NATIONAL RESERVE BANK OF TONGA

Prudential Statement No.6 *Revised 2017*

CAPITAL ADEQUACY REQUIREMENTS

Introduction

1. This statement is issued in terms of Section 15(3) of the Financial Institutions Act 2004.

2. Section 12 of the Financial Institutions Act requires that every licensed financial institution (LFI) under the Act maintain:

   a. if incorporated in Tonga, paid up capital and reserves; and

   b. if incorporated abroad, assigned capital and reserves in Tonga;

   in such minimum amount and proportion as the Reserve Bank may specify having regard to internationally accepted capital standards. Such proportion shall not be less than 8 percent of the total risk weighted assets for a licensee incorporated in Tonga. The Act also states that the minimum amount specified for the issue of a licence may not be less than $2,000,000.

3. In addition, Section 12 allows the Reserve Bank to specify minimum capital standards for the consolidated group in the case of a LFI incorporated in Tonga.

4. Section 13 provides that no LFI shall declare or pay any dividend or make any other transfer or remittance from profits:

   a. If this would contravene section 12 or the restrictions on size of exposures when measured against a LFI's capital as outlined in Section 28; and

   b. Where the payments would exceed earnings in the year to which they relate without the prior approval of the Reserve Bank.

5. This Statement describes the approach used by the Reserve Bank for assessing the capital adequacy of LFIs in Tonga (and their consolidated groups). The guidelines in this Statement focus on credit risk. Other factors need to be considered, as a separate matter, in assessing the overall capital adequacy of a LFI. These include the quality of its assets, profitability, liquidity, market risk, credit risk concentration, the adequacy of provisioning and the effectiveness of the LFI's management systems for monitoring and controlling risks. The Statement also provides for the submission of periodic reports by LFIs to monitor compliance with the minimum capital requirements and the persons responsible for ensuring the

accuracy and timely submission of required reports and possible enforcement measures in the event of non-compliance.

6. The requirements are based on the credit risk requirements in the 1988 Basel Capital Accord and the 1995 Credit conversion factor recommendations. The Reserve Bank's approach is consistent in all substantial respects with the approach recommended by the Basel Committee on Banking Supervision.

General Framework

7. It is the responsibility of a LFI'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.

8. As mentioned above the focus of these guidelines is on a LFI holding adequate capital to cover its credit risk (ie the potential risk of default by a borrower or counterparty). Account is taken, in a limited way, of collateral and guarantees.

9. 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. Off-balance sheet transactions are converted to balance sheet equivalents before being allocated a risk weight. Risk-weightings seek to take account, on a portfolio basis, of the relative likelihood of counterparties being unable to meet their obligations to a LFI. 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.

10. The sum of risk-weighted assets and risk-weighted off-balance sheet business is related to a LFI's capital/assigned capital and the resulting "risk ratio" is used as a measure of capital adequacy.

11. The methodology in this Prudential Statement applies to all LFIs including foreign LFIs operating through branches in Tonga which are required to maintain minimum assigned capital/reserves in Tonga.

12. The requirements apply to the global operations of LFI's incorporated in Tonga on a consolidated basis in accordance with International Accounting Standards. Foreign financial institutions operating in Tonga through branches are required to hold assigned capital[1] in Tonga in accordance with the requirements of this Prudential Statement to the extent of the foreign LFI's branch operations in Tonga.

13. The level of capital determined in accordance with this Prudential Statement is the basis for calculating the ceilings on credit and other risk exposures, connected

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

lending and holding of shares in terms of Sections 28, 30 and 31 respectively of the Financial Institutions Act .

14. The Reserve Bank will review aspects of the capital adequacy framework in light of developments in the Tongan financial system.

Minimum Capital

15. The minimum capital which must be paid up before issue of a licence is as follows:

    a. Banks T$2 million

    b. Credit institutions T$2 million

16. These minimum levels must be maintained at all times by the LFI regardless of whether a lower level of capital would achieve compliance with the capital ratios specified in the next section.

Minimum Capital Ratio

17. LFIs must at all times maintain on a standalone and, where applicable, consolidated basis a minimum Total Capital ratio as specified below or such higher ratio as may be set by the Reserve Bank:

    a. For Banks a minimum ratio of Total Capital-to-Risk-Weighted Assets of not less than 15%:

    b. For Credit institutions a minimum ratio of Total Capital-to-Risk-Weighted Assets of not less than 18% is to be maintained.

18. These ratios are higher than the minimum set by the Basel Committee on Banking Supervision because of the concentrations implicit in the Tongan market; the inability to adequately secure claims; and the lack of a capital market. Furthermore, the higher ratios are to cover for risks other than credit risks.

19. In determining whether a LFI will be required to maintain a higher Total Capital ratio, the Reserve Bank will consider whether the LFI is pursuing or experiencing significant growth: has an ordinate level of risk or inadequate risk management systems: poor asset quality, management, earnings or liquidity, excessive concentrations of credit or significant other risks or concerns.

Capital Management Planning

20. The board and management of a LFI is responsible for developing an internal capital assessment process and setting capital targets that are commensurate with the LFI's risk profile and control environment to ensure that the LFI has adequate

capital to support its risks beyond the core minimum requirements. Holding increased levels of capital is only one component for addressing increased risks confronting the LFI. Other means for addressing risk, such as strengthening risk management, applying internal limits, strengthening the level of provisions and reserves, and improving internal controls, must also be considered. Furthermore, capital should not be regarded as a substitute for addressing fundamentally inadequate control or risk management processes.

21. A LFI should develop a capital management plan which should be updated annually and a copy of the plan should be provided to the Reserve Bank. The capital management plan should address issues such as:

    a. Establishing a minimum buffer above the Reserve Bank's required minimum requirement;

    b. Establishing a trigger or trigger points which require management action to ensure that the LFI does not breach either its internal board approved capital requirement or the Reserve Bank's minimum requirement;

    c. The ability to access additional capital in both normal times to support growth and when the LFI is under pressure;

    d. The rate of growth of the LFI's assets;

    e. The concentration of assets;

    f. The quality of the LFI's assets and adequacy of provisioning;

    g. Dividend policies;

    h. The adequacy of its risk management processes to identify and control other risks such as operational risk.

22. Where a LFI becomes aware that it is likely to breach the minimum capital requirement, it should immediately initiate discussions with the Reserve Bank.

Definition of Capital

23. Capital is the cornerstone of a LFI's strength. The presence of substantial capital re-assures creditors and engenders confidence in a LFI. The essential characteristics of capital are that it should:

    a. represent a permanent and unrestricted commitment of funds;

    b. be freely available to absorb losses and thereby enable a LFI to keep operating whilst any problems are resolved;

c. not impose any unavoidable charge on the earnings of the LFI; and

d. rank below the claims of depositors and other creditors in the event of the winding-up of a LFI.

24. The Basel Committee on Banking Supervision recognises two tiers of capital for supervisory purposes but at this stage the Reserve Bank is only prepared to recognise Tier 1 capital as eligible for compliance with the minimum capital requirements. Tier 1 capital fully satisfies the essential elements listed above. Tier 2 capital does not satisfy all of the essential characteristics of capital but may contribute to the overall strength of a LFI as a going concern.

25. Tier 1 capital comprises:

a. Paid-up ordinary shares/Assigned Capital (if foreign incorporated).

b. Non-repayable share premium account.

c. General reserves

d. Retained earnings

e. Non-cumulative irredeemable preference shares

f. Minority interests in subsidiaries consistent with the foregoing components

26. Asset revaluation reserves (e.g. premises, securities and foreign exchange revaluation reserves) **do not qualify** for inclusion in Tier 1 capital.

27. Retained earnings exclude current year earnings. Current year losses must be deducted from retained earnings for capital adequacy purposes.

28. Non-cumulative irredeemable preference shares will not be eligible for inclusion in Tier 1 capital to the extent that they exceed 25 per cent of net Tier 1 capital (ie Tier 1 capital net of non-ordinary shares and other capital instruments).

29. Assigned capital represents the component of Balances due to Head Office which are regarded as a permanent commitment of funds for Tongan operations.

Deductions

30. In calculating capital ratios the following must be deducted from capital:

a. Goodwill and similar intangible assets are deducted from Tier 1 capital and assets (and hence from a LFI's capital base) in calculating capital ratios. Goodwill and other intangibles (e.g. in-house developed computer software and

capitalised pre-establishment expenses) may not have any value in the event of losses and are therefore not included in capital.

b. Net future income tax benefit (future tax benefit arising from income tax losses (i.e. income tax loss carry forward) net of any deferred tax liabilities). If the provision for deferred income tax liability exceeds the amount of future income tax benefits, the excess may not be added to capital. The value of the "claim" represented by net future income tax benefits depends on factors such as the future profitability of a LFI and the continuation of tax rules that allow the benefits to be utilised. As such, future income tax benefits **do not** fully satisfy the tests required for inclusion in capital.

c. Where consolidation is not judged appropriate for accounting reasons an LFI must deduct from its Tier 1 capital (and risk assets) its investments in, and any other forms of credit support provided to, a subsidiary or associate effectively controlled by the LFI. Life, general insurance and funds management subsidiaries would in the normal course not be consolidated for capital adequacy purposes.

d. To avoid double gearing of capital in the Tongan financial sector, a LFI's holdings of other LFIs' capital instruments (as shown in its books) should be deducted from the investing LFI's capital (and risk assets). This includes equity in local and overseas incorporated LFIs operating in Tonga (and their subsidiaries) held by the LFI and its subsidiaries where relevant.

Reductions in Capital and Capital Restructurings

31. Where a LFI proposes any reduction in its capital or restructure of 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 extends out for at least three years) that the LFI's capital would remain adequate after the proposed reduction. The Reserve Bank will grant or deny approval based on the following criteria:

a. The reduction should have the affirmative vote of two-thirds of all shareholders of the LFI;

b. There must be a legitimate business purpose for the reduction. Examples include:
   (i) Having shares available for use in connection with employee stock option, bonus, purchase, or similar plans;
   (ii) Having shares available to sell to a member of the Board, if Board members are required by the LFI's Articles of Association or bylaws to be shareholders of the LFI;
   (iii) Purchasing a Board member's qualifying shares upon the cessation of the his or her service in that capacity, and there is no ready market for the shares;
   (iv) To reduce costs associated with shareholder communications and meetings.

c. The LFI must be in compliance with all applicable regulatory capital requirements, and must have a positive earnings trend. The LFI's capital should have to be confirmed by an independent external audit, which should include confirmation that the LFI has made all required provisions for possible losses on loans and other assets as required by Reserve Bank guidelines, in particular Prudential Statements 1 and 2.

32. Where a LFI proposes to increase its capital through an issue of shares the LFI should seek the Reserve Bank's prior approval pursuant to sections 14 and 14A of the Financial Institutions Act.

Risk Weights

33. There are three categories of risk weight – 0, 20, and 100 per cent. Weights for particular items are given in Attachment 2.

Collateral and guarantees

34. Claims secured against cash may be weighted as for a claim on cash provided they satisfy the criteria set down in Attachment 3.

Treatment of Off-balance Sheet Items

35. Inclusion of off-balance sheet business in calculating risk based capital ratios involves a two-step process:

   a. The principal (or face value) amounts of transactions are converted into on-balance sheet equivalents ("credit equivalent amounts") by application of a credit conversion factor; and

   b. The resulting credit equivalent amount is assigned the risk weight appropriate to the counterparty, or, if relevant, the weight assigned to the guarantor or the collateral security. This amount then forms part of the LFI's total risk weighted assets.

36. Credit conversion factors for off-balance sheet transactions are given in Attachment 4.

Interest rate and foreign exchange rate contracts

37. The credit risk on interest rate, foreign exchange rate (Foreign exchange contracts with an original maturity of 14 days or less are excluded) and other market-related contracts is the cost to a LFI of replacing the cash flow specified by the contract in the event of counterparty default (At the time a contract is initiated, it can be replaced at little or no cost because interest rates or exchange rates embodied in the contract reflect those then prevailing in the market. But as time passes and market rates change, the value of the cash flow that the LFI is entitled to receive from the counterparty under the terms of the contract often will exceed the value of the cash flow it is obligated to

pay. If the counterparty were to default in such a circumstance, the LFI would have to pay a “premium” to replace, or re-establish the cash flow attaching to the original contract).

38. The cost of replacement will depend, among other things, on the maturity of the contract and on the volatility of rates underlying that type of instrument.

39. Credit equivalent amounts for market-related transactions may be calculated in one of two ways and details of the two methods of calculation are summarised in Attachment 5:

   a. A current exposure or “mark-to-market” method where financial instruments are revalued regularly (in a prudent and consistent manner) to measure current replacement value plus an allowance for potential future exposure17; or

   b. An original exposure or “rule-of-thumb” method where there is a simple conversion factor for the notional principal amount of each instrument.

40. In calculating credit equivalent amounts on market-related off-balance sheet contracts LFI’s must use the more accurate “Current Exposure Method” of calculation unless otherwise agreed with the Reserve Bank.

Netting arrangements

41. Netting is a process by which all outstanding transactions between two counterparties are combined and reduced to a single (net) sum for a party to either pay or receive. The process is formalised in a netting agreement. From a prudential viewpoint, the key issue is whether a LFI’s effective exposure against a counterparty (or counterparties) is limited to the net sum determined by a netting agreement so ensuring that the amount of credit risk is genuinely reduced. At this stage no netting is permitted for capital adequacy calculation purposes. The Reserve Bank will, however, consider including netting arrangements in the capital framework if this practice becomes common.

Reporting Arrangements

42. The LFI’s capital is to be reported in the FID 1_10 Risk Based Capital return by no later than 15 business days following the end of each calendar month (Attachment 1).

Corrective Measures in Cases of Capital Deficiencies

- *Notification of undercapitalised status*

43. In the event that a LFI fails to comply with any capital requirement under the Act or this Statement, it must immediately inform the Reserve Bank of this fact.

44. The Reserve Bank may also determine that a LFI is not in compliance with any relevant capital requirement based on the Reserve Bank's own calculation, pursuant to an inspection undertaken under Section 25 of the Act or otherwise. In this event, the Reserve Bank shall promptly inform the LFI of its determination.

- *Capital restoration plan*

45. A LFI that receives or gives a notification in accordance with paragraph 43 must provide the Reserve Bank for its approval, within 30 days of such notice, with a capital restoration plan, setting forth in detail how the LFI plans to restore its capital to the required level, and the time period within which the LFI expects to achieve compliance. The LFI must submit periodic progress reports to the Reserve Bank no less frequently than quarterly. A LFI that has an approved capital restoration plan may, after prior written notice to and approval by the Reserve Bank, amend the plan to reflect a change in circumstances. Until such time as a proposed amendment has been approved, the LFI must adhere to the capital restoration plan as approved prior to the proposed amendment.

- *Restrictions applicable to undercapitalised LFIs*

46. An undercapitalised LFI may not:
   a. engage in new business activities without the prior written approval of the Reserve Bank;
   b. increase its risk-weighted assets (including on balance sheet and off balance sheet items that are risk weighted) more than 5% per annual financial year without the prior written approval of the Reserve Bank;
   c. pay dividends or make any other transfer or remittance from profits;
   d. make discretionary payments to the members of its board of directors or senior management.

47. The restrictions of paragraph 49 of this Statement also apply to any undercapitalised LFI that fails to submit an acceptable capital restoration plan within the time period required by this Statement, or fails to implement, to the satisfaction of the Reserve Bank, a plan approved by the Reserve Bank.

48. The Reserve Bank may also impose any of the restrictions of paragraph 49 of this Statement on an undercapitalised LFI if it determines such restrictions to be necessary in order to successfully implement the capital restoration plan approved by the Reserve Bank or otherwise to protect the interests of depositors of the LFI or the financial system in Tonga.

- *Restrictions applicable to significantly undercapitalised LFIs*

49. A significantly undercapitalised LFI (that is, a LFI whose capital in any category is less than two-thirds of the required level) is prohibited from doing any of the items in paragraph 46 of this Statement, and, in addition, may not, without the prior written approval of the Reserve Bank:

   a. pay interest rates on deposits in excess of market rates;

b. increase risk-weighted assets (including on balance sheet and off balance sheet items that are risk weighted) more than 1.25% per quarter;
c. increase the salary or other form of compensation, or pay any bonus to any member of its board of directors or senior management;
d. engage in any transactions with any connected party of the LFI;
e. transfer any assets to any connected party of the LFI; or
f. accept deposits from correspondent banks, including renewals and rollovers of existing deposits.

50. The Reserve Bank may, if it deems it necessary, require a significantly undercapitalised LFI to revise any previously submitted capital restoration plan to the satisfaction of the Reserve Bank.

- *Additional measures applicable to certain LFIs*

51. The Reserve Bank may require any significantly undercapitalised LFI, and any undercapitalised LFI that fails to submit a capital restoration plan on time or does not adhere to a capital restoration plan approved by the Reserve Bank, to take one or more of the following actions:

a. endeavour to sell enough shares so that the LFI will be adequately capitalised after the sale;
b. endeavour to be acquired by a parent company, or to merge with another LFI;
c. alter, reduce, or terminate any activity, undertaken directly or through any subsidiary or associate that the Reserve Bank determines poses excessive risk to the LFI;
d. dismiss or replace any member of the board of directors or senior management, or elect an entirely new board of directors or senior management team;
e. divest itself of, or liquidate, as the case may be, any subsidiary, affiliate, or associate that the Reserve Bank determines is in danger causing a significant risk to the LFI;
f. take any other action that the Reserve Bank determines to be necessary for the LFI to become adequately capitalised.

- *Criteria for approving requests*

52. The Reserve Bank will grant approval in connection with any request by a LFI under paragraph 46 or 49 of this Statement only if:
a. The Reserve Bank has approved the LFI's capital restoration plan, or any revisions to the plan required by the Reserve Bank;
b. The Reserve Bank determines that the LFI is implementing the plan to the satisfaction of the Reserve Bank and is likely to meet the goals of the plan by the approved target dates; and
c. The Reserve Bank determines that the proposed action is consistent with, and will advance the objectives of, the plan.

- *Measures relating to critically undercapitalised LFIs*

53. If a LFI becomes critically undercapitalised (that is, its capital in any category is less than one-third of the level required by the Act or this Statement), the Reserve Bank will consider the LFI to be insolvent, or likely to become so, as the case may be, in accordance with Section 36 of the Act. In this event, the Reserve Bank will without delay and in no event more than 30 days after being notified, or making this determination, revoke the LFI's licence in accordance with Section 37 of the Act.

54. Until a critically undercapitalised LFI's licence is revoked, the LFI shall be subject to all restrictions that apply to significantly undercapitalised LFIs, and, in addition, may not:

a. accept any new deposits;
b. make any payment of principal or interest on its subordinated debt, or other senior debt with characteristics of capital;
c. enter into any significant transaction that is not in the normal course of business, including any investment, expansion, acquisition, sale of assets, or any action for which the LFI is required to provide notification to, or seek approval of, the Reserve Bank under the Act or Reserve Bank guidelines; or
d. make any material change in accounting methods.

Compliance with Prudential Statement No. 6

31. This statement is effective from 1st April 2017. Non-compliance with the requirements of this Prudential Statement will be subject to corrective actions as provided under section 33 of the Financial Institutions Act 2004 and the administrative penalties outlined in Prudential Statement No.3 Administrative Penalties.

National Reserve Bank of Tonga
February 2017

Attachment 1

Reserve Bank Financial Institutions Prudential Return

TO BE COMPLETED BY ALL FINANCIAL INSTITUTIONS

For the Month Ending:

-	-	-	-
(insert name of finacial institution)	(day)	(month)	(year)

Production Date/Time: 11/9/2011 16:36

Report all amounts in THOUSANDS of Pa'anga or equivalent

STEP 1: DETERMINING RISK WEIGHTED BALANCE SHEET ASSETS		Balance Sheet Amount	Risk Weight Factor	Risk Weighted Assets
	(a)	(b)	(c)	(d)
1.	**Cash (notes and coins)**	-	0%	
2.	**Balances With Depository Institutions**			
2.1	Depository Institutions Domestic			
2.1.1	Reserve LFI	-	0%	
2.1.2	Other Depository Institutions	-	20%	-
2.2	Depository Institutions Abroad			
2.2.1	Head Office and Other Branches			
2.2.1.1	Maturing in 1 Year or Less	-	20%	-
2.2.1.2	Maturing in More Than 1 Year	-	100%	-
2.2.2	Other			
2.2.2.1	Maturing in 1 Year or Less	-	20%	-
2.2.2.2	Maturing in More Than 1 Year	-	100%	-
3.	**Debt Securities Issues**			
3.1	Depository Institutions Domestic			
3.1.1	Reserve LFI	-	0%	
3.1.2	Other Depository Institutions	-	20%	-
3.2	Depository Institutions Abroad			
3.2.1	Maturing in 1 Year or Less	-	20%	-
3.2.2	Maturing in More Than 1 Year	-	100%	-
3.3	Other Financial Corporations Domestic	-	100%	-
3.4	Central Government	-	0%	
3.5	Statutory Non-Financial Corporations Domestic	-	100%	-
3.6	Private Non-Financial Corporations Domestic	-	100%	-
3.7	Non-Resident			
3.7.1	OECD Central Governments and Central Banks	-	20%	-
3.7.2	IBAs and Regional Development Banks	-	20%	-
3.7.3	All Other	-	100%	-
4.	**Loans and Advances**			
4.1	Of a Capital Nature	-	0%	

4.2	Secured by Cash	-	0%	
4.3	To, Guaranteed by, or Secured by Securities Issued By			
4.3.1	Depository Institutions Domestic			
4.3.1.1	Reserve Bank	-	0%	
4.3.1.2	Other Depository Institutions	-	20%	-
4.3.2	Depository Institutions Abroad			
4.3.2.1	Maturing in 1 Year or Less	-	20%	-
4.3.2.2	Maturing in More Than 1 Year	-	100%	-
4.3.3	Central Government			
4.3.3.1	Tonga	-	0%	
4.3.3.2	OECD and Central Banks	-	20%	-
4.3.4	IBAs and Regional Development Banks	-	20%	-
4.4	All Other	-	100%	-
5.	**Interbank Funds Sold**			
5.1	Depository Institutions Domestic			
5.1.1	Reserve LFI	-	0%	
5.1.2	Other Depository Institutions	-	20%	-
5.2	Depository Institutions Abroad			
5.2.1	Maturing in 1 Year or Less	-	20%	-
5.2.2	Maturing in More Than 1 Year	-	100%	-
6.	**Accrued Interest Receivable**			
6.1	Of a Capital Nature	-	0%	
6.2	Secured by Cash	-	0%	
6.3	To, Guaranteed by, or Secured by Securities Issued By			
6.3.1	Depository Institutions Domestic			
6.3.1.1	Reserve Bank	-	0%	
6.3.1.2	Other Depository Institutions	-	20%	-
6.3.2	Depository Institutions Abroad			
6.3.2.1	Maturing in 1 Year or Less	-	20%	-
6.3.2.2	Maturing in More Than 1 Year	-	100%	-
6.3.3	Central Government			
6.3.3.1	Tonga	-	0%	
6.3.3.2	OECD and Central LFIs	-	20%	-
6.3.4	IBAs and Regional Development Banks	-	20%	-
6.4	All Other	-	100%	-
7.	**Shares and Equity Investments**			
7.1	Depository Institutions Domestic	-	0%	-
7.2	Depsitory Institutions Abroad	-	0%	-
7.3	All Other	-	100%	-
8.	**Dividends Receivable**			
8.1	Depository Institutions	-	20%	-
8.2	All Other	-	100%	-
9.	**Items in Transit**	-	20%	-

		(b)	(c)	(d)	(e)	(f)
10.	**Non-Financial Assets**					
10.1	Intangible Assets	-	0%			
10.2	All Other Non-Financial Assets	-	100%	-		
11.	**Investments in Unconsolidated Subsidiaries and Affiliated Companies**	-	0%			
12.	**Other Assets**	-	100%	-		
13.	**TOTAL ADJUSTED ON-BALANCE SHEET RISK-WEIGHTED ASSETS**			-		

STEP 2: DETERMINING OFF-BALANCE SHEET RISK WEIGHTED ASSETS		**Contract Amount**	**Credit Conversion Factor**	**Credit Equivalent Amount**	**Risk-Weight Factor**	**Risk Weighted Amount**
	(a)	(b)	(c)	(d)	(e)	(f)
14.	**TRADE AND PERFORMANCE RELATED CONTINGENT ITEMS**					
14.1	**Documentary Letters of Credit**					
14.1.1	Tongan Government & Reserve Bank	-	20%	-	0%	
14.1.2	Depository Institutions					
14.1.2.1	Domestic	-	20%	-	20%-	
14.1.2.2	Abroad					
14.1.2.2.1	Maturing in 1 Year or Less	-	20%	-	20%-	
14.1.2.2.2	Maturing in More Than 1 Year	-	20%	-	100 %-	
14.1.3	OECD Central Government, Central Bank & IBAs and Region Dev Bks	-	20%	-	20%-	
14.1.4	All Others	-	20%	-	100 %-	
14.2	**Performance Related Contingencies**					
14.2.1	Tongan Government & Reserve Bank	-	50%	-	0%	
14.2.2	Depository Institutions					
14.2.2.1	Domestic	-	50%	-	20%-	
14.2.2.2	Abroad					
14.2.2.2.1	Maturing in 1 Year or Less	-	50%	-	20%-	
14.2.2.2.2	Maturing in More Than 1 Year	-	50%	-	100 %-	
14.2.3	OECD Central Government, Central Bank & IBAs and Region Dev Bks	-	50%	-	20%-	
14.2.4	All Others	-	50%	-	100 %-	
15.	**DIRECT CREDIT SUBSTITUTES**					
15.1	Tongan Government & Reserve Bank	-	100%	-	0%	
15.2	Depository Institutions					
15.2.1	Domestic	-	100%	-	20%-	
15.2.2	Abroad					
15.2.2.1	Maturing in 1 Year or Less	-	100%	-	20%-	
15.2.2.2	Maturing in More Than 1	-	100%	-	100	

Ref	Item	Amount	Conversion Factor	Equivalent	Risk Weight
	Year				%-
15.3	OECD Central Government, Central Bank & IBAs and Region Dev Bks	-	100%	-	20%-
15.4	All Others	-	100%	-	100 %-
16.	**COMMITMENTS**				
16.1	**Commitments With Certain Drawdown, Sale and Repurchase Agreement, Forward Asset Purchase Agreements**				
16.1.1	Tongan Government & Reserve Bank	-	100%	-	0%
16.1.2	Depository Institutions				
16.1.2.1	Domestic	-	100%	-	20%-
16.1.2.2	Abroad				
16.1.2.2.1	Maturing in 1 Year or Less	-	100%	-	20%-
16.1.2.2.2	Maturing in More Than 1 Year	-	100%	-	100 %-
16.1.3	OECD Central Government, Central Bank & IBAs and Region Dev Bks	-	100%	-	20%-
16.1.4	All Others	-	100%	-	100 %-
16.2	**Note Issuance & Revolving Underwriting Facilities**				
16.2.1	Tongan Government & Reserve Bank	-	50%	-	0%
16.2.2	Depository Institutions				
16.2.2.1	Domestic	-	50%	-	20%-
16.2.2.2	Abroad				
16.2.2.2.1	Maturing in 1 Year or Less	-	50%	-	20%-
16.2.2.2.2	Maturing in More Than 1 Year	-	50%	-	100 %-
16.2.3	OECD Central Government, Central Bank & IBAs and Region Dev Bks	-	50%	-	20%-
16.2.4	All Others	-	50%	-	100 %-
16.3	**Other commitments** (e.g. formal standby facilities and unused credit lines)				
16.3.1	**Unconditionally Cancelable At Any Time Without Notice**	-	0%		
16.3.2	**Non-Cancelable With a Residual Maturity of One Year or Less**				
16.3.2.1	Tongan Governent & Reserve Bank	-	20%	-	0%
16.3.2.2	Depository Institutions				
16.3.2.2.1	Domestic	-	20%	-	20%-
16.3.2.2.2	Abroad				
16.3.2.2.2.1	Maturing in 1 Year or Less	-	20%	-	20%-
16.2.3.2.2.2	Maturing in More Than 1 Year	-	20%	-	100 %-

16.3.2.3	OECD Central Government, Central Bank & IBAs and Region Dev Bks	-	20%	-	20%-
16.3.2.4	All Others	-	20%	-	100 %-
16.3.3	**Non-Cancelable With a Residual Maturity of More Than One Year**				
16.3.3.1	Tongan Goverent & Reserve Bank	-	20%	-	0%
16.3.3.2	Depository Institutions				
16.3.3.2.1	Domestic	-	20%	-	20%-
16.3.3.2.2	Abroad				
16.3.3.2.2.1	Maturing in 1 Year or Less	-	20%	-	20%-
16.3.3.2.2.2	Maturing in More Than 1 Year	-	20%	-	100 %-
16.3.3.3	OECD Central Government, Central Bank & IBAs and Region Dev Bks	-	20%	-	20%-
16.3.3.4	All Others	-	20%	-	100 %-
17.	**MARKET-RELATED CONTRACTS**				
17.1	**Foreign Exchange Contracts**				
17.1.1	Original maturity < 1 year	-	2%	-	100 %-
17.1.2	Original maturity of ≥ 1 year < 2 years	-	5%	-	100 %-
17.1.3	Original maturity of ≥ 2 years < 3 years	-	8%	-	100 %-
17.1.4	Original maturity of ≥ 3 years < 4 years	-	11%	-	100 %-
17.1.5	Original maturity of ≥ 4 years < 5 years	-	14%	-	100 %-
17.2	**Interest Rate Contracts**				
17.2.1	Original maturity < 1 year	-	0.5%	-	100 %-
17.2.2	Original maturity of ≥ 1 year < 2 years	-	1%	-	100 %-
17.2.3	Original maturity of ≥ 2 years < 3 years	-	2%	-	100 %-
17.2.4	Original maturity of ≥ 3 years < 4 years	-	3%	-	100 %-
17.2.5	Original maturity of ≥ 4 years < 5 years	-	4%	-	100 %-
18.	**TOTAL OFF-BALANCE SHEET RISK WEIGHTED ASSETS**				-

STEP 3: CALCULATION OF RISK WEIGHTED ASSETS

19.	Total On-Balance Sheet Risk Weighted Assets	-	
20.	Total Off-Balance Sheet Risk Weighted Assets	-	
21.	Total Risk-Weighted Assets		-

STEP 4: CAPITAL CALCULATIONS

22.	**Tier 1 Capital**		-	
22.1	Paid-up Ordinary Shares	-		
22.2	Paid-in Premium or Surplus	-		
22.3	Assigned Capital	-		
22.4	Retained Earnings/(Losses) (net of current period losses, if any)	-		
22.5	Other (any amount reported in this line must have the prior approval of the Reserve Bank)	-		
23.	**Less Deductions from Tier 1 Capital:**		-	
23.1	Intangible Assets			
23.1.1	Net Future Income Tax Benefit	-		
23.1.2	Goodwill and Other Intangible Assets	-		
23.2	Investments in Unconsolidated Subsidiaries and Affiliated Companies	-		
23.3	Loans of a Capital Nature	-		
23.4	Holding of Other Financial Institution's Capital Instruments	-		
24.	**TOTAL CAPITAL**			-
STEP 5: CALCULATION OF CAPITAL RATIOS				
25.	**Total Capital to Risk Weighted Assets**			-

Attachment 2

RISK WEIGHTS

Zero weight

- Notes and coin.
- Gold bullion held in own vaults or on an allocated basis to the extent backed by gold bullion liabilities.
- Balances with and claims on the Reserve Bank
- Loans and other claims or portions thereof, fully secured against cash on deposit with the lending LFI subject to the criteria set out in Attachment 3.
- All claims on the Tongan Government and claims guaranteed by the Government

20 per cent weight

- Claims on OECD central governments and central banks, and claims guaranteed by or secured against securities issued by these bodies which are denominated in the national currency and funded in that currency.
- Claims on LFIs incorporated in Tonga.
- Claims on international LFI agencies and regional development LFIs and claims guaranteed, or secured by securities issued, by these agencies and LFIs.
- Cash items in the process of collection.
- Claims on LFIs incorporated in other countries with a residual maturity of up to one year, and claims of similar maturity guaranteed by these LFIs.

100 per cent weight

- All other assets and claims not included elsewhere including credit equivalents of off-balance sheet items.

Attachment 3

ELIGIBLE CASH COLLATERAL

An exposure (on- or off-balance sheet) will qualify as collateralised by cash subject to the following conditions:

1. There is a written contractual agreement between the lender (or party holding a claim) and the party lodging the cash collateral establishing the lender's *direct* and *unconditional* recourse to the cash collateral. A common law (or bankers') right of set-off is *insufficient* on its own to satisfy this condition.

2. In the event of default, any requirement on the lender to serve notice on the party lodging the collateral should not impede the lender's recourse to the collateral.

3. Cash collateral may be lodged by a third party provided that party also indemnifies or guarantees the borrower's obligations (or those of the party on which a claim is held) to the lender.

4. Cash collateral may be lodged with the LFI or any subsidiary provided:

    a. The lender and the entity holding the collateral belong to the same consolidated group headed by a LFI in Tonga; and

    b. The entity holding the collateral is bound to act in accordance with the agreement between the lender and the party lodging the collateral.

5. The collateral may be accessed by the party lodging the cash provided the lender retains the right to block access to the collateral at any time. Where an exposure is collateralised by a CD or like instrument (issued by the LFI or its subsidiary), the lender would need to retain physical possession of the instrument until the collateral obligations are extinguished.

6. The currency in which the collateral is lodged may differ from that of the exposure against which it is held, provided that it is valued at current market exchange rates. Funds lodged with an overseas branch or subsidiary of the LFI are eligible to be treated as cash collateral, subject to (4). above.

7. When taking cash collateral, lenders must ensure that legal agreements entered into are binding in the jurisdiction in which the cash is held. In particular, where cash collateral is lodged by a third party, the lender must satisfy itself that the arrangement will not fail for lack of consideration. Set-off arrangements must satisfy all the above conditions to be recognised as cash collateral.

Attachment 4

OFF-BALANCE SHEET BUSINESS

Direct Credit Substitutes Credit Conversion Factor

- Guarantees: 100%
- Assets sold with recourse where credit risk remains with the LFI (Reverse repos (ie purchase and resale agreements) are to be treated as collateralised loans. The risk is to be measured as an exposure to the counterparty or according to the asset if it is a recognised collateral security within the risk ratio framework): 100%
- Standby letters of credit serving as financial guarantees: 100%
- Written put options over specified assets with the character of a credit enhancement: 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%
- Sale and repurchase agreements where credit risk remains with the LFI: 100%
- Forward asset purchases and amounts owing on partly paid shares and securities which represent commitments with certain drawdown and placements of forward forward deposits: 100%
- Note issuance facilities and revolving underwriting facilities. 50%
- Other commitments (eg formal standby facilities and credit lines) with an original maturity of:
  - (i) one year or less, or which can be unconditionally cancelled at any time without notice: 0%
  - (ii) over one year: 50%

Market-Related Instruments

1. Interest-rate contracts
- single currency interest rate swaps;
- basis swaps;
- forward rate agreements;
- interest rate futures contracts;
- interest rate options purchased;
- other contracts of a similar nature.

2. Foreign-exchange contracts (including contracts concerning gold)

- cross-currency swaps (including cross-currency interest rate swaps);
- forward foreign-exchange contracts;
- foreign currency futures;
- foreign currency options purchased;
- hedge contracts;
- other contracts of a similar nature.

3. Other Contracts similar to the above relating to -

- equities (whether to individual equities or indices);
- precious metals except gold (eg silver, platinum, and palladium);
- other commodities other than precious metals (eg energy contracts, agricultural contracts, base metals [eg aluminium, copper and zinc] etc);
- any contracts covering other items giving rise to credit risk.

The following types of instruments are *excluded* in the calculation of credit equivalent amounts:

- Foreign exchange contracts (except contracts concerning gold) with original maturity of fourteen calendar days or less; and
- Instruments traded on futures and options exchanges that are subject to daily mark-to-market and margin payments.

Other Items

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

Attachment 5

MARKET-RELATED OFF-BALANCE SHEET TRANSACTIONS

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

The credit equivalent amount for a transaction (contract) equals the sum of current credit exposure and an "add-on" for potential future credit exposure for the contract:

(i) Current Credit Exposure

The current credit exposure for a contract is determined by the total replacement cost (obtained by "marking to market") of the contract. If the total replacement cost of the contract has a *positive* value (ie the contract has an unrealised profit where a LFI would lose the profit in the event of a default by a counterparty) then the current credit exposure equals the positive value. If the replacement cost is zero or negative, then the current credit exposure of the contract is zero.

(ii) Potential Future Credit Exposure

The potential future credit exposure of a contract is calculated by multiplying the notional principal amount of the contract by a "credit conversion factor" (percentage) according to the residual maturity of the contract as set out in the matrix below:

Current Exposure Method – Credit Conversion Factors

	One year or less	**Over one year to 5 years**	**Over 5 years**
Interest rate	0.0 %	0.5 %	1.5 %
Foreign exchange (incl. Gold)	1.0%	5.0%	7.5%
Equities	6.0 %	8.0 %	10.0 %
Precious Metals (except Gold)	7.0 %	7.0 %	8.0 %
Other Commodities	10.0 %	12.0 %	15.0 %

Replacement costs (including future credit exposure) which are fully collateralised by cash and eligible government securities, or backed by eligible guarantees, may be given the weight of the underlying security or guarantor.

The notional or nominal principal amount, or value, of a contract is the reference amount used to calculate payment streams between counterparties to a contract.

Potential future credit exposure is calculated for all contracts regardless of whether the current exposure amount is zero, positive or negative. It will always be a positive amount.

For contracts with multiple exchanges of principal, the "credit conversion factors" are to be multiplied by the number of remaining payments (ie exchanges of principal) still to be made under the contract.

LFIs should not generally enter into contracts at off-market prices. If any contracts are undertaken at off-market prices, LFIs should contact the Reserve Bank to discuss the reasons for such actions and to agree the capital (and other prudential) treatment of these transactions. This includes historical rate rollovers on foreign exchange contracts. The Reserve Bank will need to be persuaded as to the need for dealing at off-market rates.

Original Exposure Method *(Rule-of-thumb approach)*

This method is only available to LFIs with the prior approval of the Reserve Bank for interest rate and foreign exchange (including gold) related contracts. In the normal course, LFIs are expected to use the Current Exposure Method. Credit equivalent amounts under the Original Exposure Method are to be calculated by applying the "credit conversion factors" set out below to the notional principal amounts of contracts according to the nature of the instrument and its original maturity

Original Maturity of Contracts	**Interest Rate Contracts**	**Foreign Exchange (and gold) Contracts**
One year or less	0.5%	2.0%
Over one year and less than two years	1.0%	5.0%
For each additional year	1.0%	3.0%

The Notes set out above under Current Exposure Method are also applicable where relevant.