Financial RegTech Newsletter

September 2020

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NPA management solution

Introduction

Amidst the global economic slowdown due to the COVID-19 pandemic, financial institutions (FIs) worldwide are facing a significant challenge in the form of non-performing assets (NPAs). Although most of the macroeconomic factors that aggravate the increase in NPAs are not directly controllable by FIs, it is important that the volume of NPAs is kept in check, despite the economic situation. FIs should use a robust NPA management solution to efficiently track the NPA journey, from identification to provisioning.

The Reserve Bank of India (RBI) released a circular on 14 September 2020 in which it has mandated banks to automate asset classification, provisioning and income recognition processes by 30 June 2021.[1] In this edition of PwC's RegTech newsletter, we take a closer look at the mandate, challenges posed by it and possible solutions to overcome those challenges.

1 https://www.rbi.org.in/Scripts/BS_CircularIndexDisplay.aspx?Id=11964

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Highlights of the mandate

The RBI in its earlier circular (4 August 2011) mandated banks to use appropriate information technology (IT) systems for asset classification and provisioning. However, the RBI recently observed that many banks are yet to fully automate the entire process. Banks are still dependent on manual identification of NPAs and regularly overriding the system-generated asset classification by manual intervention.

Some of the key highlights of the RBI's most recent circular are discussed below:[2]

- All borrower accounts, including temporary overdrafts, irrespective of size, sector or types of limits, shall be covered in the automated IT-based system asset classification, upgradation, and provisioning processes.
- Asset classification rules shall be configured in the system, in compliance with the regulatory stipulations.
- Calculation of provisioning requirement shall also be system based as per pre-set rules for various categories of assets and any other regulatory stipulations
- Income recognition/derecognition in case of impaired assets and amount required to be reversed from the income account should be obtained from the system without any manual intervention.
- The system shall handle both downgrade and upgrade of asset classification through Straight Through Process (STP) without any manual intervention.
- Banks should ensure that the asset classification status is updated as part of day end process and should also be able to generate classification status report at any given point of time
- Exceptions may be granted from system-driven classification in certain circumstances, which are expected to be minimum and temporary.
- In any exceptional circumstance where manual intervention is required to override the system classification, it must have at least two-level authorisation.
- Banks shall maintain logs for all exceptions which should be system generated and shall also be stored for a minimum period of three years.
- In case a separate application outside the Core Banking System (CBS) is used for NPA/NPI identification and/or classification, the system must have access to the required data from the CBS and/or other relevant applications of the bank and the borrower/investment accounts shall be updated back into the CBS automatically, wherever applicable, through STP.
- There should be periodic system audit, at least once in a year, by internal/external auditors.

2 https://www.rbi.org.in/scripts/NotificationUser.aspx?Id=11964&Mode=0

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Current challenges

Historically, banks have not been using technology efficiently for NPA management. Manual interventions and reliance on a core banking solution (CBS) for asset classification is still prevalent in most of the banks. Also, the provisioning of NPA accounts and preparation of reports using a management information system (MIS) are still done in silos. A few challenges that limit NPA automation across banks are discussed below.

- **Multiple IT systems across product life cycle:** As banks continue to grow and increase their customer base, it is common for them to have disparate source systems for different products and processes. Consistently changing regulatory guidelines have further made it difficult for banks to calculate NPAs and maintain uniformity across all their source systems.
- **Lack of a unified customer view:** Income Recognition and Asset Classification (IRAC) guidelines require asset classification at the borrower level as the worst asset classification across all the products held by the borrower. With the prevalent use of multiple source systems across products, consolidating classification at the customer/borrower level of information across systems becomes a daunting task.
- **Manual processes and absence of an automated workflow:** Distributed source systems and the unavailability of a unified customer view lead to manual interventions. Also, the absence of an automated workflow for identification and classification of NPAs across systems leads to errors and inconsistencies.

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Solutions and approach

The above challenges can be addressed by banks in two ways. They can upgrade their existing source systems so that they are in accordance with all the requisite mandates issues by the RBI. Alternatively, they can look forward to building/implementing a complete end-to-end automated workflow-based solution that complies with the IRAC guidelines prescribed by the RBI.[3]

Challenges	Upgrading existing systems	Independent system for classifying NPA accounts
Multiple source systems across product life cycles	The CBS containing account-level information should handle IRAC-related guidelines.	A rule engine enabled system complying with the IRAC guidelines is implemented.
Lack of a unified customer view	The CBS should collate all the account-level data from the secondary source systems and provide a unified view of the customer/borrower.	The system should be able to integrate data from all the involved source systems.
Manual processes and absence of an automated workflow	The CBS should have the provisions to make manual adjustment with the maker-checker workflow.	Manual intervention capabilities with an automated workflow and audit trails should be availble in the system.

3 https://www.rbi.org.in/Scripts/BS_CircularIndexDisplay.aspx?Id=11964

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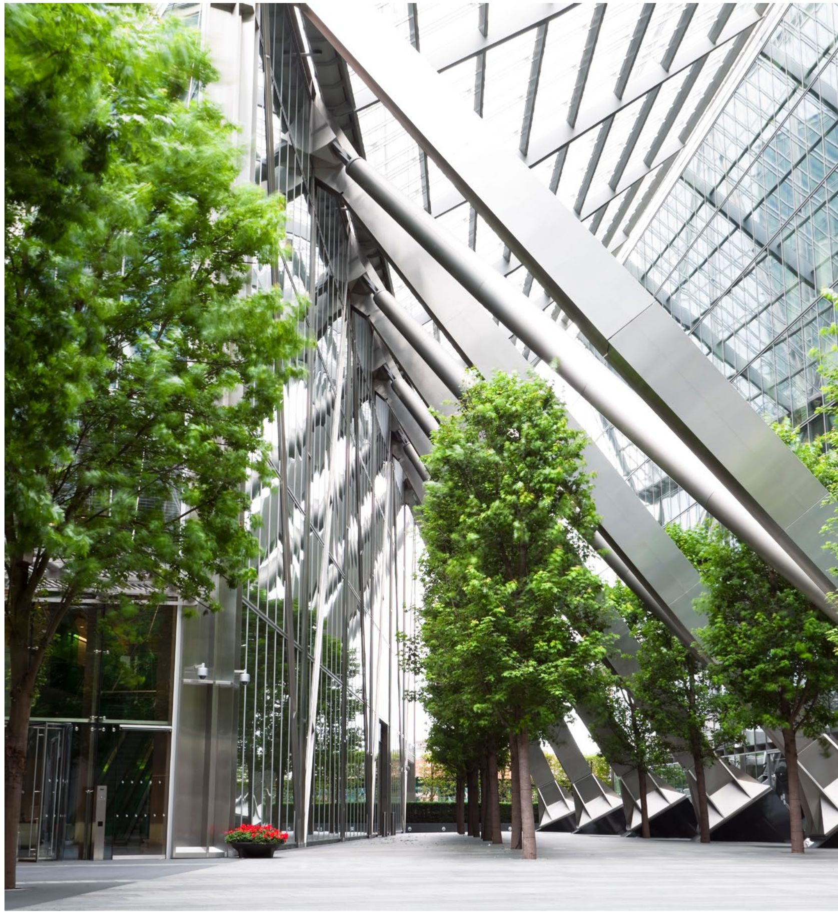
Approach

For the implementation of both the solutions, banks must follow an approach that requires the consolidation of all requisite data on a common data platform and then coming up with a rule-based configuration interface for identification, classification, provisioning and reporting of NPA accounts as per the IRAC guidelines.[4] The approach should also consider manual intervention for decisions based on banks' judgements and supported by the maker-checker workflow.

- The NPA analysis architecture should be designed to integrate data from the source systems as well as manual sources. When consolidating data from multiple source systems, it is important to ensure that adequate data quality checks are performed and the changes in master data are logged systematically.
- The rule engine for classification and calculation forms the core of the architecture required for automating NPA accounts. Data should be modelled to incorporate the complete product life cycle and the in-built rule engine can be applied as per the IRAC norms. The rule engine should be made configurable to accommodate dynamic changes in the NPA regulations as and when needed.
- Once classification and provisioning is completed on the basis of the prescribed rules, the solution should provide for manual overrides that require at least a two-factor authentication. It is mandatory to enter the details of all the overrides in the audit logs.
- The architecture should also be capable of integrating the final NPA classification results with the source systems for updating ledger entries and account statuses. The engine output would also be used in generating regulatory returns, as well as a bank's internal MIS reports and dashboards.



4 https://www.rbi.org.in/Scripts/BS_CircularIndexDisplay.aspx?Id=11964

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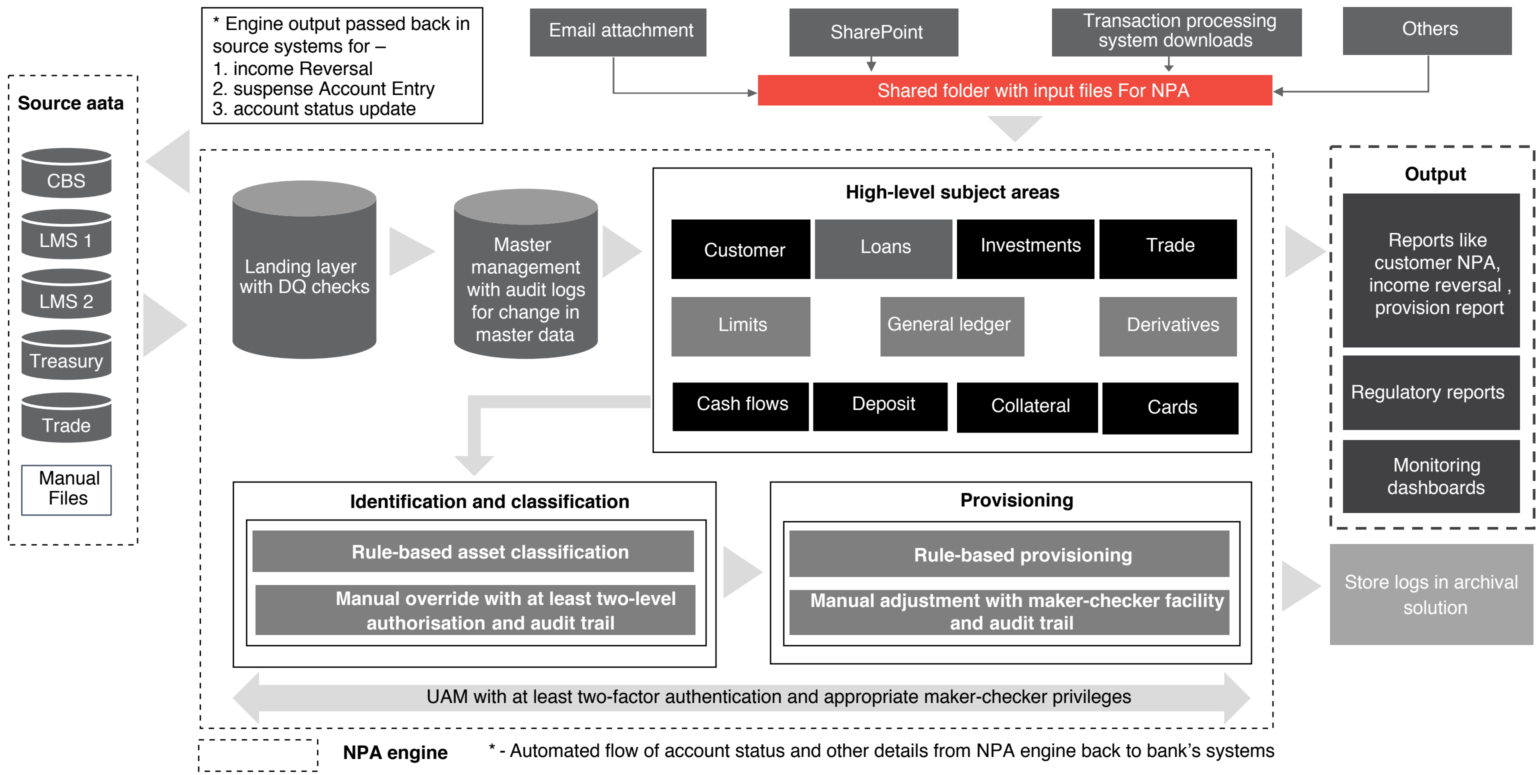
Functional architecture of an NPA analysis solution



Conclusion

The RBI is emphasising on automating NPAs to set up a streamlined and transparent process for asset classification and income recognition across banks. Such automation initiatives will help banks in reporting the details of NPA accounts to the regulators who can rely on the quality of the information shared with them.

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Interim relaxation in Ways and Means Advances (WMA) and overdraft (OD) limits

The RBI announced an increase in the WMA limit of states/union territories (UTs) to support the state governments in planning their market borrowings and undertaking COVID-19 containment measures smoothly. As of 31 March 2020, this limit was increased by 60% over and above the existing limit. This relaxation has now been extended till 31 March 2021.

OD regulations have also been relaxed till 31 March 2021 by increasing the number of days for which a state/UT can use the OD facility. The OD facility has been extended to 50 working days in a quarter.

The detailed notification can be viewed here.

Extension of Marginal Standing Facility (MSF) relaxations

The RBI allowed banks to avail funds upto 3% of their net demand and time liabilities (NDTL), i.e. cumulatively against their Statutory Liquidity Ratio (SLR). This facility, which was initially available till 30 September 2020 has now been extended till 31 March 2021.

The detailed notification can be accessed here.

Positive Pay System for Cheque Truncation System (CTS)

The RBI in its Statement on Developmental and Regulatory Policies for the month of August 2020 introduced Positive Pay System. In this process, some critical details of the cheque like the date, beneficiary name and amount will be submitted electronically by the cheque issuer. This new system will verify such details against the presented cheque through the CTS and report to the drawee and the presenting bank in case of any discrepancy.

This system is being developed by the National Payments Corporation of India (NPCI) and will be made available to all participant banks. Although the option to avail this facility lies with the account holder, banks might make it mandatory for high-value cheques worth above INR 500,000.

This detailed notification can be accessed here.

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Revised risk weights for regulatory retail portfolio

The RBI published a master circular on Basel III capital regulations. The circular assigns a risk weight of 75% to all the claims that form a part of regulatory retail capital. This means that the maximum retail exposure is capped at INR 5 crore at an aggregate level to one counterparty. To decrease the cost of loans to individuals and small businesses with a turnover of upto INR 50 crore, the RBI has decided to increase this retail exposure from INR 5 crore to INR 7.5 crore.

This recent circular can be viewed here.

Other regulatory news

Asset allocation of multi-cap funds

The Securities Exchange Board of India (SEBI) published guidelines on the categorisation of mutual fund schemes. These guidelines will help in diversifying the investments of multi-cap funds across large-, medium- and small-cap companies.

According to SEBI's guidelines, the minimum investments in equity and equity-related instruments stand at 75% of the total assets. Minimum investment in equity and related instruments for large-, medium- and small-cap companies is 25% each.

The detailed notification can be accessed here.

Review of dividend option/plan in mutual fund schemes

In accordance with SEBI's circular no. SEBI/IMD/CIR No 18/198647/2010 dated 15 March 2010, a change has been suggested by SEBI with respect to the realised gains when units are sold at a price higher than their face value.

This surplus amount should be credited in an Equalization Reserve Account that can be used to pay dividend.

This amendment should be clearly communicated to investors through offer documents and scheme-related documents.

This detailed notification can be accessed here.

Risk Management Framework for zero and negative prices

High volatility is being observed in global commodity prices as they have dropped to near-zero levels. In such a scenario, even a 100% margin will not suffice to cover such steep variations.

SEBI constituted a Task Force of Clearing Corporations (CCs) to recommend an alternative framework to cater to such scenarios.

The detailed notification can be accessed here.

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Commodity Futures Trading Commission (CFTC) and the Office of Financial Research (OFR) sign an MoU to share information

Form CPO-PQR is a report filed by the commodity pool operators (CPO) with the CFTC. Details of this report, along with data history, will help the OFR in performing their statutory responsibilities and facilitate their research on financial stability.

Exchange of this information was not possible until this memorandum of understanding (MoU) was signed between the CFTC and the OFR. Exchange of this information will also help the OFR in identifying risks and raising it to the Financial Stability Oversight Council (FSOC) at the right time.

This detailed guideline can be accessed here.

The International Swaps and Derivatives Association (ISDA) published a paper on greater colloboration between derivatives and securities financing transaction (SFT) markets

The ISDA published a white paper highlighting areas where coordination between derivatives and SFT markets can be enhanced and the two markets can be closely aligned.

It details several points, including:

1. creating a standard document for overlapping terminologies and having a single set of laws and jurisdiction
2. building processes that will help firms in updating/ implementing legal or regulatory policies consistently in both the markets
3. increasing interoperability between these two markets.

The detailed notification can be accessed here and full paper can be accessed here.

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Acknowledgements

This newsletter has been researched and authored by **Deepak Kanojia**, **Anurag Gupta**, **Sayan Maiti** and **Akanksha Mota.**

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KS/October 2020-M&C 9098