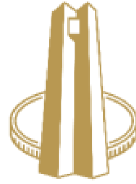

SOUTH AFRICAN RESERVE BANK
Prudential Authority

Revisions to Directive 7 of 2015: Summary of comments and way forward

1. Introduction

1.1. The Prudential Authority (PA) published a discussion paper during February 2023, with the title "Proposed revisions to *D7 of 2015*", to consult banks and other interested parties on proposed revisions to Directive 7 of 2015 (D7/2015).

1.2. D7/2015 was initially published to address inconsistencies amongst banks in the identification, prudential treatment, and reporting of distressed restructured credit risk exposures.

1.3. Since then, the following developments motivated the PA's decision to publish the paper and by so doing, initiate much needed revisions:

1.3.1. Firstly, the introduction of International Financial Reporting Standards (IFRS) 9 brought significant changes to how banks make provisions for loan losses by introducing a forward-looking expected credit loss approach. In contrast, D7/2015 still relies on the old accounting standards, International Accounting Standard (IAS) 39. The paper was intended to solicit views from banks and interested parties on how and to what extent the directive should be revised to align to IFRS 9.

1.3.2. Secondly, the Basel Committee on Banking Supervision (BCBS) also issued a guideline on the prudential treatment of problem assets (BCBS guideline), which outlined various principles on the treatment of problem loans. Again, the paper solicited comments from banks and interested parties on the guidelines,

and views on which parts of the guidelines the PA should include in the revised directive.

1.3.3. Thirdly, to a large extent, D7/2015 served the PA and industry well in terms of prescribing reasonably consistent indicators of financial distress and its implications in the context of the definition of default as prescribed in regulation 67 of the Regulations relating to banks (Regulations). However, analysis of the regulatory data over the years revealed that some inconsistencies persist.

1.3.3.1. For instance, some banks follow blanket approaches for retail portfolios, by classifying all distressed restructures in default and case-by-case approaches for wholesale portfolios[1]. Others follow a nuanced approach, with clear distinctions between business as usual (BAU) and distressed restructures. The net effect of this diversity is obvious from the BA 210 data, where the volumes and value of restructures differ widely in line with these different approaches.

1.3.3.2. The reference to IAS 39 in D7/2015 certainly complicated matters. The introduction of IFRS 9 meant that banks had to amend their provisioning polices to align the IFRS 9 requirements, whilst still having to comply with the spirit of the D7/2015 requirements which still referred to an old accounting standard.

1.3.4. For the reason listed in paragraphs 1.3.3.1 and 1.3.3.2 above, the paper consulted industry on refined and additional indicators of financial distress, as well as guidance on the application of regulation 67 of the Regulations in alignment with IFRS 9. In this regard, engagements with banks and other parties in 2022 highlighted areas in D7/2015 that will benefit from new and additional requirements as well as precision on some of the existing requirements. The paper outlined proposals to refine some of the requirements.

1.4. The proposals were organised around 26 questions, broadly covering four topics:

[1] Some comments requested a definition of wholesale: This is aligned to the BA regulatory forms, where wholesale refers to exposures to Corporate, Specialised lending, Local government, Public Sector Entities, Banks Sovereigns

1.4.1. Definition of distressed restructured credit exposures, where three options proposing definitions\indicators of financial distress were presented. In many respects, these options covered what are already practices in some banks, with additional indicators taken from the BCBS guidelines. There were also differences in levels of complexity underpinning the approaches, where the PA has attempted, to varying degrees, to balance "risk sensitivity" and consistency imperatives.

1.4.2. Curing/Rehabilitation rules, where the requirements for reclassifying loans from distress to performing were presented. The PA relied largely on the BCBS guidelines and practices of regulators in other countries. The paper consulted on the duration of the probation period, proposing to it change from the current 6 to 12 months.

1.4.3. Classification in default (regulation 67 of the Regulations) where principles on the interpretation of regulation 67 of the Regulations, and specifically the criteria for classifying some distressed restructured credit exposures in default, were presented.

1.4.4. Reporting requirements and proposed revisions to the BA 210.

1.5. The questions were guided by the principle of "consulting hard and changing later". In other words, gathering as many views on as many relevant topics as possible, and there after narrowing the scope of the proposed directive to a set of only material issues.

1.6. It is not practical for the final directive to address all the issues raised by industry, let alone those identified during the consultation phase on D7/2015 revisions in 2022. It is also not possible to design a directive that will find agreement with all parties.

1.7. Moreover, the final directive can do no more than outline minimum requirements. That in effect means that the PA expects banks to impose additional requirements and principles where business dynamics, business

models and nature of clients warrant it. Therefore, some inconsistencies will remain given the different bank-specific practices that may be above the minimum requirements outlined in the proposed directive.

1.8. Therefore, some inconsistencies are arguably not necessarily undesirable, and others are unavoidable. For example, cases where banks impose stringent requirements beyond what is prescribed in the directive will not necessarily be undesirable. The different measures banks introduce to assist counterparties in financial distress will differ, and arguably, the population of counterparties that ultimately end up in default will differ depending on the success of these measures and the capabilities within each bank to implement and manage the measures. These inconsistencies arising from these approaches are, in many respects, unavoidable.

1.9. Therefore, whilst there is merit in accepting these inconsistencies as a necessary feature of the industry, hence cannot be eliminated, the differences in practices and their implication on the prudential objective of achieving consistency, is a concern best left for the PA's supervisory efforts rather than a Tier 3 instrument. The PA will follow a continuous iterative feedback loop approach of revising the directive to incorporate experiences gathered from its ongoing supervisory activities.

1.10. It is worth acknowledging that, loan restructuring is not a necessary evil, but rather an effort by banks to assist their clients in financial distress. When properly executed it can undoubtedly yield beneficial outcomes for individual banks, their clients, the whole industry, and the wider economy even. This proposed directive is accordingly intended to balance these benefits against the financial stability imperatives of:

1.10.1. ensuring that these loans are properly identified, prudentially managed;

1.10.2. banks hold sufficient required capital and reserve funds commensurate with the risk these loans pose; and

1.10.3. more importantly, that these loans are reported to the PA consistently and in line with the Regulations.

1.11. The PA acknowledges the implications of changing the definition of default materially, as highlighted by some comments. Data systems may require reconfiguration to align current and historical data series to the possibly amended definition of default. In turn, this will mean redeveloping many credit risk models, used both for the calculation of capital and reserve funds and other internal risk management functions. This will likely take years, requiring a dedication of significant financial and human resources. Therefore, the PA accepts the need to balance the much-needed revisions to D7/2015 against the implementation costs and benefits of the process.

1.12. By the closing date of 21 April 2023, the PA received comments from 26 banks, thematic comments from the Banking Association South Africa, as well as an accounting firm. The following salient issues emerged:

1.12.1. There are certainly proposals which, judging from the comments, are non-starters, with the blanket approaches on the identification of distressed restructured credit exposures and classification in default eliciting the majority of objections. Whilst these are already practices in some banks, especially for the retail portfolios, the comments expressed a preference to leave this as a discretion to banks as opposed to making it a directive.

1.12.2. There were notable differences between the banks using the standardised (STA) and internal ratings-based (IRB) approaches in the comments. The blanket approaches may have simplicity benefits, which some comments acknowledged may be practical for smaller banks and less material portfolios. It was nonetheless reasoned that in cases where banks have capabilities to follow more nuanced approaches, the blanket approaches do not offer a risk sensitive treatment of distressed loans.

1.12.3. Views on the proposed exit criteria from the restructure probation period were mixed. Mostly IRB banks raised concerns, even during the consultation in 2022,

on the 6 consecutive payments requirements. They mentioned that this criterion may not be feasible even for loans with monthly repayment schedules and loans with short terms. The comments requested the PA to consider the inclusion of some flexibilities, to enable the consideration of a wider set of factors when deciding to reclassify loans into performing at the end of the probation period.

1.12.4. Although, there was general support for including the BCBS guidelines, some comments requested the PA to include additional guidance on some of the guidelines. There were concerns with the requirements that rely on projections, with the comments mentioning the different banks-specific practices that are likely to create inconsistencies.

1.12.5. The paper touched on derecognition and loan modification issues, although did not include specific proposals and questions on revisions to section 4 of D7/2015 in this respect. However, a consistent comment across the other proposals was for the PA to align the directive, as much as possible, to the requirements in IFRS 9.

1.12.6. The rest of the paper summarised the comments to the specific proposals and these comments shaped the proposed directive. The proposed directive is attached herewith as Annexure A.

2. Definition of distressed restructured credit exposures and indicators of financial distress (Questions 1-14)

2.1. This section proposed various options for inclusion in the revised directive to identify distressed restructured credit exposures and the supporting indicators of financial distress. In this regard, the PA proposed three options for consideration:

2.1.1. The first option was the simplest, the PA proposed to direct banks to classify all their restructured credit exposures as distressed restructured credit exposures.

2.1.2. The second option was a variant of the first option in which the PA proposed a slightly narrower blanket approach, in which the PA will direct banks to classify all retail restructures as distressed restructured exposure; and for wholesale portfolios, the third option (refer paragraph 2.1.3 below). The PA proposed to align the indicators in this third option to paragraph 39 of the BCBS guidelines. As part of this third option, the PA further proposed to include a discretion that would allow banks to deviate from the blanket approach for certain retail portfolios, with banks first obtaining prior written approval from the PA, based on proper motivation.

2.1.3. In the third option, the PA proposed to incorporate the principles of financial distress/difficulty elaborated in section 2 of D7/2015, into the directive. The PA proposed that these principles be in line with paragraph 39 of the BCBS guidelines, with the proposal that these principles apply to both retail and wholesale portfolios.

2.2. Comments were generally not in support of the first and second options. The reasons for the objections were mostly as a result of the undue simplicity the fact that the options areas were not sufficiently nuanced for application to the spectrum of lending activities banks undertake. The comments mentioned that, not all modifications of the terms and conditions of a transaction are due to a client being in financial distress. The comments also indicated that the options are likely to create an even bigger misalignment between the regulatory and IFRS 9 requirements. Finally, comments mentioned the potential unintended and negative consequences on the credit bureaus profiles of clients that fall within the National Credit Act (NCA) when classifying BAU restructures as distressed.

2.3. The PA also requested banks and interested parties to give their views on the potential impact of the first and second options on internal policies and processes. The comments acknowledged the simplicity and potential consistency advantages likely to be achieved by the options. The comments also mentioned that the options will allow previous data to be easily restated, arguably resulting in a more conservative classification of restructures which

may turn out to be fortuitous in periods of economic stress. However, the comments cautioned that these options will likely result in incorrect classification of what are effectively performing loans as being distressed, and by so doing negate the real purpose of the directive, which is to identify credit exposures that are restructured on account of financial distress.

2.3.1. The comments mentioned other internal policy related consequences of the first and second options. These include the following:

2.3.1.1. internal policies and processes, aligned to cater for assessment of "financial difficulty", that would require significant changes. A great deal of effort to unpack this principle of distressed restructures as opposed to restructures in the ordinary course had been expended.

2.3.1.2. reporting systems would also require significant changes to be made with these options. Banks considered this as undesirable given the time and efforts banks have already expended and investment to implement more nuance approaches that are aligned to business experiences, IFRS 9 and the D7/2015. The comments mentioned that the benefits of making these significant changes were not clearly articulated in the paper.

2.3.1.3. banks will require additional processes to track IFRS 9 and distressed restructures divergence. Similarly, the additional cost implications versus the benefits were not clear from the paper.

2.3.2. The comments concluded by cautioning that to classify all restructures as distressed restructures will unnecessarily overstate risk on BAU restructures and would be inappropriately detrimental to the business of banks.

2.3.3. There was a unanimous agreement to the PA's proposal to the third option and specifically the proposal to align the financial distress indicators with the BCBS guidelines on forborne exposures in paragraph 39. However, it was recommended that the PA contextualise, rather than simply referencing the

BCBS guidelines, the indicators to a South African context to ensure correct interpretation and application.

2.3.4. The comments also requested further guidance on the practical effect of some principles. For instance, how banks must determine the probability that a client will be past due or how to "*forecasts that all the counterparty's committed/available cash flows will be insufficient to service all of its loans or debts*".

2.3.5. Comments also raised a concern of the potential cost implications of these requirements, due the fact that banks may have to source credit bureau information to support their implementation.

2.4. There were exceptions to the overall preferences. For instance, one IRB bank supported the second option. This support was however subject to a caveat that the PA include the proposed discretion to allow the application of blanket approach to some portfolios based on justifiable reasons. This flexibility, it was reasoned, will allow for simpler approaches to less material and low value exposures.

2.5. Whilst the STA banks were also generally in favour of third option, one STA bank preferred the first option on account that this was their current option.

2.6. Banks and other interested parties were also asked whether and to what extent any of the options strike a balance between consistency and simplicity imperatives, and whether they thought that the proposed definitions will address inconsistencies outlined in the discussion paper.

2.6.1. In line with the support for the third option, the responses explained that it is not critical for the definition of distressed restructured credit exposures to address all indicators of financial distress although, there was general agreement that the most common indicators are covered. The respondents nonetheless suggested the PA to consider the following issues:

2.6.1.1. There was a recommendation that the categories of distressed restructures and default be kept mutually exclusive so that the revised directive provide the clearest distinction between those counterparties in financial distress and those in default.

2.6.1.2. Although the second option addresses the industry inconsistencies outlined in the paper, the PA was requested to consider the staging in IFRS 9.

2.6.1.3. There was a proposal that the directive should be aligned to the treatment in regulation 67 of the Regulations and D7/2015 for retail exposures to focus on facility levels arrears assessments. Some comments also suggested some wording in this regard.

2.6.1.4. The comments reiterated the importance of precisely defining the key concepts. These include concepts of "financial difficulty", "concession", "temporary restructure", "reduced financial obligation" and "performing vs non-performing".

2.7. Banks and other interested parties were also asked for their views on the proposed retail and wholesale indicators of financial distress i.e., are they sufficient, are they precise, amenable to consistent implementation, and if there are any additional indicators and requirements the PA should consider for inclusion in the revised directive.

2.7.1. Most respondents agreed that the indicators are reasonable, with others citing that they require expansion. One bank expressed a view that it might be useful to expand the requirements around revolving products to include indicators such as when a client exceed its limit, but to exclude cases where a limit is reduced at the request of the client or as part of normal limit management to improve profitability.

2.7.2. Regarding counterparties being past due at any time during the last six months prior to the restructure event, one bank recommends that the extent of the days past due be defined.

2.7.3. Banks further indicated that what is viewed as a BAU restructure will vary between institutions and that further consideration may be given to the scale of the modification as a backstop for classifying some BAU restructures as distressed.

2.8. The BCBS guideline only refers to material exposures, whereas the PA is proposing any exposure. The discussion paper sought views on whether the revised directive should only consider material exposures.

2.8.1. There was no consensus among the comments, with some in favour for the consideration of only material exposures, while others were in favour of all exposures regardless of materiality.

2.8.2. The banks not in support of the proposals mentioned that their current processes considered all regardless of the materiality of the exposures. Nonetheless, these respondents did not express any strong objections should the PA decide to include a materiality threshold, and they mentioned that the incorporation of this threshold will present administrative, systems or process difficulties.

2.8.3. Those banks in support commented that, from a bank perspective, a materiality threshold would help the management of compliance, but from a risk and industry risk perspective, it may possibly result in some distressed portfolios not being identified and classified appropriately. In addition, the cumulative impact of multiple small exposures could result in a material exposure not being appropriately classified.

2.8.4. Some respondents requested the PA to prescribe the materiality thresholds, with a few instead preferring the PA to leave this to banks' discretion. The respondents that were in support of a prescribed threshold suggesting a deference to IFRS 9 on modifications in this regard. Others, suggested a value-adjusted approach, given the size and nature of each bank. It was also proposed that the materiality thresholds, or the calculation of such thresholds, be prescribed separately for retail and wholesale exposures. Other comments

suggested that this threshold be specified in both relative and/or absolute terms consistent with the approach of European Central Bank.

2.9. Banks and interested parties were asked for their views on the proposal for sperate treatments of temporary vs. permanent financial distress and the proposed classification thereof.

2.9.1. A majority of the comments were in support of the proposal. These respondents however, requested the inclusion of guidance on maximum time-period for measures to be in place to qualify as temporary, with one proposal in this regard proposing any measures in place for less than one year. The minority of comments not in support indicated that the proposal would lead to further inconsistencies, with the benefits of the additional complexities not articulated in the paper. These respondents reasoned that the proposal seems to be influenced by the approach taken in Directive 3 of 2020 which addressed the temporary relief measures during Covid-19. Their view in this regard was that this was a tail event that did not warrant inclusion in the revised directive. Others mentioned that temporary and permanent distress will in any event still be classified as distressed restructured credit exposures, and hence with no consequent effect on regulatory reporting.

2.10. In terms of distinguishing distressed vs BAU restructures, the PA stated in the paper that it did not consider it critical at this stage to prescribe any distinction. The PA nonetheless welcome views in this regard. A total of 10 responses agreed that there was no need for further requirements. Those in support of the inclusion of the distinction, mentioned that practices amongst banks are currently inconsistent and therefore the directive could go some way in addressing this.

3. Exit criteria from the probation period (Questions 15 -17)

3.1. The proposals were structured around 3 questions to elicit views on 3 elements: 1) the proposed exit criteria from the probation period and extending the probation period to 12 months, as proposed in section 7 of the discussion paper

2) the proposal to only consider the arrears status at the end of the probation period for reclassification, and 3) any additional factors and/or requirements the PA needs to consider.

3.2. For the first element, relating to the length of the probation period, there were 16 responses, with 11 banks in agreement with the proposals, although some respondents suggested slight modifications. Another 5 respondents either preferred the 6 months consecutive payments, and others a shorter period to the proposed 12-month probation period in the BCBS guidelines.

3.2.1. The respondents who objected to the 12-months period mentioned that this was not appropriate for short term loans and exposures without contractually scheduled repayments, while some pointed to internal policies that already include the 6-month period. The 6 months was still considered conservative by these banks.

3.2.2. The PA proposed, as an alternative to the consecutive payments, exit requirements that consider various factors at the end of the probation period, which banks must use to assess whether a counterparty may be reclassified to performing. Whilst the majority of comments supported this proposal, there were however concerns raised with the inconsistency implications and practicality of some of the metrics to be used for the assessment. It was accordingly proposed that the PA does not include references to improvement in debt metrics and internal risk ratings to determine whether financial difficulty has been resolved as this will create incomparable data across the industry. It was also mentioned that these metrics will be difficult to apply retrospectively for modelling and monitoring purposes.

3.3. There were also proposals to prescribe certain requirement precisely to eliminate ambiguities. For instance, while some respondents preferred the starting point or commencement of the 6-month probation period to be the date of implementation or effective date of the distressed restructure, others suggested the starting period to be “scheduled start of payments under the revised terms and conditions”, as for many wholesale clients the actual payment

of interest and/or capital may only commence at the latter date. Therefore, precisely stating when the probation period must start will ensure consistent implementation through the 12 months period.

3.3.1. There was a further recommendation of additional criteria that will allow banks to move counterparties between Stage 3 and Stage 2, for instance, at least 6 months into the probation period and thereafter using the last 6 months for monitoring prior to upgrade into Stage 1. It was indicated that the net effect of this approach is that the counterparty will remain in the probation period for 12 months but monitored in line with the staging process in IFRS 9.

3.4. For the second element, there were 16 respondents, with 11 in agreement with the proposal to only consider the arrears status at the end of the probation period. However, 5 preferred a different approach.

3.4.1. Respondents in favour of the consecutive payments mentioned that the arrears assessment has some practical difficulties. For instance, during the probation period, a counterparty can miss instalments for several months and 'catch up' by the end of the term. If the consecutive payments requirement is applied, such a counterparty will remain in distress in perpetuity. Some respondents mentioned that there may very well be plausible reasons for delayed payments, such as delays in property proceeds as a result of rates clearances. The need for enablement for practical flexibility was emphasised.

3.4.2. Some respondents also mentioned ambiguities in how the discussion paper articulated some of the proposals. For instance, one part of the paper state … "…*Accordingly, assuming that the restructured loan can move across arrears bucket during the probation period, banks may use arrears status of the counterparty at the end of the period to decide on the reclassification*…"

3.4.2.1. The respondents stated that this paragraph seems to imply that the client can move out of the probation period with missed payments. This is in contradiction with an earlier part of the paragraph which reads in relevant parts "…*the*

proposal…potentially retains these loans in the probation period (distressed restructured loans) perpetually".

3.4.3. Moreover, the discussion paper states that "*The PA's view, and thus its proposals, on restructuring during the probation period, is that this must trigger an automatic classification into default.*" The respondents believe this can be read to infer that a restructuring within a probation period should result in a classified in default, meanwhile if the client is in a probation period, then they would already be classified as a distressed restructured exposures and as such classified in default. Therefore, if the PA's proposal, that a restructure during the probation period should trigger default classification, is adopted the exposure would anyway be classified in default. However, if the PA's proposals are not adopted, then a second restructuring during the probation period may need to give banks the option of differentiation based on the reasons for the second restructure rather than a blanket approach. The respondents mentioned that there may be a valid non-distress reasons for requesting a second extension/restructure during the probation, and therefore the proposal may be punitive for such exposures.

3.5. In terms of the third element, the discussion paper requested additional factors the PA should consider when finalising the directive. There were 16 responses, and many of the factors banks proposed are considered in responses to the above questions. In addition, there was a proposal for the PA to clarify what arrears status is acceptable at the end of the probation period. The respondents also proposed that the PA include the type of measures that can be used to assess recovery from financial difficulties.

4. Classification of distressed restructured credit exposures in the context of regulation 67 of the Regulations (Questions 18-26)

4.1. This section outlined the PA's proposals on the treatment of distressed restructured loans in the context of regulation 67 of the Regulations. In other words, the circumstances under which a distressed restructured loan will qualify for classification in default in terms of regulation 67 of the Regulations. In

particular, the discussion paper proposed the interpretation of the "reduced financial obligation" requirement and a proposed links to IFRS 9.

4.2. The discussion paper proposed three options, with one split into two sub-options. These options were informed largely by approaches observed by the PA amongst the various IRB banks. The options also took different approaches in terms of balancing simplicity, consistency and "risk sensitivity".

4.3. The first option was the simplest, with the PA proposing to direct banks that all distressed restructured credit exposures be classified in default. Responses in this regard were overwhelmingly against the proposed blanket approach, with reasons ranging from over broadness, which will likely result in all restructures, including BAU restructures classified in default, to the disconnect between regulatory and IFRS 9 data likely to result from this approach. Some banks further argued that this will unduly increase default populations with undesirable consequences for credit risk model estimates, risk weighted assets and internal risk management.

4.4. The second option proposed to direct banks to classify only retail distressed restructured credit exposures in default, with wholesale exposure following a proposed case-by-case approach mostly in line with the BCBS guidelines. Responses in this regard were also opposed to the option. Consistent with the objections to the first option many banks are of the view that this will be punitive especially for banks with capabilities to follow more nuanced approaches even for retail portfolios.

4.5. Option 2 proposed to classify all credit-impaired distressed restructured credit exposures in default. In terms of IFRS 9, this means all distressed restructures classified in stage 3. In addition, the PA proposed to include additional requirements and guidance for banks to assess exposures classified in stage 1 and stage 2 for possible classification in default. As an alternative, the PA proposed that instead of classification in default, the BA 210 amendment will define a category "likely to default". In this category, banks will report distressed

restructured credit exposures which, based on historical experience and projections, banks will expect to default.

4.6. These additional proposals were based on the PA's view that, whilst stage 3 distressed restructured credit exposures must be classified in default as a minimum, IRB banks should in addition perform further assessment to determine whether some stage 1 and stage 2 exposures should not be classified in default as well.

4.7. Comments in this regard were mixed, with some banks objecting to the proposals. However, the proposal was supported with some caveats, with some comments for instance supporting on condition that the PA issue clear additional guidance on the additional assessment.

5. PA general responses

5.1. The following responses do not address each and every objection raised to the proposals, but merely makes high level comments.

5.1.1. In terms of the definition of financial distress, the proposed directive makes efforts to include guidance on the practical effect of some of the requirements.

5.1.2. Although the majority of respondents supported the distinction between distress and BAU restructures, the reasons advanced by the respondents opposed to the inclusions were compelling. Therefore, the proposed directive includes a few exclusions that are intended to cover BAU restructures. The PA will welcome additional suggestions to include here.

5.1.3. Flexibilities with regards to the exit criteria is included, although the PA will closely monitor any potential inconsistencies and if warranted, reduce the flexibilities after implementation. The PA acknowledges the need for flexibilities, but is at the same time concerned by the potential misuse that may result in a "proverbial kick of the default can" down the road. Too many flexibilities runs

the risk of rendering the complementary unlikeliness to pay indicators in regulation 67 of the Regulations of limited practical relevance.

5.1.4. Therefore, some stringency is critical to ensure that where a reclassification into default during or at the end of the probation period is warranted, banks systems and process are appropriately configured to trigger such a classification.

5.1.5. The PA will adopt the 12-month probation period. The reasons for adopting the 12 months must be viewed against the imperative of aligning with international prudential standards and approaches of other jurisdictions.

5.1.6. In terms of the classification of distressed restructured credit exposures in default and the three proposals, the PA takes note of the objections. Moreover, the PA acknowledged from the onset that the obvious limitation of the blanket approaches is the likely classification of BAU restructures into default, which is certainly not the intention. The blanket approaches, admittedly, also overemphasised potential consistency benefits against alternative, viable and legitimately "risk sensitive" approaches that may be closely aligned to business and experiences.

5.2. However, the PA also mentioned in the discussion paper that this potential BAU restructures default classification will depend on the definition of restructures that a bank follows. In other words, a stringent definition of restructures may result in a small population of restructured exposures, in which case an incremental benefit of making a distinction between BAU and distress restructures may not exist. Such a bank may in turn choose to classify all restructures as distressed and in default. In fact, the PA observed this practice in some banks for their retail loans. This will contrast with a bank that may implement a nuanced definition of restructures as well as distinction between BAU and distress restructures, in which case classifying all restructures in default will admittedly result in unduly punitive default outcomes. It is nonetheless the PA's view that the blanket approaches are a viable alternative for smaller banks and immaterial exposures, given the simplicity benefits.

Accordingly, adopting these blanket approaches will not be inconsistent with the spirit of the proposed directive.

5.3. Lastly, the PA is busy with the revisions to the regulatory reporting forms to align with the Basel III reforms. Therefore, the reporting requirements for both STA and IRB banks will remain unchanged until the finalisation of the revisions to the BA 210.