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RBSA Advisors

RBI's Draft ECL Framework 2025: Aligning India's Banking System with IFRS 9 and Basel III – RBSA's Perspective

Valuation | Investment Banking
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Executive summary

The Reserve Bank of India's (RBI) released draft Scheduled Commercial Banks (Asset Classification, Provisioning and Income Recognition) Directions, 2025 to shift India's banking framework from the incurred loss model to a forward-looking Expected Credit Loss (ECL) framework.

This transition aligns Indian standards with IFRS 9 and Basel III, bridging the accounting and prudential gap. The objective is to ensure:

- Timely recognition of credit losses, improving financial stability.
- Forward-looking risk management, integrating macroeconomic trends.
- Enhanced transparency and comparability across institutions.

Rajeev R. Shah
Managing Director & CEO

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1. Core Concept: ECL Formula

$$ECL = EAD \times PD \times LGD$$

Where:

- EAD (Exposure at Default): Outstanding exposure when a borrower defaults.
- PD (Probability of Default): Likelihood of default over a defined period (12 months or lifetime).
- LGD (Loss Given Default): The percentage of the exposure that is lost if default occurs, net of recoveries.

2. Scope: Seven Financial Instruments Covered

ECL must be calculated for the following instrument types:

- Loans
- Debt Securities
- Trade Receivables
- Lease Receivables
- Loan Commitments
- Off-Balance-Sheet Exposures
- Other Financial Assets

- Each of these must be analysed for Probability of Default (PD), Loss Given Default (LGD), and Exposure at Default (EAD).
- Off-balance-sheet items require Credit Conversion Factors (CCFs) to convert notional exposures into actual credit equivalents.

3. The Three-Stage Model

Stage	Description	Provision Basis
Stage 1	Performing assets, no significant credit deterioration	12-month ECL
Stage 2	Significant Increase in Credit Risk (SICR) identified	Lifetime ECL
Stage 3	Defaulted or credit-impaired assets	Lifetime ECL + interest on amortized cost

SICR Triggers:

- Internal rating downgrade (≥2 notches)
- Overdue >30 days (rebuttable presumption)
- Financial distress or liquidity issues
- Deterioration in collateral value
- Adverse macroeconomic environment
- Restructuring or concession granted due to stress

4. Credit Conversion Factors (CCFs)

Used for estimating potential exposure for off-balance-sheet items:

Instrument Type	Example	CCF (%)
Financial Guarantees	Bank guarantee issued	100%
Performance Bonds	Contractor guarantee	50%
Trade Letters of Credit	Documentary LC	20%
Cancellable Commitments	Overdraft facility cancellable at any time	0%

Example:

If a bank has ₹100 crore in financial guarantees, ₹50 crore in performance bonds, and ₹30 crore in trade LCs:
Exposure = (100×1.0) + (50×0.5) + (30×0.2) = ₹131 crore (EAD)
ECL = 131 × PD × LGD

This approach aligns with Basel III and ensures uniform assessment of off-balance-sheet risks.

5. PD–PIT vs PD–TTC Distinction

The distinction between Point-in-Time (PIT) and Through-the-Cycle (TTC) Probability of Default (PD) is crucial in the ECL framework.

Type	Full Form	What it Reflects	Sensitivity to Economy	Used For
PD-TTC	Through-the-Cycle Probability of Default	Average default risk across an entire economic cycle	Low (stable)	Basel III capital adequacy
PD-PIT	Point-in-Time Probability of Default	Current default risk under today's and expected future macro conditions	High (changes with GDP, inflation, etc.)	IFRS 9 / RBI ECL provisioning

Example (2025–2029 Economic Cycle):

A bank lends ₹100 crore to an auto-components company. Historical average default (TTC) = 1.5%
During slowdown (2027), macro stress increases default probability by 1.8×:
PD-PIT = 1.5% × 1.8 = 2.7%

Thus, under IFRS 9 / RBI ECL, PD rises to 2.7% (PIT) in 2027, while Basel III capital models retain the 1.5% (TTC) figure.

6. Example ECL Calculations (Based on RBI Draft)

Example 1: Loan with Collateral
Loan amount ₹50,00,000 secured by property worth ₹40,00,000.
Recovery after sale = ₹35,00,000.
Unsecured portion = ₹15,00,000.
ECL = PD × LGD × Unsecured Portion = 100% × 70% × 15,00,000 = ₹10,50,000

Example 2: Multi-Scenario ECL (Base / Upside / Downside)
Loan ₹20,00,000. Base: PD 5%, LGD 40%, Weight 70% | Upside: PD 3%, LGD 30%, Weight 20% | Downside: PD 10%, LGD 50%, Weight 10%
ECL = $\Sigma(PD_i \times LGD_i \times EAD \times Weight_i)$ = ₹41,600

Example 3: Off-Balance-Sheet Exposure (with CCF)
Performance Bond ₹8 crore, CCF 50%, PD 0.05%, LGD 65%
ECL = 8cr × 50% × 0.05% × 65% = ₹1.3 lakh

7. Economic Scenario Examples

ECL models use forward-looking macro scenarios (Base, Upside, Downside, Stress). The RBI paper provides reference templates:

Scenario	GDP Growth	Inflation	Unemployment	Interest Rate
Base	6.5%	5.0%	6.0%	6.5%
Upside	7.5%	4.0%	5.0%	5.0%
Downside	5.0%	6.5%	7.5%	8.0%
Stress	3.0%	8.0%	10.0%	9.0%

Example Integration:
If GDP drops from 6.5% to 5%, and unemployment rises from 6% to 7.5%, the model scales PD upwards by 1.3×–1.8× depending on historical regression sensitivity.

8. Governance & Model Validation Framework

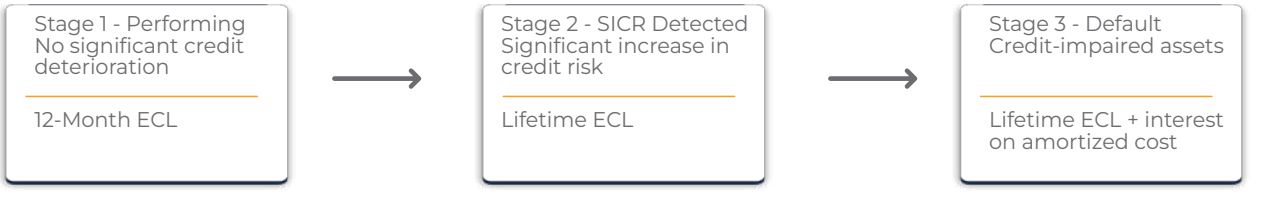
Banks must maintain robust model governance:

- Three lines of defense: model owners → risk management → internal audit
- Model inventory: maintain PD, LGD, and EAD model documentation
- Validation cycle: annual independent validation, back-testing, and sensitivity analysis
- Macroeconomic overlay governance: board-approved parameters updated quarterly

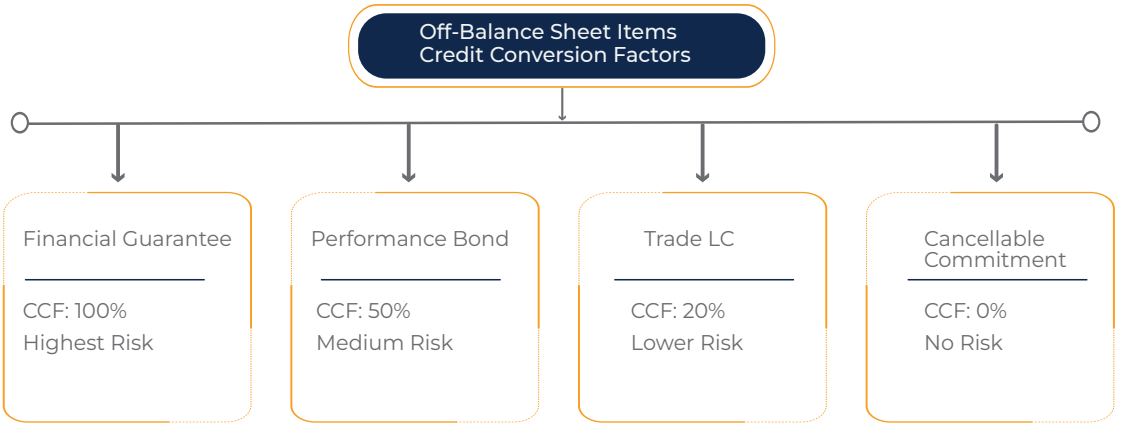
9. Summary Infographic Snapshot

ECL Estimation Flow:

Credit Risk Staging:

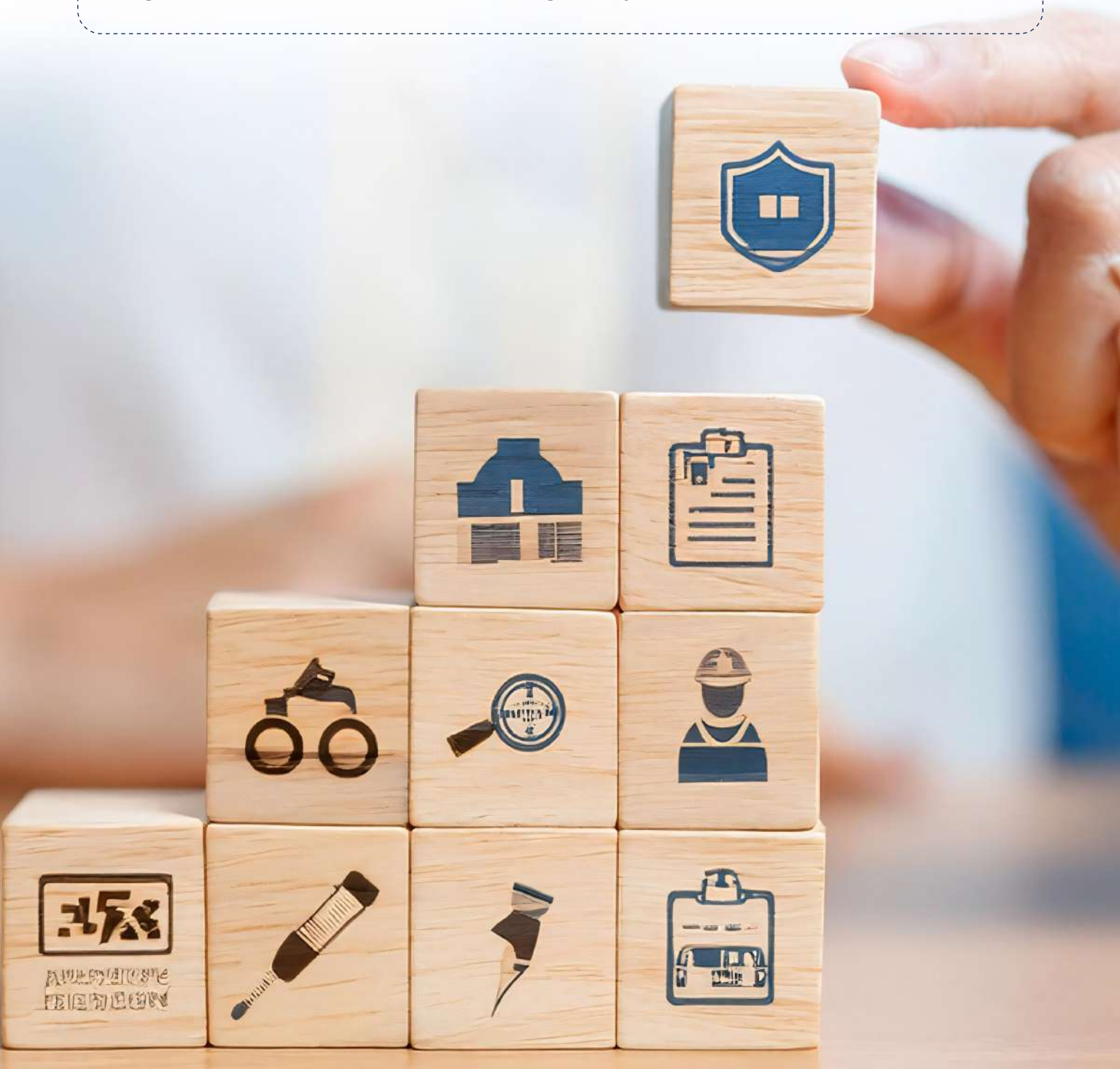


CCF Mapping for Off-Balance Sheet Items:



10. Key Takeaways for Professionals

- RBI's ECL aligns provisioning with global IFRS 9 practices.
- Encourages forward-looking credit risk recognition.
- Introduces macroeconomic sensitivity and scenario analysis.
- Enhances governance, validation, and disclosure requirements.
- Strengthens resilience of Indian banks under evolving credit cycles.



Brief Profile of the Leadership

Rajeev R. Shah
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Rajeev is the Managing Director & CEO of RBSA Advisors. His role spans across various verticals ranging from managing the overall development and operations of the firm with leadership roles across business strategy, business development and management of various advisory practices of RBSA.

Rajeev specializes in Mergers & Acquisitions, Financial Valuations, Due Diligence, Fund Raising Advisory etc. He has been involved with some of the major Mergers & Acquisition Engagements in India, as well as the Major Disinvestment and Privatization assignments on behalf of Government of India. His clients include leading Banks, Financial Institutions, Private Equity, Government & Regulators, major Indian Companies and MNCs.

He is a Mechanical Engineer, MBA, CFA. He has further specialized in Valuation and accredited himself as a Master of Valuation in Real Estate (Gold Medalist) and Master of Valuation in Plant & Machinery (Gold Medalist). He is also an Eminent Member of Royal Institution of Chartered Surveyors (MRICS), UK and Chartered Valuer and Appraiser (CVA) from the Institute of Valuers and Appraisers, Singapore (IVAS) He has been Honored with 2024 Honorary Membership Award by American Society of Appraisers (ASA). He is registered as an Insolvency Professional with Insolvency Bankruptcy Board of India (IBBI). He is the only person in India to be accredited and registered by IBBI for Valuation of all the three asset classes.

Rajeev is an active Speaker at various National & International Forums and Conferences.

Ravishu Shah
Managing Director
Co - Head Valuation

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Ravishu co-leads the Valuation practice of RBSA Advisors. Prior to RBSA, he was Executive Director with PwC. He spent 18 years with PwC India and 4 years with ACC Limited. He brings with him experience of over 23 years in the area of valuation, which encompasses exchange ratio recommendation, purchase price allocation, valuation for transfer pricing, negotiation support, entry / exit of joint venture partners, etc. He has worked across a range of industries including financial services, power, information technology, pharmaceuticals, consumer and industrial products, real estate and infrastructure.

Ravishu is Registered as a Valuer by IBBI under Companies Act for the Securities & Financial Assets. He was a part of Working Group of ICAI for formulation of ICAI Valuation Standards. He is also a speaker at various forums including ICAI, WIRC, Chamber of tax consultants, etc

Ravishu is 1996 batch Chartered Accountant from Institute of Chartered Accountants of India, with an All India rank in CA Intermediate and Final examinations. He is also a member of Association of Certified International Investment Analysts and Institute of Chartered Financial Analysts of India. He is a commerce graduate from R. A. Podar College of Commerce and Economics.

Nikhil Pandey
Executive Director

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Nikhil is an experienced finance professional with over 20 years of expertise in financial advisory, risk management, and advanced data analytics. He is a Bachelor of Science in Statistics and holds a Postgraduate Diploma in Business Management. He has been instrumental in setting up derivatives valuation desks, managing multibillion-dollar risk exposures, and developing cutting-edge financial models.

In a progressively responsible career of over 20 years, he has played multiple high impact and challenging roles which include founding and running a fintech startup, leading FRM SBU, business development, P&L management, client management, new solutions development, team and talent development, consulting and managing multibillion USD exposures. Nikhil's work includes leadership roles in team development, business strategy, and quantitative risk modeling. His expertise extends to structured product development, client relationship management, and the integration of technology into financial solutions. He has been a key contributor to advancing financial modeling. He has managed a team to provide advisory services in which includes market risk and credit risk advisory, derivatives and structured products valuations, developing and validating Monte Carlo simulation-based models for VaR and derivatives and other financial instruments valuations, CVA, DVA model development and validation, statistical model development for portfolio allocation at Big 4 firms and large conglomerates.

Financial Risk Management (FRM)

1. Complex Securities Valuation

- Audit Support Services
  - Valuation, Verification and Testing
  - Technical Accounting Support
  - Credit Value Adjustments & Debit Value Adjustments
  - Expected Credit Loss assessment
- Consulting Services
  - Valuation Advisory
  - Model Development and Validation

2. Treasury Advisory Work

- Internal Audit and Audit Support
  - Risk Assessment and Controls
  - Process Review
- Treasury Consulting
  - Strategic Advisory
  - Risk Management

3. Hedge Accounting Services

- IFRS 9/Ind AS 109 Implementation
- Ongoing Support

4. AI & ML Enhancement Capabilities

- Valuation and Risk Management Applications
- Hedge Accounting Applications
- Finance & Treasury Applications

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