Impairment Loss Methodology under Ind AS 109 - Financial Instruments

As part of the renewed push on convergence of Indian Accounting Standards (Ind AS) with the International Financial Reporting Standards (IFRS), the exposure draft (ED) of the Ind AS equivalent of the IFRS 9 Financial Instrument has been issued recently. The Exposure draft of the Ind AS 109 is a replica of the IFRS 9, except for the exclusion of two parts that accompany the IFRS 9, i.e., Basis for Conclusions (BoC) and Implementation Guidance (IG). Impairment loss recognition and measurement methodology is a critical component of the Ind AS 109 Financial Instrument. The new methodology used in the Ind AS 109, will significantly change the current accounting issues, which include 'provision for non-performing asset, general provision for standard asset and provision for bad and doubtful debts'. The author in this article explains the concept of impairment loss recognition and methodology of Ind AS 109, which has received global attention in the light of the financial turbulence across the world. Read on...

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Exposure draft (ED) of Ind AS equivalent of IFRS 9 *Financial Instrument, i.e.,* Ind AS 109, which has been issued recently, is a replica of the IFRS 9 except for the exclusion of two parts, *i.e., Basis for Conclusions* (BoC) and *Implementation Guidance* (IG). Impairment loss recognition and measurement methodology is a critical component of this Ind AS, which will significantly change the current accounting issues, *provision for Non-Performing Asset* (NPA), *general provision for standard asset* and *provision for bad and doubtful debts.*

International Standard-IFRS 9

Consequent to the onset of global financial crisis (GFS) around 2008, a joint initiative of the International Accounting Standards Board (IASB) and the US national standard-setting body, Financial Accounting Standards Board (FASB), set up to reduce the complexity and improve accounting standards on the *Financial Instruments* (*e.g.*, IAS 39), got accelerated.

During the GFS, the *Impairment Loss* methodology of IFRS and US GAAP was identified as one of the key weaknesses. Global bodies such as G20 and Financial Stability Board (FSB) took a serious note of this issue, and some of them labelled these existing impairment models as a *Too-Late-and-Too-Little* approach. The Impairment methodology finalised recently in July 2014 marks the completion of IFRS 9 and is the result of an extensive debate and deliberation of about the last five years. IFRS 9 is internationally mandatory for the accounting period on or after 1st January, 2018, but a voluntary early adoption is permitted. To address the implementation issues and guidance required, the IASB has recently formed a resource team called the *Impairment Transition Group* (ITG).

Scope of Ind AS 109 Impairment Methodology

Ind AS 109 Impairment requirements apply to certain category of *Financial Assets* (FAs) and *Financial Instruments* (FIs) given in the table below and ***do not*** apply to non-financial assets such as property, plant and equipment, intangibles, *etc.*, which are addressed in other standards, *e.g.*, Ind AS 36.

FAs/FIs within scope of Ind AS 109	*FAs/FIs within scope of other Ind ASs*
• FAs classified as measured at a) Amortised Cost (AC) b) 'Fair Value through Other Comprehensive Income (FVOCI)' • Financial Guarantees and Loan Commitments to provide loan at below market interest rates	• Lease Receivables -Ind AS 17 Leases • Trade Receivables and Contract Assets-Ind AS 115 Revenue from Contracts with Customers • Loan Commitments- Ind AS 37 Provisions, Contingent Liabilities and Contingent Assets

FAs within amortised cost or FVOCI (fair value through other comprehensive income) category can be typically loans and advances or investments in bonds, debentures and other debt securities. Ind AS 109 impairment requirements also apply to certain commitments to extend credit and financial guarantee contracts. The reason behind the inclusion of these items is that such items do have credit risks similar to on-balance sheet exposures and these are also managed together; hence, it is single impairment model, which also removes complexity of multiple models.

FAs classified as FVOCI will be subject to these impairment loss requirements because fair-value gain/loss is not recognised in the profit or loss statement (P/L), but in a separate component within Equity-OCI (Capital & Reserves). But these requirements do not apply to equity investments classified as FVOCI using the irrevocable option at initial recognition.

Overall Approach and Theme Behind

IAS 39 followed an *Incurred Loss* approach wherein the impairment losses will be recognised only upon the occurrence of a credit-risk trigger or event indicating objective evidence of impairment, *e.g.* past due or default, significant financial difficulty and so on. Losses expected from the occurrence of future events, no matter how likely, were not to be recognised, *i.e.*, no concept like general provision on standard assets. IFRS 9 differs and follows an *Expected Loss* Model:

Box 1-Expected Loss Approach based on '3 Bucket or 3 Stage' Model		
FAs Bucket based on 'Increase in Credit Risk' since initial recognition		
Stage 1 No significant increase in credit risk or FA that has low credit risk (*e.g.*, above investment grade) at the reporting date	**Stage 2** Significant deterioration in credit quality but do not yet reflect Stage 3 features *30 days past due is rebuttable presumption*	**Stage 3** Credit-impaired *90 days past due is rebuttable presumption of 'Default'*
Impairment Loss Recognition Threshold		
12-Month ECL	Lifetime ECL	Lifetime ECL

Interest Revenue Recognition Method		
Effective Interest Rate (EIR) on gross carrying amount	EIR on gross carrying amount	EIR on amortised cost amount

Time Value of Money-Credit Loss computation is based on present value of estimated cash flows discounted at original EIR (or other specified rates)

There are substantial *disclosure* requirements but those are part of the Ind AS 107. Before we look at the above prescriptions in detail, let us understand a few fundamental concepts and techniques:

Information basis: Expected Credit Loss (ECL) is recognised and measured using information that is based *not* only on historical, current conditions and events, *but* also considering *forecast future information*. But, entities are not expected to use crystal ball to gaze the future.

Impairment loss allowance: Assessed at each reporting date and difference between the opening and closing balances is recognised in the P/L as impairment gain or loss.

ECL: ECL is defined as the weighted average of credit losses with the respective risks of a default occurring as the weights. Application guide (Paragraph B5.5.28) of the Ind AS 109 elaborates this, as the ECLs are a probability-weighted estimate of credit losses *(i.e.,* the present value of all cash shortfalls) over the expected life of the financial instrument.

Box 2 – Formulaic expression of ECL					
Advanced approaches	Probability of Default (PD)	X	Loss given Default (LGD)	X	Exposure at Default (EAD)
Simple approaches*	Loss Rate or Provision %age*			X	Amount O/S
**vary based on categorisation: past due, asset quality, customers, regions, products.*					

Credit Loss (CL): The standard defines CL as the difference between all contractual cash-flows that are due to an entity in accordance with the contract and all the cash-flows that the entity expects to receive (*i.e.*, all cash shortfalls), discounted at the original effective interest rate (or credit-adjusted effective interest rate for purchased or originated credit-impaired financial assets). Cash-flows expected will include recovery from borrower, liquidation of collateral/securities, guarantees and credit enhancements. Based on above definition, one can say that a CL reflects a component of the total ECL, *i.e.,* LGD component in Box 2 above.

FAs within amortised cost or FVOCI (Fair Value through Other Comprehensive Income) category can be typically loans and advances or investments in bonds, debentures and other debt securities. Ind AS 109 impairment requirements also apply to certain commitments to extend credit and financial guarantee contracts.

Risk of default (RoD): This aspect occupies a central position in the new impairment model as it forms the basis of critical components, *i.e.*, assessment of significant increase in credit risk of FA, determining level of credit risk, *i.e.,* low or high and to differentiate measurement of 12-month ECL and lifetime ECL. RoD is a measurement of the FAs credit risk that does not require full estimation of ECL (Paragraph BC5.154 of BoC of IFRS 9). Conceptually, it is similar to PD component in Box 2, but under the IFRS, they may not always be the same. RoD can be assessed and expressed using *qualitative* criteria, *i.e.* simple rank ordering the FAs into buckets to differentiate credit risk or in explicit quantitative measures like PD or *risk ratings*, the latter may reflect total credit loss & not just RoD. *Because the RoD is a component of ECL and not the entire ECL, the standard makes it amply clear that if the entity does not apply the explicit PD approach as an input per se, such as in credit loss rate approach, it should be able to separate the changes in the risk of a default occurring from changes in other drivers of expected credit losses, such as collateral* (Paragraph B5.5.12 of Ind AS 109). Such a challenge to separate may arise in case of entities utilising rating systems that consider both the borrower-specific risk features (ability/willingness to repay) and facility-/transaction-/collateral-related risk factors, *e.g.* retail exposures risk grades under Basel II, Bank Loan /Issue Specific Rating of some external rating agencies. However, Illustrative Example 5 of IG of IFRS 9 indicates that if the collateral value has

a strong correlation with the default rates, credit risk ratings that include such factors do not require any further separations.

12-month ECL: The standard defines it as the portion of lifetime expected credit losses that represent the expected credit losses that result from *default events* on a financial instrument *that are possible within the 12 months* after the reporting date.

Lifetime ECL: The expected credit losses that result from all possible *default events over the expected life* of a financial instrument.

Therefore, lifetime cash shortfalls that will result if a default occurs *within 12 months and anytime over entire expected life* after the reporting date are 12-month ECL and lifetime ECL, respectively. As can be seen from the above definitions, the differentiation between the two thresholds is solely based on a factor that drives the occurrence of default, *i.e.*, RoD and not on any other the basis (refer to Paragraph BC5.154 and 155 of BoC of IFRS 9). Now the question arises - can this factor 'RoD', which is similar to PD, be computed for different time horizons? Yes, it is a well-known credit risk philosophy that *longer the tenor higher the RoD or PD*. Therefore, it is possible to estimate RoD (like PD) over different time horizons, say occurrence of default over next 12 months (commonly called as *Point-in-Time* PD), over an economic (or credit) cycle (commonly called *Through-the-Cycle* PD) or over the entire life time of the exposure. The first two categories are widely used by many banks especially those following advanced approaches of the *Basel II Capital Adequacy Framework*. Another point to note here is that a *12-month* ECL is also not a pro-rata allocation of *lifetime* ECL using time-proportion basis. It is equally important to note that lifetime ECL does not mean RoD or PD is 100%, but it is based on assessed level of credit risk of individual FA or counterparty (refer to Example 1 for clarity on the difference between the two).

The standard defines CL as the difference between all contractual cash-flows that are due to an entity in accordance with the contract and all the cash-flows that the entity expects to receive, *i.e*, all cash shortfalls), discounted at the original effective interest rate (or credit-adjusted effective interest rate for purchased or originated credit-impaired financial assets).

Credit-impaired FAs: Prescriptions for determining credit-impaired items are similar to that of identifying impaired FA under the IAS 39 but there is more clarity and accuracy in Ind AS 109. A financial asset is credit-impaired when one or more events that have a *detrimental impact* on the estimated future cash flows of that financial asset have occurred. The standard's intention here is to say that there is near likelihood of default and incurrence of credit loss. The standard goes on to require that there has to be evidence of impairment based on observable data about certain events. The approach here and the credit-risk events cited are broadly the same as those used in identifying impaired FAs or NPAs in the banking world such as significant financial difficulty of the borrower or issuer, breach of contract such as default, possibility of bankruptcy or financial restructuring and so on.

Default: Meaning and definition of the term *Default* assumes high significance because segmentation of FAs, which drives ECL recognition and measurement, is dependent upon the assessment of level of and change in credit risk from the viewpoint of RoD. Considering the need for and prevalence of different approaches, the standard-setters prescribe that entities can adopt definitions used in their internal credit risk management purposes and use those criteria consistently. However, the standard stipulates a rebuttable presumption that default is assumed when FA is *90 days past due*, a threshold commonly accepted, including prudential regulators across the globe and used since a very long time. Further, entities have a flexibility to adopt longer threshold than 90 days past due based on FA type/ product specific definitions (*e.g.*, retail loans, contract receivables, agricultural loans, *etc.*), but have to justify the appropriateness of different default thresholds. Also, the use of materiality and practical considerations would be needed to suitably address the isolated one off instances of past due. It is pertinent to note that some of the NPA identification criteria prescribed in the Reserve Bank of India (RBI) Master Circular on *Prudential Norms* can be adopted here also.

ECL Recognition Approach Principles

Impairment-loss allowance is recognised for both

Considering major operational challenges for longer tenor FA, *etc.*, the standard provides flexibility and accepts assessment based on comparison of RoD occurring over next 12 months, where default patterns are not concentrated at a specific point in time or significant payments obligations do not arise only beyond next 12 months.

credit-impaired and non credit-impaired (standard asset in Indian parlance) categories. However, the ECL recognition threshold *(i.e., 12-month or lifetime* ECL) varies depending upon the change in credit risk (RoD) since initial recognition or level of credit risk at reporting date. The rationale for this approach is to capture the underlying economics of the transaction, while easing operating complexities like uncertainty about estimating lifetime ECL for FAs with no signs of increase in credit risk and avoiding excessive front loading of ECLs but addressing concerns of G20/ Others about delayed recognition of credit losses under the IAS 39 (Paragraph BC5.150 of BoC of IFRS 9).

In view of the operational complexities involved in tracking changes in credit risk for entities that do not have sophisticated credit-risk management systems, a simplified approach of ECL recognition has been permitted for the certain type of FAs, *viz.* trade receivables (both categories those having and not having significant financing component), contract assets *(receivables)* and lease receivables. For these FA types, entities have the option of having accounting policy choice to always measure and recognise *lifetime* ECL instead of a two-step process.

Mechanics of Determining Significant Increase in Credit Risk

The standard provides an extensive guidance, which at times is contradictory, necessitating appropriate interpretation. Four main principles can be deduced from the standard.

(i) Change in Risk of Default (RoD): RoD or PD is one of the most relevant factors used to compute ECL. It was considered operationally simpler and better aligned with entities risk management practices to assess the change in credit risk-based on change in this factor only instead of tracking movement in the total amount of ECL. The standard lists down over 15 items that can be applied in assessing the changes in credit risk, which include changes in internal and external price indicators, *e.g.,* interest rate, credit spreads, fair value, changes (expected or actual) in internal or external credit rating, adverse change in credit risk of other FIs of the same borrower, adverse changes in business, operating and regulatory environment, breach of covenants, past due, change in credit management approach for the FA (*e.g.*, account transferred to special monitoring cells, *etc.*). Entities can apply different approaches to different financial instruments, *e.g.*, a typical commercial bank can use the following approach:

Credit Exposure Type	Risk Assessment Tools
Corporate Lending	Internal Credit Risk Grade/Score
Investment Securities	Credit Rating by agencies like S&P
Retail Exposures	Credit Score (Application/Behavioural Scores)

Assessment of RoD over expected life of FA

When assessing change in credit risk, an entity is required to consider the RoD occurring over the expected life of FA and not over shorter period, say over next 12 months. Considering major operational challenges for longer tenor FA, *etc.*, the standard provides flexibility and accepts assessment based on comparison of RoD occurring over the next 12 months, where default patterns are not concentrated at a specific point in time or significant payments obligations do not arise only beyond the next 12 months.

Change in RoD since initial recognition, Modification (Restructuring) of cash flows

Assessment of significant increase in credit risk is by comparing RoD as of Initial Recognition to current reporting date and not from last reporting date to current reporting date. It is also not based on simple comparison of *absolute level* of *credit risk* as of two reporting dates. In case of modification *(e.g.* restructuring of facilities) assessment is by considering credit risk as of initial recognition, *i.e.* unmodified original terms and *not* as of recent modification date. Hence, there is no scope for *ever greening* of credit exposures.

Collective and individual assessment basis

There may be situations where a significant increase

in credit risk may not be noticeable at individual instrument level, *e.g.,* over different exposures on a single counterparty or such assessment may not be feasible at all such as large pool of retail loans. In such cases, the assessment can be performed on collective basis by grouping the FAs based on shared credit risk characteristics, examples of which are instrument type, credit-risk ratings, borrower/industry type, geography/region, collateral type, collateral value, *e.g.,* loan-to-value ratio (if they influence or drive the RoD), origination time and remaining maturity. Here, there is some similarity with the guidance in the IAS 39 for Collective Impairment Assessment. *The key purpose of grouping FAs based on shared credit risk characteristics should be to identify appropriate credit loss on timely basis.*

Counterparty versus individual FA

It is a well-known credit-risk management practice that in case of corporate and business entities, credit-risk assessment is performed at counterparty level and not at individual facility or instrument level. Generally, a comprehensive review of all credit facilities and credit-risk assessment is performed as part of annual facility renewal policy. The question is whether an entity can recognise lifetime losses on all exposures to a counterparty based on its credit assessment at counterparty level. Reading of paragraph BC5.166 to 167, BC5.260 of BoC, Illustrative Example 7 of IG of IFRS 9 and Paragraph B5.5.1 to 6 of IFRS 9, all give contradictory and unclear positions.

(ii)30 days past due-rebuttable presumption of significant increase in credit risk

The standard does not explicitly prescribe *Quantitative* criteria as to what *Significant* increase in credit risk is. However, a few specific factors to bear in mind, highlighted by the standard are level (low or high) of credit risk at initial recognition, remaining tenor of FAs even if the credit rating is same and credit risk is expected to decrease as the time elapses, *etc.*

More importantly, the standard prescribes a rebuttable threshold of 30 days past due which can act as *backstop* measure. This threshold appears to be very stringent, but one is allowed to adopt a higher threshold, say 60 days (or even 90+ days), if an entity is able to demonstrate with adequate evidence and information that there is no significant correlation between 30 days past due and RoD either at level of individual instrument or product type or customer type or region. However, this threshold cannot be pushed to a level that is used for defining default or credit-impaired category of FA.

RBI's regulatory prescriptions (Part C of Master Circular on Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances) to identify and monitor distressed (special mention accounts-SMA0, SMA1, SMA2) exposures based on past due status would be helpful here.

(iii) This assessment cannot be solely based on *past due information* unless other more forward-looking information is *not* available without undue cost and efforts.

(iv) FIs that have low credit risk at the reporting date

In order to reduce the operational complexity and costs, the standard does not require recognition of *lifetime* ECL for FAs that have low credit risk at reporting date. In a way, in such cases, there is really no need to assess the change in credit risk since initial recognition. Here, entities can use internal credit rating or external credit rating or other globally accepted methodologies. As a guide, the standard states that external credit ratings upto *Investment Grade*, *e.g.,* BBB of S&P or its equivalent, may be considered as low credit risk.

Decrease in credit risk since initial recognition

At any reporting date, if it is identified that there is a decrease in credit risk from previously assessed level and it results in FA not meeting Stage 2 criteria or having low credit risk, ECL recognition will revert to *12-month* ECL threshold from *lifetime* ECL.

Overall, there are a number of areas that require development of robust policies and procedures, systems and close involvement of credit risk experts.

Prescriptions for determining credit-impaired items are similar to that of identifying impaired FA under the IAS 39 but there is more clarity and accuracy in Ind AS 109. A financial asset is credit-impaired when one or more events that have a *detrimental impact* on the estimated future cash flows of that financial asset have occurred.

Therefore, evaluation based on a range of possible outcomes and multiple scenarios would be appropriate to reduce uncertainty and lend higher reliability to the ECL amount. However, a large number of scenarios or outcomes are not expected always; at least, two outcomes are expected.

Measurement of ECL

- The standard prescribes uniform principles centered around *Three Factors* for measuring the ECL of all FAs regardless of credit risk level (stages).
- In view of the application of *time-value-of-money concept*, credit loss occurs even if the borrower repays full amount but later than the contractual due date or pays interest at a reduced rate than the original interest rate.

(1) Unbiased and probability-weighted outcome

The standard recognises the inherent nature of credit loss that it is subjective and judgemental and requires estimation, at times, using multifactor and holistic analysis (Paragraph B5.5.16 of Ind AS 109) by the relevant subject-matter experts. Therefore, evaluation based on a range of possible outcomes and multiple scenarios would be appropriate to reduce uncertainty and lend higher reliability to the ECL amount. However, a large number of scenarios or outcomes are not always expected; at least, two outcomes are expected. Another critical aspect to note is that impairment loss measurement is an unbiased estimated amount. It is not a worst case or best case scenario nor most likely outcome scenario.

The standard does not mandate any particular technique and method. It is not always necessary that sophisticated statistical models or complex mathematical exercises are required. The approaches depend upon the nature and complexity of credit-risk items and availability of data/information. Entities can use advanced techniques like an explicit use of PD, LGD and EAD for some type of exposures. Simple approaches like estimation based on average loss rates of a large group of items with shared credit risk characteristics would be a substitute for probability-weighted estimated amount. Similarly, practical expedients like *provision rate matrix* based on past due or other criteria are acceptable. However, one has to bear in mind the requirement to suitably group the items to reflect shared credit risk features and to adjust the historical data for changes in current conditions and expected future conditions. Further, simpler approaches like loss rates, applied should also be able to differentiate between RoD for 12-month ECL and RoD for *lifetime* ECL, relevant for Stage1 and Stage 2 categories, respectively. Perhaps, entities may have to arrive at two loss rates.

Cash-flows from collaterals need to reflect timing of receipt, cost of repossessing/selling those bearing in mind the legal and market factors. In case of undrawn loan commitments, estimation shall take into account the period over which entity will be exposed to credit risk and shall not restrict it to contractual notice period to withdraw facilities. A concept similar to computation of *Exposure At Default* (EAD) in the banking world can be applied here.

Credit-risk management and recovery or collection departments will play a major role in this estimation process. Provision percentages prescribed by RBI under *Prudential Norms* may be used, provided those are supported by justifiable and suitable data/facts about risk of default and amount of losses and are not excessively influenced by other regulatory obligations like monetary and economic policy considerations.

(2) Time value of money–present value and cash flow discounting

This is an important conceptual change introduced by the Standard. Though it is not widely used in the measurement of loan-loss provisions in India, it is required by the RBI in certain circumstances, *e.g.*, in case of provisioning for restructured NPAs, where there is an evidence of sacrifice of future interest on the loans. Prescriptions of the standard in this regard are:

- ECL shall be computed by discounting cash flows to the reporting date and not to some other date such as default date. The latter concept is used in estimating LGDs under Basel II Regulatory Framework.
- Discount rate shall be original EIR (or approximation thereof); latest EIR in case of variable (or floating) rate accounts. Also different specifications exist for lease receivables, loan commitments, financial guarantees and purchased or originated credit-impaired FAs.

Under the Ind AS 109, there is no concept of NPAs like interest recognition on Cash Basis or Interest-in-Suspense approach. The standard requires that interest income on credit-impaired item should be recognised on using the original EIR but on amortised cost base.

(3) Reasonable and supportable information

Ultimately, availability of adequate, appropriate and reliable information is a prerequisite for achieving objectives of preparing and providing decision-useful reliable financial information to the users of financial statements. The standard requires that impairment loss methodology has to be based on *Reasonable and Supportable Information* at reporting date about past events, current conditions and forecasts of future economic conditions. Consistent with the underlying objective behind ECL model, entities have to consider expected economic scenarios. This is a paradigm shift from the IAS 39 prescriptions and also Prudential Regulations which assign greater weightage to historical data. Few important guiding principles laid down are:

- Entities are not expected to go on making exhaustive research but consider *Reasonable and Supportable Information* that is available without undue cost/effort.
- It is not always necessary to incorporate future forecast conditions over the entire expected life of FA. As the forecast horizon increases, data availability and reliability decreases and estimation becomes more judgmental and uncertain.
- Historical data is a base anchor but needs to be adjusted for changes in current and future conditions. In an emerging economy like India, this aspect is very critical.
- Internal as well as external sources can be used subject to adherence to comparability requirements.

For banks in India, external data bases such as loss data consortium CordeX (an initiative of Indian Banks Association) and internal data warehouses set up for Basel II purposes can be a significant source of information. Also, RBI being the repository of extensive data about banks can play a significant role in guiding the banks and disseminating the information.

Example 1: Stage 1 and 2 accounts-explicit use of advanced credit risk parameters-PD/LGD/EAD *(refer to the appendix for detailed working)*

Notes on detailed workings
1) Column 4 reflects counterparty risk grades/ credit scores used by the entity to differentiate credit risk across exposures in internal risk management. Probability of Defaults (PD) is derived from these elements which form the basis of assessing change in RoD and level of credit risk. Accounts in Risk grades 'AAA to BBB' of Commercial banking division and credit scores up to 30 of Retail banking division are considered as 'Low Credit Risk'. Other categories are assessed for segregation into Stage 2 and Stage 3 items by considering the change in RoD, *i.e.*, by comparing risk grade/credit score as of initial recognition of FA to those as of current reporting date.
2) Column 7 represents the extent of Loss in the event of default which is called Loss given Default (LGD). It takes into account time value of money and also recoveries from sale of non-cash collaterals such as building, plant *etc*. Therefore, values of non-cash collateral are not reduced while computing net exposures to avoid double counting of collateral values. LGD as well as PD are based on data used for Bank's Regulatory Capital requirements but adjusted to reflect Ind AS prescriptions such as discount rate.
3) Off balance sheet exposures are converted into credit equivalents using percentage called 'credit conversion factors (CCFs)' which were determined based on past experience. CCF's for loan commitments and Financial Guarantees were 100% and Import Letters of Credit 20.

Example 2: Stage 3 Credit-impaired account

A term loan of ₹1000/- carrying contractual interest 10% is determined to be credit-impaired as of 31-03-2001. Contractual interest rate and EIR are same. At time of impairment, there is an unpaid interest accrued and due of ₹100/-. The bank expects to

Consistent with the underlying objective behind ECL model, entities have to consider expected economic scenarios. This is a paradigm shift from the IAS 39 prescriptions and also Prudential Regulations which assign greater weightage to historical data.

receive an amount of ₹800/- towards principal in two annual installments (31-03-2002 and 31-03-2003) and additional ₹100/-towards accrued interest along with first installment. When the account was considered as credit-impaired, against this exposure there is an ECL provision balance of ₹40 on gross basis and ₹50 on present value basis.

		31-03-2001	31-03-2002	31-03-2003
1.1	Gross Carrying Amount	1,100	600	200
1.2	Amortised Cost (1.1-5)	785	364	0
2	Expected Future Cash Flow including interest - Gross	(900)	(400)	0
3	Present Value of Expected Future Cash Flow including interest- Discounted at original EIR (10%)	(785)	(364)	0
4	ECL Provision- Gross (1 -2)	200	200	200
5	ECL Provision - Discounted (1-3)	315	236	200
6	Additional ECL Provision due to discounting (5-4)	115	36	0
7	Reduction in discount provision (unwinding of discount)	-	79	36
		-	(115-36)	(36-0)
	Memorandum Contractual Interest Accrual for the year	100	100	60

Based on the above, upon initial impairment recognition as of 31-03-2001, an amount of ₹265 (₹315 less ₹50 opening ECL) will be charged to P/L as I*mpairment Loss Charge* and credited to a Balance Sheet account called Impairment Loss Allowance. In practice, two separate b/s account may be maintained to separately track *impairment loss allowance* on gross basis and discounted basis. In the second year (31/03/2002) and third year (31-03-2003), there is a reduction of ₹79/- and ₹36/-, respectively, in the impairment-loss allowance, which will be released to the P/L. This is effectively equal to interest income recognition on amortised cost balance of ₹785/ and ₹364 at EIR of 10%.

Interest Income Recognition for Credit-Impaired Assets

This aspect is one of the more controversial aspects and a radical change in the income recognition principles of credit-impaired asset. Under the Ind AS 109, there is no concept of NPAs like interest recognition on *Cash Basis* or *Interest-in-Suspense* approach. The standard requires that interest income on credit-impaired item should be recognised on using the original EIR but on *amortised cost* base. However, contractual interest income gets recognised on accrual basis only if the bank expects to receive cash flows that cover interest claim over and above the principal outstanding. But, such fact patterns will be rare resulting in similar end result like cash basis recognition. Secondly, interest income recognised will only be unwinding (release of additional provision created) of discounting effect due to passage of time.

Conclusion

Impairment Loss Methodology of Ind AS 109 brings in new accounting concepts and global best practices which will undoubtedly enhance the quality of financial information and enable timely and adequate recognition and quantification of credit losses in the financial statements. Prescriptions of a principle-based standard founded on the conceptual framework of *Neutrality* and *Faithful Presentation* call for an exercise of significant management judgment and estimation. In a rule-based highly prescriptive reporting environment like India, there is a need for a change in *mindset* among the preparers, auditors and other stakeholders. But this issue is not insurmountable in the present economic and political scenario.

Effective and efficient implementation necessitates partnerships with subject-matter experts outside the typical accounts/finance department and comprehensive review and changes to enterprise-wide data systems and framework. Bankers have to start putting life in credit review files and invoke their unique ability, *i.e., their sixth sense.*

Example 1: Stage 1 & 2 Non Credit-impaired accounts-Explicit use of Advanced Credit Risk Parameters- PD/LGD/EAD

Borrower (1)	Type of exposure (2)	Amount (3) ₹	Risk grade (4)	PD -12 Month (5)	PD – Lifetime (6)	LGD (7)	Collateral value (8)	ECL 12-month 9 = 5x7x3	ECL Lifetime 10 = 6x7x3	Credit risk 'Stage'
Commercial banking division -On balance sheet exposures										
A	Term loan	10000	AAA	0.01%	0.02%	60%	0	0.60	NA	Stage 1 -Low Credit Risk upto Investment grade
B	Overdraft	5000	AA	0.03%	0.05%	60%	0	0.90	NA	
	Term loan	2000	AA	0.03%	0.05%	60%	0	0.36	NA	
C	Import Loan	7000	A	0.10%	0.14%	45%	0	3.15	NA	
D	Export Loan	5000	BBB	0.40%	0.70%	20%	Cash – 1000	3.20	NA	
E	Bills discounted	10000	BB	2.25%	5.25%	40%	0	Now, these require Lifetime ECL	210	Stage 2 -Significant increase in credit risk
F	Term loan	10000	B	10.00%	22.00%	30%	Building – 3000(2)		660	
G	Bonds	2000	C	30.00%	70.00%	60%	0		840	
H	Term loan	2000	D	100%	100.00%	50%	ECL Assessed using different approach			Stage 3 -Credit-impaired
Commercial banking division -Off balance sheet exposures										
B	Loan commitment	20000	AA	0.03%	0.05%	60%	0	3.60	NA	Stage 1 - Low Credit Risk
C	Letter of credit	10000	A	0.10%	0.14%	45%	LC shipment	0.90	NA	
G	Financial guarantee	10000	C	30.00%	70.00%	60%	Cash – 2000	NA	3360	Stage 2
Retail banking division -On balance sheet exposures										
a	Res mortgage	5000	80-99	0.10%	0.10%	25%	House-5500 (2)	1.25	NA	Stage 1 -Low Credit Risk
a	Personal loan	1000	60-79	1.15%	4.50%	45%	0	5.18	NA	
b	Car loan	1000	50-59	3.00%	5.00%	40%	Car – 1100	12.00	NA	
c	Student loan	500	40-49	5.00%	10.00%	70%	0	17.50	NA	
d	Res mortgage	2000	30-39	6.00%	10.00%	25%	House-2250	Now, these require Lifetime ECL	50	Stage 2 -Significant increase in credit risk
e	Overdraft	1000	20-39	20.00%	30.00%	60%	0		180	
f	Sub-prime mortgage	1500	10-19	40.00%	60.00%	50%	House-1250		450	
g	Credit card	1000	< 10	100%	100.00%	80%	ECL Assessed using different approach			Stage 3
Total ECL for on Balance sheet exposures deducted from FAs carrying amount in B/S									2434	
Total ECL for Off-Balance sheet exposures shown under Provisions and Other Liabilities									3365	