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RBI's report on financial stability and regulatory progress of banking in India

The RBI rolled out several developmental and regulatory policy measures to strengthen regulation and supervision, broaden and deepen financial markets, manage liquidity and market risk and resolve issues relating to stressed assets throughout 2017-18. The Financial Stability Report[1] (FSR) and Report on the trend and progress of Banking in India[2] covers these developments in detail. In this newsletter, we have summarised key regulatory aspects where there has been progress.

A. Financial Stability Report

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. The following regulatory developments are undertaken by the RBI:

Liberalisation of ECB norms

The RBI has revised the norms for External Commercial Borrowings (ECBs). According to the new norms, eligible ECB borrowers in the manufacturing sector can now raise ECBs of up to US$50 million (or its equivalent) with a minimum average maturity period of one year. In addition, Indian banks are now permitted to go to market and participate as arrangers, underwriters, market-makers and traders in rupee-denominated bonds (Masala Bonds) overseas.

It is aimed to check the decline of the rupee which has been losing value against the dollar and also curb the widening current account deficit (CAD). It also provides corporate entities the flexibility to choose their liability profiles.

New avenues for NBFCs

With a view to provide increased access to funding, the RBI has now allowed Non-banking Financial Companies (NBFCs) to securitise loans of more than five-year maturity after holding those for six months on their books. The Minimum Retention Requirement (MRR) for such securitised loans has been set at 20% of the loan book value.

> Banks are now allowed to provide partial credit enhancement (PCE) to bonds issued by NBFCs and housing finance companies to assist them in raising money from Provident or Pension Funds investing in highly rated instruments and insurance.

These measures are expected to ease the liquidity crunch in the sector arising due to the Infrastructure Leasing and Financial Services (IL&FS) crisis and enable flow of funds to NBFCs.

Foreign investment in debt market

The RBI has eased the minimum residual maturity requirements for Foreign Portfolio Investors (FPIs) to attract overseas investment. Consequently, FPIs can now invest in specific categories of debt securities without any minimum residual maturity requirements, compared to the earlier limit of three years. For corporate bonds, the minimum residual maturity requirement for investments has been set at one year. This will help to curb the fall in the rupee and also attract additional investment in corporate bonds.

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[1] https://rbi.org.in/Scripts/PublicationReportDetails.aspx?UrlPage=&ID=917

[2] https://m.rbi.org.in/Scripts/AnnualPublications.aspx?head=Trend%20and%20Progress%20of%20Banking%20in%20India

Basel III framework on liquidity standards

With effect from 1 October 2018, the RBI has brought changes to the Facility to Avail Liquidity for Liquidity Coverage Ratio (FALLCR) to improve liquidity in the financial system. To meet their requirement of liquidity coverage ratio, banks can now carve out additional shares of their Statutory Liquidity Reserves (SLRs). The total carve out has been increased by 2%, taking the total to 13% of Net Demand and Time Liabilities (NDTL). In addition to this, banks can also withdraw 2% from Marginal Standing Facility (MSF), taking the total withdrawal limit to 15% of NDTL.

New lending norms for the priority sector

The RBI has released new guidelines on co-origination of loans by scheduled commercial banks (excluding Regional Rural Banks and Small Finance Banks) and non-deposit-taking NBFCs in priority sectors such as agriculture, micro enterprises, social infrastructure, education and renewable energy. With new changes taking place, NBFCs will bear a minimum of 20% of the credit risk by way of direct exposure, while the balance will be borne by the banks.

This will help to augment the funding to priority sectors and make the best use of the reach of NBFCs to help banks reach their priority sector lending targets.

Revision of short-sale norms in G-securities

The RBI has revised the norms on short sale in the secondary market for government securities. Prior to this revision, scheduled commercial banks (SCBs), primary dealers and certain urban cooperative banks (UCBs) were only permitted to perform short sale in government securities.

With the new norms in place, any regulated entity with approval from regulators such as SEBI and IRDA will now be permitted to opt for short sale of government securities. This has provided participants a tool to express a two-way view on interest rates, and thereby, enhance price discovery.

The maximum amount of a security that can be short sold are:

Liquid securities	Other securities
Two percent of the total outstanding stock of each security or 500 crore, whichever is higher	One percent of the total outstanding stock of each security or 250 crore, whichever is higher

Mandatory hedging provision of External Commercial Borrowings

In recent months, the cost of borrowing in overseas markets has gone up due to the increase in interest rates in the US.

The RBI's move to reduce the mandatory hedging provision to 70% from 100% for eligible borrowers is expected to make it marginally cheap for Indian companies and banks to tap overseas debt markets. Eligible borrowers under consideration are those that raise ECBs under track I, which have an average maturity of between three and five years, and are mandatorily required to hedge their ECB exposure.

B. Progress of regulatory policies

Resolution of stressed assets

In March 2018, the *Vinyamak* newsletter[3] covered in detail the triggers that led the RBI to issue guidelines on the revised framework for resolution of stressed assets on 12

[3] https://www.pwc.in/consulting/financial-services/fintech/point-of-view/financial-regulatory-technology-insights-newsletters-vinyamak/march-2018.html

February 2018. The guidelines require all lenders to take the following measures:

1 Develop **policies and timelines** for resolution of stressed assets, which need to be developed and approved by the board.

2 The loans need to be identified as **Special Mention Accounts (SMAs)** as soon as the default takes place and the lender needs to identify the stress on an immediate basis.

3 The lenders, singly or jointly, should initiate steps to rectify the default and prepare a **Resolution Plan**, which can be in the form of:
a. Regularisation of the account by payment of all overdue amounts
b. Sale of exposures to other investors
c. Change in ownership and restructuring

The new framework also mandates strict timelines according to which insolvency proceedings need to be initiated.

- For accounts wherein the aggregate exposure is above INR20 billion, lenders are required to finalise and implement a resolution plan within 180 days from the date of first default, failing which the banks will have to refer those cases to the Insolvency and Bankruptcy Code (IBC).
- For large accounts where a resolution plan is being implemented, the account should not be in default at any point during the specified period. If there is a default within this period, the lenders will have to file an insolvency application.
- For accounts with exposure of INR100 crore to INR2,000 crore, banks will need to provide a resolution within a two-year period.

These timelines will lead to recovery of loans from borrowers. They will help to strengthen the banking system, instil transparency in the process, ensure speedy resolution of bad loans and improve prudence in lending.

Managing market risk

A sharp increase in government yields was recorded in the last quarter of 2017 and 2018 due to which banks were required to create additional provisions for Mark to Market (MTM) losses on investments held in the available for sale (AFS) and held for trade (HFT) categories.

To provide some relief, RBI allowed the banks to spread the provision requirements for quarter ended 31 December 2017, 31 March 2018 and 30 June 2018. These provisions need to be spread equally over four quarters commencing from the quarter in which the loss was incurred. Additionally, to create adequate buffers against market risk, the RBI also directed banks to create an investment fluctuation reserve (IFR) from 2018 to 2019.

C. Conclusion

The year 2018 have seen a new trend, with regulatory policies being directed at helping lenders resolve long-running issues relating to stressed assets on their Balance Sheet and prepare them for future risks. The regulatory changes and development highlighted in the FSR aims to ensure stability in India's financial system, provide new avenues to raise capital and relax certain regulations. The RBI has a positive outlook on the current stability of the financial system and is paving the way to make it stronger, more secure and competitive in the current uncertain environment.

Regulatory news

Guidelines on Loan System for Delivery of Bank Credit

The RBI has published its final guidelines, taking into account the views of stakeholders, to enhance credit-related discipline among large borrowers. The key points discussed in the guidelines include the following:

- Minimum level of 'loan component' and the effective date
- Sharing of working capital finance
- Amount and tenure of loans
- Repayment, renewal and rollover of loan component
- Risk weights for undrawn portion of cash credit limits

The RBI's guidelines will be effective from 1 April 2019. The detailed notification can be accessed here.

Foreign Exchange Management (Borrowing and Lending) Regulations, 2018

The RBI has formulated Foreign Exchange Management (Borrowing and Lending) Regulations, 2018, for borrowing and lending between a person resident in India and a person resident outside India.

The topics discussed include borrowing from outside India in foreign exchange by a person resident in India and lending in foreign exchange by a person resident in India. It also looks at borrowing in Indian rupees and lending in Indian rupees by a person resident in India.

These regulations will be effective after the date of their publication in the *Official Gazette*. The detailed notification can be accessed here.

Basel III Framework on Liquidity Standards - Liquidity Coverage Ratio (LCR), FALLCR against credit disbursed to NBFCs and HFCs

The RBI has extended facilities to ease lending to NBFCs and housing finance companies (HFCs) by banks from 31 December 2018 to 31 March 2019.

According to its earlier circular, the RBI had indicated that banks can consider government securities as Level 1 High Quality Liquid Assets under FALLCR within the mandatory SLR requirement of up to 0.5% of banks' NDTL in respect of their incremental lending to NBFCs and HFCs after 19 October 2018. Additionally, the single borrower limit for NBFCs (not financing infrastructure) has been increased from 10% to 15% of capital funds. Both the facilities above were available till 31 December 2018.

From 1 April 2019, banks will need to abide by the earlier guidelines according to a circular dated 1 December 2016, wherein banks' exposure to a single NBFC will be capped at 15% of their Tier-I capital. The detailed notification can be accessed here.

Other regulatory news

Early warning mechanism to prevent diversion of client securities

The SEBI has decided to put in place an early warning mechanism and enable sharing of information between Stock Exchanges, Depositories and Clearing Corporations.

Its objective to detect diversion of clients' securities by stock brokers at an early stage to take appropriate preventive action. The threshold for such early warning signals will be decided by intended bodies after consultation between them.

The early warning mechanism and preventive actions will be implemented in Stock Exchanges, Clearing Corporations and Depositories with effect from 1 February 2019. The detailed notification can be accessed here.

Review of risk management framework for Equity Derivative segment

The Principles for Financial Market Infrastructures (PFMI) direct that a central counterparty (CCP) needs to identify and consider several elements, including the margin period of risk (MPOR) or close-out period, when creating an appropriate margin system. This is to mitigate any risks arising from the products cleared. The assumed MPOR or close-out period should incorporate the depth of the market and the characteristics of the products cleared.

The SEBI has directed Stock Exchanges and Clearing Corporations to take necessary action to implement the directives of the circular. These include amendments to relevant bye-laws, rules and regulations. These bodies are also required to communicate the provisions of this circular to their members and also distribute these through their websites. Additionally, they need to keep SEBI updated, in the form of monthly reports, on the status of implementation of the provisions of the circular.

The provision(s) of this circular will be effective from 21 January 2019. The detailed notification can be accessed here.

Creation of segregated portfolio in mutual fund schemes

The creation of segregated portfolio of debt and money market instruments by mutual funds schemes, has been decided, in order to provide uniform treatment to all investors in the occurrence of a credit event and to deal with liquidity risk.

The report highlights points pertaining to the creation of segregated portfolios by asset management companies (AMCs) and the process of creation of segregated portfolios. It also elaborates on valuation and processing of subscriptions and redemptions, disclosure requirements and monitoring by trustees. The detailed notification can be accessed here.

Global regulatory news

Basel Committee publishes updated Basel III disclosure requirements

The Basel Committee on Banking Supervision has published, modified and ameliorated Pillar 3 disclosure requirements.

The revised Pillar 3 framework reflects post-crisis regulatory reforms. According to the published report, the framework pertains to risk areas, which include credit risk, operational risk, the leverage ratio and credit valuation adjustment (CVA) risk and risk-weighted assets (RWAs) calculated by banks' internal models according to standardised approaches and an overview of risk management, RWAs and key prudential metrics.

The implementation deadline for disclosure-related requirements pertaining to Basel III is 1 January 2022. The detailed notification can be accessed here.

EBA publishes final guidelines on disclosure of non-performing and forborne exposures

The European Banking Authority (EBA) has published its final guidelines on disclosure of non-performing and forborne exposures that will provide market players and stakeholders an enhanced view of the quality of banks' assets. It will also furnish the details of distribution of problematic and distressed assets, and the value of the collateral backing these assets in the case of troubled banks.

According to the notification, the aim of the guidelines is to endorse transparency, provide meaningful information to market participants on the quality of credit institutions' assets and address any asymmetry of information in a consistent and comparable manner.

The guidelines will apply from 31 December 2019. The detailed notification can be accessed here.

ESMA amends guidelines on the application of C6 and C7 under MiFIDII

The European Securities and Markets Authority (ESMA) has published amended guidelines on application of C6 and

C7 of Annex 1 of MiFID II. The guidelines, which are an update on the original version of the guidelines adopted under MiFID I, will be adapted to the new MiFID II regulatory framework without any change in the substance.

The competent authorities to which these guidelines apply must notify ESMA about their intention to comply with the guidelines. This should be notified within two months of the date of publication of the guidelines on ESMA's website.The detailed notification can be accessed here.

ESAs publish joint EMIR STS standards

European Supervisory Authorities (ESAs) have published two joint draft Regulatory Technical Standards (RTSs) to modify the RTS on the clearing-related obligation and risk-mitigation techniques for non-cleared over-the-counter (OTC) derivatives.

These standards provide a specific treatment for simple, transparent and standardised (STS) securitisation, to ensure a level playing field with covered bonds. With reference to the notification, the standards are required for proper implementation of the European Market Infrastructure Regulation (EMIR). Additionally, this will also amend the current regulation on clearing obligations and risk-mitigation techniques for OTC derivatives not cleared by central counterparties (CCPs).

The detailed notification can be accessed here.

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