FINANCIAL SUPERVISORY COMMISSION

Cook Islands

PRUDENTIAL STATEMENT

BPS02

CAPITAL ADEQUACY

Authority

1. This Prudential Statement is issued by the Financial Supervisory Commission (FSC) pursuant to Sections 30, 31 and 65 of the Banking Act 2011 (the Act).

Application

2. This Prudential Statement is applicable to all bank licensees (banks).

Purpose

3. This Prudential Statement is intended to ensure that each bank maintains a level of capital which
   (i) is adequate to protect the interests of its depositors and creditors;
   (ii) is commensurate with the risk activities and profile of the bank; and
   (iii) promotes public confidence for the institution and the financial sector of the Cook Islands.

Responsibility for Capital Management

4. The board of directors of each bank is responsible for ensuring compliance with the requirements of this Prudential Statement and for maintaining an adequate level of capital at all times. The capital requirements provided in this Prudential Statement are the minimum acceptable levels for banks considered fundamentally sound, well managed and with no material financial or operational weaknesses; higher capital levels may be required for individual banks based on circumstances outlined in paragraph 8 below.

Definitions

5. As used in this Prudential Statement the following terms, unless otherwise clearly indicated by the context, have the meanings specified below:

5.1 **"Capital impairments"** means, in respect of the total capital and reserves of a bank:

(1) the value of assets pledged to secure liabilities such that the pledged assets are not available for purposes of freely meeting liabilities and absorbing losses of the bank;
(2) the book value of shares or other capital instruments held by a bank in another bank;
(3) investments in non-consolidated subsidiaries of the bank.

5.2 **"Cash deposit"** means credit balances on accounts in the books of the bank over which the depositor has given the bank a formal written letter of cession as security or collateral for a loan or advance by the bank and which the bank at its discretion has transferred the amount of the cash deposit from the depositor's account(s) to a specific or general cash collateral/security account(s).

5.3 **"Subordinated term debt"** means conventional unsecured subordinated debt capital instruments which have been approved by the FSC prior to issuance by a bank. With the prior written approval of the FSC, subordinated term debt instruments which by their terms meet all of the following requirements, qualify for inclusion as a Tier-2 capital component:

(1) it must have an original term to maturity of over seven (7) years;
(2) it must clearly state that the subordinated term debt is not a deposit of the bank and is not secured or collateralised by any asset of the bank;
(3) it must clearly state that repayment is subordinated to the claims of depositors and other creditors of the bank.
(4) it must be ineligible as security for a loan by the issuing bank;
(5) it must provide that no repayment prior to maturity (other than regularly scheduled repayments stated in the subordinated term debt agreement) either pursuant to an acceleration in the event of default or otherwise may be made without the prior written approval of the FSC.
(6) it must provide that once any scheduled repayments of principal begins, all payments shall be made at least annually and the amount of principal repaid each year shall be no less than in the prior year.

5.4 **"Tier-1 capital"** means capital representing a permanent commitment of funds by the shareholders of the bank which (i) is freely available to absorb losses, (ii) does not impose any unavoidable charge on the earnings of the bank, (iii) ranks below the claims of depositors and other creditors in the event of the liquidation or closure of the bank. Tier-1 capital consists of:

(1) issued and fully paid shares;
(2) paid-in premium or surplus;
(3) retained earnings (losses) (prior years); and
(4) income (loss) year-to-date;
(5) LESS goodwill and other intangible assets.

5.5 **"Tier-2 capital"** means capital other than Tier-1 that imparts strength to a bank, and includes such of the following elements as may be available to the bank:

(1) the full extent of fixed asset revaluation reserves arising from the restatement of a bank's premises where they are carried through to the balance sheet, provided the assets are revalued at least once every three (3) years by an independent qualified appraiser in a written appraisal report acceptable to the FSC.

(2) revaluation reserves arising from the holding of equity securities at historical cost and not at market value, discounted fifty-five percent (55%) to reflect the potential volatility of this form of unrealised capital and the notional tax charge on it;

(3) provisions for bad loans, limited to a maximum of one and one-quarter percent (1.25%) of risk-weighted assets;

(4) the full extent of any subordinated term debt provided:

i. during the last five (5) years to maturity a cumulative discount (amortisation) factor of twenty percent (20%) will be applied to reflect the diminishing value of these instruments as a continuing source of strength; and

ii. the total amount of subordinated term debt shall be limited to a maximum of fifty percent (50%) of Tier-1 capital;

(5) hybrid (debt/equity) capital instruments as may be approved by the FSC such as cumulative preference shares which are unsecured and fully paid up in cash and available to meet losses;

Provided, the total of Tier-2 capital shall be limited to one hundred percent (100%) of Tier-1 capital.

5.6 **"Total capital"** means the net total of Tier-1 and Tier-2 capital after deducting (i) any capital impairments and (ii) in the case of foreign licensees the net amount of any funds due from banks abroad. This amount shall be considered as Eligible Capital for purposes of Sections 43 and 45 of the Act pertaining to restrictions on advances and equity investments in other companies

<u>Minimum Capital Ratio Requirements</u>

6. Each bank shall at all times maintain on both a consolidated group and stand-alone basis capital ratios that are not less than the greater of (i) the minimum ratios specified below, or (ii) any higher ratios that may be set by the Commission.

(1) a ratio of Tier-1 capital to total risk weighted assets of at least five percent (5%); and

(2) a ratio of total capital to total risk weighted assets of at least ten percent (10%).

7. In determining whether higher ratios will be required, the FSC will consider whether a bank is pursuing or experiencing significant growth, has an inordinate level of risk or inadequate risk management systems, less than satisfactory asset quality, management, earnings or liquidity, or any of the criteria set forth below in paragraph 8 below.

Criteria for Higher Minimum Capital Ratios

8. The FSC may require a bank to maintain higher minimum capital ratios if the bank:
    (1) has been operating less than three (3) years;
    (2) has sustained, or is expected to sustain, losses resulting in a capital deficiency;
    (3) has significant exposure to risk, whether credit, market, interest rate, liquidity, operational, legal, or from other non-traditional activities;
    (4) has a high, or particularly severe, volume of poor quality assets;
    (5) is growing rapidly, either internally or through acquisitions;
    (6) may be adversely affected by the activities or condition of its parent holding company, associates or subsidiaries; or
    (7) has deficiencies in ownership, management, shareholding structure or policies and systems for risk management; or
    (8) displays other factors related to safety and soundness, solvency or viability which, in the judgment of the FSC, warrants a higher level of capital protection.

Effectivity

9. If the eligible capital or the paid-up capital of a bank is reduced below the minimum capital requirement, the bank must within seven (7) days after becoming aware of the reduction advise the FSC in writing of the reduction and submit a detailed plan acceptable to the FSC describing the means and timetable by which the bank will achieve and thereafter comply with the required minimum capital ratios.

Computation of Total Risk Weighted Assets

10. The focus of the risk weights assigned by the FSC is credit risk, that is, the risk of default by a counter-party and country transfer risk.

11. Total risk weighted assets is the total of:
    (1) on-balance sheet assets as reported by a bank in the Quarterly Statement of Assets and Liabilities, as of the end of each calendar quarter, net of specific loan loss provisions, if any, but excluding intangible assets, multiplied by the appropriate risk weight set out in Schedule I attached; and

(2) the different types of off-balance instruments and transactions reported by a bank in the Quarterly Statement of Assets and Liabilities, Commitments and Contingencies, as of the end of each calendar quarter, are:
   i. multiplied by the corresponding credit conversion factor contained in Schedule II of this Prudential Statement to bring it to an on-balance sheet credit equivalent;
   ii. the credit equivalent is then multiplied by the corresponding risk weight for the counter-party to the instrument or transaction contained in Schedule I.

Reporting Requirements

12. Each bank shall submit returns in respect of capital adequacy in the form and frequency as prescribed from time to time in writing by the FSC.

Enforcement and Corrective Measures

13. If a bank fails to comply with the requirements contained in this Prudential Statement in a flagrant manner which results, or threatens to result, in an unsafe or unsound condition, or submits statistical or other reports to the FSC which are materially inaccurate, the FSC may pursue any or all corrective actions as provided under pertinent sections of the Act or as may be prescribed by subsequent regulations or issuances of the FSC. Directives or conditions that may also be imposed by the FSC on the operation of the bank may include but need not be limited to:
    (1) prohibition from engaging in new activities or from expanding existing activities;
    (2) suspension of lending, investment and credit extension activities;
    (3) prohibition from acquiring, through purchase or lease, additional fixed assets;
    (4) prohibition from accepting further deposits or other liabilities for borrowed money;
    (5) prohibition from declaring or paying dividends or bonuses, salary incentives, severance packages, management fees or other discretionary compensation to directors, managers and officers.

Issued by:

Paul Heckles
Commissioner
FINANCIAL SUPERVISORY COMMISSION
1 August 2013

SCHEDULE I

Risk Weight	On-Balance Sheet Asset Category
0%	(a) Cash (notes and coin) held in own vault; (b) Claims[1] on, or portions thereof, guaranteed[2] by the Government of the Cook Islands denominated in New Zealand Dollars; (c) Claims on, or portions thereof, guaranteed by, or fully secured by securities issued by other central governments and central banks with an external credit assessment rating of AAA to AA-[3] denominated and funded in the national currency; (d) Claims, or portions thereof, fully secured by cash or pledged deposits in the same bank;
20%	(a) Claims on, or portions thereof, guaranteed by, or fully secured by securities issued by other central governments and central banks with an external credit assessment rating of A+ to A-[3]denominated and funded in the national currency; (b) Claims on, or portions thereof' guaranteed by banks: (i) with an external credit assessment rating of AAA to AA-[3] and regardless of the remaining term to maturity; (ii) with an external credit assessment rating of A+ to BBB-[3] and a remaining term to maturity of three (3) months or less; or (ii) which are unrated by an external credit assessment institution but has a remaining term to maturity of three (3) months or less; (c) Cash items in process of collection; (d) Claims on multilateral development banks (Asian Development Bank, European Development Bank or others as may be approved by the FSC) and loans or portions thereof, guaranteed by, or collateralised by, securities issued by such banks;
50%	(a) Claims, or portions thereof, on, guaranteed by, or fully secured by securities issued by other central governments and central banks denominated and funded in the national currency with a credit rating of BBB+ to BBB-[3]; (b) Claims on, or portions thereof, guaranteed by banks; (i) with an external credit assessment rating of A+ to BBB-[3] and a remaining term to maturity of more than three (3) months; (ii) with an external credit assessment rating of BB+ to B-[3] and a remaining term to maturity of three (3) months or less; or (iii) which are unrated by an external credit assessment institution but has a remaining term to maturity of more than three (3) months; (c) Loans secured by first lien on real estate that is occupied by the borrower solely for residential purposes or that is intended to be rented solely for residential purposes, which are repayable in monthly instalments and where the monthly installments of such loans are not past due more than three (3) months
100%	(a) Claims on, or portions thereof, guaranteed by banks with an external credit assessment rating of BB+ to B-[3] and a remaining term to maturity of more than three (3) months; (b) Claims on the private sector; (c) Claims on commercial companies owned by the public sector; (d) Claims, or portions thereof, on, guaranteed by, or fully secured by securities issued by other central governments and central banks denominated and funded in the national currency (i) with an external credit assessment rating of BB+ to B-[3], or (ii)

Risk Weight	On-Balance Sheet Asset Category
	which are unrated by an external credit assessment institution; (e) Capital instruments issued by other financial institutions (but excluding banks); (f) Fixed assets, office furniture and equipment (including premises); (g) Claims on non-residents but excluding depository institutions abroad which are required to be risk-weighted according to the external credit assessment ratings as detailed above. (h) Accrued interest receivable. (i) All other assets (including other real estate as may be defined by the FSC).
150%	(a) Claims, or portions thereof, on, guaranteed by, or fully secured by securities issued by other central governments and central banks denominated and funded in the national currency with a credit rating below B-[3]; (b) Claims on, or portions thereof, guaranteed by banks with an external credit assessment rating below B-[3].

[1] Loans and other claims guaranteed or collateralised by securities issued by the Government of the Cook Islands will attract equivalent low weights on that part of the loan which is covered by the guarantee or the current market value of the security provided the security instrument has been properly pledged to the lending bank.

[2] To qualify for risk weighting purposes, a guarantee must be affirmed in writing and be unconditional as to the payment of principal and interest.

[3] This external credit assessment rating follows the methodology used by Standard & Poor's, equivalent ratings by other internationally recognised external credit assessment institutions (i.e. Moody's, Fitch, etc) may be used with the prior written approval of the FSC.

SCHEDULE II

Credit Conversion Factor	Off-Balance Sheet Items
100%	Bills endorsed and rediscounted (including Bankers' Acceptances)
 100% 50%	Indemnities and Guarantees (a) Lending related (including standby letters of credit serving as financial guarantees for loans). (b) Performance related (e.g. performance bonds, bid bonds, warranties, and standby letter of credit).
20%	Documentary credits fully collateralised by readily marketable commodities.
 50% 0%	Unutilised stand-by facilities, credit lines and commitments to make loans which: (a) cannot be unconditionally cancelled at any time by the issuing financial institution; (b) can be unconditionally cancelled at any time by the issuing financial institution.
50%	Underwriting exposures.
 0.5% 1.0% 1.0%	Interest Rate Contracts (Gross) (a) Over seven (7) days and less than one (1) year (b) One (1) year and less than two (2) years (c) For each additional year
 2.0% 5.0% 3.0%	Exchange Rate Contracts (Gross) (a) Over seven (7) days and less than one (1) year (b) One (1) year and less than two (2) years (c) For each additional year
100%	All other commitments and contingent liabilities.