The monthly Financial Regulatory Technology news dose

Vinyamak

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Regulatory sandbox: A step forward

Buoyed by the massive scale of opportunities, an unwavering focus on pan-India digitisation and increasing enthusiasm in the investor community, India is poised to become one of the most exciting breeding grounds for FinTech-driven innovation. The next few years should continue to see FinTech firms commercialise new age technologies for the development of innovative and low-cost products with mass appeal in the country. To sustain the momentum and steer the FinTech ship in the right direction, it is imperative for regulators, industry incumbents and FinTech firms to adopt a structured, disciplined and collaborative approach. The Reserve Bank of India (RBI) plans to operationalise a regulatory sandbox (RS) as one of the enablers of India's FinTech story.

Regulatory sandbox

Regulator	Innovators	Consumers	Incumbents
Enables them to make evidence-based regulatory changes or propose new regulation to support innovation	Enables them to understand the regulation better and modify their product offering to comply with the regulation	First-hand feedback from end consumers improves the product/ service/technology before a wider launch	Enables them to appreciate how emerging technologies work and identify possible synergies

To put it simply, an RS is a framework set up by financial sector regulators that enables firms to test and fine-tune their innovations in a temporary 'safe space' created by the regulator through special time-bound allowances such as relaxation of authorisations and licensing protocol. The proposed sandbox would definitely serve as a great platform for FinTech firms that have traditionally been impacted by limitations in quantum and variety of datasets available. In this edition of Vinyamak, we will analyse the draft enabling framework on RS published on 26 April 2019 by the RBI[1] and compare it with similar initiatives by the Monetary Authority of Singapore (MAS) in Singapore and the Financial Conduit Authority (FCA) in the UK.

Highlights of the RBI's draft enabling framework for regulatory sandbox

In 2016, an inter-regulatory Working Group (WG) was set up by the RBI to understand the regulatory issues related to FinTech and digital banking in India. One of the important recommendations of the WG was for the RBI to provide a framework for an RS which would provide regulatory oversight to innovations, thus leading to an increase in efficiency, enabling risk mitigation and providing new opportunities to customers in a time-boxed environment. The key takeaways from the framework are as below:

1. Eligibility criteria

- FinTech companies meeting the criteria of a start-up as per Government of India conditions.
- Applicants in areas where there is a lack of governing regulation or where innovation may ease financial service delivery.

2. Design

- The RS would run multiple theme-based cohorts for a specified duration—no longer than 6 months and with 10–12 selected entities.
- The RBI has provided an indicative list of in-scope innovation areas.

3. Regulatory relaxation

- The RBI is ready to relax the regulatory requirements if it deems fit, but only for the RS period.
- Mandatory regulation stays for areas like customer privacy, security and KYC/AML.

[1] Draft Enabling Framework for Regulatory Sandbox: https://rbi.org.in/scripts/PublicationReportDetails.aspx?UrlPage=&ID=920

4. Negative list

- Applicants in existing service areas may not be suitable for the RS unless they demonstrate technology differentiation.
- The Negative list of propositions includes credit registry and cryptocurrency.

5. Selection criteria

- The RBI has specified fit and proper criteria for selection of participants in the RS.
- Applicants should have an acceptable exit and transition strategy and should share results of proof of concept before admission to the RS.

6. Stages

- Each cohort shall have the following five stages: Preliminary screening (4 weeks), test design (3 weeks), application assessment (3 weeks), testing (12 weeks) and evaluation (4 weeks).

7. Legal

- Entering the RS would not limit an entity's liability towards its customers and the RBI will not be liable to bear any consumer losses as a result of the RS process.
- The RBI wouldn't be providing legal waivers.

8. Disclosure

- The RBI shall reserve the right to post any information regarding the RS process on its website and may also take part in knowledge sharing with other regulatory authorities.

Comparative analysis with other regulators

RSs have been a tried and tested approach to support innovation in many foreign markets. Both the FCA in the UK and the MAS in Singapore started experimenting through RSs since 2016 and have come a long way since then. The FCA recently closed the application process for its sixth cohort. Currently, there are more than 25 RSs being run across various countries.

Innovation scope

The RBI has been prescriptive and has issued a positive and a negative list of products, services and technology areas which it would consider in its RS. The FCA and the MAS have been more open with their scope and have accepted innovations in both traditional products and services through the use of new technology such as distributed ledger technology, application program Interfaces (APIs) as well as new products/services and business models (e.g. robo-advice).

Applicant scope

As per the RBI guidelines, only start-ups or companies that have a minimum net worth of INR 50 lakh would be considered for the RS. This criteria might leave out established financial institutions and small-sized start-ups. This is a deviation from the approach that the FCA and the MAS had taken. The FCA sandbox is open to all authorised firms and technology businesses. The MAS guideline[2] mentions that its target audience includes, but is not limited to, incumbent financial institutions, FinTech firms and professional services firms partnering or supporting such businesses.

Evaluation criteria

The RBI has provided broad eligibility criteria along with a few selection criteria similar to those of the MAS—for example, well-defined test scenarios and outcomes, appropriate boundary condition, risk mitigation controls, clear exit and transition plan, and capability for broader market deployment. The MAS has additionally provided illustrative assessment scenarios for ease of understanding. The FCA[3] has provided much more detailed eligibility criteria with examples of positive and negative indicators. For example, for the criteria of 'genuine innovation', absence of a similar proposition in the market is a positive indicator, whereas existence of multiple similar offerings in the market is a negative indicator.

[2] FinTech Regulatory Sandbox Guideline: http://www.mas.gov.sg/~/media/Smart%20Financial%20Centre/Sandbox/FinTech%20Regulatory%20Sandbox%20Guidelines%2019Feb2018.pdf

[3] FCA: Regulatory Sandbox application process: https://www.fca.org.uk/firms/regulatory-sandbox/prepare-application

Legal and regulatory waiver

The MAS, in its RS guideline, had provided examples of legal and regulatory requirements that it is “possible to relax” and requirements that it is necessary “to maintain”. Similar to the FCA, the RBI has mentioned that it would consider relaxing the regulatory waiver if it deemed fit, although it wouldn’t be providing any legal waivers. Further, the FCA has a provision to issue a “no enforcement action” letter where it feels it can’t provide a waiver, although it won’t take any disciplinary action if there are unexpected issues.

Governance

To ensure robust governance, the FCA appoints a dedicated case officer to each of the successful applicants. The officer governs the design and test implementations throughout the sandbox period and provides regulatory guidance where necessary. The RBI has not provided details on the governance structure apart from mentioning that the RS process would be overseen by its FinTech Unit (FTU).

Way forward

There is no doubt that the RS is the right way forward for the RBI to get a ringside view of the rapidly evolving FinTech space. This would enable it to have a better understanding of the regulatory flexibility required to support innovation and help in incorporating the same into its broader regulatory and policymaking work. The RS helps both innovators and incumbents to significantly reduce the time to market. However, the exploratory nature of the exercise warrants that adequate safeguards are in place in the RS environment.

The success of the RS, though, lies in how innovators use this opportunity. Innovators can get actual market feedback and assess the commercial viability of their offerings from the sandbox. The FCA, in its lessons learnt publication,[4] had highlighted that a number of start-ups which didn’t have partnerships with established financial institutions before entering the RS couldn’t make full use of the RS environment due to the lack of a customer base.

Innovators would be required to work in close coordination with other regulators and other ecosystem partners such as state governments, the Central Government and its digitisation programmes, end customers, merchants, cloud providers, incubators, accelerators, innovation labs already in operation at firms, and even educational and R&D institutes to meet the common goals faster. The final enabling framework will put together all the jigsaw pieces, bringing all contributors on the same page, clearly laying out collaboration-related expectations and, in general, weeding out all instances of ambiguity to ensure a smooth journey.

Regulatory news

Large Exposures Framework (LEF)

According to the notification, with the onset of LEF from 1 April 2019, the following key points will be considered:

- An Indian branch of foreign Globally Systemically Important Banks (G-SIB) will be considered an Indian bank and can consider exposure up to 25% of its Tier I capital on another non G-SIB in India.
- The interbank exposure limit of an Indian branch of a foreign G-SIB with its Head Office will be 20% of its Tier I capital in India.
- Accrued profits during the year, subject to provisions, will be considered as Tier I capital for the purpose of LEF for Indian banks.
- The eligible capital base for the purpose of LEF will be the effective amount of Tier I capital on satisfying a few conditions.

Additionally, non-centrally cleared derivatives exposures will not be considered under exposure limits till 1 April 2020. Also, there is no additional time allowed for banks, which breaches specific interbank limits maintained with other banks or with their Head Offices, in order to bring their exposures within limit. The detailed notification can be accessed here.

4 FCA: Regulatory Sandbox application process: https://www.fca.org.uk/firms/regulatory-sandbox/prepare-application

Disclosure in the ‘Notes to Accounts’ to the Financial Statements – Divergence in Asset Classification and Provisioning

According to the notification, the RBI has regulated that banks should disclose divergences on satisfying either or both of the conditions mentioned below:

- The additional provisioning for non-performing assets (NPAs) exceeds 10% of the reported profit before provisions and contingencies.
- The additional gross NPAs exceed 15% of the published incremental Gross NPAs.

The detailed notification can be accessed here.

Licensing as Authorized Dealer - Category II

According to the notification, the RBI has decided that Systemically Important Non-Deposit taking Investment and Credit Companies shall be eligible for Authorized Dealer - Category II (AD - Cat II) licence, subject to fulfilment of the following conditions:

- NBFCs offering such services shall have a ‘minimum investment grade rating’.
- NBFCs offering such services shall put in place a board-approved policy on (a) managing the risks, including currency risk, if any, and (b) handling customer grievances arising out of such activities.

The detailed notification can be accessed here.

Investment by Foreign Portfolio Investors (FPI) in debt – Review

The RBI has published a notification reviewing investment by FPIs in the Indian debt market. Some of the key points included in the notification are:

FPIs are now permitted to invest in municipal bonds, with a view to making debt instruments in India attractive to non-resident investors.

FPI investment in municipal bonds shall be computed within the limits set for FPI investment in State Development Loans (SDLs). The detailed notification can be accessed here.

Basel III Framework on Liquidity Standards – Liquidity Coverage Ratio (LCR), Liquidity Risk Monitoring Tools and LCR Disclosure Standards

The RBI has decided to allow banks to compute an additional 2% of government securities under the Facility to Avail Liquidity for Liquidity Coverage Ratio (FALLCR) within the mandatory Statutory Liquidity Ratio (SLR) requirement as Level 1 High Quality Liquid Assets (HQLAs). This is for the purpose of calculating LCR in a phased manner.

The timelines allowed for this are: 1 April 2019, for FALLCR requirement: 13.5% and HQLA carve out from SLR requirements: 15.5%; 1 August 2019, for FALLCR requirement: 14.0% and HQLA carve out from SLR requirements; 16.0%; 1 December 2019, for FALLCR requirement: 14.5% and HQLA carve out from SLR requirements: 16.5%; and 1 April 2020, for FALLCR requirement: 15.0% and HQLA carve out from SLR requirements: 17.0%—all expressed as a percentage of Net Demand and Time Liabilities (NDTL). The detailed notification can be accessed here.

Other regulatory news

Streamlining the Process of Public Issue of Equity Shares and convertibles - Extension of time lime for implementation of Phase I of Unified Payments Interface (UPI) with Application Supported by Block Amount (ASBA)

The SEBI has extended the timeline for Phase I implementation of UPI as the payment mode for ASBA in case of public issues by individual retail investors via intermediaries till 30 June 2019.

Phase I implementation will be followed by Phase II and Phase III implementations, the timelines for which remain the same, as mentioned in the earlier circular. The timeline is extended to ensure a smooth transition to UPI with ASBA.

The detailed notification can be accessed here.

Risk-based capital and net worth requirements for Clearing Corporations under the Securities Contracts (Regulation) (Stock Exchanges and Clearing Corporations) Regulations, 2018

SEBI has adopted a risk-based approach for the calculation of capital and net worth requirements for clearing corporations (CCPs) and depositories. This is to ensure adequate risk is captured by CCPs.

As per the notification, the computation approach comprises:

- Every recognised CCP, at the onset of operations, shall maintain capital, including retained earnings and reserves, to cover counterparty credit risk, business risk, legal and operational risk.
- Every recognised CCP shall hold additional capital to cover costs required for orderly wind down or recovery of operations.
- Every recognised CCP shall maintain, at all times, a minimum net worth of INR 100 crore or capital as determined under the regulation, whichever is higher.

A certificate mentioning compliant of this, signed by the Managing Director of CCPs, should be submitted by CCPs to SEBI within 15 days from the end of every quarter. The first submission is for the April–June 2019 quarter. The detailed notification can be accessed here.

Net worth Requirements for Clearing Corporations in International Financial Services Centre (IFSC)

The introduction of a risk-based approach for the calculation of capital and net worth requirements for CCPs has led to the amendment of IFSC guidelines.

As per the notification, the amended guidelines are:

- Every applicant seeking consideration as a CCP shall have a minimum net worth equivalent of INR 50 crore in the form of liquid assets.
- Every recognised CCP, on beginning operations, shall have, in the form of liquid assets, a minimum net worth equivalent of INR 50 crore or capital.
- Additionally, every recognised clearing corporation shall enhance its net worth to a minimum equivalent of INR 100 crore or capital over a period of three years after commencement of operations.

The detailed notification can be accessed here.

Global regulatory news

ESMA publishes MiFID II Supervisory Briefing on Appropriateness and Execution-only

ESMA has published an amended supervisory briefing on MIFID II appropriateness requirements.

According to the notification, some key areas of the report include determining situations where the appropriateness assessment is required, obtaining information from clients and assessment of appropriateness.

The supervisory briefing is aimed at the authorities defined in MIFID II. The objective of the briefing is to give market participants indications of compliance with MiFID II provisions. The detailed notification can be accessed here.

Basel Committee issues a consolidated version of its standards

The Basel Committee on Banking Supervision has started a new section on its website which combines its global standards for the regulation and supervision of banks.

The framework's objective is to enhance the accessibility of the Basel Committee's standards and to promote their consistent global interpretation and implementation.

The committee, however, has sought feedback on the consolidated framework and proposed technical changes to the standards. The deadline specified for uploading comments is 9 August 2019. The detailed notification can be accessed here.

The European Banking Authority (EBA) publishes final draft standards on the conditions to allow institutions to calculate capital requirements of securitised exposures (KIRB) in accordance with the purchased receivables approach

The EBA has published its final Regulatory Technical Standards (RTS) draft, formulating conditions to compute capital requirements of securitised exposures (KIRB) in compliance with the purchased receivables approach of the amended Capital Requirements Regulation (CRR).

The objective of the notification is to maintain the balance between acknowledging the specific circumstances for calculating capital requirements of a securitisation transaction and maintaining prudent requirements on the internal modelling of capital requirements.

As per the notification, the key points of the draft RTS are:

- General approach to the relationship between the internal ratings-based (IRB) rules and the SEC Internal Ratings-Based Approach (SEC-IRBA) regulations
- Eligibility criteria to calculate KIRB under the RTS
- IRB permissions and prior experience
- Eligibility to use the retail risk quantification standards
- Use of proxy data

The detailed notification can be accessed here.

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