



## Guidance Note AGN 220.1

### Impaired Asset Definitions

#### Scope

1. The appropriate recognition and measurement of impaired assets are key elements in the accurate reporting of an ADI's<sup>1</sup> risk profile, in the assessment of the adequacy of an ADI's provisioning and reserving policies and, most importantly, in the assessment of its capital adequacy.
2. The scope of impaired assets must cover the full range of an ADI's activities. In classifying impaired assets, an ADI must not limit itself to lending activities but must cover all facilities to which it is a party.
3. For APRA purposes, where an ADI is not required to hold capital against the value of any impaired assets sold, transferred or originated into a securitisation vehicle in accordance with paragraph 3 of *AGN 120.3 Purchase and Supply of Assets (including Securities Issued by SPVs)* (AGN 120.3), such assets must not be included in an ADI's reported impaired assets. However, where securitised assets do not meet APRA's clean sale requirements, these assets must be captured, as appropriate, in reporting of impaired assets.

#### Definition of impaired assets

##### Overall definition

4. In accordance with *APS 220 Credit Quality* (APS 220), any facility (including an off-balance sheet facility) for which there is a doubt over the timely collection of the full amount of cash flows contracted to be received must be regarded as impaired for capital and other APRA purposes. In such circumstances, the ADI must raise provisions<sup>2</sup> to cover any potential shortfall in estimated cash flows contractually due to be received. These provisions must be excluded from Tier 1 capital.
5. Existence of the following factors would, as a minimum, constitute doubt:

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<sup>1</sup> Unless otherwise indicated, references to an ADI (or to ADIs) in this Guidance Note must be read to apply to an ADI (or ADIs) on both a Level 1 and Level 2 basis (as defined in *APS 110 Capital Adequacy*).

<sup>2</sup> Such provisions may include allowances for credit losses or impairment.

- (a) a facility is 90 days past due (see paragraph 14 below) unless otherwise well secured (see paragraph 17 below);<sup>3</sup>
  - (b) a write-off has been taken on a facility even if the facility is not in breach of contractual requirements. (This does not apply in the case of some restructured facilities [see paragraph 37 below] and assets acquired through enforcement of security); and
  - (c) with respect to off-balance sheet facilities, the ADI is unlikely to receive timely repayment of the full amounts which it has exchanged or is contracted to advance.
6. A facility must be classified as impaired for capital and other APRA purposes, regardless of whether it is 90 days or more past due, when there is doubt as to whether the full amounts due, including interest and other payments due, will be achieved in a timely manner. This is the case even if the full extent of the loss cannot be clearly determined. Such a requirement applies particularly to the range of flexible financing facilities common in the Australian financial system, including loans where repayment of principal and interest occurs only as a single payment at maturity; and also to large money market transactions where doubt about collectibility arises immediately in the event that settlement does not eventuate.
7. Overdrafts and other revolving facilities that have remained continuously outside approved limits (including unadvised internally authorised excesses or extensions approved as part of the initial credit extension process) for 90 or more consecutive days, and which are not well-secured, must be treated, for the total amounts outstanding, as impaired. This 90-day threshold must also be applied to unadvised limits approved as part of the normal credit extension process.
8. Where an advised limit applied to overdrafts and other revolving facilities has been increased to accommodate higher business demand of a sound entity,<sup>4</sup> the facility need not be regarded as impaired provided, after appropriate internal review, an ADI is satisfied that the entity can meet its obligations under the higher limit.
9. Where an ADI applies specific provisions to facilities managed on a portfolio basis in accordance with requirements of APS 220 and its accompanying Guidance Notes, the facilities concerned must be treated as impaired. In particular, in accordance with *AGN 220.3 Prescribed Provisioning* (AGN 220.3), past due facilities assigned a prescribed provision (e.g. Category Two facilities that are past due 90 days or more) must be treated as impaired.

### Multiple facilities

10. An ADI must treat entities as related where there is:

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<sup>3</sup> Note arrears of contracted cash flows on a facility are not a necessary precondition for recognition of impairment.

<sup>4</sup> Includes persons and unincorporated enterprises.

- (a) a linkage by cross-guarantees;
- (b) common ownership or management;
- (c) ability to control;
- (d) financial interdependency; or
- (e) other connections which, in the ADI's assessment, would lead it to regard facilities it has provided to the various entities as representing a common risk.

ADIs are not required to treat facilities provided to family members involving retail financial products as related for the purposes of APS 220 and its associated Guidance Notes, provided an independent financial relationship exists amongst the family members concerned.

11. Where an ADI has multiple facilities to a single entity and one of the facilities is assessed as impaired on an individual basis, the ADI must classify all exposures to the entity as impaired. Similarly, if an ADI has assessed on an individual basis a facility provided to one or more of a group of related entities as impaired, the ADI must treat all facilities provided to the related entities in the group as impaired. Extension of the impairment classification is **not** required if:
- (a) the various facilities are not cross-collateralised, and there are no cross guarantee arrangements between the related entities; or
  - (b) there are cross-collateral and guarantee arrangements but, in aggregate, there is sufficient security among the group of related entities to ensure ultimate collectibility of all principal and interest on both the impaired and performing exposures.

### **Treatment of off-balance sheet exposures**

12. The principal off-balance sheet facilities to be captured by APS 220 and its associated Guidance Notes are likely to be direct credit substitutes and commitments. Direct credit substitutes (e.g. guarantees and standby letters of credit) are usually converted into on-balance sheet exposures when they are drawn. However, there may be circumstances when the ADI is reasonably certain that such instruments will be called upon at a future date because of uncertainty about the financial standing of the entity which they support, and there may also be cause to believe that the ADI may not be able to recoup, in a timely manner, the full amounts it may be required to advance. In such cases, the facilities in question must be regarded as impaired. Loan commitment facilities that are irrevocable must also be classified as impaired assets if the creditworthiness of an entity has deteriorated to an extent that the timely repayment in full by the entity of any potential loan drawdown or associated interest payments or fees is in doubt.
13. Exposure to potential losses arising from facilities such as derivative transactions, especially long-term derivative transactions, may arise if the credit

standing of an entity who is the counterparty in such facilities declines. If an ADI has doubts regarding the receipt in full in a timely manner of cash flow entitlements which are or will be due from a counterparty to a derivative transaction, it must treat such an exposure as impaired. In this regard, ADIs must calculate their derivative transaction exposures to counterparties for purposes of measuring impairment (and provisioning) using the current exposure or *mark-to-market* method (refer *AGN 112.2 Risk-Weighted Off-Balance Sheet Credit Exposures* (AGN 112.2)), or a method approved in advance by APRA. Potential exposure *add-ons* must reflect the nature of the individual facility involved. Derivative transaction exposures must be revalued regularly so as to maintain reasonably current assessments of the extent of credit risk attaching to those transactions.

### **Matters bearing on the recognition of impairment**

14. A facility subject to a regular repayment schedule is regarded for the purposes of APS 220 and its associated Guidance Notes as 90 days past due when:
- (a) at least 90 calendar days have elapsed since the due date of a contractual payment which has not been met in full; and
  - (b) the total amount<sup>5</sup> unpaid outside contractual arrangements is equivalent to at least 90 days worth of contractual payments.

A facility will remain outside contractual arrangements notwithstanding any waiver of payments unless such a facility has been formally restructured (refer paragraph 31 below).

15. A loan with a monthly repayment schedule will be 90 days past due three months from the time when the initial payment was due but not made. Facilities that do not have a contractual repayment schedule (e.g. overdrafts and revolving credit facilities) are considered 90 days past due where the facilities have remained continuously outside initially approved arrangements (i.e. 90 consecutive days, including any temporary excess approvals).
16. For the purposes of APS 220 and its associated Guidance Notes, fair value is defined as the amount for which an asset could be exchanged between knowledgeable willing parties (i.e. buyer and seller) in an arm's length transaction. If there is a range of possible fair values, the smallest value of the range of possible values must be used. Where fair value refers to the value of collateral or other forms of security held covering a facility, the fair value must have regard to the projected costs of obtaining and selling the security, whether or not realisation of the security is considered probable.
17. A well-secured facility is, for the purposes of APS 220 and its associated Guidance Notes, defined as one where the ADI judges that the fair value of the associated security is sufficient to ensure that the ADI will recover the outstanding principal<sup>6</sup> and other previously unpaid amounts, and any estimated

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<sup>5</sup> Includes all fees and any charges due but unpaid arising as a result of missed payments.

<sup>6</sup> Including any previously due but unpaid interest, fees etc.

shortfall in all remaining cash flows (eg payments) due over the life of the facility until the security is obtained and settled. Security includes any arrangement that protects the ADI from losing, partially or fully, the principal, interest or other amounts due on a facility. This will include mortgage insurance, cash collateral, guarantees, put options and interest servicing arrangements. An ADI must be able to demonstrate to APRA, if required, that any value ascribed to security is reliable in a recovery situation.

18. In determining whether the coverage provided by the security will enable an ADI to recoup all cash flows due<sup>7</sup> over the life of the facility, the ADI must take account of any costs (eg selling costs) involved in taking possession of and realising the value of security.

## **Non-accrual items**

### **Definition of non-accrual items**

19. Except for facilities managed on a portfolio basis or subject to restructuring agreements (see paragraphs 23 and 37 below), where a facility is impaired for capital and other APRA purposes, it must in accordance with APS 220 be treated as a non-accrual item.
20. The definition of non-accrual captures impaired rural facilities where repayment is dependent on returns from crop or livestock sales where failure to sell would immediately place loan repayments in doubt. However, it does not include rural facilities where capitalisation or approved deferral of interest or further advances for working capital purposes during a bad season have been pre-arranged and approved through the normal credit approval process. This is on the proviso that an ADI has not assessed any provisions against such facilities on an individual facility basis.
21. Facilities that are partially performing, but are not the subject of a formal restructuring agreement (see paragraphs 31 and 37 below), must be treated for capital and other APRA purposes as non-accrual items.

### **Facilities managed on a portfolio basis**

22. Facilities managed on a portfolio basis are typically smaller homogenous exposures and they are often managed using statistical techniques. Such facilities, by themselves, are not usually significant sources of potential credit losses. Facilities managed on a portfolio basis are also often not subject to formal regular review other than in cases where payments are past due.
23. For impaired facilities managed on a portfolio basis, an ADI can accrue interest on the facilities for capital and other APRA purposes until the dollar amount of arrears represents 180 days' worth of contractual payments. Once this point has been reached, an ADI must:
  - (a) subject the facilities to individual review; or

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<sup>7</sup> Including any outstanding payments due but not yet received.

- (b) write them off.

In the event that an ADI does not undertake individual reviews of facilities, it must write off the facilities for capital and other APRA purposes.

- 24. Where these facilities become subject to individual review, they must be treated as non-accrual items unless they are well secured.

### **Restoring non-accrual items to accrual status**

- 25. For a facility classified as non-accrual to be restored to non-impaired (and accrual) status for capital and other APRA purposes, the following conditions must be satisfied:
  - (a) a facility is fully compliant with its original contractual terms; or
  - (b) a facility has been formally restructured and meets the criteria required for such a facility to be treated on an accrual basis (see paragraph 37 below); or
  - (c) for a facility which has been classified as impaired because of arrears past due 90 days, all unpaid amounts have been reduced to below the dollar equivalent of 90 days' worth of contractual payments, provided the payment of arrears has not resulted from a further advance by the ADI (subject to paragraph 26 below). Alternatively, the facility may be reasonably considered to be well-secured. For facilities where interest is capitalised under the presumption that security will also cover the payment of these amounts, ADIs must satisfy themselves on current estimates there is a margin of comfort which would prevent facilities (including any capitalised interest) from slipping back to impaired status in the foreseeable future; or
  - (d) for a facility classified as impaired as a result of write-offs (refer paragraph 5(b) above), the facility has been fully performing for six months (or three payment cycles, whichever is greater); and
  - (e) for a facility subject to a specific provision prescribed in accordance with the requirements of APS 220 and its associated Guidance Notes, the provisions are no longer applicable to the facility.
- 26. In order for a facility classified as impaired to return to non-impaired and accrual status, an ADI must in all circumstances:
  - (a) have formed a view that the entity is capable of fully servicing all its future obligations in a timely manner under the facility or the ADI will otherwise receive the full amounts due in a timely manner as a result of access to security covering the facility;<sup>8</sup> and

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<sup>8</sup> This covers the return of off-balance sheet facilities classified as impaired – i.e. an ADI can return such facilities to a non-impaired status where the ADI has formed a belief that it is likely

- (b) no longer maintain a provision assessed on an individual basis against the facility.
27. Underlying evidence must support the view that there is no doubt about an entity meeting its future obligations. Such evidence must be appropriately documented in a written assessment that addresses the current credit evaluation of the entity's financial condition and other factors affecting prospects for repayment.
28. For revolving facilities which are not well secured (see paragraph 7 above), drawings must have returned within approved limits for a facility to return to non-impaired status. Any clearance which an ADI considers is undertaken merely to "reset" the past due status of a facility must not be recognised for purposes of assessing the past due status of facilities for impairment purposes.

## Restructured items

### Definition

29. A restructured item is defined for APRA purposes as a facility in which the original contractual terms have been modified to provide for concessions of interest, or principal, or other payments due, or for an extension in maturity for a non-commercial period for reasons related to the financial difficulties of an entity.
30. Any of the following concessions lead to a facility being classified as restructured:
- (a) a reduction in the principal amount of the facility, or the amount payable at maturity, as set down in the original loan agreement;
  - (b) an interest rate below the terms originally contracted;
  - (c) a reduction of accrued interest, including forgiveness of interest;
  - (d) a deferral or extension of interest or principal payments, including interest capitalisation;
  - (e) an extension of the maturity date or dates at a stated interest rate lower than the current market rate for new facilities with a similar risk; or
  - (f) an extension of the maturity date or dates materially beyond the maturities that would be offered to new facilities with similar risk.
31. For a facility to be classified as restructured, the ADI and the entity which is party to the facility must formally agree to the new terms. In the event that the new terms are not subject to a formal agreement, a facility must be treated as impaired.

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to receive in a timely manner the full amounts of cash flows due to it under such facilities (e.g. repayment of amounts of funds which it might be called on to advance under a guarantee).

32. A facility which is extended or renewed on terms in line with those which would be offered at that time to new clients with similar risk profiles, and where such extension or renewal does not flow from any financial difficulties of an entity, is not considered a restructured facility for capital and other APRA purposes.
33. Each ADI must have in place policies to identify, monitor and manage restructured facilities. Any restructuring of a loan or other facility must be supported by a current, well-documented credit assessment of the entity's financial condition and prospects for repayment under the modified terms. Renegotiation of a facility must not be used to obscure the poor quality of a facility's performance, or avoid an increase in provisions (and in turn reduction in Tier 1 capital). Before any concession is made to an entity, the appropriate level of management must approve the restructured facility.
34. Restructurings required under the provisions of the Consumer Credit Code that satisfy the concessions in paragraph 30 above are also included in the definition of restructured items.
35. A non-Consumer Credit Code regulated facility must not be reported as a restructured item where it is placed on restructured terms for less than twelve months due to temporary financial difficulty being experienced by the entity but where long-term viability is unquestioned, e.g. a rural facility encountering a bad season. Such a facility may be treated as non-impaired. The ADI must, however, be reasonably confident that the entity is able to fully perform with no loss of principal and the originally contracted amount of interest or other payments due, and the ADI must not maintain any provisions assessed against the facility on an individual basis.

#### **Treatment of restructured facilities**

36. Where a facility has been restructured, the value of the facility for capital and other APRA purposes must be reduced to fully reflect, at the date of restructuring, the effect of any reduction in cash flows previously due under contracted terms. Such change in value must be implemented by way of an adjustment to the value of provisions covering the facility (and, in turn, to the Tier 1 capital of the ADI).
37. Providing an appropriate adjustment has been made to the provisions covering a restructured facility (see paragraph 36 above), if a facility is restructured so that:
  - (a) an ADI expects the entity will perform on the restructured terms so that it will receive in a timely manner the full amount of cash flows now contracted to be received or is otherwise well secured;
  - (b) the restructured facility yields an effective rate of return equal to or greater than the effective rate of return which could be earned at the date of restructuring on other new facilities of similar risk;
  - (c) any other restructured terms are considered by the ADI as similar to those applicable to new facilities with similar risk;

- (d) the restructured facility has operated in accordance with the restructured terms and conditions for a period of at least six months or three payment cycles, whichever is longer; and
- (e) no provisions, other than those created at the point of restructuring, remain assessed against the facility on an individual basis;

the facility can be returned to a non-impaired (and accrual) status for capital and other APRA purposes. If a restructured facility does not satisfy these criteria, it must continue to be treated as impaired and non-accrual.

- 38. A single facility cannot be split into impaired and non-impaired parts in the absence of a formal restructuring agreement. If a facility cannot support accrual of all interest due under its restructured terms and conditions, it must be classified as non-accrual.
- 39. In certain circumstances, sufficient evidence may exist to demonstrate relative improvement in the condition and debt service capacity of an entity, apart from performance to date, which would warrant return to non-impaired status prior to the six-months (or three payments cycles) threshold. This might include the signing of lease or rental contracts, or an equity injection. Where this occurs, the ADI may return the facility to non-impaired status for capital and other APRA reporting purposes provided the other requirements specified in paragraph 37 above are satisfied.

### **Assets acquired through security enforcement (including other real estate owned)**

- 40. These are defined as assets (both real estate and other physical assets) acquired by an ADI in full or partial settlement of a loan or similar facility through enforcement of security arrangements. This category excludes *mortgagee in possession* assets (both real estate and other physical assets). Assets reported in these categories must be recorded for capital and other APRA purposes in accordance with their fair values. In determining fair values, ADIs must pay particular regard to considerations such as market liquidity and disposal costs.

### **Past due items**

- 41. Past due facilities are one consequence of the business of extending credit. APRA considers that a greater risk of default attaches to past due facilities than to those facilities maintained in accordance with contractual arrangements. ADIs are expected to have in place appropriate systems to adequately manage past due facilities with a view to minimizing the migration to impaired asset status. ADIs must therefore be able to identify and monitor the performance of past due facilities, including importantly those facilities not required to be treated as impaired assets for capital and other APRA purposes.

## Income recognition

### Non-accrual facilities

42. In accordance with the requirements of APS 220, income must only be recognised on a cash basis for facilities required to be treated as non-accrual for capital and other APRA purposes.
43. Upon the initial recognition of an impaired asset, a provision must be created by way of a charge against profit and loss (and, in turn, Tier 1 capital). Any subsequent changes to expected future cash flows must be reflected in a change in the value of the provision.
44. Once a facility is required to be treated as non-accrual, all previously accrued but unpaid income applicable to the facility must for capital and other APRA purposes be charged to provisions covering the facility (with an accompanying reduction in Tier 1 capital). That is, the provision held against a non-accrual facility must address the amount of unpaid income previously accrued.
45. Income (including principal and interest) received on a cash basis for a facility deemed to be non-accrual must be credited to provisions covering the facility. Where an ADI forms a judgment, following the receipt of such income, that the level of provisions now exceeds that appropriately required, the ADI can reverse out any excess provisions and include the proceeds as an addition to its Tier 1 capital.
46. Where a provision has been established as the difference between the face value of an impaired facility and the discounted estimated future cash flows on the facility (refer *AGN 220.2 Security Valuation and Provisioning (AGN 220.2)*), an unwinding of the discount arising from the passage of time that impacts on the provision must be treated as a reversal of the provision (and not as interest income), with a consequential increase in Tier 1 capital.

### Past due items

47. Interest on facilities that are past due but well-secured can be accrued as income for capital and other APRA purposes. Similarly, facilities managed on a portfolio basis that are past due less than 180 days can continue to accrue interest until they have reached an equivalent of 180 days' worth of contractual payments past due (refer paragraph 23 above.)

### Restructured items

48. Income on restructured items can be taken to income on either an accrual or cash basis, depending on the status of the restructured items (see paragraph 37 above).