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Andre has extensive experience in the application of advanced risk management practices. At Absa, he was leading the group's Basel II and IFRS risk implementation as well many other frameworks – stress testing, risk appetite, economic capital, credit rating systems, market risk VaR measurement, risk-reward pricing

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Dynamic Provisioning and IFRS adoption by Nigerian Banks

THE PRO-CYCLICAL NATURE OF THE CURRENT INTERNATIONAL LOAN LOSS PROVISIONING REGIME

Most banking crises have had as a direct cause the inadequate management of credit risk by institutions. Growth of bank lending is typically characterised by alternate periods of expansion and stagnation. In many countries loan loss provisions are likewise cyclical of nature. As the banking industry world-wide experienced a prolonged period of rising and record profits in the booming part of the economic cycle in the earlier part of this decade, the ratio of loan loss reserves to total loans went down, not up – even though there was broad recognition that the cycle would soon have to turn negative. When the turn finally did come, banks have had to recognize losses through a sudden series of increased provisions. Rather than being counter-cyclical, the current IFRS loan loss provisioning rules have proven to be pro-cyclical, magnifying the impact of the downturn.

HISTORY OF IFRS CREDIT LOSS PROVISIONING

Regulators favoured a system of forward looking loan loss provisioning based on future expected losses when the current IFRS provisioning rules were designed. Initially, accountants were in agreement with this and the early draft releases of the IAS were based on expected loss. However, after much debate the accounting standard setters finally opted for an 'incurred loss' based provisioning methodology when the standard became effective in 2005.

Not all countries, however, followed the incurred loss approach. The Spanish regulator for example adopted a dynamic provisioning framework based on expected loss. Spanish banks weathered the recent financial storm better than many of its international peers, reporting comparatively minor losses in 2008 – a fact many attribute to dynamic provisioning.

INCURRED LOSS VS. EXPECTED LOSS BASED PROVISIONING

IAS39 states that impairment losses are incurred if there is objective evidence of impairment as a result of one of more events that occurred. Impairment allowances must be raised for incurred losses that can be shown to exist at the

tools, etc. He was also a member of the Barclays Group Risk Technical committee, the oversight body in the Barclays group for all technical risk management frameworks implementation. During the 4 years of Basel II implementation in South Africa he served as the chairman of the credit risk task group of the accord implementation structure, lead by the SA central bank. Andre has been a regular presenter at conferences and international risk industry events. The World Bank invited him on two occasions to share his experience of Basel II implementation in South Africa with the central banks of other emerging markets at Basel II implementation planning events in Colombia and Turkey.

reporting date. Expected losses as a result of future events, no matter how likely, may not be considered. This typically results in a write back of any general provision when IFRS is implemented.

UNIVERSAL ACCEPTANCE OF DYNAMIC PROVISIONING TO PREVENT THE CRISIS FROM RE-OCCURRING

Dynamic provisioning has great appeal among regulators and risk managers as a tool that will prevent the current crisis from re-occurring and ensure banks profits will be sustainable during economic downturns. The Bank of England has come out strongly in favour of dynamic provisioning in their recent bi-annual review. John Dugan, head of the OCC recently noted: "I think there are particularly strong arguments for a more forward-looking "life of the loan" or "expected loss" concept, where permissible provisions would focus on losses expected over a more realistic time horizon, and would not be limited to losses incurred as of the balance sheet date, as under the current regime"

Accounting standard setters are thus under pressure to change the provisioning rules to prevent a repeat of the financial meltdown. A task force has been set up by the, IASB and FASB respectively, to deal with reporting issues arising from the global banking disaster. Three alternative methodologies based on expected loss are being evaluated to potentially replace the current incurred loss approach.

Although they accept that the current impaired loss model is broken because it recognises losses too late in the cycle, accounting standard setters are wrestling with the issue of whether financial statements can include dynamic provisioning and still reflect current economic reality.

SHOULD NIGERIA BANKS ADOPT IFRS NOW?

Early adoption of the IFRS rules, even whilst undergoing revision currently, is desirable.

Whilst loan loss provisioning will have the greatest impact on IFRS reported P&L for Nigerian banks, there are other aspects that will provide significant value compared to the local accounting standards. Risk and other disclosure are also significantly enhanced under the IFRS standard, which is seriously needed.

However, Nigerian bank management should be cautious to blindly use the results of the IFRS provisioning standard for internal decision making. Rather, a so called 'economic profit' approach for credit strategy decision making should be used, as we are implementing in UBA. Using this risk-reward framework, expected losses are used in the performance measurement system and for loan pricing, credit product development, loan growth target setting, etc. Use of economic profit measures incorporate dynamic provisioning principles and will ensure rational economic behaviour in credit strategy decisions.

NIGERIAN CENTRAL BANK ROLE IN FUTURE CREDIT PROVISIONING RULES

Current CBN credit risk assets classification rules date back to the early 90's and is in serious need of reform. The CBN is in the fortunate position that it has not been an early adopter of standards that are now undergoing revision. Other than in many international jurisdictions, existing loan loss provisioning rules impacting banks' P&L in Nigeria are based on regulatory and not accounting standards. This enables the CBN to set the future standard for loan loss provisioning for Nigerian banks.

In line with the new CBN risk based approach to regulation, one would expect that a dynamic provisioning approach based on expected loss, similar to what Spain has done be adopted in Nigeria, irrespective of how the revised IFRS credit provisioning rules play out. In this way, the Nigerian banking industry can be assured of through the cycle sustainable profit growth and country outperformance during the next global economic downturn.