Financial RegTech Newsletter

July 2019

RBI's June report on financial stability of banking in India

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The Reserve Bank of India (RBI) rolled out several regulatory and developmental policy measures in its biannual financial stability report (FSR)[1], June 2019 edition. These policies were designed to strengthen regulations and supervision, broaden and deepen financial markets, manage liquidity and market risk and resolve issues relating to stressed assets. The non-banking financial company (NBFC) sector, reeling under serious financial pressure since the IL&FS fiasco, has witnessed tremendous regulatory changes. In this newsletter, we have summarised key regulatory aspects where there has been progress.

1. https://www.rbi.org.in/Scripts/PublicationReportDetails.aspx?UrlPage=&ID=925

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Global and domestic economy

The International Monetary Fund (IMF) has forecast a slowdown in global economic growth in 2019, downgrading it by 20 basis points to 3.3%, with economic growth projected at 3.6% in 2020. This downgrade can be attributed to geopolitical adversities, trade tensions and the implications of central banks' actions.

The domestic economy witnessed a drop in economic activity, with annual growth for 2018-19 at 6.8% owing to the weakening of private consumption and, indirectly, the gross domestic product (GDP). While the net foreign direct investment (FDI) flows saw a positive trend, export growth reduced to 8.6% and the current account deficit widened to 2.6% of the GDP in 2018-19. This could pose challenges to exports, the government's market-borrowing programmes and interest rates.

Performance of financial institutions

The FSR presents a positive state for the banking sector as the gross non-performing asset (NPA) declined to 9.3% in March 2019, with a forecast of 9% by March 2020. The lower NPA figure indicated lower provisions and improved profits for the banking sector. The scheduled commercial banks (SCBs) recorded credit growth and capital adequacy at 13.2% and 12.2% respectively in March 2019. With recapitalisation of PSBs and legacy NPAs booked, the banking sector can witness growth in the coming period.

Recent developments have brought the NBFCs sector under stricter supervision and has reduced market access for funding. The share of bank borrowing of NBFCs grew from 23.6% in March 2018 to 29.2% of total liabilities in March 2019. This, along with reduced dependence on debentures and commercial papers, forecasted indicates the growing role of banks as a funding source for NBFCs. The loan growth of the sector declined to 18.6% in 2018-19. This can be attributed to tougher funding conditions for smaller NBFCs due to asset quality and ALM issues. As per the report, the top 10 NBFCs account for 50% of total bank exposure, while top 30 account for more than 80% of total exposure.

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The FSR elaborates on the RBI's assessment of the stability of India's financial system, and its soundness and preparedness to address various systemic and macro financial risks emanating from domestic and global economic factors. The FSR also presents different regulatory changes and developments initiated by the central bank in the financial sector.[2] The following regulatory developments are undertaken by the market regulators.

Relief for the Micro, Small and Medium Enterprises (MSME) sector

The MSME sector is a significant component of the Indian economy. However, the challenges faced by this troubled sector have only increased on account of demonetisation and the launch of the Goods and Services Tax (GST). With a view to facilitate restructuring of stressed MSME accounts, the RBI has passed a declaration permitting one-time restructuring of existing defaulted loans to MSMEs, provided the total exposure of the banks and NBFCs to the borrower is not more than INR 250 million and the accounts are still classified as 'Standard' as on Jan 1-19. An additional provision of 5% will have to be incurred for the restructured accounts.

New ECB framework

Under the new ECB framework introduced by the RBI, eligible borrowers will be able to raise ECBs up to USD 750 million or its equivalent (as against the earlier value of USD 50 million) via the automatic route, per financial year. To simplify the policy by eliminating inter-track arbitrage scope, the RBI has merged (i) The two existing tracks I and II (medium and long-term foreign currency denominated ECB respectively) into one 'Foreign Currency Denominated ECB' track and (ii) ECBs falling under the existing track III (The Indian rupee-denominated ECB) and Rupee-denominated bonds aka masala bonds into 'Rupee Denominated ECB'. Further, the eligible borrower and recognised lender base has also been widened.

Besides, the Reserve Bank has revised the ECB norms to ease the restrictions on end-use for resolution applicants under the Corporate Insolvency Resolution Process (CIRP). They can now raise ECBs from recognized lenders with certain exceptions.

2. https://www.pwc.in/consulting/financial-services/fintech/point-of-view/financial-regulatory-technology-insights-newsletters-vinyamak/december-2018.html

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Stronger Supervision for Shadow Banks

Budget 2019 depicts a clear picture of the Government's intention to give the apex bank additional powers and make it the primary regulator in the NBFC sector. This is in wake of the recent defaults in the shadow banking sector like DHFL and IL&FS. As highlighted by the Finance Minister Nirmala Sitharaman, the government is considering the proposal to amend the Reserve Bank of India Act, 1934 (RBI Act) to provide RBI with more vested power for supervision of NBFCs.[3]

The proposal states that the RBI can either remove/replace any director or take over from the Board of Directors of the NBFC (for a maximum period of 5 years). The RBI can also remove or debar an auditor from auditing if it finds the auditor guilty of not meeting the required norms.

The proposal further empowers the Reserve Bank to merge multiple NBFCs, or reconstruct or split an NBFC if the RBI considers it as beneficial for operational efficiency or any other reason.

Earlier in February 2019, the RBI had announced the merger of the following three major types of NBFCs into a single type called NBFC Investment and Credit Company (NBFC-ICC)[4] –

- Asset finance companies (AFCs)
- Loan Companies (LCs)
- Investment Companies (ICs)

This move will not only help the RBI monitor better but also help NBFCs to have an increased flexibility in their operations.

In the Union Budget of 2019-20, it was also proposed to transfer the authority from the National Housing Bank (NHB) to the RBI for the regulation of Housing Finance Companies (HFCs).

3. https://www.indiabudget.gov.in/finance_bill.php
4. https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=11483&Mode=0

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Voluntary retention route to encourage overseas investment

To attract foreign investment, the RBI, in consultation with the Securities Exchange Board of India (SEBI), launched the Voluntary Retention Route (VRR)[5] in debt on 1-Mar-19, 2019. Under this scheme, "Foreign Portfolio Investors (FPIs) will have an option to invest in a Committed Portfolio Size (CPS) for a committed retention period. Minimum retention period will be of 3 years or as decided by the Reserve Bank" as stated by the RBI. Such FPI participants will have special facilities such as permission to participate in repo/ reverse repo transactions for liquidity management and the use of currency/interest rate derivatives for hedging currency/interest rate risks. The current macro-prudential and regulatory norms for FPI in debt markets will not be applicable for investments made through VRR, provided certain conditions are fulfilled. Participants will also benefit from the removal of the earlier requirement of investing 25% of the CPS within one month.

5. https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=11561&Mode=0\

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Large exposure framework

To deal with the concentration of assets risk arising from a bank's exposure to a single client or a group of related entities, the RBI introduced Large Exposure Framework (LEF) effective from April 01, 2019. It mandates banks to apply LEF at the individual and at the group level. The exposure threshold for a single borrower and a group is 15% and 25% of the capital funds respectively. Both – on and off-balance sheet exposures are considered while applying LEF. The above-mentioned limits are to be strictly adhered to, and any violation of the same is required to be reported to the RBI immediately.

Interoperability among clearing corporations

SEBI has laid guidelines to operationalise the interoperability framework among clearing corporations. This framework will help in the linking of different clearing corporations, thus allowing the market participants to use any clearing corporation for settling the trade executed on any exchange. This consolidation is envisaged to lead to cost efficiency and better execution of trades.[6]

6 https://www.pwc.in/assets/pdfs/publications/2019/interoperability-among-clearing-corporations.pdf

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The last quarter of 2018-19 has seen a period of weak economic performance on the domestic front, majorly due to a decrease in consumption and private investment. Domestic financial market also experienced a great impact owing to the recent disturbance in the non-banking financial sector, which has become an integral and significant component of the financial system. The regulatory changes and development highlighted in the FSR are directed towards stabilising the system, restoring private investment and refining the supervisory mechanism framework, especially for the non-banking financial system. An improvement in the asset quality of banks and the recent developments in the non-banking financial sector is an indication that the economy is on the possible path of recovery with better market discipline.

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Master direction- Lead bank scheme

The RBI has issued consolidated guidelines on lead bank scheme detailing the general framework to implement the Lead Bank Scheme.

It provides guidance on implementation of direct benefit transfer, dispense loans by obtaining a "no due certificate" from individuals in rural and semi urban areas for all loans under government sponsored schemes. It also details strategy through which farmer's income can be doubled by 2022. Through the master direction the banks are advised to achieve a Credit Deposit ratio of 60% in respect to their rural and semi-urban branches separately on an all India basis.

The detailed notification can be accessed here.

RBI guidelines on LCR, FALLCR against credit disbursed to NBFCs and HFCs.

The RBI has issued guidelines to front load FALLCR by 0.5% of Net Demand and Time Liabilities (NDTL) in two phases, the first on 1st August and second on 1st December 2019. The Banks can acknowledge an increase in FALLCR of 1 percent of the banks NDTL as level 1 HQLA for computing LCR, to the extent of outstanding credit to NBFCs and HFCs over and above the amount of credit outstanding to NBFC/HFC on their books as on date.

The detailed notification can be accessed here.

External Commercial Borrowing policy- rationalisation of end-use provision

The RBI has brought to the attention of authorised dealer category banks (AD category-1) that ECB proceeds cannot be used for working capital purpose, general corporate purpose and repayment of rupee loans unless the ECB is availed from foreign equity holder for a minimum of 5 years of maturity. In order to liberalise the External Commercial Borrowings Framework, the end use restrictions has been relaxed.

The detailed notification can be accessed here.

Master circular- SHG bank linkage programme

The RBI has issued a master guideline to banks on Self-help group- bank linkage programme. All scheduled commercial banks has been asked to follow public banks and meet its entire credit requirements of SHG members as envisaged in the union budget of 2008-09. Banks have also been asked to provide incentives to their branches to finance their self-help groups and establish linkages with them. Moreover, either registered or unregistered SHG's involved in promoting saving habits among their members are allowed to open savings bank accounts with the banks.

The detailed master circular can be accessed here.

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Levy of penal interest for delayed/wrong/ non-reporting of currency chest transaction

The RBI has come out with master directive on levy of penal interest for delayed reporting, wrong reporting and non-reporting of currency chest transactions. A penal interest of 2% will be charged over the bank rate for the period due to delayed/wrong /non-reporting and inclusion of ineligible amount for currency chest transaction.

The detailed notification can be accessed here.

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Divergence in asset classification and provisioning by banks

In the circular SEBI has asked banks which have listed specified securities to disclose to the stock exchanges, about any divergences in the asset classification and provisioning. The disclosure should be made if either or both of the following conditions are satisfied:

1. The additional provisioning of NPA's assessed by RBI exceeds 10 per cent of reported profit before provisions and contingencies for the reference period, and
2. Additional gross NPA identified by RBI exceed 15 per cent of the published gross NPA for the reference period

The detailed notification can be accessed here.

Guidelines for liquidity enhancement scheme in Commodity Derivatives Contract

SEBI has issued guidelines for the Liquidity enhancement scheme (LES) in commodity derivative contracts. It states that incentives during the financial year for discount in fees or adjustment in fees will not exceed 25 % of the net profit or 25 % of the free reserve of the stock exchange, whichever is higher.

The detailed notification can be accessed here.

Streamlining process of public issue of equity shares and convertibles.

SEBI has come up with a guideline which highlights the use of united payments interface (UPI) as a payment mechanism with Application Supported by Blocked Amount (ASBA) for applications in public issues made by retail individual investors through intermediaries. The implementation of the same is to be carried out in a phased manner to ensure gradual transition to UPI with ASBA.

The detailed notification can be accessed here.

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NCAs use of sanctions under MIFID II – ESMA

National Competent Authorities (NCAs) are required to provide European Securities and Market Authority (ESMA) with consolidated information on all sanctions and measures imposed annually. Since the data on sanctions and measures imposed under MiFID II in 2018 did not provide clear trends on the imposition of sanctions and measures, or to produce a detailed statistics based on it.

The detailed notification can be accessed here.

ESMA Consults on MIFID II Compliance function requirements

As per the notification, ESMA guidelines on MIFID II compliance function enunciates about helping firms to increase the effectiveness of the compliance function, enhance clarity and to foster convergence on the expanded role of compliance function under MIFID II.

The detailed notification can be accessed here.

ESMA provides XML schema and Validation rules for securitisation reporting

ESMA has come out with a set of reporting instructions and XML schema templates in ESMA's draft technical standards on disclosure requirements. Reporting of data for all securitisations will be done using XML. ESMA considers that this directive will help create a level playing field and improve upon data quality across different data collection mechanism.

The detailed notification can be accessed here.

EBA publishes its IFRS 9 roadmap and launches its benchmarking exercise.

The EBA came out with its IFRS 9 roadmap bringing forth a comprehensive overview of monitoring activities on IFRS 9 implementation. As per the roadmap EBA maintains its view to monitor and promote a consistent application of IFRS 9. The IFRS 9 benchmarking exercise is a vital step in the on-going quantitative monitoring activities. The focus of this exercise is to ascertain the use of different modelling techniques and inputs which can lead to significant inconsistencies in terms of expected credit loss which clearly impacts own funds and regulatory ratios.

The detailed notification can be accessed here.

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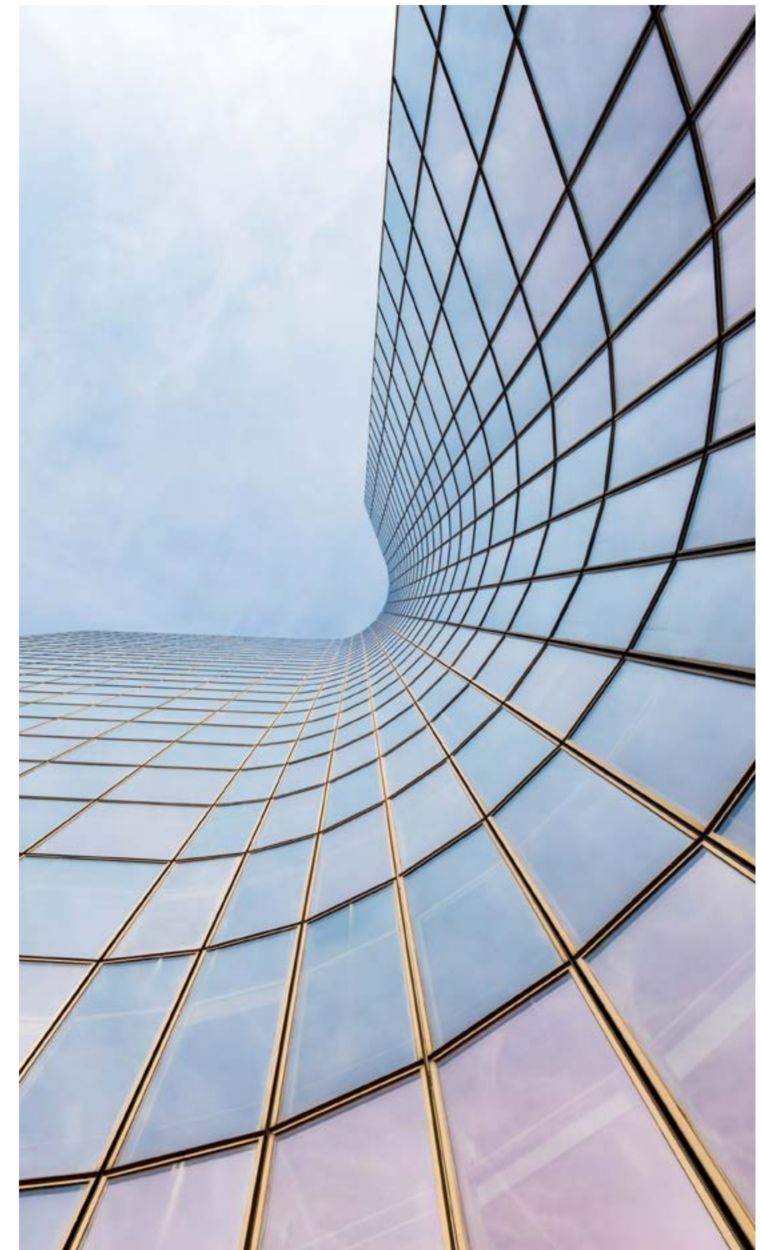
EBA publishes Report on regulatory perimeter and authorisation approaches in relation to Fintech activities

The EBA published its findings on the required regulatory framework for Fintech firms accessing the market.

The regulatory status and authorisation approach around FinTech firms showcases two notable developments:

- Shift from non-regulated to regulated activities. For example, payment services and account information services are now being subject to Payment Services Directive (PSD2)
- Ancillary/non-ancillary financial nature of the services provided by FinTech firms are not subject to any regulatory regime.

The detailed notification can be accessed here.



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