Expected Credit Loss -Based Loan Loss Provisioning Norms

For Prelims: Expected Credit Loss (ECL) Non Performing Assets, RBI, **Loan Provisioning**

For Mains: Problems of Loan loss, measures to strengthen banking sector

Why in News?

Recently, the Reserve Bank of India (RBI) said that the banks will be given ample time to implement Expected Credit Loss (ECL)-based loan loss provisioning norms.

What is the Expected Credit Loss -Based Loan Loss Provisioning Norms?

- **Background:**
  - The **RBI** had previously **proposed** the adoption of the **ECL approach for credit impairment,** and banks were given a one-year period for implementation once the final guidelines are released.
  - While the **final guidelines are yet to be announced,** it is expected that they may be notified by FY2024 for implementation starting from April 1, 2025.
  - The **Indian Banks Association (IBA)** have requested the RBI to grant an additional year for lenders to prepare for the implementation of the ECL norms.
- **About:**
  - RBI has proposed a **framework for adopting an expected loss** (EL)-based approach **for provisioning by banks in case of loan defaults.**
  - Under this, banks will need to **classify financial assets** into one of three categories **(Stage 1, Stage 2, or Stage 3).**
- **Asset Classification:**
  - **Stage 1 Assets:**
    - These are financial assets **that have not experienced a significant increase in credit risk** since their initial recognition or have low credit risk at the reporting date.
      - For these assets, **12-month expected credit losses** are recognized, and interest revenue is calculated based on the gross carrying amount of the asset.
  - **Stage 2 Assets:**
    - These are financial instruments **that have undergone a significant increase in credit risk** since their initial recognition, although there is no objective evidence of impairment.
    - **Lifetime expected credit losses are recognized** for these assets, but interest revenue is still calculated based on the gross carrying amount of the asset.
  - **Stage 3 Assets:**
    - These are financial assets **that have objective evidence of impairment at the reporting date.**
      - For these assets, lifetime expected credit loss is recognized, and interest

        - revenue is calculated based on the net carrying amount.
- **Benefits:**
    - The expected credit losses approach **will enhance the resilience of the banking system** in line with globally accepted standards.
    - It is expected to result in higher provisions compared to the shortfall seen under the incurred loss approach.
- **ECL vs IL Model:**
    - This new approach replaces the current **"incurred loss (IL)"** model, which delays loan loss provisioning, potentially increasing credit risk for banks.
    - A key **drawback in the IL model was that usually banks made provisions with a significant delay** after the borrower may have started facing financial difficulties, thereby **increasing their credit risk.** This led to systemic issues.
    - Furthermore, the delayed recognition of loan losses **resulted in an overstatement of banks' income, combined with dividend payouts,** which further eroded their capital base.
- **Transitional Arrangement:**
    - To prevent a capital shock, the RBI has proposed a transitional arrangement for the introduction of ECL norms.
    - This phased implementation will help banks absorb any additional provisions without adversely impacting their profitability.

What is the Concept of Loan-Loss Provision?

- **About:**
    - Loan-loss provision, as **defined by the RBI, refers to the allocation of funds set aside by banks to cover losses** incurred from defaulted loans.
    - In simpler terms, it is a reserve of cash that **banks keep to mitigate the impact of losses** resulting from borrowers' failure to repay their loans.
- **Provision:**
    - This provision **acts as an expense on the bank's income statement and can be utilized when borrowers** are deemed unlikely to repay their loans.
    - By using the loan-loss reserves, banks can cover the losses they incur instead of facing a direct reduction in their cash flows.
        - **Example:**
            - Consider a scenario where a bank has issued a total of USD 100,000 in loans and has a loan loss provision of USD 10,000.
                - If a borrower defaults on a USD 1,000 loan but repays only USD 500, the bank would deduct USD 500 from the loan loss provision to cover the loss.
- **Determinants:**
    - The level of loan loss provision is determined **based on the expected level required to ensure the bank's safety and stability.**

What is the Current Approach for Loan Loss Provisions?

- Banks in **India follow the incurred loss model** for making loan loss provisions.
    - This model assumes that all loans will be repaid unless evidence suggests otherwise, such as a trigger event indicating a loss.
    - Only when such an event occurs is the **impaired loan or portfolio of loans** written down to a lower value.

What are the Challenges?

- The incurred loss approach **requires banks to provide for losses that have already occurred or been incurred.**
    - However, during the financial crisis of 2007-09, this delayed recognition of expected losses worsened the downturn.
    - As defaults increased across the system, **the delayed recognition of loan losses**

forced banks to make higher provisions, depleting their capital reserves.
    - This, in turn, weakened the resilience of banks and posed systemic risks.
- Additionally, **the delays in recognizing loan losses led to an overstatement of banks'** generated income.
- Combined with dividend payouts, this impacted their capital base by reducing internal accruals, further compromising their resilience.

UPSC Civil Services Examination, Previous Year Question (PYQ)

Q. Consider the following statements: (2018)

1. Capital Adequacy Ratio (CAR) is the amount that banks have to maintain in the form of their own funds to offset any loss that banks incur if the account-holders fail to repay dues.

2. CAR is decided by each individual bank.

Which of the statements given above is/are correct?

(a) 1 only
(b) 2 only
(c) Both 1 and 2
(d) Neither 1 nor 2

Ans: (a)

Exp:

- Capital Adequacy Ratio (CAR) is a measurement of a bank's available capital expressed as a percentage of a bank's risk-weighted credit exposures. It is used to protect depositors and promote the stability and efficiency of financial systems
- It is the amount that banks have to maintain in the form of their own funds to offset any loss that banks incur if the account-holders fail to repay dues. Hence, statement 1 is correct.
- Two types of capital measured under CAR are:
    - Tier 1 Capital: It is the core capital, which consists of equity capital, ordinary share capital, intangible assets and audited revenue reserves.
    - Tier 2 Capital: It comprises of unauditedretained earnings, unaudited reserves and general loss reserves.
- CAR = (Tier 1 Capital + Tier 2 Capital)/Risk Weighted Assets
- CAR is decided by the Central bank or Reserve Bank of India (RBI) to prevent commercial banks from taking excess leverage and becoming insolvent in the process.
- Basel III norms stipulated a capital to risk weighted assets of 8%. As per RBI norms, Indian scheduled commercial banks are required to maintain a CAR of 9%, while Indian public sector banks are emphasized to maintain a CAR of 12%. Hence, statement 2 is not correct.
- Therefore, option (a) is the correct answer

Source: IE

PDF Refernece URL: https://www.drishtiias.com/printpdf/expected-credit-loss-based-loan-loss-provisioning-norms