This guideline is no longer in force. It has been superseded by the *Guideline on Scope of Application of Basel III and Eligible Capital* with effect from 1 July 2014.

BANK OF MAURITIUS

Guideline on Eligible Capital

April 2008

TABLE OF CONTENTS

INTRODUCTION

Authority

This guideline draws its authority from section 50 of the Bank of Mauritius Act 2004 and section 100 of the Banking Act 2004.

Application

This guideline applies to all banks licensed under the Banking Act 2004.

Effective date

This guideline takes effect as from 31 March 2008.

Interpretation

1. Words and terms used in the guideline shall have the following meanings:

   (a) **"bank**" has the same meaning as defined in section 2 of the Banking Act 2004;

   (b) "**fair value**" is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction;

   (c) "**portfolio provision**" means an allowance for impairment loss as determined under paragraph 4.2.2 of the Guideline on Credit Impairment Measurement and Income Recognition;

   (d) **"collective provision**" has the same meaning as "portfolio provision";

   (e) "**significant minority investments**" means having an equity interest between 20% and 50%.

REGULATORY CAPITAL

Characteristics of capital

2. The first Basel Capital Accord which was drawn up by the Basel Committee in 1988 required banks to hold sufficient capital to support the risk that arise from their business. This requirement is still being pursued under New Capital Adequacy Framework - Basel II. In order to be eligible for inclusion in regulatory capital, capital should normally possess the following characteristics:

   (a) it should be freely available to absorb losses on an ongoing basis and in the event of a winding up;

   (b) capital should be paid up; and

   (c) there should be no contractual obligation to make dividend or pay interest on the instrument.

Types of capital

3. For the purpose of calculating the capital adequacy ratio of a bank, the capital of a bank is divided into two tiers (level): Core Capital (Tier 1) and Supplementary Capital (Tier 2).

Capital base

4. For the purpose of determining the capital adequacy ratio of a bank, the capital base of a bank, being the numerator of the risk asset ratio, shall be the sum of Tier 1 and Tier 2 Capital net of the relevant deductions.

CORE (TIER 1) CAPITAL

Characteristics of Tier 1 Capital (Core Capital)

5. To qualify as Tier 1 capital, banks should ensure that instruments satisfy the following criteria:

   (a) the instrument must be subordinated and has the ability to absorb losses on an on going basis;

   (b) it must be paid up and unsecured;

   (c) the instrument must be perpetual (i.e. it does not have a maturity date);

   (d) it must be non cumulative (i.e. the bank has the discretion to make payment).

Components of Tier 1 Capital

6. Elements of Tier 1 Capital comprise paid up or assigned capital, share premium reserve, statutory reserve, general reserve (excluding any portfolio provisions for credit losses which is included in Tier 2 Capital). Disclosed reserves also include general funds (such as fund for general banking risk) of the same quality that meet the following criteria:

   (a) allocations to the funds must be made out of post tax retained earnings or out of pre-tax earnings adjusted for all potential liabilities;

   (b) the funds and movements into or out of them must be disclosed separately in the bank's published accounts;

   (c) the funds must be available to a bank to meet losses for unrestricted and immediate use as soon as they occur; and

   (d) losses cannot be charged directly to the funds but must be taken through profit and loss account.

General reserves

7. The general reserves may include fair value gains and losses designated at fair value through profit or loss on derivatives meeting the requirements of IAS 39. Fair value reserves recognised in supplementary capital should be excluded from Tier 1 capital. In addition banks should ensure that they satisfy the following conditions when applying fair value option:

   (a) the conditions as set forth in IAS 39 for fair value option of financial instruments are met;

   (b) banks have in place robust risk management system and controls prior to applying fair value option;

   (c) where the fair value of a financial instrument cannot be estimated with reliable accuracy, the fair value option should not be applied;

   (d) risk management control and policies are consistently applied and complied with for fair value option and related methodologies; and

   (e) the disclosure requirements under IFRS 7 relating to fair value option are complied with.

   Where the above criteria are not met, banks should exclude the total unrealised gains and losses from their Tier 1 capital.

   The cumulative amount of unrealised gains and losses recognised in Tier 1 capital should be disclosed separately.

Current year's earnings

8. The current year's interim retained profits, including any negative goodwill may be included in Tier 1 capital if they have been verified by the bank's external auditors. In the absence of such verification, current year's interim profits will not be included in the capital base. The verification by external auditors should entail at least the following:

(a) satisfying themselves that the figures forming the basis of the interim profits have been properly extracted from the underlying accounting records;

(b) reviewing the accounting policies used in calculating the interim profits so as to obtain comfort that they are consistent with those normally adopted by the bank in drawing up its annual financial statements;

(c) performing analytical procedures on the result to date, including comparisons of actual performance to date with budget and with the results of prior period(s);

(d) discussing with management the overall performance and financial position of the bank;

(e) obtaining adequate comfort that the implications of current and prospective litigation, all known claims and commitments, changes in business activities and provisioning for bad and doubtful debts have been properly taken into account in arriving at the interim profits; and

(f) following up problem areas of which the auditors are already aware in the course of auditing the bank's financial statements.

The external auditors must submit an opinion to the bank on whether the interim results are fairly stated.

Minority interest

9. Minority interests arising from the consolidation or sub-consolidation of an entity can be included in Tier 1 capital where the Bank is satisfied, among others, that there is no hindrance on the availability of minority interest capital to other group members.

Deductions from Tier 1 capital

10. The following deductions are made from Tier 1 capital:

(a) accumulated losses;

(b) goodwill and intangibles assets as reported in the latest audited accounts;

(c) deferred tax assets as shown in the latest audited accounts;

(d) 50 per cent of

(i) the investment in unconsolidated banking and financial subsidiary companies;

(ii) investments in capital (including lending of a capital nature and holding of capital instruments) of other banks and financial institutions;

(iii) significant minority investments in other financial entities;

(iv) the portion of investment in commercial entities that exceeds 15 per cent of the bank's capital base for individual significant investment and 60 per cent of the bank's capital base for aggregate such investments; and

(e) any amount permitted to be deducted from Tier 2 Capital.

SUPPLEMENTARY (TIER 2) CAPITAL

Tier 2 capital or supplementary capital is made up of a broad combination of capital components and has lower characteristic to absorb losses than Tier 1 capital. The total amount that can be included in Tier 2 capital is limited in proportion to Tier 1 capital. Total Tier 2 capital is limited to 100 per cent of Tier 1 capital.

Tier 2 or supplementary capital is made up of several components of capital that support the overall strength of a bank on an ongoing basis. Elements that constitute Tier 2 capital are given below.

Undisclosed reserves

11. These may be inherently of the same intrinsic quality as published retained earnings, but the Basel framework treats undisclosed freely available reserves as supplementary capital because of their lack of transparency. Accordingly, undisclosed reserves representing accumulations of post-tax profits which are not encumbered by any known liability and are not routinely used for absorbing normal loan or operating losses may be included in the supplementary capital with the prior written approval of the Bank.

Fixed assets revaluation reserves

12. These reserves will comprise surplus arising from revaluation of land and buildings that is owned by the bank and as presented in its audited statement under fixed asset. Banks should ensure that the value of its premises is reflective of market values and the revaluation surplus continues to contribute to the capital strength of banks. On this basis, therefore, the assets must be valued prudently and valuation must be undertaken by an independent professional valuer on a basis satisfactory to both the external auditors and the Bank of Mauritius, and explicitly reported in the audited accounts of the bank. Only 45 per cent of the revaluation reserves arising from land and buildings will be eligible for inclusion in Tier 2 capital.

General banking reserves and portfolio provisions

13. Collective provisions or porfolio provisions are credit allowance for impairment loss for latent losses known to exist on homogenous group of loan, but these losses cannot be identified on specific loans. Banks also hold general provision or general banking reserve that are over and above the provision made on loans assessed individually, or on a 'portfolio'. Banks adopting the Standardised Approach to Credit Risk shall include general banking reserve and collective provisions held against unidentified and unforeseen losses in their Tier 2 capital subject to an amount not exceeding 1.25 per cent of total weighted risk assets. For this purpose risk weighted

assets will be the sum of risk weighted assets for credit risk as measured under the Standardised Approach; and the risk weighted assets for market (to be introduced in due course) and operational risk.

Fair value gains on revaluation of securities not held for trading

14. These reserves arise from long-term holdings of equity securities valued at historic cost and from the revaluation of equities and debt securities that are not held for trading. These reserves may be included in supplementary capital with the prior written approval of the Bank. This also includes unrealised fair value gains on derivatives which do not meet the criteria described under paragraph 7.

    Unrealised cumulative losses on equities and debt securities that are not held for trading should be deducted from Tier 1 capital. Only 45 per cent of the fair value gains and reserves mentioned under this paragraph are eligible for inclusion in Tier 2 capital.

Irredeemable cumulative preference shares

15. These shares may be included in Tier 2 capital. To qualify as supplementary capital, the instrument must meet the following criteria:

    (a) the shares cannot be redeemed without the prior written approval of the Bank;

    (b) the instrument is able to absorb losses on an ongoing basis;

    (c) the instrument is subordinated in the right of repayment of principal and interest to all depositors;

    (d) where the instrument provides for a "step up" in dividends , the terms of the step-up are limited, fixed at the time of the issue. "Step up" in dividends will only occur after the ten year period from the issue date has lapsed.

    In principle, only one "step up" in dividends is permitted over the life of the instrument. The total amount of paid up irredeemable cumulative preference shares shall not exceed 50 per cent of Tier 1 capital. The Bank may impose any additional conditions as appropriate for these shares.

Redeemable preference shares

16. Paid up term preference shares may be included in Tier 2 capital. To qualify for Tier 2, the debt instrument must satisfy the following criteria:

    (a) the initial period to maturity for these shares should be over five years;

    (b) no such shares are to redeemed before maturity without the prior written approval of the Bank; and

    (c) where the instrument provides for a "step up" in dividends , the terms of the step-up are limited, fixed at the time of the issue. "Step up" in dividends will only occur after the five year period from the issue date has lapsed.

In principle, only one "step up" in dividends is permitted over the life of the instrument. During the last five years to maturity, a cumulative discount (or amortisation) of 20 per cent per year must be applied to reflect the diminishing value of these instruments as a continuing source of strength. The total amount of paid up redeemable preference shares shall not exceed 50 per cent of Tier 1 capital.

Term subordinated debt

17. Banks may include in their Tier 2 Capital, subordinated debt. To qualify as Tier 2 Capital, subordinated debt must satisfy the following criteria:

    (a) the instrument must be unsecured and paid up;

    (b) it must have an original maturity of over five years;

    (c) it may be redeemed before maturity only at the option of the issuer and with the prior written approval of the Bank, and

    (d) in the event of a winding up of the bank concerned, the subordinated debt shall not be repaid until the claims of depositors and other creditors have been fully satisfied.

    During the last five years to maturity, a cumulative discount (or amortisation) of 20 per cent per year must be applied to reflect the diminishing value of these instruments as a continuing source of strength. The total amount of subordinated debt included in Tier 2 must not exceed 50 per cent of the total amount of Tier 1 capital.

Deductions from Tier 2 capital

18. The following deductions are to be made from Tier 2 capital:

    (a) 50 per cent of

        (i) the investment in unconsolidated banking and financial subsidiary companies;

        (ii) investments in the capital (including lending of a capital nature and holding of capital instruments) of other banks and financial institutions;

        (iii) significant minority investments in other financial entities; and

        (iv) the portion of investment in commercial entities that exceeds 15 per cent of the bank's capital base for individual significant investment and 60 per cent of the bank's capital base for aggregate such investments.