UNIQUS Corner - shaping the regulatory and governance agenda

Discussion Paper ('DP') on Expected Credit Losses ('ECL') based approach for loan loss provisions by banks

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Dear clients and friends,

On 16 January 2023, the Reserve Bank of India ('RBI') issued a DP on ECL based approach for loan loss provisioning by banks. In this context, the RBI had sought comments and inputs on a wide range of issues pertinent to implementing the ECL approach.

The DP has proposed principles-based guidelines for determining ECL largely in line with International Financial Reporting Standards ('IFRS') 9 on financial instruments. The DP has taken a holistic view in formulating the proposed ECL based approach by covering aspects such as classification of financial assets, scope/coverage of financial assets, Effective Interest Rate ('EIR'), regulatory backstops and disclosures. However, certain other aspects relating to derecognition, application of business model for subsequent measurement, reclassification and treatment of existing provisions held by banks including those on Non Performing Assets ('NPA') have not been specifically covered in the DP.

As part of Uniqus's outreach with the RBI, further to the Early Impressions released by us on 20 January 2023, we have now articulated our point of view on the issues raised in the DP. We have formed our views on these matters based on our teams experience of having implemented ECL and IFRS 9 in the financial services sector both globally and in India.

We sincerely hope you find the enclosed submission informative. We look forward to engaging with you.

Thank you.

Sandip Khetan
Global Head of Accounting & Reporting Consulting
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Our Point of View

The proposed approach in the DP on ECL is principles-based along with regulatory backstops, wherever necessary. The DP seeks to cover all scheduled commercial banks and covers most financial assets within the scope of ECL based provisioning. The RBI has also sought comments on a range of issues pertinent to implementation of ECL including whether regional rural banks and smaller cooperative banks should be kept out of the above framework.

The proposed DP is largely consistent with IFRS 9 / Ind AS 109 with some carve outs. The financial assets in scope are required to be categorized as Stage 1, Stage 2, and Stage 3, depending upon the assessed credit losses on them and estimate provisions are based on 12 month or lifetime Probability of Default ('PD').

It is indicated that banks would be allowed to design and implement their own models for measuring ECL with certain mitigants expected to be stipulated by the RBI. Further, provisions as per the Banks' internal assessments shall be subject to a prudential floor, to be specified by the RBI based on comprehensive data analysis. To facilitate a seamless transition, as permitted under the Basel guidelines, the RBI has provided an option to phase out the effect of increased provisions on Common Equity Tier I capital, over a maximum period of five years.

We believe it is important to take a holistic view of implementing the ECL based approach as there are nuances that affect financial statements and regulatory submissions. In this context, the DP captures interlinkages arising from matters that impact both accounting and capital adequacy. For your perusal, following is the summary of our responses to the RBI's DP on ECL based approach. The responses to issues raised in the DP have been grouped based as follows:

1. **Overall approach**
2. **Scope and coverage**
3. **Risk assessment and staging**
4. **Interlinkage between finance and risk related nuances**
5. **Other matters**

Overall approach

The RBI has enquired if ECL per IFRS 9 should be adopted as compared to the Current Expected Credit Losses ('CECL') and if there should be regulatory backstops alongside principle based guidelines.

Our Point of View:

We agree with the proposal to adopt ECL approach for provisioning by banks based on IFRS 9 rather than the CECL approach for the following reasons:

1. Adoption of IFRS aligned principles will make financial statements of Indian banks comparable with those of global banks that have reported under IFRS. Also, the U.S Securities Exchange Commission permits companies to submit financial statements using IFRS.

2. Non Banking Finance Companies ('NBFCs') have transitioned to Ind AS from FY 16-17 and FY 18-19 and scheduled commercial banks have been submitting proforma Ind AS financial statements from September 2016.

We agree with the approach of regulatory backstops alongside principle based guidelines as proposed ECL based framework requires use of historical data to compute Probability of Default ('PD'), Loss Given Default ('LGD') and also forward looking macro economic factors. The regulatory backstops will help in strengthening the framework from a prudential standpoint and facilitate better governance by prescribing certain prudential floors as a regulatory backstop. While these regulatory backstops may tantamount to having certain carve outs to IFRS 9, which may lead to different treatment being followed by group entities already following Ind AS 109 in the banking conglomerates, it will help mitigate the burden of expected losses on the capital maintained by the banks.

Scope and coverage

The RBI has enquired if cooperative banks, regional rural banks should be kept outside the purview of ECL based approach and if the proposed scope of ECL based provisioning is acceptable.

Our Point of View:

We believe that the expected credit loss approach shall not be immediately extended to the co-operative banks as well as the regional rural banks. Instead RBI may consider getting the co-operative banks and the regional rural banks to file proforma Ind AS financial statements on similar lines as was required by the scheduled commercial banks. The proforma reporting will allow the management and Board to get familiar with the framework and be better prepared to adopt the new framework. Also, the proforma reporting will help RBI to determine if the regulatory backstops will need to be any different for such banks.

Para 4.6 of the discussion paper seems to suggest an exhaustive list of financial assets for application of the expected credit loss approach. We have also articulated to the RBI that the following financial assets should be additionally included in the scope of ECL (in addition to what is proposed to be included in the DP):

- Loans and advances measured at Fair Value through Other Comprehensive Income ('FVOCI')
- Contract assets
- Other financial assets measured at amortized cost e.g. trade receivables, bank balance

Risk assessment and staging of financial assets

The RBI has sought inputs on following aspects relating to risk assessment and staging of financial assets:

1. Practical expedient for low credit risk
2. Definition of default for determining Significant Increase in Credit Risk ('SICR')
3. Assessment of SICR at counterparty rather than instrument level
4. Treatment of exposures outstanding for more than 90 days vis a vis Non Performing Assets ('NPA's')
5. Regulatory backstop for determining SICR
6. Carve out for restructured assets

Our Point of View:

1. Practical expedient for low credit risk

It has been proposed that low credit risk expedient be permitted for SLR eligible investments, direct claims on central government and exposures guaranteed by central government. In this context, while we agree that SLR eligible investments can be considered to have low credit risk, we have requested RBI to clarify if State Development Loans ('SDL') or securities issued by state governments will be covered within the ambit of low credit risk exception with 12 month probability of default being applied to determine ECL thereon.

Further, while we agree that exposures guaranteed by central government and direct claims on central government can be considered to have low credit risk, we have sought clarity from the RBI on what is included within direct claims on central government and exposures guaranteed by central government to help achieve consistency in practice.

2. Definition of default for determining SICR

While we agree with the proposed definition of default, we believe the definition should be fully aligned with IFRS 9 since all modifications do not warrant a stage 3 or default classification. For instance, a reduction in interest rate in a declining rate scenario may not in isolation mean default. Also, we have suggested the RBI include watch list accounts presented to the Board of Directors ('BOD') or Audit Committee ('AC') and those beyond 30 days past due for adjudging SICR and align the treatment of exposures specific to investment in preference shares classified as Non Performing Investment ('NPI') with other credit facilities.

3. Assessment of SICR at counterparty rather than instrument level

We believe there are two possible views in this context.

- **Approach 1**
  Under IFRS 9, an assessment of whether there has been a significant increase in credit risk is made for a specific instrument rather than for counterparty, hence the proposed counterparty level approach is divergent and more conservative from the IFRS 9 requirement.

However, for some instruments a significant increase in credit risk may not be evident on an individual basis before the financial instrument becomes past due.

An assessment of whether there has been a significant increase in credit risk on an individual basis would not faithfully represent changes in credit risk since initial recognition. Hence, we agree with the proposal to require the assessment of significant increase in credit risk to be made at the counterparty level as it is a more prudent approach.

- **Approach 2**
  RBI may also consider assessment of significant increase in credit risk at an instrument level for financial reporting purposes. The assessment of significant increase in credit risk at a counterparty level rather than at instrumental level could be factored in as part of regulatory backstop. This will ensure alignment with IFRS 9/ Ind AS 109 and achieve consistency in financial reporting within the group entities for a banking conglomerate.

  In addition to the above points, we have requested RBI to help clarify the following:

  - Should the counterparty assessment extend to all entities in the same borrower group?
  - Alignment in SICR evaluation for a counterparty where a bank and its subsidiaries have exposure, while preparing consolidated financial statements?

4. Treatment of exposures outstanding for more than 90 days vis a vis Non Performing Assets ('NPA's')

We believe there are two possible interpretations in this case:

- **Interpretation 1:** Exposures which remain overdue i.e. 1 day past due to 89 days past due continuously for a period of 90 days as of the reporting date should not be treated at par with the NPA for the purpose of measuring expected credit losses as such delays could be due to administrative reasons. This is also consistent with IFRS 9/ Ind AS 109 where there is a rebuttable presumption that default does not occur later than when a financial asset is 90 days past due. Such exposures should go through the staging evaluation and be classified as stage 1 or stage 2 depending on facts on the reporting date.

- **Interpretation 2:** Exposures which remain overdue i.e. 90 days past due or more continuously for a period of 90 days anytime during the reporting period and not specifically on the reporting date. Such exposures should be treated at par with NPA for the purpose of measuring expected credit losses.

  For example: If a particular financial asset is 90 days past due as on 20th March 2022 and is 60 days overdue on 31st March 2022 by repaying one instalment, it should be treated at par with NPA for the purpose of measuring expected credit losses. This is also consistent with IFRS 9/ Ind AS 109 where there is a rebuttable presumption that default does not occur later than when a financial asset is 90 days past due.

Also, the definition of default may consider a cure or probation period i.e. if a financial asset has previously entered default, a period of satisfactory performance by the borrower to demonstrate that it can meet all of its contractual obligations, may be evaluated before the financial asset exits default.

5. **Regulatory backstop for determining SICR**
   We believe that RBI should not differ from what IFRS 9 / Ind AS 109 prescribes and hence should not propose rebuttable presumption for SICR to be considered as 60 days instead of 30 days. Further, the RBI may stipulate that BOD/AC of the bank should approve any rebuttal of the 30 days presumption as per IFRS 9.

6. **Carve out for restructured assets**
   RBI's proposal to test renegotiated/ modified financial assets for significant increase in credit risk while treating restructured financial assets as already credit impaired will mean all such exposures are classified as stage 3 with provisions being measured on lifetime PD.

   Accordingly, we have suggested that RBI may consider amending the definition of default proposed in the discussion paper and consider treating restructured assets consistent with the principles of IFRS 9 and include guidance on derecognition in the guidelines as certain renegotiation situations may stipulate a derecognition assessment.

Interlinkage between finance and risk related nuances

The RBI has sought inputs on following aspects :

1. Customised approach for ECL and mitigants to reduce variability
2. Interest income on stage 3 assets
3. Cooling period
4. Treatment of stage 2 provisions as specific or general
5. Approach for collateral / security for prudential floor
6. Quantitative and qualitative disclosures

Our Point of View:

1. Customised approach for ECL and mitigants to reduce variability

We agree with the proposal to allow banks to customize their ECL approach since these models proposed will require a host of information on factors that are specific to the borrower, historical data like the internal credit loss experience, internal and external credit ratings, external reports along with statistics, forward looking macro-economic factors. Several of these data points will be specific to each bank and accordingly approaches used to estimate ECL may vary from simpler models like the loss rate method to more complex approaches e.g. regression techniques.

We are hence in agreement with RBI's proposal to have process checks in place on an ongoing basis along with rigorous model validation framework to ensure banks take responsibility for model validation. In our view, prudential floor prescribed by RBI as a regulatory backstop will help reduce the consequent variability between the entities.

2. Interest income on stage 3 assets

In this context, we submit the following two views.

View 1: Accrue interest income on stage 3 assets

In our view, accrual of interest income for assets classified as stage 3 will be appropriate as such interest accrual represents discount unwinding given that provisions are measured on a present value basis under the ECL regime.

NBFC's have applied Ind AS 109 and interest income on stage 3 assets have been reported on accrual basis and hence introduction of a deviation from the accrual principle will pose challenges while preparing fit for consolidation financial statements. In order to address the concern on cash flow estimates not being reliable for stage 3 assets, we have suggested that the RBI stipulates additional disclosure on interest income recognized on assets classified as stage 3.

View 2: Provide for interest income on stage 3 assets as prudential backstop

Alternatively, the RBI may direct interest accrued on assets classified as stage 3 to be fully provided for through the provision line item in the income statement as a regulatory backstop. This will lead to gross up of P&L.

3. Cooling period

Globally, banks have applied a cooling off period for roll back of financial assets from stage 3 to stage 1. In our view, RBI defining a minimum cooling off period as part of the proposed guidance will help eliminate bias in determining ECL provisions.

Accordingly, we agree with the proposed approach of keeping a financial asset in stage 2 for 6 months before it transitions from stage 3 to stage 2. We have also recommended that RBI may consider a shorter cooling off period of say 3 months for financial assets like micro finance loans which have a contractual term in the range of 6 months-36 months etc.

4. Treatment of stage 2 provisions as specific or general

In this context, we would like to submit two possible views:

View 1: Under IFR 9, specific provisions are those held against loss assets (stage 3), as assets categorised as stage 2 are not considered as impaired. Hence, it may be justifiable to consider provisions held against stage 2 assets as general provisions.

Accordingly, provisions held against stage 2 assets including provisions maintained as part of prudential floor can be treated as general provisions. Treating stage 2 provisions as general provisions will also have consequential impact in calculating capital adequacy.

View 2: An alternative to the above view could be that both stage 2 and stage 3 provisions are measured using lifetime ECL approach and hence both should be treated as specific provisions.

5. Approach for collateral/security for prudential floor

The discussion paper has proposed three approaches for treating collateral. In our view, the RBI should consider option c) such that valuation of collateral is factored in while calibrating prudential floor along with guidelines for valuation of collateral to be followed for computing ECL.

In order to retain objectivity and comparability amongst banks, we have suggested that RBI should consider including following aspects in the guidance on valuation of collateral comprising various asset classes:

- Valuation methodologies
- Frequency for carrying out valuation
- Board approved policies

Further, we have recommended that RBI should consider extending the guidance on valuation of collateral for computation of LGD as well and not restrict it only for the purpose of prudential floors to help achieve better comparability.

6. Quantitative ad qualitative disclosures

We have suggested that disclosures per Ind AS 107 / IFRS 7 should be stipulated by the RBI as it will provide meaningful information to users of financial statements on policies, processes and measures used to quantify credit risk. Further, we have recommended that the impact of regulatory /prudential backstops applied should be disclosed as well.

Other matters

The RBI has sought inputs on following aspects :

1. Provisions for transitioning from incurred loss approach to expected credit losses approach
2. Other aspects germane to the proposed transition

Our Point of View:

1. **Provisions for transitioning from incurred loss approach to expected credit losses approach**
   We are in agreement with transition guidance proposed in the discussion paper as they are aligned with norms provided by Basel Committee on Banking Supervision ('BCBS'). Additionally, we have suggested that RBI may include disclosures on transition adjustments covering impact on reserves by way of an opening balance sheet / net worth reconciliation.

2. **Other aspects germane to the proposed transition**
   We have suggested the RBI consider a holistic approach for the proposed transition. Accordingly, we have articulated the following aspects as germane to the proposed transition

   - The RBI should issue formal directives to implement the concept of business model for accounting of financial assets. In this context, the RBI had issued a discussion paper stipulating principles for classification and measurement of investments. Its scope and coverage should be extended to subsequent measurement of all financial assets.

   - Include guidance on derecognition of financial instruments as it will help bring consistency with IFRS 9 particularly when there are cases of modification / restructuring of financial assets.

   - The RBI will need to clarify that once ECL provisioning is implemented, i.e. whether existing provisions such as standard asset provisions, country risk provision and floating provisions will need to be reversed as part of transition and not required to be held post transition.

   - For irrevocable loan commitments, financial guarantee contracts, the RBI should clarify how irrevocability should be evidenced in practice e.g. criteria to be applied basis which a credit committee in a bank should consider irrevocability of a facility.

   - The proposed guidance seems to suggest ECL on performance guarantees / contractual guarantees would always be measured at lifetime ECL. We have recommended that RBI should consider aligning approach used for measuring ECL on performance/ contractual guarantees and financial guarantees using 12 month or lifetime PD based on facts of each case.

   - The RBI may align with Central Board of Direct Taxes ('CBDT') on income tax implications arising from implementation of ECL.

   - Implications of applying ECL by insurance companies (subsidiaries of banks) as part of implementing Ind AS 117 / Ind AS 109 may be

examined in the context of determining the ECL approach of Banks, to ensure there is consistency in approach / accounting policies between the reporting bank and the insurance subsidiaries.

Next Steps

We believe the issuance of DP on ECL is a step in the right direction as it spells out the directional regulatory thinking on how provisioning is likely to be done in the future. While scheduled commercial banks have been submitting proforma Ind AS financial statements to the RBI, the proposed guidance in the DP should help them revisit and fine tune several working assumptions which may have been a part of their approach to prepare financial statements as per Ind AS.

Having assisted several banking clients in their journey of implementing IFRS 9 /Ind AS 109 in India and overseas, we believe banks should consider the following next steps for seamless implementation of ECL.

Governance

1. Constitute a cross functional project team comprising representatives from Risk, Finance and IT team to ascertain implications of proposed guidance in the DP. The team should review working assumptions used to estimate ECL for proforma Ind AS financial statements and assess impact of changes to such assumptions on the back of guidance in proposed DP on ECL.

2. The Risk Management Committee ('RMC') and Audit Committee ('AC') will need to be involved to provide required oversight and governance.

3. The project team should periodically engage with the RMC and AC, who should be kept informed of issues encountered, resolutions achieved and impact arising from ECL based approach as the guidelines evolve. This will help management engage better with the RBI as these guidelines are finalised.

Technology

1. Automating the process of ECL determination will be inevitable. Accordingly, enhancements will be required to IT systems for determining ECL based provisions. We expect this to be a significant activity as implementation of ECL will impact several portfolios e.g. loans, investments, off balance sheet exposures and other assets.

2. Review data quality as the same will be critical in ECL automation. This will require a coordinated effort between IT, Risk and Finance teams given various dependencies.

3. Formulate and implement data governance framework as computation of ECL will depend on governance over underlying data and to substantiate the reported ECL numbers.

Business considerations

1. Assess impact of ECL on Key Performance Indicators ('KPIs') such as risk adjusted return on capital, provision coverage ratio for various financial assets etc. This will require realignment of KPIs for business teams with ECL results.

2. In due course, engage with analysts and investors to explain impact of ECL on results and KPIs.

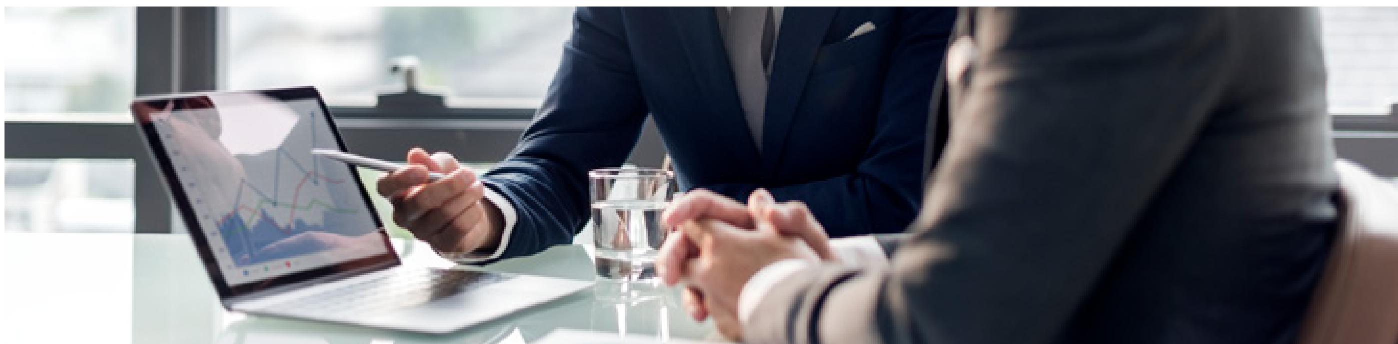
People

1. Upskill personnel in Risk and Finance teams so that they get familiar with provisioning norms per ECL approach. Banks may need to also on-board risk professionals and business analysts to implement ECL.

Reporting

1. Enhance credit rating process and related documentation as risk assessment at inception will be critical for determining significant increase in credit risk at a subsequent reporting date.

2. Adopt a holistic approach to automating ECL implementation with due consideration of existing IT architecture and outcomes from assessments carried out per points above. Further, evaluate the impact arising from accounting adjustments due to carve outs per DP that will apply to banks in the fit for consolidation financial statements as several banks have subsidiaries which have transitioned to Ind AS 109 without any carve outs.



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