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### Guidance Notes on Regulatory Capital

Central Bank of Nigeria (CBN)

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# **CENTRAL BANK OF NIGERIA**



## **Guidance Notes on Regulatory Capital**

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# 1. Introduction

This document lays down the new supervisory regulations for assessing the capital adequacy levels of all banks in Nigeria. The Rules governing regulatory capital, its components and required deductions to the capital levels, shall be applied by banks for assessment of qualifying capital.

Banks are required to maintain a minimum regulatory capital adequacy ratio (CAR) of 10%/15%<sup>1</sup> on an on-going basis. The Central Bank of Nigeria (CBN) will take into account the relevant risk factors and the internal capital adequacy assessments of each bank to ensure that the capital held by a bank is commensurate with the bank's overall risk profile. This would include, among others, the effectiveness of the bank's risk management systems in identifying, assessing / measuring, monitoring and managing various risks including interest rate risk in the banking book, liquidity risk, concentration risk and residual risk. Accordingly, CBN will consider prescribing a higher level of minimum capital ratio for each bank under the Pillar 2 framework on the basis of their respective risk profiles and their risk management systems. Furthermore, in terms of the Pillar 2 requirements of the capital adequacy framework, banks are expected to operate at a level well above the minimum requirement.

A bank shall compute its regulatory capital adequacy ratio in the following manner:

$$\text{Regulatory CAR} = \frac{\text{Qualifying Capital}}{\text{Total RWA (Credit RWA + Market RWA + Operational RWA)}}$$

Where total risk-weighted assets are calculated as the sum of:

- 1) risk-weighted on-balance sheet and off-balance sheet assets computed according to Standardised Approach for credit risk
  - 2) 12.5 times the sum of the capital charges determined for market risk and operational risk;
- and

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<sup>1</sup>A minimum regulatory capital adequacy ratio (CAR) of 15% will be applicable to banks with international authorisation and Systemically Important Banks (SIBs) while a CAR of 10% will be applicable to other banks.

**Qualifying capital is broadly classified as Tier 1 and Tier 2 capital. Elements of Tier 2 capital will be limited to a maximum of one-third (i.e. 33.33%) of Tier 1 capital, after making deductions for goodwill, deferred tax asset (DTA) and other intangible assets but before deductions of investments.**

**Banks are to note that Regulatory Risk reserve is not recognized as a component of qualifying capital. However, any balance, should be netted off against the Total RWA and such balance must be based on the last audited financial statement.**

## **2. Tier 1 capital**

This includes only permanent shareholders' equity (issued and fully paid ordinary shares/common stock and perpetual non-cumulative preference shares) and disclosed reserves (created or increased by appropriations of retained earnings or other surpluses).

Tier 1 capital would include the following elements:

- 1) Paid-up share capital;
- 2) Irredeemable preference shares;
- 3) Share premiums;
- 4) General reserve (retained profit),
- 5) SMEEIS reserves,
- 6) Statutory reserve;
- 7) Other reserves as may be determined by the CBN.

For an instrument to be treated as paid-up share capital, it must satisfy following criteria:

- 1) Represents the most subordinated claim in liquidation of the bank;
- 2) The investor is entitled to a claim on the residual assets that is proportional with its share of issued capital, after all senior claims have been paid in liquidation (i.e. has an unlimited and variable claim, not a fixed or capped claim);
- 3) The principal is perpetual and never repaid outside of liquidation;
- 4) Distributions are paid out of distributable profit or retained earnings;
- 5) There are no circumstances under which the distributions are obligatory;

- 6) Distributions are paid only after all legal and contractual obligations have been met and payments on more senior capital instruments have been made. This means that there are no preferential distributions, including in respect of other elements classified as the highest quality issued capital;
- 7) It is in the form of issued capital that takes the first and proportionately greatest share of any losses as they occur. Within the highest quality of capital, each instrument absorbs losses on a going concern basis proportionately and *pari passu* with all the others;
- 8) It should be classified as equity instruments in accordance with IFRS.

**There is no limit on the inclusion of Tier 1 capital for the purpose of calculating regulatory capital.**

## **3. Tier 2 capital**

### **3.1 Hybrid Capital Instruments**

Hybrid debt capital instruments, in this category combine certain characteristics of equity and debt. Each has a particular feature, which can be considered to affect its quality as capital. Where these instruments have close similarities to equity, in particular when they are able to support losses on an on-going basis without triggering liquidation, they may be included in Tier 2 capital.

Essentially, hybrid capital instruments should meet the following requirements:

- a) they are unsecured, subordinated and fully paid-up;
- b) they are not redeemable at the initiative of the holder or without the prior consent of the CBN;
- c) they are available to participate in losses without the bank being obliged to cease trading (unlike conventional subordinated debt);
- d) although the capital instrument may carry an obligation to pay interest that cannot permanently be reduced or waived (unlike dividends on ordinary shareholders' equity), it should allow service obligations to be deferred (as with cumulative preference shares) where the profitability of the bank would not support payment;

- e) Hybrid capital instruments that are redeemable must have an original maturity of **at least 10 years**. The contract must clearly specify that repayment is subject to authorization by the Central Bank of Nigeria.

Cumulative preference shares, having these characteristics, would be eligible for inclusion in this category.

### 3.2 Subordinated Debt

A capital instrument of the bank shall qualify as subordinated debt for inclusion as Tier 2 Capital when it satisfies the following conditions -

- a) the capital instrument is issued and fully paid-up in cash;
- b) the capital instrument is subordinated to depositors and general creditors of the bank;
- c) the paid-up amount is not secured or covered by a guarantee of the bank or any of its subsidiaries, or any other arrangement, that legally or economically enhances the seniority of the claim vis-a-vis the bank's creditors and depositors;
- d) with regard to the maturity of the capital instrument:
  - i. the capital instrument has a minimum original maturity of at least **5 years**;
  - ii. recognition of capital instrument in Tier 2 capital in its final five years to maturity is amortised on a straight-line basis by 20% per annum in accordance with table 1 below;

Table 1: Progressing discounting of debt capital instrument

Remaining Maturity of Instruments	Rate of Discount (%)
Less than one year	100
One year and more but less than two years	80
Two years and more but less than three years	60
Three years and more but less than four years	40
Four years and more but less than five years	20

- iii. there are no step-ups or other provisions that mandate or create an incentive for the bank to redeem the capital instrument;

- e) the capital instrument is callable at the option of the bank only after a minimum of five years from the issue date, subject to the following requirements:
  - i. a call option may be exercised only with the prior approval of the CBN;
  - ii. the bank shall not exercise a call option unless the bank demonstrates that its capital position is well above the minimum capital requirements after the call option is exercised;
- f) the holder of the capital instrument has no rights to accelerate the repayment of future scheduled payments (either coupon or principal), except in a bankruptcy or liquidation of the bank;
- g) The capital instrument does not have a credit sensitive dividend feature. In this regard, the capital instrument shall not have a dividend or coupon that is reset periodically, based in whole or in part on the credit standing of the bank or any banking group entity;
- h) the main features of the capital instrument are disclosed clearly and accurately; the agreement governing the issuance of the capital instrument shall not be changed without the prior approval of the CBN where such proposed changes could impact its eligibility as Tier 2 Capital;
- i) Where a bank issues the capital instrument in a foreign currency, the capital instrument shall be re-valued periodically (at least monthly) in terms of Naira at the prevailing exchange rates. Where the bank intends to use a swap to hedge the foreign exchange exposure arising from the foreign currency capital instrument, it shall consult the CBN on the capital treatment applicable to the hedge prior to such use.

### **3.3 Other Comprehensive Income Items**

Other comprehensive income items other than fixed asset revaluation reserves that are created by the adoption of the International Financial Reporting Standards (IFRS) may be accepted as part of the Tier 2 capital subject to the limitations that will be specified by the CBN from time to time.



## **4. Deductions from capital**

All items that are deducted from capital are excluded from total assets in calculating the capital adequacy ratio.

If a bank is required to make a deduction from Tier 2 capital and it does not have sufficient capital to make that deduction, the shortfall will be deducted from Tier 1 capital.

### **4.1 Goodwill, other intangibles and deferred tax assets (DTA)**

- a. Intangible assets and losses in the current period and those brought forward from previous periods should be deducted from Tier 1 capital.
- b. DTA associated with accumulated losses should be deducted from Tier 1 capital.

### **4.2 Under impairment**

Any shortfall in specific and collective impairment is to be deducted from Tier 1 capital.

### **4.3 Treasury shares**

It represents own shares purchased and held by the bank and shall be deducted from Tier 1 capital.

### **4.4 Securitization transactions**

- a. Increases in equity capital resulting from securitization transactions (e.g. capitalized future margin income, gains on sale) shall be deducted from Tier 1 capital.
- b. Securitisation exposures, eligible for deduction from capital, shall be deducted 50 per cent from Tier 1 and 50 per cent from Tier 2, except where expressly provided otherwise. Deductions from capital may be calculated net of any specific provisions maintained against the relevant securitisation exposures.

### **4.5 Reciprocal cross holdings in the common shares of banking, financial and insurance entities**

Reciprocal cross holdings in common shares (e.g. Bank A holds shares of Bank B and Bank B in return holds shares of Bank A) will be fully deducted from Tier 1 capital.

## **4.6 Investments in the capital of banking and financial institutions**

A bank's aggregate investment in all types of capital eligible instruments, issued by banks and financial institutions (except its financial subsidiaries) should not exceed 10 per cent (prudential limit) of the investing bank's capital funds (Tier 1 plus Tier 2 before deductions for investments). Any investment in excess of this limit shall be deducted at 50 per cent from Tier 1 and 50 per cent from Tier 2 capital.

A banks' investment in the following instruments issued by financial institutions will be included in the prudential limit of 10 per cent, referred to above.

- Equity shares;
- Hybrid debt capital instruments
- Subordinated debt instruments; and
- Any other instrument approved by the CBN having the nature of capital.

Financial institutions whose instruments shall qualify for capital purposes shall be as defined in the Regulation on the Scope of Banking Activities and Ancillary Matters No. 3 and any other extant regulations issued by the CBN.

## **4.7 Investment in capital of financial subsidiaries**

In the case of investment in financial subsidiaries, the treatment will be as stated below for the purpose of capital adequacy:

- i. A bank's aggregate investment in capital eligible instruments, issued by its financial subsidiaries that are outside the scope of regulatory consolidation, shall be deducted at 50 per cent from Tier 1 and 50 per cent from Tier 2 capital.
- ii. Banks should ensure that majority owned financial entities that are not consolidated for capital purposes and for which the investment in equity and other instruments eligible for regulatory capital status is deducted, meet their respective regulatory capital requirements.

## Annexure I: Illustration of capital adequacy computation

### A. Particulars

The table below represents an illustrative balance sheet of the Bank A.

*(Naira million)*

<b>Statement of financial position</b>			
Cash	2,300	Deposits	14,030
FGN bonds	3,500	Call borrowing	130
Loans secured by mortgage of residential properties	4,250	Other liabilities	520
Loans to individuals under Regulatory retail portfolio (credit risk mitigation in the form of deposits provided – N 130 million)	650	Share holders' equity	2,300
Loans to corporate entities (The amount of undrawn credit limits in overdraft accounts (revolving credits), all maturing within a year, totals N 1850 million)	6,050		
Properties, plants and equipment	230		
Total Assets	16,980	Total liabilities and Equity	16,980
Performance bonds	8,400		
Documentary credit	6,500		

### B. Other data:

1. Capital for market risk – N 45 million
2. Average annual gross income – N 320 million
3. All loans are unrated
4. Risk weight for all residential exposure – 75%
5. Performance bonds and LCs are extended to unrated corporate

## C. Solution

### 1. Credit equivalent amount of off-balance sheet exposures

Serial no	Exposure particulars	Amount	CCF (%)	Credit equivalent amount
1	Revolving credits (Undrawn credit limits)	1,850	20	370
2	Performance bonds	8,400	50	4,200
3	Documentary credit	6,500	20	1,300
	<b>Total</b>			<b>5,870</b>

### 2. Risk weighted assets of on-balance sheet exposure:

Exposures details	Gross exposure before CRM	Credit risk mitigation (CRM)	Net exposure after CRM	Risk weight (%)	RWA
Cash	2,300		2,300	0	0
FGN bonds	3,500		3,500	0	0
Loans secured by mortgage of residential properties	4,250		4,250	75	3,187
Regulatory retail portfolio	650	130	520	75	390
Corporate exposure	6,050		6,050	100	6,050
Corporate exposure (Revolving credits)	370		370	100	370
Properties, plants and equipment	230		230	100	230
Performance bonds	4,200		4,200	100	4,200
Documentary credit	1,300		1,300	100	1,300
<b>Total risk weighted assets</b>					<b>15,727</b>

### 3. Calculate operational risk capital charge:

= Relevant Indicator (gross income) x  $\alpha$  (15%)

= N 320 million x 15%

= N 48 million

**4. Calculate the total eligible capital (i.e., Tier 1 + Tier 2)**

= Shareholders' Equity

= N 2300 million

**5. Calculate the capital adequacy ratio (CAR)**

*Regulatory CAR*

$$= \frac{\text{Eligible Capital}}{\text{Credit Risk RWA} + \text{Market Risk RWA} + \text{Operational Risk RWA}} \times 100$$

$$\text{Capital Adequacy Ratio} = \frac{2300}{15727 + 12.5 * (45 + 48)} \times 100$$

= 13.62%