

APPENDIX 2

CAYMAN ISLANDS MONETARY AUTHORITY

SUMMARY OF PRIVATE SECTOR CONSULTATION AND FEEDBACK STATEMENT



MANAGEMENT OF CREDIT RISK AND PROBLEM ASSETS

Rule: Asset Classification and Asset Loss Provisioning for Banks

Section of Proposed Rule	Industry Comment	Authority's response	Consequent amendments to the draft Rule
General	Contraction of credit is already a problem as the majority of Category A banks are extremely credit risk averse. Autonomy should be given to banks to set specific provisions which match the risks and business model.	Each entity has the autonomous ability to set specific provisions that reflect realistic repayment and recovery expectations, taking into account market and macroeconomic conditions and past loss experience based on the risks presented to the credit risk holder. There is no requirement that all credit risk holders adopt uniform specific provisioning methods. Please refer to Section 5.7 of the Rule.	None
4.2 Credit risk is the risk of financial loss, despite realization of collateral, security or property, resulting from the failure of a debtor to honour its obligations to the Creditor. Credit risk may result from the following: on-balance sheet and off-balance sheet exposures, including	For clarity, amend the term "obligations" to read "financial obligations".	Agree	The Authority will amend the definition accordingly.

loans, advances, investments, inter-bank lending, derivative transactions, securities financing and trading activities.			
4.3 Credit risk holder means the person (whether bank, credit union, building society, or development bank) that engages in the provision of funds on agreed terms and conditions to a debtor who is obliged to repay the amount borrowed (together with interest thereon) whether on or off-balance sheet.	The definition of "credit risk holder" should include the informal market of lenders who offer loans at exorbitant rates.	The Authority has powers for regulated entities only as defined in the Monetary Authority Law, and informal lenders do not fall thereunder.	None
5.2.1 Strategies, policies, and procedures including those related to credit granting, asset classification, and provisioning must be approved by the credit risk holder's board of directors.	The reference to <i>strategies and procedures</i> should be removed as these are specific matters which may reasonably be the responsibility of and handled by management.	The Authority believes that the board of directors is the governing will of the entity and as such is responsible for strategies and policies and will have ultimate responsibility for the procedures. Boards can delegate the development of procedures to senior management; however the Board is responsible for approving procedures.	None
5.2.2 The board of directors must regularly review the strategies, policies and procedures and direct changes as necessary, taking into account market and macroeconomic conditions.	The reference to <i>strategies and procedures</i> should be removed as these are specific matters which may reasonably be the responsibility of and handled by management.	The Authority believes that the board of directors is the governing will of the entity and as such is responsible for strategies and policies, and thus will have ultimate responsibility of procedures. Boards can delegate the development of procedures to senior management, but must retain responsibility for the review of procedures.	None
5.2.3 The board of directors must ensure that the	The reference to <i>procedures</i> should be removed as these	The Authority believes that the board of directors is the governing will of the entity	None

<p>credit risk holder has appropriate credit risk assessment processes and effective internal controls commensurate with the size, nature and complexity of its lending operations, to consistently determine provisions for asset losses in accordance with the credit risk holder's stated policies and procedures, the applicable accounting framework and supervisory guidance.</p>	<p>are specific matters which may reasonably be the responsibility of and handled by management.</p>	<p>and as such is responsible for strategies and policies, and this will have ultimate responsibility for procedures. Boards can delegate the development of procedures to senior management; however the Board is responsible for approving procedures.</p>	
<p>5.2.4 All strategies, policies and procedures must be documented and accessible to relevant parties.</p>	<p>Clarify "relevant parties" and who this would encompass.</p>	<p>In the context of 5.2.4 the phrase "relevant parties" refers to the persons who are involved with executing functions or otherwise involved or associated with the functions described in the strategies, policies and procedures.</p>	<p>The Authority will amend Rule to clarify who is a relevant party.</p>
<p>5.3.1 Credit risk holders must operate within sound, well-defined credit – granting criteria. These criteria should include a clear indication of the credit holder's target market and a thorough understanding of the borrower or counterparty, as well as the purpose and structure of the credit, and its source of repayment.</p>	<p>Given the range of lending segments and various types and sizes of banking relationships, the word 'adequate' or 'reasonable' may be more appropriate than 'thorough'.</p>	<p>Credit risk holders should lend within the scope of their expertise and training.</p> <p>A lack of understanding of the borrower and the market can pose a significant risk to the credit risk holder and their depositors.</p>	<p>None</p>
<p>5.3.1 Credit risk holders must operate within sound, well-defined credit –</p>	<p>There is a need for the Authority to clarify "thorough understanding of the</p>	<p>Credit risk holders should lend within the scope of their expertise and training. A thorough understanding</p>	<p>None</p>

<p>granting criteria. These criteria should include a clear indication of the credit holder's target market and a thorough understanding of the borrower or counterparty, as well as the purpose and structure of the credit, and its source of repayment.</p>	<p>borrower or counterparty" and how this requirement would be evidenced.</p>	<p>would be demonstrated by reviewing the borrower's credit history, repayment ability and other relevant factors. Creditors typically would have a "loan write up" that analyses these factors, which would be available to CIMA as requested. Tangible evidence of an assessment of the borrower and credit review is expected to be in the credit risk holder's files.</p>	
<p>5.3.3 Credit risk holders are required to make credit decisions free of conflicts of interest and on an arm's length basis. In particular, credits to related companies and individuals must be authorized on an exception basis, monitored with particular care and other appropriate steps taken to control or mitigate the risks of non-arm's length lending.</p>	<p>The wording should be amended to replace "must be authorized on an exception basis" with "must be authorized in compliance with good governance, applicable laws, and regulations,"</p>	<p>Restricting related party lending to "an exception basis" has emerged as the post-financial crisis standard promulgated by the Basel Committee on Banking Supervision.</p>	<p>None</p>
<p>5.3.3 Credit risk holders are required to make credit decisions free of conflicts of interest and on an arm's length basis. In particular, credits to related companies and individuals must be authorized on an exception basis, monitored with particular care and other appropriate steps taken to control or mitigate the risks of non-arm's length lending</p>	<p>By the wording "exception basis" clarify if this would cover preferential terms that are often provided for employees.</p>	<p>Policies and procedures for employee loans are expected to be documented so that the terms and conditions are clear.</p>	<p>An amendment will be made to specify the treatment of employee loans.</p>

<p>5.3.4 The credit risk holder’s policy must prescribe that the major credit risk exposures exceeding a pre-defined amount or percentage of the credit risk holder’s capital, and credit risk exposures that are especially risky or are otherwise not in line with the mainstream of the credit risk holder’s activities are to be decided by the credit risk holder’s Board or Senior Management.</p>	<p>The following phrase should be added, “or a Credit Risk Management function independent of the Business lines with reporting and/or access to the Board.”</p>	<p>Basel Core Principle 17 Essential Criteria 6 requires that this power is retained by the Board or Senior Management.</p>	<p>Amendment will be made as it would not be contrary to Basel Core Principles.</p>
<p>5.4 Measure, Monitor, and Control Credit Risk</p>	<p>There is need for further clarity on the expected procedures.</p>	<p>Each entity must assess its operations and risks to be able to establish monitoring and control. The degree of monitoring and controls will vary based on the nature, scope, complexity and risk appetite of the institution. Broadly, the expectations are outline in sections 5.4.1 to 5.4.3.</p>	<p>None</p>
<p>5.6.3 A credit risk holder must formulate and document policies and processes for identifying and managing problem assets including its asset classification system, provisioning and write-offs.</p>	<p>The rule should clarify what is required as it can be inferred that a write-off policy needs to be developed separately.</p>	<p>Whether as a stand-alone policy or part of a broader policy, the Rule seeks to mandate that the functions relating to asset classification, provisioning and write-offs are designed and documented. Each entity will adopt an approach that best assists it in being compliant with this Rule.</p>	<p>None</p>
<p>5.6.4 Credit risk holders must conduct consistent regular reviews of their problem assets both on and off-balance sheet (at an individual level or at a portfolio level for assets with</p>	<p>The rule should clarify what frequency would be expected in the context of “regular reviews”.</p>	<p>The Authority does not propose to define regular reviews. The frequency of “regular reviews” should be set by the board of directors or audit committee in the context of the credit risk holder’s risk and the risk of the portfolio.</p>	<p>None</p>

<p>homogenous characteristics) and asset classification, provisioning and write-offs. Credit risk ratings should be reviewed and updated whenever relevant new information is received. Loans to which credit risk grades are assigned should receive a periodic formal review (e.g. at least annually) to reasonably assure that those grades are accurate and up to date.</p>			
<p>5.7.4 The Credit risk holder on a regular basis, and in relevant detail, must provide the Authority with full access to information concerning the classification of assets and provisioning.</p>	<p>It is not clear what is meant by "regular basis" and "full access to information". It is questioned whether CIMA will be introducing a Loan Classification & Provisioning Return.</p>	<p>According to section 34(8) of the Monetary Authority Law, the Authority may at all reasonable times, by notice in writing given -</p> <ul style="list-style-type: none"> (a) to a person regulated under the regulatory laws; (b) to a connected person; or (c) to a person reasonably believed to have information relevant to an enquiry by the Authority, require him - <ul style="list-style-type: none"> (i) to provide specified information or information of a specified description; or (ii) to produce specified documents or documents of a specified description, as it may reasonably require in connection with the exercise by the Authority of its regulatory functions. <p>Sheet 54 of the Quarterly Prudential Return and other similar sheets in various returns require reporting of asset classification and provisioning. This information has been</p>	<p>Amend "regular basis" to "as requested, from time to time."</p>

		<p>collected for some years now.</p> <p>Additionally, CIMA may request this information during an inspection or exercise of other regulatory functions.</p>	
5.7.4	<p>We would be grateful if the Authority would kindly clarify what frequency it would expect in the context of "regular basis"</p>	<p>According to section 34(8) of the Monetary Authority Law, the Authority may at all reasonable times, by notice in writing given -</p> <ul style="list-style-type: none"> (a) to a person regulated under the regulatory laws; (b) to a connected person; <p>or</p> <ul style="list-style-type: none"> (c) to a person reasonably believed to have information relevant to an enquiry by the Authority, require him - <ul style="list-style-type: none"> (i) to provide specified information or information of a specified description; or (ii) to produce specified documents or documents of a specified description, as it may reasonably require in connection with the exercise by the Authority of its regulatory functions. <p>Additionally in the course of inspections or regulatory reporting specific information may be required as the circumstances determine.</p>	<p>Amend "regular basis" to "as requested, from time to time."</p>

<p>5.10.1 Credit risk holders must seek the prior written approval of the Authority for the acquisition (whether by merger, acquisition, reallocation from related parties or other transfers) of adversely classified assets over the lesser of 10% of the problem assets' respective asset category or 10% of eligible capital.</p>	<p>Implementation of this rule could have adverse effects where prospective highly indebted borrowers are rejected. Regulators in jurisdictions like Jamaica, the UK, and the USA have not adopted this position.</p>	<p>It is the duty of the Cayman Islands Monetary Authority to act in the best economic interests of the Cayman Islands and promote and maintain a sound financial system in the Cayman Islands. The Authority thought it prudent to introduce this measure as a means of monitoring and controlling the rate and volume of problem assets being placed on the books of the entities licensed in the jurisdiction. For example in a single transaction several billion dollars of adversely classified loans were moved to the books of a Cayman Islands bank.</p>	<p>Amendment will be made to require prior approval for:</p> <ol style="list-style-type: none"> 1. the single or cumulative acquisition of adversely classified assets which would represent 10% of the purchaser's total assets or 10% of capital 2. The single or cumulative acquisition that would cause the purchaser's adversely classified assets to exceed 10% of total assets or 10% of capital.
<p>5.10.1</p>	<p>It would be useful if the Authority can clarify how, in each case, the 10% is to be calculated.</p>	<p>The Authority expects that prior to the acquisition that the purchaser would evaluate the assets under Cayman classification rules. The threshold for adversely classified loans would be 10% of the sum of substandard, doubtful and loss / purchaser's total assets. The alternative denominator is based on 10% of the capital.</p>	<p>None</p>
<p>5.12 Reclassification</p>	<p>Some banks capitalize interest payments or provide concessionary terms that are not standard as a Category A bank. Standardization will be too prohibitive.</p>	<p>Capitalization of interest to make a loan appear sound is "window dressing" and is an unsafe practice. The Authority has recommended three criteria for reclassification in order to curb harmful loan practices, namely:</p> <ol style="list-style-type: none"> a. All arrears have been 	<p>None</p>

		<p>cleared and the loan has been brought fully current,</p> <p>b. Repayments have been made in a timely manner over a continuous repayment period of not less than 6 months and</p> <p>c. Continued collection, in accordance with the contractual terms, is expected.</p> <p>Where variation in terms granted to borrowers is done in a manner which does not meet the criteria outlined in 5.12.1, the facility will still need to be adversely classified.</p>	
5.12.2 Credit risk holders are required to follow reclassification directives issued by the Authority under any applicable provisions in the relevant regulatory laws.	How will such directives be issued and will they be universal or specific?	These directives will be given under the powers of the relevant laws relating to credit risk holders, and would typically be in writing. The breadth of the directives, i.e. whether universal or specific, will be determined by the circumstances.	None
General	We do not offer a range of interest rates for loans that correspond with qualification criteria that ranges from favourable to unfavourable as proposed in CIMA's CRMP. Our members are expected to meet established criteria that are very rigorous and is utilized to judge all members. Therefore to mitigate our credit risk, our interest rates are based on the type of collateral used to secure the loans.	The loan qualification proposed by CIMA is in relation to categorizing loans based on performance or risk. The regulatory measures do not address interest rates.	None

<p>General</p>	<p>It is being recommended that CIMA reviews the PEARLS literature and incorporate some of its elements into the proposed law/guidance notes changes that specifically address the uniqueness of financial cooperatives.</p>	<p>PEARLS is a financial performance monitoring system designed to offer management guidance for credit unions and other savings institutions. The limitation of PEARLS is it uses strictly quantitative indicators while other models such as CAMELS uses quantitative and qualitative indicators (e.g., Management).</p> <p>Notwithstanding, the P in Pearls refers to Protection, which includes having 100% provisions for loan losses from loans that are greater than 12 months delinquent. We believe that the regulatory measure is aligned with this principle of applying sound judgment and analysis to the prospects of repayment.</p> <p>Also, the "A" in PEARLS relates to Asset Quality which is the key area of the proposed regulatory measures.</p> <p>The key issue for the regulatory measure is to promote better loan classification based on risks.</p>	<p>None.</p>
<p>General</p>	<p>As a very small financial institution any increased regulation or obligations can have a considerable impact on our resources.</p>	<p>Prior to implementing new regulatory measures, the Authority evaluates the cost-benefits of the measure. We promote regulatory measures that we feel are in the best interest of the jurisdiction.</p>	<p>None</p>

Regulatory Measure
Statement of Guidance: Credit Risk Classification, Provisioning and Management

Section	Industry Comment	Authority's response	Consequent amendments to the draft SOG
<p>3.1.1 A 'loan' is a financial asset resulting from the delivery of cash or other assets by a lender to a borrower in return for an obligation to repay on a specified date or dates, or on demand, usually with interest. Loans comprise:</p> <ul style="list-style-type: none"> a. consumer instalments, overdrafts and credit card loans; b. residential mortgages; c. non-personal loans, such as commercial mortgages, project finance, and loans to businesses, financial institutions, governments and their agencies; d. direct financing leases; and e. other financing arrangements that are, in substance, loans. 	<p>The term "loan" should be replaced with the broader term "credit" to better reflect the title.</p>	<p>We accept this recommendation.</p>	<p>Amend to read:</p> <p>3.1.1 A 'credit' is a financial asset resulting from the delivery of cash or other assets by a lender to a borrower in return for an obligation to repay on a specified date or dates, or on demand, usually with interest. Credits comprise:</p> <ul style="list-style-type: none"> a. consumer instalments, overdrafts and credit card loans; b. residential mortgages; c. non-personal loans, such as commercial mortgages, project finance, and loans to businesses, financial institutions, governments and their agencies; d. direct financing leases; and e. other financing arrangements that are, in substance, loans or credits.
<p>4.1.1 the provision of insights into the quality of a Credit Risk Holder's credit portfolio and its risk appetite at a point in time;</p>	<p>Consider whether the wording "risk appetite" should read "risk exposure" or similar.</p>	<p>This section should be read in the context of section 4.1, which speaks to the benefits of a credit risk asset classification system.</p>	<p>None</p>
<p>4.1.5 improving portfolio management, especially when</p>	<p>This section should be deleted from the SoG as this could</p>	<p>This section should be read in the context of section 4.1, which speaks</p>	<p>None</p>

<p>combined with applications that can identify degrees of risks associated with lending on an industry, geographic or counterparty basis.</p>	<p>potentially facilitate 'justifiable' or 'permitted' systematic discrimination based on geographic or counterparty bases.</p>	<p>to the benefits of a credit risk asset classification system. It is not guidance on how to lend.</p>	
<p>5.1.3 Connected parties should be classified on a group basis;</p>	<p>Clarification is needed for the term "connected parties" as well as how they should be grouped i.e. can one substandard contaminate other satisfactory or special mention assets if they are 'connected' in some way?</p>	<p>The Authority provides this definition in Rules on Large Exposures and Credit Risk Concentration for Banks as, "a group of connected counterparties means two or more individual counterparties whose exposures constitute a single exposure because the counterparties have: a) a group relationship; or b) a business interdependency that is so close that it cannot be quickly unwound and in which financial problems of one counterparty is likely to cause repayment difficulties for another counterparty within the group."</p> <p>Credit risk holders should have a global view of credits to a group of connected counterparties and should regard them as one collective exposure.</p>	<p>Add connected counterparties to definitions in the Rule and SOG.</p>
<p>5.1.4 A regular independent review function to provide assurances about the integrity of the classification process should be established (i.e. an internal audit, risk management or compliance function, and in some instances</p>	<p>The term "regular" should be clearly defined.</p>	<p>The Authority does not propose to define regular. The frequency of "regular" should be set by the board of directors in the context of the credit risk holder's risk and the risk of the portfolio.</p>	<p>None</p>

<p>the Credit Risk Holder may wish to engage the services of an independent external auditor to perform this function)</p>			
<p>5.1.7 a. Special Mention</p>	<p>CIMA should remain on par with members of the Caribbean Group of Banking Supervisors (CGBS) by stating a quantitative criteria and not remove the number of days past due but leave it as in the current <i>SOG: Credit Risk Asset Classification: section 4.1.7 a) special mention</i>, "Such loans may be current or may be in payment arrears or past maturity but for periods of less than 90 days." and "Any asset that is past due 60 days or more but less than 90 days should be classified as Special Mention, at a minimum."</p>	<p>The pace at which regulators update their respective measures will vary. These revisions are based on the 2012 Basel Core Principles changes.</p> <p>The definition of special mention used by Basel member countries, and members of the CGBS has remained consistent and CIMA is not proposing any changes. CIMA has sought to place the practical application of the guidance and the definition in better harmony by removing the quantitative ageing element. This harmony is meant to encourage better risk management and the establishment of early warning systems that would be helpful to the credit risk holder and the financial system.</p> <p>Special Mention is meant to identify potential areas of weaknesses that are yet to materialize. For example, if there was an outbreak of an epidemic that gave rise to a drastic drop in hotel occupancy rates, but there has been no actual loss or missed loan payments, this exposure to the hotel industry would be categorized as special mention. No provisions are required at this point because no loss is materialized. However</p>	<p>Time factors will be removed and a table of factors to consider will be provided. Please see Annex 1.</p>

		when the hotel has missed 89 days of payments, there is has been a clearly demonstrated occurrence of asset deterioration for which adverse classification and provisioning would be warranted.	
5.1.7 b. Substandard	CIMA should remain on par with members of the CGBS and maintain the range of <i>90 days or more in arrears but not less than 180 days</i> as stated in the current SOG. Reducing this range may result in licensees having to raise provisions for loans which have missed one payment or two payments i.e. loans which are delinquent but not non-performing. It is not unusual for customers to regularize these loans after missing these payments.	<p>The pace at which regulators update their respective measures will vary. These revisions are based on the 2012 Basel Core Principles changes made in response to the financial crisis of 2007 - 2009.</p> <p>The Authority is of the opinion that raising provisions for assets that are not performing according to contractual terms is not only appropriate but prudent.</p> <p>Additionally, section 10 of the SOG allows the use of management's judgment in determining provisions where historical loss experience or observable data may be limited or not fully relevant to current circumstances.</p>	Time factors will be removed from the definition and a guidance table will be provided as in Annex 1.
5.1.7 c. Doubtful	The range of <i>180 days or more but less than 360 days</i> as stated in the current SOG should remain. The basis for reducing this range is unclear.	While quantitative factors are useful, they are somewhat limited in comparison to multiple qualitative indicators in evaluating the risks that may be present.	Time factors will be removed from the definition and a guidance table will be provided as in Annex 1.
Section 12 Specific Provisions:	The SOG should indicate the benchmarks for provisioning instead of only indicating an example and align the	The application of an arbitrary percentage would not encourage prudent risk management. Provisions should be	None

	<p>"substandard" category with the range of <i>90 days or more in arrears but not less than 180 days</i> as stated in the current SOG.</p>	<p>based on the risk emanating from the facility and the level of expected loss.</p> <p>Credit risk holders are expected to document the rationale for provisions that are being held.</p>	
<p>6.1.2 Information on Credit Risk Holders' asset classification should be provided to the Authority on regular returns as required.</p>	<p>The Authority should clarify what frequency would be expected in the context of "regular returns".</p>	<p>Currently the Authority requires various prudential filings at quarterly, biannually or annually depending on the return.</p>	<p>None</p>

Annex 1

Credit Risk Asset Classification Considerations					
Evaluation Category	Satisfactory	Special Mention	Substandard	Doubtful	Loss
Sales/ Revenues	Sustained or improving	Deteriorating	Severe downturn	Severe downturn – prospects for turnaround in question	Prospects for turnaround unlikely
Earnings	Sustained	Losses or less than satisfactory profits with possibly a downward trend	Significant losses	Losses sustained for several periods	Losses sustained for several periods
Capital Position	Strong	Undercapitalized and overtrading or deteriorating capital position	Significantly undercapitalized	Strongly undercapitalized	Strongly undercapitalized
Cash flow from operations	Stable	Deteriorating, although still able to meet debt service	Seriously affecting ability to service debt	Unable to service debt	Unable to service debt
Debt servicing / financing	Undertaken easily	Unbalanced debt position and may have had or having difficulty obtaining financing	Little to no access to information about position. Renegotiated loans are classified as Substandard unless (i) all past due interest is paid in cash at the time of renegotiation, and (ii) a sustained record of performance under a realistic repayment program has been maintained for at least six months.	No access to information	No access to information
Management	Experienced	Inexperienced or weak or under scrutiny	Poor	Poor	Poor
Environmental Risk	Acceptable	Difficulty relating to environmental factors, economic conditions or adverse trends that may impair security values or jeopardize repayment capacity	Definable weakness identified	Serious liability identified	Serious liability identified
Credit Risk Holder Supervision Required	Normal	Close	Rigorous – to protect position	Likely a non-accrual advance	Likely a non-accrual advance
Security / Collateral Position	Not an issue	Good to strong but condition or control of collateral is deteriorating	Continues to protect, according possible avenue for recovery	Does not fully protect – loss possible	Does not fully protect and a provision is required
Sponsors / Guarantors	Quality, reputation and financial capacity strong	Commitment to support with known resources	Limited resources and commitment uncertain	Uncertain / Unlikely	No outside resources
Payment of Principal and Interest	Assured	Not currently at risk but the potential risk is greater than when the loan was originally granted	Repayment of principal and/or interest potentially at risk due to well defined weaknesses	At risk. Collection of the facility in full is improbable.	Not supportable