

IFRS 9 will become effective on 1 January 2018 and represents a fundamental change in the impairment of financial instruments. This will have a significant impact on how banks are required to calculate provisions for credit losses (impairments). The South African Reserve Bank (SARB) issued Directive 5 as a transitional arrangement and to provide clarity to banks in South Africa on how to categorise expected credit loss provisions. The transitional arrangement only applies to new provisions that did not exist prior to the adoption of the expected credit loss model.

## **Categorisation of provisions**

As banks transition from the previous “incurred loss approach” in terms of IAS 39 to the “expected credit loss” (ECL) model in terms of IFRS 9, banks must still distinguish which portions must be regarded as “general provisions” and those regarded as “specific provisions”. The accounting provisions should be categorised as follows:

- Provisions with no significant increase in credit risk since initial recognition as at reporting date (Stage 1 exposures as per IFRS 9) = General provisions
- Provisions with no significant increase in credit risk since initial recognition as at reporting date but which are credit-impaired (Stage 2 exposures as per IFRS 9) = General provisions
- Provisions that are credit-impaired as at reporting date (Stage 3 exposures as per IFRS 9) = Specific provisions

## **Transitional arrangements**

The transitional arrangements are as follows:

- Banks can apply a transition period by sending a notification to SARB before adopting IFRS 9.
- Banks must apply a 3-year transition period, amortised on a straight-line basis, on a bank legal entity and a bank controlling company (consolidated basis).
- A once-off calculation needs to be done as follows:
  - A comparison of the common equity tier1 (CET1) capital (which is based on the opening balance sheet by using IFRS 9) with the CET1 capital (which is based on the closing balance sheet by using IAS 39 ie 1 day prior to opening day).
  - The above calculation is made to isolate the impact of using the ECL model in terms of IFRS 9.
  - The decrease in the net qualifying CET1 (reflected as pre- and post-implementation) shall be phased in over a 3-year period (*line item 64 of the form BA700*).
  - The impact must be reflected net of the tax effect and all deductions such as shortfalls of eligible provisions compared to expected loss and threshold deductions.
  - No separate adjustments shall be made in respect of banks showing changes to shortfalls of eligible provisions compared to expected loss (*since this impact would already be included in line item 64 of the form BA700*).
  - The IFRS 9 transitional adjustment amount (as explained above) must be shown as follows for each year of the transitional period (*as per line item 204, column 1 of the BA700 form and line item 12 of the BA600 form*):

|               |                                 |
|---------------|---------------------------------|
| <b>Year 1</b> | <b>3/4 of adjustment amount</b> |
| <b>Year 2</b> | <b>2/4 of adjustment amount</b> |
| <b>Year 3</b> | <b>1/4 of adjustment amount</b> |

- The additional amount of special provisions (not phased in yet) shall be risk-weighted at a risk weight of 100% (*this must be included in line item 5, column 1 of the BA700 form*) post the adoption of IFRS 9. This amount shall be decreased annually on a straight-line basis over a 3-year period.
  - The impact of deferred tax assets as a result of the adoption of IFRS 9 and changes to taxation rules must be phased-in over a 3-year period.
  - Banks must calculate the difference between deferred tax assets arising from temporary differences, based on opening balance sheet by using IFRS 9, and closing balance under IAS 39 (ie one day prior to the opening day).
  - A portion of the deferred tax difference (which must be calculated as per the table above) shall be deducted (*line item 110 of form BA700*) from the deferred tax amount arising from temporary differences, net of deferred tax liabilities.
  - Banks using the SA to measure credit risk shall, on a static basis, calculate the difference between the combined stages 1 & 2 provisions (based on opening balance using IFRS 9 and closing balance of general provisions under IAS 39). The increase in general provisions as a result of IFRS 9 must be phased-in over 3 years using the table above. During the transitional period a portion of the increase in line with the table must be deducted from total general provisions before applying the limit of 1.25% of credit risk-weighted assets.
  - Banks using the internal ratings-based (IRB) approach to measure credit risk must phase in all the new excess provisions exceeding expected losses amounts over the 3-year transitional period using the table above. A portion of the excess amount (in line with the table) must be deducted from total eligible provisions before determine the maximum amount that can be added to Tier 2 capital (0.6% of credit risk-weighted assets).
- Banks must prepare a set of special purpose financial information within the first 5 months of implementing IFRS 9 for the 1<sup>st</sup> time, demonstrating the impact of IFRS 9 on opening retained earnings of the first year. This must include a reconciliation from the previously audited retained earnings (before IFRS 9) to the retained earnings balance at that date as adjusted for the IFRS 9 impact.
  - The information must contain a basis of preparation note setting out all the accounting policies relevant to the calculation of the IFRS 9 retained earnings adjustment, and other relevant notes as necessary.
  - The special purpose financial information must be audited within the first 5 months in accordance with ISA 805.