



# THE STANDARD STANCE

RBI's Draft Directions on Asset Classification, Provisioning and Income Recognition: What Changed and Why it Matters

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The Reserve Bank of India (RBI) published draft Directions titled Reserve Bank of India (Scheduled Commercial Banks – Asset Classification, Provisioning and Income Recognition) Directions, 2025 (issued as “draft for comments”) in October 2025. The draft signals one of the most significant prudential changes for Indian banks – a move away from the traditional loss provisioning model toward a forward-looking Expected Credit Loss (ECL) provisioning model, together with updates to income-recognition rules and staging/ asset-classification principles.

This issue of The Standard Stance summarises the key elements of the draft Directions, explains the reasons for the proposed changes and outlines the likely impacts and implementation challenges.

## Background

Currently, banks in India are operating under the Income Recognition, Asset Classification and Provisioning (IRACP) norms prescribed by the RBI. These norms constitute the cornerstone of extant prudential regulation and govern income recognition, classification of loans and advances, and provisioning. This prudential framework has largely been driven by an overdue-ageing approach (90 days past due used for NPA classification). Globally, accounting frameworks and prudential practices have moved to forward-looking loss recognition (i.e. Expected Credit Loss under IFRS 9 and Current Expected Credit Losses under USGAAP-like approaches). RBI’s draft Directions brings banking prudential rules closer to these international practices and aims to strengthen early recognition of credit deterioration, improve comparability and make loss provisioning more forward-looking. The draft Directions seeks to:

- introduce staging criteria for asset classification under the ECL approach, while retaining the extant norms for Non-Performing Asset (NPA) classification,
- replace the incurred-loss-based provisioning framework with an Expected Credit Loss approach; and,
- update the principles of income recognition, including aspects relating to the Effective Interest Rate (EIR) method

## I. Key Elements in the Draft Directions (2025)

### A. Introduction of an ECL-based provisioning framework (three-stage model)

- The following financial instruments shall be under the scope:
  - Loans
  - Debt securities not measured at Fair Value Through Profit or Loss (FVTPL)
  - Trade receivables
  - Lease receivables
  - Loan commitments/ undrawn commitments
  - Off-balance-sheet credit exposures
  - Any other financial assets having contractual right to receive cash
- While there may be various approaches to the calculation of ECL, a bank shall use a general approach consisting of three key functions, i.e., Probability of Default (PD), Loss Given Default (LGD) and Exposure at Default (EAD), conforming to the instructions and principles outlined in the Directions.
- Banks would be required to assess, at each reporting date, whether credit risk has increased significantly since initial recognition and to estimate PD (probability of default), LGD (loss given default) and EAD (exposure at default) for loss allowance.

### Determination of Significant Increase in Credit Risk (SICR)

- Banks shall recognise lifetime ECL for all financial instruments evidencing SICR since initial recognition. For this purpose, a bank shall adopt a “three-stage” approach, based on the credit quality of the financial instrument at the time of initial recognition, or on any subsequent reporting date:
  - **Stage 1:** financial instruments where credit risk has not increased significantly since initial recognition or has low credit risk in terms of the Directions - Recognise 12-months ECL
  - **Stage 2:** significant increase in credit risk since initial recognition (but not credit-impaired) – Recognise lifetime ECL
  - **Stage 3:** credit-impaired (equivalent to NPA under extant rules) – Recognise lifetime ECL
- There shall be a rebuttable presumption that the credit risk on a financial asset has increased significantly since initial recognition when contractual payments are more than “30 days past due” and the bank shall make lifetime ECL in respect of such facility.

- The following instruments may not be required to be tested for SICR:
  - SLR eligible investments
  - direct claims on the central government (i.e., excluding claims that arise from exposures that are guaranteed by the central government)
  - exposures to the extent guaranteed by the central government, provided that the guarantee contains suitable clauses mandating invocation within a specified period (say, 60 days) from the due date and payment of the guarantee amount within a reasonable period (say, 30 days) after the invocation

#### Measurement of credit losses

- For lease receivables and trade receivables, loss allowances shall always be measured at an amount equal to lifetime ECL, irrespective of the stage of the instrument. A bank may use the “Simplified Approach” for the same.
- The purpose of estimating ECL is neither to estimate a worst-case scenario nor to estimate the best-case scenario. The estimate of ECL shall reflect an unbiased and probability-weighted amount of loss allowance by evaluating a range of possible outcomes.
- For the above purpose, a bank shall use multiple scenarios with each scenario representing the relationship between key components of ECL and the relevant macroeconomic variable.
- The weightage of each estimate of “credit losses” shall be determined by the bank after extensive deliberation by its Top Management on the basis of inputs provided by data analysis and domain experts.

#### Segmentation of exposures

- While computing ECL at a portfolio level, a bank shall group exposures into segments with shared credit risk characteristics so that the bank can reasonably assess changes in credit risk and thus the impact on the estimate of ECL. A bank’s methodology for segmenting exposures to assess credit risk shall be documented and subject to appropriate review and internal approval.

#### Forward-looking information

- A bank shall include factors that are specific to the borrower, general economic conditions and an assessment of both the current as well as the forecast of macroeconomic variables at each reporting date for assessment of ECL.

### B. Staging Criteria, But Retention of NPA Definition

- While staging (Stage-1/2/3) is adopted for provisioning, the draft retains the existing NPA classification rules (i.e., overdue-based triggers such as 90 days past due remain relevant for NPA reporting). That means provisioning and classification operate in parallel: staging drives forward-looking provisioning; overdue triggers still matter for statutory NPA reporting.

### C. Prudential Floors and Regulatory Overlays

- The RBI draft contemplates prudential floors on ECL provisioning (i.e., minimum provisioning levels) and supervisory overlays to limit variability and ensure prudence. The floors/ overlays are intended to avoid an unintended sharp decline in reported provisions relative to current regulatory expectations while still improving forward-looking recognition.

#### Regulatory Probability of Default (PD)

- The 12-month PD for any instrument that comes under the purview of ECL shall not be taken as less than 0.05%.

#### Regulatory Loss Given Default (LGD)

- For ECL computation, a bank shall calculate its own LGD based on historical information and future macroeconomic projections. However, if the bank finds itself unable to correctly estimate LGD, it may resort to the following regulatory backstops.

	Secured Portion	Unsecured Portion
Regulatory LGD	65%	70%

- For loans or portions of loans secured by eligible collateral which act as credit risk mitigants in terms of Master Circular - Basel III Capital Regulations, a bank may use LGD of 45% if the same is not estimated internally.

### Exposure at Default (EAD)

- A bank shall properly estimate EAD, for the purpose of computation of ECL, based on the behaviour of the financial instrument in the past and future macroeconomic projections.

### Additional provisions in specific cases

- The Directions require additional provisions over and above the provisions held in terms of the Directions in certain specific cases, like resolution of stressed assets, unhedged foreign currency exposure, exposures exceeding the normally permitted lending limit, provisions for country risk, provisioning requirements for derivative exposures, wilful defaulters, etc.

### Consolidated financials

- For the preparation of consolidated financial statements, subsidiaries/ joint ventures, etc., shall prepare their financial statements as per extant accounting/ regulatory norms.

### D. Changes to Income Recognition (Alignment with EIR and Fair-value Measurement at Initial Recognition)

- The draft Directions updates income-recognition principles, aligning them with the Effective Interest Rate (EIR) method in an ECL regime. It also requires certain financial assets (including some loans) to be measured initially at fair value (plus/ minus transaction costs) before moving to amortised cost aligning them with the accounting approach under an ECL regime.
- Interest Income for financial assets such as loans shall be calculated by applying the “effective interest rate” to the gross carrying amount of a financial asset during Stage 1 and Stage 2. Initial recognition of investments such as debt securities and Interest income on investments shall continue to be recognised in terms of MD on Classification, Valuation and Operation of Investments Portfolio of Commercial Banks, 2023, as amended from time to time.
- In respect of purchased or originated credit-impaired financial assets (POCI), banks shall apply the credit-adjusted effective interest rate to the amortised cost of the financial asset since initial recognition.
- In respect of financial assets that are not POCI but subsequently have become credit-impaired or considered under default, banks shall apply the original effective interest rate to the amortised cost of the financial asset in subsequent reporting periods from the date of the asset becoming credit-impaired, i.e., being classified as Stage 3. If the credit risk on such a financial instrument improves subsequently so that the financial asset is no longer credit-impaired or considered under default, the bank shall calculate interest revenue by applying the EIR to the gross carrying amount in subsequent reporting periods.

### E. Effective Date and Transition Arrangements

- The Directions shall come into effect from 1 April 2027. The transitional adjustment amount, i.e., the difference between the ECL required as on 1 April 2027 (computed based on the balance sheet position as on 31 March 2027), and the provisions held as per the extant IRACP norms as on 31 March 2027 may, at the option of the bank, be added back to the Common Equity Tier 1 (CET 1) capital. This transition adjustment shall be spread until 31 March 2031. A bank may choose to spread the transition over a shorter period.
- The transitional adjustment amount included in CET1 capital each year during the transition period shall be taken through to other measures of capital as appropriate (e.g. Tier 1 capital and total capital), and hence to the calculation of the leverage ratio and of large exposures limits. However, the transitional adjustment amount as added back above shall not be:
  - included in Tier 2 capital
  - used to reduce exposure amounts in the standardised approach
  - used to reduce the total exposure measure in the leverage ratio
- Banks shall continue to calculate and make provisions as per the ECL framework from the FY 2027-28 onward, irrespective of the application of the transitional arrangement.

## II. Why the Change Matters – Practical Impacts

### For banks

- **Model, data and systems:** Banks must develop robust ECL models (PD/LGD/EAD), collect and maintain longer-horizon data, create model governance, back-testing and validation, and upgrade IT systems to produce periodic loss allowances.
- **P&L volatility:** Forward-looking provisions can increase short-term volatility in profit & loss, particularly during economic downturns, unless prudential floors and overlays moderate the swings.
- **Capital & ratios:** Depending on calibration, higher provisioning could affect regulatory capital ratios and return metrics – banks will need to factor this into capital planning.

### For borrowers and sectors

- **Pricing/ credit availability:** Banks may re-price new lending to reflect expected losses, especially for riskier segments. Conversely, clearer provisioning may improve long-term risk-based pricing and transparency.

### For investors and supervisors

- **Transparency and comparability:** ECL makes provisioning more comparable with international peers using IFRS 9/CECL frameworks, improving market transparency on banks' loss expectations. Regulators gain earlier visibility into credit deterioration.

## III. Key Implementation Challenges and Supervisory Expectations

- **Data quality and history:** Many banks (especially smaller ones) may lack long, granular default/ recovery histories needed for credible PD/LGD estimates. RBI's phased timeline tries to acknowledge this, but banks will still need significant data engineering.
- **Model risk and governance:** RBI will expect a strong model governance framework. There should be a robust model development, validation, independent review and documentation.
- **Operationalising “significant increase” in credit risk:** The test to move exposures from Stage-1 to Stage-2 is conceptually straightforward but operationally complex.
- **Managing P&L volatility:** Banks will need to explain provisions to stakeholders and may use capital buffers or regulatory adjustments during the transition.

### Conclusion

The Draft RBI (Scheduled Commercial Banks – Asset Classification, Provisioning & Income Recognition) Directions, 2025, marks a major shift to a forward-looking prudential architecture for Indian banks. By moving to an ECL model, aligned income-recognition rules, and supervisory floors/ transitions, RBI is balancing the objectives of earlier loss recognition, international alignment and operational feasibility. The change will require meaningful investment by banks – in models, data and governance – but promises stronger risk-sensitivity and transparency in the medium term. Stakeholders should closely monitor RBI's finalisation of the Directions and use the implementation window to prepare robustly.

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