Annexure B

Guideline for absorption of ECL for CAR Purposes

The introduction of IFRS 9 is an important development; at the same time, the capital impact of the move will be significant for some Financial Institutions (FIs). Some of the FIs would suffer in terms of reduced regulatory capital, which is likely to reduce their lending capacity and ability to support their clients. In order to mitigate the impact of expected credit loss (ECL) models on capital, especially after COVID-19, The SBP has determined that it may be appropriate for the FIs to introduce a transitional arrangement for the impact on regulatory capital from the application of ECL accounting. FIs applying a transitional arrangement must implement such an arrangement as follows:

I. The transitional arrangement must apply only to provisions that are "new" under an ECL accounting model. "New" provisions are Stage 1 and Stage 2 provisions, which do not exist under accounting approaches applied prior to the adoption of IFRS 9.

II. The transitional arrangement must adjust CET1 capital. Where there is a reduction in CET1 capital due to new provisions, net of tax effect, upon adoption of an ECL accounting model, the decline in CET1 capital (the "transitional adjustment amount") must be partially included (i.e. added back) to CET1 capital over the "transition period" of five years.

III. FIs must add-back the transitional adjustment amount in CET1 capital starting at 90%, falling to 10% in the final year throughout the transition period by recalculating it periodically to reflect the evolution of an FI's ECL provisions within the transition period.

Year	New Stage 1 & 2 Provisions add back to CET1 Capital
1	90%
2	70%
3	50%
4	30%
5	10%

IV. The transitional adjustment amount included in CET1 capital each year during the transition period must be taken through to other measures of capital as appropriate (e.g. Tier 1 capital and total capital), and hence to the calculation of the leverage ratio and of large exposures limits.

V. Any deferred tax asset (DTA) arising from a temporary difference associated with a non-deducted provision amount must be disregarded for regulatory purposes during the transitional period. This means that such DTA amount must not be considered for CET1 capital, and in return must not be subject to deduction from CET1 capital and must not be subject to risk weighting, as applicable.

VI. FIs that choose to implement a transitional arrangement must disclose in their interim and annual financial statements
   - Whether a transitional arrangement is applied; and
   - The impact on an FI's regulatory capital and leverage ratios compared to the FI's "fully loaded" capital and leverage ratios had the transitional arrangement not been applied.