

RBI Tightens Bad Loan Norms, Reform in NPA Classification and Introduction of Expected Credit Loss Framework

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The Reserve Bank of India has issued revised Master Directions on classification of non-performing assets, provisioning norms, and credit risk management. The reform aims to strengthen prudential regulation, enhance early recognition of credit risk, and align India's banking regulatory framework with internationally accepted financial reporting standards.

These norms, issued in April 2026, will be implemented from April 1, 2027, with a transition period extending up to March 31, 2030.

Non-Performing Assets (NPA)

- A **Non-Performing Asset (NPA)** is a loan or advance where the borrower has stopped making interest or principal repayments for a specified period, currently ninety days or more.

- Once classified as a NPA, the loan ceases to generate income for the bank and requires **provisioning against** potential losses.
- Non-Performing Assets are a key indicator of financial stress in the banking system and directly impact **profitability, capital adequacy, and credit growth.**
- **Regulatory Framework:** The classification and resolution of Non-Performing Assets in India is governed by a broader legal and regulatory framework, primarily including the **Banking Regulation Act, 1949** and the **Reserve Bank of India Act, 1934** for supervision and norms, along with the **SARFAESI Act, 2002** and the **Insolvency and Bankruptcy Code, 2016** for recovery and resolution of stressed assets.

Key Changes in Non-Performing Asset Classification

The **Reserve Bank of India** has introduced important changes in the way banks identify and classify bad loans.

Borrower-Level Classification of Non-Performing Assets: A major change introduced is the shift from loan-level to borrower-level classification.

- Under the revised framework, if any single credit facility of a borrower becomes a Non-Performing Asset, then all other credit facilities extended to the same borrower will also be classified as Non-Performing Assets.
- This represents a stricter and more holistic approach to credit risk recognition, replacing the earlier loan-specific classification method.

Continuation of Ninety-Day Overdue Norm: The basic definition of a Non-Performing Asset remains unchanged.

- A loan will continue to be classified as a Non-Performing Asset if interest or principal payments remain overdue for ninety days or more.
- However, the impact of such classification has now been widened across all credit facilities of the borrower.

Conditions for Reclassification as Standard Asset: A borrower who has been classified as a Non-Performing Asset can be reclassified as a standard asset only after full repayment of all outstanding arrears, including both principal and interest, across all credit facilities.

- Partial repayment or settlement of a single account will not be sufficient for reclassification.

Mandatory Automation in Classification: The Reserve Bank of India has directed banks to implement automated systems for identification and classification of Non-Performing Assets.

- This reduces reliance on manual processes, improves accuracy, and ensures timely recognition of stressed accounts.

Introduction of Expected Credit Loss Framework

A significant reform is the introduction of the Expected Credit Loss framework for provisioning against potential loan losses.

Earlier Framework: Incurred Loss Model

- Under the earlier system, banks were required to make provisions only after a loan became non-performing, that is, after ninety days of default. This approach was reactive in nature and often led to delayed recognition of stress.

New Framework: Expected Credit Loss Model

- The Expected Credit Loss model is forward-looking in nature. Banks are now required to estimate potential credit losses based on expected future risk rather than waiting for actual default.
- The Expected Credit Loss framework classifies loans based on rising credit risk and requires banks to create buffers accordingly.

Expected Credit Loss Model is structured into three stages:

- **Stage 1 (Low Credit Risk):** These are normal, safe loans where there is no major risk. Banks keep a small buffer based on expected losses over the next one year.
- **Stage 2 (Significant Increase in Credit Risk):** These are loans where risk has started increasing, but the borrower has not yet defaulted. Banks keep a higher buffer because there is a greater chance of future loss.
- **Stage 3 (Credit-Impaired Assets):** These are bad or defaulted loans. Banks keep the highest buffer because the risk of loss is already very high.

This structure ensures earlier recognition of credit stress and strengthens the resilience of bank balance sheets.

Effective Interest Rate Methodology

The Reserve Bank of India has also introduced the concept of Effective Interest Rate for calculating Expected Credit Loss provisions.

- Under this method, interest income is computed based on expected cash flows from financial instruments, taking into account all contractual terms except potential credit losses. This replaces the earlier reliance on contractual interest rates.
- The change ensures that income recognition and provisioning reflect a more realistic assessment of risk-adjusted returns.

Implementation Timeline

The transition to the new framework will be gradual:

- From April 1, 2027, all new loans will be governed by the Expected Credit Loss model and Effective Interest Rate framework.
- By March 31, 2030, all legacy loan accounts will be migrated to the new system.

This phased implementation is intended to give banks sufficient time to upgrade systems, processes, and risk management capabilities.

Significance of the Reform

The Reserve Bank of India's revised framework is an important step in modernising India's banking system by making it more transparent, risk-sensitive, and aligned with global practices.

- **Strengthening Financial Stability:** The forward-looking provisioning framework enables early identification of credit stress, thereby improving the stability and resilience of the banking system.
- **Alignment with Global Standards:** The reform aligns Indian banking practices with international financial reporting standards such as International Financial Reporting Standard 9, improving global comparability and investor confidence.
- **Improvement in Risk Management:** Banks will be required to adopt more advanced risk assessment systems, data analytics tools, and automated monitoring mechanisms, leading to stronger credit discipline.

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