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The monthly Financial Regulatory Technology news dose

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February 2018

pwc

FinTech Regulations

Key Challenges posed by FinTech to the Regulators

Across the globe, FinTech has democratized the financial services landscape. But, the rapid pace of digitization coupled with the decentralized nature of Fintech has posed unique challenges to the regulators, who have been used to supervising central hubs of activities and well-defined entities.

Protecting consumers by ensuring data security and privacy

Regulators are striving to strike a delicate balance between ensuring data security and privacy on the one hand, and facilitating the free flow of data on the other.

Data Privacy	Data Security	Open Data
• Rise of misuse of consumer data • Consent based access to consumer data	• Cybercriminals perpetrating financial crimes • Cybersecurity is the key to safeguarding consumer trust	• Data is crucial for insight generation • Restrictive policies could hamper free flow of data

Keeping pace with the technological innovation

Policymakers would need to swiftly respond to the emerging technologies and the FintTech models, by fully understanding its implications on the financial system and reining in its potential risks.

Potential risks of emerging technologies

Payments technology	Digital wallets, eMoney etc. could lead to single point of failure risks if industry concentration is high.
Alternative lending	Alternate lenders could lead to asset quality risks if poor underwriting standards are followed. Online lending scams should be clamped down on.
Distributed ledger technology	DLTs – Operational risk as they would be critical infrastructural providers. Cryptocurrencies could pose money laundering risks.
Artificial Intelligence	Algorithmic trading could amplify the market volatility and cause systemic risks.

Ensuring soundness and stability of the Financial System

This is the most critical challenge facing the regulators. While FinTech could help forge a more diverse and resilient FS ecosystem, the increased interconnectedness and entry of disruptive operating models could engender new systemic risks such as concentration and single point of failure risks.

Systemic risks

Increased interconnectedness could lead to concentration and single point of failure of risks.

Regulatory arbitrage

Using local regulations to supervise technology firms which operate globally leads to increased potential for regulatory arbitrage.

Risk frameworks

New entrants need to adhere to the same enterprise risk standards of their larger counterparts to prevent operational risks.

Operating model

Although FinTech players adopt asset light models, they need to put in place a robust governance structure to ensure sound functioning.

Global trends for FinTech regulation and supervision

Regulatory Sandbox/Innovation Hub

International standard setting bodies including regulatory authority of different jurisdiction are setting up task forces on FinTech to have understanding of major innovations, a potential impact of FinTech on the Industry and assess risks for banks and any implication on supervision.

A regulatory sandbox is a hub that enables live or virtual testing of new products and services, in a controlled testing environment. Regulator provides the appropriate support by relaxing specific legal and regulatory requirements, for the duration of the sandbox. There is a defined entry criteria to these sandboxes as well as an exit strategy in case the participant fails.

Currently, there are more than 20 regulatory sandboxes across the globe, at different stages of development.

Regulatory and Supervisory response in India

RBI as the regulator and supervisor of the banking industry has in the recent times taken important leaps via FinTech to encourage innovation in the industry such as strengthening of payment eco-systems. Following are the initiatives taken by the RBI and other industry regulators in their lines of services, to support this journey of growth on the engine of innovation.

SEBI

- Screen Based Trading, nationwide trading systems and dematerialisation of shares
- Adoption of algorithmic and machine based trading
- Robot Advisors in the Investment advisory space

RBI

- Categorised P2P lending platform as NBFC-P2P without the adherence of stringent norms of a typical NBFC.
- Issuance of in-principle approvals for payments bank
- Allowed non-banks into payments business
- Issuance of direction on Account Aggregators
- Authorised payment solutions provided by NPCI such as NACH, AEPS, IMPS, UPI
- Issuance of in-principle approval for National electronic toll collection project
- Set up the framework for the electronic Trade Receivables Discounting System (TReDS)SEBI

IRDA

- Digital Channels, Process Automation and Establishment of innovation labs
- Development of Advanced statistical models
- Mitigation of pricing risk by automating the underwriting collected data

Way ahead - RBI Working Group POV

The recommendation by the working group tries to answer questions around regulatory uncertainty, provide level playing field to the market participants, remove entry barriers and avoid systemic risk.

Regulation

Regulators need to ensure that the enough encouragement is given to the new players/ start-ups as they bring positive competition in the market along with the financial innovation that benefits the end consumer. Also at the same time, it is to be ensured that no undue favor is given to the new entrants mere in the name of fostering the competition.

> The Watal Committee Report recommends that the regulator should enable a formal framework for a regulatory sandbox that can be used to carve out a safe and conducive space to experiment with FinTech solutions.

IDRBT - an institute established by the RBI, should continuously interacts with RBI, banks, solution providers for testing of new products and services to fasten the journey of growth by implementation of the innovative financial solutions.

Regulators must act in the interests of the end consumer and the overall systemic concerns should be addressed. Certain activities should be on an on-going basis by the regulators:

- Publishing research papers on FinTech developments
- Proactive engagement with existing firms and new entrant FinTech firms
- Modifications to supervisory processes basis the industry environment
- New guidance or regulations to cater the changing landscape

> Legal framework should be created to encourage the level-playing field where a non-banking firm can compete with a bank for a non-bank payment service. This would induce the competition and the overall growth of the payments industry.

Realignment of regulatory approach

Regulators need to review their approach basis the balance of equation it should strive between the growth of innovation, competition and the benefits of the end consumer considering the quantum of structural changes FinTech brings on.

Reg Tech

Reg Tech is a sub-set of FinTech that focuses on technologies that facilitate the delivery of regulatory requirements more efficiently and effectively than existing capabilities. The emerging focus of Reg Tech for regulators may include regulatory reporting, risk and compliance monitoring, protecting customer interest and detecting financial crime. Some of the key benefits and features are given below:

Alternative Reporting Methods	Shared Utilities
Semantic tech and data point models	Shared data ontology
Robo-Handbook	Big data analytics
Risk and compliance monitoring	Inbuilt compliance
System monitoring and visualisation	

Looking Ahead - PwC Point of View on FinTech Regulations

FinTech has brought a new way of thinking into Financial Services. Those driving FinTech often come from engineering and/or entrepreneurial backgrounds –meaning they're not bankers, and represent organisations with whom financial regulators and lawmakers may rarely have engaged with in the past. This is both an opportunity but may also present some new challenges. It has also become clear that there is an urgent need for a deeper examination of how India can evolve its regulatory and legislative frameworks to support the emergence of a successful, productive and innovative FinTech industry in this country –while also enabling our financial services business to apply the resulting solutions to best effect.

Increase the speed of reform in the legal system

Smart Contracts based on private decentralised encrypted Distributed Ledger Technology (DLT) raises the question of ownership–who is ultimately held responsible should something go wrong and participants or consumers seek redress, or a case ends up in court? There is no quick-fix solution to this open-ended question of ownership, but it is clear that the legal system will need to adapt to the emergence of digital innovations in a quicker, more agile manner.

> Financial institutions taking part in a private encrypted DLT would need to be trusted and would be expected to sign up to a number of legally-binding rules. The wording of these legal contracts should help avoid much of the confusion over liability should a transaction result in dispute.

Issue guidance around block chain regulation

Provide an indication of the planned policy direction around the use of blockchain technology (BCT). This will give blockchain startups the confidence they need to innovate and grow without the fear of being penalized. Guidance around security mechanism to access block chain, a consistent technology standard for BCT and information sharing set up for BCT would go a long way to encourage growth in this sector.

> For an effective regulation around block chain, any system of regulation should reflect a risk-based approach and be proportionate to the risks posed; any alternative bears the risk that action would suppress innovation and growth in this sector.

A system of self-regulation by market participants. Industry participants could develop a code of best practice and apply its standards as part of a formal accreditation scheme. This would allow the market to signal clearly to users which businesses offer greater security without imposing expensive compliance costs on start-ups wishing to enter the market.

Specific amendment to the Consumer Protection Act to include provisions relating to blockchain technology. For example if it has a direct role in facilitating transactions in regulated financial instruments.

Encourage competition and provide a nurturing environment to innovate

Introduce a new regulated activity of 'sandboxing' for testing. It could allow for a streamlined authorization process and less regulatory requirements when testing. Also encourage FS firms (through RBI) to participate in readiness testing as part of the sandbox.

> Open up the Sandbox to allow different types of entrants in related FS markets, e.g. 'unauthorized innovators' such as insurance underwriters and investment managers, to take advantage of the lenient regulatory environment.

Benefits of sandbox to the regulators

- **Increased market efficiency**
- **Better risk management**
- **Staying on top of technological innovation**
- **New opportunities to consumers**

Benefits of sandbox to FinTech players

- **Management of the regulatory risk during testing period itself** — 01
- **Reduced time to market** — 02
- **More partnerships with legacy companies and access to their APIs** — 03
- **Regulatory clarity, which is critical to secure funding** — 04

As is the case with most innovations, the biggest winner, however, will continue to be the end-user

KYC utility to simplify the customer on-boarding

Any businesses feel that the most burdensome and difficult part of a transaction is the identity verification process. We believe that more immediate and pragmatic solutions could lie in new technologies (such as the mutually distributed ledger technology) that have entered the market and have the ability to simplify the customer on-boarding process. The potential of these solutions to shoulder the burden of AML/KYC requirements for businesses should be encouraged.

> A government-sponsored utility to provide a KYC on-boarding solution, would help reduce the cost and increase the efficiency of identity verification.

Regulatory News

Relief for MSME Borrowers registered under Goods and Services Tax (GST)

Presently banks and NBFCs classify a loan account as Non-Performing Asset (NPA) based on 90 days and 120 days delinquency norms respectively. Due to the introduction of the GST regime and subsequent changes in the business operations as well as formalization of business through registration under GST has adversely affected the cash flow of the smaller entities during the transition phase. As a result, these smaller entities have faced difficulties in meeting their repayment obligations to banks and NBFCs. To support these small entities in their transition to a formalized business environment, RBI has decided that the exposure of banks and NBFCs to MSMEs shall continue to be classified as standard asset if –

i. The borrower is registered under the GST regime as on January 31, 2018.

ii. The aggregate exposure, including non-fund based facilities, of banks and NBFCs, to the borrower does not exceed ₹ 250 million as on January 31, 2018.

iii. The borrower's account was standard as on August 31, 2017.

iv. The amount from the borrower overdue as on September 1, 2017 and payments from the borrower due between September 1, 2017 and January 31, 2018 are paid not later than 180 days from their respective original due dates.

v. A provision of 5% shall be made by the banks/NBFCs against the exposures not classified as NPA in terms of this circular. The provision in respect of the account may be reversed as and when no amount is overdue beyond the 90/120 day norm, as the case may be.

vi. The additional time is being provided for the purpose of asset classification only and not for income recognition, i.e., if the interest from the borrower is overdue for more than 90/120 days, the same shall not be recognized on accrual basis

Here is the link to the official notification.

Resolution of Stresses Assets – Revised Framework

The Reserve Bank of India has issued various instructions aimed at resolution of stressed assets in the economy, including introduction of certain specific schemes at different points of time. In view of the enactment of the Insolvency and Bankruptcy Code, 2016 (IBC), RBI has decided to substitute the existing guidelines with a harmonised and simplified generic framework for resolution of stressed assets.

The main pillars of the revised framework are –

a. Early identification and reporting of stress - Lenders shall identify incipient stress in loan accounts, immediately on default, by classifying stressed assets as special mention accounts (SMA)

b. Implementation of Resolution Plan - All lenders must put in place Board-approved policies for resolution of stressed assets under this framework, including the timelines for resolution. As soon as there is a default in the borrower entity's account with any lender, all lenders – singly or jointly – shall initiate steps to cure the default

c. Implementation condition for Resolution Plan (RP) - A RP in respect of borrower entities to whom the lenders continue to have credit exposure, shall be deemed to be 'implemented' only if the following conditions are met:

i. the borrower entity is no longer in default with any of the lenders;

ii. If the resolution involves restructuring; then

I. All related documentation, including execution of necessary agreements between lenders and borrower / creation of security charge / perfection of securities are completed by all lenders; and

II. The new capital structure and/or changes in the terms of conditions of the existing loans get duly reflected in the books of all the lenders and the borrower.

d. Prudential Norms

Read more about the revised framework

RBI introduces Ombudsman Scheme for Non-Banking Financial Companies

The Reserve Bank of India (RBI) has launched the Ombudsman Scheme for Non-Banking Financial Companies (NBFC) for redressal of complaints against NBFCs registered with RBI under Section 45-IA of the RBI Act, 1934. The Scheme will provide a cost-free and expeditious complaint redressal mechanism relating to deficiency in the services by NBFCs covered under the Scheme. The offices of the NBFC Ombudsmen will function at four metro centers viz. Chennai, Kolkata, Mumbai and New Delhi and will handle complaints of customers in the respective zones. Read more

RBI forms a committee to look into divergences in asset classification and provisioning

RBI has reiterated its confidential instructions and mandated the banks to implement, within the stipulated deadlines, the prescribed measures for strengthening the SWIFT operating environment in banks.

RBI has decided to constitutes an Expert Committee, to look into the reasons for high divergence observed in asset classification and provisioning by banks vis-à-vis the RBI's supervisory assessment, and the steps needed to prevent it; factors leading to an increasing incidence of frauds in banks and the measures (including IT interventions) needed to curb and prevent it; and the role and effectiveness of various types of audits conducted in banks in mitigating the incidence of such divergence and frauds. Read More

Other Regulatory News

Revision in the manner of achieving minimum public shareholding

With a view to further facilitate listed entities to comply with minimum public shareholding requirements, the following additional methods are now allowed –

a. Open Market sale – Sales of shares held by the promoters up to 2% of the total paid-up equity share capital of the listed entity in the open market, subject to five times' average monthly trading volume of the shares of the listed entity

b. Qualified Institutions Placement - Allotment of eligible securities through Qualified Institutions Placement in terms of Chapter VIII of the Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009. **Read more**

Acceptance of Bank Guarantees by Clearing Corporations in International Financial Services Centre (IFSC)

SEBI has now amended the Eligible collateral paragraph of its original circular (SEBI/HO/MRD/DSA/CIR/P/2016/125) dated November 28, 2016 to read as under –

2.6.3. Eligible collateral: Clearing corporations in IFSC shall be permitted to accept cash and cash equivalents (which shall include major foreign currencies as may be decided by the clearing corporation from time to time, term deposit receipts and bank guarantees issued by bank branches located in IFSC), Indian securities held with foreign depositories, foreign securities including units of liquid mutual funds and gold, as eligible collateral for trades in all product categories. However, cash and cash equivalents shall form at least 50% of the total liquid assets at all times. Read more

SEBI amends computation of Daily Contract Settlement Value – Interest Rate Futures

SEBI has decided to provide flexibility to the exchanges with regards to the computation methodology of Daily Contract Settlement Value of Interest Rate Futures.

Now, The Daily Contract Settlement Value shall be = Pw *2000

Here Pw is volume weighted average futures price of last half an hour. In the absence of last half an hour trading, theoretical futures price shall be considered for computation of Daily Contract Settlement Value. Read more

Global Regulatory News

The Basel Committee consults on revisions to the Pillar 3 disclosure framework

Summary: The Basel Committee issued Pillar 3 disclosure requirement for consultation on 27th Feb, 2018. The proposed disclosure requirements are related to finalization of the Basel III post crisis regulatory reforms in December 2017 and include requirements for;

i) Credit Risk, Operational Risk, Leverage Ratio and Credit Valuation Adjustment (CVA)

ii) Benchmarking of bank's risk-weighted assets (RWA) calculated by its internal models against the RWA calculated according to the standardized approaches.

iii) Overview of risk management, key prudential metrics and RWA.

These requirements forms a part of third phase with the first phase and second phase being published in January 2015 and

March 2017 respectively, all the three phases together would comprise the single Pillar 3 framework.

All details of the directive can be viewed [here.]()

Sound Practices: implications of FinTech developments for banks and supervisors issued by the Basel Committee

The Basel committee published a paper on Sound Practices on the implications of FinTech developments for banks and bank supervisors. The paper describe five stylized scenarios of the potential impact of FinTech on banks.

i) The better bank: modernisation and digitisation of incumbent players
ii) The new bank: replacement of incumbents by challenger banks
iii) The distributed bank: fragmentation of financial services among specialised FinTech firms and incumbent banks
iv) The relegated bank: incumbent banks become commoditised service providers and customer relationships are owned by new intermediaries
v) The disintermediated bank: banks have become irrelevant as customers interact directly with individual financial service providers

The observations made in the paper suggest the rapid adoption of enabling technologies and emergence of new business models pose various opportunities and risks to incumbent banks.

All details of the directive can be viewed [here.]()

New credit card rules introduced by the FCA

The Financial Conduct Authority (FCA) published new rules for the credit card market. The FCA estimates the changes will save consumers between £310 million and £1.3 billion a year in lower interest charges. The new rules come into force on 1 March 2018, but firms have until 1 September 2018 to comply. As per the new rules firms would need to provide help to customers to break the cycle of persistent debt. The steps which firms are required to take in order to break this cycle are;

i) Customers who are in persistent debt for over 12 months won't be provided any increases to their credit card limit.
ii) Firms would need to contact customers who have been under persistent debt over 18 months and inform them to change their repayment pattern.
iii) Customers who are under persistent debt for more than 36 months, firms need to offer them a way to repay their balances in a reasonable timeframe.

All details of the directive can be viewed [here.]()

FCA publishes report on the supervision of Algorithmic Trading

FCA published a report on the supervision of algorithmic trading on 12th February, 2018 highlighting the significant benefits to the investors. The report also focuses on five key areas of compliance in wholesale markets;

- Defining Algorithmic Trading
- Development and Testing Process
- Risk Controls
- Governance and Oversight
- Market Conduct

The Prudential Regulation Authority (PRA) has also published a consultation paper focusing on a firm's governance and risk management of algorithmic trading.

All details of the directive can be viewed [here.]()

EBA issues Opinion on measures to address macro prudential risk

The European Banking Authority (EBA) published an Opinion following the notification by the National Bank of Belgium (NBB) of its intention to modify capital requirements in order to address an increase in macro prudential risk. The modified capital requirements introduces a new micro prudential risk measure based on two components;

i) A flat 5 percentage point risk weight add on to micro prudential risk weight for mortgage exposures for IRB banks.
ii) Applying an additional proportional 33% macro prudential risk weight add-on on top of the micro prudential risk weight, which is to be applied to each (IRB) bank's (residential) mortgage portfolio.

EBA acknowledges the NBB notification in line with the ESRB warning on the vulnerabilities of the residential real estate sector, that the combined increase in house prices and debt levels could pose a threat to the financial stability of banks in Belgium in the event of a downturn.

All details of the directive can be viewed [here.]()

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