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Market Watch

# View: A rescue raft for sinking NBFCs

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By Sai Venkateshwaran &amp; Manoj K Vijai

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As corporate India continues to try to comprehend the extent of Covid-19-instigated impact on their businesses, many non-banking financial companies (NBFCs) have the added complexity of adopting the new [Indian Accounting Standards \(IAS\)](#), which became mandatory in phases between March 31, 2019, and March 31, 2020.

Until now, practices relating to critical areas such as classification and recognition of non-performing loans (NPLs), accounting for securitisation transactions, investment classification and valuation, were primarily driven by RBI regulations. These were more prescriptive compared to IAS, which are more principles-based and require significant judgement in their application.

With the absence of any regulatory guidance on implementation at the time of transition, there was diversity in interpretations, which impacted comparability. These diverse practices were evident in the disclosures relating to loan loss provisioning using the new expected credit losses (ECL) model.

According to RBI's March 13 notice, the 'new guidelines' have provided guidance on implementation of IAS by NBFCs and asset reconstruction companies (ARCs) to bring consistency, and facilitate comparison and better supervision of such entities.

Essentially, the new guidelines place a greater responsibility on boards and those charged with governance on ensuring high quality and an unbiased implementation of IAS on two of the most subjective aspects of IAS: business model assessment and ECL. Also, a significant change brought about is in respect of prescribing a [prudential](#) floor for recognising expected credit losses by requiring entities to appropriate profits, to the extent of the incremental losses be recorded into a separate 'impairment reserve'.

These new guidelines are welcome and have provided much-needed clarity on important areas. However, this has also come at a time when NBFCs face far more complex challenges in the light of Covid-19. Some of these issues will be further put to test, in totally uncharted waters.

On the one hand, the current crisis will lead to greater stress for borrowers, both corporate and retail, impacting their repayment abilities due to economic uncertainties. On the other hand, government and regulatory authorities, both in India and across the world, have adopted several support measures aimed at financial institutions, businesses and individuals to provide increased [liquidity](#), loan repayment moratoria, deferral of regulatory liabilities, etc.

These circumstances may, therefore, have either a temporary impact on a borrower's liquidity, or a more significant impact on the credit risk over the expected life of the borrowing. All these will need to be considered in developing ECL estimates, with limited historical evidence to fall back on, and even lesser sense of how the future situation will unfold — and to a great extent driven by the assessment of how each

borrower or sectors will be impacted.

The current liquidity situation will also lead to NBFCs dealing with the asset portfolio quite differently. Some resultant decisions may not be consistent with the business model documentation, which could lead to complexity in evaluation.

Recognising this uncertainty in accounting for expected credit losses by applying International Financial Reporting Standard 9 (IFRS 9), Financial Instruments (IFRS equivalent of IAS 109), International Financial Reporting Standards Board (IASB) and the International Organisation of Securities Commissions (Iosco) issued separate press releases highlighting the challenges in accounting for ECL in this environment.

They highlight that in assessing forecast conditions, NBFCs should consider both the negative effects of Covid-19, as well as the positive impacts of the significant government support measures being undertaken.

They also recognise that in these times of uncertainty, efforts must be made to make estimates based on reasonable and supportable information, accompanied by detailed disclosures to provide as much transparency to users of financial statements. NBFCs have a challenging task on hand in determining the extent of losses to be recorded this year-end, and determining their financial position and performance. While RBI guidance brings clarity on many issues, the Covid-19 crisis has muddled the waters even more, and will remain challenging in the near- to short-term.

**(Venkateshwaran is partner, [KPMG](#) India, and Vijai is a chartered accountant)**

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