FINANCIAL REGULATOR
Rialtóir Airgeadais

Credit Institutions

Regulatory Document

Impairment Provisions for Credit Exposures

26 October 2005

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1. Introduction and Application

This paper sets out the requirements and supervisory perspective of the Irish Financial Services Regulatory Authority (Financial Regulator) with regard to the policies and procedures to be adopted by credit institutions for credit loss provisioning. This document expands on the high level principles outlined in section 8.1 of the Licensing and Supervision Requirements and Standards for Credit Institutions in relation to provisioning. This policy paper is divided into two parts, the first part contains qualitative requirements on credit risk management and impairment provisioning while the second part of the paper documents the Financial Regulator's perspective on impairment provisioning setting out quantitative criteria and reporting guidelines.

The second part of this paper is based on the IFRS 'incurred loss[1]' approach to impairment provisioning, specifically outlined in IAS 39. From 2005 all listed companies are required to produce their consolidated accounts in accordance with the International Financial Reporting Standards ("IFRS"). Furthermore other companies, whether listed or not have been granted the option to adopt IFRS or retain their current method of reporting their accounts.

Financial Reporting Standard ("FRS") 26 will implement IAS 39 'Financial Instruments: Recognition and Measurement' in the Republic of Ireland, when applied by entities. Therefore part 2 of this paper will also be of relevance to credit institutions applying FRS 26.

1.1 Application of Paper

This paper applies to all credit institutions regulated by the Financial Regulator, comprising licensed banks and building societies (subsequently referred to as "credit institutions"). This paper also covers foreign subsidiaries of Irish credit institutions on consolidation. Branches of international banks operating in the State fall outside the remit of this document.

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[1] An incurred loss approach requires that impairment losses are recognised where objective evidence of impairment exists at the balance sheet or provisioning date that is supported by measurement techniques consistent with IAS 39.

2. Legal Basis

The credit risk management policies and procedures outlined in section 3 of this paper apply to all credit institutions regulated by the Financial Regulator. These credit risk management requirements are, imposed by the Financial Regulator, as conditions to which all credit institutions are subject pursuant to Section 10 of the Central Bank Act, 1971, and Section 17 of the Building Societies Act, 1989. The remaining sections of this paper will only be of relevance to credit institutions that adopt IFRS and those implementing FRS 26. As referred to above part two represents the Financial Regulator's perspective on impairment provisioning.

Part 1 Qualitative Requirements

3. Credit Risk Management Policies and Procedures

3.1 Board of Directors and Senior Management

As part of managing the business, the board of directors' ("the board") responsibilities include:

- understanding and determining the nature and level of risk in the credit institution;
- setting the credit institution's tolerance for risks;
- ensuring that there are appropriate processes, systems and reporting lines in place to monitor and manage these risks, this includes ensuring that there are processes and systems to capture credit risk for all aspects of the business conducted by an individual credit institution or group;
- appointing a credit committee;
- adequately resourcing the credit function with suitably qualified personnel;
- ensuring that the sophistication of the risk management processes is appropriate in light of the credit institution's risk profile and business plan; and
- reviewing the adequacy of provisions for impairment losses and amounts written off.

It is the responsibility of the board to ensure that the requirements of the Financial Regulator with regard to impairment provisions are reflected in either the credit institution's credit policy or a separate impairment provisioning policy. The policy will be reviewed and approved by the board on at least an annual basis to ensure its continued appropriateness.

Senior Management's responsibility for managing credit risk in the context of impairment provisioning includes, but is not limited to:

- establishing a policy document for credit risk management processes, to be approved by the board;
- establishing the methodology for determining impairment provisions;
- reviewing and approving on a regular basis the processes and systems in place (as outlined in the policy document) to monitor and manage the quality of the credit portfolio in a timely manner, and the methodology for determining the provisions;
- ensuring that the credit exposures are appropriately valued, with an appropriate level of provisions for impairment made or uncollectable amounts written off;
- establishing procedures to ensure that all collateral held by the credit institution in addition to available for sale financial assets, are appropriately valued by personnel independent of the credit origination function;
- establishing a programme to periodically monitor and analyse collateral, which should be valued on a prudent basis. This is particularly important for exposures that are relying on the value of collateral in assessing whether an impairment provision is required. For example, for significant commercial real estate loans, credit institutions should obtain sound appraisals of the current fair value of the collateral from qualified professionals either internal or external to the credit institution. Management have the responsibility for reviewing each appraisal's assumptions and conclusions to ensure timeliness and reasonableness, exercising appropriate judgement to recognise the inherent subjectivity of valuation estimates. Appraisals should take into account, on a discounted basis, the ability of the real estate to generate income over time based on reasonable and supportable assumptions;
- evaluating the sensitivity and reasonableness of key assumptions used in the impairment provision assessment and measurement system, this may include

the performance of stress tests to incorporate economic conditions that may affect credit exposures;

- providing appropriate disclosures to the Financial Regulator; and
- providing the board with regular reports on the adequacy of impairment provisions and amounts written off.

3.2 Written Policy for Impairment Provisioning

The board will approve a written policy for impairment provisioning, which will address, but not be limited to:

3.2.1 Procedures and Internal Controls

- The roles and responsibilities of the credit institution's departments and personnel (including the lending function, credit review, financial reporting, internal audit, senior management, audit committee, and the board) in relation to correctly implementing the policy, determining impairment and measuring provisions.
- A description of the procedures and internal controls the credit institution employs in determining impairment provisions or general and specific provisions. This should include, but not be limited to:
    - an effective grading system that is consistently applied, identifies differing risk characteristics and quantifies problems accurately and in a timely manner, and prompts appropriate administrative actions;
    - sufficient internal controls to ensure that all relevant information is appropriately considered in determining whether impairment has occurred and in estimating the impairment provision; and
    - clear formal communication and coordination between a credit institution's credit administration function, financial reporting group, management, the board, and others involved in the determination or review of impairment provisions.
- A description of the independent credit review process (as discussed in Section 3.3 below), indicating who is responsible for performing the review and how often it takes place.

3.2.2 Credit Risk Management

- A description of the methodology for assessing credit risk;
- A description of the credit risk management system. This should include disclosures of policies and procedures regarding:

(i) credit risk classification systems (loan grading systems);

(ii) requiring collateral and guarantees;

(iii) periodic review of exposures and collateral;

(iv) internal credit quality reviews;

(v) monitoring overdue credits;

(vi) limiting and controlling exposures; and

(vii) where applicable;

  i. reducing exposures through legally enforceable netting arrangements; and
  ii. the use of credit derivatives and credit insurance (including how these instruments affect the credit institution's recognition and measurement of losses).

3.2.3 Measuring Impairment

- Credit institutions not applying IFRS will document the methodology for establishing the level of general and specific provisions under local GAAP.
- Credit institutions applying IFRS will document the following information in their written policy:
    - A description of the methodology for assessing exposures for objective evidence of impairment, and measuring impairment, on an individual basis. The methods used to identify exposures to be analysed individually should be disclosed.
    - A description of the methodology for assessing exposures for objective evidence of impairment, and measuring impairment, on a collective basis. A description of how information on historical loss experience has been gathered by the credit institution for different categories of exposures, current conditions, changes in portfolio composition, and trends in delinquencies and recoveries should be disclosed. If using peer group experience, the credit institution should explain how this

was sourced. The period used in accumulating the historical loss experience should be stated, along with the adjustments that were made to the results due to different conditions, and why these adjustments were necessary. The factors that were considered when establishing appropriate timeframes over which to evaluate loss experience should also be disclosed.

  - Each policy should require that a description of the observable data that is used in the measurement of the impairment of each portfolio is retained on file.
  - The method of segmenting portfolios for collective evaluation should be disclosed, along with the types of exposures in each portfolio.

3.2.4 Actual Loss Review

- How often actual losses in the preceding period are compared to historical experience for each portfolio.
- How often actual losses are compared to the impairment provisions held against such losses.

3.2.5 Collateral Valuation

- When using the fair value of collateral in assessing the recoverable amount of the exposure, the following should be documented:

(i) how the fair value was determined, including the use of appraisals, valuation assumptions, and calculations;

(ii) the supporting rationale for adjustments to appraised values, if any;

(iii) the determination of costs to sell, if applicable; and

(iv) appraisal quality, and the expertise and independence of the appraiser.

- When the observable market price is used to assess the recoverable amount of the exposure, the amount, source and date of the observable market price should be documented on file.
- The credit institution should ensure that this procedure is consistent across the institution and its subsidiaries.

3.2.6 Other

- The policy for releasing provisions.
- How often the provisioning policy is reviewed by senior management and approved by the board, and the date of the last approval.
- 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.

3.3 Role of Internal Audit/Credit Review Function

The credit institution must ensure that an internal independent function reviews the credit risk processes and the methodology for determining the level of provisions in order to confirm their effectiveness. This function may be performed by either a department of the credit institution itself, or, in the case of subsidiaries, a department of the parent credit institution. This role may be performed by the Internal Audit or Risk Management Functions. This review will be performed at least every two years and should include at a minimum, a review of the following:

- the appropriateness of the credit risk assessment processes given the nature, scope and complexity of the credit institution's operations;
- the reasonableness, accuracy and completeness of data inputs and parameters into the assessment processes;
- the reasonableness of the collective assessment methodology/general assessment methodology;
- the adequacy of
  - (i) impairment provisions (with particular emphasis on the adequacy of impairment provisions for restructured facilities to include a review of restructured facilities where an impairment provision was not created);
  - (ii) stress tests; and
  - (iii) supporting documentation.

The outputs of this review will be appropriately documented and reported to senior management and the board. Any areas of weakness identified are to be addressed on a timely basis.

3.4 Frequency of Review

The board will review the impairment provisioning policy at least on an annual basis to ensure that it is still appropriate for the business the credit institution undertakes and the economic environment in which it operates. In doing so, it will review and sign off on the processes and systems for credit risk, and the methodology used in determining the level of impairment provisions. In certain circumstances the Financial Regulator would expect the board to review the impairment provisioning policy more frequently than once a year e.g. where a catastrophic event occurs that is likely to affect a sector to which the credit institution engages in lending activity.

Part 2 Supervisory Perspective on Impairment Provisioning For Credit Institutions Adopting IFRS

The following sections of this paper do not purport to interpret or comprehensively refer to the requirements of IAS 39 in relation to impairment provisions. This paper outlines the Financial Regulator's views in relation to impairment provisions and how reporting of impairment of exposures is envisaged for those credit institutions that have adopted or propose to adopt IFRS or that implement FRS 26. The thinking of the Financial Regulator may evolve further in this area as more work is done at a European level to ensure convergence of supervisory practices.

The exposures covered in this guidance include all financial assets that are subject to impairment review in accordance with the terms of IAS 39, which requires that "all financial assets except those measured at fair value through the profit and loss are subject to review for impairment."

4. Objective Evidence of Impairment

For the purpose of this paper and in accordance with IAS 39 an exposure is considered to be impaired when "there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset (a 'loss' event) and the loss event (or events) has an impact on the estimated future cash flows[2].” Impairment occurs if the estimated recoverable amount of an exposure is lower than its relevant carrying amount.

All exposures should be assessed for impairment by the credit institution either individually or collectively as discussed in section 5. If there is objective evidence of impairment either individually or collectively, the exposure or group of exposures should be measured for an impairment provision. If a credit institution determines that no objective evidence of impairment exists for an individually assessed exposure, that exposure should be included in a group of exposures with similar credit risk characteristics that are collectively assessed for impairment.[3]

The following sections discuss what constitutes objective evidence of impairment, and how to determine whether impairment has in fact occurred. The methodology for assessing impairment and the calculation of the impairment provision are discussed in sections 5 and 6 respectively.

4.1 Loss Events

A credit institution should assess all credit exposures for objective evidence of impairment based on current information and events at the date of assessment. Objective evidence of impairment would include, but not be limited to, one of the following loss events[4]:

- significant financial difficulty of the issuer or obligor;
- a breach of contract, such as a default or delinquency in interest or principal payments;
- the lender, for economic or legal reasons relating to the borrower’s financial difficulty, granting to the borrower a concession that the lender would not otherwise consider;
- it becoming probable that the borrower will enter bankruptcy or other financial reorganisation;

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[2] Per paragraph 59 of IAS 39.
[3] Paragraph 64 of IAS 39.
[4] Paragraph 59 of IAS 39.

- the disappearance of an active market for that loan because of financial difficulties; or
- the existence of observable data indicating that there is a measurable decrease in the estimated future cash flows from a group of financial assets since the initial recognition of those assets, although the decrease cannot be identified with the individual financial assets in the group, (this objective evidence includes adverse changes in the payment status of borrowers in the group and national or local economic conditions that correlate with defaults on the assets in the group).

The following factors should also be taken into consideration:

- 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.

Exposures that are not in breach of contract should nonetheless be reviewed for impairment regularly. For example, a loan for which significant repayment occurs only at maturity may be impaired prior to maturity, when the counterparty’s financial condition has deteriorated significantly so that full repayment is not expected.

If a credit institution has advanced multiple loans to a borrower, some of which are performing according to the contract, and others which are in default, all exposures to this borrower should be assessed for objective evidence of impairment.

4.2 Occurrence of Impairment

If any such objective evidence of impairment exists, as discussed in section 4.1, the credit institution should estimate the recoverable amount of the exposure or group of exposures. Impairment occurs if the estimated recoverable amount of an exposure is lower than its relevant carrying amount. It must be possible to reliably measure the impact on the estimated future cash flows. An impairment provision should be created to decrease the carrying amount to the recoverable amount in the case of exposures. The methodology for assessing impairment on an individual or group basis is discussed in section 5 and the calculation of the amount of the impairment provision is outlined in section 6.

4.3 Restructured/Rescheduled Facilities

Restructured facilities should be monitored closely to assess whether they have actually become impaired. It should be noted that not all restructured facilities necessarily require an impairment provision. For example, if a facility is restructured but the credit institution will be compensated appropriately, (e.g. additional interest will be earned on postponed payments, or the facility is extended or renewed at the current interest rate for new debt with similar risk) these additional payments will be reflected in the discounted future cash flows, and therefore may not necessarily lead to an impairment provision.

An alteration in the timing or amount of cash flows will affect the recoverable amount of the facility through the discounting process, therefore any postponement of payments will need to be adequately compensated for in the restructured agreement, otherwise an impairment provision will be necessary i.e. if repayment under any restructured terms is less than under the original contract an impairment provision will be necessary.

5. Methodology for Assessing Impairment

5.1 Individually Significant and Non-Significant Exposures

Exposures should be assessed for objective evidence, measurement, and recognition of impairment on an individual basis for individually significant exposures. Where a credit institution has a number of individually significant exposures to one counterparty each loan should be individually assessed while also considering the overall position of the counterparty. Exposures that are not individually significant may be assessed for impairment either on an individual or a group basis.

5.2 Individual Assessment

An impairment assessment should be performed for exposures for which there is objective evidence of impairment, as follows:

- Individually Significant Exposures; and
- Exposures that are not Individually Significant[5].

Exposures that are individually assessed for impairment and for which an impairment provision has been recognised are not included in a collective assessment of impairment[6]. If a credit institution determines that no objective evidence of impairment exists for an individually assessed exposure, whether significant or not, it includes this in a group of exposures with similar credit risk characteristics that are collectively assessed for impairment[7]. These groups should be determined based on the criteria outlined in section 5.3.1 below. When reporting the level of impairment provisions in Appendix 1 and 2 credit institutions should include all exposures where objective evidence of impairment exists on an individual basis, which is supported by appropriate calculations, under individual provisions.

5.3 Collective Assessment – Portfolio Provision

A collective assessment should be performed for exposures as follows:

(i) Exposures that have been individually assessed (as per section 5.2) and were found not to be impaired on an individual basis;

(ii) Exposures that have not been individually assessed.

Portfolio impairment provisions are recognised for incurred losses not specifically identified but which experience in addition to observable data indicates are present in the portfolio of exposures at the date of collective assessment, i.e. incurred but not reported. When reporting the level of portfolio impairment provisions in Appendix 1 and 2, credit institutions should include all exposures where a collective assessment

[5] Exposures that are not Individually Significant may be assessed on an individual or a group basis.

[6] This requirement of IAS 39 is outlined in paragraph IN 21, IAS 39.

[7] Paragraph IN 21, IAS 39 states “an asset that has been individually assessed for impairment and found not to be individually impaired should be included in a collective assessment of impairment”.

has been performed in accordance with the above test and an impairment provision is required.

5.3.1 Credit Risk Characteristics

Exposures are grouped on the basis of similar credit risk characteristics that are indicative of the counterparty's ability to repay according to the contractual terms. If a credit institution does not have a group of assets with similar risk characteristics, this assessment is not performed.

The following characteristics should be taken into consideration when grouping exposures:

- Asset type;
- Industry;
- Geographical location;
- Collateral type;
- Past-due status; and
- Other Relevant Factors.

5.4 Other Factors.

Exposures that have been assessed and are impaired on a group basis should be monitored for the occurrence of objective evidence of impairment on an individual basis. As soon as information is available that specifically identifies losses on individually impaired exposures in a group, those exposures are removed from the group[8].

5.5 Frequency

Although the Financial Regulator would expect credit institutions to monitor their portfolios on an ongoing basis, impairment should be formally assessed and measured on at least an annual basis. However, if any new information comes to light in the period between impairment measurements, this should be used to update the

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[8] Per AG 88, IAS 39.

impairment provision for that exposure or group of exposures, at least on a quarterly basis.

5.6 Supporting Documentation

Credit institutions should maintain supporting documentation on each individual exposure or group of exposures, including:

- documentation of the rationale for determining whether an exposure should be assessed individually or collectively for impairment;
- documentation of the rationale for determining appropriate groupings of exposures, including observable data supporting the conclusion that the exposures in each grouping have similar attributes or characteristics. This data must be assessed periodically as circumstances change or as new data that is more relevant and more directly representative of loss become available; and
- if there is objective evidence of impairment, the credit institution should document the type of objective evidence existing. If no objective evidence of impairment exists, the credit institution should document the steps taken in arriving at this conclusion.

6. Impairment Provision Calculation

The amount of the impairment provision should be calculated by reducing the carrying amount of an exposure to the estimated recoverable amount. The estimated recoverable amount is determined as follows:

6.1 Individual Assessment

The estimated recoverable amount and thus the amount of the provision required can be calculated using 3 different methods:

- the estimated recoverable amount is equal to the present value of the estimated future cash flows[9], discounted at the exposure's original effective interest rate[10];

[9] Changes in the amount and timing of estimated cash flows may have a significant impact on the overall impairment provision, and consequently the assumptions used by a bank with respect to the timing of the cash flows must be prudent and supportable.

- the estimated recoverable amount may be measured on the basis of an exposures fair value using an observable market price (e.g. on secondary markets); or
- the estimation of the recoverable amount of a collateralised exposure reflects the cash flows that may result from foreclosure, whether or not foreclosure is probable. If an exposure is collateralised, the estimated recoverable amount is equal to the fair value of the collateral less costs for obtaining the collateral. The time, costs and difficulties involved in obtaining repayment through collateral or guarantees should be taken into account when determining the recoverable amount.

The Financial Regulator considers the discounted cash flow method to be the principal method to be used in the calculation of impairment provisions for exposures carried at amortised cost.

6.2 Collective Assessment – Portfolio Provision

The future cash flows of a group of exposures that are collectively evaluated for impairment, are calculated on the basis of the estimated contractual cash flows[11] of the exposures in the group and historical loss experience for exposures with credit risk characteristics similar to those in the group. Credit institutions may develop an emergence period for each portfolio or group of exposures, that is utilised in calculating a portfolio provision. An emergence period is the period of time between a loss event occurring and objective evidence of the event coming to the attention of a credit institution.

Factors to take into consideration when determining the historical loss experience are:

- analysis of impairment;
- ageing of balances;

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[10] The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the exposure to the net carrying amount of the asset, per IAS 39.
If an exposure has a variable interest rate, the discount rate for measuring any impairment loss is the current effective interest rate(s) determined under the contract, per AG 84, IAS 39.

[11] In determining the effective interest rate for a group of exposures that are collectively evaluated for impairment, the estimated stream of cash receipts rather than the contractual stream of cash receipts should be tested.

- past loss experience;
- current economic conditions; and
- other relevant circumstances.

Credit institutions that do not have the necessary historical loss experience for evaluating impairment shall use peer group experience[12] (for example, sourced from peer group information published by rating agencies) for a portfolio that is representative of the credit institution's own portfolio.

Historical loss experience should be adjusted to reflect the effects of current conditions that did not affect the period that the historical loss experience covers, and historical conditions that do not currently exist. Current factors to be considered that are likely to cause losses associated with the credit institution's portfolio to differ from historical experience, include, but are not limited to:

- changes in lending policies and procedures, including underwriting standards and collection, write-offs, 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 exposures, as well as trends in the volume of impaired exposures and restructurings;
- 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 credit institution's current portfolio; and
- changes in the risk profile of the portfolio as a whole.

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

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[12] Per AG 89, IAS 39.

The methodology and assumptions used for estimating cash flows should be reviewed regularly to reduce any differences between loss estimates and actual loss experience.

6.3 Off-Balance Sheet Transactions

Impairment of exposures should be made after the initial recognition of the asset. Additional disclosure of contingent liabilities under the terms of IAS 37 on Provisions, Contingent Liabilities and Contingent Assets is not proposed in this paper and will continue to be reported for capital adequacy purposes in the DCI format of the Prudential Return on OBS Credit Substitutes.

6.4 Restructured Facilities

When a facility is restructured, in assessing impairment the restructured terms (payment and timing of principal and interest) on the asset should be discounted using the effective interest rate before the restructure. If the exposure has a variable interest rate, the discount rate is the current effective interest rate determined under the contract. The reduction, if any, from the original carrying value should be recognised as an impairment provision.

Where a problematic exposure is restructured in such a way that the cashflows no longer appear doubtful, such restructured exposures must be continuously monitored for a reasonable period and until such time as revised contractual payments are deemed to be collectible in a timely manner. Restructured facilities should be reviewed by internal audit/the credit review function to evaluate the need for impairment provisions where none are created and to assess the adequacy of impairment provisions that have been created for restructured facilities.

6.5 Other Matters

6.5.1 Review of Impairment Provisions

The credit institution should regularly compare assumptions and parameters used to create the portfolio provision against experience. This should involve testing or verifying on an annual basis:

- comparison of actual losses to provision held for major categories of exposures;
- analysis of recent experience that considers recent economic conditions; and
- consistent review over portfolios and time. When new methods are introduced, the rationale should be documented and results on both the new and old methodology compiled over one year.

Stress testing of the exposures (particularly loans) should be performed at regular intervals. These tests should incorporate both normal and extreme conditions, and immediate and long-term horizons. The results of the stress tests should be appropriately documented and reported to senior management, and appropriate action taken if results exceed agreed tolerances.

6.5.2 Credit Concentration Risk

As part of the measurement of portfolio provisions, credit institutions should be cognisant of credit concentration risk. Credit risk concentrations are based on similar or positively correlated risk factors, which, in times of stress, have an adverse effect on the creditworthiness of each of the individual counterparties making up the concentration. Such concentrations include, but are not limited to:

- significant exposures to an individual counterparty or group of related counterparties;
- credit exposures to counterparties in the same economic sector or geographic region;
- credit exposures to counterparties whose financial performance is dependent on the same activity or commodity; and
- indirect credit exposures arising from a credit institution's credit risk mitigation techniques (e.g. exposure to a single collateral type or to credit protection provided by a single entity).

A credit institution should have in place effective internal policies, systems and controls to identify, measure, monitor, and control their credit risk concentrations. The internal policies, systems and controls should be clearly documented and should include a definition of the credit risk concentrations relevant to the credit institution and how they and their corresponding limits are calculated. A credit institution's management should conduct periodic stress tests of its major credit risk concentrations and review against expectations.

The Financial Regulator will carry out a review of sectoral requirements and this work will also consider other regulatory developments in this area currently taking place.

6.5.3 Supporting Documentation

In addition to the disclosures required in Section 8 below and the supporting documentation required in Section 5.6 above, the following supporting documentation should be maintained on files (particularly loan files) in relation to the calculation of the impairment provision:

- the method and result of the impairment provision calculation for each individually measured exposure, including where relevant how the most appropriate technique for measurement was determined;
- when using the discounted future cash flows method:
  - the amount and timing of cash flows;
  - the effective interest rate used to discount the cash flows; and
  - the basis for the determination of cash flows, including consideration of current environmental factors and other information reflecting past events and current conditions;
- when using the observable market price method:
  - the amount, source, and date of the observable market price;
- when using the fair value of collateral method:
  - how fair value was determined;
  - the supporting rationale for adjustments to appraised values, and the amount of the adjustments;
  - the determination of expected costs to sell; and
  - appraisal quality, and the expertise and independence of the appraiser;

- for collectively evaluated exposures, the supporting rationale for adjustments made to the historical loss experience of each group, and the quantity of the adjustment; and

- documentation supporting the opinion that the credit institutions estimates have an economic relationship to, and are representative of, impairment of a group of exposures.

7. Restoration of Exposure to Unimpaired Status

An impaired exposure 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 agreement. Objective evidence must exist subsequent to the initial recognition of the impairment to justify restoration to unimpaired status. Typically, this should take place when:

- the credit institution has received repayment of the loan's past due principal and interest, none of the principal and interest is due and unpaid, and the credit institution expects repayment of the remaining contractual principal and interest as scheduled in the agreement;
- the counterparty has resumed paying the full amount of the scheduled contractual principal and interest payments for a reasonable period and all remaining contractual payments (including full compensation for overdue payments) are deemed to be collectible in a timely manner; or
- the exposure becomes well secured and is in the process of collection.

A credit institution's determination of the ultimate collectability of an exposure should be supported by a current, well documented credit evaluation of the counterparty's financial condition and other factors affecting the prospects for repayment, including consideration of the counterparty's repayment performance and other relevant factors.

8. Disclosure to Financial Regulator

Once implemented the following quantitative disclosures as outlined in Appendices 1 and 2 should be made to the Financial Regulator on a quarterly basis:

- the opening balance, movement in the period, and closing balance on the individual provision account, including existing provisions being written off in the period;
- the opening balance, movement in the period, and closing balance on the portfolio provision account;
- the charge in relation to amounts being written off in the period;
- total investment in each exposure class, both gross and net of provisions;
- total impaired exposures in each exposure class; and
- total individual provisions, portfolio provisions and write-offs for each exposure class.

The required quantitative disclosure should be analysed in accordance with the asset classes under Pillar I of the Capital Requirements Directive. It is planned that this section of the requirements will not be implemented for credit institutions until the prudential reporting formats for the Capital Requirements Directive are finalised. We are also awaiting the outcome of the CEBS Consultation Process on the '*New Solvency Ratio: Towards a Common Reporting Framework.*'

It is also planned to incorporate a requirement for the following disclosures, as outlined in Appendix 3, to be submitted to the Financial Regulator on a quarterly basis with appendices 1 and 2:

- the total carrying amount of the 10 largest restructured facilities, and any related impairment provision and
- exposures with the 10 largest provisions.

9. Capital Adequacy Treatment

This paper advocates an 'incurred loss' model. The Capital Requirements Directive is based on expected and unexpected losses. The Basel Committee has removed expected losses from the risk weight functions in the Internal Ratings Based Approach. The Basel Committee has set out requirements to ensure that expected losses, which are not covered by capital under the Internal Ratings Based Approach or impairment provisions, are captured. Therefore it is envisaged that any shortfall or surplus of expected losses over impairment provisions will be dealt with for capital adequacy purposes in accordance with the Capital Requirements Directive Proposals once they become effective.

10. Regulatory Review and Timeframe

This document outlines the minimum requirements and regulatory perspective for credit institutions in relation to credit risk management and impairment provisions. The Financial Regulator will monitor the implementation of these requirements by credit institutions, the methodology adopted in relation to credit risk assessment as well as the level of impairment provisions. Monitoring will be carried out during on-site reviews, inspections and through the use of independent third party reports e.g. external audit reports. Sections 1-3 of this paper are to be implemented and effective within credit institutions regulated by the Financial Regulator by 1 January 2006. Part 2 of the paper will be utilised by the Financial Regulator when reviewing impairment provisions in credit institutions applying IFRS and implementing FRS 26, as part of its ongoing work.

11. Glossary of Terms

Carrying Amount of a loan: The principal amount of the loan, taking into account payments applied to reduce principal, and adjusted to reflect accrued but uncollected interest, write-offs, unamortised premium or discount, and unamortised loan fees and costs, and reduced by any impairment provision.

Contractual amounts due: Principal and interest payments outstanding as set out in the loan contract.

Counterparty**:** The borrower or other party to the credit transaction agreement.

Estimated Future Cash Flows: Forecasted principal and interest payments (not necessarily contractual amounts due) as well as any cash flows from foreclosure of collateral.

Exposure: The total potential loss which a credit institution could incur in the event of non-payment by a counterparty. An exposure includes an amount outstanding on a loan, both principal and interest.

Individually significant exposure: The Financial Regulator will not define individually significant exposures as it considers the definition of such exposures to be specific to each credit institution.

MDB: Multilateral Development Banks. Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions states that MDB shall mean “the International Bank for Reconstruction and Development, the International Finance Corporation, the Inter-American Development Bank, the Asian Development Bank, the African Development Bank, the Council of Europe Resettlement Fund, the Nordic Investment Bank, the Caribbean Development Bank, the European Bank for Reconstruction and Development, the European Investment Fund and the Inter-American Investment Corporation”.

Appendix 1 - Standardised Approach

Exposure Class	Corporate	Institutions	Central Govt. and Central Banks	Regional Govt. and Local Authorities	Admin. Bodies and Non-Commercial Undertakings	MDB	Intl. Orgs	Secured on Real Property	Retail	Other	Total
Total Exposure Gross of Impairment Provisions											
Total Exposure Net of Impairment Provisions											
Impaired Exposures											
Individual Impairment Provision:											
Opening Balance											
Charge for the period											
Recoveries during the period											
Transfer to write-offs											
Closing balance											
Portfolio Impairment Provision:											
Opening balance											
Charge/release for the period											
Transfer to Individual Provision											
Closing balance											
Write-offs:											
Charge to P&L A/c											
Transfer from Individual Provision											
Total write-offs											

Appendix 2 - Internal Ratings Based Approach

	Corporate				Retail				
Exposure Class	**Corporates**	**Specialised Lending**	**Institutions**	**Central Govt. and Central Bank**	**Exposure Secured by Real Estate**	**Qualifying Revolving Retail Exposures**	**Other Retail Exposures**	**Other**	**Total**
Total Exposure Gross of Impairment Provisions									
Total Exposure Net of Impairment Provisions									
Impaired Exposures									
Individual Impairment Provision:									
Opening Balance									
Charge for the period									
Recoveries during the period									
Transfer to write-offs									
Closing balance									
Portfolio Impairment Provision:									
Opening balance									
Charge/release for the period									
Transfer to Individual Provision									
Closing balance									
Write-offs:									
Charge to P&L A/c									
Transfer from Individual Provision									
Total write-offs									

Appendix 3 - Other Disclosures

(a) Restructured Facilities - Largest Restructured Facilities with Impairment Provisions				
	Name of Exposure	Exposure Class	*Carrying Amount € 000	Impairment Provision € 000
1				
2				
3				
4				
5				
6				
7				
8				
9				
10				

(b) Loans with Largest Provisions				
	Name of Exposure	Exposure Class	*Carrying Amount € 000	Impairment Provision € 000
1				
2				
3				
4				
5				
6				
7				
8				
9				
10				

* = The Carrying Amount to be reported should be Gross of Impairment Provision amounts.