नेपाल राष्ट्र बैंक

बैंक तथा वित्तीय संस्था नियमन विभाग

केन्द्रीय कार्यालय
बालुवाटार, काठमाडौं।
फोन नं.: ४४१९८०४/५
Web Site: www.nrb.org.np
पोष्ट बक्स:७३

पत्र संख्या : बै.वि.नि.वि./नीति/सूचना/९/०८०/८१

मिति: २०८०/०९/२६

सूचना

सम्पूर्ण सरोकारवाला व्यक्ति तथा निकायहरु

विषय: राय/सुझाव उपलब्ध गराउने सम्बन्धमा।

यस बैंकद्वारा तयार गरिएको NFRS 9-Expected Credit Loss Related Guidelines, 2024 को मस्यौदा यस बैंकको वेबसाइट www.nrb.org.np/category/notices/ मा राखिएको व्यहोरा अनुरोध छ।

संलग्न मस्यौदा उपर तहाँको राय/सुझाव २०८०, माघ मसान्तभित्र यस बैंकमा उपलब्ध हुने गरी लिखित रुपमा अथवा इमेल ठेगाना **nrbbfirdppd@nrb.org.np** मा उपलब्ध गराईदिनहुन अनुरोध छ।

भवदीय,

कार्यकारी निर्देशक

NFRS 9- Expected Credit Loss Related Guidelines, 2024

NEPAL RASTRA BANK

Banks and Financial Institutions Regulation Department

Baluwatar, Kathmandu

January, 2024

Exposure Draft for Consultation

Table of Contents

1. Introduction 1

2. Existing Provisions 1

2.1. Regulatory provisions 1
2.2. NAS 39 Incurred Loss Model 3
2.3. Carve out of ICAN 3
2.4. Applicability of NFRS 9 3

3. Objectives of Guidelines 3

4. Scope of Expected Credit Loss 4

5. Basic Core Principles regarding ECL accounting framework 4

6. Principles for Sound Credit Risk Management and for Expected Credit Losses 5

7. Requirement of Approved ECL policies 6

8. Expected Credit Losses 7

8.1. 12 month Expected Credit Losses 7
8.2. Lifetime Expected Credit Losses 7

9. Indicators of Significant Increase in Credit Risk 8

10. Interest income Recognition 9

11. Guidance for computation of Expected Credit Loss (based on PD, LGD and EAD) 10

12. ECL Model Governance & Validation 14

13. Role of Internal Audit 15

14. Transitional Regulatory requirements 15

14.1. Calculation of Transitional Adjustment 15
14.2. Consequential Adjustments 16
14.3. Disclosure Requirements *16*

15. Regulatory Backstop Measures 16

16. Guidance on staging for expected credit losses 16

17. Transfer criteria between stages 18

18. Forward Looking Information 19

Exposure Draft for Consultation

1. Introduction

1.1. Initially, the updated standard of NFRS 9: Financial Instruments (in line with IFRSs 2018) was pronounced by ICAN to be effective from 16th July 2021. However, due to various reasons including challenges posed by emergence of COVID, limited time availability and lack of technical expertise, full implementation of NFRS 9 was deferred till FY 2080/81, for banks and financial institutions. Hence, the provisions of NFRS 9 that includes expected credit loss, will be fully effective from FY 2081/82.

1.2. While the responsibility of preparation, presentation and disclosure of financial statements in line with applicable Nepal Financial Reporting Standards is vested with the board of directors and senior management of licensed banks and financial institutions, Nepal Rastra Bank with the intent to promote consistent and prudent application of NFRS 9 in the banking sector, has drafted the guidelines for implementation of expected credit loss provision outlined in NFRS 9.

1.3. These guidelines have been prepared based on international best practices and guidelines issued by regulators of various jurisdictions on implementation of Expected Credit Loss of IFRS 9- Financial Instruments.

1.4. These guidelines should be adopted within the requirements of NFRS 9.

2. Existing Provisions

2.1. Regulatory Provisions

i) As per Unified Directives issued to Banks and Financial Institutions (A, B and C class), Loans and advances are broadly categorized into performing and non performing loans, primarily based on past due period of interest or principal receivable. Pass and watchlist categories fall under performing loans whereas non performing loans include substandard, doubtful, loss and restructured/rescheduled loans.

ii) The minimum loan loss provision (expressed as % of loans and advances outstanding) as stipulated in Unified Directives to A, B and C class financial institutions are broadly summarized as follows:

Category of Loans	Past due period	Other indicators of credit risk/bases	Minimum Loan Loss Provision (%)
Performing Loans (General Loan Loss Provision)			
Pass	Current and Up to 1 month	• Loan against FD and government bonds • Gold and silver loan up to 10 lakhs with adequate security	1.25
Watchlist	1 to 3 months	• Negative net worth or net loss for consecutive 3 years (with some exceptions) • Debt equity ratio greater than 80:20 • Inadequate Debt to income ratio	5

Exposure Draft for Consultation

		• Loans at multiple banks without consortium (> 2 billion) • Non performing loans at other BFIs • Based on NRB inspection	
Non Performing Loans (Specific Loan Loss Provision)			
Sub-standard	3 to 6 months		25
Doubtful	6 months to 1 year		50
Loss	> 1 year	• Borrower not in contact • Misuse of Credit • Business/Project not in operation • More than 90 days past due for Force Loans, Credit card and purchased/discounted bills • Loans to blacklisted persons • Diversion of Loan to related persons • Inadequate security coverage over loan	100
Restructured/Rescheduled			• 12.5 to 25 for Pass • 5 for loans to be restructured/rescheduled within 2080 Poush & Chaitra meeting various conditions • Respective provision for Others as per category

Note: Exemptions/concessions on above rates exist for projects with longer grace period, loans insured with deposit and credit guarantee fund and others. Furthermore, additional 20% in addition to existing provision, is applicable for loans without adequate security and loans with security of personal guarantee only, with some exceptions.

iii) Unified Directives has also required banks and financial institutions to transfer shortfall in loan loss provision as per Nepal Accounting Standards in comparison to required provision as per directives, from retained earnings to Regulatory Reserve, annually.

Exposure Draft for Consultation

2.2. NAS 39 Incurred Loss Model

The standard *NAS 39: Financial Instruments: Recognition and Measurement (equivalent to IAS 39 issued in 2013 before update in 2018)* recognised impairment of financial assets using an 'incurred loss model'. An incurred loss model assumes that all loans will be repaid until evidence to the contrary (known as a loss or trigger event) is identified. Only at that point is the impaired loan (or portfolio of loans) written down to a lower value. An entity has to assess at the end of each reporting period whether there is any objective evidence that a financial asset or group of financial assets is impaired. If there is evidence of impairment, impairment loss is recognized. For individually significant exposures, as well as for all exposures which are not individually significant, where a bank determines impairment on an individual basis, it is necessary to establish whether there is objective evidence that the exposure is impaired. Entities are also required to make a collective assessment of impairment for all exposures that are not deemed to be individually significant and are therefore not assessed for impairment on an individual basis. Losses expected as a result of future events, no matter how likely, are not recognized.

2.3. Carve out of ICAN

A non-optional carve out has been provided by ICAN till FY 2080/81 on the recommendation of Accounting Standards Board, Nepal for banks and financial institutions, with respect to NFRS 9. The carve out has allowed the use of incurred loss model of impairment till aforementioned period. Furthermore, carve out also states that financial institutions registered as per Bank and Financial institution Act 2073 shall measure impairment loss on loan and advances as the higher of amount derived as per the norms prescribed by Nepal Rastra Bank for loan loss provision and amount determined under incurred loss model.

2.4. Applicability of NFRS 9

Since the carve out/deferral is valid only till FY 2080/81 and NFRS 9 (2018) has already been pronounced by Accounting Standards Board, Nepal to be applicable from 16th July 2021, the banks and financial institutions are required to adopt the expected credit loss impairment model of NFRS 9. Since default is a lagging indicator of credit risk and since classification of non performing loans normally takes place after a borrower is overdue for more than 90 days, loan loss provisions are presently made by banks with significant delays after the borrower may have started facing financial difficulties thereby increasing the credit risk of banks and financial institutions. Generally, there will be a significant increase in credit risk before a financial asset becomes credit impaired or an actual default occurs. As Expected Credit Loss (ECL) Impairment model incorporates more forward looking approach and assesses significant change in credit risk in determining impairment as against extant 'incurred loss' approach, the adoption of ECL model is expected to enhance credit risk management and resilience of banks and financial institutions.

3. Objectives of Guidelines

The objectives of issuing these guidelines are outlined as follows:

Exposure Draft for Consultation

a) To set out supervisory guidance for ease in implementation of ECL that does not contradict with the applicable accounting standards.
b) To promote uniformity and comparability of ECL amongst banks and financial institutions.
c) To set out objective criteria for determining significant increase in credit risk.
d) To prescribe prudential floor as a regulatory backstop for impairment determined under ECL model.
e) To strengthen accounting recognition of loan loss provisions by incorporating a broader range of credit information.

4. Scope of Expected Credit Loss

NFRS applicable licensed banks and financial institutions are required to calculate expected credit losses for the following:

a) Financial Assets measured at Amortized Cost
b) Financial Assets measured at fair value through other comprehensive income (the financial asset is held within a business model whose objective is achieved by **both collecting** contractual cash flows **and selling** financial assets and the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.
   However, the loss allowance shall be recognized in other comprehensive income and shall not reduce the carrying amount of the financial asset in the statement of financial position.
c) A Lease receivable
d) Contract Asset
e) Loan Commitments (except those measured at Fair value through Profit or Loss)
f) Financial guarantee contracts (initially measured at higher of : the amount of the loss allowance determined and the amount initially recognised less, when appropriate, the cumulative amount of income recognised in accordance with the principles of NFRS 15) except those measured at Fair value through Profit or Loss

5. Basic Core Principles regarding ECL accounting framework*

a) Application of proportionality, materiality and symmetry
BFIs are expected to adopt sound allowance methodologies commensurate with the size, complexity, structure, economic significance, risk profile and, more generally, all other relevant facts and circumstances.

Due consideration should also be given to the application of the principle of materiality. However, this should not result in individual exposures or portfolios being considered immaterial if, cumulatively, these represent a material exposure to the bank. In addition, materiality should not be assessed only on the basis of the potential impact on the profit or loss statement at the reporting date. For instance, large portfolio(s) of high-quality credit exposures should be considered material despite having high

Exposure Draft for Consultation

collateral. Further, it must be ensured that bias is not being introduced in the design of an ECL methodology and its implementation.

Nepal Rastra Bank recognises that NFRS 9- ECL framework is symmetrical in the way that subsequent changes (both deteriorations and reversals of those deteriorations) in the credit risk profile of a debtor should be considered in the measurement of the loss allowances.

b) Reasonable and supportable information
BFIs are required to consider a wide range of information when applying ECL accounting models. Information considered should be relevant to the assessment and measurement of credit risk to the particular lending exposure being assessed and should include information about past events, current conditions and forecasts of future economic conditions. Information which is ultimately included in the assessment of credit risk and measurement of ECL should also be reasonable and supportable based on relevant facts and experienced credit judgment.

c) Consideration of forward-looking information
Consideration of forward-looking information, including macroeconomic factors, is a distinctive feature of ECL accounting frameworks and is critical to the timely recognition of ECL. Banks will have to employ sound judgment consistent with generally accepted methods for economic analysis and forecasting supported by a sufficient set of data. Appropriate oversight and an effective internal control system should help to ensure that bias is not introduced in the ECL assessment and measurement process. The information used shall include an unbiased consideration of relevant factors and their impact on creditworthiness and cash shortfalls. Relevant factors include those intrinsic to the bank and its business or derived from external conditions.

**Source: Basel Committee on Banking Supervision*

6. Principles for Sound Credit Risk Management and for Expected Credit Losses

The failure to identify and recognize increases in credit risk in a timely manner can aggravate underlying weaknesses in credit quality, adversely affect bank capital adequacy, and hinder appropriate risk assessment and control of a bank's credit risk exposure. The bank risk management function's involvement in the assessment and measurement of accounting ECL is essential to ensuring adequate allowances in accordance with the applicable accounting framework. The detailed supervisory guidance issued by BCBS (Basel Committee on Banking Supervision) is structured around following 11 principles.

Supervisory guidance for credit risk and accounting for expected credit losses

Principle 1: A bank’s board of directors (or equivalent) and senior management are responsible for ensuring that the bank has appropriate credit risk practices, including an effective system of internal control, to consistently determine adequate allowances in accordance with the bank’s stated policies and procedures, the applicable accounting framework and relevant supervisory guidance.

Exposure Draft for Consultation

Principle 2: A bank should adopt, document and adhere to sound methodologies that address policies, procedures and controls for assessing and measuring credit risk on all lending exposures. The measurement of allowances should build upon those robust methodologies and result in the appropriate and timely recognition of expected credit losses in accordance with the applicable accounting framework.

Principle 3: A bank should have a credit risk rating process in place to appropriately group lending exposures on the basis of shared credit risk characteristics.

Principle 4: A bank's aggregate amount of allowances, regardless of whether allowance components are determined on a collective or an individual basis, should be adequate and consistent with the objectives of the applicable accounting framework.

Principle 5: A bank should have policies and procedures in place to appropriately validate models used to assess and measure expected credit losses.

Principle 6: A bank's use of experienced credit judgment, especially in the robust consideration of reasonable and supportable forward-looking information, including macroeconomic factors, is essential to the assessment and measurement of expected credit losses.

Principle 7: A bank should have a sound credit risk assessment and measurement process that provides it with a strong basis for common systems, tools and data to assess credit risk and to account for expected credit losses.

Principle 8: A bank's public disclosures should promote transparency and comparability by providing timely, relevant and decision-useful information.

Supervisory evaluation of credit risk practices, accounting for expected credit losses and capital adequacy

Principle 9: Banking supervisors should periodically evaluate the effectiveness of a bank's credit risk practices.

Principle 10: Banking supervisors should be satisfied that the methods employed by a bank to determine accounting allowances lead to an appropriate measurement of expected credit losses in accordance with the applicable accounting framework.

Principle 11: Banking supervisors should consider a bank's credit risk practices when assessing a bank's capital adequacy.

7. Requirement of Approved ECL policies

BFIs shall have in place the written policies with regard to ECL where such policies must be clearly defined, well-documented and in accordance with the relevant accounting standards. Such policies must be approved by the board of directors, and shall include, at minimum, the following:

Exposure Draft for Consultation

(1) Roles and responsibilities of board of directors, sub-committees, senior management and relevant unit/staff.

(2) Control procedures for the development and validation of ECL models

(3) Criteria for assessment of loan portfolio on individual and collective basis including definition of large exposures

(4) Criteria or indicators of Significant Increase in Credit Risk

(5) Criteria for staging, which shall at least cover qualitative and quantitative factors, and methodologies used for measurement of ECL.

(6) Criteria for upgrading of exposures from higher to lower stages

(7) Sources to be used for forward looking information including macroeconomic factors

Such policies must be regularly reviewed at least once a year.

8. Expected Credit Losses

Expected Credit Losses are a probability weighted estimate of credit losses (i.e present value of all cash shortfalls) over the expected life of the financial instrument. A cash shortfall is the difference between cash flows that are due to an entity in accordance with the contract and cash flows that the entity expects to receive. (NFRS 9)

8.1. 12 month expected credit losses

Twelve month expected credit losses is the portion of lifetime expected credit losses that represent the expected credit losses that result from default events on a financial instrument that are possible within 12 months after reporting date. An amount equal to 12 month ECL is not only losses expected in next 12 months rather, it is the expected cash shortfalls over the life of the lending exposure or group of lending exposures due to loss events that could occur in the next 12 months.

Twelve month expected credit losses are to be recognized for financial instruments with low credit risk or no significant change in credit risk since initial recognition, at the reporting date. A nil allowance is rare as ECL estimates are probability weighted amount (BCBS).

8.2. Lifetime Expected Credit Losses

Lifetime Expected Credit Losses are the expected credit losses that result from all possible default events over the expected life of a financial instrument.

Lifetime expected credit losses are to be recognized for financial instruments with significant increase in credit risk since initial recognition, whether assessed on individual or collective basis, considering all reasonable and supportable information, including that which is forward looking.

Exposure Draft for Consultation

It is the change in risk of default rather than change in amount of expected credit losses that is of concern for assessment of changes in credit risk (before consideration of effects of credit risk mitigants such as collateral or guarantees).

In the case of modified/restructured/renegotiated exposures, the assessment of increase in credit risk by comparing risk of default occurring at the reporting date based on modified contractual terms with risk of default occurring upon initial recognition based on original, unmodified contractual terms. (should not move back to 12 month ECL unless there is sufficient evidence)

For purchased or originated credit impaired financial assets, only cumulative changes in lifetime expected credit losses since initial recognition are recognized.

9. Indicators of significant increase in credit risk

The recognition of lifetime or 12 month expected credit losses requires assessment of significant increase in credit risk since initial recognition. Therefore, the following conditions (non-exhaustive list) can be deemed as indicators of significant increase in credit risk.

i) More than 30 days past due
ii) Absolute Lifetime PD is 5% or more
iii) Relative Lifetime PD is increased by 100% or more
iv) Risk rating (internal or external) downgraded by 2 notches since initial recognition
v) Risk rating downgraded to non-investment grade by external credit rating agency (BB+ or below) or by bank's internal credit rating system
vi) Deterioration of relevant determinants of credit risk (eg future cash flows) for an individual obligor (or pool of obligors)
vii) Expectation of forbearance or restructuring due to financial difficulties
viii) Deterioration of prospects for sector or industries within which a borrower operates
ix) Borrowers affected by macro economic conditions based on reasonable and supportable forecasts.
x) Modification of terms resulting in restructuring/rescheduling
xi) Credit Quality Indicators determined as per internal credit assessment of performing loans which are subject to individual monitoring and review, are weaker than that in the initial recognition
xii) Management decision to strengthen collateral and/or covenant requirements for credit exposures because of changes in the credit risk of those exposures since initial recognition

Both qualitative and quantitative factors are encouraged to be considered while assessing whether there has been significant increases in credit risk. Accurate identification of drivers of credit risk and reliable demonstration of linkage between those drivers and level of credit risk is also critical.

Internal risk rating systems of banks and financial institutions should include sufficient number of grades to appropriately distinguish credit risk whilst change in credit risk can occur prior to a movement in a credit grade.

Exposure Draft for Consultation

For the purpose of determining significant increases in credit risk and recognizing loss allowance on a collective basis, banks and financial institutions can group financial instruments on the basis of shared risk characteristics. Examples of shared credit risk characteristics may include, but are not limited to, the:

a) instrument/Product type
b) credit risk ratings
c) collateral type
d) date of initial recognition
e) remaining term to maturity
f) industry/sector
g) geographical location of borrower
h) value of collateral relative to financial asset only if it has an impact on probability of default occurring.

Assessment of significant increase in credit risk on a collective basis may be needed, for example: on group or sub group of financial instruments, even if evidence of such significant increases in credit risk at individual instrument level is not yet available.

In order to assess changes in credit risk since initial recognition, it is recommended to measure risk of default of retail or other exposures that have less borrower-specific information via collective or group assessment (based on shared risk characteristics) and of exposures classified under Stage 3 and large exposures via individual assessment. However, if additional information becomes available that is considered to have impact on repayment capacity of individual borrower falling within a group assessed via collective assessment, additional adjustment should be made in measurement of risk of default factoring in such information. To measure ECL on collective basis, among different shared credit risk characteristics considered, BFIs should at least include credit risk rating to group or segment exposures.

10. Interest income recognition

Interest income on financial assets measured at amortized cost shall be calculated on following basis:

a) For exposures classified under Stage 1 and Stage 2:
By applying effective interest rate to the gross carrying amount of financial asset (before deduction of loss allowances)
b) For exposures classified under Stage 3:
On actual receipt basis.

Interest income recognition guidelines, 2019 issued by Nepal Rastra Bank shall be repealed upon implementation of this guideline.

Exposure Draft for Consultation

11. Guidance for computation of Expected Credit Loss (based on PD, LGD and EAD)

In view of the fact that most ECL models require the determination of Probability of Default (PD), Loss Given Default (LGD), Exposure at Default (EAD), BFIs are required to take following factors into account:

*ECL = PD * LGD*EAD*

a) *Probability of Default (PD)*

PD is an estimate of the likelihood of a default over a given time horizon.

With regards to PD estimation, the following measures are to be considered by BFIs:

i) Derive PD based on historical default migration rates and other data, internal and external credit rating etc.
ii) Incorporate forward looking PD information as well by adjusting PD to its sensitivity to changes in certain macroeconomic factors.
iii) Use at least five-year historical data for calculating PDs and validate any smoothing of data or inputs by the Risk Management Department.
iv) Can link their internal rating scale to external credit rating for the determination of PD. However, BFIs should avoid using proxies to compute PDs.
v) Compute PDs by using a sovereign PD which is linked to the external credit rating scale, with respect to exposures denominated in foreign currencies issued by the foreign sovereigns.

Irrespective of results derived by the model of BFIs, prudential floor of 2.5% for credit exposures PD has been prescribed as a regulatory backstop measure. Based on experience of 5 years post implementation period of this guideline, NRB shall review above prudential floor.

b) *Loss Given Default (LGD)*

LGD is the percentage of exposure that is not expected to be recovered in the event of a default. For example, a 60% LGD implies that if a default happens only 60% of the balance at the point of default will be lost and the remaining 40% may be recovered (through realization of security or cash collection).

i) Factors to consider for LGD

a) The BFIs are advised to initiate development of LGD models based on historical data, historical experience of cash recovery from defaults (including settlements), cost and time of recoveries and all other relevant and supportable information (including forward looking information).
b) If BFIs are unable to compute LGDs due to lack of data or inputs, such BFI is required to use a minimum LGD of 45 per cent for such credit exposures.
c) BFIs shall use LGD of 0 per cent for same currency denominated cash backed loans with a haircut of over 10 per cent subject to meeting following conditions:

(i) BFIs shall have the right to take legal possession of such cash deposit, in the event of default, or insolvency or bankruptcy of borrower.

Exposure Draft for Consultation

(ii) All documentation used in cash collateralized transactions shall be binding on all parties and legally enforceable.

d) Foreign currency denominated exposures backed by Government of Nepal guarantees shall have minimum LGD of 20 per cent.

e) All subordinated claims on corporates, banks and foreign sovereigns will be assigned a minimum of 75% LGD. A subordinated loan is a facility that is expressly subordinated to another facility.

f) BFIs should avoid using proxies to compute LGDs.

ii) Collateral Valuation

a) While determining loss rate or recovery rate for the purpose of calculation of loss allowance, expected cash flows from collateral realization are to be considered based on latest reliable valuations (within last 2 years)

b) Any increase in valuation of collateral in comparison to valuation report is to be supported by evidence

c) Valuation (prudential floors) for ECL calculation

Following bases shall be taken for determination of net realizable value of different kind of collateral.

a) Net realizable value of collateral of land or land and building shall be calculated as current fair value less 5 % of the value as realization cost (brokerage charges, documentation charges, legal charges, capital gain taxes etc.) less 25% hair cut for possible down fall in price due to force sale transaction of the collateral.
b) Net realizable value of collateral of shares and debenture shall be determined as current fair value less 5% of the value as realization cost (brokerage charges, legal charges, capital gain taxes etc.) less 10% hair cut for possible down fall in price due to immature and volatile share and debenture market.
c) Net realizable value of collateral of inventories and fixed assets other than land or land and building shall be determined as current fair value less 5% of the value as realization cost less 25% hair cut for possible down fall in price due to force sale transaction of the collateral. In case, the fair value of such asset is not determinable at the valuation date, the net realizable value of the assets shall be taken as book value of such assets less 50% flat hair cut on such value.
d) Net realizable value of collateral of debtors/receivables shall be determined as fair value of non due and debtors due for 3 months less 5% of the value as realization cost less 25% as hair cut of fair value of due debtors. Value of the debtors/receivables which are due for more than 3 months shall not be taken into account.
e) Net realizable value of collateral of gold, silver and other precious metals shall be determined as current fair value less 10% as realization cost.
f) Net realizable value of collateral of Government Bonds and Nepal Rastra Bank's securities shall be determined as current fair value less 2% as realization cost.

Exposure Draft for Consultation

g) Net realizable value of all other collateral shall be determined as current fair value less 25% hair cut.
h) Other forms of recognized collateral such as guarantee of top 1000 banks, multilateral development banks, third party collateral may be taken into account provided that the value of such collateral can be determined with reasonable certainty and the entity shall make 25% hair cut on the value determined.

c) *Exposure at Default (EAD)*

EAD refers to the expected exposure to a borrower in the event of default. The methodology for EAD varies according to the nature of product. BFIs are required to consider the following factors, in relation to EAD.

i) Since ECL is a forward-looking measure, EAD input will be forward-looking as well as based on the time period when the default is likely to occur.
ii) Model to be developed for computing credit conversion factor on off balance sheet exposures based on past experience and forward looking information, which is required for EAD.
iii) EAD to include all outstanding exposure and off balance sheet exposure after adjustment with contractual cash flows to reflect expected exposure when default occurs.
iv) For closed end loans, EAD to be capped at maximum contractual period over which entity is exposed to credit risk.
v) BFIs are not permitted to use the legally enforceable contractual period for revolving credit facilities unless analysis of historical data shows that, in practice, management action consistently limits the period of exposure to the contractual period. BFIs are expected to consider all relevant historical information that is available without undue cost and effort when determining the exposure period of a revolving credit facility.
vi) For revolving products (such as overdraft, credit cards), period longer than actual contractual period may be required based on past experience and forward looking information.
vii) BFIs to document such longer period for ECL losses.
viii) If data is not available for off balance sheet exposures, BFIs may use Credit Conversion Factor (CCF) for the calculation of EAD for off balance sheet exposures as defined as follows:

Off Balance Sheet Exposure	**CCF**
Any commitments those are unconditionally cancelable at any time by the bank without prior notice, or that effectively provide for automatic cancellation due to deterioration in a borrower's creditworthiness (for example bills under collection)	0%
Forward exchange contracts.	10%
Short Term Trade-related contingencies Contingent liabilities arising from trade-related obligations, which are secured against an underlying shipment of goods for both issuing and confirming bank and are short term in nature. This includes documentary letters of credit, shipping guarantees issued and any other trade-related contingencies with an original maturity up to six months.	20%

Exposure Draft for Consultation

Undertaking to provide a commitment on an off-balance sheet items	20%
Unsettled[1] securities and foreign exchange transactions between bank to bank and between bank and customer	20%
Long term irrevocable Credit Commitments **Any un-drawn portion of committed credit lines sanctioned for a period of more than 1 year.**	50%
Performance-related contingencies Contingent liabilities, which involve an irrevocable obligation to pay a third party in the event that counterparty fails to fulfill or perform a contractual non-monetary obligation, such as delivery of goods by a specified date etc. This includes issue of performance bonds, bid bonds, warranties, indemnities, underwriting commitments and standby letters of credit in relation to a non-monetary obligation of counterparty under a particular transaction.	40%
Long term irrevocable Credit Commitments Any un-drawn portion of committed credit lines sanctioned for a period of more than 1 year. This shall include all unutilized limits in respect of revolving working capital loans e.g. overdraft, cash credit, working capital loan etc. except for trade finance exposures.	50%
Short term irrevocable Credit Commitments Any un-drawn portion of committed credit lines sanctioned for a period of upto 1 year. This shall include all unutilized limits in respect of revolving working capital loans e.g. overdraft, cash credit, working capital loan etc. except for trade finance exposures.	20%
Repurchase agreements, securities lending, securities borrowing, reverse repurchase agreements and equivalent transactions This includes sale and repurchase agreements and asset sales with recourse, where the credit risk remains with the purchasing bank.	100%
Direct credit substitutes Any irrevocable off-balance sheet obligations which carry the same credit risk as a direct extension of credit, such as an undertaking to make a payment to a third party in the event that a counterparty fails to meet a financial obligation or an undertaking to a counterparty to acquire a potential claim on another party in the event of default by that party, constitutes a direct credit substitute. This includes potential credit exposures arising from the issue of financial guarantees and credit derivatives, confirmation of letters of credit (acceptances and	100%

[1] An unsettled transaction is one where delivery of the instrument is due to take place against receipt of cash, but which remain unsettled five business days after the due settlement date.

Exposure Draft for Consultation

endorsements), issue of standby letters of credit serving as financial guarantees for loans, securities and any other financial liabilities, and bills endorsed under bill endorsement lines (but which are not accepted by, or have the prior endorsement of, another bank).	
Unpaid portion of partly paid shares and securities	100%
Other Contingent Liabilities	100%

12. ECL Model Governance & Validation:

ECL assessment and measurement may involve models and assumption based estimates for risk identification and measurement which requires the use of both internal and external data. ECL assessment and measurement models should consider the impact of changes to borrower and credit risk-related variables such as changes in PDs, LGDs, exposure amounts, collateral values, migration of default probabilities and internal borrower credit risk grades based on historical, current and reasonable and supportable forward-looking information, including macroeconomic factors.

BFIs are expected to, at least:

i) Identify and document the ECL assessment and measurement methods to be applied to each exposure or portfolio
ii) Document the inputs, data and assumptions used in ECL assessment and measurement process and also reasons why the selected method is appropriate
iii) Ensure that the models and ECL estimations are consistent with the objectives of NFRS 9.
iv) Ensure that the rationale and justification for any changes in the expected loss models is documented and justified by the senior management and approved by the BOD.

As the development and use of ECL assessment and measurement models involves extensive judgment, effective model validation policies and procedures are crucial. A bank should have policies and procedures in place to appropriately validate models used to assess and measure expected credit losses. Model validation should be conducted when the ECL models are initially developed and when significant changes are made to the models. A sound model validation process should include, but not be limited to, the following elements:

a) Assignment of clear roles and responsibilities for model validation with adequate independence and competence. Model validation should be performed independently of the model development process and by staff or external parties with necessary experience and expertise. The findings and outcomes of validation should be reported timely to the appropriate level of authority.
b) An appropriate model validation scope and methodology which includes review of model inputs, model design and model outputs/performance.
c) Documentation of the methods used to validate models for ECL measurement (eg backtests), any changes in validation methodology and tools, and the range of data used, validation results and any remedial actions taken where necessary.

Exposure Draft for Consultation

d) Review of model validation process which is to be conducted by independent parties (such as internal audit or external parties) in order to evaluate the effectiveness of model validation process and independence of model validation process from the development process. The findings of review should be reported timely to the appropriate level of authority.

BFIs shall monitor output of the model prediction and actual outcome at least on annual basis and assess the requirement of any adjustment in the model based on such monitoring.
Nepal Rastra Bank shall also check compliance with ECL guidelines during the onsite inspection and offsite supervision.

13. Role of Internal Audit

The internal auditors of BFIs are expected to:

i) Evaluate effectiveness of credit risk assessment and measurement, inputs and assumptions used and acceptability of credit judgements involved in ECL assessment and measurement process.
ii) Report to audit committee on such effectiveness.
iii) Be sufficiently skilled to carry out such periodic evaluation.

14. Transitional Regulatory Requirements

The transition to ECL accounting can lead to in an increase in the overall amount of loan loss provisions in comparison to existing provisions in Unified Directives No. 2, resulting in reduction of capital adequacy ratios of BFIs. Therefore, to address such Day 1 impact, a maximum of 4 year period transitional arrangement will be introduced for BFIs for adjustment in Common equity Tier 1 capital. If ECL provisions are less than existing regulatory loan loss provisions, no transitional arrangement will be applicable and existing capital adequacy calculations shall continue to prevail.

14.1. Calculation of Transitional Adjustment Amount

Consider a bank whose accounting provisions immediately before implementing ECL accounting i.e on Asadh end 2081, is NPR 1,000 million and immediately after implementation i.e on 1st Shrawan 2081, is NPR 1,350 million. The impact of the adoption of ECL accounting on the bank's CET1 capital amount would be a reduction of NPR 245 million net of tax effects (assuming tax effect @30%). Therefore, transitional adjustment amount would be NPR 245 million.

Day 1 impact on CET1 capital spread over 4 years

The period of transition shall commence from FY 2081/82.

Cumulative Percentage of Day 1 Transition Adjustment Amount to be added back in CET1 capital				
Year 1	**Year 2**	**Year 3**	**Year 4**	**Year 5 onwards**
FY 2081/82	**FY 2082/83**	**FY 2083/84**	**FY 2084/85**	
80%	**60%**	**40%**	**20%**	**0%**

Exposure Draft for Consultation

14.2. Consequential Adjustments

An accounting provision amount not deducted from CET1 capital (i.e added back) should not:

i) be included in Tier 2 capital, even if the provision meets the definition of "general" or "excess" provisions.

ii) reduce exposure amounts in the 'Standardized approach' even if it meets the definition of a "specific" provision.

iii) reduce the total exposure measure in the leverage ratio.

14.3. Disclosure Requirements

Banks and financial institutions are also required to disclose publicly :

i) whether a transitional arrangement is applied; and
ii) the bank's regulatory capital and leverage ratios compared to the bank's "fully loaded" capital and leverage ratios had the transitional arrangement not been applied.

15. Regulatory Backstop Measures

BFIs are required to recognize impairment on credit exposures as the higher of ECL calculated as per NFRS 9 and existing regulatory provisions in Unified Directives. Such regulatory backstop shall prevail for a minimum of 5 year period until further review.

16. Guidance on staging for expected credit losses

Bank and financial institutions are required to segregate their financial instruments in three stages for the purpose of measurement of expected credit loss. 12 months expected credit loss shall be recognized for stage 1 whereas life time expected credit loss shall be recognized for stage 2 and stage 3.

a) Stage 1

Includes the following:

i) Initially recognized financial instruments, unless it is purchased or originated credit-impaired financial assets
ii) Financial instruments that do not have significant increase in credit risk since initial recognition
iii) Financial instruments that have low credit risk at the reporting date

For this purpose, instruments with low credit risk are as follows:

a. All exposures on Nepal Government/Province/Local Level or Nepal Rastra Bank
b. Exposures fully guaranteed by Nepal Government/Province/Local Level
c. Foreign Sovereign exposures having rating BBB- and above from an external rating agency at the reporting date.

Exposure Draft for Consultation

d. All exposures on BIS, IMF, EC, ECB and multilateral development banks with risk weight of 0% as defined in Capital Adequacy Framework 2015

e. Debenture/bonds having rating of AA or above at reporting date from external credit rating agency.

BFIs are required to determine at each reporting date as whether the financial instruments meet the requirement of low credit risk. If the instrument does not meet the requirement of low credit risk, the BFIs shall determine whether the risk of default on financial instrument has been increased significantly or not after the initial recognition. If the risk has been increased, the instrument shall be classified under stage 2 and accordingly life time ECL shall be recognized.

iv) Financial assets in which contractual payments are not overdue or is overdue for up to 30 days.

b) Stage 2

Includes the following:

i. Financial instruments having significant increase in credit risk since initial recognition

ii. Financial instruments having contractual payments overdue for more than 30 days but not exceeding 90 days

iii. Loans classified under 'Watchlist' as per NRB Directive on prudential provisioning

iv. Loans without approved credit line or with credit line revoked by the bank

v. Loan that has been restructured/rescheduled but not classified as non-performing loan as per existing provisions of NRB directives. However, rescheduling of instalment/EMI based loans resulting reduction in number of instalments due to prepayments or change in number of instalments due to change in interest rates under floating interest rate are not applicable.

vi. Claims on non investment grade financial instruments i.e. with credit rating of BB+ or below

c) Stage 3

Includes the following:

i) Financial instruments having contractual payments overdue for more than 90 days

ii) BFIs consider that the borrower is unlikely to pay its credit obligations to the bank in full, without realizing security (if held). The indicators of unlikeliness to pay includes:

a) bank puts credit obligation on non-accrued status

b) bank consents to distressed restructuring of credit obligation resulting in reduction in financial obligation due to material forgiveness, postponement of principal, interest

c) bank has filed for debtor's bankruptcy or a similar order in respect of the borrower's credit obligation

d) The bank sells a part of the credit obligation at a material credit-related economic loss.

e) The debtor has sought or has been placed in bankruptcy or similar protection where this would avoid or delay repayment of the credit obligation.

f) there is evidence that full repayment based on contractual terms is unlikely without bank's realization of collateral regardless of whether the exposure is current or past due by few days

Exposure Draft for Consultation

iii) Loan is classified as non-performing as per the NRB prudential provisioning directive.

iv) Credit impaired financial instruments with objective evidence of impairment

A financial instrument is credit-impaired when one or more events that have a detrimental impact on the estimated future cash flows of that financial instrument have occurred. Evidence that a financial instrument is credit-impaired include observable data about the following events:

(a) significant financial difficulty of the issuer or the borrower;

(b) a breach of contract, such as a default or past due event;

(c) the lender(s) of the borrower, for economic or contractual reasons relating to the borrower's financial difficulty, having granted to the borrower a concession(s) that the lender(s) would not otherwise consider;

(d) it is becoming probable that the borrower will enter bankruptcy or other financial re-organization;

(e) the disappearance of an active market for that financial instrument because of financial difficulties; or

(f) the purchase or origination of a financial instrument at a deep discount that reflects the incurred credit losses.

Credit impaired financial instrument shall also include credit impaired defined by BFIs as per their risk management practices

Banks and financial institutions are recommended to classify loss allowances on Stage 1 and Stage 2 assets as general provisions and loss allowances on Stage 3 assets as specific provisions.

17. Transfer criteria between stages

Transfer From Stage 2 to Stage 1: Where there is evidence of significant reduction in credit risk, BFIs should continue to monitor exposures for a minimum probationary period of 90 days before upgrading such exposure from Stage 2 to Stage 1.

Transfer Out of Stage 3: Though the conditions for an exposure to be classified in Stage 3 no longer exist, BFIs should continue to monitor a minimum probationary period of 90 days to upgrade from Stage 3 to 2. An exposure cannot be upgraded from Stage 3 to 1 directly and should be upgraded to Stage 2 initially.

For restructured/rescheduled exposures: BFIs need to monitor exposures in Stage 2 and Stage 3 for a minimum probationary period of 24 months before upgradation to Stage 1 and Stage 2 respectively.

Upgrading of stages for exposures should be executed by Risk Management department in line with policies approved by the Board of Directors of BFIs.

Exposure Draft for Consultation

18. Forward Looking Information

BFIs should have board approved policies to specify the sources and methodologies to be used for economic analysis and forecasting. Wider range of forward looking information including macroeconomic factors, for measurement of expected credit loss need to be considered for formulating such policies. Information should not be excluded from that process simply because an event has a low likelihood of occurring or the effect of that event on the credit risk or the amount of expected credit losses is uncertain. BFIs need to employ sound judgment consistent with generally accepted methods for economic analysis and forecasting supported by sufficient and reliable data. Appropriate oversight and an effective internal control system should be in place to ensure periodic sensitivity assessment of ECL to each forward-looking parameter applied and to ensure that bias is not introduced in the ECL assessment and measurement process.

BFIs may consider a minimum of three economic scenarios for ECL forecasting: normal, best and worst case scenarios. For weightages of the economic scenarios, BFIs may use recognized statistical methodologies.

BFIs should use the forecasts and projections published by authentic sources (such as Central Bureau of Statistics, Nepal Rastra Bank, International Monetary Fund, World Bank, Asian Development Bank etc) where available and also other alternative credible sources when adjusting ECL models to reflect the economic conditions and forecasts and maintain documentary evidence for such data.

Exposure Draft for Consultation