BANK OF PAPUA NEW GUINEA

PRUDENTIAL STANDARD 4/2003

LIMITS ON LOANS TO RELATED PARTIES

Arrangement of Paragraphs

PART I: PRELIMINARY

1: **Short Title** – Loans to related parties.

2: **Authorization** – The Bank of Papua New Guinea (Bank) is authorized to issue prudential standards under Section 27 of the Banks and Financial Institutions Act 2000 (Act) in relation to prudential matters to be complied with by all Authorized Institutions.

3: **Application** – All banking institutions licensed by the Bank to conduct banking business in Papua New Guinea (PNG).

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

1) **"associate"** – means, for purposes of this standard, in relation to a person, a company or body corporate of which that person is a director, managing officer and/or shareholder controller of that company, and also a partnership or joint venture, including the members of such partnerships and joint ventures, of which that person is a member.

2) **"bank"** - means all banks and other licenced financial institutions authorized under the Act to carry on banking business.

3) **"capital base"** – means Total Capital as defined in Prudential Standard 1/2003 Capital Adequacy.

4) **"employee"** – means any person employed by a bank in a full-time capacity, either on a permanent or a contractual basis but excluding casual or part-time staff; the term employee is meant to include all line staff, supervisory staff, and officers but not to include professionally certified, licensed or registered persons such as accountants, appraisers, attorneys, or others who perform services on a client-professional basis.

5) **"exposure"** – means any direct or indirect advance of funds (including obligations as maker or endorser arising from discounting of commercial/business paper) made to a person on the basis of an obligation to repay the whole of funds advanced, or which is repayable from specific property pledged by or on behalf of a person.

6) **"officer"** – means any person, regardless whether such person has an official title, who participates or has authority to participate (other than as a member of the board of directors) in major policy-making functions of the bank and who has or can exercise the authority to lend or invest bank funds or cause the bank to incur liabilities in the normal course of operations. For purposes of this standard, a person may be designated as not being an officer by (i) resolution passed by the board of directors or (ii) the bylaws of the bank and that person must not participate in major policy-making functions.

7) **"person"** – means, for the purposes of this standard, a natural person or individual.

8) **"related party"** – means any person who is a director, officer and/or shareholder controller of the bank that is in a policy-making position, together with his/her financially-dependent children or other relatives, his/her business associates, the holding company of which the bank is a subsidiary, or other company that is affiliated

with the bank or holding company through common ownership, control or management.

PART II: STATEMENT OF POLICY

1: **Purpose** – This standard is intended to prevent related parties of a bank from borrowing, individually and in the aggregate, an excessive amount relative to the bank's capital base. This standard is also intended to assure that all exposures of a bank to its related parties are on substantially the same terms and conditions as exposures to non-related borrowers.

2: **Scope** – This standard applies to all banks licensed and operating in PNG and to any loan or exposure by a bank to a related party, to a bank holding company of which the lending bank is a subsidiary, and to any other affiliate of the bank or its holding company. This standard also applies to any loans by a bank to a company or the business enterprise that is controlled by a related party or to a person for the direct benefit of a related party.

3: **Responsibility** – It is the responsibility of the board of directors of each bank to establish policies and procedures to ensure that all exposures to related parties (a) fully comply with the limitations set forth in the Act and in this standard, and (b) are made and administered according to prudent lending practices.

PART III: IMPLEMENTATION AND SPECIFIC REQUIREMENTS

1: **Limits and Requirements** - The following limits and prohibitions shall apply:
(a) **Single party limit:** the total of all exposures outstanding at any time to any one related party shall not exceed 25% of the bank's capital base.

(b) **Aggregate limit:** the total of all exposures outstanding at any time to all related parties of the bank shall not exceed 50% of a bank's capital base.

(c) **Security:** all exposures to a related party shall be fully secured at all times, and the bank shall maintain adequate documentation thereof. However, exposures to any one related party that do not, in the aggregate, exceed the lesser of K20,000 or 1% of the bank's capital base are exempt from this requirement.

"Fully secured" means that the value of the security equals or exceeds, at all times, the amount of the exposure. The value of the security is the amount calculated by discounting the security to current market conditions and deducting reasonable and estimable costs of recovery and sale (i.e. legal fees, valuation costs, estate agent fees, insurance cover to date of sale, costs of maintenance, security, and expenses necessary to put the collateral in a saleable condition).

(d) **Terms and creditworthiness**: all loans or exposures to related parties shall: (i) be on the same terms and conditions (including interest rates, security and repayment) as similar loans or exposures to non-related parties: (ii) conform to credit underwriting procedures that are no less stringent than those applicable to similar loans or exposures to non-related parties; and (iii) not involve more than the normal risk of repayment or pose other unfavourable features.

(e) **Exceptions:** notwithstanding the limits and requirements immediately preceding, the following exceptions shall apply:

i) **correspondent deposit accounts** - the limits and requirements of paragraphs (a), (b) and (c) shall not apply to a deposit account maintained in the ordinary course of business by a bank in another bank that is (1) the controlling shareholder of the depositing bank, or (2) a subsidiary of the holding company of which the depositing bank is also a subsidiary;

ii) the limits and requirements of paragraphs (a), (b) and (c) shall not apply to exposures of a bank made in the ordinary course of business to a subsidiary bank or to another financial institution for the specific purpose of direct on-lending to one or more counterparties which are not related to the bank.

iii) **concessionary rates of interest** – a bank may make a loan at a concessionary rate of interest to any <u>person</u> who is an employee of the bank (but not to a non-executive director or to a company, partnership or joint venture owned or controlled by an employee) provided the loan is made pursuant to an employee benefits-compensation policy. <u>For this exception to apply, such policy must</u>:

(A) be in writing and formally adopted by the board of directors;
(B) apply substantially the same to all employees of the bank and not give preference to any one or more persons over other employees;
(C) allow only for a concessionary interest rate (i.e. price) but not for any concessions in respect of credit underwriting standards (i.e. quality);
(D) restrict the loan purpose to (1) purchase or improvement of the residence of the employee, (2) educational or medical expenses, or (3) personal and household expenditures for private, non-commercial purposes;
(E) restrict the total outstanding balance of loans made to an employee at concessionary rates to not more than the lesser of (1) three times the employee’s annual cash compensation (i.e. salary plus cash bonus) in the prior calendar year, or (2) K400,000, but in no event shall such total balance exceed 25% of the bank’s capital base;
(F) require that all other terms and conditions (i.e. repayment terms, types of collateral, security margins, income requirements, etc.) must be no more favourable than for similar loans to persons who are not related parties; and
(G) comply, in form and substance, with all applicable laws and regulations of the Government of PNG or any agency or authority thereof.

(f) **Prior board approval**: if the total of any new loan plus all other loans outstanding to a related party will exceed the lesser of K100,000 or 5% of the bank's capital base, then: (i) all pre-existing <u>outstanding loans must first be acknowledged</u> by the board of directors; (ii) the new loan must be <u>approved in advance by a majority of the entire board</u> of directors; and (iii) the <u>related party must abstain</u> from participating in the voting process whether directly or indirectly. Participating in discussions, or any other attempt to influence the voting of the board, in respect of a loan to a related party shall constitute indirect participation in the voting process.

(g) **Determination:** for purposes of this standard, the Bank will decide whether a person is a related party and subject to the limits and requirements above.

2: <u>**Nonconforming loans**</u> **-** (a) if a loan to a related party complies with the requirements in ¶1 when made but later fails to comply because (i) the bank’s capital base declines, (ii) the bank merges with another bank that also has loans to the related party, (iii) the lending limit or capital base rules change, or (iv) the security for the loan fails to satisfy ¶1(c), then the loan will be considered 'nonconforming'.

(b) if an exposure to a related party becomes 'nonconforming' for reasons (i-iii) above, then the bank must promptly take all reasonable actions to bring the exposure into compliance with lending limits unless doing so would be inconsistent with safe and sound banking practices.

(c) if an exposure becomes 'nonconforming' for reason (iv), then the bank must bring the exposure into compliance within 10 calendar days, unless judicial proceedings, regulatory actions, or other circumstances beyond the bank's control prevent taking action.

3: **Reports by officers** - (a) every director and officer of a bank who becomes indebted to any other bank/s in an aggregate amount greater than 5% of the capital base of the bank where he is a director or officer, shall make a written report to the board of directors of the bank where he is a director or officer within 10 days after exceeding the 5% level. Such report shall provide, at a minimum, the following details: (i) the names of all banks to which the officer is indebted; (ii) the date, amount, terms and security for each loan; (iii) the use of proceeds and source of repayment for each loan; and (iv) the current balance and repayment status of the loan/s.

(b) every director and officer of a bank shall submit a report to the board of directors of the bank where he is a director or officer annually by 15th January detailing the following information: (i) the names of all financial institutions, domestic or foreign, to which he is indebted as at 31st December of the year immediately preceding; (ii) the amount/s of such loan/s, (iii) the purpose of such loan/s; and (iv) the current status of the loan/s. For (ii), the amount/s may be shown in size ranges (PGK 0-20,000; PGK 20,001-100,000; PGK 100,001-500,000; greater than PGK 500,000). For (iii) the purpose of a loan may be described generally, i.e. to purchase/refinance/remodel home, to purchase securities or investments, to purchase vehicle, to pay personal, medical or education expenses, etc. For (iii) the current status of a loan may be shown in the following categories: Current (0-60 days in arrears), Overdue (60-90 days in arrears), Delinquent (90+ days in arrears).

4. **Reports by publicly-traded banks -** if the shares of a bank are traded on a public stock exchange, and if a related party directly or indirectly owns, controls, or has the power to vote 5% or more of the ordinary shares of the bank, then the bank shall be required to disclose in its annual audit report the name of the related party, the total of all exposures outstanding to that related party on the audit report date, and the percentage such exposures represent of the bank's capital base.

5: **Reporting requirements.** Each bank shall submit to the Bank such returns as the Bank may require and in the form and frequency as the Bank may prescribe.

PART IV: CORRECTIVE MEASURES

1: **Remedial measures and sanctions** - If a bank breaches any provision of this prudential standard in a flagrant manner which results, or threatens to result, in an unsafe or unsound condition, or fails to comply with the instructions and reporting requirements, or if there is risk that the existing capital base will be impaired and result in a condition that threatens the interests of depositors or the general public, the

Bank may pursue appropriate corrective actions and sanctions by imposing or varying conditions on the bank's licence as provided in Section 14 of the Act.

Such conditions imposed on a bank's licence under Section 14 may include, but are not limited to, the following –

a) Require the bank to take certain steps or to refrain from adopting or pursuing a particular course of action or to restrict the scope of its business in a particular way, including a prohibition from engaging in any further foreign exchange activities for a specified period of time;
b) Impose limitations on the acceptance of deposits, the borrowing of money, the granting of credit or the making of investments;
c) Prohibit the bank from soliciting deposits, either generally or from persons who are not already depositors;
d) Prohibit the bank from entering into any other transaction or class of transactions;
e) Suspend access to the credit facilities of the Bank; or
f) Suspend or require the removal of any directors, managers or chief executives.

PART V: EFFECTIVE DATE

1: **Effective date** – The effective date of this standard shall be 1st October 2003.

2: **Supercedance** – This Standard supercedes and replaces Prudential Standard 4/2003 issued in June 2003.

Questions relating to this prudential standard should be addressed to The Manager, Financial System Supervision Department, Bank of PNG, Tel: 322-7200.