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The monthly Financial Regulatory Technology news dose

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Renewed focus on Corporate Governance

Corporate Governance (CG) refers to the principles and processes put in place by an organisation to help it keep its commitments, not only to its creditors and shareholders, but also to its employees, regulators and society.

While it goes without saying that a stable economy demands exemplary corporate governance in its financial institutions, we have seen alleged deviations in recent times. Failures range from process-related disasters to incorrect disclosures and lapses in audit, and have not been limited to inadequately regulated non-banking financial companies (NBFCs). In this newsletter, our focus is to try and bring back the lost focus on corporate governance, a regulator's means to enforce it and new enablers today.

Corporate CG responsibilities

An organisation's board identifies goals, related risks and its risk appetite. The appointment of independent directors on the board enable it to set these objectives. In addition, it entrusts its CXOs with the responsibility of putting in place controls throughout the organisation to control these risks. The efficacy of CG depends on the following classical 'three lines of defence[1]' mechanism:

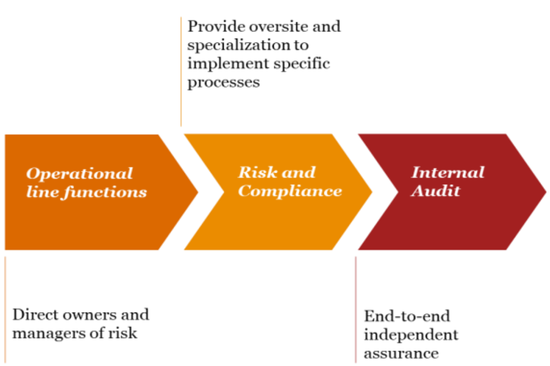

Fig 1: Three lines of defence

[1] https://www.iia.org.uk/resources/audit-committees/governance-of-risk-three-lines-of-defence/

However, a regulator needs to have its own means to ensure CG in its regulated entities (REs).

Responsibility of central banks

In order to ensure the stability of financial institutions, central banks need to enforce CG. Global regulators play a central role in shaping legal, institutional and regulatory frameworks within which governance systems are developed. The financial crises in Asia, Russia and other places in the world has amply demonstrated that distorted governance structures lead to inefficient economic decision-making. In the US, major corporate scandals led to the formulation and implementation of the Sarbanes–Oxley Act of 2002, with the aim of improving the accuracy and reliability of corporate disclosures. Thereafter, the Basel Committee on Banking Supervision (BCBS) revisited its 2006 guidance on corporate governance and brought out its principles for enhancing corporate governance in October 2010.

A central bank typically employs the means depicted in the figure below to enforce CG:

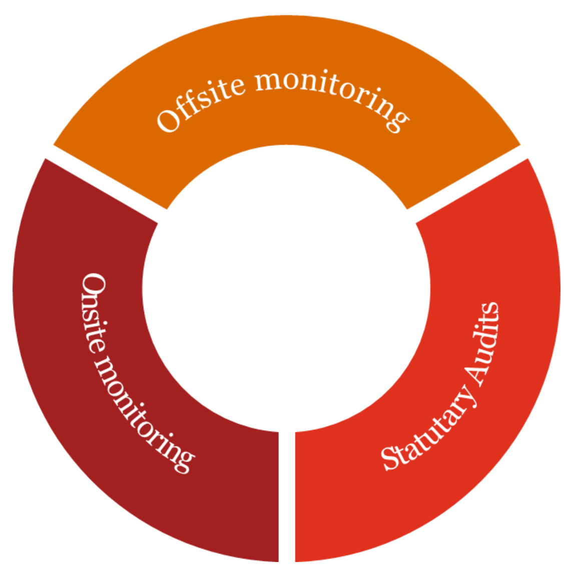

Fig 2: Central banks' means to enforce CG

A. Offsite monitoring

Offsite monitoring is a cost-effective way to ensure that entities provide timely information across a wide range of categories to the regulator. This information includes financial information, stakeholder information and risks.

The Reserve Bank of India (RBI) covers these aspects through its various Automatic Data Flow (ADF) and Risk-based Supervision (RBS) reports.

B. Onsite monitoring

While onsite monitoring is expensive, it provides adequate assurance to the regulator.

The Capital Adequacy, Asset Quality, Management, Earning, Liquidity and Systems and Controls (CAMELS) supervisory rating model developed by the RBI was an attempt to cover various aspects of CG. The RBI uses the onsite monitoring channel in its current form to validate information submitted by probing transaction processing systems directly.

C. Statutory audit

While mandating a statutory audit is a cost-effective and the universal method adopted by regulators, it translates to significant costs incurred by REs. And although it has indisputable merit, it has witnessed a fair share of failures and criticism time and again.

Any failure to abide by the requirements set out by a regulator may lead to imposition of heavy fines and cancellation of a license to operate.

RBI's guidance on CG for NBFCs

In April 2015, the RBI issued a guidance[2] on CG for NBFCs. Its framework provides a comprehensive insight into the central bank's authority and means to enforce CG.

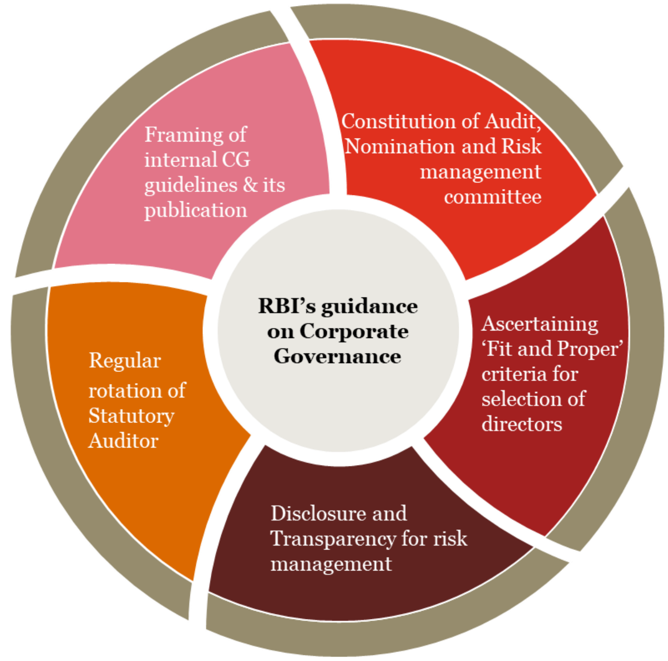

Fig 3: RBI's guidelines on CG to NBFCs

Special note on prompt corrective action

To promote corporate governance[3] in banks in India, the RBI has set trigger points on the basis of capital to risk weighted asset ratio (CRAR), non-performing assets (NPAs) and return on assets (ROA). Banks need to follow the RBI's mandatory action and discretionary action plans. The main reason for classification of the rule-based action points into mandatory and discretionary is that some of the actions that need to be taken are essential to restore the financial health of banks and must be mandatorily taken by them. On the other hand, banks can take some other actions at the discretion of the RBI, depending on their profile.

Achieving the desired result

Effective CG starts with cascading of ethical behaviour from an organisation's board down to its ranks. However, good intentions alone are not sufficient to achieve intended results, and senior management needs to be

[2] https://www.rbi.org.in/scripts/BS_CircularIndexDisplay.aspx?Id=9659

[3] https://rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=10921

entrusted with the responsibility of converting the board's mandate into reality.

To start with, processes have to be standardised and documented. Furthermore, the right controls need to be set at every level to monitor effectiveness and compliance. At the next step, processes and controls need to be automated wherever possible.

The horizons of Robotic Process Automation (RPA) are no longer restricted to back-office functions. And improved information ingestion technologies such as Optical Character Recognition (OCR) and Natural Language Processing (NLP) have helped RPA enhance customer-facing processes.

Standardisation and automation lead to a bank of valuable information at an organisation's disposal. However, this information needs to be used effectively to monitor controls and to be compliant. On another front, regulators have evolved to review submitted returns against front office databases. Consequently, REs need to ensure data accuracy more than ever before. Overall data governance is a key peg in the machinery.

Standardisation and automation are a given. Governance of data is the key to ensure monitoring and control at all levels in an organisation.

Conclusion

Today, financial institutions face rapidly evolving issues such as changing customers' demands, the rapidly growing competitive landscape, emerging technologies and regulatory mandates. An organisation's CG goals needs to closely follow changing dynamics to keep its business viable. However, evolving technologies enable cheap, fast and effective CG. Depending on an organisation's CG goals, it needs to establish its target operating model through the blue-printing process and standardise its controls. And most importantly, the right selection of enablers help it achieve its desired results.

Regulatory news

Basel III Framework on Liquidity Standards– Net Stable Funding Ratio (NSFR) – final guidelines

Draft guidelines relating to NSFR were issued on 17 May 2018. This ratio applies to all banks that are engaged in international banking. According to the RBI's notification, the final NSFR guidelines will come into effect from 1 April 2020.

The details can be accessed here.

Real Time Gross Settlement (RTGS) System —Implementation of Positive Confirmation

The RBI has directed all banks that they should provide a positive confirmation message to a remitter or sender of funds on completion of funds transfer through RTGS in the same way in which confirmation to the remitter is conveyed via the NEFT payment method. This facility will assure a remitter or sender of funds that the transferred amount has been credited successfully to the beneficiary or receiver's bank account.

To communicate the confirmation message in RTGS, a new message format (camt.059) will be introduced to communicate acknowledgement to the remitting bank (with the date and time of credit made to the beneficiary account). The message will flow through a Structured Financial Messaging System (SFMS) to the remitter bank, which will subsequently send an SMS or email confirmation to the remitter.

More details can be accessed here.

Relaxation on guidelines to NBFCs on securitisation of transactions

The RBI wants to encourage emerging NBFCs to securitise or assign their eligible assets by relaxing its Minimum Holding Period (MHP) requirement. This will be applicable for loans with an original maturity of more than five years with receipt of repayment of six monthly instalments or two quarterly instalments (as applicable), and some additional requirements.

However, the relaxation is also available for a period of six months from issuance of this circular.

The details on the circular can be accessed here.

Interest Equalisation Scheme on Pre- and Post-Shipment Rupee Export Credit

The Government of India had earlier announced its Interest Equalisation Scheme on Pre- and Post-Shipment Rupee Export Credit for eligible exporters. The scheme has been effective from 1 April 2015. Scheduled commercial banks and urban cooperative banks holding AD category-I licenses are eligible under the scheme.

Under this scheme, the Government has decided to increase the Interest Equalisation rate from 3% to 5% for exports by MSME sector manufacturers.

The complete details of the speech can be accessed here.

Other regulatory news

Operating guidelines for alternative investment funds in International Financial Services Centres

The SEBI has earlier introduced International Financial Services Centre (IFSC) Guidelines, 2015. These guidelines enable setting up of a broad framework for Alternative Investment Funds.

Furthermore, the SEBI has decided to put in place 'Operating Guidelines for Alternative Investment Funds in IFSC' to protect the interest of investors in securities and promote the development and regulation of the securities market.

More details can be viewed here.

Fund raising by issuance of debt securities by large entities

To operationalise the Union Budget announcement 2018-19, the SEBI will also consider mandating that large entities in the market need to meet about 25% of their financing needs from the debt market.

During the following financial year, the framework for entities will be effective from 1 April 2019, with the following calendar year as their financial year. This framework will be applicable from 1 April 2020.

More details can be viewed here.

Interoperability among clearing corporations

Interoperability ensures linking of multiple clearing corporations. It will lead to market participants being able to consolidate their clearing and settlement functions at a single CCP, irrespective of the exchange on which they execute trade.

This interoperability should lead to efficient allocation of capital among market participants and not only save costs, but also enable enhanced execution of trade.

The master circular can be accessed here.

Global regulatory news

ESMA has published a version ameliorated of its supervisory briefing on MiFID II suitability requirements.

The Essential Services Maintenance Act (ESMA) has published an updated version of its supervisory briefing on MiFID II suitability requirements. This version incorporates the content of ESMA's guidelines on a few aspects to a certain extent of the MIFID II suitability requirements in a publication dated 28 May 2018.

Supervisory briefing includes determination of situations where assessment of suitability is required by obtaining information from clients on record-keeping and many other topics.

The detailed report can be accessed here.

FSI-GPFI conference on impact of Fintech and other regulatory and supervisory developments on financial inclusion

The Bureau of Indian Standards' (BIS') Financial Stability Institute (FSI) and Global Partnership for Financial Inclusion (GPFI) congregated the fourth biennial conference on global standard-setting bodies (SSBs) and innovative financial inclusion in Basel in Switzerland.

The discussions that took place were in the context of accelerating change in the financial services landscape in countries across income bands, not only to expand opportunities for financial inclusion, but also address new challenges for country-level authorities and SSBs.

The complete details of the paper can be accessed here.

FSB and standard-setting bodies issue concluding report on effect of reforms on incentives to centrally clear over-the-counter (OTC) sale

The Financial Stability Board (FSB), Basel Committee on Banking Supervision (BCBS), Committee on Payments and Market Infrastructure (CPMI) and International Organisation of Security Commissions (IOSCO) have published a report on incentives to centrally clear OTC derivatives.

Some post-crisis reforms are, directly or indirectly, relevant to incentives to centrally clear OTC. The Derivatives Assessment Team's (DAT's) report evaluates interaction of these reforms and their impact on incentives. The findings of this evaluation report will be analysed by relevant standard-setting bodies, and if warranted, could be a basis for fine-tuning post-global financial crisis-related reforms in line with their original objectives. This does not necessarily imply scaling back of reforms or undermining members' commitment to their implementation.

The detailed report can be accessed here.

European Banking Authority (EBA) issues EU-wide stress test results

The EBA has issued the results of the EU-wide stress test conducted in 2018. This revealed that various financial players, especially banks in the EU and EEA countries, account for broadly 70% of the assets of the total EU banking sector. This adverse scenario has had an impact of -395 bps on banks' fully loaded capital ratio (CET1) at-410 bps on a transitional basis, leading to a 10.1% CET1 capital ratio at the end of 2020 (10.3% on a transitional basis).

The main aim of this exercise is to assess, in a consistent manner, the resilience of banks in the face of shocks. The inferences constitute an input in the supervisory decision-making process and promote market discipline.

The complete details of the paper can be accessed here.

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