Expected credit loss analysis for non-banking financial companies

An analysis of published standalone financial statements of NBFCs for the year ended 31 March 2020

EY

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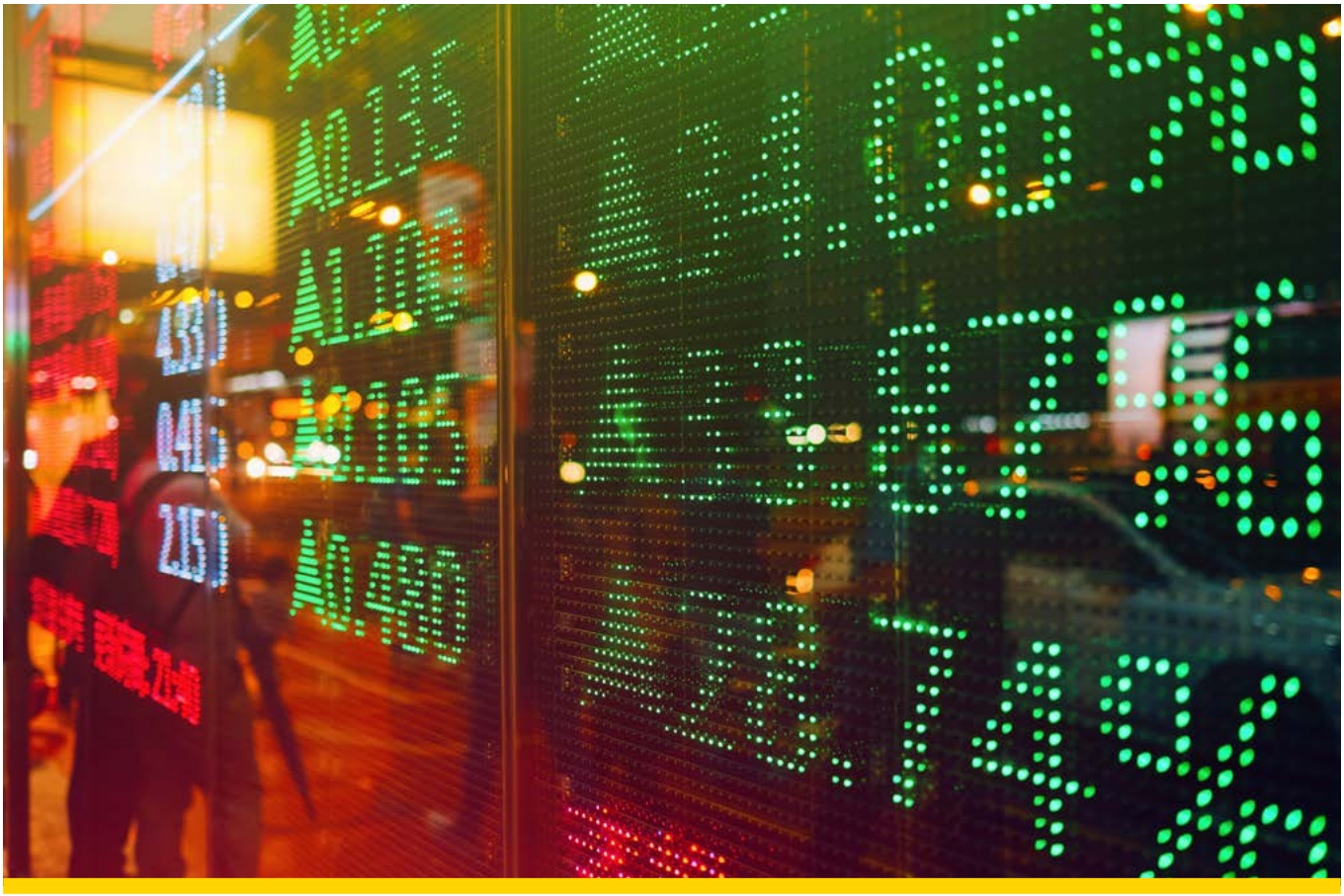
Contents

Overview

In June 2020, EY published an analysis of Ind AS impact for Phase 1 NBFCs based on published standalone financial statements (SFS) for the year ended 31 March 2019. The analysis mainly focused on key GAAP differences, their impact on SFS and challenges faced by NBFCs in the implementation process.

In the analysis, it was found that expected credit loss (ECL) has had one of the major impacts on SFS of NBFCs on transition to Ind AS.

In this publication, we aim to analyze the impact of ECL for NBFCs for the year ended 31 March 2020 and understand how the unprecedented situation of the COVID-19 pandemic has impacted ECL estimates. The Reserve Bank of India (RBI) has deferred the implementation of Ind AS for banks till further notice and hence, the requirements relating to ECL are not applicable to banks.



EY India's Financial Accounting Advisory Services (FAAS) has performed an analysis of the reported SFS of 42 NBFCs (including HFCs) for the year ended 31 March 2020. Our focus was on:

- Change in ECL allowance and expense
- Change in provision coverage ratio
- The magnitude of the COVID-19 impact
- How the impact has been assessed
- Understanding underlying ECL drivers
- Approaches on staging, scenarios, models and overlays

Overview of Ind AS 109 impairment requirements

The impairment requirements apply to debt instruments recorded at amortized cost or at fair value through other comprehensive income, trade receivables, lease receivables, contract assets, loan commitments and financial guarantee contracts that are not measured at fair value through profit or loss.

The guiding principle is to reflect the general pattern of deterioration, or improvement, along with a forward-looking framework in credit quality of financial instruments.

ECL is recognized on loans based on the general approach wherein lifetime ECL is to be recognized if there is a significant increase in credit risk since origination. For assets which have not undergone a significant increase, a 12-month ECL shall be recognized.

Under this general approach, assets are generally classified under three stages based on the evaluation of the following criteria:

- Stage 1 – Loans with low credit risk and where there is no significant increase in credit risk.
- Stage 2 – Loans with significant increase in credit risk.
- Stage 3 – Credit impaired loans.

The standard also provides a rebuttable presumption of 30 days past due (DPD) to assess significant increase in credit risk and also of 90 DPD to assess default. NBFCs can rebut these presumptions when there is reasonable and supportable information available that demonstrates otherwise.

Apart from the above, there are several qualitative and quantitative factors that may be considered by NBFCs to assess whether there is a significant increase in credit risk. Ind AS 109 provides an illustrative list of such factors. Based on our analysis, some of the factors that companies consider are as follows:

- Multiple notches rating downgrade, internal as well as external;
- Borrowers in an industry under stress owing to adverse changes in the business, economy or any other macro-economic parameter;
- Borrowers showing early warning signals and accordingly designated as watchlist accounts;
- Negative operating results, low sales velocity, decline in net-worth or any other significant financial difficulty faced by the borrower;
- Existing or suspected fraud by borrowers;
- Progress of construction of the property and that if it is very slow in the last one year;
- Borrowers filing for bankruptcy;
- Covenant breach not waived by the company.

The assessment of significant increase in credit risk may be done at an individual borrower's level if reasonable and supportable information is available without undue cost or effort. Otherwise, the same can be done at a collective level by segmenting borrowers based on shared credit risk characteristics. Examples of such characteristics may include product type, risk ratings, industry, etc.

As ECL model is a forward-looking framework, NBFCs are required to consider reasonable and supportable information that includes forecasts of future economic conditions including, where relevant, multiple macro-economic scenarios. When incorporating forward-looking information, such as macro-economic forecasts to determine expected credit losses, an entity should consider the relevance of information (and the availability of more relevant information) for each specific financial instrument or group of financial instruments. This is because forward-looking information that is relevant for one financial instrument, may not be relevant, or as relevant, for other financial instruments depending on specific drivers of credit risk.

Key highlights

Overall provision coverage rate: increase by **26%**

ECL allowance: increase by **33%**

ECL allowance on stage 1 and stage 2 assets: increase by **56%**

ECL allowance on stage 3 assets: increase by **25%**

ECL expense: increase by **219%**

Cost of risk ratio: increase by **202%**

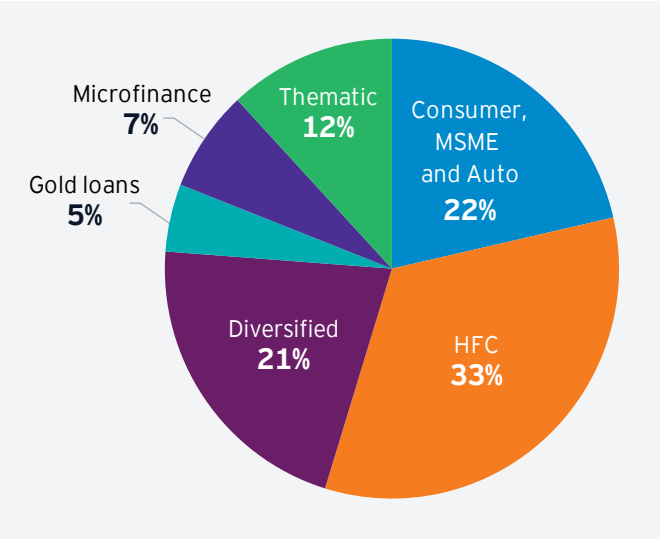
COVID-19 impact as a percent of ECL expense: **32%**

COVID-19 impact as a percent of ECL allowance: **19%**

Study methodology

We have analyzed SFS from the annual reports of 42 NBFCs (28 NBFCs and 14 HFCs) unless specified otherwise. We have excluded core investment and asset management companies from our analysis. We have compared the SFS for the year ended 31 March 2020 with that for the year ended 31 March 2019. The information on the impact of COVID-19 which was not available in SFS, have been sourced from investor presentations available on websites, where available.

We have covered the following categories of NBFCs in our analysis:



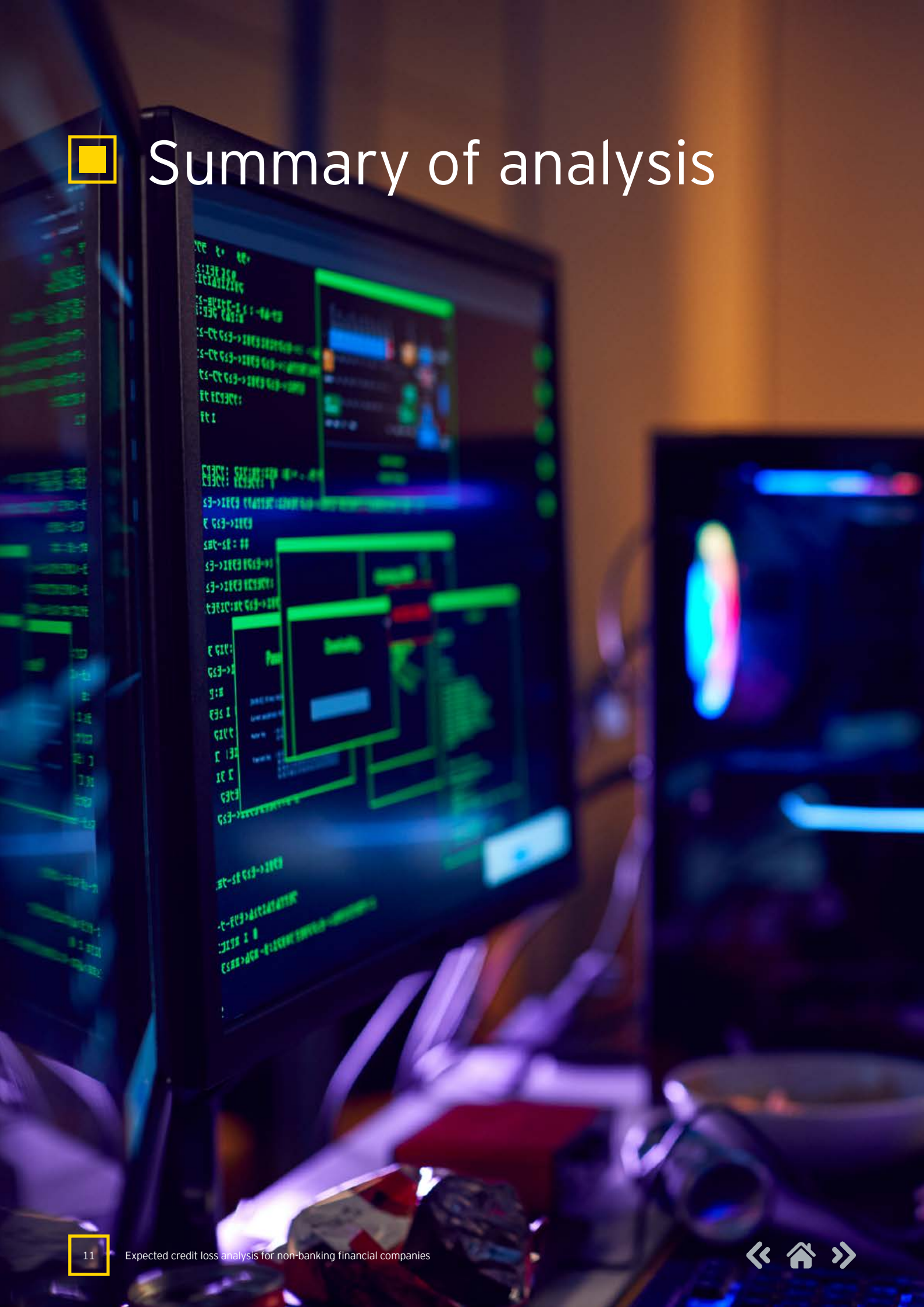
The publication covers an analysis of ECL on loan assets of the company. Gross loans are calculated as a sum of stage-wise gross loans disclosed by NBFCs in the reconciliation of gross carrying amount tables. Stage-wise provision coverage rates are calculated by dividing stage-wise provisions by stage-wise gross loans. The cost of risk ratio is computed by dividing ECL expense by gross loans. Average gross and net NPAs are calculated by dividing gross NPA loans and net NPA loans by total gross loans and total net loans, respectively. Simple averages of all the companies have been calculated and covered in our analysis. ECL expense also includes write-offs.

The impact on ECL on account of COVID-19 has generally been explicitly indicated in SFS/investor presentations. The analysis relating to consideration of macro-economic factors and the approach adopted for estimating the impact of COVID-19 on ECL is based on disclosures provided in annual reports and our interpretation of the disclosure.

It is pertinent to note that EY's analysis solely depends on and is limited by depth and width of transparency and quality of information available in SFS. The analysis relies on the impact of the pandemic as presented by companies in their SFS or any public document pertaining to annual reporting.

This publication has been prepared for general guidance on matters of interest only and does not constitute professional advice. You should not act upon the information contained in this publication without obtaining specific professional advice. This information should not be used or relied for decision-making. Further, certain values and percentages referred to in this publication should be considered as indicative and may change if computed differently and/or on use of different set of assumptions. The analysis done should not be considered as an accounting or legal opinion or any form of assurance on or concurrence with a specific entity's accounting matters, financial statements, any financial or other information or internal controls. EY can accept no responsibility for loss occasioned to any person acting or refraining from action as a result of any material in this publication. You should consult with EY or other professional advisors familiar with your particular situation for advice concerning specific audit, tax or other matters before making any decisions. EY did not conclude on the appropriate accounting treatment based on specific facts or recommend which accounting policy/treatment a specific entity should select or adopt. The views expressed in this publication represent our perspectives as of November 2020. We may identify additional issues as we analyze the standard and entities continue to interpret these standards, and our views may evolve during that process. We expect to periodically update our guidance to provide the latest implementation insights.

Summary of analysis

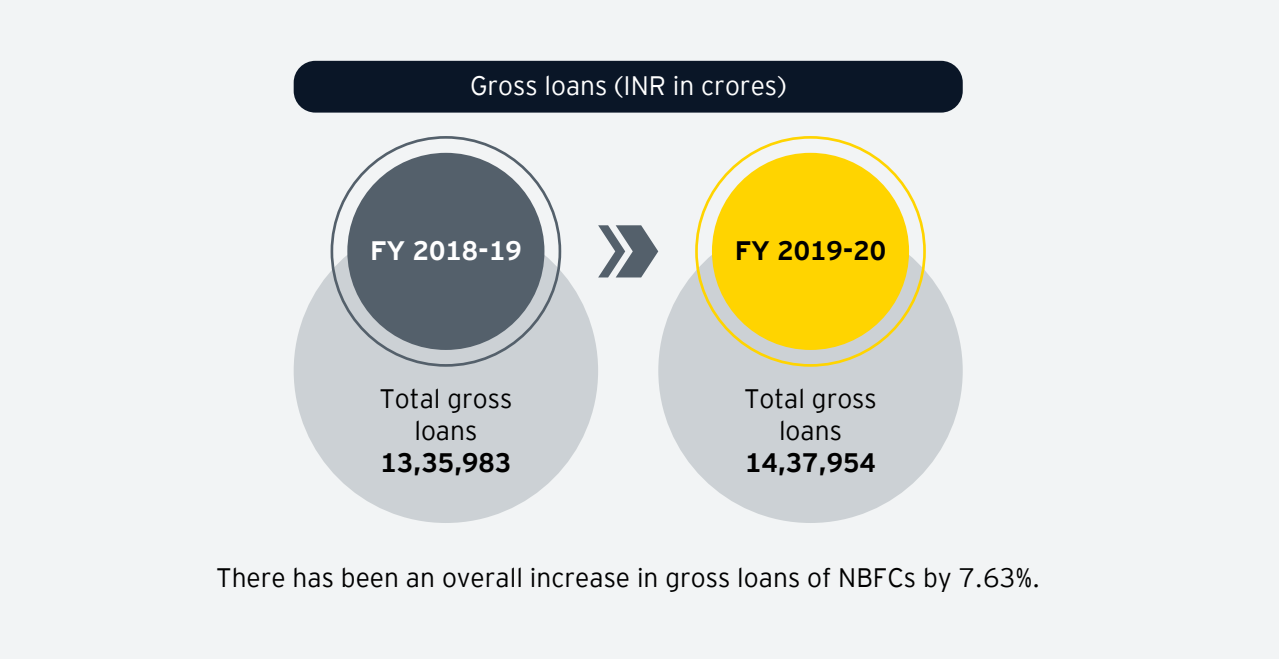


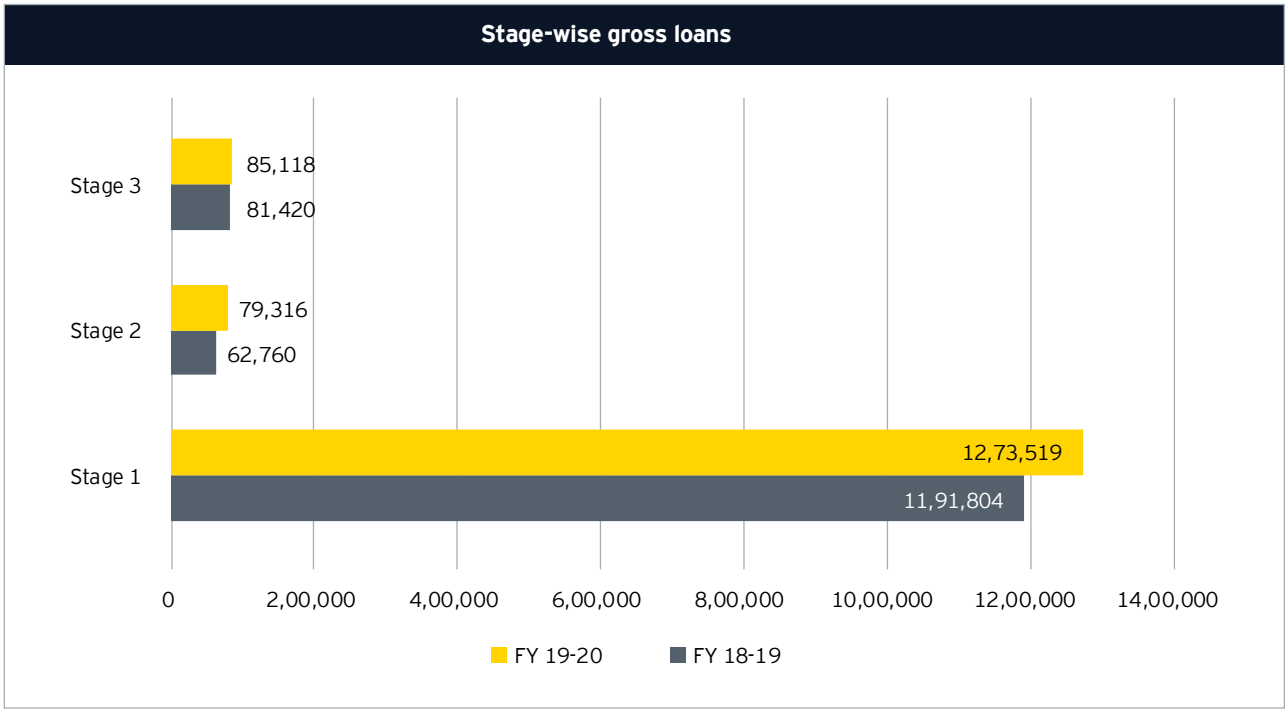
We have analyzed SFS of 42 companies which include 28 NBFCs and 14 HFCs. SFS of NBFCs and HFCs have been analyzed separately.

Impact for the year ended 31 March 2020

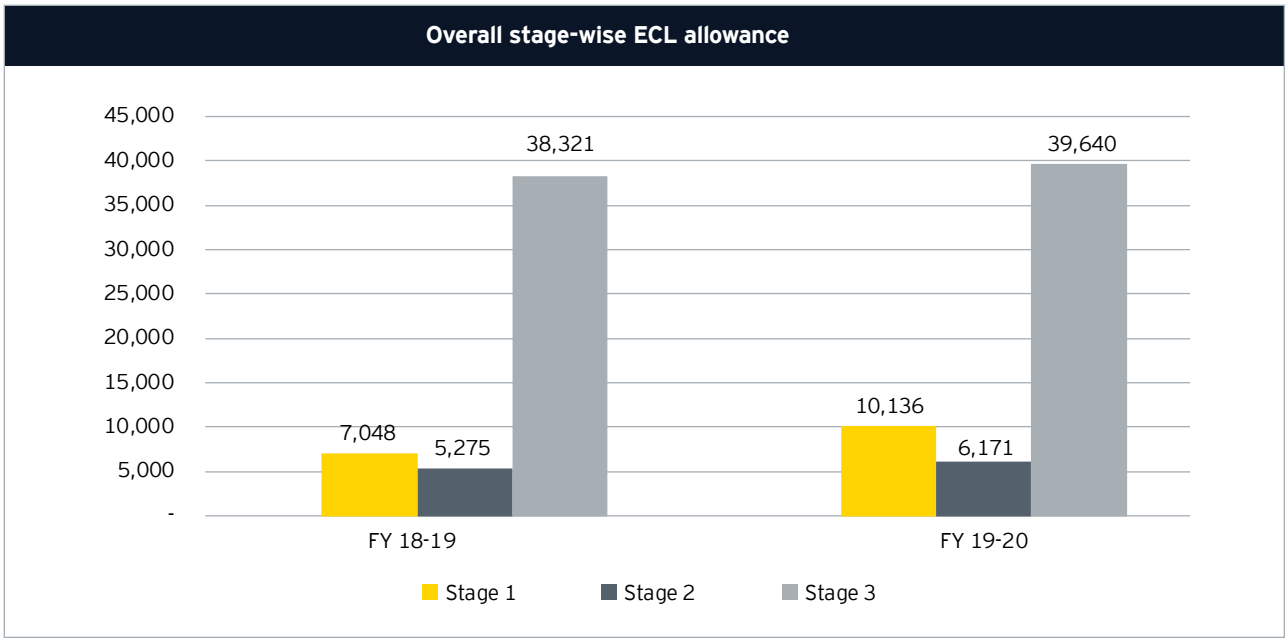
1 Overall change in gross loans, ECL allowance and ECL expense

NBFCs





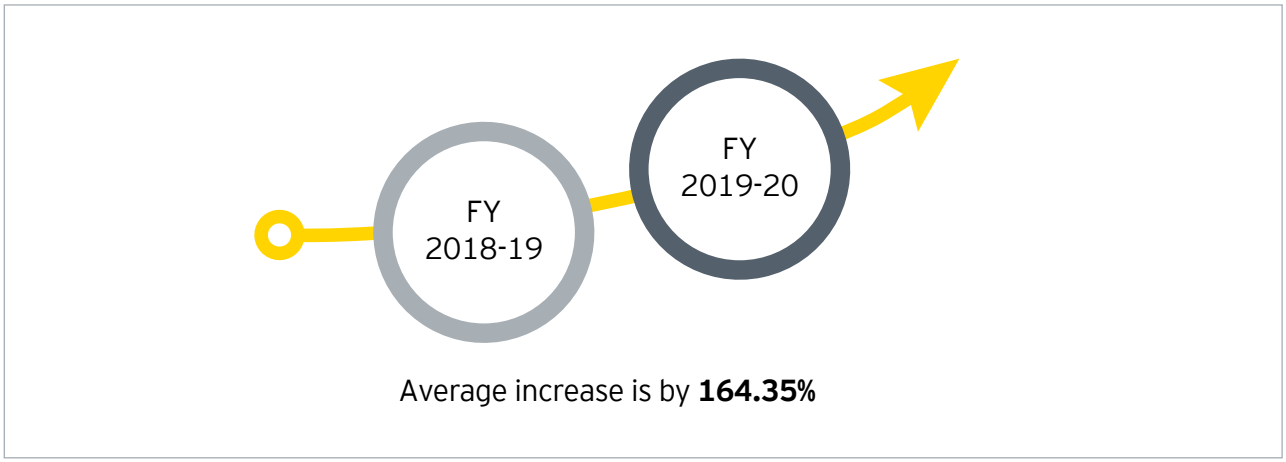
Comparison of ECL allowance between FY 2018-19 and FY 2019-20 (including stage split)



An average overall increase in ECL allowance is by 10.61%.

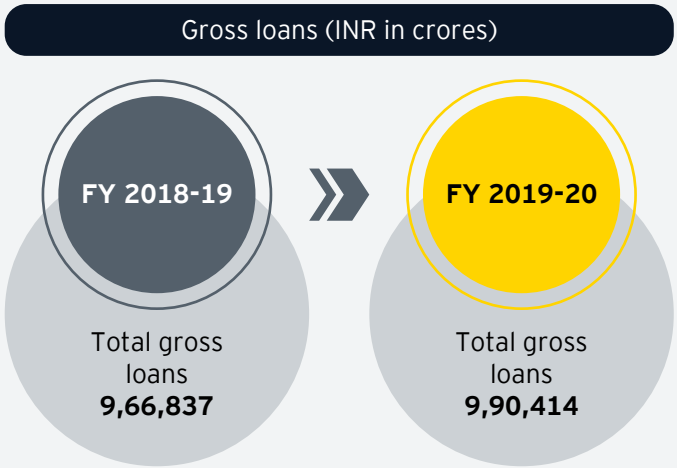
An average increase in ECL allowance of NBFCs in Stage 1 accounts is by 43.82%, Stage 2 accounts is by 16.99% and in Stage 3 accounts is by 3.44%.

ECL Expense:

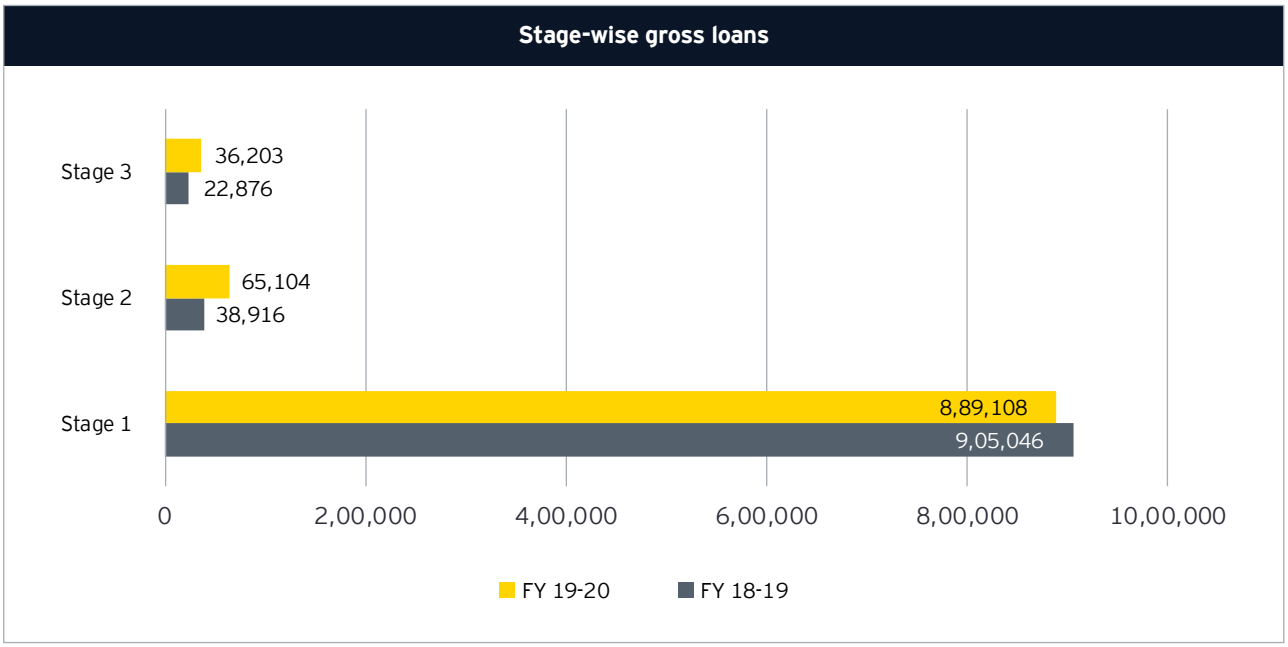


- For accounts where moratorium has been granted, it appears that many companies have frozen DPD status which has not triggered a Stage 2 or Stage 3 transfer. Consequently, it appears that an additional ECL allowance has been recognized by way of management overlay to mitigate the future impact on ECL due to expected deterioration of the portfolio once the moratorium is over.
- The increase in ECL allowance seems to be largely attributable to the impact of COVID-19 and other macro-economic factors.
- The increase in ECL expense appears to be largely on account of additional provision for COVID-19 and write-offs.

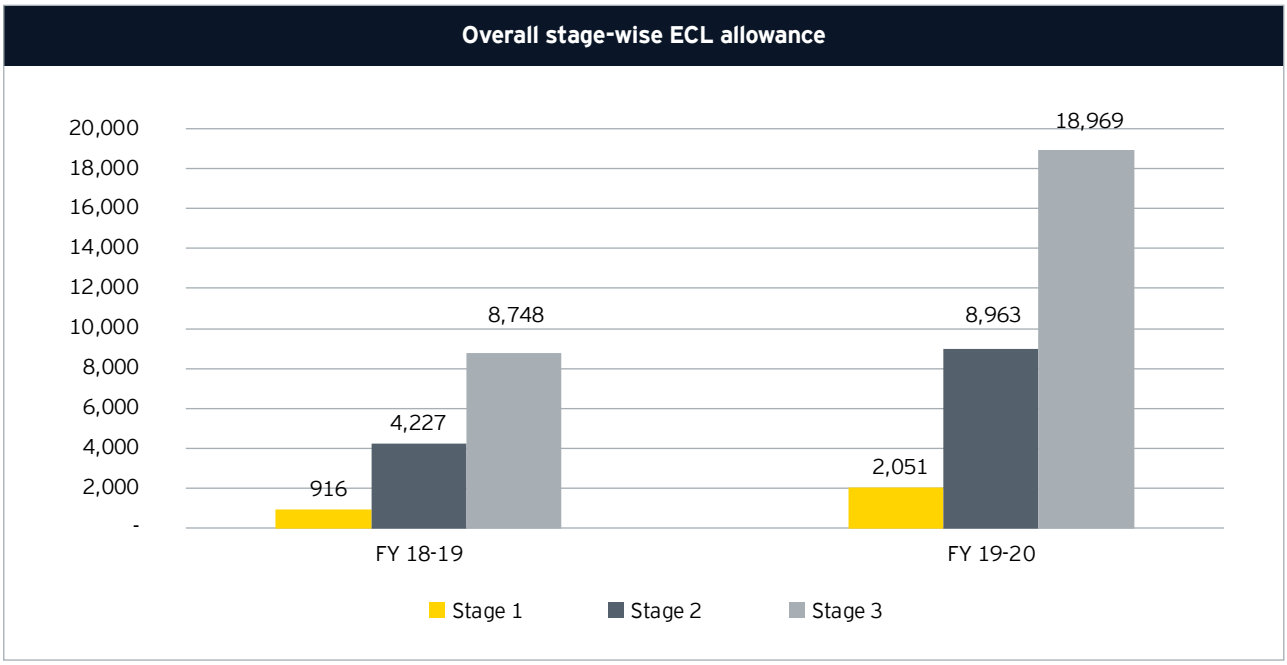
HFCs



An overall increase in gross loans of HFCs is by 2.44%.



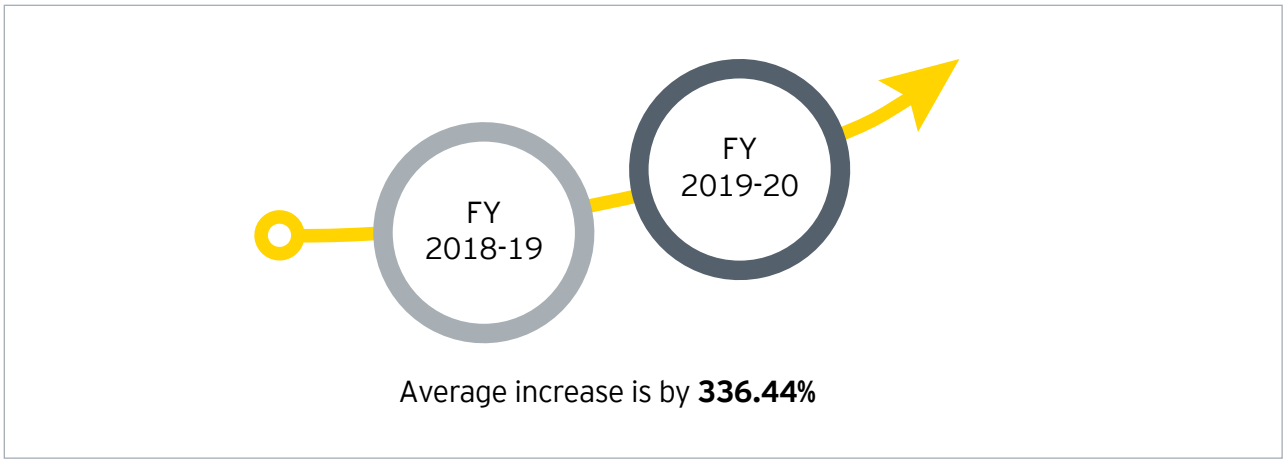
A comparison of ECL allowance between FY 2018-19 and FY 2019-20 (including stage split)



An average overall increase in ECL allowance is by 116.17%.

An average increase in ECL allowance of HFCs in Stage 1 accounts is by 123.87%, in Stage 2 is by 112.01% and Stage 3 accounts is by 116.84%.

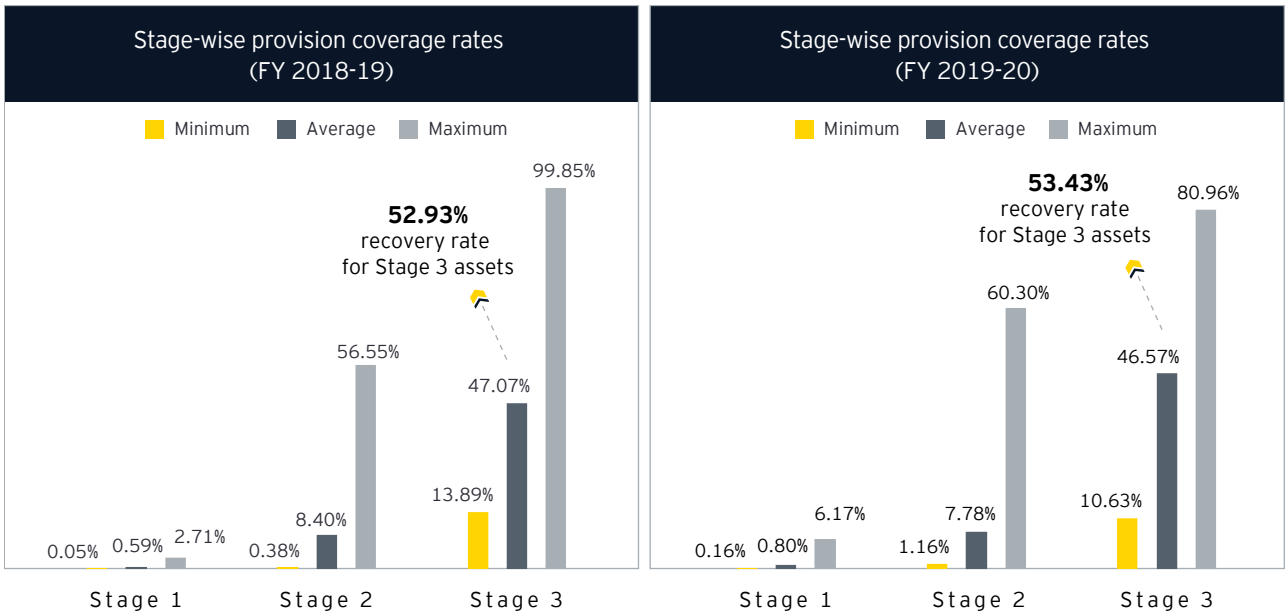
ECL Expense:



- It appears that an additional provision has been made on account of COVID-19. There has also been deterioration in asset quality which has led to an increase in Stage 2 and Stage 3 gross loans. Four HFCs have contributed more than 85% to increase Stage 2 and Stage 3 loans. Consequently, there is an overall increase in ECL allowance and ECL expense.

2 Overview of stage-wise provision coverage

NBFCs



The overall provision coverage rate for NBFCs has increased marginally from 3.79% in FY 18-19 to 3.90% in FY 19-20.

Out of 28 NBFCs

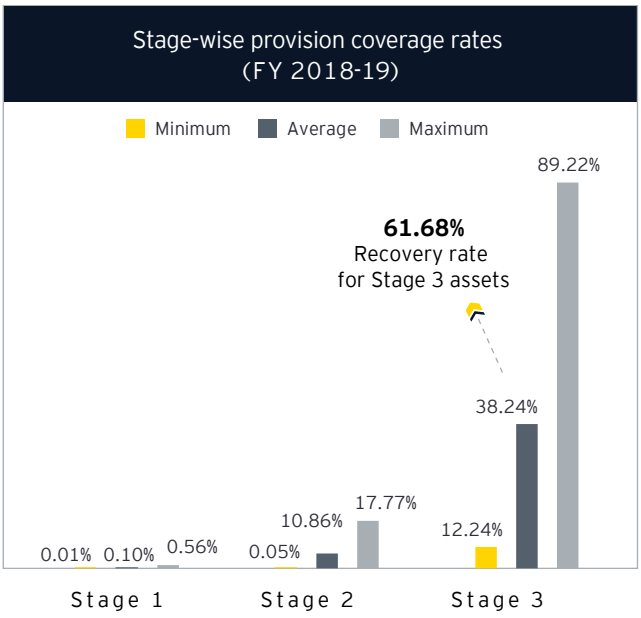
20 Increase in provision coverage rate

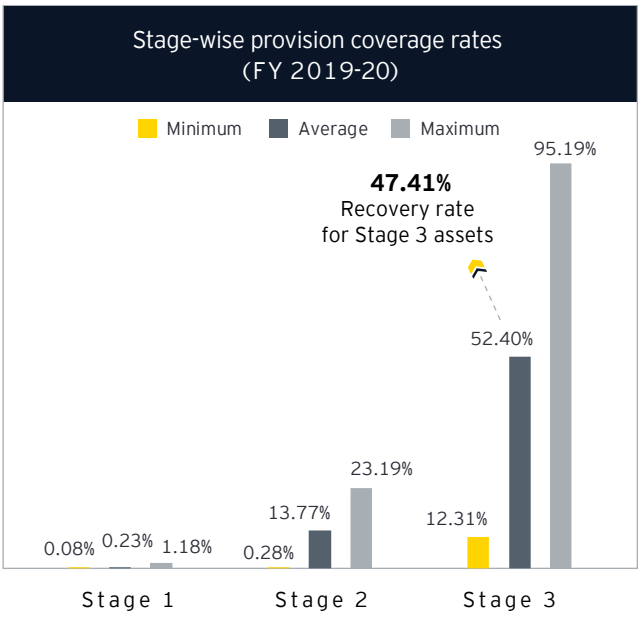
8 Decrease in provision coverage rate

Out of the 20 NBFCs where an increase in provision coverage rate has been witnessed, six of them have reported the increase of more than 100%.

- While provision coverage rates in majority of NBFCs have increased, the same has been compensated by a decrease in others.
- More specifically, the increase in the provision coverage rate has been witnessed primarily in consumer, MSME, auto finance and micro-finance companies, whereas the decrease has been witnessed primarily in case of infrastructure finance companies.
- However, the overall marginal decline in the provision coverage ratio on Stage 3 assets may be attributable to a significant increase in write-offs.

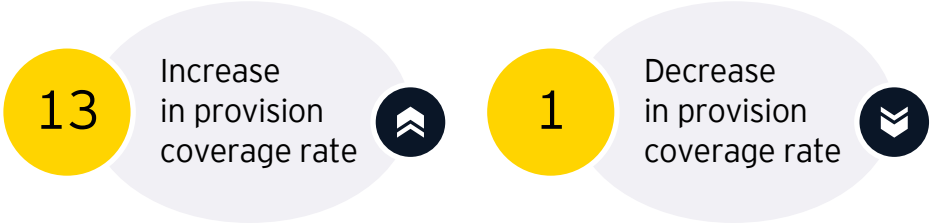
HFCs





Overall provision coverage rate for HFCs has increased from 1.44% in FY 18-19 to 3.03% in FY 19-20.

Out of 14 HFCs

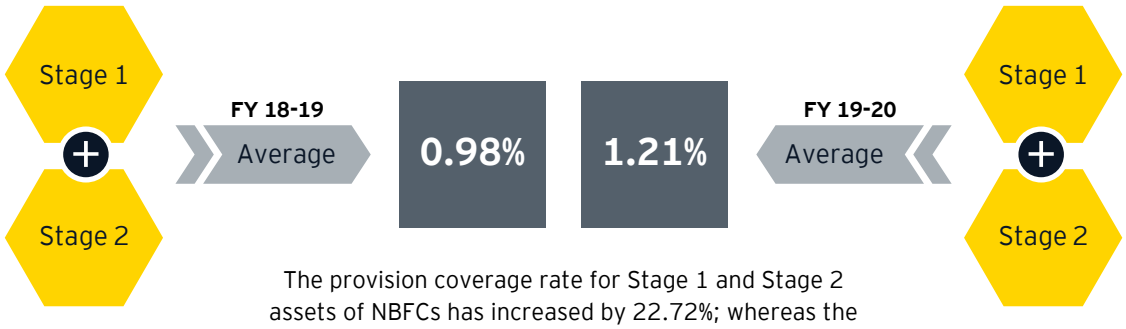


Out of the 13 HFCs where an increase has been witnessed, three of them reported the increase of more than 300%.

- As cited above, there is a significant increase in provision coverage rate of Stage 2 and Stage 3 assets which can be attributable to deterioration in asset quality in few specific HFCs. However, it is not apparent from their financials whether such increase is attributable to corporate lending or retail lending.
- The increase could also be due to estimated decline in the value of collaterals, given the impact of COVID-19 on the real estate sector.

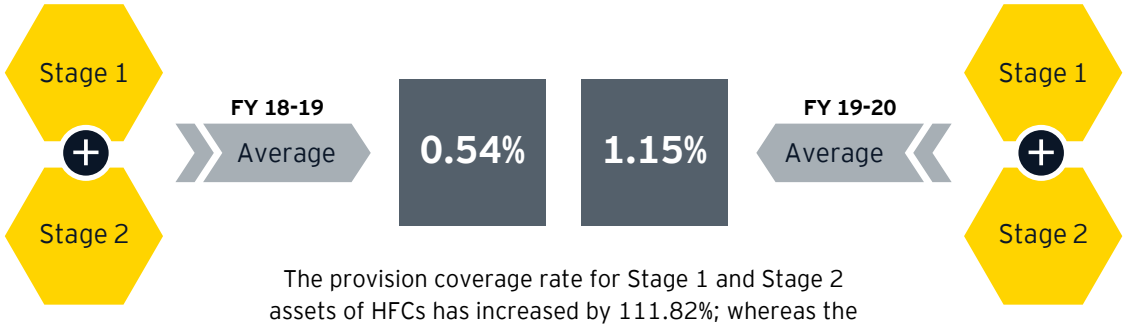
3 Provision coverage rate for Stage 1 and Stage 2 assets

Provision coverage rate for Stage 1 and Stage 2 assets (NBFCs)



The provision coverage rate for Stage 1 and Stage 2 assets of NBFCs has increased by 22.72%; whereas the same for Stage 1 assets has increased by 34.59%.

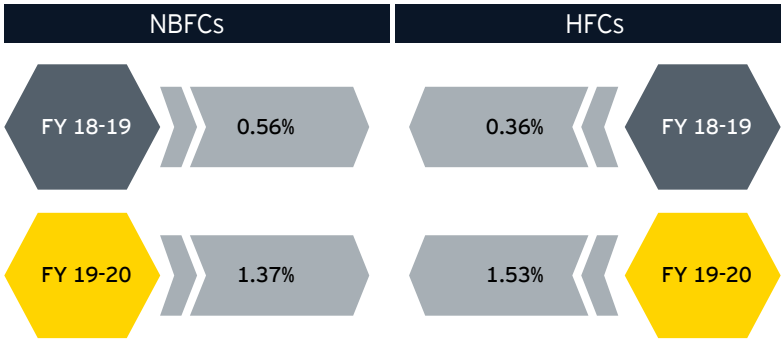
Provision coverage rate for Stage 1 and Stage 2 assets (HFCs)



The provision coverage rate for Stage 1 and Stage 2 assets of HFCs has increased by 111.82%; whereas the same for Stage 1 assets has increased by 127.88%.

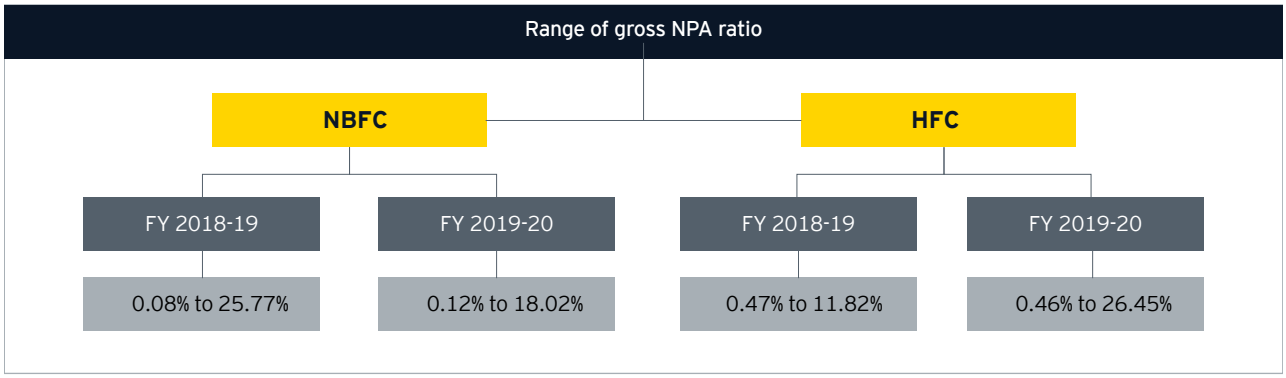
Calculating the coverage ratio for Stage 1 and Stage 2 loans can provide an indicator of the overall ECL approach adopted by NBFCs on their 'good book'. Overall, there is an increase in the provision coverage ratio for Stage 1 and Stage 2 loans. One reason for this increase could be on account of additional ECL allowance on such loans on account of uncertainties due to the pandemic and the macro-economic environment. This could be even in cases where companies have applied DPD freezing. However, as per ICAI COVID-19 FAQs on Ind AS dated 6 May 2020, it is to be noted that granting of moratorium by itself should not be considered as a trigger for significant increase in credit risk.

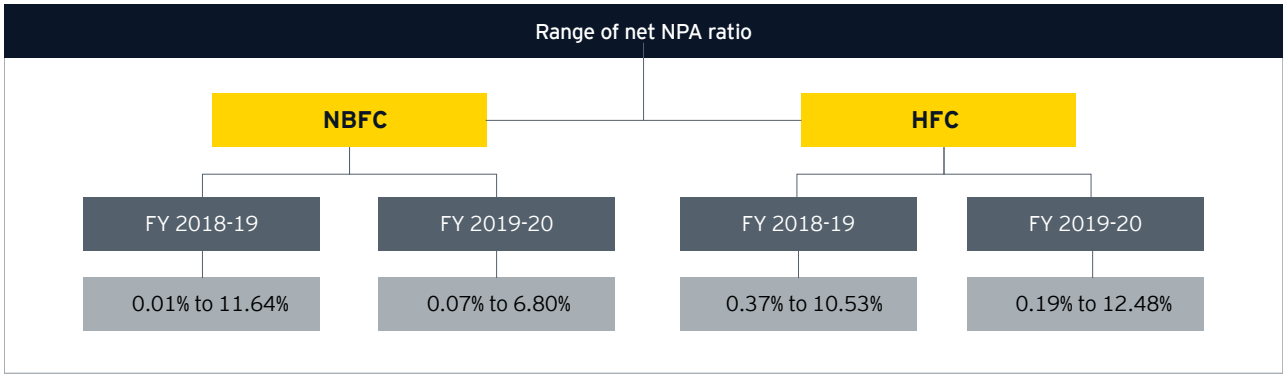
4 Cost of risk ratio



A helpful way to analyze the impact of ECL year-on-year is through the lens of the cost of risk ratio. This is more relevant in FY 2019-20 as various companies considered the impact of COVID-19 on ECL. The cost of risk ratio is typically high for companies who have front loaded the credit losses expected to arise due to the pandemic.

5 Range of gross and net NPA ratio





The above figures are derived from gross loans and provision for stage 3 assets available in the annual report.

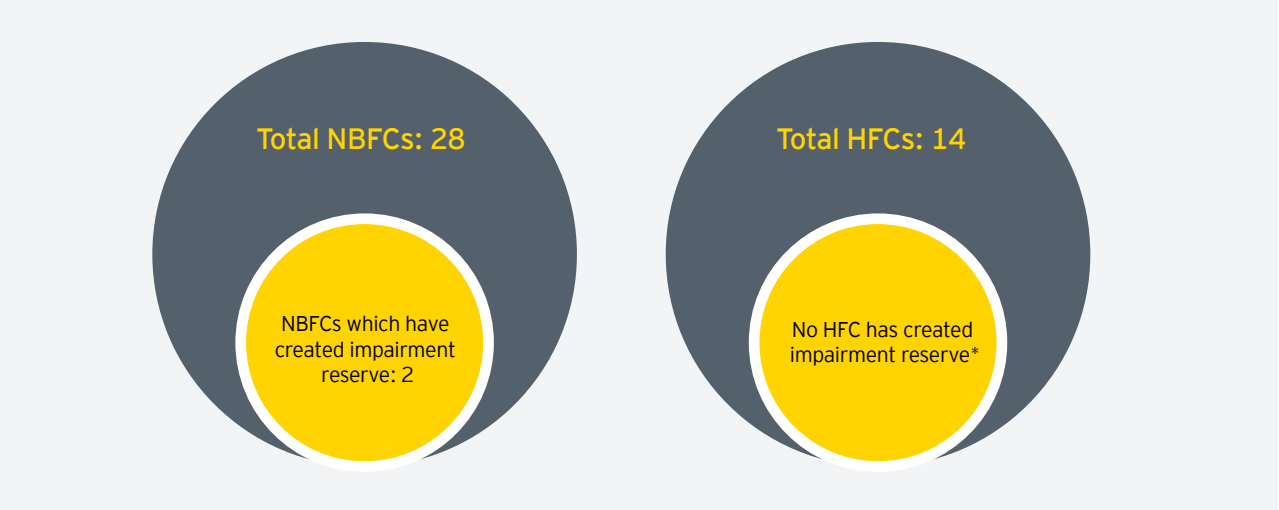
On an average, the gross NPA% for NBFCs is 6.09% in FY 2018-19 and 5.92% in FY 2019-20; whereas for HFCs, the same is 2.37% in FY 2018-19 and 3.66% in FY 2019-20.

Similarly, on an average, the net NPA% for NBFCs is 3.32% in FY 2018-19 and 3.25% in FY 2019-20; whereas for HFCs, the same is 1.47% in FY 2018-19 and 1.77% in FY 2019-20.

- There has been a marginal decline in gross and net NPA for NBFC. It seems to be because of stage freezing due to the moratorium provided to the borrowers. However, there has been an increase in gross and net NPAs in 27 companies out of 42.
- Further, the decline could also be attributed to an increase in write-off to a certain extent.

6 Impairment reserve

The Reserve Bank of India (RBI) issued a notification on 13 March 2020 stating that NBFCs should simultaneously maintain asset classification and compute provisions as per extant prudential norms on income recognition, asset classification and provisioning (IRACP), including borrower-/beneficiary-wise classification, provisioning for standard and restructured assets, and NPA ageing. In case where impairment allowance under Ind AS 109 is lower than the provisions required as per IRACP, the difference should be appropriated from net profit or loss after tax to a separate 'impairment reserve'. The balance in the 'impairment reserve' shall not be reckoned for regulatory capital. Further, no withdrawals shall be permitted from this reserve without prior permission from the Department of Supervision, RBI. The requirement for 'impairment reserve' shall be reviewed, going forward. A comparison, as per the prescribed template between provisions required under IRACP and impairment allowances made under Ind AS 109 should be disclosed by NBFCs in notes to their financial statements to provide a benchmark to their Board of Directors, RBI supervisors and other stakeholders, on adequacy of provisioning for credit losses.



*As can be seen from the above, no HFCs have created impairment reserve. This could be because the circular which included the above requirement for HFCs was issued by the RBI on 22 October 2020.

As can be noted, almost all the companies have recognized higher impairment allowance compared to the provisions required under IRACP.

7 Macro-economic factors

Ind AS 109 requires an entity to measure expected credit losses of a financial instrument in a way that reflects:

a. an unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes;

b. the time value of money; and

c. reasonable and supportable information that is available without undue cost or effort at the reporting date about past events, current conditions and forecast of future economic conditions.

Further, it also states that an entity shall adjust historical data, such as credit loss experience, on the basis of current observable data to reflect the effects of the same on current conditions and their forecasts on future conditions that did not affect the period on which the historical data is based.

Accordingly, to consider the impact of forward-looking information, NBFCs analyze co-relation of a wide range of factors with their default patterns and shortlist the factors that are relevant to their respective businesses. ECL estimates are then adjusted to consider the impact of these short-listed factors.

The list of macro-economic factors considered for ECL computation could be ascertained from SFS of ten NBFCs and three HFCs. Following is the list of macro-economic factors considered by them:

Macro-economic factors considered by various categories of NBFCs

As depicted above, GDP and unemployment rate were the most common macro-economic factors that were considered by the companies while evaluating the impact on their ECL computation. Further, many companies also considered inflation and interest rates. However, it is to be noted that while companies may have analyzed various macro-economic factors that could have an impact on the ECL, it may not be necessary that all the macro-economic factors would have a direct co-relation with the ECL.

COVID-19 specific impact

1 Approach adopted for computing COVID-19 impact

NBFCs have applied various approaches to estimate the impact of COVID-19 on ECL. This includes use of management overlays.

NBFCs

No. of NBFCs*	Type of approach adopted in deriving impact of COVID-19 on ECL
2	Higher probabilities applied to downside scenarios
2	Considered downside scenario, i.e., 100% probability to downside scenario
5	Change in model through stressing base case scenario, change in weights assigned to scenarios, applying PD applicable to rating which is a notch below the actual rating, etc.
1	Borrower-wise scenario analysis by estimating future cashflows based on factors like collateral, industry, LTV, tenure of the loan, etc.
4	Management overlay due to loss-given-default based on stress in collateral valuation
1	Management overlay on PD based on factors like analysis of the impact of significant economic events on the past PDs, actual observed change in tele-calling of borrowers, etc.
8	Management overlay based on factors like early warning indicators, delayed payments, deterioration in macro-economic factors, etc.
3	Management overlay on PD (no rationale or underlying factors have been disclosed)
2	Management overlay (no rationale or specific underlying factors have been disclosed)

*For six NBFCs, the approach for computation of COVID-19 impact could not be ascertained from SFS/investor presentations.

And one NBFC, has reported additional provision required as per RBI circular dated 17 April 2020 relating to COVID-19 regulatory package – asset classification and provisioning as COVID-19 impact.

HFCs

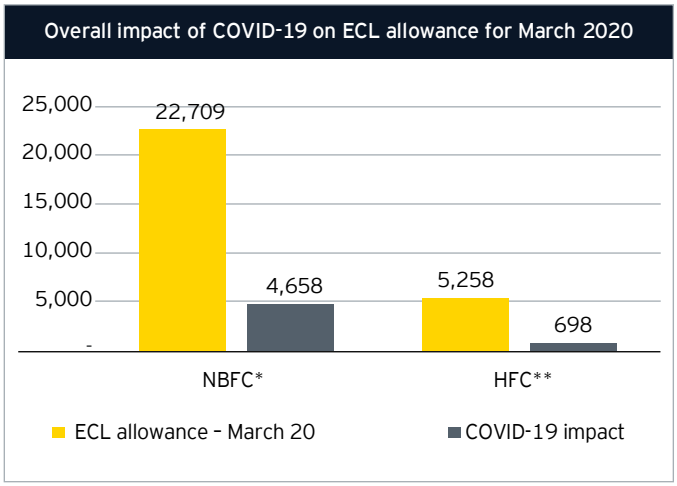
No. of HFCs*	Type of approach adopted in deriving the impact of COVID-19 on ECL
1	Considered downside scenario, i.e., 100% probability to downside scenario
2	Change in model through additional scenarios considering the impact of COVID-19 have been considered by assigning suitable weights.
1	Borrower-wise scenario analysis by estimating future cashflows based on factors like sale velocity, repayment track record, location advantage, project completion stage, etc.
2	Management overlay on loss-given-default based on stress in collateral valuation, under-construction properties, expected delay in sale of collateral, etc.
2	Management overlay on PD based on factors like identifying highly impacted borrowers, comparison of pre- and post-financial crisis (2008) PD, etc.
3	Management overlay based on factors like stress in specific sectors, comparison of outstanding exposure with third-party collateral valuation reports, internal as well as external sources of information like economic forecasts, industry reports, etc.
1	Management overlay (no rationale or specific underlying factors have been disclosed)

* For four HFCs, the approach for computation of the impact of COVID-19 could not be ascertained from SFS/investor presentation.

And one HFC has reported additional provision required as per RBI circular dated 17 April 2020 as COVID-19 impact.

The assessment of the impact of the COVID-19 outbreak on ECL involved significant judgement specifically because it is not directly comparable with any recent similar events. Different companies have applied different approaches to determine the impact of forward-looking factors while estimating ECL. Majority of them have applied a management overlay approach to embed the expected impact that is not fully captured by their ECL models.

2 COVID-19 impact on ECL allowance



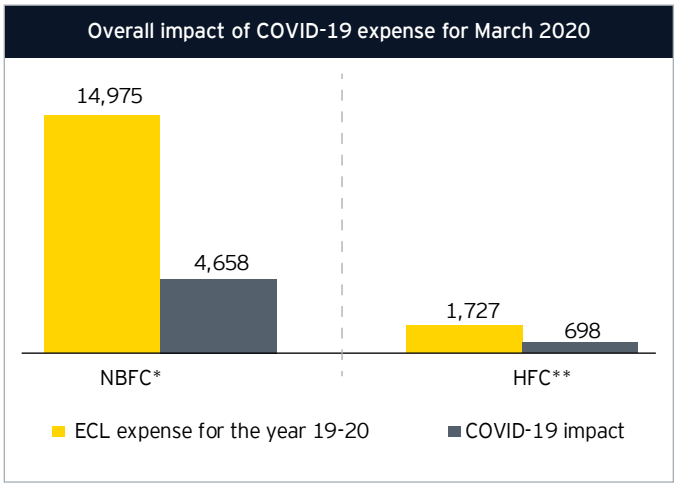
On an overall basis, out of the total ECL allowance as at 31 March 2020, 20.51% is on account of COVID-19 for NBFCs* and the same for HFCs** is 13.28%.

The proportion of COVID-19 impact as compared to ECL allowance for the year ended 31 March 2020 ranges from 8% to 75% for NBFCs and for HFCs the same ranges from 3% to 39%.

*For ten NBFCs, the quantification for COVID-19 impact was not explicit/could not be ascertained from SFS/ investor presentations.

**For seven HFCs, the quantification for COVID-19 impact was not explicit/could not be ascertained from SFS/ investor presentations.

3 COVID-19 impact on ECL expense



On an overall basis, out of the total charge to profit and loss statement for the FY 2019-20, 31.11% is due to COVID-19 for NBFCs and 39.50% for HFCs.

The proportion of COVID-19 impact as compared to ECL expense for the year ended 31 March 2020 ranges from 9%-91% for NBFCs* and 29%-66% for HFCs.

*For ten NBFCs, the quantification for COVID-19 impact was not explicit/could not be ascertained from SFS/ investor presentations.

**For seven HFCs, the quantification for COVID-19 impact was not explicit/could not be ascertained from SFS/ investor presentations.

4 Impact of moratorium on staging

Due to extension of moratorium to the borrowers, many companies have extended the asset classification benefits to their borrowers by rebuttal of the DPD presumption as per Ind AS 109.

We have observed that policies for computation of DPD for the purpose of staging under Ind AS are not explicitly/ clearly disclosed by eight companies (three HFCs and five NBFCs). Rest all the companies have excluded the moratorium period from computation of days past due as indicated by the staging policy. As a result, staging has been determined by freezing the DPD status of the borrowers at the beginning of the moratorium period.

Way forward

While businesses across various parts of the country are resuming their operations gradually with some visibility of the pandemic situation, they are still facing challenges due to the change in the macro-economic environment.

As NBFCs gear up for financial results for the coming quarters as well as the year end, they will have to consider the impact of these challenges on the economy, additional insights on the economic impact of the pandemic and several regulatory developments as a part of stimulus packages provided by the government. ECL estimates may have to be revised in the wake of these developments. Also, given the inherent level of uncertainty and sensitivity of judgements and estimates, disclosures of the key assumptions used, and judgements made in estimating ECL are particularly important.

Let us look at some of the factors which would require consideration in the estimation of ECL going forward:

- **Stage 2/ 3 transfers post moratorium period –** Post moratorium period staging will be based on actual days past due status. Hence, companies are likely to see an increase in Stage 2 and Stage 3 exposure due to defaults by borrowers severely impacted by COVID-19.
- **Payment behavior of borrowers post completion of moratorium –** Companies may have to consider this in staging the borrowers as a qualitative input. They may also have to strengthen the early warning signal framework to assess the increase in credit risk. For instance, if there is a consecutive delay in payment by any borrower, this may be an indicator of increase in credit risk of the borrower.
- **Government support measures –** For borrowers facing financial stress on account of the COVID-19 pandemic, the RBI has provided a resolution framework, vide its circular dated 6 August 2020, to the lenders which can be implemented for certain borrowers. Companies will have to consider the implications of restructuring done as per the provisions of the circular on their estimate of ECL.
- **Changes in macroeconomic scenarios and assumptions –** Due to significant impact on the macro-economic environment, many agencies have forecasted further fall in GDP and deterioration of other factors like unemployment rate in the coming financial year. Companies will have to consider these changes in computation of forward-looking PD.

As per RBI's circular dated 13 March 2020, the regulator expects the Board of Directors to approve sound methodologies for computation of ECL that address policies, procedures and controls for assessing and measuring credit risk on all lending exposures, commensurate with the size, complexity and risk profile specific to the company. The parameters and assumptions considered as well as their sensitivity to the ECL output should be documented.

While NBFCs are struggling to predict and manage credit risk amidst the pandemic, it has become imperative for them to have a strong risk management framework. Some of the factors that NBFCs may consider in risk management are:

- **Assessment of creditworthiness of the borrower -** This assessment may be conducted at borrower level or through segmentation of borrowers based on factors like industry and product characteristics such as security type, customer demographics like salaried/self-employed, etc. The type of assessment will vary for corporate and retail customers. NBFCs can also develop early warning indicators and leverage upon them for timely identification of credit risk.
- **Mitigation of credit risk -** NBFCs need to review appropriateness of value of collaterals on a regular basis which can help them in mitigating credit risks. For instance, no active market for security may have adverse impact on share-backed lending portfolios. Similarly, falling demand for real estate could impact the commercial or residential real estate lending portfolios.
- **Regular back-testing -** In order to reduce the differences between an entity's estimates and actual credit loss experience, the estimates of ECL should be back-tested and re-calibrated. Entities should regularly review their inputs, assumptions, methodology and estimation techniques used for calculation of ECL.

Hence, it is time for companies to have a strong focus on risk management backed by data and analytics.

List of Abbreviations

CPI	Consumer Price Index
DPD	days past due
ECL	expected credit loss
FAAS	Financial Accounting Advisory Services
GAAP	Generally Accepted Accounting Principles
GDP	Gross Domestic Product
HFC	Housing Finance Company
HPI	Housing Price Index
IRACP	Income Recognition, Asset Classification and Provisioning
LGD	loss given default
LTV	loan to value
MSME	Micro, Small and Medium Enterprises
NBFC	Non-banking Financial Company
PFCE	Private final consumption expenditure
PD	probability of default
RBI	Reserve Bank of India
SFS	standalone financial statements

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