

4711 Yonge Street  
Suite 700  
Toronto ON M2N 6K8  
Telephone: 416-325-9444  
Toll Free 1-800-268-6653  
Fax: 416-325-9722

4711, rue Yonge  
Bureau 700  
Toronto (Ontario) M2N 6K8  
Téléphone : 416 325-9444  
Sans frais : 1 800 268-6653  
Télécopieur : 416 325-9722



**Date: November 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.

### **Table of Contents**

	Page
A. Introduction	2
B. Individual (Specific) Allowance	2
i. Individual Loans	2
ii. Individually Significant Loans	2
iii. Measuring Impairment	3
iv. Income Recognition	5
C. Collective (Non-specific) Impairment and Allowance	5
i. Measurement	6
ii. Elements of Collective Impairment	6
iii. Level of Collective Impairment	6
iv. Changes to the Collective Allowance	7
v. Documentation	7
D. The Board and Senior Management	7
E. DICO's Risk Assessment Process	8
Appendix 1: Approaches for Determining the Collective Allowance	9

## 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.

“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. 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. When considering materiality and the use of the discount method, credit union's 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.

#### 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)	\$19,148	F	C*D*E
Loan Allowance (non Discounted)	\$10,000	G	B-C
Loan Allowance (Discounted)	\$10,882	H	B-F
Difference (\$)	\$852	I	H-G
Difference (%)	4%	J	I/C
Allowance Required	\$10,000	K	G

In Example 1, the allowance calculated under the discount method is \$10,852 compared to \$10,000 when not using the discount method. As the difference between the two methodologies is not considered material by the credit union, the use of the discount method is **NOT** required.

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

<b>Description</b>			<b>Calculation/Comments</b>
Original Loan	\$75,000	A	
Carrying Value (Outstanding loan amount)	\$50,000	B	
<b>Estimated Fair Value of Security</b>	<b>\$45,000</b>	C	
Estimated Time to realize on Security	12 months	D	
Interest Rate (Variable)	12%	E	
Estimated Future Cash Flows (Discounted)	\$41,963	F	C*D*E
Loan Allowance (not Discounted)	\$5,000	G	B-C
Loan Allowance (Discounted)	\$10,065	H	B-F
Difference (\$)	\$5,065	I	H-G
Difference in Security Values (%)	11%	J	I/C
Allowance Required	\$10,065	K	H

In Example 2, the allowance calculated under the discount method is \$10,065 compared to \$5,000 when not using the discount method. As the difference between the two methodologies is considered material by credit union, 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 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.

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. 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). 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 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

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

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

## 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. 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. 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 (using delinquency >1 day). 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 loan portfolio (delinquent loans >1 day) for each group of loans (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 Average Loan Delinquency >1 day			Weight	Total Weighted Losses
	Personal (secured)	Personal (unsecured)	Conventional Mortgages		
Year 1	2.9%	6.0%	0.8%	1	
Year 2	5.9.4%	11.3%	0.0%	2	
Year 3	9.1%	17.6%	6.0%	3	
Year 4	17.3%	26.7%	0.00%	4	
Year 5 (most current year)	11.8%	33.3%	2.0%	5	
Total Weighted Losses	50.4 % (B1)	94.9% (B2)	8.8% (B3)	15(A)	
Average Weighted Losses	3.4% (C1)	6.3% (C2)	0.8% (C3)		
Current Gross Delinquency >1 days	\$400,000 (D1)	\$650,000 (D2)	\$,450,000 (D3)		
Collective Allowance Required (Rounded to nearest \$1,000)	\$13,000 (E1)	\$41,000 (E2)	\$3,000 (E3)		\$57000,000(E4 )
Additional Collective Allowance Required	NIL (F1)	\$10,000 (F2)	0 (F3)		\$10,000 (F4)
Total Collective Allowance Required this period	\$13,000 (G1)	\$51,000 G2)	\$3,000 (G3)		\$67,000 G4)
Collective Allowance previous period	\$15,000 (H1)	\$35,000 (H2)	\$0,000 (H3)		\$50,000 (H4)
Change in Collective Allowance required this period	\$(2,000 (I1)	\$16,000 (I2)	\$3,000 (I3)		\$17,000(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.