STUDENTS' ECONOMIC FORUM

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Theme 260

DYNAMIC PROVISIONING

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Theme No. 260 : Dynamic Provisioning

A well informed customer will make the policy makers as well as organisations which produce goods and services more responsive to the customer needs. This will also result in healthy competition among organisations and improve the quality of goods and services produced.
The "SIB Students' Economic Forum" is designed to kindle interest in economic affairs in the minds of our younger generation. We highlight one theme in every monthly meeting of the "Forum". This month, we discuss on a proposal for introduction of Dynamic Loan Loss Provisioning frame work in Indian Banks.

What do you know about Loan Loss Provisioning?
When borrowers default, there is a risk involved in repayment of depositors' money. In order to cover this risk, banks usually keep a portion of their profit to cover the anticipated default. Provisioning for loan losses refers to the mechanism used to recognise credit impairments. Provisioning is a critical component to effective financial reporting and prudential supervision. Provisions for loan losses reduce an institution's reported net income in the period in which the provision is recognized.

What is the present position of loan loss provisioning prevailing in Indian banks?
Provisions against loan losses can be broadly divided into two categories:

- General provisions
- Specific provisions.

Indian banks make additional provisions and the four types of loan loss provisions followed by them are:

- General provisions for standard assets
- Specific provisions for NPAs
- Floating provisions
- Provisions against the diminution in the fair value of a restructured asset.

But the present provisioning policy has certain drawbacks. The rate of standard asset provisions has not been determined based on any scientific analysis or credit loss history of Indian banks. Banks make floating provisions at their own will without any pre-determined rules and not all banks make floating provisions. It makes inter-bank comparison difficult. Traditionally, provisioning was meant as a cover for the loss already incurred. But the recent bank failures in Europe, pointed towards developing a framework to provide more in boom times for use in bad times. The present provisioning framework does not have countercyclical or cycle smoothening elements. Though RBI has been following a policy of countercyclical variation of standard asset provisioning rates, the methodology has been largely based on current available data and judgement, rather than on an analysis of credit cycles and loss history. In view of the above, there is a need for introducing a comprehensive provisioning framework for banks in India with dynamic and countercyclical elements. RBI has released a discussion paper on “Introduction of Dynamic Provisioning Framework for Indian Banks” for comments and feedback from the banks and the other stakeholders.

What is the need for introducing a counter cyclical provisioning frame work in India?
RBI in its discussion paper has stated that there is a need for introducing a comprehensive provisioning frame work for Indian Banks with dynamic and counter cyclical elements. A business cycle or economic cycle passes through various stages such as boom, recession, depression and recovery. During boom times banks make huge profits and the rate of default is less whereas during recession and depression the profits decline with higher default rate in loans. Dynamic provisioning means maintain higher provisions in better times to make good for bad times. Countercyclical provisioning approaches have been implemented in some countries even before the financial crisis.

We discuss below the two essential categories.

1. Pure Dynamic Provisioning Policies:

This approach uses the dynamic provisioning only to smoothen the cyclical variations in specific provisions thereby avoiding fluctuations in the P&L through the cycle.

2. Conservative Dynamic Provisioning Policies:

The approach , in addition to targeting the smoothening of the cyclical variations in P&L due to specific provisions, also tend to build-up reserve of general provisions in good times to be used in case the cyclical downturn turns out to be more severe than the earlier one.

Which are the two provisioning approaches followed in our country?

1. Incurred Loss Model:

The accounting model for recognizing credit losses being followed presently by most of the countries (as well as under US GAAP and IFRS) is referred as “incurred loss model”. Under the approach, provision is made against the loans only on occurrence of an identifiable event that questions the collectability of principal and interest in full. The timing and measurement of losses are, therefore, based on estimating losses that have been incurred as of the reporting date. The current accounting standards based on incurred loss approach do not permit recognizing credit losses based on events that are expected to occur in the future. The incurred loss-based accounting approaches to provision are generally of two type viz., rule based and principle based. While the rule based approach does not give the bank management freedom from deviating from the set rules, the principle based approach leaves bank management with freedom to pursue the set outcomes in ways that they deem most suitable, given the realities of their own institution. A combination of the above two types is also practiced in some jurisdictions. The global financial crisis thus highlighted the need to review the impairment-accounting framework for financial assets, which is currently getting the attention from accounting standard setters, the Basel Committee and other international bodies.

2. Expected Loss Model

Banks have introduced the concepts of expected losses (EL) and unexpected losses (UL) to measure the potential losses in a credit portfolio. It is generally accepted that banks should cover the unexpected losses by capital and expected losses by provisions. The EL is generally derived as the mean of the credit loss distribution. The Basel II Framework provided a further push to this approach by clearly requiring banks to separately measure EL and UL. EL-based provisioning has a forward-looking element as it is capable of incorporating through the cyclic view of probability of default. The recent financial crisis has provided a still further fillip to the search for a forward-looking provisioning approach due to pro-cyclical considerations. To address this, Basel Committee on Banking Supervision (BCBS) under Basel III reforms is introducing a number of measures. First, it is advocating a change in the accounting standards towards an expected loss (EL) approach. The Basel Committee strongly supports the initiative of the International Accounting Standards Board (IASB) to move to an EL approach. The goal is to improve the usefulness and relevance of financial reporting for stakeholders, including prudential regulators. It has issued publicly and made available to the IASB a set of high level guiding principles that should govern the reforms to the replacement of IAS-39. The Basel Committee also supports an EL approach that captures actual losses more transparently and is also less pro-cyclical than the current "incurred loss" approach. Second, it is updating its supervisory guidance to be consistent with the move to such an EL approach. Such guidance will assist supervisors in promoting strong provisioning practices under the desired EL approach. Third, it is addressing incentives to stronger provisioning in the regulatory capital framework.

What is the present proposal for a dynamic provisioning frame work to be introduced in Indian Banks?

The objective of the Dynamic Provisioning framework is to smoothen the impact of incurred losses on the P&L through the cycle, and not to provide general provisioning cushion for expected losses. This smoothening can be achieved based on the presumption that average losses and hence average specific provisions, through the cycle will be equal to EL. Consequently, the dynamic provision created during a year will be the difference between EL and the specific provisions made during the year.

Dynamic Provisioning =Expected Average Loss on total loans – Actual provisioning in a year.

$$\Delta DP = EL - \Delta SP$$

$= \alpha C_t - \Delta SP$ where á is the average estimate of credit loss, C_t is stock of loans in amount, ΔSP is the incremental specific provisions in amount. Where Specific Provisions "SP" made during a year as per RBI guidelines and will be debited to P&L account.

It is the difference between the long run average expected loss of the portfolio for one year and the incremental specific provisions made during the year. This is based on FSA (Financial Services Authority) approach. It is assumed that when the approach is implemented for the first time, the bank has adequate specific provisions to cover its NPAs. Positive value of $\alpha C_t - \Delta SP$ will increase the credit balance in DP Account. Negative value will represent a drawdown from the DP Account. This will generally ensure that every year the charge to P&L on account of specific provisions and DP is maintained at a level of αC_t.

How do we plan to implement the Dynamic Provisioning Framework?

With a ten year data base drawn from 9 banks representing 32% of the banking sector, RBI has calculated the average total loss of Indian banking system as also the group wise expected average losses in normal years and in bad years. Since 1.37% is the average loss in a bad year, RBI has advised all Indian Banks to maintain total provisions of 1.37% of its book at all times.

What are the major pitfalls in the above provisioning?

The mandatory average provisioning of 1.37% is applicable in a bad year. So it is a conservative and strict rule. Most banks are yet to provide enough to reach the provision coverage ratio of 70% in the first year. Banks can use the money from the accumulated dynamic provisioning during bad times, only when RBI says there is a downturn. The dynamic provisioning is for expected losses, not yet incurred. Still banks have to pay tax on these provisions. The provisioning is not based on expected loss experience of individual banks. Banks, with capability to calibrate their own parameters may, with the prior approval of RBI, introduce dynamic provisioning framework using the theoretical model. Banks, not able to introduce dynamic provisioning based on their data, may use the standardized calibration as shown herewith.

Dynamic Provisioning Framework

Nature of Incremental Provisions/Reserves	Formula	Remarks
Specific Provisions (SP)	As per regulatory guidelines issues by RBI	Charged to P&L
Dynamic Provisions (DP)	$\alpha C_t - \Delta SP$	Charged to P&L.

Values of Parameters	Corporate Loans	Retail Loans	Housing loans	All other Loans	Total Loans
Alpha (α)	0.62%	2.67%	0.27%	2.26%	1.37%

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