South African Reserve Bank
Prudential Authority

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To: All banks, branches of foreign institutions, controlling companies, eligible institutions and auditors of banks or controlling companies

Guidance Note issued in terms of section 6(5) of the Banks Act 94 of 1990

Matters relating to the application of International Financial Reporting Standard (IFRS) 9 in response to the Coronavirus pandemic (Covid-19)

<u>Executive summary</u>

The impact of Covid-19 on the global economy and the South African financial sector has prompted regulators, including the Prudential Authority (PA) to issue guidance to the banking sector to assist in applying the requirements of IFRS 9.

The guidance is especially important to banks, branches of foreign institutions and controlling companies (hereinafter collectively referred to as 'banks') that will be providing relief to clients in a variety of ways in an effort to stabilise financial markets and reduce the impact on the local economy. This Guidance Note therefore outlines the expectations of the PA when the requirements of IFRS 9 are applied to payment holidays and other relief measures, including government guarantees and other subsidies provided as a result of Covid-19.

Guidance on macroeconomic factors taken into consideration in models used for the purposes of expected credit loss provisioning is also provided.

1. Introduction

1.1 International Financial Reporting Standard 9 (IFRS 9) requires the determination of expected credit losses that takes into account all reasonable and supportable forward-looking macroeconomic information. The onset of Covid-19 and the devastating impact it has had on financial markets and the global economy will invariably impact expected credit loss provisioning, both as a result of changes in credit quality and macroeconomic information taken into account in determining provision levels. There is no doubt that the Covid-19 crisis will have adverse macroeconomic consequences for the South African and global economies. The PA acknowledges that quantifying the impact of

Covid-19 at this stage is challenging as it is characterised by many assumptions or uncertainties.

1.2 The PA is responsible, among others, to promote and enhance the safety and soundness of financial institutions, and is mindful that it is not the accounting standard setting body in South Africa and as such cannot make any binding accounting pronouncements. However, since the respective frameworks issued by the Basel Committee, and by extension, the Regulations relating to Banks, use IFRS as a basis for the regulatory capital calculation, the PA has a direct interest in a sound and consistent application of the accounting principles as they relate to expected credit loss provisioning across the banking industry.[1]

2. Guidance

The PA is cognisant of the initiatives taken by banks to provide relief to clients during this period of financial stress, such as payment holidays. The PA is supportive of Covid-19 support packages being offered by banks in order to provide relief to certain borrowers in order to mitigate the impact of the pandemic. The PA also recognises that these initiatives are not driven by profit incentives, but by the banks' corporate responsibility and the application of sound risk management practices to provide relief to South Africans during this period in order to minimize the adverse economic impact. Consequently, the PA has considered measures to ensure that these initiatives do not result in unintended consequences such as higher capital requirements for banks. These measures would, however, require that banks consistently apply the requirements of IFRS 9 in order to achieve similar outcomes. For this reason, the PA has provided the guidelines below for banks to consider in their classification and measurement of exposures and expected credit loss provisioning.

2.1 Payment holidays and restructured credit exposures

2.1.1 The PA acknowledges that disruption of normal economic activity as a result of Covid-19 has in many instances resulted in an increase in credit risk for many clients, the extent of which is difficult to quantify at this stage. It is the view of the PA that the relief that is being granted by banks to selected retail portfolios in the form of short-term payment holidays should be assessed in conjunction with other factors prior to determining whether accounts to which such relief is provided move either to stage 2 or stage 3.

2.1.2 All reasonable and supportable information that is available to make a distinction between those accounts/portfolios whose credit risk has increased significantly and those whose credit risk has not increased significantly should be carefully considered. If, for example, an account is up to date prior to the relief measure and the account is expected to remain in up-to-date status once

[1] While this Guidance Note relates to banks, branches of foreign institutions, controlling companies and eligible institutions only, the guidance may also be useful for other entities such as Mutual Banks and Insurance firms applying IFRS 9.

the relief period ends, all other factors remaining constant, it may be regarded reasonable to assume that no significant increase in credit risk has occurred and the account need not be moved to stage 2. If however, there are adverse changes in other circumstances which are not expected to be temporary in nature over and above the relief provided (e.g. a mortgage debtor is retrenched or an SME enters business rescue or suffers losses that put into question its ability to repay the outstanding balance), it can be reasonably concluded that a significant increase in credit risk has occurred, warranting the migration of the account into stage 2 (or stage 3 for accounts modified in stage 2). Taking the above factors into account, it is considered that the assessment, where possible, would be more reliable when made at an individual account/obligor level rather than at a portfolio level.

2.1.3 In making the assessment above, it is important for banks to ensure that only accounts that are reasonably expected to remain up to date during the relief period are not modelled as having experienced a significant increase in credit risk. Those accounts that are not expected to remain in good standing or those that despite the relief measures, still exhibit signs of distress, should be modelled in a way that illustrates the sustained increase in credit risk, evidenced by reduced forecasts of present values of future cash flows and higher expected credit losses. This is in order to prevent a situation where payment holidays and other relief measures that are put in place result in sustained financial distress beyond the stress period, which may result in underreporting of risk. This may in turn lead to inaccurate information for management and supervisory decision making and result in other adverse consequences in the medium to long term. It is therefore in the best interests of the industry and all other relevant stakeholders that the extent of distressed restructures is presented accurately.

2.2 Government and other assistance

2.2.1 It is the view of the PA that any government, quasi-government or other subsidies or guarantees that are or may in future be provided should not be taken into account in determining the probability of default or considering whether an increase in significant credit risk has occurred, but should be incorporated in determining the loss given default (LGD) when calculating expected credit loss provisions.

2.3 Macro-economic models

2.3.1 It is considered to be in the best interests of the industry and financial stability to avoid undue short-term volatility in the reporting of expected credit losses. As such, the PA is of the view that banks should avoid procyclical assumptions in their IFRS 9 modelling during this time.

2.4 Loan modifications

2.4.1 The provisions of IFRS 9 in relation to modifications of contractual cash flows should be duly considered when the abovementioned relief measures are provided. The PA considers that since these relief measures are intended to provide temporary relief, it is unlikely that these would result in substantial modifications resulting in derecognition of the financial assets. It is therefore expected that any change in the present value of the modified contractual cash flows would be reflected as a modification gain or loss, potentially changing the exposure amount on which risk weighted assets would be calculated for regulatory purposes.

3. Further action

The PA will continue to engage with the banking industry and all other relevant stakeholders during this time and will issue further guidance or any additional measures as and when necessary.

4. Acknowledgement of receipt

Kindly ensure that a copy of this guidance note is made available to your institution's independent auditors. The attached acknowledgement of receipt duly completed and signed by both the chief executive officer of the institution and the said auditors should be returned to this Office at the earliest convenience of the aforementioned signatories.

Kuben Naidoo
Deputy Governor and CEO: Prudential Authority

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