

FINANCIAL SUPERVISORY COMMISSION



Cook Islands

PRUDENTIAL STATEMENT

BPS08

LARGE EXPOSURES

Authority

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

Application

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

Purpose

3. 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.
4. Excessive exposure to a single customer or group of customers is a significant risk for banks. The FSC seeks to promote diversification in order to reduce credit risk in a bank's loan portfolio.
5. It is the responsibility of the board of directors and managing officers of each bank to adopt policies and procedures which ensure that all exposures comply with the limits set forth in the Banking Act 2011 and this Prudential Statement. They must ensure that the policies and procedures are made and administered in accordance with prudent lending practices.

6. The Commission's approach to large exposures is based on Principle 19 of the Basel Core principles for Effective Banking Supervision (Revised Sept. 2012). This states that "The Supervisor determines that banks have adequate policies and processes to identify, measure, evaluate, monitor, report and control or mitigate concentrations of risk on a timely basis. Supervisors set prudential limits to restrict bank exposures to single counterparties or groups of connected counterparties."

Definitions

7. "**associate**" – means a person wherein another person's shareholding is at least 20% (twenty per cent) of the outstanding voting stock or where that other person has the power to exercise influence over the policies of management of the person;

8. "**capital**" – For the purposes of determining large credit exposure limit, total capital for licensed banks incorporated in the Cook Islands, as determined by the FSC is defined in the Prudential Statement BPS02.

9. "**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.

10. "**common enterprise**" – a common enterprise exists when:

- 1) the expected source of repayment is the same or substantially the same for advances made to different but related borrowers;
- 2) exposures are made to persons related by common control where the persons are engaged in interdependent businesses;
- 3) there is substantial financial interdependence among persons.

11. "**control**" – for purposes of this Prudential Statement, control is presumed to exist when:

- 1) one or more persons acting together directly or indirectly own, control, or have power to vote 20% or more of the voting shares of another person; or
- 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) 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.

12. **“corporate group”** – means a corporation plus all its subsidiaries and associates;
13. **“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.
14. **“exposure”** – means any loan or advance, funded or unfunded, given to a person on the basis of an obligation to repay or which is repayable from specific property pledged by or on behalf of a person. The term exposure also includes indirect exposures as defined below.
 - 1) Funded exposures are those for which the bank has provided funds to the borrower or to a third party on behalf of the borrower;
 - 2) Unfunded exposures are those which have not yet been funded but the bank is legally obligated to do so at a future date or event;
 - 3) Direct exposures are funded and unfunded exposures where the borrower is the primary obligor or is a co-maker to the loan and is the person to whom the bank and courts must look first for repayment of the obligation;
 - 4) Indirect exposures are 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.
 - 5) 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.
15. **“large exposure”** - means any exposure to a single borrower or to a group of related borrowers which, in aggregate, equals or exceeds 10% of the licensees' eligible capital.
16. **“person”** means an individual or any legal entity.
17. **“related persons”** – two persons will be considered to be related if one person has the ability, directly or indirectly, to control the other person or to exercise significant influence over the financial and operating decisions

of the other person, or if both persons are subject to common control or common significant influence.

18. **“group of connected borrowers”** - means two or more persons who are closely related through common ownership, control, management, financial inter-dependence or cross-guarantees. The definition also includes persons who are family members that are financially inter-dependent upon one or more persons within the group.
19. **“significant influence”** – means the ability to participate in a material way in the financial and operating policies and decisions of another person. The absence of absolute control does not preclude the ability to exert significant influence over the policies and decisions of another person. If one person holds, directly or indirectly through subsidiaries, 10% or more of the voting power over another person, it will be presumed that the first person exerts or has the ability to exert significant influence over the second person. Conversely, if a person holds, directly or indirectly through subsidiaries, less than 10% of the voting power over another person, it will be presumed that the first person does not exert or have ability to exert significant influence unless there are compelling circumstances to the contrary. A substantial or majority ownership in one person by a second person does not preclude a third person from having significant influence over the first person.
20. **“subsidiary”** – means a person in which another person owns, directly or indirectly, more than fifty per cent of the outstanding voting stock.

Limits on Loans and Advances

21. Limitations:

- a. **Single borrower limit:** The total direct exposure at any time, funded or unfunded by a bank to a single person or group of interrelated persons shall not exceed 25% of capital without the prior written approval of the FSC. A bank should notify the FSC immediately of any breach of the 25% limit.
- b. **Large exposure limit:** The total of all large exposures shall not at any time exceed 400% (four hundred per cent) of the licensee's eligible capital. Any breach must be immediately notified to the FSC. A bank must also notify the FSC in advance before the total of its large exposures, excluding exempt exposures, exceeds 300% of the licensee's eligible capital.
- c. **Compliance:** All loans and advances granted by a bank shall comply with a written, board-approved lending policy that is fully adequate for the lending activities of the bank.

Exceptions to Limits on Loans and Advances

22. The following exceptions shall apply to the limits in paragraph 21 above:
- a. Interbank transactions: Transactions between banks or between the branches of a bank shall be exempt;
 - b. Telegraphic transfer transactions: The purchase of telegraphic transfers shall be exempt;
 - c. 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 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 paragraph 21 unless the Cook Islands Government has unconditionally guaranteed in writing or is directly obligated for the debts of such companies;
 - d. 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;
 - e. 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:
 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
 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.
 - f. Indirect exposures: Exposures, or portions thereof, that are indirect as defined herein shall be exempt; however, the FSC may aggregate indirect exposures with direct exposures for purposes of applying the 25% limit if the particular facts and circumstances indicate that an unsafe credit concentration is arising by virtue of this exception.

Combining Loans to Separate Persons

23. An exposure to one person will be attributed to and aggregated with the exposures to another person for purposes of determining compliance with the limits in paragraph 21 when:
- a. the proceeds from the credit facility are re-loaned or given to another person (i.e. accommodation);

- b. the proceeds from the credit facility are used for the direct benefit of another person (the "use" test); or
 - c. 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).
24. 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.

Loans to Partnerships

25. **To the partnership:** For purposes of this Prudential Statement, the total exposure of a partnership shall include the loans and advances to all general partners but not the credits to limited partners unless (i) the proceeds of loans and advances to limited partners are used for the direct benefit of the partnership, or (ii) the loans and advances to limited partners are repayable primarily from the profits of the partnership.
26. **To partners:** For 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 (i) the proceeds of credits to limited partners are used for the direct benefit of the general partner/s or (ii) the credits limited partners are repayable primarily from funds provided by the general partner/s.
27. **For purchasing an interest in a partnership:** For purposes of this Prudential Statement, a loan to a person for the purpose of purchasing an interest in the partnership will be combined with loans made to the partnership.
28. **Limited interests:** If a partnership agreement specifies that limited partners are not liable for the debts of the partnership, the rules in paragraphs 25, 26 and 27 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 their partnership interest, then their pro rata share of the partnership debt will be combined with their personal loans to determine their total exposure to the bank.

Other Loans

29. **Loans written off:** The limits in paragraph 21 above will 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 in paragraph 21.

- 30. Loan participations:** Any exposure or portion thereof that has been sold as participation to another bank shall not count against the limits in paragraph 21. For this exception to apply, the participation must be covered by a written agreement which specifies that (i) 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 borrower, (ii) the maturity of the portion of the exposure sold under the participation agreement is not longer than the maturity shown in the contract between the lending bank and the borrower, and (iii) 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.
- 31. Loan syndications:** 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 paragraph 21 above 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.
- 32. Capitalised interest:** Accrued but uncollected interest is not subject to the limits in paragraph 21. 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 in paragraph 21.
- 33. Nonconforming exposures** – Exposures which do not conform to the limits in paragraph 21 when this Prudential Statement comes into effect, or which subsequently become nonconforming, will be treated as follows:
- a. Exposures made prior to the date of this Prudential Statement which exceed the limits in paragraph 21 will not be cited in contravention of this Prudential Statement but will be noted as "nonconforming". A bank may renew, extend the maturity of, or restructure a nonconforming exposure without contravening this Prudential Statement provided the bank makes a documented good faith effort to bring the exposure into conformance with the requirements of this Prudential Statement, unless:
 1. the bank increases the exposure or otherwise advances additional or new funds to the person;
 2. a new borrower replaces the original borrower;

3. the FSC determines that the renewal, extension, or restructuring of the exposure is designed to evade the limits in paragraph 21; or
 4. the renewal, extension or other modification of the maturity of the exposure exceeds one year.
- b. If an exposure conforms to the limits in paragraph 21 when made but subsequently exceeds the limits because:
1. the bank's capital declines as a result of operating losses; or
 2. the borrower merges or forms a common enterprise with another borrower; or
 3. the bank merges with another bank which also holds exposures to the borrower; or
 4. of changes to the lending limits or the method for calculating capital; or
 5. an exception under paragraph 21 no longer applies
- then the exposure will be treated as "nonconforming".
- c. If an exposure becomes "nonconforming", the board of directors or chief executive officer shall be required to act promptly to bring the exposure into compliance unless doing so would adversely affect the ability of the bank to receive full repayment of the credit.

Reporting Requirements

34. Each bank shall submit returns in respect of exposures yearly in the form as prescribed from time to time in writing by the FSC.
35. A bank should notify the FSC of all new large exposures when the exposure is incurred. Notifications for exempted exposures under section 22 are not required.

Enforcement and Corrective Measures

36. A bank which fails to comply with the requirements contained in this Prudential Statement or submits reports to the FSC which are materially inaccurate will be considered as following unsound and unsafe practices as provided in Section 20(1)(a)(ii) of the Banking Act 2011.
37. The Financial Supervisory Commission of the Cook Islands may pursue any or all corrective measures as provided in Part 3 of the Banking Act 2011 to enforce the provisions of this Prudential Statement including:
- a. the imposition of terms and conditions on the licensee;
 - b. the issuance of an order to cease and desist from the unsound and unsafe practices and;
 - c. action to replace or strengthen the management of the bank.

Issued by:

A handwritten signature in black ink, consisting of several overlapping, sweeping strokes that form a cursive, somewhat abstract shape.

Paul Heckles
Commissioner
FINANCIAL SUPERVISORY COMMISSION
1 August 2013