

Prudential Guidelines for licensed banks

issued by Central Bank of Nigeria (CBN), Lagos

FOREWORD

Banking is essentially an international business, especially now that domestic financial markets in many countries are being internationalised. One implication of international banking is the necessity to develop and continuously review the reporting systems which allow for a high degree of comparability of banking performance across national borders. Such systems have been evolved in such areas of banking practice as credit portfolio classification and disclosure, interest accrual, and off-balance-sheet engagements.

The apex institution in the Nigerian banking system, the Central Bank of Nigeria (CBN), is consciously moving banks in the country towards compliance with international banking practices. To this end, the Banking Supervision Department (BSD) issued on November 7, 1990 Circular Letter No. BSD/DO/23/VOL.1/11 to all licensed banks and their auditors. The Circular titled "Prudential Guidelines For Licensed Banks" addressed requirements for asset classification and disclosure, provisioning, interest accruals and off-balance-sheet engagements. In view of the importance of this Circular to bank management, bank auditors and bank examiners, we have reproduced the Circular in this publication .

The publication is intended as a handbook to the target groups identified above, especially bank examiners. It is the examiners' task to prevent bank failures by identifying bank problems at an early stage to allow for intervention and/or corrective action before the situation gets out of hand. In going about this task, bank examiners carry out appraisals of the quality of a bank's assets.

This publication is intended therefore as a useful guide to bank examiners, bank auditors and bank inspectors/branch managers in the performance of their responsibilities.

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PRUDENTIAL GUIDELINES FOR LICENSED BANKS

1.0 INTRODUCTION

Without prejudice to the requirements of the Statement of Accounting Standard on Accounting By Banks and Non-Bank Financial Institutions (Part 1) to be issued by the Nigerian Accounting Standards Board (NASB) in the near future, all licensed banks shall be required to adhere to the prudential guidelines enunciated in this circular for reviewing and reporting their performance, with immediate effect. In view of the international nature of banking, the guidelines are based on practices endorsed by reputable international financial institutions and regulatory authorities.

These guidelines should be regarded as minimum requirements and licensed banks which already have more stringent policies and practices in place are encouraged to continue with them.

2.0 CREDIT PORTFOLIO CLASSIFICATION SYSTEM

2.1 Licensed banks should review their credit portfolio continuously (at least once in a quarter) with a view to recognising any deterioration in credit quality. Such reviews should systematically and realistically classify banks' credit exposures based on the perceived risks of default. In order to facilitate comparability of banks' classification of their credit portfolios, the assessment of risk of default should be based on criteria which should include, but are not limited to, repayment performance, borrower's repayment capacity on the basis of current financial condition and net realisable value of collateral.

2.2 Credit facilities (which include loans, advances, overdrafts, commercial papers, bankers acceptances, bills discounted, leases, guarantees, and other loss contingencies connected with a bank's credit risks) should be classified as either "performing" or "non-performing" as defined below:

- (a) a credit facility is deemed to be performing if payments of both principal and interest are up-to-date in accordance with the agreed terms;
- (b) a credit facility should be deemed as non-performing when any of the following conditions exists:
 - (i) interest or principal is due and unpaid for 90 days or more;
 - (ii) interest payments equal to 90 days interest or more have been capitalised, rescheduled or rolled over into a new loan (except where facilities have been reclassified as specified in 2.3 below).

2.3 The practice whereby some licensed banks merely renew, reschedule or roll-over non-performing credit facilities without taking into consideration the repayment capacity of the borrower is objectionable and unacceptable. Consequently, before a credit facility already classified as “non-performing” can be reclassified as “performing” the borrower must effect cash payment such that outstanding unpaid interest does not exceed 90 days.

2.4 Non-performing credit facilities should be classified into three categories namely, sub-standard, doubtful or lost on the basis of criteria below:

(a) **Sub-Standard**

The following objective and subjective criteria should be used to identify sub-standard credit facilities:

(i) Objective Criteria: facilities as defined in 2.2(b) on which unpaid principal and/or interest remain outstanding for more than 90 days but less than 180 days.

(ii) Subjective Criteria: credit facilities which display well defined weaknesses which could affect the ability of borrowers to repay such as inadequate cash flow to service debt, undercapitalisation or insufficient working capital, absence of adequate financial information or collateral documentation, irregular payment of principal and/or interest, and inactive accounts where withdrawals exceed repayments or where repayments can hardly cover interest charges.

(b) **Doubtful**

The following objective and subjective criteria should be used to identify doubtful credit facilities:

(i) Objective Criteria: facilities on which unpaid principal and/or interest remain outstanding for at least 180 days but less than 360 days and are not secured by legal title to leased assets or perfected realisable collateral in the process of collection or realisation.

(ii) Subjective Criteria: facilities which, in addition to the weaknesses associated with sub-standard credit facilities, reflect that full repayment of the debt is not certain or that realisable collateral values will be insufficient to cover bank’s exposure.

(c) **Lost Credit Facilities**

The following objective and subjective criteria should be used to identify lost credit facilities:

- (i) Objective Criteria: facilities on which unpaid principal and/or interest remain outstanding for 360 days or more and are not secured by legal title to leased assets or perfected realisable collateral in the course of collection or realisation.
- (ii) Subjective Criteria: facilities which in addition to the weaknesses associated with doubtful credit facilities, are considered uncollectible and are of such little value that continuation as a bankable asset is unrealistic such as facilities that have been abandoned, facilities secured with unmarketable and unrealisable securities and facilities extended to judgment debtors with no means or foreclosable collateral to settle debts.

2.5 Banks are required to adopt the criteria specified in paragraphs 2.1 to 2.4 to classify their credit portfolios in order to reflect the true accounting values of their credit facilities. Licensed banks should note that the Central Bank of Nigeria reserves the right to object to the classification of any credit facility and to prescribe the classification it considers appropriate for such credit facility.

3.0 PROVISION FOR NON-PERFORMING FACILITIES

3.1 Licensed banks are required to make adequate provisions for perceived losses based on the credit portfolio classification system prescribed in paragraph 2 in order to reflect their true financial condition. Two types of provisions (that is specific and general) are considered adequate to achieve this objective. Specific provisions are made on the basis of perceived risk of default on specific credit facilities while general provisions are made in recognition of the fact that even performing credit facility harbours some risk of loss no matter how small. Consequently, all licensed banks shall be required to make specific provisions for non-performing credits as specified below:

- (a) For facilities classified as Sub-Standard, Doubtful, or Lost:
 - (i) interest overdue by more than 90 days should be suspended and recognised on cash basis only.
 - (ii) principal repayments that are over due by more than 90 days should be fully provided for and recognised on cash basis only.
- (b) For principal repayments not yet due on non-performing credit facilities, provision should be made as follows:
 - (i) Sub-Standard Credit Facilities: 10% of the outstanding balance;
 - (ii) Doubtful Credit Facilities: 50% of the outstanding balance;
 - (iii) Lost Credit Facilities: 100% of the outstanding balance.

3.2 For prudential purpose, provisioning as prescribed in 3.1 should only take cognisance of realisable tangible security (with perfected legal title) in the course of collection or realisation. Consequently, collateral values should be recognised on the following basis:

- (a) For credit exposure where the principal repayment is in arrears by more than six months, the outstanding unprovided principal should not exceed 50% of the estimated net realisable value of the collateral security.
- (b) For credit exposure where the principal repayment is in arrears by more than one year, there should be no outstanding unprovided portion of the credit facility irrespective of the estimated net realisable value of the security held.
- (c) For a credit exposure secured by a floating charge or by an unperfected or equitable charge over tangible security, it should be treated as an unsecured credit and no account should be taken of such security held in determining the provision for loss to be made.

3.3 General Provisions

Each licensed bank is required to make a general provision of at least 1% of risk assets not specifically provided for.

4.0 CREDIT PORTFOLIO DISCLOSURE REQUIREMENT

- (a) Each licensed bank is required to provide in its audited financial statements, an analysis of its credit portfolio into “performing” and “non-performing” as defined in paragraphs 2.2 and 2.4.
- (b) The amount of provision for deterioration in credit quality (that is, losses) should be segregated between principal and interest.
- (c) A maturity profile of credit facilities based on contracted repayment programme, should be provided along with the maturity profile of deposit liabilities in the financial statement.

5.0 INTEREST ACCRUAL

5.1 It is the responsibility of bank management to recognise revenues when they are earned or realised and make provision for all losses as soon as they can be reasonably estimated. However, experience revealed a wide diversity amongst licensed banks on income recognition. While a few banks cease accruing interest on non-performing credit facilities after three months, some after six months or a year, some do not appreciate the need to suspend interest on such facilities.

5.2 In order to ensure the reliability of published operating results, the following criteria should be adopted by all licensed banks for the treatment of interest on

non-performing credit facilities:

- (a) All categories of non-performing credit facilities should automatically be placed on non-accrual status that is, interest due thereon should not be recognised as income.
- (b) All interest previously accrued and uncollected but taken into revenue should be reversed and credited into suspense account specifically created for this purpose which should be called “interest in suspense account” unless paid in cash by the borrower. Future interest charges should also be credited into same account until such facilities begin to perform.
- (c) Once the facilities begin to perform, interest previously suspended and provisions previously made against principal debts should be recognised on cash basis only. Before a “non-performing facilities”, can be re-classified as “performing”, unpaid interest outstanding should not exceed 90 days.

6.0 CLASSIFICATION OF OTHER ASSETS

6.1 The term “Other Assets” relate to those asset items, not shown separately in the balance sheet of a bank. These items include, Impersonal Accounts (of various descriptions), Suspense Accounts such as frauds and cashiers’ shortages, Cheque Purchased, Uncleared Effects and Inter-branch Items. More often than not, the accounts usually grouped together as “Other Assets” contain fictitious or intangible assets. The accounts could contain many long outstanding items, the origins of which had been long forgotten, untraceable as well as unreconcilable. In situations like these, the items if not material should be written off and where material (i.e. at least 10% of aggregate balance of Other Assets) should be classified as below. It should be noted that items enumerated below are by no means exhaustive:

- (a) **Sub-Standard**
 - (i) Cheques purchased and uncleared effects outstanding after the permissible clearing period.
 - (ii) Fraud cases of up to 6 months old and under police investigation regardless of the likely outcome of the cases.
 - (iii) Inter-branch items of between 2 months to 3 months.
 - (iv) All other intangible suspense accounts existing in the books for up to 3 months.

A minimum provision of 10% should be made for “Other Assets” items classified as sub-standard.

(b) **Doubtful**

The above listed features must have been aggravated and are likely to result in losses higher than recommended for sub-standard items. Items for doubtful classification should include, but are not limited to the following:

- (i) Cheques purchased of between 3 to 6 months old but which had been withdrawn or cancelled and substituted with new ones. Similar treatment should be accorded to uncleared effects for which values had been given.
- (ii) Outstanding fraud cases of 6 to 12 months old and with slim chances of full recoveries.
- (iii) Inter-branch items outstanding for between 3 to 6 months.
- (iv) All other intangible suspense accounts outstanding for between 6 months and 12 months.

A minimum of 50% provision should be made for "Other Assets" items classified as doubtful.

(c) **Lost**

Items for lost classification should include, but are not limited to the following:

- (i) Cheques purchased and uncleared effects over 6 months old and for which values had been given.
- (ii) Outstanding fraud cases over 12 months and involving protracted litigations.
- (iii) Inter-branch items over 6 months old whether or not the origins are known.
- (iv) All other intangible suspense accounts over 12 months old.

Full provision (i.e. 100%) should be accorded to items classified lost.

7.0 OFF-BALANCE-SHEET ENGAGEMENTS

- 7.1 A proper appraisal of Off-Balance-Sheet engagements should be undertaken with a view to determining the extent of loss a bank may likely sustain. Off-Balance-Sheet items include Letters of Credits, Bonds, Guarantees, Indemnities, Acceptances, and Pending or Protracted Litigations (the outcome of which could not be easily determined).

7.2 The following factors should be taken into consideration in recognising losses on Off-Balance-Sheet engagements:

- (i) Date the liability was incurred
- (ii) Expiry Date
- (iii) Security Pledge
- (iv) Performance of other facilities being enjoyed by the customer, e.g. loan and advances
- (v) Perceived Risk.

Full provisions must be made for any loss that may arise from Off-Balance-Sheet transactions.

7.3 Off-Balance-Sheet Engagements should not form part of balance sheet totals while their disclosure in note form should distinguish between:

- (a) direct credit substitutes, such as guarantees, acceptances and standby letters of credit serving as guarantees.
- (b) transaction related contingencies, such as bid bonds, performance guarantees and standby letters of credit related to particular transactions;
- (c) short-term self liquidation trade related contingencies resulting from the movement of goods; and
- (d) other contingencies.

SIGNED:

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