

2004-12-20

**TO ALL BANKS, BRANCHES OF FOREIGN BANKS AND MUTUAL BANKS**

**BANKS ACT CIRCULAR 21/2004**

**PROVISIONS IN TERMS OF REGULATION 28 OF THE REGULATIONS RELATING TO BANKS AND IMPAIRMENTS IN TERMS OF ACCOUNTING STANDARD AC 133**

**1. Executive Summary**

Regulation 28 of the Regulations relating to Banks ("the Regulations") prescribes that the regulatory credit provisions, consisting of specific and general credit provisions, determined through the completion of the form DI 500 (credit-risk return) constitute the minimum required level of credit provisions to be maintained by a bank.

Accounting Standard AC 133 ("AC 133"), *inter alia*, replaced the previously prevailing generally accepted accounting practice relating to the determination of the appropriate level of accounting credit provisions to be created and maintained, by prescribing a materially different approach and methodology to determining the appropriate level of credit impairments, consisting of specific and portfolio impairments.

This Office requires banks to adhere to the following prescriptions:

- Specific impairments computed in terms of AC 133 should exceed specific provisions computed in terms of regulation 28 of the Regulations. Should this not be the case, additional specific impairments should immediately be raised to eliminate the shortfall.
- Total impairments, consisting of specific and portfolio impairments, computed in terms of AC 133 should exceed total regulatory provisions, consisting of specific and general provisions, computed in terms of regulation 28 of the Regulations. Should this not be the case, an additional general credit-risk reserve ("GCRR"), on a pre-tax basis equal to or exceeding the shortfall, should immediately be created through an appropriation of distributable reserves to eliminate the shortfall.

**2. Terminology used in this circular**

The "Regulations relating to Banks" ("the Regulations") were issued under section 90 of the Banks Act, 1990 (Act No. 94 of 1990), by way of Government Notice R.1112, contained in *Government Gazette* No. 21726 dated 8 November 2000 ("the Regulations").

Regulation 28 of the Regulations contains prescriptions relating to regulatory credit provisions ("regulatory provisions").

Accounting Statement AC 133, which came into effect in relation to financial periods commencing on or after 1 July 2002, contains prescriptions relating to credit

impairments (“impairments”), being the AC 133 terminology for what previously, in terms of the then prevailing generally acceptable accounting practice, was referred to as credit provisions (“accounting provisions”).

### 3. **Rationale for circular**

In view of the changes brought about by the introduction of AC 133, there is uncertainty about the appropriate treatment of regulatory credit provisions.

### 4. **Purpose of circular**

The purpose of this circular is to remove the uncertainty arising from the introduction of AC 133, by giving guidance on the treatment of the minimum regulatory credit provisions required in terms of regulation 28 of the Regulations.

### 5. **Context**

This section gives context to the issues that this circular addresses.

#### 5.1 **Regulation 28**

Regulation 28 of the Regulations states, *inter alia*, that “The purpose of form DI 500 is to determine –

(b) the **adequacy of overall provisions** to absorb estimated credit losses”.

Regulation 28 furthermore provides, *inter alia*, that “The provisioning percentages indicated in category 1 of form DI 500 shall be regarded as a minimum”.

#### 5.2 **Regulation 28 and accounting provisions**

Prior to the introduction of AC 133, the practice (“greater of test”) was for banks to create and maintain a level of accounting provisions equal to at least the greater of the following:

- the prescribed minimum required level of regulatory provisions, as determined in accordance with regulation 28 of the Regulations; or
- the computation of accounting provisions in accordance with the previously prevailing prescriptions of generally accepted accounting practice.

Recently, prior to the introduction of AC 133, there was generally little discrepancy between regulatory provisions and accounting provisions.

#### 5.3 **AC 133**

The approach and methodology prescribed in terms of AC 133 for determining the appropriate level of impairments differs materially from the respective approaches and methodologies prescribed by -

- regulation 28 of the Regulations; and
- the generally accepted accounting practice prevailing prior to the introduction of AC 133.

Unlike the previously prevailing generally accepted accounting practice-

- AC 133 does not permit the raising of impairments for unexpected losses, only for actual and expected losses. In this sense, AC 133 is less conservative than regulatory provisioning.
- On the other hand, AC 133 requires that the time value of money be taken into account. This results in a more conservative outcome than regulatory provisioning.

## **6. Discussion**

The introduction of AC 133 does not in itself imply that the quantum or nature of the credit risk has changed. Accordingly, the introduction of AC 133 should not in principle result in a higher level of regulatory provisions being required.

### Schematic representation

The table below sets out, in a schematic format, the impact of the implementation of AC133.

	Non-performing loans				Performing loans		
	Identified losses				Unidentified losses		
	Expected/inherent			Discount	Expected/inherent		Unex-pected
	Sub-standard	Doubtful	Loss		Special mention	Standard	
Pre AC133	Specific provision			-	General provision		
Post AC133	<b>Specific impairment (including discounting)</b>				<b>Portfolio impairment</b>		-
Regulatory	Specific provision	Specific provision	Specific provision	-	Specific provision	General provision	

As illustrated in the table above, since the introduction of AC 133, the general experience has been that the application of AC 133 results in the following:

- The figure for specific impairments determined through the application of AC 133 is higher than the regulatory specific provisions determined in terms of regulation 28 of the Regulations.
- The figure for portfolio impairments determined through the application of AC 133 is lower than the regulatory general provisions determined in terms of regulation 28 of the Regulations.

### 7. Prescription

This Office requires banks to adhere to the following prescriptions:

- Specific impairments computed in terms of AC 133 should exceed specific provisions computed in terms of regulation 28 of the Regulations. Should this not be the case, additional specific impairments should immediately be raised to eliminate the shortfall.
- Total impairments, consisting of specific and portfolio impairments, computed in terms of AC 133 should exceed total regulatory provisions, consisting of specific and general provisions, computed in terms of regulation 28 of the Regulations. Should this not be the case, an additional general credit-risk reserve ("GCRR"), on a pre-tax basis equal to or exceeding the shortfall, should immediately be created and maintained through an appropriation of distributable reserves to eliminate the shortfall.

For purposes of this circular, this Office considers both the AC 133 portfolio impairment and the GRR (to the extent of the shortfall between the aggregate of all AC 133 impairments and the aggregate of all required regulatory provisions), on a post-tax basis, to constitute "secondary reserve funds" and, therefore, to constitute secondary capital.

**8. Acknowledgement of receipt**

Two additional copies of this circular are enclosed for the use of 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.

**E M Kruger**  
**Registrar of Banks**

The previous circular issued was Banks Act Circular 20/2004 dated 14 December 2004.