



Islamic Republic of Afghanistan
Da Afghanistan Bank

Summary

Da Afghanistan Bank (DAB) issued a regulation on credit extended to related persons. The circulation of the regulation for comment is consistent with article 3 of banking law. The 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

Article 40 of the Banking Law sets forth a definition for related person and then details numerous prohibitions on these types of credits. These include:

No bank shall extend credit to a related person or for the benefit of a related person,

- a). if the credit and its financial terms and conditions have not been approved by its Management Board or its Board of Supervisors;
- b). if the credit is granted to an administrator of the bank and the credit would cause the aggregate amount of credit disbursed by the bank to that person and outstanding to exceed the equivalent of 25 percent of the annual remuneration of that person, or if the credit would cause the aggregate amount of credits disbursed to all related persons and outstanding to exceed or increase the amount by which such aggregate exceeds the unimpaired capital and reserves of the bank; except that the foregoing percentage limits shall not apply to any principal amount of credit that is secured by a mortgage on property whose appraised value at the time that the credit is granted exceeds the principal amount of the credit by not less than one-third of that principal amount; or
- c) if the credit is granted on terms and conditions that are less favorable to the bank than the terms and conditions that are offered by the bank to the public in the ordinary course of business when the credit is granted.

The purpose of this rule is to detail the procedures required for credits extended to related persons. This regulation is generally in keeping with Principle 10 of the Basle Committee on Banking Supervision’s Core Principles Methodology.

Background and summary of rule

Persons who own or control banks, or serve as members of the boards of banks, occupy important positions of trust. Depositors place their funds in banks in order that those funds will be kept safely and put to constructive uses. There is a potential risk that persons who control or manage banks will regard the banks as convenient sources of funds for loans to themselves or entities that they own or control without adequate consideration of credit quality or the ability of the bank to earn a fair return on its investment. This is often the case when banks are members of larger corporate groups, in which one or major shareholders of the bank also possess major shareholdings in other financial or non-financial companies. In these situations, the bank is sometimes used as a financing vehicle for these other companies on preferential terms or to such an extent that the bank no longer has a diversified loan portfolio. Such actions by bank insiders undermine public confidence in the banking system, and can result in significant damage to the bank and threats to the safety of the depositors' funds.

The regulation addresses the various procedures required when a bank undertakes lending to related persons. It details the procedures involved with a Management Board or Board of Supervisor's approval of a loan to a related person, primarily to assure that those persons benefiting from the loan-making decision are not involved in or otherwise inappropriately allowed to influence the process. Additionally, procedures are promulgated pursuant to Article 40.1(2) of the Banking Law, whereby certain mortgage-related loans are exempt from the percentage limitations on lending to related persons detailed in the Banking Law. Finally, the regulation gives explanatory examples detailing the types of favorable terms and conditions that DAB will consider in violation of Article 40.



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Article Four: Credit Extended to Related Persons

Part A — General

§ 4.1.1. Authority

This regulation on credit extended to related persons is pursuant to the authority granted to DAB by Article 40 of the Decree Law of Banking in Afghanistan (Banking Law).

§ 4.1.2. Definitions

- a) *Credit* – any disbursement or commitment to make a disbursement of a sum of money in exchange for a promise to repay the amount disbursed and to pay interest or other charges on such amount, whether secured or unsecured; any extension of the due date of a debt; any guarantee issued; and any purchase of a debt security or other promise to pay a sum of money and to pay interest either directly or by a discounted purchase price. For the purposes of this regulation, “guarantees” include financial and performance-based standby letters of credit as well as other guarantees. “Credits” also include: accounts receivable, wherein not money, but goods or services of monetary value are advanced by the bank in exchange for a promise to pay by the obligor, whether this promise to pay has a definite fulfillment date or not, and whether interest is chargeable on the outstanding balance or not; purchase of securities under agreements to resell at a later date; overdrafts, whether or not prearranged, but not an intra-day overdraft for which payment is received before the close of business of the bank that makes the funds available; and loans or extensions of credit that have been charged off on the books of the bank in whole or in part, unless the loan or extension of credit is no longer legally enforceable.
- b) *Unimpaired capital and reserves* – for the purposes of this regulation, unimpaired capital and reserves is defined as the regulatory capital of the bank, calculated in accordance with the regulation on capital.¹

¹ The term “unimpaired capital and reserves” is used in the Bank Law but is not defined. This regulation declares that “unimpaired capital and reserves” is equivalent to “regulatory capital,” and the latter term will be used throughout.

Part B—Prohibitions and Exceptions

§ 4.2.1. Prohibitions—Approval by Management Board or Board of Supervisors.

No bank shall extend credit to a related person, as defined in Article 40.3, if the credit and its financial terms and conditions have not been approved by its Management Board or its Board of Supervisors. The procedures for this approval shall be as follow:

- a) An administrator of the bank shall not participate in the consideration, influence or attempt to influence the decision of the board, or vote on the approval of any transaction between the bank and:
 - i. himself;
 - ii. any person who is related to an administrator as defined in Article 40.3 of the banking law;
 - iii. any person who alone or in concert has a qualifying holding and related entities and administrators as defined in Article 40.3.
- b) A related person who is not an administrator of the bank must not influence or attempt to influence the decision of the board on the approval of any proposed transaction between the bank and himself or any of his related persons.
- c) The decision of the board on any transaction between a bank and a related person must be based on full disclosure of all relevant facts about the transaction. This includes the amount of the credit, interest rate, frequency of payment of interest, financial information of the borrower demonstrating ability to repay the credit, and information verifying the value of any collateral for the credit.
- d) The Audit Committee of the bank must maintain a written record of such approval, including signatures of those approving and those dissenting, and the same relevant facts about the transaction as listed in paragraph c) above.
- e) After approval and funding of a loan to a related person, such loan must be administered in the same manner as other loans of similar kinds to other persons are administered. These include the requirements for loan classification and loan loss provisioning. Investments in a legal entity that is a related person must be monitored and evaluated periodically in the same manner as other investments that do not involve such persons.

§ 4.2.2. Prohibitions—Percentage Limitations and Exception Thereto.

No bank may extend credit to a related person:

- a) if the credit is granted to an administrator of the bank and the credit would cause the aggregate amount of credit disbursed by the bank to that person and outstanding to exceed the equivalent of 25 percent of the annual remuneration of that person, or
- b) if the credit would cause the aggregate amount of credits disbursed to all related persons and outstanding to exceed or increase the amount by which such aggregate exceeds 100 percent of the unimpaired capital and reserves of the bank, but
- c) the foregoing percentage limits shall not apply to any principal amount of credit that is secured by a mortgage on property whose appraised value at the time that the credit is granted exceeds the principal amount of the credit by not less than one-third of that principal amount;

As detailed above (from Article 40.1(2) of the Banking Law), the percentage limitations do not apply to any principal amount of credit that is secured in compliance with standards prescribed by regulation of DAB by a mortgage on property whose appraised value exceeds the principal amount of the credit by not less than one-third of that principal amount. The standards for such credits are as follows:

- a) The credit is secured by a first mortgage on the residence, and the residence is owned (or expected to be owned after granting of the credit) by the person.
- b) In the case of refinancing, that only the amount of the credit used to pay off the outstanding loan together with closing costs are included in this amount.
- c) The initial market value of the collateral is ascertained and recorded; the debtor has rights in the collateral; the debtor has authenticated a security agreement that contains a description of the collateral or the bank has possession of the collateral; a financing statement that contains the name of the debtor, the name of the bank, and the collateral to be covered has been filed in the appropriate jurisdiction according to the applicable laws of Afghanistan; and no other secured creditor has a prior claim to the same collateral

§ 4.2.3. Prohibitions—Terms and Conditions.

No bank shall extend credit to a related person if the credit is granted on terms and conditions that are less favorable to the bank than the terms and conditions that are offered by the bank to the public in the ordinary course of business when the credit is granted. Less favorable terms or conditions include, but are not limited to:

- a) charging lower interest on credits than would be charged to unrelated persons or requiring interest payments to be made less frequently;

- b) accepting collateral that is of lower value, than that which is required of unrelated persons;
- c) making a loan that would not be made to unrelated persons, due to the level of risk in the transactions or the lower creditworthiness of the borrower;
- d) engaging in any other transaction with the related person that would have the same economic effect as the transactions noted in a), b), c) such as paying a higher rate of interest on guarantee deposits to the related person than would be paid an unrelated person, arranging with another bank to guarantee each others' loans to related persons, or other similar schemes.

Part C—Violation of Prohibitions

§ 4.2.1. Responsibility of administrators for credits granted in violation of prohibitions.

If credit has been provided by a bank to a related person in violation of the provisions of Part B, the obligor must immediately repay the credit. If this is not done within 30 days of the discovery of the violation by an administrator of the bank or by DAB, the members of the Management Board and Supervisory Board will be personally liable, jointly and severally, for payment of principal of, and interest and other charges on, credit granted in violation of Part B with their knowledge and without their objection. All members of the Management Board and Supervisory Board are liable, whether they personally participated in the decision or not, unless their prior objections to the granting of the credit are on file with the Audit Committee as described in §4.2.1(d) above. The liable parties must themselves agree on their financial contribution to the loan repayment and actually repay the bank within 60 days of the discovery of the violation. If this is not done, DAB reserves the right to designate some or all of the members of the Management Board and Supervisory Board as severally liable.