BANKING COMMISSION

P.O. Box 1408
Majuro, Marshall Islands 96960

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INSTRUCTIONS AND REPORTING FORMS 8

OFF-BALANCE SHEET BUSINESS

PURPOSE

The form has been introduced to incorporate risks that are not captured on-balance sheet in the calculation of risk weighted capital adequacy for the purpose of determining compliance with the conditions of license of locally incorporated banks.

STATUTORY REFERENCE

Under Section 37 (1), the Commissioner is obligated to notify banks in writing of regulatory reporting requirements intended to strengthen supervision of the RMI banks.

Instructions 8 represent the official reference source applicable for the Off-Balance Sheet return, for use by bank personnel with responsibility for regulatory reporting.

Banks that fail to submit timely and accurate Off-Balance Sheet returns may be subject to fines under Section 37 (3).

Under Section 50, the Commissioner may prescribe the method for determining the capital adequacy of banks.

FREQUENCY/SUBMISSION DATE

All licensed banks are required to submit the Off-Balance Sheet return within 30 days after the last business day of each quarter.

RECEIPIENT

Banking Commission, MIDB Building, Floor 5 Room 501, Majuro.

Phone: (692) 625-6310; Fax (692) 625-6309: E-mail: bankcomm@ntamar.net

SIGNING AUTHORITY

The Senior RMI Officer of the institution concerned, or in his absence a designated officer must sign the completed return, to certify the accuracy of the information submitted.

INSTRUCTIONS 8
Off-Balance Sheet Business

GENERAL DEFINITIONS

Instruction 8 represents the general reference source for the Quarterly Off-Balance Sheet report. Branches of foreign banks are only required to complete Column 1.

Risk weighted off-balance sheet business exposures are determined in a two-stage process. 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
- the resulting credit equivalent amount is assigned the risk weight appropriate to the counter party, or, if relevant, the weight assigned to the guarantor or the collateral security. This amount then forms part of the bank's total risk weighted assets.

For example if a bank provides a guarantee of the obligations of an individual borrower, the calculation would be:

Amount of Guarantee x 100% credit conversion factor x 100% risk weight

If the bank provided a performance bond in relation to the obligations of a municipal government, the calculation would be:

Amount of Performance bond x 50% credit conversion factor x 20% risk weight

SPECIFIC INSTRUCTIONS

Direct credit substitutes represent any undertaking that involves an irrevocable obligation to make a payment to a counter party or a third party in the event that a counter party fails to meet a financial obligation, or where a third party can be reasonably expected to rely on the undertaking in deciding whether to enter into a financial transaction with the counter party. Similarly, any undertaking by a bank by which it acquires a potential claim on another party in the event of default by that party or at the discretion of a third party also constitutes a direct credit substitute.

Obligations which effectively serve as direct substitutes for credit carry the same risk as a direct extension of credit – i.e. the risk of loss depends on the creditworthiness of the counter party or the party on which a potential claim has been acquired. The credit conversion factor for these items are 100 per cent of the principal amount of the claim. This category includes financial guarantees, standby letters of credit serving as guarantees.

Contingent liabilities that relate to trade and performance related obligations generally carry less than a full credit risk. Performance related obligations (e.g. performance bonds, bid bonds, warranties, and standby letters of credit related to a particular transaction) involve an undertaking or guarantee that a counter party will fulfill a contractual non-monetary obligation – i.e. an obligation that does not involve, in the first instance, the payment of money (such as the delivery of goods by a specified date, etc). The risk of loss depends on a future event, which is not directly related to the creditworthiness of the counter party involved. Such obligations are assigned a 50 per cent credit conversion factor.

Documentary letters of credit and other trade financing transactions which are normally secured against an underlying shipment of goods, are self-liquidating, of fairly short term and where the bank retains title to the underlying shipment, are assigned a 20 per cent credit conversion factor.

Commitments, which are certain to be drawn down, attract a 100 per cent credit conversion factor. Other commitments with an original maturity exceeding one year – i.e.: which are not required to be drawn in full within one year are assigned a 50 per cent credit conversion factor. Commitments with an original maturity of one year or less are assigned a zero credit conversion factor.

Commitments of any maturity, which can be unconditionally revoked at any time without notice (e.g.: undrawn line of credit and credit card facilities) and where the bank provides for any outstanding unused commitment to be reviewed at least annually, receive a zero credit conversion factor.

The amount to be included as an off-balance sheet item in a bank's risk assets is the maximum unused portion of the commitment which could be drawn during the remaining period to maturity. The drawn portion of a commitment forms part of a bank's on-balance sheet risk assets.

Irrevocable commitments to provide off-balance sheet facilities should be assigned credit conversion factors appropriate to the underlying facilities. For example, an irrevocable commitment for eighteen months to provide a guarantee in support of a counter party attracts the 100 per cent credit conversion factor applicable to the guarantee. Where a commitment to provide off-balance sheet facilities may be unconditionally revoked at any time without notice, a zero credit conversion factor can be applied.

All commitments are included in the risk based capital ratio calculation regardless of whether or not they contain "material adverse change" clauses or any other provisions which are intended to relieve a bank of its obligations under certain conditions.

Computation of Risk Weighted Off-Balance Sheet Assets:

The amounts in Column 3 should be risk weighted according to the relevant risk weights of the counter party (i.e.: 0% for central government; 20% for banks; 50% for commitments secured by mortgage and residential property; 100% for business and individuals).

BANKING COMMISSION
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