

CENTRAL BANK OF NIGERIA



GUIDANCE NOTES ON REGULATORY CAPITAL FOR NON-INTEREST FINANCIAL INSTITUTIONS IN NIGERIA

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Table of Contents

DEFINITION OF TERMS	3
SECTION 1: INTRODUCTION	6
1.1 Background.....	6
1.2 Objectives of the Guidance Notes	6
SECTION 2: REGULATORY CAPITAL	6
2.1 Components of Capital.....	6
2.2 Tier 1 Capital.....	6
2.2.1 Common Equity Tier 1 Capital	7
2.2.2 Additional Tier 1 Capital	9
2.3 Tier 2 Capital	10
SECTION 3: TREATMENT OF PSIA, PER AND IRR	12
SECTION 4: REGULATORY ADJUSTMENTS AND DEDUCTIONS	12
SECTION 5: ISLAMIC WINDOWS	16
SECTION 6: METHODS OF CALCULATING CAR	16
6.1 The Standard Formula Approach.....	16
6.2 The Supervisory Discretion Formula Approach	17

DEFINITION OF TERMS

Affiliate Entity of Non-Interest Financial Institution (NIFI)	An affiliate of a NIFI is defined as a company that controls, or is controlled by, or is under common control with the NIFI. Control of a company is defined as: (1) ownership, control, or holding with power to vote 20% or more of a class of voting securities of the company; or (2) consolidation of the company for financial reporting purposes.
Deferred Tax Assets (DTAs)	DTAs are amounts of income tax paid which have the effect of reducing the amount of income tax payable in subsequent periods and which are therefore recognised as assets. When DTAs are recognised but their realisation through reduction of future taxes payable is uncertain, they should be deducted from capital.
Islamic Financial Services Board (IFSB)	The Islamic Financial Services Board is an international standard-setting Organisation, which promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry, broadly defined to include banking, capital markets and insurance sectors. The Malaysia-based institution complements the efforts of Basel Committee on Banking Supervision (BCBS) and other international standard setters on prudential regulation that focus on conventional financial institutions.
IFSB-15	Revised Capital Adequacy Standard for Institutions Offering Islamic Financial Services issued in December 2013 by the IFSB. This Guidance Notes is adapted from IFSB-15.
IFSB-16	Revised Guidance on Key Elements in the Supervisory Review Process of Institutions Offering Islamic Financial Services issued in March 2014 by the IFSB.
Investment Risk Reserve (IRR)	The amount appropriated by the NIFIs out of the income of Investment Account Holders (IAH), after allocating the <i>Mudarib</i> 's share in order to cushion against future investment losses for IAH.
Non-Interest Banking Window	A Non-Interest banking Window is part of a conventional financial institution that mobilises deposits and provides fund management (investment accounts), financing and investment, and other banking services that are Shariah compliant, with proper segregation of funds from the parent bank.
<i>Ijarah</i> (Leasing)	An <i>Ijarah</i> contract refers to an agreement made by NIFIs to lease to a customer an asset specified by the customer for an agreed period against specified instalments of lease rentals. An <i>Ijarah</i> contract commences with a promise to lease that is

	binding on the part of the potential lessee prior to entering the <i>Ijarah</i> contract.
<i>Ijarah Sukuk</i>	<i>Sukuk</i> issued on the basis of <i>Ijarah</i> principle.
Minority Interest	Minority interest is capital in a subsidiary that is owned by other shareholders from outside the Group. It includes such third parties' interests in the common shares, retained earnings and reserves of the consolidated subsidiaries.
<i>Mudarabah</i> (Trust Partnership)	A contract between the capital provider (<i>Rabbul-Mal</i>) and a skilled entrepreneur (<i>Mudarib</i>) whereby the capital provider contributes capital to an enterprise or activity that is to be managed by the entrepreneur as the <i>Mudarib</i> (or labour provider). Profits generated by the enterprise or activity are shared in accordance with the terms of the <i>Mudarabah</i> agreement, while losses are borne solely by the capital provider, unless the losses are due to the <i>Mudarib</i> 's misconduct, negligence or breach of contractual terms.
<i>Mudarabah Sukuk</i>	<i>Sukuk</i> issued on the basis of <i>Mudarabah</i> principle.
<i>Musharakah</i> (Partnership)	A <i>Musharakah</i> is a contract between a NIFI and a customer to contribute capital to an enterprise, whether existing or new, or to ownership of a real estate or moveable asset, either on a temporary or permanent basis. Profits generated by the enterprise or real estate/asset are shared in accordance with the terms of the <i>Musharakah</i> agreement whilst losses are shared in proportion to each partner's share of capital.
<i>Musharakah Sukuk</i>	<i>Sukuk</i> issued on the basis of <i>Musharakah</i> principle.
Non-Interest Financial Institutions	Means banks and other financial institutions under the regulatory purview of the Central Bank of Nigeria that provide banking and other financial services on the basis of Islamic Commercial Jurisprudence.
Paid-in Capital	Refers to capital that has been received with conclusiveness by the NIFI, reliably valued and fully under its control.
Profit Equalization Reserve (PER)	PER is the amount appropriated by the NIIs out of the <i>Mudarabah</i> income, before allocating the <i>Mudarib</i> 's share, in order to maintain a certain level of return on investment for IAH and to increase owners' equity.
Restricted Investment Account (RIA)	An account in which the holder authorizes a NIFI to invest funds based on <i>Mudarabah</i> or <i>Wakalah</i> contracts with certain restrictions as to where, how and for what purpose these funds are to be invested.
Regulatory Capital	This is the amount of capital a NIFI shall hold as required by the CBN. It is usually expressed as a ratio of Capital to risk-weighted assets.

Unrestricted Investment Accounts (UIA)	The account holders authorize the NIFI to invest their funds based on <i>Mudarabah</i> or <i>Wakalah</i> contracts without imposing any restrictions. The NIFI can commingle these funds with their own funds and invest them in a pooled portfolio.
<i>Sukuk</i> (Islamic Investment Certificates)	<i>Sukuk</i> are certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services, or (in the ownership) of assets of particular projects or special investment activity.
<i>Wakalah</i> (Agency Contract)	<i>Wakalah</i> is a contract where one party, the principal (<i>Muwakkil</i>), appoints the other as agent (<i>Wakil</i>) to carry out a business or transaction on his behalf with or without any fee.
<i>Wakalah Sukuk</i>	<i>Sukuk</i> issued on the basis of <i>Wakalah</i> principle.

SECTION 1: INTRODUCTION

1.1 Background

1. This Guidance Notes (GN) defines eligible capital for the purpose of computing Capital Adequacy Ratio (CAR) by Non-Interest Financial Institutions (NIFIs) in Nigeria. The Rules governing regulatory capital, its components and required deductions to the capital levels shall be applied by the NIFIs for assessment of qualifying capital.
2. NIFIs are required to maintain a minimum regulatory CAR of 10% or 15% for banks with National or International licence respectively as may be determined by CBN from time to time.
3. Accordingly, CBN will consider prescribing a higher level of minimum capital ratio for each NIFI under the IFSB-15 on the basis of their respective risk profiles and risk management processes. Furthermore, in terms of the IFSB-15 requirements of the capital adequacy framework, NIFIs are expected to operate at a level well above the minimum requirement.

1.2 Objectives of the Guidance Notes

4. The main objectives of this Guidance Notes are as follows:
 - To assist the NIFIs in the implementation of a capital adequacy framework that will ensure effective coverage of risk exposures and allocation of appropriate capital to cover these risks, thus enhancing the resilience of the NIFIs;
 - To provide guidance on the maintenance of high-quality regulatory capital components by NIFIs, which comply with *Shari`ah* rules and principles;
 - To provide guidance on items that shall be deducted from NIFIs' capital; and
 - To adapt international best practices, as well as current and emerging standards relating to capital adequacy for NIFIs.

SECTION 2: REGULATORY CAPITAL

2.1 Components of Capital

5. This Section specifies the components of Regulatory (eligible) Capital for NIFIs. The eligible capital shall be used as the numerator and total Risk-weighted Assets (RWAs) as denominator in the formula for calculating CAR. The Section will further explain the criteria and characteristics of each component of eligible capital.

2.2 Tier 1 Capital

6. Tier 1 capital consists of Common Equity Tier 1 (CET1) and Additional Tier 1 (AT1). CET1 consists of common equity share capital, retained earnings and some other reserves. AT1 capital consists of *Shari`ah*-compliant instruments and reserves that

meet the criteria specified in paragraph 11. Tier 1 (CET1 and AT1) capital is considered as "going concern" capital which absorbs losses while the NIFI is solvent.

2.2.1 Common Equity Tier 1 Capital

7. CET1 capital forms the highest quality of capital for NIFIs. There are stringent criteria for an instrument to be considered as CET1 capital so as to ensure its permanence and loss absorption capacity.
8. CET1 capital comprises the sum of elements (a)–(f), minus (g), below:
 - (a) Common shares issued by the NIFIs: This is the main shareholders' equity issued by NIFIs, which should be fully paid up and should meet the criteria of being classified as common shares.
 - (b) Stock surplus: Stock surplus (share premium) from the issue of common shares.
 - (c) Retained earnings: The amount of net earnings which is carried forward from previous financial periods shall be recognized and included in the calculation of CET1 capital. Retained earnings include interim profit or loss recognized by CBN.
 - (d) Other disclosed reserves and comprehensive income, including interim profit or loss. Dividends declared and payable are not included in CET1 as such amounts are classified as liabilities in accordance with International Financial Reporting Standards (IFRS). Other comprehensive income includes interim profit or loss.
 - (e) For interim profit or loss, CBN may seek verification by external auditors.
 - (f) Common shares issued by consolidated subsidiaries of NIFIs: Such common shares that are issued by a NIFI's consolidated subsidiaries and held by third parties (minority interest) and meet the criteria of being included in CET1 provided in paragraph 10.
 - (g) Regulatory adjustments/deductions applicable to CET1.
9. Shareholders' portion of Profit Equalization Reserves (PER) are not considered as part of CET1 reserves in the computation of CAR.
10. Specific criteria for common equity are set out below:
 - (a) Loss absorbency**
Common equity represents the most subordinated claim in the event of liquidation of the NIFI having a claim on the residual assets after all senior claims have been repaid. In terms of sharing any losses as incurred, common equity serves as a first loss position and is able to absorb losses on a going concern basis. Going concern capital allows a NIFI to continue its activities and helps to prevent insolvency. Going concern capital is considered to be CET1. The purest form of going concern capital is common equity.

(b) Issuance process and procedure

At the issuance of common equity instruments, the NIFI shall not create an expectation or state in the contractual terms that the instrument will be redeemed, cancelled or bought back (call option) under any circumstances.

Common equity is directly issued and **paid-in** such that no related party of the NIFI directly or indirectly purchases it or funds the purchase. The issuance receives the formal approval of the existing common shareholders of the issuing NIFI either directly or indirectly based on the approval of the Board of Directors or according to the applicable laws in Nigeria.

(c) Permanence

The principal amount of common shares is perpetual in nature and is never repaid except in the case of liquidation. However, in some cases, the law and the NIFI's statutes may permit common shares to be repurchased, subject to the approval of the CBN.

(d) Distribution of profit or dividends

There is no circumstance in which distribution of profits (or payment of dividends) is obligatory. Non-payment of dividends, therefore, is not a default event. Distributions shall be made out of distributable items which normally consist of profits for the year that are attributable to common equity and, subject to the approval of the CBN, retained earnings. The level of distribution of profit must be independent of, and not linked or tied to, the amount paid in at issuance). Distributions can only be made after meeting all legal and contractual obligations and payments to more senior capital instruments. There are no preferential distributions on the eligible instruments.

e) Equity in nature

The paid amount is recognized as equity capital in the NIFIs' balance sheet and classified as equity under the applicable accounting standards. However, where associates and joint ventures are accounted for under the equity method, earnings of such entities are eligible for inclusion in the CET1 of the NIFIs to the extent that they are reflected in retained earnings and other reserves of the NIFIs and are not excluded by any of the regulatory adjustments.

(f) Unsecured in nature

The amount paid in at issuance is neither secured nor guaranteed by the NIFI or its related entity (parent/ subsidiary or sister of the company or Islamic Window or other affiliate group). There shall be no contractual terms or arrangements in the issue of eligible instruments that enhance the seniority of claims under the instruments in insolvency or liquidation.

(g) Disclosure requirement

Common Equity shall be clearly stated and disclosed on the NIFIs' balance sheet.

2.2.2 Additional Tier 1 Capital

11. Additional Tier 1 (AT1) capital shall consist only of instruments such that they have a high degree of loss absorbency. AT1 capital comprises the sum of elements (a)–(c) minus (d) below:

Add:

- (a) Instruments issued by NIFIs that meet the criteria for inclusion in AT1 capital.
- (b) Any premium received on the issue of instruments included in AT1 capital, and which is not included in CET1;
- (c) Instruments or qualifying capital issued by consolidated subsidiaries of the NIFIs to third-party investors that meet the criteria for inclusion in AT1 capital and are not included in CET1.

Minus:

- (d) Regulatory adjustments/deductions applicable to AT1 capital.

12. Specific criteria for classification of instruments as AT1 capital are set out below.

(a) Loss absorbency

Any instrument other than Common Equity issued by NIFIs that is able to absorb losses will qualify for inclusion in AT1 capital.

(b) Issuance process and procedure

All AT1 instruments issued by NIFIs require prior CBN approval. The instrument is issued and paid-up and neither the NIFI nor a related party over which it exercises control or significant influence can purchase the instrument, or fund its purchase, either directly or indirectly. Repayment of principal through repurchase or buy-back is allowed subject to CBN approval. The repayment however, shall be without any expectation being created by the NIFI.

(c) Maturity and Callability

The qualifying instrument shall be perpetual in nature and has no maturity date. It shall not have step-up features (i.e. periodic increases in the rate of return) and is without any other incentive to the issuer to redeem it. However, if the instrument is callable, the issuer is permitted to exercise a call only after five years and subject to certain requirements such as:

- i. Prior CBN approval;
- ii. No call expectation is created by the NIFIs; and
- iii. Ability to replace the called instruments with the same or better quality of capital, either before or concurrently with the call.

The NIFI shall not exercise a call unless it proves that its capital position is above the regulatory capital requirement after the call is exercised. Instruments which qualify for AT1 capital cannot have any features that hinder recapitalization (provisions that require the NIFI to compensate investors if a new instrument is issued at a lower price during a specified time frame). If an instrument is issued out of a Special Purpose

Entity (SPE), proceeds must be immediately available without limitation to the NIFI in a form which meets or exceeds all of the other criteria for inclusion in AT1 capital.

(d) Distribution of profits

The contract shall provide that non-distribution of profits would not constitute a default event. Distributions shall not be linked to the credit rating of the NIFI, either wholly or in part.

(e) Unsecured in nature

The amount paid at issuance is neither secured nor guaranteed by the NIFI or any related entity. In addition, there shall not be any arrangement that legally or economically increases the seniority of the instrument's claim.

13. Musharakah Sukuk can be issued as Additional Tier 1 capital by NIFIs. This is due to it being the most loss absorbing instrument from a Shari'ah perspective. It can also be treated *parri passu* with shareholders' funds.

2.3 Tier 2 Capital

14. Tier 2 (T2) Capital consists of *Shari'ah*-compliant instruments and reserves. T2 capital is considered to be "gone concern" capital which absorbs further losses in the event of non-viability of the NIFIs and therefore, helps to protect the Current Account Holders and other creditors of the NIFIs. Various eligible adjustments/deductions shall apply to the respective type of capital.
15. NIFIs shall maintain T2 capital which comprises the sum of elements (a)–(d) minus (e) below:

Add:

- (a) Instruments issued by NIFIs that meet the criteria for inclusion in T2;
- (b) General provisions or reserves held against future, presently unidentified losses on financing.
- (c) Any premium paid on issue of T2 capital instruments;
- (d) Instruments or qualifying capital issued by consolidated subsidiaries of a NIFI to third party investors that meet the criteria of T2 capital;

Minus:

- (e) Regulatory adjustments/deductions applicable to T2 capital.

16. Specific criteria for classification of instruments as T2 are set out below:

(a) Loss absorbency

Any instrument other than Common Equity and Additional Tier1 issued by a NIFI that is able to absorb losses will qualify for inclusion in T2 capital.

(b) Issuance process and procedure

The instrument is issued and paid-up, and neither the NIFI nor a related party over which the NIFI exercises control or significant influence can purchase the instrument or fund the purchase of the instrument, either directly or indirectly. Issuance that takes

place outside an operating entity of the NIFI or the holding company in the consolidated group such as through an SPE shall follow specific requirements. For instance, the proceeds of issuance must be made immediately available to an operating entity or holding company in the consolidated group, in a form that meets or exceeds all the other criteria of Tier 2.

(c) *Maturity and callable option*

The original minimum maturity shall be at least five years. The instrument shall not have step-up facilities and be without any incentive to redeem by the issuer. For recognition in regulatory capital, any amortization of the principal will be on a straight-line basis in the remaining five years before maturity. If the instrument is callable, the issuer is permitted to exercise a call option only after five years and subject to certain requirements, such as:

- (i) Prior CBN approval;
- (ii) There is no call expectation created by the NIFIS; and
- (iii) Ability to replace the called instruments with the same or better quality of capital, either before or concurrently with the call. NIFI shall not exercise a call unless it successfully exhibits that its capital position is above the regulatory capital requirement.

As an exception, a call option by the NIFI as an issuer is permitted only in case of a tax or regulatory events. Subject to meeting other conditions specified from (i) to (iii) above, CBN may permit a NIFI to exercise the call only if it is convinced that the NIFI was not in a position to anticipate the event at the time of issuance.

(d) *Distribution of Profits*

The distribution of profits to the holders of the instruments shall not be linked to the credit rating of the NIFIs, either wholly or in part. Future scheduled payments should not be accelerated at the option of investors, except in the case of liquidation or bankruptcy.

(e) *Unsecured in Nature*

The amount paid during issuance is neither secured nor guaranteed by the NIFIs or any of their related entities. Besides, there shall not be any arrangement that legally or economically increases the seniority of claim in the event of liquidation.

Mudarabah or *Wakalah Sukuk* can be issued as Tier 2 capital by NIFIs as they have met the criteria (a)-(e) mentioned above.

17. The eligible capital requirements for NIFIs with regional or national authorization shall not be less than 10% of total RWA at all times. Such NIFIs shall maintain CET1 capital of at least 5.6% and Additional Tier1 of 1.9% of RWA at all times. Furthermore, Tier 1 capital (CET1=5.6% plus AT1= 1.9%) shall be at least 7.5% of RWA at all times while Tier 2 capital shall be at least 2.5% of RWA at all times.

SECTION 3: TREATMENT OF PSIA, PER AND IRR

18. Profit-sharing investment accounts of NIFIs are not classified as part of the capital because they do not meet the above-mentioned criteria of core or additional capital. Similarly, all the Investment Risk Reserve (IRR) and a portion of the Profit Equalization Reserve (PER) belong to the equity of Investment Account Holders, and thus are not part of the capital of the NIFIs.

As the purpose of a PER is to smooth the profit payouts and not to cover losses, any portion of a PER that is part of the NIFIs' reserves shall not be treated as part of their regulatory capital. It should be noted that the impact of PER and IRR has already been incorporated in the denominator of the supervisory discretion formula for calculation of the CAR.

SECTION 4: REGULATORY ADJUSTMENTS AND DEDUCTIONS

19. The adjustments to regulatory capital are intended to make its quantification more conservative so that it is available at all times to absorb losses. In order to achieve this objective, the assets that may not have a stable value in stressed market conditions (e.g. goodwill) are deducted, and gains that have not been realised are not recognised in the calculation of regulatory capital. Elements which shall be recognized or adjusted in the calculation of eligible capital from a regulatory perspective are as follows, subject to the stated conditions:

(a) Minority interest:

Minority interest arising from the issue of capital instruments by a fully consolidated subsidiary of the NIFIs may be treated as CET1 or AT1 capital subject to meeting the following conditions and criteria:

Common Equity Tier 1: The conditions are:

- i. The subsidiary issuing the instrument shall be a NIFI itself; and
- ii. The relevant instrument shall meet all the criteria for being considered as common shares for regulatory purposes.

The amount recognised in consolidated CET1 is equal to the total minority interest (meeting the above conditions) minus the *surplus CET1 of the subsidiary attributable to minority investors*. The surplus CET1 of the subsidiary (**i.e. the amount in excess of 7.0% of RWA** – which is the sum of the minimum CET1 requirement of the subsidiary plus the capital conservation buffer) should be multiplied by the percentage of CET1 that is held by minority shareholders in order to arrive at the amount of the surplus CET1 of the subsidiary attributable to the minority shareholders.

Tier 1 Capital (CET1 and AT1 Capital): The condition is that the relevant instruments issued by a fully consolidated subsidiary of the NIFIs to third-party investors should meet all the criteria for being considered as Tier 1 (CET1 or AT1) capital. The amount recognised in Tier 1 capital is equal to the amount of the Tier 1 capital instruments issued to third parties minus the surplus Tier 1 capital of the

subsidiary attributable to the third-party investors. The surplus Tier 1 capital of the subsidiary (**i.e. the amount of 8.5% of RWA** – which is the sum of the minimum Tier 1 capital requirement of the subsidiary plus the capital conservation buffer) should be multiplied by the percentage of the subsidiary's Tier 1 capital that is held by third-party investors. The amount of the Tier 1 capital that will be recognised in “additional capital” will exclude amounts already considered part of CET1.

Total Capital (CET1, AT1 and T2 Capital): The condition is that the relevant instruments issued by a fully consolidated subsidiary of the NIFIs to third-party investors shall meet all the criteria for being considered as CET1, AT1 or T2 capital. The amount recognised in consolidated total capital is equal to the amount of the total capital instruments issued to third parties (meeting the above condition) minus the *surplus total capital of the subsidiary attributable to the third-party investors*. The surplus total capital of the subsidiary (**i.e. the amount in excess of 10.5% of RWA** – which is the sum of the minimum total capital requirement of the subsidiary plus the capital conservation buffer) should be multiplied by the percentage of the subsidiary's total capital that is held by third-party investors in order to arrive at the amount of the *surplus total capital of the subsidiary attributable to the third-party investors*.

(b) Unrealized gains and losses:

NIFIs shall derecognize from CET1 any component of equity resulting from changes in the fair value of liabilities due to their own credit risk variations.

(c) Investment in own shares (Treasury shares) and capital:

NIFI's investment in its own shares shall be deducted in the calculation of CET1 since such an investment has an effect similar to calling the shares – that is, to reduce the capital. Furthermore, in case of any contractual obligation of the NIFI to purchase its own shares, such shares will be deducted from CET1. It shall equally deduct investments in its own additional capital in the calculation of additional capital.

(d) Goodwill and other intangible assets:

Goodwill and other intangible assets should be deducted from CET1. Also deducted is goodwill that is part of the valuation of significant investments in the capital of banking, financial and *Takaful* entities which are outside the scope of regulatory consolidation. NIFIs shall use International Financial Reporting Standards (IFRS) and AAIOFI Standards, where applicable, to identify elements which fall under the definition of intangible assets.

(e) Pension fund assets and liabilities:

A NIFI may have its own pension fund, while some NIFIs may establish a pension fund, subject to fulfilling CBN regulatory requirement. Where such pension funds are

on the balance sheet or consolidated balance sheet of the NIFI, the net assets of the fund should be deducted from CET1 capital.¹

(f) Deferred Tax Assets (DTAs):

CBN may allow recognition of DTAs. Such DTAs may be used to reduce any subsequent period's income tax expense of the NIFI as recognized in its income statement. DTAs which have been recognized, but rely on the future profitability of the NIFI and are yet to be realized, shall be deducted from the calculation of CET1. All DTAs that depend on the future profitability of the NIFI to be realized and that arise from net operating losses shall be deducted from CET1 in full. DTAs and associated "deferred tax liabilities" can be netted off only if the tax authority has levied the taxes and permitted the set-off.

(g) Cash-flow hedge reserve:

If an NIFI has a cash-flow hedge reserve, the amount of this reserve that relates to the hedging (by means of *Shari'ah*-compliant hedging instruments which are reported at fair value in the NIFI's balance sheet) of items which are themselves not reported at fair values in the NIFI's balance sheet, including projected cash flows, should be derecognized in the calculation of CET1. This means that positive amounts should be deducted and negative amounts added back. The element of the cash-flow hedge reserve that gives rise to artificial volatility in common equity is thereby removed, since such an element reflects only the fair value of the hedging item but not that of the hedged item.

(h) Securitization Exposure:

Any increase in equity capital resulting from a securitization transaction shall be deducted from the calculation of CET1. Certain securitization exposures arise from the provision of credit enhancement by the NIIFIs as originators by retaining a residual equity interest in a percentage of the securitized asset. In such cases, the capital treatment of the NIFI's residual equity share will be a risk weighting of 1250%. This has been mentioned in the Guidance Notes on Credit Risk Capital Computation. However, subject to CBN discretion, the risk weighting of 1250% will be used irrespective of the minimum capital requirement.

(i) Investment in the capital of banking, financial and Takaful entities:

This derecognizing adjustment applies to an investment in the capital of NIIFIs that are outside the scope of regulatory consolidation. Such investment is addressed and classified under two categories:

- a) ***Where the NIFI does not own more than 10% of the issued common shares of the entity:*** The amounts below the 10% of its common equity (after applying all

¹ The Wisdom behind deducting the NIFI's Pension fund assets is that the funds are not loss absorbing or permanent. Since pension fund assets and liabilities belong to the pension fund holders (i.e. bank employees) and will be periodically drawn down due to retirement or staff claims, they cannot be considered part of regulatory capital for these reasons.

other regulatory adjustments) will not be deducted and will continue to be risk-weighted. Thus, instruments in the trading book shall be treated as per the market risk rules, and instruments in the banking book shall be treated as per the standardized approach.

- b) ***Where the NIFI owns more than 10% of the issued common shares of the entity***, Holdings of both the banking book and the trading book should be included in these calculations, after application of all the regulatory adjustments mentioned prior to this category. “Capital” includes common shares and, where applicable, convertible or subordinated *Sukuk* that qualify for recognition as regulatory capital.
20. Furthermore, if *the entity is an Affiliate of the NIFI*, the NIFI shall deduct the amount of the investment in full even if the investment does not fall under the definition of common equity. The objective of this deduction is to prevent the double counting of capital – that is, to ensure that the bank is not boosting its own capital with the capital that is also used to support the banking, *Takaful* or other financial subsidiary.

“The deduction shall also follow the "corresponding deduction" approach – that is, the deduction should be applied to the same component of capital for which the capital would qualify if it were issued by the NIFI itself. This means that the amount to be deducted from common equity should be calculated as the total of all holdings which in aggregate exceed 10% of the NIFI’s common equity multiplied by the common equity holdings as a percentage of the total capital holdings. This would result in a common equity deduction which corresponds to the proportion of total capital holdings held in common equity. Similarly, the amount to be deducted from additional capital should be calculated as the total of all holdings which in aggregate exceed 10% of the bank’s common equity multiplied by the additional capital holdings as a percentage of the total capital holdings

However, under the corresponding deduction approach, if the NIFI is required to make a deduction from a particular component of capital and it does not have enough of that component of capital to satisfy that deduction, the shortfall will be deducted from the next-higher components of capital. (For example, if a NIFI does not have enough additional capital to satisfy the deduction, the shortfall will be deducted from CET1.)”

(j) Reciprocal cross-holdings in the capital of banking, financial and Takaful entities

Any cross-holdings of capital that serve to inflate artificially the capital position of the NIFI shall be required to be subject to a full deduction, using a “corresponding deduction approach” to such investments. This approach requires the NIFIs to apply the deduction to the same component of capital for which the capital would qualify if it were issued by the NIFI itself.

(k) Exposures to entities within a group

NIFIs shall deduct any exposure granted to entities within the group from the parents' capital.

SECTION 5: ISLAMIC WINDOWS

21. All conventional banks with Islamic Windows shall allocate a notional capital fund (not Share capital) for the operations of the Window. The banks shall establish a separate and self-accounting Islamic banking department, with designated management as contained in the CBN Guidelines for the Regulation and Supervision of Institutions Offering Non-Interest Financial Services in Nigeria.
22. A Window's minimum level of capital fund requirement at any point in time shall be determined by the level of its RWAs.

SECTION 6: METHODS OF COMPUTING CAPITAL ADEQUACY RATIO

23. Capital Adequacy Ratio of NIFIs shall be calculated through the following two methods:
 - (a) **The standard formula**, in which NIFIs shall not hold Regulatory Capital in respect of risk arising from assets funded by Profit-Sharing Investment Accounts (PSIA), so that the Risk-weighted Assets (RWA) in respect of commercial risks (credit and market risks) funded by such accounts are excluded in calculating the denominator of the CAR; and
 - (b) **The supervisory discretion formula**, in which NIFIs shall hold Regulatory Capital in respect of Displaced Commercial Risk (DCR). In this approach, commercial risks of assets financed by Unrestricted PSIA (UPSIA) are considered to be borne proportionately by both the Unrestricted Investment Account Holders (UIAH) and the NIFIs. Hence, a proportion of the (risk-weighted) assets funded by UPSIA, symbolized as "alpha" is required to be included in the denominator of the CAR, the permissible value of alpha being subject to CBN discretion. The CBN may also decide to extend this treatment to restricted investment accounts.

6.1 The Standard Formula Approach

24. NIFIs shall compute their regulatory capital adequacy ratio in the following manner:

Eligible Capital

{Total Risk-Weighted Assets (Credit + Market Risks) plus Operational Risk

Less

Risk-Weighted Assets Funded by PSIA (Credit and Market Risks)}

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 The Standardised Approach for credit risk (Refer to The Standardized Approach –TSA in the Guidance Notes on the calculation of capital requirement

- for Operational Risk for Non-interest Banks and other Financial Institutions in Nigeria).
- 2) 12.5 times the sum of the capital charges determined for market risk and operational risk; and
 - 3) 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.

6.2 The Supervisory Discretion Formula Approach

25. Alternatively, NIFIs shall compute their regulatory capital adequacy ratio by using the supervisory discretion formula approach as follows:

$$\begin{aligned}
 & \text{Eligible Capital} \\
 \hline
 & \{ \text{Total Risk-Weighted Assets (Credit + Market Risks)} \text{ Plus Operational Risk} \\
 & \quad \text{Less} \\
 & \quad \text{Risk-Weighted Assets Funded by Restricted PSIA (Credit and Market Risks)} \\
 & \quad \text{Less} \\
 & \quad (1 - \alpha) [\text{Risk-Weighted Assets Funded by Unrestricted PSIA (Credit and Market Risks)}] \\
 & \quad \text{Less} \\
 & \quad \alpha [\text{Risk-Weighted Assets funded by PER and IRR of Unrestricted PSIA (Credit and Market Risks)}] \}
 \end{aligned}$$

26. In applying the Supervisory Discretion Formula Approach, the following should be noted:

- Total RWAs include those financed by both restricted and unrestricted PSIA.
- Credit and market risks for on- and off-balance sheet exposures.
- Where the funds are co-mingled, the RWAs funded by PSIA are calculated based on their pro-rata share of the relevant assets. PSIA balances include PER and IRR, or equivalent reserves.
- "Alpha (α)" refers to the proportion of assets funded by unrestricted PSIA which shall be determined by the CBN.
- The relevant proportion of RWAs funded by the PSIA's share of PER and by IRR is deducted from the denominator. The PER has the effect of reducing the displaced commercial risk, and the IRR has the effect of reducing any future losses on the investment financed by the PSIA.