Financial RegTech Newsletter

January 2021

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RBI's Report on Trend and Progress of Banking in India 2019-20

The Report on Trend and Progress of Banking in India 2019–20 released by the Reserve Bank of India (RBI) on 29 December 2020 highlights the development in the banking sector for the year that ended on 30 June 2020 against the backdrop of the global economy being impacted by the COVID-19 pandemic.[1] The challenges faced by the Indian economy and the policies formulated by the Government and banking authorities to help with its revival are discussed at length in this report, including the impact of the latter on existing as well as new market participants like payment banks.

This edition of the Financial RegTech newsletter provides an overview of the RBI report.

1. https://rbidocs.rbi.org.in/rdocs/Publications/PDFs/0RTP2020_F3D078985540A4179B62B7734C7B445C9.PDF

Global banking developments

The COVID-19 pandemic globally impacted trade, investment and growth. The top priority for central banks worldwide was to adopt strategies to mitigate its impact.

Additionally, policies were formed to build resilient financial institutions by implementing improved Basel frameworks and financial disclosures, and strengthening governance frameworks to reduce misconduct risks, among others.

Performance of the global banking sector

- **Bank credit growth** decelerated across global economies along with **return on assets (ROA)**, a key indicator in measuring a bank's profitability.
- **Asset quality and capital adequacy ratios (CAR)** showed improvement.
- **Leverage ratio**, which continued to show improvement in 2019 across the global banking system on account of regulatory policies, declined in the first half of 2020.
- The above factors accounted for increased **stock prices** for banks in 2019. Stock prices declined steeply as COVID-19 gradually became a global crisis by March 2020. Though the prices recovered later, they never reached the pre-pandemic levels.

- Efforts were made to improve capital levels through restrictions on profit distribution by means of share buybacks and dividends, government loan guarantees and other country-specific measures.
- Bank profitability remained low despite improvement in asset quality and capital position.
- Looking at the current situation of low interest rate and pandemic-induced asset stress, profitability is expected to be muted even in the immediate future.

The impact of COVID-19 in India and the RBI's measures to tackle it

The initial strict lockdown and loss of jobs, coupled with reverse migration, resulted in repercussions on the operations and capital flow of major financial entities – non-banking financial companies (NBFCs), small finance banks (SFBs), payment banks, co-operative banks and home finance companies (HFCs).

NBFCs were returning to normalcy in 2019–20 post the fiasco involving an infrastructure development and finance company when the pandemic hit their operations again.

The level of impact on niche players depends on various factors like their evolution stage, initial financial health and business model, and hence differed across entities.

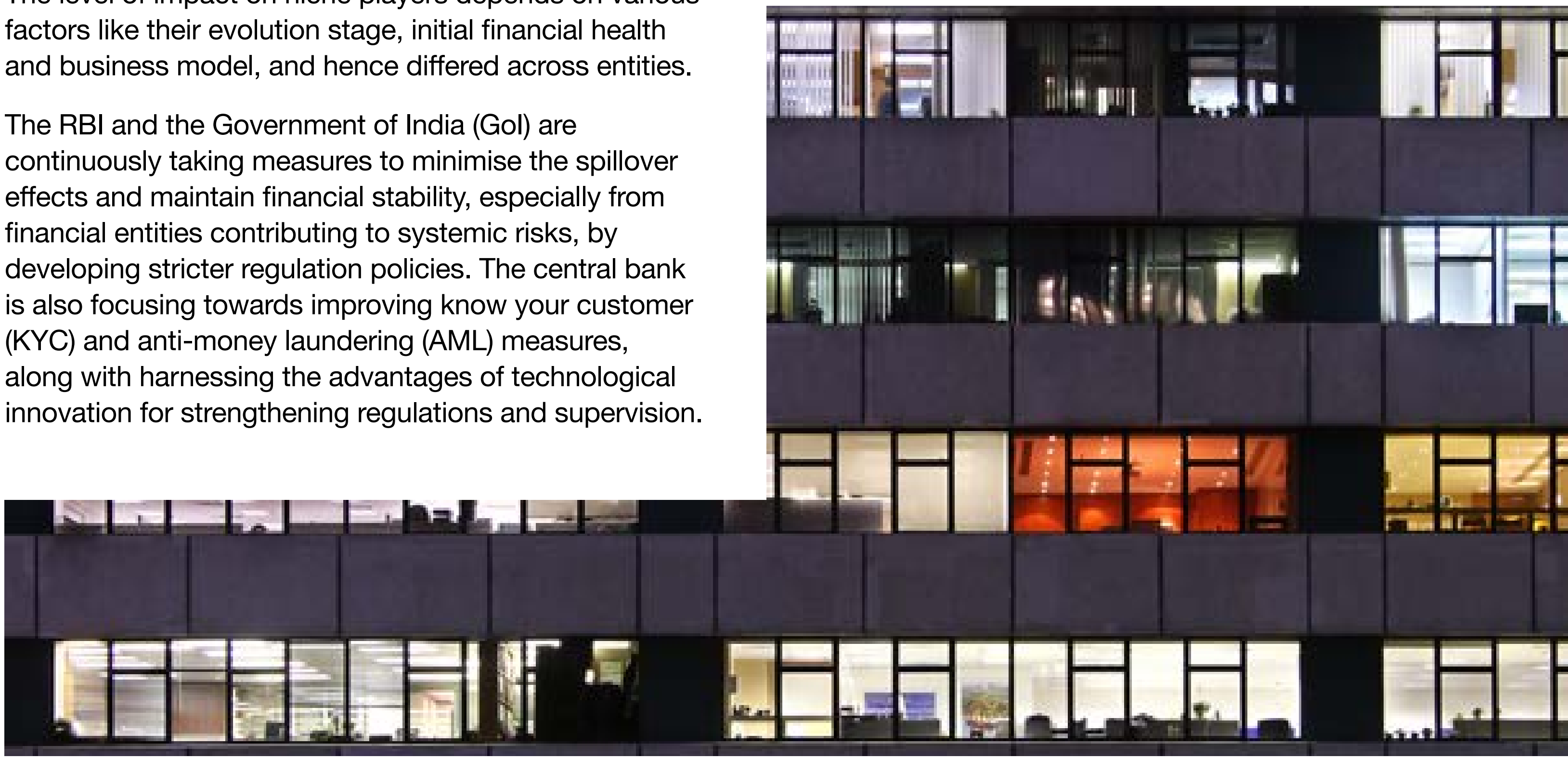
The RBI and the Government of India (GoI) are continuously taking measures to minimise the spillover effects and maintain financial stability, especially from financial entities contributing to systemic risks, by developing stricter regulation policies. The central bank is also focusing towards improving know your customer (KYC) and anti-money laundering (AML) measures, along with harnessing the advantages of technological innovation for strengthening regulations and supervision.

Policy environment

Monetary policy and liquidity management

Repo rate has been reduced by 250 basis points (bps) since February 2019 and reverse repo rate decreased cumulatively by 155 basis points to 3.35% to revive the economy and ensure adequate liquidity in the system. Other active measures included:

- repo/reverse repo auctions with fixed or variable rates and maturities
- open market operations (OMOs)
- forex swaps.



Regulatory policies

The central bank introduced numerous regulatory policies targeted individually at various players like commercial banks, small finance banks (SFBs) and regional rural banks (RRBs).

Loan moratorium was one of the major policies introduced in the wake of the disruption caused by COVID-19 and aimed at providing relief to impacted households and businesses. Other significant measures included:

- debt restructuring options
- subordinate debt scheme to provide liquidity to micro, small and medium enterprises (MSMEs)
- implementation of video-based KYC
- relaxation of existing policies on opening new branches for scheduled commercial banks (SCBs)
- permission given to RRBs to open banking outlets, issue perpetual debt instruments (PDIs) and function as merchant-acquiring banks using digital banking platforms.

Supervisory policies

Supervisory policies were aimed at ensuring financial stability and finding the root causes for instability in the banking system, viz. poor compliance practices, inefficient banking strategies and issues in governance structure to undertake corrective actions. Post the merger of Dena Bank and Vijaya Bank with the Bank of Baroda, 10 additional public sector banks (PSBs) were merged to form four entities with a view to source the benefits of synergies and economies of scale.[2]

Some of the measures targeted at the NBFC sector included – introduction of a special liquidity scheme (SLS) to provide NBFCs with required liquidity, direction to implement Indian Accounting Standards (Ind-AS) for reporting standardisation across the sector and reduction in the eligibility criteria of asset size to INR 100 crore and above in order to take recourse under the SARFAESI Act, 2002. Though these measures helped the NBFC sector to cope with the liquidity stress, they were unable to boost its credit growth. The RBI is closely monitoring this sector for its systemic implication on the financial system.

2. https://rbidocs.rbi.org.in/rdocs/Publications/PDFs/0RTP2020_F3D078985540A4179B62B7734C7B445C9.PDF

Foreign exchange policies

Foreign exchange policies were introduced to ease the process of doing business and regulate external transactions of goods/services.

Restrictions related to external commercial borrowings (ECBs) were relaxed to help corporates meet their business requirements.

Licensed banks are now allowed to participate in offshore derivative markets dealing in non-deliverable rupee products. Import advance limit without bank guarantee has been increased to USD 5 million and Japanese Yen has been added as the settlement currency under the Asian Clearing Union (ACU) mechanism.

Credit delivery and financial inclusion

The central bank and the GoI are trying to bring awareness among the masses and make banking facilities and credit access available to low-income groups and weaker sections of the society. Several measures have been undertaken with a focus on priority sector lending (PSL) and MSMEs. Banks were also directed to make provisions for providing doorstep banking services for differently abled people and senior citizens.

Owing to the steps taken in the direction of financial inclusion:

- the number of branches in the country per 100,000 adults increased to 14.6 from 13.6
- the number of deposit accounts reached to 41.4 crore with an average balance of INR 3,140 under the Pradhan Mantri Jan Dhan Yojana (PMJDY).

Consumer protection

As the customer base and the usage of technology-based financial products are increasing day by day, initiatives taken by the RBI are aimed at ensuring safe and reliable digital transactions, and protection of consumer interests. These include increasing the insurance cover limit for depositors to reduce their liability, strengthening of ombudsman schemes, enhancing the grievance redressal system by implementing an end-to-end complaint management system (CMS) for digital transactions and increasing customer awareness, especially in the digital field. These proactive measures have helped build and retain customer trust in the system.

Payment and settlement systems

Digital payment systems have rapidly gained importance in the last few years. Social distancing requirements during the pandemic have also resulted in higher growth in Unified Payments Interface (UPI) transactions.[3]

The RBI is focusing on promoting innovation in the digital space, adding newer services and expanding the existing ones. The central bank is also well aware of the risks involved in the process of innovation and proactively involved in regulating the same. Few of the measures brought in this area are as listed below:

- The National Electronic Funds Transfer (NEFT) system and Real Time Gross Settlement (RTGS) system are now available on a 24x7x365 basis.
- The RBI further initiated a one-tap authorisation for payment systems, limited the use of QR codes to two standard codes – UPI QR and Bharat QR – and established a guideline framework for supervision of payment system operators.
- A regulatory sandbox (RS) has been set up to provide opportunity and an environment to selected applicants for field testing their innovative products/ services in the digital space.
- FASTags will soon become mandatory for all vehicles in the country to pay toll fares directly from a prepaid account, thus broadening the National Electronic Toll Collection (NETC) system.

- Consecutive rate cuts, liquidity infusion measures and timely actions by the RBI helped ease the immediate stress that was created as a result of the pandemic.
- The challenge is to revive and stabilise the economy and rewind the relaxation norms at a suitable time to avoid any negative impacts.
- The RBI report states that as of August 2020, nearly 40% of the loans disbursed by NBFCs and banks were still under moratorium.

3. https://rbidocs.rbi.org.in/rdocs/Publications/PDFs/0RTP2020_F3D078985540A4179B62B7734C7B445C9.PDF

Operations and performance of banks and NBFCs

Commercial banks

The consolidated balance sheet of SCBs had shown early signs of growth in H1 2020–21 after a slowdown in FY 2019–20, reflecting muted economic activity and deleveraging of corporate balance sheets. On the liability side, the deposit growth of SCBs remained high during the first three quarters of FY 2019–20, corresponding to the period since September 2017. In terms of assets, SCBs witnessed a decline in credit growth in FY 2019–20 because of low credit demand and corporate deleveraging.

Muted credit growth and accelerated deposit growth during the FY19–20 resulted in lower borrowing requirements. Moreover, there was a slowdown in the loan growth of SCBs after a gap of two years owing to sluggish demand and risk aversion. Nevertheless, increased income from interests has helped SCBs to register a higher net interest margin in FY19–20 compared to FY 18–19.

Mergers and capital infusion worth INR 3.16 lakh crore by the Government in the last five years has helped SCBs to improve their capital-to-risk-weighted assets ratio (CRAR) to 15.8% at the end of September 2020. Liquidity Coverage Ratio (LCR) improved as well and was at 159.1% at the end of March 2020 compared to 128.9% during the same period last year.

The gross non-performing assets (GNPA) and net non-performing assets of SCBs declined to 8.2% and 2.8% respectively in FY19–20, indicating an increase in provisioning and write-offs.

Among other banks, RRBs and payment banks have registered net losses, whereas small-finance banks and local area banks have registered an increase in profitability.

Cooperative banks

The combined balance sheet of UCBs narrowed because of higher competition, stagnant growth in loans and advances, and deposits. Balance sheet growth slipped to 4.2% from 6.4% in FY19–20. The credit-to-deposit ratio of UCBs continued to be lower compared to SCBs as UCBs depend heavily on deposits to fund different loans.

UCBs registered net losses as a result of increased interest accompanied with higher provisioning and other expenditures. Moreover, the asset quality of UCBs weakened in FY19–20, which resulted into higher gross NPA and net NPA ratios. Gross NPA ratio and net NPA ratio increased from 7.3% to 10.8% and 3.3% to 5.1% respectively in FY19–20.

The profitability of SCBs increased as income from interest improved faster than interest expenditures, whereas the profitability of central cooperative banks in districts continued to diminish because of higher provisioning.

NBFCs

The growth rate of NBFCs declined sharply after touching double digits for three years due to muted loan growth and weak demand. Year-on-year (YoY) balance sheet growth came down to 8.9% in FY19–20 from 20.6% in FY18–19. However, NBFCs have managed to strengthen their capital base.

In FY19–20, bank borrowings constantly grew at a substantial rate compared to market borrowings. NBFCs also increased their exposure to long-term borrowings to alter their borrowing profile.

Profitability ratios improved in FY19–20 on account of lower expenses. Returns on assets and equity ratios increased from 0.2% to 1.2% and 0.9% to 4.9% respectively. However, the asset quality of NBFCs weakened because of reduction in standard assets and increase in doubtful assets.

Conclusion

The banking system displayed signs of strength and resilience during 2019–20. Asset quality and capital position improved, but stunted credit growth impacted bank profitability. The RBI's report highlights that the real asset-quality problems may be suppressed behind the COVID-19 measures and the situation will become clearer once the moratorium is lifted. Profitability is expected to be low even in the immediate future due to a reduced scope for credit expansion, constant low rates of interest and the imminent stress on assets due to the pandemic. The RBI expects to present a more comprehensive picture of the capital position of banks in its upcoming Financial Stability Report (FSR).

Though there is not much clarity on the outlook for financial reforms in 2021, there is hope that financial institutions would emerge out of the ongoing crisis and return to normalcy.

Regulatory news

Foreign Exchange Management (Export and Import of Currency) (Second Amendment) Regulations, 2020

The RBI has amended the Foreign Exchange Management (Export and Import of Currency) Regulations, 2015, by changing the short title and commencement, and including a new regulation. The short title and commencement explain the amendment's new name and its enforcement. Regulation 10 has been introduced via this amendment which grants the RBI the power to restrict export and import of Indian currency and foreign currency by an individual on a case-to-case basis.

The detailed notification can be accessed here.

Introduction of Legal Entity Identifier for Large Value Transactions in Centralised Payment Systems

The Legal Entity Identifier (LEI) is a 20-digit unique identification number used to identify parties involved in financial transactions worldwide.

The RBI has introduced an LEI for participants in over-the-counter (OTC) derivatives and non-derivatives markets. The identifier is also applicable to large corporate buyers.

The RBI has decided to introduce this identifier system for transactions worth INR 50 crore or more done by non-individuals using the RTGS or NEFT payment systems.

The detailed announcement can be accessed here.

Amendment to Master Direction (MD) on KYC - Centralized KYC Registry - Roll out of Legal Entity Template and other changes

The Centralized KYC Registry (CKYCR) is maintained for individual customers. The RBI has decided to increase its scope by extending the CKYCR to legal entities (LEs). Regulated entities (REs) will have to upload the KYC data of all legal entities opened on or after 1 April 2021 on the CKYCR. The legal entity template will be released by the Central Registry of Securitisation Asset Reconstruction and Security Interest (CERSAI). The regulated entities will have to upload KYC data of legal entities opened before 1 April 2021 during periodic updates as per section 38 of the master direction. They will have to update the KYC data as per customer due diligence (CDD) standards during the periodic updates.

The amendment also applies to individual customers. For all individual accounts opened before 1 January 2017, the legal entities shall upload the KYC data of such customers to the CKYCR during the periodic updates or when the updated KYC data is received from the customer, whichever is earlier.

The detailed notification can be accessed here.

Introduction of Liquidity Adjustment Facility (LAF) and Marginal Standing Facility (MSF) for Regional Rural Banks (RRBs)

The RBI has announced that the LAF and MSF will be extended to scheduled RRBs having a core banking system in place. These banks should have a minimum CRAR of 9% and should be fully complaint with the terms and conditions of the LAF and MSF.

The detailed notification can be accessed here.

Other regulatory news

Procedural Guidelines for Proxy Advisors

The Securities and Exchange Board of India (SEBI) has issued guidelines for proxy advisors by amending the clause in its previous circular. The new modified guidelines focus on circulating alerts to clients with a strict timeline. It states that proxy advisors shall alert clients within 24 hours of receipt of information about any factual errors or any awaiting material modification to their reports. In case of material revision, the same shall be communicated to clients within 72 hours of receipt of information.

The detailed notification can be accessed here.

Uniformity in applicability of Net Asset Value (NAV) across various schemes upon realisation of funds

SEBI has issued a circular regarding uniformity in applicability of Net Asset Value (NAV) after realisation of funds across various schemes. SEBI has extended the date of implementation of this circular to 1 February 2021 from 1 January 2021.

The decision was taken considering operational challenges faced by the Association of Mutual Funds in India (AMFI).

The circular also contains information about modification on trade execution and allocation related to the order management system used by asset management companies (AMCs).

The detailed notification, can be accessed here.

Global regulatory news

ECB extends pandemic emergency longer-term refinancing operations (PELTROs)

The Governing Council of the European Central Bank (ECB) has decided to increase pandemic emergency longer-term refinancing operations (PELTROs). The ECB has decided to offer four additional PELTROs on a quarterly basis during 2021, each with a tenor of approximately one year. These operations will ensure the smooth functioning of money markets. These operations will also serve as liquidity support for the Euro area banking system.

The detailed notification can be accessed here.

ECB digital euro consultation ends with record level of public feedback

The European Central Bank recently ended its public consultation on the digital euro after receiving a record response from citizens, firms and industry associations. The consultation was launched on 12 October 2020. This consultation will help shape the future of the digital euro. Privacy, security and pan-European reach were top three preferences in the consultation, covering 41%, 17% and 10% of replies respectively. The consultation will also act as a decisive factor in the launch of the digital euro project. The digital euro will be an electronic form of central bank money accessible to everyone and make payments faster, easier and secure.

The detailed notification, can be accessed here.

BIS, Swiss National Bank and SIX announce successful wholesale CBDC experiment

The Bank for International Settlements' Innovation Hub (BISIH), Swiss Centre, the Swiss National Bank and the financial services operator SIX announced the successful completion of a joint proof-of-concept (PoC) experiment related to the central bank digital currency (CBDC) project Helvetia. The project focused on the integration of token-based digital assets and central bank money. The project also explored the legal and technical aspects for transfer of digital assets via issuing a CBDC onto a distributed digital asset platform and linking this platform to wholesale payment systems. The project demonstrated robustness from both technical and legal aspects in a near-live environment.

The detailed notification can be accessed here.

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