THE BERMUDA MONETARY AUTHORITY

BANKS AND DEPOSIT COMPANIES ACT 1999:

The Management and Control of Credit Risks and the Implementation of the Statutory Provisions for Large Exposures

May 2007

Introduction

1 This paper revises and replaces the existing policy guidance set out in 'Implementation of Provisions for the Reporting and Control of Large Exposures', published in November 1999. It has been the subject of detailed consultation with the banking industry based on proposals set out in a Consultation paper published in December 2006.

2 The effectiveness of institutions' credit risk management processes is a key element in determining their soundness. It is, therefore, an important part of the Bermuda Monetary Authority's (the 'Authority's') assessment of their ongoing compliance with the minimum licensing criteria requirements for business to be conducted in a prudent manner, as set out in the Second Schedule to the Banks & Deposit Companies Act 1999 ('the Act'). The 'prudent manner' criterion includes specific reference to the arrangements that institutions have in place for ensuring adequate provision is made for depreciation or diminution in the value of their assets, including provision for bad and doubtful debts. Judgments as to the effectiveness of the arrangements that institutions have in place for this aspect of the prudent conduct of their business are also fundamental to the Authority's determination of the adequacy of their capital. The Authority seeks to satisfy itself that institutions maintain processes that have suitable regard to their individual risk profile, and that they adopt prudent policies and arrangements for identifying, measuring, monitoring and controlling their credit risk, including counterparty risk. Appropriate policies and practices need to cover the initial granting of loans and making of investments, together with the ongoing evaluation and management of loans and investment portfolios.

The Credit Process

3 Each institution's Board of Directors must determine, and periodically review, the credit risk management strategy that is to be followed, together with the key policies and processes for taking on, identifying, measuring, controlling and reporting credit risk, including counterparty risk. Such policies must make provision for the largest credit risks (as well as other credits that are identified as particularly high risk or outside the normal business activity of the institution) to require approval at a senior management level. Policies must also be in place, designed to ensure that the institution's credit decisions are free of conflicts of interest and that the terms and conditions attached to lending are on an arm's length basis. The Board must ensure that it receives on a regular basis timely and appropriate information on the condition of the institution's asset portfolio, including classification of credits, provisioning levels and material problem assets.

4 In the course of its supervisory work, the Authority periodically reviews the implementation of the strategy, policies and processes approved by the Board. The

Authority looks, in particular, to be satisfied that an adequately controlled credit risk environment is in place, including:

i. a well documented strategy for assuming credit risk, with sound and prudent related policies and processes;
ii. well - defined criteria for approving new exposures (and for renewing and refinancing existing exposures) and establishing appropriate levels of authority for approving exposures, reflective of their size and complexity;
iii. effective administration policies and processes, including continuing analysis and assessment of borrowers' ability to meet their obligations, monitoring of documentation (including legal covenants, contractual requirements and collateral), and (other than in the case of the smallest institutions or those with a very simple balance sheet) a credit classification system that takes into account off-balance-sheet transactions and is suited to the nature, size and complexity of the institution's activities;
iv. comprehensive policies and processes for ongoing reporting of credit exposures;
v. prudent lending controls and limits, including policies and processes for monitoring exposures in relation to limits and for dealing with approvals against limits and exceptions to limits;
vi. policies and procedures that include potential future exposure (having regard to the nature of individual products or transactions and the size or complexity of the institution itself) in identifying, measuring, monitoring and controlling counterparty credit exposure; and
vii. policies and procedures for aggregating, monitoring and reporting total indebtedness of counterparties.

Problem Assets

5 Institutions must put in place and apply policies and procedures for the effective management of problem assets. These policies and procedures must include arrangements for periodic review of problem assets and an appropriate framework for the classification of impaired assets and for setting appropriate levels of provisioning. Such systems must operate to assess credits individually, except where credits with homogeneous characteristics can be satisfactorily reviewed at a portfolio level.

6 Where there is reason to believe that all amounts due (both principal and interest) will not be collected in accordance with the contractual terms, credits must be recognized as impaired. Credits must also be classified as impaired when contractual payments of interest or principal fall into arrears exceeding 90 days. Where credits that would otherwise fall into arrears are subject to refinancing arrangements, the action of refinancing should not result in an improved classification for the credit.

7 The Authority maintains under review the adequacy of institutions' classification and provisioning policies and procedures for impaired assets, as well as the effectiveness with which they are implemented in order to ensure that provisioning levels remain adequate for prudential purposes. In particular, the Authority reviews the arrangements in place for the early identification of deteriorations in asset quality, for determining institutions' provisioning decisions, for ongoing monitoring of problem assets, for assessing the value of risk mitigants, including guarantees and collateral (reflecting net realizable value), for collecting on past due obligations, and for determining write-offs, having regard to realistic repayment and recovery expectations. Where the Authority determines that the level of provisioning is inadequate, it requires immediate action on the part of the institution to remedy the deficiency. Where this does not occur, other regulatory action is likely, including the possibility of restrictions in the business, an increase in required capital ratios, or both.

Exposures to Related Parties

8 In order to prevent abuses arising out of exposures to related parties, institutions need to have in place policies and procedures for countering the conflicts of interest and other risk issues that may be involved. 'Related parties' includes any party able to exercise control over the institution or over which the institution itself can exert control, together with the institution's major shareholders, any of its directors, senior management and key staff, as well as close family members of those persons. The term also includes an institution's subsidiaries and affiliates, together with major shareholders, all directors, senior management and key staff of these entities, as well as close family members of these persons. Limits applying to related party exposures must be at least as strict as those applying to non—related counterparties. Institutions need to put in place arrangements for identifying all related parties and establish specific policies and procedures requiring exposures to such persons to be conducted on an arm's length basis. They must also ensure that these exposures are carefully monitored to prevent abuse, that appropriate steps are taken to control and mitigate risks arising from such exposures and that provisioning and write-off policies are fully consistent with those applying to the generality of exposures.

9 Where institutions believe that specific exposures or classes of exposure, while falling within the above definition, should not properly fall to be treated or reported as 'related', they may seek approval from the Authority on a case by case basis for a particular counterparty or class of counterparties to be treated as non-related.

10 Institutions may not grant exposures to related parties on terms that are more favourable (whether as to credit assessment criteria, interest rates, repayment schedules, collateral requirements or other material aspects) than those attaching to corresponding exposures to non-related counterparties. Staff loans made on a concessionary basis are permitted but these should not extend to directors. Institutions must also ensure that any of their management or staff who may benefit

from the related party exposure (or any persons related to such a person) are excluded from the process of granting the exposure or from its subsequent management. Institutions also need to put in place policies and procedures whereby all material related exposures, all such exposures posing special risks, and all proposals for material write-offs of related party exposures are subject to express prior approval by the Board. For this purpose, any Board member who faces a conflict of interest in relation to the particular exposure must be excluded from the approval process.

11 The Authority maintains under regular review the policies and procedures in place within institutions for identifying related party exposures, both individually and in aggregate, together with the arrangements in place for monitoring and reporting on such exposures, including through an independent credit review process. Exceptions to policies, procedures and limits must be reported as necessary to senior management, including where appropriate to the Board, for effective follow-up; the Authority will review the effectiveness of these arrangements.

12 The Authority monitors carefully an institution's material exposures to related parties. Where it concludes that an exposure may not be on a wholly arm's length basis or where it has concerns about the aggregate level of related party exposures, it may determine that particular exposures are to be deducted from the institution's capital base in assessing capital adequacy, or seek some other type of remedial action.

Concentration risk

13 Excessive concentration of risk within an institution's credit exposures is historically one of the most common causes of bank failure, since quality of assets is left vulnerable to the impact of a relatively small number of adverse changes. The Authority needs to be satisfied that institutions have policies and procedures in place, enabling management to identify, set prudent maximum limits (both individually and in aggregate) for, and manage concentrations within their portfolios. The Authority requires institutions to draw up a general statement explaining their approach to the acceptance, control and management of large exposures. This policy statement must be given formal approval by the Board and also be subject to regular review. Institutions also need to ensure that they have adequate arrangements in place (consistent with their general policy approach) for the regular review and reporting of concentration risk, and that all material concentrations are regularly reported and reviewed by the Board. The extent to which institutions are exposed to concentrations of risk in their portfolios is a factor that the Authority takes into account in determining the minimum capital adequacy ratios that it judges prudent in individual cases.

14 The Act imposes strict statutory controls on large exposures. The requirements appear in section 38 of the Act. The detailed provisions applied by the Authority in

this regard are set out in this paper. Broadly, a large exposure is an exposure to a counterparty or group of closely connected counterparties which exposes an institution to risk of loss exceeding 10% of its capital base. All exposures on this scale must be carefully monitored and reported regularly to the Authority. No exposures to a counterparty or group of connected counterparties where the risk of loss to the institution exceeds 25% of its capital base may be undertaken without the Authority's prior written consent. Exposure is very widely defined to include all claims on a counterparty, including both actual claims and potential claims (eg from a drawdown of undrawn, advised facilities or from assets which an institution has committed to purchase or underwrite) as well as most contingent liabilities. The Act also requires that exposures to two or more counterparties must be treated as exposures to a single counterparty where the persons are connected with each other in such a way that the financial soundness of one may affect the financial soundness of them all.

15 The Authority expects institutions to be able to monitor their large exposures on a daily basis, and it reviews regularly the effectiveness of institutions' monitoring and control arrangements for such exposures. While the legal controls in section 38 of the Act apply only at the level of the licensed institution, the Authority requires monitoring and reporting systems to be in place on a group-wide basis, ensuring (where relevant) that exposures to a single counterparty of group of connected counterparties can be identified and controlled for the group as a whole.

Country Risk and Transfer Risk

16 In addition to monitoring and controlling their individual counterparty concentrations, institutions need to monitor their portfolios actively for other types of concentrations within them. This includes factors such as excessive concentrations to individual (or linked) economic sectors, and to particular geographical areas or regions, as well as concentrations of exposure denominated in particular currencies. The Authority expects institutions to remain alert for such risk concentrations and to put in place suitable monitoring and reporting systems.

17 In particular, institutions need to pay close attention to their policies and procedures for identifying, measuring, monitoring and controlling country risk in their international lending and investment activities – that is to say, concentrations of exposure to counterparties located in particular jurisdictions and where the economic situation of the jurisdiction may introduce an added dimension of risk, separate from the counterparty risk. Such policies and procedures need also to take into account transfer risk – that is to say, where the institution is relying on guarantees or other arrangements the effect of which is to transfer risk from a counterparty in one jurisdiction to one in another jurisdiction.

18 Institutions that take on material international lending business must establish prudent country limits, having regard to the perceived likelihood of payment

difficulties which may adversely affect the ability of borrowers to service their obligations in a timely manner. They must also monitor, assess developments in and control their country risk (and transfer risk) on an ongoing basis. Exposures to foreign sovereigns or to their public sector bodies may create particular difficulties for lending institutions with regard to the need to recognize and measure eventual impairment of loan values in the event of national payment difficulties or a force majeure situation.

19 The Authority reviews country risk and transfer risk information regularly to ensure that institutions operate consistently with the policies and procedures they have in place. The Authority pays particularly close attention to related provisioning judgments reached by institutions, in particular in determining the appropriateness of provisioning decisions for impaired sovereign exposures, having regard to likely risk of loss.

The Statutory Large Exposures Provisions

20 In addition to the above general matters regarding the credit process and risk concentration, the Act (section 38) also places specific reporting obligations on institutions. They are required to make a report to the Authority where they enter into a transaction or transactions relating to any one person as a result of which they are exposed to the risk of incurring losses in excess of 10% of available capital resources. Moreover, they are required to report beforehand whenever they propose to enter into a transaction or transactions to any one person, which would expose them in aggregate to incurring losses in excess of 25% of their available capital resources.

21 The Authority requires institutions to calculate, monitor and report these concentration risks on a ‘worst case’ basis, as set out below. The standard reporting obligation for large exposures is met through completion of a quarterly Large Exposures Return, provided to the Authority as part of the Prudential Information Return (PIR). Other than where certain specific types of exposures are concerned (see paragraph 24 below), the Authority gives consent to exposures of in excess of 25% of capital only in exceptional circumstances, and where the risk of loss can be demonstrated as being extremely small.

<u>Large Exposures Reporting: Definitions and Rules</u>

Definition of Capital

22 The limits and reporting obligations which are to be observed involve the assessment of large exposures in relation to an institution’s available capital resources. The capital base to be used for this purpose (" the LE capital base") is

the sum of allowable Tier 1 and Tier 2 capital, less any deductions. (The Authority has published a separate paper bringing together the definitions of the various elements of capital as the basis for capital adequacy calculations. The definition of the LE capital base is based on that definition.) The current figure for each institution's LE capital base is confirmed by the Authority in writing, at least annually; that notified figure must be used as the basis for LE reporting until such time as the Authority notifies a later figure.

Definition of Large Exposure

23 As noted above, a *large exposure* is an exposure to a counterparty or group of closely related counterparties which is greater than 10% of an institution's LE capital base. An *exposure* is the maximum loss (in aggregate) that an institution might suffer if a counterparty fails, or the loss that might be experienced in realising any assets or off-balance sheet positions. It therefore includes all claims on a counterparty including both actual claims and potential claims (e.g. from a draw-down of undrawn, advised facilities or from assets which an institution has committed itself to purchase or underwrite), as well as most contingent liabilities. As indicated above, the object is to assess the ‘worst case’ exposure, and very few items can therefore be excluded in calculating an exposure. Similarly, most exposures are reported for LE purposes at their full values, and are not scaled down by the risk weights which may apply for capital adequacy purposes. However, claims and other assets already deducted from the institution's capital base for capital adequacy and LE purposes need not be included. This is also the case for counterparty risk on futures and options where the contracts are traded on an exchange and are subject to daily margining requirements; and also for bill endorsements on bills already endorsed by another bank. The amount at risk should also include any accrued interest.

Treatment of Collateral and Netting

24 In reporting large exposures, the existence of collateral held by the lending institution is not generally taken into account. Exposures therefore need to be reported gross, although the amount of any collateral held is also reported as a memorandum item. This reflects the fact that, although reporting is on a gross basis, the holding of cash or certain other high quality collateral will be taken into account by the Authority in considering requests from institutions to exceed the normal 25% ceiling. In order to qualify for such treatment, the Authority needs to be satisfied that the lender has proper title to the collateral and can apply set-off; satisfactory legal advice in all relevant jurisdictions should have been taken. In the same way, the Authority believes that there are very few circumstances in which institutions may prudently apply netting procedures in monitoring and reporting large exposures. But where, for example, an institution undertakes sale and repurchase arrangements with a counterparty under a recognised master agreement,

and is in possession of satisfactory legal advice as to the efficacy of that documentation, the Authority is content to accept that the net margin given to the counterparty should constitute the amount of the exposures for LE purposes.

Lower Risk Exposures

25 In certain cases where the exposure is likely to involve much lower than normal credit risk, the Authority is prepared to approve individual exposures in excess of 25% of capital. These involve:

i. exposures of one year or less to licensed deposit-taking institutions, licensed investment firms that are subject to risk-based capital requirements, exchanges and clearing houses (other than where they are connected to the reporting institution);

ii. exposures to, or guaranteed by "Zone A" central governments and central banks or monetary authorities. (For the definition of Zone A, see the Authority's paper, The Assessment and Measurement of Capital Adequacy).

It is stressed that all such exposures remain fully subject to the LE regime, including the obligation to seek specific consent from the Authority where an exposure in excess of 25% of capital is contemplated. (In the case of standard inter-bank exposures, consent is generally handled through the Authority's approval of institutions' agreed inter-bank limits.)

Credit Equivalent Amounts

26 In the case of a number of types of exposure, the Authority accepts that the real amount at risk for large exposure purposes is likely to be less than the nominal amount of the exposure. This is true, most notably, in the case of certain interest-rate and foreign-exchange-rate related contracts. In these cases, the Authority agrees specific rules for calculating that proportion of the nominal amount which can reasonably be held to be at risk; and only the relevant proportion of the normal exposure is included in calculating the overall exposure. In calculating these *credit equivalent amounts*, institutions are normally able to choose between a replacement cost and an original exposure methodology; however, where material amounts of off-balance sheet contracts of this type are employed, banks normally have to use the more accurate replacement cost methodology - which includes both the total replacement cost on a mark to market basis and an allowance for potential future credit exposure which takes account of the nature of the underlying instrument and the remaining contract duration.

Reporting of Large Exposures

27 The reporting provisions and limits apply to any person on which the institution, directly or indirectly, has a claim. A person includes both a natural and a legal person and therefore covers, for example, exposure to a government, to a local authority, a public sector entity, a trust, corporation, unincorporated business or non-profit-making body. The relevant person will normally be the borrower; the person guaranteed (where the institution is providing a guarantee); the counterparty to a derivatives contract; or the issuer of a security (where a security is held by the institution). In certain circumstances when a third party has provided an unconditional irrevocable guarantee, an exposure may be reported as being to the guarantor rather than to the borrower; such cases should, however, be agreed specifically with the Authority.

Connected Parties

28 At the same time, section 38 of the Act makes it clear - again reflecting the wish to take a worst case approach - that exposures to two or more individual counterparties need to be treated as exposures to a single counterparty where the persons are connected with each other in such a way that the financial soundness of any of them may affect the financial soundness of the other or others, or if the same factors may affect the financial soundness of both or all of them. Relationships between individual counterparties likely to give rise to common risk include: entities within the same group; entities whose ultimate owner (wholly or significantly) is the same individual or individuals, although not having a formal group structure; companies having common directors or management; and counterparties linked by cross-guarantees. Where institutions are uncertain whether particular counterparties should be treated as constituting a single risk, they should approach the Authority for a ruling.

Consolidated Reporting

29 The legal reporting obligations and large exposures limits in the Act relate purely to the licensed entity. However, the Authority conducts prudential supervision of institutions on both a solo and a consolidated basis. Institutions must, therefore, be able to monitor and report their large exposures for their consolidated group, as well as for the stand-alone entity. In addition to quarterly reports of large exposures for the solo institution, similar consolidated reports are required, on a half-yearly basis.

Related Parties

30 This framework for monitoring and controlling large exposures also provides a mechanism for dealing with the question of exposures to counterparties connected

to the lending institution itself. The Authority has always paid particular attention to such related party lending, given the risk that an institution may take a less objective view than it applies to the generality of its business (see paragraphs 8-12 above). The Authority therefore applies the LE reporting requirements and controls also to aggregate related exposure. Thus, at the solo level, the aggregate of an entity’s related exposures (including eg total exposures to other companies within the group to which it belongs, to other associated companies, to directors, controllers and their associates, as well as, potentially, to other non-group companies with which a lending institution's directors or controllers are associated) falls to be treated as a reportable exposure to a single person. The amount is therefore reportable as a large exposure when it exceeds 10% of LE capital base; and it remains subject to the 25% limit, and cannot be exceeded without prior supervisory consent. The Authority sees this as providing an important additional means of monitoring and controlling intra-group exposures between licensed institutions and other members of their groups, as well as between them and other related parties.

Breaches

31 As noted earlier, institutions must pre-notify the Authority of any proposed exposure exceeding 25% of LE capital base before entering into any commitment. The Authority would normally expect to have at least 48 hours' notice in order to ensure that it can respond on a timely basis; and where a case seems likely to raise complex issues, institutions should provide longer notice. They must also notify the Authority immediately if they become aware of any inadvertent breach of the 25% limit or of other counterparty limits agreed with the Authority for large exposures' purposes. Where institutions fail to identify or report large exposures on a timely basis, the Authority is likely to wish to consider whether the institution continues to meet the licensing criteria. At the same time, such breaches can, clearly, arise as a result of factors outside an institution’s control, such as a merger or take-over among its customers. In such cases, the Authority will agree with an affected institution the remedial action that may be necessary, together with a time-table within which the breach is to be repaired.

Underwriting

32 The Authority recognises that special treatment may be appropriate for certain discrete underwriting exposures undertaken by institutions in connection with the bringing to the market of new or existing securities, reflecting the intensive analysis likely to have been undertaken and the short time-horizons generally involved. When institutions would wish to seek a special concessionary treatment for such temporary exposures, they should approach the Authority directly to get agreement to the treatment that is to apply.

Clustering

33 In addition to reviewing individual large exposures, the Authority also views the extent of aggregate large exposures within an institution's portfolio as an important indicator of potential risk. Accordingly, the Authority also expects institutions to monitor carefully their overall 'clustering' position – that is to say the total of their exposures (excluding short-term inter-bank exposures) in excess of 10 % of capital - as part of their efforts to ensure proper diversification of their risks. The Authority does not intend to introduce a specific clustering limit; and, indeed, it is very conscious of the fact that inherent differences in the nature of the business in different institutions must cast doubt on the validity of any simple numerical limit. However, it monitors carefully the trend of such 'clustering' for each institution and discusses with its management the levels that are felt to be prudent.

Information Flows: Legal Obstacles

34 The Authority recognises that the reporting of individual large exposures, may on occasion, raise particularly sensitive issues of client confidentiality in certain jurisdictions. Institutions' managements clearly need to ensure that they are able to obtain from overseas offices and related companies all the information that is necessary for them to run their business prudently. The Authority would not expect institutions to face problems over obtaining the data necessary for them to monitor and control their large exposures effectively. Where such a concern arises, the Authority must be notified immediately