प्रेस प्रकाशनी PRESS RELEASE

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RBI releases Discussion Paper on Expected Loss (EL)-based Approach for loan loss provisioning by banks

As part of the Statement on Developmental and Regulatory Policies released on September 30, 2022, RBI had proposed to adopt an expected loss-based approach for loss allowances required to be maintained by banks in respect of their loan exposures. It was announced that a discussion paper on the various aspects of the transition will be issued shortly.

Accordingly, RBI has today released the Discussion Paper (DP) that comprehensively examines various issues and proposes a framework for adoption of an expected loss-based approach for provisioning by banks in India.

The proposed approach is to formulate principle-based guidelines supplemented by regulatory backstops wherever necessary. Further, regional rural banks and smaller cooperative banks (based on a threshold to be decided based on comments) are proposed to be kept out of the above framework.

The key requirement under the proposed framework shall be for the banks to classify financial assets (primarily loans, including irrevocable loan commitments, and investments classified as held-to-maturity or available-for-sale) into one of the three categories - Stage 1, Stage 2, and Stage 3, depending upon the assessed credit losses on them, at the time of initial recognition as well as on each subsequent reporting date and make necessary provisions.

Banks would be allowed to design and implement their own models for measuring expected credit losses for the purpose of estimating loss provisions in line with the proposed principles. However, to mitigate the concerns relating to model risk and considering the significant variability that may arise, the DP proposes the following mitigants:

i) RBI shall be issuing broad guidance that will be required to be considered while designing the credit risk models. The guidance shall specify detailed expectations on the factors and information that should be considered by banks while making determination of credit risk, drawing from the guidance provided in IFRS 9 and principles laid out by BCBS.

ii) The expected credit loss models proposed to be adopted by banks shall have to be independently validated to verify whether the models follow the guidance issued by RBI, based on sound reasoning, calibrated use of relevant data that is available with the bank and, whether proper back-testing and internal validation of the models have been done to remove any bias, etc.

iii) The provisions as per the banks' internal assessments shall be subject to a prudential floor, to be specified by the RBI based on comprehensive data analysis, rather than merely re-prescribing extant provisioning norms.

iv) A non-exhaustive list of disclosures by banks shall be prescribed.

Considering the complexities involved in designing the models and the time required to test them, sufficient time shall be provided for implementation of the framework after issue of the final guidelines. Further, in order to enable a seamless transition, as permitted under the Basel guidelines, banks shall be provided an option to phase out the effect of increased provisions on Common Equity Tier I capital, over a maximum period of five years.

The DP flags certain critical issues on which a final view shall be taken based on the feedback received as well as comprehensive data analysis. Comments are sought on the specific discussion questions articulated in the DP, supported by well-reasoned arguments and wherever necessary, supported by detailed data analysis and quantitative evidence. Comments may be submitted by February 28, 2023 to The Chief General Manager, Credit Risk Group, Department of Regulation, Central Office, Reserve Bank of India, 12th Floor, Central Office Building, Shahid Bhagat Singh Marg, Fort, Mumbai – 400001 or by e-mail with the subject line "Discussion Paper on expected credit loss approach for provisioning by banks".

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