Sound Practices for Loan Accounting, Credit Risk Disclosure and Related Matters

Consultative paper issued by the Basle Committee on Banking Supervision

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Task Force on Accounting Issues
of the Basle Committee on Banking Supervision

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This paper has also benefited from contributions made by the Basle Committee's Transparency Sub-group, chaired by Ms. Susan Krause of the Office of the Comptroller of the Currency.

TABLE OF CONTENTS

SOUND PRACTICES FOR
LOAN ACCOUNTING, CREDIT RISK DISCLOSURE AND RELATED MATTERS

OCTOBER 1998

EXECUTIVE SUMMARY

This document provides guidance to banks, banking supervisors and accounting standard-setters on recognition and measurement of loans, establishment of loan loss allowances, credit risk disclosure and related matters. It sets out banking supervisors' views on sound loan accounting and disclosure practices for banks. The document also serves as a basic framework for supervisory evaluation of banks' policies and practices in these areas.

Various international bodies, including the Basle Committee, have called for progress in accounting and disclosure practices for banks' lending business and related credit risk. Accounting treatments generally, and loan accounting treatments specifically, can significantly affect the accuracy of financial and supervisory reporting and related capital calculations. Moreover, sound accounting and disclosure practices are essential to ensure the enhanced transparency needed to facilitate the effective supervision and market discipline of financial institutions. In addition to the Basle Committee, the G-7 Finance Ministers, G-10 central bank Governors and international agencies such as the International Monetary Fund (IMF) and the World Bank have called for progress in this area.

The paper begins by stating the overall objectives of the Basle Committee in addressing the topic of sound practices for loan accounting and disclosure. It then summarises key terms and ties this guidance to the credit risk management process. The paper then provides guidance on sound practices with respect to key loan accounting issues, such as the initial recognition and measurement of loans, subsequent measurement of impaired loans, the establishment of loan loss allowances, income recognition and issues relating to troubled debt restructurings. Moreover, the paper presents sound disclosure practices for loan portfolios, troubled loans, loan loss allowances and related risk management practices. The paper concludes with a brief discussion of the role of supervisors in assessing a bank's management of asset quality and the adequacy of loan loss allowances.

Three primary concerns of supervisors are a) the adequacy of an institution's process for determining allowances, b) the adequacy of the total allowance and c) the timely recognition of identified losses through either specific allowances or charge-offs.

The publication of this paper is a component of the Committee's long-standing work to promote effective banking supervision and safe and sound banking systems. It complements the Basle Core Principles in the field of accounting and disclosure for banks' lending business and related credit risk. International implementation of the guidelines in this paper should help achieve enhanced bank accounting policies and practices, which are consistent with sound risk management practices, in both G-10 and non-G-10 countries, as well as increased convergence of such policies and practices across banks and countries.

Invitation to comment

This paper is being released for consultation. Comments are invited from non-G-10 supervisory authorities, and also from banks, industry groups, accounting and auditing bodies, and other interested parties. All comments must be received no later than ***15th March 1999***. The Committee intends to release a final version of the paper in the first half of 1999.

Comments should be sent to:

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LIST OF SOUND PRACTICES

FOUNDATIONS FOR SOUND ACCOUNTING

1) ***A bank should adopt a sound system for managing credit risk.***

2) ***Judgements by management relating to the recognition and measurement of impairment should be made in accordance with documented policies and procedures that reflect such principles as consistency and prudence.***

3) ***The selection and application of accounting policies and procedures should conform with fundamental accounting concepts.***

ACCOUNTING FOR LOANS

Recognition, discontinuing recognition and measurement

4) ***A bank should recognise a loan, whether originated or purchased, in its balance sheet when the bank becomes a party to the contractual provisions that comprise the loan.***

5) ***A bank should remove a loan (or a portion of a loan) from its balance sheet when the bank realises the rights to benefits specified in the contract, the rights expire or the bank surrenders or otherwise loses control of the contractual rights that comprise the loan (or a portion of the loan).***

6) ***A bank should measure a loan, initially, at cost, which is the fair value of the consideration given for it.***

Impairment - recognition and measurement

7) ***A bank should identify and recognise impairment in a loan or a collectively assessed group of loans when it is probable that the bank will not be able to collect, or there is no longer reasonable assurance that the bank will collect, all amounts due according to the contractual terms of the loan agreement. The impairment should be recognised by reducing the carrying amount of the loan(s) through an allowance or charge-off and charging the income statement in the period in which the impairment occurs.***

8) ***A bank should measure an impaired loan at its estimated realisable value.***

Restructured troubled loans

9) ***A bank should recognise a loan as a restructured troubled loan when the lender, for economic or legal reasons related to the borrower's financial difficulties, grants a concession to the borrower that it would not otherwise consider.***

10) ***A bank should measure a restructured troubled loan by reducing its recorded investment to net realisable value, taking into account the cost of all concessions at the date of restructuring. The reduction in the recorded investment should be recorded as a charge to the income statement in the period in which the loan is restructured.***

Adequacy of the overall allowance

11) ***The aggregate amount of specific and general allowances should be adequate to absorb estimated credit losses associated with the loan portfolio.***

Income recognition

12) ***A bank should recognise interest income on an unimpaired loan on an accrual basis.***

13) ***When a loan is identified as impaired, a bank should either cease the accrual of interest or continue to accrue interest but set aside a specific allowance for the full amount of interest being accrued. Where an impaired loan is carried at the present value of expected future cash flows, interest may be accrued on the carrying amount and included in net income to reflect updated present values.***

PUBLIC DISCLOSURE

14) ***A bank should disclose information about the accounting policies and methods followed to account for loans and the allowance for impairment.***

15) ***A bank should disclose information on methods used to determine specific and general allowances and key assumptions used.***

16) ***A bank should disclose information on the risk management and control policies and practices adopted by the bank relating to credit risk of the loan portfolio.***

17) ***A bank should disclose geographical information about loans, impaired loans and past due loans including the related amount of specific and general allowances.***

18) ***A bank should disclose balances of loans, impaired loans and past due loans by major categories of borrowers and the amounts of specific and general allowances established against each category.***

19) ***A bank should disclose information on significant concentrations of credit risk.***

20) ***A bank should disclose balances of loans where the accrual of interest in accordance with the terms of the original loan agreement has ceased because of a deterioration in credit quality.***

21) ***A bank should disclose a reconciliation of movements in the allowance for loan impairment ('continuity schedule') showing separately various types of allowances.***

22) ***A bank should disclose balances of and other information about loans that have been restructured during the year.***

23) ***A bank should disclose contractual obligations with respect to recourse arrangements and the expected losses under those arrangements.***

ROLE OF SUPERVISORS

24) ***Banking supervisors should evaluate a bank's policies and practices for assessment of loan quality.***

25) ***Banking supervisors should be satisfied that the methods employed by a bank to calculate allowances produce a reasonable and appropriately conservative valuation in accordance with appropriate policies and procedures.***

SOUND PRACTICES FOR
LOAN ACCOUNTING, CREDIT RISK DISCLOSURE AND RELATED MATTERS

OCTOBER 1998

I. INTRODUCTION

1. This document, issued by the Basle Committee on Banking Supervision,[1] provides guidance on recognition and measurement of loans, establishment of loan loss allowances, credit risk disclosure and related matters. It sets out banking supervisors' views on sound loan accounting and disclosure practices for banks.[2] The document also serves as a basic framework for supervisory evaluation of banks' policies and practices in these areas.

(a) Objectives

2. Three objectives underlie the issuance of this document on loan accounting, credit risk disclosure and related matters:

1) To provide guidance on sound practices to banks, supervisory agencies and accounting standard-setters.
2) To promote enhanced policies and practices, which are consistent with sound risk management practices, of banks in both G-10 and non-G-10 countries.
3) To promote convergence of policies and practices across banks and countries.

3. The guidance in this document is founded on the precept that accounting policies and practices should ensure that loan assets, capital and income are fairly and prudently stated. In many respects, the document sets out principles that are already widely accepted in many countries. Nevertheless, the Basle Committee believes that this document can play a useful

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1 The Basle Committee on Banking Supervision is a committee of banking supervisory authorities which was established by the central bank Governors of the Group of Ten countries in 1975. It consists of senior representatives of bank supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States. It usually meets at the Bank for International Settlements in Basle, where its permanent Secretariat is located.

2 Other financial institutions with significant lending activities and their supervisors may also find the guidance in the paper useful.

role by addressing the need for improvements in accounting and disclosure standards for banks' lending activities.

4. This guidance emphasises that three of supervisors' primary concerns should be a) the adequacy of an institution's process for determining allowances, b) the adequacy of the total allowance and c) the timely recognition of identified losses through either specific allowances or charge-offs.

5. The publication of this paper is a component of the Committee's long-standing work to promote effective banking supervision and safe and sound banking systems. In the Basle Core Principles,[3] the Committee defines minimum requirements for an effective banking supervisory system and discusses arrangements to promote stability in financial markets. This document elaborates on certain of the Core Principles, which require banking supervisors to be satisfied that:

- banks establish and adhere to adequate policies, practices and procedures for evaluating the quality of assets and the adequacy of loan loss provisions and loan loss reserves (Principle 8);[4]
- each bank maintains adequate records drawn up in accordance with consistent accounting policies and practices that enable supervisors to obtain a true and fair view of the financial condition of the bank and the profitability of its business (Principle 21, 1st clause);
- each bank publishes on a regular basis financial statements that fairly reflect its condition (Principle 21, 2nd clause).

(b) Scope

6. Since this paper is an elaboration of certain of the Basle Core Principles, it applies to all banking organisations. As discussed later, the methods by which the guidance is implemented should reflect the scope and complexity of individual banks' operations.

7. The focus of this paper is primarily on accounting and disclosure practices relating to the credit risk in loans held in the banking book. Credit risk is of course present in activities other than lending. While valuation and the establishment of allowances relating to credit risk in other banking activities (e.g., trading and derivatives activities) are generally outside the

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3 The *Core Principles for Effective Banking Supervision* were issued by the Basle Committee in September 1997 after consultation with banking supervisors worldwide.

4 As discussed in the section on terminology, this paper uses the term "allowance" instead of "reserve" since many accountants for conceptual reasons would avoid the latter term in the context of loan impairment.

scope of this paper, the Basle Committee believes that banking organisations should ensure that the credit risk in these areas is prudently measured, managed and disclosed in their financial statements.[5] Many of the principles in this paper should be helpful to institutions and their supervisors in addressing those accounting and disclosure issues.

8. In many countries, accounting policies are to a greater or lesser extent influenced by fiscal considerations. For example, most countries that are members of the Basle Committee grant tax deductibility to specific allowances/charge-offs in the year they occur. However, convergence in tax treatments lies outside the scope of this paper.

(c) Background

9. Banking supervisors have a legitimate interest in sound and prudent accounting principles and practices, and in appropriate disclosures by banking organisations. Generally, banking supervisors provide supervisory guidance that includes supervisory reporting standards and capital adequacy requirements. In some jurisdictions, banking supervisors have no authority to decide on accounting principles and practices. However, in several countries, banking supervisors do provide accounting standards, accounting guidance or elaborate on generally accepted accounting principles for banks' public financial statements and prudential reports used by supervisors. Accounting treatments generally, and loan accounting treatments specifically, can significantly affect the accuracy of financial and supervisory reporting and related capital calculations. Moreover, sound accounting and disclosure practices are essential to ensure the transparency needed to facilitate the effective supervision and market discipline of financial institutions.

10. There is considerable interest in achieving further harmonisation and in strengthening transparency of loan valuation, the establishment of loan loss allowances, and credit risk exposures. In addition to the Basle Committee, the G-7 Finance Ministers, G-10 central bank Governors and international agencies such as the International Monetary Fund (IMF) and the World Bank have called for progress in this area.

11. All supervisors are encouraged to review their current rules or recommendations against the guidance provided in this paper and amend their rules, as appropriate, in ways that are best suited to their national systems.[6] This guidance may also be of assistance to

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5 The Basle Committee, jointly with the IOSCO Technical Committee, has issued disclosure guidance in the annual survey reports on trading and derivatives disclosure of banks and securities firms; the most recent report was issued in November 1997. Also, the Euro-currency Standing Committee's discussion paper on *Public Disclosure of Market and Credit Risks by Financial Intermediaries* (September 1994) contains disclosure recommendations for financial institutions' trading and derivatives activities.

6 Some supervisors may wish to complement the sound practices set out in this paper by providing more detailed guidance.

accounting standard-setters as they work on setting more uniform rules. Also, supervisors may have reasons to recommend enhancements in national accounting or disclosure rules and to consider introducing special regulatory guidance, e.g. for capital adequacy and supervisory reporting purposes, in countries where national rules do not lead to sufficient levels of loan loss allowances.

12. ***Accounting:*** Adequate accounting policies and practices for a bank's lending activities are an essential part of a sound and effective credit risk management process in a bank. Experience indicates that the most common cause of bank failures, by far, is poor credit quality and credit risk management. Failure to identify and recognise deterioration in credit quality in a timely manner can aggravate and prolong the problem. Unless deterioration is identified and losses recognised by the establishment of adequate allowances or charge-offs in a timely manner, a bank may well persist in highly risky lending strategies or practices and thus accumulate significant loan losses, possibly resulting in failure. From a safety and soundness perspective, therefore, it is important to bank supervisors that the accounting principles used by banks reflect prudent and realistic measurements of assets, liabilities, equity, derivative contracts, off-balance sheet commitments, and related profits and losses. Capital adequacy requirements provide some cushion against loan losses, but if underlying accounting policies are weak, the resulting capital situation may well be overstated.[7] Thus, inadequate accounting treatments undermine the usefulness of capital requirements and hamper proper assessments and sound management and control of a bank's credit risk exposure. Moreover, significant differences in accounting treatments may be a source of competitive distortions.

13. ***Disclosure:*** Sound accounting standards also are necessary to achieve satisfactory transparency, i.e., public disclosure of reliable information that enables market participants and other users of that information to make an accurate assessment of a bank's financial condition and performance, its business activities and the risks related to those activities.[8] Disclosure of reliable information based on sound accounting principles and internal control systems facilitates market discipline and strengthens confidence in the banking system. In contrast, insufficient disclosure increases the chance that misleading information could cause market instability. By facilitating market discipline, accounting and disclosure help reinforce

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7 The *Basle Capital Accord* defines minimum capital requirements for banks on the basis of a risk-weighted approach to credit risk and market risk. In principle, specific allowances reduce risk-weighted amounts, while both specific and general loan loss allowances reduce tier 1 capital since these allowances are created through a charge to earnings which reduces equity capital. Under the Capital Accord, general loan loss allowances are included in tier 2 capital under certain conditions.

8 The Basle Committee has issued general recommendations about disclosures by banks in the paper *Enhancing Bank Transparency*, issued in September 1998.

supervisory efforts to encourage banks and other market participants to maintain sound risk management practices and internal controls. Experience indicates that the degree of transparency with respect to the credit risk of banks' lending activities in G-10 and non-G-10 countries can be improved.

14. It is recognised that discussions are underway among national and international accounting standard-setters on ways in which accounting for financial instruments, including loans, can be harmonised and improved. For instance, the International Accounting Standards Committee (IASC) and several national accounting standard-setters are undertaking a joint long-term project addressing recognition and measurement issues with respect to financial assets and financial liabilities, including consideration of fair value accounting.[9]

15. The Basle Committee will continue to keep accounting and disclosure matters under review to the extent that they affect supervisors' mandate to promote safety and soundness of banks and the stability of financial systems. It intends to work with accounting standard-setters to promote the enhancement and harmonisation of accounting standards as they relate to banks. Moreover, the Committee is currently developing a separate paper on credit risk management, a complex topic in which accounting policies play an important part.

(d) Outline of paper

16. Following a brief discussion of some fundamental considerations pertaining to accounting and credit risk management in ***section 2***, the paper in ***section 3*** elaborates on sound practices for loan valuation, establishment of loan loss allowances and other loan accounting issues. Sound disclosure practices regarding lending activities and credit risk are discussed in ***section 4*** of this paper. Emerging issues, such as fair value accounting and new provisioning approaches, are discussed in ***section 5***. The role of supervisors in assessing a bank's loan accounting policies and practices is set out in ***section 6***.

(e) Terminology

17. In international discussions of loan accounting and disclosure, misunderstandings can arise due to differences in terminology across countries. In this paper, a consistent terminology is applied:

- A '***loan***' is a financial asset resulting from the delivery of cash or other assets by a lender to a borrower in return for a promise to repay on a specified date or dates, or on demand, usually with interest. Loans comprise:

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9 The IASC issued the discussion paper *Accounting for Financial Assets and Financial Liabilities* in March 1997. An Exposure Draft of an interim international accounting standard on recognition and measurement of financial assets and financial liabilities (E62) was issued in June 1998.

a) consumer instalments, overdrafts and credit card loans;

b) residential mortgages;

c) non-personal loans, such as commercial mortgages, project finance, and loans to businesses, financial institutions, governments and their agencies;

d) direct financing leases; and

e) other financing arrangements that are, in substance, loans.

- The '***recorded investment'*** in a loan or group of loans is the face or principal amount, taking into account payments applied to reduce principal, and adjusted to reflect accrued but uncollected interest, charge-offs, unamortised premium or discount (i.e., a difference between acquisition cost and principal) and unamortised loan fees and costs.
- The '***carrying amount***' of a loan or a group of loans is the net amount reported for the loan or group of loans on the balance sheet, i.e., the recorded investment less any specific and general allowances.[10]
- Loan '***impairment***' represents deterioration in the credit quality of one or more loans such that it is probable that the bank will be unable to collect, or there is no longer reasonable assurance that the bank will collect, all amounts due according to the contractual terms of the loan agreement(s).[11]
- An '***allowance***'[12] for loan impairment is the amount that reduces the recorded investment in a loan or a group of loans to the carrying amount on the balance sheet.
    - A '***specific allowance***' is an allowance that is established against a loss that is identified in an individual loan. As a practical expedient, specific allowances against losses in pools of collectively assessed small-balance loans with

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10 In most countries, loans are reported net of allowances on the asset side of the balance sheet. However, in some countries, the asset side shows the recorded investment and loan loss allowances are reported on the liabilities side.

11 An insignificant delay or insignificant shortfall in amounts of payments does not necessarily constitute impairment, if, during such a period of delay, the lender can reasonably expect to collect all amounts due.

12 Allowances are sometimes referred to as provisions or valuation reserves. It should be noted that some accountants consider the use of the terms "provision" and "reserve" inappropriate when referring to accumulated value adjustments of loan assets: The IASC defines a provision as a type of liability, while a reserve is defined as a part of equity capital (*IASC Framework for the Preparation and Presentation of Financial Statements*).

common characteristics (e.g., credit card balances) can be established on a formula basis.[13]

- A '***general allowance***' is an allowance that is established for latent losses that are known to exist, but cannot yet be ascribed to individual loans.[14]

- A '***charge-off***' (or write-off) is made when all or part of a loan is deemed uncollectible or there is otherwise no realistic prospect of recovery. A charge-off reduces the recorded investment in the loan and, if allowances previously have been established, the amount of allowances.[15]

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13 Allowances established on a group basis against losses in pools of collectively assessed small-balance loans are considered as specific allowances only to the extent they substitute for allowances established against losses identified on a loan-by-loan basis.

14 In some countries, the process used to estimate the amount of latent losses in the loan portfolio considers the collectibility of some loans (generally larger-balance loans) individually and other loans (generally smaller-balance loans) on a pool basis.

15 The timing of charge-offs differs considerably between countries for legal, fiscal and other reasons. In some countries, a charge-off is taken against an individual loan rather than establishing a specific allowance against that loan. Nevertheless, banks should keep memorandum records of charged-off loans for the amounts still formally owed by debtors.

II. FOUNDATIONS FOR SOUND ACCOUNTING

1) A bank should adopt a sound system for managing credit risk.

18. Effective risk management and control policies and practices are essentially related to sound and timely accounting and valuation.

19. To be able to prudently value loans and to determine appropriate allowances, it is particularly important that banks have a system in place, whether established by the institution itself or by the supervisor, to reliably classify loans on the basis of risk. A credit risk classification system may include categories or designations that refer to varying degrees of credit deterioration, such as substandard loans, doubtful loans, and irrecoverable loans. A classification system typically takes into account the borrower's current financial condition and paying capacity, the current value of collateral, and other factors that affect the prospects for collection of principal and interest.

20. Accounting and valuation processes must be complemented by effective internal controls commensurate with the size, nature and complexity of the bank's lending operations. The board of directors has ultimate oversight responsibility for establishing and maintaining a system of effective internal controls that, among other things, should ensure that lending transactions are promptly recorded, loan documentation is complete and internal loan review procedures are effective. The Basle Committee will address principles for credit risk management in more detail in a separate paper.

2) Judgements by management relating to the recognition and measurement of impairment should be made in accordance with documented policies and procedures that reflect such principles as consistency and prudence.

21. Recognition and measurement of loan impairment cannot be based totally on specific rules. Actual valuation, recognition and income measurement involve a mix of formal rules and judgements by management. Judgements are necessary but the scope for actual discretion should be prudently limited; in particular within the following constraints:

- There should be an approved and documented analytical framework for assessing loan quality, which is applied consistently over time.
- Estimates should be based on reasonable and supportable assumptions.
- Assumptions concerning the impact on borrowers of changes in general economic activity should be realistic and conservative in relation to economic conditions existing at the date of preparation of financial statements.

22. Assessments should be performed in a systematic way and in accordance with established policies and procedures.

3) The selection and application of accounting policies and procedures should conform with fundamental accounting concepts.

23. Sound accounting principles require the selection and application of accounting policies and procedures to be governed by certain fundamental accounting concepts, such as prudence and consistency. These overall guiding concepts are established in the accounting literature and in concepts statements issued by leading accounting standard-setters.[16] They are also discussed in the Basle Committee's recently issued report on Enhancing Bank Transparency. Normally, these concepts apply irrespective of whether the accounting information is produced for the purposes of published financial statements, the calculation of regulatory solvency requirements, or the determination of distributable profits. Moreover, they apply equally to accounting for loans and other economic activities conducted by banks. Some of the more fundamental accounting concepts that should be applied in the accounting for loans are discussed below.

24. A bank's financial reporting should convey a true and fair view, or present fairly, the financial position and financial performance of the bank (***true and fair view / fair presentation***).[17] Financial reporting should include adequate disclosure and reasonable detail, and should be free from bias. Where compliance with applicable accounting standards is not in itself sufficient to give a true and fair view or a fair presentation, additional disclosure should be given.

25. A bank should have a realistic view of its business activities and adequately consider uncertainty and risks inherent in those activities in preparing and presenting accounting information (***prudence and conservatism***). From a safety and soundness perspective, it is important that the accounting principles used by a bank reflect prudent and conservative valuations. Provisions or allowances should be made for all expenses and losses that are probable and can be reasonably estimated on the basis of available information. Judgements needed to make estimates should include a reasonable degree of caution, so that assets, equity or income are not overstated and liabilities or expenses are not understated.

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16 E.g., *International Accounting Standard (IAS) No. 1* (revised 1997), *IASC Framework for the Preparation and Presentation of Financial Statements*, Canadian Institute of Chartered Accountants' (CICA) *Handbook Section 1000 on Financial Statement Concepts*, UK Accounting Standards Board's Exposure Draft *Statement of Principles for financial reporting*, U.S. Financial Accounting Standards Board's (FASB) *Statements of Financial Accounting Concepts No. 2 and 5*, and certain provisions in the EU Accounting Directives.

17 Supervisory reports should also follow this principle. However, to the extent supervisory reports are more timely or frequent than audited financial statements, supervisors may permit banks to make more use of estimates in the preparation of the accounting information in these reports.

However, this does not justify the establishment of hidden (undisclosed) reserves through undervaluation of assets or overaccrual of liabilities.

26. A bank should select and apply accounting policies in a way that ensures that accounting information is reliable **(*reliability*)**. In particular, accounting information should:

- represent faithfully that which it purports to represent or could reasonably be expected to represent;
- reflect the economic substance of events and transactions and not merely their legal form;
- be verifiable;
- be neutral, i.e., free from material error or bias;
- be prudent, and
- be complete in all material respects.

27. Bank's financial reports should present or disclose each material item separately **(*materiality*)**. Information is material if its omission or misstatement could have changed or influenced the judgement or decision of a user relying on that information. Magnitude by itself, without regard to the nature of the item and the circumstances in which the judgement has to be made, is not generally a sufficient basis for a materiality judgement.

28. A bank should use consistent accounting policies and procedures from period to period, and consistent measurement concepts and procedures for related items **(*consistency*)**. Changes should not be made unless they can be justified as being more appropriate, e.g., because of a revision in accounting standards issued by a competent standard-setter. The consistency requirement does not preclude items being reclassified, e.g., because of a change in their use.

29. A bank should recognise transactions and events when they occur and not as cash or its equivalent is received or paid, and they should record and report them in the periods to which they relate **(*accrual basis of accounting*)**. Expenses should be reported in the period in which they are incurred and income in the period in which it is earned. Expenses should be matched against the income they relate to, so that net income is measured by the difference between income over associated expenses during the same period.

30. Finally, a bank should select and apply accounting policies in a way that promotes comprehensiveness, relevance and timeliness of accounting information.

III. ACCOUNTING FOR LOANS

31. The previous section referred to general principles that are particularly important in managing credit risk and accounting for loans. This section outlines sound principles of a more specific nature.

(a) Recognition, discontinuing recognition and measurement

4) A bank should recognise a loan, whether originated or purchased, in its balance sheet when the bank becomes a party to the contractual provisions that comprise the loan.

32. When a bank becomes a party to the contractual terms comprising the loan it controls the economic benefits associated with the loan. Normally, a bank becomes a party to the contractual provisions that comprise a loan (i.e., acquires legal ownership of the loan) on the date of the advance of funds or payment to a third party. As a result, a commitment to lend funds is not recognised as an asset on the balance sheet.[18] In certain jurisdictions, the acquisition of legal ownership is viewed more as a process than a discrete event. However, providing consideration (the advancement of funds) is typically one of the more important factors constituting ownership.

5) A bank should remove a loan (or a portion of a loan) from its balance sheet when the bank realises the rights to benefits specified in the contract, the rights expire or the bank surrenders or otherwise loses control of the contractual rights that comprise the loan (or a portion of the loan).

33. Control of a loan is surrendered when the ability to obtain future economic benefits relating to the loan and the ability to restrict the access of others to those benefits is transferred to others. Control is not surrendered if there are terms that would require or economically compel the bank or the transferee to revoke the transfer and essentially put things back where they were. Moreover, control is not surrendered if the bank is entitled and obligated to purchase or redeem the transferred loans at a fixed or determinable price that effectively provides the transferee with a rate of return that is equivalent to interest on the funds it has provided to the bank. The bank's retention of servicing rights is not considered to be a factor in the determination of whether it has surrendered control over the underlying loans. An example of a case where control has not been surrendered is where a bank has transferred a loan with an obligation to repurchase it at a future date.

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18 However, a binding commitment or guarantee can constitute a credit risk that may require the accrual of an amount to be reported as a liability. In some countries, the full amount of guarantees is recognised on the balance sheet.

6) A bank should measure a loan, initially, at cost, which is the fair value of the consideration given for it.

34. A loan should initially be recorded at its fair value which represents its acquisition cost. For loans originated by the bank, the cost is the amount lent to the borrower.[19] Where a loan has been acquired from a third party, the cost is the fair value of the consideration given to acquire the loan at the time of acquisition.[20]

(b) Impairment – recognition and measurement

35. Before discussing sound practices for recognition and measurement of loan impairment, it should be noted that the philosophy behind the establishment of allowances differs in certain fundamental respects across countries.

36. In some countries, there is considerable attention given to the procedure of determining an appropriate size of overall loan loss allowances. The main question is whether the level of loan loss allowances is sufficient to cover probable losses associated with the total loan portfolio. In these countries, all or the bulk of a bank's allowances are general allowances and identified losses are charged off at an early stage.

37. In other countries, the focus is primarily on the procedure to arrive at the net book value of individual loans with the principal question being one of whether specific allowances are sufficient to cover all ascertained and expected losses inherent in those loans on an item-by-item basis. In these countries, identified but not yet finally determined losses are often recognised through specific allowances where these losses would have been charged off in the first set of countries.[21] As a second step, banks in some of these latter countries establish additional general allowances to cover latent losses which are not yet identified but which are known to exist.

38. Despite these differences, common sound practices for the establishment of loan loss allowances can be formulated as set out below. This guidance emphasises that three of supervisors' primary concerns should be a) the adequacy of an institution's process for determining allowances, b) the adequacy of the total allowance and c) the timely recognition of identified losses through either specific allowances or charge-offs.

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19 In some countries, the amount lent to the borrower is adjusted by origination fees and costs.

20 The fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction. An arm's length transaction is a transaction entered into by unrelated parties each acting in its own best interest.

21 It should be noted, however, that also in these latter countries loans are eventually charged off (written off).

7) ***A bank should identify and recognise impairment in a loan or a collectively assessed group of loans when it is probable that the bank will not be able to collect, or there is no longer reasonable assurance that the bank will collect, all amounts due according to the contractual terms of the loan agreement. The impairment should be recognised by reducing the carrying amount of the loan(s) through an allowance or charge-off and charging the income statement in the period in which the impairment occurs.***

39. To ensure that impairment in loans is identified in a timely manner, loans should be reviewed for impairment in credit quality in the preparation of annual and interim financial reports, taking into consideration the economic and other conditions at the reporting date. Moreover, an evaluation of loan impairment should be made between reporting dates whenever substantive information exists that indicates a significant deterioration has occurred in the credit quality in all or part of the loan portfolio.

40. The evaluation of each loan should be based upon the creditworthiness of the particular borrower. The focus of the assessment is the ability of the borrower to repay the loan. The assessment should reflect all relevant factors as of the evaluation date that affect the collectibility of principal and interest. Factors relevant to the assessment of the debtor's ability to repay may include the debtor's payment record, overall financial condition and resources, debt service capacity, financial performance, net worth and future prospects; the prospects for support from any financially responsible guarantors; the nature and degree of protection provided by the current and stabilised cash flow and value of any underlying collateral; and country risk. Consideration of one factor only, e.g., the value of the collateral, is normally not sufficient for the determination of impairment status. However, as other sources of repayment become inadequate over time, the importance of the collateral's value in the analysis increases.

41. Collateral should be valued on a prudent basis. For example, for significant commercial real estate loans, banks should obtain sound appraisals of the current fair value of the collateral from qualified professionals either internal or external to the bank. Management should review each appraisal's assumptions and conclusions to ensure timeliness and reasonableness. Typically, appraisal assumptions are based on the current performance of the collateral or similar properties. Many supervisors also expect appraisals to take into account, on a discounted basis, the ability of the real estate to generate income over time based on reasonable and supportable assumptions.

42. Recognition of impairment should be considered whenever circumstances cause uncertainty about whether the estimated realisable amount of a loan is lower than its carrying

amount.[22] Management should use both internal information, e.g., the borrower's delay in making principal or interest payments, and external information, e.g., public disclosure and other financial information on the borrower (liquidity, cash flow projections), downgrading of credit status by a credit rating agency and declines in the value of collateral and guarantees.

43. One factor that generally indicates that there has been a deterioration in the credit quality of a loan is that the borrower has defaulted in making interest or principal payments when due on the loan. As a starting point, loans generally should be identified as impaired when payments are contractually a minimum number of days in arrears reflecting domestic payment practices for the type of loan in question (e.g., 30-90 days). As an exception, loans need not be identified as impaired when the loan is fully secured, and there is reasonable assurance that the collection efforts will result in repayment in a timely manner of principal and interest (including full compensation for overdue payments).[23] Clearly, the existence of significant payment arrears is only one of many factors to consider when identifying impairment. Loans that are not seriously delinquent, or indeed not delinquent at all, as well as overdrafts, also need to be reviewed for deterioration in credit quality.[24] A special case is where a bank advances to a borrower, who is about to default on interest or principal payments on a loan, additional funds that enable the borrower to meet current payment obligations. In this situation, it is clear that the borrowers' current ability to pay does not justify classifying the loan as unimpaired.

44. Inevitably, bank management has some discretion in determining when reasonable assurance of collecting the contractual amounts no longer exists. However, this discretion should be based on a sound and timely credit evaluation, and should be exercised in accordance with the considerations discussed in section 2 and should be subject to the disclosures outlined in section 4.

8) A bank should measure an impaired loan at its estimated realisable value.

45. The valuation of loans should reflect any diminution in the estimated realisable value below their recorded investment. The carrying amount of a loan that has been identified as impaired should therefore be reduced to its estimated realisable value. The determination of

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22 Loans purchased at a significant discount or premium should be evaluated for impairment based on the expected yield at the date of purchase. This expected yield, which is based on the loan's expected cash flows, differs from the contractual yield specified in the original loan agreement. Amortisation of discounts and premiums is discussed in section 3(e).

23 Normally, the use of this exception requires that the collateral is readily marketable.

24 For example, a loan for which significant repayment occurs only at maturity after a number of years may be impaired even when current, when the borrowers' financial condition has deteriorated significantly so that full repayment is not expected.

this amount should take into account all relevant information such as the current economic situation of the borrower, the solvency of the debtor, the enforceability of personal guarantees and the ability of guarantors to perform, the current value of collateral, and rating agency ratings. The estimated realisable value should be calculated by using the following methods:[25]

- The present value of expected future cash flows discounted at an appropriate interest rate, i.e., the effective interest rate inherent in the loan. The estimates of future cash flows should be the bank's best estimate based on reasonable and supportable assumptions and projections;
- The fair value of the collateral[26] to the extent the loan is collateral-dependent. A loan is fully collateral-dependent if repayment of the loan is expected to be provided solely by the underlying collateral;
- The observable market price, if it is a reliable indicator of the loan's estimated realisable amount.

46. Larger-balance loans and, where practicable, other loans should be reviewed on an individual loan basis. Credit deterioration in individually identified loans should be timely recognised to the greatest extent possible through the establishment of ***specific allowances*** or through charge-offs.[27]

47. For groups of homogeneous loans of small amounts, e.g., portfolios of consumer loans, it is often not practicable to investigate the creditworthiness of each individual borrower on a regular basis. In such cases, the extent of impairment and the related allowances or charge-offs should be determined on a portfolio basis by applying formulae that take into consideration factors such as an analysis of arrears, ageing of balances, past loss experience, current economic conditions and other relevant circumstances.

48. When latent losses are known to exist, but they cannot yet be ascribed to individual loans, ***general allowances*** should be established. General allowances include allowances against impairment that has been determined to be present in a group or pool of loans that share common identifiable characteristics. In some countries, general allowances are also established against the portfolio based on an analysis of its various components, including a

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25 This does not preclude the use of other practical methods to estimate the amount of impairment in groups of loans where it is not practicable to determine the impairment on an individual loan basis as indicated in paragraphs 47 and 48.

26 The bank should consider any significant estimated costs to sell the collateral.

27 As discussed in this paper, national practices regarding the timing of loan charge-offs vary. From a supervisory perspective, it is essential that impairment is timely recognised either by establishing specific allowances **or** through charge-offs.

review of all significant loans on an individual basis. General allowances are not a substitute for the establishment of adequate specific allowances or the recording of appropriate charge-offs.

49. General allowances are often considered to represent an interim step pending the identification of losses on individual loans that are impaired. The occurrence of a loss event might not be immediately known to the bank. However, the effect of those events should ordinarily become apparent within a reasonable time frame through delinquency or the receipt of new financial statements or other information that triggers the classification of the loan. As soon as adequate information is available to identify losses on individually impaired loans, the general allowances would be replaced by specific allowances (or charge-offs).

50. Past experience and current economic and other relevant conditions, including changes in factors such as lending policies, nature and volume of the portfolio, volume and severity of recently identified impaired loans and concentrations of credit should be taken into account in determining general allowances.

51. General allowances should be determined by using one or several of a number of different methodologies including:

- applying a formula to the group that takes into account the analysis of arrears, ageing of balances, past loss experience, current economic conditions and other relevant circumstances;
- migration analysis;[28]
- various statistical methodologies;[29]
- estimating impairment in the group based on the bank's judgement of the impact of recent events and changes in economic conditions that indicate the existence of impairment.

52. The bank should review the assumptions used against actual experience at regular intervals, as necessary, throughout the reporting period.

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28 Migration analysis is a statistical tool that tracks changes in loan classification against loss rates for each loan grade. Typically, historical loss rates are used to project expected losses within each loan grade. Adjustments may be needed to reflect changes in the economic environment and recent trends in loan loss experience. In addition to loan grades, migration analyses may factor in geographical and other attributes, e.g., when loans were originated.

29 Statistical methodologies include ratio and peer group analyses. However, in determining general allowances, a bank should not rely solely on peer bank comparisons or particular ratios. Ratio analysis is also discussed in section 3 (d).

53. Statistical methodologies are not appropriate in all cases. For instance, they are not appropriate for banks that do not have the capabilities of using these approaches. Moreover, the adequacy, accuracy and reliability of statistical methodologies need to be properly established.

54. Allowances should be calculated in a conservative manner so that they cover the imprecision inherent in most estimates of credit losses.

(c) Restructured troubled loans

9) A bank should recognise a loan as a restructured troubled loan when the lender, for economic or legal reasons related to the borrower's financial difficulties, grants a concession to the borrower that it would not otherwise consider.

55. Restructured troubled loans are loans for which the lender has granted a concession to the borrower due to a deterioration of the borrower's financial condition. The restructuring may include:

- a modification of terms, e.g., a reduction in the interest from that originally agreed or a reduction in the principal amount. However, a loan extended or renewed at a stated interest rate equal to the current interest rate for new debt with similar risk is not a restructured troubled loan;
- the transfer from the borrower to the bank of real estate, receivables from third parties, other assets, or an equity interest in the borrower in full or partial satisfaction of the loan.

56. A restructuring may also involve the substitution or addition of a new debtor for the original borrower.

10) A bank should measure a restructured troubled loan by reducing its recorded investment to net realisable value, taking into account the cost of all concessions at the date of restructuring. The reduction in the recorded investment should be recorded as a charge to the income statement in the period in which the loan is restructured.[30]

57. In conjunction with a restructuring of a loan, a bank should assess the collectibility of the loan and determine if a credit loss has been incurred and, if so, the amount of the loss.

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30 In cases where allowances were previously established against the loan, the charge to the income statement may be offset by a corresponding reduction in the allowance account.

The recorded investment in the loan should be reduced with a charge to the income statement being recorded in the period in which the loan is restructured.[31]

58. A loss on the restructuring of a loan involving a modification of terms should be measured in accordance with the principles for measuring impaired loans, taking into account the cost of all concessions at the date of restructuring. A restructuring may also include the acceptance of property in partial satisfaction of the loan. In such a case, the recorded investment in the loan is reduced by the fair value less cost to sell the property received. The bank should measure any impairment on the remaining recorded investment in the restructured loan as for impaired loans.

59. The method used to measure the reduction in the recorded investment in a restructured loan must be reasonable. The accrual of interest on restructured troubled loans is discussed in sub-section (e) below.

(d) Adequacy of the overall allowance

11) The aggregate amount of specific and general allowances should be adequate to absorb estimated credit losses associated with the loan portfolio.

60. A bank should maintain an overall allowance at a level that is adequate to absorb estimated credit losses associated with the loan portfolio. The adequacy of specific and general allowances should be reviewed in the preparation of annual and interim reports or more frequently, if warranted, to ensure that the aggregate amount of allowances is consistent with current information about the collectibility of the loan portfolio.

61. Estimates of credit losses should reflect consideration of all significant factors that affect the collectibility of the loan portfolio as of the evaluation date. The assessment of the appropriate level of allowances necessarily includes a degree of subjectivity. However, the exercise of management discretion should be subject to established policies and procedures in accordance with the considerations discussed in section 2. Assessments should be performed in a systematic way, in a consistent manner over time, in conformity with objective criteria and be supported by adequate documentation.

62. The method of determining the overall allowance should ensure the timely recognition of loan losses. While historical loss experience and recent trends in losses are a reasonable starting point for the institution's analysis, these factors are not, by themselves, a

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[31] A restructured troubled loan would not automatically be classified as an impaired loan. A restructured troubled loan should be classified as impaired if it is probable that the bank will not be able to collect, or there is no longer reasonable assurance that the bank will collect, all amounts due according to the contractual terms of the restructured troubled loan.

sufficient basis to determine the appropriate level for the overall allowance. Management should also consider any current factors that are likely to cause losses associated with the bank's portfolio to differ from historical loss experience, including:

- Changes in lending policies and procedures, including underwriting standards and collection, charge-off, and recovery practices.
- Changes in national and local economic and business conditions and developments, including the condition of various market segments.
- Changes in the trend, volume and severity of past due and classified loans; as well as trends in the volume of non-accrual loans, troubled debt restructurings and other loan modifications.
- The existence and effect of any concentrations of credit, and changes in the level of such concentrations.
- The effect of external factors such as competition and legal and regulatory requirements on the level of estimated credit losses in the institution's current portfolio.

63. When a bank uses this approach to determine the adequacy of the allowance, there must be documentation that clearly demonstrates the estimated impact of the changes in the factors on the historical loss experience.

64. Ratio analysis can be useful as a supplemental check or tool for evaluating the overall reasonableness of the allowances by identifying divergent trends (compared with other institutions and over time) in the relationship between the overall allowance and various measures such as to past due and non-accrual loans, and to total loans. Although these comparisons may provide a useful benchmark for judging the adequacy of the allowances, they are not by themselves a sufficient basis for determining the adequacy of the overall allowance. In particular, they do not eliminate the need for a comprehensive analysis of the loan portfolio and the factors affecting its collectibility.

(e) Income recognition

12) A bank should recognise interest income on an unimpaired loan on an accrual basis.

65. Interest earned on unimpaired loans should be recognised in the income statement on a level-yield basis as it accrues using the effective interest rate method, and not as it is received in cash or becomes due. The effective interest is calculated as the rate of interest required to discount the contractual cash flows over the term of the loan to equate to the

acquisition cost of the loan.[32] Interest revenue is then allocated to periods over the term of the loan by applying the effective interest rate so as to achieve interest being reported at a constant yield on the recorded investment. Interest includes the amount of amortisation of any discount or premium between the cost of a loan and its amount at maturity and the amortisation of any loan fees and costs.

13) When a loan is identified as impaired, a bank should either cease the accrual of interest or continue to accrue interest but set aside a specific allowance for the full amount of interest being accrued. Where an impaired loan is carried at the present value of expected future cash flows, interest may be accrued on the carrying amount and included in net income to reflect updated present values.

66. Interest on impaired loans should not contribute to net income if doubt exists concerning the collectibility of loan principal or interest. Therefore, for impaired loans a bank should either cease the accrual of interest or establish specific allowances to offset the full amount of interest being accrued.[33] Uncollected interest that has been previously accrued should be reversed or included in the loan balance with an adequate specific allowance established against it. For impaired loans carried at the present value of expected future cash flows, interest may be accrued and reported in net income to reflect updated present values.

67. Unless proscribed by law, regulation or supervisory requirements, some or all of the cash interest payments received on an impaired loan may be reported as interest income on a cash basis as long as the recorded investment in the loan less any specific allowance is deemed fully collectible in a timely manner.[34]

68. An impaired loan may be restored to unimpaired status when the contractual amount of principal and interest is deemed to be fully collectible. As a general principle, this should take place when (a) none of the loan's principal and interest is due and unpaid, and the bank expects repayment of the remaining contractual principal and interest in a timely manner, or (b) when it otherwise becomes well secured and in the process of collection. For purposes of this first criteria, the bank should have received repayment of past due principal and interest, unless (1) the loan has been formally restructured (as discussed below), (2) the loan has been acquired at a discount and the discount that is considered collectible is accreted

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32 Normally, the effective interest rate of unimpaired loans (with no discount or premium) originated by the bank is equal to the contractual interest rate.

33 In some countries, banks must accrue interest on impaired loans in their financial statements to protect their right of repayment or comply with a prohibition against dual accounting. To eliminate the income effect of this accrual, a corresponding specific allowance should be set aside.

34 In some countries, laws or regulations may specify whether payments on impaired loans are reflected as interest or principal payments in banks' internal records and annual accounts.

in accordance with sound principles, or (3) the borrower has resumed paying the full amount of the scheduled contractual principal and interest payments for a reasonable period[35] and all contractual payments are deemed to be collectible in a timely manner.

69. A loan that has been restructured so as to be reasonably assured of repayment and performance according to its modified terms, may be returned to normal accrual status. Circumstances that provide evidence of a relative improvement in the borrower's condition and debt service capacity include substantial and reliable sales, lease or rental contracts obtained by the borrower or other developments that are expected to significantly increase the borrower's cash flow and debt service capacity and the borrower's commitment to repay. Also, a reasonable period of sustained payment performance, whether prior or subsequent to the date of the restructuring, is an important factor in determining whether there is reasonable assurance of repayment and performance according to the loan's modified terms.

70. A bank's determination of the ultimate collectibility of a loan, whether for purposes of reporting interest income on a cash basis or restoring an impaired loan to unimpaired status, should be supported by a current, well documented credit evaluation of the borrower's financial condition and prospects for repayment, including consideration of the borrower's repayment performance and other relevant factors. Similarly, the returning of a restructured loan to normal accrual status should be supported by a current, well documented credit evaluation.

35 In some countries, a period of six months may reflect a reasonable period of resumed borrower repayments of contractual principal and interest.

IV. PUBLIC DISCLOSURE

71. The existence of differences in the ways that banks in different countries account for loans, as well as the degree of judgement that their managements use make it particularly important that the banks make adequate disclosures.[36] These disclosures should be clearly linked to the recognition and measurement principles. This section presents sound principles on disclosure focusing on the credit risk of the loan portfolio. These recommendations are in line with the broad direction in the Basle Committee's recently released paper on Enhancing Bank Transparency.

72. Users of a bank's financial reports need information on the institution's credit risk exposure and risk management practices, the quality of the loan portfolio, its profitability and the impact of losses on the financial position and performance of the bank. Disclosure in a bank's annual financial report should include clear and concise information on the matters discussed below. These disclosures should be adapted to the size and nature of the bank's operations in accordance with the materiality concept (discussed in section 2). Thus, an institution may not necessarily provide all the disclosures recommended below if a particular disclosure item is not relevant to the assessment of the bank. On the other hand, banks relying on capital markets and larger institutions with complex operations, such as those with significant international operations, would generally be expected to make more extensive disclosures.

73. Institutions should be encouraged to provide as much of the information listed below as possible in audited financial statements, i.e., primary financial statements and supporting notes. In particular, disclosure of accounting policies should be in the audited part of the financial report. As an exception, information on risk management and control policies and practices and methods to determine specific and general allowances adopted by the bank relating to credit risk may be disclosed in the unaudited part of the financial report, e.g., in management's discussion and analysis.

14) A bank should disclose information about the accounting policies and methods followed to account for loans and the allowance for impairment.

74. A bank should give information about all significant accounting policies for the accounting for loans, loan impairment and related allowances (including the accounting for

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[36] For example, the use of charge-offs in some countries versus specific allowances in others under similar circumstances leads to significant difficulties in comparing banks across countries. In countries where charge-offs are used to a larger extent, impaired and non-performing loans as a percentage of the loan portfolio (and of total allowances) tends to be much lower than in countries where specific allowances are used.

the effects of changes in those policies), and the methods employed to apply those policies. It should disclose information about its policies for:

- basis of measurement for unimpaired loans at their initial recognition and subsequently;
- income recognition on unimpaired loans (e.g., effective interest rate method);
- determining how and when to recognise impairment in a loan and the basis of measurement for impaired loans;
- determining allowances (specific and general);
- determining when loans are considered past-due for accounting and disclosure purposes (number of days in arrears);
- charging off loans;
- accounting for recoveries;
- determining when to cease accruing interest on a loan;
- how it recognises income from impaired loans, including interest recognition and the treatment of fees and expenses.

75. The above list should not be considered to be exhaustive. Examples of other items and circumstances that may necessitate separate disclosure of accounting policies include the following:

- country risk provisioning;
- securitisation transactions where there is a continuing interest in, or involvement with, the securitised loans;
- premiums or discounts on loans acquired from third parties;
- hedging relationships affecting the measurement of loans;
- loans held-for-sale (where applicable).

15) A bank should disclose information on methods used to determine specific and general allowances and key assumptions used.

76. A bank should explain the methods it has employed to calculate specific and general allowances. It should disclose the key assumptions used, such as how it has considered historical default experience for different categories of loans, current conditions, changes in portfolio composition and trends in delinquencies and recoveries. Moreover, it should disclose information about any other relevant factors, e.g., the existence and effect of concentrations of credit and changes in the level of such concentrations, changes in the

operating environment of borrowers and changes in lending policies and procedures including underwriting standards and collection and recovery practices.

16) A bank should disclose information on the risk management and control policies and practices adopted by the bank relating to credit risk of the loan portfolio.

77. A bank should disclose a description of its objectives and strategies in managing and controlling credit risk in the loan portfolio.[37] This disclosure should include relevant information about the bank's risk management and control policies and practices to mitigate credit risk, such as the policies and practices for:

- requiring collateral and guarantees;
- periodic review of loans and collateral;
- credit risk classification systems (loan grading systems);
- organisational structure for managing credit risk (e.g., credit committees);
- monitoring overdue credits;
- limiting and controlling exposures;
- reducing exposures through legally enforceable netting arrangements; and
- the use of credit derivatives and credit insurance.

17) A bank should disclose geographical information about loans, impaired loans and past due loans including the related amount of specific and general allowances.

78. A bank should disclose its domestic and international loans, and the allocation of the allowance for these categories of loans. It should provide further breakdown (in line with the materiality principle) of the amount of domestic and international loans by relevant geographic region, indicating sovereign loans separately, and where appropriate, by country within region. Additional information about the amount of impaired and past due loans by region should also be disclosed. If practical, a bank should also disclose the amount of specific and general allowances relating to each geographic region.

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37 Given that institutions incur credit risk from different kinds of activities (including lending, trading and investment activities), it may be appropriate to disclose risk management and control policies relating to the loan portfolio as a part of the disclosure of overall risk management and control policies and practices.

18) A bank should disclose balances of loans, impaired loans and past due loans by major categories of borrowers and the amounts of specific and general allowances established against each category.

79. A bank should disclose information about the composition of the loan portfolio based on a meaningful categorisation of borrowers (e.g., commercial loans, consumer loans, related parties). For each major category of borrowers and for the overall loan portfolio, there should be separate disclosure of:

- total loans, before and after allowances;
- total impaired loans, showing separately those that are past-due (e.g., 90 days or more);[38]
- unimpaired past-due loans (e.g., 90 days or more);
- specific allowances;
- general allowances.

80. If there is a portion of the general allowance that is not allocated to a major category of borrowers, the amount of the unallocated allowance should be disclosed separately. Institutions are encouraged to disclose other meaningful measures of deterioration of credit quality in the loan portfolio.

81. A bank should disclose commercial loans by significant industry sector (e.g., real estate, mining).

82. It can be also appropriate to give summary information about the composition of the loan portfolio categorised by type of loan (e.g., mortgage loans, credit card loans, finance leases), type of collateral (e.g., residential property, commercial property, government guaranteed, unsecured) and/or creditworthiness (e.g., based on internal or external ratings).

19) A bank should disclose information on significant concentrations of credit risk.

83. Significant concentrations of credit risk can arise in relation to individual borrowers, related borrowers or groups of borrowers, a particular economic sector or a particular country or region. Loans are grouped so that loans with similar characteristics in terms of credit risk and that can be expected to be affected similarly by changes in economic or other conditions are classified together, e.g., to particular industrial sectors. A bank should disclose its policy for determining concentrations and for each concentration disclose a

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[38] Institutions are encouraged to provide an ageing analysis of past-due loans (30-89 days, 90-179 days, 180 days or more).

description of the shared characteristics that identify the concentration and the magnitude of the exposure. These disclosures should be designed in a way that is consistent with any confidentiality requirements.

20) A bank should disclose balances of loans where the accrual of interest in accordance with the terms of the original loan agreement has ceased because of a deterioration in credit quality.

84. A bank should disclose information about balances of non-accrual loans and the impact that non-accrual of interest has on its income statement.[39]

21) A bank should disclose a reconciliation of movements in the allowance for loan impairment ('continuity schedule') showing separately various types of allowances.

85. A bank should disclose the details of the movements in allowances during the period separately for specific allowances and general allowances. The information should indicate:

- the opening balance of the allowance;
- charge-offs (or write-offs) during the period;
- recoveries of previous charge-offs (or write-offs) during the period;
- amounts set aside (or reversed) for estimated probable loan losses during the period;
- any other adjustments to the allowance (e.g., exchange differences, business combinations, acquisitions and disposals of subsidiaries); and
- closing balance of the allowance.

86. Charge-offs and recoveries that have been recorded directly in the income statement should also be disclosed.

22) A bank should disclose balances of and other information about loans that have been restructured during the year.

87. A bank should disclose information about the magnitude and nature of the grants and concessions that it has made on troubled restructured loans. The method used to measure the reduction in the recorded investment in a restructured loan should also be disclosed. If full

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39 As discussed in the section on income recognition, banks in some countries accrue interest on impaired loans and set aside specific allowances for the full amount of interest being accrued.

repayment is expected, the restructured loan need not be disclosed after performance for a reasonable period in accordance with the modified terms.

23) A bank should disclose contractual obligations with respect to recourse arrangements and the expected losses under those arrangements.

88. Recourse arrangements are transactions where a bank is liable for payment on a loan in the event the borrower defaults, e.g., because it has sold the loan to a third party with a guarantee. These arrangements may expose a bank to significant credit risk, but are often not recognised on the balance sheet.

V. EMERGING ISSUES

(a) Fair value accounting and disclosure

(i) Fair value accounting

89. Leading accounting standard-setters are currently discussing advantages and disadvantages of moving toward greater use of fair value accounting for financial instruments. In particular, the International Accounting Standards Committee (IASC) and several national accounting standard-setters are undertaking a joint project focusing on the prospects of introducing comprehensive fair value accounting for financial assets and financial liabilities.

90. Without prudent and balanced standards for the estimation of fair values, particularly when active markets do not exist (such as is often the case for loans), the use of a fair value model could reduce the reliability of financial statement values and increase the volatility of earnings and equity measurements.

91. The Basle Committee believes that fair value accounting is appropriate when such an approach is workable, e.g., for financial instruments held for trading purposes. However, more work is necessary to provide the appropriate guidance on the estimation of fair values and on the treatment of the value adjustments before this system of accounting can be extended to all banking book financial assets and liabilities. While many of the goals of the fair value approach are desirable, the Basle Committee has serious reservations about the adoption of comprehensive fair value accounting in the balance sheet and income statement at the present time, as was outlined for example in a 1997 IASC discussion paper.

(ii) Fair value disclosure

92. As an alternative approach to full fair value accounting, the Basle Committee believes that disclosure requirements for major market participants could be expanded to include supplemental disclosure of fair value of financial instruments on a consolidated basis along with additional quantitative and qualitative disclosures. The disclosure of fair value information in respect of financial instruments may be a useful addition to assist preparers to experiment with different presentations and to assist readers to gain a better understanding of the size and movements of the figures involved.

93. In some countries that are represented on the Basle Committee, banks and other companies are required to disclose the fair value of their financial instruments, including their loan portfolio. These requirements are also set forth in the standards of the IASC (IAS 32). Institutions that do provide supplemental fair value disclosures should disclose the methods adopted to determine the fair values, any significant assumptions used in its estimation and are encouraged to discuss issues associated with the estimation of fair values.

(b) New approaches to credit risk provisioning

94. Some banks are exploring approaches to loan provisioning that rely on credit modelling techniques. Under these techniques, banks attempt to measure exposure to credit risk over a longer-term horizon than traditionally has been the case, and allowances under this approach may be set up earlier than otherwise. Such loan loss allowances are based on statistical analyses of historical loss data and other factors, from which the institution derives forecasts of future loss behaviour. The statistical techniques used may be similar to those underlying banks' credit risk management and pricing models.

95. The Basle Committee has been studying industry practice in the area of credit models more generally. It recognises that advances in credit modelling techniques also may have implications for how internationally active banks determine and assess the adequacy of their overall loan loss allowance. From a supervisory perspective, it is desirable that accounting principles be able to accommodate appropriate use of statistical methodologies that fairly and realistically portray a bank's financial position, financial performance and risk management activities. The Committee, therefore, will keep these developments and the issues they present under review to determine whether they improve the quality of loan loss provisioning, and may provide further guidance on the use of these provisioning techniques as they evolve.

VI. Role of Supervisors

24) Banking supervisors should evaluate a bank's policies and practices for assessment of loan quality.

96. Supervisors should be satisfied that:

- the quality of the bank's loan review system in identifying, classifying, monitoring and addressing loans with credit quality problems in a timely manner is adequate,
- appropriate information about the credit quality of the loan portfolio and related allowances is provided to the board of directors and senior management on a regular and timely basis; and
- management judgement has been exercised in an appropriate manner, is reasonable and respects the considerations discussed in section 2 above.

97. In making these assessments, supervisors may elect to collect information not publicly disclosed through regular supervisory reporting or through on-site examinations.

25) Banking supervisors should be satisfied that the methods employed by a bank to calculate allowances produce a reasonable and appropriately conservative valuation in accordance with appropriate policies and procedures.

98. Supervisors should be satisfied that:

- the procedures used by a bank to establish allowances on an individual loan basis are prudent and take into account the criteria mentioned in this paper, including updated valuation of collateral and cash flow predictions based on current assessments of economic conditions;
- the framework for establishing general allowances is adequate and that the methodology used is reasonable.
- the process used by management in determining the total allowance is adequate and the assumptions and judgements used by management in that process are appropriate;
- the total allowance is adequate in relation to total credit risk exposure in the loan portfolio;
- that identified losses have been recognised in a timely and appropriate manner through specific allowances or charge-offs;

- the bank is following accounting principles and practices consistent with those outlined in this paper.