EXCLUSIVE INTERVIEW

Mr. Jameel Ahmad

Governor
State Bank of Pakistan (SBP)

> "Pakistan is among the earliest adopters of IFRS in the region, and SBP is proud to have played a pivotal role in the implementation of the latest accounting standards in Pakistan. SBP has taken several initiatives to assist financial institutions in addressing the technical and operational challenges related to implementation of IFRS-9"

ICMA: How has the implementation of IFRS impacted accounting and reporting practices for banks and financial institutions in Pakistan?

Governor SBP: Before I respond to the question, let us recall the need to have the IFRS-9 framework. As you may know, IFRS-9 encapsulates the global experience of supervisory authorities and standard setting bodies after the Global Financial Crisis (GFC) of 2008. The GFC impressed upon a need to revise the approach on categorization and measurement of financial instruments and recording of impairments. The solution, IFRS-9, requires classification of financial assets based on the business model and the cash flow characteristics of the instrument. It also introduced forward-looking approach to measure financial assets and liabilities. Specifically, IFRS-9 introduced the Expected Credit Loss (ECL) approach to timely recognize credit risks and maintain sufficient allowances based on past, current and forward-looking information about systemic and idiosyncratic factors.

As you may be aware, SBP implemented the IFRS-9 for banks and DFIs with effect from January 1, 2024. This has had a significant favorable impact on the accounting and reporting practices of financial institutions. For instance, financial institutions (FIs) are now required to reclassify their financial assets based on their business models and cash flow characteristics of the financial instruments. Meanwhile, the introduction of ECL model under IFRS-9 requires FIs to enhance their credit risk assessment and provisioning methodologies and update their systems accordingly. Further, to improve transparency and provide insights into risk profile, the FIs are required to provide both qualitative and quantitative information about their risk management practices, accounting assumptions, changes in the levels of risk exposures and associated allowances, and the impact of forward-looking information.

In short, the adoption of IFRS-9 has significantly enhanced the quality of financial reporting and disclosure regime that would help in strengthening the governance framework in financial institutions, improving market discipline, and ensuring overall financial stability in the country.

Mr. Azeem Hussain Siddiqui, Chairman National CPD Committee and Mr. Aamir Ijaz Khan, Excutive Director ICMA in a meeting with Governor SBP

ICMA: How effective has the implementation of IFRS-9 been for development banks, financial institutions, and microfinance banks in Pakistan since its applicability from 1st January 2024?

Governor SBP: In line with SBP's instructions, financial institutions have prepared their financial statements of March 2024 under IFRS-9. The preliminary analysis suggests that large and medium-sized banks are mostly compliant with the requirements of the standard. Small banks have also achieved a fair degree of compliance with the standards and, as they gain experience and strengthen capacity; degree of their compliance with IFRS-9 is expected to improve. Meanwhile, microfinance banks are scheduled to implement the standard from January 1, 2025. The financial institutions are required to align their existing policies, procedures and systems to meet the requirements of the Standard, which will take significant time, effort and investment in technology. We at SBP are closely coordinating with our regulated financial institutions to identify and address any teething issues in the adoption of IFRS-9.

ICMA:What specific challenges have banks encountered in the adoption of IFRS?

Governor SBP: Globally, from implementation perspective, IFRS-9 is considered one of the complex and challenging standards as it requires extensive involvement of forecasting and estimations, particularly related to credit loss allowances. The incorporation of ECL forecasts necessitated a robust suite of forecasting models and approaches that supplement other objective parameters in driving decision-making at financial institutions. During the multi-year process in which our financial institutions have gradually adopted IFRS-9, some challenges naturally came up. These included:

> SBP implemented the IFRS-9 for banks and DFIs with effect from January 1, 2024. This has had a significant favorable impact on the accounting and reporting practices of financial institutions

- **Availability and quality of data and modeling complexities:** Gaps in historical data for development of robust quantitative models to forecast ECLs was challenging. Moreover, firms had to invest in skilled human resource and infrastructure upgrades to develop a robust suite of ECL models that accurately capture credit risk under different scenarios. In fact, enhancing capability of relevant human resources to optimally implement the new standard required extensive amount of time and resources.

- **Changes in System and Processes:** A significant outlay of funds was required for the upgradation of technology-dependent accounting systems. Updating IT systems and processes to accommodate new classification, measurement, and impairment requirements presented significant operational challenges.

- **Consolidation of overseas subsidiaries and associates of FIs where IFRS-9 has not been adopted:** This necessitated a significant outlay of funds and resources as it involved access to detailed customer data and history. Moreover, such data generally has cross-border disclosure restrictions.

- **Effective interest rate:** The Standard requires the usage of effective interest rate to measure fair value of restructured and rescheduled loans (modified loans under IFRS-9). This change may have adverse impact on the profitability and capital adequacy of the institutions.

Mr. Azeem Hussain Siddiqui, Chairman National CPD Committee, on behalf of Mr. Muhammad Yasin, Vice President ICMA and Chairman, Research & Publications Committee, is presenting a souvenir to Mr. Jameel Ahmad, Governor SBP. Mr. Aamir Ijaz Khan, Executive Director ICMA and Mr. Shahid Anwar, Director, Research & Publications are also present

- **Implementation of the Standard on Shariah-compliant products:** The presence of profit/loss sharing clauses or equity contribution of financial institutions posed some challenges in the adoption of IFRS-9 standards. Moreover, in case of some Islamic products such as Istisna, Salam, Tijarah, Musharaka, income is recognized on the culmination of transaction, which is not in accordance with the effective interest method prescribed under IFRS-9.

ICMA: What initiatives has the SBP undertaken to assist banks in addressing technical and operational challenges related to IFRS?

Governor SBP: Pakistan is among the earliest adopters of IFRS in the region, and SBP is proud to have played a pivotal role in the implementation of the latest accounting standards in Pakistan. SBP has taken several initiatives to assist financial institutions in addressing the technical and operational challenges related to implementation of IFRS-9. These included the issuance of detailed instructions and guidelines to facilitate the adoption of the new standards. In 2019, SBP issued initial instructions that required institutions to complete essential groundwork and establish board-level committees by January 2020. SBP then issued detailed guidance notes and interpretations to clarify the application of IFRS-9 in 2022. The "IFRS-9 Application Instructions", developed in consultation with the banking industry, were issued to guide institutions through the adoption process. SBP's policy and supervisory departments remained constantly engaged with the industry to understand the operational challenges and provided them necessary regulatory support. Specifically, based on engagements and evaluation of quarterly parallel reporting via pro-forma reports, Frequently Asked Questions (FAQs) were prepared and shared with the industry in 2024.

SBP also closely monitored the implementation process to ensure adherence to standards and to promptly address any issues encountered during this period. Overall preparedness of the industry was also assessed, which involved comprehensive off-site reviews of major elements, including existing credit risk management practices, governance structure, policies and procedures, model development and monitoring and incorporation of forward-looking information in estimation of ECLs. Accordingly, weaknesses identified during assessment were shared with the financial institutions for improvement before the implementation date. SBP also assigned responsibilities to Boards of Directors and Management Steering Committees of banks to ensure effective development of requisite systems for the implementation of IFRS-9.

ICMA: Could you elaborate on the SBP's role in facilitating the transition to IFRS for banking institutions?

Governor SBP: SBP has a strong interest in improving the financial reporting and disclosure standards and promoting the sound credit risk practices in the country. Therefore, we decided to implement IFRS-9 in a manner that promotes transparency and strengthen risk governance, while avoiding undue and abrupt pressure on capital levels of financial institutions. To facilitate a smooth and successful transition, SBP played a proactive role over the course of multiple years from both policy and supervisory perspectives. First, SBP's instructions and guidelines for the implementation of the standard duly took into account the local macroeconomic environment and the health of the domestic financial sector.

> "The adoption of IFRS-9 has significantly enhanced the quality of financial reporting and disclosure regime that would help in strengthening the governance framework in financial institutions, improving market discipline, and ensuring overall financial stability in the country"

As such, while we established clear timelines and requirements for the adoption of IFRS-9, we remained flexible in our implementation approach to cater to evolving exogenous shocks and exigencies. For instance, the timelines were extended during the COVID-19 pandemic and again after the devastating 2022 floods. We have also allowed more time to microfinance banks, keeping in view their peculiar constraints; these institutions are allowed to implement the standard effective from January 1, 2025.

Second, during the course of implementation of the standards, SBP remained closely engaged with the industry and other relevant stakeholders, including audit firms, to assess the impact of the standard on financial metrics and identified areas which required regulatory interventions and support. This was facilitated by instructions to financial institutions to prepare and submit financial results as per IFRS-9 on parallel run basis. Moreover, SBP advised the industry to assess the impact of IFRS-9 on their profitability and capital adequacy, carry out system upgrades, and ensure employee trainings and capacity during the implementation process. SBP also maintained regular communication with financial institutions to provide updates, guidance, and support throughout the transition period.

ICMA: In what ways has the implementation of IFRS-9 influenced risk management practices within banks?

Governor SBP: The implementation of IFRS-9 has improved overall risk governance in banks through its influence on various aspects of risk management practices. These include:

- **Enhanced Credit Risk Assessment:** Banks now utilize a forward-looking approach to management of credit risk, enabling more proactive risk management and mitigation strategies. Business units have started to account for expected credit losses in the pricing of the products to reflect credit risk of the borrowers. The risk-based pricing in turn influences risk appetite, business strategies and capital allocation. For timely recognition of credit risk, banks now incorporate forward-looking information and macroeconomic factors in their credit risk assessments to maintain adequate allowances. This approach has led to the development of sophisticated risk assessment models and tools for timely monitoring the changes in the drivers of credit risk; thus, placing banks in a better position to timely recognize credit risk deterioration, take proactive measures to mitigate risk, and maintain healthy credit portfolios in line with their risk appetite and economic outlook. The incorporation of macroeconomic factors in decision making process and enhanced focus on risk-return matrix will augment the sustainable profitability and solvency position of banks and address macro-prudential challenges, e.g. pro-cyclicality, in banks' business decisions.

> "SBP has a strong interest in improving the financial reporting and disclosure standards and promoting the sound credit risk practices in the country"

> "The implementation of IFRS-9 has improved overall risk governance in banks through its influence on various aspects of risk management practices"

- **Integration of risk and finance:** The integration of risk and finance functions of banks has improved as the risk assessment is now directly reflected in financial statements. Banks have revised policies and procedures in various areas, including classification and measurement, impairment assessment, ECL model development, back testing, benchmarking, and validation of ECL models, along with reporting of financial results.
- **Greater transparency:** Enhanced transparency in the reporting of risk exposures and potential losses synergizes decision-making throughout the organization. New disclosure requirements have helped banks to be more transparent in terms of management of their risk exposures, changes in credit risk and level of allowances. This improvement would help in boosting investor confidence.
- **Enhanced role of internal audit:** The internal audit function has now an added responsibility to evaluate entire implementation process, with enhanced focus on timely recognition of credit risk and ensuring adequacy and accuracy of allowances.
- **Data retention:** Banks will now maintain comprehensive database of their borrowers to ensure accurate calculation of ECL allowance and adherence to accounting methodologies. The IT function has garnered a pivotal role in the automation and upgradation of systems.

*The ICMA delegation thanks **Mr. Jameel Ahmad, Governor, State Bank of Pakistan (SBP)** for sparing from his precious time to give exclusive interview for Chartered Management Accountant Journal.*