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Letter to All Banks and Discount Houses

GUIDANCE NOTE TO BANKS AND DISCOUNT HOUSES ON THE IMPLEMENTATION OF IFRS 9 (FINANCIAL INSTRUMENTS) IN NIGERIA

We hereby forward the Central Bank of Nigeria's initial Guidance Note on the implementation of IFRS 9 (Financial Instruments) in the Nigerian banking sector.

The Guidance Note communicates supervisory expectations for the implementation of the new standard, especially in areas where banks are expected to exercise considerable judgment and/or elect to use simplifications and other practical expedients permitted under the standard. The Note also specifies information to be submitted to CBN not later than April 30, 2017 on IFRS 9 Implementation Projects while requiring banks to submit monthly status updates on the implementation projects starting May 2017.

To ensure a seamless implementation, the CBN has established a Project Team and banks are encouraged to seek clarifications, if any, on the Guidance Notes by contacting the Project Manager, Mr. C. D. Nwaegerue, via email on cdnwaegerue@cbn.gov.ng.

Yours faithfully,

'TOKUNBO MARTINS (MRS)
DIRECTOR OF BANKING SUPERVISION

<u>GUIDANCE NOTE TO BANKS AND DISCOUNT HOUSES ON THE IMPLEMENTATION OF IFRS 9 (FINANCIAL INSTRUMENTS) IN NIGERIA</u>

1.0 INTRODUCTION

The International Financial Reporting Standard (IFRS) was adopted in the Nigerian banking sector on January 1, 2012 as part of measures to improve reporting practices, transparency and disclosures in the sector. Nigeria's adoption of the IFRS implies that all revisions to existing standards as well as new accounting standards issued by the International Accounting Standards Board (IASB) must be adopted by all reporting entities. In July 2014, the IASB issued the final version of IFRS 9 (Financial Instruments) to replace IAS 39 (Financial Instruments: Recognition and Measurement) requiring all reporting entities that have adopted IFRS to implement the new accounting standard by January 1, 2018.

IFRS 9 prescribes new guidelines for the classification and measurement of financial assets and liabilities, making fundamental changes to the methodology for measuring impairment losses, by replacing the "incurred loss" methodology with a forward-looking "expected loss" model. The implementation of IFRS 9, especially the Expected Loss Impairment Methodology would entail the exercise of considerable judgement by banks.

In order to ensure robust and consistent implementation of IFRS 9, this Guidance Note, details supervisory expectations, especially in areas where banks are expected to exercise considerable judgment and/or elect to use simplifications and other practical expedients permitted under the Standard.

Section 2.0 clarifies the Central Bank of Nigeria's (CBN) expectations on IFRS 9 implementation while Section 3.0 details the information to be provided by banks to the CBN on their IFRS Implementation Projects.

2.0 CLARIFICATIONS ON REGULATORY EXPECTATIONS

In order to ensure proper application of the IFRS 9 requirements in the Nigerian banking industry, this Section provides clarification on the CBN's expectations from banks on how they should exercise judgment in certain areas.

2.1 Measurement of Financial Instruments

2.1.1 Assessment of Significant Increase in Credit Risk

The standard requires an entity, at each reporting date, to assess whether the credit risk on a debt instrument measured at Amortised Cost and Fair Value through Other Comprehensive Income (FVOCI) has increased significantly since initial recognition, using among other factors the change in the risk of a default occurring over the expected life of the instrument. The CBN expects banks to put in place policies and systems as well as governance arrangements and controls to identify instances where their exposures have suffered significant increase in credit risk.

In assessing significant increase in credit risk, banks are to consider quantitative, qualitative and 'backstop' (30 days past due presumption) indicators.

In using quantitative elements, banks should consider the change in lifetime Probability of Default (PD) by comparing the lifetime PD at the reporting date with the lifetime PD at initial recognition. The criteria for relative quantitative increases in PD indicative of a significant increase in credit risk should be defined and documented by banks. The assessment by banks should among others consider changes in credit risk at counterparty and individual credit level.

Generally most qualitative factors indicative of a significant increase in credit risk are reflected in PD models and therefore, are included in the quantitative assessment. However, where it is not possible to include all current information about qualitative factors in the quantitative assessment, banks should recalibrate PDs or adjust estimates when assessing significant increase in credit risk or calculating Expected Credit Losses (ECLs).

In addition to the criteria provided in B5.5.17 of the Standard, banks are advised to consider the following qualitative factors in assessing significant increase in credit risk:

- ✓ Classification of the exposure by any of the licensed private credit bureaux or the Credit Risk Management System;
- ✓ Deterioration of relevant credit risk drivers for an individual obligor (or pool of obligors);
- ✓ Expectation of forbearance or restructuring due to financial difficulties;
- ✓ Evidence that full repayment of interest and principal without realisation of collateral is unlikely, regardless of the number of days past due; and
- ✓ Deterioration in credit worthiness due to factors other than those listed above.

The CBN expects that financial assets which are more than 30 days past due or have been granted forbearance should be considered to have significantly increased in credit risk.

However, the CBN expect banks not to rely solely on the 30 days past due presumption, but to incorporate reasonable and supportable forward-looking information. The 30 days past due presumption can only be applied if the forward looking information is not available without undue cost or effort.

Where the 30 days past due presumption is rebutted on the basis that there has not been a significant increase in credit risk, the bank shall accompany the assertion by documented, reasonable and supportable information that a more lagging criterion is appropriate. The CBN, however, expects that this would only be used in limited circumstances.

Where a bank sets its transfer threshold for groups of financial assets, it is important that all financial instruments in that portfolio must have similar credit risk characteristics at initial recognition such as a credit rating within a relatively narrow band.

In assessing whether there is an increase in credit risk or not, banks are required to consider macroeconomic indices and sector/industry/geographical idiosyncrasies and ensure that economic assumptions are consistent across all risk management and capital planning documents (i.e. RRP, ICAAP, ECL, ILAAP, ERMF, Budget, etc.).

To ensure appropriate identification of significant increase in credit risk, banks should avoid applying absolute PD or credit rating threshold to all exposures in a portfolio except the exposures are of a similar credit risk at initial recognition. The use of absolute threshold is only permitted if it would appropriately capture significant increase in credit risk since initial recognition in a manner consistent with the requirements of IFRS 9.

Banks should consider both counterparty and individual exposures of the obligor and connected obligors, in determining significant increase in credit risk. This would ensure that the impact of multiple exposures to the same obligor originated at different periods with different initial PDs have been taken cognisance of in compliance with IFRS 9.

2.1.2 Staging and Transfer Criteria

At transition, banks are expected to place financial instruments without significant increase in credit risk in the 12-months ECL bucket irrespective of the obligor's credit risk rating at origination. However, where significant increase in credit risk has been observed, such credits are moved to Lifetime ECL.

Where there is evidence that there is significant reduction in credit risk, banks would continue to monitor such financial instruments for a probationary period of 90 days to confirm if the risk of default has decreased sufficiently before upgrading such exposure from Lifetime ECL (Stage 2) to 12-months ECL (Stage 1). In addition to the 90 days probationary period above, banks are expected to observe a further probationary period of 90 days to upgrade from Stage 3 to 2. For the avoidance of doubt, banks are required to observe a probationary period of 180 days before upgrading financial assets from Lifetime ECL (Stage 3) to 12-months ECL (Stage 1).

Banks are required to adopt a definition of "default" consistent with the provisions of the paragraph 12.1(b) (2) of the Prudential Guidelines 2010.

2.1.3 Impairment of Financial Instruments

Banks are required to put in place appropriate policies to ensure sound credit risk assessment and measurement processes as well as systems, tools and data that appropriately aid the assessment of credit risk and computation of ECLs. In accordance with Section 5.5.1 of the Standard, banks are to determine ECL for financial assets measured at amortised cost, FVOCI, lease receivables, contract asset, loan commitment and financial guarantee contract.

Banks shall adopt sound ECL methodologies commensurate with their size, complexity, structure and risk profile. ECL should reflect the probability-weighted outcome, time value of money and best available forward-looking information.

Banks should consider such factors as extent of systemic risk posed by the bank (whether the bank is designated as a D-SIB), level and volatility of historical credit losses, complexity of products and other lending related modelling methodologies in determining the level of sophistication required in implementing the ECL model. Irrespective of the approach adopted, banks are expected to ensure that ECL measurements are unbiased (neutral and not biased towards optimism or pessimism) and determined by evaluating a range of possible outcomes.

Banks are required to compute ECLs on significant exposures and credit-impaired loans individually while ECLs for retail exposures and exposures to small and medium-sized enterprises that have less borrower-specific information may be measured on collective basis. To measure ECL on collective basis, banks should have credit risk rating processes in place to appropriately group exposures on the basis of shared credit risk characteristics.

ECLs could either be 12-month or Lifetime depending on whether there has been significant increase in credit risk since initial recognition. Banks are required to carry out credit review and update their ECLs, at least quarterly, to reflect changes in credit risk since initial recognition. The methodologies and assumptions underlying the ECL methodology should be reviewed at least annually.

Banks may adopt simpler approaches[1] in the computation of ECL.

In view of the fact that most ECL models require the determination of PD, Loss Given Default (LGD), Exposure at Default (EAD) and Discount Rate, banks are required to take cognisance of the following factors:

Probability of Default

Banks that are already using the Advanced Internal Rating Based (AIRB) models for their internal credit assessment purposes may use the outputs from the models as a starting point for calculating IFRS 9 PDs. The output from the AIRB models should, however, be validated based on reasonable and supportable information to ensure that they are fit for purpose under IFRS 9. They are also required to make adjustments that would make the PDs comply with the requirements of the standard where necessary, such as conversion to an unbiased estimate, removal of bias towards historical data, aligning definition of default used in the model with that of IFRS 9, etc.

Where the bank determines lifetime ECL from the 12-months ECL, it should reflect expected movements in default risk by sourcing historical default data, perform vintage analysis to understand how default rates migrate over time and extrapolate trends to longer periods.

Banks that develop new models to produce PDs, are required to ensure that all key risk drivers and their predictive power are identified and calibrated based on historical data for at least three years. Those that do not have three years historical data may utilise data sourced externally.

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[1] These may include Term to Maturity Approach, Loss Rate Approach, etc.
Term to Maturity Approach does not estimate PD, EAD and LGD for separate time intervals but uses a single measure for PD, EAD and LGD for the remaining term to measure ECL.
In the Loss Rate Approach, the PD and LGD are assessed as a single combined measure, based on past losses, adjusted for current and forecasts of future conditions.

Banks are not permitted to assume a constant marginal rate of default over the remaining lifetime of a financial instrument without appropriate supporting analysis. As provided under paragraph B5.5.5 of IFRS 9, only exposures that have similar credit risk characteristics can be grouped together for the purpose of calculating the PDs.

Loss Given Default

Under IFRS 9, LGD reflects credit enhancements that are integral to the terms of the exposure and are not accounted for separately. Therefore, banks are required to analyse relevant macroeconomic indicators that influence LGD or its components to aid estimation of collateral values when modelling the term/structure of LGD. Banks that intend to use Basel LGD values should effect necessary adjustments to comply with IFRS 9.

The modelling methodology for LGD where appropriate should be designed at a component level with the calculation of LGD broken down into drivers. For secured exposures, at a minimum the bank should consider forecasts of future collateral valuations (including expected sale discount), time to realisation of collateral (and other recoveries), allocation of collateral across exposures where there are several exposures to the same obligor, cure rates and external costs of realisation of collateral.

Exposure at Default

Banks are to ensure that the period of exposure in the model is not shorter or longer than the maximum contractual period over which the entity is exposed to credit risk. To determine the period of exposure that equals the historical average life of loans, banks are required to evaluate whether it is consistent with forward-looking expectations based on reasonable and supportable information.

For revolving credit facilities within the scope of IFRS 9.5.5.20 (loan and undrawn loan commitment) a bank shall estimate 12-month ECL based on its expectations of the portion of the loan commitment that will be drawn within 12 months of the reporting date while lifetime ECL is calculated based on the expected portion of the loan commitment that will be drawn over the expected life of the loan commitment.

In determining the period of exposure for revolving credit facilities, banks shall take cognisance of their expected credit risk management measures which serves to mitigate credit risk, including terminating or limiting credit exposure.

ECL computation for financial guarantee contracts shall consider expected payments to reimburse the holder for a credit loss that it incurs, less any amount banks expects to receive from the holder, debtor or any other party.

Banks are not permitted to use the legally enforceable contractual period for revolving credit facilities unless analysis of historical data shows that, in practice, management action consistently limits the period of exposure to the contractual period. Banks are expected to consider all relevant historical information that is available without undue cost and effort when determining the exposure period of a revolving credit facility.

Banks are required to demonstrate that their EAD models are fit for purpose under IFRS 9. The basis for inputs and adjustments should be documented. Banks should not use 12-month EAD as a proxy for lifetime EAD without appropriate justification.

Discount Rate

Banks are required to make appropriate adjustments to the discount rate employed for regulatory purposes when computing IFRS 9 ECL/LGD, reflect the effect of time value of money in ECL and ensure that the discount rate used approximates the EIR.

For a financial guarantee contract, the discount rate should reflect the current market assessment of time value of money and risks specific to the cash flows. Assumptions about prepayments, extensions and utilisation during the period of exposure used in the ECL calculations shall be updated to reflect currently available information consistent with that used in estimating interest income.

2.1.4 Model Validation

Banks should have policies and procedures in place to validate models used to assess and measure ECL. They should ensure that the validation process allows for systematic evaluation of robustness, consistency and accuracy of the model as well as its relevance to the underlying portfolio.

The scope for validation should include review of assumptions, inputs, design and outputs. The scope of validation should also establish thresholds for model performance which, if breached, should lead to remedial actions such as model recalibration or redevelopment. Model validation should be conducted when the ECL models are initially developed and when significant changes are made to the models. Model validation should be performed independently of the model development process and by experienced personnel(s) with requisite expertise. The outcome of the validation process should be documented and subjected to review by the bank's internal and external auditors. The findings and outcomes of model validation should also be reported in a prompt and timely manner to senior management and board. Above notwithstanding banks should conduct reviews to ensure that their ECL models are appropriate at least annually.

The CBN would periodically evaluate the effectiveness of banks' credit risk management practices to ensure among others, that the methods used for determining accounting allowances lead to appropriate measurement of ECLs in line with the Standard.

2.1.5 Low Credit Risk Simplification

IFRS 9 permits that a financial instrument, which is considered to have low credit risk on the reporting date, needs not be assessed for significant increase in credit risk since its initial recognition. CBN expect banks to exercise this simplification in limited circumstances. Accordingly, banks are required to use this simplification for only risk free and gilt edged securities.

2.1.6 Reasonable and Supportable Information without Undue Cost and Effort

The CBN recognises that data quality, granularity and availability are significant challenges faced by banks in migrating to the ECL model. Consequently, banks are encouraged to identify data gaps early to aid the design of new data fields that would track market data required for measurement and assessment of significant increase in credit risk. In this vein, banks should conduct detailed analysis of their risk assets on a regular basis using all available and reliable data (internal and external), incorporating expert credit judgment and all known relevant factors (regulatory, industry, geographical, economic, political, etc.) that may affect these assets.

The CBN expects that management's judgment should align with established parameters set by the board and are consistently applied across the bank's risk management and capital planning processes e.g. RRP, ICAAP, ILAAP, ERMF, budget, ECL etc. The Standard requires consideration of forward-looking information in the ECL model and that reporting entities would apply sound judgment in forecasting macroeconomic parameters.

Consequently, banks are enjoined to avoid the following:

a. Application of a single future economic scenario for a portfolio with no separate adjustments to take account of non-linear impacts, unless the portfolio has no potential material asymmetric exposures to ECL;
b. Use of only internally developed forecasts or reference to a single external source;
c. Development of ECL methodologies that are not commensurate with the bank's complexity, structure, economic significance and risk profile; and
d. Use of inconsistent macroeconomic parameters across risk management and capital planning processes (RRP, ICAAP, ILAAP, ERMF, ECL etc.).

Banks should monitor whether their approaches to analysing forward-looking information continues to be appropriate in the light of changing circumstances. For the avoidance of doubt, the forward looking information integrated into banks' ECL models must be related to the credit risk drivers for particular exposures of portfolios.

2.1.7 Write-off of Non-Performing Facilities

Paragraph 5.4.4 of IFRS 9 requires an entity to write-off the portion of the gross carrying amount of a financial asset for which the entity has no reasonable expectations of recovery, with such write-off considered as a de-recognition event.

In determining that there is no reasonable expectation of recovering a non-performing financial asset or any part thereof, banks are required to abide by relevant extant regulations guiding write off of non-performing financial assets.

2.1.8 Modified Financial Assets

The contractual terms of a financial asset may be modified or renegotiated for a number of reasons, including factors not related to current or potential credit deterioration of the customer (e.g. changing market conditions, customer retention, etc.)

Modifications or renegotiations can however, mask increases in credit risk, thereby resulting in ECL being underestimated, and/or delaying the transfer to lifetime ECL for obligors whose credit risk has significantly deteriorated. Credit modifications may also result in, inappropriate movement from lifetime ECL to 12-month ECL. Consequently, banks are enjoined to treat the modification of a distressed asset as an originated credit-impaired financial asset requiring recognition of lifetime ECL after the modification.

It is pertinent to state that the credit risk on a financial asset will not automatically decrease merely because the contractual cash flows have been modified. The probationary requirements as detailed in Section 2.1.2 of this Guidance Notes shall also apply to modified financial assets.

Financial assets transferred to lifetime ECL but subsequently renegotiated or modified should not be moved to 12-months ECL unless there is sufficient evidence that there had been no significant increase in credit risk over the life of the exposure compared with that upon initial recognition and the bank demonstrates history of up-to-date and timely payment of principal and interest against the modified contractual terms for the required probationary period..

Banks are required to fully disclose all modified financial assets that result in de-recognition in its financial statements in line with the requirements of IFRS. Furthermore, banks are required to submit quarterly returns to the CBN, to be received within 10 days of the end of the quarter effective 1st quarter of 2018, on all financial assets derecognized during the affected quarter as a result of modification.

Transition Requirements and Other Arrangements

Restatement of Comparatives

Although IFRS 9 generally requires reporting entities to apply the standard retrospectively, it only permits an entity to restate prior periods only if it is able to do so without the use of hindsight. Banks are encouraged to embrace the exception to retrospective application contained in the Standard.

Other Arrangements

- All deposit money banks (DMBs) are expected to commence parallel run of the new impairment system from July 1, 2017 in order to ensure seamless transition to IFRS 9 by January 1, 2018. Banks are also to obtain External Auditor/Independent Consultant's validation/certification of their IFRS 9 accounting policies/systems and models by third quarter of 2017.

- The CBN remains committed to the principles of IFRS 9 and would update the Prudential Guidelines in due course. Meanwhile, the provisions of Section 12.4 of the Prudential Guidelines remain extant.

3.0 INFORMATION TO BE SUBMITTED TO CBN ON BANKS' IFRS 9 IMPLEMENTATION PROJECTS

Banks are required to have in place adequate arrangements, processes and systems to effectively support transition to the new reporting requirements. Consequently, banks are required to submit their IFRS implementation plans covering the areas below to the Director, Banking Supervision Department not later than April 30, 2017 with soft copies forwarded to the Project Team via email: ifrsprojectteam@cbn.gov.ng.

3.1 Project Governance Structure

Banks are required to set up appropriate governance structure to ensure that the standard is effectively implemented within the expected timeframe. Accordingly, banks are required to describe the project structure, governance and delivery timelines including the role of the board, senior management, project supervisor, key project members (internal and external) and training plan.

3.2 IFRS 9 Gap analysis and impact assessment

Details of IFRS 9 Gap analysis and impact assessment conducted to ascertain the quantitative and qualitative impacts of the standard on the bank. This should include, among others, changes in accounting policy, credit risk rating system and capital plan.

3.3 Expected Credit Loss Model

Detailed information on existing and/or proposed model(s) for ECL calculation. In addition, banks should provide information on:

a. Number of years loss data available to the bank;
b. Supporting analyses, input, assumptions and rationales in ECL model;
c. Macroeconomic metrics (types and sources) for forecasting;
d. Haircut policy for LGD valuation;
e. Policy for classifying financial assets into stages 1, 2 and 3 using the format below:

Stage	**Description**	**Criteria (Quantitative)**	**Criteria (Qualitative)**	**Criteria (others)**
Stage 1	**12-Month ECL**			

Stage 2	**Lifetime ECL – Loans that have witnessed significant increase in credit risk**			
Stage 3	**Lifetime ECL – default**			

f. Policy for upgrading/downgrading financial assets in the various stages;

g. Detailed information for the valuation of equity investments inclusive of details of valuation models; and

h. Policies for modification and renegotiation of financial assets.

3.4 Classification of Financial Assets and Liabilities

In addition to the above, banks are required to provide information on the classification/designation of their financial assets/liabilities as at December 31, 2016, to IFRS 9 classifications, in line with the template below:

S/N	**Financial Assets**	**IAS 39 Classification** **N**	**IFRS 9** **N**					
			Debt instruments			**Equity**		**Derivative**
			BM – 1 HTC	**BM – 2 FVTPL**	**BM-3 FVOCI**	**FVTPL**	**FVOCI**	**FVTPL**

S/N	**Financial Liabilities** **N**	**IAS 39 Classification** **N**	**IFRS 9** **N**	
			FVTPL	**Other Liabilities**

4.0 PROJECT STATUS REPORT

Beginning May 2017, banks are required to submit monthly updates on the project implementation status to the CBN. The status report should show all major aspects of the implementation plan that are running on schedule, ahead of schedule, or behind schedule. If behind schedule, banks should indicate remedial steps being taken. The report should reach the Director, Banking Supervision not later than the 10th day of the subsequent month.

5.0 ABBREVIATIONS AND TERMS USED

AIRB	Advanced Internal Rating Based
CBN	Central Bank of Nigeria
DMB	Deposit Money Banks
D-SIB	Domestic Systemically Important Bank
EAD	Exposure at Default
ECL	Expected Credit Loss
EIR	Effective Interest Rate
ERMF	Enterprise Risk Management Framework
FVOCI	Fair Value through Other Comprehensive Income
IAS 39	Financial Instruments: Recognition and Measurement
IASB	International Accounting Standards Board
ICAAP	Internal Capital Adequacy Assessment Process
IFRS	International Financial Reporting Standard
IFRS 9	Financial Instruments
ILAAP	Internal Liquidity Adequacy Assessment Process
LGD	Loss Given Default
PD	Probability of Default
RRP	Recovery and Resolution Plan