



FairConnect Business Advisors Private Limited

FairConnect Comment

Expected Credit Loss (ECL) Framework may necessitate a shift in product pricing and capital allocation

Key Highlights:

- **Transition from Rule based provisioning to Expected Credit Loss Provisioning:**

Among several changes¹, Ind AS prescribes move from current rule based provisioning to expected credit loss (ECL) base provisioning, which is likely to change lenders provisioning requirement significantly.

- **Impact on profitability could vary across asset classes:**

The change in norms will impact profitability on an ongoing basis. The extent of change in credit provisioning will depend upon the underlying asset class, and likely default rates, for example secured asset classes such as **housing loans, gold loan or higher credit rated corporate loans (AAA, AA rating category)** could witness **release of provisions** from current levels while other asset classes, more specifically **lower rated corporate exposures, unsecured loans and asset classes** where delinquencies have been on higher side are likely to attract **higher credit provisioning**.

- **One time change could erode capital for some**

The change in provisioning requirement would have significant one-time impact too, as on the first day of implementation lenders will need to adjust their provisioning requirement in line with Ind AS vs. current rule based provisioning for existing loan book which could impact their net worth / capital adequacy on first day of implementation.

More specifically, existing stressed loans, where existing provisioning cover is lower than expected credit loss on these loans, will lead to significant increase in provisioning requirement. This may change capital planning for severely impacted entities.

¹ Most notables are income recognition norms moving to effective interest rate (EIR) method, income recognition for securitization contracts and changes required in structuring of securitization contracts, classification and measurement of financial instruments

- **Implementation to start from April 1, 2018**

Indian lenders such as Banks, Financial Institutions and Large NBFCs/HFCs (with net worth of Rs. 5 billion and above) will be required to adopt Ind AS for the accounting periods beginning April 1, 2018; Other NBFCs (which are listed or having a net worth of more than Rs. 2.5 billion but less than Rs. 5 billion) will move to Ind AS for the accounting periods beginning April 1, 2019.

- **RBI is yet to announce / revise the prudential norms to align with Ind AS**

For banks and other financial sector entities, RBI's prudential norms pertaining to asset classification, provisioning and income recognition supersede prevailing accounting standards. RBI is yet to issue revised norms to align with Ind AS 109, the extent of impact on adoption of Ind AS will also depend on the level of alignment of RBI norms with Ind AS and transitional arrangement, if any, provided by RBI.

- **The FairConnect Edge**

The adoption of expected credit loss provisioning could have significant impact on profitability and capital planning of lenders.

If you are a bank / NBFC/ Financial Institution, **FairConnect** can assess the impact so that you are ahead of the curve in re-assessing business strategy / product design / pricing / capital planning.

1. Adoption of Ind AS

Indian lenders such as Banks, Financial Institutions, and Non-Banking Finance Companies (NBFCs) and Housing Finance Companies (HFCs) will be required to adopt Ind AS. The schedule of Ind AS implementation for lenders is as follows:

Table-1: Ind AS Implementation Schedule for Financial Sector Entities

Entity	Required to adopt Ind AS from
Banks, Financial Institutions, and large NBFCs / HFCs (with net worth of Rs. 5 billion and above)	April 1, 2018
Other NBFCs / HFCs (which are listed or having a net worth of more than Rs. 2.5 billion but less than Rs. 5 billion)	April 1, 2019

2. Ind AS prescribes move from current rule based provisioning to expected credit loss based provisioning

Among several changes², Ind AS prescribes move from current rule based provisioning to expected credit loss base provisioning, which is likely to change lender's provisioning requirement significantly.

Key difference between existing provision approach and ECL approach	
Existing provisioning approach largely consider losses that arises from past events	Expected credit loss (ECL) framework is forward looking approach
Current framework largely covers only outstanding loan book	ECL framework covers outstanding loan book as well as non-fund based exposures and undrawn commitments

Under Ind AS, lender's entire loan book will be divided in three categories (stages) and provisioning requirement will depend on the stage of loan:

Stage-1: Standard loans (neither impaired nor witnessed significant increase in credit risk)

Stage-2: Significant increase in credit risk since initial recognition

Stage-3: Credit impaired financial assets

² Most notables are income recognition norms moving to effective interest rate (EIR) method, income recognition for securitization contracts and changes required in structuring of securitization contracts, classification and measurement of financial instruments

New norms will bring significant change in lender's provisioning requirement, *table-2* brings out the key difference in provisioning requirement under RBI's current framework and ECL framework under IAS 109.

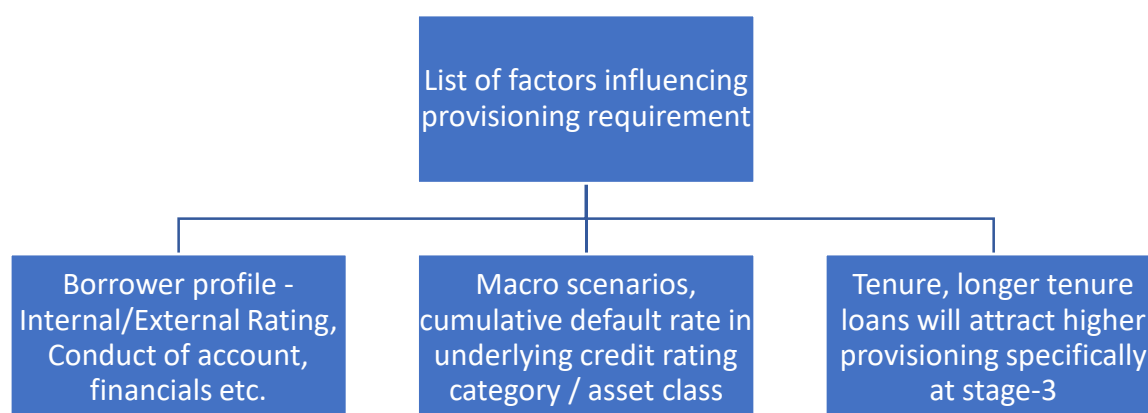
Table-2: Comparison on Provisioning Requirement

		Current RBI norms	Expected Credit Loss Framework (Ind AS 109)
Stage-1	At origination or for outstanding portfolio as on each reporting date	Standard asset provisioning of 0.4%	12-month expected credit losses ³ i.e. Probability of Default within next 12 months X Loss Given Default
Stage-2	Significant increase in credit risk since initial recognition (Refer Annexure-1 for indicative list of instances to determine whether credit risk has increased significantly)	As such no specific provisioning	Lifetime expected credit losses i.e. Probability of Default X Loss Given Default X Exposure at Default
Stage-3	Credit impaired financial asset	NPA provisioning, depending on duration of NPA and nature secured / unsecured - 10%/15%-100%	Difference between the asset's gross carrying amount and the present value of estimated future cash flows discounted at the underlying asset's original effective interest rate (EIR). This also mean that likely loss of future interest income is also to be provided under ECL. This provision will reverse, if assumption on recovery does not change, with passage of time (in a way interest income booking on impaired contracts), post initial provision creation.

³ 12-month expected credit losses are the portion of lifetime expected credit losses that represent the expected credit losses that result from default events on a financial instrument that are possible within the 12 months after the reporting date; Default definition that is consistent with the definition used for internal credit risk management purposes, while 90+ DPD is guided as default under IND AS 109, unless an entity has reasonable and supportable information to demonstrate that a more lagging default criterion is more appropriate.

However, the extent of change on account of Ind AS implementation will depend upon the underlying asset class, and likely default rates, for example secured asset classes such as housing loans, gold loan or higher credit rated corporate loans (AAA, AA rating category) could witness release of provisions from current levels while other asset classes, more specifically lower rated corporate exposures, unsecured loans and asset classes where delinquencies have been on higher side are likely to attract higher credit provisioning.

List of factors which would have significant impact on provisioning requirement under ECL framework



3. Change in provisioning requirement will have one time impact as well as will impact profitability for large number of lenders

The change in provisioning requirement would have significant one-time impact too, as on implementation lenders will need to adjust their provisioning requirement in line with Ind AS vs. current rule based provisioning for existing loan book which could impact their net worth / capital adequacy. More specifically, existing stressed loans, where existing provisioning cover is lower than expected credit loss on these loans, will lead to significant increase in provisioning requirement. This may change capital planning for severely impacted entities. The change in norms will also impact profitability on an ongoing basis (over and above one-time impact).

4. RBI yet to finalise norms, extent of impact will depend on level of alignment of RBI norms with Ind AS and transitional arrangement, if any, provided by RBI

For banks and other financial sector entities, RBI's prudential norms pertaining to asset classification, provisioning and income recognition supersede prevailing accounting standards. RBI is yet to issue revised norms to align with Ind AS 109, the extent of impact on adoption of Ind AS will also depend on the level of alignment of RBI norms with Ind AS and transitional arrangement, if any provided by RBI.

As the adoption of expected credit loss provisioning could have significant impact on profitability and capital planning of lenders, FairConnect is of the view that the change may require re-assessment of business strategy / pricing / capital planning for several entities in financial sector.

FairConnect team has significant experience in credit risk, credit analytics and assessing the impact of various regulatory and evolving issues on business risk profile of entities. The team offers advisory services in the field of credit risk management, stressed asset management and business & financial advisory. The team aims to assist its clients on timely assessment of expected credit loss framework and changes required in MIS and IT systems to reliably assess the impact of these changes and fine tune policies and strategy.

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Annexure-1: Indicative List of Significant Increase in Credit Risk

Ind AS 109 had indicated the scenarios to determine whether credit risk has increased significantly since initial recognition; following are some of key points mentioned in indicative list of significant increase in credit risk under Ind AS 109

- More than 30 days past due contracts / borrowers
- An actual or expected significant change in the borrower's external or internal credit rating or significant decline in credit score used internally to assess credit risk of the borrower
- Significant increase in credit spread or credit default swap for the borrower
- An actual or expected significant change in operating results of the borrower
- Significant changes in the value of collateral supporting the obligation

Significant changes in expected performance or behavior of the borrower leading to waiver of finance covenants, interest or principal repayment holidays or deferment, requiring additional collateral / guarantees

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