Office of the Superintendent of Financial Institutions Canada | Bureau du surintendant des institutions financières Canada

Guideline

Subject: **Impairment - Sound Credit Risk Assessment and Valuation of Financial Instruments at Amortized Cost**

Category: **Accounting**

No: **C-1** **Date:** **July 2007**
Revised: **July 2010**

In accordance with the Basel Committee on Banking Supervision's (BCBS) June 2006 paper *Sound Credit Risk Assessment and Valuation for Loans (SCRAVL)*[1], an institution's senior management is responsible for ensuring that the institution has appropriate credit risk assessment processes and effective internal controls to consistently determine provisions in accordance with the institution's stated policies and procedures, the applicable accounting framework and supervisory guidance.

This Guideline provides federally regulated financial institutions with additional guidance to *IAS 39, of the International Accounting Standards Board's (IASB) International Financial Reporting Standards*. This Guideline is intended to supplement, but not contradict, the guidance contained in IAS 39. In addition, OSFI encourages the incorporation of the principles detailed in the BCBS SCRAVL paper in the credit risk assessment process.

This Guideline applies to financial instruments classified at amortized cost under IAS 39. While off balance sheet instrument are not within the scope of this guideline, OSFI expects that an equally robust process would be followed to support provisions for credit losses for off-balance sheet exposures that are not at fair value such as certain guarantees and bankers acceptances, letters of credit, undrawn commitments, and loan substitutes. Provisions for credit losses for off-balance sheet exposures are recorded in accordance with IAS 37 in other liabilities.[2]

The Guideline does not need to be applied to amortized cost financial instruments of immaterial amounts. Refer to the Framework for the Preparation and Presentation of Financial Statements paragraphs 29-30 of the IASB's International Financial Reporting Standards on materiality.

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[1] Available on the Bank for International Settlements website at the following location: http://www.bis.org/publ/bcbs126.htm

[2] Note that this update to Guideline C-1 does not change OSFI policy but is intended to better reflect accounting practices for off-balance sheet exposures and fair value financial instruments.

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Recognition of Impairment

Impairment should be recognized in accordance with IAS 39[3] and should consider the loss events detailed therein. Given the loss events described in IFRS (IAS 39.59a-f), and in particular the impact of significant financial difficulty of the issuer or obligor, a breach of contract, such as a default or delinquency in interest or principal payments, and adverse changes in the payment status of borrowers[4], OSFI considers the below listed conditions to be indicative of non performing status. OSFI further recognizes that the below listed conditions should not limit the earlier recognition of impairment losses incurred in accordance with IAS 39:

- a payment on a deposit with a regulated financial institution or a restructured loan is contractually 90 days in arrears;
- a payment on any other loan (excluding credit card loans) is contractually 90 days in arrears unless the loan is fully secured, the collection of the debt is in process and the collection efforts are reasonably expected to result in repayment of the debt or in restoring it to a current status within 180 days from the date a payment has become contractually in arrears; or
- a payment on any loan is contractually 180 days in arrears. Any credit card loan that has a payment 180 days in arrears should be written off.

These conditions are not considered indicative of non performing status for up to 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 amortized cost financial instrument or group of amortized cost financial instruments.

Measurement of Impairment

The measurement of impairment of financial instruments at amortized cost is governed by IFRS's IAS 39 s.58-65 and AG84-AG93.

In reviewing the adequacy of the allowance for impairment of financial instruments held at amortized cost, in each case where the estimated realizable amounts have been measured by discounting the expected future cash flows, OSFI examination staff will want to be able to easily identify the following:

i) the shortfall between the undiscounted expected future cash flows of the amortized cost financial instrument and the instrument's carrying value; and

ii) the amount resulting from discounting the expected future cash flows at the effective interest rate inherent in the amortized cost financial instrument.

[3] See IAS 39.58-62
[4] See IAS 39.59 a, b, and f

In addition, OSFI examination staff may elect to obtain information through on site examination, or through information requests, to evaluate whether:

i. the institution's internal review function is robust and provides adequate testing and documentation of internal compliance with the institutions credit risk grading criteria;

ii. the quality of the institution's processes and systems for identifying, classifying and monitoring and addressing amortized cost financial instruments with credit quality problems in a timely manner is adequate;

iii. appropriate information about the credit quality of the portfolio and related allowances and provisions is provided to senior management on a regular and timely basis;

iv. procedures used by the institution to establish allowances on individually impaired amortized cost financial instruments are prudent and take into account criteria such as updated valuation of collateral and cash flow predictions based on current assessment of economic conditions; and

v. allowances are appropriate in relation to total credit risk exposure in the portfolio.

It is the responsibility of senior management of each institution to oversee and monitor the credit risk assessment and impairment processes. This includes ensuring the appropriateness of credit risk assessment processes and internal controls in place to determine impairments. Institutions should use consistent credit risk assessment and valuation policies and procedures from period to period and consistent measurement concepts and procedures for related items.

Please refer to OSFI's *Corporate Governance Guideline* for OSFI's expectations of institution Boards of Directors in regards to operational, business, risk and crisis management policies.

Income Recognition

To maintain a complete record of write-offs and recoveries in the allowance for impairment account for financial instruments held at amortized cost, OSFI expects write-offs and recoveries related to impaired financial instruments held at amortized cost to be recorded through this account rather than being recorded directly as a charge or credit for impairment in the income statement. Write-offs and recoveries, that are charged or credited to the allowance account during an accounting period, are reflected as a charge or credit for impairment in the income statement at the end of the period when the ending balance in the allowance account is established.[5]

Where subsequent payments (whether designated as interest or principal) are received on an impaired financial instrument held at amortized cost, OSFI expects this to be recorded as a reduction of the financial instruments' carrying value. When the carrying value in the amortized cost financial instrument is completely written off, the subsequent payments are credited to the allowance account.[6]

[5] Consistent with IAS 39.63 and IAS 39.65.
[6] Consistent with IAS 39.65.

OSFI expects interest income to be recognized on impaired financial instruments held at amortized cost using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss.[7]

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[7] See IAS 39.AG93.