The monthly Financial Regulatory Technology update

May 2019

RBI's draft guidelines on the liquidity risk management framework for shadow banks

Understanding the framework

Decoding the changes

The way forward

Regulatory news

Other regulatory news

Global regulatory news

Contacts

The IL&FS crisis brought Indian financial markets to the brink of economic slowdown. The crisis impacted the Non-Banking Financial Companies (NBFCs) sector with rating downgrades, increasing debt defaults and serious mismatches in the books by short term borrowings. There was an urgent need to have a stronger asset liability management (ALM) framework to help tackle liquidity problems in the sector.

The Reserve Bank of India (RBI) in its much awaited "Liquidity Risk Management Framework for Non-Banking Financial Companies and Core Investment Companies – Draft guidelines for public comments"[1] has proposed liquidity risk management framework guidelines and introduced Liquidity Coverage Ratio (LCR) for the NBFC sector.

The draft framework is applicable to all non-deposit taking NBFCs with an asset size of over ₹100 crore and all core investment companies (CICs) registered with the RBI, while the LCR requirement is only for those having an asset size of ₹5,000 crore and above.

1. https://www.rbi.org.in/Scripts/BS_PressReleaseDisplay.aspx?prid=47125

RBI's draft guidelines on the liquidity risk management framework for shadow banks

Understanding the framework

Decoding the changes

The way forward

Regulatory news

Other regulatory news

Global regulatory news

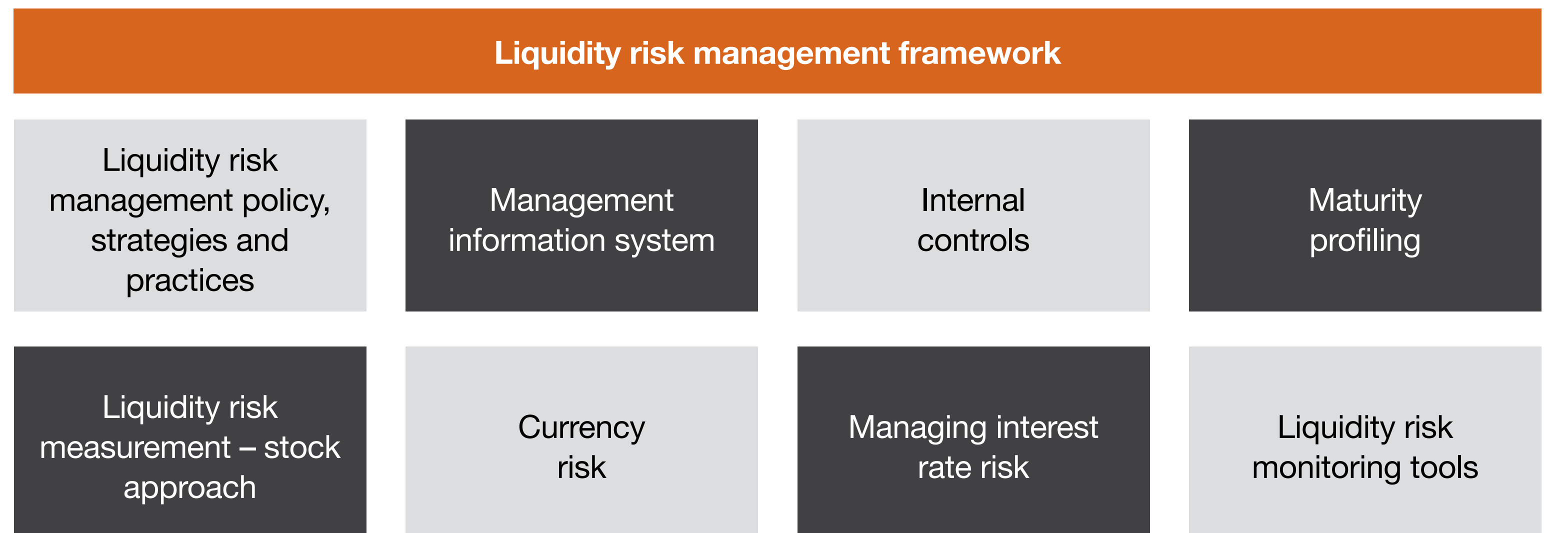
Contacts

Understanding the framework

RBI has proposed eight guidelines (Figure 1) for NBFCs to provide a regulatory architecture consistent with a stronger asset liability management (ALM) framework and also to promote resilience to potential liquidity disruptions.

The existing ALM framework[2] focuses on three pillars namely ALM organisation which includes structure and responsibilities, ALM information systems that deal with MIS, availability and accuracy of information, and ALM process that focuses on risk measurement and management.

Figure - 1



The new proposal includes having a comprehensive governance structure, an Asset Liability Management (ALM) Support Group, internal controls, collateral position management, diversified funding strategies, enhanced maturity profiling and public disclosure.

2. https://rbidocs.rbi.org.in/rdocs/notification/PDFs/MD44NSIND2E910DD1FBBB471D8CB2E6F4F424F8FF.PDF

RBI's draft guidelines on the liquidity risk management framework for shadow banks

Understanding the framework

Decoding the changes

The way forward

Regulatory news

Other regulatory news

Global regulatory news

Contacts

Decoding the changes

While a few of the existing guidelines on the risk framework have been recast, certain new guidelines have also been introduced. Some of the major changes are decoded below.

Granular maturity buckets and tolerance limits

RBI has introduced bifurcation of existing guideline of 1-30 days' time bracket into granular maturity buckets of 1-7 days, 8-14 days, and 15-30 days, with cumulative cash outflows not exceeding 10%, 10% and 20%, respectively. NBFCs will need to monitor their cumulative mismatches across all other time buckets up to 1 year by establishing internal prudential limits. This will ensure that NBFCs' reliance on external debt to repay its maturing debt is reduced.

Liquidity risk monitoring tools

Along with the prescribed monitoring tool, Statement of Structural Liquidity in the existing framework, RBI proposes to adopt additional monitoring tools to capture any possible liquidity stress. These include concentration of funding by counterparty/ instrument, availability of unencumbered assets, and early warning market-based indicators. This will encourage diversification of funding sources, use of unencumbered assets as collateral to raise secured funding, and monitoring of potential liquidity difficulties.

Adoption of stock approach to liquidity

RBI recommends NBFCs to adopt stock approach as opposed to cash flow approach to ensure liquidity adequacy. This involves monitoring certain ratios such as short-term liability to total assets; short-term liability to long term assets; and putting in place internally approved limits.

Public disclosure

An NBFC should publicly disclose information quarterly to help market participants make informed decisions on liquidity positions. This includes publishing information on funding concentration based on significant counterparty/instruments, Top 20 large deposits, Top 10 borrowings and stock ratios with respect to commercials, non-convertible debentures (NCDs) and other short-term liabilities.

RBI's draft guidelines on the liquidity risk management framework for shadow banks

Understanding the framework

Decoding the changes

The way forward

Regulatory news

Other regulatory news

Global regulatory news

Contacts

Decoding the changes

Introduction of Liquidity Coverage Ratio

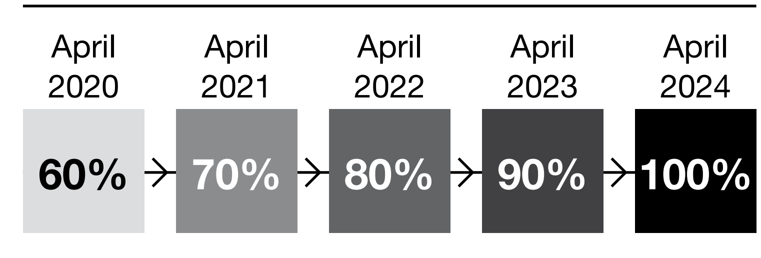
The Reserve Bank of India introduced Liquidity Coverage Ratio (LCR) for NBFCs along similar lines of the banking framework[3]. Indian banks are currently required to maintain a liquidity coverage ratio of 100%, with RBI aiming the same for NBFCs by April 2024.

In the current regulatory framework, NBFCs are supposed to maintain a Capital to Risk Assets Ratio (CRAR) of 15%. Deposit-taking NBFCs are required to hold 15% of deposits in liquid assets.

The newly introduced LCR will promote resilience of NBFCs by ensuring the NBFCs maintain adequate liquidity in case of an acute liquidity stress scenario lasting for 30 days. In short, LCR is the proportion of High Quality Liquid Assets (HQLA) set aside to meet short-term obligations.

NBFCs shall maintain a minimum LCR of 60% by 1 April, 2020, which will be gradually increased to 100% by 1 April, 2024.

The new guidelines also propose LCR disclosure standards for NBFC to annually disclose information related to HQLA, cash outflow and cash inflow.



Other key changes

Apart from the above-mentioned changes, some of the other guidelines include:

- Formation of Asset Liability Management Support Group responsible for analysing, monitoring and reporting the liquidity risk profile.
- A contingency funding plan to be formulated to respond to severe disruptions in the funding abilities.
- Stress testing on a regular basis for a variety of short-term, entity specific and market specific situations. This is to be included as part of governance.
- Management of interest rate and currency risk.

3. https://rbidocs.rbi.org.in/rdocs/content/pdfs/CA09062014_A.pdf

RBI's draft guidelines on the liquidity risk management framework for shadow banks

Understanding the framework

Decoding the changes

The way forward

Regulatory news

Other regulatory news

Global regulatory news

Contacts

The way forward

In the context of draft guidelines, most NBFCs would need to expand their liquidity management function to include the new LCR requirements. Along with having a strong governance structure in place, the NBFCs will also be required to take complex decisions on diversified funding strategies, collateral management, management of HQLA and control of exposure & liabilities. Amidst increased cost of borrowing, NBFCs will aim to improve returns and maintain profitability.

With the new guidelines and a significant amount of financial data to exploit, data analytics can help NBFCs perform market analysis for effective asset allocation and portfolio mix. It can also help forecast LCR and other ratios for long-term visibility. Data analytics along with automation could help streamline both internal and external LCR reporting. The insights generated would assist the management in its decision-making process to improve profitability and maintain a robust financial position.

RBI's draft guidelines on the liquidity risk management framework for shadow banks

Understanding the framework
Decoding the changes
The way forward
Regulatory news
Other regulatory news
Global regulatory news
Contacts

Regulatory news

Priority Sector Lending- Targets and classification

The RBI has decided to enhance the housing loan limits for eligibility under priority sector lending to bring regional rural banks (RRBs) and small finance banks (SFBs) on a par with other scheduled commercial banks.

According to the notification, housing loans to individuals up to ₹ 35 lakh in metropolitan cities and ₹ 25 lakh in other centres, will be eligible for classification under Priority Sector Lending, with the overall cost of the dwelling unit in the metropolitan cities and at other centres not exceeding ₹ 45 lakh and ₹ 30 lakh, respectively.

Additionally, the existing family income limit eligibility of ₹ 2 lakh per annum, towards loans for construction of houses for Economically Weaker Sections (EWS) and Low Income Groups (LIG), has been revised to ₹ 3 lakh and ₹ 6 lakh per annum respectively.

The detailed notification, can be accessed here.

Risk Management System – Appointment of Chief Risk Officer (CRO) for NBFCs

The RBI has directed NBFCs with asset size of ₹50 billion and above to appoint a CRO with a specified role and responsibilities. The need arises as a consequence of NBFCs increasing involvement with direct credit intermediary.

In this context, the RBI has mandated that the appointed CRO shall be a senior official of the NBFC. The CRO will be involved in the process of identification, measurement and mitigation of risks. His/her appointment shall be for a fixed tenure with the approval of the management board. In terms of credit proposals, the CROs role shall be limited to being an advisor.

The detailed notification can be accessed here.

Understanding the framework
Decoding the changes
The way forward
Regulatory news
Other regulatory news
Global regulatory news
Contacts

Regulatory news

'Voluntary Retention Route' (VRR) for Foreign Portfolio Investors (FPIs) investment in debt

The RBI has published amendments to its earlier direction on VRR. It has introduced a separate category, VRR-Combined which means Voluntary Retention Route for FPI investment for the instruments eligible under two categories i.e. VRR-Govt and VRR-Corp.

Also, the successful allottees are directed to invest 75% of the committed portfolio size (CPS) within 3 months from the date of allotment instead of 25% of CPS investment within one month of allotment. Further, FPIs are allowed to hold their investment till the date of its maturity or sale, whichever is earlier.

The regulations will come into force with immediate effect. The detailed notification can be accessed here.

RTGS - Extension of timings for customer transactions

The RBI has extended timings for customer transactions (initial cut-off) in RTGS from 4:30 pm to 06:00 pm. The time varying charges have also been changed. These changes have come into effect from 01 June, 2019.

The detailed notification can be accessed here.

RBI's draft guidelines on the liquidity risk management framework for shadow banks

Understanding the framework

Decoding the changes

The way forward

Regulatory news

Other regulatory news

Global regulatory news

Contacts

Other regulatory news

Mutual Funds - Reporting for Artificial Intelligence (AI) and Machine Learning (ML) applications

The application of AI/ML in financial markets is growing at an exponential rate. Owing to increased usage of Artificial Intelligence and Machine Learning, the SEBI has directed market intermediaries and participants to participate in the reporting process by submitting the AI/ML reporting form.

The scope of these systems include any application or system which is used internally or is being offered to investors.

All Fin-tech initiatives that involve AI/ML and are being undertaken by market participants are also covered under these guidelines. Annexure B to the Circular provides a comprehensive list of systems or applications which would be considered to be based on AI & ML technologies.

The detailed notification can be accessed here.

Framework for "Innovation Sandbox"

The SEBI has proposed a framework on "Innovation Sandbox" for fin-tech companies. This sandbox is intended to be a testing environment in which fin-tech firms and entities not regulated by SEBI, including individuals, may use it to test technology-oriented products and services. This will provide users with access to market related data to test their innovations effectively before going live.

The circular details the features and structure of the "Innovation Sandbox" along with eligibility criteria for inclusion, implementation and the outcome of its use.

The detailed notification can be accessed here.

RBI's draft guidelines on the liquidity risk management framework for shadow banks

Understanding the framework
Decoding the changes
The way forward
Regulatory news
Other regulatory news
Global regulatory news
Contacts

Other regulatory news

Framework for the process of accreditation of investors for the purpose of the Innovators Growth Platform (IGP)

According to the notification, accredited investors (AI) for the limited purpose of IGP are investors whose holding in the issuer company is eligible for the computation of at least 25% of the pre-issue capital in accordance with the SEBI regulations.

The key topics discussed in the circular include eligibility for AI, procedure for accreditation, validity of accreditation and responsibility of merchant bankers at the time of listing of IGP with regard to AIs.

The SEBI has directed the exchanges or depositories to implement the accreditation procedure within 45 days from the date of this circular.

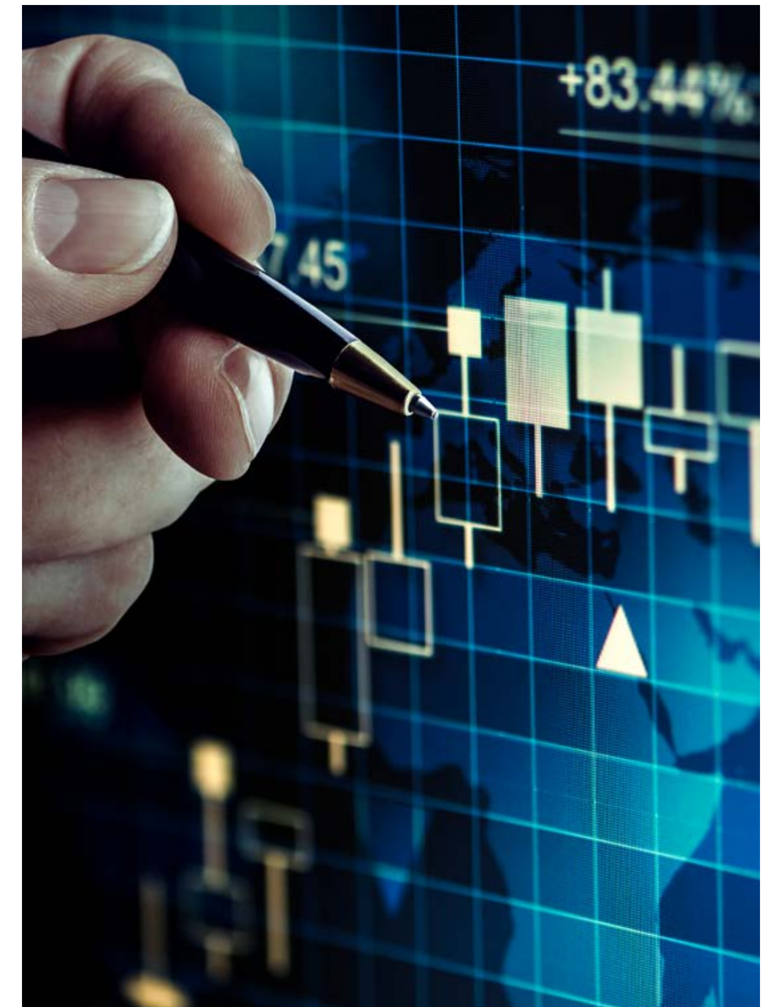
The detailed notification can be accessed here.

Enhanced disclosures for listed debt securities

With a view to protect the interest of investors, SEBI has issued guidelines to issuers of debt securities, registered debenture trustees and recognised stock exchanges to provide information around compensation arrangement with clients, updated list of debenture holders to the debenture trustees by issuers, additional covenants in case of a privately placed issue.

This is being done to enhance transparency and ensure debenture trustees perform their duties efficiently.

The detailed notification can be accessed here.



RBI's draft guidelines on the liquidity risk management framework for shadow banks

Understanding the framework

Decoding the changes

The way forward

Regulatory news

Other regulatory news

Global regulatory news

Contacts

Global regulatory news

MiFID II: The European Securities and Markets Authority (ESMA) publishes data for Systematic Internaliser calculations for equity, equity-like instruments and bonds

The ESMA has published an update on the total number of trades and total volume for Systematic Internaliser (SI) calculations for equity, equity-like instruments and bonds.

The data also includes the OTC trading data and for instruments not available for trading, EU trading venues from end of March.

The deadline for SI calculations and compliance with SI obligations by the investment firm was set to 24 May 2019.

The detailed notification can be accessed here.

Sixteenth progress report on adoption of the Basel regulatory framework

The BCBS has published a progress report that provides Basel Committee's members' progress in adopting Basel III standards.

The report focuses on the status of adoption of the Basel III risk-based capital standards, standards for global and domestic Systemically Important Banks (SIBs), the leverage ratio, the Net Stable Funding Ratio (NSFR), Interest Rate Risk in the Banking Book (IRRBB), the large exposures framework and the disclosure requirements.

The detailed report can be accessed here.

Understanding the framework

Decoding the changes

The way forward

Regulatory news

Other regulatory news

Global regulatory news

Contacts

Global regulatory news

European Central Bank (ECB) amends monetary policy implementation guidelines

The ECB has published updates to its prevailing directions on the implementation of monetary policy in the Euro system.

One of the amendments is to further harmonise the definition of agencies as issuers or guarantors of debt instruments. The Eurosystem also takes into account the transparency requirements of the EU securitisation regulation into its collateral framework. Additionally, the Eurosystem diminishes the use of rating tools from its general framework for monetary policy operations as a consequence of cost-benefit considerations.

Moreover, the ECB also provides clarification on the credit claims in its collateral framework. The ECB is also amending the criteria for own-use of covered bonds. From 1 February 2020, covered bonds must have an External Credit Assessment Institution (ECAI) rating to be eligible for own-use.

The detailed notification can be accessed here.

EBA publishes technical standards on supervisory and resolution reporting for EU institutions.

To ensure reporting requirements are in line with changes in the regulatory framework and with the evolving needs for supervisory authorities risk assessments, EBA published amendments to the Implementing Technical Standards (ITS) on supervisory reporting.

It contains an updated Data Point Model (DPM) and XBRL taxonomy including amendments to liquidity as well as to resolution planning reporting.

The detailed notification can be accessed here.

RBI's draft guidelines on the liquidity risk management framework for shadow banks

Understanding the framework

Decoding the changes

The way forward

Regulatory news

Other regulatory news

Global regulatory news

Contacts

Contacts

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