ECL Based Loan Loss Provisioning Framework

Why in News?

Lenders in India have approached the **Reserve Bank of India (RBI)** seeking a **one-year extension** for the implementation of the **Expected Credit Loss (ECL)-based loan loss provisioning framework.**

- Earlier in January 2023, the **RBI came out with a draft guidelines proposing adoption of expected credit loss approach** for credit impairment.

What is ECL-based Loan Loss Provisioning Framework?

- **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) has requested the **RBI to grant an additional year for lenders to prepare for the implementation of the ECL norms.**
- **About ECL Framework:**
  - In the expected credit loss framework, **banks are mandated to forecast anticipated** credit losses **through forward-looking estimations, rather than waiting for credit losses to materialise before making corresponding provisions for those losses.**
    - Banks will be required to classify financial assets **(primarily loans, including irrevocable loan commitments, and investments classified as held-to-maturity or available-for-sale)** into three categories: **Stage 1, Stage 2, and Stage 3,** based on the **assessed credit losses at the time of recognition and subsequent reporting dates.**
      - Provisioning will be made accordingly for each category.
- **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 Loan Loss Provisioning?

- It is a regulatory requirement enforced by the **RBI,** to ensure the financial stability of banks and protect the interests of depositors.

- It refers to the **practice followed by banks and financial institutions to set aside a portion of their earnings** as a provision to cover **potential losses arising from** non-performing assets (NPAs) **or bad loans.**
    - RBI defines **NPAs in India as any advance or loan that is overdue for more than 90 days.**
- It helps banks to **accurately reflect the true value of their loan portfolios and assess their overall risk exposure.**
    - Adequate provisioning also enhances the **transparency of a bank's financial statements** and provides a **more accurate picture of its financial health to stakeholders.**

What is the Indian Bank Association?

- **Indian Bank Association (IBA)** is a voluntary association of banks in India. It was formed on **26th September 1946** with the objective of promoting and **coordinating the interests of the Indian banking industry.**
- The members comprise of:
    - **Public Sector Banks.**
    - Private Sector Banks.
    - Foreign Banks having offices in India.
    - **Co-operative Banks.**
    - **Regional Rural Banks.**
    - **All India Financial Institution.**

Source: IE