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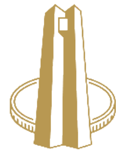

SOUTH AFRICAN RESERVE BANK
Prudential Authority

Ref.: 15/8/1/3

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

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

Prudential treatment of distressed restructured credit exposures

Executive summary

Effective credit risk management must have, as one key element, systems and processes that enable banks, controlling companies and branches of foreign institutions (hereinafter collectively referred to as 'banks') to continuously assess, monitor and manage credit assets quality. Related to this, banks must be consistent and have credible categorisation schemes that allow the distinction of credit exposures based on differences in credit quality. This in turn requires precise and consistent definitions of the various asset quality metrics.

In this regard, the Prudential Authority (PA) has a responsibility of ensuring that banks have effective systems and processes in place to identify, monitor and manage any deterioration in credit quality of their credit exposures. This also includes a responsibility of ensuring that the identification and reporting of the credit quality of credit exposures in the statutory returns is done consistently across all banks.

Distressed restructured credit exposures is one such category which the PA uses to monitor the quality of credit exposures on which banks grant various concessions to counterparties experiencing financial difficulties.

Regulation 67 of the Regulations relating to Banks (Regulations) prescribes a prudential treatment of distressed restructured exposures for banks using the internal ratings-based (IRB) approach to calculate their risk weighted assets (RWA) and required capital and reserve funds for credit risk. This definition has been a source of diverse and inconsistent interpretation amongst banks, with undesirable consequences for the default datasets used in the development of credit risk models used under the IRB approach.

The purpose of this proposed directive is to specify minimum requirements relating to the definition and reporting of distressed restructured credit exposures. It also clarifies the interpretation of regulation 67 of the Regulations which is aligned to International Financial Reporting Standards (IFRS).

Unless specifically stated otherwise, the requirements of this proposed directive apply to all banks using the standardised (STA) and IRB approaches to calculate their minimum required capital and reserve funds for credit risk.

This proposed directive is intended to replace Directive 7 of 2015 (dated 12 May 2015)

1. Introduction

1.1. Regulation 67 of the Regulations defines a restructure as a credit exposure in respect of which the bank grants a concession owing to a deterioration in the obligor's financial condition[1].

1.2. Therefore, the act of restructuring a credit exposure is essentially a deviation from the original terms and conditions agreed between the bank and its client. This deviation mostly takes the form of concessions on the original loan agreement, and includes, but are not limited to, the following:

1.2.1. extending the term of the loan;

1.2.2. rescheduling the dates of principal and interest payments;

1.2.3. payment holidays, including the postponement of principal, interest or fee amounts;

1.2.4. easing of covenants of the agreement;

1.2.5. offering a revised interest rate that is lower than the effective interest rate the bank will offer to a counterparty with similar risk characteristics; and

1.2.6. changing an amortising loan to an interest payment only loan.

1.3. A key distinguishing characteristic of distressed restructuring as referred to in the Regulations, in contrast to any other form of restructuring or what banks often refer to as business-as-usual (BAU) restructures, is the underlying reason for the restructure.

1.4. As the definition of default states, in regulation 67 of the Regulations, a distressed restructured credit exposure refers to an exposure that is restructured due to evidence pointing to financial distress of the counterparty, which distress is likely to prevent the counterparty from continuing to honour their debt obligations in line with the original terms and conditions of the loan agreement.

1.5. The financial distress may be temporary, in which case the bank may offer temporary concessions, but may also be permanent, in which case the bank may offer permanent concessions.

1.6. Importantly, distress restructuring is about avoiding loss. In other words, banks grant concessions in order to maximise their chances of recovering all that is due under the loan agreement, in view of the changed financial circumstances of the counterparty.

1.7. Regulation 67 of the Regulations prescribes a prudential treatment of distressed restructured exposures for banks using the IRB approach to calculate their RWA

[1] Throughout this proposed Directive, a distinction is made between distressed restructured, as defined in regulation 67 of the Regulations, and what is referred to as business-as-usual restructures (BAU). Therefore, unless specifically stated otherwise, restructures will mean all restructures, including distressed and BAU restructures.

and required capital and reserve funds for credit risk. In relevant parts, regulation 67 of the Regulations specifies that all distressed restructured credit exposures that are “likely” to result in reduced financial obligations must be classified in default.

1.7.1. The word likely in this case is instructive, partly because the inability to honour debt obligations may not have yet materialised, at least in an objective sense. For instance, a counterparty could still be up to date with their loan repayments, and still performing in line with the terms and conditions of the loan agreement. However, immediate changes in financial circumstances may create financial distress, with the inability to honour debt obligations then only manifesting objectively in future.

1.8. The PA observed inconsistent approaches used by banks to identify and report distressed restructured credit exposures. The PA also observed different influences and reliance on IFRS 9 in the interpretation and implementation of the reduced financial obligation requirement. These inconsistencies are reflected in the quarterly form BA 210, with some banks reporting all their restructured credit exposures and others only their distressed restructured credit exposures.

1.9. The interpretation of the reduced financial obligation requirement has also been a source of diverse and inconsistent interpretation amongst banks using the IRB approach.

1.10. Accordingly, this proposed directive is intended to address inconsistencies identified in the identification, treatment and reporting of distressed restructured credit exposures by:

1.10.1. firstly prescribing a minimum set of indicators of financial distress which banks must use when identifying and classifying credit exposures as distressed restructured credit exposures;

1.10.2. prescribing an appropriate interpretation of regulation 67 of the Regulations (i.e. default treatment), and specifically the reduced financial obligation requirement, for banks using the IRB approach; and

1.10.3. providing clarity on reporting requirements for the completion of the quarterly form BA210.

1.11. Unless specifically stated otherwise, the requirements of this proposed directive apply to all banks using the standardised (STA) and IRB approaches to calculate their minimum required capital and reserve funds for credit risk.

2. Proposed Directive

2.1. In accordance with the provisions of section 6(6) of the Banks Act, 1990 (Act No.94 1990-Banks Act), banks are hereby directed as follows:

2.2. A bank must put in place the relevant policies outlining criteria for identifying and reporting distressed restructured credit exposures, in line with the provisions of this proposed directive. These policies must also outline the relevant approval process and appropriate delegated authority for approving any distressed restructures.

2.3. The senior management of the bank, through relevant internal committees, must exercise an oversight responsibility on the overall management of distressed credit exposures and all relevant practices used by the bank to assist counterparties who are experiencing financial distress.

2.4. The bank must also put in place a monitoring mechanism to continuously monitor the volumes and values of distressed restructured credit exposures, the migration of exposures across the various performance categories, for example the reclassification of a restructured loan from distressed to performing.

2.5. It is also the ultimate responsibility of the board of directors of the bank to ensure compliance with the requirements of this proposed directive and other relevant internal policies relating to the identification, treatment, classification and reporting of distressed restructured credit exposures.

2.6. In some cases, distressed restructured credit exposures may be initiated at the request of the counterparty, and in others, they may result from the initiative of the bank in its efforts to assist counterparties that may be experiencing financial distress.

2.6.1. In both cases, the distressed restructured credit exposure must be supported by an assessment of the counterparty's current financial position and affordability considerations under the revised terms and conditions. This assessment must in turn be supported by objective and credible documentation of the counterparty's financial status, overall current debt obligations and how this is likely to impact the counterparty's performance under the revised terms and conditions of the distressed restructured credit exposure.

2.7. Importantly, a bank must not restructure any credit exposures with the intention of obscuring a deterioration in the credit quality of a counterparty.

2.8. Indicators of financial distress

2.8.1. To decide if a restructured credit exposure must be classified as a distressed restructured credit exposure, a bank must determine whether the credit exposure is being restructured due to the financial distress of the counterparty.

2.8.2. Financial distress in this regard, must be identified at a credit exposure level, at which the bank grants the concession. To that end, banks' internal systems must be sufficiently granular to enable the identification and flagging of financially distressed counterparties.

2.8.3. In general, indicators of financial distress will include, but are not limited to:

2.8.3.1. a credit exposure that is in arrears[2] (excluding technical arrears[3]) at the time of the restructure;

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[2] 'In arrears' for the purpose of this proposed Directive will mean a payment or portion of a payment that is one day past due in terms of the contractual due date.

[3] 'Technical arrears' for the purpose of this proposed Directive will mean any account that is classified as being 'in arrears' for technical reasons such as operational errors or the bank's information technology system not updating the relevant information on time.

2.8.3.2. a credit exposure that is in arrears at any point during the past six months prior to the restructure;

2.8.3.3. a credit exposure that is not in arears at the time of the restructure, but it is probable that the counterparty will be past due in the foreseeable future if the bank does not grant a concession;

2.8.3.4. a restructure of a counterparty's debt obligations on account of changed financial circumstances, which cause the bank to offer revised terms and conditions which the bank will ordinarily not grant to a counterparty of similar risk characteristics; and

2.8.3.5. the counterparty cannot obtain an effective interest rate at least equal to the current market interest rate for similar loans to a counterparty that is not experiencing financial distress.

2.8.4. In addition to the indicators listed in paragraph 2.8.3., banks must also consider other indicators that are specific to retail and wholesale[4] exposures. These indicators include, but are not limited to:

Wholesale credit exposures

2.8.4.1. counterparty voluntarily applies for, or is subject to, liquidation;

2.8.4.2. counterparty voluntarily enters, applies for, business rescue as provided for under the Companies Act, 2008 (Act No. 71 of 2008);

2.8.4.3. a counterparty's listed shares have been delisted, or are in the process of being delisted, or are under threat of being delisted from an exchange due to non-compliance with the listing requirements or for financial or other reasons;

2.8.4.4. on the basis of actual performance, estimates and projections that encompass the counterparty's current capabilities, the bank forecasts that all the counterparty's committed/available cash flows will be insufficient to service all of its loans or debt obligations in accordance with the contractual terms of the existing agreement for the foreseeable future. These estimates may be based on analysis of the counterparty's financial statement and other qualitative metrics, including but not limited to its leverage, debt to earnings, liquidity, and loan-to-value (LTV) ratios; and

2.8.4.5. a bank must also consider other complementary qualitative and quantitative indicators that may indicate financial distress, including significant losses over sustained periods, sustained losses in market share and competitive position, and management instabilities.

Retail credit exposures

2.8.4.6. counterparty applies for debt counselling as provided for under the National Credit Act, 2005 (Act No. 34 of 2005);

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[4] Wholesale credit exposures covers credit exposures classified in the following regulatory asset classes: corporates (including specialised lending and SME corporates), public sector entities, local government, sovereign (including central government and central bank), banks and securities firms.

2.8.4.7. on the basis of actual performance, estimates and projections that encompass the counterparty's current capabilities, the bank forecasts that all the counterparty's committed/available cash flows will be insufficient to service all of its loans or debt obligations in accordance with the contractual terms of the existing agreement for the foreseeable future. These may be based on the counterparty's debt-to-income, debt service coverage, LTV ratios, credit scores, and credit bureau information; and

2.8.4.8. the bank reduces the counterparty's limit on its revolving facility below its current limit and/or outstanding balance. This will exclude cases where the counterparty requests a reduction in the limit to the current outstanding balance.

Exclusions

2.8.5. The PA acknowledges that not all restructures that banks perform should be regarded as distressed restructures.

2.8.6. Accordingly, banks' internal policies must make a clear demarcation between BAU restructures and distressed restructures. These policies must be applied consistently over time and across all credit exposures.

2.8.7. Unless the loan is in arrears, the following will not be regarded as distressed restructuring:

2.8.7.1. changes in payment frequency, date, or reduction of term with a commensurate increase in the agreed instalment;

2.8.7.2. revisions to terms and conditions based on changes in a counterparty's business activities, the industry in which it conducts business or the nature of its revenues. These changes must not be due to financial distress, but a reflection of changes in the counterparty's business conditions which give rise to different banking needs, for example, changes in revenue streams of a counterparty which may necessitate a change in the payment schedules of its loans from monthly to quarterly; and

2.8.7.3. a bank offers a counterparty revised and relatively more favourable terms and conditions, for instance for competitive reasons. In other words, to prevent a counterparty from migrating to competitors. Importantly, these revisions must be in line with the concession the bank ordinarily grants to counterparties of similar risk characteristics as part of its BAU activities.

2.8.8. Where a bank is applying a blanket approach by, for example, classifying all or portions of restructured exposures as distressed restructured credit exposures, this must be well documented in its credit or impairment policies and reporting in the form BA 210 must be in line with this internal blanket approach. The PA must be notified in writing where a bank chooses to apply this approach.

2.9. **Criteria for the restructured exposure to exit the distressed restructure categorisation**

2.9.1. A bank must not reclassify a distressed restructured credit exposure as performing until it meets the following exit criteria:

2.9.1.1. all payments, as per the revised contractual terms, have been made in a timely manner over a continuous repayment period of not less than 12 months (probation period). The starting period of the probation period must be the scheduled start of the payments under the revised terms. Importantly, in no case may a distressed restructured credit exposure be reclassified as performing within 12 months after the restructure;

2.9.1.2. when the terms and conditions of a distressed restructured credit exposure are revised during the probation period, this must trigger a restart of the probation period; and

2.9.1.3. the bank must establish, and be able to demonstrate to the satisfaction of the PA, that the counterparty has resolved its financial difficulties and that the revised terms and conditions will result in the amortisation of the credit exposure over the revised and remaining term of the loan.

2.9.2. In most cases, the requirement in paragraph 2.9.1.1. above will equate to 12 full consecutive monthly payments, or fewer payments for exposures with remaining terms shorter than 12 months, under the revised terms and conditions during the probation period. However, in cases where a counterparty misses any of the monthly instalments or only partially pays, but subsequently makes additional payments to catch up, such that the counterparty is fully up to date at the end of the probation period, then the bank may still reclassify the credit exposure to performing, subject to satisfying the requirement specified in paragraph 2.9.1.3.

2.9.2.1. In the case of wholesale counterparties with payment schedules other than monthly, the reclassification of distressed credit exposures as performing must be subsequent to an evaluation and approval by the bank's relevant credit committee. This evaluation must consider all relevant qualitative and quantitative factors to assess compliance with the revised terms and conditions of all the counterparty's credit obligations.

2.10. **Derecognition of distressed restructured credit exposures and significant increase in credit risk**

2.10.1. Distressed restructured credit exposures may result in revisions to the terms and conditions of the loan agreement. Most often, the net effect of the distressed restructure will be the renegotiation and modification of the contractual cashflows.

2.10.2. In respect of distressed restructured credit exposures, banks must comply with the requirements of IFRS 9 which deals with the modification of contractual cash flows.

2.10.3. In addition, financial distress is an indication of a deterioration in the counterparty's credit risk quality. Accordingly, subsequent to performing/conducting the distressed restructure, the bank must assess the credit exposure for a significant increase in credit risk (SICR) in line with the requirements of IFRS 9.

2.10.4. However, a bank's impairment policy may trigger the movement of a distressed restructured credit exposures to either stage 2 or stage 3 under IFRS 9, regardless of the outcome of the SICR assessment. This approach will not be regarded as inconsistent with the provisions of this proposed directive.

2.11. Definition of default under the IRB approach

2.11.1. Regulation 67 of the Regulations in relevant parts defines default to include all credit exposures on which the bank consents to a distressed restructuring, which is likely to result in a reduced financial obligation, caused by example, the postponement of principal, interest or fees.

2.11.2. Reduced financial obligation in this case must be interpreted to refer to instances where the distressed restructure results, or is likely to result, in a loss for the bank over the revised terms and conditions of the credit exposure. In other words, if the revised terms and conditions result in the bank not recovering the total amount due, both interest and capital amounts, under the original agreement, then the bank must classify the loan as being in default.

2.11.3. The following are some of the factors for a distressed restructure that is likely to result in a loss for the bank (and must be classified as being in default):

2.11.3.1. the distressed restructure reduces the instalment without an extension of the term;

2.11.3.2. the reduction in the interest rate charged; and

2.11.3.3. the bank forgives a part of the credit obligation.

2.11.4. In cases where the revised terms and conditions result in a renegotiation or otherwise modification of the contractual cashflows, and such renegotiation or modification result in the recognitions of a *modification loss*, as defined in IFRS 9, then such a distressed restructured credit exposures must be classified in default.

2.11.5. Unless compelling evidence suggest a different classification, if a bank performs a distressed restructure whilst the credit exposure is still in its probation period, then such a credit exposure must immediately be classified as being in default. The PA may grant deviations from this requirement, if a bank demonstrates to the satisfaction of the PA that a deviation from the requirements is justified for certain exposures.

2.11.6. To reiterate, a bank must not perform restructures to obscure a deterioration of credit quality of their counterparties. Therefore, in cases where the bank performs at least two restructures, for the same counterparty, within a 24-month period, then the bank must classify the credit exposure as being in default.

2.11.7. A bank must put in place stringent internal measures to prevent the misuse of restructure practices to obscure a deterioration of counterparties' credit quality.

2.11.8. Where a distressed restructure results from a bank granting a concession that it would otherwise not grant to counterparties with similar risk characteristics, then such a distressed restructured credit exposure must be classified as being in default.

2.12. Formalisation of the restructured loan agreement

2.12.1. Paragraph (b)(iv) of the definition of a restructured credit exposure in regulation 67 of the Regulations states that the restructuring agreement must be in writing. For the purpose of this proposed directive, “in writing” shall include:

2.12.1.1. paper-based or electronic documentation of the revised terms and conditions, signed physically or electronically by both parties;

2.12.1.2. verbally agreed changes to the original terms and conditions, which are digitally recorded; and

2.12.1.3. electronic communication of the revised terms and conditions to the counterparty (for example by electronic mail or short message service).

2.12.2. It is essential that the legal position of the bank is protected when the terms and conditions of an agreement are revised. It follows that where there is uncertainty regarding the legal enforceability of a particular method of communication, the bank should obtain legal opinion to that effect.

2.12.3. When a bank decides not to formalise the revised terms and conditions in writing as specified by this proposed directive, footnote 1 to lines 22 to 42 (for banks using the STA approach) and lines 257 to 284 (for using the IRB approach) of the form BA 210 states that the relevant credit exposure shall be regarded as credit-impaired.

2.13. Reporting requirements

Standardised Approach

2.13.1. For banks using the STA approach, distressed restructured credit exposures across the various asset classes must be reported to the PA quarterly in line items 22 to 42 and columns 1 to 3 of the form BA 210.

2.13.2. Column 3 of line items 22 to 42 of the form BA 210 also requires banks using the STA approach to report the value of their distressed credit exposures as a percentage of their credit exposure.

2.13.3. As a minimum, distressed restructured credit exposures must be classified as sub-standard for the purposes of regulation 24(5)(c) of the Regulations.

IRB approach

2.13.4. Banks using the IRB approach must report their distressed restructured credit exposures quarterly in line items 257 to 284 and columns 1 to 3 of the form BA 210.

3. Invitation for comment

3.1. All interested persons are hereby invited to submit their comments on the proposed directive, to SARB-PA@resbank.co.za and RSD-CreditRisk@resbank.co.za, for the attention of Ms Nobuzwe Mafanya and Mr Makgale Molepo, by no later than 27 November 2023.

Fundi Tshazibana
Chief Executive Officer

Date: