2
ON REGULATORY CAPITAL

I. AUTHORITY AND APPLICABILITY

This instruction is issued by the Central Payments Office of East Timor, hereinafter referred to as "CPO", pursuant to Sections 4, 5.1(b), 11.2, 12, 26.1(a), 26.3, 27.1(e), 35.1, and 49(s) of UNTAET Regulation No. 2000/8 on Bank Licensing and Supervision.

This instruction applies to all banks unless a higher minimum requirement for Regulatory Capital is established by the CPO for an individual bank in a written enforcement agreement, in a written order to cease and desist, or as a condition for approval of an application.

II. REQUIREMENTS

A. **Minimum Amount of Regulatory Capital**—Banks must maintain the minimum amount of Regulatory Capital according to the capital required for the level of license.

B. **Minimum Capital Adequacy Ratio**—Banks must maintain a Capital Adequacy Ratio of at least 12 percent. This instruction only deals with credit risk. As the banking system develops the market risk and others shall be addressed.

Branches of foreign banks must maintain the minimum amount of regulatory capital in East Timor, or a guarantee accepted by the CPO, provided that the capital of the bank is sufficient to satisfy the legal capital requirements of its home country supervisor. With reference to the Capital Adequacy Ratio, branches of foreign banks must follow their home country requirements if those standards are not less than the standards set by the Basel Committee on Banking Supervision. However, they must report to the CPO, according to specific instructions.

III. CALCULATIONS

A. REGULATORY CAPITAL

Regulatory Capital is calculated by adding together Tier One Capital and the eligible amount of Tier Two Capital and deducting from that sum investments in the capital of other banks and financial institutions.

1. **Tier One Capital**—The core constituent of Regulatory Capital consists of the following elements.

Add:
- a. Issued and fully paid ordinary shares, provided that no shares may be paid for in-kind.
- b. Issued and fully paid perpetual noncumulative preferred shares, provided that no shares may be paid for in-kind.
- c. Capital surplus—funds in excess of par value obtained from the sale of shares included in items a. and b.
- d. Retained earnings; and deducting therefrom

Deduct:
- e. Goodwill—an intangible asset arising from the acquisition of an enterprise including a bank. Goodwill is calculated as the excess of the cost of the acquired enterprise over the sum of the amounts assigned to identifiable assets acquired less liabilities assumed.

2. **Tier Two Capital**—the supplementary constituent of Regulatory Capital consists of the following elements; provided, however, that the amount of Tier Two Capital eligible to be included in Regulatory Capital shall be limited to a maximum of 100 percent of the total of Tier One Capital.

    a. Hybrid debt/equity capital instruments, including noncumulative preferred shares, provided that the following requirements are met:

        (1) they are unsecured, subordinated and fully paid up;
        (2) they are not redeemable at the initiative of the holder or without the prior consent of the CPO;
        (3) they are available to participate in losses without the bank being obliged to cease trading unlike conventional subordinated debt; and
        (4) although the capital instrument may carry an obligation to pay interest that cannot permanently be reduced or waived, unlike dividends on ordinary shareholders' equity, it should allow service obligations to be deferred, as with noncumulative preferred shares, where the profitability of the bank would not support payment.

    b. Subordinated term debt and limited life redeemable preferred shares, provided that the following requirements are met:

        (1) they are unsecured;
        (2) they carry a minimum original fixed term to maturity of over five years;
        (3) during the last five years to maturity, a cumulative discount (or amortization factor of 20 percent per year will be applied to reflect the diminishing value of these instruments as a continuing source of strength; and
        (4) the combined total amount of subordinated term debt and limited life redeemable preferred shares eligible for inclusion in Tier Two Capital shall be limited to a maximum of 50 percent of the amount of Tier One Capital.

B. CAPITAL ADEQUACY RATIO

This ratio is used to assess the capital adequacy of banks by comparing a bank's Regulatory Capital to its assets and off-balance sheet exposures which have been weighted according to their relative riskiness.

$$\frac{\text{Regulatory Capital}}{\text{Total Risk-Weighted Assets}} \times 100$$

C. RISK-WEIGHTED ASSETS

To determine a bank's Total Risk-Weighted Assets which is the denominator of the Capital Adequacy Ratio, the bank's assets, and certain off-balance-sheet accounts, are assigned to one of five categories having a specific risk weight. Multiplying the risk weight by each particular asset assigned to it results in the risk-weighted asset. Adding all risk-weighted assets together determines the bank's Total Risk-Weighted Assets.

1. On-Balance-Sheet Assets

Risk Weight	Category of on-balance-sheet asset
0 %	Cash
	Claims on central governments and central banks denominated in national currency and funded in that currency.
	Other claims on OECD-***1*** central governments and central banks.
	Claims collateralized by cash of OECD central-government securities or guaranteed by OECD central governments-***2***
20 %	Claims on multilateral development banks-***3*** and claims guaranteed by, or collateralized by securities issued by such banks-***4***.
	Claims on banks incorporated in the OECD and claims guaranteed by OECD incorporated banks-***5***
	Claims on securities firms incorporated in the OECD subject to comparable supervisory and regulatory arrangements, including in particular risk-based capital requirements-***6***, and claims guaranteed by these securities firms.
	Claims on banks incorporated in countries outside the OECD with a residual maturity of up to one year and claims with a residual maturity of up to one year guaranteed by banks incorporated in countries outside the OECD.
	Claims on non domestic OECD public-sector entities, excluding central government, and claims guaranteed by or collateralized by securities issued by such entities-*7*.
	Cash items in process of collection.
50 %	Loans fully secured by mortgage on residential property that is or will be occupied by the borrower or that is rented.
100 %	Claims on the private sector.
	Claims on banks incorporated outside the OECD with a residual maturity of over one year.
	Claims on central governments outside the OECD (unless denominated and funded in national currency, see above).
	Claims on commercial companies owned by the public sector.
	Premises, plant and equipment and other fixed assets.
	Real estate and other investments (including non consolidated investment participation in other companies).
	All other assets.

Footnote:

1 Organization for Economic Cooperation and Development. For purposes of risk weighting the OECD group comprises all members of the OECD or countries that have concluded special lending arrangements with the International Monetary Fund associated with the Fund's General Arrangements to Borrow, and which have not rescheduled their external sovereign debt within the previous five years.

2 Commercial claims partially guaranteed by these bodies will attract equivalent low weights on the part of the claim which is fully covered. Similarly, claims partially collateralized by cash, or by securities issued by OECD central governments, OECD non-central government public-sector entities, or multilateral development banks will attract low weight on that part of the claim which is fully covered.

3 Such as IBRD, IDB, AsDB, AfDB and EBRD

4 See footnote 2.

5 See footnote 2

6 i.e., capital requirements that are comparable to those applied to banks in the Basel Capital Accord and its Amendment, the bank for International Settlements' Basel Committee on Banking Supervision, to incorporate market risks. Implicit in the meaning of the word "comparable" is that the securities firm, but not necessarily its parent, is subject to consolidated regulation and supervision with respect any downstream affiliates.

7 See footnote 2.

2. Off-Balance Sheet Accounts

Off-balance items, which represent risk to the bank, are assigned to a risk category in a similar manner as with on-balance sheet assets. First, however, off-balance sheet exposures must be converted to a "Credit Equivalent." Then, each converted off-balance sheet exposure is assigned to a risk category.

First the off-balance sheet account is multiplied by the Credit Conversion Factor located in the tables below to obtain the Credit Equivalent; then, the Credit Equivalent is assigned to one of the five risk weight categories in Section C.1 as for on-balance-sheet assets.

(a) For all banks:

Credit Conversion Factor	**Instruments**
100 %	Direct credit substitutes, e.g., general guarantees of indebtedness including standby letters of credit serving as financial guarantees for loans and securities and acceptances including endorsements with the character of acceptances.
50 %	Certain transaction-related contingent items for example performance bonds, bid bonds, warranties and standby letters of credit related to particular transaction.
20 %	Short-term self-liquidating trade-related contingencies such as documentary credits collateralized by the underlying shipments.
100 %	Sale and repurchase agreements and asset sales with recourse,[1] where the credit risk remains with the bank.
100 %	Forward asset purchases, forward deposits and partly-paid shares and securities, which represent commitments with certain drawdown.
50 %	Note issuance facilities and revolving underwriting facilities.
50 %	Other commitments, for example formal standby facilities and credit lines) with an original maturity of over one year.
0 %	Similar commitments with an original maturity of up to one year, or which can be unconditionally canceled at any time.

[1]These items are to be weighted according to the type of asset and not according to the type of counter party with whom the transaction has been entered into. Reverse repos, that is purchase and re-sale agreement—where the bank is the receiver of the asset, are to be treated as collateralized loans, reflecting the economic reality of the transaction. The risk is therefore to be measured as an exposure on the counter party. Where the asset temporarily acquired is a security which attracts a preferential risk weighting, this would be recognized as collateral and the risk weighting would be reduced accordingly.

(b) For banks with License Levels of A or B:

Forwards, swaps, purchased options and similar derivative contracts are treated differently from the off-balance-sheet accounts included in the previous section (a), because banks are not exposed to credit risk for the full face value of their contracts, but only to the potential cost of replacing the cash flow if the counter party defaults.

In order to determine the Credit Equivalent of these off-balance sheet items, apply one of the following two sets of conversion factors to the notional principal amounts of each instrument according to the nature of the instrument and its maturity. Then, the Credit Equivalent is assigned to one of the five risk weight categories in Section C.1. as for on-balance-sheet assets. Instruments traded on exchanges may be excluded where they are subject to daily receipt and payment of cash variation margin.

Original Maturity	**Interest Rate Contracts**	**Exchange Rate Contracts and Gold**
One year or less	0.5 %	2.0 %
Over one year to two years	1.0 %	5.0 %
For each additional year	1.0 %	3.0 %

IV. RESTRICTIONS ON CAPITAL DISTRIBUTION

A bank shall not make a capital distribution, as defined in Section 49(f) of UNTAET Regulation No. 2000/8 on Bank Licensing and Supervision, if the bank does not, or will not after making the distribution, have both the minimum required amount of Regulatory Capital or the minimum Capital Adequacy Ratio.

V. REPORTING REQUIREMENTS

Each bank shall submit to the CPO a report as of each month-end and in the format prescribed by the CPO showing the calculation of Regulatory Capital, Risk-Weighted Assets, and the Capital Adequacy Ratio in accordance with this Instruction. The format of the report is as follows:

26 October 2000

Fernando De Peralto, General Manager

REPORT ON REGULATORY CAPITAL

Name of Bank:
CPO Identification Number:
Report for Month Ended:

Tier One Capital		
1.	Issued and fully paid ordinary shares, and related capital surplus	
2.	Issued and fully paid perpetual non cumulative preferred shares, and related capital surplus	
3.	Retained earnings	
4.	Subtotal 4 = (1 + 2 + 3)	
5.	Goodwill	
6.	**Total Tier One Capital** 6 = (4 - 5)	
Tier Two Capital		
7.	Hybrid (debt/equity) capital instruments	
8.	Subordinated term debt and limited life redeemable preferred shares. Limit: 50 % of Tier One Capital (line 6). If line 8 is greater than 50 % of line 6, enter 50 % of line 6. If line 8 is equal to or less than 50 % of line 6, enter the amount on line 8	
9.	Subtotal 9 = (7 + 8)	
10	**Eligible Tier Two Capital**. Limit: 100 % of Tier One Capital (line 6). If line 9 is greater than the amount on line 6, enter the amount on line 6. If line 9 is equal to or less than the amount on line 6, enter the amount on line 9	
11.	Subtotal 11 = (6 + 10)	
12.	Investments in the capital of other banks and financial institutions	
13.	**Regulatory Capital** 13 = (11 - 12)	
14.	**Total Risk-Weighted Assets** (1) Assign the bank's assets and the Credit Equivalents of the bank's applicable off-balance sheet accounts to one of the five risk-weight categories contained in the Instruction (off-balance sheet accounts must be multiplied by the appropriate Credit Conversion Factor to obtain their Credit Equivalents). (2) Multiply each asset and Credit Equivalent by their assigned risk weight. (3) Sum all risk-weighted assets and Credit Equivalents and indicate the total risk-weighted assets here.	
15.	**Capital Adequacy Ratio** 15 = (13/14) x 100	

Signature of Authorized Officer / Date:

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