Sound Practices for Loan Accounting and Disclosure

Basel Committee on Banking Supervision

Basel

July 1999

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

Chairman:	Former Chairman:
Prof. Dr Arnold Schilder	Mr Nick Le Pan
De Nederlandsche Bank, Amsterdam	Office of the Superintendent of Financial Institutions, Ottawa

Commission Bancaire et Financière, Brussels	Mr Marc Pickeur
Office of the Superintendent of Financial Institutions, Ottawa	Ms Donna Bovolaneas Mr David Robertson
Commission Bancaire, Paris	Mr Philippe Bui
Deutsche Bundesbank, Frankfurt am Main	Mr Karl-Heinz Hillen
Bundesaufsichtsamt für das Kreditwesen, Berlin	Mr Ludger Hanenberg
Banca d'Italia, Rome	Dr Carlo Calandrini
Bank of Japan, Tokyo	Mr Hirotaka Hideshima Mr Hiroshi Ota
Financial Supervisory Agency, Tokyo	Mr Satoshi Hirata
Commission de Surveillance du Secteur Financier, Luxembourg	Ms Isabelle Goubin Mr Guy Haas
De Nederlandsche Bank, Amsterdam	Mr Jacques Peters Mr André Van Dorssen
Finansinspektionen, Stockholm	Mr Bengt-Allan Mettinger
Eidgenössische Bankenkommission, Bern	Dr Andreas Bühlmann
Financial Services Authority, London	Mr David Swanney
Board of Governors of the Federal Reserve System, Washington, D.C.	Mr Gerald Edwards
Federal Reserve Bank of New York	Mr Stefan Walter
Office of the Comptroller of the Currency, Washington, D.C.	Mr Zane Blackburn
Federal Deposit Insurance Corporation, Washington, D.C.	Mr Robert Storch
European Commission, Brussels	Mr Patrick Brady
Secretariat of the Basel Committee on Banking Supervision, Bank for International Settlements	Mr Magnus Orrell

The paper has also benefited from contributions made by the Basel Committee's Transparency Group, chaired by Ms Susan Krause of the Office of the Comptroller of the Currency.

TABLE OF CONTENTS

SOUND PRACTICES FOR LOAN ACCOUNTING AND DISCLOSURE

JULY 1999

EXECUTIVE SUMMARY

This document provides guidance to banks and banking supervisors 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. It may also be helpful to accounting standard-setters.

Various international bodies, including the Basel 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 Basel Committee, the G7 Finance Ministers, G10 central bank Governors and international financial institutions such as the International Monetary Fund and the World Bank have called for progress in this area.

The paper begins by stating the overall objectives of the Basel Committee in addressing the topic of sound practices for loan accounting and disclosure. It 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, and income recognition. Moreover, the paper presents sound disclosure practices focusing on the credit risk in the loan portfolio. The paper also includes a brief discussion of the role of supervisors in assessing a bank's management of asset quality and the adequacy of loan loss allowances.

Four primary concerns of supervisors regarding loan accounting and disclosure are a) the adequacy of an institution's process for determining allowances, b) the adequacy of the total allowance, c) the timely recognition of identified losses through either specific allowances or charge-offs and d) timely and accurate credit risk disclosures.

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 Basel 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 G10 and non-G10 countries, as well as increased convergence of such policies and practices across banks and countries.

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, derecognition and measurement

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

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

6) *A bank should measure a loan, initially, at cost.*

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 recoverable amount.*

Adequacy of the overall allowance

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

Income recognition

10) ***A bank should recognise interest income on an unimpaired loan on an accrual basis using the effective interest rate method.***

11) ***When a loan is identified as impaired, a bank should cease accruing interest in accordance with the terms of the contract.***

PUBLIC DISCLOSURE

12) ***Disclosures in a bank's annual financial reports should be adapted to the size and nature of the bank's operations in accordance with the materiality concept.***

Accounting policies and practices

13) ***A bank should disclose information about the accounting policies, practices and methods it uses to account for loans.***

14) ***A bank should disclose information on the accounting policies and methods it uses to determine specific and general allowances, and it should explain the key assumptions it uses.***

Credit risk management

15) ***A bank should disclose qualitative information on its credit risk management and control policies and practices.***

Credit exposures

16) ***A bank should disclose information about loans by major categories of borrowers.***

17) ***A bank should disclose information about loans by geographic areas.***

18) ***A bank should disclose information about significant concentrations of credit risk.***

19) *A bank should disclose summary information about its contractual obligations with respect to recourse arrangements and the expected losses under those arrangements.*

Credit quality

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

21) *A bank should disclose geographic information about impaired and past due loans including, if practical, the related amounts of specific and general allowances.*

22) *A bank should disclose a reconciliation of changes in the allowances for loan impairment.*

23) *A bank should disclose balances of loans on which the accrual of interest - in accordance with the terms of the original loan agreement - has ceased because of deterioration in credit quality.*

24) *A bank should disclose summary information about troubled loans that have been restructured during the year.*

ROLE OF SUPERVISORS

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

26) *Banking supervisors should be satisfied that the methods employed by a bank to calculate allowances produce a reasonable and appropriately prudent measurement, on a timely basis, in accordance with appropriate policies and procedures.*

SOUND PRACTICES FOR LOAN ACCOUNTING AND DISCLOSURE

JULY 1999

I. INTRODUCTION

1. This document, issued by the Basel 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.

2. Since the Basel Committee is not an accounting standard-setter, its member organisations are working closely with national accounting standard-setters, and the Basel Committee itself is working with the International Accounting Standards Committee (IASC) to promote due consideration of prudential issues in the development of domestic and international accounting standards. The Basel Committee supports efforts to harmonise and improve accounting standards internationally.[3] The Committee recognises that the guidance in this statement of sound practices in several areas goes beyond that issued by the IASC and some national accounting standard-setters, for instance with respect to public disclosures.[4] For

---

1 The Basel 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 Basel, 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.

3 Following a request by the G7 Finance Ministers and Central Bank Governors in October 1998, the Basel Committee is undertaking a review, from a banking supervisory perspective, of International Accounting Standards issued by the IASC. A prominent standard in this regard is International Accounting Standard (IAS) 39, *Financial Instruments: Recognition and Measurement*. Because this review is still under way, the Basel Committee is not yet in a position to endorse the use of the entire set of International Accounting Standards for banks, e.g., for supervisory purposes.

4 For example, IAS 30, *Disclosures in the Financial Statements of Banks and Similar Financial Institutions*, was issued in 1990. Since then, credit risk management practices have evolved significantly. Therefore, this paper provides recommended additions to International Accounting Standards that are applicable to banks.

this reason, a progressive implementation of certain of the sound practices in the paper may be appropriate in some countries. The Committee believes that the supplemental guidance provided in this paper is essential to identify sound practices for loan accounting and related disclosures.

(a) Objectives

3. The prime objective underlying the issuance of this document on loan accounting and disclosure is to facilitate effective banking supervision and market discipline of banks. To this end, this paper:

1) provides guidance to banks and supervisory agencies on sound loan accounting and disclosure practices;[5]
2) promotes enhanced loan accounting and disclosure policies and practices, which are consistent with sound risk management practices, of banks in both G10 and non-G10 countries;
3) promotes convergence of loan accounting and disclosure policies and practices across banks and countries.

4. The guidance in this document is founded on the precept that accounting policies and practices should ensure that loan assets and income are fairly and prudently stated, and, as a result, that capital is properly measured. In many respects, the document sets out principles that are already widely accepted in many countries. Nevertheless, the Basel Committee believes that this document can play a useful role by addressing the need for improvements in accounting and disclosure standards for banks' lending activities.

5. This guidance emphasises that four primary concerns of supervisors regarding loan accounting and disclosure are a) the adequacy of an institution's process for determining allowances, b) the adequacy of the total allowance, c) the timely recognition of identified losses through either specific allowances or charge-offs, and d) timely and accurate credit risk disclosures.

6. 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 Basel Core Principles,[6] the Committee defines minimum requirements for an effective banking supervisory system and discusses arrangements to promote stability in financial

---

5 The paper may also be helpful to accounting standard-setters.

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

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);[7]
- "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);
- "the bank publishes on a regular basis financial statements that fairly reflect its condition" (Principle 21, 2nd clause).

(b) Scope

7. Since this paper is an elaboration of certain of the Basel Core Principles, it applies to all banking organisations. However, the methods by which the guidance is implemented should reflect the scope and complexity of an individual bank's operations.

8. The focus of this paper is on accounting and disclosure practices relating to the credit risk in loans held in the banking book.[8] Therefore, the paper does not discuss sound practices with respect to the accounting for loans held for trading purposes. Credit risk is of course present in activities other than lending. While measurement and the establishment of allowances relating to credit risk in other banking activities (e.g., trading and derivatives activities) are generally outside the scope of this paper, the Basel Committee believes that banking organisations should ensure that the credit risk in these areas is prudently measured, managed and disclosed in their financial statements.[9] Many of the principles in this paper

---

7 As discussed in Section I (e), 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.

8 Losses in connection with loans can of course arise from causes other than credit risk, for example, unmatched interest rate positions. This paper, however, is primarily concerned with issues arising from credit risk.

9 In February 1999, the Basel Committee, jointly with the Technical Committee of the International Organization of Securities Commissions (IOSCO), issued a consultative paper with *Recommendations for Public Disclosure of Trading and Derivatives Activities of Banks and Securities Firms*. 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. In July 1999, the Basel Committee issued a consultative paper on *Best Practices for Credit Risk Disclosure*.

should be helpful to institutions and their supervisors in addressing those accounting and disclosure issues.

9. 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 Basel Committee grant tax deductibility to specific allowances or charge-offs in the year they occur. While convergence in tax treatments lies outside the scope of this paper, it is important that tax treatments do not provide a disincentive to timely and adequate loan loss provisioning.

10. The Basel Committee recognises that there are a number of issues that are closely related to the topics discussed in this paper. Such issues include loan classification and accounting issues related to credit substitutes (e.g., guarantees and letters of credit), retained rights and obligations in transferred loans (e.g., recourse obligations in securitisations), reallocation of credit risk (e.g., credit derivatives and credit insurance) and country risk. The Basel Committee will consider whether elaborating sound practices also in these or other areas is desirable as part of its work programme to promote enhanced policies and practices.

11. The Committee is aware that some banks are exploring approaches to provisioning that rely on credit risk modelling techniques. 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. Provisioning on this basis is quite different from the basis currently followed in financial accounting by many institutions. These new approaches are briefly referred to in Section VI(b) at the end of this paper. The Committee will keep these developments and the issues they present under review.

12. The Basel Committee has developed separate papers on a number of related topics in the area of credit risk. In April 1999, the Committee issued a paper on credit risk modelling (*Credit Risk Modelling: Current Practices and Application*), which discusses current practices and issues in credit risk modelling. In July 1999, the Committee issued a consultative paper on credit risk management (*Principles for the Management of Credit Risk),* a complex topic in which accounting policies play an important part. At the same time, the Committee published a consultative paper on credit risk disclosure (*Best Practices for Credit Risk Disclosure*), which complements the disclosure guidance in this paper by focusing on credit risk not only in lending activities, but also in other types of banking activities, including trading, investments, liquidity/funding management and asset management.

(c) Background

13. While the Basel Committee is not an international accounting standard-setter, 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.

14. There is considerable interest in achieving further harmonisation and in strengthening transparency of loan measurement, the establishment of loan loss allowances, and credit risk exposures. In addition to the Basel Committee, the G7 Finance Ministers, G10 central bank Governors and international financial institutions such as the International Monetary Fund and the World Bank have called for progress in this area.

15. 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.[10] 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 or credit risk disclosures. Supervisors should, where possible, play a role in the development of accounting standards to ensure that national accounting standards are adequate.

16. ***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

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

accounting policies are weak, the resulting capital situation may well be overstated.[11] 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.

17. ***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.[12] 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, sound practices for accounting and disclosure help reinforce 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 G10 and non-G10 countries can be improved. In promoting transparency, supervisors and other public policy makers need to consider that public disclosure involves costs and can have potential drawbacks in certain circumstances.[13] However, this does not refute the proposition that disclosure provides incentives for banks to continue conducting their operations in a sound and efficient manner.

18. 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 IASC and several national

---

11 The *Basel 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 may be included in tier 2 capital to the extent they do not reflect an identified deterioration in the valuation of particular assets, whether individual or grouped, subject to a limit of 1.25 percentage points of risk-weighted assets.

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

13 For instance, when the market becomes aware that a bank is in a weakened position it may react more harshly than is desirable from the point of view of the authorities who have responsibilities for depositors' protection and for managing systemic risk. Nevertheless, supervisors also need to take into account market reactions to a lack of timely and credible information.

accounting standard-setters are undertaking a joint long-term project addressing recognition and measurement issues with respect to financial assets and financial liabilities.[14]

19. The Basel 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.

(d) Outline of paper

20. Following a brief discussion of some fundamental considerations pertaining to accounting and credit risk management in ***Section II***, the paper in ***Section III*** elaborates on sound practices for the measurement of loans, establishment of loan loss allowances and other loan accounting issues. Sound disclosure practices regarding lending activities and credit risk are discussed in ***Section IV*** of this paper. The role of supervisors in assessing a bank's loan accounting policies and practices is set out in ***Section V***. Emerging issues, such as fair value accounting and new provisioning approaches, are discussed in ***Section VI***.

(e) Terminology

21. 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 an obligation to repay on a specified date or dates, or on demand, usually with interest. Loans comprise:
  - 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.

---

14 The IASC issued the discussion paper *Accounting for Financial Assets and Financial Liabilities* in March 1997. An interim international accounting standard on recognition and measurement of financial instruments (IAS 39) was adopted by the IASC Board in December 1998.

- 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.[15]
- 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).[16]
- An ‘***allowance***’[17] 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.[18]
    - 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.[19]

---

15 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 liability side.

16 It is recognised that accounting guidance sometimes indicates that one or the other of these two impairment tests (“it is probable that the bank will be unable to collect” and “there is no longer reasonable assurance that the bank will collect”) should be used. For instance, the probability test is prescribed by IAS 39 and by the US Financial Accounting Standards Board’s (FASB) Statements of Financial Accounting Standards 5 and 114, while a test of “reasonable assurance” is used in the Canadian Institute of Chartered Accountants’ (CICA) Handbook Section 3025.03 and guidance issued by the British Bankers’ Association. 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.

17 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. For example, 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* and IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*).

18 As a practical expedient, specific allowances against losses in pools of collectively assessed small-balance loans with common characteristics (e.g., credit card balances) can be established on a formula basis as a substitute for allowances established against losses identified on a loan-by-loan basis.

- A '***charge-off***' (or write-off) reduces the recorded investment in the loan and, if allowances previously have been established, the amount of allowances.[20] A charge-off is made when all or part of a loan is deemed uncollectible or there is otherwise no realistic prospect of recovery.
- A loan is 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.
- The '***effective interest rate***' of a loan is the rate of return implicit in the loan, i.e., the interest rate required to discount the contractual cash flows over the term of the loan to an amount that equals the cost of the loan. For this purpose, the contractual interest rate generally is adjusted for any net deferred fees or costs that are similar in nature to interest (e.g., are calculated on a time basis or by reference to the amount of the loan) and any discount or premium existing at the origination or acquisition of the loan.

---

19 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.

20 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.

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

23. 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 all 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 and realisability of collateral, and other factors that affect the prospects for collection of principal and interest.

24. 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, internal loan review procedures are effective and an appropriate management information system is in place. Credit risk management encompasses more than appropriate accounting practices. The Basel Committee has addressed principles for credit risk management in more detail in a separate paper.[21]

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.

25. 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 and documentation should be in place to enable an understanding of the procedures performed and judgements made by management; 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.

21 *Principles for the Management of Credit Risk*, issued by the Basel Committee in July 1999.

- 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.

26. 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.

27. Sound accounting principles require the selection and application of accounting policies and procedures to be governed by certain fundamental accounting concepts. These overall guiding concepts are established in the accounting literature and in concepts statements issued by leading accounting standard-setters.[22] They are also discussed in the Basel Committee's 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.

28. 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*)**.[23] Financial reporting should include adequate disclosure and reasonable detail, and should be free from undue 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.

29. 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;

---

22 E.g., IAS 1, *Presentation of Financial Statements* (revised 1997), *IASC Framework for the Preparation and Presentation of Financial Statements*, CICA Handbook Section 1000 on *Financial Statement Concepts*, UK Accounting Standards Board's Draft *Statement of Principles for financial reporting*, FASB Statements of Financial Accounting Concepts No. 2 and 5, and certain provisions in the European Union's Accounting Directives.

23 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.

- 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.

30. 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*)**. From a safety and soundness perspective, it is important that the accounting principles used by a bank reflect prudent and conservative measurements. 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 and income are not overstated and liabilities and expenses are not understated. While judgements should be both conservative and prudent, this does not encompass the deliberate understatement of assets, equity or income or the deliberate overstatement of liabilities or expenses, e.g., by consistently reporting amounts that are at the higher or lower end of a range when those amounts do not reflect the best estimates within the range. The establishment of hidden (undisclosed) reserves through undervaluation of assets or overaccrual of liabilities is not justified.

31. 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.

32. 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.

33. 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. For instance, material

fees and commissions received by a bank as a result of a loan transaction should generally not be taken into income in the period the transaction occurs, but instead should be deferred and amortised over the life of the loan if they are in substance an integral part of the interest income on the loan. Expenses should be matched against the income to which they relate, so that net income is measured by the difference between income over associated expenses during the same period.

34. 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

35. 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, derecognition and measurement

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

36. When a bank becomes a party to the contractual terms comprising a loan and as a consequence has the legal right to receive principal and interest payments on 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.[24] 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, and only when, the bank loses control of the contractual rights that comprise the loan (or a portion of a loan). A bank loses such control if it realises the rights to benefits specified in the contract, the rights expire or the bank surrenders those rights.

37. 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.[25] 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

---

24 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.

25 If despite having lost control of the contractual rights of a loan, the bank continues to act as a guarantor or otherwise retains risks related to the loan, this obligation should be recognised as a liability or disclosed as a contingent liability. However, this issue is beyond the scope of this paper.

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.

6) A bank should measure a loan, initially, at cost.

38. For loans originated by the bank, the cost is the amount lent to the borrower adjusted for any net deferred loan fees or costs that are similar in nature to interest (e.g., are calculated on a time basis or by reference to the amount of the loan).[26] Where a loan has been acquired from a third party, the cost generally is the fair value of the consideration given to acquire the loan at the time of acquisition.[27]

(b) Impairment – recognition and measurement

39. 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.

40. 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.

41. 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.[28] 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.

---

[26] However, if a loan is granted not in cash, but by transferring loans or other assets to the borrower, the cost is the fair value of those assets at the time of the origination of the loan.

[27] 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.

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

42. 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 regarding matters that affect the accounting for loan loss allowances 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.[29]

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.

43. To ensure that impairment in loans is identified in a timely manner, loans should be reviewed for impairment in credit quality on a regular basis and, in particular, in the preparation of annual and interim financial reports, taking into consideration all available information, including the economic and other conditions at the reporting date. Loans should be reviewed for impairment between reporting dates whenever substantive information exists that indicates a significant deterioration has occurred in the credit quality in a material part of the loan portfolio.

44. The evaluation of each loan or group of related loans should be based upon the creditworthiness of the particular borrower and the creditworthiness of the group to which the borrower belongs. The focus of the assessment of impairment is the ability of the borrower to repay all amounts due according to the contractual terms of the loan agreement. 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 bank's ability to collect the loan 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 determining whether a loan is impaired. However, as other

[29] As previously indicated, a fourth primary concern of supervisors is timely and accurate credit risk disclosures.

sources of repayment become inadequate over time, the importance of the collateral's value in the analysis increases.

45. Management should establish a programme to periodically monitor and analyse collateral, which 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. Weaknesses in legal systems and other obstacles that make it difficult to ensure rights in, foreclose on, and dispose of, collateral should also be taken into account.

46. Recognition of impairment should be considered whenever circumstances cause uncertainty about a borrower's ability to repay all amounts due according to the contractual terms of the loan agreement. Management should use both internal and external information. Evidence of impairment includes:

- information about significant financial difficulties of the borrower (e.g., as indicated by liquidity or cash flow projections),
- an actual breach of contract (e.g., the borrower's delay in making principal or interest payments),
- a high probability of bankruptcy or other financial reorganisation of the borrower (e.g., as indicated by a downgrading of credit status by a credit rating agency),
- the granting by the lender to the borrower, for economic or legal reasons relating to the borrower's financial difficulties, of a concession that the lender would not otherwise consider.

47. 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., 60 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).[30] 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.[31] A special case is where a borrower is about to default on interest or principal payments on a loan, and the bank advances additional funds that enable the borrower to meet its current payment obligations. In this situation, the borrower's current ability to pay does not necessarily justify classifying the loan as unimpaired. However, if there is reasonable assurance that the borrower will be able to repay all principal and interest in full (including compensation for additional advances to meet the borrower's current payment obligations) in accordance with the terms of the loan agreement(s), or that the loan is fully secured and collection efforts will achieve the same results, the loan need not be classified as impaired.

48. As indicated above, evidence of impairment includes a troubled loan restructuring, i.e., where the lender has granted a concession to the borrower due to a deterioration of the borrower's financial condition or other financial difficulties. Concessions granted in a troubled loan restructuring may include, but are not necessarily limited to, the following situations:

- 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.

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

50. Inevitably, bank management has some discretion in determining when reasonable assurance of collecting the contractual amounts no longer exists or when collecting the contractual amounts is not probable. However, this discretion should be based on a sound and

30 Normally, the use of this exception requires that the collateral is readily marketable. Further, collateral should be periodically re-evaluated as indicated previously.

31 For example, a loan for which significant repayment occurs only at maturity may be impaired prior to maturity, when the borrowers' financial condition has deteriorated significantly so that full repayment is not expected.

timely credit evaluation, and should be exercised in accordance with the considerations discussed in Section II and should be subject to the disclosures outlined in Section IV.

8) A bank should measure an impaired loan at its estimated recoverable amount.

51. The measurement of loans should reflect any diminution in the estimated recoverable amount below their recorded investment. 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.[32] The carrying amount of an individual loan that has been identified as impaired should therefore be reduced to its estimated recoverable amount. The determination of this amount should take into account all relevant information such as the economic situation and solvency of the borrower, the enforceability of personal guarantees and the ability of guarantors to perform, the current value of collateral, and rating agency ratings. The assessment of the protection provided by guarantees, collateral and other secondary sources of repayment should take into account the time, costs and difficulties involved in obtaining repayment through such sources. In many countries, collection against collateral and guarantees may well be problematic.

52. Acceptable methods for calculating the estimated recoverable amount of an individual impaired loan are:

- The present value of expected future cash flows discounted at an appropriate interest rate, i.e., the effective interest rate inherent in the original loan agreement.[33] The estimates of future cash flows should be the bank's best estimate based on reasonable and supportable assumptions and projections; [34]

---

32 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.

33 For instance, if the effective interest inherent in the original loan agreement is 10% fixed interest rate (assuming no net deferred fees or costs) and the interest rate is reduced for reasons related to the borrower's financial difficulties to 5% fixed interest rate, the expected future cash flows of this restructured troubled loan are discounted at 10% for the purposes of measuring impairment. This paper does not suggest discounting at the current market interest rate since that would be inconsistent with the amortised cost approach. Discounting is appropriate where the time value of money is material. Therefore, it may not be necessary to discount the cash flows of short-term receivables.

34 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. While a formula approach for groups of loans may not explicitly discount expected future cash flows, it should result in a measure of impairment that implicitly discounts expected future cash flows.

- The fair value of the collateral[35] to the extent the loan is collateral-dependent. A loan is 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 recoverable amount.

53. A bank should measure the estimated recoverable amount of a restructured troubled loan taking into account the cost of all concessions at the date of restructuring. The restructuring may 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 of the property received less cost to sell.

54. 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.

55. 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 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.

56. 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 on an individual loan 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).

[35] The bank should consider any significant estimated costs to sell the collateral.

57. 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.

58. 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;[36]
- various statistical methodologies;[37]
- 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.

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

60. 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.

61. Allowances should be calculated in a prudent and conservative, but not excessive, manner so that they cover - within an acceptable range of estimated losses - the imprecision inherent in most estimates of credit losses. Allowance estimates should be well documented and appropriately supported.

62. An impaired loan should only be restored to unimpaired status when the contractual amount of principal and interest is deemed to be fully collectible in accordance with the terms of the loan agreement. As a general principle, this should take place when

---

36 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.

37 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 III (c).

(a) the bank has received repayment of the loan's past due principal and interest, none of the loan's principal and interest is due and unpaid, and the bank expects repayment of the remaining contractual principal and interest as scheduled in the loan agreement,

(b) the borrower has resumed paying the full amount of the scheduled contractual principal and interest payments for a reasonable period,[38] and all remaining contractual payments (including full compensation for overdue payments) are deemed to be collectible in a timely manner, or

(c) the loan otherwise becomes well secured and is in the process of collection.

63. A bank's determination of the ultimate collectibility of a loan for purposes of restoring an impaired loan to unimpaired status should be supported by a current, well documented credit evaluation of the borrower's financial condition and other factors affecting the prospects for repayment, including consideration of the borrower's repayment performance and other relevant factors.

(c) Adequacy of the overall allowance

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

64. 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. When establishing allowances, the bank should not understate or overstate loan losses in order to achieve a desired level of earnings in current or future reporting periods.

65. 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 II. 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.

---

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

66. 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 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[39] and collection, charge-off, and recovery practices.
- Changes in international, 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 adversely classified loans;[40] as well as trends in the volume of impaired 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.
- Changes in the risk profile of the portfolio as a whole.

67. When management adjusts allowance estimates for these factors, there must be documentation that clearly demonstrates the estimated impact of the changes in the factors on the historical loss experience.

68. 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 impaired 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

[39] The bank's general lending policy will typically be supplemented by more detailed underwriting standards, guidelines and procedures to steer the bank's loan approval process and maintain desired levels of risk. For instance, underwriting standards may specify customer size standards, amortisation requirements, maturity standards, collateral coverage, collateral valuation, and guarantor standards.

[40] A loan classification or loan grading system classifies all loans according to the degree of risk of loss.

allowance. In particular, they do not eliminate the need for a comprehensive analysis of the loan portfolio and the factors affecting its collectibility.

(d) Income recognition

10) A bank should recognise interest income on an unimpaired loan on an accrual basis using the effective interest rate method.

69. 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 an amount that equals the cost of the loan.[41] 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. Thus, under the effective interest rate method, 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.

11) When a loan is identified as impaired, a bank should cease accruing interest in accordance with the terms of the contract.

70. As discussed in Section III(b), impaired loans should be measured at their estimated recoverable amount. 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 cease reflecting in net income the accrual of interest in accordance with the original terms of the contract.[42] Uncollected interest that has been previously accrued should be reversed or included in the loan balance with an adequate specific allowance established against it. In some countries, when an impaired loan is carried at the present value of expected future cash flows, interest may be accrued and reported in net income to reflect updated present values based on the effective interest rate inherent in the original loan agreement. An institution that applies a present value approach, but does not accrue interest to reflect updated present values, may include the changes in present values in the adjustment to allowances that is reported in the income statement.

---

41 Normally, the effective interest rate of loans (with no discount or premium) originated by the bank is equal to the contractual interest rate adjusted for the effect of any net deferred loan fees or costs.

42 In some countries, banks as a result of laws or regulations must accrue interest on impaired loans in accordance with the original terms of the contract 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 generally should be established with an offsetting charge to interest income.

71. Unless proscribed by law, regulation or supervisory requirements, some or all of the cash interest payments received on an impaired loan for which the accrual of interest has ceased 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.[43]

72. A loan on which a bank has ceased to accrue interest should only be restored to accrual status when the loan has returned to unimpaired status as discussed in Section III(b) unless (1) the loan has been formally restructured (as discussed below) or (2) the loan has been acquired at a discount that relates to its credit quality and the discount that is considered collectible is accreted in accordance with sound principles.

73. An impaired loan that has been restructured so as to be reasonably assured of repayment and performance according to its modified terms may be returned to accrual status. Circumstances that may 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 demonstrated payment performance in accordance with the modified terms is an important factor in determining whether there is reasonable assurance of repayment and performance according to the loan's modified terms.

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

---

43 In some countries, laws or regulations may specify whether payments on impaired loans are interest or principal payments.

IV. Public Disclosure

75. The existence of differences in the ways that banks in various 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.[44] These disclosures should be clearly linked to the recognition and measurement principles discussed in this paper. This section presents disclosure guidance focusing on the lending activities of banks and the credit risk in their loan portfolios that complements the accounting guidance provided in other sections of this paper. These recommendations are in line with the broad direction in the Basel Committee's paper on *Enhancing Bank Transparency*.

76. 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. While each bank's specific disclosures will vary in scope and content according to its level and type of activities in accordance with the materiality concept discussed below, all banks should provide timely information that allows users of bank financial reports to obtain a full and accurate picture of the bank's credit risk profile.

77. As a minimum, the Committee has identified the following four broad areas in which all banks in their annual financial reports should provide clear and concise information with respect to the credit risk in their loan portfolio:[45]

- Accounting policies and practices;
- Credit risk management;
- Credit exposures (including information about types of loans, domestic versus international loans, loans secured by collateral and unsecured loans);
- Credit quality (including information about past due and impaired loans, changes in credit quality during the period and changes in allowances).

78. The Basel Committee believes that the four areas listed above represent minimum disclosures, which are applicable to all banks. The Committee expects all banks to adopt these rapidly, to the extent they have not already been implemented. The disclosure guidance presented in this paper is generally consistent with the comprehensive guidance on credit risk

---

44 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 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.

45 As discussed in the Basel Committee's paper *Best Practices for Credit Risk Disclosure*, a bank should also disclose earnings information to enhance the transparency of its credit risk profile.

information presented in the Basel Committee's consultative paper *Best Practices for Credit Risk Disclosure*, issued in July 1999. The guidance in that paper complements the recommendations in this paper by discussing credit risk not only in lending activities, but also other sources of credit risk, including trading, investments, liquidity/funding management and asset management. The detailed disclosure guidance below should not be considered to require disclosure of proprietary information or information subject to confidentiality requirements about a bank's customers or risk management practices.

12) Disclosures in a bank's annual financial reports should be adapted to the size and nature of the bank's operations in accordance with the materiality concept.

79. All of the disclosure sound practices identified in this section should be applied in line with the materiality principle (discussed in Section II). 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 or with higher-risk loan portfolios and larger institutions with complex operations (such as those with significant international operations, loan sales or credit risk hedging activities) would generally be expected to make more extensive disclosures.

80. Institutions are 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. Information on risk management and control policies and practices may be disclosed in the unaudited part of the financial report, e.g., in management's discussion and analysis.

(a) Accounting policies and practices

13) A bank should disclose information about the accounting policies, practices and methods it uses to account for loans.

81. A bank should provide information on its accounting policies and practices in the accounting for loans and loan impairment (including the accounting for 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, including interest recognition and the treatment of fees and expenses (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 when loans are considered past-due for accounting and disclosure purposes (number of days in arrears where appropriate); the basis for charging off

loans; accounting for recoveries; determining when to cease accruing interest on a loan; and how it recognises income from impaired loans, including interest recognition.

82. 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; netting and set-off arrangements affecting the presentation of loans on the balance sheet; and loans held-for-sale (where applicable).

14) A bank should disclose information on the accounting policies and methods it uses to determine specific and general allowances, and it should explain the key assumptions it uses.

83. A bank should explain the accounting policies and methods it uses in determining specific and general allowances, including allowances for groups of loans of small amounts. Such information should include a description of the types of allowances and the key assumptions used in determining allowances, such as default rates, 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.

(b) Credit risk management

15) A bank should disclose qualitative information on its credit risk management and control policies and practices.

84. A bank should disclose information on its strategies, objectives and practices in managing and controlling credit risk in the loan portfolio.[46] This disclosure should be supplemented by relevant information about the bank's organisational structure for managing credit risk (e.g., credit committees). Disclosures should include information on its 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;

[46] 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.

credit risk classification systems (loan grading systems); internal credit quality reviews; monitoring overdue credits; limiting and controlling exposures; reducing exposures through legally enforceable netting arrangements; and the use of credit derivatives and credit insurance (including how these instruments affect the bank's recognition and measurement of losses).

(c) Credit exposures

16) A bank should disclose information about loans by major categories of borrowers.

85. 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). To obtain a full view, this numerical information should be presented in the context of the disclosure of a bank's risk management policies, in particular the effects of risk-mitigation techniques such as hedging, use of collateral, and netting of offsetting transactions should be clearly presented.

86. Commercial loans should be disclosed by significant industry sector (e.g., real estate, mining).

87. 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 creditworthiness (e.g., based on internal or external ratings).

17) A bank should disclose information about loans by geographic areas.

88. A bank should disclose summary information about the geographic distribution of loans, including its domestic and international loans. It should provide further breakdown (in line with the materiality principle) of the amount of domestic and international loans by relevant geographic area, indicating sovereign loans separately. Geographical areas may comprise individual countries or groups of countries or regions within countries. A bank should also disclose how loans are allocated to geographic areas (e.g., domicile of the borrower).

18) A bank should disclose information about significant concentrations of credit risk.

89. A bank should disclose its policies and methods for determining concentrations, what it considers to be a "significant" concentration, and for each concentration disclose a 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. 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. Typically, 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.

19) A bank should disclose summary information about its contractual obligations with respect to recourse arrangements and the expected losses under those arrangements.

90. A bank should disclose information about recourse transactions - transactions where it has sold loan(s) but retains responsibility for payment in the event the borrower(s) defaults or fails to fulfil other contractual or implied obligations, e.g., because it has sold the loan to a third party with a guarantee. Disclosures should include summary information about the terms of recourse arrangements and the expected losses under such arrangements. These arrangements may expose a bank to significant credit risk, but are often not recognised on the balance sheet.

(d) Credit quality

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

91. A bank should provide comprehensive information on impaired and past due loans and allowances, including breakdowns by major categories of borrowers. For each major category of borrowers[47] 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);[48] unimpaired past-due loans (e.g., 90 days or more); specific allowances; and general allowances.

92. If there is a portion of the general allowance that is not allocated to a major category of borrowers, the amount of this portion of the allowance should be disclosed

[47] If a bank has loans to related parties, it should disclose the nature and amount of such loans.

[48] Banks should disclose how "past-due" has been defined. Institutions are encouraged to provide an ageing analysis of past-due loans (30-89 days, 90-179 days, 180 days or more).

separately.[49] Institutions are encouraged to disclose other meaningful measures of deterioration of credit quality in the loan portfolio.

21) A bank should disclose geographic information about impaired and past due loans including, if practical, the related amounts of specific and general allowances.

93. Information about the amount of impaired and past due loans by geographical area should also be disclosed. If practical, a bank should also disclose the amount of specific and general allowances relating to each geographic area. If there is a portion of the general allowance that is not allocated to a geographical area, the amount of this portion of the allowance should be disclosed separately.

22) A bank should disclose a reconciliation of changes in the allowances for loan impairment.

94. A bank should disclose the details of the movements in allowances during the period ("continuity schedule") showing separately specific allowances and general allowances. The information should indicate: a description of the type of allowance; the opening balance of the allowance; charge-offs (or write-offs) taken against the allowance during the period; recoveries of previous charge-offs (or write-offs) added back to the allowance 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), including transfers among allowances; and the closing balance of the allowance. Charge-offs and recoveries that have been recorded directly in the income statement should also be disclosed.

23) A bank should disclose balances of loans on which the accrual of interest - in accordance with the terms of the original loan agreement - has ceased because of deterioration in credit quality.

95. A bank should disclose information about balances of non-accrual loans net of allowances[50] and the impact that non-accrual of interest has on its income statement.[51]

---

49 If a bank is using portfolio modelling techniques to determine an overall allowance level, it may not be possible to provide a breakdown. Then, additional information should be provided about the use and key assumptions of the modelling technique.

50 As discussed in Section III (d), banks in some countries accrue interest on impaired loans and set aside specific allowances for the full amount of interest being accrued.

51 If a bank is accruing interest on impaired loans (e.g., at an amount less than the terms of the original loan contract), that bank is encouraged to disclose the amount of accrued interest for the period which has not yet been received in cash.

24) A bank should disclose summary information about troubled loans that have been restructured during the year.

96. A bank should disclose aggregate information about the magnitude and nature of the grants and concessions that it has made on restructured troubled loans during the period. The method used to measure the reduction in the carrying amount of a restructured loan should also be disclosed.

V. Role of Supervisors

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

97. 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 II above.

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

26) ***Banking supervisors should be satisfied that the methods employed by a bank to calculate allowances produce a reasonable and appropriately prudent measurement, on a timely basis, in accordance with appropriate policies and procedures.***

99. 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;
- 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.

VI. Emerging Issues

(a) Fair value accounting and disclosure

(i) Fair value accounting

100. 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 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.

101. 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.

102. The Basel 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 Basel Committee has serious reservations about the adoption of comprehensive fair value accounting in the balance sheet and income statement at the present time.

(ii) Fair value disclosure

103. As an alternative approach to full fair value accounting, the Basel Committee believes that disclosure requirements for major market participants could be expanded to include supplemental disclosure of the 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.

104. In some countries that are represented on the Basel 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 30 as amended by IAS 39, and IAS 32). Institutions that do provide supplemental fair value disclosures should disclose the methods adopted to determine the fair values and 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

105. Many banks have in place internal credit rating or classification systems which they use to identify and monitor the credit risk of the loan portfolio. These systems may also have an important role in banks' evaluations of the adequacy of their loan loss allowances. The Basel Committee has been studying internal credit rating systems of banking organisations and plans to review emerging practices and the use of these systems in banks' risk management and loan review processes.

106. 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.

107. The Basel Committee has been studying industry practice in the area of credit models more generally.[52] 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.

---

52 In April 1999, the Basel Committee issued the paper *Credit Risk Modelling: Current Practices and Application*. This paper provides a description of current practices and issues in credit risk modelling and assesses the potential implications and limitations of credit risk modelling for supervisory and/or regulatory purposes.

Annex

Table of concordance: International Accounting Standards

To help readers compare the sound practices guidance provided in this paper with International Accounting Standards (IAS) issued by the International Accounting Standards Committee (IASC), the table below matches these two sets of recommendations.

Sound practices in this paper	***International Accounting Standards (IAS)***
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.	IAS 1.20, Framework
4. A bank should recognise a loan, whether originated or purchased, in its balance sheet when, and only when, the bank becomes a party to the contractual provisions of the loan.	IAS 39.27
5. A bank should remove a loan (or a portion of a loan) from its balance sheet when, and only when, the bank loses control of the contractual rights that comprise the loan (or a portion of the loan). A bank loses such control if it realises the rights to benefits specified in the contract, the rights expire or the bank surrenders those rights	IAS 39.35
6. A bank should measure a loan, initially, at cost.	IAS 39.66
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.	(IAS 39.109, IAS 39.111)
8. A bank should measure an impaired loan at its estimated recoverable amount.	(IAS 39.111)
9. The aggregate amount of specific and general allowances should be adequate to absorb estimated credit losses associated with the loan portfolio.	
10. A bank should recognise interest income on an unimpaired loan on an accrual basis using the effective interest rate method.	IAS 18.30, IAS 39.73

Sound practices in this paper	***International Accounting Standards (IAS)***
11. When a loan is identified as impaired, a bank should cease accruing interest in accordance with the terms of the contract.	(IAS 39.116)
12. Disclosures in a bank's annual financial reports should be adapted to the size and nature of the bank's operations in accordance with the materiality concept.	IAS 1.29, IAS 30, Framework
13. A bank should disclose information about the accounting policies, practices and methods it uses to account for loans.	IAS 1.97, IAS 30.43, IAS 32.47
14. A bank should disclose information on the accounting policies and methods it uses to determine specific and general allowances, and it should explain the key assumptions it uses.	IAS 1.97, IAS 30.43, IAS 32.47
15. A bank should disclose qualitative information on its credit risk management and control policies and practices.	IAS 32.43A (as amended by IAS 39)
16. A bank should disclose information about loans by major categories of borrowers.	
17. A bank should disclose information about loans by geographic areas.	(IAS 14)
18. A bank should disclose information about significant concentrations of credit risk.	IAS 32.66 (b), IAS 30.40
19. A bank should disclose summary information about its contractual obligations with respect to recourse arrangements and the expected losses under those arrangements.	(IAS 30.26, IAS 37.86)
20. A bank should disclose impaired and past due loans by major categories of borrowers and the amounts of specific and general allowances established against each category.	(IAS 30.43 (c))
21. A bank should disclose geographic information about impaired and past due loans including, if practical, the related amounts of specific and general allowances.	
22. A bank should disclose a reconciliation of changes in the allowances for loan impairment.	IAS 30.43 (b)
23. A bank should disclose balances of loans on which the accrual of interest - in accordance with the terms of the original loan agreement - has ceased because of deterioration in credit quality.	IAS 30.43 (d)
24. A bank should summary information about troubled loans that have been restructured during the year.	
25. Banking supervisors should evaluate the effectiveness of a bank's policies and practices for assessment of loan quality.	
26. Banking supervisors should be satisfied that the methods employed by a bank to calculate allowances produce a reasonable and appropriately prudent measurement, on a timely basis, in accordance with appropriate policies and procedures.	