Proposed ECL Framework Likely to Have Moderate Impact on Banks

CareEdge RATINGS

November 07, 2023 | Ratings

Summary

The proposed transition to the 'Expected Credit Loss (ECL)' framework from the current incurred loss approach is a step forward for the Indian banks towards the Indian Accounting Standards (Ind AS). The transition to the ECL framework would have a one-time impact on the profitability and capital levels. Currently, it is difficult for market participants to quantify the impact due to a lack of public data and banks awaiting a detailed framework. Based on limited disclosures in analyst calls as well as management interaction with select banks, as of now, the likely impact is estimated to be up to 2.5% (subject to deferred tax benefit) on the capitalisation levels.

The impact on private sector banks, mainly the frontline ones, is likely to be lower due to contingency provisions maintained during Covid-19 time as well as better historical asset quality parameters. For a few public sector banks, the impact would be lower considering the contingency provisions made. Also, a significant improvement in slippages is further likely to improve the probability of default (PD) multiples thereby reducing the ECL estimates. While the RBI has proposed a maximum time frame of five years after the date of implementation for spreading out these provisions, it is expected that most of the banks would manage the impact of the transition much earlier.

RBI came out with a discussion paper on 'Expected Credit Loss (ECL)-based approach for loan loss provisioning by Banks on January 16, 2023, and on October 4, 2023, a committee was formed which constituted an external working group on Expected Credit Loss (ECL) based Framework for Provisions by Banks. The working group is chaired by R Narayanaswamy, former Professor, IIM Bangalore and includes experts from industry and academia. The panel is expected to come up with recommendations that the Indian Banks should consider while making a transition to ECL based provisioning method.

Under the proposed transition, banks would be seeing a paradigm shift from the current provisioning method based on 'incurred loss' approach to a more proactive 'expected loss' approach. Under the incurred loss approach, the recognition of the credit loss happens much later as compared to ECL approach, wherein the loss is recognised and provided for at an earlier point in time based on forward looking estimates. The delay in making provisions, required the banks, when faced with increased defaults, to make unusually higher provisions which led to reduction in capital base of the banks.

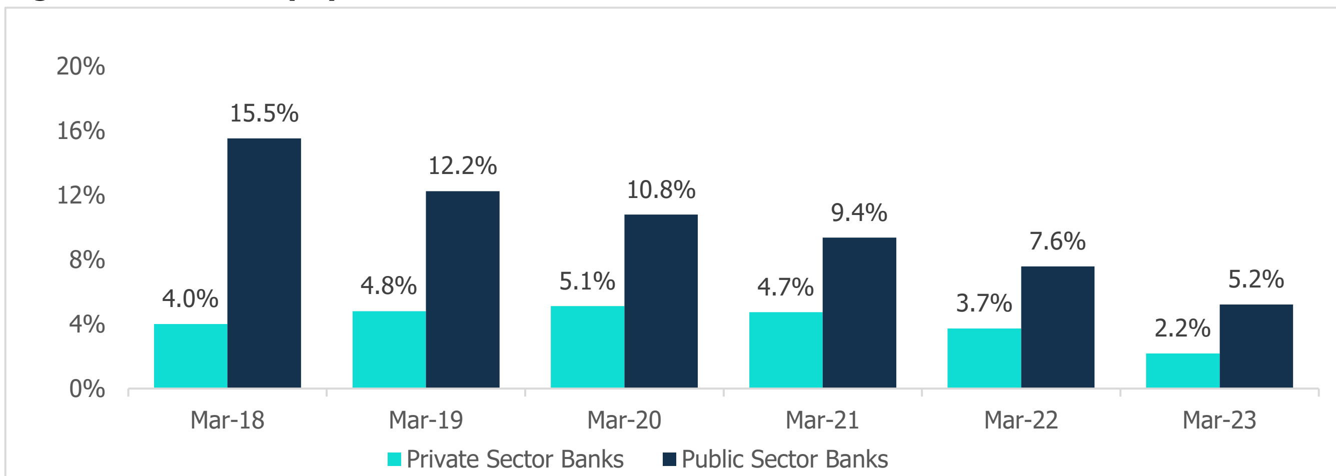
The proposed approach is to formulate principle-based guidelines supplemented by regulatory backstops. Banks would be required to develop their own model for measuring expected credit losses for the purpose of estimating loss provisioning in line with the proposed principles.

Based on the models, banks would be required to categorise their financial assets (including loans and investments) into one of the three categories Stage 1, Stage 2 and Stage 3 depending upon the assessment of credit losses on the assets, at the time of initial recognition and each subsequent reporting date and make provisions accordingly.

Asset Quality of Banks

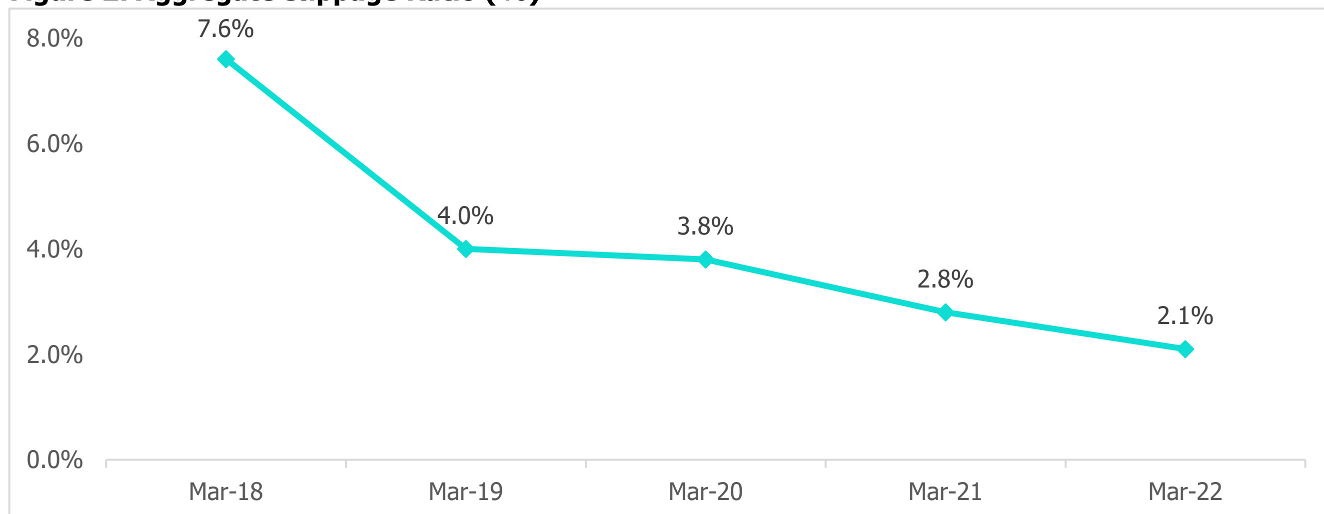
Banks saw a rise in NPAs post the asset quality review (AQR) during 2015-2016, which was largely in the corporate segments. This increased the level of provisioning and write-offs and a general shift of banks towards retail lending. Over the last three years, notwithstanding the stress during the Covid-19 period, the banking system has seen significant improvement in NPA ratios.

Figure 1: Gross NPA (%)



Source: RBI

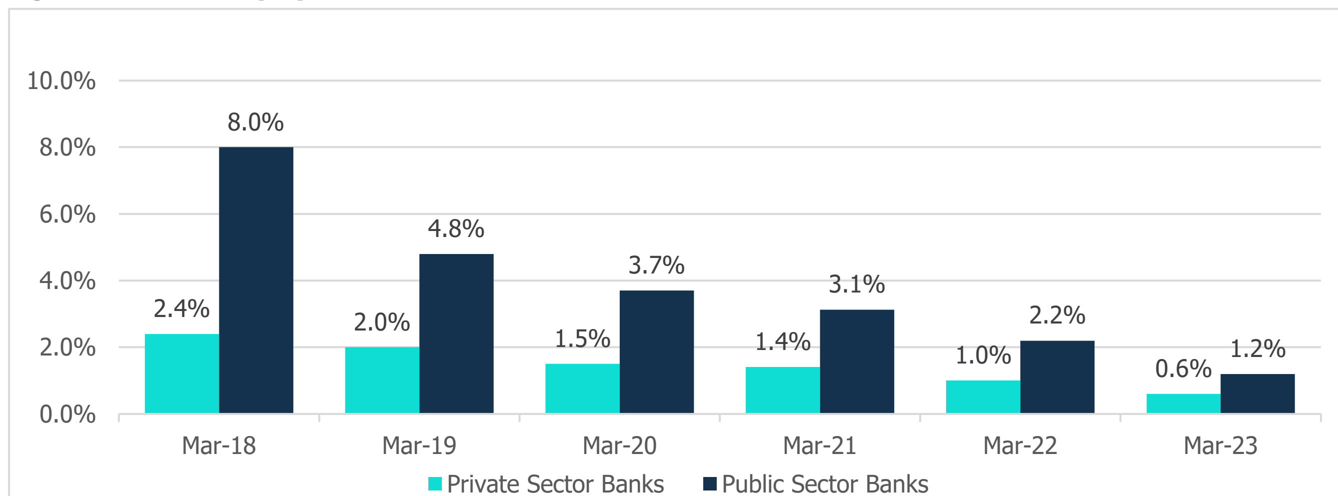
Figure 2: Aggregate Slippage Ratio (%)



Source: RBI's Report on Trend and Progress of Banking in India

The aggregate Gross NPA ratio for the entire sector has declined to 3.76% as on March 31, 2023, from 8.66% as on March 31, 2020, and 11.85% on March 31, 2018. This has been accompanied by a significant reduction in other stressed asset categories such as SMA 0-2 and restructured assets. Notably, most of the NPAs and stressed assets pertained to the corporate loan book. This class of banking assets has seen significant improvement in asset quality even as its proportion in overall banking assets has decreased substantially.

Figure 3: Net NPA (%)



Source: RBI's Report on Trend and Progress of Banking in India

The entire banking sector has been making provisioning resulting in an aggregate provision coverage ratio (PCR) of 76.3% and a Net NPA ratio of 0.95% for the sector as on March 31, 2023.

Capital Position of Banks

Over the last three years, the capitalisation levels of banks have improved due to capital raise and improvement in profitability. Private sector banks raised equity capital in anticipation of expected losses during Covid-19 and were supported with internal accruals while the public sector banks saw infusion by the Government of India (GoI) as well as equity capital raise from capital markets apart from accretion of profits.

Figure 4: Capital Adequacy for PSU Banks

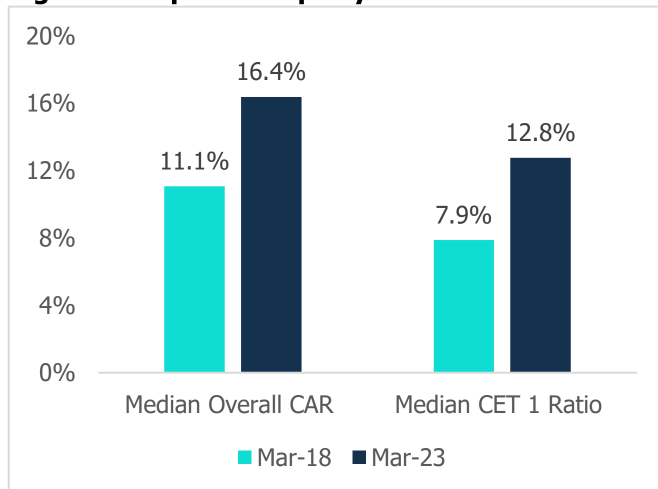
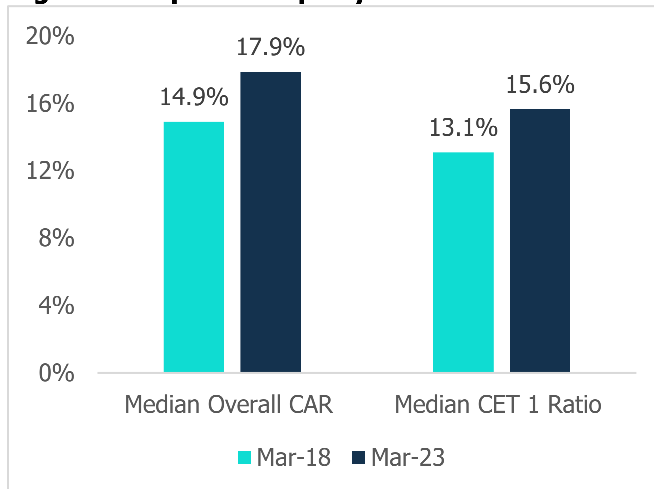


Figure 5: Capital Adequacy for PVT Banks



Source: RBI

The banking sector is in a relatively better position now given the healthy capitalisation levels and significantly improved asset quality and profitability; that would enable the banks to absorb the impact of the implementation of ECL norms better.

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