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

Guideline

Subject: **General Allowances for Credit Risk**

Category: **Accounting**

No: **C-5** **Date:** **October 2001**
Revised: **November 2007**

This guideline outlines the regulatory framework for general allowances and should be considered in conjunction with *Guideline C-1, Impaired Loans*. The guideline takes effect for fiscal years commencing on or after November 1, 2001.

The guideline replaces the draft policy statement *General Allowances for Credit Risk* issued July 1997 and subsequent direction provided to the industry in letters issued April 1998, October 1998, August 1999 and November 1999. It confirms the requirement that banks and trust and loan companies maintain adequate general allowances to recognize credit losses within their portfolios. In addition, this guideline addresses a number of outstanding issues from the 1997 draft including measurement guidance and criteria for assessing supporting methodologies.

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Table of Contents

A. Introduction

The OSFI policy on provisioning for credit losses has evolved over time. This guideline replaces the draft policy statement, *General Allowances for Credit Risk*, issued July 1997 and subsequent direction provided to the industry in letters issued April 1998, October 1998 and August 1999. This updated guidance confirms the principles underlying the establishment of a general allowance for credit risk in accordance with section 3025 of the CICA Handbook and provides additional direction on the methodology for developing general allowances.

Objectives

The objectives of this guideline are to promote:

- risk management processes that are adequate and appropriate to the business;
- the adoption by institutions of an active, anticipatory approach to measuring and reporting risk and the probability of loss;
- calculations of general allowances that clearly and accurately reflect the loss within the portfolio; and
- adequate disclosure of general allowances and related accounts.

B. Framework

Experience has demonstrated that there is a period of time between when a loss event occurs – that is, an event that results in a borrower's inability to repay interest and/or principal – and when management is able to identify such an event. Accordingly, general allowances for credit risk must be established to recognize losses that management estimates to have occurred in the portfolio at the balance-sheet date relating to loans or credits not yet specifically identified as impaired.

General allowances are not a substitute for specific allowances. Accordingly, as individual assets can be identified as impaired, specific allowances are to be established. OSFI requires that institutions be able to demonstrate that the level of both general and specific allowances is adequate.

Historical evidence indicates that problem credits often originate in periods of economic growth. Typically, as the business/economic cycle peaks and begins to decline, more loans are likely to become impaired. However, many problem credits will not become specifically identified as impaired until some time later when the evidence of impairment becomes more explicit.

Although a variety of methodologies may be appropriate for determining an institution's general allowance, it is important to recognize these dynamics when establishing the methodology for the general allowances. The balance of the general allowance account is expected to increase to reflect portfolio growth and/or evidence of deterioration in credit quality through the economic cycle. Since general allowances are influenced by the concurrent level of specific allowances, there could be a counterbalancing impact on the level of the general allowance as specific provisions are identified. The extent of this impact on the level of the general allowance will depend on many factors, including the growth in the portfolio, the change in the credit profile of the portfolio, and the magnitude of the specific allowance.

During all points of an economic cycle, an institution must maintain a level of general allowances commensurate with the profile of the institution's risk portfolio. As general and specific allowances are related, it is necessary to review and assess regularly the adequacy of the general allowances in light of developments within the portfolio.

C. Measurement Guidance

Scope

Loans that are not specifically identified as impaired should be grouped into pools of loans with common risk characteristics. To capture the extent of impairment fully, the general allowance must reflect exposures across all portfolios/categories that give rise to credit risk including, but not limited to, the unimpaired portion of the loan portfolio, undrawn commitments, letters of credit, guarantees and bankers acceptances, credit derivatives and loan substitutes.

Credit risk may also arise from exposure to various other off-balance sheet instruments, and an allowance against expected losses would be appropriate. Recognition of these losses would be consistent with CICA Handbook section 3290 "Contingencies".

Components of Collective Loan Impairment

The assessment of impairment for pools of loans should be based on all available and relevant information. Institutions are likely to identify multiple components of collective loan impairment.

Components of collective loan impairment may relate to:

- historical loss experience;
- current environmental conditions;
- attributes specific to a defined group of borrowers; and
- other characteristics directly affecting the collectability of a pool or portfolio of loans, and that are unique to a defined group of borrowers within a pool or portfolio.

Each identified component should be assessed individually and should be supported by observable data. Institutions must be able to demonstrate that data supporting their estimates have an economic relationship to, and are representative of, impairment of a group of loans. Observable data should provide a basis for concluding that it is probable that an asset has been impaired at the balance sheet date.

Although the appropriate level of general allowance will normally lie within a range of estimates, OSFI believes the level chosen should be conservative, reflecting such factors as the imprecise nature of the estimate.

Changes to the General Allowance

The level of general allowance is expected to fluctuate in accordance with the nature and composition of the institution's portfolio, shifts in the economic cycle and the effectiveness of the institution's own credit risk policies and procedures. Management must closely monitor changing conditions and resulting impairments and reflect such changes through increases or decreases in general and specific allowances as appropriate. Routine adjustments, which are consistent with the institution's methodology to establish the allowance, do not require notification to OSFI.

Amounts will flow from general to specific allowances. In normal circumstances, transfers occur as specific allowances are established to recognize impairment on an individual loan basis. A transfer from the general to the specific allowance is appropriate only to the extent that the individual exposure can be identified with categories/subgroups of risk for which the general allowance has been established. The level of the residual general allowance must continue to be maintained at a reasonable level as supported by the institution's methodology to establish the allowance.

Increases and/or decreases to general allowances are to be systematic and rational and should be supported by observable changes/shifts in the identified components of impairment. Changes in the general allowance should be directionally consistent with changes in the identified components of impairment.

The methodology for establishing the level of general allowances must be supported by appropriate observable data. This data must be assessed periodically as circumstances change or as new data that are more relevant and directly representative of loss become available. If changes in circumstances or improvements in the availability of data result in material changes to the methodology for establishing general allowances, OSFI must be advised.

Where the condition/composition of an underlying portfolio has materially changed, it will be appropriate for the institution to review the components of impairment; this may, in turn, result in a reassessment/recalibration of a portion of the general allowance. OSFI must be notified prior to a material, one-time adjustment of this type. The institution would be expected to demonstrate that:

- the circumstances under which an institution had previously established its level of general allowance have undergone material change;
- the residual general allowance is sufficient to meet any minimum level that OSFI may establish for either the institution or the industry; and
- the adjustment is justified by the institution's methodology to establish the level of allowance.

There may also be instances when it is appropriate to realign the allocation of the general allowance among categories/subgroups in order to reflect specific events and/or to reflect better the underlying distribution of risk. OSFI must be notified prior to a material adjustment of this type. Furthermore, a material reallocation between portfolio segments would trigger a review by the institution of its underlying methodology for establishing the general allowance.

Threshold/minimum levels

The methodology for establishing general allowances should include a threshold, or minimum, level of general allowance that is reflective of the probability of loss in an institution's risk portfolio. Given the industry's historical loss experience, OSFI would not normally expect general allowances to represent less than 0.25 per cent of loans and bankers acceptances, excluding reverse repos, at any given time.

Documentation

In order to support OSFI's assessment, and until greater experience is gained with these methodologies, OSFI will require that institutions retain on file sufficient documentation of their data and management judgements to support their estimates of impairment.

D. Disclosure

OSFI supports the concept of market discipline and the role that quality disclosure plays in it. Section 3025 and other sections of the CICA Handbook contain a number of disclosure requirements on loan loss allowances and related accounts. OSFI believes these requirements strike an appropriate balance between the need for meaningful disclosure to allow the operation of market discipline and the protection of proprietary information or information subject to confidentiality requirements about an institution's customers or risk management practices. Accordingly, OSFI does not believe GAAP disclosure requirements need be supplemented at this time.

E. The Board and Senior Management

The board and senior management are responsible for understanding and determining the nature and level of risk being taken by the institution and how these risks relate to the level of general and specific allowances. They are also responsible for ensuring that the formality and sophistication of the risk management processes are appropriate in light of the institution's risk profile and business plan.

The board of directors has responsibility for setting the institution's tolerance for risk. It should also ensure 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 for managing risk in the context of general allowances include, among other things:

- monitoring and managing the quality of the risk portfolio;
- ensuring that the risk portfolio is soundly and appropriately valued, uncollectible credits written off, and expected or probable losses adequately provided for;

- exercising appropriate judgement to recognize the imprecision in valuation estimates;
- maintaining effective systems and controls for identifying, measuring, monitoring, and addressing asset quality problems in a timely manner;
- establishing documented policies and procedures for the determining and maintaining of general allowances;
- providing appropriate disclosure; and
- documenting its process for vetting both quantitative and qualitative methods used in determining its general allowance.

F. Capital Treatment

The Capital Adequacy Requirements (CAR) guidelines for federally regulated deposit-taking institutions are based on the capital adequacy framework set out in the 1988 BIS Capital Accord and amended in June 2006. The inclusion of general allowances in tier 2 capital, subject to the specified limits was based on the concept that such "reserves" were freely available to meet losses not currently identified. Within this framework, OSFI is prepared to permit general allowances for credit risk to be included in tier 2 capital subject to the following specifications:

1. Qualifying general allowances may not exceed 1.25 per cent of risk weighted assets for institutions using the Standardized Approach.
2. Institutions using the Internal Ratings Based (IRB) approach are required to calculate an allowance excess or shortfall. Excess allowances can be included in tier 2 capital up to a limit of the lower of 0.6 per cent of IRB credit risk-weighted assets or the excess amount of available general allowances. Refer to General Allowances in section 2.2.2.2 of the CAR A-1 Guideline.
3. As a temporary measure, institutions using IRB approaches may use the proportional split method to allocate general allowances between portfolios carried on the Standardized Approach and portfolios carried on an IRB approach. Refer to General Allowances in section 2.2.2.3 of the CAR A-1 Guideline.

The inclusion of general allowances in capital is subject to the prior written approval of OSFI. Approval is conditional on an institution being assessed as complying with this guideline. This approval will be reviewed periodically as part of OSFI's ongoing supervisory process.

G. OSFI's Assessment Process

OSFI's assessment of an institution's compliance with this guideline will be conducted in two ways:

i. OSFI's supervisors will assess an institution's general allowance policy and associated methodologies against the assessment criteria described below; and

ii. OSFI will assess the overall reasonableness of the level of general allowances.

Assessment of General Allowance Policy and Associated Methodologies

As part of OSFI's ongoing supervisory processes, supervisors will review each institution's general allowance policy and methodology against the principles outlined in this guideline to ensure that it has in place appropriate criteria for measuring credit risk commensurate with the complexity, size and diversity of its credit risk portfolios.

Annex 1 provides the criteria that OSFI will use to assess the adequacy of the process used to establish the general allowance. These criteria have been segmented into four areas:

- adequacy of corporate governance over the general allowance process;
- methodology for establishing the estimate of credit losses captured by the general allowance including the integrity of the data used in the estimate and the testing/verification of the output; and
- integrity of the institution's risk assessment and measurement processes generally.

Within each area, criteria have been identified and, for each criterion, assessment guidelines have been developed. Conformity with the guideline implies being assessed as "Acceptable" on the majority of the criteria. Even where the majority of criteria are assessed as "Acceptable", an overall assessment of "Not Acceptable" may be given in circumstances where a weakness in an individual criterion is deemed sufficiently serious to outweigh any "Acceptable" ratings. In evaluating compliance with the criteria, OSFI will consider the conservatism of the institution's assumptions.

Assessment of Level of Allowances

The balance of general allowances will be assessed for reasonableness, taking into consideration such criteria as:

- the institution's historical loss experience,
- the nature and composition of the portfolio, including the extent of concentration,
- the level of specific provisions and the institution's record of recognizing impairment,
- the rate of growth in the portfolio, and
- the quality of the portfolio at the time of examination.

OSFI will assess the level of allowances as either "Acceptable" or "Not Acceptable."

Implications of Assessment

Institutions having a methodology and/or level of general allowances that is assessed as "Not Acceptable" will be required to submit an action plan and timeline for compliance with the guideline. Until such time as the institution achieves an "Acceptable" or better rating, the institution may be subject to enhanced monitoring of its risk management processes. Approval to include general allowances in tier 2 capital may be reduced below 0.875 per cent of risk-weighted assets or may be denied. Also, institutions that do not achieve an "Acceptable" rating for their general allowance methodology will be expected to apply an additional element of conservatism when arriving at an estimate of the appropriate level of general allowances.

H. Application

This guideline applies to all federally regulated deposit-taking institutions, including those institutions that have not applied for capital treatment of their general allowance. It is, however, recognized that there may be a limited number of federally regulated trust companies with little exposure to credit risk and for which a general allowance may not be appropriate.

Foreign Bank Branches

Foreign bank branches are not separate legal entities but rather operating units of authorized foreign banks, often large international banks. In recognition of these unique characteristics, OSFI does not require authorized foreign banks to maintain general allowances for credit risk on the books of their Canadian branch, although they may do so voluntarily.

Authorized foreign banks must, however, be able to demonstrate effective risk management including:

i. a risk review system and control policies in conformity with OSFI's current framework on general allowances for credit risk; and
ii. adequate procedures for identifying latent losses believed to exist in the branch's risk portfolio but that cannot yet be ascribed to individual risk assets.

OSFI's supervisory approach for foreign bank branches is, in large measure, predicated on regular communication with, and assessment of, the home country supervisor and the foreign bank's head office. As part of this process, OSFI will have to satisfy itself, not only at the time of application to establish a foreign bank branch, but also on an ongoing basis after establishment, that general allowances for credit risk in the Canadian branch are being maintained on a consolidated basis and that the methodology supporting the general allowances produces a reasonable and prudent measurement, on a timely basis, in accordance with appropriate policies and procedures. OSFI will expect the home bank to demonstrate and disclose to OSFI the proportion of its general allowance that is allocated for the benefit of the Canadian branch. In addition, authorized foreign banks will be required to maintain, locally, sufficient evidence to support their assessment and management of risk associated with business booked in Canada.

OSFI maintains the discretion to require the establishment of general allowances for risk on the books of the Canadian branch where recommended as part of the supervisory process in an attempt to address specific concerns or issues. General allowances, including those established voluntarily, should be reported as a segregation of a portion of its "due to related depository institutions" accounts.

I. Implementation

OSFI will begin assessing institutions against this guideline commencing with the 2002 examination cycle. Assessments will be carried out, over time, within the context of the normal supervisory process.

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Annex 1 - Criteria and Guidelines for Assessment of General Allowances Methodology

	Criteria	Assessment Guidelines
	Corporate Governance	
1.	Board oversight	Evidence that the board of directors: - has set the institution's tolerance for credit risk; - regularly reviews portfolio quality reports and takes action as warranted; - reviews and approves the balance of the allowance for loan impairment; and - approves any material divergences between established policies as documented and actual practice.
2.	An approved General Allowance Policy	The policy: - provides an explicit definition of the general allowance; - clearly outlines the concepts underpinning the general allowance, including the manner in which the allowance is expected to operate; and - is regularly reviewed and approved by the board of directors.
3.	Periodic, independent reviews of the credit risk management processes and the general allowance methodology	Areas that should be reviewed include: - the appropriateness of the credit risk assessment processes as they relate to the general allowance and given the nature, scope and complexity of the institution's operations; - the reasonableness, accuracy and completeness of data inputs and parameters into the assessment processes; - the reasonableness of the general allowance methodology; - the reasonableness of data outputs; - the adequacy of stress tests; and - the adequacy of supporting documentation. Findings are documented. Areas of weakness are identified and addressed on a timely basis.

	Criteria	Assessment Guidelines
Design and Operation (Inputs/Methodology/Outputs)		
1.	The completeness and integrity of the data and parameters underlying the general allowance methodology can be supported/empirically verified.	The institution considers all relevant and available data in its methodology and in estimating key parameters and factors. Institutions may have primary sources of information and use others as points of comparison or potential adjustment. A comprehensive process to vet data inputs, including an assessment of accuracy, completeness and suitability. Where the methodology relies on historic data, the data should capture a full business cycle. Where external data are employed as inputs into the general allowance methodology, the extent to which the data links reasonable to the institution's experience and the appropriateness of any adjustments to the data Consistency of data over time supporting the general allowance methodology and the nature, degree and appropriateness of any adjustments designed to compensate for data deficiencies.
2.	Recognition and resolution of structural data issues (for example, the lag effect of historical measures, unstable transition matrices, and the introduction of new products or inclusion of new markets).	Documentation of data issues including an analysis/assessment of the impact on the accuracy/integrity of the general allowance estimate. Documentation of data exceptionality excluded from inputs to calculations, and review of these exclusions in the vetting of general allowances. Conservatism where there are doubts about mapping to data sets or the uncertainty in estimates is high. Plans, where appropriate, to address identified data issues.
3.	The methodology used to calculate the general allowance is conceptually sound.	This includes such factors as: - the methodology provides for meaningful differentiation of risk in the context of the institution's portfolios and experience; - there is an explicit and conservative definition of "default" and "loss"; and - the methodology is based on management's best estimate of losses in the current portfolio and considers the maturity profile of the portfolio.
4.	Credit exposure across all loan portfolios is captured in the calculation of the general allowance.	An institution must be able to demonstrate that an appropriate component of the general allowance corresponds to every net exposure.

Criteria		Assessment Guidelines
5.	The methodology provides that changes in risk will result in appropriate changes in the general allowance.	To achieve sensitivity to risk, the general allowance methodology will use data and parameters relevant to the differentiation of risk; for example, segmentation by line of business, method of distribution, rating class, etc. Among others, the following changes in an institution's strategy or approach would be expected to result in an increase in the estimate of the general allowance: - relaxation in the underwriting standards; - increasing sales of higher risk products or products with less collateral or less robust risk mitigation; and - new distribution methods, or increased distribution through channels that result in higher losses. Period-over-period changes in the general allowance are consistent with changes in portfolio risk.
6.	The methodology provides for frequent and appropriate updates of the general allowance.	The general allowance must calculated at least quarterly. A change control process must exist to ensure that: - the general allowance is calculated in a consistent fashion from period to period. - changes are not made to the methodology except to achieve an estimate that is better related to risk. and - the effects of changes to the methodology are effectively disclosed.
7.	The institution regularly compares assumptions/parameters used to develop the general allowance against experience.	Testing/verification includes: - comparison of actual to expected losses for major categories of loans; - verification that segmentation and risk factors used in risk management, particularly the calculation of general allowances, are supported by experience; - comparison over an economic cycle; - analysis of recent experience that considers recent economic conditions; and - consistent review over portfolios and time. When new methods are introduced, the rationale should be documented and results on both the new and old methodology compiled over several years. Adjustments are made to the risk management processes and the calculation of general allowances as indicated by review against experience.

Criteria		Assessment Guidelines
8.	Regular stress/sensitivity tests of the general allowance estimate.	Stress/sensitivity tests appropriate to the institution's methodology are conducted at regular intervals. Stress/sensitivity tests incorporate both: - normal and extreme conditions; and - immediate and longer term horizons. The results of stress/sensitivity tests are appropriately documented and reported to senior management, and appropriate action is taken if results exceed agreed tolerances.
9.	Variability	Consideration is given to uncertainty in the estimate of the general allowance.
Risk Measurement and Assessment		
1.	The general allowances methodology should be firmly grounded in the institution's process for meaningful differentiation of risk.	The parameters used in the estimate of the general allowance provide for a meaningful differentiation of risk. Evidence exists that management is ensuring, on an ongoing basis, that the risk rating system is operating properly. The extent to which the institution has a credible track record in the use/application of internal ratings information. OSFI will consider internal and external audit results, risk management reviews and the results of OSFI's supervision program in making this assessment.
2.	The analysis of credit risk should adequately identify any weaknesses at the portfolio level, including any concentrations of risk.	Evidence of: - appropriate portfolio segmentation based on underlying risk characteristics; - portfolio analysis/aggregation; and - identification, monitoring and management of large exposures and risk concentrations. Recognition, within the estimate of the general allowance, of the impact of concentrations and borrower interdependence.

Criteria		Assessment Guidelines
3.	Appropriate change control processes	A change control processes that stipulates the procedures to be followed: - before changing the general allowance methodology; - in response to review against experience; and - as new products are sold, underwriting or distribution methods are adopted, or other changes occur that are likely to affect the institution's risk profile. Changes to methodology (including data sources) are appropriately documented.
4.	The risk assessment processes used to arrive at an estimate for the general allowance must be integrated with other credit risk measurement and management processes employed by the institution.	Data and assumptions used in the context of general allowances should be consistent with those used in processes such as: - customer or portfolio profitability analysis; and - risk adjusted return on capital.