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Indian Banks’ Adoption of IFRS Unlikely to Drive Rating Changes

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Fitch Ratings-Mumbai/Hong Kong-20 January 2023: Long-term benefits to the Indian banking sector from the implementation of IFRS accounting standards should outweigh short-term risks, says Fitch Ratings. The transition will probably negatively affect banks’ capital levels, as more impairment charges are front-loaded, but should bring qualitative benefits in credit risk management over the longer term. The adoption of IFRS is unlikely to drive rating changes in and of itself, but specific banks’ capital and risk management responses could influence their standalone Viability Ratings.

In a discussion paper released on 16 January, the Reserve Bank of India (RBI) proposes to broadly align itself with the principles of IFRS9. We see the expected transition from incurred loss provisioning to expected credit loss (ECL) provisioning as the most important aspect of IFRS adoption from a credit perspective. The ECL framework primarily addresses the problem of procyclical provisions, as banks are required to estimate ECL ahead of adverse credit events, instead of making provisions after loans have become impaired, as is the current norm.

We expect the adoption of ECL provisioning and the associated build-up of excess pre-emptive provisions - particularly for Stage 1 and Stage 2 loans and investments - to weigh on capital in the short term. However, we anticipate the RBI will smooth the process over a period not exceeding five years.

Whether or not the increase in provisioning affects banks' overall loss-absorption buffers will depend in part upon their management of capital levels. The probability that buffers prove insufficient in the event of unexpected shocks that weaken asset quality could increase if banks respond to the increase in provisioning under the transition to IFRS by running down capital ratios closer to regulatory thresholds, leaving little room to absorb unexpected stress. Fitch has previously highlighted the risk that higher-than-anticipated capital consumption due to loan growth could weigh on intrinsic creditworthiness.

State banks could be more vulnerable than private banks to such a risk due to their more modest buffers overall relative to their risk appetite. However, state banks' Issuer Default Ratings are driven by our expectations that they would receive extraordinary support from the government if needed, so would not be affected.

We believe that the shift to ECL provisioning bodes well for risk underwriting and control as banks will need to develop models to assess credit impairment risks across borrowers and product lines and will face related pressure for risk management functions to become more actively involved in provisioning assessment. This should complement the RBI's ongoing initiatives to strengthen bank risk frameworks.

Banks will be able to exercise management flexibility and subjectivity in calculating ECL under IFRS, but we expect close regulatory supervision to ensure the reasonableness of their assumptions. The RBI proposes to issue guidance specifying its expectations on the factors and variables relevant for determining credit risk, as well as to subject ECL models to external validation and supervisory assessment. In addition, a prudential floor, to be prescribed by the RBI, will act as a further regulatory backstop.

The timing of IFRS adoption is not yet clear. The RBI has asked that comments on its discussion paper be submitted by end-February 2023, and we think the final guidelines could be introduced before the end of the current financial year in March (FY23). Indian banks' preparations in recent years in anticipation of the change in accounting standards may mean that the sector is able to recalibrate to the central bank's final guidelines quickly, once they are announced. This could enable banks to undertake a parallel pilot run using IFRS accounting in FY24 ahead of a final transition from FY25.

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