Financial RegTech Newsletter

December 2020

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Accelerating financial market reforms in India

This edition of the Financial Reg Tech newsletter focuses on the address delivered by Shaktikanta Das, Governor, Reserve Bank of India (RBI), on the fourth annual day of the Foreign Exchange Dealers Association of India (FEDAI).

The address covered the key developments in financial markets, with a primary focus on foreign exchange markets. It also highlighted the various liberalisation schemes and efforts being taken by the RBI for creating a robust Indian financial market.

The address started with the impact of the COVID-19 crisis on the Indian economy and how recovery from the crisis has been better than expected. The International Monetary Fund (IMF) has revised its forecast favourably for the global economic outlook in FY 2020, as many countries worldwide have started recovering.

Domestic markets were in good shape in the beginning of 2020 but were significantly impacted by the pandemic, leading to worsening of market liquidity and increasing volatility in asset pricing. The country's financial conditions started deteriorating with the yield curve steepening strongly amidst growing concerns of economic slowdown and sell off by foreign portfolio investments. Soon, the commercial paper and corporate bond market followed suit, with growing volatility affecting market conditions.

However, the RBI was closely monitoring the situation and acted swiftly to re-establish market confidence. The RBI came up with various measures for easing market rules and controlling risks. The RBI Governor also assured that the central bank would continue to monitor the situation for smooth functioning of financial markets.

Accelerating financial market reforms in India

The governor also spoke about financial markets and their progress in the last three decades, emphasising especially on the Indian bond market.

- The bond market has experienced a broad-based growth, with wider market participation, deeper instrument base and development of derivative and repo markets.
- The sovereign yield curve spans till 40 years and plays a significant role in pricing of instruments.
- The foreign exchange market has also expanded its base with a diverse set of instruments and participants.
- State-of-the-art infrastructure has been developed for enabling the issuance process and an efficient dematerialised depository system has been set up within the RBI, trade reporting, central counterparty settlement and electronic trading platforms.

The governor also highlighted some imperfections that are still present in the wider market.

- The benchmark tenors in the secondary market of government securities were limited, even with increased liquidity.
- The interest rate derivative market was limited to only one product and a few participants.
- New product development in the foreign exchange market was restricted because of regulatory restrictions in place due to prior experience with complex products and less participation.
- Different events and news related to wrongdoings in the global market were on the rise, emphasising the need for a robust governance framework to protect domestic markets from any such event.

However, the abovementioned imperfections did not prove to be a deterrent for the RBI in establishing a strong market, as it focused on the opportunities opened up by these market gaps.

Against this backdrop, the RBI is all set to enter the next phase of transformation in promoting reforms, which are bucketed under the below four categories:

1. liberalising financial markets and simplifying market regulations
2. internationalising financial markets
3. protecting buy-side user protection
4. ensuring resilience and safety.

Liberalising financial markets and simplifying market regulations

The focus of recent regulatory changes is to provide ease of access to market participants with minimum market entry cost and flexibility in their operations. A principle-based regulation will help them in achieving this goal for derivatives and foreign exchange markets. Some of the initiatives taken are:

a. Restrictions have been lifted for cancellation and rebooking of foreign exchange trades and design of derivative contracts.

b. Foreign entities can have the same entry and exit criteria as their domestic counterparts.

c. With the easing of hedging rules, permission has been granted to hedge additional expected exposure.

d. A user having limited or small hedging requirements can enter into contracts equivalent to USD 10 million without establishing the existence of underlying exposures.

e. The newly passed Bilateral Netting of Qualified Financial Contracts Act, 2020, is another step in the liberalisation of markets and improving the operating environment. The bill will be a framework for offsetting cash and derivative market transactions.

f. These initiatives have helped in improving operating conditions by reducing costs and removing inefficiencies.

Internationalisation of financial markets

Internationalisation of markets results in greater efficiency and lower cost of transactions. India has witnessed a transformational change in the last three decades, with increasing global connectivity and a huge volume of international transactions.

a. Inward foreign direct investment (FDI) has been allowed in most sectors. Additionally, external commercial borrowing (ECB) has improved with reduced maturity requirements and fewer restrictions for end users.

b. Foreign portfolio investment (FPI) limits under the medium-term framework have been increased. A voluntary retention route (VRR) has been introduced for relaxation from macro-prudential controls along with a provision of a minimum retention period.

c. Introduction of the Fully Accessible Route (FAR) would help non-residents in investing in specified government securities without any barriers. Capital account convertibility will be taken up as a process in relation to current macroeconomic conditions.

d. Domestic banks have been recently permitted to trade in offshore rupee derivative markets and deal in foreign currency markets beyond usual onshore market hours supporting real-time markets. Additionally, banks and exchanges operating from the GIFT city have been allowed to trade in over the counter (OTC) and exchange-traded rupee derivatives.

Safeguarding buy-side user protection

The RBI has taken many initiatives to protect the buy side. Some of the initiatives are:

a. A user classification framework has been introduced to identify retail and non-retail investors for over the counter (OTC) foreign exchange and interest rate derivative transactions. The aim of the move is to help retail investors by offering them only non-complex products. Product innovation option is also available for non-retail investors, basis their business requirements.

b. The launch of the FX-Retail Platform by the Clearing Corporation of India (CCIL) is an effort for promoting user protection and transparency. The FX-Retail is an anonymous order-matching electronic trading system. This will help in price discovery, even for small-ticket size transactions, thereby helping retail investors.

c. With recent advancements in the derivatives market, the regulations are being reviewed, considering the regulatory environment for assessing product aptness and user relevance.

Ensuring resilience and safety

Financial markets in India have remained robust during previous crises. The RBI has undertaken many initiatives to keep the markets resilient.

a. The RBI introduced a regulatory framework for ushering in fair market conduct and improving trust in the financial ecosystem.

b. The RBI is introducing measures to implement the G-20 OTC derivatives market reforms. A draft framework on variation margin for derivative products has been released recently for reduction of counterparty risks from derivative trades that are not cleared centrally.

c. The RBI has made usage of legal entity identifier (LEI) mandatory. This is used for unique identification of market participants across the globe.

d. Another important global measure is the transition from the London Interbank Offered Rate (LIBOR) to some alternative reference rate. The Indian Banks' Association is consulting market participants for a smooth transition and creating customer awareness.

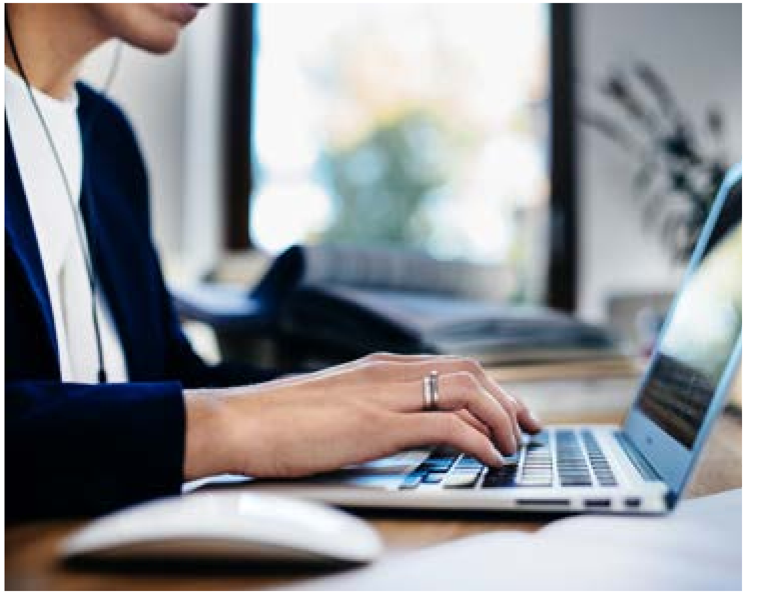
In the end of the address, the governor emphasised on the critical role that market participants and their associations, including FEDAI, have to play in designing new products, risk management systems and new market segments for achieving the desired outcomes.

Regulatory news

Issue of revised guidelines on opening of current accounts by banks

The RBI has issued revised guidelines on existing current accounts and opening of new current accounts by banks to ensure that the processes are more disciplined ones. The revised guidelines mandate that a bank's exposure should be less than 10% of the total exposure to a borrower, current accounts should be regularly monitored and withdrawals should not be routed from term loans through current accounts. Banks shall ensure that the above guidelines are complied with within three months of issuance of the guidelines.

The detailed notification can be accessed here.



Co-origination of loans by banks and NBFCs for lending to the priority sector

The Co-Lending Model (CLM) devised by the RBI aims to leverage advantages of banks and NBFCs, provide operational flexibility to institutions and provide funds to the priority sector at an affordable cost. Banks can now enter into an agreement with a registered NBFC (including HFCs), formulate board-approved policies related to the CLM and publish them on their websites.

The detailed terms and scope of the CLM can be accessed here.

Discontinuation of returns/reports under the Foreign Exchange Management Act, 1999

The RBI has decided to discontinue 17 returns/reports as part of the Foreign Exchange Management Act, 1999, with immediate effect. This will help in improving ease of doing business and reducing compliance cost.

The detailed notification and list of discontinued reports can be accessed here.

24/7 availability of the Real Time Gross Settlement (RTGS) system

The RBI has announced that the Real Time Gross Settlement (RTGS) system would be available for customer and interbank transactions round the clock on all days with effect from 00.30 hours on 14 December 2020. Banks and other members are advised to have necessary infrastructure in place for smooth RTGS operations.

The detailed notification can be accessed here.

Maintenance of an additional escrow account with scheduled commercial banks

The RBI has decided to allow prepaid payment instruments PPIs and payment aggregators PAs to maintain an additional escrow account in a different scheduled commercial bank with a view to diversify risks and address concerns related to business continuity.

The detailed notification can be accessed here.

Other regulatory news

Flexi-cap fund – introduction of a new category under equity schemes

The Securities and Exchange Board of India (SEBI) has issued guidelines on the newly introduced equity scheme category – flexi-cap fund.

Based on the recommendations of the Mutual Fund Advisory Committee, a new equity scheme category named flexi-cap fund has been introduced. This would be an open-ended scheme investing across large cap, mid cap and small cap, and 65% of total assets invested in equity and equity-related instruments. Mutual funds also have an option to convert an existing fund to a flexi-cap fund.

The detailed notification can be accessed here.

Regulatory compliance – relaxation in timelines

Keeping in view the ongoing COVID-19 pandemic, SEBI has decided to extend the regulatory compliance timelines for trading members, clearing members and depository participants.

The compliance requirements for which the timelines are extended include internal audits, system audits, half-yearly net worth certificates and cyber security audits, amongst others.

The detailed notification can be accessed here.

Other regulatory news

Clarifications on Investor Grievance Redressal Mechanism (IGRM)

SEBI has issued clarifications to its earlier circulars released with respect to Investor Grievance Redressal Mechanism (IGRM).

The clarifications include guidelines on timelines and resolution of service-related complaints by Stock Exchange, handling of complaints by the Investor Grievance Redressal Committee (IGRC), arbitration and specific guidelines to Stock Exchange on IGRM.

The detailed notification can be accessed here.

Enhancement of overseas investment limits for mutual funds

In its recent circular, SEBI has decided to enhance the overseas investment limits for mutual funds. With this decision, the below changes in limit would come into effect:

- Overseas investments can be worth a maximum permissible amount of USD 600 million per mutual fund, with an industry limit of USD 7 billion.
- Investment in overseas Exchanged Traded Funds (ETFs) can be worth a maximum permissible amount of USD 200 million per mutual fund, with an industry limit of USD 1 billion.

The detailed notification can be accessed here.

Global regulatory news

Fallback to EURIBOR – public consultations launched

The working group on euro risk-free rates has launched two public consultations on fallback provision to EURIBOR. The aim of these consultations is to gather views on fallback rates and spread adjustments methodologies to devise most suitable fallback provisions per asset classes.

The consultations take into consideration both forward-looking rates and backward-looking rates, and the deadline to provide views is 15 January 2021.

The detailed notification can be accessed here.

ECB publishes consolidated banking data for end-June 2020

The European Central bank (ECB) has published the quarterly consolidated banking data for end-June 2020, which provides various EU banking indicators on profitability and efficiency, balance sheets, liquidity and funding, asset quality, asset encumbrance, etc.

Some of the key highlights of the report are as given below:

- Total assets saw a quarter-on-quarter (QoQ) increase of 7.6% from €27.6 trillion in June 2019 to €29.7 trillion in June 2020.
- Non-performing asset (NPA) ratio saw a year-on-year (YoY) decline of 0.17 percentage points to 2.87% in June 2020.
- Average return on equity stood at 0.58% in June 2020.

The detailed notification can be accessed here.

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