2. Application of ECL model in context to COVID-19 for the financial services sector

This article aims to:

Highlight the impact of COVID-19 on the ECL provision recognised by NBFCs and HFCs.

Background

The coronavirus (COVID-19) pandemic has raised global concerns regarding the health and safety of people, it has disrupted financial markets and created a challenging operating environment. While this environment has affected almost all major sectors of Indian economy to varying effect, banks, Non-Banking Financial Companies (NBFCs), Housing Finance Companies (HFCs) (collectively referred to as 'lending institutions') have been significantly impacted especially in terms of their exposure to almost all major sectors of the Indian economy.

In order to mitigate the burden of debt servicing brought by disruptions on account of COVID-19 and to ensure continuity of viable business, the Reserve Bank of India (RBI) has introduced regulatory and development measures. These measures amongst other matters included specific relaxations in relation to moratorium on term loans/ deferment of interest on working capital loans and asset classification as well.

The measures referred to above were introduced by RBI vide announcements dated 27 March 2020, 17 April 2020 and 23 May 2020.

Key elements of the measures in relation to moratorium and asset classification are as follows:

a. All lending institutions initially permitted to grant a moratorium of three months from 1 March 2020 to 31 May 2020 (vide 27 March 2020 announcement) and thereafter permitted to grant moratorium for an additional period of three months up to 31 August 2020. This covered payments of instalments of principal/interest components, bullet repayments and Equated Monthly Instalments (EMIs) pertaining to term loans, as well as credit card dues.

b. The moratorium referred to above covered eligible borrowers as determined by the policy approved by the respective lending institutions' board of directors having payments falling due between 1 March 2020 and 31 August 2020.

c. In the cases where a customer opts for a moratorium, the repayment schedules and residual tenor for all such loans to be shifted across the board by three months (or the period of moratorium availed) after the moratorium period. However, interest may continue to accrue on the outstanding portion of the loans during the moratorium period.

d. For all accounts classified as standard as on 29 February 2020, even if overdue, the moratorium period to be excluded by lending institutions from the number of days past-due for the purpose of asset classification under the IRAC[1] norms. Accordingly, asset classification would remain standstill for the stipulated period.

e. Similar relaxations in terms of moratorium and asset classification introduced in relation to interest on certain working capital facilities.

f. Additional provision of 10 per cent to be recognised in relation to accounts (in default but standard) to which moratorium is offered and asset classification benefit is also extended. The additional provision is permitted to be phased over two quarters (not less than five per cent during quarter ended 31 March 2020 and not less than five per cent during quarter ended 30 June 2020).

Application of Ind AS

Financial statements of companies incorporated in India (which are either listed or whose net worth is in excess of INR250 crore) are required to be prepared in accordance with requirements of Indian Accounting Standards (Ind AS). While NBFCs and HFCs are required to apply Ind AS while preparing their financial statements; banks and insurance companies are not covered under Ind AS requirement. Financial statements of banks are prepared in accordance with Indian Generally Accepted Accounting Principles (Indian GAAP) which also in the case of banks includes relevant notifications, circulars and other guidelines issued by the RBI from time to time.

Accordingly, RBI specified that while the requirements relating to asset classification and additional provisions are applicable to banks; NBFCs and HFCs which were covered by the requirements of Ind AS would continue to be guided by the guidelines duly approved by their respective Boards and as per advisories issued by the Institute of Chartered Accountants of India (ICAI) for recognition of impairment.

The ICAI on 10 April 2020 issued specific guidance in relation to impact of COVID-19 on financial reporting in so far as it relates to estimation of impairment loss for financial instruments under the Expected Credit Loss (ECL) approach including considerations which apply in relation to loan moratorium offered based on the RBI announcements referred to above.

1. Income Recognition and Asset Classification

Key elements of the guidance are as follows:

a. **No bright lines:** Ind AS 109, *Financial Instruments* being a principles-based standard does not require a mechanistic application of the requirements of ECL. Accordingly, the standard suggests certain rebuttable presumptions instead of setting bright lines.

b. **Significant Increase in Credit Risk (SICR):** Classification of financial instruments in Stage 2 requires evaluation of SICR based on likelihood of risk of default over the entire expected life of the financial instrument and not just over the next 12 months.

c. **Regulatory support measures:** Prudential regulatory support measures such as temporary repayment moratoriums to provide relief from the impact of COVID-19 should not be applied mechanistically to reclassify the financial instrument into Stage 2 requiring lifetime expected credit losses.

   One of the guiding factors to retain these financial instruments in their existing category is whether the instruments where moratorium was granted were regular with no signs of credit deterioration at the time of granting moratoriums and whether these financial instruments are expected to remain regular during the relief period and thereafter.

d. **Adjustments to ECL model:** In addition, given that entities may find it difficult to incorporate all reasonable and supportable information while measuring the ECL in credit risk measurement models, entities may consider post model overlays or adjustments to its impairment models.

Accordingly, based on the above guidance, for the quarter ended 31 March 2020 and consequently for the year ended 31 March 2020, NBFCs and HFCs were expected to recognise additional ECL provisions after considering the guidance referred to above.

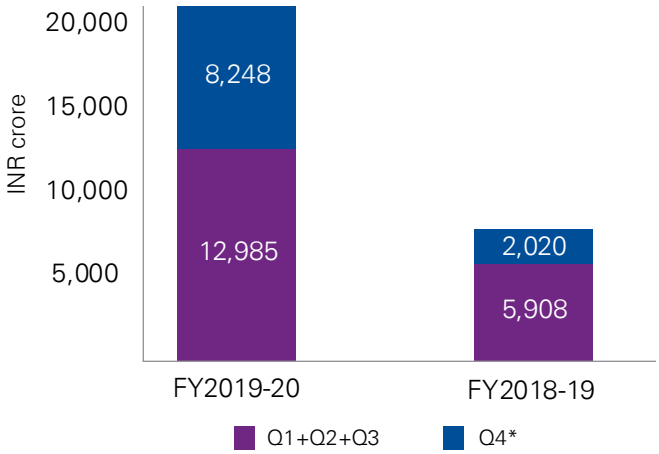
Such additional provisions would especially be relevant for exposure to categories of customers (based on sector, sources of income, etc.) which were adversely affected by the COVID-19 much more than the other categories. It is, therefore, pertinent to note that the process of determining such categories of customers and quantum of additional provisions or nature of adjustments to existing ECL models would be highly judgemental and would differ from company to company.

We have prepared an analysis based on the financial results published by 12 companies which includes eight NBFCs and four HFCs (collectively referred to as 'covered companies') in accordance with the Securities and Exchange Board (Listing Obligations and Disclosure Requirements) Regulations (Listing Regulations).

Of the 12 covered companies, four companies had debt securities listed on the stock exchanges while the remaining eight companies had equity securities listed on the stock exchange. Accordingly, in case of debt listed companies information for the quarter ended 31 March 2020 would not be available (as debt listed companies are only required to publish their results every six months).

The following chart shows ECL comparison for the covered companies.

Chart 1: ECL provision recognised by the covered companies



(Source: KPMG in India's analysis, 2020 basis financial results of covered companies for the year ended 31 March 2020)

**For debt listed companies, Q4 represents relevant figures for the half-year ended 31 March 2020.*

The ECL charge for the covered companies for the year ended 31 March 2020 (comprising of provision for impairment and bad debts written off) aggregated INR21,233 crore as compared to a charge of INR7,928 crore for the year ended 31 March 2019. This represented approximately 1.8 per cent of the loans outstanding as of 31 March 2020 and 0.7 per cent of the loans outstanding as of 31 March 2019 respectively.

Of the total charge of INR21,233 crore for the year ended 31 March 2020 for the covered companies, approximately INR8,248 crore reflected the total charge for the covered companies for the quarter ended 31 March 2020 (in case of debt listed entities relevant figures for the half-year ended 31 March 2020 have been considered).

Disclosures of additional provisions on account of COVID-19 have not been specifically made by all the covered companies. This may be on account of the fact that where adjustments to models are made to reflect higher provisions on account of COVID-19, the amount of additional provision may not be separately quantifiable.

Of the 12 covered companies, seven companies have disclosed the quantum of additional provision recognised in the quarter ended 31 March 2020 on account of COVID-19. The aggregate additional provision recognised on account of COVID-19 by these seven companies approximated INR4,088 crore. The total ECL charge for the quarter ended 31 March 2020 for these seven companies was INR5,855 crore (in case of debt listed companies relevant figures for the half-year ended 31 March 2020 have been considered).

Conclusion

COVID-19 pandemic has impacted companies and individuals across the country and across the sectors as well. This has had a consequential impact on the quality of the exposure of banks and NBFCs/HFCs. While the RBI has prescribed for banks an additional provision to be provided for in cases where the customer opts for moratorium and classification benefit is availed, NBFCs and HFCs have determined the provision in accordance with the requirements of ECL. The provision charge in the quarter and year ended 31 March 2020 has significantly increased as compared to corresponding previous year figures. Additional provision on account of COVID-19 wherever disclosed appear to be contributing a significant portion of the charge for quarter ended 31 March 2020. Companies would have to track events during the current year closely to determine whether the assumptions and expectations applied for determining the provision as of 31 March 2020 are valid or whether they require a significant revision during the year ended 31 March 2021.