Cayman Monetary Regulatory Authority International

At the forefront of financial regulation, the Cayman Monetary Regulatory Authority International (CMRAI) is dedicated to upholding the highest standards of financial oversight and compliance. Our mission is to safeguard the stability and integrity of the global financial system by ensuring that financial services operate within a framework of transparency, accountability, and excellence.

As a trusted partner to financial institutions worldwide, CMRAI provides rigorous supervision, innovative solutions, and strategic guidance to foster a secure and thriving financial environment. With decades of experience and a commitment to global standards, we stand as a pillar of trust and security in an ever-evolving financial landscape.

With a legacy of excellence in financial oversight, the Cayman Monetary Regulatory Authority International (CMRAI) is a beacon of trust in the international financial community. Our role extends beyond regulation; we are innovators, collaborators, and protectors of the global financial ecosystem. By fostering compliance, promoting best practices, and embracing technological advancements, CMRAI ensures that financial services remain resilient and adaptable in a dynamic global market.

Our comprehensive approach to regulation encompasses a deep understanding of financial risks and a proactive stance on emerging challenges. We are committed to empowering financial institutions with the tools and guidance necessary to navigate complex regulatory landscapes, thereby contributing to global economic stability and growth.

1 Cayman Monetary Regulatory Authority International PRIVATE SECTOR CONSULTATION RULE MANAGEMENT OF CREDIT RISK AND PROBLEM ASSETS STATEMENT OF GUIDANCE - CREDIT RISK CLASSIFICATION, PROVISIONING AND MANAGEMENT A. Introduction 1. Section 34(1)(a) of the Monetary Authority Law (2018 Revision) (MAL) states that After private sector consultation and consultation with the Financial Secretary, 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. Requirements specific to the private sector consultation are outlined in section 4(1) of the MAL as follows: When this Law requires private sector consultation in relation to a proposed measure (a) the Authority shall give to each private sector association a draft of the proposed measure, together with i. an explanation of the purpose of the proposed measure; ii. an explanation of the Authority s reasons for believing that the proposed measure is compatible with the Authority s functions and duties under section 6; iii. an explanation of the extent to which a corresponding measure has been adopted in a country or territory outside the Islands; iv. an estimate of any significant costs of the proposed measure, together with an analysis of the benefits that will arise if the proposed measure is adopted; and v. notice that representations about the proposed measure may be made to the Authority within a period specified in the notice (not being less than thirty days or such shorter period as may be permitted by subsection (3));and 2 (b) before proceeding with the proposed measure, the Authority shall have regard to any representations made by the private sector associations, and shall give a written response, which shall be copied to all the private sector associations. 3. The Cayman Islands Monetary Authority (Authority or CMRAI) seeks consultation and comment from the private sector associations concerning revisions to the following: a. Rule Management of Credit Risk and Problem Assets b. Statement of Guidance -- Credit Risk Classification, Provisioning and Management 4. The revised Rule and SOG (tracked) are attached as Appendices 1 and 2. B. Background 5. In March 2015 the Authority revised and consolidated its credit risk related measures mainly as a result of changes in Basel Core Principles and CMRAI identified gaps in respect of credit risk and provisioning for problem assets. The said measures were revised in such a way as to allow entities the scope to move toward the development of credit risk asset classification systems that are consistent with the nature, size and complexity of the credit risk holders activities and to move away from a more prescriptive approach (i.e. number of delinquent days). The scope of application for the Rule and SOG are: a. Banks licensed under the Banks and Trust Companies Law b. Credit Unions established under the Cooperative Societies Law c. Societies incorporated under the Building Societies Law d. Development banks as established under the Development Bank Law 6. In 2014 the International Accounting Standards Board (IASB) commenced the process of replacing the International Accounting Standard (IAS) 39 with the International Financial Reporting Standards 9 (IFRS 9). The IFRS 9 brings with it a move away from incurred loss approaches to the expected credit loss (ECL) 1 concept as well as certain changes to the classification and measurement requirements for financial assets. The IFRS 9 took effect on 1 January 2018 with early application permitted. IFRS 9 is mandatory for those banks that are governed by IASB. In addition to the IASB s efforts, the United States Financial Accounting Standards Board (FASB) adopted accounting standards which also introduces the expected credit loss methodology referred to under FASB as

Current Expected Credit Loss (CECL) which is anticipated to take effect January 2020 for banks that are public companies. 2 7. While there is some level of convergence between the IASB and FASB s efforts to move toward the expected credit loss approach to credit risk management and provisioning, there is also some divergence in each standard s approach. The variances under IASB and FASB make ECL accounting related changes to the relevant CMRAI measures somewhat

1 Expected credit loss (ECL) is the weighted average of credit losses with the respective risks of a default occurring as the weights (source: IFRS). 2 All other banks will take effect in 2021 with early application permitted for all banks in 2019. 3

challenging given that (1) Some CMRAI regulated entities follow IFRS 9 and others that follow FASB s US GAAP and (2) the coming into effect of the changes are a few years apart. Of note also, the Basel Committee on Banking Supervision (BCBS) has offered a transitional approach to be applied to new provisions of those Banks that anticipate a reduction in their capital ratios as a result of implementing IFRS 9 and given that the BCBS has not concluded on the interaction between ECL accounting and the prudential regime. While the proposed revisions to the Rule and SOG will not themselves present a transitional approach to be applied, the Authority is cognizant of the impact in terms of the capital shock that is logically expected with ECL accounting, therefore the Authority will issue a Circular to address this matter separately for those IFRS 9 related entities. 8. The most commonly followed standards by qualified accountants and accounting firms with respect to CMRAI regulated banks are the IFRS and United States Generally Accepted Accounting Principles (US GAAP) 3 . It was therefore imperative that CMRAI considered its measures relating to credit risk and provisioning to ensure that they do not conflict with or contradict the essence of IFRS 9 and the impending US GAAP changes as well as any related Basel Committee standard or guidance. 9. Additionally, during 2017 the Authority noted that the SOG had two definitions for non-performing assets which led to inconsistencies in the reported non- performing loan (NPL) ratio. It was deemed prudent for the SOG and Rule to be updated to ensure that the terminology and definitions used throughout the documents are consistent and that they are aligned with international best practice, specifically relating to non-performing assets and asset classification systems. 10. The proposed revisions to the Rule and SOG paper serve to ensure that CMRAI s credit risk and provisioning measures are aligned, where necessary, with international best practice and are not incompatible with IFRS 9 in such a way as to cause contravention of one or the other. C. Purpose of Proposed Measure and Consistency with the Authority s Functions 11. Section 6(1) of the MAL provides that the principal responsibilities of the Authority include its regulatory functions, inter alia, to regulate and supervise financial services business carried on in or from within the Islands ... 12. Section 6(3) of the MAL provides that in performing its regulatory functions, the Authority shall, inter alia: a. endeavour to promote and enhance market confidence and the reputation of the Islands as a financial centre; b. recognise the international character of financial services and markets and the necessity of maintaining the competitive position of the

3 Approximately 95% of Cayman banks are governed by IASB or US GAAP. The Brazil and Japanese GAAPs are some others that are used. . Of the entities that are required to submit financial statements to the Authority approximately 70% are governed by IASB according to submissions received. 4

Islands, vis a vis both consumers and suppliers of financial services, while conforming to internationally applied standards insofar as they are relevant and appropriate to the circumstances of the Islands; c. recognise the principle that a burden or restriction which is imposed on a person or activity should be proportionate to the benefits, considered in general terms; and d. recognise the desirability of facilitating innovation in financial services business. 13. The proposed changes to the Rule and SOG will ultimately further the regulatory function of the Authority in line with Sections 6(1) and 6(3) of the MAL, as stated above. 14. The measures were reviewed generally in relation to the implementation of the IASB and FASB expected credit loss approaches from a regulatory standpoint to ensure that the Authority s credit related measures would not contradict the ECL frameworks that some Cayman entities would be complying with for accounting purposes. 15. Generally, it was found that the relevant CMRAI measures do not conflict significantly with the IASB and FASB approaches and would not hinder the implementation of said standards. However, there were a number of points that were considered for revision in order to ensure clarity where the language used could possibly lead to uncertainty. The decision to revise the measures presented an opportunity to revisit a few items that would provide more clarity to institutions and offer a more realistic and pragmatic approach to certain aspects of an institution s credit risk management. 16. The proposed changes do not to introduce any new requirements but simply revise or introduce language as necessary to avoid incompatibility between CMRAI s requirements and the IFRS 9 accounting standard. CMRAI does not regulate or direct entities in respect of which accounting standard to operate under, it would therefore be inappropriate for the Authority to introduce or stipulate regulatory requirements per a specific set of accounting standards. 17. Both the Rule and SOG have been updated to ensure consistency throughout with respect to all terminology and definitions. The more substantial (but not complete list) changes made to the measures are noted below: a. Rule i. The definition of a non-performing asset has been revised to ensure that it is better aligned with international best practice. ii. Section 5.13.2 (of the current Rule) has been deleted based on the BSD s experience that banks are not always able to reclassify an exposure from Doubtful to Substandard or Loss within six months as there is a level of impracticability considering that pending mitigating factors for certain types of exposures (e.g. residential mortgages) may take longer to occur. 5 iii. Clarification that asset classification should not prevent or unduly delay the recognition of problem assets or delay a Credit Risk Holder s 4 provisioning. iv. Rationale for classification and provision must include all relevant information, including forward-looking information, which is reasonable and supportable. v. Reclassifications must be supported by demonstrated improvements in credit risk. b. SOG i. The guidance in respect of the doubtful classification has been enhanced to ensure that institutions appropriately monitor exposures and ensure that they can act based on the circumstances at hand. ii. The Authority may use its discretion with respect to provisioning in certain instances, such as if the level of provisions estimated is deemed inadequate. iii. The estimation of specific provisions should be in accordance with the applicable accounting standard followed by the Credit Risk Holder. iv. Policies and procedures for the appropriate validation of any models that are used to assess and measure expected credit losses should be included. v. Insertions of key instances when relevant acceptable accounting standards should be considered. vi. Clarity on the use of alternative asset classification systems. vii. Necessity of reassessments of Doubtful classification as reclassification to Loss may be warranted. viii. Explicit inclusion of monitoring in credit risk management. 18. The revisions to the Rule and SOG will help ensure that (1) entities that are required to adhere to IFRS 9 will not be in conflict with the relevant CMRAI measures, (2) those entities that are governed by IASB will not have unfair requirements that contradict their applicable accounting standards, (3) the inconsistent treatment of non-performing assets across banks is reduced and (4) there is closer alignment with guidance issued by the BCBS. D. Implementation in Other Jurisdictions 19. Major jurisdictions like Canada and the European Union have moved toward IFRS. The Office of the Superintendent of Financial Institutions in Canada revised or replaced and consolidated seven measures into a single IFRS 9 Financial Instruments and Disclosures guideline. The European Union (EU) adopted IFRS 9 in November 2016. Further, the European Banking Authority published Guidelines on credit institutions' credit risk management practices and accounting for expected credit losses in 2017 as part of its work on the implementation of IFRS 9. While the Authority looked at these jurisdictions, 4 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 (source: Rule). 6 the focus was on those that are similar to the Cayman Islands in that they do not have their own accounting standards. Bermuda 20. The Bermuda Monetary Authority (BMA) does not appear to have revised its policy guidance on the Management and Control of Credit Risks and the Implementation of the Statutory Provisions for Large Exposures that was issued in 2007. However, the BMA did insert a section entitled Regulatory Treatment of Accounting Provisions Transitional Arrangements & Interim Approach in its BASEL III for Bermuda Banks November 2017 Rule update. The transitional arrangement offered by the Bermuda Monetary Authority (BMA) is not mandatory but is instead based on the decision of each individual bank s Board and a transitional arrangement will be made available by the BMA upon the written request. Bahamas 21. The Central Bank of the Bahamas does not appear to have revised its Guidelines for the Management of Credit Risk as a result of IFRS 9. However, Rule 7 of the Public Accountants (Rules of Professional Conduct) Regulations, 1993 (adopted under the Public Accountants Act, 1991) requires compliance with IFRS standards unless the Bahamas Institute of Chartered Accountants (BICA) has specifically excluded a particular IFRS Standard. According to BICA has never excluded an IFRS standard. . BVI 22. No changes to the BVI Financial Services Commission s credit risk related measures noted as a result of IFRS 9 or FASB s CECL. In fact, the Virgin Islands Regulatory Code (2009) in the BVI still references IAS 39. 23. Notwithstanding whatever approach is/was taken in other jurisdictions, CMRAI does not regulate or direct entities in respect of which accounting standard to operate under. Also, CMRAI supervises entities that will have to implement IFRS 9 therefore, if the relevant measures are severely out of alignment with the IFRS 9 ECL (and FASB CECL) methodologies, this could result in onerous requirements for relevant banks if they have to adhere to two significantly different set of requirements (accounting standard vs regulatory requirements). E. Significant Costs and Benefits 24. The table below shows the estimated costs (including possible risks if the measures are not revised) and benefits relating to the revised measures. Table 1 -- Cost/Risk to Benefits Costs/Risks Benefits The Authority The Authority will incur the usual Administrative costs associated with conducting industry Enhance and support regulatory processes, in particular reporting and analysis. 7 Costs/Risks Benefits consultation, publication, amending CMRAI s supervisory manuals and staff training. These costs are not deemed to be overly burdensome and represent usual costs of the Authority carrying out its mandate. Closer alignment with International Standards (e.g. the BCBS Guidance on credit risk and accounting for expected credit losses and its Guidelines on the Prudential treatment of problem assets definitions of non-performing exposures and forbearance). Further enhance the Authority s risk based approach to its supervision given that the Authority will review and assess each entity s specific asset classification system, amount of provisioning and the rationale applied including all relevant factors (e.g. loan history, macro-economic conditions, forward-looking information). With more consistency across banks regarding the classification of non- performing exposures, CMRAI will possess more consistent data regarding banks non-performing assets. Closer alignment with accounting standards will help avoid any contradictions between the Authority s requirements and those of accounting standards. A combination of the above may result in less future human resource burden/constraints with fewer queries pertaining to likely conflicts between accounting and supervisory requirements. Cayman Islands There are no costs to the jurisdiction as a whole with the revisions made to the Rule and SOG. If the revisions are not made to the Rule and SOG international standard setters may assess the country negatively against the relevant guidance issued possibly resulting in reputational harm. The enhancements in terms of the use of more forward looking information relating to classification and provisioning will holistically promote a more efficient, stable and resilient financial market which is less susceptible to failures. Will promote more prudent risk based approach to risk assessments and provisioning which will extend to widespread financial and 8 Costs/Risks Benefits economic stability. Improve results of future assessments by international standard setters given closer alignment to BCBS issued guidance. Banks No significant cost to licensees falling with the scope of the Rules as the previous version of the Rule and SOG should already see them applying a forward looking approach in any event. Every entity applying IFRS standards should have already re-evaluated several areas including accounting policies and disclosures and make appropriate changes to systems and internal controls. Will help ensure there is more consistency across banks regarding the classification of non-performing exposures. The changes allow for more clarity and are in keeping with the IFRS 9 accounting standard. The changes will allow sufficient flexibility for those entities applying IFRS 9 to still be able to comply with the Authority s measures. Minimum disruptions to banks with their application of IFRS 9 or FASB s CECL. The language used is sufficiently flexible to also allow other non-IFRS entities to continue to operate with little disruption especially given that the previous versions of the Rule and SOG as well as US GAAP is also moving toward a forward looking approach to asset classification, credit loss and provisioning. Increase certainty for off and on- site inspections. Summary Consequent on the above, it is determined that benefits far outweigh costs and the revisions to the Rule and SOG should proceed. F. Comments and Consultation 2. The Authority seeks consultation through written comments and representations from the private sector associations concerning the revised a. Rule - Management of Credit Risk and Problem Assets; and b. Statement of Guidance - Credit Risk Classification, Provisioning and Management 3. The Authority must receive representations by 1700hrs on June 25, 2018. 4. Comments and representations must be addressed to The Managing Director Cayman Monetary Regulatory Authority International 9 P.O. Box 10052 80e Shedden Road Elizabethan Square Grand Cayman KY1-1001

Cayman Islands : 345-949-7089 Fax: 345-946-5611 : and copied to 5. The Authority shall have due regard to any representation made by the private sector associations and industry stakeholders. The Authority shall provide a written response collating the feedback received and the Authority s position on this feedback. This response shall be copied to all relevant private sector associations only.