IFRS 9 FINANCIAL INSTRUMENTS
APPLICATION INSTRUCTIONS

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 requirements under IFRS 9 obliges FIs to establish provisions for expected credit losses, which requires banking industry to develop and establish new systems and models to evaluate financial assets and calculate ECL accordingly.

In this regard, these instructions are being issued to regulate the FIs' application of IFRS 9. These application instructions are not intended to prescribe methodologies, action plans, standardized systems and models for all FIs.

1.2 **Scope of Application:** The following instructions apply on all FIs at standalone as well as at consolidated financial statements level. However, the financial statements of overseas branches, subsidiaries and associates that are prepared for the purpose of consolidation at FI level should be based on their respective host country's regulatory accounting practices till one year from the effective date of IFRS 9 implementation. Afterwards, FIs will be required to comply with the requirements of these application instructions for consolidated financial statements. The application of these instructions will not apply on the standalone statutory financial statements of FIs' associates, subsidiaries and overseas branches that shall be prepared according to their rules and regulations applicable to them. The SBP's instructions / regulations that will be superseded by the application of these instructions are attached at Annexure-A.

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 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 the three main classification categories:

i. Amortised Cost
ii. Fair Value through Other Comprehensive Income (FVTOCI)
iii. 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:

i. The Business Model Test.
ii. The Contractual Cash Flow Characteristics Test

2.1.3 **Business Model Test:** 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:

i. **Hold to Collect Business Model:** Holding assets in order to collect contractual cash flows
ii. **Hold to Collect and Sell Business Model:** Collecting contractual cash flows and selling financial assets
iii. **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. The FIs' business model can still be "to hold financial assets to collect contractual cash flows" even if sales of financial assets occur. However, if more than infrequent number of sales or sale of significant value is made out of a portfolio, the FI will assess how sales are consistent with 'hold-to-collect' objective. This assessment should include reason(s) for sales, expected frequency of sales, and holding period relative to contractual maturity. Following are the examples[1] of sales that would not contradict holding financial assets to collect contractual cash flows:

i. Selling of financial asset to realize cash to deal with an unforeseen need for liquidity
ii. Selling of financial asset due to significant internal restructuring/business combinations
iii. Selling of financial asset close to its maturity and proceeds from sales approximate the collection of remaining contractual cash flows
iv. Selling of financial asset due to increase in credit risk or to manage credit concentration risk
v. Selling of financial asset in 'stress case' scenario

SBP expects that sales of financial assets held under HTC business model will be rare and will happen in exceptional circumstances. FIs should have approved policy from the board or its sub-committee for the sales under HTC Business Model.

2.1.3.2 **Hold-to-Collect & Sell (HTC&S) Business Model:** Under this model, the intention of FIs is to hold asset to collect its contractual cash flows and to sell 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 selling financial assets can be an integral to achieve the FIs' business objectives. Following are some of the objectives consistent with this type of business model:

i. To manage everyday liquidity needs
ii. To maintain a particular interest yield profile
iii. To match duration of the financial assets and liabilities funding those assets

2.1.3.3 **Other Business Models:** Financial assets are measured at FVTPL if they do not fall in either HTC or HTC&S business models. Following are some of the examples of such business models:

i. FI manages financial assets with the objective of realizing cash flows through the sale of the assets *(Held-for-Trading)*
ii. FI manages and evaluates a portfolio of financial assets on a fair value basis

2.1.3.4 The business models including objective criteria of their determination shall be approved by the board. The FI's business model for managing financial assets is a matter of fact and not merely an assertion. It is typically observable through activities that the FI undertakes to achieve the objective of the business model. The FIs must consider all relevant evidence that is available at the time of assessment. Such evidence may include:

i. How the financial assets held within a particular business model are evaluated and reported to the entity's key management personnel.
ii. The risks that affect the financial assets held within a business model and management of the risks thereof.
iii. 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 (Amortised 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 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

[1] *These examples are just an indicative list and does not provide the only cases, where sales can occur under HTC business model.*

classification treatment. The minimum standard for meeting 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. The contractual features 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.

The Islamic Banking Institutions (IBIs) may consider the international practices for the application of SPPI test for similar kind of instruments in the classification of their financial assets, while assessing their contractual cash flow test under IFRS 9. The IBIs may also refer to the published guidance / accounting literature by the AAOIFI in this regard.

2.1.5 Investments and Other Assets:

2.1.5.1 Quoted Securities: Government Securities, Term Finance Certificates (TFCs), Participation Term Certificate (PTCs,) Sukuk 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, Sukuk shall be measured at their fair value.

2.1.5.2 Unquoted Securities: PTCs, TFCs and Sukuk shall be classified in accordance with criteria prescribed under section 2.1.2 and ECL shall be calculated as required for debt instruments measured as amortised cost or FVTOCI.

2.1.5.3 Other Assets: The financial assets falling within “Other Assets” shall also be classified in accordance with the criteria described in section 2.1.2.

2.1.6 **Use of Fair Value Option:** FIs may designate, at initial recognition, a financial asset as measured at FVTPL if it eliminates or significantly reduces any ‘accounting mismatch’ arising from measuring assets or liabilities on different basis. Financial assets designated at FVTPL are not subject to the reclassification requirements of IFRS 9.

The FIs may apply Fair Value Option under this criterion if: (a) it is consistent with a documented risk management strategy and eliminates or significantly reduces[2] measurement or recognition inconsistency of measuring financial assets or liabilities on a different basis, and (b) fair values are reliable at inception and throughout 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.

2.1.7 **Financial Liabilities:** Financial liabilities will be measured at amortised cost except those classified as held for trading and FIs opt to measure them at fair value. The FIs will apply Fair Value Option only if: (a) 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) fair values are reliable at inception and throughout the life of the instrument. The FIs are required to disclose liabilities resulting 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

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

can be categorized 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 basis at the time of its purchase and should be properly documented. The FIs may categorize the equity securities of a same company as FVTOCI and FVTPL depending on its business model.

2.2.2 **Unquoted Equity Securities:** FIs are advised to measure investment in unquoted equity securities at lower of cost or breakup value till December 31, 2023. In case where the breakup value of such securities is less than the cost, the difference of the cost and the breakup value will be classified as loss and provided for by charging it to the Profit and Loss account.

Afterwards, all FIs are required to measure unquoted equity instruments at fair value, as IFRS 9 does not allow for the recognition of unquoted equity securities 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 fair valuation of unquoted equity securities 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 instruments including their cost, fair value and basis of fair value should be disclosed in the statutory financial statements. Moreover, the details of inputs, evidence, and methods used to arrive at fair value should be disclosed in the statutory financial statements.

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

2.3 Re-Classification

The FIs are allowed to reclassify financial assets only when, they change their business model for managing 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 made in accordance with the board approved policy. FIs need to document rationale for change in the business model that has led to the reclassification. Following changes in circumstances will not be considered as change in business model for the purposes of reclassification:

i. A change in intention related to a particular financial assets
ii. A temporary disappearance of a particular market for financial assets
iii. Transfer of financial assets between parts of entity with different business models

Changes to the classification should be clearly disclosed in the statutory financial statements, where material. For investments, 5% change in the total portfolio of an existing business model will be considered material. Following information must be disclosed in financial statements for reclassification:

i. Circumstances for change in Business Model
ii. Time duration in previous classification category
iii. Description of accounting consequences
iv. Impact on financial statements
v. Impact on regulatory ratios

Chapter – 3: Expected Credit Loss (ECL)

3.1. The FIs are expected to be prudent while exercising judgment in the application of ECL requirements. The management judgement should be based on reasonable and supportable assumptions.

3.2. The credit exposure (in local currency) that have been guaranteed by the Government and Government Securities are exempted from the application of ECL Framework.

3.3. The following are the general provisions (3.3.1 to 3.3.5) 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, nature, scope and complexity of their activities and portfolios. The use of properly designed ECL Framework enable FIs to adopt sound provision methodologies commensurate with the size, complexity, structure, economic significance, risk profile, etc. of a bank and its group (if any).

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 collateralized. However, for individually most significant exposures (to be decided by FIs), the FIs may assess their cash flows individually. Further, it must be ensured that bias is not being introduced in the design of an ECL methodology and its implementation.

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 framework is symmetrical in the way that subsequent changes (both deteriorations and its reversals) 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 should be relevant to the assessment and measurement of credit risk and should include information about past events, current conditions and forecasts of future economic conditions. 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:** ECL accounting framework should 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 supported by sufficient data.

FIs should apply prudent credit judgment to consider future scenarios and take into account potential consequences of future events and their impact on the ECL. To avoid biasness in ECL measurement, the FIs should use 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. FIs may consider a minimum of three economic scenarios while developing ECL forecast namely: a base, an upside and a downside case scenarios. The FIs should develop internal controls, systems and mechanisms to periodically assess sensitivity of ECL to each forward-looking parameter applied. For weightages of the macroeconomic scenarios, FIs may use recognized statistical methodologies.
Information should not be excluded from the process simply because an event has a low likelihood of occurring or its impact on the ECL is uncertain. Given that these circumstances would be exceptional

in nature, FIs should provide a clearly documented, robust justification for such circumstances.

3.3.4 **Data Requirements:** To enable the calculation of ECL, FIs will have to gather historic data and develop forward-looking capabilities in their credit risk management. FIs are required to develop Probability of Default (PD), Loss Given Default (LGD) and Exposure At Default (EAD) models based on forward-looking assumptions. In order to assess significant deterioration in credit quality, FIs are required to use life time PD / internal / external credit ratings as the relevant measure for credit risk. This requires FIs to develop capability to determine forward-looking PDs for 12-months period and life of a credit exposure. In addition to calculating forward-looking ECL, PDs are required to be adjusted keeping in view the impact of economic factors.

FIs, whose IFRS 9 effective implementation date is January 1, 2023, should have a minimum of 5 years data till December 31, 2022, whereas for all other FIs this requirement will be applicable from December 31, 2023. Going forward every year, one more year's data would be added until the FIs would at least have 10 years of data. The FIs should ensure that requisite data is readily available for preparation of all such models.

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 statutory financial statements. This will be applicable only for newly build portfolios where the considerable history of defaults is not available and / or recoverability benchmarking with other portfolios are not possible, such as greenfield projects.

3.3.5 **Alignment with Risk Management:** The information related to credit risk directly affects the level of ECL impairment. 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 (that have not been superseded by these instructions) on the portfolios of specific credit facility classification, provision determinations, collateral/security benefits, rescheduling restructuring instructions will be read in conjunction with these instructions.

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 same is reflected in the Annexure-C of the application instructions.

3.6. **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 ECL provisions. The financial instruments are not considered to have low credit risk simply because of the value of collateral have a lower risk of default than the entity's other financial instruments. The assets with low credit risks include:

i. Investments (debt instruments) having rating AA and above from an external rating agency at the reporting date.
ii. All exposures on multilateral development agencies.
iii. Sovereign exposures (in foreign currency) having rating BBB and above from an external rating agency at the reporting date.

FIs should assess whether there has been a significant increase in credit risk on exposure classified as low credit risk. If so, they should recognize lifetime ECL.

3.7. **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. 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.

3.8. For the definition of default, regulatory requirements should be considered as minimum, while the FIs can consider stringent default criteria. Additionally, FIs are advised to 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 PD or internal/ external rating by comparing them with the ones initially recognized. The Board should approve criteria for relative quantitative increases in PD or ratings indicative of SICR.

The assessment should, among others, consider changes in credit risk at counter party level, obligor credit level and also product/facility level (e.g. retail exposures). Generally, the qualitative factors indicative of SICR 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 SICR or calculating ECL. In addition to above, the FIs should consider qualitative factors relevant to their portfolio including those given in IFRS 9. The following factors for assessing changes in credit risk may also be considered:

i. Classification of borrower on the overdue exposure reported by other FIs as per Credit Information Bureau (eCIB) Report
ii. Unavailable/inadequate financial information/financial statements
iii. Expectation of forbearance (restructuring/rescheduling)
iv. Qualified report by external auditors
v. Significant contingent liabilities
vi. Pending litigation
vii. Loss of key staff and frequent changes in senior management
viii. Increase in operational risk and higher occurrence of fraudulent activities
ix. Continued delay and non-cooperation by a borrower in providing relevant documentation(s)
x. Borrower is subject to litigation by third parties
xi. Intra-group transfer of funds without underlying transactions
xii. Deferment/delay in the date for commencement of commercial operations by more than one year

In case 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) in determining SICR. Further, the impact of multiple exposures to the same obligor originated at different periods needs to be considered in compliance with IFRS 9.

3.9. The credit ratings used for ECL computations should be:

i. Reviewed with sufficient frequency (at least annually or earlier whenever objective evidence exist for SICR)
ii. Reflective of the lifetime risk of default

3.10. **Transfer From Stage 2 to Stage 1:** Where there is evidence that there is significant reduction in credit risk, the FIs would continue to monitor such financial instruments / credit exposures for a probationary period (as decided by the FIs) 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).

3.11. **Transfer Out of Stage 3:** An exposure cannot be upgraded from Stage 3 to 1 directly and should be upgraded to Stage 2 initially. For the purpose of reversal of provisions, the PRs requirements will be followed for the Stage 3/classified assets.

3.12. The FIs are advised to recognize income on impaired assets (loans classified under PRs i.e. OAEM and Stage 3 loans) on a receipt basis in accordance with the requirements of Prudential Regulations issued by SBP.

3.13. **Rebuttable Presumptions:** The transfers between stages are based on relative movement in credit risk since origination instead of absolute level of risk. Moreover, IFRS 9 includes a rebuttable presumption that a default does not occur later than 90 days past due and it also presumes that there is SICR 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 a specific credit facility and its stage allocation under IFRS 9 is mentioned in Annexure-C. However, FIs are free to choose more stringent days past due criteria.

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.

3.14. **Mapping of Internal Ratings to External Rating:** FIs should map their internal credit risk rating models to credit definitions by well-established independent rating agencies as far as possible. In cases where both external and internal ratings of a particular financial asset are available, the FIs are advised to use the more conservative risk rating in this respect.

3.15. **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.

3.16. **Loss Given Default (LGD):** LGD determines the amount of loss that will arise if the borrower defaults. The FIs are advised to work on development of LGD models based on historical data, historical experience of cash recovery from defaults (including settlements), cost and time of recoveries and recovery projection. FIs are required to gather all relevant and supportable information to enable them to arrive at accurate information for the purpose of LGD calculation FIs credit risk model for ECL should have the capability to calculate ECL based on seasonality of the exposure as LGD and EAD are reduced during off-season. Nevertheless, the FIs, whose effective date of IFRS 9 implementation is January 1, 2023, are advised to develop their own LGD model till December 31, 2022, whereas rest of FIs are advised to develop the same till December 31, 2023.

In the absence of LGD model during the aforesaid period, the FIs can use the LGD percentages prescribed under Basel Foundation – Internal Rating Based (F-IRB) approach to determine ECL under BSD Circular No. 08 dated June27, 2006.

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.

3.18. **Credit Conversion Factor (CCF):** The FIs are advised to estimate expected portion of a commitment that will be drawn down over the expected life of a commitment on the basis of its past experience and forward-looking information. If not possible, 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. Nonetheless, FIs, whose effective date of IFRS 9 implementation is January 1, 2023, are advised to develop their own CCF model till December 31, 2022, whereas rest of FIs are advised to develop the same till December 31, 2023.

3.19. **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.

3.20. **Eligible Collateral:** The FIs are advised to consider only those collaterals as eligible collateral, which have following characteristics;

i. Legal certainty and enforceability
ii. History of enforceability and recovery

3.21. **Impact of Provisions on Regulatory Capital:** Under the existing Basel regulatory capital framework, the treatment of impairment is primarily dependent on the approach that an FI 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 allowed to include provisions for Stage 1 and Stage 2 in Tier 2 capital up to a limit of 1.25% of total credit risk-weighted assets (CRWAs).

In order to mitigate the impact of expected credit loss (ECL) provisioning on capital, a transitional arrangement is allowed to the FIs to absorb the impact on regulatory capital. Accordingly, FIs, which choose to apply transitional arrangement, may implement this arrangement in accordance with the guidelines given at Annexure B.

3.22. **ECL Model Governance & Validation of Models:** IFRS 9 requires robust credit risk models that can predict PDs, LGDs and EADs. In order to avoid "black box risk", 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:

i. Model validation including data quality review, back testing of assumptions, performance, sensitivity analysis and comparisons of alternative methods should be carried out with sufficient regularity so that these models remain current and relevant.
ii. It should be ensured that independent teams are responsible for model build and model validation review
iii. 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 ECL model for the purposes of profit smoothening. The rationale and justification for any change in the ECL model should be documented by the Chief Risk Officer and approved by the board / sub-committee of the board.

3.23. **Capacity Building:** The FIs are advised to invest in the capacity building and training of relevant human resource to facilitate transition and implementation of IFRS 9.

3.24. **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 the relief packages provided by SBP.

3.25. **Verification by the Auditors:** The external auditors shall verify compliance of application instructions during the course of statutory audit. The SBP inspection team shall also check the adequacy of compliance during the on-site inspection.

Chapter – 4: Derivatives and Hedge Accounting

Derivatives: Derivative financial instruments under IFRS 9 are required to be carried at FVTPL. In case derivative is designated into a hedging relationship, then hedge accounting rules are applied.

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