FINANCIAL INSTITUTIONS COMMISSION

PRUDENTIAL REGULATION
FIC-PR-04

SINGLE BORROWER and LARGE EXPOSURE LIMITS

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PART I: PRELIMINARY

1: **Short Title** – Loan limits.

2: **Authorization** – The Financial Institutions Commission (the Commission) of the Republic of Palau (Palau) is authorized to promulgate regulations under Sections 12 and 80 of the Financial Institutions Act of 2001 (the Act) as amended. In addition, Section 54 of the Act establishes limits for credits to any single person or group of interrelated persons and for large credits.

3: **Application** – This regulation applies to all Palau banks and the branches of foreign banks licensed by the Commission to conduct financial activities in Palau whose deposits are not insured in accordance with a government sponsored depository insurance program (hereafter collectively referred to as "bank").

4: **Definitions** – Terms used within this regulation are as defined in the Act, as defined below, or as reasonably implied by contextual usage:

1) "**associate**" – means any person over whom another person exerts or has the ability to exert significant influence and who is not a subsidiary of the first person; also referred to as an "affiliate" or "affiliated person".

2) "**capital**" – means Tier 1 capital as defined in the Commission's Prudential Regulation FIC-PR-01, Capital Adequacy.

3) "**cash deposit**" – means a sum of money held by the lending bank in either an escrow account or 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.

4) "**common enterprise**" – a common enterprise exists when (i) the expected source of repayment is the same or substantially the same for advances made to different but related borrowers, (ii) exposures are made to persons related by common control where the persons are engaged in inter-dependent businesses, (iii) there is substantial financial inter-dependence among them, or (iv) two or more borrowers are so closely affiliated as to be reasonably considered a common enterprise.

5) "**control**" – for purposes of this regulation, control is presumed to exist when (i) 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
(ii) 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
(iii) 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.

6) "**corporate group**" – means a corporation plus all its subsidiaries and associates or affiliates; an enterprise is a subsidiary or an associate of another corporation if the other

corporation exerts, or has the power to exert, control or have significant influence over 50% or more of the voting shares of the enterprise.

7) **"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.

8) **"exposure"** – means a "credit" as defined in the Act and includes any loan or credit, 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. The term includes the placement of funds or deposits with another bank with maturities more than seven days.

8.1 funded exposures are those for which the bank has provided funds to the borrower or to a third party on behalf of the borrower;

8.2 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;

8.3 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;

8.4 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.

8.5 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.

9) **"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.

9.1 group of interrelated persons means two or more persons, companies, corporations, partnerships or other business enterprises 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.

10) **"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.

11) **"subsidiary"** – means a company that is controlled by another which is referred to as the 'parent'. Control means the power to influence, directly or indirectly, the policies and decisions of a company so as to gain benefits from its activities.

PART II: STATEMENT OF POLICY

1: **Purpose** – This regulation restricts credit risk, relative to capital, for exposures to a single person, a group of closely-related or financially inter-dependent persons, a corporate group, and large exposures in aggregate. This regulation also promotes diversification of credit risk and wider access to credit by limiting concentrations of credit.

2: **Scope** – This regulation applies to all exposures, direct or indirect, held by banks licensed by the Commission to conduct financial activities in Palau.

3: **Responsibility** – It is the responsibility of the board of directors and managing officers of each bank to adopt policies and procedures which are adequate and which ensure that all exposures (i) comply with the limits set forth in the Act and this regulation, and (ii) are made and administered in accordance with prudent lending practices.

PART III: IMPLEMENTATION AND SPECIFIC REQUIREMENTS

1: **Limitations** – The following limits shall apply:
(a) **Single person**: the total direct exposures at any time, funded or unfunded, by a single person or group of interrelated persons, shall not exceed 20% of capital.

(b) **Large exposures**: the total of all large exposures, as defined in this regulation, shall not at any time exceed 800% of capital.

(c) **Compliance with policy**: all credit extended by a bank shall comply with a written, board-approved lending policy that is fully adequate for the lending activities of the bank.

2: **Exceptions** – The following exceptions shall apply to the limits in paragraph 1 above:

(a) **Government-backed debts.** Exposures, or portions thereof, which the national government of the Republic of Palau has unconditionally guaranteed as to payment of both principal and interest, or that are fully secured by full faith and credit obligations of the national government, are exempt from the limits in paragraph 1 above. However, exposures of companies that are owned or controlled by the national government, whether directly or indirectly or wholly or in part, but which are separate legal entities shall be subject to the limits in paragraph 1 unless the national government has unconditionally guaranteed or is directly obligated for the debts of such companies.

(b) **Exposures secured by cash deposits.** Exposures, or portions thereof, that are fully secured by cash deposits in the lending bank shall be exempt from the limits in paragraph 1 above. However, for this exception to apply, the deposit must be (i) explicitly assigned to the bank in writing by the customer, (ii) segregated and under the sole control of the bank, and (iii) the bank must have legal right to set off the deposit against the exposure at any time. If a cash deposit is in a different currency than the loan, 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.

(c) **Indirect exposures.** Exposures, or portions thereof, that are indirect as defined herein shall be exempt from the limits in paragraph 1 above. However, the Commission will aggregate indirect exposures with direct exposures for purposes of applying the 20% limit if the particular facts and circumstances indicate that an unsafe credit concentration is arising by virtue of this exception.

(d) **Bank guaranteed debts.** Exposures, or portions thereof, that are fully guaranteed by another bank shall be exempt from the limits in paragraph 1 above. However, the total of all exposures backed by guarantees issued by any one bank may not exceed 200% of the lending bank's capital at any time. For this exception to apply, the guaranteeing bank must not be (i) related to the lending bank or (ii) rated lower than the three highest grades by an internationally recognized bank rating agency, and the guarantee must be (iii) unconditional and irrevocable, and (iv) acceptable to the Commission as to form and content.

If the Commission demands performance on a bank guarantee issued for this exception, then the bank which is the beneficiary of the guarantee will be restricted from (i) declaring or paying cash dividends, (ii) repatriating or distributing profits or capital funds to any shareholder, and (iii) paying amounts to any related person or associate for management or advisory services or other fees related to supervisory, executive, managerial, or policy-making functions until the obligation under the guarantee has been paid in full. This restriction does not apply, however, to reasonable and ordinary payments for data processing, auditing, or mortgage servicing made pursuant to pre-existing, written contracts unless the Commission specifically restricts such payments.

3: **Attribution and aggregation** – Credits extended to one person shall be attributed to and aggregated with credits to another person and shall be subject to the 20% single borrower limit when (i) loan proceeds are re-loaned to another person (i.e. accommodation), (ii) loan proceeds are used for the direct benefit of another person (the 'use' test), or (iii) the

two persons constitute a common enterprise and the enterprise is expected to generate or provide the funds to repay the loan/s (the 'source' test). For purposes of this regulation, the Commission will determine, based on the particular facts and circumstances, when a credit nominally granted to one person shall be combined with credits to another person.

4: **Loans to partnerships** – (a) **To the partnership**: For purposes of this regulation, the total exposure of a partnership shall include the credits to all general partners but not the credits to limited partners unless (i) the proceeds of credits to limited partners are used for the direct benefit of the partnership, or (ii) the credits to limited partners are repayable primarily from the profits of the partnership.

(b) **To partners**: For purposes of this regulation, the total exposure of each general partner shall include credits to the partnership but not credits 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 interests in partnership**: For purposes of this regulation, 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 shall 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.

5: **Loans written off** – The lending limits in paragraph 1 (a) and (b) above apply to all loans, including any loans which have been written off in whole or in part. Loans that have been discharged by a court in bankruptcy or that are no longer legally enforceable shall not be included in the total for determining compliance with the limits in paragraph 1.

6: **Loan participations** – Any credit or portion thereof that has been sold as a participation to another bank shall not count against the limits in paragraph 1. For this exception to apply, the participation must be covered by a written agreement which specifies that 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.

7: **Loan syndications** – When two or more banks extend credit to a single borrower under a single credit facility (e.g. a syndicated credit), the limits in paragraph 1 above apply only to the funds provided by each bank and representing that bank's pro rata share of the total loan. 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.

8: **Capitalized interest** – Accrued but uncollected interest is not subject to the limits in paragraph 1 unless it has been capitalized by adding to the principal of the loan with a corresponding entry to interest income.

9: **Nonconforming exposures** – Exposures which do not conform to the limits in paragraph 1 when this regulation comes into effect, or which subsequently become nonconforming, will be treated as follows:

(a) If an exposure conforms to the limits when made but subsequently exceeds the limits because (i) the bank's capital declines, (ii) the borrower merges or forms a common enterprise with another borrower, (iii) the bank merges with another bank which also holds exposures to the borrower, (iv) the lending limits or the method for calculating the capital base changes, or (v) an exception under paragraph 2 no longer applies, then the exposure will be treated as 'nonconforming'.

(b) 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 bank to receive full repayment of the credit.

10: **Reporting Requirements** – Each bank shall submit returns in respect of exposures in the form and frequency as the Commission may prescribe.

PART IV: CORRECTIVE MEASURES

1: **Remedial measures and sanctions** – If a bank, or any director or administrator of a bank, violates any provision of this regulation in a willful, negligent or flagrant manner which results, or is likely to result, in an unsafe or unsound condition for the bank or that threatens the interests of depositors, creditors or the general public, or if a bank, or any director or administrator of a bank, fails to comply with the instructions and reporting requirements in this regulation, the Commission may impose any one or more of the remedial measures or penalties provided in the Act.

PART V: EFFECTIVE DATE

1: **Effective date** – The effective date of this regulation shall be 1st September 2008.

Questions relating to this regulation may be addressed to the Financial Institutions Commission of the Republic of Palau.

Adopted July 23, **2008**

[redacted]
Governing Board
Financial Institutions Commission
Republic of Palau

Approved July 29, **2008**

[redacted]
Honorable President
Tommy E. Remengesau, Jr.