

17 January 1990

The Chief Executive
All locally incorporated authorised institutions

Dear Sir ,

Capital Adequacy

A number of institutions have sought clarification about how surpluses arising from revaluations of premises are to be incorporated into the calculations of their capital adequacy ratios.

One strand of comment concerned the treatment of “latent values” arising from not showing the full revaluation of premises in the published accounts. Linked to this was a concern that banks which traditionally valued their premises conservatively, for example taking only 70% of the appraised value of the premises into their revaluation reserves, would be handicapped in meeting their capital ratio targets.

Under the new capital adequacy framework, reserves created by the revaluation of banks premises will be counted as supplementary capital only if the revaluation is formally carried through to the balance sheet. Revaluation should be carried out by professional valuers on a basis satisfactory to the Commissioner’s office and the external auditors. The amount arising from the revaluation which will be included in the capital base will be limited to 70% of the published increase in value. For the same prudential reasons , the book value of premises and the revaluation reserves should be adjusted in full for any diminution in value. This approach is in line with that recommended by the Basle Committee. An extract from their report is attached at Annex A; see paragraphs 16-17.

It is also follows from their report (paragraph 15) that revaluation reserves should not be included within a bank’s inner reserves if it is to count as supplementary capital. A number of banks have in the past included revaluation reserves within their inner reserves. It would be premature, therefore, without further consideration of these issues, and appropriate consultation, fully to follow the Basle Committee’s approach.

An illustration of the way in which reserves arising from the revaluation of premises will be brought into account in the calculation of the capital base is outlined in Annex B.

Yours faithfully,

A W Nicolle
Commissioner of Banking