ICRA

BANKING SECTOR

Proposed ECL framework for banks - A step closer to Ind-AS implementation

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Highlights

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- RBI releases a discussion paper on implementation of ECL-based loss provisioning for banks
- ECL provisioning will be an outcome of banks' own historical data on probability of default (PD) and loss given default (LGD)
- Board and senior management will be responsible for credit risk practices and adequacy of ECL frameworks
- Banks will be allowed to spread out the impact on capital over a 5-year period after the final guidelines are issued
- NBFCs currently classify 30+ days past due (dpd) loans as Stage 2; however, 60+ dpd loans proposed for banks
- ECL provisioning will be extended to off-balance sheet items (sanctioned loan facilities and other exposures like LCs/BGs)
- The RBI to specify a floor for provisioning; higher of ECL-based provisioning/specified floor to be applicable
- Restructured book in monitoring period; performing well and will attract lower/floor provisions than Stage 3
- On exit from monitoring period, restructured book to be upgraded to Stage 1 only after six months as Stage 2

- We expect opening balance sheets and net worth, as on April 1, 2025, to be based on ECL provisions
- NPAs expected to be at lowest level in the last decade by March 2024; timing is apt for implementation
- Additional provisions will be required on restructured loans, 60+ dpd loans and off-balance sheet exposures
- Wholesale loans have seen moderation in the 60+ dpd, while such loans could be high in the retail segment
- Banks operating with a higher share of unsecured advances may require high provisioning
- ICRA's discussions with some banks indicate that impact of transitioning to IND-AS on core capital to be as high as 300-400 bps including ECL loss provisions
- A five-year time frame beyond April 2025 for provisions could ease the impact on reported capital ratios
- Banks with high share of overdue, restructured loans and lower capital cushions will need to raise capital
- Recent corporate NPA cycle had high LGDs; hence, ECL provision based on recent past could be a challenge
- While ECL framework addresses key factors while transitioning to IND-AS, mark-to-market on HTM investments will be another area to look at while eventually shifting to IND-AS

Source: rbi.org, ICRA Research; ***Stage 1*** *- Financial assets without significant increase in credit risk, 12-month ECL applied and interest recognised on gross carrying value,* ***Stage 2*** *- Financial assets with significant increase in credit risk, lifetime ECL applied and interest recognised on gross carrying value,* ***Stage 3*** *- Financial assets with objective evidence of impairment, lifetime credit losses applied and interest recognised on cash realization, NPA-Non Performing Assets*

Key proposals in discussion paper (DP) on ECL - I

Migration from 'incurred loss' approach under existing regulations governing provisions for NPAs to provisioning on the basis of ECLs will be the biggest step towards shifting to IND-AS. Adoption of ECL approach will largely address one of the key aspects of transitioning to IND-AS from a profitability/capital perspective

The provision coverage on NPAs is now at a multi-year high and incremental slippages are largely expected to be lower in the next few years compared to the previous decade. As a result, incremental provisioning, while transitioning to ECL-based provisioning on existing NPAs, is likely to remain limited by the time it is implemented. Going by precedents, draft/final guidelines could be issued by FY2024. Further, the optionality to spread out the impact on capital over a 5-year period beyond our estimated timeline of April 1, 2025, in our view, gives adequate time to banks to prepare and manage the impact on their capital

One of the key proposals is the inclusion of only 60+ dpd loans as a part of Stage 2 assets, which would provide some relief to banks as NBFCs have been including 30+ dpd loans in Stage 2. A classification similar to NBFCs could have entailed higher transitioning provisions for banks, though one could expect tighter stipulation on this for banks over the long term. As per the RBI's financial stability report, SMA-2 loans for exposures >Rs. 5 crore for the banking system remained <2% for public banks and <1% for private banks. However, the retail book for most banks witnessed stress during the Covid-19 pandemic and the 30+ dpd book could be high for many banks despite the gradual moderation from the peak level in FY2022. Accordingly, the incremental ask, in terms of provisioning on the 60+ dpd loans, is a big relief for most banks

Source: rbi.org, ICRA Research

Key proposals in DP on ECL - II

Under the proposed norms, ECL provisioning will be extended to include irrevocable loan commitments, i.e. sanctioned limits under revolving credit facilities, lease receivables, and irrevocable guarantees. As a result, there could be higher provisions upon the inclusion of these facilities as 'financial assets'. Currently, under the extant guidelines, standard asset provisioning is not applied to most of the off-balance sheet/sanctioned limits and even the off-balance sheet exposure does not attract loss provisions till it becomes a funded exposure

The RBI has proposed a carve-out for restructured loans, where restructuring/modification was done on account of commercial consideration and not due to the underlying stress. This would mean that such loans would attract lower provisioning. Restructured loans, which are in the monitoring period but are performing well/in a timely manner, should attract lower provisioning compared to other Stage 3 assets. Hence, during the monitoring period, these loans will attract prudential floor provisions, which could be lower than the ECL model provisions for a Stage 3 asset. Also, upon exiting the monitoring period, these exposures will initially move to Stage 2, where they will be observed for six months or more before being upgraded to Stage 1

For loans and advances that are already a part of Stage 3 assets, it is proposed that direct movement to Stage 1, upon regularisation/payment of dues by the borrower, should not be allowed. Such exposures are proposed to be shifted to Stage 2 first, where they will remain for a cooling period of six months or more before being shifted to Stage 1. Currently, most NBFCs shift Stage 3 assets directly to Stage 1 on rectifying delays/defaults

Source: rbi.org, ICRA Research

Key proposals in DP on ECL - III

The RBI has also proposed to notify prudential floors in draft guidelines across all three stages of classification, which will kick in when the ECL estimates of banks are lower than these floors. The minimum percentage of provisioning, irrespective of the ECL-driven outcomes and step-ups based on the ageing of the NPAs, will be applied by banks as is being currently done by NBFCs

The recent precedent of the implementation of the prompt corrective action (PCA) framework for NBFCs shows that NBFCs had to increase their provisions beyond the ECL calculations to reduce their net NPAs below the PCA thresholds. While this is unlikely to impact any bank at present as all of them have low net NPAs, this could be a consideration for provisions in future

As the above changes will impact the loss provisions on the assets held by banks, and the capital adjusted for these transitioning provisions could be lower than those currently being reported by banks, a period no longer than five years is being proposed to absorb these transitional provisions

With the expectation of implementation from April 1, 2025, and improved profitability as well as capital position, we expect banks to have sufficient time to prepare for the same and take a one-time hit on their capital. In some cases, the transitioning period will come as a relief for the other banks. Based on our discussions with a few banks, the impact on core capital could on transitioning to IND-AS could be as high as 300-400 bps, including the ECL loss provisions.

The CET-I was not lower than 9.5% for any public bank and not lower than 10% for any private bank as on September 30, 2022, indicating a lowest cushion of 150 bps and 200 bps for any of public and private bank respectively. Further, the outlook on the profitability of banks is strong with an estimated RoA of 0.9-1.0% and 1.2-1.3% for FY2023 and FY2024. The existing capital cushions and internal capital generation till implementation will provide some headroom to banks to absorb the incremental provisions upon transition

Source: rbi.org, ICRA Research

Proposed approach and comments on questions raised in DP - I

	Proposed approach	Discussion question	ICRA's comments
Adoption of ECL approach (as per IFRS 9) for loss provisioning	Adoption of ECL as per the IFRS 9 framework, which prescribes a principle-based approach over the current expected credit losses (CECL) approach adopted by the Financial Accounting Standards Board (FASB) in USA	Do you agree with the proposal to adopt ECL approach for provisioning by banks based on IFRS 9 rather than the CECL approach? Do you agree with the proposed regulatory approach of principle-based guidelines with regulatory backstops?	▪ ***IFRS-based approach more widely accepted:*** As per the RBI, the IFRS-based approach is more widely accepted internationally, while the CECL approach is aligned to the requirements of banks and regulators based in USA, which could also lead to higher provisions for stressed assets. ▪ ***RBI likely to adopt IFRS for banks:*** We believe the RBI is likely to adopt IFRS for banks as NBFCs have been following IFRS for ECL provisions for the last few years. Moreover, it has proposed some changes to the IFRS approach in certain areas to align it with the current prudential norms. ▪ ***Absence of regulatory backstops could be self-defeating:*** With ECL provisioning built on PD and LGD assumptions, a reasonable degree of management estimates and subjectivity will be needed. Thus, the absence of regulatory backstops could be self-defeating while transitioning to ECL-based provisioning. This is also similar to the current approach for NBFCs.
Applicability of ECL to regulated entities	ECL-based approach should be implemented only by scheduled commercial banks, while cooperative and RRBs to be left out	Do you agree with the proposal to implement ECL approach for only scheduled commercial banks while keeping all cooperative banks and RRBs outside the purview of the proposed regime? If not, what could be a reasonable asset size threshold in respect of cooperative banks?	▪ ***Scheduled commercial banks better-positioned to handle challenges:*** To start with, scheduled commercial banks may be more adept at handling the challenges/changes that banks may face to transition to ECL. ▪ ***Staggered timelines could be notified for others:*** Currently, NBFCs with a net worth of more than Rs. 500 crore are required to adopt IND-AS and hence ECL-based provisions. As many RRBs and cooperative banks are bigger than the NBFCs under ECL-based provisions, it will be desirable to implement this framework for these banks as well to strengthen the financial system. This can be based on their size with a staggered timeline to comply with these changes.

Source: rbi.org, ICRA Research

Proposed approach and comments on questions raised in DP - II

	Proposed approach	Discussion question	ICRA's comments
Definition /inclusions in definition of 'Financial Asset' for estimating impairment losses	It is proposed that the ECL approach would apply to all loans and advances including irrevocable loan commitments (including sanctioned limits under revolving credit facilities), lease receivables, irrevocable financial guarantee contracts, and investments classified as held-to-maturity or available-for-sale	Do you agree with the proposed scope of the ECL-based provisioning regime concerning the financial assets held by the banks?	▪ ***Proposed approach is welcome:*** The total guarantees and acceptances /endorsements for the banking system stood at Rs. 10.3 trillion and Rs. 11.4 trillion, respectively, as on March 31, 2022, accounting for a sizeable ~20% of the fund-based exposures. Moreover, it was seen that banks carried limited provisions on these off-balance sheet exposures till they crystallised, thus exposing their capital. With extant regulations not covering this risk, the proposed approach is welcome. ▪ ***Sanctioned and LC/BG exposures could be biggest drivers:*** While there has been a lot of clean-up in the off-balance sheet exposures of banks, we expect that their sanctioned exposures and other LC/BGs could be the biggest drivers of incremental ECL provisioning. In many cases, these LC/BG exposures are backed by margin money and liquid collateral though this could offset the ECL provisioning. Also, the RBI has proposed that even if the sanctioned lines are 'uncommitted', it will go by behavioural pattern on disbursements for such lines for ECL provisions and such approach will be prudent.
Measurement of 'Financial Asset'	With respect to SLR investments, direct claims on Central Government and exposures that are guaranteed by the Central Government will attract low credit risk	Do you agree with the proposed coverage of situations in which practical expedient for low credit risk can be used by the banks? Are there other situations which warrant inclusion?	▪ ***No standard asset provisioning for such investments:*** Banks hold large volumes of Government securities, which will attract very low credit risk. Under the current 'incurred loss' approach, no standard asset provisioning is made on these investments as should be the case under the ECL model. Currently, NBFCs also do not recognise any provision under ECL on investments in Government securities.

Source: rbi.org, ICRA Research

Proposed approach and comments on questions raised in DP – III

ICRA

	Proposed approach	Discussion question	ICRA's comments
Periodic testing of increase in credit risk since initial recognition on each reporting date	Testing of increase in credit risk, assessed as increase in risk of default. For this purpose, the definition of default includes NPAs, restructured exposures (under monitoring) as well as exposures where bank has reason to believe the borrower is unlikely to repay	Do you agree with the proposed definition of 'default' for the purpose of adjudging significant increase in credit risk under the proposed provisioning regime? Do you agree with the proposal to require the assessment of a significant increase in the credit risk to be made at the counterparty level rather than at the instrument level?	▪ ***Could be at counterparty level:*** The proposed definition of default includes borrowers who may be timely in debt servicing but are likely to default (broadly defined by a set of indicators that point towards unlikeliness to pay) on their dues. In our view, many of these indicators (suggestive indicators) would usually coincide with the borrower defaulting on their dues. However, there are occasions when there may be a gap between defaults and such events may be useful to classify such assets as Stage 2/ Stage 3. These may include credit rating downgrades to deep non-investment grade categories or default or other market indicators such as debt or equity price movements, which could also be seen as an increase in the credit risk. ▪ As banks are currently marking all loan exposures (not necessarily investments) at the counterparty level as NPAs, the PD can be at the counterparty level. There could always be an argument of the LGD being classified at the instrument level, but precedents show that many times, the collateral value may erode if the enforcement/resolution takes long. Hence, the availability of collateral may not necessarily result in a better recovery.
Treatment of accounts that are overdue by more than 90 days	Treating overdue accounts like NPAs as there will be always be a time-value-related loss due to delayed repayments in accounts that are classified as 'standard' because payments are regularised before being tagged as NPA	Is there a case for treating exposures that remain overdue continuously for more than 90 days at par with NPAs for the purpose of measuring ECL? What would be the impact?	▪ ***Better to classify as Stage 3:*** Experience suggests that the accounts that are very close to being classified as NPA or remain continuously overdue are more likely to default and should ideally attract higher provisioning. Under the proposed regime, these would be classified as Stage 2 assets, which would attract higher provisioning compared to standard/Stage 1 loans. ▪ However, if the resolution of such accounts could take more time and such accounts stay overdue for longer period, it could be better for classifying such accounts as Stage 3.

Source: rbi.org, ICRA Research

Proposed approach and comments on questions raised in DP – IV

ICRA

	Proposed approach	Discussion question	ICRA's comments
Objective parameters that would indicate increase in credit risk	While accounts/exposures that are 30+ dpd indicate increased stress like credit risk, accounts that are 60+ dpd will be considered as part of Stage 2/exposures where credit risk has risen Besides this, inclusion of 'watch list' exposures by banks may be considered to have seen an increase in credit risk	Do you agree with the proposed approach for the determination of a significant increase in the credit risk? Are the proposed regulatory backstops adequate?	▪ ***Banks will migrate to tighter Stage 2 classification in the long run:*** Exposures that are 60+ dpd are more likely to default and can be considered to have seen a significant increase in the credit risk. While NBFCs classify 30+ dpd exposures as a part of Stage 2, the proposal is lenient for banks. Currently, 60+ dpd exposures do not attract any incremental provisioning and this will result in banks making provisions before some of these actually become NPAs. Further, 60+ dpd wholesale loans have declined in the banking system, though retail and small ticket size loans still account for a sizeable portion of the 30-60+ dpd, given the impact of the pandemic. We expect that banks will also migrate to a tighter classification for Stage 2 over the longer term. ▪ ***Rule-based watchlist disclosure a better option:*** The watchlist disclosures by banks are not uniform, in our view, and certain banks could be penalised for better disclosures. Hence, a rule-based watchlist disclosure, which can be uniformly applied, could be a better approach.
Measurement of ECL	Banks will be permitted to design their ECL models, in line with directives that will be issued by RBI. Also, as a backstop arrangement, loss provisions will be the higher of model outcomes and regulatory floor. Differentiated treatment for modified assets (apart from restructured loans) also proposed	Do you agree with the proposal to permit banks to develop customised approaches for ECLs subject to principles/ expectations laid out by the RBI? Are the mitigants, proposed to reduce the consequent inevitable variability between the entities, adequate? Do you agree with the proposed carve-out for restructured assets as a special class of modified assets?	▪ ***Adequate regulatory floor provides good coverage against stress:*** To start with, the lifetime and 12-month loss estimates will generally differ across institutions. However, we expect that some convergence could happen over time as the regulatory supervisor and market participants compare these. Meanwhile, an adequate regulatory floor will act as a good coverage against stress. ▪ ***Approach looks reasonable:*** The proposed approach of treating loans that have been restructured/modified due to commercial considerations and not on account of stress also appears to be reasonable.

Source: rbi.org, ICRA Research

Proposed approach and comments on questions raised in DP – V

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	Proposed approach	Discussion question	ICRA's comments
Classification of applicable financial asset and income recognition	Financial assets to be classified in three stages, i.e. Stage 1 (low credit risk, would attract 12-month ECL), Stage 2 (significant increase in credit risk but not yet impaired, would attract lifetime ECL) and Stage 3 (evidence of impairment/NPAs as recognised by RBI, would attract lifetime ECL) Also, income recognition on Stage 1 and Stage 2 on gross carrying value, while no interest accrual proposed for Stage 3 (except on cash realisation)	Do you agree with the specified classification of financial assets under the proposed provisioning regime and the measurement approaches for corresponding interest income from each stage of assets?	▪ ***Broadly similar to NBFCs:*** The proposed classification broadly remains similar to that followed by NBFCs except for the classification of Stage 2 accounts, which are proposed to be standard accounts that are 60+ dpd. ▪ ***Proposal looks prudent:*** Under IFRS, interest is accrued even on Stage 3 assets (on net carrying value after deducting credit provisions), although this would be a departure from the current prudential norms. However, the proposal to continue with the current norms by not accruing interest on Stage 3 assets and limiting the same only upon cash realisation is prudent and will ensure lower interest reversals on such assets while minimising income/profit variability on account of the same.
Direct upgrade to Stage 1 from Stage 3 not allowed	It is proposed to shift performing accounts wherein irregularities are cured or rectified to Stage 1, only after a cooling-off period of six months or more, during which it remains a Stage 2 account	Do you agree with this proposal, which could ensure that the reduction in the credit risk is sustainable?	▪ ***Fair proposal:*** Stage 1 assets would attract lower provisioning, though recently regularised Stage 3 exposures could still pose a higher credit risk. As a result, it is fair to classify such an exposures as Stage 2 and a 6-month period to ascertain the performance on a sustained basis could provide more confidence before finally upgrading to Stage 1. This would also be more appropriate before reversing the ECL provisions on such exposures.

Source: rbi.org, ICRA Research

Proposed approach and comments on questions raised in DP – VI

	Proposed approach	Discussion question	ICRA's comments
Prudential floor for loss provisioning	ECL measured in respect of an asset classified as Stage 1-3 will be subject to prudential floor and to a step-up, depending upon the time a financial instrument spends as a Stage 2 or 3 asset Performing restructured assets during the monitoring period will be considered less risky than other Stage 3 assets, though prudential floor will apply till monitoring period ends For Stage 2, two alternatives are proposed, i.e. to treat provision (including higher amount as per floor) as general provision **OR** to treat the ECL estimated provision as specific provision and the gap between floor and ECL as general provision	Which of these options do you agree with?	▪ ***Step-up apt for Stage 2/restructured accounts:*** The prudential floor on stage 2 or restructured accounts will kick in if assets in these categories remain unresolved for a longer period. As the value of the asset erodes if the stress remains unresolved, a floor that is step-up, based on time, is apt for considering erosion for such assets. ▪ ***Specific provisions suitable for long unresolved assets:*** As floor-based provisioning is expected for long unresolved assets, it will be prudent to carry such provisions as specific provisions against these assets to reflect the asset value closer to the realisable value of these assets.

Source: rbi.org, ICRA Research

Proposed approach and comments on questions raised in DP – VII

	Proposed approach	Discussion question	ICRA's comments
Definition of secured/ unsecured assets and valuation of underlying security/ collateral	Financial asset to be treated as secured only to the extent of distressed valuation of the security cover available; such distressed valuation should be not older than 12 months against current practice of 36 months Also, unsecured exposure should be defined as one where the realisable value is not more than 51% of the outstanding exposure	Which of these approaches or a combination thereof should be used regarding the security/collateral available in respect of a loan exposure for the purpose of prudential floors?	Compared to the extant/IRAC norms, unsecured loans are defined as those where the value of the collateral is not more than 10% of the outstanding exposure. However, as per the proposed norms, unsecured loans will be redefined as those where the 'realisable' value of the security is equal to or lower than 51% of the outstanding exposure. This may have two implications: 1) A higher share of loans/advances could potentially be classified as unsecured and could attract higher prudential floor-linked provisions, particularly if the final guidelines adopt differentiated floor provisioning for secured and unsecured loans/assets. The total share of unsecured advances for the banking system stood at ~25% as of March 2022 and could increase further with the reclassification. 2) This apart, valuation testing at shorter periods will align provisions closer to market prices, though it may entail additional operational costs for banks.

Source: rbi.org, ICRA Research

Proposed approach and comments on questions raised in DP – VIII

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	Proposed approach	Discussion question	ICRA's comments
Effective date and transitioning	The transitional adjustment amount, i.e. the difference between the accounting provisions held on the adoption of the ECL approach as on the effective date and the provisions computed as per the extant provisioning norms, net of tax effects, may be allowed to be added back to the Common Equity Tier 1 (CET-I) capital This benefit shall be phased out over a maximum of five years. Banks may also choose to spread the transition over a shorter period	Do you agree with these arrangements for transitioning from the extant provisioning regime based on 'incurred loss' approach to the proposed regime based on 'ECLs'?	***Proposed ECL provisioning is forward-looking:*** As we have seen during the last asset quality cycle, the incurred loss approach was backward-looking and some banks were severely undercapitalised, leading to a huge burden on the GoI to recapitalise public banks and failure of few private banks. The proposed ECL provisioning is forward-looking for estimating credit losses and the financials will reflect/recognise the risk and its impact more objectively. The implementation of IND-AS and ECL has been on the horizon for a few years and was delayed because of asset quality issues in the banking sector and later because of the onset of the pandemic. With better asset quality, capital position and improved profitability outlook, banks are now much better placed to transition to the ECL-based provisioning approach. Based on precedents, we expect that the draft guidelines could be issued within the next one year and the final guidelines should be notified in FY2024. We expect that the opening balance sheets of banks, as on April 1, 2025, shall reflect the impact of the ECL-based provisions on the capital. Given the expected timelines and the likely transition period after April 2025, banks could enhance their capital cushions through capital accretion or by raising equity. In our view, banks, particularly those operating with thinner capital cushions and with higher overdue books, are likely to see more transitioning pain and would need to raise capital. With almost two years to possibly transition to the ECL approach, such banks should enhance their capital position and take corrective actions to reduce their overdue exposures to smoothly transition to ECL-based provisions. While a time frame of up to five years is being proposed, banks which avail such forbearance are not viewed favourably by investors. It becomes even more difficult for such institutions to raise capital in such a situation.

Source: rbi.org, ICRA Research

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Analytical Contact Details

	Karthik Srinivasan	Anil Gupta	Aashay Choksey
	Senior Vice-President	*Senior Vice-President*	*Vice-President*
	karthiks@icraindia.com	anilg@icraindia.com	aashay.choksey@icraindia.com
	+91-22-6114 3444	+91-124-4545 314	+91-22-6114 3430

Business Development/Media Contact Details

	L. Shivakumar	Jayanta Chatterjee	Naznin Prodhani
	Executive Vice-President	*Executive Vice-President*	*Head Media & Communications*
	shivakumar@icraindia.com	jayantac@icraindia.com	communications@icraindia.com
	022- 6114 3406	080 – 4332 6401	0124 – 4545 860

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Thank You!