What is the Expected Credit Loss (ECL) Regime?

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Why in News?

- The Reserve Bank of India (RBI) recently proposed to move the banking system to an expected credit loss-based provisioning approach from an "incurred loss" approach.

What is a loan-loss provision?

- The RBI defines a loan loss provision as an **expense that banks set aside for defaulted loans.**
- Banks set aside a **portion of the expected loan repayments from all loans** in their portfolio **to cover the losses either completely or partially**.
- In the event of a loss, instead of taking a loss in its cash flows, the **bank can use its loan loss reserves to cover the loss.**
- The level of loan loss provision is **determined based on the level expected to protect the safety and soundness of the bank.**

What is the Expected Credit Loss (ECL) regime?

- Under this practice, a **bank is required to estimate expected credit losses based on forward-looking estimations** rather than wait for credit losses to be actually incurred **before making corresponding loss provisions.**
- 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**.
- This will be in **contrast to the** existing approach of **incurred loss provisioning**, **whereby** step-up **provisions are made based on the time the account has remained in the Non-Performing Asser (NPA)** category**.**
- **Benefits of the ECL regime**:
    - 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 system** in line with globally accepted norms.

What is the problem with the incurred loss-based approach?

- It **requires banks to provide for losses that have already occurred or been incurred.**
- The **delay in recognizing loan losses resulted in banks having to make higher levels of provisions** which affected the bank's capital. This affected banks' resilience and posed systemic risks.
- The **delays in recognizing loan losses overstated the income generated by the banks,** which, coupled with dividend payouts, **impacted their capital base**.

Q1) What is a Non-Performing Asset (NPA)?

A NPA refers to a classification for loans or advances that are in default or in arrears. A loan is in arrears when principal or interest payments are late or missed. A loan is in default when the lender considers the loan agreement to be broken and the debtor is unable to meet his obligations.

Source: Banks can absorb expected credit loss regime impact: India Ratings