CENTRAL BANK OF SOLOMON ISLANDS
Financial Market Supervision Department

Prudential Guideline No. 1
On Capital Adequacy

Applicability

1. This Prudential Guideline is applicable to all financial institutions licensed by the Central Bank of Solomon Islands (CBSI). Foreign owned financial institutions operating through branches in the Solomon Islands are required to hold assigned capital[1] in accordance with the requirements of this Prudential Guideline.

Purpose of Prudential Guideline

2. This Prudential Guideline outlines the approach used by the CBSI in assessing the capital adequacy of financial institutions and is intended to assure that each financial institution maintains a level of capital which (i) is adequate to protect its depositors and creditors, (ii) is commensurate with the risk profile and activities of the financial institution, and (iii) promotes public confidence in financial institutions. The Prudential Guideline also provides for the submission of periodic reports by financial institutions to monitor compliance with the minimum capital requirements as provided in The Financial Institutions Act 1998 (the Act), the persons responsible for ensuring the accuracy and timely submission of required reports, and the confidentiality of information submitted to the CBSI.

3. The board of directors of each financial institution is responsible for ensuring compliance with the requirements of this Prudential Guideline and for maintaining at all times an adequate level of capital. The capital requirements provided in this Prudential Guideline are the minimum acceptable levels for financial institutions that are fundamentally sound, well managed and which have no material financial or operational weaknesses

4. Financial institutions are expected to maintain a working buffer above the applicable minimum capital ratios required in this Prudential Guideline and to engage in active capital planning.

Definitions

5. **"Capital impairments"** means, in respect of Total Capital:
   a. a financial institution's holding as shown on its books of other financial institutions' capital instruments;
   b. capital instruments in non-consolidated subsidiaries of a financial institution as shown on its books;
   c. loans, advances or other debt obligations granted by a financial institution to a counter-party, whether secured or unsecured, for the purpose of purchasing,

[1] For foreign bank branches operating in the Solomon Islands, assigned capital means the net liability of the foreign bank branch in the Solomon Islands to its Head Office and other branches of that bank.

investing in, or financing the holding of shares or other capital instruments of the lending financial institution.

6. **"Tier 1 capital"** means capital which (i) represents a permanent and unrestricted commitment of funds, (ii) is freely available to absorb losses, (iii) does not impose any unavoidable charge on the earnings of the financial institution, and (iii) ranks below the claims of depositors and other creditors in the event of the winding-up of the financial institution. Tier-1 capital consists of:
   a. paid-up ordinary shares;
   b. paid-in premium or surplus;
   c. audited retained earnings (net of tax and expected or announced dividend payments, appropriations or distributions of income)
   d. partly paid ordinary shares to the extent that the financial institution has received funds;
   e. LESS any capitalized establishment/organizational costs;
   f. LESS any current year losses (whether audited or not) including unrealized losses on securities and foreign exchange holdings;
   g. LESS any goodwill and other intangible assets;
   h. LESS any future income tax benefits (not deducted elsewhere) arising out of losses or timing differences after netting deferred tax liabilities;
   i. other capital instruments as may be approved in writing by the CBSI[2].

7. **"Tier 2 capital"** means capital other than Tier 1, which imparts strength to a financial institution but does not meet all the requirements to be categorized as a of Tier 1 capital instrument. Tier 2 capital can not exceed Tier 1 capital. Tier 2 capital may include the following:
   a. reserves arising from the revaluation of (i) premises (but excluding any and all items of furniture, fixtures and equipment not permanently attached the premises) and/or (ii) debt securities held in the accounts at historical cost but which do not pass through the profit and loss account discounted 55 percent to reflect the potential volatility of this form of unrealized capital and the notional tax charge on it;
   b. general provisions for doubtful debts (net of associated tax benefits) up to 1.25 percent of risk-weighted. To be eligible for inclusion in Tier 2 capital, general provisions must be created against future, presently unidentified losses and must be freely available to cover losses in any the loan portfolio. General provisions created against identified losses or an identified deterioration in the value of a particular loan, whether individual or grouped, are to be excluded;
   c. unaudited retained earnings (net of tax and expected or announced dividend payments, appropriations or distributions of income);
   d. other capital instruments as may be approved in writing by the CBSI.

8. **"Total capital"** means the net total of Tier 1 and Tier 2 capital after deductions for capital impairments. In the case of branches of foreign financial institutions the net amount of funds due from the head or parent office or branches abroad will also be deducted from Total Capital for the purpose of determining compliance with the requirements of this Prudential Guideline.

[2] Financial institutions should obtain the written approval of the CBSI prior to the issuance of any capital instrument.

Minimum Capital Ratio Requirements

9. Each financial institution shall at all times maintain on a stand alone and, where applicable, on a consolidated basis:
   a. a ratio of Total Capital-to-Risk Weighted Assets of not less than 15%; and
   b. a ratio of Tier 1 Capital-to-Risk Weighted Assets of not less than 7.5%.

10. Provided, the CBSI may require a financial institution to maintain higher minimum capital ratios where a financial institution is pursuing or experiencing significant growth as compared to other financial institutions, has an inordinate level of risk or inadequate risk management systems, poor asset quality, management earnings or liquidity or in the case of a newly established financial institution.

Computation of Total Risk Weighted Assets

11. Total risk weighted assets is the total of:
    a. on-balance sheet assets as reported by a financial institution in the Monthly Statement of Assets and Liabilities, Form 1, but excluding any assets required to be deducted from Tier 1 Capital or capital impairments, multiplied by a risk weight which is based largely on the nature of the counter-party set out in Schedule I attached; plus
    b. the different types of off-balance instruments and transactions reported by a financial institution in the Monthly Statement of Assets and Liabilities, Form 1, as of the end of each calendar quarter, which are:
       i. multiplied by the corresponding credit conversion factor contained in Schedule II of this Prudential Guideline to bring it to a on-balance sheet credit equivalent; and
       ii. multiplying the credit equivalent amount by the corresponding risk weighting for the counterparty to the instrument or transaction as contained in Schedule I of the Prudential Guideline; plus
    c. operational risk assets, calculated as the average annual total gross income[3] where positive, for each of the previous three calendar years

Reporting Requirements

12. Every financial institution shall submit to the CBSI not later than 30 days following the end of each calendar quarter (March 31, June 30, September 30, and December 31) a report in such form as may be prescribed from time to time by the Financial Market Supervision Department of the CBSI (FMSD) giving an analysis of each financial institutions' capital, risk weighted and operational risk assets, and ratios of Tier 1 and Total Capital to risk-weighted assets.

13. Each financial institution shall maintain adequate records in support of any information submitted in such reports as required under Paragraph 12 of this Prudential Guideline and it shall preserve every such record for a period of at least seven (7) years.

[3] Gross income is defined as net interest income plus net non-interest income. This measure must (i) be gross of general and specific provisions for doubtful debts; (ii) be gross of operating expenses, including fees paid to outsourcing service providers, or in the case of foreign bank branches fees paid to the head/parent office or other branches of the head/parent office, or subsidiary or affiliate of the head office or parent for services; (ii) exclude realized profits/losses on securities; and (iv) exclude extraordinary or irregular items.

Persons Responsible for Submission of Report

14. The accuracy and correctness of the information required to be submitted under this Prudential Guideline shall be attested to by the chief executive officer of the financial institution or such other person by whatever title with responsibility for the overall daily management of the affairs of the financial institution and the implementation of policies by the financial institution’s board of directors, and the chief accountant of the financial institution, or such other person by whatever title with responsibility for maintaining the books, ledgers and accounts of the financial institution on a day-to-day basis.

Enforcement and Corrective Measures

15. A financial institution which fails to comply with the requirements contained in this Prudential Guideline or submits reports to the Central Bank of Solomon Islands which are materially inaccurate will be considered as following unsound and unsafe practices as provided in Section 16 (1) (a) of the Financial Institutions Act 1998.

16. The Central Bank of Solomon Islands may pursue any or all corrective measures as provided in Section 16 of the Financial Institutions Act 1998 to enforce the provisions of this Prudential Guideline including:
    (a) issuance of an order to cease and desist from the unsound and unsafe practices and
    (b) action to replace or strengthen the management of the financial institution.

Effective Date

17. The effective date of this Prudential Guideline is 1 January 2010.

Issued this ***4th*** day of ***September***, 2009

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Governor Denton Rarawa
Central Bank of Solomon Islands

SCHEDULE I

Risk Weight	On-Balance Sheet Asset Category
0%	(a) Notes and coin (including foreign cash); (b) Gold bullion held in the financial institution's own vaults or on an allocated basis to the extent backed by gold bullion liabilities; (c) All claims on the central Government of the Solomon Islands other than Restructured Bonds; (d) Balances with and claims on the Central Bank of Solomon Islands; (e) All claims on central Governments and central banks of other countries, which are denominated in the national currency and funded in that currency; (f) Loans and other claims, or portions thereof, secured by cash on deposit with the lending bank or guarantees[4] or securities issued by central banks and governments as above.
20%	(a) Claims on depository institutions[5] (including cash items in the process of collection) in the Solomon Islands; (b) Claim on Provincial Governments; (c) Claims on Central Government of Solomon Islands on Re-structured Bonds; (d) Claims on international banking agencies and regional development banks; (e) Claims on depository institutions incorporated in other countries with a residual maturity of less than one year.
50%	(a) Loans to individuals fully secured by a properly registered mortgage on residential property that is occupied by the borrower, or that is rented for residential purposes but excluding any such loans where the loan proceeds have been used by the individual to finance business, investment or other interests/activities.
100%	(a) Premises, sites equipment and other fixed assets; (b) Operating leases covering plant and equipment, etc.; (c) Equity investments and capital instruments issued by entities other than license financial institutions; (d) Loans to individuals and corporations (but excluding qualifying residential mortgage loans as above) unless such loans are past due 90 days or more for the payment of principal or interest and are not otherwise fully secured by cash on deposit with the lending bank or guarantees or securities issued by a central bank or government as above shall be risk-weighted as follows: i. 150% risk-weight when specific provisions against such loans are less than 20% of the outstanding principal balance of the loans; ii. 100% risk-weight when specific provisions against such loans are more than 20% of the outstanding principal balance of the loans; (e) All other assets and claims not included elsewhere.

Note

Claims secured or collateralized by National Provident Fund benefits, insurance contracts, put options, forward sales contracts, bank paper, securities issued by the private sector are not considered to be covered by eligible collateral or guarantees and should be risk weighted according to the weight applicable to the original counter-party.

[4] Guarantee agreements must be in writing and provide for the direct, explicit, irrevocable and unequivocal repayment of all principal and interest.

[5] Depository institutions means those financial institutions licensed, among other things, to accept deposits of money withdrawable or payable upon demand. Depository institutions specifically exclude credit corporations.

SCHEDULE II

Credit Conversion Factor	Off-Balance Sheet Items
100%	**Direct Credit Substitutes:** (a) Guarantees of indebtedness where the financial institution undertakes to meet financial obligations of a counter-party which fails to do so. (b) Standby letters of credit serving as a financial guarantee. (c) Bills endorsed and rediscounted (including Bankers' Acceptances)
20%	**Trade and Performance Related Contingent Items:** (a) Documentary letters of credit secured against underlying shipment of goods. (b) Warranties, bid bonds, indemnities, performance bonds related to particular non-monetary obligations.
 100% 0% 20% 50%	**Commitments:** (a) Commitments with certain drawn down. (b) Other commitments: i. which can be unconditionally cancelled at any time without notice[6] (e.g. unadvised, non-confirmed overdrafts, credit card facilities) and where the facility provides for review at least annually; ii. with a residual maturity of one year or less which are not unconditionally cancelable at any time without notice; iii. with a residual maturity of more than one year which are not unconditionally cancelable at any time without notice
 2% 5% 3%	**Foreign Exchange Contracts[7]:** (a) Original maturity of one year or less; (b) Original maturity of more than one year but less than 2 years: (c) For each additional year or portion thereof.

[6] In determining whether a commitment can be unconditionally cancelled at ay time without notice "material adverse change" clauses or any other similar provisions which are intended to relieve a financial institution of its obligations under certain conditions should be disregarded.
[7]Gross contracts outstanding for the purchase and sale of foreign exchange.