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3 April 2020
Mr Kuben Naidoo
Deputy Governor and CEO: Prudential Authority
South African Reserve Bank
Prudential Authority
370 Helen Joseph Street
Pretoria
0002

Attention: Ms Margaux Noble and Ms Zine Mshengu

Dear Mr Naidoo

Proposed directives on temporary measures related to restructured credit exposures and matters related to capital relief in light of Coronavirus (COVID19) pandemic

In response to your request for comments on the abovementioned directives which are in relation to relief measures as a result of the stresses brought about by the Covid-19 pandemic, the South African Institute of Chartered Accountants (SAICA) Banking Project Group ('BPG') has put together comments for your consideration in finalising the directives.

The BPG is a leading specialist forum for stakeholders in the areas that affect financial and regulatory reporting within the banking industry, with a view to making improvements in financial and regulatory reporting in South Africa, Africa and globally.

The banking sector remains committed to the ongoing provision of banking services to help our clients in these difficult times, but must balance these with our requirements to comply with existing and evolving banking regulations. We are required to maintain capital and liquidity requirements as well as effective and efficient payment and clearing services, whilst managing our business in an environment of revenue pressures, increased impairments and expectations in respect of the role we play in society.

We commend the Prudential Authority ('PA') for taking active and swift steps to address the accounting and regulatory implications and impacts as a result of the Covid-19 currently sweeping the globe. We believe these steps will help cushion some of the impact on the economy and South Africa's citizens resulting from the contraction in economic activity that has taken place during the last weeks, and which is likely to take place in the coming months. In response to the proposed directives and Guidance Note issued by the PA in response to Covid-19, please find included below the comments prepared by the BPG.

Please do not hesitate to contact us should you wish to discuss any of our comments.

Yours Sincerely

Bruce Thomas	Kedibone Pilusa
SAICA BPG Chairman	SAICA Project Director: MIB Technical

The BPG grouped responses to the proposed directives and guidance note issued by the PA based on the relevant proposed directives and guidance note received:

1. **Proposed Directive: Matters related to the treatment of restructured credit exposures due to the Coronavirus (Covid-19) pandemic:**

General considerations of the Directive:

-Effective date of the proposed directive:
The BPG requests that the proposed directive be instituted on a retrospective basis. To ensure consistency in application, the BPG requests that the PA consider indicating that pre-Covid-19 distress should be determined based on whether the loan was up to date at 29 February 2020, rather than at the point of restructure as currently indicated in paragraph 2.1.1 of the proposed directive. The BPG's reading of the current wording in the proposed directive is that it would only apply to borrower's who proactively ask for Covid-19 restructures/payment holidays prior to missing a payment. The BPG is of the view that where a client is not proactive in seeking relief, this should not preclude the bank from applying the proposed directive to those accounts which were up to date at 29 February 2020.

It would be helpful if the PA clarifies in the directive that while banks may use different dates to assess qualification for their relief programmes that this should not affect the relief provided in terms of the proposed directive.

- *Scope:*
The scope of the proposed directive applies to retail and small and medium sized enterprises - retail ('SME') customers; whilst these customers are likely to be most affected by the impact of the Covid-19 pandemic, the proposed scope may not encompass the interdependencies of the SA economy (e.g. individuals that are employed by the corporate and business banking sectors) should restructures occur in such sectors.

The BPG would recommend expanding the scope of the proposed directive to include credit exposures to both corporate and SME - corporate sectors. The BPG is concerned about the potential negative feedback loop that could occur in terms of corporate and business banking job losses where banks are unable to assist corporate and business banking clients because a Covid-19 restructure is viewed as a distressed restructure.

The BPG also noted that the last sentence in point 2.2 of the proposed directive states: *"*Therefore, restructures due to sustained financial distress beyond the crisis period and restructured loans to obligors other than retail (including SME retail) should still be regarded as distressed restructures and treated in terms of the requirements of D7/2015."

Notwithstanding our abovementioned recommendation and any associated specific dispensation granted by the PA, it is the BPG's view that all Covid-19 related wholesale restructures undertaken should continue to be assessed on a case by case basis to determine whether such restructures meet (or do not meet) the definition of a distressed restructure under paragraphs 2.4 – 2.7 of D7/2015, and thus are not automatically considered as restructures as result of 'financial distress'. The current wording in paragraph 2.2. of the proposed directive could be read to indicate that all non-retail (including all SME retail) restructures due to Covid-19 are automatically distressed restructures. The PA's clarification in this regard, would be helpful.

It would also be helpful if the PA clarify whether the proposed directive is intended to apply, to exposures to borrowers outside of South Africa, and for the purposes of the BA610, whether the proposed directive should be implemented for banking entities outside of South Africa.

- Timing for reinstatement of the full D7/2015 Directive requirements:
The BPG notes that the amendment will only be implemented over a specific time period due to the unique circumstances created by the pandemic. Specifically, it was noted that "it is the PA's intention to reinstate the requirements of D7/2015 in full after the impact of Covid-19 has subsided and economic conditions have normalised."

Where practically possible, it would be useful if the PA provides clarification or guidance on the basis for considering the timing of when the impact of Covid-19 has subsided and economic conditions have normalised, as this assist banks in modelling scenarios, and cash flow and capital assessments. If possible, clarity on the minimum time period would assist in providing a level of certainty for banks.

In addition, the BPG requests, that sufficient notice be provided to the banking industry as to the timing of D7/2015's reinstatement and the point at which the PA believes economic conditions have normalised. It is the BPG's suggestion that a period of no less than three months' notice be provided. It is the BPG's view that notice of the intention to reinstate D7/2015 should only occur once all government's emergency measures (such as the national lock down/social distancing/restriction on size of gatherings) have been lifted.

The BPG, in terms of transition, suggests two alternatives for the PA to consider:

1) D7/2015 to be applied prospectively to restructures that occur after the re-instatement date. Covid-19 restructures performed under the proposed directive continue to be treated in terms of the proposed directive, i.e. not classified as distressed restructures.
2) A grandfathering approach to appropriately phase out the application of the proposed directive. By way of an example, the PA should make consideration of the reinstatement in instances whereby a group had provided a qualifying client with a six month payment holiday and the PA had issued notice (three months suggested as above) of D7/2015 reinstatement one month into the six month payment holiday, the capital relief provided by the proposed directive will survive throughout the notice period and beyond the effective date of D7/2015 reinstatement.

- Classification as Covid-19 related restructures:
We understand that the test to consider whether a restructure is not a distressed restructure in terms of proposed directive is: 1) determining whether the restructure is a Covid-19 related restructure, 2) determining whether the customer's loan is currently up to date (the BPG would propose on 29 February 2020 as discussed earlier in this letter), and 3) determining whether the customer is expected to be up to date after the relief period (when economic conditions are normalised).

It is the BPG's view that in applying part 3 of the consideration above, the directive should rather state that the assessment process should determine who is not likely to not remain up-to-date after the relief period ends, rather than who is likely to remain up to date, as it is unlikely that banks will be able to reliably determine these accounts at inception of the relief.

The BPG also notes a potential disconnect in wording used in the Guidance Note for IFRS 9 as to when the "relief period ends" versus the proposed directive's requirement on "when economic conditions have normalised", which may be interpreted differently by different stakeholders and should be clarified.

- Calculation of minimum required capital and reserve funds under standardised and internal ratings-based approach:
The BPG noted that under both the standardised and internal ratings-based approaches, it seems that the PA assumed only two applicable scenarios: the risk-weighting and probability of default ('PD') determination under a pre- and post-Covid-19 restructure. The BPG believes, however, that an additional factor should be considered, which would incorporate the further deterioration in the financial condition of the counterparty post-Covid-19 restructure, as using the pre-restructure risk-weighting or PD may understate the risk at the point of such deterioration. For example, the PD may further deteriorate post the restructure based on circumstances that occurred during the relief period (e.g. reduction in income). It is therefore recommended that, in line with the guidance, that a restructured account should not reflect improved PDs, that similarly it would be reasonable to anticipate that where further evidence of deterioration is available, that the PD deterioration should be considered in the calculation.

The BPG believe that the proposed directive should also address the inter-relationship of a restructured credit exposure and the Liquidity Coverage Ratio (LCR). For instance, it would be helpful for the PA to detail in its proposed directive whether exposures that meet the 'restructured exposure' definition should be included or excluded from 'cash inflows' for the purposes of the LCR, assuming such an exposure remains 'performing' under the proposed directive. The basis for this query is that the inclusion of an asset (inflow) considered to meet the definition of a distressed restructure within the determination of the LCR implies that the cash flow profile associated with that asset remains unaltered, which may be contrary to the principle of a distressed restructure.

- Impact of general provisions on tier 2 qualifying capital and reserve funds criteria:
With regards to the PA's guidance on qualifying criteria for inclusion into tier 2 capital, it would be useful to obtain clarity on the reasoning to separate the base impairment from the Covid-19 impairment, as there is a general increase in client risk (PD), loss given default ('LGD') and exposure at default ('EAD'), which may be reflected either as a direct model impact or as an overlay.

In addition, the wording contemplated in the proposed directive could nullify banks' overall capital relief, as banks that are raising the "general provision" will not receive a benefit, but instead take the full increase in provisions through the income statement, which may result in Retained Earnings (i.e. CET 1) depletion. Even if additional add-back is allowed, the cap (0.6% of RWA) may be reached.

- General comment for noting by the PA:
The BPG will consider establishing additional working groups, e.g. modelling, accounting policy, audit and disclosure groups. The BPG has reconstituted the BPG modelling working group to discuss modelling approaches to the staging criteria for purposes of calculating expected credit losses due to Covid-19 related restructures, ensuring timely discussion, clarification and responses to amendments and to ensure consistency where possible.

2. Guidance Note: Matters relating to the application of International Financial Reporting Standard (IFRS) 9 in response to the Coronavirus pandemic (Covid-19):
While the BPG notes that the PA has indicated that the guidance note on IFRS 9 was not issued for comment, the BPG believes that the following items may require clarification or re-wording in the guidance note.

- *Macro-economic models:*

While the wording used by the PA is similar to that issued by other another global regulator (the European Central Bank (ECB)), the slight amendments to the wording create an impression that could be read as suggesting SA banks should not comply with the requirements of IFRS 9. The ECB built context into their statement on procyclical assumptions and it may be helpful for the PA to do the same in a guidance note to clarify this statement further and to align it with the requirements of IFRS 9.

The BPG suggests that the PA clarifies its Guidance Note as follows*: It is possible that entities will encounter challenges in generating reasonable and supportable short-term economic forecasts. Greater weight may need to be placed on longer-term outlooks. When making forecasts, entities should consider the nature of the economic shock (i.e. whether the effects of Covid-19 are expected to be temporary) and the impact that economic support and relief measures will have on credit risk over the expected life of the instruments, which includes, depending on the instruments' maturities, longer term estimates. In this way, excessive procyclicality can be avoided when modelling the impacts of Covid-19 in the determination of expected credit losses.*

- *Government and other assistance:*

The BPG is of the view that there may be instances where direct government support may be considered in determining the PD of an exposure or in considering whether a significant increase in credit risk (SICR) has occurred. As noted at the Impairment Transition Group meeting in April 2015, in line with the examples included in IFRS 9 paragraph B5.5.17, credit enhancements may be relevant to assessing changes in credit risk to the extent that it affects the likelihood of the borrower defaulting on the instrument. As a result, the BPG suggests that the PA clarifies its Guidance note as follows: *Where government and other assistance provided directly to borrowers to mitigate the adverse effects of Covid-19, these forms of assistance may be considered in the assessment of the SICR of the financial instrument where the assistance affects the likelihood of the borrower defaulting on the instrument. Where considerations relating to credit enhancements in the form of government and other assistance are considered to involve significant judgment, these judgments should be disclosed in the financial statements of the entity.*

- *Payment holidays and restructured credit exposures:*

The BPG notes that the PA's Guidance note mentions that an assessment of whether an account subject to relief should be moved to Stage 2 or 3 would be more reliable when made at an individual account level rather than at a portfolio level. The BPG, however, notes that other regulators globally, such as the European Banking Authority (EBA) and the European Securities and Markets Authority (ESMA), have issued guidance indicating that, should difficulties be encountered in identifying the Covid-19 effects at an instrument level, that the assessment of an account moving to Stage 2 or 3 should be performed at a portfolio level. This is in line with the requirements of IFRS 9 paragraph B 5.5.1. The BPG believes it would be helpful if the PA clarifies the wording in the guidance note.

The BPG suggests that the PA clarifies its Guidance Note as follows: *If entities encounter difficulties in identifying the effects of Covid-19 at an individual account level, it may be necessary to perform the assessment at a portfolio level.*

3. Proposed Directive: Matters related to temporary capital relief to alleviate risks posed by the Covid-19 pandemic:

- *General comments on the Directive*

The BPG notes the temporary relaxation of the Pillar 2A capital requirement per the directive. With the reduction of Pillar 2A capital requirement, the surplus capital of banks will increase at a point in time. It should, however, be noted that the reduction in the minimum required capital will result in less minority interest capital being able to qualify from subsidiaries of banks at a group level, in line with the calculations of Circular 7/2016. The BPG believe that further clarification from the PA in the proposed directive, in this regard, would be helpful.

The BPG also noted the PA's statement in the proposed directive that banks are not required to maintain capital to meet the counter-cyclical capital buffer (CCyB) requirement. The BPG would just like to note that while no CCyB requirement is imposed by South Africa currently, that many banks have exposures to counterparts in jurisdictions where such CCyB requirements have been imposed. The BPG, thus, suggests that the PA only refers to the fact that South Africa has not imposed any CCyB capital requirements, as it may create confusion as to whether no CCyB should be held at all.

- *Alternative proposal for capital relief to alleviate risks posed by the Covid-19 pandemic*

The BPG suggests that the PA considers whether old-style perpetual preference shares, currently subject to phase-out, could be considered as additional Tier 1 capital, on a temporary basis.