



South African Reserve Bank

From the Office of
the Registrar of Banks

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

Directive issued in terms of section 6(6) of the Banks Act 94 of 1990

Regulatory treatment of accounting provisions – interim approach and transitional arrangements including disclosure and auditing aspects

Executive summary

In July 2014 the International Accounting Standards Board (IASB) issued International Financial Reporting Standard 9: *Financial Instruments* (IFRS 9). IFRS 9 will become effective on 1 January 2018 and banks, branches of foreign institutions and controlling companies (hereafter collectively referred to as banks) will have to report in terms of the new requirements for financial years starting on or after that date.

IFRS 9 represents a fundamental change in accounting for financial instruments and in particular it will have a significant impact on how banks are required to determine impairments. While International Accounting Standard (IAS) 39 was based on an incurred loss approach, IFRS 9 does not require a loss event to occur before a provision is raised. The expected credit loss (ECL) model required by IFRS 9, which takes into account information that is forward-looking, is expected to result in a significant increase in impairments raised by banks, thereby affecting available capital.

This directive directs banks and auditors of banks regarding the classification of impairments as either general or specific under IFRS 9, during the interim approach, the transitional arrangements of the ECL accounting provisions for regulatory capital purposes, the disclosure requirements relating to such transitional arrangements as well as requirements regarding the auditing of the balances and adjustments that shall be implemented once IFRS 9 becomes effective.

1. Introduction

- 1.1 In July 2014 the IASB issued IFRS 9 which will become effective for annual periods beginning on or after 1 January 2018 and replaces IAS 39 – Financial Instruments: Classification and Measurement.

- 1.2 IFRS 9 fundamentally changes the way banks have been calculating provisions for credit losses, also called impairments. The IAS 39 impairment calculation was based on an incurred loss model which required a loss event to have occurred before a provision could be raised. Losses expected as a result of future events, no matter how likely, were not recognised¹.
- 1.3 IFRS 9 requires entities to take into account all information that is available without undue cost or effort, including that which is forward-looking when determining impairments that should be raised. IFRS 9 therefore introduces the concept of ECL for financial reporting purposes.
- 1.4 The move towards an ECL accounting framework is an important step forward in resolving the weaknesses identified during the global financial crisis. This development of ECL accounting frameworks is also consistent with the April 2009 call by the Group of Twenty (G20) leaders for accounting standard setters to “strengthen accounting recognition of loan loss provisions by incorporating a broader range of credit information”².
- 1.5 In October 2016, the Basel Committee on Banking Supervision (BCBS) released for public comment a consultative document and a discussion paper on the policy considerations related to the regulatory treatment of accounting provisions under the Basel III capital framework. The consultative document sets out the BCBS’s proposal to retain, for an interim period, the current regulatory treatment of provisions under the standardised approach (SA) and the internal ratings-based (IRB) approach for credit risk.
- 1.6 In March 2017 the BCBS published a document titled: *Regulatory treatment of accounting provisions – interim approach and transitional arrangements*³. As indicated in this document, the BCBS decided that, given the diversity of accounting and supervisory policies in respect of provisioning and capital across jurisdictions, and the uncertainty about the capital effects of the change to an ECL accounting model, it will retain the current treatment of provisions under both the SA and IRB frameworks for an interim period.
- 1.7 The BCBS acknowledges that this interim approach is not expected to mitigate the existing varied practices across jurisdictions regarding the distinction between general provisions (GP)⁴ and specific provisions (SP)⁵ as ECL accounting models are implemented. Nevertheless, the BCBS is of the view that it is more important to focus its efforts on considering alternative approaches for the longer-term regulatory capital treatment of accounting provisions that would ultimately replace the interim approach.
- 1.8 As banks transition to ECL accounting models, it will be important for banks to define which, if any, portions of provisions should be regarded as SP and GP respectively for regulatory purposes, pending the BCBS’s determination of the appropriate longer-term regulatory treatment of provisions. As such, a distinction between GP and SP does not exist under accounting frameworks;

¹ IAS 39, paragraph 59

² Available at www.g20.org

³ Available at <https://www.bis.org/bcbs/publ/d401.htm>

⁴ Also referred to as portfolio credit impairments

⁵ Also referred to as specific credit impairments

the BCBS recommends that regulatory authorities provide guidance, as appropriate, on how they intend to categorise ECL provisions as GP or SP respectively in their jurisdiction, to ensure consistency in this categorisation by the banks within their jurisdiction.

- 1.9 The Office of the Registrar of Banks (this Office) deemed it appropriate to introduce a transitional arrangement in order to avoid an immediate capital shock and to allow banks to rebuild capital resources following the initial negative impact arising from the introduction of IFRS 9. Further, this Office is of the view that a transitional arrangement is warranted by the macroeconomic uncertainties that banks operating in its jurisdiction are exposed to, in particular those banks that are using the SA for credit risk, as the impact for such banks is expected to be larger than for the banks on the advanced internal ratings (AIRB) approach. Supervisory decisions will be based solely on regulatory metrics which incorporate the effect of the transitional arrangement. The transitional arrangement shall only apply to new provisions that did not exist prior to the adoption of the ECL accounting model.
- 1.10 Banks will be required to disclose (through their Pillar 3 disclosures) their regulatory capital and leverage ratios compared to their 'fully loaded' capital and leverage ratios if the transitional arrangement had not been applied.
- 1.11 The purpose of this directive is to provide clarity to banks operating in South Africa on how to categorise ECL provisions as GP or SP respectively. Furthermore, this directive would clarify the phase-in period of the day-one impact on common equity tier 1 (CET 1) capital, calculated once at the point of transition, as well as consequential adjustments.

2. Directive

- 2.1 Based on the aforesaid and in accordance with the provisions of section 6(6) of the Banks Act 94 of 1990, banks are hereby directed to categorise accounting provisions as either GP or SP as follows:
 - 2.1.1 Any relevant provision in relation to financial instruments for which the bank determined that at the reporting date⁶ there had been no significant increase in credit risk since initial recognition, in line with section 5.5 of the IFRS 9 requirements, that is, Stage 1 exposures, shall be treated as GP for regulatory purposes.
 - 2.1.2 Any relevant provision in relation to financial instruments for which the bank determined that at the reporting date there had been a significant increase in credit risk since initial recognition, in line with section 5.5 of the IFRS 9 requirements, but that are not credit-impaired as defined by IFRS 9 requirements, that is, Stage 2 exposures, shall be treated as GP for regulatory purposes.

⁶ Reporting date in this directive refers to reporting prescribed in terms of regulation 7 of the Regulations relating to Banks.

- 2.1.3 Any relevant provision in relation to financial instruments for which the bank determined that at the reporting date they were credit impaired as defined by IFRS 9 requirements, that is, Stage 3 exposures, shall be treated as SP for regulatory purposes.
- 2.2 Banks may elect to apply a transition period by providing prior written notification to this Office before the adoption date of IFRS 9. The transition arrangements must be applied as follows:
- 2.3 Banks that opt for a transition period are hereby directed to apply a three-year transition period, amortised on a straight-line basis, on a bank legal entity (solo reporting) and a bank controlling company (consolidated basis)⁷ only, and calculated as follows:
- 2.3.1 A bank shall follow a static approach (a once-off calculation), whereby the bank compares CET1 capital based on the opening balance sheet using IFRS 9 with CET1 capital based on the closing balance sheet, that is, one day prior to the opening day, under IAS 39, in order to isolate the impact of using an ECL model. The decrease in net qualifying CET 1, as reflected pre- and post-implementation, in line item 64 of the form BA 700 shall be phased-in over a three-year period. Therefore, the impact must be reflected net of the tax effect and all deductions such as shortfalls of eligible provisions compared to expected loss and threshold deductions. Furthermore, no separate adjustments shall be made in respect of banks showing changes to shortfalls of eligible provisions compared to expected loss⁸, since this impact would already be included in line item 64 of the form BA 700.
- 2.3.2 In terms of paragraph 2.4 below, the impact on deferred tax assets must be phased-in, and must also be reflected in line item 64 of the form BA 700. Furthermore, the treatment of eligible provision surpluses are specified in paragraphs 2.6 and 2.7 below.
- 2.3.3 The IFRS 9 transitional adjustment amount (adjustment amount), as calculated in terms of paragraph 2.3.1 above, must be included in line item 204, column 1 of the form BA 700 and line item 12 of the form BA600, in terms of the following schedule for each year during the transitional period:

Table 1

Year 1	3/4 of adjustment amount
Year 2	2/4 of adjustment amount
Year 3	1/4 of adjustment amount

- 2.3.4 The inclusion of the adjustment amount in line item 204, column 1 of the form BA 700 would automatically ensure that other measures such as tier 1 and total capital ratios, the leverage ratio, and large exposure limits are also adjusted.
- 2.3.5 In addition to the aforementioned capital impact, the additional amount of SP, not phased in yet, shall be risk weighted at a risk weight of 100% and be

⁷ No transition period would be applied on foreign operations of South African banks (form BA610).

⁸ In respect of defaulted exposures, the best estimate of expected loss is expected to be an amount equal to or higher than stage 3 provisions.

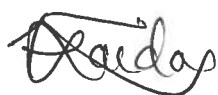
included in line item 5, column 1 of the form BA 700 during each year, post the adoption of IFRS 9, in respect of the SA only. The amount shall also be decreased annually on a straight-line basis over a three-year period. This would ensure that an institution would not benefit from both an increase in its CET1 capital due to transitional arrangements as well as a reduced exposure value.

- 2.4 The deferred tax asset impact as a result of both the adoption of IFRS 9 and the changes to taxation rules will be phased in over a three-year period. Banks shall, on a static basis, calculate the difference between deferred tax assets arising from temporary differences, based on the opening balance sheet using IFRS 9 and the closing balance of deferred tax assets, that is, one day prior to the opening day, under IAS 39. A portion of this amount, calculated in line with the table above, shall be deducted in line item 110 of the form BA 700, from the deferred tax amount arising from temporary differences, net of deferred tax liabilities. The consequential adjustments to the threshold deductions and to the risk-weighted asset impact would be calculated automatically in the form BA 700.
- 2.5 The adjustment amount included in line item 204, column 1 of the form BA 700 shall be added to the leverage exposure measure and be included in line item 238 of the form BA 700 as a positive value, over the transition period. Furthermore, provisions in respect of exposures in stages 1, 2 and 3, in terms of IFRS 9, shall be included fully in line item 242 of the form BA 700 with effect from the first reporting date post the adoption of IFRS 9.
- 2.6 Banks applying the SA to measure credit risk capital requirements shall, on a static basis, calculate the difference between the combined stages 1 and 2 provisions, based on the opening balance sheet using IFRS 9 and the closing balance of GP, that is, one day prior to the opening day, under IAS 39. For purposes of regulation 23(22)(c) of the Regulations relating to Banks (the Regulations), the increase in GP as a result of IFRS 9 must be phased-in over three years using Table 1 specified in paragraph 2.3.3 above. This means during the transitional period a portion of the increase in line with the table specified in paragraph 2.3.3 above, must be deducted from total GP before applying the limit of 1.25% of credit risk-weighted assets. The net amount, after taking into account this adjustment and after applying the limit in terms of regulation 23(22)(c) of the Regulations must be reported in line item 84 of the form BA700 and line item 12 of the form BA600.
- 2.7 Banks applying an IRB approach to measure credit risk capital requirements must phase in all the new excess provisions exceeding expected loss amounts over the three-year transitional period using Table 1 specified in paragraph 2.3.3 above. This means that a portion of the excess provision, in line with Table 1 specified in paragraph 2.3.3 above, must be deducted from total eligible provisions before determining the maximum amount that can be added to Tier 2 capital in terms of regulation 23(22)(d) of the Regulations, that is, 0.6% of credit risk-weighted assets. The net amount, after taking into account this adjustment and after applying the limit in terms of regulation 23(22)(d) of the Regulations must be reported in line item 85 of the form BA700 and line item 12 of the form BA600.

- 2.8 Banks shall, solely for the purposes of duly discharging this Office's supervisory responsibilities, prepare a set of special purpose financial information within the first five months of the implementation of IFRS 9 for the first time, demonstrating the impact of the implementation of IFRS 9, on the opening retained earnings in respect of the first year for which IFRS 9 is effective. The special purpose financial information shall include a reconciliation from the previously audited retained earnings, before IFRS 9 implementation (e.g. as at 31 December 2017 for banks with December year-end) to the retained earnings balance at that date as adjusted for the IFRS 9 impact. The special purpose information shall also contain a basis of preparation note setting out all the accounting policies relevant to the calculation of the IFRS 9 retained earnings adjustment, as well as all relevant notes considered necessary to provide this Office with a proper understanding of the reconciliation. Auditors shall, within five months of the implementation of IFRS 9 for the first time, for the sole purpose of duly discharging this Office's supervisory responsibilities, prepare and submit an International Standards on Auditing (ISA) 805 audit report on this special purpose financial information.
- 2.9 All banks shall, on a consolidated basis as stipulated in Regulation 43(3) of the Regulations, disclose the fact that transition arrangements are applied and, on a quarterly basis, they shall disclose rows 1 to 14a of template KM 1⁹ as contained in the document titled: *Pillar 3 disclosure requirements – consolidated and enhanced framework* published by the BCBS during March 2017 (Pillar 3 disclosure). Disclosure commences on the first quarter end following the implementation of IFRS 9 and information on previous quarter ends that relates to the period prior to the implementation of IFRS 9 must not be disclosed. This Office will provide guidance at a later stage, on the commencement date of disclosure requirements of the remainder of template KM 1 and the additional templates included in the aforementioned document.

3. Acknowledgement of receipt

- 3.1 Kindly ensure that a copy of this directive 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 Registrar of Banks

Date: 21/11/2017

The previous directive issued was Directive D4/2017, dated 27 September 2017.

⁹ Available at (<http://www.bis.org/bcbs/publ/d400.htm>)