SOUTH AFRICAN RESERVE BANK
Prudential Authority

Summary of comments:

Proposed directive on the prudential treatment of distressed restructured credit exposures

1. Introduction

1.1. The Prudential Authority (PA) published a proposed directive in October 2023 to consult banks and other interested parties on the prudential treatment of distressed restructured credit exposures. This proposed directive is intended to replace the current Directive 7 of 2015 (D7/2015).

1.2. In total, the PA received 98 comments from banks, submitted both individually and through the Banking Association South Africa (BASA), accounting firms and other interested parties.

1.3. Most of the comments focused on the sections detailing the indicators of financial distress (section 2.8) and the criteria for classifying certain distressed restructured credit exposures in default, in line with regulation 67 of the Regulations relating to Banks (Regulations) (section 2.11). The exit criteria from the probation period received relatively favourable responses (section 2.9), albeit with recommendations to word (or reword) certain requirements precisely, clarify others or remove some altogether.

1.4. The sections on the formalisation of the restructured loan agreement reporting requirements did not change materially compared to D7/2015. As a result, only two comments were received for section 2.13.

1.5. The PA also issued the proposed directive to consult banks and other interested parties on the completion of the regulatory return relating to credit risk (form BA 210 return). The proposed directive focused on the section of the BA 210 return relating to the collection of data on distressed restructures, which was amended to allow the collection of granular data. The development costs of these proposed revisions came under criticism, with some comments reasoning that these costs are not in line with the simplicity objectives of the revisions to D7/2015 that were articulated by the PA in the 2023 discussion paper titled 'Annexure A_Restructuring D7 of 2015_Proposals on the treatment of distress restructures'.

1.6. Banks raised various concerns about the proposed directive, but also made recommendations on changes.

1.7. Notably, some comments expressed the view that the proposed directive misinterprets the definition of default in regulation 67 of the Regulations, which could possibly result in a more punitive treatment than intended by the Regulations. In addition, some comments indicated that the proposed directive did not sufficiently articulate any meaningful links between the regulatory and accounting treatments of distressed restructure and classification in default.

1.8. The distinction, or the lack thereof, between business as usual (BAU) and distressed restructure was also criticised. Some comments argued that the Regulations are not very clear on the distinction between the two terms and, by implication, the proposed directive did not provide meaningful guidance either. In many respects, some comments acknowledged that this distinction is fraught with various challenges, partly due to the current and diverse banking practices. The underlying thread of the comments revealed an understandable desire for the final directive not to veer significantly from current industry practices. However, the question remains: is there an appropriate balance that the directive must strike between bank-specific nuances and the diverse internal practices, versus an industry-wide directive that is motivated by consistency imperatives? The comments did not offer much clarity on this point.

1.9. Given that some of the requirements are new, some banks requested guidance on the retrospective application of the final directive, particularly in relation to the

requisite restatement/reconfiguration of historical datasets that may be required to align with the revised definition of default. It was mentioned that this will have a significant impact on datasets used for the internal ratings-based (IRB) approach. Apart from data revision, credit risk models used for the IRB approach will be required to align with the new definition. Related to this is the potentially significant number of model applications that will require the PA's prior written approval.

1.10. The PA' remains concerned that there is alarmingly insufficient consensus regarding the meaning of "*consented to a distressed restructuring,…which restructuring is likely to result in a reduced financial obligation"* as outlined in regulation 67 of the Regulations. There is also lack of consensus on how this reduction in financial obligation should be linked to International Financial Reporting Standard (IFRS) 9.

1.11. Nonetheless, the overall view was that the link between regulation 67 of the Regulations and IFRS 9 treatments were not articulated very well in the proposed directive, with the concern that this will result in inconsistent classifications among IRB banks. For instance, while there was support for only classifying stage 3 accounts in default, the PA's proposed wider scope was criticised, with many comments regarded it as imprecise.

1.12. There was strong objection on the proposed treatment of overdraft facilities. Some comments were rather direct, stating that "the proposals should be removed from the directive completely". However, this was a request from industry, and therefore the implication of this recommended removal was not clear from the comments. Moreover, none of the comments indicated whether the PA should abandon efforts to include requirements on overdraft facilities or still consider the inclusion of alternative requirements. Some views in this regard would be helpful.

1.13. Given the comments received and the lack of consensus on key requirements in the proposed directive, the PA will issue a revised proposal for a second round of consultation. The revised directive will aim to (i) improve the links between the indicators of financial distress and the definition of default in regulation 67 of the Regulations; (ii) incorporate additional and hopefully clearer exit criteria from the

distressed restructure category; and (iii) align the reporting requirements with the revised BA 210 return.

1.14. Some banks raised concerns about the revisions to the BA 210 return, mainly due to the development cost of the new forms. The other concern related to the complexity and lack of precision of some of the data fields. One comment recommended that the section on distressed restructures be removed from the BA 210 return and be reported separately, since it is not related to the rest of the return. It was queried why the revisions to the BA 210 return were not consistent with the PA's initial intended objective of simplifying the requirements and treatment of distressed restructures.

1.15. There were, however, no suggestions on how the BA 210 return could be revised to simplify the reporting requirements. The PA would welcome suggestions in this regard. In the interim, columns 3, 6, 8 and 10 for both the STA and IRB sections of the BA 210 return, which collect data on distressed restructured credit exposures, will be greyed out.

1.16. The rest of the document summarises the comments on the various sections of the proposed directive. It then concludes with the PA's proposed edits to the proposed directive and the way forward.

2. Summary of comments

2.1. The structure of the summary is aligned to the different sections in the proposed directive.

2.2. Introduction to the directive

2.2.1. The comments recommended that the definition of distressed restructures be revised to exclude some BAU restructures. For instance, in terms of paragraph 1.2.1 of the proposed directive, specifically the wording "…*extending the term of the loan*…", other comments argued that a bullet payment restructure, which includes refinancing, would be regarded as a distressed restructure, although this may not

always necessarily be the case. On this point, the comments recommended that the refinancing of bullet payments be excluded from the definition of restructure to avoid interpretation inconsistencies.

2.2.2. Further, paragraph 1.2.4 of the proposed directive refers to the easing of covenants on the agreement as another indicator. It was, however, recommended that this be limited only to default covenants, since covenants and related breaches come in various forms. It was argued that some covenants, such as pricing covenants, are ordinarily not concessions that make it easier for clients to meet their contractual agreements.

2.3. Paragraph 1.5 of the proposed directive states that financial distress may be temporary or permanent. In this regard, some comments requested clarity on whether the proposed directive envisions different treatments for temporary or permanent distress. Assuming the proposed directive envisions a different treatment, it was recommended that this be articulated precisely.

2.4. **Policies, systems, processes and board responsibilities**

2.4.1. There were concerns about the generic phrasing of paragraph 2.4 of the proposed directive. It was highlighted that the meaning of "*various performance categories" and "performing*" is unclear and may lead to inconsistent interpretations across banks. It was stated that the use of the word 'performance' has the potential to create confusion, as it may imply a cure event from regulatory default. In this regard, it was proposed that the word 'performing' be replaced with 'rehabilitated' or 'no longer a distressed restructure'.

2.4.2. Paragraph 2.5 of the proposed directive, which places the ultimate responsibility on the board of directors (board) to ensure compliance with the requirements of the directive, was interpreted by some comments to require the board's involvement in the day-to-day operations of the bank, which was viewed as impractical. A proposal was made to replace 'Board of Directors' with 'Executive Management' so that

banks can, as they already do, leverage existing delegation structures. Other comments recommended that the paragraph in its entirety be removed.

2.4.3. It was recommended that paragraph 2.6.1 of the proposed directive, which refers to distressed restructures, be reworded to include all restructures. The argument in support of this rewording is that it is only after the assessment of financial distress that a bank can determine whether a restructure is a 'BAU restructure' or a distressed restructure.

2.5. **Indicators of financial distress**

2.5.1. A significant number of comments in this section were clarification requests, and effectively request that the directive be more precise on certain requirements or provide clarity on what certain requirements mean. The feasibility of implementing some of the indicators, from a system and credit risk models standpoint, also featured in the comments. For some indicators, the comments expressed reservations on their practicality.

2.5.2. In other cases, comments mentioned that counterparties exhibiting some of the indicators will not, as a matter of good business practice, be restructured. For instance, it was mentioned that banks will not ordinarily restructure a counterparty in liquidation.

2.5.3. The proposed directive directs that the assessment of financial distress be performed at a counterparty and/or exposure level. In this regard, comments raised a concern about the exclusion of an exposure materiality threshold. Some banks argued that including a threshold would reduce the risk of misclassifying distressed restructures, particularly in cases where counterparties have small individual exposures that could potentially be significant when combined.

2.5.4. Views were, however, split on the trade-offs between consistency and the benefit of prescribing a single threshold, versus the 'risk sensitivity' utility of leaving it to the discretion of each bank. In other words, if the proposed directive were to propose a

single materiality threshold, this may not be suitable for all banks versus leaving the threshold determination to each bank.

2.5.5. Views were, however, split on whether the threshold should be prescribed or left to the discretion of each bank. Views were also split on how this threshold should be specified, with some banks proposing a flat, absolute and relative figure and other banks proposing a value-adjusted figure.

2.5.6. There was also a suggestion for the final directive to make a distinction between wholesale counterparties – where financial distress assessments and restructures are performed at a counterparty level – and retail counterparties – where the assessments and restructures are performed at a facility level.

2.5.7. Concerns were also raised with the practicality of the forward-looking indicators. Some comments suggested that either the PA remove these indicators from the final directive or phrase them in more general principle terms, but with guidance on how these must be implemented.

2.5.8. The proposed directive refers to *"revised terms and conditions"* a few times, and some comments argue that the meaning is not always clear or consistent. Related to this, there was also a request to elaborate on the meaning of the wording "*terms and conditions, the bank may not otherwise grant*…".

2.6. **Exclusions**

2.6.1. The PA was requested to clarify whether the statement in paragraph 2.8.7.1 "…*commensurate increase*…" implies keeping the net present value (NPV) unchanged. Furthermore, it was recommended to move paragraph 2.8.7.1 to 2.8.8, which would result in the current 2.8.8 being renumbered as 2.8.9 and the current directive of 2.8.7.1 being independent of the arrears statement.

2.6.2. Moreover, some comments recommended that the sections which require banks to put in place policies and processes make a distinction between BAU and distress

restructures, and referencing the examples of this distinction in paragraph 2.8.6 may be beneficial. It was also recommended that the directive be explicit in that the distinction excludes counterparties that have triggered any of the associated financial distress indicators/considerations.

2.6.3. It was also mentioned that the implementation of this BAU and distress restructure distinction will present some challenges, especially for modelling under the IRB approach. It was requested that the PA include guidance on the implementation, especially on the older data periods ~2008 that maybe require reconfiguration to align with the new financial distress restructures.

2.7. **Exit from distressed restructure categorisation**

2.7.1. It was recommended that the header for this section be changed to 'Criteria for accounts classified as default, because of distressed restructure with reduced financial obligation, to return to performing'. It was argued that this interpretation will capture the essence that the majority of references in the proposed directive relate to distressed restructures, and at least make the distinction that this section relates to distressed restructures that are ultimately classified in default.

2.7.2. Moreover, some banks read the heading and the body of the section to suggests that all distressed restructures will be classified in default. However, this will be inconsistent with other sections of the directive that seem to suggest only some distressed restructured credit exposures will be classified in default.

2.7.3. The comments also proposed the replacement of the word 'performing' in paragraph 2.9.1 with 'rehabilitated' or 'no longer a distressed restructure', considering that 'performing' in the paragraph implies that all distressed restructures should be classified as in default which would be in contradiction with the requirements of other sections of the proposed directive.

2.7.4. It was also recommended that for paragraph 2.9.1.1, which prescribes requirements for restructured credit exposures with non-monthly payment schedules, the prescribed starting point of the 12-month probation period be the date of

implementation of the restructured loan agreement or the effective date of the distressed restructure, as opposed to the scheduled start of the payments under the revised terms. The view in this regard is that the current wording penalises non-monthly payments. For example, for credit exposures with yearly payment schedules, the first payment may only be in a year's time, which will imply a probation period of 24 months, especially when considering the wording "*continuous repayment period of not less than 12 months*".

2.7.5. Accordingly, the recommended rewording of the first part of 2.9.1.1 is "*all payments (allowing for technical arrears), as per the revised contractual terms, have been made in a timely manner over a continuous repayment period of not less than 12 months*".

2.7.6. There were not many objections to the length of the probation period, although one comment was supportive of a probation period of 12 months for retail exposures and a probation period of six months for wholesale exposures. It was reasoned that distress restructuring for wholesale exposure is a mandated committee assessment process which is often done after six months.

2.7.7. Overall, the comments objected to the proposed indicators for revolving facilities, with some banks proposing that they be removed altogether from the directive. It was argued, for instance, that limit changes are not always indications of financial distress, and therefore to use limit changes as an indicator will result in a misclassification of the significant number of revolving facilities in both retail and wholesale asset classes.

2.7.8. There was criticism of 2.9.1.3, especially the wording "…*the revised terms and conditions will result in the amortisation of the credit exposure*…". It was mentioned in this regard that not all loans are intended to amortise. Development loans to corporates was provided as an example, where the intention is for the loans to convert to a full loan once the projects have been completed.

2.7.9. Clarity was also requested on the treatment of restructured credit exposures that are not up to date at the end of the probation period.

2.10. Derecognition of distressed restructured credit exposures and SCIR test

2.10.1. Several comments raised concerns with the derecognition of the distressed restructured requirement in paragraph 2.10.3. These comments suggested that it may be helpful to explicitly state that a distressed restructure would, at a minimum, be expected to trigger a significant increase in credit risk (SICR) and would therefore be expected to be classified in Stage 2. It was argued that, as currently worded, the paragraph could be read to mean that financial distress should automatically trigger a SICR test under IFRS 9, or in other cases to mean a change in staging. Furthermore, there is a view that 2.10.3 suggests that default definitions can differ between capital models and IFRS 9 models.

2.10.2. Clarification was sought on the intention of paragraph 2.10.4. It was inquired whether the intention was to provide the banks with flexibility in terms of the staging of an exposure once a distressed restructure has been implemented, assuming one of the defaulting events in another paragraph is not met.

2.11. Definition of default under the IRB approach

2.11.1. It is certainly not the intention of the proposed directive to classify all distressed restructured credit exposures in default; however, that seems to have been the reading of some commentors. However, the feedback in this regard is that this intention is not articulated clearly in the proposed directive. In fact, some comments mentioned that various sections in the proposed directive are not only contradictory (e.g. 1.7.1. and 2.9.1) but also generally ambiguous.

2.11.2. Some comments mentioned that the treatment is not aligned with IFRS 9 and highlighted that this was the PA's stated intention in the 2023 discussion paper. In that paper, the PA stated its intention to align, as far as possible, a consistency between the regulatory and accounting approaches regarding the classification of distressed restructures in default as required by regulation 67

of the Regulations. However, it is worth noting that this will not be possible in all respects and therefore some divergences are unavoidable.

2.11.3. Other comments mentioned the impact of a retrospective implementation of some of the criteria on default datasets, and the knock-on effect on all credit risk models used for the IRB approach.

2.11.4. It was also requested to prescribe different criteria for retail and wholesale loans given the different approaches banks follow when assessing exposures for classification or exit from default, and how this translates to the staging under IFRS 9.

2.11.5. Comments also requested the PA to consider including some criteria for counterparties that cure while classified in default (e.g. whether the probation period and the default criteria will apply to these counterparties as well).

2.11.6. In some cases, comments agreed with some of the criteria but recommended explicit exclusions. For example, in terms of the monitoring period prescribed in paragraph 2.11.6, term extensions were recommended as one exclusion.

2.12. Formalisation of the restructured loan agreement

2.12.1. There were only two clarification-related comments for this section. The one comment requested clarity on whether the formalisation process relates only to distressed or to all restructured credit exposures. The other comment requested clarity on what was deemed as an ambiguity in paragraph 2.12 regarding the enforceability of agreements in cases where these are imposed by the bank.

3. Conclusion and way forward

3.1. After incorporating the suggested changes and addressing the concerns in the comments received from the first round of consultations, the PA will issue the proposed directive for a second round of consultations. The following are the key changes:

3.1.1. The revised articulation of the links between the definition of distressed restructure and the default definition of regulation 67 of the Regulations as well as the reduced financial obligation requirement is noted. It is the PA's view that emphasising references to the BAU versus distressed restructure demarcation, beyond what is already included in the first draft of the proposed directive, could overly complicate the proposed directive even more. Accordingly, the PA included a narrow list of exclusions and examples, which are intended to create the starting point for defining the demarcation. It remains the responsibility of each bank to clearly articulate the demarcation in line with the specific requirements and the overall intent of the proposed directive and its internal risk management practices. Nonetheless, the PA will still welcome views on further additional indicators to further clarify the demarcation.

3.1.2. It is also not the intention of the proposed directive to prescribe the accounting treatment of distressed restructured credit exposures. This is now stated more explicitly in the revised proposed directive. In cases where the proposed directive refers to IFRS 9, the intention is for banks to rely on their impairment policies and methodologies put in place to give effect to the requirements outlined in the proposed directive.

3.1.3. Another issue that is not intended by the proposed directive is that not all restructures must be classified in default. This too is now mentioned explicitly in the proposed directive, given that some comments suggested there was confusion in how the various sections articulated this issue. However, there are some exceptions, namely for retail exposures and restructured distressed credit exposures that are not rehabilitated at the end of the probation period.

3.1.4. The concern around the complexity and development costs of the proposed revisions to the BA 210 are noted. In this regard, the PA is proposing to grey out certain columns in the BA 210 section on distressed restructured credit exposures.

3.1.5. After much consideration, the PA has decided not to include any materiality thresholds in the proposed directive, despite requests from some banks for their

inclusion. While the PA accepts that the inclusion of material thresholds has some merits, there are, however, countervailing factors that gave the PA cause for pause:

3.1.5.1. The PA could not agree on the structure of and the methodology for determining these thresholds, nor on whether they should be prescribed across the industry or tailored for each bank. The risk of determining these thresholds arbitrarily carries significant risk in the flagging as well as appropriate treatment and reporting of distressed restructured credit exposures.

3.1.5.2. Moreover, South Africa's retail portfolio is significantly different from that of some of the countries that prescribe these thresholds. Therefore, relying on these jurisdictions to determine the thresholds for the South African market also carries with it many unknown risks. For instance, thresholds that are too high run the risk of excluding too many small retail loans that cumulatively can add up to a significant portion of a bank's retail portfolios, but still be excluded from the scope of the directive.

3.1.5.3. The potential impact of including these thresholds is also not clear at this stage. However, the PA is not ruling out the possibility of including the thresholds in future revisions of the directive. It is a topic that still requires further discussions and consideration with the industry.