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

Guideline

Subject: **Impaired Loans**

Category: **Accounting**

No: **C-1** **Date:** **March 1995**
Revised: **July 2007**

This Guideline provides federally regulated financial institutions with application guidance to Section 3025, Impaired Loans, of the *Canadian Institute of Chartered Accountants (CICA) Handbook*. It comes into effect with the adoption of Section 3025. The recommendations of Section 3025 are presented in italics. This guideline is intended to provide application guidance to supplement the guidance contained in the discussion paragraphs and examples in Section 3025.

OSFI expects the standards established in Section 3025 to also be used to recognize and measure impairment of deposits with regulated financial institutions and acceptances. Guidance is also provided on accounting for impairment of certain off-balance sheet items.

The Guideline does not need to be applied to loans of immaterial amounts. Refer to paragraph 1000.17 of the *CICA Handbook* on materiality.

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Recognition of Impairment

.03 *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.*

A loan or portfolio of loans should be recognized as impaired in accordance with this recommendation. As stated in paragraph 3025.06, arrears of payments with respect to the contractual terms of a loan is not a necessary precondition for recognition of impairment.

With respect to the impact of a current default in making interest or principal payments, as contemplated in paragraph 3025.07(c), OSFI considers the existence of any of the following conditions to be an indication that the lender no longer has reasonable assurance of timely collection of the full amount of principal and interest and the loan should be recognized as impaired:

- 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.

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 a Canadian government (federal or provincial) or a Canadian government agency, the validity of the claim is not in dispute, and as a consequence the lender has reasonable assurance of collection of the principal and interest, including full compensation for overdue payments calculated at the loan's contractual interest rate.

Allowances in respect of off-balance sheet items such as certain guarantees[1] and letters of credit should be recognized in accordance with the recommendations of Section 3290, Contingencies.

In accordance with the requirements of Section 3025, the allowance for loan impairment will be deducted from the applicable asset for balance sheet items. The allowance for impairment will be included in other liabilities for off-balance sheet items.

[1] Refer to CICA, EIC-128 for guarantees that are to be measured at fair value.

Measurement of Impairment

.14 *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 cash flows at the effective interest rate inherent in the loans. When the amounts and timing of future cash flows 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.

OSFI expects all loans valued using the observable market price to be valued on a loan-by-loan basis.

OSFI expects discounting to be applied on a loan-by-loan basis to each loan that is significant to the institution, including those loans measured under option (a). Under option (a), the estimated realizable amount should be measured by discounting the fair value of the underlying security from the most probable date of sale unless that time period has already been taken into account in the determination of the fair value of the security.

Where discounting has been applied on a loan-by-loan basis, OSFI expects that the aggregate value of all loans will constitute a significant proportion of the total recorded investment of all impaired loans measured by discounting.

Institutions may have a number of individually identified, but relatively small, impaired loans where it may not be practical to apply discounting on a loan-by-loan basis. OSFI expects that an institution's approach to identifying the types of impaired loans where it is not practical to apply discounting on a loan-by-loan basis will be reasonable in the circumstances of the particular institution, and be consistently applied.

Where the expected future cash flows of smaller loans have not been discounted on an individual loan basis, OSFI expects institutions to aggregate smaller loans that share common characteristics (e.g., exposure to the same industry) into groups and apply a discount factor to each group that is representative of the group's expected recovery pattern. The institution's experience with larger individually discounted loans sharing similar characteristics would be one factor to be taken into account in developing appropriate discount factors.

In reviewing the adequacy of the allowance for loan impairment, 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 components of the allowance:

i) the shortfall between the undiscounted expected future cash flows of the loan and the recorded investment in the loan; and

ii) the amount resulting from discounting the expected future cash flows at the effective interest rate inherent in the loan.

Estimating the timing of the future cash flows associated with an impaired loan is an integral component of discounting. Changes in the timing of estimated cash flows may have a significant impact on the overall allowance for impairment that is maintained by an institution, and consequently, OSFI expects that the assumptions used by an institution with respect to the timing of the cash flows will be conservative and supportable. While the timing of near-term cash flows may be projected with reasonable precision, simplifying assumptions such as receipt at mid-year may be required for the longer-term cash flows. Where used, OSFI expects such simplifying assumptions will be applied to all impaired loans measured on a discounted cash flow basis and applied consistently from period to period.

Income Recognition

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

.27 *When an impaired loan is measured on the basis of expected future cash flows 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.

.28 *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.*

To maintain a complete record of write-offs and recoveries in the allowance for loan impairment account, OSFI expects write-offs and recoveries related to impaired loans to be recorded through this account rather than being recorded directly as a charge or credit for loan 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 loan impairment in the income statement at the end of the period when the ending balance in the allowance account is established.

Where subsequent payments (whether designated as interest or principal) are received on an impaired loan, OSFI expects them to be recorded as a reduction of the recorded investment in the

loan. When the recorded investment in the loan is completely written off, the subsequent payments are credited to the allowance for loan impairment.

OSFI expects interest income to be recognized on loans accounted for in accordance with paragraphs 3025.27(b) and 3025.28 only when all charges for loan impairment have been reversed.

Restructured Loans

.32 *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 cash flows 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.*

.33 *When a loan has been restructured and collection of the scheduled future cash flows in accordance with the modified terms is reasonably assured, interest income should be recognized on the recorded investment in the loan at the effective interest rate inherent in the loan transaction at the time the loan was recognized as being impaired.*

OSFI expects a reduction in the recorded investment on restructuring a loan to be recorded as a charge against the allowance for loan impairment rather than as a direct charge for loan impairment in the income statement. The impact of a reduction in the recorded investment will be reflected in income when the allowance for loan impairment is adjusted to the required level at the end of the period.

Foreclosed Assets

Foreclosed assets are accounted for in the same manner as an acquisition of the asset and are to be recorded initially at fair value if held for use, or at fair value less cost to sell where the asset meets the criteria to be classified as held for sale. Refer to *CICA Handbook – Accounting, Section 3025.38 to 3025.42* for the accounting treatment of foreclosed assets effective for all asset foreclosures on or after May 1, 2003.

Under this revised approach, estimated operating losses/revenues incurred during the period the foreclosed asset is held for sale are reported in income when incurred and do not increase/ decrease the carrying amount of the foreclosed asset. These operating losses/revenues are reported in the appropriate expense/income account depending on the nature/classification of the foreclosed asset.

When an entity forecloses on a loan, the lender takes title, directly or indirectly, to the assets and, hence, the indebtedness of the borrower would be replaced by title to the assets. A "Power of Sale" obtained by a lender does not constitute foreclosure since title remains in the name of the borrower.

Vendor-Take-Back Loans

Financial institutions may receive real property or other assets through foreclosure or loan restructuring. To facilitate the sale of these assets, financial institutions sometimes offer vendor-take-back loans on favourable terms. OSFI expects the initial carrying amount of these loans to be determined by discounting the expected future cash flows at the current market interest rate for loans with similar collection risk.

If a vendor-take-back loan is made to a borrower related to the previous borrower, OSFI expects the loan to be accounted for as a restructured loan.

OSFI expects that when a vendor-take-back loan has been issued and collection of the scheduled future cash flows is reasonably assured, interest income will be recognized on the recorded investment in the loan at the current market interest rate at the time the loan was issued.

Presentation and Disclosure

.42 *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 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;*
- (c) *the net charge or credit to income in respect of loan impairment, identifying separately recoveries of loans written off in previous periods;*
- (d) *write-offs of loans during the reporting period, identifying separately amounts relating to loans restructured during the reporting period;*
- (e) *the recorded investment in loans foreclosed during the period and the amount of the reversal of allowance for loan impairment;*
- (f) *the method or methods for determining fair value of a long-lived asset acquired through foreclosure (whether based on a quoted market price, prices for similar assets, or another valuation technique); and*
- (g) *loans accounted for in accordance with paragraph 3025.27(a), the amount included in interest income.*

Since foreclosed assets are not included in impaired loans, the asset is reported in the asset class appropriate to the nature of the asset and reflecting management's intent to hold or dispose of the foreclosed asset.

.43 *The basis of determining the amount 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.*

A loan cannot be split into unimpaired and impaired portions for the purpose of reducing the recorded investment in impaired loans that is required to be disclosed unless this is done to reflect a change in the underlying legal agreements. The existence of a partial government guarantee or insurance does not preclude a loan from being disclosed as an impaired loan when reasonable assurance of the timely collection of the full amount of principal and interest does not exist.

The total recorded investment in loans that have payments contractually 90 days to 180 days in arrears but have not yet been recognized as impaired is expected to be disclosed.

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