



Reference: Guideline for Banks, FBBs and
T&L

Our File: P2050-15

October 31, 2001

Subject: General Allowances for Credit Risk, Guideline C-5

OSFI is releasing a guideline which provides banks and federally regulated trust and loan companies with guidance on the regulatory framework for general allowances. Guideline C-5, General Allowances for Credit Risk, is effective for fiscal years commencing on or after November 1, 2001, with the exception of the increase in the ceiling for capital treatment, which is effective immediately. This guideline should be considered in conjunction with *Guideline C-1, Impaired Loans*.

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 in April 1998, October 1998, August 1999 and November 1999. It confirms the requirement that banks and trust and loan companies must maintain adequate general allowances to recognize credit losses within their portfolios. In addition, the guideline addresses a number of outstanding issues from the 1997 draft, including measurement guidance, disclosure requirements and criteria for assessing supporting methodologies.

Practices in this area are evolving rapidly and are being influenced by work in related areas such as the BIS requirements for using internal models for measuring credit risk. As a result, this guideline is seen as transitional and will be revised as necessary to reflect industry best practice and international developments in credit capital requirements, accounting and disclosure.

Capital Treatment

A letter to the industry, dated November 1999, confirmed that OSFI is prepared to permit general allowances for credit risk to be included in tier 2 capital to a maximum of 0.75 per cent of risk weighted assets. The ceiling of 0.75 per cent recognized, in part, the impact on capital quality of future income tax assets that arise from anticipated levels of general allowances without making an explicit deduction for future income tax assets. The ceiling is being increased to 0.875 per cent, effective immediately, to reflect recent changes in federal and provincial tax rates.



Implementation

The guideline introduces a two-part evaluation process that assesses both the strength of an institution's underlying general allowance methodology and the adequacy of the level of general allowance as viewed against "selective assessment criteria." These criteria were referred to in OSFI's letter to the industry dated October 22, 1998. Assessments will be carried out, over time, within the context of the normal supervisory process.

OSFI had previously indicated that it would establish criteria for assessing general allowance methodologies. OSFI also advised that, if an institution applied and its methodologies met an appropriate standard, OSFI would be prepared to rely more on the institutions' own methodologies in OSFI's assessment of appropriate levels of general allowances and less on the "selective assessment criteria".

OSFI recognizes that the general allowance methodology of many institutions will not fully meet the criteria in the guideline at this time, even though their level of allowances is adequate. The purpose of the policy is to communicate OSFI's expectations and to encourage adoption of these principles by the industry.

Applications should be limited to those institutions that believe that their methodology fully complies with the criteria outlined in the Annex to the guideline. Based on current knowledge, OSFI anticipates that only a limited number of institutions would meet this requirement. Institutions that believe they meet the requirement should apply to OSFI for a review of their policy and methodology in order to confirm their internal assessment and to discuss with OSFI the appropriate level of allowance that results. Institutions should not expect to achieve rapid reductions in their general allowance levels as a result of this process.

The guideline is available in English and French on OSFI's Web site (<http://www.osfi-bsif.gc.ca>) under the Publications section. It may also be obtained by contacting Mr. Stéphane Dupel, General Services Division, by e-mail at pub@osfi-bsif.gc.ca or by facsimile at (613) 954-4331.

Questions concerning the guideline should be addressed to Mr. Richard Holder, Accounting Policy, at (416) 954-0489 or by facsimile at (416) 952-1662.

Nicholas Le Pan
Superintendent