South African Reserve Bank

**Opening remarks by Francois Groepe,
Deputy Governor of the South African Reserve Bank,
at the workshop on the impact of IFRS 9 on banks and regulators in Africa,
jointly hosted by the Working Group on Cross-border Banking Supervision
and the South African Reserve Bank**

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Introduction

Good morning, distinguished guests, ladies and gentlemen.

It gives me great pleasure to warmly welcome you to this workshop on the impact of International Financial Reporting Standard (IFRS) 9 on banks and regulators in Africa, which the South African Reserve Bank (SARB) is hosting jointly with the Working Group on Cross-Border Banking Supervision.

I would like to thank the Association of African Central Banks and, in particular, the Working Group on Cross-Border Supervision of the Committee of African Banking Supervisors for being present here today. We are indeed privileged to host fellow central bankers and regulators from across the African continent to discuss matters relating to the implementation of IFRS 9. The SARB truly values the cooperation with its peers from the continent and opportunities like this allow us to nurture networks and build relationships, share experiences and learnings, and contribute towards improving the overall quality of our continent's prudential supervision of the financial sector.

Financial reporting

It is believed that Luca Pacioli, a Franciscan monk known as the father of accounting, was the first to codify the double-entry system of bookkeeping in his mathematical textbook titled *Summa de arithmetica, geometria proportioni et proportionalita* which was published in Venice in 1494. The celebrated German writer Johann Wolfgang von Goethe sang the praises of this system and described it as the finest invention of the human mind as it allowed the merchant to survey the whole of his business activities at any time; he even suggested that 'every prudent master of a house should introduce it into his economy'.

As any system, however, this system also has its challenges and shortcomings, and the renowned investor Warren Buffet warns that financial accounting is an imperfect language and that to understand accounting one needs to understand its nuances. Buffet further warns that, 'in the long run, management's stressing of accounting appearance over economic substance usually achieves little of either'. It is therefore critical that, to extract the most from the system of financial accounting, one is mindful of the inherent shortcomings of the system.

In order to address some of the challenges in this area, much progress has been made towards the ideal of developing a set of high-quality international accounting standards that are widely used. In this regard, international standard-setting bodies, such as the International Financial Reporting Standards Foundation, play a vital role in working towards this goal. This Foundation has as its mission the development of standards that bring transparency, accountability, and efficiency to financial markets around the world and serving the public interest by fostering trust, growth, and long-term financial stability in the global economy. The International Accounting Standards Board (IASB), an independent private sector body which was established in 2001 and operates under the oversight of the International Reporting Standards Foundation, has been tasked with the development and approval of IFRSs, as well as the issuing of interpretations of these IFRSs.

IFRSs are now required in 125 jurisdictions and South Africa too subscribes to the accounting standards issued by the IASB, as do many of the jurisdictions represented here today. Irrespective of whether your respective jurisdiction has adopted IFRS or not, I am sure that all of you will find benefit from the discussions and presentations that will take place during this workshop.

IFRS 9 and the G20

On 24 July 2014, the IASB issued a new accounting standard on financial instruments called IFRS 9, which replaced the existing standard, namely International Accounting Standard (IAS) 39, and which has a mandatory effective date of 1 January 2018. IFRS 9 inter alia specifies how an entity should classify and measure financial assets and liabilities. One of the fundamental changes that IFRS 9 introduces is the concept of Expected Credit Loss (ECL) provisioning. This new principle replaces the current incurred losses model and will materially change the way in which companies, and in particular banks, are required to approach and account for impairments for credit losses.

According to the Bank for International Settlements (BIS), the great financial crisis of 2007-09 highlighted the systemic costs of a delayed recognition of credit losses on the part of banks and other lenders, and the application of the prevailing standards at the time was seen as having prevented banks from provisioning appropriately for credit losses likely to arise from emerging risks. These delays resulted in the recognition of credit losses that were widely regarded as 'too little, too late', and gave rise to questions of procyclicality by spurring excessive lending during the boom and forcing a sharp reduction in the subsequent bust.

The development of the ECL accounting framework is consistent with the call by the leaders of the Group of Twenty (G20) in April 2009 to strengthen accounting recognition of loan loss provisions by incorporating a broader range of credit information. One of the consequences of this new framework is the fact that while, in the past, a loss event had to have occurred before an impairment was raised by a bank. The standard now requires that loss provisions be raised earlier and take into account not only past and present information but also forward-looking information, which emphasises the future probability of credit losses in determining them. This standard is aimed at resolving the weaknesses identified during the global financial crisis of 'too little, too late' referred to above, and this will hopefully result in a more robust financial system that is more resilient and hence better able to withstand shocks.

The adoption of IFRS 9 will give rise to higher levels of credit impairments. A study undertaken by the European Banking Authority estimated that the implementation of IFRS 9 would give rise to an average increase of 13% in loss provisions compared to the current levels under IAS 39; it is further expected that the Core Equity Tier (CET) 1 ratios will decrease by an average of 45 basis points. Smaller banks, which mainly use the standardised approach to measuring credit risk, estimate a larger impact on their own fund ratios than the larger banks. Estimates of the exact impact differ, however, and only time will tell which of these estimates was accurate.

There are those that argue that the adoption of IFRS 9 may in fact increase procyclicality, because during recessionary conditions there may be a sharp fall in CET 1 capital levels and this, in turn, may lead to a sharp easing in credit extension due to the so-called 'cliff effect' of the staged approach prescribed by IFRS 9. Others, notably the BIS, reject this argument on the basis that banks, after the global financial crisis, are now better capitalised with higher buffers and thus are better able to absorb losses. They further argue that the early loss recognition of credit losses enables a quicker 'clean-up' of banks' balance sheets, thus enabling them to support economic recovery.

This debate is clearly not yet settled and we will need to wait and see how this plays out during the next recession. The economic impact is, however, not only limited to the level of losses and the timing of the recognition; the implementation of IFRS 9 is also likely to impact on the pricing of products which may thus impact on overall credit extension within the economy and ultimately consumption and hence economic growth.

It is furthermore likely that banks' earnings will be more volatile in the future due to the effect of the forward-looking approach that is required under IFRS 9. Therefore, disclosure and the education of stakeholders on how to interpret financial information under IFRS 9 will be imperative and an important consideration.

Over the past two years, many seminars, workshops, and training sessions have been provided by a range of organisations. However, very few of these have focused on jurisdictions from the African continent. There are factors that are unique to Africa that need to be taken into account. With this workshop, we want to fill this gap and provide a platform for African regulators to discuss the specific issues and concerns that may affect them in the implementation of IFRS 9. In this context, we are very much looking forward to the presentation from the Bank of Zambia on its in-country regulator perspective.

Auditors

The BIS correctly points out that the effectiveness of the new standards will not only depend on how banks implement them but will also depend on the contributions of central banks, supervisors, and other stakeholders, such as auditors. The BIS highlights that supervisors can play a very important role in promoting sound bank implementation practices through their banking supervision activities in a manner that complements the efforts of accosting standard setters.

The auditing profession, as mentioned, is an important stakeholder when it comes to the implementation of IFRS 9, so a discussion of IFRS 9 would not be complete without reference to their role. There is little doubt that the audit profession is likely to be challenged with the introduction of IFRS 9. The reason is that the audit of accounting estimates, such as impairments, has always been a very complex area and the introduction of IFRS 9 will further add to that complexity.

We are extremely pleased to have multiple representatives from the audit profession in our midst today and tomorrow. We will listen to presentations from both PwC and KPMG dealing with audit expectations, while EY will provide us with their perspective during the panel discussion tomorrow. We especially want to welcome the representatives from PwC Kenya who will be sharing with us their experience to date.

Before I conclude, I would like to touch on two audit-related topics, namely mandatory audit firm rotation and the recent developments that engulfed the global audit firm KPMG.

The Independent Regulatory Board for Auditors (IRBA) recently issued a new rule on mandatory audit firm rotation, which limits audit firm appointments to a maximum period of 10 years. The efforts by IRBA to improve independence are to be welcomed. The SARB has been proactive with regard to auditor independence, for example section 61 of the Banks Act provides that the Registrar of Banks must approve the appointment of an auditor before such an auditor can take up office. Such an appointment further requires that the Audit Committee do a proper assessment of the suitability of the auditor to hold office, after which the Office of the Registrar of Banks would also do a fit and proper assessment prior to the approval of the auditor’s appointment.

The SARB, from a supervisory perspective has furthermore, for many years now, required large banks to appoint joint auditors as this further reduces the independence-related risk. The SARB therefore, while broadly supportive of the principle of mandatory audit firm rotation, believes that banks should be exempted from these requirements as our supervisory standards and practices as it relate to auditor independence far exceed those that have recently been put in place. We further believe that the maximum period of appointment should be increased from the proposed 10 years to a longer period of between 15 and 20 years, as individual audit partner rotation is already in effect. The challenges around skills shortages are furthermore a reality that may act as an obstacle to achieving this objective of rotating audit firms after 10 years.

If mandatory audit firm rotation is retained in the current form, the SARB may be compelled to revisit the requirement of joint auditor appointments for large financial institutions due to some of these practical considerations. Although the removal of the requirement of joint auditors for large financial institutions will lead to reduced audit fees and other efficiencies, we believe that this is likely to weaken auditor independence and may detract from the current high levels of audit quality and thus possibly erode the effective oversight and supervision of banks. This would not be in the public interest. We further remain unconvinced that mandatory audit firm rotation represents an effective policy intervention to address the stated secondary objectives of redressing the high levels of market concentration and to promote transformation within the auditing profession.

As a regulator, the SARB as a rule does not comment on individual firms. We, however, took the extraordinary step to comment publicly on the developments surrounding KPMG last week as they are the auditors to three of the big four banks, as well as to other banks and insurance companies. Our interest stems solely from a public policy perspective that arises from our financial stability mandate. We had noted with concern the regrettable auditing practices and serious errors of judgment that had occurred at KPMG and which had led to significant damage being inflicted on certain individuals, organisations, and the country as a whole.

During our engagement with the local and global leadership of KPMG, we have noted the increasing and firm commitment of the new management team to fully own up to past mistakes and to work towards restoring the public trust. The recent announcements in this regard are recognised as important first steps towards this end and we are eagerly awaiting the results of the independent investigations undertaken by IRBA and the more recently announced one by KPMG. As a regulator, we do not pick winners or losers, but we are concerned stemming from our extensive experience of regulating banks this unfolding situation may take the form of a bank run with contagion risk that extends beyond an individual firm. This situation calls for thoughtful leadership and restraint as we believe that our economy will be better served if we can avoid further market concentration within the auditing and auxiliary professional services sector.

These recent developments have, however, provided us cause to pause. In the coming months and years, the following policy considerations may need to be pondered in the interest of further strengthening governance and transparency within the auditing and accounting professions. These include:

(i) The requirement that audit firms may be ‘too big to fail’ and whether this may require regulatory intervention, including limiting the extent to which audit firms provide non-audit services, especially to audit clients. The imposition of caps regarding the value of non-audit services rendered to audit clients and prohibiting the rendering of certain category of non-audit services to audit clients in line with the reforms announced by the European Commission in 2016 should enjoy serious consideration.

(ii) A far greater degree of disclosure and transparency by the auditing and accounting profession are required, given the public functions that audit firms perform when they inter alia attest the financial statements of public companies. Hence, consideration should be given to making the full public disclosure of a comprehensive set of audited financial statements mandatory, irrespective of the form or legal structure of ownership of such firms.

(iii) The appointment of independent boards of directors and the strengthening of the risk management function within audit firms will further strengthen oversight and governance within auditing and accounting firms.

(iv) The publication of an integrated report by the large and medium size audit firms as this may contribute to improve transparency around transformation initiatives and could assist to accelerate transformation within this sector. Full disclosure regarding compliance with governance frameworks such as King IV could also assist in improving governance arrangements within these firms.

While this list is not exhaustive, it would be useful if there were a public discourse around these policy questions. We firmly believe that the implementation of some of these proposals may go some way to strengthening the governance within the audit and accounting professions and could assist to further support and possibly strengthen the trust that society places in them.

Conclusion

The saying goes that change is the only constant in life. IFRS 9 certainly represents a major change for the banking industry. It is certainly a change that needs to be embraced. The regulated sector will be looking towards their regulators for guidance, hence we need to be up to date and well versed in order to be able to provide effective guidance. To this end banks, auditors and regulators will have to work together to ensure that the implementation of IFRS 9 will be a success. I hope that this workshop will contribute towards this goal.

I am sure that during the next one and a half days, there will be very interesting and fruitful discussions that will benefit all the jurisdictions present here today and even after the workshops, I am sure conversations will continue. I wish you well on your IFRS 9 implementation journey and hope you will enjoy the workshop.

Thank you.