SSBCrack EXAMS

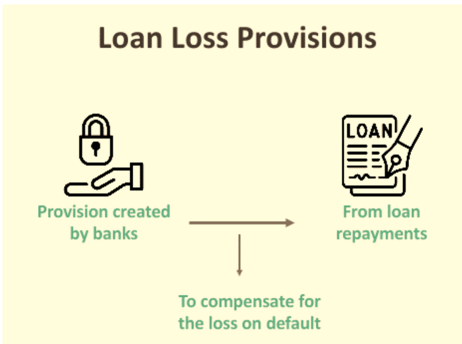
RBI Forms External Working Group On ECL Based Framework

Why In News

- The Reserve Bank of India constituted a 9 member external working group to get independent views on **Expected Credit Loss based framework** for provisioning by banks.
- This move comes after RBI released a discussion paper in January this year on shifting from the incurred-loss approach to the ECL model, a transition aimed at making the banking system more resilient.

What Is Loan Loss Provisioning

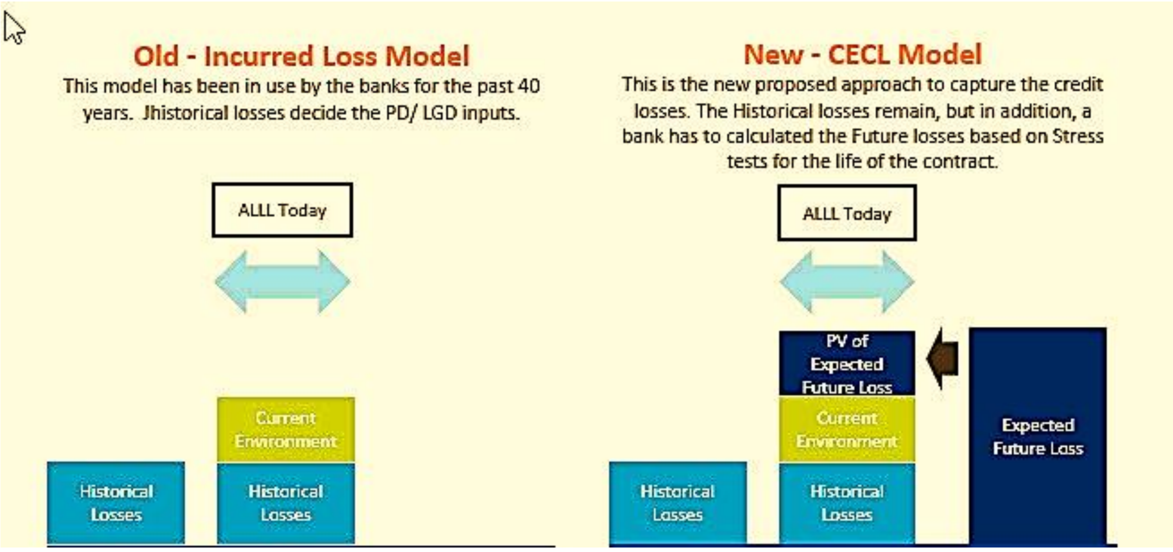
- A loan loss provision is an **income statement expense set aside** to allow for uncollected loans and loan payments.
- Banks are required to account for potential loan defaults and expenses to ensure they are presenting an accurate assessment of their overall financial health.



ECL Framework

- Under the ECL framework, banks will have to assess expected loss on their overall financial assets and make provisions after assessment, rather than making it after the loan turns into a non-performing asset (NPA).
- As per the proposed framework, banks will need to classify financial assets (primarily loans) as **Stage 1, 2, or 3,** depending on their credit risk profile, with Stage 2 and 3 loans having higher provisions based on the historical credit loss patterns observed by banks.

- Thus, through ECL, banks can estimate the forward-looking probability of default for each loan, and then by multiplying that probability by the likely loss given default, the bank gets the percentage loss that is expected to occur if the borrower defaults.
- It will result in excess provisions as compared to a shortfall in provisions, as seen in the incurred loss approach.
- It will further enhance the resilience of the banking systemin line with globally accepted norms.
- **Currently,** banks are required to make loan loss provisions based on an **incurred loss approach** which needs banks to provide for losses that have occurred or incurred.
- Incurred loss provisioning, whereby step-up provisions are made based on the time the account has remained in the Non-Performing Asser (NPA) category.



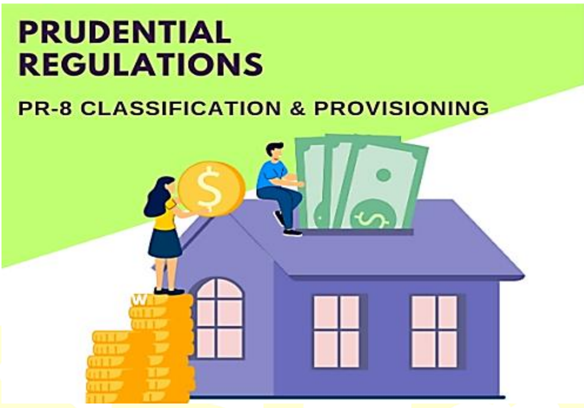
Leadership and Composition

- RBI said that the working group will be chaired by **Prof. R. Narayanaswamy**, Former Professor, IIM Bangalore. Additionally, the group will have eight more expert members from academia and industry as well as representatives of some banks.

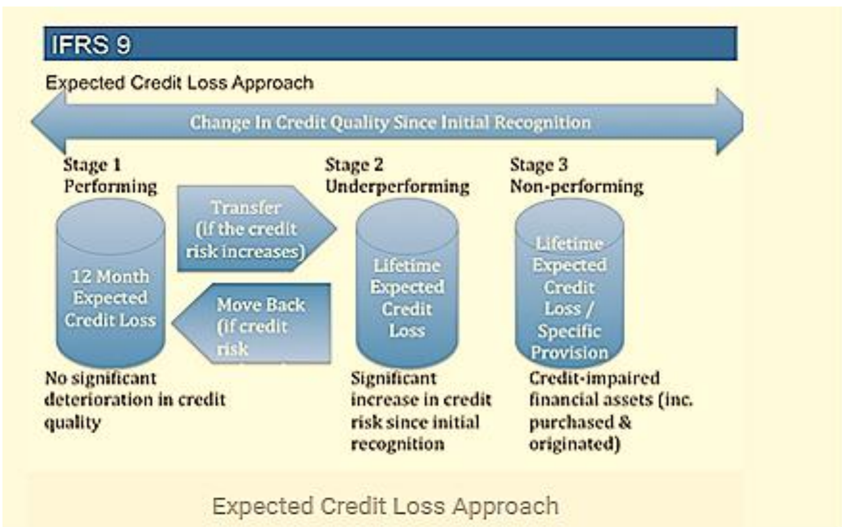
- The **list of members** include Prof. Sanjay Kallapur, ISB, Hyderabad, Rajosik Banerjee, KPMG, S Srinivasa Rao, State Bank of India (SBI), Rajendra Khandelwal, ICICI Bank, Susanta Baishya, HDFC Bank, Adish Yadav, Canara Bank, Pravinkumar Taparia, Saraswat Co-operative Bank and Sridharan N, Equitas Small Finance Bank.

Objectives

- **Establishing Principles for Credit Risk Models**: The committee will define the fundamental principles that banks should follow when developing credit risk models for assessing and quantifying anticipated credit losses.
- **Addressing Components of Credit Risk**: They will suggest the key components that banks should take into account when assessing credit risks, drawing insights from IFRS 9 guidelines and principles outlined by the Basel Committee on Banking Supervision.



- **Validation Approach**: The expert panel will offer guidance on the methodology for independently validating these models to ensure their accuracy and dependability.
- **Introducing Prudential Floors**: Utilizing comprehensive data analysis, the group will put forth recommendations for prudential floors related to provisioning, which will contribute to enhancing the overall stability of the banking industry.



RBI Say

- The RBI said the recommendations of the working group would be **duly factored in while framing the draft guidelines**, which will be put in the public domain for comments before issue of final guidelines.