



# **BERMUDA MONETARY AUTHORITY**

## **GUIDANCE NOTES**

### **TROUBLED DEBT RESTRUCTURING (TDR) SUPERVISORY EXPECTATIONS**

**OCTOBER 2015**

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## I. Overview

1. The Bermuda Monetary Authority (the Authority or BMA) is introducing Troubled Debt Restructuring (TDR) guidelines to provide a form of standardisation for processing and managing TDRs for all Bermuda licensed banking and deposit taking institutions.
2. The following guidelines are designed to provide assistance to relevant lending institutions and are **not intended to replace or override established accounting guidance governing TDRs.**
3. Since 2008, Bermuda's banking sector has experienced significant and unprecedented deterioration in credit quality across their domestic loan portfolios (i.e. retail and commercial) due to the global and local economic downturn.
4. As a consequence of the difficult economic conditions, local lenders have consistently reported greater stresses within their loan portfolios as highlighted in the increasing levels of non-performing loans (NPLs) in both their commercial and retail loan books.
5. With the increasing level of NPLs, local banks have sought alternative methods to the standard foreclosure and/or repossession of physical collateral backing these troubled loans. Such attempts include granting concession(s) to borrower(s) to rehabilitate the loan facility by restructuring the original agreed upon terms for a specified period of time.
6. From previous on-site, thematic and desk based reviews, the Authority has noted a level of inconsistency between banks on their classification and treatment of TDRs. As noted above, this guidance will be utilised by the Authority to ensure that banks are adhering to prudent and widely accepted TDR practices in terms of definition, classification and internal rating.
7. Subsequent to the publication of this document on the Authority's website on 15<sup>th</sup> October, 2015, the Authority's supervisory team will utilise the information contained herein to assess the probity and overall effectiveness of each bank's TDR management.

## II. Definition of a TDR

8. The most widely used definition used by local banks to determine what constitutes a TDR is derived from the Financial Accounting Standards Board.<sup>1</sup>
9. A TDR is defined as when a creditor, for economic or legal reasons related to the debtor's financial difficulties, grants a concession to a debtor it would not otherwise consider.
10. A TDR may include, but is not necessarily limited to, one or a combination of the following:
  - i. Transfer of receivables to the creditor from third parties, real estate or other assets to satisfy fully or partially a debt (including a transfer resulting from a foreclosure or repossession);
  - ii. Issuance or granting of equity interest to the creditor to satisfy fully or partially a debt unless the equity interest is granted, pursuant to existing terms for converting debt into an equity interest;
  - iii. Reduction (absolute or contingent) of the stated interest rate for the remaining original life of the debt;
  - iv. Extension of the maturity date at a stated interest rate lower than the current market rate for new debt with similar characteristics;
  - v. Reduction (absolute or contingent) of the face amount or maturity amount of the debt; and
  - vi. Reduction (absolute or contingent) of accrued interest.
11. Changes to a loan agreement, such as the following listed below, are not considered to be TDR as per the applicable accounting standards:
  - i. Changes in lease agreements of the underlying collateral;
  - ii. Changes in employment-related agreements;
  - iii. Decrease in interest rate to reflect a general decrease in market interest rates; and
  - iv. Decrease in risk by maintaining a relationship with a debtor that can readily obtain funds from other sources at the current market interest rate.
12. In order for a restructure to be classified as a TDR, two conditions must be present:
  - i. The debtor must be experiencing financial difficulties; and
  - ii. The creditor must grant a concession in consequence of the debtor's financial difficulties.
13. Loan renewals, extensions and modifications that occur before a payment reset date or conversion to amortising status, are not automatically considered TDRs. However, these facilities should be analysed to determine whether they meet the TDR classification criteria.

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<sup>1</sup> Topic 310 – A Creditor's Determination of Whether a Restructuring is a TDR – issued April 2011.

### **III. Supervisory Expectations**

#### *Determining if a debtor is experiencing financial difficulties*

14. Accounting standards do not provide definitive guidelines on how to determine if a borrower is experiencing financial difficulties which would qualify for a TDR. However, several indicators have been noted to assist in identifying a borrower's financial difficulties. These include:
- i. A debtor currently in payment default on any of its outstanding debts;
  - ii. The probability of a borrower going into default in the foreseeable future in the absence of a restructuring of the loan(s). Debtors may be about to face financial difficulties – even if they are currently not in payment default;
  - iii. If a debtor has declared, or is in the process of declaring, bankruptcy;
  - iv. A cash-flow forecast highlighting the potential for the debtor to be unable to meet payments in accordance with the contractual terms of the existing agreement in the foreseeable future;
  - v. If a debtor is unable to procure funds from sources other than their existing creditors at an effective interest rate equal to current market interest rates and applicable to similar debt for a non-troubled debtor; and
  - vi. If a commercial borrower has been involuntarily delisted or is in the process of being delisted from a stock exchange.

#### *Determining if a concession has been granted*

15. Concessions can be granted by the creditor or imposed by the courts.
16. A creditor has granted a concession when, as a result of the restructuring, it does not expect to collect all amounts due, including interest accrued at the original contract rate.
17. Lenders may restructure a debt in exchange for additional collateral and/or guarantee(s). When this occurs, a concession has been granted when the additional collateral and/or guarantee(s) do not serve as adequate compensation for the other restructured terms.
18. If a debtor does not otherwise have access to funds at a market rate for debt with similar risk characteristics as the restructured debt, the restructuring would be considered to be at a below-market rate, which may indicate that the creditor has granted a concession
19. Temporary or permanent changes to the original contractual interest rate do not automatically preclude the restructuring from being considered a concession. The new interest rate can still be below prevailing market rates for debt with similar characteristics.

20. A restructuring resulting in a delay of payment considered to be insignificant is not a concession. To determine the ‘significance’ of a payment delay in light of a restructure, the following factors should be taken into account:

- i. The amount of the restructured payments to experience a delay and its significance relative to the unpaid principal or collateral value of the debt;
- ii. The delay in timing of the restructured payment period and its significance relative to any one of the following:
  - a. frequency of payments due under the debt
  - b. the original contractual maturity
  - c. the debt’s original expected duration

*Acceptable forms of concessions*

21. The Authority has noted, via thematic reviews and other forms of prudential supervision, that local institutions have predominantly granted the following concessions to troubled loan facilities:

- Amended maturity date
- Capitalisation of arrears
- Reduced payments
- Interest rate reduction
- Principal holidays (i.e. interest only)
- Consolidated debt
- Deferred payments

(The listing above is not an exhaustive list of possible concessions to be granted when restructuring a facility.)

22. The Authority expects that the approved concession types/categories will be embedded within the relevant TDR policies adopted by the institution accompanied by the circumstances (i.e. loan characteristics) in which each concession is applicable.

*TDR performing/non-performing treatment*

23. A TDR can be in either performing or non-performing status at the time of restructure.

24. A loan in non-performing status at the time of modification does not have to be maintained for its remaining life in a non-performing status if the requisite characteristics (i.e. capacity to repay) have been restored to the facility in question.

25. To restore a TDR loan from non-performing to performing status, the institution must perform a well-documented credit analysis supporting the performing status reclassification based on the

debtor's financial condition and prospects for repayment, as per the restructured terms. The analysis must consider the debtor's sustained repayment performance for a reasonable period of time.

26. **For supervisory purposes, a reasonable sustained period of repayment performance is considered to be no less than six months and would involve receiving payments in the form of cash and cash equivalents only.**
27. Based on a current, well-documented credit analysis, a performing loan modified as a TDR can remain in performing status if a collection of principal and interest, as per the modified terms, is reasonably assured. The debtor should also demonstrate repayment performance for a reasonable sustained period after the modification.
28. Approval of a TDR reclassification from non-performing to performing status should be issued from the relevant management level credit risk committee and/or the credit risk function. Such approval should not be granted by the front line credit function.

#### *Asset Classification*

29. For an impaired loan dependent solely on the sale of the collateral for repayment, any portion of the recorded investment in the loan exceeding the amount adequately secured by the fair value of the collateral, less the estimated costs to sell, is deemed to be uncollectible. Therefore, it should be appropriately credit risk graded and classified for regulatory purposes.
30. Any portion of the loan's recorded investment not charged off should generally be adversely credit risk rated and classified accordingly. However, if circumstances warrant a more conservative credit risk grade (i.e. doubtful or loss), these classifications can be attached to the entire balance.

#### *TDR Approval and Risk Reporting*

31. As restructured loan facilities are inherently riskier, the Authority expects ultimate approval of the restructured terms to be granted by the relevant management level credit committee and/or the credit risk function. The front line credit teams should not be involved in this process.
32. All TDR proposals should be reviewed and either approved or denied by the credit risk management function and/or a management level loan/credit committee or equivalent.
33. TDR approval matrices should be included within the relevant TDR policy, which in turn should be reviewed on at least an annual basis, to ensure it remains adequate and applicable to current circumstances.
34. Reporting of TDRs should be made to the relevant management committees, as well as to the Board on at least a quarterly basis.

35. Such reporting should be sufficient as to encompass the current volume of TDRs, the current nominal outstanding balances of the TDRs approved, the types of concessions granted, any related impairment charges and the types of loans (i.e. retail or commercial) that have been restructured.
36. **Evidence of such TDR reporting should be clearly documented and available for review both for internal and regulatory purposes.**