



**FINANCIAL SUPERVISORY COMMISSION
OF THE
COOK ISLANDS**

Banking Prudential Statement

BPS08

Large Exposures

Objective and key requirements of this Prudential Statement

This Prudential Statement aims to ensure that all banks implement proper procedures, measures, and prudent limits to control their large exposures.

The key requirements of this Prudential Statement are that a bank must:

- have an effective methodology of defining large exposures through the thorough analysis and understanding of key counterparty exposures;
- have a robust system for the prompt identification, monitoring, measurement and control of its large exposures; and
- identify large exposures and their relationship to credit and other risks in the bank.

Contents

Authority	4
Application	4
Definitions	4
Key Principles	7
Control of Large Exposure Concentrations	7
Limits on Large Credit Exposures	8
Loans to Partnerships	9
Notification Requirements	10
Concentration of Risk	10
Other Matters	10
FSC Final Authority	11

Authority

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

Application

2. This Prudential Statement is applicable to all financial institutions licensed under the Banking Act 2011.

Definitions

3. This Prudential Statement has used the following terms, which unless otherwise indicated, have the meanings specified below:
 - 3.1. **Bank** - an entity licensed under the Banking Act 2011.
 - 3.2. **Cash Deposit** - means a sum of money held by the lending bank in a deposit account at the lending bank and the owner of the money has pledged the funds in writing as security for a loan from the bank.
 - 3.3. **Common Enterprise** - a common enterprise exists when:
 - 3.3.1. the expected source of repayment is the same or substantially the same for advances made to different but related borrowers;
 - 3.3.2. exposures are made to persons related by common control where the persons are engaged in interdependent businesses; and
 - 3.3.3. there is substantial financial interdependence among persons.
 - 3.4. **Control** - control is presumed to exist when:
 - 3.4.1. one or more persons acting together directly or indirectly own, control, or have power to vote 10% or more of the voting shares of another person; or
 - 3.4.2. one or more persons acting together control, in any manner, the election of a majority of the directors, trustees, or others exercising similar functions over another person; or
 - 3.4.3. any other circumstances exist which indicate that one or more persons acting together exercise a controlling influence, directly or indirectly, over the activities, management, practices or policies of another person.
 - 3.5. **Direct Benefit** - means that the proceeds of a loan, or assets purchased with loan proceeds, are transferred to or for the benefit of another person unless the transfer is part of a normal business transaction where the proceeds are used to acquire property, goods or services in a bona fide arm's length transaction.

- 3.6. **Eligible Capital** - means eligible capital as provided for in the Prudential Statement BPS02 on Capital Adequacy.
- 3.7. **Exposure** - means
- 3.7.1. Any loan or advance, funded or unfunded, given to a person (borrower), or third party on behalf of a borrower, on the basis of an obligation to repay or which is repayable from specific property pledged by or on behalf of a person. This includes exposures which have not yet been funded but the bank is legally obligated to do at a future date or event.
- 3.7.2. It also includes commitments and contingent liabilities arising from on-and off-balance sheet transactions, in both the banking, investment and trading books, to single counterparties and groups of connected counterparties, or groups of related counterparties reflecting the maximum possible loss from their failure to perform on such exposures.
- 3.7.3. The term exposure also includes indirect exposures.
- 3.7.4. A bank should not calculate the size of its exposure to a customer/counterparty by netting its various claims and obligations relating to that customer/counterparty unless there is a legally enforceable contract which provides a right of set-off.
- 3.7.5. The term exposure excludes the following:
- 3.7.5.1. exposures deducted from a bank's capital;
- 3.7.5.2. exposures to the extent that they are secured by cash deposits;
- 3.7.5.3. exposures to the extent that they are guaranteed by, or secured against securities issued by, governments or central banks (being the Cook Islands government, foreign governments and central banks which receive a zero per cent risk-weight);
- 3.7.5.4. interbank transactions; and
- 3.7.5.5. telegraphic transfer transactions.
- 3.8. **Group of Connected Borrowers** - where two or more individual borrowers are linked by cross guarantees, common ownership through significant interest of 10% or more, the ability to exercise control over the borrower, whether direct or indirect, or other financial interdependency such that the financial soundness of any of them may affect the financial soundness of the other(s); or other connections or relationships which, according to a bank's assessment, identify the counterparties as constituting a single risk. The definition also includes persons who are family members that are financially inter-dependent upon one or more persons or companies within the group.

- 3.9. **Indirect Exposure** - means a bank's exposure to a person where a person agrees and becomes obligated to repay a debt in the event that the primary obligor defaults or is unable to repay. An example of indirect exposure is where a loan given to one person is guaranteed by another person: the recipient of a loan is the "primary" obligor and is a direct exposure while the guarantor is the "secondary obligor" and is an indirect exposure. Both persons may, however, be equally liable under the law to repay the obligation.
- 3.10. **Large Exposure** - exposure to a single borrower or a group of connected borrowers which is equal to, or greater than, 10% of a bank's total eligible capital.
- 3.11. **Single Borrower** - means a single borrower or group of closely related borrowers. A group of closely related borrowers (legal, natural or both) is also to be regarded as a single borrower. This means that a bank's exposure to each borrower which belongs to a group will be combined and the combined exposure will be deemed to be in respect of a single borrower. The general test to be applied is whether the combined exposure represents a single risk to the lending bank, i.e. the borrowers are so interconnected that if one borrower experiences financial difficulties, the other borrower or borrowers are also likely to encounter payment difficulties.
- 3.11.1. Indications (and examples) of such interconnections or group relations which are generally classified as a single risk are as follows:
- 3.11.1.1. Companies with common ownership or cross ownership (e.g. a parent or holding company and its subsidiaries);
 - 3.11.1.2. Borrowers linked by guarantees or cross-guarantees or which share the same collateral, the proceeds from the credit facility are re-loaned or given to another person (i.e. accommodation);
 - 3.11.1.3. the proceeds from the credit facility are used for the direct benefit of another person (the "use" test); or
 - 3.11.1.4. the two persons constitute a common enterprise and the enterprise is expected to generate or provide the funds to repay the credit facility/ies (the "source" test). A common enterprise includes loans to borrowers who are related directly or indirectly through common control, provided that 50 percent or more of one borrower's gross receipts or gross expenditures are derived from transactions with the other borrower.
- 3.12. **Total Capital** - for the purposes of determining the large credit exposure limit means the capital of a bank incorporated in the Cook Islands.

Key Principles

4. The purpose of this Prudential Statement is to protect the safety and soundness of banks by preventing excessive investments in or loans to any one person or group of interrelated persons who are financially interdependent (connected borrowers).
5. Excessive exposure to a single customer or group of customers can be a significant risk for banks. This Prudential Statement seeks to promote diversification in order to reduce credit risk in a bank's loan portfolio.

Control of Large Exposure Concentrations

6. A bank must incorporate the management of risk relating to large exposure concentrations to counterparties, industries, geographical areas and asset classes into its risk management framework.
7. The Board of a bank (Board) is responsible for establishing and monitoring compliance with policies governing large exposure concentration risks of the bank. The Board and senior management of a bank should ensure that:
 - 7.1. adequate systems and controls are in place to identify, measure, monitor, and control large exposure concentration risks of the bank in a timely manner; and
 - 7.2. large exposure concentrations of the bank are regularly reviewed.
8. The Board must ensure that these policies are reviewed regularly (at least every two years) and that they remain adequate and appropriate for the bank. Any material changes to established policies must be approved by the Board.
9. A bank's large exposures and concentrations policy must, at a minimum, cover the following:
 - 9.1. specific exposure limits to capital for:
 - 9.1.1. various types of counterparties (e.g. governments, banks and foreign equivalents, corporate and individual borrowers);
 - 9.1.2. a group of related counterparties;
 - 9.1.3. individual industry sectors;
 - 9.1.4. geographical areas if applicable; and
 - 9.1.5. various asset classes (e.g. property holdings and other investments) that are commensurate with the bank's capital base and balance sheet size;

- 9.2. the circumstances in which the above exposure limits may be exceeded and the authority required for approving such excesses; and
 - 9.3. the procedures for identifying, measuring, monitoring and reporting large exposures of the bank.
10. A bank must, where appropriate, conduct stress testing and scenario analysis of its large exposures and risk concentrations to assess the impact of changes in market conditions or key risk factors (e.g. economic cycles, interest rate, liquidity conditions or other market movements) on its risk profile and earnings.

Limits on Large Credit Exposures

11. The total direct exposure at any time, funded or unfunded by a bank to a single borrower or group of connected borrowers shall not exceed twenty-five percent (25%) of the bank's total capital¹ without the prior written approval of the FSC. A bank should notify the FSC immediately of any breach of the 25% limit.
12. Banks should treat the twenty-five percent (25%) limit as the upper limit for large exposure to a single borrower or group of connected borrowers. The FSC expects banks to establish lower internal limits for its daily activities, in line with their risk appetite.
13. The total of all large exposures shall not at any time exceed four hundred percent (400%) of the bank's eligible capital². A bank must also notify the FSC in advance before the total of its large exposures, excluding exempt exposures, exceeds 300% of the bank's eligible capital and provide details of the bank's plan to manage its large exposures within the 400% limit. Any breach of the 400% limit must be immediately notified to the FSC.
14. In cases of uncertainty for purposes of this Prudential Statement, the FSC has the final determination based on the particular facts and circumstances, when exposures nominally granted to one person shall be combined with credits to another person.

Exemptions to Limits on Large Credit Exposures

15. The large exposure limit does not apply to:
 - 15.1. Interbank transactions;
 - 15.2. Telegraphic transfer transactions;
 - 15.3. Government guaranteed loans: Exposures, or portions thereof, which the Cook Islands Government has unconditionally guaranteed in writing as to payment of both principal and interest shall be exempt. However, exposures of companies that are

¹ Total Capital for the purposes of determining the large credit exposure limit means the capital of the bank incorporated in the Cook Islands.

² Eligible Capital as set out under paragraph 5.6 of BPS02 on Capital Adequacy means the net total of Tier-1 and Tier-2 capital after deducting any capital impairments and in the case of foreign licensees or branches of foreign banks the net amount of any funds due from banks abroad.

owned or controlled by the Cook Islands Government, whether directly or indirectly or in whole or in part, which are separate legal entities, shall be subject to the limits in this Prudential Statement unless the Cook Islands Government has unconditionally guaranteed in writing or is directly obligated for the debts of such companies;

15.4. Acceptances: The purchase of bills of exchange or documents of title to goods, where the holder of those bills or documents is entitled to payment outside the Cook Islands, for exports from the Cook Islands, or to advances made against those transfers, bills or documents shall be exempt;

15.5. Cash secured loans: Exposures, or portions thereof, that are fully secured by cash deposits in the lending bank shall be exempt. However, for this exception to apply the deposit must be:

15.5.1. explicitly assigned to the bank in writing by the owner of the deposit or deposit account granting the bank the legal right to set off the deposit against the exposure at any time upon default or non-repayment of the exposure, and

15.5.2. segregated and under the sole control of the lending bank. If a cash deposit is in a different currency than the exposure, then the amount of exposure exempt from the limit shall be the amount of the deposit converted into the same currency as the loan using the current rate of exchange.

16. Family members are not considered to be connected where the bank can demonstrate that any extension of credit is supported by a clearly defined and authenticated separation of family member financials. This includes separate financial statements, income sources, sources of repayment, and deposit accounts. Comingling of funds supports the conclusion that a connection exists. Notwithstanding the above, a bank can choose to treat such exposures as connected should it consider appropriate to do so.

Loans to Partnerships

17. For the purposes of this Prudential Statement, the total exposure to a partnership shall include the loans and advances to all general partners but not the credits to limited partners unless:

17.1. the proceeds of loans and advances to limited partners are used for the direct benefit of the partnership; or

17.2. the loans and advances to limited partners are repayable primarily from the profits of the partnership.

18. For the purposes of this Prudential Statement, the total exposure of each general partner shall include exposures to the partnership but not exposures to limited partners unless:

- 18.1. the proceeds of credits to limited partners are used for the direct benefit of the general partners; or
 - 18.2. the credits of limited partners are repayable primarily from funds provided by the general partners.
19. For the purposes of this Prudential Statement, a loan to a person for purchasing an interest in the partnership will be combined with loans made to the partnership.
 20. If a partnership agreement specifies that limited partners are not liable for the debts of the partnership, the rules in paragraphs 17, 18, and 19 above will apply to all general partners but not to limited partners. However, if the partnership agreement specifies that limited partners are liable for a portion of the partnership debt in proportion to their partnership interest, then their pro rata share of the partnership debt will be combined with their personal loans to determine the total exposure of the bank.

Notification Requirements

21. A bank must notify the FSC immediately of any breach of the limits specified in this Prudential Statement or other specific limits imposed by the FSC, including remedial actions taken or planned to deal with the breach.
22. A bank must inform the FSC immediately where it has concerns that its large exposure concentrations have the potential to impact materially upon its capital adequacy, along with proposed measures to address these concerns.

Concentration of Risk

23. Where a bank has several large exposures or where in the FSC's opinion, the bank is exposed to a significant level of large exposure concentration risk, the FSC may require the bank to maintain a higher capital ratio. In considering whether a bank's capital ratio should be increased, the FSC will take account of the following factors:
 - 23.1. compliance with the bank's policy on large exposures and risk concentrations;
 - 23.2. the number of exposures, their individual and combined size and risk grading; and
 - 23.3. the characteristics of the bank, including the nature of its business and the experience of its management.
24. The FSC may also direct a bank to take measures to reduce its level of risk concentration.

Other Matters

25. The limits in this Prudential Statement apply to all exposures, including any loans and advances which have been written off in whole or in part, or against which the bank has raised specific provisions for losses. Loans and advances that have been discharged by a

court or that are no longer legally enforceable shall not be included in the total for determining compliance with the limits.

26. Any exposure or portion thereof that has been sold as participation to another bank shall not count against the limits in this Prudential Statement. For this exception to apply, the participation must be covered by a written agreement which specifies that:
 - 26.1. the interest rate on the portion of the exposure sold under the participation agreement is equal to or less than the interest rate shown in the contract between the lending bank and the counterparty;
 - 26.2. the maturity of the portion of the exposure sold under the participation agreement is no longer than the maturity shown in the contract between the lending bank and the counterparty; and
 - 26.3. in the event of a default both banks will share in payments and recoveries on a pro rata basis according to their respective participation percentages at the time of default.
27. When two or more banks grant an exposure to a single borrower under a single credit facility (e.g. a syndicated credit), the limits in this Prudential Statement apply only to the funds provided by each bank and representing that bank's pro rata share of the total credit facility. For this exception to apply, the syndication agreement must be in writing and must specify explicitly the terms and exposures of each bank in the syndicated credit.
28. Accrued but uncollected interest is not subject to the limits in this Prudential Statement. Capitalised interest (that is, interest which has been added to the outstanding principal balance of a credit facility as a result of a renewal or restructuring of the credit facility and which has not been reversed or otherwise suspended from income) however, will be considered when determining compliance with the limits.

FSC Final Authority

29. In cases of uncertainty for the purposes of this Prudential Statement, the FSC has the final determination based on the particular facts and circumstances, when exposures nominally granted to one person shall be combined with credits to another person.
30. Notwithstanding the limits in this Prudential Statement, the FSC may, in writing, set specific limits on a bank's exposure to particular counterparties, groups of counterparties, industry sectors, countries or asset classes, including property holdings and any other investments, on a case-by-case basis, having regard to the bank's individual circumstances.

Issuance Details

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