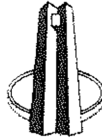

South African Reserve Bank

From the Office of
the Registrar of Banks

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

Guidance Note 2/2015 issued in terms of section 6(5) of the Banks Act 94 of 1990

Meetings to be held during the 2015 calendar year with the boards of directors of banks and controlling companies

Executive summary

This guidance note serves to inform all banks, controlling companies and branches of foreign institutions (hereinafter collectively referred to as 'banks') of the flavour-of-the-year topics for the discussions to be held with the respective boards of directors during 2015.

A. Meetings with boards of directors

1. Introduction

In order to assist the Office of the Registrar of Banks (this Office) to discharge its supervisory responsibilities, the scope of the meetings with banks' boards of directors (boards) and, in terms of branches of foreign institutions, the executive committees, to be held during the 2015 calendar year will consist of a discussion on the following two flavour-of-the-year topics:

1.1 IFRS 9: Financial Instruments, including adequacy of current levels of credit impairments; and

1.2 shadow banking.

PO Box 8432 Pretoria 0001 · 370 Helen Joseph Street Pretoria 0002 · South Africa · Tel +27 12 3133911/0861 12 7272 · Fax +27 12 3133758 · www.reservebank.co.za

2. Format of the meetings to be held with banks' boards of directors

All banks' boards will be required to make a presentation and engage in discussions on the above-mentioned flavour-of-the-year topics. The duration for each presentation should be limited to 45 minutes. It is intended that each presentation should cover only the key elements of the specific topic. This Office also requires to be provided with a copy of each presentation at least three weeks prior to the board or executive committee meeting. The two flavour-of-the-year topics are discussed in greater detail below.

3. IFRS 9: Financial Instruments, including adequacy of current levels of credit impairments

3.1 Background

The International Accounting Standards Board (IASB) published the final version of *IFRS 9: Financial Instruments* on 24 July 2014, which includes the new standard for impairment accounting. The main objective of the new impairment requirements is to provide users of financial statements with more useful information about an entity's expected credit losses on financial instruments. The new model requires an entity to recognise expected credit losses at all times and to update the amount of these losses recognised at each reporting date to reflect changes in the credit risk associated with the financial instruments. IFRS 9 applies to financial assets measured at amortised cost or mandatorily measured at fair value through other comprehensive income (FVOCI), trade receivables, lease receivables, loan commitments and financial guarantee contracts.

The major difference between IFRS 9 and the previous standard (IAS 39) is that the new standard requires the recognition of expected losses, whereas under the previous standard only incurred losses were recognised.

This Office will cover the implementation and impact assessment of the new IFRS 9 standard over the next two years, with a key focus on practical implementation and readiness, during 2015. A more detailed understanding of the impact on the financial statements and regulatory capital will subsequently be covered during 2016.

Since a core element of banks' business is the provision of credit facilities, a significant portion of the balance-sheet assets is therefore attributable to credit risk exposures. IFRS 9 will therefore have an impact on all banking institutions, although the extent of this impact may differ across institutions depending on their existing models, provisioning policies and the magnitude of such exposures.

The requirement for entities to recognise 12-month expected losses from day one will mean that from 1 January 2018 (should the standard not be adopted early), there will be a significant expected increase in the portfolio impairments raised. Another major consideration is the design of banks' systems and processes so that they become enablers for the implementation of the new requirements. This is more of a consideration particularly for banks using the

standardised approach to calculate their regulatory capital requirements for credit risk.

This Office has no intention to require banks to adopt the IFRS 9 requirements before the effective implementation date as set by the IASB.

Given the current macroeconomic position and outlook, it is imperative that banks, under regulation 23(22) of the Regulations relating to Banks, ensure their current levels of credit impairments, both portfolio and specific, are adequate. Robust systems and processes should be in place to ensure that the credit impairment calculated is in accordance with the requirements of current IFRSs.

The Board should also ensure that it has sufficient oversight of all credit impairment processes, systems and policies to ensure the adequacy thereof.

3.2 Format of discussion

The chairperson of either the capital and risk management subcommittee or the audit subcommittee (or equivalent) will be required to make high-level presentations to this Office, focusing on the preparedness of their institutions (banks solo and consolidated banking groups) as well as the steps their management teams have taken to ensure readiness and compliance with the new requirements by the implementation date of 1 January 2018. The discussion should include, but not be limited to, the following:

3.2.1 Practical or system implementation

a. Design of systems and processes to incorporate the changes (including the associated cost impact thereof).
b. Changes in the development of impairment models to take the new requirements into account (including data considerations for the development or revision of such models).
c. Training or education of staff on the new requirements.
d. Consideration for internal audit involvement.

3.2.2 Credit risk management

e. Key differences in IFRS 9 requirements and existing credit risk management in the organisation, including elements such as challenges in assessing credit quality deterioration.
f. Anticipated changes in credit policies.
g. Changes in provisioning policies.
h. Internal definition or interpretation of significant credit deterioration.
i. Enhancements required to existing advanced internal ratings-based (AIRB) approach models or economic capital models, or alternatively the approach to be adopted for portfolios on the standardised approach.

3.2.3 Other aspects to consider

j. Degree of integration among various divisions such as finance, risk and economists etc., as a result of IFRS 9.
k. Investor or shareholder awareness of the changes and the impact thereof.
l. Possible changes to balance-sheet management.
m. Changes in financial reporting and disclosure requirements.

Banks are also to note that the Accounting Experts Group of the Basel Committee on Banking Supervision is currently working on an update to the sound credit risk assessment and valuation for loans (SCRAVL) guidance, which was originally issued in June 2006, to take the provisions of IFRS 9 into account, and should therefore be aware and prepared that changes to the existing regulatory framework relating to the measurement of the credit risk capital requirement will follow.

Although this Office will conduct a more in-depth review and analysis of the impact on the income statement, the balance sheet and regulatory capital in 2016, this Office would appreciate:

n. An initial impact assessment by the bank on its financial position, based on initial investigations.

3.2.4 Adequacy of current credit impairment levels

o. How, and on what basis, do the Board members satisfy themselves that the current levels of credit impairments are adequate given the current macro-economic position and outlook?

4. Shadow banking

4.1 Background

Increased disintermediation, both globally and within the South African financial system, remains a key focus area for regulators. The Financial Stability Board states in its *2014 Global Shadow Banking Monitoring Report* that intermediating credit through non-bank channels can have important advantages and contributes to the financing of the real economy. However, such channels can also become a source of systemic risk, especially when they are structured to perform bank-like functions (e.g. maturity and liquidity transformation and leverage), and when there is strong interconnectedness with the banking system.

Vehicles used to facilitate shadow banking include structured finance vehicles and various types of investment funds, such as equity, fixed income, hedge, money market and other funds. Additionally, insurance companies and pension funds are becoming increasingly active in credit intermediation by expanding lending activities traditionally performed by banks. In some instances these types of vehicles and activities are facilitated through banking institutions. Another vehicle used to match borrowers and lenders directly

without going through a traditional financial intermediary is peer-to-peer lending, which has emerged during the past decade. Given current lending systems, infrastructure, access to consumer credit data and knowledge of the lending industry, banks are regarded as being perfectly positioned to operate or partner with peer-to-peer platforms.

In light of the above, it is important for this Office to obtain a better understanding of banks' strategic perspective regarding the type of shadow-banking activities described above and the extent of their involvement in and facilitation of these activities, or alternatively the impact of shadow banking on their own operations and preparing therefor.

4.2 Format of discussion

Utilising the format outlined below, a non-executive member of the Board will be required to make a presentation on the following aspects:

a. An overview of the bank's strategic perspective regarding shadow-banking activities described above, specifically elaborating on the associated risks and benefits.
b. The specific extent of the bank's involvement with the activities described above and any future strategic business opportunity identified.
c. The potential impact of the type of activities described above on the bank's business and business model.
d. What assets or liabilities have been moved off-balance sheet in the last couple of years that may be considered a form of shadow banking?

B. Acknowledgement of receipt

Two additional copies of this guidance note are enclosed for use by 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.

René van Wyk
Registrar of Banks

The previous guidance note issued was Guidance Note 1/2015, dated 27 January 2014.