IFRS 9 FINANCIAL INSTRUMENTS

APPLICATION INSTRUCTIONS

For Parallel Reporting

BANKING POLICY & REGULATIONS DEPARTMENT

STATE BANK OF PAKISTAN

Chapter – 1: Preamble

1.1 *Introduction:* The Financial Institutions (FIs) are required to prepare their financial statements in accordance with approved accounting standards as applicable in Pakistan. The application of new accounting requirement under IFRS 9 will oblige FIs to establish provisions for expected credit losses, which will require the current banking systems to develop and establish new systems in order to evaluate all types of the FIs' financial assets, according to the requirements of IFRS 9.

In this regard, these instructions are being issued to regulate the FIs' application of the IFRS 9, and specify the requirements of the transitional phase that precedes application. These implementation instructions are not intended to prescribe methodologies, action plans and standardized systems and models for the standard to be applied at all FIs, as this should be undertaken by the executive management of each FIs and its Board of Directors.

1.2 *Scope of Application:* The following instructions applies on all FIs both at standalone as well as at consolidated financial statements level of the FIs. The financial statements of subsidiaries, associates and overseas branches that are prepared for the purpose of consolidation at FI level should be compatible with IFRS 9 requirements. However, this will not apply to standalone statutory financial statements of associates, subsidiaries and overseas branches, which shall be prepared according to their rules and regulations, applicable to them. **For the purpose of parallel reporting**, any instructions/regulations of investments accounting (other than NPL provisioning requirements) issued by SBP, that are in conflict with these instructions should be considered as superseded by these instructions.

Chapter – 2: Classification of Financial Assets and Liabilities

2.1 Classification and Measurement Requirements for Debt Securities

2.1.1 *Initial Measurement:* The financial instruments will be initially measured at fair value plus or minus, transaction costs that are directly attributable to the acquisition or issue of the financial instruments. However, transaction costs in relation to Financial Assets measured at Fair Value through Profit and loss, should be recognized as an expense when incurred.

2.1.2 *Initial Classification:* Financial assets under IFRS 9 will be classified into one of three main classification categories i.e.

- Amortized Cost
- Fair Value through Other Comprehensive Income (FVTOCI)
- Fair Value through Profit and Loss (FVTPL)

The financial assets have to meet the following tests in order to be subsequently measured at either amortized cost or fair value based on the following:

- The business model used in managing the asset.
- The contractual cash flow characteristics of the asset

2.1.3 *Business Model Assessment:* In order to classify the financial assets, the FIs will have to analyze the nature of their key operating units. This will be accomplished by reviewing how groups of financial assets are managed together in order to achieve a particular business objective. The FIs will apply the business model test at a level that is consistent with the practices used to manage their assets. Eventually, the financial assets will fall under either of the following three business models:

- **Hold to Collect business model (**Holding assets in order to collect contractual cash flows, "HTC Business Model");

- **Hold to Collect and Sell business model (**Collecting contractual cash flows and selling financial assets, "HTC&S Business Model")
- **Other business models** (resulting in fair value through profit or loss classification, "FVTPL Business Model")

2.1.3.1 *Hold-to-Collect (HTC) Business Model:* The 'hold-to-collect' business model does not require that financial assets are always held until their maturity. A FI's business model can still be "to hold financial assets to collect contractual cash flows" even when sales of financial assets occur. However, if more than an infrequent number of sales or sale(s) of significant value are/is made out of a portfolio, the FI will assess whether and how the sales are consistent with the 'hold-to-collect' objective. This assessment should include the reason(s) for the sales, the expected frequency of sales, and whether the assets that are sold are held for an extended period of time relative to their contractual maturities. Examples[1] of sales that would not contradict holding financial assets to collect contractual cash flows include:

- Selling the financial asset to realise cash to deal with an unforeseen need for liquidity;
- Selling the financial asset due to significant internal restructuring/business combinations;
- Selling the financial asset close to its maturity and the proceeds from the sales approximate the collection of the remaining contractual cash flows;
- Sale of the financial asset when there is an increase in credit risk or to manage credit concentration risk. The FIs will sell a financial asset if it no longer meets the credit criteria specified in their documented investment policy. (Sale due to an increase in credit risk);
- Sales in 'stress case' scenario (e.g., a run on the bank's deposits).

SBP expects that sales of financial assets held under HTC business model will be rare and will happen in exceptional circumstances. The FIs should have approved Board's sub-committee[2] policy for the sales under HTC business model and significant sale(s)/reclassification has to be approved by the Board's sub-Committee.

2.1.3.2 *Hold-to-Collect & Sell (HTC&S) Business Model:* Under this model, the intention of FIs is to hold the asset to collect its contractual cash flows and to sell the financial asset. The FIs will need to exercise judgement in determining whether they have a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets as it involves greater frequency of sales. This is because selling financial assets is integral to achieving the business model's objective instead of being only incidental to it as in the case of HTC business model. There are various objectives that may be consistent with this type of business model e.g. the objective of the business model may be to manage everyday liquidity needs, to maintain a particular interest yield profile or to match the duration of the financial assets to the duration of the liabilities that those assets are funding.

2.1.3.3 *Other Business Models:* Financial assets are measured at fair value through profit or loss if they are not held within a business model whose objective is to hold assets to collect contractual cash flows or within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets. IFRS 9 gives a number of examples of such models, including one where:

- FI manages the financial assets with the objective of realising cash flows through the sale of the assets *(Held-for-Trading)*
- FI manages and evaluates a portfolio of financial assets on a fair value basis
- a portfolio of financial assets that does not fall under the HTC and HTC&S Business Models.

[1] These examples are just an indicative list and doesn't provide the only cases, where sales can occur under HTC business model.
[2] This Board's sub-committee hereinafter refers to the Committee, which has been assigned with the responsibility to oversee the implementation process of IFRS 9 in accordance with BPRD Circular No. 4 dated Oct 23, 2019

2.1.3.4 The financial assets will be classified on the basis of their business models used in managing the financial asset. The business models (decision on managing the financial assets) including objective criteria of determination shall be approved by the board upon the recommendation of boards' sub-committee and it should be properly documented. The FI's business model for managing financial assets is a matter of fact and not merely an assertion. It is typically observable through the activities that the FI undertakes to achieve the objective of the business model. The FIs will need to use judgement when it assesses its business model for managing financial assets and that assessment is not determined by a single factor or activity. The FIs must consider all relevant evidence that is available at the date of the assessment. Such relevant evidence includes, but is not limited to:

- how the performance of the business model and the financial assets held within that business model are evaluated and reported to the entity's key management personnel;
- the risks that affect the performance of the business model (and the financial assets held within that business model) and, in particular, the way in which those risks are managed;
- how managers of the business are compensated (e.g., whether the compensation is based on the fair value of the assets managed or on the contractual cash flows collected).

The FI may hold the same type of instrument, such as government bonds, in all three classification categories (Amortized Cost, FVTOCI and FVTPL) depending on its intention and model for managing the assets.

2.1.4 *Contractual Cash Flow Characteristics Test:* This test is to be done at the **asset level** and seeks to establish whether the contractual cash flows of an asset are based "solely on payments of principal and interest" (SPPI). Only assets that meet this criterion can qualify for Amortised Cost and FVTOCI classification treatment. The minimum standard for meeting the SPPI determination is that the contractual cash flows compensate the holder for (a) the time value of money plus (b) credit risk plus (c) other allowable components such as liquidity risk. As such, for the contractual cash flows of an asset to qualify as SPPI, they must be consistent with a basic lending arrangement. Contractual features that introduce exposure to risks or volatility into the contractual cash flows that are unrelated to a basic lending arrangement, such as exposure to changes in equity or commodity prices via a structured note security, would not pass the SPPI assessment. The SPPI determination should only be performed once for each individual type of asset. This should not be a recurring, periodic test. However, the FIs will need to establish procedures to ensure that newly purchased or originated assets are tested.

2.1.5 *Contractual Cash Flows Test of Islamic Products:* The Islamic Banking Institutions are advised to consider the international practices for the application of SSPI test for similar kind of instruments in the classification of their financial assets, while assessing their contractual cash flow test under IFRS 9. The FIs may also refer to the published guidance/accounting literature by the AAOIFI in this regard.

2.1.6 Investments and Other Assets:

2.1.6.1 *Other Unquoted Securities:* PTCs and TFCs and Sukuk shall be classified in accordance with criteria prescribed under 2.1.2 and ECL shall be calculated as required for debt instruments measured as amortised cost or FVTOCI. For Non-performing assets, i.e. stage 3 assets the level of provision shall any way be higher of IFRS 9 or regulatory provisions.

2.1.6.2 *Quoted Securities:* Government Securities, TFCs, PTCs, Sukuks will be classified as per the criteria prescribed under 2.1.2 and in case, if they are classified as FVTOCI or FVTPL, then the government instruments shall be valued at PKRV (Reuter Page) and the TFCs, PTCs, Sukuks shall be measured at their fair value/market value.

2.1.6.3 *Other Assets:* The financial assets falling within "Other Assets" shall also be classified in accordance with the criteria described in 2.1.2.

2.1.7 *Use of Fair Value Option:* It is to be noted that IFRS 9 contains an option to designate, at initial recognition, a financial asset as measured at FVTPL if doing so eliminates or significantly reduces an ‘accounting mismatch’ that would otherwise arise from measuring assets or liabilities on different bases. Financial assets designated at FVTPL are not subject to the reclassification requirements of IFRS 9. This option should not be used for loans and advances.

The financial institutions may apply the Fair Value Option under this criterion if: (a) consistent with a documented risk management strategy, it eliminates or significantly reduces[3] the measurement or recognition inconsistency of measuring financial assets or liabilities together on a different basis, and (b) the fair values are reliable at inception and throughout the life of the instrument. Nonetheless, this option should be avoided, where the fair value option is applied for financial instruments that are categorized as Level 3 in terms of the IFRS 13 hierarchy.

2.1.8 *Financial Liabilities:* Financial liabilities will be measured at amortised cost except for those liabilities which are held for trading and those where the FI opts to measure them at fair value. The FI will apply the Fair Value Option only if: (a) the institution has a documented risk management strategy to manage the group of financial instruments together on a fair value basis and can demonstrate that significant financial risks are eliminated or significantly reduced, and (b) the fair values are reliable at inception and throughout the life of the instrument. The FIs are required to disclose the liabilities that would result in their measurement at fair value.

2.2 Classification and Measurement Requirements for Equity Securities

2.2.1 *Classification of Equity Investments:* Investments in equity securities will be measured at fair value and will not be subject to impairment testing. The equity securities that are traded in an active market can be categorized by FIs for held for trading purposes and will be classified as FVTPL. The equity securities that are not categorized as held for trading may be classified as FVTOCI (irrevocable option). The decision can be made on instrument by instrument basis at the time of purchase and documented. The FIs may hold the equity instrument of the same company in both categories (FVTOCI and FVTPL) depending on its business model for managing the assets.

2.2.2 *Unquoted Equity Securities:* IFRS 9 does not allow for the recognition of unquoted equity investments at cost, though it acknowledges that in rare circumstances cost of an instrument may be an appropriate estimate of fair value. The FIs are advised to be prudent in carrying out the valuation of unquoted equity investments based on relevant information and meticulously adhere to the valuation disclosure requirements of IFRS 13 for such cases. Further, details of the outstanding investments in unquoted equity investments including their cost, fair value and basis for arriving at the fair value should be disclosed in the financial statements for the purpose of reporting in accordance with BPRD Circular No. 4 dated Oct 23, 2019. The details of inputs, evidence, and methods used to arrive at fair value is to be disclosed in the financial statements. The FIs are also advised to disclose the difference between the fair value of unquoted equity instruments assessed and the carrying amount of the instrument (at date of valuation).

2.2.3 *Investments in Subsidiaries and Associates:* The investments in subsidiaries and associates shall be valued at cost by FIs for their standalone financial statements and these investments and will be subject to testing for impairment and they will be tested separately for impairment under IAS-36. However, the investments in associates will be measured using equity method of accounting in their consolidated financial statements.

[3] *“Significantly reduce” is to be determined by the FIs and will be subject to internal and external audit review.*

2.3 Re-Classification

FIs are allowed to reclassify financial assets only when, they change their business model for managing these financial assets. Reclassification of financial assets will only be made in exceptional cases as they will only occur when an entity significantly changes the way it does business. The reclassification of financial assets managed under different business models should be approved by the board's sub-committee along with the rationale for the change in the business model (under which they were managed) that has led to the reclassification. Such changes must be demonstrable to external parties. The following changes in circumstances will not be considered as change in business model for the purposes of reclassification:

- a change in intention related to particular financial assets
- a temporary disappearance of a particular market for financial assets
- transfer of financial assets within different business models.

Changes to the classification should be clearly disclosed in the financial statements, where material. For investments, 5% change with respect to total portfolio of its existing business model will be considered material. The following information, but not limited to, must be disclosed in financial statements with regards to reclassification.

- Circumstances of change in Business Model;
- Time in previous classification category;
- Description of accounting consequences; and
- Impact on financial statements and regulatory ratios;

Chapter – 3: Expected Credit Loss (ECL)

3.1. SBP expects that when exercising management judgment in the application of IFRS 9 ECL requirements, FIs will be prudent (based on reasonable and supportable assumption) and will not make any judgments that have the potential to decrease impairment levels.

3.2. While the implementation of the IFRS 9 ECL accounting framework will require an investment in both resources and system developments/upgrades, SBP has given FIs a considerable time-period to transition to the IFRS 9 accounting requirements. On that basis, SBP has significantly high supervisory expectations that FIs will have a high-quality implementation of the IFRS 9 ECL accounting framework. The following are the general provisions (3.3.1 to 3.3.6) that will be considered by the FIs for the application of ECL accounting framework.

3.3.1. *Application of proportionality, materiality and symmetry:* FIs are advised to comply with the application of ECL in a manner that is appropriate to their size and nature, scope and complexity of their activities

and portfolios. The use of properly designed proportionate approaches should not jeopardise the high-quality implementation of the IFRS 9 - ECL accounting framework; rather their use should enable FIs to adopt sound provision methodologies commensurate with the size, complexity, structure, economic significance, risk profile and, all other relevant facts and circumstances of the bank and the group (if any) to which it belongs.

FIs should also give due consideration to the application of the principle of materiality. However, this should not result in individual exposures or portfolios being considered immaterial if, cumulatively, these represent a material exposure to the FI. In addition, materiality should not be assessed only on the basis of the potential impact on the profit or loss statement at the reporting date. For instance, large portfolio(s) of high-quality credit exposures should be considered material even if they are highly collateralised. It is important to ensure that bias is not being introduced in the design of an ECL methodology or in its implementation. It means that a FI will chooses to adopt an approach to ECL estimation that would generally be regarded as an approximation to "ideal" measures. It is important that such approximation methods are designed and implemented so as to avoid bias. However, for individually most significant exposures such as 5% of the portfolio, the FIs may assess the cashflows individually.

The objective of ECL application is the timely recognition of provisions, so that the recognition of credit deterioration is not delayed. Nevertheless, SBP recognizes that the IFRS 9 ECL accounting framework is symmetrical in the way that subsequent changes (both deteriorations and reversals of those deteriorations) in the credit risk profile of an obligor should be considered in the measurement of the provisions.

3.3.2. *Reasonable and supportable information:* FIs are required to consider a wide range of information when applying ECL accounting models. Information considered should be relevant to the assessment and measurement of credit risk to the particular credit exposure being assessed and should include information about past events, current conditions and forecasts of future economic conditions. Information which is ultimately included in the assessment of credit risk and measurement of ECL should also be reasonable and supportable. FIs should use their experienced credit judgment in determining the range of relevant information that should be considered and in determining whether information is considered to be reasonable and supportable. The information will be considered as reasonable and supportable, if it is based on relevant facts and sound judgment.

3.3.3. *Consideration of forward-looking information:* It is a distinctive feature of the ECL accounting framework to consider forward-looking information, including macroeconomic factors, for timely recognition of ECL. FIs will have to employ sound judgment consistent with generally accepted methods for economic analysis and forecasting. As credit risk management is a core competence of FIs, SBP expects that FIs consideration of forward-looking information will be supported by a sufficient set of data.

SBP will view the biased consideration of forward-looking information as speculative and expects FIs' management to apply its experienced credit judgment to consider future scenarios and to take into account the potential consequences of events occurring or not occurring and the resulting impact on the measurement of ECL. The FIs are advised to establish oversight and effective internal control systems. FIs are advised to avoid biasness in the ECL assessment and measurement process. To safeguard against bias, the FIs may choose forward looking information from credible external available sources. A single set of forward looking information may not be suitable for entire portfolio and FIs shall identify the relationship of forward looking information to key ECL drivers of a given portfolio segmented for the purpose of ECL calculations. It is also expected that FIs shall consider a minimum of three economic scenarios when developing their forecast namely: a base case, an upside case scenario and a downside case scenario. The FIs should develop internal controls and mechanism to periodically assess the sensitivity and relevance of the ECL to individual forward-looking economic parameters applied and to update these if required.

FIs should be able to demonstrate how they have considered relevant, reasonable and supportable information in the ECL assessment and measurement process. FIs should apply experienced credit judgement in the consideration of future scenarios and take into account the potential consequence of events occurring or not occurring, and the resulting impact on the measurement of ECL. Information should not be excluded from that process simply because an event has a low likelihood of occurring or the effect of that event on the credit risk or the amount of expected credit losses is uncertain. In certain circumstances, information relevant to the assessment and measurement of credit risk may not be reasonable and supportable and should therefore be excluded from the ECL assessment and measurement process. Given that these circumstances would be exceptional in nature, FIs should provide a clearly documented, robust justification for such circumstances. The information used shall include an unbiased consideration of relevant factors and their impact on creditworthiness and cash shortfalls. Relevant factors include those intrinsic to the FI and its business or derived from external conditions.

For weightages of the macroeconomic scenarios, FIs are advised to use recognized statistical methodologies.

3.3.4. *Data requirements:* To enable the calculation of ECL, FIs will have to gather historic data as well as develop forward-looking capabilities in their credit risk management systems and techniques e.g. in order to judge significant deterioration in credit quality, FIs are required to use life time PD/internal/external credit ratings as the relevant measure (See 3.8 "Significant Increase in Credit Risk"). In practice this means that life time Probability of Default (PD) information is required on a year by year basis at origination and at IFRS 9 implementation date (and on an ongoing basis at each assessment date thereafter). This requires FIs to develop capability to determine forward-looking PDs for each year of the life of a credit exposure. In addition, to calculate forward-looking ECL PDs are required to be adjusted keeping in view the impact of macroeconomic factors that have an impact on PDs. This means that FIs shall need to collect data on macroeconomic factors that affect particular exposures and calculate the sensitivity of PDs in respect of those factors, requiring advanced modelling techniques and the relevant data. The FIs are advised to ensure data used for ECL is cleansed and is of high quality.

In addition, FIs will be required to develop or enhance their existing loss given default ("LGD") and exposure at default ("EAD") models based on forward-looking assumptions. All of this effort is based on availability and collection of data. The FIs are advised to prioritize data collection in their overall IFRS 9 implementation plans during the parallel run period in order to avoid issues at its implementation date.

ECL estimation is complex and inherently judgmental and is dependent on a wide range of data, which may not be immediately available, including forward-looking estimates of key macro- and micro-economic factors and management's assumptions about the relationship between these forecasts and the amounts and timing of recoveries from borrowers. With respect to number of years for which credit data is available, FIs should have a minimum of 5 years data till Dec 31, 2021. Going forward every year, one more year's data would be added until the FIs would at least have 10 years of data. If the historical data is not available for a 5-year period, the FI should disclose this fact together with the alternative methodology or data used in its financial statements, subject to the prior approval of SBP.

3.3.5. *Alignment with risk management:* Under IFRS 9 the information that is captured in credit risk departments will feed and directly affect the levels of impairment to be recognised. For example, PD information captured will directly impact the decisions to determine correct categorisation of exposures into various provisioning stages and the calculation of expected losses. Following the same principles, judgments made by financial reporting functions, such as what constitutes significant increase in credit risk will impact the data that credit risk teams will have to collect to aid decision making and expected loss recognition by finance departments. Accordingly, FIs are advised to review the interaction between credit risk and financial reporting departments and align processes, policies, and procedures to ensure coordination between the two departments and alignment of approaches to deliver a successful transition and ongoing reporting under IFRS 9 after its effective implementation.

3.4. *SBP's Instructions on Classification and Provision Determination***:** The directives set out by State Bank of Pakistan in respective Prudential Regulations on the portfolios of specific credit facility classification, provision determinations, collateral/security benefits, rescheduling/Restructuring instructions will be read in conjunction with the following instructions, unless it is stated otherwise. The same is illustrated in the enclosed Annexure-I.

3.5. It is expected that provisioning as per IFRS 9 requirements would generally be higher than that under Prudential Regulations. However, from a supervisory perspective, an inefficient model, could lead to substantial under-provisioning for impairment. Therefore, in the initial stages, until there is supervisory comfort with the models being used by FIs and the implementation of IFRS 9 has stabilized, a two-track approach analogous to the present regulations is required. The requirements for provisioning for impairment of financial assets are as below. The same is reflected in the Annexure-I of the circular letter.

3.6. FIs should concurrently compute the total provisions for impairment as required by existing instructions and IFRS 9 guidelines on performing, underperforming and non-performing credit exposures.

3.7. *Low Credit Risk Assets:* FIs are required to develop policies to determine assets that can be considered as 'low credit risk'. The financial assets classified as having 'low credit risk' will be required to book 12-month expected credit losses provisions. The financial instruments are not considered to have low credit risk simply because of the value of collateral or simply because they have a lower risk of default than the entity's other financial instruments. According to SBP, the assets with low credit risks include:

- Investments (debt instruments) having rating (AAA) or (AA) from an external rating agency at the reporting date.
- All exposures on multilateral development agencies; and
- Sovereign exposures (in foreign currency) with investment grade rating from an External Rating Agency (BBB- or equivalent or higher) at the reporting date.

Simplifying low credit risk is not intended to be considered as a standard practice to recognise a 12-month ECL. Rather, if credit risk is no longer low, FIs should assess whether there has been a significant increase in credit risk to determine whether they should recognize the lifetime expected credit losses.

3.8. *Significant Increase in Credit Risk (SICR):* The FIs are advised to devise their own assessment criteria for the SICR in line with the IFRS 9 Standard. IFRS 9 does not specify what constitutes a SICR but it provides a guidance as to what events can be construed as SICR. FIs are required to sufficiently document and consider all other relevant information that indicate a significant increase in credit risk. They are expected to have a clear view of the relation between macroeconomic factors and obligor/facility attributes, and the level of credit risk in a portfolio. The reasonable and supportable information (as required by IFRS 9) for SICR consists of information about past events, current conditions and forecast of future economic conditions (i.e. forward looking macroeconomic information).

3.9. FIs have to establish their own policies for what they consider as default and apply that definition consistently with that used for internal credit risk management purposes. They should also consider qualitative factors (e.g. financial covenants) when appropriate. The definition of default used should be aligned and consistent with the default criteria used for regulatory purposes. Regulatory requirements will be considered as minimum, while the FIs can consider more stringent default criteria.

Additionally, FIs are advised to also use other expedients like 'days past due' and 'investment grade rating' to identify transition from one stage to the other (i.e. From Stage 1 to Stage 2, Stage 2 to 3, or vice versa). In using quantitative elements, FIs should consider the change in Probability of Default (PD) or internal/ external rating by comparing the PD or internal/ external rating at the reporting date with the PD or internal/ external rating at initial recognition. The criteria for relative quantitative increases in PD or ratings indicative of a significant increase in credit risk should be defined and clearly documented and approved by the Board's sub-committee.

The assessment should, among others, consider changes in credit risk at counter party level, obligor credit level and also at a product/facility level (e.g. retail exposures). Generally, most qualitative factors indicative of a significant increase in credit risk are reflected in PD or credit risk models and therefore, are included in the quantitative assessment. However, where it is not possible to include all current information about qualitative factors in the quantitative assessment, FIs should recalibrate PDs or adjust estimates when assessing significant increase in credit risk or calculating Expected Credit Losses (ECLs). In addition to above, the FIs, should consider qualitative criteria which are relevant to their portfolio including the factors given in IFRS 9 B5.5.17 and the following factors for assessing changes in credit risk:

- Classification of the borrower by other Banks/DFIs/MFBs on the overdue exposure reported by banks/ DFIs/ MFBs as per the Credit Information Bureau Report;
- All instructions on the restructured/rescheduled credit exposure in the relevant Prudential Regulations (PRs) will be complied with, by the FIs. The status change of classification of restructured/rescheduled credit exposure of non-performing assets will also be made after meeting the conditions of relevant PRs. The restructured/rescheduled loans should be transferred to Stage 2 after meeting the PRs requirements for the change in the status of its classification and for transfer to Stage 1, they will follow the requirements given in paragraph 3.11.
- The following may be considering factors where applicable:
  - Restructuring/Rescheduling due to credit reasons
  - Unavailable/inadequate financial information/financial statements;
  - Expectation of forbearance (restructuring/rescheduling) occurring
  - Qualified report by external auditors;
  - Significant contingent liabilities;
  - Pending litigation resulting in a detrimental impact;
  - Loss of key staff to the organization;
  - Increase in operational risk and higher occurrence of fraudulent activities; and
  - Continued delay and non-cooperation by the borrower in providing relevant documentation(s).
  - Borrower is the subject of litigation by third parties that may have a significant impact on his financial position.
  - Frequent changes in senior management.
  - Intra-group transfer of funds without underlying transactions.
  - Deferment/delay in the date for commencement of commercial operations by more than one year.

Where FI sets its transfer threshold (such as rating or past due days) for groups of financial assets, it is important that all financial instruments in that portfolio must have similar credit risk characteristics at initial recognition of contract(s). FIs should consider both counterparty and individual exposures of the obligor(s) (including syndicate loans) for corporate/commercial loans, in determining significant increase in credit risk. Further, the impact of multiple exposures to the same obligor originated at different periods needs to be considered in compliance with IFRS 9.

3.10. The following changes in credit quality grades will act as a backstop to determine any significant change in PD by the FIs unless there is delay in payment of due installments is past due or any other change(s) in FIs SICR criteria.

Obligor Risk Rating	**Significant change in credit quality grade**
1-2	Three notches downgrade
3-5	Two notches downgrade
6 onwards	One notch downgrade

The credit quality ratings as used in ECL computations should be:

- Reviewed with sufficient frequency (at least annually)
- Include all reasonable and supportable information (including forward looking when used for SICR)
- Reflective of the lifetime risk of default.

3.11. *Transfer from Stage 2 to Stage 1:* Where there is evidence that there is significant reduction in credit risk, FIs would continue to monitor such financial instruments/credit exposures for a minimum probationary period of 6 months 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).

3.12. *Transfer Out of Stage 3:* An exposure cannot be upgraded from Stage 3 to 1 directly and should be upgraded to Stage 2 initially after following a six-month probation period and thereafter follow the same probation period as mentioned in paragraph 3.11 before upgrading to Stage 1.

3.13. As per IFRS-9, FIs are required to calculate interest income using the effective interest rate method on impaired financial assets (classified as stage-3). However, the FIs for parallel reporting are advised to recognize income on impaired assets (under Stage 3) on a receipt basis in accordance with the requirements of Prudential Regulations issued by SBP. It means that mark-up recorded as Memo against classified advances as per Prudential Regulation will not be accounted for under IFRS 9 parallel run.

3.14. *Rebuttable Presumptions:* The transfers between Stages under IFRS 9 are based on relative movement in credit risk since origination rather than based on absolute level of risk. Moreover, IFRS 9 includes a rebuttable presumption that a default does not occur later than when a credit exposure is 90 days past due and it also presumes that there is a significant increase in credit risk since initial recognition if credit exposure is more than 30 days past due. In order to bring consistency, the backstop to the rebuttable presumption of days past due of credit portfolio against the specific credit facility and their stage allocation under IFRS 9 is mentioned in Annexure-I.

Nonetheless, the FIs are encouraged to use the days past due criteria given under IFRS 9 as a backstop (without rebuttable presumptions) for the stage allocation purposes except for the microfinance loans (Stage 3), as given in Annexure-I. The SBP expects that the banking industry will strive its best to use 30 days past due to be considered as SICR for transfers from Stage 1 to Stage 2. The backstops on days past due rebuttable presumption in Annexure-I are given for prudence purposes (FIs are free to choose more stringent DPD criteria) and it is advised not to exceed the days past due criterion given in Annexure-I for SICR purposes.

The FIs are advised not to rely solely on the days past due presumption, but to incorporate reasonable and supportable forward-looking information. The days past due presumption can only be applied if the forward-looking information is not available without undue cost or effort.

Where the 30 days past due presumption is rebutted on the basis that there has not been a significant increase in credit risk, the FI shall accompany the assertion by sufficiently documented, reasonable and supportable information that a more lagging criterion is appropriate, as given in Annexure-I.

3.15. *Mapping of internal ratings to external rating definitions:* In order to facilitate better comparison and comprehension of their internal ratings, FIs should map their internal credit risk rating models (that has been aligned with SBP's risk rating guidelines) to credit definitions by internationally well-established independent rating agencies as far as possible. Where such mapping is not possible, the reasons thereof should be disclosed in the financial statements for parallel reporting. In cases where both external and internal ratings of a particular financial asset are available, the FIs are advised to use the higher risk rating in this respect.

3.16. *Forward Looking Probability of Default:* In order to derive forward-looking PD information, FIs are required to overlay specific macroeconomic information to the PD information. This can be achieved, for example, by adjusting the PD information for its sensitivity to changes of certain macroeconomic factors.

FIs will be required to perform their own analysis to assess the impact of such macroeconomic factors on their credit exposures and determine forward-looking PD information to be used for ECL calculations.

3.17. *Exposure at Default (EAD):* EAD represents the amount of potential exposure that is at risk. Since ECL is a forward-looking measure, EAD input will be forward-looking as well as based on the time-period when the default is likely to occur. Therefore, it includes all outstanding exposure and off balance sheet exposures after adjustment with contractual cash flows to reflect the exposure expected when default occurs. For closed-end loans, the EAD of the facilities will be capped at the maximum contractual period over which the entity is exposed to credit risk. For revolving products (such as overdrafts, running finance and credit cards), the FIs are advised to not limit its exposure to credit losses to the contractual notice period and calculate expected credit losses over a period longer than the actual contractual period. The FIs are advised to clearly document such a longer period over which expected losses would be estimated and the information that supports such a decision in the financial statements of parallel reporting.

Eligible collateral: The FIs are advised to consider only those collaterals as eligible collateral in the EAD calculation, which have following characteristics;

- Legal certainty and enforceability
- History of enforceability and recovery

It is expected that only liquid collaterals (defined in Prudential Regulations) would meet this criterion in the context of domestic operations. The FIs are advised to disclose the eligible collateral(s) used in the EAD calculation along with the haircut applied, if any.

Treatment of Collateral Realization: Due to the complexities involved regarding non-liquid collateral realization, the FIs are advised not to consider recoveries from the realization of non-liquid collateral(s) for credit exposures in Stage 1 and Stage 2.

Credit Conversion Factor (CCF): The FIs are advised to estimate the expected portion of the commitment that will be drawn down over the expected life of the commitment on the basis of their past experience and forward-looking information. If not possible, the FIs may use the CCF for the calculation of EAD for off balance sheet exposures as defined under BSD Circular No. 08 of 2006 dated June 27, 2006 (Minimum Capital Requirements – Implementation of Basel -II). **Nonetheless, the FIs are advised to develop their own CCF till Dec 31, 2021.**

3.18. *Loss Given Default (LGD):* LGD is the percentage that determines the amount of loss that will arise if the borrower was to default. The FIs are advised to work on development of LGD models based on their historical data, historical experience of cash recovery from defaults (including settlements), cost and time of recoveries, collateral or recoveries projection, and expected recoveries from realization of collateral. SBP requires FIs to gather all relevant and supportable information to enable them to arrive at accurate information for the purpose of LGD calculation e.g. value of the collateral at a future point in time (if LGD is estimated based on recoverability of collateral). In arriving at the LGD, FIs should make reasonable and supportable estimates of the value of the collateral. In case, the FIs has not been able to develop the LGD model, (or in case of newly build portfolios where the considerable history of defaults are not available and recoverability benchmarking with other portfolios will also not be possible) the FI can use the LGD percentages prescribed under Basel F-IRB approaches to determine Expected loss under BSD Circular No. 08 of 2006 dated June27, 2006 (Minimum Capital Requirements – Implementation of Basel-II) i.e. 45% LGD for secured portfolio and 75% LGD for unsecured portfolio. **The FIs are advised to establish their LGD model by Dec 31, 2021.**

3.19. *Impact of Provisions on Regulatory Capital:* Under the existing Basel regulatory capital framework, the treatment of impairment is primarily dependent on the approach that a financial institution adopts for computing its regulatory capital for credit risk. Under the Standardized approach, the exposures are measured net of specific provisions and gross of general provisions for calculating capital requirements. The FIs are permitted to include provisions for Stage 1 and Stage 2 in Tier 2 capital, as given in para 3.6, up to a limit of 1.25% of total credit risk-weighted assets (CRWAs).

3.20. *ECL Model Governance & Validation of Models:* IFRS 9 is an accounting driven regulation that requires robust credit risk models that can predict PDs, LGDs and EADs. The models developed by FIs should be validated using reasonable statistical techniques and best practices. In order to avoid "black box risk" with above estimates used for accounting provision and not for business decisions, it is important to use such models for business decision-making purpose alongside IFRS 9 impairment requirements. FIs should set up a robust model governance mechanism including three lines of defense. Model validation including data quality review, back testing of assumptions, reperformance, sensitivity analysis and comparisons of alternative methods should be carried out with sufficient regularity so that these Models remain current and relevant. It should be ensured that independent teams are responsible for model build and model validation review. The Internal Audit of the FI should be sufficiently skilled and should carry out periodic review of IFRS methodology and Impacts calculated by the Management. FIs are advised to desist from making changes in the parameters, assumptions and other aspects of their expected loss model for the purposes of profit smoothening. The rationale and justification for any change in the expected loss model should be documented and justified by the Chief Risk Officer and approved by the board's subcommittee responsible for IFRS 9 implementation.

3.21. *Capacity Building:* The FIs are advised to train their credit risk and finance teams in aspects of IFRS 9 implementation, which will affect their operations, so that they are able to apply the requirements for the purposes of initial transition and on an ongoing basis under IFRS 9.

3.22. *Impact of COVID-19:* The FIs are advised to consider the guidance provided by the International Accounting Standard Board and Basel Committee on Banking Supervision on the impact of COVID-19 on the credit exposure and keeping in view of the relief packages.

Chapter – 4: Derivatives and Hedge Accounting

Derivatives: Derivative financial instruments under IFRS 9 are required to be carried at fair value with movements in fair value recorded in profit and loss, unless the derivative is designated into a hedging relationship and hedge accounting is applied. In the case where a derivative is designated into a hedging relationship, then the hedge accounting rules are applied.

Chapter – 5: DISCLOSURES

FIs should ensure compliance with the disclosure requirements laid down by IFRS 9 and IFRS 13: Fair Value Measurement. Further, the FIs would refer to the disclosure requirements given under BPRD Circular No. 4 dated October 23, 2019.

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