

DEPOSIT INSURANCE CORPORATION OF ONTARIO

BY-LAW NO. 5

STANDARDS OF SOUND BUSINESS AND FINANCIAL PRACTICES

A by-law made under paragraph (g) of subsection 264(1) of the Credit Unions and Caisses Populaires Act, 1994 (the “Act”) to prescribe standards of sound business and financial practices for credit unions.

BE IT ENACTED AND IT IS HEREBY ENACTED as By-law No. 5 of the DEPOSIT INSURANCE CORPORATION OF ONTARIO (hereinafter called the "DICO") as follows:

The standards set out DICO’s minimum requirements regarding sound business and financial practices for credit unions. The standards are designed in such a way to make them adaptable to every credit union regardless of size or complexity, recognizing that approaches will differ among credit unions.

DICO will consider material non-compliance with this By-law as evidence that a credit union is:

- in breach of the standards of sound business and financial practices for the purposes of cancellation of deposit insurance under section 274(1) of the Act; or
- conducting its affairs in a way that might be expected to harm the interests of members or depositors or that tends to increase the risk of claims by depositors against DICO for the purposes of ordering a credit union under Supervision under section 279(1) of the Act

All credit unions are required to comply with the standards of sound business and financial practices outlined in Section A. Class 2 credit unions must also comply with additional standards as set out in Section B.

Guidance for meeting the standards is provided separately for Class 1 and Class 2 credit unions in DICO’s Guidance Notes, Reference Manual on Sound Business and Financial Practices, Director’s Handbook, Audit Committee Handbook, Self-Assessment Workbooks, Examination Manual, Enterprise Risk Management (ERM) Framework and other related publications, as may be amended from time to time. As a Class 1 credit union approaches the criteria to become a Class 2 credit union, it should ensure that adequate planning is in place to address the additional requirements and expectations for Class 2 credit unions.

Reporting Requirements

At least annually, the board shall review and assess the operations of the credit union and submit to DICO within 75 days of the end of the financial year, a board resolution, in the form outlined in Appendix A confirming that:

- management has provided a representation letter to the board of directors regarding its assessment of adherence to management’s responsibilities under the standards of sound business and financial practices; and
- the board of directors is familiar with, and is acting in compliance with, the standards of sound business and financial practices

STANDARDS

SECTION A: CLASS 1 AND CLASS 2 CREDIT UNIONS

1. Corporate Governance: Board of Directors

The board of directors is ultimately responsible for ensuring that the credit union is operated in a safe and prudent manner and for ensuring adherence to these standards of sound business and financial practices. In fulfilling its responsibilities, the board of directors should be guided by co-operative principles and ensure that the credit union operates on a co-operative basis.

At a minimum, the board of directors shall:

- establish appropriate and prudent risk management policies, including:
 - Capital Management
 - Credit Risk Management
 - Operational Risk Management
 - Market and Investment Risk Management
 - Structural Risk Management
 - Liquidity Risk Management;
- obtain reasonable assurance that the credit union is adhering to its risk management policies for significant risks;
- establish the responsibilities, accountability and authority of the audit committee and other board committees;
- establish standards of business conduct and ethical behaviour;
- appoint appropriately skilled and experienced management to implement the board's objectives;
- establish the business objectives of the credit union consistent with co-operative principles and approve the credit union's business strategy and business plans;
- evaluate the credit union's actual operating and financial results against business plans;
- evaluate the effectiveness of the board and the audit committee;
- evaluate the effectiveness of management

2. Corporate Governance: Audit Committee

At a minimum, the audit committee shall:

- develop a work plan for all meetings for the year that addresses all the duties and responsibilities set out in the Act and Regulations;
- establish an effective internal audit function to evaluate internal controls and mitigate any material weaknesses;
- confirm full compliance with the Act, Regulations and other legislative requirements;
- ensure appropriate follow-up on all outstanding issues, weaknesses and deficiencies including findings and recommendations of examinations

3. Corporate Governance: Management

Management is responsible to ensure that the credit union applies the processes, procedures and controls necessary to prudently manage the risk and to provide the board of directors with timely, relevant, accurate and complete information to enable it to assess that delegated responsibilities are being discharged effectively.

At a minimum, management shall:

- implement appropriate and prudent risk management policies, procedures and controls;
- monitor the effectiveness of risk management practices and controls for its significant risks;
- develop and implement an appropriate and prudent business strategy and business plans;
- provide the board of directors with timely, relevant, accurate reports on the implementation of the credit union's business strategy, business plans and any material risk that may affect business objectives

SECTION B: CLASS 2 CREDIT UNIONS

Each Class 2 credit union is required to implement a robust enterprise wide risk management (ERM) framework that is appropriately scaled to recognize its size, complexity and risk profile.

The ERM framework includes the processes and methods that the credit union uses to identify and manage significant risks and to realize opportunities related to the achievement of their objectives. It involves an independent and pro-active enterprise wide view of all risks and risk tolerances to ensure that they are fully aligned with corporate objectives and strategies, and reflect the quality and limitations of people, technology and capital.

Strong corporate governance practices include the processes, structures and information used for directing and overseeing the management of a credit union. An effective risk management process includes the identification of significant risks, documented policies and procedures, measurement techniques, reporting and controls.

The ERM framework involves the implementation of processes to:

- identify significant risks;
- measure significant risks;
- assess significant risk impacts, tolerances and gaps;
- define appropriate responses to significant risks;
- monitor significant risks and the adequacy of responses; and
- report on the effectiveness of management for significant risks

Class 2 credit unions are expected to implement an ERM which address the following requirements;

1. Corporate Governance: Board of Directors

The board of directors shall:

- Understand and Fulfill Responsibilities
- Exercise Independent Judgment
- Establish CEO’s Responsibilities and Accountability
- Select and Evaluate the CEO
- Review Compensation
- Oversee Strategic Management
- Oversee Risk Management
- Oversee Liquidity and Funding Management
- Oversee Capital Management
- Affirm a Control Environment
- Oversee the Independent Internal Audit Function
- Ensure the Credit Union is “In Control”

2. Corporate Governance: Audit Committee

As part of the ERM process, the audit committee shall:

- Review management’s identification of the significant risks the credit union faces
- Ensure there are risk management processes in place to measure, monitor, manage and mitigate those risks including appropriate policies, procedures and controls
- Report to the board on the extent of risk management practices

3. Corporate Governance: Management

As part of the ERM process, management shall address:

Risk category	Standard
Governance Risk: Management	<ul style="list-style-type: none"> • Strategic Management Process • Risk Management Process • Business Conduct and Ethical Behaviour • Process to Ensure Control • Reporting Risk
Credit Risk	<ul style="list-style-type: none"> • Commercial • Consumer
Financial Risk	<ul style="list-style-type: none"> • Investment and Market Risk • Asset / Liability Matching Risk • Liquidity and Funding Management • Capital Management
Operational Risk	<ul style="list-style-type: none"> • Fiduciary Risk • Operational Risk • Regulatory Compliance Risk • Control Environment • Information Technology Risk • Personnel Risk

Specific Assessment Criteria

When reviewing each of these responsibilities and risk area areas, the board should ensure that specific criteria are developed for review and consideration in determining and assessing risk levels. The following are examples of minimum criteria relating to the assessment of the control environment and risk management practices. Further guidance can be found in the ERM Framework document for criteria surrounding other responsibilities and risk areas.

Ensure the Credit Union is “In Control”.

When assessing whether the credit union is “in Control”;

- Does the board understand the nature and extent of the self-assessment work conducted by senior management to enable conclusions to be reached on whether the credit union is “in control”?
- Does the board understand the nature and extent of the validation process conducted by the independent inspection/audit group?
- Does the board receive enterprise-wide reports about all significant weaknesses or breakdowns and the actions taken or planned to address them?
- Does the board understand how weaknesses or breakdowns are determined to be significant at different levels in the organization and the criteria for “filtering” the results of the “in control” assessment to senior management and ultimately to the board?
- Is senior managements’ assessment of whether the credit union is “in control” consistent with the observations of independent third parties (e.g. external auditors, examiners regulators)?

Risk Management Process

When assessing the “Risk Management Process”;

- Is there a comprehensive and consistent set of definitions and common terms for risks and risk management that are applied on an enterprise-wide basis?
- Are there unambiguous lines of responsibility and accountability for managing and reporting on specific strategic, business and process level risks?
- Are individuals at all levels aware of the risks related to their responsibilities and the requirement for them to manage these risks?
- Does the risk management process enable the overall aggregation of risks in support of strategic and risk management and control related decision-making?
- Do risk management priorities focus on issues that are most important to the achievement of the business objectives and strategy, rather than on issues that are the easiest to address?

Process to Ensure Control

When assessing the “Process to Ensure Control”;

- Are self-assessment assertions concerning whether these operations are being effectively managed, provided by individuals who manage operations and do they set out the significant related issues?
- Do these self-assessment reports prioritize the significant issues and set out how they will be addressed?
- Does the independent inspection/audit group periodically validate the quality and integrity of the self-assessment process including the underlying support for the resulting assertions?
- How, and to what extent, are observations from external sources about the management of the credit union’s operations and risks taken into account?

Definitions

The following definitions apply with respect to this By-law:

"appropriate" means that it is suitable for its intended purpose, having regard to the nature, magnitude, complexity and implications of the matter in question.

"co-operative principles" are outlined in the "Statement on the Co-operative Identity" from the International Co-operative Alliance. These principles include, voluntary and open membership; democratic member control; member economic participation; autonomy and independence; education, training and information; co-operation among co-operatives; concern for community.

"effective" means that it is achieving, or can reasonably be expected to achieve, its intended purpose.

"representation letter" means any report, document or letter in the format as specified by the board of directors.

"material or significant risk" means a risk or a combination of risks that is important because of the probability of occurrence, the severity of impact or both, that could have an adverse effect on the credit union's earnings, liquidity, capital or reputation, or on the ability of the credit union to achieve its business objectives or implement its business strategy and business plans.

"prudent" means that it is the result of careful and practical judgment, having regard to business objectives, risks, the business and economic environment, and the quantity, quality and sustainability of earnings, liquidity, capital and other resources.

Transitional

A credit union will be required to be in full compliance with this by-law by the end of its first financial year ending on or after December 31, 2011.

Effective Date

By-law No. 5 of DICO made on 15th day of September 2004 is hereby repealed and replaced by this by-law.

Enacted as a by-law of DICO by the Board of Directors on the day of September, 2010

Approved by the Lieutenant Governor in Council by Order dated day of 2010

APPENDIX A: Sample Board Resolution

Resolution of the Board of Directors

It is resolved that:

This resolution is made in respect of <name of credit union > (the "credit union") and concerns its adherence to the Deposit Insurance Corporation of Ontario ("DICO") Standards of Sound Business and Financial Practices (the "Standards") as set out in DICO By-law No.5.

The board of directors (the "board") of the credit union is familiar with the contents of the Standards By-law and acknowledges its responsibilities under the Standards.

The board of directors of the credit union is, to the best of its knowledge and abilities, fulfilling its responsibilities under the Standards [*if applicable, add: "except as indicated below"*].

The board has carefully considered the management representation letter dated <month> <day>, <year> addressed to the board concerning adherence to the Standards. The board has also carefully considered other information, and made such inquiries as it deems appropriate and relevant to the forming of its opinion on whether the credit union is following the Standards. It is the opinion of the board that to the best of its knowledge, it has obtained reasonable assurance that the credit union is following the Standards [*add, if applicable: "except as indicated in the representation letter and/or below"*].

[*If applicable, add: "With respect to the deficiency (ies) or exception(s) not indicated in the representation letter, the board of directors confirms that an action plan (plans) addressing their correction has(have) been prepared and is(are) being implemented. A copy of the action plan(s) is being (has been) submitted to DICO and/or the Financial Services Commission of Ontario."*]

The foregoing is certified as a true copy of a resolution of the board of directors of <name of credit union > passed at a meeting of the board held on the <day> of <month>, <year>. Dated at <insert place> this <day>of<month>, <year>.

Corporate Secretary

Copy to: Deposit Insurance Corporation of Ontario

DEPOSIT INSURANCE CORPORATION OF ONTARIO
BY-LAW NO. 6
RESERVES AND MONTHLY PROVISION FOR DOUBTFUL LOANS

**A By-law made under section 90 of the Credit Union and Caisses Populaires Act,
1994 and section 24 of Ontario Regulation 237/09**

This by-law provides direction on the methodology for establishing reserves and determining the monthly provision for doubtful loans.

1. ESTABLISHING RESERVES AND DETERMINING THE MONTHLY PROVISION FOR DOUBTFUL LOANS

A credit union shall assess at the end of each month whether a loan or group of loans is impaired. If there is objective evidence that impairment has occurred, then the carrying amount of the loan must be reduced either directly or through the use of a reserve by establishing an allowance for impaired loans. The amount of the impairment must be recognized in the calculation of the credit union's profit or loss for that month as a monthly provision for doubtful loans. When determining the allowance for impaired loans and the amount of the impairment, credit unions are required to follow the standards and interpretations issued by the International Accounting Standards Board (IASB). The following provides additional guidance to these standards and interpretations:

A. Recognizing impairment

Individual Allowance

Each credit union is required to establish an individual allowance for individually significant loans and other specifically identified individual loans

Each credit union is required to establish in its lending policies the amount at which a loan is considered "significant" for the purpose of assessing impairment for individually significant loans. This may be based on a dollar amount or percentage of capital or other criteria but would generally result in ensuring that the largest value loans for each loan category are assessed for impairment on a regular basis.

While arrears of payments with respect to the contractual terms of a loan is not a necessary precondition for recognition of impairment, DICO considers the existence of any of the following conditions to be an indication of objective evidence of impairment as required by the standards and interpretations of the IASB:

- a) 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;
- b) payment on any loan, excluding a credit card loan, is contractually 180 days in arrears. Any credit card loan that has a payment 180 days in arrears should be written off.
- c) the debt is assigned to a collection agency;
- d) 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
- e) 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 of the loan.

Collective Allowance

Each credit union is required to establish a collective allowance for the remaining loans excluding those loans where an individual allowance has already been taken. The methodology and assumptions used are to be reviewed at least annually to reduce any differences between loss estimates and actual loss experience. The allowance should reflect management's experience and judgement surrounding changes in economic and other conditions that have occurred which may indicate a group of loans is impaired.

B. Measuring Impairment

In accordance with IASB standards and interpretations, the allowance is determined as the excess of the loan's carrying amount (i.e. outstanding principal plus interest owing less any allowance) above the loan's present value of estimated future cash flows discounted at the original effective interest rate. Further guidance on discounting, materiality, and other issues related to measuring impairment can be found in the DICO Guidance Note: Impaired Loans.

When determining estimated future cash flows, credit unions should consider the fair value of any security less any estimated legal and other costs related to the holding and disposition of the secured asset. The valuation of the security must be based on current market values and include documentation of the valuation source. Board policy must establish monetary limits and 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.

No value may be assigned to a security interest in tangible property which the credit union does not possess, which is not duly registered, or on which the registration is not in good standing (or for which the credit union does not hold non-filing insurance). No value may be given to security interests in intangibles such as goodwill, quotas, wage assignments, personal or third-party guarantees (excluding government guarantees), or lodgment of title.

C. Loan Loss Allowance Reversal

A loan may no longer be considered impaired when the borrower’s financial circumstances have changed such that future repayment is not in doubt and the loan does not satisfy any of the conditions of impairment outlined in section A above or the standards and interpretations of the IASB. In these cases the allowance for impairment may be reversed in accordance with the standards and interpretations of the IASB.

D. Income Recognition

Write-offs and recoveries related to impaired loans should be recorded through the loan allowance account rather than being recorded directly as a charge or credit for loan impairment in the income statement. 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. Interest income on impaired loans should continue to be recognized and must be reflected in the allowance.

E. Disclosure

Credit unions shall provide separate disclosure of individual and collective allowances by providing a reconciliation of changes to each of these accounts during the period.

2. DEFINITIONS

For the purposes of this by-law:

“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.

3. APPLICATION OF BY-LAW:

This by-law applies to all financial years of a credit union that start after December 31, 2010. By-law No. 6 made on June 28th, 1995 continues to apply to all financial years of a credit union that started or starts prior to January 1, 2011.

ENACTED as a By-law of the Corporation by the Board of Directors on the _____ day of _____, 2010

APPROVED by the Lieutenant Governor in Council by Order dated the _____ day of _____, 2010

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Date: September 2010

Guidance Note: Class 1 Institutions

Impaired Loans – Loan Loss Allowances

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.

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A. INTRODUCTION

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. 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 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 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 or a 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.

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

Guidelines for Determining Individually Significant Loans

Loan Type	Individually Significant Loans
Personal (Secured)	Largest 5 loans and all loans >\$100,000
Personal (unsecured)	Largest 10 loans
Residential Mortgage Loans	Largest 5 loans and all loans >\$250,000

(iii) Measuring Impairment

The allowance for loan impairment is based on the difference between the carrying amount of the loan and the present value of any security or estimated future cash flows. Institutions will need to determine the degree of materiality when measuring loan impairment and whether the use of the discount method is required.

In most cases, where the security value is less than \$25,000 and any security is expected to be realized within 6 months, use of the discount method may not be practical and is NOT expected to result in any material difference.

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.

In other cases, where the estimated value of security is greater than \$25,000 or where the realization of security (or estimated future cash flows) is expected to take longer than 6 months or, institutions may need to use the discount method.

As a general rule, DICO considers a difference of more than \$1,000 OR 5% to be a material difference for Class 1 Institutions.

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.

EXAMPLE 1: Estimated Value of Security \$20,000

Description			Calculation/Comments
Original Loan	\$40,000	A	
Carrying Value (Outstanding loan amount)	\$30,000	B	
Estimated Fair Value of Security	\$20,000	C	
Estimated Time to realize on Security	5 months	D	
Interest Rate (Variable)	10.5%	E	
Estimated Future Cash Flows (Discounted)	\$19,125	F	C*D*E
Loan Allowance (non Discounted)	\$10,000	G	B-C
Loan Allowance (Discounted)	\$10,875	H	B-F
Difference (\$)	\$875	I	H-G
Difference (%)	4%	J	I/C
Allowance Required	\$10,000	K	G as difference <\$1,000 (I) AND <5% (J)

In Example 1, the allowance calculated under the discount method is \$10,875 compared to \$10,000 when not using the discount method. As the difference between the two methodologies is less than \$1,000 AND 5%, the use of the discount method is **NOT** required.

EXAMPLE 2: Estimated Value of security \$45,000

Description			Calculation/Comments
Original Loan	\$75,000	A	
Carrying Value (Outstanding loan amount)	\$50,000	B	
Estimated Fair Value of Security	\$45,000	C	
Estimated Time to realize on Security	9 months	D	
Interest Rate (Variable)	9%	E	
Estimated Future Cash Flows (Discounted)	\$41,963	F	C*D*E
Loan Allowance (not Discounted)	\$5,000	G	B-C
Loan Allowance (Discounted)	\$8,038	H	B-F
Difference (\$)	\$3,038	I	H-G
Difference in Security Values (%)	7%	J	I/C
Allowance Required	\$8,038	K	H as difference >\$1,000 (I) and >5% (J)

In Example 2, the allowance calculated under the discount method is \$8,038 compared to \$5,000 when not using the discount method. As the difference between the two methodologies is more than \$1,000 AND 5%, the use of the discount method is 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 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.

(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.

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.

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. 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 an assessment of impairment on the remaining loans on a “collective” (or portfolio) basis as outlined in IAS 39 (59). 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.

(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 impact of current or projected 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

(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.

(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 amount of actual losses and 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 material change in credit risk during the year 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. At least annually, institutions should ensure that the most current loss history is incorporated in the assumptions used for determining the 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.

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. BASIC APPROACH (Model 1)

The following approach is an example of a possible methodology for smaller less complex (Class 1) institutions that have a fairly basic portfolio of loans and which do not experience significant levels or variances in loan defaults. Loan losses are limited to personal loans and there is no material distinction of loss experience between secured or unsecured loans. 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. This approach is not considered sufficiently robust for Class 2 institutions with commercial or agricultural loans.

Suggested Steps

1. At the end of each year, update the calculation of historical loss experience and determine the average historical loss experience for the (at least) latest five years. (A)
2. It is recommended that “weighted” average loss experience is used rather than a simple average as this ensures that the trend of more current losses is appropriately reflected as opposed to earlier losses. Institutions may use more than five year historical loss experience if available and deemed appropriate. The weights are based on the number of years used (B)
3. Determine the aggregate weighted losses of the period selected (C)
4. Determine the Collective Allowance (D).
5. 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. (E)
6. Determine total collective allowance required (F)
7. Determine “change” in collective provision required (H)

Model 1

	Actual Losses	Weight	Weighted Losses
2005	\$20,000	1	\$20,000
2006	\$11,512	2	\$23,024
2007	\$18,032	3	\$54,096
2008	\$26,278	4	\$105,112
2009 (most current year)	\$17,323	5	\$86,615
Total	\$93,145 (A)	15 (B)	\$288,847 (C)
Collective Allowance Based on Average Annual Loss Experience (C÷B) (Rounded to nearest \$1,000)			\$19,000 (D)
Additional collective allowance required			\$20,000 (E)
Total Collective (Portfolio) Allowance (D + E) Current Period			\$39,000,(F)
Total Collective (Portfolio) Allowance Previous Period			\$35,000 (G)
Change in the Collective (Portfolio) Allowance required this period (F-G=I)			\$4,000 (H)

Under this example the weighted average historical losses over the past five years are \$19,256 or \$19,000 (rounded to the nearest \$1,000). Management has also estimated that an additional credit exposure exists with potential losses of \$20,000 as a result of the recent economic downturn and announced layoffs in the coming year which will likely result in additional losses especially in unsecured loan portfolio. This is supported by the higher loss experience in the latest few months after announcement of the plant closure and is a best estimate within a range of possible losses.

Total projected exposure is \$39,000. As total the current collective allowance is \$35,000 the net additional collective allowance required this period is \$4,000.

2. BASIC APPROACH (Model 2)

The following approach is an example of another possible methodology for smaller less complex (Class 1) institutions that have a fairly basic portfolio of loans and which do not experience significant levels or variances in loan defaults. Loan losses are limited to personal loans and there is no material distinction of loss experience between secured or unsecured loans. In this model, historical losses are based on the percentage of total loans rather than actual dollar amounts. This ensures that the weighted losses reflect any growth or decline in the loan portfolio. 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. This approach is not considered sufficiently robust for Class 2 institutions with commercial or agricultural loans.

Suggested Steps

1. At the end of each year, calculate the historical loss experience and determine the average percentage historical loss experience for the (at least) latest five years. (A)
2. It is recommended that “weighted” average loss experience is used rather than a simple average as this ensures that more the trend of current losses is appropriately reflected as opposed to earlier losses. Institutions may use more than five year historical loss experience if available and deemed appropriate. The weights are based on the number of years used (B)
3. Determine the aggregate weighted % losses of the period selected (C)
4. Determine weighted average % losses for the period selected (D)
5. Determine the Collective Allowance (E) based on current total loan portfolio.
6. 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. (F)
7. Determine total collective allowance required (G)
8. Determine “change” in collective provision required (I)

Model 2

	Actual Losses as % of total loans (A)	Weight	Weighted Losses as % of total loans
2005	1.2%	1	1.2%
2006	1.4%	2	2.8%
2007	1.7%	3	5.1%
2008	1.2%	4	4.8%
2009 (most current year)	1.0%	5	5.0%
Total		15 (B)	18.9% (C)
Weighted Average Loss % (C÷B)			1.3% (D)
Collective Allowance Based on Average Annual Loss Experience (D* \$3,350,000) (Rounded to nearest \$1,000)			\$42,000 (E)
Additional collective allowance required			\$NIL (F)
Total Collective (Portfolio) Allowance (E + F) this period			\$42,000 (G)
Total Collective (Portfolio) Allowance Previous period			\$45,000 (H)
Change in the Collective (Portfolio) Allowance required this period (G – H)			(\$3,000) (I)

Under this example the weighted average historical losses over the past five years as a percentage of loans are calculated as 1.3%. Based on current loan balances of \$3,350,000, this equates to average losses of \$42,210 (or \$42,000 rounded to nearest \$1,000). Management has also estimated that no additional credit exposure exists as the loan portfolio remains stable and there are no external factors known that may lead to additional losses at this time. As the collective allowance for the previous period is more than determined for the current period, a reduction in the collective provision of \$3,000 is recommended.

3. MODIFIED BASIC APPROACH (Model 3)

The following approach may be acceptable for less complex institutions that have a fairly basic portfolio of loans but which exhibit some variance in loan defaults between different loan types. 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. This approach is not considered sufficiently robust for Class 2 institutions with commercial or agricultural loans.

Suggested Steps

1. Segregate loans into different loan categories. At a minimum, segregate personal loans (secured), personal loans (unsecured) and residential mortgage loans. Institutions may also segregate residential mortgage loans into insured or conventional groupings.
2. At the end of each year, calculate the weighted average % historical loss experience for the (at least) latest five years for each group of loans. It is recommended that “weighted” average % loss experience is used rather than a simple average as this ensures that more the trend of more current losses is appropriately reflected as opposed to earlier losses. Institutions may use more than five year historical loss experience if available and deemed appropriate. The weights are based on the number of years used (A)
3. Determine the aggregate weighted % losses for each group of loans for the period selected (B1,2,3)
4. Determine weighted average % losses for each group of loans for the period selected (C1,2,3)
5. Determine the Collective Allowance (E1,2,3,4) based on current total loan portfolio (D1,2,3)
6. 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. (F1, 2, 3, 4).
7. Determine total collective allowance required (G1,2,3,4)
8. Determine “change” in collective provision required (I1,2,3,4)

Model 3

	Weighted Losses as % of Loan Portfolio			Weight	Total Weighted Losses
	Personal (secured)	Personal (unsecured)	Conventional Mortgages		
Year 1	1.0%	2.7%	0.13%	1	
Year 2	2.2%	3.8%	0%	2	
Year 3	3.8%	6.4%	0.09%	3	
Year 4	4.2%	8.5%	0%	4	
Year 5 (most current year)	5.0%	14.0%	0.11%	5	
Total Weighted Losses	16.3% (B1)	35.3% (B2)	0.33% (B3)	15(A)	
Average Weighted Losses	1.1% (C1)	2.4% (C2)	0.1% (C3)		
Current Loan Portfolio	\$12,000,000 (D1)	\$820,000 (D2)	\$35,000,000 (D3)		
Collective Allowance Required (Rounded to nearest \$1,000)	\$130,000 (E1)	\$19,000 (E2)	\$22,000 (E3)		\$171,000(E4)
Additional Collective Allowance Required	NIL (F1)	\$20,000 (F2)	0 (F3)		\$20,000 (F4)
Total Collective Allowance Required this period	\$130,000 (G1)	\$39,000 (G2)	\$22,000 (G3)		\$191,000 (G4)
Collective Allowance previous period	\$130,000 (H1)	\$35,000 (H2)	\$22,000 (H3)		\$187,000 (H4)
Change in Collective Allowance required this period	\$NIL (I1)	\$4,000 (I2)	\$NIL (I3)		\$4,000(I4)

Under this example the average historical weighted average % losses for the latest five years are used for three different loan groups. However, loan losses are increasing for unsecured loans. This allows management to clearly see the difference in loss experience for different loan types and to make appropriate adjustments to reflect estimated loss exposure as a result of the recent economic downturn etc. which will likely result in additional losses in unsecured personal loan portfolio.

In contrast, no additional exposure is expected for secured personal loans or the residential loan portfolio.

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Date: September 2010

Guidance Note: Class 2 Institutions

Impaired Loans – Loan Loss Allowances

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.

(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

Loan Type	Individually Significant Loans
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.”

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.

As a general rule, DICO considers a difference of less than \$5,000 OR 5% not to be material.

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.

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	9 months	D	
Interest Rate (Variable)	7%	E	
Estimated Future Cash Flows (Discounted)	\$132,650	F	C*D*E
Loan Allowance (non Discounted)	\$40,000	G	B-E
Loan Allowance (Discounted)	\$47,350	H	F-E
Difference (\$)	\$7,350	I	H-G
Difference (%)	5.2%	J	I/C
Allowance Required	\$47,350	K	G as difference >\$5,000 AND >5%

In Example 1, the allowance calculated under the discount method is \$47,350 compared to \$40,000 when not using the discount method. As the difference is greater than \$5,000 AND 5% 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)	\$81,813	F	C*D*E
Loan Allowance (not Discounted)	\$15,000	G	B-E
Loan Allowance (Discounted)	\$18,188	H	F-E
Difference (\$)	\$3,188	I	H-G
Difference (%)	3.7%	J	I/C
Allowance Required	\$15,000	K	G as difference <\$5,000 and <5%

In Example 2, the allowance calculated under the discount method is \$18,188 compared to \$15,000 when not using the discount method. As the difference is less than \$5,000 and 5%, 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 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.

(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.

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 manner¹. 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 an assessment of impairment on the remaining loans on a "collective" (or portfolio) basis 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".

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:

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

- 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 impact of current or projected 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 amount of actual losses and 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 establish the level of materiality for on-going changes to the 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.

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 New Loans for new loans (LGD) (**)	35%	80%	40%
Collective Allowance Required (Rounded to nearest \$1,000) [Portfolio Balance 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.

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	(\$6,000)	\$5,000	\$7,000

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

Table 2: Secured Personal Loan Group (000s)

Loan Loss History Secured Personal Loans	2009	2008	2007	2006	2005	Average
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%

Loan Provisioning Discounting Test - CLASS 1

This template helps determine whether the discount method is required to determine the amount of any loan loss allowance. In the discount method, the "net present value" of the security is calculated using the loan's interest rate and the estimated period to dispose of any security. The discount method should be used if there is a material difference in the amount of the required allowance. Materiality is based on a difference of either \$1,000 or 5% of the current fair value of the pledged security.

STEPS:

INPUT CELLS ARE HIGHLIGHTED IN YELLOW

- A Input the materiality limits if more conservative than those set out in the Guidance Note: Impaired Loans. (Cell D18 and D19)
- B Input Loan Numbers (Cell B24, B25, etc.)
- C Input Original Loan Amount (Cell C24, C25, etc.)
- D Input Loan Carrying Value/Outstanding Balance (Cell D24, D25, etc.)
- E Input Estimated Security Value based on most current information (Cell E24, E25, etc.)
- F Input Estimated Time in months to dispose of security (Cell F24, F25, etc.)
- G Input the Loan Interest Rate. If it is a fixed rate loan, input the original rate of the loan. If it is a variable rate loan, input the current variable rate.(Cell G24, G25, etc.)

	A1	A2
Materiality Limit (% of Security value)	5%	\$ 1,000

B	C	D	E	F	G	H = E - [(F ÷ 12) x E]	I = (D - E)	J = (D - H)	K = (J - I)	L = (K ÷ E)			
Loan Number	Original Loan Amount	Carrying Value	Estimated Fair Value of Security	Estimated Time to Dispose of Security (in months)	Loan Current Interest Rate	Estimated Future Cash Flows (Discounted)	Loan Allowance (not Discounted)	Loan Allowance (Discounted)	\$ Difference	% Difference	% Material?	\$ Material?	Provision to be taken
1	\$ 40,000	\$ 30,000	\$ 20,000	5	10.50%	\$ 19,125	\$ 10,000	\$ 10,875	\$ 875	4%	NO	NO	\$ 10,000
2	\$ 75,000	\$ 50,000	\$ 45,000	9	9.00%	\$ 41,963	\$ 5,000	\$ 8,038	\$ 3,038	7%	YES	YES	\$ 8,038

EXAMPLE 1

A member purchased a car in 2009 with a loan from the credit union which is now considered impaired. The original loan was for \$40,000 and currently has a variable rate of 10.5%. The carrying value of the loan is \$30,000. The current estimated fair value of the car is \$20,000. The credit union expects to be able to sell it in 5 months.

Result: With a materiality limit of 5% of the security value, the difference between Provision A & Provision B results in a difference of \$875 which is not considered material. The provision to be taken for this loan would be \$10,000.

EXAMPLE 2

A member took out a personal loan to renovate his home \$75,000 and provided his cottage as security in 2008 which has now become impaired. The carrying value of the loan is now \$50,000 and the variable rate is 9%. The security value of the cottage is \$45,000. The credit union expects to be able to sell the cottage in 9 months.

Result: With a materiality limit of 5% of the security value, the difference between Provision A & Provision B results in a difference of \$3,051 which is considered material to this credit union. The provision to be taken for this loan would be \$8,038.

Loan Provisioning Discounting Test - CLASS 2

This template helps determine whether the discount method is required to determine the amount of any loan loss allowance. In the discount method, the "net present value" of the security is calculated using the loan's interest rate and the estimated period to dispose of any security. The discount method should be used if there is a material difference in the amount of the required allowance. Materiality is based on a difference of either \$5,000 or 5% of the current fair value of the pledged security.

STEPS:

INPUT CELLS ARE HIGHLIGHTED IN YELLOW

- A Input the materiality limits if more conservative than those set out in the Guidance Note: Impaired Loans. (Cell D18 and D19)
- B Input Loan Numbers (Cell B24, B25, etc.)
- C Input Original Loan Amount (Cell C24, C25, etc.)
- D Input Loan Carrying Value/Outstanding Balance (Cell D24, D25, etc.)
- E Input Estimated Security Value based on most current information (Cell E24, E25, etc.)
- F Input Estimated Time in months to dispose of security (Cell F24, F25, etc.)
- G Input the Loan Interest Rate. If it is a fixed rate loan, input the original rate of the loan. If it is a variable rate loan, input the current variable rate.(Cell G24, G25, etc.)

	A1	A2
Materiality Limit (% of Security value)	5%	\$ 5,000

B	C	D	E	F	G	H = E - [(F ÷ 12) x E]	I = (D - E)	J = (D - H)	K = (J - I)	L = (K ÷ E)			
Loan Number	Original Loan Amount	Carrying Value	Estimated Fair Value of Security	Estimated Time to Dispose of Security (in months)	Loan Current Interest Rate	Estimated Future Cash Flows (Discounted)	Loan Allowance (not Discounted)	Loan Allowance (Discounted)	\$ Difference	% Difference	% Material?	\$ Material?	Provision to be taken
1	\$ 250,000	\$ 180,000	\$ 140,000	9	7.00%	\$ 132,650	\$ 40,000	\$ 47,350	\$ 7,350	5%	YES	YES	\$ 47,350
2	\$ 150,000	\$ 100,000	\$ 85,000	5	9.00%	\$ 81,813	\$ 15,000	\$ 18,188	\$ 3,188	4%	NO	NO	\$ 15,000

EXAMPLE 1

A credit union made a commercial variable rate loan for \$250,000 in 2009 which is now considered impaired. The current variable rate is 7%. The carrying value of the loan is \$180,000. The business had pledged machinery as security which has a current estimated fair value of \$140,000. The credit union expects to be able to sell it in 9 months.

Result: With a materiality limit of 5% of the security value, the difference between the Discounted and not Discounted Loan Allowances results in a difference of \$7,350 which is considered material. The provision to be taken for this loan would be \$47,350.

EXAMPLE 2

A member took out a personal variable rate loan to renovate his home \$150,000 in 2008 and provided his Lambouguini as security. The loan has now become impaired. The carrying value of the loan is now \$100,000 and the current variable rate is 9%. The security value of the car is \$85,000 and is expected to be able to be sold in 5 months.

Result: With a materiality limit of 5% of the security value, the difference between the Discounted and not Discounted Loan Allowances results in a difference of \$3,188 which is not considered material. The provision to be taken for this loan would be \$15,000.

