ADDITION OF IFRS 9 BY NIGERIAN BANKS…
A MARKET ANALYSIS

INTRODUCTION

With the 1 January 2018 deadline set by the Central Bank of Nigeria (CBN) for the implementation of the new International Financial Reporting Standard (IFRS) 9 (“IFRS 9” or the “Standard”) having passed, Nigerian banks are gearing up for the full implementation of the Standard in time for their mid-year reports. The Standard, which introduces a new loss impairment model with limited amendments to the classification and measurement requirements for financial assets, was published in 2014 and became mandatorily effective in January 2018. In the main, the Standard specifies how an entity should classify and measure financial assets, financial liabilities, and certain contracts for the sale and purchase of non-financial items. It also introduces a new methodology for financial instruments classification and the ‘incurred loss impairment model’ is replaced with a more forward looking ‘expected loss model’ as well as new requirements for hedge accounting (an accounting practice based on the deferral of gains and losses on financial market until the corresponding gain or loss in the underlying exposure is recognised). IFRS 9 will no doubt have significant effect on the reporting and accounting methodologies applied to financial instruments by Nigerian corporates and financial institutions in particular.

Briefly stated, IFRS 9 articulates new global best practice for transparent and sound accounting. This is expected to increase the threshold of prudence in the affairs of financial institutions, cushion the effect of improper classification of financial assets and ultimately reduce the risk of bank failures and the consequent economic disruption. Adoption of the Standard is set to have a significant impact on Nigerian banks, particularly, it will appear in relation to the level of non-performing Loans (NPLs) reported in their books, potentially worsening an ongoing trend as NPLs rose to a five year high of 15.18% as at the end of September 2017. With limited signs of this trend abating in the near future, the adoption of this new accounting standard, while undoubtedly a matter to be heralded, is not without its risks in the context of Nigeria’s relatively fragile banking sector. In the ensuing paragraphs we will consider briefly the history and development of the new IFRS standard as well as taking a closer look at the likely impact of the adoption of IFRS 9 on the Nigerian banking sector particularly in view of the current level of NPLs within the sector.

IFRS 9 – A Brief History

In the aftermath of the 2009 Global financial crisis, the widespread use of dubious accounting methods by supposedly responsible financial institutions was generally recognised as a significant contributor to the crash. To address perceived deficiencies, the G20, amongst other things, called for an improvement in standards for the valuation of financial instruments and welcomed recommendations by the financial stability forum regarding, amongst other things, the interaction between accounting techniques, the value of goods and services and the global economy.
These efforts led to IFRS 9 as the new accounting standard for the classification and measurement of financial assets and liabilities prepared by the International Accounting Standards Board (IASB) and in July 2014, the IASB issued the final version of IFRS 9 (Financial Instruments) to replace IAS 39 (Financial Instrument: Recognition and Measurement) necessitating a need amongst all reporting entities that have adopted the IFRS to implement the new standard.

The CBN Guidance note

The CBN pursuant to its regulatory powers under the CBN Act (the Act) subsequently issued the “Guidance Note to Banks and Discount Houses on the Implementation of IFRS 9 (Financial Instruments) in Nigeria (the “guidelines”) in December 2016, detailing its expectations particularly in relation to areas where banks are required to exercise judgement and/or elect to use simplifications and other practical expedients permitted under the standard. The Guidelines, among other things, provides clear guidance on the measurement of financial instruments, assessment of significant increase in credit risk, transfer criteria for financial assets, impairment of financial instruments, period of exposure at default and the parameters for the exercise of a banks considerable judgement.

The rules create a consistent standard for the measurement, treatment and reporting of financial instruments including the requirement for regular recharacterisation of such instruments based on an assessment of the probability of default.

Market Impacts

Significantly, 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 expectation 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 thereof, the CBN noted that banks are required to abide by the relevant extant guidelines and regulations with respect to the write off of non-performing financial assets. Relatedly loans that had escaped classification as non-performing loans (NPLs) may now be caught pursuant to the implementation of IFRS 9 in the 2018 financial results for banks.

In addition, there is the likelihood of banks reporting a greater ratio of NPLs than was previously the case thus increasing the level of provisioning required for the extra NPLs. The ultimate consequence (given the marginal level of compliance by a number of banks in the presently difficult economic climate) may be that overall compliance with capital adequacy and other regulatory thresholds may deteriorate.

By the provisions of Banks and Other Financial Institutions Act (BOFIA), failure by a bank to maintain and observe regulatory ratios entitle the CBN to prohibit the bank from (i) seeking or receiving new deposits; (ii) granting credit; (iii) making investments; and (iv) paying cash dividends to shareholders (notably, the CBN has recently taken separate action to limit the payment of dividends to shareholders of banks underperforming banks, i.e. banks whose capital adequacy ratio (CAR) is below the regulatory requirement). The CAR for Nigerian banks is currently set at 10% and 15% for national/regional banks and banks with international banking licence, respectively and a 2017 report by the International Monetary Fund indicates that as many as three Nigerian banks were undercapitalised with a CAR far
below the regulatory threshold. If this situation is not addressed (or, indeed, if it worsens) any failure to meet minimum CAR thresholds could ultimately result in revocation of the defaulting bank’s banking license.

From a documentation perspective, given that IFRS 9 essentially focuses on financial reporting and accounting standards, it remains to be seen whether there will be any corresponding changes to the representations and warranties, financial covenants or other parts of standard commercial loan documentation. One can also imagine possible consequences of IFRS 9 on the performance of existing financial covenants and it remains to be seen how lenders will react to technical breaches as a result of the adoption of the new standard. As always, it is important for solicitors involved on either side of commercial loan transactions to be aware of changes affecting their clients and the potential impact on their transaction documents.

Options & Solutions

The forgoing in mind, some banks may need to move quickly to shore up their capital base to cushion the potential adverse effect of IFRS 9. The adoption of the Standard from January 2018 only heightens the urgency as attendant changes will need to be reflected in banks’ half yearly accounts, thus dragging down earnings and posing a threat to customer and shareholder confidence.

In the first instance, Nigerian banks must now be even more vigilant with their internal capital adequacy assessments to ensure that their capital is commensurate with their overall risk profile. This would include, among others, developing and implementing effective risk management systems, capable of identifying, assessing, measuring, monitoring and managing various risks.

Beyond improving corporate governance mechanisms some banks may also need to explore options for raising additional capital. In this regard, the recent successes enjoyed by Nigerian corporates (including some banks) indicate that there is high investor appetite in local and international capital markets. One solution would thus be to explore the level of investor appetite for the issuance of instruments that would qualify as additional Tier 1 (under the Basel III convention) or Tier 2 capital such as long tenures convertible bonds and subordinated notes. Another option which some banks may want to consider in the coming months would be to undergo further consolidations and mergers in order to increase the capacity of the banks to raise capital and satisfy the capital adequacy ratio requirements under the law.

As an alternative to raising their size and capital, banks struggling to meet their regulatory capital requirements can also improve their performance by reducing the burden created by their non-performing assets through a sale of such NPLs to third parties. Notably, in this regard, the CBN has recently recognised the existence and importance of a new breed (in the Nigerian context) of financial institution, private asset management companies, whose role shall be to purchase distressed assets from struggling banks for profit. The establishment and operation of PAMCs (as they are known) is now regulated by the CBN and while a few early loan purchase deals have been struck in recent years, it remains to be seen whether and to what extent this sub-sector able to take off and find success where banks have largely failed, i.e. in collecting on bad loans.

Whatever option is chosen, the long overdue adoption of IFRS 9 in Nigeria has the potential to significantly disrupt the financial sector, it is hoped, for the better.
For further information, please contact:

Yewande Senbore  
Partner  
+234-1-2702551 Ext 2715  
ysenbore@olaniwunajayi.net

Adedamilotun Aderemi  
Associate  
+234-1-2702551 Ext 2632  
aaderemi@olaniwunajayi.net

Adetola Adebesin  
Associate  
+234-1-2702551 Ext 2729  
aadebesin@olaniwunajayi.net