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Letter to all Banks and Discount Houses

TRANSITIONAL ARRANGEMENTS
TREATMENT OF IFRS 9 EXPECTED CREDIT LOSS FOR REGULATORY PURPOSES BY BANKS IN NIGERIA

Following the issuance of the '*Guidance Note to Banks and Discount Houses on the Implementation of IFRS 9 (Financial Instruments) in Nigeria'* dated December 20, 2016, the Central Bank of Nigeria (CBN) hereby clarifies its expectations regarding the regulatory treatment of accounting provisions under the Standard as well as recommend transitional arrangements to cushion the impact of IFRS 9 on January 1, 2018, the initial date of application.

In March 2017, the Basel Committee on Banking Supervision (BCBS) published its standard titled "Regulatory Treatment of Accounting Provisions – Interim Approach and Transitional Arrangements". This was to address the diversity in accounting and supervisory policies in respect of provisioning and capital requirements across different jurisdictions and the uncertainties surrounding the capital effects of the change from Incurred Loss model to Expected Credit Loss (ECL) accounting model. The BCBS recommends the use of transitional arrangements with the primary objective of cushioning the impact of ECL accounting on regulatory capital, by giving banks time to rebuild their capital resources.

The CBN IFRS 9 impact assessment for the banking industry revealed that the transition to the ECL model resulted in higher provisions for credit losses, with implications for retained earnings and capital adequacy. Consistent with the recommendations of the BCBS, the CBN hereby provides the following guidance on the treatment of ECL provisions for regulatory purpose and introduce a four-year transitional arrangement to cushion the effect on tier 1 regulatory capital, as detailed in the sections below:

1. **Utilisation of Regulatory Risk Reserve to cushion the impact of IFRS 9 ECL Provisions on Transition Date**

   Section 12.4 of the CBN Prudential Guidelines requires the creation of a non-distributable reserve, the Regulatory Risk Reserve (RRR), with banks required to transfer the difference between prudential provisions and IFRS provisions to the regulatory reserve, when the prudential provisions are greater than the IFRS provisions.

   In order to cushion the impact of IFRS 9 on regulatory capital on January 1, 2018, banks are required, in the first instance, to apply the balance in their RRR to reduce the additional ECL provisions to be recognized in the opening retained earnings on January 1, 2018. The amount to be deducted from RRR shall be limited to the excess of ECL provisions over the IAS 39 provisions on the transition date. Accordingly, banks are required to effect appropriate accounting entries to reflect the transfer from RRR to the retained earnings.

Where the additional ECL provision is higher than the balance in RRR, the excess shall be amortised in line with the transitional arrangements in Section 2 below. However, where the RRR fully absorbs the additional ECL provision, the transitional arrangement in Section 2 shall not apply. Banks shall continue to account for differences between the IFRS and Prudential provisions in line with Section 12.4 of the CBN Prudential Guidelines post-transition date.

2. Transitional Arrangement of the ECL Accounting Provisions for Regulatory Capital Purpose

Further to Section 1 above, the excess of the ECL provisions over IAS 39 provisions adjusted for the RRR shall be termed "Adjusted Day One Impact" for the purpose of the transitional arrangement, using the Static Approach. This approach requires banks to hold static the Adjusted Day One Impact and amortise on a straight-line basis over the four-year transition period by writing back to the Tier 1 capital as indicated in the table below:

Table 1

Period	**Provisions to be written back**
Year 0 (January 1, 2018)	4/5 of Adjusted Day One Impact
Year 1 (December 31, 2018)	3/5 of Adjusted Day One Impact
Year 2 (December 31, 2019)	2/5 of Adjusted Day One Impact
Year 3 (December 31, 2020)	1/5 of Adjusted Day One Impact
Year 4 (December 31, 2021)	Nil

No Adjusted Day One Impact shall be included in Tier 1 capital beginning from the first day of year 4, while the provisions of the CBN Guidance Notes on Regulatory Capital remain extant. *(See Appendix 1 for illustration).*

For the avoidance of doubt, the transitional arrangement shall be based solely on Tier 1 capital of banks.

3. Categorization of ECL Provisions as General Provision and Specific Provision for Regulatory Purposes

The CBN shall retain the classification of provisions as General and Specific in accordance with the Prudential Guidelines.

4. Regulatory Reporting and Disclosure Requirements

During the four-year transitional arrangement period, banks are required to submit their Capital Adequacy Ratio (CAR) computations to the CBN on monthly basis showing the CAR before and after adding back the amortised "Adjusted Day One Impact". This is to enable the CBN monitor the impact of the additional ECL provisions on the banking industry.

Consequently, the CBN has redesigned the CAR Computation template which reflects the impact of the transitional arrangement. Banks are required to use the new template to:

- Resubmit monthly CAR from January 2018 to September 2018, and
- Monthly CAR for the rest of the transitional period, (*See Appendix II for template)*.

Banks shall disclose the above-mentioned information in their audited financial statements to enhance stakeholders' understanding of the impact of the four-year transitional arrangement.

Banks are also required to report on the ECL Coverage Ratios for each stage of their financial instruments, showing the gross carrying amount and the proportion of ECL provisions, in each stage *(See Appendix III for template).*

All banks are required to comply with the transitional arrangement and where necessary seek clarifications from the CBN IFRS 9 Project Team via email on ifrsprojectteam@cbn.gov.ng

Yours faithfully,

AHMAD ABDULLAHI
DIRECTOR OF BANKING SUPERVISION

Appendix 1- Sample transitional arrangement for capital adequacy ratio computation

Bank XYZ Limited

Regulatory Capital Reporting Template – Amount in Millions				
Capital Adequacy as at		**31 Dec. 2017**	**1 Jan. 2018**	**Adjusted Day-one Impact of IFRS 9 transition on 1 Jan. 2018**
		IAS 39	**IFRS 9**	
Tier 1 Capital: Instruments & Reserves				
Paid-up Share capital	1	10,000	10,000	
Irredeemable Preference Shares	2	-	-	
Share premium	3	88,000	88,000	
General reserve (Retained Profit)	4	30,000	20,000**	10,000
Transitional Adjustment				
SMEEIS reserve	5	1,000	1,000	
Statutory reserve	6	400	400	
Other reserves	7	600	600	
Tier 1 Capital Before Regulatory Deduction	A=Sum(1:7)	**130,000**	**120,000**	**10,000**

**The Retained Profit of ₦20billion has reflected the impact of ECL provision of ₦15 billion (-ve) and RRR balance of ₦5billion (+ve).

Bank XYZ had accounting provisions of ₦23billion as at 31 December 2017 under the incurred loss model and accounting provisions of ₦38billion immediately after applying the ECL accounting model on 1 January 2018. Additionally, Bank XYZ had a balance of ₦5billion in its RRR as at 31 December 2017.

In this case, the Day-One Impact is a decrease in Tier 1 capital of ₦15billion (₦38billion minus ₦23billion). However, Bank XYZ is required to adjust the ₦15billion by the RRR balance of ₦5billion to arrive at the Adjusted Day One Impact of ₦10billion on the transition date.

Therefore, the Adjusted Day One Impact of ₦10billion shall be phased-in over a four-year period on a straight line basis by adding back the portion of the Adjusted Day One Impact to Tier 1 capital as shown in the table below:

Table 1

Reporting dates	IFRS 9 Tier 1 capital on 1 January 2018 (₦'million)	IFRS 9 transition adjustment amount (to be added back)	Tier 1 capital for regulatory purpose (₦'million)
Year 0 (1 January 2018)	120,000	4/5 x 10,000 = 8,000	128,000
Year 1 (31 December 2018)	120,000	3/5 x 10,000 = 6,000	126,000
Year 2 (31 December 2019)	120,000	2/5 x 10,000 = 4,000	124,000
Year 3 (31 December 2020)	120,000	1/5 x 10,000 = 2,000	122,000

Year 4 (31 December 2021)	120,000	Nil	120,000

We have assumed that the Tier 1 capital is constant over the 4 years for illustration purposes.

Appendix II – ECL Coverage Ratio

	Gross Carrying Amount					**ECL Provision**					**ECL Coverage Ratio**			
Financial statements items	**Stage 1**	**Stage 2**	**Stage 3**	**Total**		**Stage 1**	**Stage 2**	**Stage 3**	**Total**		**Stage 1**	**Stage 2**	**Stage 3**	**Total**
	₦’million	**₦'million**	**₦'million**	**₦'million**		**₦'million**	**₦'million**	**₦'million**	**₦'million**		**%**	**%**	**%**	**%**
On-balance sheet items														
Cash and balances with central banks														
Placements and other short term investments														
Loans and advances to customers at amortised cost														
Debt investment securities at amortised cost														
Debt investment securities at FVOCI														
Other financial assets measured at amortised cost														
- Please list others														
Sub total														
Off-balance sheet items														
Loan and other credit related commitments														
- Letter of credits														
- Letter of credits														
- Please list others														
Financial guarantee and similar contracts														
- financial guarantees														
- Please list others														
Sub total														
Total														