Thematic Credit Review Report

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1.0 Introduction & Scope

In early 2020, the COVID-19 pandemic was declared and countries across the world experienced and continue to go through unprecedented times which have generated significant instability and high volatility in global markets including the Banking Industry. One area that has been significantly affected by the pandemic is credit risk. It is against this backdrop that the Cayman Islands Monetary Authority (the "Authority") conducted a thematic credit review (the "Thematic Credit Review") of nine financial institutions (the "Selected Lending Institutions" or "SLIs") from 18 March 2021 to 30 June 2021.

The objectives of the Thematic Credit Review were to:

a) assess the credit policies and procedures, corporate governance structure and internal control environment of the Selected Lending Institutions, in particular regarding loans and advances, in order to ascertain compliance with the Monetary Authority Act (2020 Revision) (the "MAA"), the Bank and Trust Companies Act (2020 Revision) (the "BTCA") where applicable, the Cooperative Societies Act (2020 Revision) (the "CSA") where applicable, the Rule on Management of Credit Risk and Problem Assets (the "Rule"), the Rules on Large Exposures and Credit Risk Concentration for Banks (the "Rules on Large Exposures"), the Statement of Guidance on Credit Risk Classification, Provisioning and Management (the "SOG on Credit Risk"), the Statement of Guidance on Large Exposures and Credit Risk Concentration for Banks as well as other applicable legislations and accepted standards of best practice

b) assess the impact of COVID-19 on the loan portfolios of the participating financial institutions and to understand the nature of concessions granted to customers as well as risk mitigation measures

c) identify themes in implementation of credit risk management frameworks across peer institutions supervised by the Authority

In order to achieve the stated objectives, the Thematic Credit Review focused specifically on an assessment of:

a) The impact of COVID-19 on the credit portfolio
b) The adequacy of the credit risk management policies and procedures
c) The adequacy of the credit rating methodology adopted by the Selected Lending Institutions compared to the minimum requirements established under the Rule
d) The adequacy of credit loss provisions

e) The effectiveness of the credit review and monitoring processes for early detection and management of problem loans
f) The adequacy of corporate governance processes over credit

The following key areas or components of credit were out of scope for the Thematic Credit Review:

a) Loan origination/underwriting
b) Collateral Management
c) Implementation of Expected Credit Losses ("ECL") models per International Financial Reporting Standard (IFRS) 9 and Current Expected Credit Loss ("CECL") models per ASC 326 and the assumptions used for such provision models
d) Forms of credit other than loans and advances
e) Off-balance sheet credit exposures
f) Write-off of uncollectible credits

In some instances, documentary evidence relating to these areas of credit that were not in scope was obtained in order to make appropriate conclusions for specific customer files tested.

This Thematic Credit Review Report (the "Report") highlights the general themes observed across the Selected Lending Institutions including the good practices as well as highlights the areas of concerns. Through bilateral communication, the Authority has outlined to each participating SLI the deficiencies identified as well as the requirements in order to enhance the SLI's credit risk management framework.

From the Thematic Credit Review, good practices and/or areas of concerns were identified in the following areas:

a) Credit administration including credit ratings and ongoing monitoring
b) Loan loss provisioning
c) Write-off of uncollectible credits
d) Restructuring and reclassification of credit facilities
e) Credit controls and internal audit
f) Collateral management.

2.0 Impact of COVID-19

The Authority noted that the Cayman Islands loan books have been generally resilient through the pandemic for the Selected Lending Institutions; and where SLIs are part of groups with presence in the Caribbean region, it was observed that the best outcome was seen in the

Cayman Islands. Some of the institutions attributed the resilience of their loan books to the robustness of underwriting practices as well as diversification efforts that were already in place as part of the institutions' ongoing preparedness for hurricanes and other weather-related events in the Cayman Islands.

The resilience as noted from the loan books was also attributable to the successful efforts by the Cayman Islands Government to control the spread of the virus through 2020 which helped the economy to quickly stabilize after the initial shock. With the borders remaining closed, the resilience of the Cayman Islands economy was supported by:

a) Existence of a robust financial services sector which has significantly expanded in recent years partly because of opportunities created by changes in regulations such as the Private Funds Act
b) Introduction of the "Global Citizen Concierge Program" to attract financially independent persons to live in Cayman while working remotely for up to 2 years
c) Global high net worth individuals buying luxurious real estate in a largely COVID-19 free Caribbean island

The above factors have occasioned an increase in demand for housing over recent years which has resulted in a construction boom. From discussions with the management of the retail Selected Lending Institutions, the Authority was informed that the pre-construction agreements signed between the customers and the property developers before the pandemic proceeded to close at the same values at completion despite the pandemic. The property values have continued to trend upwards.

The most adversely impacted sectors in the Cayman Islands were tourism, hospitality, and transport sectors. Generally, the SLIs were well diversified with no significant concentration in these sectors. The borrowers from these impacted sectors were granted concessions through payment moratoria for a significant portion of 2020 as encouraged by the Cayman Islands Government. With the continuing adverse impact of the pandemic to these sectors, the SLIs have entered into repayment arrangements with the customers; for example, through restructuring the debt facilities. The customers have also taken necessary steps to comply with the new terms. For instance, the Authority noted instances where tours and car hire businesses downsized their older fleets, thus enabling them to service the interest on their loans. Hotels reduced their staff complement and used the low period to undertake needed renovations on their facilities. Foreclosures were temporarily halted by retail SLIs at the onset of the pandemic.

In March/April 2020, all the SLIs financing the domestic retail segment granted waivers to their customers but the approaches were varied, with some granting blanket waivers and others, on a case-by-case basis to customers most impacted by the pandemic. The Authority

notes that there was insufficient education by the lending institutions to the customers on the long-term financial impact of these concessions. Sufficient information would have enabled the customers to make informed decisions and those that didn't necessarily need the waiver to opt-out if they considered the terms unfavourable to them. Understandably, the Cayman Islands and the world generally was going through unchartered territory at the time and the institutions were challenged to remain operational in a remote working environment. Institutions should develop, implement, and maintain mechanisms of clearly communicating the terms and implications of waiving loan payments and how these decisions will impact customers. This information should be disseminated to the customers prior to granting loan payment waivers, should the institutions be faced by a similar situation in the future.

In response to COVID-19, some institutions made temporary adjustments to their risk appetite. Some adopted more conservative lending and underwriting practices while others restricted lending to tourism and other significantly impacted sectors.

Summary of good practices:

i. Prompt review of the risk appetite in response to a crisis
ii. Well diversified portfolios in terms of product, geography, collateral etc.
iii. Granting concessions only to customers whose facilities are current and on a case-by-case basis based on demonstrable need
iv. Effective business continuity plans
v. Striking a balance between supporting customers and credit risk management

Summary of areas for improvement:

i. Need for prior education to the public on the long-term financial impact of concessions
ii. Granting waivers to customers whose facilities were not current without appropriately classifying the facilities mask the true asset quality of the portfolio
iii. Blanket waivers which do not consider customer specific circumstances e.g. extension of credit period past the retirement date
iv. Need for preparedness for handling a similar situation should it occur e.g. enhancements to record keeping of engagement with customers

3.0 Findings From The Thematic Credit Review

3.1 CORPORATE GOVERNANCE

3.1.1 Board involvement

The Board of Directors is responsible for determining the institution's credit risk appetite and strategy. Some of the Selected Lending Institutions have separate credit risk board committees while for others, the full board provides oversight and direction to the credit risk management team.

The Authority noted that credit risk management was covered in the board packs and that the packs were sent to the directors at least one (1) week in advance of the board meetings (which were held, in most cases, quarterly). The Authority noted that the credit risk component of the board packs was in most cases sufficiently comprehensive including: delinquency trends, high risk accounts, loans requiring board approval based on the delegated limits, level of provisions, concentration per product, geography, sectors and collateral, large exposures, other exceptions, and results of any internal audit reviews, inter alia.

For most institutions the risk appetite is set and approved by the board annually. The board also approves temporary deviations from the risk appetite during quarterly meetings.

3.1.2 Policies and procedures

The credit policies and procedures for the SLIs were in most cases comprehensive and addressed underwriting procedures for different product types, credit approval limits, credit ratings/grading, connected parties and group exposures guidelines, credit ratios (loan to value and debt service coverage ratios), restructuring, reclassification, watch listing, valuation of collateral, indicators of deterioration, provisioning and write-offs of uncollectible exposures. However, most of the policies and procedures did not include the exposure limits per products.

The Selected Lending Institutions have implemented delegated approval limits for varying loan thresholds. Assessment of adherence to these limits was out of scope for the review.

Summary of good practices:

i. Comprehensive board packs covering key aspects of credit risk management
ii. Sufficient time allowed for the board members to review the board packs ahead of the meetings
iii. Clear documentation of policies and procedures for credit risk management approved by the board or authorized board committee

iv. Well documented delegated lending authority for varying loan thresholds and loan types

Summary of areas for improvement:

i. Need for enhancements to the policies and procedures for some SLIs where they were noted to be incomplete or not sufficiently comprehensive
ii. Lack of documented concentration limits per product type, collateral type

3.2 CREDIT ADMINISTRATION

3.2.1 Risk Rating of Credit Facilities

Categorization of assets on a continuous basis is an integral part to the monitoring and management of credit risk. The Rule and SOG on Credit Risk establishes five (5) minimum categories of credit risk asset classification.

The Authority expects the institutions to consider both objective/quantitative criteria (such as number of days past due) and subjective/qualitative criteria (such as existence of financial difficulty or other weaknesses). The qualitative criteria, which is considered ex-ante, may necessitate a downgrade of a credit facility before a default has materialized which gives an institution the opportunity to take the necessary steps in advance to stem or limit the losses.

The Authority noted instances where the SLIs failed to categorize loans that have evidence of weakness or deterioration as non-performing where they consider the quality of collateral held to be sufficient. Collateralization should play no direct role in categorization of credit facilities, instead, collateral should be considered, alongside other factors while assessing whether the borrower is likely to pay.

Some of the SLIs had a credit risk asset classification methodology that differentiates credit facilities at origination based on the product risk for instance secured versus unsecured facilities, fully amortizing versus revolving and committed versus uncommitted.

Retail Portfolio

For most of the SLIs, the retail portfolio is comprised of loans to individuals and small businesses. The SLIs that offer retail lending had a material retail portfolio in aggregate, in some cases, significantly larger than the corporate loans segment.

It is generally acceptable to classify retail credit facilities based on repayment performance. However, where an institution becomes aware of loss or a material deteriorating event e.g. death of a customer, bankruptcy, fraud loans etc., the facilities should be immediately

classified irrespective of the current delinquency status unless if the institution can sufficiently demonstrate and document that repayment is likely to occur.

The Authority noted that the majority of the SLIs only assign a credit rating to retail customers at onboarding and these ratings are not updated to reflect the repayment performance and changing credit profile of the customer and in some cases, no ratings were assigned at all. On the other hand, two of the SLIs implemented a credit risk asset classification system which would downgrade a customer based on repayment performance (number of days in arrears). For one institution, the Authority noted evidence of consideration of qualitative indicators in the classification of retail customers when the institution became aware of weaknesses even though the facilities were not contractually in arrears.

The Authority noted that for some SLIs, where a retail customer has numerous facilities, if one facility was classified as non-performing, the other facilities were also downgraded irrespective of performance. This ensures that the SLI is monitoring the entire relationship. The Authority noted that two SLIs did not adopt the same approach for retail customers, instead, only the credit facility in default was classified. The Authority considered the recommendation by Basel Committee on Banking Supervision as per the Guidelines for Prudential Treatment of Problem Assets as best practice in this scenario and therefore has no objection to the classification at facility level for retail portfolio. However, the Authority requires the supervised institutions to ensure that while assessing the status of any specific retail facility, all the other exposures to the same borrower are considered. In the event the assessment of the borrower indicates the existence of financial difficulty, all the other retail facilities should be downgraded even if they are less than ninety (90) days in arrears.

Corporate Customers

The corporate exposures are assessed at the counterparty level. Where one material exposure is non-performing, the institutions are expected to consider all the exposures to that counterparty as non-performing. The institutions are expected to classify connected parties on a group basis. However, in some instances, the SLIs did not consider personal loans to the ultimate beneficial owners ("UBOs") or directors of such corporate customers while undertaking the periodic reviews.

Generally, the corporate portfolio was subject to annual reviews and reassessment of the credit ratings (except for one SLI which did not update the credit ratings assigned at onboarding for both the retail and corporate portfolio). More frequent interim reviews were conducted for large exposures, watch listed accounts and those cases where material deterioration was identified.

Summary of good practices:

i. Robust customer assessment tools at onboarding
ii. Annual reviews and proper risk classification of corporate customers, including utilization of dual rating system by one of the SLIs which considers both a borrower's score and a facility score

Summary of areas for improvement:

i. Failure to implement a credit risk asset classification methodology for all credit customers which reflects repayment performance of the customer and other indicators of deterioration
ii. Failure to consider qualitative indicators in categorization of credits
iii. Failure to appropriately categorize non-performing exposures due to the quality of collateral held
iv. Failure to consider the personal facilities of the UBOs and directors in the periodic credit reviews for corporate customers
v. Failure to document how the SLIs credit risk asset classification methodology map into the ratings as per the Rule and the SOG on credit

3.2.2 Ongoing monitoring

The SLIs have implemented various tools for early detection of warning signs. The use of technology has improved the ability of the institutions to assess the customers' risk profile during origination and to monitor credit facilities as well as the collateral/risk mitigants. The SLIs have designated special units to oversee management of non-performing facilities through early engagement with customers, recovery by sale of collateral or where appropriate, restructure of the facilities to align to customers' financial ability and willingness to repay.

Retail Portfolio

Except for two SLIs which have implemented a policy on periodic review for retail facilities based on a specified threshold, the other SLIs have not implemented any periodic reviews for retail customers, instead, this portfolio is solely managed through delinquencies. The Authority notes that the two SLIs that have implemented a threshold based periodic review for the retail portfolio have a relatively smaller credit portfolio compared to the other SLIs. The retail portfolio typically consists of a large number of loans with relatively homogenous and smaller-value loans (per customer) which renders it inefficient and burdensome to review

the portfolio on a loan by loan basis and therefore management of retail portfolio based on repayment performance is consistent with industry practice.

In the absence of periodic reviews and updated information for retail portfolio, there is need for prudent credit administration otherwise the lending institutions may be exposed to significant losses. This is especially important considering that the retail portfolio is susceptible to broad economic issues such as unemployment, interest rate changes and other systemic factors. Therefore, there is need to build loss rates associated with this portfolio more reliably into their pricing. Systems for prompt identification of early-stage delinquency signs or increase in utilization rates for revolving credit is essential.

Corporate portfolio

For most of the SLIs, corporate loans are placed on a watch list once the SLI becomes aware of situations that could lead to potential weaknesses in the customers' future cash flow. The policies and procedures included early warning indicators that would trigger a review of customer accounts and based on further review, an assessment on whether the account should be included in a watch list for constant monitoring. For most of the SLIs, loans on the watchlist were often closely monitored, in most cases, monthly. Additionally, these loans are reviewed by Credit Risk Management and reported the Board of Directors.

The Authority noted instances where some corporate loans that are supposed to be reviewed annually were not reviewed timely.

Summary of good practices:

i. Early identification of indicators of deterioration, adding to watch list and taking early steps to minimize loss
ii. Robust management of credits at early, mid or late delinquency stages

Summary of areas for improvement:

i. Though required as per the policies and procedures, some SLIs did not conduct timely annual review for the corporate customer accounts
ii. Using days in arrears as the only criteria for adding accounts on watch list without considering qualitative factors
iii. Absence of oversight by an independent risk function in the addition or removal of accounts from the watch list

3.2.3 Concentration risk

The institutions are expected to be alert to concentrations with regard to products, business lines, geography, collateral and legal entities (large exposures) that can significantly elevate risk. All the SLIs that are operating under a banking licence issued by the Authority were aware of the requirements under the Rule on Large Exposures. These include disclosure of any exposure to any individual counterparty or Group of connected counterparties that exceed 10% of a bank's capital base and to seek the Authority's prior approval for any exposure that exceeds 25%. Also, the total of all exposures to related counterparties must not exceed 25% of a bank's capital base and the aggregate of all large exposures should not exceed 800% of a bank's capital base.

Since most of the SLIs are materially concentrated in the Cayman Islands, the institutions have implemented various approaches to minimize the risk including limiting exposures to any single major project including by use of syndicated loans for material undertakings within the Islands, monitoring concentration of collateral in any one area, diversifying acceptable forms of collateral, sizable overseas trading book, and participating in opportunities in other regions coordinated through the parent companies, among other approaches.

Summary of good practices:

i. Adherence to the requirements as per Rule and SOG on Large Exposures
ii. Establishment of concentration limits which ensure the credit portfolios are well diversified
iii. Limit monitoring through periodic exceptions reports which compare actual against established thresholds

3.3 PROVISIONING AND CHARGE-OFF OF UNCOLLECTIBLE CREDITS

The Authority noted that all the retail SLIs except one had long outstanding credit facilities, over 1,000 days in arrears with some as high as 4,500 days in arrears. It was also noted that some of these credit facilities were not adequately provided for.

Significant delays in reclassifying credit facilities from doubtful category to loss category even in instances where reasonable avenues for recovery had been substantially exhausted were noted. Some residual balances were still being carried on the books long after the sale of collateral.

A review of the full provisioning models; ECL models for IFRS 9 and CECL Models as per US GAAP ASC 326 and the related assumptions, was not in scope for review by the Authority.

The Selected Lending Institutions adopted either IFRS 9 or ASC 326 (CECL method per US GAAP). The Selected Lending Institutions made specific provisions for non-performing loans, that is, at a minimum, loans that are ninety (90) days or more in arrears and made a provision at the portfolio level for the performing book as per the requirements of the applicable accounting standards.

Summary of good practices:

i. Writing off residual loan balances after the sale of collateral ii. Writing off non-performing unsecured loans after not more than 180 days in arrears or as soon as the lender determines that the customer is unlikely to pay, whichever is earlier iii. Immediate write-off of credit card fraud loans

Summary of areas for improvement:

i. Delay in reclassifying accounts from doubtful to loss despite the fact that reasonable collection efforts have been exhausted and consequently delaying the write-off of uncollectible credits ii. Failure to make provisions timely for uncollectible credits

3.4 RESTRUCTURE & RECLASSIFICATION OF CREDITS FACILITIES

Most of the retail SLIs reported a decline in restructuring of facilities in 2020 compared to prior years. This is likely explained by the opportunities for borrowers to participate in the COVID-19 waivers. The Authority noted an increasing trend of restructuring of facilities in early 2021 after the end of the formal waiver period.

Most of the SLIs observed a continuous performance period of six (6) months or more before reclassifying the facilities to satisfactory status, with one institution taking a more conservative approach of twelve (12) months which is consistent with the common practice across the Caribbean. One institution however did not comply with this requirement.

The Authority noted the application of policy exceptions by the SLIs especially in regard to loan-to-value (LTV) ratios, debt service ratios, pricing, updates to valuations, holiday waivers etc. The institutions should on an ongoing basis assess how these exceptions are impacting the risk profile of the portfolio, whether positively or negatively. The assessment should consider volume, nature and trends of the exceptions and monitor the performance of the facilities that received these exceptions. If the assessment indicates higher risk than envisioned as per the institution’s risk appetite, stricter adherence to policy is required while

a better long-term performance, that is directly linked to the exceptions, indicates a need to update the policies.

In addition to the COVID-19 waivers, the Authority noted other instances where some of the SLIs granted temporary payment deferrals/waivers to their customers before the onset of the pandemic. These deferrals result in a longer credit period, which makes the facilities more susceptible to income declines, borrower life events such as illness, job losses or retirement, financed assets exceeding or approaching the end of their useful life and other concerns. The Board of Directors and senior management should assess the full impact of such concessions and ensure a balance is achieved between supporting the customers and the increased risk of credit losses to the institution.

Summary of good practices:

i. Only reclassifying facilities to current status following at least six (6) months of continued performance and when there is sufficient evidence that the trend is expected to continue

Summary of areas for improvement:

i. Modification of terms of a loan with insufficient evidence of ability of the customer to comply with the new requirements leading to underestimation of defaults and the required provisions
ii. Non-compliance with the Rule in reclassification of non-performing credit facilities to performing status

3.5 CREDIT CONTROLS AND INTERNAL AUDIT

Most of the Selected Lending Institutions regularly conducted internal audit reviews of the credit function. An effective third line of defense is essential for an independent review of the institutions' credit risk management environment. The Authority noted that for one institution, no internal audit reviews covering the credit function were conducted in a five-year window. The Authority also noted instances where the internal audit function was not adequately resourced for the size, nature and complexity of the SLI's credit and other operations.

Most of the internal audit review reports reviewed for different SLIs resulted in 'Satisfactory' assessment except for one report that assessed a segment of an SLI's credit risk management environment as 'Needs Improvement'. No instances of delays in remediation of internal audit concerns were noted. However, instances of repeat findings were noted.

Summary of good practices:

i.	Regular internal audit reviews and timely remediation of the identified deficiencies

Summary of areas for improvement:

i.	Failure by one SLI to conduct internal audit reviews of the credit function in over four (4) years
ii.	Insufficient internal audit resources to undertake a comprehensive credit review in consideration of the size, nature and complexity of the institution's operations

3.6 COLLATERAL MANAGEMENT

Collateral management was not in scope for the Thematic Credit Review. Nevertheless, in the course of reviewing the selected customer files, the Authority determined that the collateral instruments were mostly equity and other investments, residential and commercial real estate, motor vehicles, personal guarantees, cash, debentures over company assets and life insurance.

Two SLIs whose portfolios were predominantly secured by investments had current values of collateral, with one SLI having the collateral marked to market on a daily basis and the customers to post a margin for any shortfall.

The Authority noted from the policies and procedures that most of the Retail SLIs required new valuations every three (3) years for land and buildings for non-performing loans. However, the Authority noted numerous instances among the institutions where up to date valuations were not obtained. In the absence of independent valuation of collateral, the Authority did not see any evidence of internal assessments.

The Authority noted that the SLIs considered the concentration of collateral in the ongoing monitoring of their credit portfolios.

Summary of good practices:

i.	Use of current values of risk mitigants
ii.	Active management of collateral concentration risk

Summary of areas for improvement:

i.	Use of outdated values of risk mitigants in determining provisions for non-performing loans

ii. Failure to have documented internal valuations or assessment of collateral in the absence of current independent values of collateral

4.0 Other Observations

4.1 Low interest rate environment

The Authority noted that the protracted low interest rate environment which was exacerbated by COVID-19, has resulted in compressed interest margins and intense competition, especially among the institutions serving the domestic market. As a result, the Selected Lending Institutions had to diversify into non-interest income.

4.2 LIBOR Transition

For some of the Selected Lending Institutions reviewed, LIBOR was the primary rate used to price credit facilities, while some of the retail institutions had few corporate credit facilities priced using LIBOR. Most of the institutions that had facilities priced at LIBOR were working in conjunction with the parent companies to identify a new reference rate and to manage the transition.

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