CENTRAL BANK OF SRI LANKA
BANK SUPERVISION DEPARTMENT

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Guidelines to Licensed Banks on the Adoption of Sri Lanka Accounting Standard - SLFRS 9: Financial Instruments

The Central Bank of Sri Lanka with a view to establishing consistent and prudent practices on the adoption of Sri Lanka Accounting Standard - SLFRS 9: Financial Instruments by licensed banks in Sri Lanka, encloses the Guidelines to licensed banks on the above for immediate implementation.

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Bank Supervision Department

Central Bank of Sri Lanka

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1. Introduction

1.1 The new Sri Lanka Accounting Standard, ***'SLFRS 9: Financial Instruments'*** shall be applicable for financial reporting periods beginning on or after 01.01.2018 and the adoption of SLFRS 9 has a significant impact towards banks and other financial institutions.

1.2 While the responsibility of preparation, presentation and disclosure of financial statements in line with the applicable Sri Lanka Accounting Standards is vested with the Board of Directors (BoD) and the senior management of licensed banks, the Central Bank of Sri Lanka (CBSL) promotes consistent and prudent application of SLFRS 9 in the banking sector.

1.3 In this respect, discussions were held with the Institute of Chartered Accountants of Sri Lanka, the Panel of Auditors and the banking sector to understand the concerns of licensed banks in the adoption of SLFRS 9.

1.4 These guidelines are prepared based on the 'Guidance on Credit Risk and Accounting for Expected Credit Losses' issued by the Basel Committee on Banking Supervision in December 2015, the best practices and guidelines issued by the monetary authorities/regulators on implementation of International Financial Reporting Standards 9: Financial Instruments and taking into consideration the comments received from CA Sri Lanka, Panel of Auditors and licensed banks in this regard.

1.5 These Guidelines should be adopted within the requirements of SLFRS 9.

2 Objectives of Issuing Guidelines on Adoption of SLFRS 9

2.1 CBSL expects to establish consistent and prudent practices on adoption of SLFRS 9 by licensed banks in Sri Lanka.

2.2 Accordingly, licensed banks are required to adhere to the following Guidelines (in addition to the existing applicable regulations) as a minimum; on classification and measurement of financial assets and financial liabilities, management of credit risk, impairment of financial assets, valuation of collaterals, role of the internal audit, regulatory and reporting requirements; when preparing, presenting and publishing financial statements.

3. Classification and Measurement of Financial Assets and Financial Liabilities

3.1 Classification and measurement of Financial Assets

(a) Business models approved by BoD (overseeing authority in respect of banks incorporated outside Sri Lanka) shall be in place to facilitate classification of financial assets. For this purpose, sufficient documentation on objectives, definitions, characteristics, criteria and operating policies along with adequate procedures and systems for assessing the business models on an on-going basis shall be in place.

(b) Such operating policies shall include, at a minimum, the decision-making authorities for business model decisions, level of sales to be considered as infrequent and insignificant, time period for near term selling to be considered for trading purposes, election of fair value option for instruments through profit or loss and through other comprehensive income.

(c) In terms of SLFRS 9, debt instruments shall pass the SPPI test (contractual cash flows to meet Solely Payments of Principal and Interest) and if so such instruments shall be classified as 'financial assets at amortised cost (AC)' or 'financial assets at fair value through other comprehensive income (FVOCI)' based on the outcome of the business model test.

(d) Licensed banks are required to maintain standardised processes, detailed checklists and decision trees in order to assess and identify SPPI features of their products and contracts.

(e) Accordingly, broad classification and subsequent measurement of financial assets are given in Table 1 below.

Table 1 - Classification and Measurement of Financial Assets

Business Model	Key Characteristics	Classification & Subsequent Measurement
Debt Instruments[1]		
Held-to-collect	- Hold assets to collect contractual cash flows - Meet SPPI test - Infrequent and insignificant sales	Amortised Cost

[1] In addition to these key characteristics other features of the product, management compensation, risk management aspects, frequency and significance of sales, etc. must also be considered.

Both held to collect and for sale	- Both collecting contractual cash flows and sales - More frequent and significant sales	Fair value through other comprehensive income
Other business models, including; - Trading - Managing assets on a fair value basis - Maximising cash flows through sale	- Neither 'held-to-collect' nor 'held to collect and for sale' - Collection of contractual cash flows is incidental	Fair value through profit or loss
Equity and Derivative Instruments		
Equity Instruments	- Held for trading	Fair value through profit or loss
	- Not for trading and not elected the irrevocable OCI option	Fair value through profit or loss
	- Not for trading and elected the irrevocable OCI option	Fair value through other comprehensive income
Derivative Instruments		Fair value through profit or loss

3.2 **Classification and measurement of Financial Liabilities**

(a) Broad classification and measurement of financial liabilities are given in Table 2 below.

Table 2 - Classification and Subsequent Measurement of Financial Liabilities

Classification of Financial Liabilities	Subsequent Measurement	Accounting for Fair Value Gain
Financial liabilities held for trading	Fair value	Through profit or loss
Financial liabilities designated at fair value	Fair value	The amount of change in fair value attributable to changes in credit risk in liability presented in other comprehensive

		income [2] and remaining amount shall be presented in income statement.
Other financial liabilities at amortised cost	Amortised Cost	-

(b) If a licensed bank is accounting for its financial liabilities as designated through profit or loss, changes in value of such liabilities due to changes in own credit risk are required to be assessed and accounted through other comprehensive income as stated above. Licensed banks are requested to formulate internal guidelines and criteria for this purpose

3.3 **Reclassification**

(a) If the objective of the business model of the licensed bank for its financial assets changes and its previous model assessment would no longer apply, reclassification is required between financial assets under the provisions of SLFRS 9.

(b) In line with the requirements of SLFRS 9, such changes in business models and reclassifications shall be approved by the BoD and shall be notified to the Director of Bank Supervision within 7 working days of the date of such approval.

3.4 **Measurement at Fair Value**

When financial instruments are subsequently measured at fair value, licensed banks shall comply with the requirements given in 'Sri Lanka Accounting Standard - SLFRS 13: Fair Value Measurement' and are required to:

(a) Use an appropriate valuation technique for which sufficient data is available;

(b) Apply the selected valuation technique consistently;

(c) Maximise the use of relevant observable inputs. In exceptional circumstances, unobservable inputs may be used; and

(d) If inputs under level 3 hierarchy are used in the respective valuation technique, the Chief Risk Officer or most senior officer overseeing the risk management function shall confirm the appropriateness and reliability of such inputs.

4. Principles for Sound Credit Risk Management

4.1 BoD and the senior management are responsible for ensuring that the licensed banks have appropriate credit risk practices, including an effective system of internal control, to consistently determine adequate impairment allowances in accordance with the policies and

[2] If that treatment creates or enlarges an accounting mismatch in profit or loss, an entity shall present all gains or losses on that liability (including the effects of changes in the credit risk of that liability) in profit or loss.

procedures of licensed banks, the applicable Sri Lanka Accounting Standards and relevant supervisory guidance.

4.2 Licensed banks shall document and adhere to sound methodologies that address policies, procedures and controls for assessing and measuring credit risk on all financial assets. The measurement of impairment allowances should build upon those robust methodologies and result in the appropriate and timely recognition of expected credit losses in accordance with the applicable Sri Lanka Accounting Standards.

4.3 The aggregate amount of impairment allowances of licensed banks, regardless of whether allowance components are determined on a collective or an individual basis, should be adequate and consistent with the objectives of the applicable Sri Lanka Accounting Standards.

4.4 Licensed banks shall have policies and procedures in place to validate models used to assess and measure expected credit losses.

4.5 Licensed banks shall use experienced credit judgment, especially in the robust consideration of reasonable and supportable forward-looking information, including macro-economic factors, to measure the expected credit losses.

4.6 Licensed banks should have a sound credit risk assessment and measurement process with the support of adequate systems, tools and data to assess credit risk and to account for expected credit losses.

4.7 Licensed bank’s public disclosures should promote transparency and comparability by providing timely, relevant and useful information.

5. Impairment of Financial Assets

5.1 Calculation of Expected Credit Losses

Licensed banks are required to calculate expected credit losses for the following:

(a) Financial assets measured at AC

(b) Financial assets mandatorily measured at FVOCI

(c) Loan commitments when there is an obligation to extend credit (except those measured at Fair Value through Profit or Loss)

(d) Financial guarantee contracts (except those measured at Fair Value through Profit or Loss)

(e) Lease receivables within the scope of LKAS 17: Leases

(f) Contract assets within the scope of SLFRS 15: Revenue from Contracts with Customers

5.2 Life-time Expected Credit Losses and 12 Month Expected Credit Losses

(a) At each reporting date, licensed banks shall measure the loss allowance for financial instruments at an amount equal to life-time expected losses, if the credit risk of a financial instrument has increased significantly since initial recognition (except for the purchased or originated credit-impaired financial assets).

(b) For purchased or originated credit impaired financial assets, lifetime expected credit losses shall be measured.

(c) In principle, life time expected credit losses and credit impaired loans are provided on an individual basis. However, due to lack of borrower-specific information, licensed banks may perform the assessment on appropriate groups or portfolios on a collective basis.

(d) At the reporting date, if the credit risk of a financial instrument has not increased significantly since the initial recognition, licensed banks shall measure the loss allowance for that financial instrument at an amount equal to 12 month expected credit loss.

5.3 **Economic Factor Adjustment**

(a) Licensed banks shall use the forecasts and projections published by CBSL, International Monetary Fund and/or World Bank in all instances where such projections are available when adjusting credit provisioning models to reflect the economic conditions and forecasts.

(b) If the required information is not available through above sources, licensed banks shall use credible alternative sources and shall maintain documentary evidence.

(c) BoD approved policies shall be available to specify the sources to be used and licensed banks shall not cherry pick sources in their favour.

5.4 **Significant Increase in Credit Risk**

For the purpose of calculating life-time expected losses, as a minimum, if one or more of the following factors/conditions are met, it shall be considered as a significant increase in credit risk:

(a) When contractual payments of a customer are more than 30 days past due [3] (subject to the rebuttable presumption in the SLFRS 9);

(b) When the risk rating of a customer or an instrument has been downgraded to B+ by an external credit rating agency and/or when there is a two-notch downgrade in the banks internal rating system. In the event no external credit rating is available, licensed banks are required to map their internal credit risk ratings with the ratings issued by the External Credit Assessment Institutions (ECAI). For this purpose, licensed banks are required to refer the mapping of external credit ratings given in Direction No. 1 of 2016 on Capital

[3] Days past due shall be calculated from contractual due date of the payment.

Requirements under Basel III for Licensed Commercial Banks and Licensed Specialised Banks;

(c) When reasonable and supportable forecasts of future economic conditions directly affect the performance of a customer/group of customers, portfolios or instruments;

(d) When there is a significant change in the geographical locations or natural catastrophes that directly impact the performance of a customer/group of customers or an instrument;

(e) When the value of collateral is significantly reduced and/or realisibility of collateral is doubtful. Limits shall be set and documented by licensed banks;

(f) When a customer is subject to litigation, that significantly affects the performance of the credit facility;

(g) Frequent changes in the senior management of an institutional customer;

(h) Delay in the commencement of business operations/projects by more than two years from the originally agreed date;

(i) Modification of terms resulting in concessions, including extensions, deferment of payments, waiver of covenants etc.;

(j) When the customer is deceased/insolvent;

(k) When the bank is unable to contact or find the customer;

(l) A fall of 50% or more in the turnover and/or profit before tax of the customer when compared to the previous year; and

(m) Erosion in net-worth by more than 25% when compared to the previous year.

5.5 **Models for Calculation of Expected Credit Losses**

(a) Licensed banks shall consider all available and relevant internal and external data when estimating expected credit losses, ensuring that the estimates are robust, unbiased and reflective of current exposures.

(b) Licensed banks shall develop robust models to determine expected credit losses under SLFRS 9. Such models shall be tailored to reflect the bank’s risk profile.

(c) Licensed banks shall ensure that the relevant officers are well trained and competent on understanding the models adopted by them for this purpose.

(d) When obtaining support from external vendors/consultants in respect of model development, rigorous governance and internal control processes shall be adhered.

(e) If different models are used for different portfolios and instruments, licensed banks are required to document the reasons why the selected model is appropriate and all credit models must be reviewed at least annually.

(f) An effective model validation process shall be established to ensure that the credit risk assessment and measurement methods are able to generate accurate, consistent and unbiased predictive estimates on an ongoing basis.

(g) Licensed banks are required to desist from making changes in the parameters, inputs and assumptions used for the purpose of profit smoothening. The rationale and justification for any changes in the expected loss models shall be documented and justified by the Chief Risk Officer and approved by the BoD.

(h) Assumptions concerning the impact of changes in general economic developments on borrower's repayment capacity, shall be made with sufficient prudence.

(i) In cases where banks incorporated outside Sri Lanka use models developed by head office or regional offices, to ensure appropriateness of the credit models to the Sri Lankan context, the local implementation team should carry out appropriate validation procedures.

5.6 Further, in respect of impairment of financial instruments, licensed banks shall follow the guidance given in Annex I.

5.7 These guidelines are expected to be reviewed in future, looking at the market developments, data quality, model development and capacity within the banking sector.

6. Collateral Valuation

6.1 Expected cash flows from collateral realization shall be based on latest observed reliable market valuations and shall appropriately reflect the inherent uncertainty associated with distressed property liquidation (including the time taken for such realisation).

6.2 Any increase in valuations shall be substantiated by solid evidence that such increases are sustainable.

7. Role of Internal Audit

7.1 The Internal Audit function shall independently evaluate the effectiveness of the credit risk assessment, measurement systems and processes of licensed banks and shall ensure the acceptability of credit judgments.

7.2 Internal Audit function shall validate and evaluate all credit risk assessment models, inputs and assumptions used along with data smoothening, if any.

7.3 Internal audit function shall provide assurance over the adequacy and effectiveness of back testing, in order to ensure that the key drivers have been captured and calibrated accurately.

8. Regulatory Requirements

8.1 In line with the international best practices, CBSL is of the view that the existing prudential regulations pertaining to assets classification, measurement and provisioning should be in force.

8.2 Accordingly, licensed banks shall submit all periodical information including web based statutory returns to CBSL in accordance with the existing Orders, Determinations, Directions, Guidelines, Circulars and Instructions issued.

8.3 Licensed banks shall maintain adequate data/records and systems separately to identify, reconcile and report requirements under the Sri Lanka Accounting Standards and under the existing regulatory framework.

8.4 Impact on expected credit loss provisioning is required to be captured when preparing capital planning and stress testing processes of licensed banks.

8.5 In order to avoid stress on capital and in line with the guidance given by the Basel Committee on Banking Supervision, licensed banks shall stagger audited additional credit loss provisions arising from SLFRS 09 when compared with credit loss provisions under LKAS 39 as at first day of adoption of SLFRS 9, net of any other adjustment on first day impact to retained earnings and net of tax effects, throughout a transitional period of four years as given below for the purpose of calculating the Capital Adequacy Ratio (CAR) under Banking Act Directions No. 01 of 2016 on Capital Requirements under Basel III.

Table 3 - Staggering of First Day Impact for Capital Adequacy Ratio Computation

Cumulative Percentage of Absorption of First Day Impact				
01.01.2018	**31.12.2018**	**31.12.2019**	**31.12.2020**	**31.12.2021**
12.5	25	50	75	100

9. Regulatory Reporting and Disclosures

9.1 Licensed banks shall disclose the total amount of first day impact arising from the adoption of SLFRS 9 and its impact to CAR as specified in 8.5 above throughout the transitional period in the financial statements.

9.2 However, the first day impact shall be fully adjusted in the financial statements on the first day of adoption of SLFRS 9.

9.3 Licensed banks are required to report the information set out in Tables 4 and 5 below to the Bank Supervision Department through bsddb@cbsl.lk within 30 days after the end of each quarter, commencing 31.12.2018.

Table 4 – Probability of Defaults (PD) and Loss Given Defaults (LGD) on Collective Impairment as at ……..

Business Segment/Product/ Category or any Other Basis	PD			LGD		
	Stage 1	Stage 2	Stage 3	Stage 1	Stage 2	Stage 3

Table 5 - Upgrading of Credit Facilities/Exposures for the Computation of Expected Credit Losses for the Quarter Ended as at ……….

Number of Facilities upgraded From stage 2 to stage 1 From stage 3 to stage 1 From stage 3 to stage 2	
Value of Total Facilities Upgraded From stage 2 to stage 1 (Rs.mn) From stage 3 to stage 1 (Rs.mn) From stage 3 to stage 2 (Rs.mn)	
Total of interest income re-recognised to the income statement on upgrading to Stages 2 and 1. (Rs.mn)	

Annex I

Additional Guidance on Impairment of Financial Instruments

The following guidance is provided with a view to improving and maintaining the consistent application and comparability within the banking sector when calculating expected credit losses under SLFRS 9.

1. Guidance on Minimum Criteria to be met by all licensed banks for categorisation of credit facilities/exposures into stages for computation of expected credit losses is as follows:

1.1 **Stage 1**

All credit facilities, which are not categorised under Stages 2 or 3 below.

1.2 **Stage 2**

(a) Credit facilities, where contractual payments of a customer are more than 30 days past due, other than the credit facilities categorised under Stage 3 below, subject to the rebuttable presumption as stated in SLFRS 9.

(b) All restructured[1] loans, which are restructured up to two times, other than credit facilities/exposures mentioned in 3.2 below.

(c) Under-performing credit facilities/exposures as identified in paragraph 5.4 of the "Guidelines to Licensed Banks on the Adoption of SLFRS 9: Financial Instruments".

1.3 **Stage 3**

(a) Credit facilities where contractual payments of a customer are more than 90 days past due, subject to the rebuttable presumption as stated in SLFRS 9.

(b) All restructured loans, which are restructured more than twice, other than credit facilities/exposures mentioned in 3.2 below.

(c) All rescheduled[2] loans, other than credit facilities/exposures mentioned in 3.2 below.

(d) All credit facilities/customers classified as non-performing as per CBSL Directions.

(e) Non-performing credit facilities/customers as identified in the paragraph 5.4 of the "Guidelines to Licensed Banks on the Adoption of SLFRS 9: Financial Instruments".

[1] Restructured facilities are where the original repayment terms have been amended due to a deterioration in credit quality, while the respective credit facility remained as Performing loans and advances as per CBSL Directions.

[2] Rescheduled facilities are where the original repayment terms have been amended, while the respective credit facility remained as Non-performing loans and advances as per CBSL Directions.

2. Guidance for computation of the Probability of Default (PD) and Loss Given Default (LGD) to be used as a minimum for the calculation of expected credit losses is as follows.

2.1 Licensed banks shall use at least five-year data when calculating PDs and any smoothing of data or inputs must be validated by the Risk Management Department.

2.2 Licensed banks shall not use proxies to compute PDs and LGDs, unless the bank is a newly incorporated bank with inadequate credit history of less than 5 years.

2.3 When the licensed bank is unable to compute LGDs due to lack of data or inputs, such bank is required to use a minimum LGD of 45 per cent for such exposures.

2.4 Licensed banks shall use of an LGD of 0 per cent for same currency denominated cash backed loans with a haircut of over 10 per cent and subject to meeting the conditions in section 4(2) of Banking Act Direction No.3 and 4 of 2008 Classification of Loans and Advances, Income Recognition and Provisioning.

2.5 With respect to exposures denominated in foreign currencies issued by the sovereigns, following shall be considered:

(a) Licensed banks shall compute PDs by using a sovereign PD which is linked to the external credit rating scale.

(b) A 20 per cent LGD shall be applied as a minimum when computing expected losses.

2.6 When calculating LGD for exposures guaranteed by the Government of Sri Lanka:

(a) An LGD of zero can be applied to exposures with the guarantee of the Government provided that the guarantee is fully covered with the interest and reported as liabilities of the Government.

(b) LGD for any other form of assurance other than in item 2.6 (a) above shall be computed instead of using a zero LGD.

(c) A minimum LGD of 20 per cent shall be applied for Government guarantees denominated in foreign currency.

3. Other Guidance

3.1 **Off-balance sheet exposures:** when converting off-balance sheet exposures for expected credit loss calculations, licensed banks may use the values as per the credit conversion factors specified in the Banking Act Direction No. 01 of 2016 on Capital Requirements under Basel III, if historical data is not available.

3.2 **Upgrading of credit facilities**: when upgrading credit facilities from a higher stage to a lower stage (e.g., from stage 3 to stage 2)

(a) The upgrading of credit facilities shall only be carried out by Risk Management Department and be independent from the loan review mechanism.

(b) Such upgrading shall be supported with a BoD approved policy, rationale and with adequate documentation.

(c) When upgrading restructured facilities, satisfactory performing period of a minimum 90 days must be considered subsequent to the due date of the 1^{st} capital and/or interest installment post-restructure. With respect to upgrading rescheduled facilities, licensed banks must comply with Banking Act Directions No.3/4 of 2008 on Classification of Loans and Advances, Income Recognition and Provisioning.

3.3 **Internal Rating Based (IRB) credit rating:** A licensed bank shall not use IRB credit information for expected credit loss calculations without complying with the following:

(a) Pricing mechanism shall be mapped with IRB information;

(b) Shall have at least five-year IRB based historical data subject to 3.3 (a); and

(c) BoD approved policies shall be in place and IRB inputs and models needs to be reviewed independently by the Risk Management Department.