



# 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 unaudited retained earnings, unaudited reserves and general loss reserves.
- $CAR = \frac{\text{Tier 1 Capital} + \text{Tier 2 Capital}}{\text{Risk Weighted Assets}}$
- 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**