



South African Reserve Bank

From the Office of
the Registrar of Banks

C2/2010

2010-06-02

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

**Circular 2/2010 issued in terms of section 6(4) of the Banks Act, 1990:
Interpretation of definition of default as outlined in regulation 65 of the
Regulations relating to Banks**

Executive summary

“Default”, as defined in regulation 65 of the Regulations relating to Banks (the Regulations), in relation to the internal rating-based (IRB) approach for the measurement of a bank’s exposure to credit risk is aligned with the *International Convergence of Capital Measurement and Capital Standards, A Revised Framework* (Basel II).

Default relating to instalment-based products appears to be inconsistently interpreted across the banking industry. For many portfolios the product systems implemented by banks use a day-count approach to define defaulted assets and accordingly these are in full compliance with the prescribed definition of default, that is, more than 90 days past due. However, this Office is aware that for certain portfolios, such as instalment-based products, the product systems implemented by banks are based on a missed monthly instalments approach.

The purpose of this circular is to inform all banks, controlling companies and branches of foreign institutions (hereafter referred to as “banks”) of the interpretation to be applied when monitoring defaulted exposures in relation to the IRB approach for the measurement of a bank’s exposure to credit risk.

1. Introduction

During this Office’s implementation of Basel II on 1 January 2008, it had been adopted in its letter and spirit as an absolute minimum. The definition of default is extensively dealt with in Basel II, paragraphs 452 to 459. The Regulations are duly aligned to Basel II and therefore default, as defined in regulation 65 of the Regulations, require no amendment.

Furthermore, the strict day-count approach to define defaulted assets is in full compliance with the prescribed definition of default in accordance with Basel II, the Regulations and most other supervisory authorities.

However, default relating to instalment-based products appears to be inconsistently interpreted across the banking industry and this Office is aware that for certain instalment-based products, the product systems implemented by banks track missed monthly instalments.

2. Interpretation of the definition of default

After due consideration of banks' system development plans, read with the provisions of regulation 1 of the Regulations, this Office has concluded that the use of a three missed monthly instalments approach to determine whether a default has occurred approximates a similar outcome as the use of the day-count approach.

Therefore, banks that adopted the IRB approach for the measurement of their exposure to credit risk may use a three missed monthly instalments approach to determine whether a default has occurred, as opposed to using the strict day-count approach, for those exposures where the product systems implemented are based on a missed monthly instalments approach, provided that the bank shall formally, in writing

- 2.1 inform this Office of its intention to use the three missed monthly instalments approach instead of the strict day-count approach;
- 2.2 specify the portfolios in respect of which this approach will be applied;
- 2.3 quantify the portfolios affected as a percentage of total credit exposure;
- 2.4 demonstrate that their approach is consistent over time and across and within impacted portfolios;
- 2.5 demonstrate that their approach is used as a basis for internal management- and external reporting; and
- 2.6 provide an action plan, if any, to move towards the strict day-count approach.

Banks that choose not to use the three missed monthly instalments approach, shall comply with the strict day count definition of default (that is, more than 90 days past due) for every relevant credit portfolio.

Failure to do so will result in non-compliance with the Regulations and will be subject to a formal submission to this Office stating the reasons for non-compliance and indicating the measures that are being taken to comply with either of the above-mentioned two approaches, including the timeframe for rectification and compliance.

3. Acknowledgement of receipt

Two additional copies of this guidance note 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 and the said auditors must 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 1/2010 dated 1 June 2010.