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The monthly Financial Regulatory Technology news dose

Vinyamak

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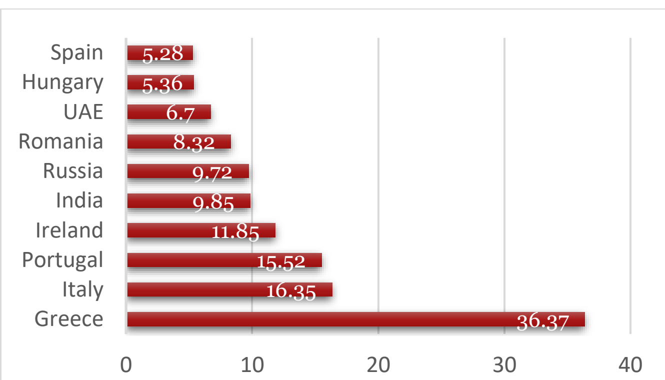
NPA Crisis and way forward

Although the NPA crisis has been long in making, it was only since RBI spoke about Asset Quality Recognition (AQR) in 2015, there has been a substantial increase in the pace of recognizing such assets.

The genesis of the NPA crisis can be traced back to the onset of financial and economic boom in mid-2000s. Indian economy during this period entered the exuberant phase with economic growth surging to the 9% - 10% range. Riding on the economic and financial boom, the private non-financial players, especially in the manufacturing sector, drew up large investment plans. India's investment to GDP ratio moved from 26% in financial year 2004 to 35% in financial year 2008. This was backed by the unprecedented credit boom in the Indian history. In 2008, as the world was plagued by the global financial crisis, the boom in India came to a sudden stop. Fresh investments became more expensive and the Reserve Bank of India tightened its rules around lending.

The sudden increase in the financing cost coupled with the depreciation of the Indian currency and global impact of the financial crisis increased the burden of repayment on the corporates. Today, as per a report by CARE ratings[1], India has the highest level of NPA amongst the BRICS countries and is overall ranked fifth on a list of countries with the highest level of NPAs.



Graph 1: High Level of NPAs

Among the major economies of the world, India has the second highest ratio of NPAs (9.85%). In contrast, China, whose economic growth is largely fueled by borrowings, has only 1.75% NPA. Among the various industries, basic metals and cement industries are the most indebted, with 45.8% and 34.6% stressed assets respectively. The numbers are unlikely to improve as the metal industry continues to be hamstrung by slow demand and cheaper imports.

> As per the Reserve Bank of India data, the bad loans of Public Sector Banks (PSBs) stood at around INR 7.34 lakh crore where as that of the private sector banks was considerably lower at INR 1.03 lakh crore at end of September 2017. A bulk of the bad loans comes from corporate defaulter.

RBI has also recently withdrawn a host of restructuring schemes (e.g. 5:25, Strategic Debt Restructuring, Scheme for Sustainable Structuring of Stressed Assets, Corporate Debt Restructuring). An estimated 3% of banking assets currently under such schemes may become NPAs.

Challenges in managing NPAs

The regulatory landscape is changing with focus on early identification of underperforming assets and taking appropriate steps for managing bad assets. However, NPAs will continue to pose a serious challenge for the banks. Corporate borrowers continue to be under tremendous pressure as a result of slowdown in trade. The banks are still in the process of ensuring that they have consistent and reliable data available to them in order for them to recognize signs of stress at an earlier stage.

RBI has suggested measures on a periodical basis to strengthen the operational risk management and to generate an early warning signal for stressed assets. The early warning systems are not properly implemented they are manual and are performed in silos. Moreover, there is no effective mechanism for utilizing the decision parameters or KPIs for identifying a potential NPA. The analytical tools available in market covers only objective parameters for financial and operational aspects, which are quantitative in nature. But there is no way of identifying and using the subjective or qualitative parameters in decision making. This has resulted in manual decision making by Bank Management, both at the stage of loan origination and loan management, with partial support from the analytical tools.

[1] http://www.careratings.com/upload/NewsFiles/SplAnalysis/NPAs%20Globally%20speaking.pdf

RBI guidelines for NPA

The RBI revised framework[2] has substituted the existing guidelines with a harmonized and simplified generic framework for resolution of stressed assets. Following are the constituents of the framework:

Early identification and reporting of stress

As per new guideline immediately on default, lenders will have to identify incipient stress in loan accounts and classify the stressed assets under categories SMA-0, SMA-1 and SMA-2 based on principal or interest payment or any other amount wholly or partly overdue between 1-30 days, 31-60 days and 61-90 days, respectively. For borrowers having aggregated credit exposure of INR 50 million or above will have to be reported under Central Repository of Information on Large Credits based on the SMA categories.

Implementation of Resolution Plan (RP)

Lenders will have to initiate steps to cure the default as soon as there is a default in borrower entity's account with any lender/ all lenders, irrespective of the fact if the account is singly or jointly held. There has been no change in terms or conditions of RP, hence it needs to be clearly documented by all the lenders.

Implementation Conditions for Resolution Plan (RP)

RP will be deemed implemented when borrower entities with whom the lenders continue to have credit exposure, is no longer in default with any of the lenders. In case the resolution involves restructuring; then

- All related documentation, including execution of necessary agreements between lenders and borrower / creation of security charge / perfection of securities have to be completed by all lenders
- The new capital structure and/or changes in the terms of conditions of the existing loans should get duly reflected in the books of all the lenders and the borrower[2]

Stringent supervisory / enforcement actions will be taken by RBI in case of failure to adhere to the prescribed timelines or an actions with an intent to conceal the actual status of accounts or evergreen the stressed accounts by the lender, and it will not be limited to higher provisioning on such accounts and monetary penalties.

RBI has also issued various circulars last year relating to NPA:

01 Additional provisions for standard advances at higher than the prescribed rates

02 Disclosure in the 'Notes to Accounts' to the financial statements -Divergence in the asset classification and provisioning

03 Guidelines on compliance with Accounting Standard (AS) 11

Approach to address NPA issues and Regulatory requirement

Technology when used effectively can go a long way in solving the concern of rising NPA. Historically banks have not been using Information technology effectively for NPA management. However now the regulators/banks around the world are identifying key role that IT can play in NPA management. Banks have been mandated to have automated data management, using which regulatory reporting of NPA can be done with minimum manual intervention.

> Easy access to unified data would enable banks to identify the signals of distress in form of early warning signals and help banks to take necessary remediating steps before situation worsens. Moreover, the first level coordination and actions which is largely manual when building a EWS solution can be improved by using RPA with EWS analytics. Further, stringent controls needs to be built in system to ensure any divergence to underwriting norms is flagged.

Automated data management would enable banks in getting MIS on sectoral/industry wise break up of advances, quantum wise NPA and movement of NPA. It will also enable banks in assessing asset quality, forecast potential NPA, monitor movement of asset class and assess provision requirements.

Banks can also analyze NPA dimensions across various verticals like geographical areas, industry, sector, activities. This would help in identifying the verticals which are on higher risk of default and hence any advance to these verticals need to be thoroughly scrutinized and tracked. Technology can also help in

[2] https://rbidocs.rbi.org.in/rdocs/notification/PDFs/131DBRCEC9D8FEED1C467C9FC15C74D01745A7.PDF

performing sensitivity analysis of potential impacts of policy changes from regulator or government.

Another use of technology would be to create a big data platform which processes data related to a company from various sources including social media and then use analytical tools to provide insightful information on borrowers. External sources can provide industry sentiment of corporate borrower. This would provide insights to prevent borrowers from having the arbitrage out of distributed, unconnected and diverse databases.

EWS solution with Big Data capability can help in identifying stress in corporate and improve Underwriting and Loan management lifecycle. Further Big Data platform can be leveraged in ECL calculation that can assist in loan underwriting decision making and NPA management.

Blockchain technology can help financial industry in ensuring transparent and clean transactions. Key aspect of blockchain is its decentralization feature where in no single authority has full control over it and there is no central point of control. Storing data in blockchain eliminates the risk that comes with storing data centrally. Blockchain helps remove intermediaries in transactions, maintains auditable logs and facilitates real time execution of transactions. Smart contract in case of banking, is a program capable of digitally facilitating, verifying or enforcing the negotiation or performance of a contract.

Blockchain has the capability of identifying any inconsistencies in the transaction basis reconciliation with Core Banking System and raising red flag. Connected ecosystem can ensure all the parties share the collective intelligence. If the core banking system is integrated with blockchain, willful defaulters and clients breaching individual or group borrowing limits can be immediately identified.

Along with Blockchain; analytic models can easily decipher patterns of siphoning of funds from multiple points in the financial system based on unique identifiers and big data.

To summarize automating Loan management and leveraging emerging technologies can help in:

- Flagging non-performing accounts using EWS
- Analysis of repayment capacity so that bank can offer flexible payment choices
- Identification and resolution of root cause of occurrence of NPA

Regulatory News

Priority Sector Lending – Targets and Classification

After reviewing Priority sector Lending profiles of foreign Banks with 20 branches or more, In order to create level playing field within banks, RBI has issued a new circular making sub-targets of 8% of Adjusted net Bank Credit (ANBC) or Credit Equivalent Amount of Off-Balance Sheet Exposure (CEOBE), whichever is higher, applicable for foreign banks having 20 branches or more, for lending to the small and marginal farmers from FY 2018-19. Similarly, Sub-targets of 7.5% of ANBC or CEOBE, whichever is higher, for bank lending to Micro enterprises (ME), also becomes applicable from Current FY (2018-2019).

The official notification on the same can be accessed here.

Discontinuance of Letters of Undertaking (LoUs) and Letters of Comfort (LoCs) for Trade Credits

The Reserve Bank of India has decided to discontinue the practice of issuance of LoUs/ LoCs for Trade Credits for imports into India by AD Category –I banks with immediate effect after review of extant guidelines. However, Letter of Credit and Bank Guarantees may continue to be issued for trade credits for imports into India subject to compliance guidelines.

Here is the link to the official notification.

Taking over of valuation of Government Securities (G-Sec) by Financial Benchmark India Pvt. Ltd. (FBIL)

FBIL has been advised to take over the responsibility of Valuation of Government Securities (issued by both centre and the states) with effect from 31st of March 2018, erstwhile done by FIMMDA. As per current Directions, All the RBI regulated entities, including Banks, NBFC's, Primary Dealers, Co-operative banks and All India Financial Institutions who value securities using FIMMDA Prices, shall use FBIL Prices with effect from 31st March 2018. Other Market Participants who have been using yields published by FIMMDA for valuation may use FBIL yields.

Here is the link to the official communication.

Submission of returns by the Government-owned Non-Banking Financial Companies

The Reserve Bank of India has asked all government owned NBFCs to place a reporting system for filing periodic returns with the bank as per extent applicable to them basis their size and acceptance of public deposits. The returns shall be compiled on the basis of figures available in the book of accounts of NBFCs and filed with the RBI on-line using COSMOS Software package by an authorized official. All weekly, quarterly, returns up to 31st December shall be submitted April 15, 2018.
Details of the notification can be accessed here.

Foreign Exchange Management (Cross Border Merger) Regulations, 2018.

RBI has issued new regulations related to cross border merger related to Foreign exchange management. The new set of regulations has defined inbound and outbound merger in detail along with guidelines to be considered for valuation, reporting and approval.
The official notification can be viewed here.

Separate limit of Interest Rate Futures (IRFs) for Foreign Portfolio Investors (FPIs)

In order to promote further marker market development and to ensure the access of FPIs to IRFs remains uninterrupted, RBI has decided to allocate FPIs a separate limit of INR 5000 cr for long position in IRFs. As per existing rules, FPI limit in Government securities (G-secs) is fungible between investments in G-secs and investments in FPIs. FPI long positions in IRF are not allowed on G-sec limit utilization reaching 90%. Detailed operational guidelines will be issued separately by SEBI. The limits prescribed for investment by FPIs in G-secs (currently ₹ 3,01,500 crore) will be exclusively available for investment in G-secs. All other terms and conditions of the extant IRF directions will remain unchanged.
The official notification can be viewed here.

Other Regulatory News

Due diligence and reporting requirements under Foreign Account Tax Compliance Act (FATCA) and Common Reporting Standards (CRS)

SEBI has issued guidelines via Circular to all Reporting Financial institutions (RFI) regarding due diligence and reporting requirements falling in ambit of FATCA and CRS. The circular emphasizes the need to have proper framework, process and system in place to validate the information collected.
Here are the details of the disclosures to be made in this regard.

Decision on the Recommendations of Kotak Committee on Corporate Governance

Following the recommendations made by Kotak Committee on Corporate government, SEBI met in Mumbai and accepted several recommendations of the committee without any modifications. Some of these include recommendations such as reduction in number of directorships from 10 to 8 for listed entities, expansion of eligibility criteria for independent directors, auditor credentials disclosure, etc.
Other details of the notification can be viewed here.

Discussion Paper on Compliance with SEBI Regulations by listed entities undergoing Corporate Insolvency Resolution Process under Insolvency and Bankruptcy Code, 2016

The Securities and Exchange Board of India has published a paper for public comments on corporate insolvency resolution process under insolvency and Bankruptcy Code 2016. The report consists of Existing Provisions and Proposals for Sections under consideration. Interested parties can send their comments by post or email till April 15, 2018. The official communication from SEBI for the same can be viewed here.

Global Regulatory News

Basel Committee publishes follow-up reports on Basel III implementation assessments and an updated Handbook for jurisdictional assessments

The Basel Committee on Banking Supervision has published reports of follow up action taken as of end 2017 to address deviations from the Basel standards. The reports have been published on the Basel committee website along with Regulatory consistency assessment Program (RCAP). The committee has also published an updated version of its Handbook for Jurisdictional assessments. An Important addition to this handbook is the RCAP self-assessment questionnaire which is used for preparing assessments by its member's jurisdictions. The official press release can be viewed here.

Basel Committee proposes revisions to minimum capital requirements for market risk

The Basel Committee on Banking Supervision has announced revisions to minimum capital requirement. These revisions are part of overall efforts being taken by Basel for improving the global regulatory standards since global financial crisis. These revisions will address issues which were identified during the monitoring the implementation and impact of the market risk standard issued in Jan 2016. The committee has also asked for comments on consultative document which can be uploaded by 20th June 2018. The proposed changes emphasizes on standardized approach and its measurement for enhancement of risk sensitivity including changes to FX risk.
The final press release can be viewed here.

FCA sets out its Approach to Supervision and Enforcement

Financial Conduct Authority (FCA) has published its approach to supervision and approach to enforcement as committed during the launch of its mission. These will help in explaining regulation in more detail with transparency in its thought process. The detailed communication cab be viewed here.

ECB launches public consultation on draft guides for banks on their capital and liquidity management

In continuation to multi-year plan for ICAAPs and ILAAPs, ECB has launched a public consultation on draft principles basis its expectations for bank's internal capital adequacy assessment processes (ICAAPs) and internal liquidity adequacy assessment processes (ILAAPs). The consultation runs from 2 March to 4 May 2018. The ECB will also hold a public hearing on 24 April 2018 via telephone conference. After receiving first round of feedback on ICAAPs and ILAAPs between February and April 2017, ECB is now inviting financial industry and other interested parties to provide feedback on updated guide.

ECB's official press release for the same can be viewed here.

ECB aims to ensure that banks apply rules on internal models in a consistent manner

European Central Bank (ECB) has published first chapter of its guide to Internal Models for Consultation. The purpose of the guide is to ensure a common and consistent approach on internal models for banks directly supervised by ECB. First chapter talks about various general and non-specific-model topics related to Internal Ratings based (IRB) approach, implementation, validation, audit, usage of the model, involvement of third party. Complete guide will include all model specific chapters for credit, market and counterparty Risks. These chapters will be consulted by ECB on a later date.

The details of the reference database can be accessed here.

ECB sets out its supervisory expectations for new NPLs

European Central Bank (ECB) has published addendum to its previous guidance to banks on non-performing loans (NPLs).
This addendum is non-binding and lays down the supervisory expectations for prudent levels of provisions for new NPLs. The addendum addresses loans classified as NPLs in line with the European Banking Authority's definition after 1 April 2018.The official notification from PRA can be viewed here.

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