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Preface

Based on the five- pillar framework for developmental and regulatory measures, the changes in the regulatory landscape for the month April 2014 are evident. The measures are as set out by the RBI in the Second Quarter Monetary Policy Review announced in October 2013. The same has been reiterated in the bi-monthly monetary policy released on 1 April 2014. A large majority of the guidelines issued in the month were also in tandem with the bi-monthly monetary policy statement.

Additionally, several recommendations from the Expert Committee to revise and strengthen the Monetary Policy Framework have been implemented including the formal adoption of new CPI (combined) as the key measure of inflation and explicit recognition of the glide path for disinflation. As per the committee's recommendations, the Reserve Bank has also decided to further reduce access to overnight repos under the LAF while compensating fully with a commensurate expansion of the market's access to term repos from the Reserve Bank. The primary objective is to improve the transmission of policy impulses across the interest rate spectrum and for evolving better market based benchmarks for pricing of financial products.

Further, taking into consideration the suggestions of Committee on Financial Benchmarks, the RBI has issued guidelines with respect to the policy level expectations and operational requirements of the benchmark submitters. An analysis of the guideline has been provided in the further sections of this document. The RBI has also released a report on the Working Group on Pricing of Credit, which has recommendations that are no doubt progressive and forward looking. However, we feel that there are certain areas in the proposed framework where a certain amount of clarity and / or elaboration might be helpful for the banks.

Significant progress has been made in rationalizing the investment environment and establishing a comprehensive regulatory framework for the Foreign Portfolio Investors (FPIs) over the past quarter. As a result of the notifications issued in April 2014, the onus of KYC related procedures for FPIs has been shifted to Designated Depository Participants (DDPs), thereby simplifying the procedures for opening bank accounts for them. However, there is still some ambiguity regarding the DDPs' responsibilities with respect to KYC / due diligence procedures and the same needs to be addressed by the regulators before the FPI regime goes live.

Going forward, the five-pillar approach model will continue to guide the design and calibration of developmental measures. The Reserve Bank will strive to increase the reach of financial services to everyone, however remote or small, by using technology, new products, and new entities to link people up to the formal financial system. Priority sector lending will become an effective vehicle to promote greater financial access. Simultaneously, the Reserve Bank will take steps for early recognition and resolution of cases of distress with a focus on putting real assets back to work in their best use.

Working group on pricing of credit - a special feature article

Working group on pricing of credit- a special feature

A new credit pricing landscape

The reforms that are highlighted in the Working group report by the regulator are about incremental changes and will trigger a shift to a new credit pricing landscape. Many on the new requirements are intended to be positive for the market as a whole through promoting transparency, competition, customer satisfaction and the orderly functioning of the credit pricing mechanism.

Background

The primary objective of any credit pricing framework is to achieve the following goals:

- Protection to consumers from lenders' unfair practices
- Effective mechanism for monetary policy transformation
- Provide flexibility to banks for adjusting interest rates
- Enhance credit pricing methodologies of products

While the country has come a long way from a regulated interest rate regime to a market determined mechanism of interest rates, the market was required to be fair and transparent to determine the interest rates and ensure that customers remain unaffected. Indian banks face challenges around providing customer satisfaction, a part of these challenges stem from the fact that monetary policy transmission for reduction in interest rates to customers is with a lag and at times policies adopted by banks lead to discrimination in pricing of credit due to the use of qualitative judgment, which is not necessarily fair. Further, customers complained around issues relating to sanction delays, lack of communication on sanction decisions, inadequate dissemination of information to the borrowers, lack of standardized procedures, etc. Given that there were challenges in achieving the credit pricing objectives in its entirety, in the second quarter review of Monetary Policy in October 2011, the Reserve Bank announced that a working group will be constituted to examine the reasons for the non-achievement of objectives and suggested recommendations for revising the credit pricing framework to help achieve the same. Accordingly, a group was constituted under the Chairmanship of Shri Anand Sinha, Deputy Governor, Reserve Bank of India ("RBI") comprising members from banks, IBA, academia and the RBI.

Revised credit pricing framework – a step in the right direction

The recommendations of the working group are focused to determine the appropriate framework for resolving the two components of the interest rate – the benchmark rate and the credit spread – to help achieve the objectives of an ideal credit pricing framework. Typically, the benchmark rate used for credit pricing can either be an inter-bank market rate or the overnight market rate or the banks internal cost of funds index. The spread comprises of various factors that include specific product operating cost, credit risk premium, tenor premium, competition, strategy, customer relationship, etc. The working group has made a total of 16 recommendations and all of them are primarily made with an intention to improve market and customer confidence.

The recommendations are no doubt progressive and forward-looking. However, we feel that there are certain areas in the proposed framework, as mentioned below, where a certain level of clarity and / or elaboration may help the banks to improve their credit pricing framework

- Base rate methodology modification by banks - The draft report critically examines the methodology and major components of the base rate. Based on their extent of usage and relevance to the financial system, the working group has proposed changes to the methodology for computation of the base rate in order to improve transparency of the credit pricing mechanism, reduce customer complaints and improve the interest rate risk management function at banks. The working group has also laid down guidelines for introduction of a new base rate driven benchmark for floating rate products, which may be used by the banks for offering base rate linked products.

  While the industry is supportive of the efforts by the working group for reforming the base rate as mentioned in the draft report, clarity on whether the banks will be allowed to change / amend their existing base rate methodology and policy to reflect the changes proposed in light of the report by the working rgoup is required. The clarification by the working group will be of a significant help to banks in complying with the report, as the extant guidelines, dated 9 April 2010, do not allow for a change in the base rate methodology once the same has been implemented by a bank

- Introduction of IBBR, a new benchmark for lending - The draft report has placed significant emphasis on the development of a new benchmark for floating interest rate product and recommends that the floating rate shall be equivalent to or above the base rate of the bank at the time of sanction and renewals. While we acknowledge the merit of such a requirement, clarity on how the bank will address a situation where a new loan has been given on the basis of a floating rate benchmark, which on the date of sanction is higher than the current base rate, whereas on the next reset date the floating rate falls below the base rate is missing. Such a scenario is not possible in the extant of base rate regime. Accordingly, the working group should provide clarification in this regard to enable banks in dealing with such situations.

- Target RAROC based pricing framework for behavioral components - The draft report, specifically, emphasizes on addressing weaknesses in methodologies followed by banks for determining behavioral components like business strategy of the bank, customer relationship, competition with other market participants, etc. and suggests incorporation of a target RAROC methodology for determination of credit spread to be charged to the customers. However, there is no elaboration on the exact framework that will be adopted to achieve the same. Hence, the working group would need to provide more clarity on a broad framework including the methodology or the key components of the methodology for pricing the components of spread to avoid competitive distortion amongst banks.

- Phase in period for the proposed recommendations in the working group report - The draft report proposes a wide range of changes to the existing framework for pricing of credit, viz. transition to marginal cost of funds, board approved policy on rationale and a range of spreads over the base rate, implementation of a RAROC methodology, publication of pricing information on websites for customer empowerment, updation of loan documents and enhancement of grievance redressal systems. In light of the proposed changes and to optimally manage the burden of implementing them on banks, the working group would need to consider providing a timeline for transition period to facilitate a seamless and effective implementation of the proposed recommendations.

- Determining credit spread in case of credit deterioration - Banks employ credit spread, over and above the base rate, for the purpose of pricing loans. Further, one of the components of this credit spread is related to the credit profile of the loan applicant. As per the proposed recommendations in the draft report, banks would mandatorily be required to ensure that the change in the spread over the base rate after loan sanction is only in case of the credit deterioration. Another feature which would be of importance in this scenario is the collateral provided for the loan requirements and / or credit profile of the guarantor, as they both contribute to the rating provided to a customer and are considered for identifying the credit spread to be charged over and above the base rate. Therefore, if the value of the collateral provided by the customer undergoes fluctuations and / or the credit profile of the guarantor undergoes changes, there is ambiguity on whether this shall constitute to the change in the credit quality of the customer and lead to change in credit spreads. The working group will need to provide clarification in this area as consistent application of it is critical to avoid competitive distortion.

- Change in Annual Percentage Rate (“APR”) or total cost of loans and its impact - The draft report proposes that the applicable APR or total cost of credit to the customers should be crystallized and made available to customer as a loan covenant in the sanction letter provided to them. While this would provide them with the representation of the APR that is in line with current structure of loan and credit profile, as of the sanction date the applicable APR or total cost of credit would be different than that mentioned in the sanction letter, should there be any change in the credit quality of the customers or the structure of the facility. We would suggest that the working group provide due consideration to this challenge and provide clarification in this matter

- Disclosures on interest rates, fees and charges - The working group in its draft report has made several recommendations for banks to publish their interest rate, fees, other charges, etc. to bring in greater transparency in pricing and enable comparability across banks for customers to make an informed decision. While we concur with the desire to promote harmonization of disclosure requirements, we wish to emphasize that the banks should be allowed to publish interest rate range representing larger population and outliers should be excluded. Therefore, interest rate falling in top and bottom 10 percentile (or any other range, as the working group deems fit) should be excluded to ensure that the objective of ensuring a particular borrower is aware of the rates, which other borrowers of the similar profile receive for the same product is achieved. The working group should define the specific formats for disclosure across product classes, currencies, etc. to avoid confusion in the borrowers mind.

The consideration by the RBI working group of the above mentioned aspects would go a long way in ensuring and effective and efficient roll out of the credit pricing methodology by various banks, helping bring about the much needed standardization and consistency in the credit pricing framework.

Our point of view on key RBI guidelines issued in April 2014

Liquidity adjustment facility/ term repo under liquidity adjustment facility

RBI circular reference: RBI/2013-2014/549; RBI/2013-2014/550
Date of notification: 1 April 2014
Applicable entities: Scheduled Commercial Banks (excluding RRBs) and Standalone Primary Dealers

Background and objective

As mentioned in the bi-monthly monetary policy of the RBI dated 1 April 2014, the Reserve Bank has decided to further reduce access to overnight repos under the Liquidity Adjustment Facility (LAF) while compensating fully with a commensurate expansion of the market's access to term repos from them. The primary objective of this move is to move towards the interest rate regime as suggested by Urjit Panel Committee by making repo rate irrelevant over long term and adoption of rates via term repo auctions. The repo rate as a policy tool has been rather ineffective. However, now, through term repos the RBI can control both the liquidity as well as the rate at which it provides funds to banks. This 'on the go' rate setting via auctions is expected to give central bank a tighter grip over the market rates. Also, by controlling the amount of liquidity that RBI provides to banks at each auction, it gets to set the market rates for short-term funds at levels desired by it. This shift is expected to help the retail borrowers. The policy rates will also get reflected in the banks' lending rates more quickly.

Directives issued by RBI

As announced in the First bi-monthly Monetary Policy Statement 2014-15, it has been decided to decrease the quantum of liquidity provided under overnight repos under the Liquidity Adjustment Facility (LAF) from 0.5 per cent of bank-wise NDTL to 0.25 per cent with immediate effect.

All other terms and conditions of the current LAF scheme will remain unchanged.

Also, it has been decided to increase the quantum of liquidity provided under 7-day and 14-day term repos from 0.5 per cent of net demand and time liabilities (NDTL) of the banking system to 0.75 per cent with immediate effect.

All other terms and conditions of the current term repo scheme will remain unchanged.

Implications

By increasing the quantum of liquidity provided under 7-day and 14-day term repos from 0.5% of NDTL to 0.75%, RBI has ensured that banks will have more liquidity for a period of 7 and 14 days to ascertain any liquidity mismatches in the balance sheet as well as giving them a clearer picture on the interest expenditure that they will be paying for that period as compared to overnight repo transactions. It also allows market participants to hold liquidity for a longer period, thereby providing the opportunities for engaging in term transactions in the market, evolving better market-based benchmarks for pricing various financial products and also improving efficiency in cash management. However, banks only borrow a miniscule of their fund requirement via repo window. Hence, this move will not have any significant impact on either the deposit rate or the lending rate.

Also, reducing the amount that banks can borrow under this window for overnight repos from 0.5% to 0.25% of the NDTL and substituting this by increasing the quantum of borrowing in the new 'term repo' provided by the RBI allows RBI to supply funds from time to time, with banks bidding for the rates at which they will borrow this money in the term repo auctions. This will increase the bank's costs of funds and they may have to reduce their reliance on the RBI for liquidity support at a fixed rate and instead, adapt to 'floating' rates that RBI prefers to accept on each auction.

Through this move, RBI aims to move towards a transparent and effective interest rate framework.

Know Your Customer (KYC) norms /Anti-Money Laundering (AML) standards/ Combating of Financing of Terrorism (CFT)/ Obligation of banks under Prevention of Money Laundering Act (PMLA), 2002 – Harmonization of KYC norms for Foreign Portfolio Investors (FPIs)

RBI Circular reference: RBI/2013-14/552
Date of notification: 3 April 2014
Applicable entities: The Chairpersons/ CEOs of all Scheduled Commercial Banks (Excluding RRBs)/Local Area Banks / All India Financial Institutions

Background and objective

After the release of draft guidelines based on working group on Foreign Investment in India (WGFI) report, SEBI formed the "Committee on Rationalization of Investment Routes and Monitoring of Foreign Portfolio Investment" to amend required rules / regulations to rationalize / harmonize different routes for foreign portfolio investments. One of the recommendations of this committee was a risk based approach towards KYC and simplification of KYC for category I FPIs and progressively stringent norms for category II and category III.

The introduction of this guideline forms a part of the initiatives taken to pave the way for implementation of the FPI regime that was notified by SEBI in January 2014. Through this guideline, the KYC related procedures for opening bank account by FPIs have been simplified. FPIs duly registered in accordance with SEBI guidelines have to first undergo the required KYC due diligence / verification through authorized designated depository participants. Now, custodians / intermediaries regulated by SEBI are required to share the relevant KYC documents with the banks for opening a bank account for the purpose of investment under Portfolio Investment Scheme (PIS).Prior to the issue of this notification, the banks had to carry out the KYC documentation procedures independently for FPIs, which was inadvertently increasing the paperwork for both the banks and the FPIs. RBI has also been rationalizing and expanding limits for FPI investments in debt markets to encourage longer maturity flows and this guideline will be a further step towards inducing investments by FPIs. The main objective of this guideline is to rationalize the process of collecting the KYC documents from the FPI for opening of the bank account by removing the process of collection of the same documentation at multiple layers, thereby enabling a smooth operation of the regime.

Directives issued by RBI

Consequent to the Budget proposal for the year 2013-2014 and the recent amendments to the Prevention of Money Laundering (Maintenance of Records) Rules, 2005 (Rules), Securities and Exchange Board of India (SEBI) has rationalised the KYC norms for entry of FPIs (vide their circular MIRSD/07/2013 dated 12 September 2013). The Reserve Bank has been receiving suggestions regarding rationalisation of KYC norms in case of FPIs for opening bank accounts along similar lines. The matter has since been examined in consultation with the Government and it has been decided to simplify the KYC norms in the case of FPIs.

FPIs have been categorized by SEBI based on their perceived risk profile as detailed in Annex I. In terms of rule 9 (14)(i) of the rules, simplified norms have been prescribed for those FPIs who have been duly registered in accordance with SEBI guidelines and have undergone the required KYC due diligence / verification prescribed by SEBI through a custodian / intermediary regulated by SEBI. Such eligible/registered FPIs may approach a bank for opening a bank account for the purpose of investment under Portfolio Investment Scheme (PIS) for which KYC documents prescribed by the Reserve Bank (as detailed in Annex II) will be required. For this purpose, banks may rely on the KYC verification done by the third party (i.e. the custodian / SEBI regulated intermediary) subject to the conditions laid down in rule 9 (2) [(a) to (e)] of the rules.

In this regard, SEBI has been requested to advise custodians / intermediaries regulated by them to share the relevant KYC documents with the banks concerned based on written authorization from the FPIs. Accordingly, a set of hard copies of the relevant KYC documents furnished by the FPIs to the custodians / regulated intermediaries may be transferred to the concerned bank through their authorised representative. While transferring such documents, the custodian / regulated intermediary shall certify that the documents have been duly verified with the original or notarised documents have been obtained, wherever applicable. In this regard, a proper record of transfer of documents, both at the level of the custodian / regulated intermediary as well as at the bank, under signatures of the officials of the transferor and transferee entities, may be kept. While opening bank accounts for FPIs in terms of the above procedure, banks may bear in mind that they are ultimately responsible for the customer due diligence done by the third party (i.e. the custodian / regulated intermediary) and may need to take enhanced due diligence measures, as applicable, if required. Further, banks are required to obtain undertaking from FPIs or global custodian acting on behalf of the FPI to the effect that as and when required, the exempted documents as detailed in Annex II will be submitted.

It is further advised that to facilitate secondary market transactions, the bank may share the KYC documents received from the FPI or certified copies received from a custodian / regulated intermediary with other banks / regulated market intermediaries based on written authorization from the FPI.

The provisions of this circular are applicable for both new and existing FPI clients. These provisions are applicable only for PIS by FPIs. In case the FPIs intend to use the bank account opened under the above procedure for any other approved activities (i.e. other than PIS), they would have to undergo KYC drill as prescribed in our Master Circular DBOD.AML.BC.No. 24/14.01.001/2013-14 dated 1 July 2013 on Know Your Customer (KYC) norms / Anti-Money Laundering (AML) standards/Combating of Financing of Terrorism (CFT)/Obligation of banks under PMLA, 2002.

Banks may revise their KYC policy, in the light of the above instructions, and ensure strict adherence to the same.

Implications

For both existing and new bank account opening for FPI, banks can comply with the KYC norms either by relying on the KYC documents maintained by SEBI or by its authorized custodians, hence reducing FPIs KYC documentation hassle for banks.

But the banks should bear in mind that they are ultimately responsible for the customer due diligence done by the third party (i.e. the custodian / regulated intermediary) and may take enhanced due diligence measures.

Banks will, thus, need to ensure that all the documentation as required according to categorization of the FPI have been obtained and verified. Enhanced due diligence measures, if any, need to be incorporated as a part of the processes.

Further, banks are required to obtain undertaking from FPIs or global custodian acting on behalf of the FPI to the effect that as and when required, the exempted documents as detailed in Annex II will be submitted.

Foreign investment in India in Government Securities

RBI circular reference: RBI/2013-14/556
Date of notification: 7 April 2014
Applicable entities: All Category – I Authorised Dealer Banks

Background and objective

The Reserve Bank has been rationalizing and expanding limits for FPI investments in debt markets. To encourage longer maturity flows, investments by FPIs in G-Secs shall henceforth, be permitted only in dated securities of residual maturity of one year and above, and existing investment in treasury bills will be allowed to taper off on maturity / sale. The objectives are to develop the debt market by increasing participation of the players, to reduce volatility in exchange rate and to ensure longer maturity foreign exchange inflow in the country by way of investment in debt markets for a period of more than one year.

Directives issued by RBI

On a review, to encourage longer term flows, it has now been decided that foreign investment by all eligible investors including RFPIs shall henceforth, be permitted only in government dated securities having residual maturity of one year and above and existing investments in T-bills and government dated securities of less than one year residual maturity shall be allowed to taper off on maturity/ sale.

Implications

As a step towards encouraging longer-term flows, which would help reduce the volatility of rupee against the dollar; investments by FPIs in G-Secs shall henceforth, be permitted only in dated securities of residual maturity of one year and above, and existing investment in treasury bills will be allowed to taper off on maturity / sale.

The overall limit for FPI investment in G-Secs will, however, remain unchanged at US$ 30 billion, so the investment limits vacated at the shorter end will be available at longer maturities.

As a result of this guideline, there will be no fresh investments in T-bills and government dated securities of with residual maturity of less than one year, which would help in the increase of the long term foreign flows. The move is expected to prevent interest rate-related volatility as a result of restriction of investments in short-term securities.

Risk management and Inter-bank dealings: Booking of forward contracts - Liberalisation

RBI circular reference: RBI/2013-14/557
Date of notification7 April 2014
Applicable entities: All Authorised Dealer Category – I banks

Objective

Forward contracts are entered for the purpose of hedging exchange rate risk in respect of transactions for which sale and / or purchase of foreign exchange is permitted under the FEMA 1999. The broader perspective in forward contract booking is its one such derivative instrument wherein investors can hedge their currency risk against the underlying or against the past performance facility with any AD Category – I bank. The RBI makes changes, which it sees adequate, from time to time in its master circular on “Risk Management & Interbank Dealing” with regards to booking of forward contracts by residents with AD Category – I bank.

RBI in its circular No.15 dated 29 October2007 and under its special dispensation scheme in the master circular on risk management and inter-bank dealings liberalised the booking of forward contracts, in order to broaden the reach of this facility among SMEs and individuals. Resident individuals were given a special provision allowing them a leeway to hedge their foreign exchange exposures arising out of actual or anticipated remittances, both inward and outward, without producing any underlying documents, given they fulfil certain conditions. As far as SMEs were concerned, RBI had allowed them to hedge direct and / or indirect exposures to foreign exchange risk, without production of underlying documents to manage their exposures effectively, irrespective of the fact whether it is a booking / cancellation / roll over of forward contract subject to the prevailing conditions.

Directives issued by RBI

With a view to further liberalising the existing facilities, it has now been decided to allow all resident individuals, firms and companies, who have actual or anticipated foreign exchange exposures to book foreign exchange forward contracts up to USD 250,000 on the basis of a simple declaration without any requirement of further documentation. The existing facilities, in terms of the aforementioned circular for Small and Medium Enterprises (SMEs) having direct and/ or indirect exposures to foreign exchange risk, permits them to book/ cancel/ roll over forward contracts without production of underlying documents to manage their exposures effectively subject to conditions specified therein shall remain unchanged.

Implications

To encourage more hedging among resident individuals, firms and companies, RBI had liberalized the hedging limit for domestic investors to USD 250,000 from the existing USD 100,000 on the basis of a simple declaration without any requirement of further documentation, whereas for SMEs the limit remains unchanged.

On cancellation and rebooking front, RBI has specified that in case of mismatches in cash flows or other exigencies, the contracts booked under this facility will be freely allowed to be cancelled and re-booked. The notional value has also now been increased from USD 100,000 to USD 250,000 for transactions by an individual, annually.

However, this notification might not have a major impact on banks who have limited exposure to the SME sector.

Further, RBI has revised the format of reporting of 'Application cum declaration for booking of forward contracts by resident individuals, firms and companies' and also quarterly 'statement – details of forward contracts booked and cancelled under self-declaration', which are required to be submitted to RBI.

Differential rate of interest for Micro and Small Enterprises (MSEs)

RBI circular reference: RBI/2013-14/564
Date of notification: 15 April 2014
Applicable entities: All Scheduled Commercial Banks

Background and objective

The fourth pillar of development polices of the Second Quarter Monetary Policy, released in October 2013 talks about financial inclusion. The RBI has identified a need to accelerate the flow of credit to those at the bottom of the pyramid. The RBI has issued this guideline with a view to ensuring fair and transparent credit pricing and to give a fillip to the flow of credit to micro and small enterprises (MSEs) borrowers, in alignment with the fourth pillar of its developmental objectives.

With the issue of this circular, MSEs can borrow at differential interest rate under the credit guarantee cover. Lending at differential rates will also enhance the Credit Guarantee Fund Trust for Micro and Small Enterprises (‘CGTMSE’) Scheme’s acceptability and usage with a view to facilitating increased flow of collateral free credit to the Micro and Small Enterprises.

Directives Issued by RBI

While pricing their loans to MSE borrowers, banks should take into account the incentives available to them in the form of the credit guarantee cover of the Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE) and the zero risk weight for capital adequacy purpose for the portion of the loan guaranteed by the CGTMSE and provide differential interest rate for such MSE borrowers, than the other borrowers. However, banks should note that such differential rate of interest is not below the Base Rate of the bank.

Further, banks are advised to undertake a review of their loan policy governing extension of credit facilities to the MSE sector, with a view to using Board approved credit scoring models in their evaluation of the loan proposals of MSE borrowers.

Implications

Banks will be required to revise their loan pricing model for MSE borrowers with a view to allow the accounting for loans covered by credit guarantee cover of CGTMSE. Additionally, such loans should be given a zero risk weightage for capital adequacy purpose. Banks will, however, have to ensure that loans forwarded to such MSEs are not below the Base Rate of the bank.

They will also need to review their loan policy governing extension of credit facilities to the MSE sector; incorporating Board approved credit scoring models for evaluating loan proposals of MSE borrowers.

Enhanced Domestic Credit Guarantee Scheme acceptability as a result of lending at differential lending rates, will help the commercial banks / foreign banks with twenty or more branches to meet the targets for priority sectors lending along with achieving the objective of financial inclusion.

Financial benchmarks- Governance framework for benchmark submitters

RBI circular reference: RBI/2013-14/565
Date of notification: 16-Apr-14
Applicable entities: All Scheduled Commercial Banks and Primary Dealers

Background and objective

In the aftermath of revelations that several key global benchmark rates like the Libor, Euribor of European Union, Tibor of Tokyo, etc. were manipulated by leading market operators like RBS, and several global standard setting bodies, the RBI had set up a committee under its Executive Director,P Vijaya Bhaskar with a mandate to study the various issues relating to financial benchmarks. The panel was set with an agenda to enhance the robustness and reliability of financial benchmarks.

With the proposition of creation of a benchmark administration framework, it becomes very important to suggest a model code of conduct for the market participants, to ensure transparency and fairness in the benchmark administration process. While, most of the banks, especially the foreign banks, have already adopted some form of code of conduct around the benchmark submission process, given their group regulator pressures around the same, these guidelines help define the principles of transparency and fairness that are expected to be adopted by the market participants in the Indian Banking system.

Directives issued by RBI

The bank has since advised the FIMMDA and FEDAI to act as the administrator of the Indian rupee interest rate and foreign exchange benchmarks, respectively, and to take necessary steps to implement the recommendations of the committee. In order to overcome the possible conflicts of interest in the benchmark setting process arising out of the current governance structure of the FIMMDA and FEDAI, an independent body, either separately or jointly, may be formed by the FIMMDA and FEDAI for administration of the benchmarks. In case of benchmarks determined based on polled submissions, the FIMMDA and FEDAI may select the benchmark submitters on the basis of their standing, market-share in the benchmark / instrument linked to the benchmark and representative character and may put in place a Code of Conduct that specifies various provisions including hierarchy of data inputs for submissions as recommended by the committee. The benchmark submitters, thus, selected by the respective administrator, have to necessarily participate in the polling process and comply with the various provisions specified in the Code of Conduct. The benchmark submitters may extend necessary support and cooperation to the respective benchmark administrator in strengthening the benchmark determination process.

In order to strengthen the governance framework for benchmark submission, the benchmark submitters are advised to implement the following measures:

The benchmark submitters, may put in place, an internal board approved policy on governance of the benchmark submission process. The policy may ensure that clearly accountable personnel at appropriate senior positions with requisite knowledge and expertise are responsible for benchmark submissions.

They may put in place an effective conflicts of interest policy which facilitates identification of potential and actual conflicts of interest, with respect to, benchmark submissions and lays down procedures to be followed for management, mitigation or avoidance of such conflicts.

They may establish a maker-checker system to ensure integrity of the submissions. The submissions may be periodically reviewed by appropriate senior level officials in terms of minimum variance threshold with respect to the published benchmark levels.

They may establish appropriate internal controls to secure compliance with the benchmark submission procedures. The transactions, which are taken as the basis for submission may be recorded so as to verify that they represent bonafide arm's length commercial transactions, and are not undertaken solely for the purpose of benchmark submission. The personnel involved in benchmark submissions may document the verifiable basis for their qualitative assessment in absence of actual transaction data.

They may establish an effective whistleblowing policy to facilitate early detection of any potential misconduct or irregularities in the benchmark data submissions.

They may retain all records relating to benchmark submissions including those containing procedures and methodologies governing the submissions; names and roles of personnel responsible for submissions and oversight of submissions; declaration of conflicts of interest by the related personnel; relevant communications between submitting parties; interactions with benchmark administrator; exposure of individual traders as well as the aggregate exposures of the benchmark submitters to the instruments referenced to the benchmark; findings of internal and external audits and remedial actions taken thereof for a minimum period of eight years.

They may subject the benchmark submissions to periodic internal audit, and where appropriate, to external audit.

They may undertake submissions by way of written communications or through robust contribution devices which leave an audit trail to eliminate possibilities of errors.

They may conduct a reality self-check of their existing governance framework vis-à-vis the above guidelines and report the status to the respective benchmark administrator by 31 May 2014.

They may periodically (periodicity to be specified by the respective benchmark administrator) submit a confirmation to the benchmark administrator for having complied with the regulatory guidelines, as well as the provisions of the Code of Conduct to be issued by the respective benchmark administrator.

Implications

An analysis of the guidelines would reveal that the benchmark submitters for the rates and currency products are required to ensure the following, with respect to the themes mentioned below:

Policy level expectations

- A policy on benchmarking submission would need to be put in place by the Head of Trading within global markets business of the bank and the same would need to be approved by the global market head.
- A policy on managing conflict of interest would need to be jointly developed by the compliance function of the bank and the global markets team. A process for periodic review of the conflict of interest would need to be embedded by compliance as a part of their compliance testing procedures. A robust conflict of interest policy is the core of the governance framework for benchmark submitters and we expect a substantial amount of time being spent on the development of this policy.
- The whistleblower policy of the banks need to be amended to include the aspect of whistleblowing, with respect to, irregularities in the benchmark submission process

- There needs to be a rotation policy that may need to be applied, with respect to, benchmark submissions and all benchmark submissions need to be approved by an independent team, preferably the back office, rather than someone from the front office team. However, the banks may evaluate the cost benefit trade-offs and may choose to have the checker within the front office team, in which case, there needs to be an additional check of a periodic review built in with the back office at a pre-defined frequency, preferably on a weekly basis.

Operational expectations

- Thresholds, with respect to, each of the benchmarks need to be defined in line with the average volatility for the benchmarks and a reporting framework needs to be established at a treasury mid office level to report instances of benchmark submissions being higher than the defined thresholds. There should also be a process for periodic review of thresholds for each of the benchmarks, to ensure that the thresholds are reflective of the market realities.

- All documents with respect to benchmark submissions should have an audit trail and would need to be maintained for a minimum period of eight years. Most of the banks would have a record retention policy, which can be directly applied to these processes.

- The internal audit plan of the banks needs to include the checks around the governance framework for benchmark submissions. It would initially make sense for the internal audit teams to leverage special expertise in this domain, prior to including it as a part of their internal audit plan.

- One time confirmation of the adherence of the aforementioned guidelines would need to be submitted by the banks to the benchmark administrators by 31 May 2014. On an on-going basis, the banks would be expected to confirm periodic compliance to these governance requirements and model code of conduct, as may be defined by the benchmark administrators.

Fund/non-fund based credit facilities to overseas Joint Ventures (JV) / Wholly Owned Subsidiaries (WOS) / Wholly owned Step-down Subsidiaries of Indian Companies (WoSDS)

RBI circular reference: RBI/2013-14/568
Date of notification: 22 April 2014
Applicable entities: The Chairman and Managing Director/Chief Executive Officer All Scheduled Commercial Banks (Excluding Local Area Banks and Regional Rural Banks)

Background and objective

RBI permitted banks in India to extend credit facilities (fund / non fund based.) to overseas Joint Ventures (JV)/Wholly Owned Subsidiaries (WOS)/Wholly owned Step-down Subsidiaries (WoSDS) of subsidiaries of Indian companies up to 20 per cent of their unimpaired capital funds.

This move was intended to assist Indian companies in conducting their overseas business by offering such trade and working capital financing facilities.

However, Indian corporates were using their overseas arms to obtain cheaper funding through credit facilities offered by the overseas subsidiaries of Indian banks. This increased the systemic risk in the Indian banking system and also led to the practice of “evergreening”, a common term for refinancing, rather than restructuring non-performing loans.

Through this notification, the RBI is thus also forcing banks to deal with stressed loans by restricting the practice of "evergreening", because of which the amounts of non-performing loans in the Indian banking system have been grossly understated. This notification aims to curtail the misuse of offshore borrowing by Indian corporates to service rupee obligations.

Directives issued by RBI

It is advised that, banks, including overseas branches / subsidiaries of Indian banks, shall not issue standby letters of credit / guarantees / letter of comforts, etc. on behalf of overseas JV / WOS / WoSDS of Indian companies for the purpose of raising loans/advances of any kind from other entities except in connection with the ordinary course of overseas business. We further advise that while extending fund/non-fund based credit facilities to overseas JV / WOS / WoSDS of Indian companies in connection with their business, either through branches in India or through branches/subsidiaries abroad, banks should ensure effective monitoring of the end use of such facilities and its conformity with the business needs of such entities.

Repayment of rupee loans availed from domestic banking system through ECBs extended by overseas branches/subsidiaries of Indian banks will, henceforth, not be permitted.

In terms of circular A.P. (DIR Series) circular No.134 dated 25 June 2012, Indian companies in the manufacturing and infrastructure sector were allowed to avail of external commercial borrowings (ECBs) for repayment of rupee loans availed of from domestic banking system and / or for fresh rupee capital expenditure, under the approval route, subject to satisfying certain conditions. However, if the ECB is availed from overseas branches/subsidiaries of Indian banks, the risk remains within the Indian banking system. It has, therefore, been decided that repayment of rupee loans availed of from domestic banking system through ECBs extended by overseas branches/subsidiaries of Indian banks will, henceforth, not be permitted.

As per instructions contained in paragraph 4(1)(i) of notification no.FEMA 8/2000-RB dated 3 May 2000, Authorised dealer banks have been allowed to issue guarantees in respect of a debt, obligation or other liability incurred by an exporter, on account of exports from India. It was intended to facilitate execution of export contracts by the exporter and not for other purposes. It has, however, come to our notice that some exporter borrowers are using export advances, received on the strength of guarantees issued by Indian banks, for repayment of loans availed of from Indian banks. This is a clear violation of our instructions except in cases where banks have received approvals under FEMA and banks are advised to desist from such practices.

Implications

After the introduction of this guideline, JV/WOS /WoSDS of Indian companies can avail non-fund based facilities from Indian banks only for the purpose of their business and not for repayment of rupee loans. Companies, may however, avail loans from foreign banks and repay rupee loans.

As regards companies in manufacturing and infrastructure sectors, they will not be permitted to raise ECB from overseas branches of Indian banks to repay rupee loans. Domestic banks operating through foreign branches / subsidiaries will need to amend their ECB policy since the RBI has disallowed the repayment of Rupee loans availed of from domestic banking system through ECBs extended by overseas branches/subsidiaries of Indian banks.

To deter exporters from using export advances, received on the strength of guarantees issued by Indian banks, they will not be allowed to avail guarantees from Indian banks for the purpose of repayment of rupee loans, except when banks have received approvals under FEMA.

To ensure compliance with the points discussed above, banks need to institute a mechanism to monitor the end use of such facilities and its conformity with the business needs of such entities. This may involve certain banks to collect additional declarations or put in place enhanced due diligence before extending credit facilities to Indian JV / WOS / WoSDS.

Though this notification aims to improve transparency and prevent a build-up of risks within the Indian banking system, it could leave more companies facing funding squeeze.

Scaling up of the Business Correspondent (BC) Model – issues in cash management

RBI circular reference: RBI/2013-14/570
Date of notification: 22 April 2014
Applicable entities: The Chairman/ Managing Director/ Chief Executive Officer All Scheduled Commercial Banks

Background and objective

Business correspondents (BCs) are agents that transact on behalf of the bank, typically for deposits and payments. The Reserve Bank of India has taken several initiatives over the years for increasing banking outreach and ensuring greater financial inclusion - the Fourth pillar of RBI's development objectives.

A significant step in this direction was the issue of RBI guidelines in January 2006 for engagement of Business Correspondents (BCs) by banks for providing banking and financial services. Since then, the regulatory framework for the BC model has been through changes to ensure that consumer protection is not compromised while facilitating enhanced outreach of banking services.

They have gained importance over past one year due to recommendations of Mor Committee, which suggested inclusion of new entities as BCs and increasing their reach to the small and hitherto unbanked areas of the country. Such entities are necessary for achievement of financial inclusion. The objective of these guidelines is to reduce impediments to the growth of BCs.

Directives issued by RBI

The RBI advises that, after opening of large number of banking outlets in the last three years in hitherto unbanked areas of the country through the BC-ICT model, the time has come to monitor the usage in terms of transactions per BC so as to ensure sustainability of the BC model. One of the critical issues identified in this regard has been of cash management of BCs.

The insistence by banks on BCs to fully prefund their accounts even after considerably long business relationship has become a major impediment in scaling up operations of BCs. Similarly, low/delayed payment of remuneration of BCs and passing on the responsibility of insuring cash to BCs have also been proving to be irritants in increasing the usage in large number of bank accounts opened. It is, therefore, important for banks to recognize that cash handled by BCs, while doing banking business on behalf of the bank, is bank's cash. In view of the above and with a view to scale up the BC model it has been decided that:-

The Boards of the Banks must review the operations of BCs at least once every six months with a view to ensuring that requirement of prefunding of Corporate BCs and BC Agents should progressively taper down with the passage of time. Ideally in all normal cases the prefunding should progressively come down in such a manner so as to reach around 15% of the limits fixed for each BC/CSP in case of deposits and 30% in case of Bank Guarantees, etc. in say 2 years from the time a BC starts operations.

The board should also review the position of payment of remuneration of BCs and should also lay down a system of monitoring by the top management of the Bank. The issue of allowing BCs to handle deposit and payment transactions of various credits, remittance, overdraft and other products of banks must also be examined by the Board from time to time. Complaints redressal system in this regard should also be laid down by the Board.

As the cash handled by BCs is bank’s cash, the responsibility for insuring this cash should rest with the banks.

Implications

Following implications stem out from this guideline:

- Prefunding of accounts by BCs should be gradually reduced to 15% of limits fixed for them in case of deposits and to 30% in other cases (like Bank guarantees) within 2 years from the time BC starts its operations
- Board of the banks need to review BC's operations on a semi-annual basis.
- The board should also ensure that the payment to BCs is adequate and timely. This should be monitored by the top management.
- All the complaints of the BCs should be addressed by establishing a complaint redressal framework.
- Cash handled by BCs should be insured by the banks and not BCs.
- The internal audit framework within the banks would need to be aligned with these revised expectations.

All the points mentioned above clearly point out that the RBI intends to remove all the hurdles that stand in the way of growth of BCs and that it is committed towards its objective of financial inclusion.

Other guidelines issued by RBI during the month

S. No.	Guideline reference	Date of issue	Particulars	Impact
1	RBI/2013-14/553	4 April 2014	Foreign Exchange Management Act, 1999 (FEMA), Foreign Exchange (Compounding Proceedings) Rules, 2000 (the Rules) - Compounding of Contraventions under FEMA, 1999	As a measure to facilitate the operational convenience and customer service, RBI had decided to delegate the powers to the regional offices of the Reserve Bank of India for the following contraventions: i. Delay in reporting inward remittance received for issue of shares (Beyond 30 days from the date of receipt of the amount of consideration) ii. Delay in filing form FC (GPR) after issue of shares (beyond 30 days from the date of issue of shares) iii. Delay in issue of shares / refund of share application money beyond 180 days, mode of receipt of funds, etc. iv. Violation of pricing guidelines for issue of shares. v. Issue of ineligible instruments such as non-convertible debentures, partly paid shares, shares with optionality clause, etc. vi. Issue of shares without approval of RBI or FIPB respectively, wherever required. The above contraventions will be compounded by all regional offices (except Kochi and Panaji) without any limit on the amount of contravention. Kochi and Panaji regional offices can compound the above contraventions for amount of contravention below rupees one hundred lakh (INR1,00,00,000/-). The contraventions above rupees one hundred lakh (INR1,00,00,000/-) under the jurisdiction of Panaji and Kochi regional offices and all other contraventions of FEMA will continue to be compounded at Cell for Effective Implementation of FEMA (CEFA)

2	RBI/2013-14/559	9 April 2014	Policy for sale and purchase of property and acquiring/letting out property on lease/rental basis by banks at their overseas centres	Banks will have to lay down policies and formulate detailed operational guidelines to protect their interest with regard to agreements for acquiring / letting out premises on rental / lease basis. These policies and guidelines should be compliant with the provisions of Foreign Exchange Management Act, 1999, Banking Regulation Act, 1949 and other relevant Indian laws along with all the applicable laws of the host country / city or locality of the said premises.
3	RBI/2013-14/562	10 April 2014	Trade Credits for Imports into India – Review of all-in-cost ceiling	RBI has decided to allow all companies in the infrastructure sector to avail trade credit for imports into India till 30 June 2014.
4	RBI/2013-14/561	10 April 2014	External Commercial Borrowing (ECB) Policy – review of all-in-cost ceiling	The existing all-in-cost ceiling for ECBs i.e. 6 month LIBOR* + 350 bps for average maturity of 3 to 5 years and 6 month LIBOR* + 500 bps for average maturity more than 5 years will continue to be applicable till 30 June 2014.
5	RBI / 2013 – 14/575	28 April 2014	Usage of Transaction Type Code (TTC) in RTGS	It had been brought to the notice of the RBI that some of the RTGS participants are initiating Own Account Transfers (OAT) from RTGS settlement account to their current account maintained with RBI using the customer transaction code. All RTGS participants will now have to strictly adhere to the RTGS System Regulations, 2013 and use appropriate TTC Value while originating RTGS transactions. The TTC codes as confirmed by RBI are: "1000" - Customer Transactions "1800" - Own Account Transfers The RBI notification is silent regarding the penalty in case of non- adherence.

* for the respective currency of borrowing or applicable benchmark

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