BERMUDA MONETARY AUTHORITY

GUIDANCE NOTE

BANKS AND DEPOSIT COMPANIES

SUPERVISORY LOAN TO VALUE LIMITS
AND
SUPERVISORY GUIDELINES ON TOTAL DEBT SERVICE RATIOS
FOR REAL PROPERTY LOANS

MAY 2014

INTRODUCTION

The Bermuda Monetary Authority ("Authority or BMA") intends to introduce Supervisory Loan to Value (LTV) limits and Total Debt Service Ratio (TDSR) guidelines for real estate loans undertaken within the licensed Banks and Deposit Companies operating in Bermuda. These limits will be deemed a supervisory baseline and are not to be used as a replacement for more conservative and tailored limits appropriate to the inherent risk of the loans underwritten by the respective originating institution. Upon the issuance of these guidance notes, the Authority will review the operations of licensed entities as part of our regular prudential assessment to ensure that they have incorporated this guidance into their policies and procedures.

BACKGROUND

Since 2008, the deposit taking sector has witnessed a significant and unprecedented decline in real estate values that secure large portions of their domestic loan portfolios. While reduced real property values experienced by the country was the largest driver of - this decline, the existence of high LTVs and generously computed TDSRs were aggravating factors that precipitated additional losses as borrowers with minimal equity and/or insufficient income were much more likely to default on their obligations.

Consequently, the Authority commenced a review of applicable LTV limits in other jurisdictions (See Appendix #1) and developed what it believes to be prudent yet reasonable limits for the Bermuda deposit taking sector. These limits are being put in place to safeguard the sector from excessive risk taking and are not intended to supplant sound and prudent risk selection. Each institution within the sector will continue to be viewed and assessed in the context of its risk appetite, capital adequacy and the strength of its corporate governance structure. Lastly, the selection of these supervisory LTV limits already reflect current practice within the sector and will serve to deter a repeat of the actions that are partially responsible for the current problems being experienced with loan quality. For the TDSR, the Authority convened several meetings with the Bermuda banking sector to come to a workable consensus on an appropriate approach covering the computation and level of the TDSR.

While the LTV and TDSR are pertinent credit factors to be considered when underwriting a real property loan, other factors such as the borrower's employment stability, credit history and condition of the collateral property should also be documented in the loan file with evidence of how these elements were incorporated into the final lending decision.

SUPERVISORY LTV LIMITS

In establishing the limits presented in this Guidance Note, the Authority looked at several comparable offshore jurisdictions, Canada, US and UK, to ascertain a range of observations that would place Bermuda within the mainstream of global standards. We found that 70% was the lower boundary noted while limits as high as 90% (with private mortgage insurance) formed the upper boundary. Bermuda does not presently have an

active mortgage insurance market available to its borrowers, thus adopting a limit at the upper end of the boundary would not be prudent.

The Authority believes that the limits it has adopted strike a proper balance between protecting institutions from losses on default and fostering an active lending market that meets the needs of the Bermuda economy.

All licensed institutions should establish their own internal LTV limits for **real estate loans**. These limits should be based on an assessment of the lending market, with consideration given to additional collateral (including a conservative use of any secured guarantees) obtained and any other factors directly relevant to establishing the LTV relationship. These limits must be consistent with an institution's approved risk appetite and capital position. As a general rule, an institution's internal limits must not exceed the Authority's published supervisory limits on the following types of collateral:

Real Property Loans (under construction or permanent loans[1])	
- Residential Owner-Occupied	80%
- Residential Non-Owner Occupied or Multi-tenant[2]	75%
- Commercial Real Estate where owner occupation is less than 20% of usable area	75%

The limits expressed above will not apply to the following cases:

a. **Abundance of Caution.** Any loan for which a lien on or interest in real property is taken as additional collateral through an abundance of caution may be excluded from the supervisory LTV limits. The Guidelines specifically state that "abundance of caution" exists when an institution takes a blanket lien on all or substantially all of the assets of the borrower, and the value of the real property is low relative to the aggregate value of all other collateral.

b. **Loans Sold Promptly, Without Recourse, to a Financially Responsible Third Party.** Loans that are to be sold promptly after origination, without recourse, to a financially responsible third party may be excluded from supervisory LTV limits.

c. **Business Loans Where Real Estate is not the Primary Source of Repayment**. Loans that are underwritten primarily on the basis of business

[1] Properties under Construction are valued based on the "as completed" market value and permanent loans can be for purchase or refinance purposes. Does not include loans restructured due to delinquency or default.

[2] Multi-tenant units are defined as those structures containing more than four rentable units

cash flow and other bona fide sources may also be excluded from the supervisory LTV limits only if there is clear documentation that sufficient amounts can be generated from these sources to meet all debt service requirements on the loan.

d. **Loans Exceeding the LTV Limits due to Subsequent Decline in Property Value.** Loans that are subject to subsequent re-valuation of the collateral property not related to the granting of a new loan may be excluded from the supervisory LTV limits.

TDSR GUIDELINES

The TDSR Guidelines that follow will be based on gross income (percentage of total monthly debt obligations to gross monthly income). These guidelines provide all licensed institutions with a uniform standard for assessing the debt servicing ability of borrowers applying for real property loans, taking into consideration their other outstanding debt obligations. Any institutions using other methods to compute the TDSR will be responsible for demonstrating comparability with this standard. These guidelines will not apply to commercial lending situations where the source of debt service coverage is derived from the operation of a business entity. While loans of this nature should be underwritten with due levels of prudence and inherent conservatism, they nonetheless fall outside the scope of the TDSR Guidelines.

Barring loans excluded above, the TDSR will apply to loans for the purchase of all types of real property, loans secured by real property and the re-financing of all such loans.

The methodology for computing the TDSR will be standardised, with all licensed institutions required to:

a. Take into account the monthly repayment for the real property loan that the borrower is applying for plus the monthly repayments on all other outstanding property and non-property debt obligations of the borrower:

    i. In addition to the obligations cited above, banks must collect and consider relevant information on a borrower's recurring costs of home ownership such as real estate taxes, common area maintenance charges, homeowner's association fees and property insurance;
    ii. Apply a specified margin over the current interest rate or the prevailing market interest rate, whichever is higher, to the real property loan that the borrower is applying for when calculating the TDSR;
    iii. Apply a haircut of at least 30% to all variable income (e.g. bonuses) and rental income; and
    iv. Apply haircuts to and calculate the available cash flow from any eligible financial assets taken into consideration in assessing the borrower's debt servicing ability, in order to convert them into 'income streams' in computing the TDSR.

Institutions will be required to verify and maintain relevant documentation on a borrower's debt obligations and income used in computing the TDSR.

The Authority expects that any real property loan extended by licensed institutions will not exceed a TDSR threshold of 60% and will regard any property loan in excess of a 60% TDSR to be imprudent, absent mitigating factors. The threshold is initially set at 60% to allow both the institutions and borrowers to familiarise themselves with the TDSR framework and its computation methodology. The Authority will monitor and review the 60% threshold over time, with a view to further encouraging financial prudence and responsible lending.

The TDSR framework and the guidance relating to the application of supervisory LTV limits are structural in nature, and will be in place for the long term. They aim to encourage prudent borrowing by households and strengthen banks' credit underwriting standards. The current LTV and TDSR limits are not permanent limits and will be reviewed depending on the state of the local property market and observed practices.

LOANS IN EXCESS OF THE SUPERVISORY LTV LIMITS AND TDSR GUIDELINES

The Authority recognises that appropriate limits and application of guidelines vary not only among categories of real estate loans but also among individual borrowers, due to other credit impacting factors. Therefore, it may be appropriate in limited individual cases to originate loans with LTV and/or TDSR ratios in excess of the supervisory guidance, based on the documented quality of the support provided by other documented credit factors. Such loans will be deemed exceptions and as such, should be specifically authorised in the institution's policy, subject to the approved risk appetite and clearly identified in the institution's records, with the aggregate amount reported at least quarterly to the Board of Directors. Furthermore, the aggregate amount of all loans underwritten or renewed subsequent to the issuance of this guidance and which continue to remain in excess of the supervisory LTV or TDSR limits must not exceed 25% of Common Equity Tier 1 (CET1) capital.

APPENDIX #1

LTV SURVEYS FROM SELECTED JURISDICTIONS

The Authority researched the applicable handling of LTV limits for the jurisdictions listed below:

Canada – Maximum of 80% for conforming residential loans with prudent underwriting.

Cayman – No maximum limit specified but prudent use of LTV encouraged.

Hong Kong – *Maximum* of 70% for residential "self-use" property.

Malta – No maximum limit specified but prudent use of LTV encouraged.

Singapore – Maximum of 80% for a "first housing loan".

United Kingdom – No specified level set by the Financial Conduct Authority but the Prudential Regulatory Authority has stated that LTV limits would be considered as a macro prudential tool.

United States – Up to 90% LTV with evidence of bona fide Private Mortgage Insurance, otherwise 80%. Exceptions allowed under limited conditions; subject to defined capital limits and Board approval.