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**Date: March 22, 2019**

To,
Shri Shaktikanta Das
Governor,
Reserve Bank of India,
Central Office Building,
18th Floor, Shahid Bhagat Singh Road,
Mumbai-400001

**Subject: Representation on issues related to Implementation of Large Exposures Framework**

Dear Sir,
The CFO Board is a group of senior finance professionals in the country to share their knowledge/ experience and also to deliberate on various regulatory developments affecting the industry and act as a sounding board between the government and industry to highlight the concerns and suggestions to improve the regulatory framework for advancement of industry and commerce.

The CFO Board debated the key requirements of the Circular on Large Exposure Framework (LEF Circular) issued by the Reserve Bank of India (RBI) on December 1, 2016, and its implications from corporate India's perspective.

The attached whitepaper is a high level analysis of some of the key issues that maybe relevant for RBI to consider before the framework becomes effective on April 1, 2019. Keeping in mind the intent of the LEF Circular and the challenges faced by the industry, it is our humble request that the suggestions made in this whitepaper be considered favourably. We would be glad to present our views in person if an opportunity of such meeting is granted by your good office.

Thanking you,
Yours truly,

For CFO Board

P.K. Ghose
Former Executive Director & CFO, TATA Chemicals
Member, The CFO Board

Manoj Naik
Member, The CFO Board

# Implementation of Large Exposures Framework

CFO Board's recommendations to the Reserve Bank of India

## A. Background

Large exposures regulation has been developed by the Basel Committee on Banking Supervision (the Basel Committee) as a tool for limiting the maximum loss a bank could face in the event of a sudden counterparty failure to a level that does not endanger the bank's solvency. In the Indian context, the Reserve Bank of India (RBI) has issued various instructions / guidelines to banks relating to exposure norms for better risk management. In order to align the exposure norms for Indian banks with the Basel Committee standards, guidelines were issued by RBI on December 1, 2016 (RBI LEF Circular) to limit exposure of large companies on bank books. The RBI capped banks' exposure to a group of connected companies at 25 per cent of the Bank's Tier 1 capital, seeking to reduce concentration risk in a banking industry laden with bad loans. The guidelines are effective from April 1, 2019.

## B. Key issues and challenges

Despite the two year window for compliance with these new requirements, there are multiple challenges that exist which may prevent the effective implementation of these requirements or may cause unintended consequences, including on credit growth in the country. Some of these issues and challenges and potential solutions are discussed in the following sections of this note.

### Structural challenges

#### 1. Structural deficiency in the Corporate Bond Market

The development of the India's corporate bond market has been widely accepted as an important policy priority in India. The Indian corporate debt market as a percentage of GDP has grown from less than 5% to about 15% of GDP over a span of recent 5 years starting in 2012, this growth is considerably less as compared to the other emerging ASEAN markets where the corporate debt penetration is higher than 40% of the GDP. The current lending environment where Banks and Financial institution has been the dominant player for funding the corporates in India, now face a bigger problem of rising NPAs, PCA Banks and high capital requirements under the new Accounting Standard and Basel III. This may pose a liquidity crunch from funding side in the coming years hampering the credit growth in various sectors with high NPA levels leading application of sectoral caps either by regulator or the internally by Banks and FIs. Further, Indian companies do not have ready access to global sources of capital and face several regulatory and other restrictions when seeking to raise offshore debt.

There are several constraints for companies to access the Bond market due to structural issues. There are specified as follows:

i. Insurance companies currently need to maintain a minimum of 50% of their total assets in central and state government securities and they can only invest maximum of 5% of their assets in bonds rated below A.
ii. Pension funds are allowed only to invest in bonds with a rating of AA or better
iii. FPIs have been prohibited from investing in bonds with maturity up to 3 years which is largely confined by low rated issuers

iv. The existence of all-in cost ceiling for offshore foreign currency bonds which makes it possible only for the Indian marquee companies and national champions to explore the funding through offshore foreign bond market.
v. The offshore foreign currency bonds can only be issued by Indian companies only for refinancing the Indian rupee loan with a prior approval from RBI.
vi. Unlike, government securities market where all trades take place on NDS-OM. The corporate bond market is yet to establish a trading platform and hence an electronic screen based trading platform is required to maintain transparency among the investors.
vii. Stress in the NBFC sector and reduced credit availability from NBFCs leading to additional pressure on banks as a source of funding for corporates

## Implementation challenges

### 2. Clarity in definition of connected counterparties

*Connected counterparty through control criterion*

Control has been defined ambiguously to include "significant influence on the administrative, management and supervisory body". The definition of connected counterparties for this circular is ambiguous and would include even large diversified conglomerates as a group of connected counterparties.

In this context, it is important to note that the Basel Standards have also been implemented in other jurisdictions across the world, including the European Union. The European Banking Authority (EBA) has published its Guidelines on connected clients under the EU Regulations (the equivalent of the term "connected counterparties" used in RBI's LEF Circular). The EBA Guidelines are consistent with the Basel Standards but are more detailed than the Basel Standards and are effective from January 1, 2019.

The EBA Guidelines expressly state that the banks should rely solely upon the clients' consolidated financial statements (prepared in accordance with applicable EU regulations) for determining control.

Therefore, unlike in EU, the determination of connected counterparties based on control criterion specified under the RBI circular can be a fairly subjective exercise and this can potentially result in inconsistent interpretations and diversity in practice.

*Connected counterparty through economic interdependence criterion*

Although unlike the Basel Committee Standard, the RBI LEF Circular does not have economic interdependence as one of the two conditions in establishing if an entity is a connected counterparty, para 6.1 of the RBI LEF Circular brings in this concept. The test referred to in paragraph 6.1 of the RBI LEF Circular is if one of the parties were to "fail", the other party would also "very likely fail". The RBI LEF Circular does not set out any other criteria or basis for determining economic inter-dependency between two parties.

In comparison to RBI LEF Circular, the Basel Standards explain the test for economic inter-dependency as one where if one of the parties were to experience financial problems, in particular funding or repayment difficulties, the other party, as a result, would also be likely to encounter funding or repayment difficulties. The Basel Standards also set out certain criteria under paragraph 26 of the Basel Standards for banks to assess connectedness based on economic inter-dependence.

The criteria for assessing connectedness of counterparties based on economic inter-dependence, as set out in paragraph 26 of the Basel Standards, are set out in detail in the Annexure.

## 3. Scope of exemptions

Further, where control has been established based on any of the above criteria, the framework allows a bank to demonstrate to the RBI in **exceptional cases**, e.g., existence of control between counterparties due to specific circumstances and corporate governance safeguards, that such control does not necessarily result in the entities concerned constituting a group of connected counterparties.

Instead of requiring individual banks to demonstrate that control does not necessarily result in the entities concerned constituting a group of connected counterparties, RBI needs to clearly lay down exceptions to be made for large conglomerates with independent operating entities and diversified business interests.

Some of these situations are listed below:

### *Scope of exemptions – independent listed entities*

There is a need to understand the independent nature of operating group companies under a large conglomerate, especially listed entities. Classification of a large conglomerate under a single umbrella would go against the principle of autonomous nature of independent, listed, board managed companies.

Hence exposures to independently listed entities of a conglomerate should be included in the list of exemptions from the exposure limits.

### *Scope of exemptions – non-recourse bank debt*

Legal provisions in India clearly define recourse of lenders only to the borrower unless the borrowing is explicitly supported by way of a guarantee. Hence the lenders typically do not factor in the credit of the guarantor in evaluating the credit of the borrower if a guarantee is not being provided. In such cases, at best, the lenders may take comfort from the governance policies of the Group. Such loans are also priced based on the standalone credit quality of the borrower.

Hence, in the list of exemptions from the exposure limits, an appropriate modification needs to be brought in to carve out such non-recourse bank debt from the definition of group borrowing.

### *Scope of exemptions – entities in financial services sector subject to sectoral regulatory oversight*

For entities within a corporate group which are operating in the financial services sector, capital is the raw material. Their own risk exposures are already well-regulated by the RBI by way of regulatory capital requirements, provisioning norms, ALM prescriptions and regular audits.

Hence, exposures to such entities should be included in the list of exemptions from the exposure limits unless explicitly supported or guaranteed by the promoter.

## 4. Utilization of Single Borrower Limit and Group Borrower Limit for BGs issued

Performance bank guarantees (BGs) are used only as a security mechanism by Govt and infrastructure companies to ensure performance of long-term contracts by their counterparties. Hence, for banks these represent non-funded contingent exposure to the corporate on whose behalf such BGs are issued.

The history of invocation of such BGs shows that an invocation is rare in case of corporates which have good demonstrated track record. Therefore, it is suggested that:

i. LEF framework should apply rating-based risk weightage to performance BGs when calculating the banks' exposures to corporates, rather than require the entire face value of the BGs to be counted towards the GBL of the borrower.
ii. These companies require primarily bank guarantees as part of their working capital facilities which by definition cannot be obtained from any other source except from banks. In order to reduce the exposure of Indian banks to such performance BGs, RBI may allow tying up of BG limits with banks outside India under Indian / international law for issuance of performance BGs in India.

### 5. Implementation date and transitional arrangements: Transition provisions

Currently the RBI LEF Circular does not have any transitional provisions other than stating that "Banks must gradually adjust their exposures so as to comply with the LE limit with respect to their eligible capital base by that date".

Considering that the large exposure framework will pose significant knock-on impact on single and group borrowers, and given that the corporate bond market in India are still in its nascent stage for alternate funding options, it would be advisable to have a phased transition approach for the implementation of LEF guidance. This will address the issue of reducing concentration risk on single/group borrowers without impairing credit growth.

The phased transition approach could apply to all existing exposures as of April 1, 2019 which can be grandfathered with an approach to have such exposures reduced to the stated levels over a period of 2-3 years with a targeted reduction in each of the years. Such a transition approach should be accompanied by enhanced disclosures on the part of the borrowers as well as the banks together with other checks and balances to be instituted by RBI to identify potential risks of any counterparty failure at a level that could endanger any bank's solvency.

## C. Summary of recommendations

In summary, we recommend that RBI consider the following changes in implementing the RBI LEF Circular.

1. Clarify definition of connected counterparties, providing specific criteria for assessing control and economic interdependence
2. Expand scope of exemptions to cover situations involving independently listed entities forming part of a group, non-recourse loans and exposures to financial services entities
3. Provide relief on bank guarantees in determining exposure limits and open up other avenues for obtaining bank guarantees
4. Considering the structural issues in the Indian market, including the deficiency in the Corporate Bond Market, RBI should consider introducing some transitional guidelines to ease the implementation of these new limits

# Annexure

## Criteria for assessing connectedness of counterparties based on economic inter-dependence

Please see below a table setting out the guidance under the Basel Standards for assessing economic inter-dependency and our analysis in respect of each of those.

| **Criteria under the Basel Standards** |
| --- |
| Where 50% or more of one counterparty's gross receipts or gross expenditures (on an annual basis) is derived from transactions with the other counterparty (e.g. the owner of a residential/commercial property and the tenant who pays a significant part of the rent); |
| Where one counterparty has fully or partly guaranteed the exposure of the other counterparty, or is liable by other means, and the exposure is so significant that the guarantor is likely to default if a claim occurs; |
| Where a significant part of one counterparty's production/output is sold to another counterparty, which cannot easily be replaced by other customers; |
| When the expected source of funds to repay each loan one counterparty makes to another is the same and the counterparty does not have another source of income from which the loan may be fully repaid; |
| Where it is likely that the financial problems of one counterparty would cause difficulties for the other counterparties in terms of full and timely repayment of liabilities; |
| Where the insolvency or default of one counterparty is likely to be associated with the insolvency or default of the other(s); |
| When two or more counterparties rely on the same source for the majority of their funding and, in the event of the common provider's default, an alternative provider cannot be found - in this case, the funding problems of one counterparty are likely to spread to another due to a one-way or two-way dependence on the same main funding source. |