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Reliance Capital Limited
Policy Expected Credit Loss (ECL)

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1. Introduction

This Expected Credit Loss (ECL) Policy outlines the principles and methodologies used by Reliance Capital Limited ("the Company") to measure and recognize impairment on financial instruments in accordance with Ind AS 109 - Financial Instruments and relevant guidelines issued by the Reserve Bank of India (RBI).

2. Purpose

The purpose of this Expected Credit Loss (ECL) policy is to:

- Establish a comprehensive framework for measuring and recognizing expected credit losses on the Company's financial instruments, including but not limited to loans, debt instruments, loan commitments, and financial guarantee contracts.
- Ensure full compliance with Ind AS 109 - Financial Instruments, as notified by the Ministry of Corporate Affairs (MCA), and all relevant regulations and guidelines issued by the Reserve Bank of India (RBI) concerning the recognition and measurement of credit losses.
- Provide a robust and transparent basis for recognizing and measuring credit losses in the financial statements, reflecting the Company's best estimate of expected credit losses and providing users of financial statements with more useful information about the entity's expected credit losses on financial instruments.

3. Scope

This Expected Credit Loss (ECL) policy applies to the following financial instruments held by RCL:

- Debt instruments that are measured at amortized cost.
- Debt instruments that are measured at Fair Value through Other Comprehensive Income (FVOCI).
- Loan commitments and financial guarantee contracts that are not measured at Fair Value through Profit or Loss (FVTPL).
- Lease receivables recognized under Ind AS 116: Leases

Specifically, the ECL framework outlined in this policy encompasses all loan portfolios, including those originated by the Company, acquired through direct assignment or securitization, and those managed through business correspondence arrangements.

The ECL calculations in accordance with this policy will **not** apply to:

- Investments in mutual funds.
- Equity investments.
- Security receipts.
- Any other financial instruments that are measured at Fair Value through Profit or Loss (FVTPL).

4. Regulatory Framework

This Expected Credit Loss (ECL) policy is established and will be implemented in accordance with the following regulatory framework:

- **Ind AS 109 - Financial Instruments:** The accounting and reporting requirements for financial instruments, including the measurement of ECL, are governed by Ind AS 109, as notified by the Ministry of Corporate Affairs (MCA).
- **Reserve Bank of India (RBI) Regulations:** As an unlisted Non-Banking Financial Company - Core Investment Company (NBFC-CIC), RCL is subject to the regulatory framework set by the RBI. The key Master Directions and circulars relevant to income recognition, asset classification, provisioning, and ECL include, but are not limited to:
- **Companies Act, 2013:** The provisions of the Companies Act, 2013, also govern the accounting and financial reporting practices of the Company, including compliance with Ind AS.

5. Definitions

Expected Credit Loss (ECL):

- The probability-weighted estimate of credit losses, representing the present value of all cash shortfalls expected to result from default events over the expected life of a financial instrument.

- ECL is a forward-looking measure that considers a range of possible outcomes, the time value of money, and reasonable and supportable information about past events, current conditions, and forecasts of future economic conditions.

Probability of Default (PD):

- The likelihood that a borrower will be unable to meet its financial obligations and default on a financial instrument over a specific time horizon.
- PD is a crucial input in the ECL calculation, reflecting the creditworthiness of the borrower.
- PD is calculated for two time horizons: 12-month PD and Lifetime PD.

Exposure at Default (EAD):

- The estimated amount of a financial instrument that is expected to be outstanding at the time of a borrower's default.
- EAD can vary from the current outstanding amount due to factors like prepayments, additional drawdowns on loan commitments, and credit conversion factors for off-balance sheet exposures.

Loss Given Default (LGD):

- The estimate of the loss expected to be incurred in the event of a borrower's default, representing the portion of the EAD that will not be recovered.
- LGD is influenced by factors such as the value of collateral, the seniority of the claim, and recovery costs.
- LGD is measured in a way that reflects the time value of money.

Stage 1:

- Financial instruments that have not experienced a significant increase in credit risk since initial recognition or that have low credit risk at the reporting date.
- For Stage 1 assets, 12-month expected credit losses are recognized.

Stage 2:

- Financial instruments that have experienced a significant increase in credit risk since initial recognition (unless they have low credit risk at the reporting date) but that do not yet have objective evidence of impairment.
- For Stage 2 assets, lifetime ECL are recognized.

Stage 3:

- Financial assets that have objective evidence of impairment at the reporting date.
- For Stage 3 assets, lifetime ECL is recognized.

12-month ECL:

- The portion of lifetime ECL that represents the expected credit losses resulting from default events on a financial instrument that are possible within the 12 months after the reporting date.

Lifetime ECL:

- The expected credit losses that result from all possible default events over the expected life of a financial instrument

6. ECL Model Overview

The Company employs a three-stage approach, as required by Ind AS 109, to recognize Expected Credit Losses (ECL) on its financial instruments:

- **Stage 1:**
  - Financial instruments are classified as Stage 1 when there has been no significant increase in credit risk since initial recognition, or if the instrument has low credit risk at the reporting date.
  - For Stage 1 assets, ECL is measured at an amount equal to 12-month expected credit losses.
- **Stage 2:**

- Financial instruments are classified as Stage 2 when there has been a significant increase in credit risk since initial recognition (unless they have low credit risk at the reporting date) but are not yet considered credit-impaired.
- For Stage 2 assets, ECL is measured at an amount equal to lifetime expected credit losses.

- **Stage 3:**
  - Financial instruments are classified as Stage 3 when there is objective evidence of impairment at the reporting date. These assets are considered credit-impaired.
  - For Stage 3 assets, ECL is measured at an amount equal to lifetime expected credit losses.

The basic formula for calculating ECL is:

ECL = PD x EAD x LGD

Where:

- PD = Probability of Default
- EAD = Exposure at Default
- LGD = Loss Given Default

This formula is applied within each stage to determine the appropriate ECL amount.

7. ECL Model Components

7.1. **Portfolio Segmentation**

- Financial instruments are segmented based on shared credit risk characteristics to facilitate more accurate ECL calculations.
- Segmentation criteria include, but are not limited to:
  - Product type (e.g., term loans, working capital loans)

  - Credit quality (e.g., internal risk ratings)
  - Geographic location
  - Industry
- Segmentation is crucial for grouping instruments with similar risk profiles, allowing for consistent application of ECL methodologies.
- The segmentation is reviewed and updated periodically to reflect changes in the portfolio composition and risk characteristics.

7.2. **Staging Criteria**

- The ECL model uses a three-stage approach to reflect changes in credit risk over time.
- The assessment of whether there has been a significant increase in credit risk since initial recognition is based on both quantitative and qualitative factors.
- Factors considered may include:
  - Changes in internal credit ratings
  - External credit ratings (where available)
  - Past due status (e.g., days past due)
  - Adverse changes in business or economic conditions
  - Breach of covenants
- The policy defines specific thresholds and triggers for moving assets between stages, ensuring objectivity and consistency.
- A rebuttable presumption is used that credit risk has increased significantly since initial recognition if contractual payments are more than 30 days past due.

7.3. **Probability of Default (PD)**

- PD is the likelihood that a borrower will default on its financial obligation within a defined time horizon.
- PD is a key input in the ECL calculation.

- PD is estimated using a combination of:
  - Historical data on default rates
  - Current market conditions
  - Forward-looking information (see 7.6)
- PD models are developed for each segment to capture segment-specific risk characteristics.
- Both 12-month PD and Lifetime PD are calculated, reflecting the different time horizons relevant for ECL measurement in different stages.
- PD estimates are regularly back-tested and validated to ensure accuracy and reliability.

7.4. **Exposure at Default (EAD)**

- EAD is the estimated outstanding amount at the time of default.
- EAD considers factors that may cause the exposure to change before default, such as:
  - Prepayments
  - Drawdowns on committed facilities
- For off-balance sheet items (e.g., loan commitments, financial guarantees), EAD is estimated using credit conversion factors to reflect the likelihood of these items being drawn down.

7.5. **Loss Given Default (LGD)**

- LGD is the estimated loss in the event of default, representing the portion of the EAD that is expected to be irrecoverable.
- LGD estimates are based on factors such as:
  - Historical recovery rates
  - The value and type of collateral

- Recovery costs
- Seniority of the claim

- LGD estimates may be adjusted to reflect potential changes in recovery rates under economic downturn scenarios.

7.6. **Forward-Looking Information**

- ECL calculations incorporate reasonable and supportable forward-looking information to reflect the impact of future economic conditions on credit risk.
- Forward-looking information includes macroeconomic factors such as:
    - GDP growth
    - Inflation rates
    - Interest rates
    - Unemployment rates
- Multiple economic scenarios are considered (e.g., base case, optimistic, pessimistic), and probability weights are assigned to each scenario.
- Forecasts are obtained from reputable external and internal sources and are regularly updated to ensure they remain relevant.

7.7. **Discounting**

- ECL is discounted to its present value using the effective interest rate of the financial instrument.
- Discounting reflects the time value of money, ensuring that ECL represents the present value of expected credit losses.

8. ECL Calculation

- ECL is calculated for each financial instrument or portfolio of financial instruments, reflecting the expected credit losses over the life of the instrument.

- The calculation considers the stage of the asset (Stage 1, 2, or 3), Probability of Default (PD), Exposure at Default (EAD), Loss Given Default (LGD), and forward-looking information.
- The general formula for ECL calculation is:
  - ECL = PD x EAD x LGD
- The application of PD varies based on the stage:
  - For Stage 1 assets, 12-month PD is used to calculate ECL.
  - For Stage 2 and Stage 3 assets, Lifetime PD is used to calculate ECL.

Explanation of Components:

- **Probability of Default (PD):** The likelihood that a borrower will default on their obligation. 12-month PD is the probability of default within 12 months, while Lifetime PD is the probability of default over the remaining life of the financial instrument.
- **Exposure at Default (EAD):** The estimated amount owed to the lender at the time of default. This may differ from the current outstanding balance due to potential future drawdowns or repayments.
- **Loss Given Default (LGD):** The estimated percentage of the EAD that the lender expects to lose in the event of a default, after considering recoveries from collateral or other sources.

Example:

Let's consider a loan with the following characteristics:

- **Outstanding Balance:** ₹100,000
- **Stage:** Stage 2 (Significant increase in credit risk)
- **Lifetime PD:** 5% (0.05)
- **EAD:** ₹100,000 (Assume no additional drawdowns)
- **LGD:** 40% (0.40)

The ECL would be calculated as:

ECL = 0.05 x ₹100,000 x 0.40 = ₹2,000

Therefore, the lender would recognize an ECL of ₹2,000 for this loan.

9. Model Validation and Governance

The ECL model is subject to rigorous validation and governance processes to ensure its accuracy, reliability, and ongoing suitability.

- **Model Validation:**
  - The ECL model is validated regularly, both at inception and periodically thereafter, to assess its performance and identify any potential weaknesses.
  - The validation process includes:

- **Back-testing:**
- Comparing actual outcomes (e.g., default rates) with model predictions to assess the accuracy of PD, EAD, and LGD estimates.
- Back-testing is performed on a regular basis (e.g., quarterly, annually) and results are documented and analyzed.
- **Sensitivity Analysis:**
- Assessing the impact of changes in key model inputs and assumptions on the ECL calculation.
- Sensitivity analysis helps to identify the most critical drivers of ECL and the model's vulnerability to changes in these factors.
- **Stress Testing:**
- Evaluating the model's performance under stressed economic scenarios (e.g., severe recession) to assess its resilience and identify potential weaknesses.

- Stress testing helps in understanding the model's behavior in extreme but plausible conditions.
- **Data Quality Assessment:**
- Evaluating the accuracy, completeness, and relevance of the data used in the ECL model.
- Data quality is critical for model reliability, and any data issues are identified and addressed.
- **Conceptual Soundness Review:**
- Assessing whether the model is theoretically sound and consistent with best practices and accounting standards.
- This involves reviewing the model's methodology, assumptions, and limitations.

- **Governance Framework:**
    - The ECL process is governed by a robust framework to ensure accountability, transparency, and control.
    - Key elements of the governance framework include:

- **Clear Roles and Responsibilities:**
- Defining the roles and responsibilities of individuals and teams involved in the ECL process, including:
- Model development and maintenance
- Data management
- Model validation
- ECL calculation and reporting
- Oversight and approval
- **Independent Review and Approval:**

- Ensuring that the ECL model and its outputs are subject to independent review and approval by qualified personnel who are not directly involved in the model's development or operation.
- The review and approval process covers:
- Model methodology and assumptions
- Model inputs and outputs
- Validation results
- Changes to the model
- **Documentation:**
- Maintaining comprehensive documentation of the ECL model, including:
- Model methodology and assumptions
- Data sources and quality
- Model validation results
- Change control procedures
- Governance processes
- **Change Control Procedures:**
- Establishing formal procedures for managing changes to the ECL model, ensuring that all changes are:
- Properly documented
- Thoroughly tested
- Approved by authorized personnel
- Communicated to relevant stakeholders
- **Audit Trail:**
- Maintaining an audit trail of all key activities in the ECL process, including:
- Data inputs

- Model calculations
- Adjustments and overrides
- Approvals
- **Policy Review:**
- The ECL policy and related procedures are reviewed and updated regularly to reflect:
- Changes in accounting standards and regulatory requirements
- Changes in the Company's business and risk profile
- Findings from model validation and audit activities

10. Accounting Treatment

- The accounting treatment for Expected Credit Losses (ECL) is governed by Ind AS 109 - Financial Instruments. The core principles are as follows:
- **Recognition of Impairment Allowance:**
- An impairment allowance is recognized in the financial statements to reflect the ECL on financial assets measured at amortized cost and FVOCI, as well as on loan commitments and financial guarantee contracts not measured at FVTPL. [cite: User uploaded a file named "29. ECL Model Document Reliance Capital.docx" with snippets: ...The Company recognizes a loss allowance for such losses at each reporting date....]
- The amount of the impairment allowance is determined based on the stage of the financial instrument:
- **Stage 1:** The loss allowance is measured at an amount equal to 12-month ECL.
- **Stage 2:** The loss allowance is measured at an amount equal to lifetime ECL.
- **Stage 3:** The loss allowance is measured at an amount equal to lifetime ECL.

- **Changes in Impairment Allowance:**
- Changes in the impairment allowance between reporting periods are recognized in the Profit and Loss statement as an impairment gain or loss. [cite: User uploaded a file named "29. ECL Model Document Reliance Capital.docx" with snippets: ...The Company recognizes a loss allowance for such losses at each reporting date....]
- An increase in the impairment allowance (e.g., due to a significant increase in credit risk or deterioration of credit quality) results in an impairment loss, which reduces profit.
- A decrease in the impairment allowance (e.g., due to an improvement in credit risk or recoveries) results in an impairment gain, which increases profit.
- **Accounting Entries (Illustrative):**
- **Initial Recognition of ECL (Impairment Loss):**
- Debit: Impairment Loss Expense (Profit and Loss)
- Credit: Impairment Allowance (Balance Sheet - Contra-Asset Account)
- **Increase in ECL (Further Impairment Loss):**
- Debit: Impairment Loss Expense (Profit and Loss)
- Credit: Impairment Allowance (Balance Sheet - Contra-Asset Account)
- **Decrease in ECL (Impairment Gain):**
- Debit: Impairment Allowance (Balance Sheet - Contra-Asset Account)
- Credit: Impairment Gain (Profit and Loss)
- **Write-offs:**
- Financial assets are written off (derecognized) when there is no reasonable expectation of recovery. This assessment is made after considering all available information and having exhausted all reasonable recovery efforts.
- Write-offs reduce the gross carrying amount of the financial asset and the related impairment allowance.

- **Accounting Entry for Write-off:**
- Debit: Impairment Allowance (Balance Sheet - Contra-Asset Account)
- Credit: Financial Asset (Balance Sheet - Asset Account)
- **Example (Simplified):**
- Assume company has a loan outstanding of ₹100,000. At the reporting date, the ECL assessment requires an impairment allowance of ₹5,000.
- **Initial Recognition:** The following entry is made:
- Debit: Impairment Loss Expense ₹5,000
- Credit: Impairment Allowance ₹5,000
- The loan will be presented on the balance sheet at its amortized cost of ₹100,000, less the impairment allowance of ₹5,000, resulting in a net carrying amount of ₹95,000. The ₹5,000 impairment loss will be recognized in the Profit and Loss statement.
- **Increase in ECL:** In the subsequent period, due to a significant increase in credit risk, the ECL assessment now requires an allowance of ₹8,000. The following entry is made:
- Debit: Impairment Loss Expense ₹3,000 (₹8,000 - ₹5,000)
- Credit: Impairment Allowance ₹3,000
- The additional impairment loss of ₹3,000 is recognized in the Profit and Loss.
- **Write-off:** After exhausting all recovery efforts, the loan of ₹100,000 is deemed unrecoverable. The following entry is made:
- Debit: Impairment Allowance ₹8,000
- Credit: Loan Receivable ₹100,000
- The gross carrying amount of the loan is reduced, and the impairment allowance is utilized. The net effect on the balance sheet is the removal of the asset.

11. Policy Review and Updates

- This policy is reviewed and updated at least annually or more frequently as needed.