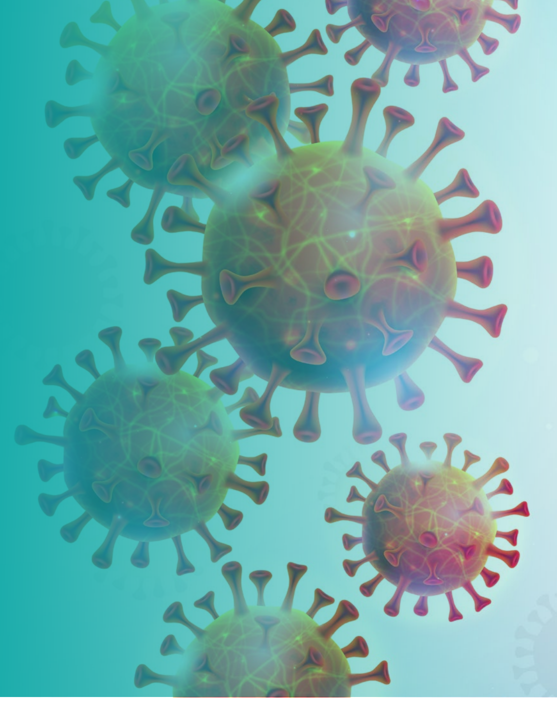
KPMG

COVID-19: The Central Bank of Nigeria (CBN) Support Measures

Financial Reporting Considerations for Banks and other financial institutions

KPMG in Nigeria | May 2020



Introduction

COVID-19 pandemic has put pressures on policy makers and supervisory institutions across the globe, sparking off a number of mitigating initiatives by government agencies to combat the potential negative social-economic impacts on households and businesses.

On 16 March 2020, the Central Bank of Nigeria (CBN) released a circular on its policy response to the outbreak to reflate the economy and support businesses. These measures include;

- extension of one year moratorium on principal repayments effective March 1, 2020,
- reduction of interest rate on all CBN intervention facilities from 9 to 5 percent effective March 1, 2020,
- creation of a N50billion targeted credit facility for households and small- and medium-sized enterprises (SMEs) that have been particularly hard hit by COVID-19,
- creation of a credit support for healthcare industry,
- regulatory forbearance, and
- the strengthening of CBN Loan Deposit Ratio (LDR).

Banks and other financial institutions in Nigeria are also responding with different initiatives to support their customers during this challenging time. Some of these initiatives include loan payment holiday, special waivers on payment of fees on credit cards, increasing credit card limits, short term support facilities and a waiver of charges on a specified number of transactions on digital platforms.

In this newsletter we will be discussing the accounting and financial reporting implications of the various measures proposed in the circular and providing practical guidance on the accounting.

Accounting considerations from a lender's perspective

The following are the key accounting issues that should be considered as banks and financial institutions implement the intervention measures:

- *Determining whether the measure constitutes a modification of financial asset, and will result in the derecognition of the financial asset;*
- *Determining whether there is a significant increase in credit risk of the modified financial assets*
- *Other Impairment considerations and in particular assumptions on forward looking information*

Determining whether a modification of financial asset results in derecognition

Modifications of financial instruments exist when the contractual terms or cash flows are amended in a way not originally intended when entering into the contract.

The following CBN COVID-19 measures introduce a modification to the original contractual cashflows of the applicable intervention facilities.

- An extension of moratorium of one year on principal repayments
- Regulatory forbearance on loans granted to businesses and households most affected by the pandemic
- Reduction of interest rate on all applicable CBN intervention facilities

Modification of contractual terms

When there is a modification to the contractual terms of a financial asset, an assessment is required to determine whether the amendment results in a substantial modification of the contractual terms of the asset. International Financial Reporting Standards (IFRS 9) - Financial Instruments does not provide specific guidance on when a modification of a financial asset should be considered substantial.

In our view, lenders should perform a quantitative and qualitative evaluation of whether the modification is substantial. In doing so, the lender may, but is not required to, analogise to the guidance on the derecognition of financial liabilities. Terms are considered to have been substantially modified when the net present value of the cash flows under the new terms, including any fees paid net of any fees received and discounted using the original effective interest rate differs by at least 10 percent from the present value of the remaining cash flows under the original terms (the so called '10 percent test' or 'quantitative assessment'). [IFRS 9.B3.3.6]

If the difference in the present value of the cash flows under the quantitative assessment is at least 10 percent, then a modification should be accounted for as an extinguishment in all cases. However, if the difference in the present values of the cash flows is less than 10 percent, then lenders should perform a qualitative assessment to determine whether the terms of the two instruments are substantially different. The purpose of a qualitative assessment is to identify substantial differences in terms, that by their nature are not captured by quantitative assessment. An example of a qualitative factor is where the modified cashflows alter the classification and measurement category of a financial asset from amortised cost to fair value through profit or loss.

The assessment of whether a modification is substantial should be properly defined in the lender's accounting policy manual and may require some level of judgement.

Forbearance of a financial asset and the derecognition principle

As encouraged by the CBN circular, all lenders are encouraged to grant forbearance to households and businesses that are most affected by the pandemic by either reducing interest rates, delaying the payment of principal or amending covenants to allow the borrower sufficient capacity to service their obligations. Generally where a financial asset is modified as part of forbearance, it is more difficult to come to the conclusion that the original financial asset should be derecognised. This is because in such a case the objective and nature of the modification is usually to maximise recovery of the original contractual cash flows rather than to originate a new asset on market terms.

Modifications that result in derecognition

However, where the forbearance results in cash flows that are substantially different from the contractual rights to cash flows from the original financial asset, the original financial asset is deemed to have expired and accordingly can be derecognised. The modified asset is recognised as a new financial asset and initially measured at its fair value plus eligible transaction costs. A gain or loss is recognised on derecognition as the difference between the:

- the amortised cost of the old asset; and
- the fair value of the new asset minus the amount of expected credit losses (ECLs) recognised as an impairment allowance on the new asset.

Modifications that do not result in derecognition

Where there is no substantial difference in cash flows arising from the forbearance and the contractual rights to cash flows from the original financial asset, the modification does not result in the derecognition of the original financial asset. Under this circumstance, the gross carrying amount of the financial asset is recalculated at the instrument original effective interest rate and the resulting gain or loss is recognised immediately in profit or loss.

Determining whether there is a significant increase in the credit risk of modified financial assets

As lenders grant forbearances or implement CBN Covid 19 Pandemic measures, they will need to evaluate the relevant facts and circumstances especially to determine whether the direct impact of such measures increases or reduces credit risks. The discussion below provide some useful guidance in this respect.

Qualitative assessment of significant increase in credit risk

The significant increase in credit risk (SICR) assessment considers changes in the risk of default occurring over the life of the instrument. COVID-19 generally represents a credit deterioration affecting many borrowers. A key issue will be to distinguish between cases where:

- the moratorium/forbearance provides relief from short-term liquidity constraints impacting the borrower that do not amount to a significant increase in credit risk (SICR) considering the entire life of the instrument; and
- there is a significant increase in the risk of default over the entire remaining life of the instrument.

The above distinction could be difficult to make and therefore lenders should evaluate the macroeconomic impact on a holistic basis i.e how severe and long the macroeconomic problems will be, when and how quickly there may be a return to longer-term "normal" economic trends.

Quantitative assessment of significant increase in credit risk

There is a rebuttable presumption that a significant increase in credit risk has arisen when the contractual payments are more than 30 days past due. An entity can rebut this presumption if it has a reasonable and supportable information that demonstrates that credit risk has not increased significantly since initial recognition even though the contractual payments are more than 30 days past due. (IFRS 9.5.5.11, B5.5.20)

Where the lender has a reasonable and supportable information that the loan obligor would receive assistance from the government to resolve a short-term liquidity constraint as a result of COVID-19, the lender may rebut the 30 days past due presumption. However, such a rebuttal will need to be accompanied by a thorough analysis clearly demonstrating that 30 days past due is not correlated with a significant increase in credit risk.

Regulatory forbearance on loans granted to businesses and households most affected by the pandemic

In our experience, if the modification of a financial asset amounts to granting forbearance, then this is generally regarded as evidence of a significant increase in credit risk and may also represent evidence that the financial asset is credit- impaired. For an asset that is modified while having an allowance equal to lifetime ECLs, an example of evidence that the criteria for recognising lifetime ECLs are no longer met includes a history of up-to-date and timely payment performance against the modified contractual terms.

Typically, a borrower would need to demonstrate consistently good payment behaviour over a period of time before the credit risk is considered to be improved - e.g. a history of missed or incomplete payments are not typically ignored if the customer makes one payment on time following the modification. The CBN guidance note to banks and discount houses on the implementation of IFRS 9 dated 20 December, 2016 states that " 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 ".

Equally, as the International Accounting Standards Board (IASB) has stated in the context of COVID-19, the extension of payment holidays to all borrowers in particular classes of financial instruments should not automatically result in the asset being considered to have suffered a significant increase in credit risk. However, for a distressed asset that has been modified substantially and meets the derecognition criteria, the modified financial asset is considered credit impaired at initial recognition.

Other Impairment considerations and in particular assumptions on forward looking information

A number of assumptions underlying the way ECL requirements of IFRS 9 are implemented may no longer hold because of the pandemic. It is likely to be difficult at this time to incorporate the specific effects of COVID-19 and government support measures on a reasonable and supportable basis. However, changes in economic conditions should be reflected in macroeconomic scenarios applied by entities and in their weightings. If the effects of COVID-19 cannot be reflected in models, post-model overlays or adjustments will need to be considered. The environment is subject to rapid change and updated facts and circumstances should continue to be monitored as new information becomes available. (IASB document on IFRS 9 and COVID-19)

Recognition of impairment on a collective basis

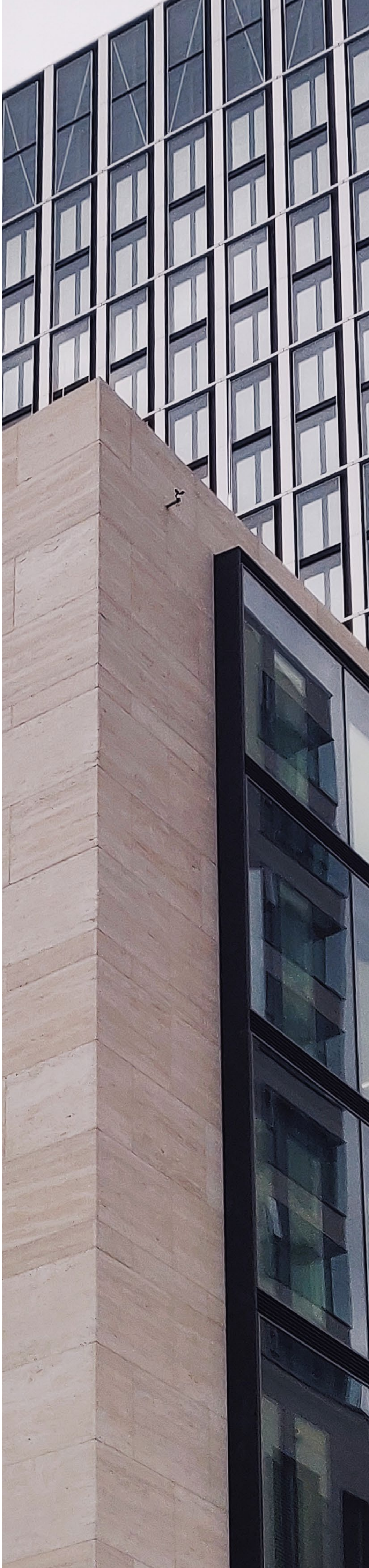
The rapid onset of the COVID-19 outbreak, the large number of borrowers affected, the extreme difference between its economic impacts and other recent financial shocks and the high level of uncertainty regarding its future economic effects means that the potential impacts of the pandemic are unquantifiable at this time. Based on the reports on the world economic outlook released by International Monetary Fund (IMF) in April 2020, the global economy is projected to contract sharply by 3 percent with Sub-Saharan Africa expected to shrink by 1.6 percent in the year 2020. In a recent publication on the threat of COVID-19 crisis to financial stability released on IMF blog on the 14 April 2020, it was noted that there is a great uncertainty about the severity and length of the COVID-19 pandemic at this point. World Bank Group (WBG) president, David R. Malpass in his remarks at the Development Committee virtual meeting on 17 April, 2020 stated that the WBG's estimates of the impacts from the COVID-19 pandemic suggest a much deeper global downturn than the Great Recession.

Consequently, it is unlikely that the lender is able to perform a comprehensive definitive assessment, including forward looking information, for each individual exposure. When this is the case, lifetime expected credit losses are recognised on a collective basis that considers comprehensive credit risk information, including forward-looking information, in order to approximate what the result would have been on an individual basis. This may mean segmenting portfolio by relevant shared credit risk characteristics considering how different groups might be impacted by COVID-19.

If a lender is not able to group financial instruments for which the credit risk is considered to have increased since initial recognition based on shared credit risk characteristics, lenders should recognise lifetime expected credit losses on a portion of the financial assets for which credit risk is deemed to have increased significantly. Determining the portion in each case will consider the different risk characteristics of each segment and will require experienced credit judgement. It may be useful to pay particular attention to borrowers who were showing signs of some credit deterioration or elevated risk even before the onset of COVID-19. (IFRS 9.B5.5.6, IE39)

Disclosures:

Banks and other financial institutions should consider all relevant financial statement disclosures in their next published financial reports and conduct a thorough assessment of whether the COVID-19 impacts should be considered an adjusting event. The disclosures should also incorporate various intervention measures and government supports where applicable.



Financial/Business impacts

As a bank/financial institution, It is important to evaluate and better understand the impact of COVID-19 and the support measures by the government and other supervisory institutions. Some of the possible financial impacts to consider include:

- lower net interest margin due to reduction in interest rates on intervention facilities from 9 percent to 5 percent per annum.
- reduced profitability resulting from reduction in net interest margin, waiver of fees on electronic transactions and the negative impact of modification of financial assets on the bottom line among others.
- Worsened asset quality especially in the oil & gas including retail portfolio.
- delayed cash inflows from loan repayments due to loan forbearance and moratorium on principal repayments.
- pressure to meet financial targets due to negative impacts of various palliative measures.
- disruption to liquidity plan and increased liquidity cost arising from payment holidays and other loan restructuring.

Key message

As banks and financial institutions continue to implement various COVID-19 intervention measures including other support initiatives, it is critical to be clear and be better prepared for their accounting implications and understand the impact on their strategy and business model.
Please contact us if you require assistance on how to navigate through the accounting challenges and other associated financial risks.

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COVID-19 – A Business Impact Series.