Unfolding the impact of ECL for Non-banking financial companies

An analysis of published standalone financial statements of NBFCs for the year ended 31 March 2021

March 2022

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Overview

Overview

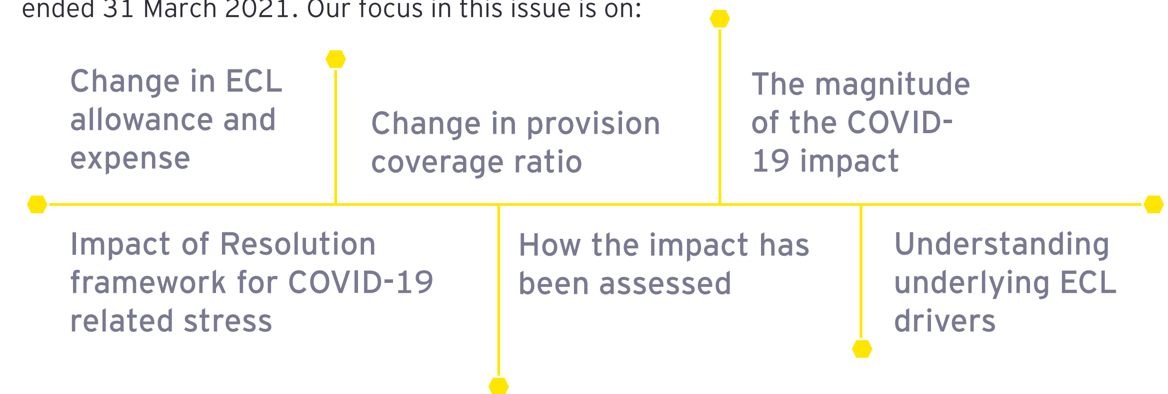
In December 2020, we had published an analysis on "Expected credit loss analysis for non-banking financial companies". This publication had mainly focused on the impact of ECL for NBFCs for the year ended 31 March 2020 and how the unprecedented situation of the COVID-19 pandemic impacted ECL estimates.

In the current publication, we aim to analyse the impact of ECL for NBFCs for the year ended 31 March 2021 and understand how the companies have performed during the COVID-19 pandemic.

The ECL methodology, approach and assumptions have evolved significantly during this period to ensure a more prudent provisioning with an intent to absorb any future losses due to uncertainty around any visibility on the end of this pandemic.

During the year ended 31 March 2021 and subsequently in May 2021, the RBI announced several relief measures as part of calibrated strategy to minimize the impact of COVID-19 on various businesses.

EY India's Financial Accounting Advisory Services (FAAS) team has performed an analysis of the reported Standalone Financial Statements (SFS) of 40 NBFCs (including HFCs) for the year ended 31 March 2021. Our focus in this issue is on:



Overview of Ind AS 109 impairment requirements

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 a 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:

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

The standard defines credit loss as the difference between all contractual cash flows that are due to an entity in accordance with the contract and all cash flows that the entity expects to receive (i.e., all cash shortfalls), discounted at the original EIR (or credit-adjusted EIR for purchased or originated credit-impaired financial assets). When estimating cash flows, an entity is required to consider:

All contractual terms of the financial instrument (including prepayment, extension, call, and similar options) over the expected life of the financial instrument. The maximum period to consider when measuring ECLs is the maximum contractual period (including extension options at the discretion of the borrower) over which the entity is exposed to credit risk (with an exception for revolving facilities)

Cash flows from the sale of collateral held or other credit enhancements that are integral to the contractual terms

Also, the standard goes on to define ECLs as 'the weighted average of credit losses with the respective risks of a default occurring as the weights.

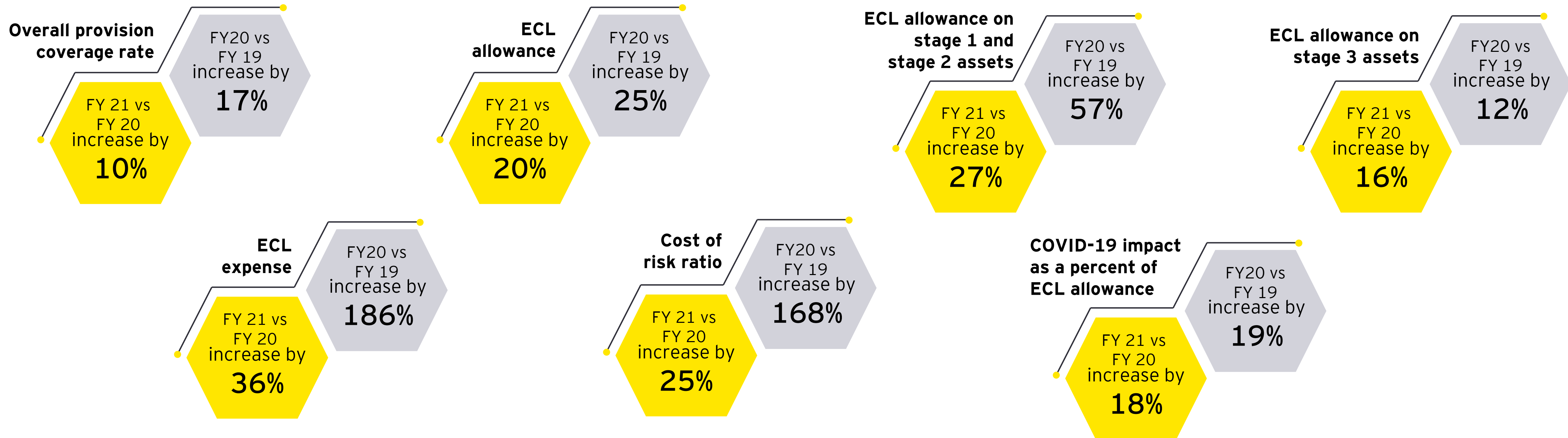
The standard does not prescribe specific approaches to estimate ECLs, but stresses that the approach used must reflect the following:

- An unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes;
- The time value of money and
- Reasonable and supportable information that is available without undue cost or effort at the reporting date about past events, current conditions, and forecasts of future economic conditions.

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.

As per RBI Circular dated 13 March 2020 on implementation of Indian Accounting Standard (Ind AS), NBFCs shall hold ECL allowances as required by Ind AS. However, in parallel, companies shall also maintain the 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 as well as restructured assets, NPA ageing, etc. Where ECL allowance under Ind AS 109 is lower than the provisioning required under IRACP, NBFCs shall appropriate the difference from their net profit or loss after tax to a separate 'Impairment Reserve'.

Key highlights



Some key highlights were as follows:

- In FY 20 there was a sharp increase in the ECL allowance and expense when compared with FY 19 since FY 20 was the first year impacted due to COVID-19 pandemic. In FY 21 though there is an increase in ECL allowance and ECL expense as compared to FY 20, the rate of increase has dropped. This could be because companies had already largely factored in the potential impact of COVID-19 in FY 20 itself. The overall reduction in the rate of increase appears to be primarily on account of reduction in rate of increase in ECL allowance on stage 1 and stage 2 loans.
- As detailed in the later part of publication, it has been observed that the reduction in rate of increase in the ECL expense is the result of a lower rate of increase in ECL expense for NBFCs combined with a reduction in ECL expense for HFCs when compared from previous year.
- It appears that significant management overlays on account of COVID-19 were already considered in FY20 and consequently there is a lower rate of increase in current year.

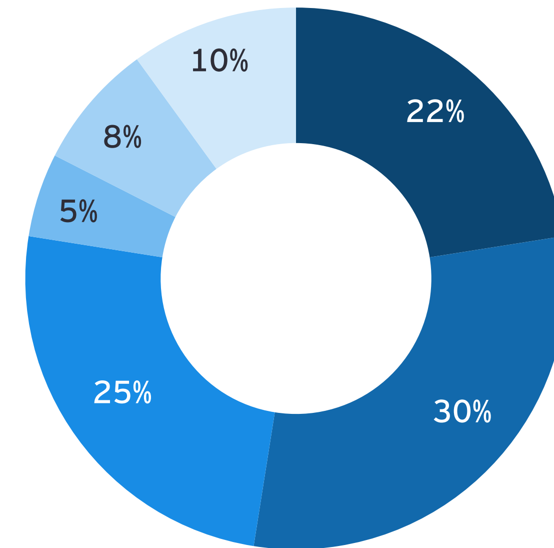
Study methodology

Study methodology

We have analyzed SFS from the annual reports of 40 NBFCs (28 NBFCs and 12 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 2021 with that for the year ended 31 March 2020. In the previous publication, we had analyzed the SFS from annual reports of 42 NBFCs which included two companies – one NBFC and one HFC that were merged in another NBFC during the year ended 31 March 2021 due to which the merged NBFC is considered in our analysis for 31 March 2021. Hence there is a difference in the NBFCs and HFCs considered for the current year analysis when compared to the previous year and to that extent the analysis provided in the publication may not be entirely comparable with that of the previous year. Also, in the current publication, we have not considered one company which was considered in the previous publication since the annual report for the year ended 31 March 2021 was not available until the date of this publication in the public domain and hence to that extent the previous year analysis has been suitably modified.

The information on the impact of COVID-19, which was not available in SFS, have been sourced from investor presentations as available on websites.

We have covered the following asset class of NBFCs in our analysis



Study methodology

The basis for computation of the key parameters analyzed in this publication is as below:

- 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 (Stage 3 exposure less Stage 3 provision) by total gross loans and total net loans (total gross exposure less Stage 3 provision), 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.

Current year refers to FY21 and previous year is FY20

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 and the disclosure on restructured loans as presented by companies in their SFS or any public document pertaining to annual reporting.

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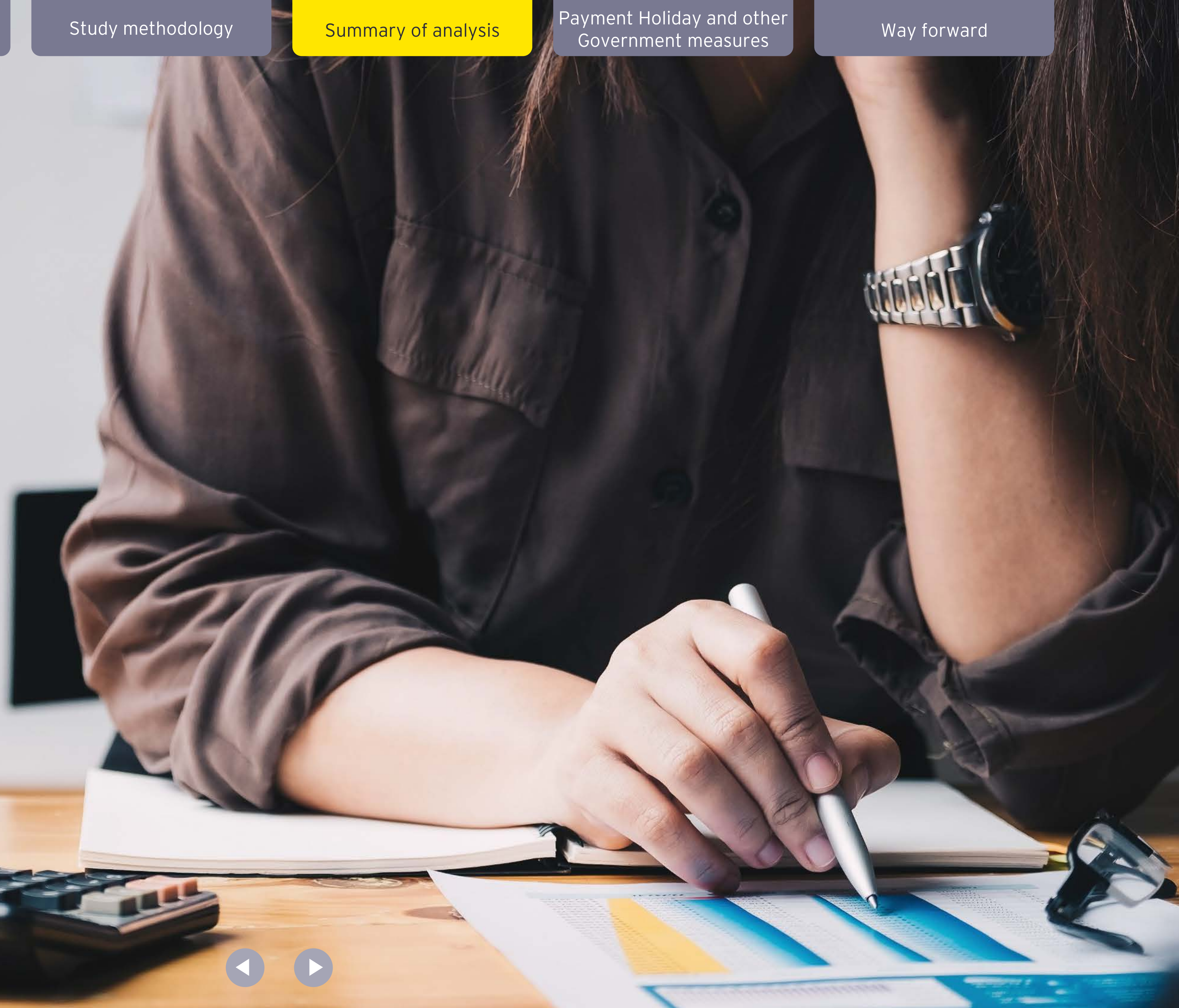
Summary of analysis



Summary of analysis

Impact for the year ended 31 March 2021

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

NBFCs

Gross loans (INR in crores)

There is an overall increase in the current year's Gross loans by 11.07% whereas previous year's increase was 7.63%.

In the current year, there has been an increase in Gross loans exposure in 19 NBFCs and the average rate of increase is approximately 10%, of which, four NBFCs have witnessed an increase of more than 20% and three NBFCs have witnessed an increase of more than 10%.

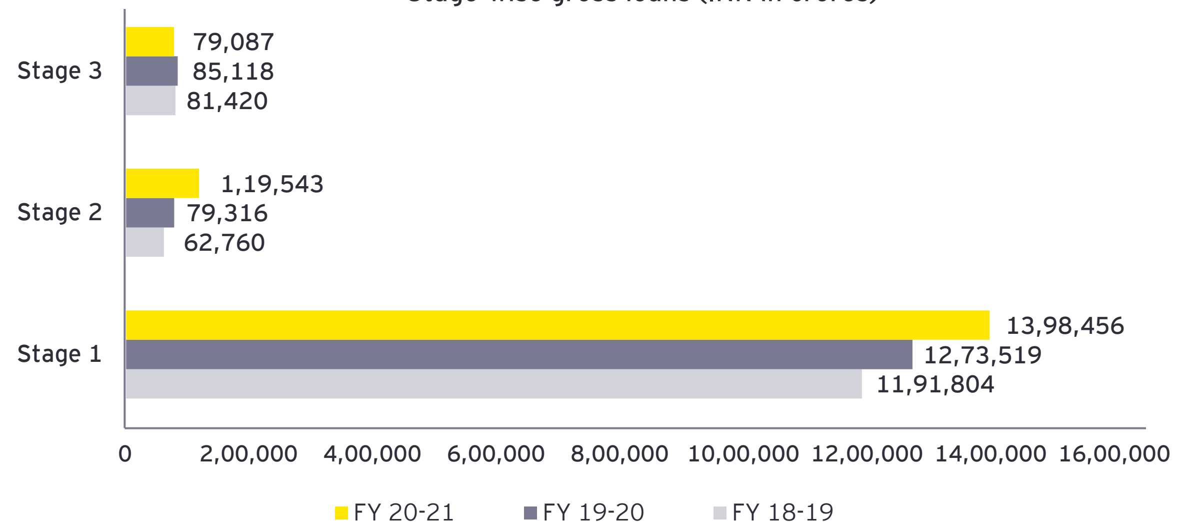
There is a decrease in Gross loans exposure for eight NBFCs and the average rate of decrease is approximately 10%, of which, three NBFCs have witnessed a decrease in Gross loans by more than 10%.

On analysis of top 10 NBFCs by gross loan exposure, there is an increase in the gross loan exposure for nine NBFCs.

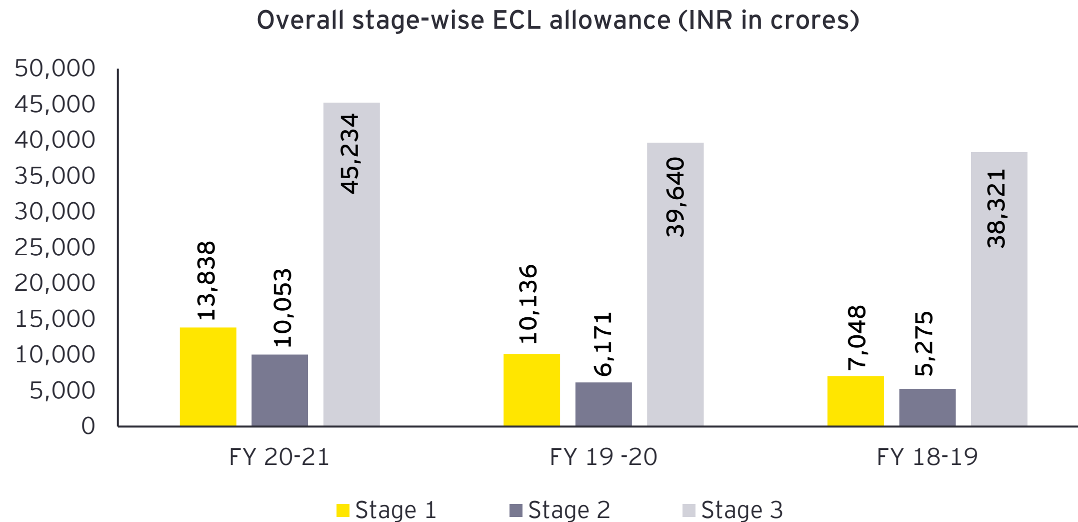
The portfolio of loans where increase in Gross loan exposure is more than 10% is primarily in case of NBFCs providing infrastructure finance, gold loans, LAP, consumer, MSME and micro-finance loans.

The portfolio of loans where decrease in Gross loan exposure is witnessed are primarily by NBFCs providing asset finance and vehicle finance. In case of vehicle finance it appears that the disbursements during the year were lower as compared to the previous year primarily due to drop in industry volumes across segments caused by the lockdown during the COVID-19 pandemic.

FY 21 was a year of unprecedented upheaval and uncertainty. The economies were at a standstill in the beginning of FY 21 on account of the pandemic. Even as the year progressed, there was uncertainty on the business outlook. The lockdown significantly impacted repayments especially in marginal communities and self-employed semi-formal segments. Salaried customers too faced salary cuts and retrenchments. However, with increased economic activity in later part of the year, collection efficiencies showed significant improvement.



Comparison of ECL allowance between FY 2018-19, FY 2019-20, and FY 2020-21 (including stage split)



There is an average overall increase in ECL allowance by 23.55%.

When compared to last year, ECL allowance has increased across all three stages; for stage 1 the allowance has increased by 36.52%, for stage 2 it has increased by 62.91% and for stage 3 it has increased by 14.11%. There has been an increase in Gross loans in stage 1 and stage 2 by 9.81% and 50.72% respectively whereas there has been a decrease in stage 3 gross loans by 7.09%.

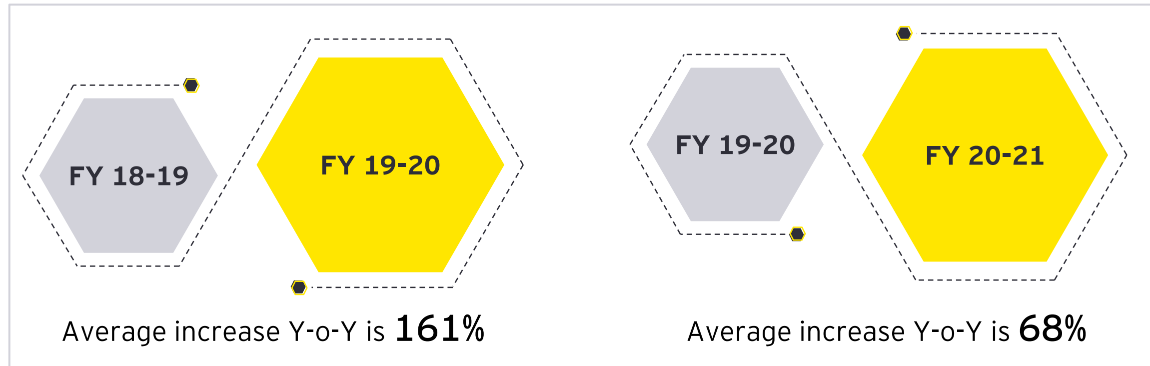
Despite decrease in stage 3 gross loan exposure there has been an overall increase in ECL allowance for stage 3 portfolio, one of the reasons attributable to this could be increase in LGD percentages compared to previous years (this has been analysed by dividing the stage 3 provision with the stage 3 exposure. In the absence of clear disclosures, the provision amount may also include the impact of additional management overlay on account of COVID-19).

Information regarding the portfolio of loans most impacted is not clearly available from the annual reports of companies, only three companies out of the top 10 NBFCs have provided disclosures at a pool level in their annual financial statements.

In line with the reduction in gross loan exposure of Stage 3 in the current year compared to the previous year, the GNPA ratio has also reduced compared to previous year. One of the reasons for reduction in Stage 3 exposure may be on account of increase in write-off of loans during the current year. Since the ECL allowance has increased in the current year compared to previous year the same resulted on Net NPA ratio being reduced when compared to the previous period. (For further insights refer section 5 below).

If we analyze top 10 NBFCs, stage 3 gross loan exposure has increased for five NBFCs. The average rate of increase in Stage 3 exposure in these five NBFCs is approximately 12% and for the balance NBFCs the average rate of decrease in Stage 3 gross loan exposure is approximately 18%. However, in case of the five NBFCs where stage 3 gross loan exposure has reduced, the ECL allowance has increased by approximately 20%.

ECL expense



- ECL expense for FY 20 witnessed a sharp increase of 161% when compared with FY 19, being the first COVID impacted year. Subsequently in FY 21, though ECL expense has increased further, but the year-on-year increase is 68%.
- One of the reasons in increase in ECL expense could be attributed to increase in management overlay, however, the same cannot be appropriately quantified and analyzed as out of top 10 NBFCs, information pertaining to quantification of management overlay estimate has been provided by only four NBFCs. The companies have determined management overlay after considering company's historical experience, collection efficiencies post completion of moratorium period, internal assessment, and other emerging forward-looking factors on account of the pandemic.
- Also, in the previous year, most companies had frozen the DPD status which had not triggered a Stage 2 or Stage 3 transfer.
- The analysis of ECL expenses at a pool level seems difficult since very few companies have provided ECL disclosures at a pool level. Only seven NBFCs have provided disclosures at a pool level.

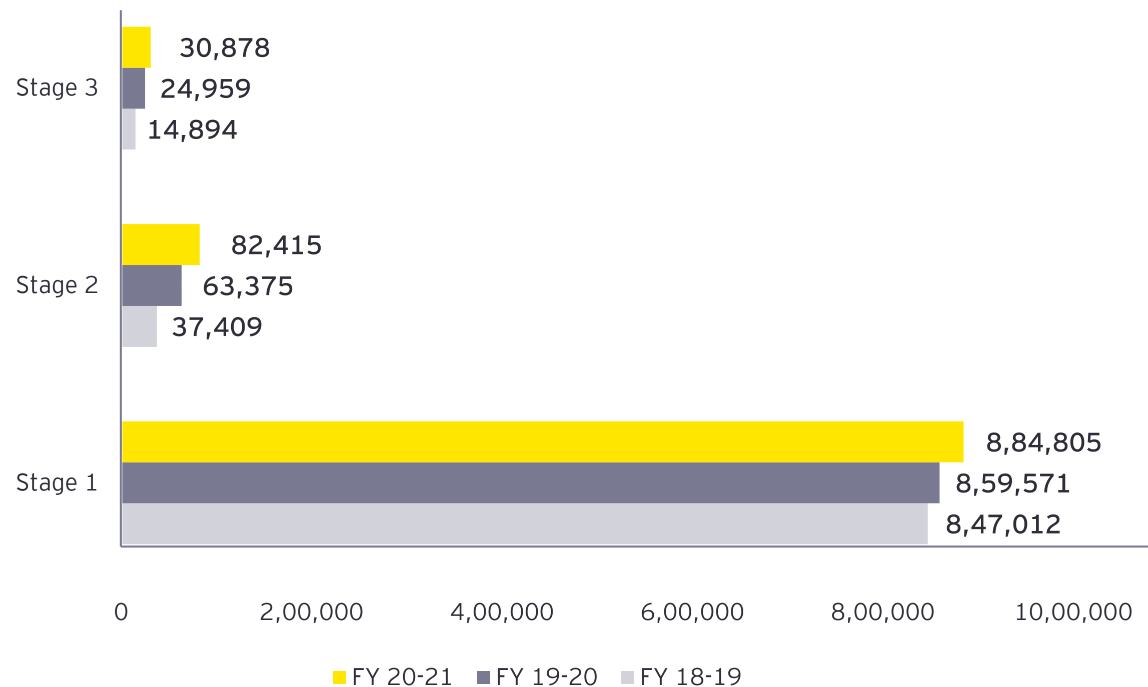
HFCs

Gross loans (INR in crores)

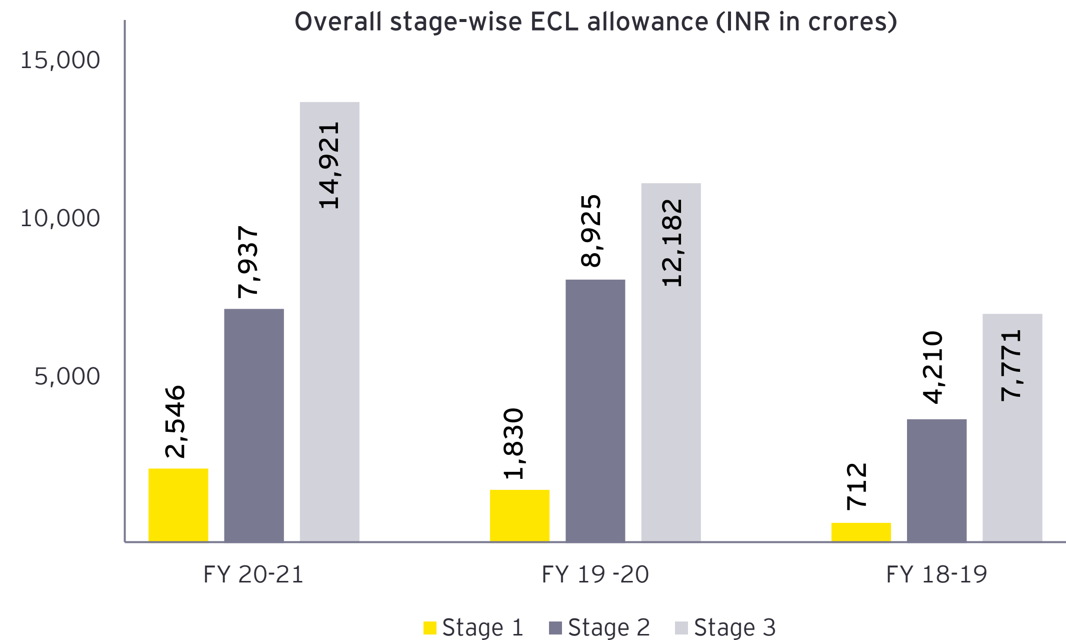
There has been equivalent increase in gross loans of HFCs in the year 21 when compared to FY 20 (increase by 5.30%). The increase in gross loan exposure in FY 20, when compared to FY 19 was 5.40%.

In the current year, there are seven HFCs where total gross loan exposure has increased, and the average rate of increase is approximately 11%. In case of balance HFCs the total exposure has reduced, and the average rate of decrease is approximately 6%. If we observe top five HFCs by gross loan exposure there is average 5.82% decrease in gross loan exposure for three companies and increase in gross exposure for two companies by average rate of 10.40%.

As disclosed and explained in the annual report and investor presentations of a few companies, the year under review was a challenging one for the Indian economy and it had a domino effect on the housing finance sector. The subdued growth rate can be attributed to the disruption caused by the COVID-19 pandemic making it difficult for home buyers to purchase property, thereby possibly causing an adverse impact on HFC. The industry saw moderation in the growth rate and the overall housing portfolio reported low growth in the first half of FY 21, due to uncertainty and financial crisis faced by the borrowers. In the second half of the financial year, the demand for housing remained robust, with growth trends exceeding expectations. Growth in home loans was aided by low interest rates, softer or stable property prices, continued fiscal benefits on home loans and concessional stamp duty rates offered in certain states.



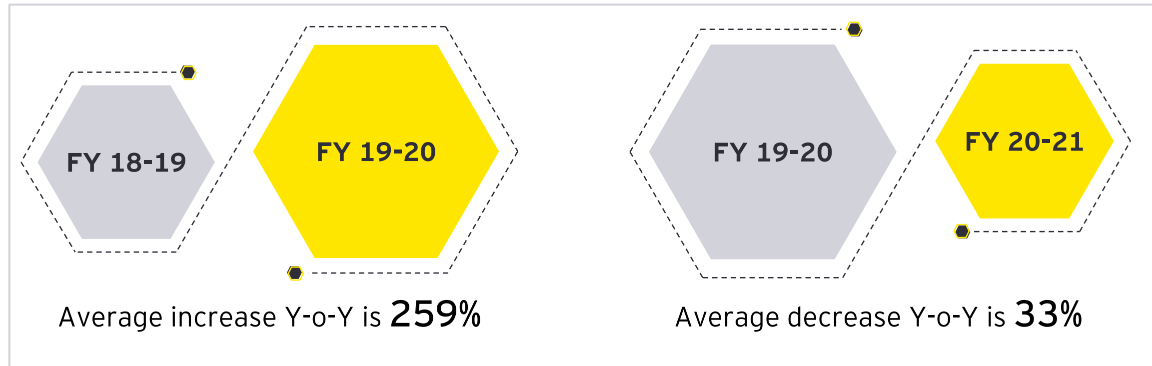
A comparison of ECL allowance between FY 2018-19, FY 2019-20, and FY 2020-21 (including stage split)



There is an average overall increase in ECL allowance by 10.76%.

When compared to the previous year there is an increase in stage 1 gross exposure and ECL allowance by 2.94% and 39.12% respectively. In case of Stage 2 assets the gross exposure has increased by 30.04% and ECL allowance has decreased by 11.07%.The Gross exposure and allowance for Stage 3 assets has increased by 23.71% and 22.48% respectively.

ECL expense



In the current year there is a significant decrease in ECL expenses compared to previous year (FY 20).

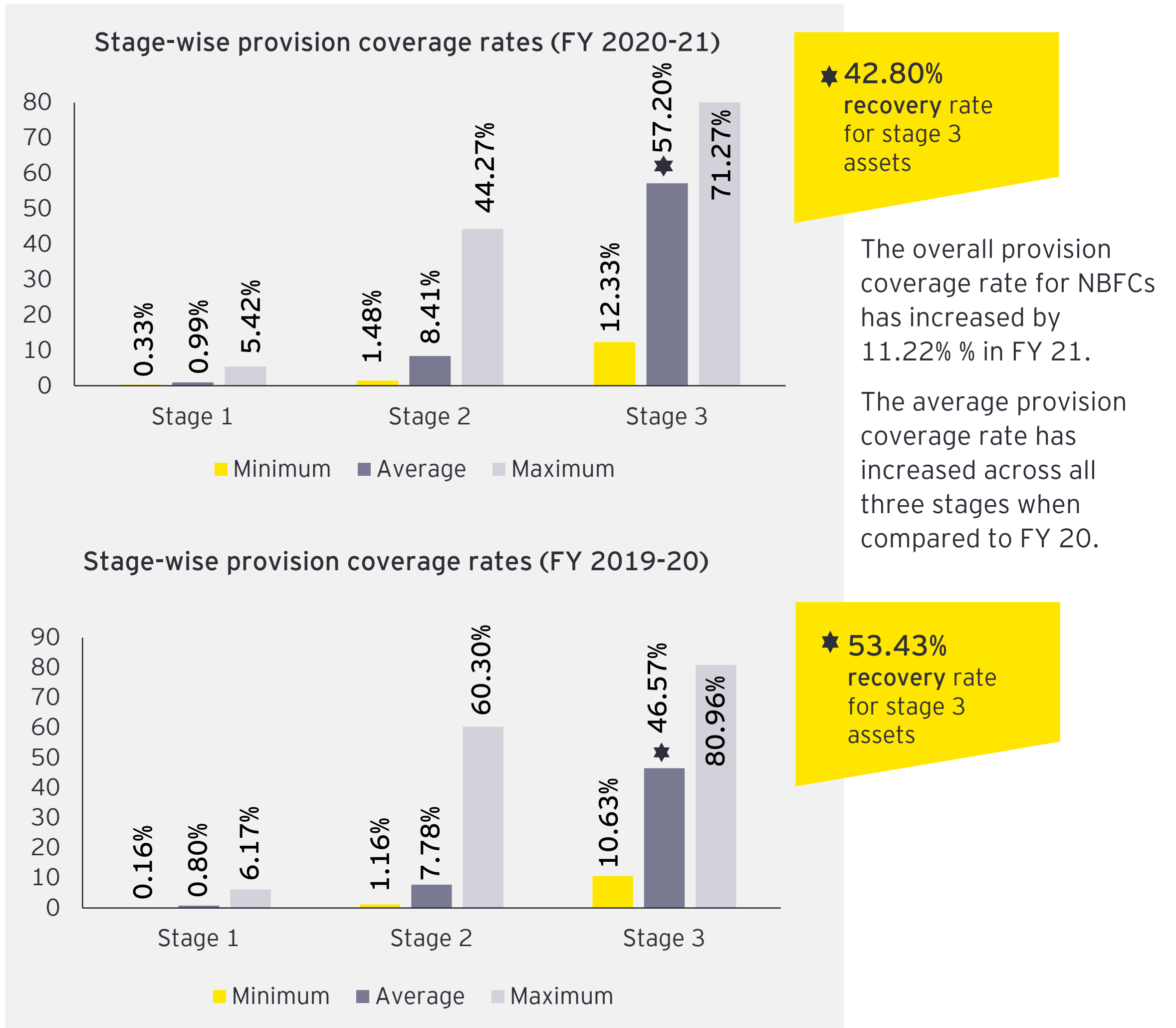
Out of top five HFCs, the ECL expense for the year has increased for two HFCs. In case of remaining three HFCs the ECL expense has reduced by an average of approximately 49%.

In the previous year, the rate of increase of ECL expense for HFCs was substantially higher almost more than 100% across all three stages due to which in current year we can observe a significant decline in ECL expense for HFCs.

In case of two HFCs the ECL allowance under Ind AS was lower than requirement as per the IRACP norms and accordingly the companies have created an impairment reserve.

2. Overview of stage-wise provision coverage

NBFCs



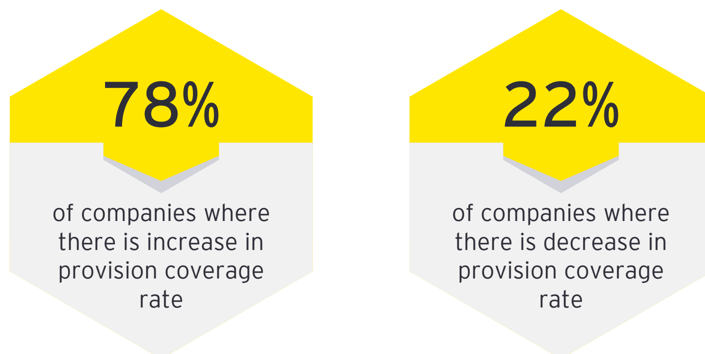
42.80% **recovery** rate for stage 3 assets

The overall provision coverage rate for NBFCs has increased by 11.22% % in FY 21.

The average provision coverage rate has increased across all three stages when compared to FY 20.

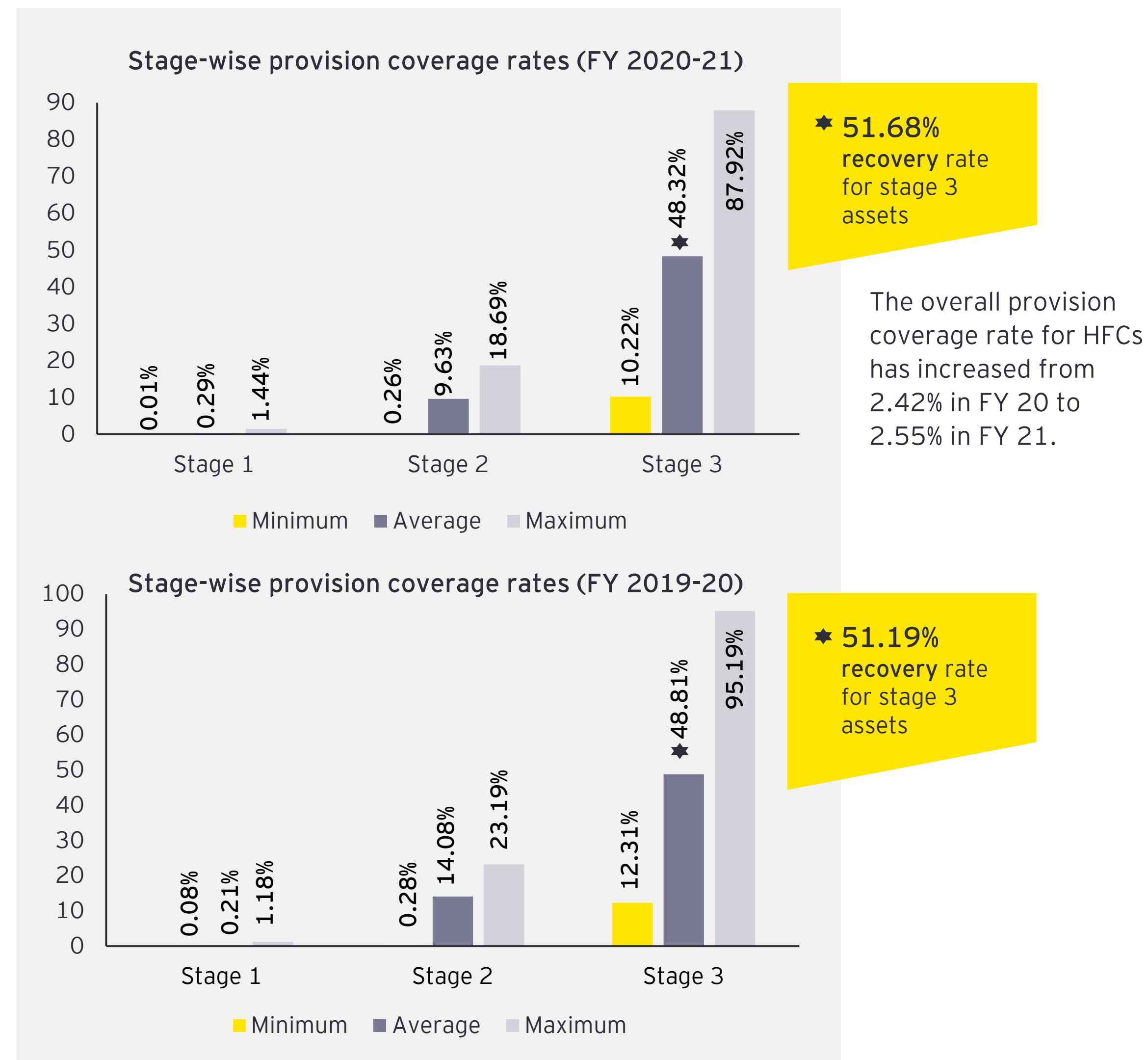
53.43% **recovery** rate for stage 3 assets

NBFCs



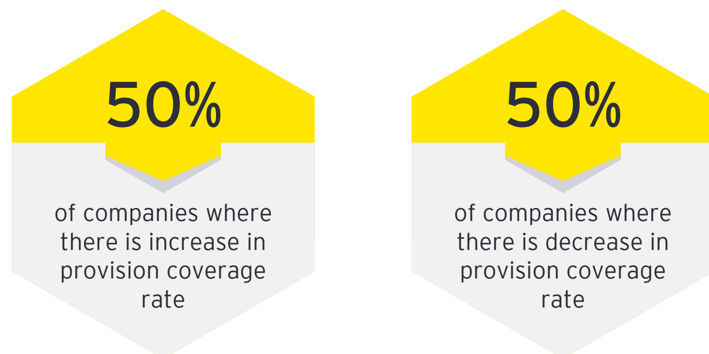
- Two NBFCs have reported increase in coverage rate by more than 100% compared to previous year.
- While provision coverage rates in majority of NBFCs have increased, the same has been compensated by a decrease in others.
- More specifically, the increase in the provision coverage rate has been witnessed primarily in micro-finance and companies providing consumer loans, vehicle/auto loans and business loans to MSME. The decrease has been witnessed primarily in case of infrastructure finance companies.
- There has been a significant increase in stage 3 ECL allowance for at least 10 NBFCs where the increase in stage 3 ECL allowance is more than 50%.

HFCs



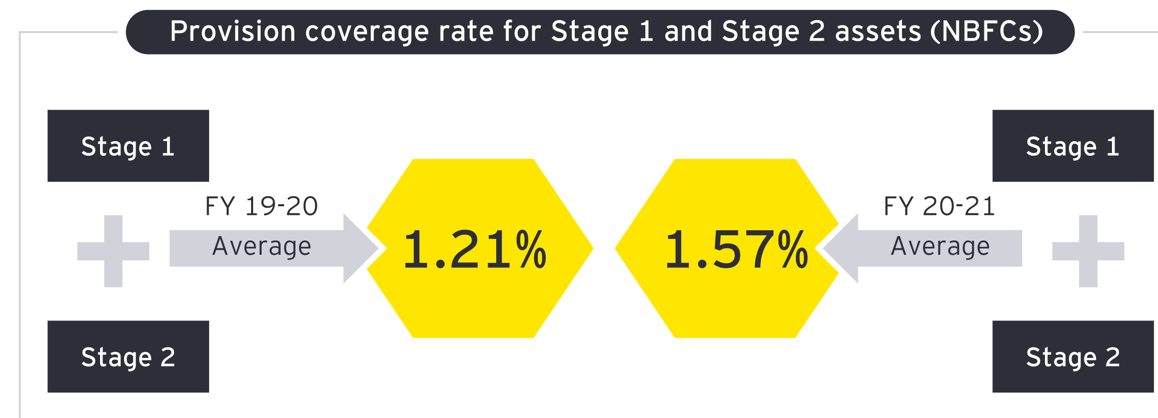
The overall provision coverage rate for HFCs has increased from 2.42% in FY 20 to 2.55% in FY 21.

HFCs

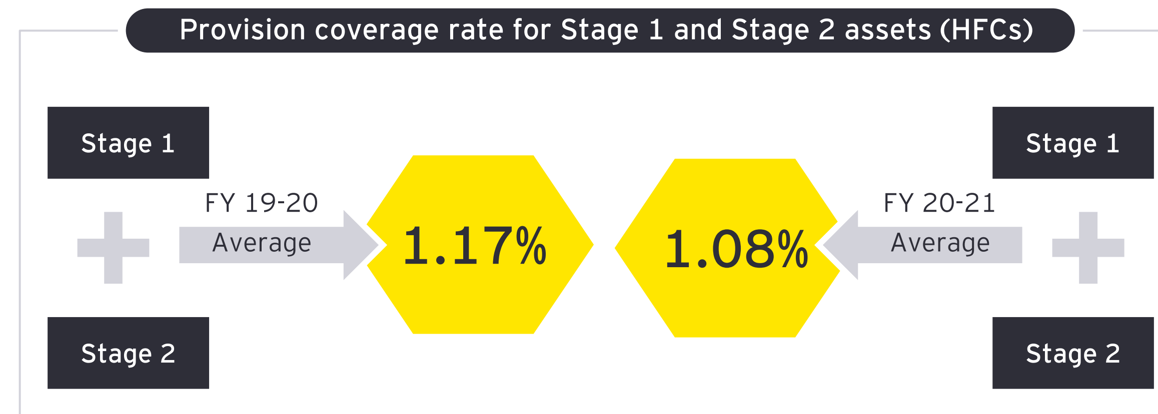


- In HFCs where there is a decrease in PCR, the average rate of decrease is approximately 17% whereas in HFCs where there is an increase in PCR, the average rate of increase in PCR is approximately 44%.
- Out of top five HFCs by exposure, the provision coverage rate has increased for three HFCs where the average rate of increase is approximately 30% whereas the average rate of decrease in the remaining two HFCs is approximately 18%.
- The increase in provision coverage rate can be attributed to marginal increase in gross exposure and increase in ECL allowance.

3. Provision coverage rate for Stage 1 and Stage 2 assets



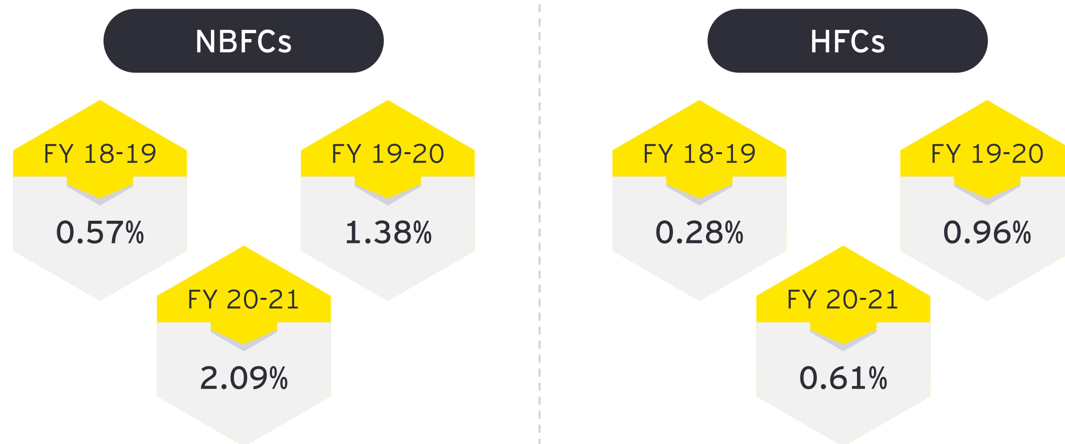
The provision coverage rate for Stage 1 and Stage 2 assets of NBFCs has increased by 29.75%; whereas individually for Stage 1 assets has increased by 24.33%.



The provision coverage rate for Stage 1 and Stage 2 assets of HFCs has decreased by 7.69%; whereas individually for Stage 1 assets has increased by 35.15%.

Calculating the coverage ratio for Stage 1 and Stage 2 loans can provide an indicator of the overall ECL approach adopted by NBFCs and HFCs on their non-credit impaired book. In case of NBFCs, one reason for the increase in provision coverage is also because there is an increase in Stage 1 and Stage 2 exposure compared to previous year especially Stage 2 exposure. There is also an increase in ECL allowance and expense leading to an increase in the coverage ratio. The decline in the coverage ratio for HFCs can be correlated to the decrease in the ECL expense.

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 21 as there is an overall increase in ECL allowance for NBFCs. There are six NBFCs where the cost of risk ratio is more than 5%. One of the reasons for increase in Cost of risk ratio is that the percentage increase in ECL expense is higher than the percentage increase in Gross exposure.

In case of HFCs, there is a decrease in the cost of risk ratio which can be explained due to a decrease in ECL expense and increase in gross exposure.

5. Range of gross and net NPA ratio

Range of gross NPA ratio

	FY 18-19	FY 19-20	FY 20-21
NBFCs	0.08% - 25.77%	0.12% - 18.02%	0.60% - 45.65%
HFCs	0.47% - 5.44%	0.46% - 5.82%	0.91% - 6.65%

Source: EY analysis

Range of net NPA ratio

	FY 18-19	FY 19-20	FY 20-21
NBFCs	0.01% - 11.64%	0.07% - 6.80%	0.40% - 7.72%
HFCs	0.37% - 3.33%	0.19% - 3.32%	0.50% - 5.14%

Source: EY analysis

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

On an average, the gross NPA% for NBFCs is 6.09% in FY 19, 5.92% in FY 20 and 4.95% in FY 21; whereas for HFCs, the same is 1.66% in FY 19, 2.63% in FY 20 and 3.09% in FY 21.

Similarly, on an average, the net NPA% for NBFCs is 3.35% in FY 19, 3.25% in FY 20 and 2.18% in FY 21; whereas for HFCs, the same is 0.80% in FY 19, 1.37% in FY 20 and 1.62% in FY 21.

In case of NBFCs, there is a decline in gross and net NPA. The decline in average Gross NPA and average Net NPA in the current year is about 16% and 33% respectively.

If we analyze the NBFCs, there are approximately 15 companies where Gross NPA ratio has increased and 11 companies where it has reduced compared to previous year. Net NPA ratio has increased and decreased for equal number of companies.

In case of HFCs there is marginal increase in Gross and Net NPA when compared with the previous year. There are five HFCs as part of our analysis where the Gross NPA ratio is above 4% and five HFCs where Net NPA is above 2%.

- The decrease in Gross NPA in case of NBFCs may be attributed to decrease in Stage 3 exposure compared to previous year and increase in Gross NPA in case of HFCs is due to increase in stage 3 exposure compared to previous year.
- Some of the reasons that may be attributable for decrease in Stage 3 exposure in case of NBFCs are improved collection and recovery process, resolution/restructuring of its Stage 3 assets and enhanced focus on maintaining the asset quality of the loan book by having a robust credit appraisal mechanism.

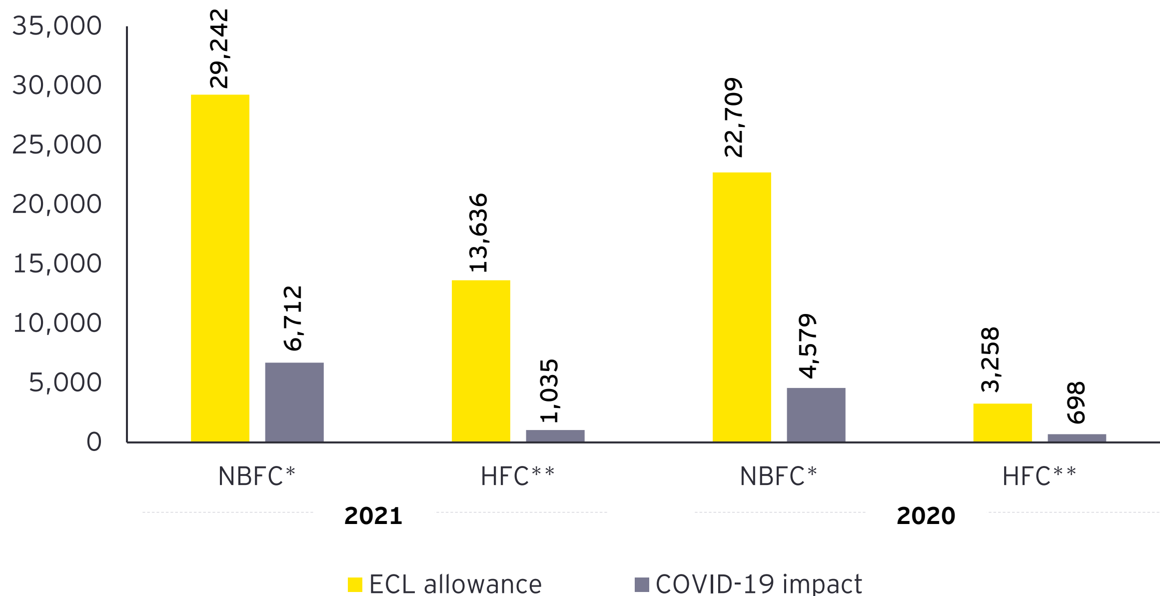
6. Management Overlay including COVID-19

One of the important aspects of Ind AS 109 ECL provisions is to provide a probability weighted outcome of ECL over a range of specific scenarios. NBFCs and other lending institutions can achieve this through a mix of approaches, ranging from management overlay or statistical models linking macroeconomic indicators (like GDP, Inflation, etc.) to credit risk indicators. 'Overlay' is a term that can be used to describe a gamut of adjustments that are made outside the primary ECL models.

In the previous year, the management overlay in NBFCs and HFCs were determined through various methods and assumptions primarily to factor in the uncertainties arising due to COVID-19. The most common methods (basis the companies we analysed) were as follows:

1. Factors like early warning indicators, delayed payments, deterioration in macro-economic factors, etc.
2. 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.
3. Loss-given-default based on stress in collateral valuation
4. 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.

In the current year as well, companies have applied management overlays to their ECL computation. In cases where companies have disclosed, they have kept the same method as last year to determine the management overlay. Companies have prima facie determined the management overlays after evaluating the current situation and any potential deterioration in macro-economic factors.



On an overall basis, out of the total ECL allowance as of 31 March 2021, 22.95% is on account of COVID-19 for NBFCs* and the same for HFCs** is 7.59%.

The proportion of COVID-19 impact as compared to ECL allowance as on 31 March 2021 ranges from 6% to 61% for NBFCs and for HFCs the same ranges from 6% to 48%.

*Quantification of impact on ECL allowance due to COVID-19 was not explicit/could not be ascertained from SFS/investor presentations for 15 NBFCs for FY ended 31 March 2021 (10 NBFCs for FY ended 31 March 2020).

**Quantification of impact on ECL expense for the year due to COVID-19 was not explicit/could not be ascertained from SFS/investor presentations for seven HFCs for FY ended 31 March 2021 (seven HFCs for FY ended 31 March 2020).

Payment Holiday and other Government measures

Payment Holiday and other Government measures

The economic fallout on account of the COVID-19 pandemic has led to significant financial stress for borrowers across the board. The resultant stress can potentially impact long-term viability of many firms, otherwise having a good track record, as due to COVID-19 there is a mismatch between their cash flow generation abilities and their debt burden. Such wide-spread impact could impair the entire recovery process, posing significant financial stability risks.

After two rounds of moratoriums of three months each on 27 March 2020 and 23 May 2020 respectively, the RBI came up with a large-scale restructuring scheme. RBI with the intent to facilitate revival of the sectors activities and mitigate the impact on ultimate borrowers, had proposed restructuring frameworks to allow restructuring of the loan account having stress on account of Covid19 basis the eligibility criteria as per their circular dated 06 August 2020, 05 May 2021 and 04 June 2021.

The resolution framework primarily focused on Micro, small and medium enterprises (MSME), individuals and small businesses, personal loans etc.

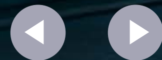
As per the circular lending institutions are required to make the certain prescribed disclosures in the quarter and annual financial statements. The disclosures pertain to the following:

1. Number of accounts where resolution plan has been implemented under this window
2. Exposure to accounts mentioned at 1. above before implementation of the plan
3. Of 2 above, aggregate amount of debt that was converted into other securities
4. Additional funding sanctioned, if any, including between invocation of the plan and implementation
5. Increase in provisions on account of the implementation of the resolution plan

Out of 28 NBFCs, there were 21 NBFCs where loans were restructured, and the amount and number of accounts were disclosed in the financial statements. On an average, 2% of the Gross loans are restructured by the companies. Also, if we analyse the top 10 NBFCs by exposure, the accounts restructured are largely pertaining to personal loans and MSME loans, however in some cases corporate loans were also restructured.

Out of 12 HFCs, there were nine HFCs where loans were restructured, and the amount and number of accounts were disclosed in the financial statements. On an average 1.14% of the Gross loans are restructured by the companies.

Way forward



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. Although the companies have developed models, methodologies to determine the ECL provision estimate even after two annual reporting cycles are evolving.

In such circumstances, it is imperative that NBFCs focus on enhancing the existing risk management framework. To reduce the differences between an entity's estimates and actual credit loss experience, the entities may take into consideration following factors for estimation of the expected credit loss allowance for FY22 and onwards:

Recalibrating existing ECL models

NBFCs would need to recalibrate their existing models and reassess the management overlays currently applied and back them up by empirical evidence to justify their purpose to its external auditors and audit committees. Where management overlays/post model adjustments are necessary due to uncertain economic events, care should be applied that the adjustments are at the most granular level possible and is subject to robust governance and control procedures.

Regulatory considerations

The RBI is also monitoring the current situation very closely and has been issuing new/ revised norms on bad assets from time to time to avoid any ballooning of NPAs. These regulatory changes necessitate NBFCs to capture resultant changes in borrower risk profiles going forward.

On 12 November 2021, with a view to ensuring uniformity in the implementation of IRACP norms across all lending institutions, the RBI provided clarifications on certain aspects of the extant regulatory guidelines. As per the clarifications, inter alia, it was clarified that loan accounts classified as NPAs may be upgraded as ‘standard’ asset only if entire arrears of interest and principal are paid by the borrower. Further, it also clarifies that the date of NPA shall reflect the asset classification status of an account at the day-end of that calendar date.

Such regulatory measures need to be analysed and assessed by the companies and ensure that they are appropriately factored in the ECL computation.

Back-testing

The main purpose of back-testing is to gauge the effectiveness of the methodology adopted by the entity; hence, it is important that companies perform back-testing at regular intervals. Since, it appears from the disclosures given that majority of the companies in the past 2 years have considered management overlay or post model adjustments in their ECL computation, it becomes imperative that companies assess the accuracy of these overlays through back-testing.

Updated board approved policies

As per RBI circular dated 13 March 2020, ‘Implementation of Indian Accounting Standards’ for NBFCs, which required companies to have board approved ECL policy. Hence, the companies should ensure that this policy is updated at regular intervals to capture any changes in the ECL computation methodology and cover in detail the method or factors considered to determine management overlay or post model adjustments.

Process Automation

In ECL computation, the accuracy and granularity of data plays a very important role; hence it would be imperative for financial institutions to move towards a more automated and system driven approach with focus on integrating the data into the accounting-relevant processes, IT systems and the internal control system.

Disclosures

ECL is a very important performance indicator for any financial institution monitored by various stakeholders. Ind AS requires extensive disclosures such as inputs and assumptions used in calculating ECL, stage-wise disclosures of gross loans and allowance, etc. Accordingly, companies should consider providing enhanced and detailed disclosures at a granular level to the extent possible to enable the stakeholder to understand the impact of ECL on the performance of the company.

List of abbreviations

Abbreviation	Full form
CPI	Consumer Price Index
DPD	Days past due
ECL	Expected credit loss
FAAS	Financial Accounting Advisory Services
EIR	Effective Interest Rate
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
PCR	Provision Coverage Rate
SICR	Significant increase in credit risk

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