South African Reserve Bank
Prudential Authority

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G6/2020

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

Further guidance on matters relating to the application of International Financial Reporting Standard (IFRS) 9 in response to the Coronavirus Disease pandemic (Covid-19)

Executive summary

On 26 March 2020 the Prudential Authority (PA) issued Guidance Note 3/2020 (G3/2020) to all banks, branches of foreign institutions, controlling companies, eligible institutions and auditors of banks or controlling companies (hereinafter collectively referred to as 'banks') on matters relating to the application of IFRS 9 in response to Covid-19.

This Guidance Note 6/2020 elaborates further on some of the aspects contained in G3/2020.

1. Introduction

1.1 Subsequent to the issuance of G3/2020 on matters relating to the application of IFRS 9 in response to Covid-19, the PA was requested by industry to provide further guidance and clarification on some of the aspects contained in G3/2020. This guidance note elaborates on some of the aspects contained in G3/2020 and should therefore be read in conjunction therewith.

1.2 The objective of the PA is, inter alia, to promote and enhance the safety and soundness of its regulated financial institutions. The PA is mindful that it is not an accounting standard-setting body and as such cannot make any authoritative accounting pronouncements on accounting standards. However, since the respective frameworks issued by the Basel Committee on Banking Supervision (BCBS), and by extension, the Regulations relating to Banks, use International Financial Reporting Standards as a basis for the calculation of minimum required capital and reserve funds, 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]

[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.

1.3 The PA fully supports the expected credit loss model required by IFRS 9 issued by the International Accounting Standards Board and any guidance provided is intended to support banks' ongoing compliance with the accounting standard.

2. General

2.1 The PA wishes to confirm that the guidance provided in G3/2020 and in this Guidance Note G6/2020 applies to both retail and corporate portfolios.

2.2 The guidance provided in G3/2020 and in this Guidance Note G6/2020 also applies to the regulatory reporting to the PA by banks on their foreign operations.

3. Guidance

3.1 Payment holidays and restructured credit exposures

3.1.1 It is the PA's view that the provision of short-term payment holidays and similar restructures as part of Covid-19 related relief measures to both retail and corporate clients should not be the sole or automatic indicator for determining whether an individual loan or loan portfolio should be transferred to either Stage 2 or Stage 3 in terms of IFRS 9. Other factors that could be considered include the impact of Covid-19 on the industry that the client is engaged in and the impact of the pandemic, including the effects of extended lockdown measures. The PA is of the view that banks should consider all reasonable and supportable information that is available without undue cost or effort, including that which is forward-looking, in an effort to determine the staging of accounts subject to Covid-19 relief. In addition, each bank should identify, based on its products, processes and systems, what information is available and appropriate to make this determination. Where it is determined that the increase in credit risk is not significant enough to warrant a move to either stage 2 or stage 3 in terms of IFRS 9, an assessment of the adequacy of the expected credit loss provision would still be required.

3.1.2 Where previous indicators of a significant increase in credit risk (SICR) have become unreliable or are no longer appropriate in the circumstances, e.g. credit bureau scores, the bank should endeavor to identify other, more accurate factors that would indicate whether a SICR has occurred. Such indicators could be more qualitative in nature. The PA recommends that the basis for all decisions taken in this regard be adequately documented and subject to the relevant governance processes for audit purposes.

3.1.3 Although the PA believes that in some cases, it may be possible to perform a staging assessment at an individual account level as indicated in paragraph 2.1.2 of G3/2020, banks may, in some instances, only be able to perform the assessment on a portfolio basis. In fact, in some cases, a portfolio assessment may be necessary where reasonable and supportable information is not available to identify a SICR at an individual account level. In this regard, the PA has in the past emphasised the guidance provided by the BCBS in its document entitled "Guidance on Credit Risk and Accounting for Expected Credit Losses"[2]. Banks' attention is drawn to paragraph A33 in the appendix of the aforementioned document, which states that in instances where it is apparent that some exposures in a group have

[2] https://www.bis.org/bcbs/publ/d350.pdf

experienced a significant increase in credit risk, a subset or a proportion of the group will transfer to lifetime expected credit losses even though it is not possible to identify this on an individual exposure basis. The PA continues to support this view. Examples of relevant information to consider when conducting a portfolio assessment could include, amongst others, the industry to which a portfolio of clients is exposed as well as the geographical location of the clients in the portfolio. While it is not possible for the PA to provide an exhaustive list of portfolio information that could be used in such cases as this may be specific to each bank and product portfolio, banks are encouraged to ensure close cooperation between their finance and risk functions so that exposures with similar credit risk characteristics are readily identified and grouped together. While this has always been necessary under IFRS 9, it is particularly important in the current situation.

3.1.4 Furthermore, the PA noted the request for guidance on what key modelling assumptions should be used in order to identify accounts that are not expected to remain in good standing despite Covid-19 relief measures. In this regard, the PA believes that both idiosyncratic and systemic factors should be considered for a more reliable estimate of expected credit losses. These may include the industries in which the clients operate, current debt levels of the clients and political factors. However, it is reiterated that the PA cannot give an exhaustive list of factors to consider and the responsibility for determining all relevant factors remains with the banks.

3.2 Government and other assistance

3.2.1 In G3/2020 the PA expressed a view regarding the treatment of Covid-19 related government, quasi-government or other subsidies or guarantees. In providing the guidance as set out in G3/2020, the PA had specifically envisaged instances where certain undertakings of support are made by government and/or other institutions to certain sectors of business, thereby not affecting the likelihood of the borrower defaulting, but impacting the amount expected to be recovered. It should be noted however, that in order for such assistance to be considered in the determination of expected credit losses, the estimate of expected cash shortfalls shall reflect the cash flows expected from collateral and other credit enhancements that are part of the contractual terms and not recognised separately by the entity. The PA acknowledges that there could be circumstances where such assistance would affect the likelihood of the borrower defaulting on the instrument, in which case the assistance may be considered in the assessment of whether a SICR has occurred. Where considerations relating to credit enhancements in the form of government and other assistance are considered to involve significant judgment, appropriate information related to these judgments should be disclosed in the financial statements of the entity.

3.3 Macro-economic models

3.3.1 In G3/2020 the PA stated that banks should avoid procyclical assumptions in their IFRS 9 expected credit loss modelling during the period of the Covid-19 pandemic. The guidance given is not intended to contradict IFRS 9 which requires all reasonable and supportable information to be taken into account, including that which is forward-looking. However, it is possible that banks may encounter challenges in generating reasonable and supportable short-term economic forecasts. Greater weight may need to be placed on longer-term outlooks.

PO Box 8432 Pretoria 0001 · 370 Helen Joseph Street Pretoria 0002 · South Africa · Tel +27 12 313 3911 / 0861 12 7272 · Fax +27 12 313 3758 · www.resbank.co.za

When making forecasts, banks should consider the nature of the economic shock (i.e. whether the economic effects of Covid-19 are expected to be temporary) and the impact that economic support and relief measures are likely to have on credit risk over the expected life of the instruments, which includes, depending on the instruments' maturities, longer term estimates. In addition, it may be necessary for banks to assess the appropriateness of the probability weightings applied to each macroeconomic scenario.

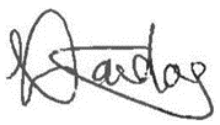
3.3.2 The PA is also mindful of the possibility that due to the nature of the crisis and the urgency with which banks may need to reassess expected credit loss models and produce revised estimates, there may be a need for post-model adjustments, or overlays, to expected credit losses in the interim period. The PA therefore wishes to emphasise the importance of careful consideration of these adjustments and that strict governance procedures are adhered to in order to ensure that these adjustments are based on reasonable and supportable information in line with IFRS 9 requirements. Banks must note the contents of paragraphs 50 and 51 of the BCBS's document entitled "Guidance on Credit Risk and Accounting for Expected Credit Losses", referenced in paragraph 3.1.3 above, in this regard. It should be noted, however, that these adjustments should not take priority over the appropriate assessment, staging and modelling of accounts where this is feasible.

4. Further action

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

5. 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 the PA at the earliest convenience of the aforementioned signatories.



Kuben Naidoo
Deputy Governor and CEO: Prudential Authority

Date: 29 May 2020

Encl. 1

The previous guidance note issued was Guidance Note 5/2020, dated 15 May 2020.