

DEPOSIT INSURANCE CORPORATION OF ONTARIO
STANDARDS OF SOUND BUSINESS AND FINANCIAL PRACTICES:
IMPAIRED LOANS

BY-LAW NO. 6

PREAMBLE

This By-law, which has been authorized by the Deposit Insurance Corporation of Ontario (DICO) and approved by the Lieutenant Governor in Council, sets standards of sound business and financial practices under Section 264 of the Credit Unions and Caisses Populaires Act, 1994 (the Act). This By-law is given further authority by Section 22 of Regulation 76/95 which states that the prescribed monthly provision for doubtful loans by credit unions/caisses populaires is the provision DICO requires in its By-laws.

This By-law, which is effective for all fiscal years starting after the By-law is enacted, provides Ontario's credit unions/caisses populaires with guidance on Section 3025 (Impaired Loans) of the Handbook of the Canadian Institute of Chartered Accountants (CICA). The goal is to establish consistent industry practices on the allowance for impaired loans.

Section 213 of the Act requires credit unions/caisses populaires to follow Generally Accepted Accounting Principles (GAAP) in preparing their financial statements. This By-law specifies conditions for the application of such principles in a number of instances where latitude exists for alternative judgements, so that similar economic events are disclosed in the same way on financial statements. This By-law also gives some practical advice on conservatively estimating loan impairment, which is not expected to cause material departures from generally accepted accounting principles.

Member institutions should carefully examine Section 3025 of the CICA Handbook and its appendices before reviewing By-law No. 6.

1. DEFINITIONS

By-law No. 6 recognizes all the definitions in Section 3025 of the CICA Handbook and also uses the following terms:

(a) **Fair Value of Security, Net of Realization and Legal Costs**

Management's reasonable estimate of how much cash the credit union/caisse populaire can realize from the disposal of security underlying a loan, after paying real estate or legal/court fees, taxes, and holding costs for management and preservation of property. When disposal of loan security is expected to take longer than six months from the date of loan impairment, cash flows from the realization of the security must be discounted using the interest rate applicable on the impaired loan (i.e. the original interest rate for fixed-rate loans, or the rate prevailing when a variable-rate loan becomes impaired).

Security valuations must be based on current market values and include an objective appraisal. (Board policy must establish monetary limits and criteria for properties on which an **independent** qualified appraisal is required, and the published sources or qualifications of other persons providing other objective opinions of value.) All valuations must reflect that a liquidation market yields less than the open market. Security valuations must be current within 12 months, except in the case of real estate where less current valuations may be used if there has been no significant economic change since the last valuation, or if the previous valuation confirms a low loan value to security value ratio.

No value may be assigned to a security interest in tangible property which the credit union/caisse populaire does not possess, which is not duly registered, or on which the registration is not in good standing (or for which the credit union/caisse populaire does not hold nonfiling 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 co-signors. 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.

(b) **Fully Secured**

A loan which is fully secured by charges on real property or security interests in personal property that have a fair security value, net of realization and legal costs to discharge the outstanding principal and accrued interest in full. (See definition (a) above.)

(c) **Formally Restructured Loans**

A loan is considered formally restructured when the lender, for economic or legal reasons related to the borrower's financial difficulties, rewrites the loan to allow for economic concessions it would not otherwise make. Such concessions may include:

- (a) a lower interest rate;
- (b) **uncompensated** deferral or extension of principal repayments or interest payments;
- (c) forgiveness of some of the principal or accrued interest;
- (d) acceptance of assets other than cash to settle a larger amount of the loan than the estimated net proceeds from sale of the assets;
- (e) other concessions which would not be made if the borrower were not in a weakened condition.

2. ESTABLISHING AN ALLOWANCE FOR IMPAIRED LOANS

Each credit union/caisse populaire incorporated under the Act shall establish an allowance for impaired loans following the rules set out in this By-law, which reflect Generally Accepted Accounting Principles (GAAP).

Accounting principles for impaired loans, found in Section 3025 of the CICA Handbook, appear in italics in this By-law, followed by DICO's application requirements.

The allowance for impaired loans should be deducted from total loans on the balance sheet.

3. RECOGNIZING IMPAIRMENT

Section 3025.03 of the CICA Handbook:

When a loan or portfolio of loans becomes impaired as a result of a deterioration in credit quality to the extent that the lender no longer has reasonable assurance of timely collection of the full amount of principal and interest, the carrying amount of the loans should be reduced. The reduction in carrying amount should be recognized as a charge in the statement of income in the period in which impairment is identified.

In addition to the factors cited in CICA Handbook Section 3025.07, these conditions also indicate doubt about collecting the full amount of principal and interest on time:

- payment on a formally restructured loan is 90 days in arrears;
- payment on any other loan is 90 days in arrears, unless the loan is fully secured, debt collection is in process and the collection efforts are reasonably expected to result in repayment or restoring the debt to current status within 180 days of the date payment went into arrears;
- payment is 180 days in arrears, regardless of security or collectibility;
- 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 petition under the Bankruptcy and Insolvency Act of Canada, or has made a proposal to creditors;
- any loan which has been postponed where the recovery of principal is significantly deferred beyond the loan's original term.

Although not all impaired loans may need to have their carrying values reduced per the requirements for measuring impairment, as detailed below, the aggregate balance of all identified impaired loans must be disclosed in the notes to the financial statements.

4. MEASURING IMPAIRMENT

Calculating the Allowance

The amount that is established as an allowance for an impaired loan identified in paragraph 3 above, is the excess of the **carrying amount** of that loan (i.e. outstanding principal plus interest owing, less any specific allowance previously established) over the loan's **estimated realizable amount**.

Section 3025.14 of the CICA Handbook:

When loans are identified as impaired, their carrying amounts should be reduced to their estimated realizable amounts. Estimated realizable amounts should be measured by discounting the expected future cashflows at the effective interest rate inherent in the loans. When the amounts and timing of future cashflows cannot be estimated with reasonable reliability, estimated realizable amounts may be measured at either:

- (a) *the fair value of any security underlying the loans, net of expected costs of realization and any amounts legally required to be paid to the borrowers; or*
- (b) *observable market prices for the loans.*

For purposes of measuring estimated realizable amounts, DICO considers the following conditions necessary to demonstrate: (i) reasonable reliability of future cashflows and (ii) observable market prices for impaired loans.

(i) **Reasonable Reliability of Future Cashflows**

Reasonably reliable future cashflows, which are necessary to discount the impaired loan under GAAP, are considered to exist for purposes of this By-law, only when a credit union/caisse populaire has converted the impaired loan into a formally restructured loan (i.e. a rewritten loan which allows for economic concessions). Discounting is required since such a loan sets a new repayment schedule that will net less than the original repayment schedule. (Loans should only be rewritten, however, when conventional credit granting criteria support the establishment of such new loans, and these loans shall no longer be accounted for as impaired.)

Until such time that an impaired loan has been formally restructured, its future cashflows cannot be reasonably estimated, on an individual basis, given that present uncertainties relating to the borrower's condition continue to cause the loan's impairment. As a result, when an impaired loan has not been formally restructured, its estimated realizable amount shall be its fair value of security, net of realization and legal costs, as defined in this By-law.

Credit unions/caisses populaires may, however, discount an impaired loan which has not been formally restructured by grouping it together with other loans of similar size and credit purpose. Although it may not be possible to determine with reasonable certainty, an individual impaired loan's future repayment schedule, average historic recoveries for groups of similar loans, where determinable, may be used to reliably discount aggregate impaired loans. Refer to CICA Handbook, Section 3025.20 for methodology in this regard. Note that any impaired loan which has not been formally restructured and which is either large or atypical, cannot be grouped with other loans, and must be valued using the fair value of security, net of realization and legal costs.

For small consumer loans which have been formally restructured, required discounting under GAAP may be implicitly and alternatively achieved by using the fair value of security, net of realization and legal costs. (DICO defines "small consumer loans" as loans under \$15,000; credit unions/caisses populaires which choose a higher threshold must ensure that no material differences in the

application of GAAP are so created). Generally, consumer loans are secured by consumer products or some form of intangible security; therefore, their fair value as determined in accordance with this By-law, would be conservative. Most consumer products (e.g. automobiles) depreciate rapidly immediately after purchase and thereafter, continue to slowly depreciate. As a result, the appraised value of such collateral used to measure the value of a formally restructured loan would be less than the loan's recorded value and would be an acceptable alternative to discounting.

(ii) **Observable Market Prices for Impaired Loans**

Observable market prices for impaired loans shall be valued individually and there must be adequate documentation for the potential purchase of such loans.

Non Specific Provision

In accordance with CICA Handbook, Section 3025.10, the allowance should include an estimate of probable losses on any loan group for which specific events or recent changes in economic conditions suggest the group's credit quality has deteriorated (although this may not yet be evident in individual impaired loans). Such a non-specific allowance should be set using management's judgement and experience, net of both: (i) loans in the group for which specific provisions have been made, and (ii) insured or government-guaranteed loans.

5. RESTRUCTURED LOANS

Section 3025.32 of the CICA Handbook:

When a loan is restructured, the recorded investment in the loan should be reduced as of the date of restructuring to the amount of the net cashflows receivable under the modified terms, discounted at the effective interest rate inherent in the loan at the time the loan was recognized as being impaired. The reduction in the recorded investment should be recognized as a charge for loan impairment in the statement of income in the period in which the loan is restructured.

Only formally restructured loans (i.e. loans rewritten with economic concessions) require a reduction in their recorded values (i.e. recorded loan principal and accrued interest). When a formally restructured loan is discounted, the recorded value of the loan should be lowered to the net present value of the rescheduled interest and principal payments, discounted at the interest rate of the original loan. The carrying values of loans that have been restructured informally (i.e. without formal amendments to the loan agreements) should be lowered by setting allowances for loan impairment. Paragraph 4 of this By-law outlines the alternative ways of measuring and lowering carrying values of impaired loans.

6. RECOGNITION OF INCOME

Sections 3025.26 and .27 of the CICA Handbook:

When a loan becomes impaired, recognition of interest income in accordance with the terms of the original loan agreement should cease.

When an impaired loan is measured on the basis of expected future cashflow discounted at the loan's effective interest rate, changes in the estimated realizable amount arising subsequent to initial recognition of impairment should be reflected in the income statement in the current period in accordance with either (a) or (b) as follows:

- (a) *the increase in present value attributable to the passage of time should be reported as interest income and the balance of the change in the estimated realizable amount as a charge or credit for loan impairment; or*
- (b) *the entire change in the estimated realizable amount should be reported as a charge or credit for loan impairment.*

When an impaired loan is measured on the basis of the fair value of security underlying the loan or an observable market price for the loan, 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.

Under this By-law, applying this accounting principle shall have the following effects on income recognition:

- Impaired loans which have been formally restructured (thus becoming new loans that are no longer impaired) accrue interest on their new recorded values at the interest rate set in the original loan agreements. All cash received on these loans should reduce the recorded values of these loans (i.e. adjusted principal balance plus accrued interest).
- Impaired loans which have not been formally restructured shall not accrue interest income after being identified as impaired. However,
 - (i) If impaired loans are grouped for discounting, the total carrying costs should be adjusted to equal the recalculated, discounted amount of these loans at subsequent financial statement reporting dates, by increasing or decreasing the allowance. The change in the allowance for impairment should be treated as an income charge or credit for loan impairment (i.e. in accordance with Section 3025.27(b) instead of 3025.27(a)).
 - (ii) If impaired loans are valued individually using the method of fair valuation of security, less realization and legal costs, the loans' current

carrying costs should be adjusted by any material increase/decrease in their security valuations on subsequent financial statement reporting dates. Such adjustments to the carrying costs must be credited/charged to the income statement (through the provision for loan impairment) and offset to the balance sheet (through the allowance for loan impairment).

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

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.

Loans in a particular industry or geographic group for which a non specific provision has been established, may continue to recognize interest income, in accordance with the terms of their original loan agreement, as long as these loans have not been individually identified as impaired.

7. FINANCIAL STATEMENT DISCLOSURE

Section 3025.48 of the CICA Handbook:

The following information should be disclosed in the financial statements:

- (a) *the total recorded investment in individual loans identified as impaired and the amount of the related allowance for loan impairment, analyzed by groups of loans with similar characteristics;*
- (b) *the total recorded investment in foreclosed assets held for sale and the amount of the related allowance for loan impairment;*
- (c) *the recorded investment in each group of loans against which an allowance for loan impairment has been established collectively and the amount of the related allowance for loan impairment;*
- (d) *the net charge or credit to income in respect of loan impairment, identifying separately recoveries of loans written off in previous periods;*
- (e) *write-offs of loans during the reporting period, identifying separately amounts relating to loans restructured during the reporting period; and*
- (f) *for loans accounted for in accordance with paragraph .27(a), the amount included in interest income.*

The basis of determining the amounts of the allowance for loan impairment as well as the events and conditions considered in determining the charge to income for the period in respect of the allowance for loan impairment should be disclosed.

On the disclosure requirement under (e), this By-law also requires disclosure of the total number and amount of formally restructured loans (i.e. loans rewritten with economic concessions).

8. SUMMARY OF ACCOUNTING REQUIREMENTS

- (a) All provisions for impaired loans (i.e. charges against income) should be recorded with an offsetting increase in the allowance for loan impairment.
- (b) The recorded investment in a loan (i.e. principal plus any uncollected interest) should be written off against the allowance when it is realized through foreclosure or sale.
- (c) When a loan is formally restructured, the recorded investment in that loan should be written down to equal its reduced economic value, as a result of a reduction in: the interest rate, the principal amount due on maturity, or the amount of accrued interest on the loan.

(Note that discounting is not required and will not reduce the recorded value of an impaired loan if it has been rewritten without economic concessions or the loan has simply been postponed with compensating interest charged at the original loan rate.)

- (d) Subsequent recoveries on loans that were written off should be credited to the allowance.
 - (e) At the end of each fiscal period, the balance in the allowance should be adjusted to the required level with an offsetting increase or decrease in the provision for loan impairment.
 - (f) Income should be recognized and accounted for as noted in paragraph 6 of this By-law.
- 9.** By-law No. 6 of the Corporation made on December 13, 1989 is hereby repealed and replaced by this By-law.

ENACTED as a By-law of the Corporation by the Board of Directors on the 28th day of June, 1995.

APPROVED by the Lieutenant Governor in Council by Order dated the 31st day of January, 1996.