## III.1 Supervisory Requirements

All credit institutions have to comply continuously with the stipulations of the State Ordinance on the Supervision of the Credit System (SOSCS), as well as the Bank's supervisory directives.

**SOLVENCY** (section 13 of the SOSCS)

**Risk - weighed capital ratio**

$$= \frac{\text{Test capital}}{\text{Total risk value balance sheet and off-balance sheet items}} \quad (\text{minimum} = 14\%)^*$$

(Refer to Appendix 7: Risk-weighted solvency test for further details.)

* Internationally active banks with an offshore establishment in Aruba are allowed to maintain a minimum risk-weighted capital ratio of 8%, provided that these internationally active banks meet the definition as mentioned in the Bank's admission and licensing policy rule for banks.

**LIQUIDITY** (section 14 of the SOSCS):

**Liquidity ratio**

$$= \frac{\text{Liquid assets}}{\text{Total assets (excluding goodwill)}} \quad (\text{minimum} = 15\%)$$

Liquid assets ❶ is the sum of the following monthly statement items:

1. Cash
2.a Centrale Bank van Aruba, current account
2.b Centrale Bank van Aruba, time deposits (excluding the reserve requirement)
3.a Due from deposit money banks, demand deposits
3.b.1 Due from deposit money banks, time deposits, time to maturity: one year and below
4.a Investments, treasury bills
4.b.1 Government bonds, time to maturity: one year and below
4.b.2 70% of the value reported under "Government bonds with a maturity over one year
4.c 50% of the reported value under "Other marketable securities"

❶ Assets pledged may not be included in the calculation of the prudential liquidity ratio. Furthermore, assets encumbered by liens, or in any way committed to third parties and not available in the normal operations of a bank, may not be included in the calculation of the prudential liquidity ratio.

For "Total Assets", refer to monthly statement item with same description. Insofar applicable, the goodwill may be deducted from the "Total Assets".

**Loan-to-deposit ratio**

$$= \frac{\text{Total loans (Net)}}{\text{Total deposits (Liabilities)}} \quad (\text{maximum} = 80\%)$$

For "Total loans (Net)" and "Total Deposits", refer to the monthly statement items with the same description.

**IMMOBILIA-RULE** (section 13 of the SOSCS)

**Fixed-assets-to-capital ratio**

$$= \frac{\text{Fixed assets}}{\text{Test capital}} \quad (\text{maximum} = 100\%)$$

"Fixed assets" is the sum of the following monthly statement items:

- 6. Premises and equipment
- 7. Other real estate owned
- 8.a Other investments and advances to subsidiaries, banks
- 8.b Other investments and advances to subsidiaries, banklike institutions
- 8.c Other investments and advances to subsidiaries, other companies
- 8.d Other investments and advances to subsidiaries, advances to subsidiaries

For "Test capital", refer to Appendix 7: Risk-weighted solvency test.

**Other-real-estate-to-capital ratio**

$$= \frac{\text{Other real estate owned}}{\text{Test capital}} \quad (\text{maximum} = 25\%)$$

For "Other real estate owned", refer to the monthly statement item 7 with the same description.

For "Test capital", refer to Appendix 7: Risk-weighted solvency test.

The immobilia-rule, which is partly a liquidity requirement, envisages to ensure that assets which are in principle illiquid are completely financed by funds which are permanently available (Test capital).

## LARGE EXPOSURES (Section 13 of the SOSCS)

### Large exposure rule

$$\frac{\text{Large exposures to one client or a group of connected clients}}{\text{Test capital}} \quad (\text{maximum} = 25\%)$$

For further guidance on this issue refer also to III-2.

For "Test capital", refer to Appendix 7: Risk-weighted solvency test.

Based on the Large exposure rule exposures to any one client or a group of connected clients may not exceed 25% of the institution's "Test Capital" (Tier 1 + Tier 2 capital). Only in exceptional cases and under the strict conditions that 1. it concerns an A-1 client with an excellent financial position and track record, and 2. the loan is well collateralized, the management of a credit institution may decide to exceed this limit. However, under no circumstances the individual exposure to a client or a group of clients may exceed 35% of a credit institution's test capital.

Exposures to the local Government, as well as short term ($\leq$ 1 year) investments with financial institutions are exempted from this rule, under the conditions that subject financial institutions have a solid financial position and fall under effective supervision. The banks are required to periodically evaluate the financial position of these institutions.

Large loans, that comprise credits which equal 15% of a credit institution's test capital are to be reported in Appendix 3: "Monthly report of large loans". The total of the loans reported under appendix 3 (excluding the loans to local Government) may not exceed 600% of a credit institution's test capital.

## CREDIT EXTENSIONS TO INSIDERS (Section 13 of the SOSCS)

The aggregate amount of all credit extensions to insiders may not exceed 2% of the credit institution's test capital, or 1% thereof in case of any individual credit extension. The Bank reserves the right to deduct any amount in excess of the 2% limit from the credit institution's test capital.

For further guidance on this issue refer also to III-3.

For "Test capital", refer to Appendix 7: Risk-weighted solvency test.

## III.2 Large exposures to a Group of Connected Clients

Directive on large exposures to a group of connected clients by virtue of Section 13 of the State Ordinance on the Supervision of the Credit System (AB 1998 no. 16) (SOSCS) for credit institutions licensed by the Central Bank of Aruba (the Bank).

### 1. Introduction

The objective of the "large exposure rule" is to limit the concentration of risk, i.e., the risk - on a consolidated basis - incurred in respect of a single client, or a group of connected clients or in respect of other (non-client-driven) business, such as investments in bonds, stocks, participating interests etc. Exposures are understood to be the assets, as well as the off-balance sheet items of the credit institutions.

### 2. Definitions

A group of connected clients consists of:

- either two or more natural or legal persons who, unless it is shown otherwise, constitute a single risk because one of them, directly or indirectly, has control over the other(s); or

- two or more natural or legal persons between whom there is no relationship of control as referred to above but who are to be regarded as constituting a single risk because they are so interconnected that, if one of them were to experience financial problems, the other or all of the others would be likely to encounter repayment problems.

Interconnection may be evident in the case of:

- common shareholders or partners;
- common director(s);
- cross-guarantees;
- direct commercial interdependence which cannot be undone at short term.

### 3. Directive

Exposures to any one client or a group of connected clients may not exceed 25% of the institution's "Test Capital" (Tier 1 + Tier 2 capital). Only in exceptional cases and under the strict conditions that 1. it concerns an A-1 client with an excellent financial position and track record, and 2. the loan is well collateralized, the management of a credit institution may decide to exceed this limit. However, under no circumstances the individual exposure to a client or a group of clients may exceed 35% of a credit institution's test capital.

Exposures to the local Government, as well as short term ($\leq$ 1 year) investments with financial institutions are exempted from this rule, under the conditions that subject financial institutions have a solid financial position and fall under effective supervision. The banks are required to periodically evaluate the financial position of these institutions.

As of January 1, 2003 the Bank's prior approval is no longer required for exceeding the 25% limit, because the responsibility for granting large loans should explicitly remain with the management of the credit institution, who is also accountable for keeping within the limits as indicated in this directive. To enable the Bank to make an evaluation of the credit institution's policy in this respect, all loans exceeding the 25% limit should be tagged with the letter A in appendix 3.

Moreover, the total of all large loans reported under Appendix 3 of the monthly statement, comprising of loans in excess of 15% of a credit institution's test capital, may not exceed 600% of a credit institution's test capital.

## III.3 Credit extensions to Insiders

### Definitions

For purposes of this Directive:

(a) "Bank" means Centrale Bank van Aruba;

(b) "credit extensions" means: loans, overdraft facilities, guarantees and all other forms of credit, irrespective form or collateral;

(c) "insiders" means any manager, director and/or shareholder including partners or relatives in the first and second degree and related/affiliated companies;

(d) "manager" means any person conducting the day-to-day management of the credit institution and whose function as such has been laid down in the articles of incorporation or any other regulation of the institution and whose appointment has been approved by the Bank;

(e) "director" means a member of the Supervisory Board of the credit institution or a body with a similar task;

(f) "shareholder" means a natural person/legal entity who/that:

1) holds a direct or indirect interest of more than 5% of the issued share capital of the bank; or
2) can exercise directly or indirectly more than 5% of the voting rights in the bank; or
3) can exercise directly or indirectly a similar control in the bank;

(g) "majority shareholder" means a shareholder as defined under (f) with an interest or voting rights of more than 50%;

(h) "capital base" means "test capital" (refer to Appendix 7: “Risk-weighted solvency test”).

### Lending limits

The aggregate amount of all credit extensions to insiders may not exceed 2% of the institution’s capital base, or 1% thereof in case of any individual credit extension. The Bank reserves the right to deduct the amount in excess of the 2% limit from the credit institution’s test capital.

**Related companies**

Credit extensions to enterprises in which insiders are a majority shareholder are included in the calculation of credit extensions to insiders. The terms and conditions of credit extensions to insiders may not be more favorable than those granted to non-related borrowers under similar circumstances.

**Staff loans**

Credit extensions to staff members of the credit institution are excluded from the lending limits to insiders, provided they can be considered fringe benefits and are granted in accordance with the guidelines of the credit institution. The credit institution should seek the redemption of such credits or the conversion thereof into regular terms upon or immediately after the resignation of the relevant staff member. The bank is to establish a written comprehensive policy with regard to credit extensions to staff members.

# III.4 Loan Loss Provisioning

Directive on loan loss provisioning by virtue of Section 13, paragraph 1 of the State Ordinance on the Supervision of the Credit System (AB 1998 no. 16) (SOSCS) for credit institutions licensed by the Central Bank of Aruba (the Bank).

## 1. Introduction

The objective of this directive is to provide the credit institutions with guidelines for the establishment of effective policies and criteria for loan loss classification and provisioning. It deals with both the general (unallocated) and allocated loan loss provisions.

## 2. General (Unallocated) Loan Loss Provision

### 2.1 Purpose and definition

The unallocated loan loss provision should be considered as a special form of a dynamic determined provision related to the general risk a credit institution runs, directly or indirectly, originating from granting loans and conducting other banking activities. This provision serves as a buffer for losses, which cannot be foreseen and therefore cannot be quantified, (e.g. frauds, contingent liabilities and severe (loan) losses caused by a deterioration in the general economic situation).

### 2.2 Required minimum

Additions to the general provision have to be made systematically, thereby aiming at a minimum size, which stands in a reasonable relation to the possible risks involved. When deciding on this minimum management should take, amongst other things, into account:

- the domestic and international economic situation;
- (change in) character and composition of the balance sheet;
- past loss experience and relevant expectations;
- contingent liabilities.

Due to the one-sided structure of the Aruban economy and the ensuing modest opportunities for an adequate diversification of the loan portfolio and other bank activities, the Bank requires, for prudential reasons, that each bank should build up a general provision of at least 3% of the net loan portfolio plus other risk items on the asset side of the balance sheet. The net portfolio is calculated as gross loans minus allocated provisions.

### 2.3 Exceptions

Only in the case of local branches, whereby this provision is built up for the whole banking group by the parent company abroad, the absence of an unallocated loan loss provision may be justified.

## 3. Allocated Loan Loss Provision

### 3.1 Purpose and definition

The allocated loan loss provision is a specific provision for loans for which it is foreseen that full repayment will not take place. As part of its on-site examinations, the Bank performs credit reviews at the supervised institutions. These reviews result in the following classifications: good, special mention, substandard, doubtful and loss. Below an outline is provided of the Bank's loan classification and its provisioning policy. All credit institutions should review their own classification and provisioning policies and bring these in line with the policies mentioned below.

### 3.2 Loan classification

<u>Good</u>

The loan is sound and all principal and interest payments are current. Repayment difficulties are not foreseen under current circumstances and full repayment is expected.

<u>Special mention</u>

The loan is subject to conditions that, if left uncorrected, could raise concerns about full repayment. These loans require more than normal attention.

<u>Substandard</u>

Full repayment is in doubt due to inadequate protection (e.g. obligor net worth or collateral), and/ or interest or principal or both are more than 90 days but less than 180 over due. These loans show underlying, well-defined weaknesses that could lead to probable loss if not corrected and, thus, may become impaired assets. A specific provision of 10 - 20% of the uncollateralized amount is required.

<u>Doubtful</u>

Assets for which collection/ liquidation in full is determined by bank management to be improbable, due to current conditions, and/ or interest or principal or both are overdue more than 180 days but less than one year. Assets in this category are impaired, but are not yet considered total losses, because some pending factors may improve the asset's quality (via new financing or capital injection). A specific provision of at least 50% of the uncollateralized amount is required under these circumstances.

<u>Loss</u>

An asset is downgraded to loss when management considers the facility to be virtually uncollectible, and/ or when interest or principal or both are overdue more than one year. A specific provision of 100% of the uncollateralized amount is required under these circumstances.

# III-5 Appointment of an External Auditor

Directive on the appointment of an external auditor by virtue of Section 15, paragraph 1 of the State Ordinance on the Supervision of the Credit System (AB 1998 no. 16) (SOSCS) for credit institutions licensed by the Central Bank of Aruba (the Bank).

## 1. Introduction

It is important that bank supervisors obtain the information they need to properly form an opinion on the financial strength of each credit institution. This information is obtained, amongst others, from the financial reports that are filed, supported by information obtained through communication with the external auditor. Therefore, banking supervisors have a clear interest in ensuring that there exists an adequate relationship between them and the credit institutions' external auditors, essentially based on the principles as formulated by the Basel Committee on Banking Supervision in its paper of January 2002. In this respect, high standards of auditing are indispensable. Therefore, the audit performed should be carried out by external auditors who:

- are properly licensed and in good standing;
- have relevant professional experience and competence;
- are subject to a quality assurance program;
- are independent in fact and in appearance;
- are objective and impartial; and
- comply with all ethical requirements.

Pursuant to section 1 of the SOSCS an external auditor is defined as an auditor, who is not employed by a credit institution, and who is registered at the Royal Netherlands Institute of Chartered Accountants or is registered elsewhere at a similar institute as the Royal Netherlands Institute of Chartered Accountants and, in the opinion of the Bank, is subject to a similar regime of rules of conduct, professional code and discipline.

## 2. Provision of information by auditors / engagement letter

The provision of information to the Bank by the external auditors of credit institutions is covered in section 23, paragraph 2 of the SOSCS. This section states that when granting the auditor the assignment to audit the annual accounts, the credit institution shall instruct its auditor in writing to:

a. after consultation with the credit institution that granted the assignment, provide the Bank forthwith with a copy of the auditor's report to the Supervisory board, of the letters of the Managing board and of the correspondence that relates directly to the auditor's report, in so far as these documents are considered to be necessary in reason for the proper fulfillment of the Bank's supervisory tasks;

b. after consultation with the credit institution, inform the Bank in writing forthwith of circumstances that could hinder the issue of an auditor's report stating that the annual accounts give a true and fair view of the financial position of the credit institution;

c. after consultation with the credit institution that granted the assignment, inform the Bank in writing forthwith of circumstances which could endanger the continuity of the credit institution, or from which it appears that there is a serious suspicion of an extensive fraud;

d. furnish the Bank, if required, with additional information on the documents referred to under a. and on the circumstances referred to under b. and c.

Subject provisions should be included in the engagement letter. A copy of said letter should be attached to the request for the appointment of an external auditor.

### 3. Directive

For any appointment of, or change in external auditor, the Bank's prior written approval is required. The Bank should be informed on the reasons of the intended change.

The Bank will grant its approval if the external auditor complies with the requirements as stipulated in section 1 of the SOSCS and if there are no circumstances that, in the opinion of the Bank, would make the external auditor unfit for the assignment.

The Bank maintains at all times the right to revoke its approval if there are circumstances that in the opinion of the Bank justify such an action.

# III-6 Publication of the Audited Annual Financial Statements

Directive on the Publication of the Audited Annual Financial Statements by virtue of Section 15, paragraph 1 of the State Ordinance on the Supervision of the Credit System (AB 1998 no. 16) (SOSCS) for credit institutions licensed by the Central Bank of Aruba (the Bank).

## 1. Introduction

In order to promote the soundness and integrity of the financial sector it is necessary that stakeholders (including the public in general) have access to sufficient information to evaluate the financial position and performance of financial institutions. Transparency plays an important role in the constant improvement of the quality of the financial sector. In view thereof, a requirement to publish a credit institution's audited annual financial statements is included in the Basel Core Principles for effective Banking Supervision.

Moreover, according to Section 76 sub d., Volume I of the Aruban Code of Commerce, all credit institutions incorporated under Aruban law should, within 8 days after their balance sheet and income statement have been approved, file complete transcripts of these documents and the accompanying notes with the Chamber of Commerce.

## 2. Directive

In line with the above, the Bank has decided to issue a directive requiring all credit institutions, as of the reporting year 2005, to publish their audited annual financial statements or an (for the Bank acceptable) extract thereof within 6 months after the end of each financial year (by filing subject statements with the Chamber of Commerce).

Branches should publish the audited annual financial statements of the legal entity of which they form part.

# III-7 Managing Directors and members of the Supervisory Board

The day–to-day policy of a credit institution must be determined by at least two persons, while it should have a Supervisory board or a comparable body of at least three natural persons.

In order to safeguard the good reputation of the financial sector of Aruba, the Centrale Bank van Aruba (the Bank) in its licensing procedure, applies certain requirements as to the integrity, knowledge and experience of directors of the credit institutions. These criteria are also applied in cases where new directors are appointed. In view of these requirements, the Bank may object to the appointment of one or more persons who determine the day-to-day policy of a supervised institution because his, her or their knowledge is considered inadequate to engage in the business of a credit institution. Likewise, the Bank may object one or more persons accepting a post involving the (co-) determination of the policy of a supervised institution if, based on the intentions or the past history of that person or those persons, the Bank holds the opinion that the interests of the creditors or future creditors of the institution could be jeopardized.

Pursuant to section 9 of the SOSCS any appointment of a new Managing Director and/or member of the Supervisory Board, needs the Bank's prior written approval. In order to assess the intended appointment in the light of the criteria above, the candidate is required to complete the Bank's questionnaire (Annex 1), sign and return it to the Bank via the institution concerned. A formal request together with the filled-out questionnaire and requested documents should be send to the Bank. Reference is made to paragraph 2 of the Directive on Sound Business Operations for further information on the integrity and suitability assessment conducted by the Bank.

The questions must be answered truthfully and as fully as possible. Questions relating to legal proceedings, convictions, refusal of licenses, supervision of payment or bankruptcy must be answered regardless of whether these facts occurred in Aruba or elsewhere and regardless of the nature of the facts (economic or other offenses).

The Bank's decision is taken on the basis of all available information, including that about the nature of the position and of the institutions. The answers to the questionnaire are merely one among many considerations.

Together with the filled out questionnaire the applicant must submit a declaration of good conduct.

The Bank informs the institutions concerned of its decision.

The information obtained is covered by the secrecy obligation provided for in Article 35 of the State Ordinance on the Supervision of the Credit System.

# III-8 Prospective (In-) Direct Shareholders- Natural Persons

**CHANGE IN SHAREHOLDING** (section 17 of the SOSCS)

Pursuant to section 17 sub 1a of the SOSCS any natural person or legal entity needs the Bank's prior written approval to hold, acquire or increase a qualifying holding in a credit institution or to exercise any control attaching to a qualifying holding. The prospective shareholder should fill in the Bank's questionnaire for prospective shareholders (Annex 2). A formal request together with the filled-out questionnaire and requested documents should be send to the Bank. Reference is made to paragraph 2 of the Directive on Sound Business Operations for further information on the integrity and suitability assessment conducted by the Bank. If such an interest or control could lead to any influence on the credit institution, which is contrary to sound banking policy, the Bank may refuse authorization.

According to section 1 of the SOSCS a qualifying holding is defined as: a direct or indirect holding of more than 10 per cent of the issued share capital of an enterprise or institution or the ability to exercise directly or indirectly more than 10 per cent of the voting rights or the ability to excise directly or indirectly a comparable degree of control in an enterprise or institution.