

CENTRAL BANK OF SOLOMON ISLANDS
Financial Market Supervision Department

Prudential Guideline No. 5
Large Credit Exposures

Applicability

1. This Prudential Guideline is applicable to all financial institutions¹ licensed by the Central Bank of Solomon Islands (CBSI).

Purpose of Prudential Guideline

2. Excessive exposure to a single customer or group of customers is a significant risk for financial institutions and the CBSI sees it as highly important to protecting the safety and soundness of financial institutions to prevent excessive investments in or loans to any one person or group of interrelated persons who are financially interdependent and to promote diversification in order to reduce credit risk in a financial institution's loan portfolio.
3. It is the responsibility of the board of directors and managing officers of each financial institution to adopt policies and procedures which are adequate and which ensure that all exposures comply with the limits set forth in the Financial Institutions Act of 1998 and this Prudential Guideline, and are made and administered in accordance with prudent lending practices.

Definitions:

4. **“affiliate”** – 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;
5. **“capital”** – For purposes of determining large credit exposure limit, total capital for licensed financial institutions incorporated in Solomon Islands, as determined by CBSI is defined in the Prudential Guideline No. 1.

For financial institutions incorporated outside Solomon Islands, capital for the purpose of determining a single borrower or group of related borrowers limit under this guideline shall include the sum of the global consolidated issued paid-up capital and published reserves of that licensed financial institution as shown in the most recent annual report published by the financial institution.

6. **“cash deposit”** – means a sum of money held by the lending financial institution in a deposit account at the lending financial institution and the owner of the money has pledged the funds in writing as security for a loan from the financial institution.

¹ As defined in the Financial Institutions Act 1998, a financial institution “includes any body corporate doing banking business” in the Solomon Islands.

7. **“common enterprise”** – a common enterprise exists when:
 - (a) the expected source of repayment is the same or substantially the same for advances made to different but related borrowers;
 - (b) exposures are made to persons related by common control where the persons are engaged in inter-dependent businesses; or
 - (c) there is substantial financial inter-dependence among persons.
8. **“control”** – for purposes of this Prudential Guideline, control is presumed to exist when
 - (a) 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
 - (b) 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
 - (c) 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.
9. **“corporate group”** – means a corporation plus all its subsidiaries and affiliates;
10. **“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.
11. **“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 include indirect exposures as defined below.
 - (a) funded exposures are those for which the financial institution has provided funds to the borrower or to a third party on behalf of the borrower;
 - (b) unfunded exposures are those which have not yet been funded but the financial institution is legally obligated to do so at a future date or event;
 - (c) 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 financial institution and courts must look first for repayment of the obligation;
 - (d) 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.
12. **“large exposure”** - means any direct exposure to a single borrower or to a group of related borrowers which, in aggregate, equals or exceeds 10% of capital.
13. **“person”** means an individual or any legal entity.
14. **“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.

15. **“group of related borrowers”** - means two or more persons which 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.
16. **“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 second person does not preclude a third person from having significant influence over the first person.
17. **“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

18. Limitations:
 - (a) **Single Borrower Limit:** The total direct exposure at any time, funded or unfunded by a financial institution to a single person or group of interrelated persons shall not exceed 25% of capital.
 - (b) **Large Exposure Limit:** The total of all large exposures shall not at any time exceed 800% (eight hundred per cent) of capital.
 - (c) **Compliance:** All loans and advances granted by a financial institution shall comply with a written, board-approved lending policy that is fully adequate for the lending activities of the financial institution.

Exceptions to Limits on Loans and Advances

19. The following exceptions shall apply to the limits in paragraph 18 above:
 - (a) **Interbank Transactions:** Transactions between financial institutions or between the branches of a financial institution shall be exempt;
 - (b) **Foreign Exchange Transactions:** the purchase of telegraphic transfers shall be exempt;
 - (c) **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 Solomon Islands**, for exports from Solomon Islands, or to advances made against those transfers, bills or documents shall be exempt.
 - (d) **Government Guaranteed Loans:** Exposures, or portions thereof, which the Solomon 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 Solomon 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 18. Unless the Solomon Islands Government has unconditionally guaranteed in writing or is directly obligated for the debts of such companies;

- (e) **Cash Secured Loans:** Exposures, or portions thereof, that are fully secured by cash deposits in the lending financial institution shall be exempt; however, for this exception to apply the deposit must be (i) explicitly assigned to the financial institution in writing by the owner of the deposit or deposit account granting the financial institution the legal right to set off the deposit against the exposure at any time upon default or non-repayment of the exposure, and (ii) segregated and under the sole control of the lending financial institution. 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 CBSI 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.

20. **Combining Loans to Separate Persons:** 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 18 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).

For purposes of this Prudential Guideline, the CBSI will determine, based on the particular facts and circumstances, when exposures nominally granted to one person shall be combined with credits to another person.

21. **Loans to partnerships:**

- (a) **To the Partnership:** For purposes of this Prudential Guideline, 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.
- (b) **To Partners:** For purposes of this Prudential Guideline, 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.
- (c) **For Purchasing an Interest in a Partnership:** For purposes of this Prudential Guideline, a loan to a person for the purpose of purchasing an interest in the partnership will be combined with loans made to the partnership.

- (d) **Limited Interests:** If a partnership agreement specifies that limited partners are not liable for the debts of the partnership, the rules in paragraphs (a), (b) and (c) 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 financial institution.
22. **Loans Written Off:** The limits in paragraph 18 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 financial institution 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 18.
23. **Loan Participations:** Any exposure or portion thereof that has been sold as a participation to another financial institution shall not count against the limits in paragraph 18. 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 financial institution 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 financial institution and the borrower, and (iii) in the event of a default both financial institutions will share in payments and recoveries on a pro rata basis according to their respective participation percentages at the time of default.
24. **Loan Syndications:** When two or more financial institutions grant an exposure to a single borrower under a single credit facility (e.g. a syndicated credit), the limits in paragraph 18 above apply only to the funds provided by each financial institution and representing that financial institution'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 financial institution in the syndicated credit.
25. **Capitalized Interest:** Accrued but uncollected interest is not subject to the limits in paragraph 18. Capitalized interest, 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 18.
26. **Nonconforming Exposures** – Exposures which do not conform to the limits in paragraph 18 when this Prudential Guideline comes into effect, or which subsequently become nonconforming, will be treated as follows:
- (a) Exposures made prior to the date of this Prudential Guideline which exceed the limits in paragraph 18 will not be cited in contravention of this Prudential Guideline but will be noted as “nonconforming”. A financial institution may renew, extend the maturity of, or restructure a nonconforming exposure without contravening this Prudential Guideline provided the financial institution makes a documented good faith effort to bring the exposure into conformance with the requirements of this Prudential Guideline, unless:

- (i) the financial institution increases the exposure or otherwise advances additional or new funds to the person;
 - (ii) a new borrower replaces the original borrower;
 - (iii) the CBSI determines that the renewal, extension, or restructuring of the exposure is designed to evade the limits in paragraph 18.; or
 - (iv) 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 18 when made but subsequently exceeds the limits because:
 - (i) the financial institution's capital declines as a result of operating losses;
 - (ii) the borrower merges or forms a common enterprise with another borrower;
 - (iii) the financial institution merges with another financial institution which also holds exposures to the borrower;
 - (iv) the lending limits or the method for calculating capital; or
 - (v) an exception under paragraph 19 no longer applies, then the exposure will be treated as 'nonconforming'.
- (c) If an exposure becomes 'nonconforming', the board of directors or branch manager shall be required to act promptly to bring the exposure into compliance unless doing so would adversely affect the ability of the financial institution to receive full repayment of the credit.

Reporting Requirements

27. Each financial institution will submit returns in respect of exposures in the form and frequency as the CBSI may prescribe.

Enforcement and Corrective Measures

28. 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.
29. 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

30. This Prudential Guideline is applicable to all financial institutions licensed by the Central Bank of Solomon Islands (CBSI) and shall be effective in force from 2nd December 2011.

Issued this **18th** day of *November, 2011*



Governor Denton Rarawa
Central Bank of Solomon Islands