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Vinyamak

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Shadow Banking

The term shadow banking as we use it today was coined by PIMCO's Paul McCulley in 2007 after the global financial crisis, as it highlighted the bank-like functions performed by entities outside the regular banking system. A comprehensive definition was provided by Financial Stability Board (FSB) as "credit intermediation involving entities and activities outside the regular banking system". In this article, we will deep dive on Shadow Banking and regulatory landscape around the same.

Overview on Shadow Banking

Shadow banking came into force as financial firms started to explore avenues to bypass regulation, benefit from tax havens and develop means for innovation and speculative activity. Shadow Banking, by definition, has two important components:

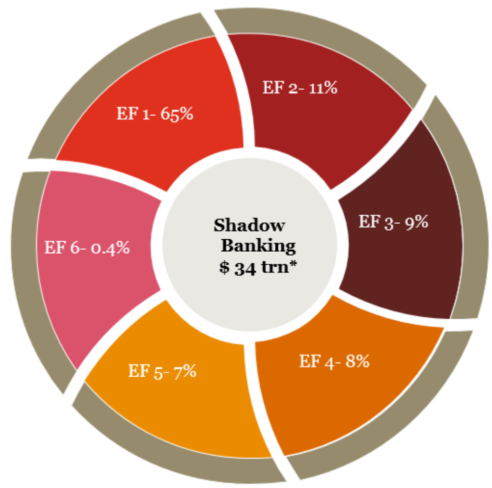
- non-bank financial entities or entities outside the banking system that engage in the "bank like" activities of undertaking credit risk transfer and using direct or indirect financial leverage
- activities such as securitization, securities lending and repo transactions that act as important sources of funding for non-bank entities

Globally, shadow banking entities could be covered under the broad heads of Money Market Funds, Credit investment Funds, Hedge Funds, finance companies accepting deposits, Securities brokers dependent on wholesale funding, Credit insurers, financial guarantee providers and Securitization vehicles.

A very important and noteworthy aspect on Shadow institutions is that neither they operate under banking licenses nor do they take deposits. This helps these institutions to remain outside the regulatory purview. While they largely operate as intermediaries between investors and borrowers, they still form a relevant part of the overall financial sector and continues to be a growing challenge in terms of size and regulatory concerns.

Size of Shadow Banking system

Shadow Banking forms 10.5% of the entire financial Assets as on end of 2015. The further composition for shadow banking is as follows;



Classification by Economic Functions:

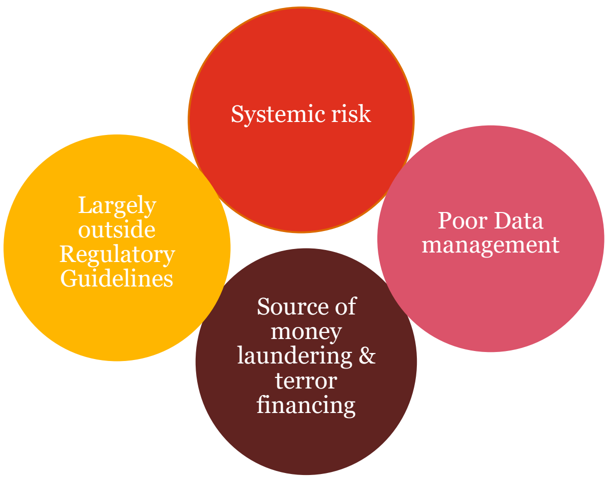
Economic function	Definition	Entities type
EF 1	Collective investment vehicles with features that make them susceptible to runs	MMFs, fixed income funds, mixed funds, credit hedge funds, real estate funds
EF 2	Loan provision that is dependent on short-term funding	Finance companies, leasing companies, factoring companies, consumer credit companies
EF 3	Dependent on short-term funding or on secured funding of client assets	Broker-dealers, securities finance companies
EF 4	Facilitation of credit creation	Credit insurance companies, financial guarantors
EF 5	Securitization-based credit intermediation and funding of financial entities	Securitization vehicles, structured finance vehicles, asset-backed securities

*Source: Global Shadow Banking Monitoring Report 2015 by Financial Stability Board (FSB)

Challenges posed by Shadow Banking

Shadow banking system is always under the radar of supporting illegal activities such as money laundering, terror financing etc. They carry some prominent risks such as Contagion risk, Regulatory Arbitrage, Asset Liability mismatch and Regulatory risk.

Another major challenge that Shadow firms pose is the absence of a robust data management system. This is a deterrent in maintenance of necessary risk data and transparency



Challenges: Shadow Banking

Finally, Shadow Bank has been a source of systemic risk due to its involvement in bank-like activities, transforming maturity/liquidity and creating leverage like banks. They provided a lucrative alternative to mainstream banking system. Absence of robust controls and measures puts the entire banking system under risk and even small shocks has the potential of causing havoc in the financial sectors.

Current Regulatory Landscape

The need to regulate shadow banking system was first identified during the financial crisis in 2008. As immediate response to this problem, FSB laid down a detailed two pronged strategy:

Assess source of systemic risk

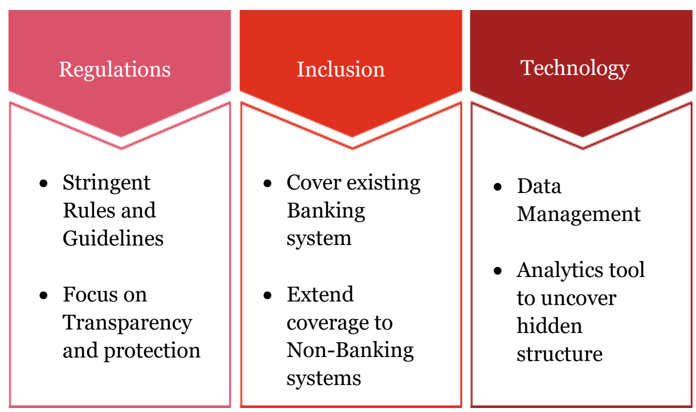
Regulate financials firms to deter participation

- Assess source of Systemic Risk - a framework wherein authorities can assess the sources of systemic risk in a forward-looking manner
- Regulate financials firms - policies that can identify bank's involvement in shadow banking, keep a check on the leverage being created promote transparency in the operations such as securitization.

Other prominent regulatory bodies such as BIS, FCA and ESMA has proactively tried to address problems of Shadow Banking by laying down rules and guidelines. In India, RBI has played an active role in regulating NBFCs to safeguard institutions and customers and at the same time ensure that NBFCs continues to fill the important gaps in financial inclusions outside the banking domain.

Addressing the Challenges

It is extremely essential to recognize and address the threats that the system is bringing about. An effective strategy to combat this problem is to rely on strict guidelines in regulations, use latest technology to aid in identification of Shadow structures and focus to cover firms across financial sector setup.



Increased focus on detailed and timely reporting will deter existing setup to enter shadow banking arena. A top-down push from regulators to financial institutions for regulatory compliance will also help to overcome the challenges.

Conclusion

We strongly believe that the risks and downsides associated with Shadow Banking system is a source of constant threat in future. However, increased focus from regulators to address this problem, through upcoming regulations, is a sincere effort in this regards. Financial sector will benefit from a regulated environment that dissuades shadow banking.

Regulatory News

Refinancing of External Commercial Borrowings

In order to provide a level playing field to overseas branches or subsidiaries of Indian Banks, the Central Bank along with the Government of India has decided to permit Indian banks overseas branches/subsidiaries to refinance External Commercial Borrowings (ECBs) of highly rated (AAA) corporates as well as Navratna and Maharatna PSUs. However, the outstanding maturity of original borrowing should not be reduced. Additionally, the all-in-cost of fresh ECB should be lower than the existing ECB.

Here is the link to the official notification.

XBRL Returns – Harmonization of Banking Statistics

The Reserve Bank of India has released harmonized definitions of 83 data elements that are covered in the banking/ regulatory returns received across RBI departments. These data elements pertain to major balance sheet, profit and loss and off-balance sheet items. This is in addition to the previously released list of 106 data element definitions. Some of the data elements defined by RBI include pre-shipment credit, funded credit, restructured accounts, HFT, AFS, HTM, Adjusted Net Bank Credit, Net Funded Exposure, Hurdle Rate etc.

The definition of these 83 data elements can be viewed here.

Assignment of Lead Bank Responsibility in Assam

With the creation of eight new districts in Assam by the state government, RBI has released the lead bank responsibility list for the new and erstwhile districts. District working code details for the purposes of BSR reporting has also been updated accordingly. This list can be accessed here.

Other Regulatory News

Transaction Charges by Commodity Derivatives Exchanges

In order to promote competition in the market, bring in greater efficiencies and lower transaction costs to the market participants, Securities and Exchange Board of India (SEBI) had issued a few norms while levying transaction charges in Commodity Derivative Exchanges. As per the norms, the ratio between the highest and lowest transaction charges in the turnover slab of any contract should not exceed 1.5:1. Also, concessional transaction charges are to be charged only on incremental volume and not on the entire volume. In view of these norms, SEBI has directed all exchanges to make the necessary amendments to the relevant bye-laws, rules and regulations for implementation of the same.

Here is the link to the official notification.

Online Registration Mechanism and Filing System

In order to ease the process for application of registration, renewal, reporting and other filings, SEBI has introduced a digital platform for online filings related to Stock Exchanges and Depositories. The portal can also be used for filings related to public issues, rights issues, institutional placement programme, schemes of arrangements, takeovers and buybacks. The portal address along with details of the documents required to be uploaded for Stock Exchanges, Depositories and Offer Documents, Takeovers and Buybacks can be viewed at respective links.

Partial withdrawal process for subscribers and nodal offices under NPS

The Pension Fund Regulatory and Development Authority (PFRDA) has modified the norms for withdrawal for funds under National Pension Scheme (NPS). As per the revised norms, a subscriber is permitted to withdraw up to 25% of the total contributions made to his/her individual pension account. Such a partial withdrawal shall only be permitted for purposes of higher education of children, marriage of children, treatment of specific illnesses, purchase or construction of a residential house provided there exists no other residential property in the withdrawers name (other than ancestral property).

The official communication from PFRDA can be viewed here.

Circulars concerning various regulations by IRDAI

The Insurance Regulatory and Development Authority of India (IRDAI) has released a few circulars concerning various regulations. The links to these circulars are as under

- Exposure Draft on Reinsurance Regulations
- Exposure draft on minimum information for inspection or investigation
- Insurance Brokers Regulations

Global Regulatory News

New report assesses structural changes in global banking

The report highlights how has the global financial crisis impacted the bank's balance sheets, cost base, scope of activities and geographic presence and also how has there been a change in regulation, competition and macroeconomic landscape. In line with the new regulations banks have significantly strengthened their capital, liquidity and funding structures which has led to a stronger banking sector. However there has mixed outcome in the economy wherein the banks which were directly affected by the crisis have become more selective in their international activities, whereas the less affected have expanded internationally.

All details of the directive can be viewed here.

Statement on communications in relation to PRIIPs

In order to provide a fair and a clear understanding of Packaged Retail and Insurance-based Investment Products (PRIIPs) regulators have made it mandatory for the PRIIP manufactures to prepare and publish a standalone standardized document KID from 1st January 2018. KID would detail down the risks, performance scenarios, costs and all the pre-contractual information in a standardized way. The regulations also state that in scenarios where firms selling or advising on PRIIP have any concern regarding the performance scenarios they can provide additional explanation in context of their calculations.

All details of the directive can be viewed here.

EBA publishes final Guidelines on disclosure requirements of IFRS 9 transitional arrangements

EBA has published a uniform template which institutions need to use to report information on own funds, capital and leverage ratios with and without the impact of IFRS9 or expected credit loss (ECLs). This will help the users of the information to understand the impact due to the changes in reporting requirement. The template also takes into consideration the international disclosure requirement mainly Basel Pillar3 requirements of capital metrics comparability with non-EU banks.

All details of the directive can be viewed here.

EBA launches 2018 EU-wide stress test exercise

The stress test will primarily focus on resilience of EU banks to economic shocks, the methodology also incorporates IFRS9 accounting standards. Apart from the baseline scenario published in December EBA also proposed four adverse risk scenarios;

- Abrupt and sizeable repricing of risk premium in global financial markets.
- Adverse feedback loop between weak bank profitability and low nominal growth resulting from the decline in economic activity in the European Union.
- Public and private debt sustainability concerns.
- Liquidity risks in the non-bank financial sector

All details of the directive can be viewed here.

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Contacts

Subhojit Das
Associate Director
subhojit.das@in.pwc.com
+91 - 99207 12927

Vishal Motwani
Associate Director
vishal.motwani@in.pwc.com
+91 – 75068 00901

Hardik Gandhi
Associate Director
hardik.gandhi@in.pwc.com
+91 – 98193 79703

Ramya Ramaswamy
Senior Consultant
Ramya.ramaswamy@in.pwc.com
+91 – 99208 50334

Pranav Thakur
Senior Consultant
pranav.thakur@in.pwc.com
+91 – 99168 237 81

Abhash Mishra
Senior Consultant
abhash.mishra@in.pwc.com
+91 – 91677 52821

Kartik Singh
Senior Consultant
kartik.o.singh@in.pwc.com
+91 – 96621 33980