



# CAYMAN ISLANDS MONETARY AUTHORITY

[December 2018]

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## Rule

### Management of Credit Risk and Problem Assets

#### 1 STATEMENT OF OBJECTIVES

To set out the Cayman Islands Monetary Authority's (the "Authority") Rule on Credit Risk and Problem Asset Management (the "Rule"), pursuant to the Monetary Authority Law ("MAL").

#### 2 STATUTORY AUTHORITY

Section 34 of the MAL provides that the Authority may issue rules:

*34. (1) After private sector consultation and consultation with the Minister charged with responsibility for Financial Services, the Authority may –*

*(a) issue or amend rules or statements of principle or guidance concerning the conduct of licensees and their officers and employees, and any other persons to whom and to the extent that the regulatory laws may apply;*

- 2.1 This Rule must be read in conjunction with the Statement of Guidance ("SOG") on Credit Risk Classification, Provisioning and Management.

#### 3 SCOPE OF APPLICATION

- 3.1 This Rule applies to Credit Risk Holders as defined below including:
- Banks licensed under the Banks and Trust Companies Law
  - Credit unions established under the Cooperative Societies Law
  - Societies incorporated under the Building Societies Law
  - Development banks as established under the Development Bank Law

#### 4 DEFINITION

- 4.1 **Credit** is the provision of funds on agreed terms and conditions to a debtor who is obliged to repay the amount borrowed (together with interest thereon). Credit may be extended, on a secured or unsecured basis.
- 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 financial obligations to the Creditor. Credit risk may result from the following: on-



# CAYMAN ISLANDS MONETARY AUTHORITY

**[December 2018]**

---

balance sheet and off-balance sheet exposures, including, but not limited to, 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.
- 4.4 **Credit risk management** is the process of controlling the impact of credit risk-related events on the Credit Risk Holder. This management involves identifying, understanding, quantifying and monitoring the degree of potential loss and the consequent taking of appropriate measures and applying suitable controls designed to minimise the risk of loss to the Credit Risk Holder.
- 4.5 **Problem Asset** – an asset is defined as a problem asset when there is reason to believe that all amounts due, including principal and interest, will not be collected in accordance with the contractual terms of the agreement.

## 5 RULES

### 5.1 Establishment of a Credit Risk Management Framework

- 5.1.1 Credit Risk Holders must establish, implement, and maintain strategies, policies, and procedures for credit risk management appropriate for the size, complexity, and nature of their activities to create an appropriate **credit risk environment that:**
- a. Facilitates a sound credit-granting process
  - b. Measures, monitors and controls credit risk
  - c. Includes a reliable credit risk asset classification system
  - d. Identifies and manages problem assets
  - e. Establishes adequate provisions in a timely manner
  - f. Manages the use of risk mitigants
  - g. Includes adequate reporting to the Board
  - h. Accords with the applicable acceptable accounting framework, as necessary

### 5.2 Credit Risk Environment

- 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.
- 5.2.2 The board of directors must regularly review the strategies, policies and



# CAYMAN ISLANDS MONETARY AUTHORITY

## **[December 2018]**

---

procedures and direct changes as necessary, taking into account market and macroeconomic conditions.

- 5.2.3 The board of directors must ensure that the 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 adequate provisions for asset losses in accordance with the Credit Risk Holder's stated policies and procedures, the applicable accounting framework and supervisory guidance.
- 5.2.4 All strategies, policies and procedures must be documented and accessible to relevant parties. Relevant parties refer to those persons who are involved with executing functions or otherwise involved or associated with the functions and roles described in the strategies, policies and procedures.
- 5.2.5 Strategies and policies must clearly articulate the Credit Risk Holder's risk tolerance, including how much, and what types of risk it is prepared to undertake.
- 5.2.6 Senior Management must implement the strategy and framework set by the Board.

### **5.3 Sound Credit Granting Process**

- 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.
- 5.3.2 Credit Risk Holders must establish overall credit limits at the level of individual borrowers and counterparties, and groups of connected counterparties that aggregate in comparable and meaningful manner different types of exposures, both in the banking and trading book and on and off the balance sheet.
- 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. Policies and procedures that govern employee loans should be documented so that the terms and conditions for granting such loans are clear.
- 5.3.4 The Credit Risk Holder's policy must prescribe that the major credit risk



# CAYMAN ISLANDS MONETARY AUTHORITY

**[December 2018]**

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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 or a credit risk management function independent of the business lines with reporting and access to the Board.

- 5.3.5 Credit Risk Holders must have a clearly-established process in place for approving new credits as well as the amendment, renewal and re-financing of existing credits.

## **5.4 Measure, Monitor and Control Credit Risk**

- 5.4.1 Credit Risk Holders must have policies and processes to monitor the total indebtedness of entities to which they extend credit and any risk factors that may result in default including significant unhedged foreign exchange risk.
- 5.4.2 A Credit Risk Holder must take the necessary steps to measure, monitor and control credit risk derived from both on and off balance sheet assets.
- 5.4.3 Loans to which credit risk ratings are assigned should receive a periodic formal review (e.g. at least annually) to reasonably assure that those ratings are accurate and up to date. Credit risk ratings should be reviewed and updated whenever relevant new information is received.
- 5.4.4 Credit Risk Holders must include credit risk exposures in their stress testing programs for risk management purposes.

## **5.5 Credit Risk Asset Classification**

- 5.5.1 A Credit Risk Holder must have a system in place to reliably classify assets on the basis of credit risk. Asset classification should not prevent or unduly delay the recognition of problem assets or delay a Credit Risk Holder's provisioning.
- 5.5.2 Credit Risk Holders, at a minimum, must adversely classify assets when they are contractually in arrears. For portfolios of credit exposures with homogeneous characteristics, the exposures are classified when payments are contractually in arrears for a minimum number of days (e.g. 30, 60, 90 days).
- 5.5.3 As a minimum, asset classification systems must have the following categories:
- a. **Satisfactory**, where the asset is performing in accordance with the contractual terms and there is full expectation that the principal and interest will be collected in full;



# CAYMAN ISLANDS MONETARY AUTHORITY

**[December 2018]**

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- b. **Special Mention**, where a credit has potential weakness that deserve management's close attention. If left uncorrected, these potential weaknesses may, at some future date, result in the deterioration of the repayment prospects for the credit or the institution's credit positions. Special mention credits are not considered as part of the classified extensions of credit category and do not expose the Credit Risk Holder to sufficient risk to warrant classification;
  
- c. **Substandard**, where well identified and defined weaknesses are evident which could jeopardize repayment, particularly of interest. The Credit Risk Holder will sustain some loss if the deficiencies are not corrected. The credit is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged or guarantee(s) given, if any;
  
- d. **Doubtful**, where the situation has deteriorated to such a degree that collection of the facility amount in full is improbable and the licensee expects to sustain a loss; and
  
- e. **Loss**, where facilities are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the credit has absolutely no recovery or salvage value, but rather that it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be effected in the future.

## **5.6 Identifying and Managing Problem Assets**

- 5.6.1 An asset must be identified as a problem asset when there is reason to believe that all amounts due, including principal and interest, will not be collected in accordance with the contractual terms or as otherwise defined by applicable acceptable accounting standards.
  
- 5.6.2 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.
  
- 5.6.3 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 homogenous characteristics) and asset classification, provisioning and write-offs.
  
- 5.6.4 Credit Risk Holders must have organizational resources for the early identification of deteriorating assets, for ongoing oversight of problem assets, and for collecting on past due obligations.



# CAYMAN ISLANDS MONETARY AUTHORITY

**[December 2018]**

---

## **5.7 Determining Provisions**

- 5.7.1 Credit Risk Holders must have appropriate policies and processes to ensure that provisions and write-offs are timely and reflect realistic repayment and recovery expectations, taking into account market and macroeconomic conditions and past loss experience.
- 5.7.2 A Credit Risk Holder's aggregate amount of individual and collectively assessed asset loss provisions must be adequate to absorb estimated credit losses and consistent with the objectives of the applicable accounting framework.
- 5.7.3 Credit Risk Holders must have and retain adequate documentation to support the asset classification and provisioning levels. The rationale for the provisioning and classification must consider all relevant factors (e.g. loan history, macro-economic conditions, forward-looking information) and reasonable and supportable information.
- 5.7.4 The Credit Risk Holder must provide the Authority with full access to information concerning the classification of assets and provisioning in relevant detail, as requested from time to time.
- 5.7.5 Should the Credit Risk Holder use a model to assess and measure expected credit losses, the Credit Risk Holder must have policies and procedures in place to appropriately validate such models.

## **5.8 Use of Risk Mitigants**

- 5.8.1 Credit Risk Holders must have appropriate mechanisms in place for regularly assessing the value of risk mitigants, including guarantees, credit derivatives and collateral. The valuation of collateral reflects the net realizable value, taking into account prevailing market conditions.
- 5.8.2 Credit Risk Holders must periodically assess whether the types and volume of risk mitigants used pose a concentration risk and whether it is within the tolerance levels defined by the board of directors.

## **5.9 Disclosure to Board**

- 5.9.1 Credit Risk Holders are required to provide to their respective Board timely and appropriate information on the condition of their asset portfolio, including classification of assets, the level of provisions and reserves and major problem assets.
- 5.9.2 The information includes, at a minimum, summary results of the latest asset



# CAYMAN ISLANDS MONETARY AUTHORITY

**[December 2018]**

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review process, comparative trends in the overall quality of problem assets, and measurements of existing or anticipated deterioration in asset quality and losses expected to be incurred.

## **5.10 Prohibition on Purchase or Allocation of Adversely Classified Assets**

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:

- a. Single or cumulative acquisition of adversely classified assets which would represent 10% of the purchaser's total assets or 10% of capital;
- b. Single or cumulative acquisition of adversely classified assets that would cause the purchaser's adversely classified assets to exceed the lesser of 10% of total assets or 10% of eligible capital.

## **5.11 Refinancing and Rescheduling**

5.11.1 If assets are refinanced or rescheduled, Credit Risk holders must consider the adequacy of provisioning and the appropriateness of the classification status.

## **5.12 Reclassification**

5.12.1 A problem asset can only be reclassified as performing when:

- a. All arrears have been cleared and the loan has been brought fully current;
- b. Repayments have been made in a timely manner over a continuous repayment period of not less than 6 months; and
- c. Continued collection, in accordance with the contractual terms, is expected.

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.

5.12.3 Credit Risk Holders must support upgraded reclassifications with demonstrated improvements in credit risk. That is, upgrades should be supported with evidence that the borrower's capacity to repay and financial condition have substantially improved.

## **5.13 Write offs**

5.13.1 Assets classified as Loss must be fully written off within 90 calendar days.



# CAYMAN ISLANDS MONETARY AUTHORITY

**[December 2018]**

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## **6 ENFORCEMENT**

- 6.1 Whenever there has been a breach of the Rules, the Authority's regulatory policies and procedures as contained in its Enforcement Manual will apply, in addition to any other powers provided in the Banks and Trust Companies Law, Building Societies Law, Cooperative Societies Law and the Development Bank Law, where applicable, and the MAL, as amended.