RESERVE BANK OF VANUATU

DOMESTIC BANK

PRUDENTIAL GUIDELINE NO 4

CAPITAL ADEQUACY OF BANKS

1.This Statement describes the approach used by the Reserve Bank of Vanuatu (Reserve Bank) for assessing the capital adequacy of Vanuatu banks (and their consolidated groups). These guidelines focus on credit and operational risk. Other factors need to be considered, as a separate matter, in assessing the overall capital adequacy of a bank. These include the quality of its assets, profitability, liquidity, market risk, credit risk concentrations, adequacy of provisioning and the effectiveness of the bank's management systems for monitoring and controlling risks.

2. It is the responsibility of a bank's board and management to ensure that it has in place adequate systems to identify and measure risks and appropriate capital cover against those risks.

3. The Reserve Bank attaches great importance to ensuring that the capital resources of individual banks are adequate for the size, quality and type of their business. The Reserve Bank's approach is consistent in all substantial respects with the approach recommended by the Basle Committee on Banking Supervision.

GENERAL FRAMEWORK

4. The focus of these guidelines is on banks holding adequate capital to meet their credit risk (i.e. the potential risk of default by a borrower or counterparty) including country transfer risk and operational risk. For credit risk, account is taken, in a limited way, of collateral and guarantees.

5. For purposes of assessing credit risk, balance sheet assets and off-balance sheet exposures are weighted according to broad categories of relative risk, based largely on the nature of the counterparty. The higher the risk, the greater is the capital backing required.

6. Risk-weightings seek to take account, on a portfolio basis, of the relative likelihood of counterparties being unable to meet their obligations to a bank. The risk weights used reflect broad judgements about potential risk of types of counterparties and are not intended to be a detailed guide to the assessment of credit risk associated with exposures to individual counterparties. It is the responsibility of each bank to individually assess the credit risk associated in dealing with a counterparty, to allocate the appropriate amount of capital to cover that risk and to suitably price the transactions to reflect the risk.

7. Off-balance sheet transactions are converted to balance sheet equivalents before being allocated a risk weight.
8. For purposes of assessing capital coverage of operational risk, average gross income[1] over the previous three years is converted into "operational risk-weighted" assets using a fixed percentage. When calculating average gross income, any year in which annual gross income is negative or zero is excluded from both the numerator and denominator when calculating the average.

9. The sum of risk-weighted balance sheet assets, risk-weighted off-balance sheet business and operational risk-weighted assets is related to a bank's capital and the resulting "risk ratio" is used as a measure of capital adequacy.

COVERAGE AND CONSOLIDATION

10. The guidelines apply to all Vanuatu banks. Foreign banks operating through branches in Vanuatu are not subject to these guidelines; they are required to be subject to equivalent capital adequacy standards by their home country supervisors.

11. The primary focus of these guidelines is on the global operations of a bank and its subsidiaries.

MINIMUM CAPITAL STANDARDS

12. Each Vanuatu bank is expected to maintain a minimum ratio of total capital to risk-weighted assets, on both a consolidated group and stand-alone basis, of 12 per cent (of which at least one-half must be Tier 1 capital). These levels will be kept under review.

13. The Reserve Bank may require a bank to maintain a higher minimum ratio, eg for a newly established bank, or a bank judged to have an excessive concentration of credit risk exposures or significant other risk exposures.

DEFINITION OF CAPITAL

14. Capital is the cornerstone of a bank's strength. The presence of substantial capital re-assures creditors and engenders confidence in a bank.

[1] Gross income is calculated as the balance of net interest income plus non-interest income but excluding any gains/losses from securities transactions and provisions for bad loans.

15. The essential characteristics of capital are that it should:
    i. represent a permanent and unrestricted commitment of funds;
    ii. be freely available to absorb losses and thereby enable a bank to keep operating whilst any problems are resolved;
    iii. not impose any unavoidable charge on the earnings of the bank; and
    iv. rank below the claims of depositors and other creditors in the event of the winding-up of a bank.

16. Capital, for supervisory purposes, is considered in two tiers. Tier 1 (or core capital) comprises the highest quality capital elements. Tier 2 (or supplementary capital) represents other elements which do not satisfy all of the characteristics of Tier 1 capital but which contribute to the overall strength of a bank as a going concern. A summary of the main elements of capital is given in Attachment I.

17. A bank's capital base (or total capital) is the sum of its Tier 1 and Tier 2 capital less any deductions. At least 50 per cent of a bank's capital base must be Tier 1 capital.

Tier 1 Capital

18. The foundation of a bank's capital is made up of permanent shareholders' equity and disclosed reserves (created or increased by appropriation of retained earnings or other surplus). Such elements fully meet the essential characteristics of capital and represent capital resources which can best contribute resilience and flexibility to a bank experiencing financial difficulties.
19. 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 bank, and (iii) ranks below the claims of depositors and other creditors in the event of the winding-up of the bank. 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 bank has received funds;
    e. minority interests in subsidiaries which are consistent with other named capital instruments are eligible to be counted in the calculation of Tier 1 capital of the consolidated group;
    f. other capital instruments as may be approved in writing by the Reserve Bank[2].

20. With regards to servicing Tier 1 capital elements, aggregate dividend payments by a bank in any one year should not exceed the earnings of the bank during that year; as a practical matter, the relationship between dividends and earnings is lagged one year for preference shares (except in the first year of issue when dividends will be allowable notwithstanding any loss in the period preceding the issue date). The Reserve Bank is, however, prepared to modify this requirement, on a case by case basis, if it believes the proposed level of dividends can be justified by reference to other considerations, such as an assessment of the bank's capital position, including commitments to raise capital, and the bank's core profitability.

Tier 2 Capital

[2] A bank should obtain the written approval of the Reserve Bank prior to the issuance of any capital instrument.

21. There are other capital elements that impart strength to a bank's position but to a varying degree fall short of the qualities of Tier 1 capital instruments. These may be included in a bank's capital base as Tier 2 capital up to an amount equal to the bank's Tier 1 capital.

22. Tier 2 capital cannot exceed Tier 1 capital. Tier 2 capital may include the following:
   a. reserves arising from the revaluation of debt securities held in the accounts of the bank at historical cost. To be eligible for inclusion in Tier 2 capital, revaluation reserves of debt securities must satisfy the following conditions:
      i. The debt securities must be directly held by the bank or its subsidiary;
      ii. The reserves (i.e. the difference between the market value and the book value) must be shown on the balance sheet or notes to the accounts without passing through the profit and loss accounts;
      iii. The reserves must incorporate the amount of any diminution in the value of the debt securities (i.e. net of devaluations); and
      iv. Only 45 per cent of the net revaluation surplus (net of devaluations) can be included in Tier 2 capital.
   b. general provisions for doubtful debts (net of associated tax benefits) up to 1.25 percent of total risk-weighted assets. 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 current or prior year earnings (net of tax and expected or announced dividend payments, appropriations or distributions of income) provided any unaudited current or prior year losses are to be deducted from Tier 1 capital;
   d. Term subordinated debt and similar limited life instruments (including redeemable preference shares) are eligible to be included in Tier 2 capital up to 50 per cent of Tier 1 capital. Term subordinated debt must be appropriately subordinated to the repayment of all other depositors and creditors of the bank and have an original maturity of at least seven years[3]. During the last five years to maturity the amount of such instruments eligible to be counted as Tier 2 capital will be reduced each year by 20 per cent of the original amount issued;
   e. other capital instruments as my be approved in writing by the Reserve Bank.

DEDUCTIONS FROM CAPITAL

Tier 1

Goodwill

23. Goodwill and similar intangible assets are deducted from Tier 1 capital (and hence from a bank's capital base) in calculating capital ratios.

Unaudited current or prior year losses

[3]Banks should obtain the written approval of the Reserve Bank prior to the issuance of any term subordinated debt instruments. .

24. Unaudited current or prior year losses are deducted from Tier 1 capital in calculating capital ratios.

Capital Base

Inter-bank holdings of capital

25. To avoid double gearing of capital, a bank's holdings of other banks' capital instruments (as shown in its books) should be deducted from the investing bank's capital base (and risk assets). This includes both equity and debt capital investments in local and overseas banks (and their subsidiaries) held by the bank and its subsidiaries.

Investments in non-consolidated subsidiaries

26. In the normal course, the Reserve Bank supervises the capital adequacy of banks and their subsidiaries on a fully consolidated basis. Exceptions to this approach will be considered where consolidation is not judged appropriate for accounting reasons and/or where the non-consolidated subsidiary is subject to effective supervision by another authority. In these cases, there would need to be co-operation between the Reserve Bank and the other supervisor concerned so that the Reserve Bank is reasonably assured the subsidiary/associate involved would not compromise the stability of a Vanuatu bank. Life and general insurance subsidiaries would in the normal course not be consolidated for capital adequacy purposes.

27. A bank is required to deduct from its capital base (and risk assets) its equity and/or other capital investments in *non-consolidated* subsidiaries or associates which are effectively controlled by the bank.

28. Where a bank invests capital in, or provides a guarantee or similar support to, an entity which undertakes the role of manager, responsible entity, trustee or custodian in relation to funds management or the securitisation of assets, then the capital or guarantee should be deducted from the bank's capital base.

Assets Pledged to Secure Liabilities and Borrowings

29. In the ordinary course of operations, a bank may be faced with the need for additional liquidity to meet demands by depositors, creditors and/or borrowers for funds or the maintenance of minimum liquidity requirements prescribed from time to time by the Reserve Bank. Where additional funds cannot be obtained from existing deposit customers, a bank may seek to raise additional funds or liquidity by "borrowing" from the Reserve Bank or through the wholesale market (that is, to attract large depositors by offering higher interest rates than those to existing customers). These borrowings may be on a secured or unsecured basis.

30. Assets pledged, hypothecated or otherwise encumbered to secure borrowings from the Reserve Bank or the wholesale market are not freely available in the event of a liquidation to repay depositors and creditors and as such will be deducted from the Capital Base for purposes of determining compliance with the Total Capital to Risk-Weighted Assets requirements outlined in this paragraph 10.

REDUCTIONS IN CAPITAL

31. Where a bank proposes any reduction in its capital it should obtain the prior written agreement of the Reserve Bank. The Reserve Bank would need to be satisfied on the basis of a capital plan (which included pro forma balance sheet and income and expense statement for at least the next three calendar years) provided by the bank that the bank's capital would remain adequate after the proposed reduction.

RISK WEIGHTED ASSETS

32. There are four categories of risk weight – 0, 20, 50 and 100 per cent. Weights for particular items are given in an Attachment II.

33. Total risk weighted assets is the total of:
    a. on-balance sheet assets as reported by a bank in the Monthly Statement of Assets and Liabilities multiplied by a risk weight based on the nature of the counter-party as set out in Attachment II; plus
    b. the different types of off-balance instruments and transactions reported by a bank in the Monthly Statement of Assets and Liabilities which are:
        i. multiplied by the corresponding credit conversion factor contained in Attachment III to bring it to a on-balance sheet credit equivalent; and
        ii. multiplying the credit equivalent amount by the corresponding risk weighting for the counter-party to the instrument or transaction as contained in Attachment II; plus
    c. operational risk assets, calculated as the average annual total gross income[4] where positive, for each of the previous three calendar years (12 month period ending 31 December), multiplied by a factor of 1.25. See Form 4 for more details and calculations.

REPORTING REQUIREMENTS

34. Each bank is required to submit returns in respect of capital adequacy in the form and frequency as prescribed by the Bank Supervision Department of the Reserve Bank of Vanuatu.

[4] Gross income is defined as Total Operating Income (Code 10000) minus any realized profits (losses) from the sale of securities LESS Interest Expense (Code 12100) as required to be calculated and reported in RBV Form 4, Quarterly Statement of Profit and Loss. Figures for any year in which annual gross income is negative or zero should be excluded from both the numerator and denominator when calculating the average.

ATTACHMENT I

DEFINITION OF CAPITAL

Tier 1 (Core) Capital[5]

- Paid-up ordinary shares.
- Non-repayable share premium account.
- General reserves (but excluding general provisions for doubtful debts).
- Audited retained earnings and unaudited prior and current year losses.
- Non-cumulative irredeemable preference shares.
- Minority interests in subsidiaries consistent with the foregoing components.

Tier 2 (Supplementary) Capital[6]

- General provisions for doubtful debts.[7]
- Asset revaluation reserves.[8]
- Mandatory convertible notes and similar capital instruments.
- Perpetual subordinated debt.
- Term subordinated debt[9].

Unaudited retained earnings

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5 Goodwill and similar intangible assets are deducted from Tier 1 capital and capital base.
6 The total of all Tier 2 capital components cannot exceed the total of all Tier 1 capital components.
7 Amount included is limited to a maximum of 1.25 per cent of total risk-weighted assets.
8 Assets should be valued in writing regularly, but at least at the end of each calendar quarter, and prudently.
9 Amount included is limited to 50 per cent of Tier 1 capital

ATTACHMENT II

Risk Weight	On-Balance Sheet Asset Category
0%	(a) Notes and coin (including foreign cash); (b) Gold bullion held in the bank's own vaults or on an allocated basis to the extent backed by gold bullion liabilities; (c) All claims on the central Government of Vanuatu; (d) Balances with and claims on the Reserve Bank of Vanuatu; (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[10] or securities issued by central banks and governments as above.
20%	(a) Claims on depository institutions (including cash items in the process of collection) in Vanuatu; (b) Claim on provincial and local governments; (c) Claims on international banking agencies and regional development banks; (d) 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 (i) the loan proceeds have been used by the individual to finance business, investment or other interests/activities, (ii) the loan is past due 90 days or more for the payment of principal or interest.
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 banks; (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 20% or more of the outstanding principal balance of the loans; (e) All other assets and claims not included elsewhere.

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

ATTACHMENT III

Off-Balance Sheet Business	Credit Conversion Factor
Direct Credit Substitutes	
• Guarantees	100%
• Standby letters of credit serving as financial guarantees.	100%
• Bills endorsed under bill endorsement lines.	100%
Trade and Performance Related Contingent Items	
• Warranties, bid bonds, indemnities, performance bonds and standby letters of credit related to particular non-monetary obligations.	50%
• Documentary letters of credit secured against underlying shipment of goods.	20%
Commitments	
• Commitments with certain drawdown.	100%
• Forward asset purchases and amounts owing on partly paid shares and securities which represent commitments with certain drawdown.	100%
• Other commitments (eg formal standby facilities and credit lines) with a residual maturity of:	
(a) one year or less, or which can be unconditionally cancelled at any time without notice;	0%
(b) over one year or otherwise non-cancellable without notice or other conditions.	50%

Other Items

For items not included above, credit conversion factors to be used should be discussed with the Reserve Bank.

ATTACHMENT IV

Foreign Exchange, Interest Rate and Other Market Related Off-Balance Sheet Transactions

Current Exposure Method ***(Mark-to-market approach)***

Credit equivalent amounts are represented by the sum of current credit exposure and potential credit exposure:

(i) Current Credit Exposure

This is the mark-to-market valuation of all contracts with a *positive* replacement cost (i.e. contracts with an unrealised profit where a bank would lose the profit in the event of a default by a counterparty). (Negative replacement costs are disregarded.)

(ii) Potential Credit Exposure

This is calculated as a percentage of the nominal principal amount of a bank's portfolio of interest rate and exchange rate related contracts split by residual maturity as follows:

Remaining Term to Maturity	Interest Rate Contracts	Exchange Rate Contracts
Less than one year	Nil	1.0%
One year or longer	0.5%	5.0%

Original Exposure Method (Rule-of-thumb approach)

Credit equivalent amounts would be calculated by applying credit conversion factors to the principal amounts of contracts according to the nature of the instrument and its original maturity.

Original Maturity of Contracts	Interest Rate Contracts	Exchange Rate Contracts
Less than one year	0.5%	2.0%
One year and less than two years	1.0%	5.0% (e.g.2.0% + 3.0%
For each additional year	1.0%	3.0%