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# **Guidance Note: Class 2 Institutions**

## **Impaired Loans – Loan Loss Allowances**

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This Guidance Note provides additional guidance and DICO's expectations for determining loan impairment and for establishing loan loss allowances which are contained in International Accounting Standard (IAS) 39, Financial Instruments: Recognition and Measurement and DICO By-Law # 6, Reserves and Monthly Provisions for Doubtful Loans. This Guidance Note comes into effect with the first time conversion to International Financial Reporting Standards (IFRS) and adoption of IAS 39 which become effective for financial years commencing on or after January 1, 2011. The recommendations outlined in IAS 39 are presented in italics.

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## A. INTRODUCTION

This Guidance Note provides additional guidance and DICO's expectations for determining loan impairment and for establishing loan loss allowances which are contained in International Accounting Standard (IAS) 39 and DICO By-Law # 6. This Guidance Note is intended to supplement, but not contradict, the guidance contained in IAS 39 relating to establishing individual and collective loan loss allowances. Information on alternative methods that may be considered in determining the collective allowance is outlined in Appendix 1.

## B. INDIVIDUAL (SPECIFIC) ALLOWANCE

### (i) Individual Loans

Each insured institution shall establish an allowance for impaired loans following the principles set out in IAS 39. Objective evidence that a loss has been incurred that may indicate impairment is outlined in IAS 39 (59) and includes:

- a) significant financial difficulty of the borrower
- b) a breach of contract, such as default or delinquency in interest or principal payments
- c) the borrower is granted a concession that the lender would not otherwise consider as a result of the borrower's financial difficulties
- d) the borrower is likely to become bankrupt or obtain other financial reorganization

In addition to the loss events outlined in paragraph IAS 39 (59), DICO considers the existence of any of the following conditions to be potential indicators of objective evidence of impairment and the loan should be recognized as impaired:

- payment on any loan excluding credit card loans is contractually 90 days in arrears, EXCEPT where the loan is **fully secured**, the debt collection is in process and the collection efforts are reasonably expected to result in full repayment or restoration of the debt to current status within 180 days of the date payment went into arrears in which case the loan is not considered impaired;
- payment on a **fully secured** loan and any other loan, excluding credit card loans, is contractually 180 days in arrears
- the debt is assigned to a collection agency;
- the member has absconded, has made a voluntary assignment for his creditors' benefit, has been named in a creditor's application for a bankruptcy order under the Bankruptcy and Insolvency Act of Canada, or has made a proposal, consumer proposal, or a notice to make a proposal under the Bankruptcy and Insolvency Act of Canada
- any loan which has been postponed where the recovery of principal and interest is deferred by more than six months beyond the loan's original term

An exception to these conditions is made for not more than 365 days from the date a loan is contractually in arrears where the loan is guaranteed or insured by the Canadian government (federal or provincial) or a Canadian government agency, the validity of the claim is not in dispute, and as a consequence the loss event does not have an impact on the estimated future cash flows.

“Fully Secured” is a loan which is fully secured by charges on real property (such as land and buildings) or security interests in personal property (such as automobiles, securities) where the fair value of security or estimated net realizable amount is sufficient to discharge the outstanding principal and accrued interest in full.

**(ii) Individually Significant Loans**

In addition to the factors noted above, each individually significant loan should be reviewed and assessed for impairment. Institutions should establish the amount for the purpose of assessing impairment for individually significant loans.

This may be based on a dollar amount or a percentage of capital or other criteria but would generally result in ensuring that the largest value loans (individual or connected person) for each loan category are assessed for impairment on a regular basis even though they may not meet the specific default conditions for impairment outlined above.

When establishing limits for individually significant loans, institutions should be guided by the following *minimum* expectations:

**Guidelines for Determining Individually Significant Loans**

<b>Loan Type</b>	<b>Individually Significant Loans</b>
Personal	Largest 10 loans and all loans >\$500,000
Residential Mortgage Loans	Largest 10 loans and all loans >\$1 million
Commercial/Agricultural	Largest 10 loans and all loans >\$5 million

**(iii) Measuring Impairment**

***Section IAS 39 (63)***

*“If there is objective evidence that an impairment loss on loans and receivables or held to maturity investments carried at amortized cost has been incurred the amount of the loss is measured as the difference between the asset’s carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the loan’s effective interest rate computed at initial recognition.”*

***Section IAS 39 (AG 84)***

Cash flows relating to short term receivables are not discounted if the effect of discounting is immaterial.

In many cases, future cash flows cannot be reasonably estimated given that present uncertainties relating to the borrower's circumstances continue to cause the loan's impairment. In these cases, and where there is no tangible security or the realization of any security is still under consideration, the use of discounting (the discount method) may not be practical. Also, in many cases, unless the realization of the security is expected to take more than 6 months or the amount

of the security deficiency compared to the carrying value of the loan is large, the use of discount method is not likely to result in a material difference in the required allowance. In these cases, institutions may measure the allowance as the difference between the loan's carrying value and estimated net realizable value of any security.

Institutions will need to determine materiality when measuring loan impairment and whether the use of the discount method is required. In some cases, where the number of impaired loans is large, it may be appropriate to consider materiality based on a "portfolio" basis (e.g. personal loans). When considering materiality and the use of the discounting, the credit union may need to review recommendations with the external auditor.

Examples of determining the amount of allowance under different circumstances are provided below. Please also refer to sample template which is available on DICO's web site which may be adapted as appropriate.

**EXAMPLE 1: Estimated Value of Security \$140,000**

Description			Calculation/Comments
Original Loan	\$250,000	A	Calculation/Comments
Carrying Value	\$180,000	B	
Estimated Fair Value of Security	\$140,000	C	
Estimated Time to realize on Security	15 months	D	
Interest Rate (Variable)	8%	E	
Estimated Future Cash Flows (Discounted)	\$126,719	F	C*D*E
Loan Allowance (non Discounted)	\$40,000	G	B-E
Loan Allowance (Discounted)	\$53,281	H	F-E
Difference (\$)	\$13,281	I	H-G
Difference (%)	9%	J	I/C
Allowance Required	\$53,281	K	H

In Example 1, the allowance calculated under the discount method is \$53,281 compared to \$40,000 when not using the discount method. As the difference is considered material by the credit union the use of the discount method is required.

**EXAMPLE 2: Estimated Value of Security \$85,000**

Description			Calculation/Comments
Original Loan	\$150,000	A	
Carrying Value	\$100,000	B	
Estimated Fair Value of Security	\$85,000	C	
Estimated Time to realize on Security	5 months	D	
Interest Rate (Variable)	9%	E	
Estimated Future Cash Flows (Discounted)	\$81,883	F	C*D*E
Loan Allowance (not Discounted)	\$15,000	G	B-E
Loan Allowance (Discounted)	\$18,117	H	F-E
Difference (\$)	\$3,117	I	H-G
Difference (%)	3.7%	J	I/C
Allowance Required	\$15,000	K	G

In Example 2, the allowance calculated under the discount method is \$18,117 compared to \$15,000 when not using the discount method. As the difference is not considered material by the credit union the use of the discount method is **NOT** required.

While the loan is impaired, the fair value of security should be adjusted where appropriate to reflect any changes in current market values and any changes in the estimated costs of disposal.

### **Security Valuations**

The valuation of the security should be based on current market values and include documentation of the valuation source. Once a loan becomes impaired, security values should be reviewed and updated to reflect the most current information as necessary with appropriate adjustments to the fair value of security, estimated net realizable amount and the loan loss allowance.

Credit Risk Management Policy should establish:

- the frequency of security valuation reviews;
- the criteria that define when an independent qualified appraisal is required; and
- the published sources or qualifications of other persons providing other objective opinions of value.

It is expected that at a minimum, security values related to impaired loans are reviewed at least quarterly, with adequate documentation and evidence to support the current valuation.

**No value** may be assigned to a security interest in:

- tangible property which the insured institution does not possess, which is not duly registered, or on which the registration is not in good standing (or for which the insured institution does not hold non-filing insurance); or
- intangibles such as goodwill, quotas, wage assignments, personal or third-party guarantees (excluding government guarantees), or lodgement of title.

Exceptions may be made for co-signors, personal guarantors or third-party guarantors: (i) who bring the loan payments up to date and have enough resources to cover the debt or (ii) who provide a security interest in tangible property, sufficient to cover the debt.

### **(iv) Income Recognition**

Interest continues to accrue on impaired loans. The loan loss allowance should be adjusted monthly to reflect any additional accrued interest outstanding. Changes in the estimated realizable amount arising subsequent to initial recognition of impairment should be reflected in the income statement in the current period as a charge or credit for loan impairment.

Write-offs and recoveries related to impaired loans should be recorded through the loan loss allowance account rather than being recorded directly as a charge or credit for impairment in the income statement. Institutions should establish an active write-off policy which requires write-off as soon as possible once collection efforts have been exhausted and no further recovery is likely. Any credit card loan that has a payment 180 days in arrears should be written off.

Subsequent payments (whether designated as interest or principal) on an impaired loan should be recorded as a reduction of the recorded investment in the loan. When the recorded investment in the loan is completely written off, payments should be credited to the allowance for loan impairment. In both cases, the result will be a credit to loan costs upon revaluation of the allowance at period-end.

Note: When an impaired loan no longer meets the criteria for impairment as outlined in section (i) above, the loan may be treated as a performing loan and any outstanding allowance for impairment may be reversed.

## **C. COLLECTIVE LOAN IMPAIRMENT AND ALLOWANCE**

Institutions are required to adopt and document a sound loan impairment methodology including policies, procedures and controls, for identifying problem loans and determining allowances in a timely manner<sup>1</sup>. As there is often a period of time between when a loss event occurs and when management is able to identify the event, collective allowances should recognize management's best estimates of losses in the portfolio at the reporting date that have not yet been individually recognized as impaired.

Although a variety of methodologies may be appropriate for determining the collective allowance, it is important to recognize that the balance of collective allowances is expected to increase in line with portfolio growth and/or evidence of deterioration in credit quality through the economic cycle.

Institutions should ensure that they maintain an adequate level of collective allowances that recognize the risk profile of the loan portfolio.

### **(i) Measurement**

Once individual loans are assessed for impairment, institutions are required to make a collective assessment of impairment as outlined in IAS 39 (59).

*IAS 39 (59) "A financial asset or group of financial assets is impaired and impairment losses are incurred if, and only if, there is objective evidence of impairment as a result of one or more events (a loss event) that occurred after the initial recognition of the asset and that loss event (or events) has an impact on estimated future cash flows of the financial asset or group of financial assets that can be reliably estimated".*

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<sup>1</sup> Sound Credit Risk Assessment and Valuation for Loans Guideline issued by the Basel Committee on Banking Supervision, June 2006 (BCBC "SCRAVL")

Loans that are NOT individually identified as impaired in accordance with section B above should be grouped on the basis of similar credit risk characteristics that reflect the borrowers' capacity to pay all contractual amounts due in accordance with terms of the loan. Institutions should have appropriate systems in place that reliably classify all loans on the basis of credit risk. This may require establishing a number of sub groups within any particular loan portfolio.

Types of objective evidence outlined in IAS 39 (59) include:

- Observable data that there is a measurable decrease in the estimated future cash flows from a group of loans since origination although the decrease cannot yet be identified with an individual loan within the group, including:
  - Adverse changes in the payment status of borrowers within the group such as an increase in the number of delayed payments within the group
  - National or local economic conditions that correlate with defaults on loans within the group such as an increase in unemployment rates, decrease in property values or adverse changes in industry conditions that affect borrowers in the group

## **(ii) Elements of Collective Impairment**

The assessment for collective impairment should be based on all available and relevant information. The methodology used should be appropriate for the complexity of the institution, reflect actual loss experience and management's best estimates of the projected impact of changes to economic conditions. The methodology should be supported by appropriate observable data and is expected to incorporate:

- Current and reliable data;
- Historical loss experience (or peer group experience for comparable groups of loans where insufficient loss experience is available);
- Management's experienced judgement and all known relevant internal and external factors that may affect repayment;
- Adjustments to historical loss experience to reflect the effects of current conditions; and
- Reasonable and supportable assumptions and adequate documentation

The methodology and assumptions used are to be reviewed regularly (i.e. back tested) to reduce any differences between loss estimates and actual loss experience. This data should be assessed periodically as circumstances change or as new data that are more relevant and directly representative of loss become available. Where the condition/composition of an underlying portfolio has materially changed, it will be appropriate for the institution to review the components of impairment and ensure that the methodology used to determine the collective allowance is sufficiently robust to ensure that exposure to impairment is adequately captured.

### **(iii) Level of Collective Allowance**

In accordance with the Basel Committee “guideline”, an institution’s aggregate amount of individual and collective allowances should be adequate to absorb estimated credit losses in the portfolio. Historical loss experience may be limited or not fully relevant to current circumstances. The use of experienced credit judgement and estimates are an essential part of the recognition and measurement of losses as noted in IAS 39. Estimated credit losses should reflect consideration of the institution’s net “charge off” rate adjusted upward or downward for changes in trends, conditions, and other relevant factors that affect the repayment of these loans at the reporting date.

The level of the collective allowance is expected to fluctuate to reflect the nature and composition of the loan portfolio, changes in the economic cycle and the effectiveness of the institution’s credit risk policies, procedures and practices. Where the collective allowance lies within a range of estimates, the best estimate within that range should be chosen in accordance with IAS 39 (AG86).

*IAS 39 (AG 86) "The process for estimating the amount of an impairment loss may result in a single amount or in a range of possible amounts". In the latter case, the entity recognizes an impairment loss equal to the best estimate within the range taking into account all relevant information available before the financial statements are issued about conditions existing at the end of the reporting period."*

### **(iv) Changes to the Collective Allowance**

Management should closely monitor changing conditions and resulting impairments and reflect changes through increases or decreases in the collective and individual allowances as appropriate.

At a minimum, institutions should review the level of collective allowances on a quarterly basis to ensure that it remains at an appropriate level or range. Adjustments to the collective allowance should be considered where appropriate to account for any significant or abnormal change in credit risk as a result of economic or specific events that have occurred which are expected to either higher or lower loan losses than the historical averages. These would recognize any increase in bankruptcies, higher than normal levels of (or increasing) delinquency, plant closures, plant lockouts or strikes, etc. At least annually, institutions should ensure that the most current loss history is incorporated in the assumptions used for determining the collective allowance.

In normal circumstances, amounts are expected to flow from the collective to individual allowances where an individual loan that is now impaired can be identified within groups of loans for which a collective allowance had previously been established. Adjustment to the collective allowances may also arise from changes in the methodology which may be necessary to reflect changes in the condition or composition of the underlying portfolio or improvement in available data. Increases and decreases in the collective allowances are to be systematic and rational and any material change should be supported by observable changes/shifts in the

identified elements of impairment (refer section iii above). Board policy should provide direction on the requirement and approach regarding maintaining an appropriate collective allowance.

#### **(v) Documentation**

Institutions are expected to maintain adequate documentation of the methodology, data and management judgement used to support the level of collective allowances. Any material change in the collective allowance should be supported by adequate documentation and rationale.

### **D. THE BOARD AND SENIOR MANAGEMENT**

The board and senior management are responsible for ensuring that the institution has appropriate and effective credit risk assessment processes and internal controls to measure the level of impairment within the loan portfolio. This includes understanding and determining the level of risk being taken by the institution and how these risks relate to the level of collective and individual allowances.

The board of directors has responsibility for setting the institution's risk tolerance and for ensuring that management:

- Establishes a measurement system for assessing risk;
- Develops a system to relate risk to the institution's allowance levels; and
- Establishes a method of monitoring compliance with internal policies

Management's responsibilities include:

- Monitoring and managing the quality of the loan portfolio;
- Maintaining effective systems and controls for identifying, measuring, monitoring and addressing credit problems in a timely manner;
- Developing documented policies and procedures for determining the collective allowances; and
- Reporting to the board any material changes in the collective and individual allowances

### **E. DICO'S ASSESSMENT PROCESS**

DICO will review each institution's collective allowance policy and methodology against the principles outlined in this guidance note as part of its Examination. This review will include an assessment of the:

- adequacy of corporate governance over the collective allowance process;
- adequacy of methodology for establishing the estimate of credit losses captured by the collective allowance including the integrity of the data used in the estimate and the testing/verification of the output;
- relevance of the methodology and its relationship to the institution's historical loss experience, the nature and composition of its current portfolio of credit risk, as well as the projected rate of growth of the portfolio; and
- integrity of the institution's risk assessment and measurement processes in general

## **Appendix 1: Approaches for Determining the Collective Allowance**

There is no one single approach for determining the collective allowance. Smaller institutions that have a fairly simple offering of loan products may likely be able to use a relatively basic approach. Class 2 institutions in general offer more loan products, including commercial and agricultural loans and are expected to implement a more robust methodology that more fully recognizes the difference in credit risk across a number of loan types. Larger more complex institutions are expected to implement more sophisticated models that adequately reflect changes in risk profiles that lead to impairment across all loan categories. Also, it is expected that larger institutions will have access to more data and better analytical capabilities. In some cases, more than one approach may be used with a best estimate made within a range of projections.

**Examples of the following approaches are available on DICO's web site and may be modified as appropriate to meet the needs of individual institutions.**

### **1. LOSS DEFAULT APPROACH (Model 4)**

The following approach may be appropriate for Class 2 institutions that have a more complex loan portfolio including commercial and agricultural loans which exhibit variance in loan defaults and loss experience. Each institution should review the methodology adopted with their external auditors and ensure that it appropriately reflects historical trends and any other circumstances that are likely to lead to increasing loan loss exposure and default.

#### **Suggested Steps**

1. Segregate loans into different loan categories. Loans are segregated into their distinct loan types such as: personal (secured), personal (unsecured), residential mortgages, commercial, agricultural, institutional. Institutions may also segregate residential mortgage loans into insured or conventional groupings.
2. At the end of each year, calculate the loan loss allowance for each portfolio group. This could be based on payment delinquency, risk ratings or other meaningful segregation. (The model outlined below is based on loan default and losses of new loans made in each year)  
Note: The carrying value of each group of loans should be reduced by the carrying value of any loan for which an individual (specific) allowance has been made
3. Using management's best estimate and judgment, determine any change in loss exposure as a result of economic or risk conditions (e.g. recently announced plant closure and pending layoffs, plant re-opening, significant increase in delinquency above 30 days, changes in unemployment rates or property prices, etc.) that indicate a change in credit quality and level of incurred loss events that are expected to lead to losses that differ from the weighted average historical loss experience. Each condition should be associated with observable data used to estimate the change in incurred losses.
4. Increase/Decrease the collective allowance as appropriate.
5. Review on on-going basis and make additional adjustments as deemed appropriate for any events that indicate a potential material change in loss exposure.

### Model 4

	Summary Calculations		
	Personal (secured)	Personal (unsecured)	Commercial Loans
Portfolio Balance (less Individual Impaired Loans)	\$18,095,000	\$1,500,000	\$5,000,000
Average Probability of Default for New Loans (PD) (**)	4%	8%	10%
Average Loss Given Default for New Loans (LGD) (**)	35%	80%	40%
Collective Allowance Required (Rounded to nearest \$1,000) [Portfolio Balance (exclude new loans <30 days) ) x PD x LGD]	\$233,000	\$96,000	\$200,000
Projected additional Exposure based on management's best experience and judgement	\$NIL	\$NIL	\$ 50,000
Total Collective Allowance Required	\$233,000	\$96,000	\$250,000
Less Current Collective Allowance	\$240,000	\$85,000	\$225,000
Change in Collective Allowance required this period	(\$7,000)	\$11,000	\$25,000

\*\* Refer Table 1 below for sample calculations for Personal (secured) loans.

**Table 1: Secured Personal Loan Group (000s)**

Loan Loss History Secured Personal Loans	2009	2008	2007	2006	2005	Average
New loans issued in the year (A)	6,500	6,300	6,200	6,250	6,100	
Actual losses (B)	176	56	49	86	23	
Principal Amount of loans where losses occurred (at time of impairment) (C)	290	298	210	303	50	
Probability of Default (PD) [C ÷ A]	4%	5%	3%	5%	1%	4%
Loss Given Default (LGD) [B ÷ C]	61%	19%	23%	28%	45%	35%

## 2. LOSS DEFAULT APPROACH (Model 5)

The following approach may be appropriate for Class 2 institutions that have a more complex loan portfolio including commercial and agricultural loans which exhibit variance in loan defaults and loss experience. Each institution should review the methodology adopted with their external auditors and ensure that it appropriately reflects historical trends and any other circumstances that are likely to lead to increasing loan loss exposure and default.

In some cases, more than one approach may be used with a best estimate made within a range of projections

## Suggested Steps

1. Segregate loans into different loan categories. Loans are segregated into their distinct loan types such as: personal (secured), personal (unsecured), residential mortgages, commercial, agricultural, institutional. Institutions may also segregate residential mortgage loans into insured or conventional groupings.
2. At the end of each year, calculate the loan loss allowance for each portfolio group. This could be based on payment delinquency, risk ratings or other meaningful segregation. (The model outlined below is based on loan default and losses of delinquent loans)
3. Note: The carrying value of each group of loans should be reduced by the carrying value of any loan for which an individual (specific) allowance has been made
4. Using management's best estimate and judgment, determine any change in loss exposure as a result of economic or risk conditions (e.g. recently announced plant closure and pending layoffs, plant re-opening, significant increase in delinquency above 30 days, changes in unemployment rates or property prices, etc.) that indicate a change in credit quality and level of incurred loss events that are expected to lead to losses that differ from the weighted average historical loss experience. Each condition should be associated with observable data used to estimate the change in incurred losses.
5. Increase/Decrease the collective allowance as appropriate.
6. Review on on-going basis and make additional adjustments as deemed appropriate for any events that indicate a potential material change in loss exposure.

### Model 5

	Summary Calculations		
	Personal (secured)	Personal (unsecured)	Commercial Loans
Current Loan Portfolio (excluding Individual Impaired Loans)	\$18,450,000	\$2,690,000	\$1,750,000
Average Probability of Becoming in Arrears (PA) (**)	2.1%	5.0%	6.5%
Average Probability of Default for Delinquent Loans (PD) (**)	22%	65%	70%
Average Loss Given Default Delinquent Loans (LGD) (**)	38%	80%	40%
Collective Allowance Required (Rounded to nearest \$1,000) [Current Portfolio Balance x PA x PD x LGD)	\$34,000	\$70,000	\$32,000
Projected additional Exposure based on management's best experience and judgement	\$NIL	\$10,000	\$ 50,000
Total Collective Allowance Required	\$34,000	\$80,000	\$82,000
Less Current Collective Allowance	\$40,000	\$75,000	\$75,000
Change in Collective Allowance Required this period	<b>(\$6,000)</b>	<b>\$5,000</b>	<b>\$7,000</b>

\*\* Refer Table 2 below for sample calculations for Personal (secured) loans.

**Table 2: Secured Personal Loan Group (000s)**

<b>Loan Loss History Secured Personal Loans</b>	<b>2009</b>	<b>2008</b>	<b>2007</b>	<b>2006</b>	<b>2005</b>	<b>Average</b>
Average Monthly Delinquency (A)	400	375	325	500	380	
Average Outstanding Loans (B)	18,450	19,000	18,750	18,500	17,600	
Probability of Becoming in Arrears (PA) [A ÷ B]	2.2%	2.0%	1.7%	2.7%	2.2%	2.1%
Principal Amount of loans where losses occurred (at time of impairment) (C)	32	142	99	114	50	
Probability of Default (PD) [C ÷ A]	8%	38%	31%	23%	13%	22%
Actual Losses (D)	17	7	32	63	23	
Loss Given Default (LGD) [D ÷ C]	55%	5%	32%	55%	45%	38%