Financial RegTech Newsletter

December 2019

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RBI's Financial Stability Report

The Reserve Bank of India (RBI) published its biannual Financial Stability Report (FSR) on 27 December 2019, the twentieth in the series. The FSR focuses majorly on macro-financial risks and the key factors impacting global growth, domestic economy and markets. While there has been an improvement in the resilience of banks globally due to adoption of macro-prudential tools and policy measures, the susceptibilities have moved from banking to non-banking financial intermediaries, corporates debts and market liquidity, which require policy response.

On the domestic front, the RBI has initiated policy measures for Non-Banking Financial Companies (NBFCs) to improve governance culture, introduce a liquidity management system, resolve stressed assets challenges and develop payment infrastructure. Given the complexity of Indian accounting standards (Ind AS), new accounting standards introduced in the NBFC sector, subjective interpretation needs attention from financial firms.

The Indian financial system stays steady despite weakening domestic growth. Results of the systematic risk survey conducted between April 2019 and October 2019 showed increased domestic growth risk, fiscal risk, corporate sector risk and banks' asset quality risk.[1] About 32% of the respondents felt that the Indian banking sector's prospects are going to improve marginally in the next one year, while 25% of the respondents felt that the prospects are going to deteriorate marginally. Respondents said that under the Insolvency and Bankruptcy Code (IBC), the resolution of legacy assets will enable the banking system to contribute to the aspiration of economic growth.

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Macro-financial risk

There is a significant reduction in the growth rate of both the global and domestic economy. The International Monetary Fund (IMF) has revised global growth for 2019 to 3% in its October 2019 outlook, which is 60 basis points (BPS) below its October 2018 projections.[2]

There is a symmetric slowdown in growth projection for both advanced economies (AEs) and emerging market and developing economies (EMDEs).

2 RBI's report on Macro-Financial Risks.

The global macro-financial condition, along with geo-political uncertainties, are causing risks to spill over into emerging markets. The spillovers can be noticed through:

- central banks' actions and stakeholders' behaviour
- global uncertainties and related spillovers
- commodity market behaviour
- capital flows.

Uncertainties such as the delay in the Brexit deal, international trade tensions, impending recession, oil-market disruption and geo-political risks have hampered consumers' confidence and business sentiments and investments. The forecast for the world's trade growth for 2020 has been reduced by 70 BPS to 3.2% from April 2019 forecast. Strained trade relations between the US and China have had significant impact on global trade, as well as commodity price outlook.

The US Energy Information Administration (EIA) and International Energy Agency (IEA) anticipate that the slowing global economic growth will result in a fall of oil prices. Due to the worsening economic environment, base metal space and manufacturing conditions will continue to suffer. Capital flows to the emerging markets have increased but that doesn't have any significant contribution to their gross domestic product (GDP).

Coming to the domestic macro-financial development, due to a decrease in aggregate demand in the quarter of July to September 2019, growth of economy has slowed down. While there is a positive capital inflows outlook, there might be a decline in India's exports due to the global slowdown. The banking sector's credit growth remained at 8.7% in September 2019.

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Post the Infrastructure Leasing and Financial Services (IL&FS) incident, there are efforts going on to bring market discipline in NBFC sector and the housing sector, as well as to enable cost-effective market access. The adverse rating quality of some borrowers from the banking sector is affecting their own financials. The poor health of the corporate sector is impacting the banking sector's performance. There is a dull phase in the housing market as well. Although the Government has infused liquidity based on the market conditions, consumers' expectations related to pricing are affecting the real estate sector. To bring discipline and to safeguard consumers in the housing market, the Real Estate (Regulation and Development) Act (RERA) has been implemented. It has made real estate companies careful about new launches in short-run.

Spillovers from the global financial markets continue to hinder consumption and investment in the Indian economy.

Financial institutions: Soundness and resilience[3]

Credit growth for scheduled commercial banks (SCBs) has remained quiet at 8.7% whereas for private sector banks (PVBs) it's 16.5%, which is a slight decrease basis year-on-year comparison. The current position of the various financial institutions is given below.

3 The RBI's report on Financial Institutions: Soundness and Resilience

A. Scheduled commercial banks (SCBs)

The soundness and resilience of SCBs can be described in terms of performance and resilience. Aggregate credit growth of SCBs was 8.7% (year-on-year) in September 2019 which was a decrease from 13.2% in March 2019. On the other hand, deposit growth has increased to 10.2% in September 2019 from 9.9% in March 2019. Among banks, credit growth and deposit growth of PSBs are sluggish. There is a slowdown in the growth of net interest income (NII), which could be due to higher growth in deposits as compared to credit. Nevertheless, SCBs were able to get good earnings before provisions and taxes (EBPT) due to higher growth in other operating income.

Profitability ratios of PSBs were dampened due to lack in credit growth as well as slow resolution of non-performing assets (NPAs). With the introduction of the corporate tax rate cut, some of the banks decided to avail the option of a lower tax rate available under Section 115BAA of the Income Tax Act, 1961, which provides the option to companies to pay lower tax subject to certain terms and conditions. The lower tax rate helped improved their profitability. Basis this rate cut, some of the banks have reassessed their deferred tax assets as on 31 March 2019 at lower tax rate and the impact has been taken through profit and loss account. Gross non-performing assets (GNPA) ratio of SCBs' remained the same, whereas the net non-performing assets (NNPA) ratio declined, indicating an

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increase in provisioning. There was also an improvement in the capital to risk-weighted assets ratio (CRAR) of SCBs, which was at 15.1% in September 2019 as compared to 14.3% in March 2019. This could be due to recapitalisation of PSBs by the government.

As per GNPA ratio measurement, the asset qualities of agriculture and services sectors worsened for the period of July to September 2019. The slippage ratios of textiles, rubber and construction industries increased for this period. However, during this quarter, the overall slippage ratio for the industry sector had declined. The share of large borrowers in the total loan portfolio of SCBs' and their share in GNPA has decreased to 51.8% and 79.3% respectively, in September 2019. According to the Banking Stability Indicator (BSI), in September 2019 there was a development in the banking sector's soundness, profitability, efficiency and liquidity. The indicator is a complete evaluation of deviations in underlying conditions and risk factors which have an impact on stability of the banking sector during a period. The indicator represents the five dimensions of soundness, asset quality, profitability, liquidity and efficiency.

B. Scheduled urban co-op banks (SUCBs)

SUCBs had a significantly worse performance for the period of March to September 2019. Their CRAR declined to 9.8% in September 2019. Negative return on assets (ROA) (-3.6%) was recorded for SUCBs in September 2019. There are high chances that the banks would fail to maintain the minimum CRAR requirement in stressed scenarios and will encounter liquidity stress.

C. Non-banking financial companies (NBFCs)

NBFCs also faced stress in their asset quality during the period of July to September 2019. The GNPA ratio increased to 6.3% in September 2019 but the NNPA ratio remained steady. The RBI introduced the Liquidity Coverage Ratio (LCR) requirement for NBFCs to address the concern of asset liability mismatch. Due to the declining CRAR, many companies are not able to comply with the minimum regulatory requirements.

D. The real estate sector

With various financial intermediaries supporting real estate (RE), there is a significant increase in the aggregated exposure for the RE sector. The aggregate share of home finance companies (HFCs) and PVBs in RE exposure has increased, while there is a decline in the share of PSBs. On the other hand, PSB exposure remains huge in aggregate impaired exposure, and it's steadily increasing.

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E. Consumer credit and developments in the non-banking space – a follow-up

There is an adverse selection bias in the consumer credit sector, where NBFCs and HFCs have a higher delinquency ratio than PSBs. Delinquency in auto loans is stabilised across the financial intermediaries except in NBFCs. Similarly, in the case of home loans, HFCs are showing increased delinquency. There is a significant increase in delinquencies for loans against properties (LAPs), which is adversely affecting the NBFCs and PSBs. These developments show that consumer credit is a challenging area for NBFCs.

F. Network of the financial system

The links within the financial institutions support each other in gains and risk-diversification. They also help their risk-transmission during financial crisis. The year-on-year growth in bilateral exposure of the financial system declined to 7.7% in September 2019 from the double-digit growth witnessed earlier.

SCBs continued to have the highest share in this bilateral exposure. The share of NBFCs in bilateral exposure has also shown an increasing trend.

Financial sector: Regulations and developments[4]

A. International and domestic developments

- According to the Global Financial Stability Report (GFSR) of October 2019, the sources of vulnerability have moved from the banking sector to the corporate and emerging market indebtedness and asset market illiquidity. GFSR cautions about three specific vulnerabilities – an increasing corporate debt burden, illiquidity of institutional investor portfolios and increased reliance on external borrowings by emerging market economies.
- International Monetary Fund (IMF) has urged that to avoid unintentional consequences brought in by generally accommodative monetary policies being adopted globally, macroprudential policies could be tightened.
- The countercyclical buffer (CCyB) regime was phased-in in parallel with the capital conservation buffer between January 2016 and December 2018 and became fully effective on January 01, 2019. Three major reasons for adopting CCyB are stabilising credit to GDP ratio, absolute growth in credit, and real estate prices.

4 The RBI's report on Financial Sector Regulation and Developments

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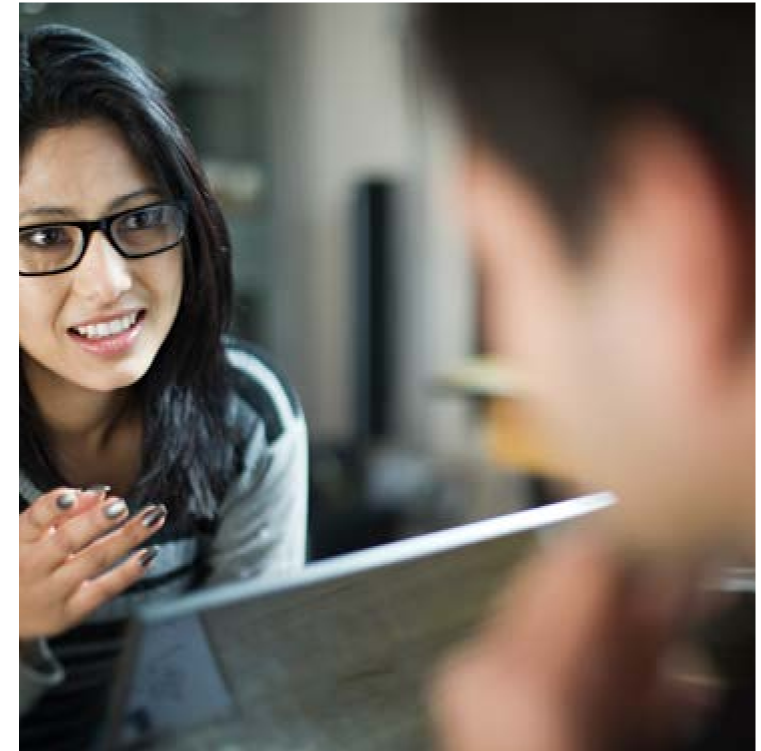
- The Bank for International Settlements' (BIS) quarterly review recently showed a comparative analysis of global systemically important banks (G-SIBs) and domestic systemically important banks (D-SIBs) for the US and the and UK. The performance on specific risk metrices of returns on capital (RoC), risk-weighted assets (RWA) and price to book (P/B) ratio showed superior return performance of D-SIBs.
- Probability of default is one of the vital metrics for judging the riskiness of a credit portfolio. With the implementation of the International Financial Reporting Standards (IFRS) based expected credit loss-oriented accounting regime (from the erstwhile incurred loss-based regime), the definition of 'default' gets more complex and hence there is a need to harmonise various aspects of regulatory and accounting measurements of the default risk. The European Banking Authority (EBA) recently released the final draft of the Regulatory Technical Standards (RTS). The guidelines clarify all aspects related to the application of the definition of default. Materiality threshold is to be composed of both an absolute and a relative threshold. The absolute threshold refers to the sum of all past due amounts related to a borrower's credit obligations towards the institution. The relative threshold is defined as percentage of a credit obligation past due amounts in relation to the total on-balance-sheet exposures to the obligor excluding equity exposures. In a case where both these limits are breached for 90 consecutive days (or 180 days if the competent authority has decided to replace 90 days with 180 days in accordance with Article 178(1)(b) of the Capital Requirements Regulation [CRR], it would be considered that a default has occurred. The RTS guidelines are expected to be implemented by the end of 2020 but institutions are encouraged to introduce the necessary changes as soon as possible. This may be relevant in the Indian context with the implementation of Ind AS by Indian authorities for NBFCs.
- The RBI has laid down rules for compensation packages offered to the top management of private lenders and foreign banks and introduced mandatory rules to claw back the rewards if a lender falter. This is in order to entrust sound corporate governance and robust compliance culture.



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- The RBI is taking steps to integrate fraud reporting of NBFCs and urban co-operative banks (UCBs) in its central fraud registry database. A clear-cut guideline will be issued with respect to reporting of frauds and declaration and processing of red flagged accounts (RFAs). With the help of market intelligence and data analytics banks are required to put in place robust transaction monitoring systems and define the scope of forensic audit. Further, to ensure effective implementation of early warning signals (EWS), banks are being provided with a list of EWS that should mandatorily be part of their tracking system. There is also a list of optional EWS, which may be included as per the specific requirements of each entity.
- The Deposit Insurance and Credit Guarantee Corporation (DICGC) functions primarily in reimbursing the depositors of failed member banks. The extent of devolvement for all the banks -'under direction' or weak banks going into liquidation/ ordered to be wound up, would be INR 3,414 crore in the case of state co-operative banks (StCBs)/ District Central Co-operative Banks (DCCBs) and INR 10,684 crore in the case of (UCBs) (including the Punjab and Maharashtra Co-operative (PMC) Bank.

B. Regulatory initiatives

Here are a few of the recent regulatory initiatives taken by the Indian banking sector:

Reserve Bank of India (RBI)

Here are a few of the recent regulatory initiatives taken by the Indian banking sector:

- Implementation of Leverage Ratio under Basel III Capital Regulations to mitigate the risk of excessive leverage and enhanced financial stability (June 2019).
- Rationalisation of end-use provisions in External Commercial Borrowings (ECBs) policy to further liberalise the ECB framework (July 2019).
- Report of the Task Force on the Development of a Secondary Market for Corporate Loans to enhance secondary market for corporate loans (September 2019).
- The RBI has made it mandatory for banks to link all new floating retail and small and medium enterprise (SME) loans to external benchmark lending rate. The move is aimed at faster transmission of monetary policy rates (September 2019).
- As per its Large Exposure Framework (LEF), the RBI revised bank exposure limit to single NBFC (excluding gold loan companies) to 20% of their Tier-1 capital. (September 2019)

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Securities and Exchange Board of India (SEBI)

- Guidelines for the Liquidity Enhancement Scheme (LES) in Commodity Derivatives Contracts (July 2019)
- Design of Commodity Indices and Product Design for Futures on Commodity Indices (June 2019)

Insurance Regulatory and Development Authority of India (IRDAI)

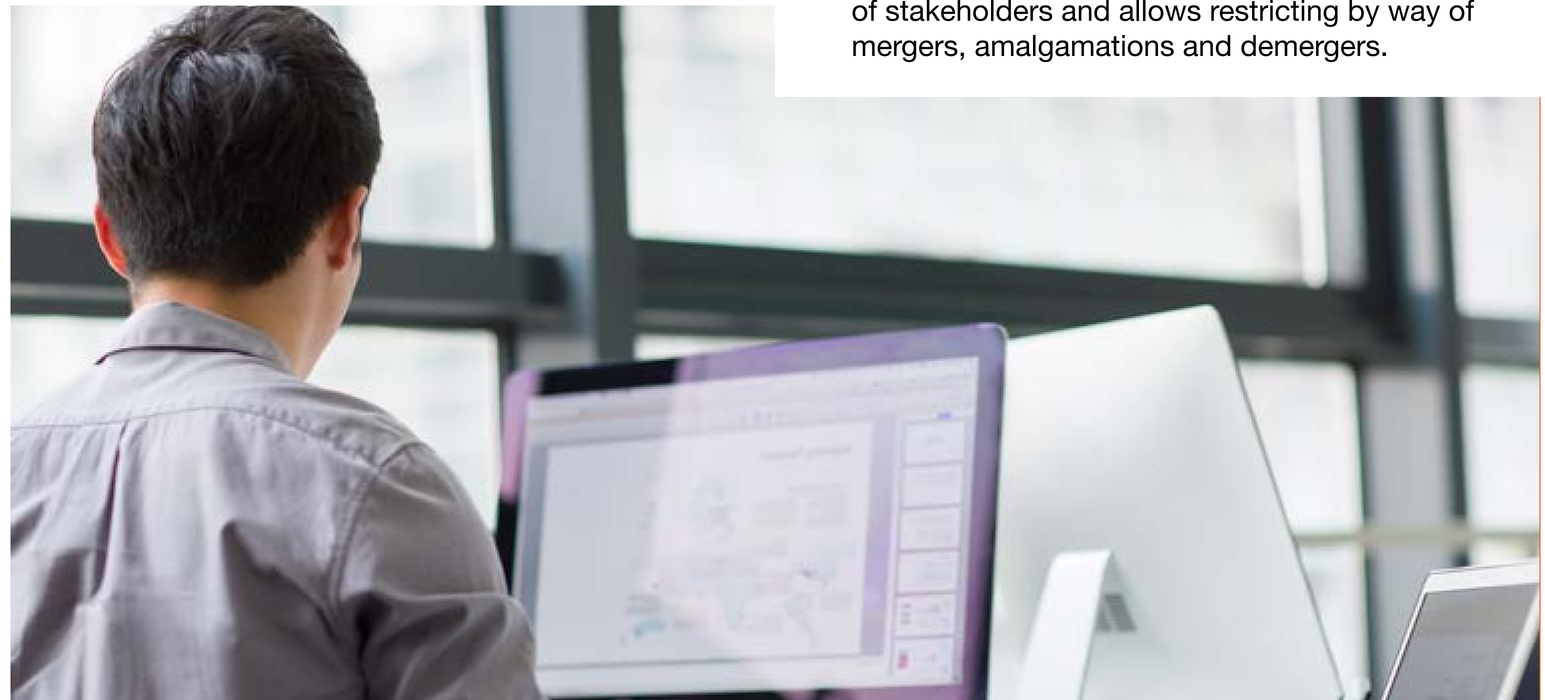
- IRDAI (regulatory sandbox) regulations (August 2019)
- Strengthening the corporate governance process of the insurers (September 2019)

Pension Fund Regulatory and Development Authority (PFRDA)

- Utilisation of SEBI's know your customer (KYC) registration agencies (KRAs) by points of presences (PoPs) for onboarding subscribers to the National Pension System (NPS) (September 2019)
- PoP relying on third-party client due diligence (KYC) for onboarding subscribers in NPS (August 2019).

Insolvency and Bankruptcy Board of India (IBBI)

- The Insolvency and Bankruptcy Code (Amendment) Act, 2019, ensures that the objective of the codes and timelines provided are strictly adhered to. The amendment seeks to balance the interest of stakeholders and allows restricting by way of mergers, amalgamations and demergers.



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Cyber Security controls for Third party ATM Switch Application Service Providers

The RBI has mandated that third-party ATM Switch application service providers (ASPs) need cyber security controls in their systems. Since ATM Switch ASPs are subjected to payment systems, they are exposed to cyber-attacks. They must provide on-site/off-site access to the RBI for supervision.

The detailed notification can be accessed **here.**

Setting up of IFSC Banking Units (IBUs) – Permissible activities

The RBI has issued a circular with the updates related to IFSC Banking Units (IBUs). According to the latest update, the RBI will not impose any limit for short-term liabilities from banks. But, the IBUs need to maintain LCR as applicable to Indian banks as per liquidity risk management guidelines issues by RBI.

They can't open savings accounts. They can open foreign currency current accounts for non-resident institutional and corporate borrowers subject to certain conditions. However, they are not allowed to raise liabilities from retail customers including high net-worth individuals (HNIs).

The detailed notification can be accessed **here.**

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Availability of National Electronic Funds Transfer (NEFT) System on 24x7 basis

The RBI has decided that National Electronic Funds Transfer (NEFT) will be available on a 24x7 basis, all days of the year, inclusive of holidays. It was mandated that there will be 48 half-hourly batches every day. Any NEFT transactions after banking hours have to be automated using 'Straight Through Processing (STP)'. Credit to the beneficiary's account or return of the transaction to the originating account within two hours of settlement of the respective batch run will continue as per existing guidelines. Member banks need to share positive confirmation messages for all NEFT credits.

Member banks need to maintain liquidity in their current accounts with the RBI in order to facilitate successful batch settlements.

The detailed notification can be accessed **here.**

Reporting of Large Exposures to Central Repository of Information on Large Credits (CRILC) – UCBs

The RBI has directed UCBs to report Central Repository of Information on Large Credits (CRILC). UCBs with total assets of INR 500 crore or above have to report credit information including Special Mention accounts (SMAs) for all borrowers having aggregate exposure of INR 5 crore or more.

Initially, UCBs are mandated to submit CRILC report on a quarterly basis to the RBI. Otherwise, there will be penal action as per the provisions of the Banking Regulation Act, 1949.

The detailed notification can be accessed **here.**

Enhancing facilitation of National Electronic Toll Collection (NETC) system

The RBI has allowed more payment options to the customers to pay various payments like toll, parking fees etc. The National Electronic Toll Collection (NETC) system has allowed authorised payments and instruments to be linked with FASTags.

It has also advised on the Turn Around Time (TAT) for the failed transactions occurred through the NETC system. Under this system, transactions can be performed without any Additional Factor of Authentication (AFA) and/or any notification. The National Payments Corporation of India (NPCI) should process the requests received from banks or non-bank entities for this.

The detailed notification can be accessed **here.**

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Introduction of a new type of semi-closed Prepaid Payment Instrument (PPI) – PPIs upto INR 10,000/- with loading only from bank account

The RBI has introduced a new type of semi-closed Prepaid Payment Instrument (PPI) to help digital payments and to boost user experience.

In order to issue the PPI, minimum details of the PPI holder are required which includes a verified mobile number with a one-time password (OTP), and self-declaration of the name and unique identity/ identification number of any 'mandatory document' or 'officially valid document' (OVD) etc as per (KYC) directives.

The monthly amount loaded in PPI is limited to INR 10,000 and the total amount loaded during a financial year will be up to INR 120,000. It can used to purchase goods and services only.

The detailed notification can be accessed **here.**

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Measures to strengthen the conduct of Investment Advisers (IAs)

SEBI has a provided Code of Conduct to the Investment Advisers (IAs) in order to reinforce IAs' conduct and protect investors' interests during investments.

IAs should not advise prospective clients during the free trial of any product or service. They should not take partial payments like advance fees. Before providing investment advice, they need to complete the risk profile of the client and get the consent from the client. They can receive payments through banking channels only.

The detailed notification can be accessed **here.**

Circular on Investment in units of Mutual Funds in the name of minor through guardian and ease of process for transmission of units

SEBI has provided guidance on the investment process in the name of a minor, via guardians. This is to bring uniformity across asset management companies (AMCs).

Payments for investments can be done through cheques, demand drafts or any other mode from the bank account of the minor or from the joint account of the minor, which is held along with the guardian only. It is advised that AMCs implement image-based processing when the claimant is a nominee or a joint holder in the investor folio.

The detailed notification, can be accessed **here.**

Management and advisory services by AMCs to Foreign Portfolio Investors

SEBI has instructed AMCs that they can provide management and advisory services to the Foreign Portfolio Investors (FPIs) which come under the prescribed categories, such as entities in which at least 75% of the ownership is with the Government or Government-related investors. Services can also be provided to regulated entities like pension funds, insurance or reinsurance entities, mutual funds and banks or any regulated FPIs in which more than 50% shares are owned by mentioned Government entities or any regulated entities.

These changes are made to ensure regulation in the securities market and to protect investors' interests.

The detailed notification can be accessed **here.**

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Monetary policy decisions

The European Central Bank (ECB) has opted for no change in the interest rate on main refinancing operations, on marginal lending facilities and on deposit facilities which stand at 0.00%,0.25% and -0.05% respectively.

The governing council has planned to continue reinvesting in order to maintain liquidity and monetary arrangements.

The detailed notification can be accessed **here.**

ESMA: Further action needed on fees for credit ratings and trade repository services

In continuation to the Thematic Report, the European Securities and Markets Authority (ESMA) has directed good practices to be implemented by Credit Rating Agencies (CRAs) and Trade Repositories (TRs) in order to have fee transparency, fee setting and cost-monitoring.

Revision of pricing policies should reflect fee-related requirements to the CRA regulation and need to be published on CRAs' websites. In case of TRs, they should publish fee schedules of their services, along with advance notice of updates to clients and request clients' feedback on their transparency.

The detailed notification can be accessed **here.**

ESMA provides updated XML schema and reporting instructions for securitisation reporting

The ESMA has published updated reporting instructions and XML schema. This has been introduced to ensure that it is aligned with the technical standards as well as the feedback provided by the stakeholders.

ESMA's website has updated its securitisation policy segment with information on technical standards which was also published on the portal of the European Commission.

The detailed notification can be accessed **here.**

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Acknowledgements

This newsletter has been researched and authored by **Prachi Gujare** and **D Kalyani**

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Data Classification: DC0

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SG/January2020-M&C4435