



SEBI'S GUIDELINES FOR ENHANCED DISCLOSURES BY CREDIT RATING AGENCIES (CRAs): AN OVERVIEW

INTRODUCTION

A credit rating is a quantified assessment of the creditworthiness of a borrower in general terms or with respect to a particular debt or financial obligation. A credit rating can be assigned to any entity that seeks to borrow money — an individual, corporation, state or provincial authority, or sovereign government. In the current decade, credit ratings have achieved wide significance among investors in Indian financial market. Credit Rating Agencies (“CRAs”) being participant of the credit rating mechanism have been assigned with the job of providing credit ratings to the debtors, predicting their capability to pay back debt in a timely manner simultaneous with the chances of a debtor making default. However, with the increasing number of instances of debt defaults and the failure of CRAs to caution the investor against the worsening position of the credit profiles of the borrowing entities in the market, the Securities and Exchange Board of India (“SEBI”) has, *vide* a Circular No. SEBI/ HO/ MIRSD/ DOS3/ CIR/ P/ 2019/ 70¹, dated 13th June 2019 (the “Guidelines”), has come out with wider and stricter disclosure norms and guidelines to be followed by the CRA while rating different Securities and debt instruments.

I. Main features of the Guidelines:

The main features of the Guidelines are the enhanced disclosures which would now be required to be made by the CRAs, including computation of Cumulative Default Rates (“CDR”), Standard Operating Procedure (“SOP”) in respect of tracking and timely recognition of default, Probability of Default (“PD”) benchmarks for CRAs, rating symbol for instruments having explicit credit enhancement feature, disclosure of rating sensitivities in press release, disclosure on liquidity indicators and tracking deviations in bond spreads,

which have been further enumerated and elaborated below:

❖ **Calculation and disclosure of CDR:**

SEBI, in order to align the norms followed globally for computation of default rates has, by way of the Guidelines provided the manner of computation of CDR by the CRAs. The CDR so required to be calculated by the CRAs shall now be calculated individually for each issuer, using their monthly static pools, using the Marginal Default Rate (“MDR”) approach.

The CRAs have to further disclose on an annual basis, the average one-year, two-year and three-year CDR calculated by the CRAs, each for:

- (a) Last 10-financial years period (Long-run average default rates); and
- (b) 24, 36 and 48 months most recent cohorts, respectively (Short-run average default rates).

❖ **Framing and adoption of SOP:**

The CRA now shall also frame and adopt a uniform SOP in respect of tracking and timely recognition of default, in consultation with SEBI. This SOP so adopted by the CRA shall also be disclosed and published on its website for the reference and ease and comfort of the investors and the general public.

❖ **PD benchmarks for CRAs:**

In order to enable investors to discern the performance of a CRA vis-a-vis a standardised PD benchmark scale, CRAs, in consultation with SEBI, are required to prepare and disclose standardised and uniform PD benchmarks for each rating category on their website, for one-year, two-years and three-years cumulative default rates, both for short-run and long-run, to be calculated and treated with certain permitted tolerance levels. SEBI has further defined and provided the “Rating Categories” so required to be adopted for long term

¹ <https://www.sebi.gov.in/legal/circulars/jun-2019/guidelines-for-enhanced-disclosures-by-credit-rating-agencies-cras-43268.html>



as well as short term instruments to be used for both long-run and short-run. These ratings, as calculated by the CRAs are required to be disclosed by the CRAs on their website before 31st December 2019.

❖ **Standardization of Rating symbol for Instruments having explicit Credit Enhancement feature:**

SEBI, *vide* circulars dated 3rd May 2010 and 15th June 2011, had mandated the use of suffix “SO” to be used in respect of rating of certain structured finance products, namely, instruments/ pay-outs resulting from securitization transactions. Initially the suffix “SO” was to be used and assigned by the CRA for securitized and asset backed instruments; but as observed by SEBI, CRAs have also been assigning this suffix “SO” for instruments based on some form of explicit credit enhancement from a third party/ parent/group company, in the form of corporate guarantee/ letter of comfort/ pledge of shares, etc.

With the need to differentiate between the securitized and asset backed instruments and the instruments enhanced by credit from a third party/ parent/group company, SEBI has now instructed the CRAs to use the suffix “CE” (Credit Enhancement) in the rating of the instruments having explicit credit enhancement.

❖ **Requirement of disclosure of rating sensitivities in press release:**

In order to improve transparency and for the better understanding of the risks for the investors, SEBI has further mandated that the ratings disclosed by the CRAs shall have a specific section on ‘Rating Sensitivities’ in the press release which shall explain the broad level of operating and/ or financial performance levels that could trigger a rating change, upward and downward. SEBI has further added that “*Such factors shall be disclosed in quantitative terms to the extent possible, discernible to the investors, and should not read like a general risk factor*”.

❖ **Standardized terminology for liquidity indicators:**

SEBI, in the Guidelines, has also prescribed terms like *Superior/Strong, Adequate, Stretched* and *Poor* to indicate the liquidity of an instrument to make the disclosures more meaningful for the investor.

❖ **Tracking deviations in bond spreads:**

The CRAs may now treat sharp deviations in bond spreads of debt instruments vis-à-vis relevant benchmark yield as a material event, while reviewing material events, for which the CRAs are required to devise a model to track deviations in bond spreads, in line with the SEBI circular No. SEBI/ HO/ MIRSD/ DOS3/CIR/P/2018/140 dated 13th November 2018.

II. Observation and Conclusion:

According to SEBI, CRAs should act as an alert system before the actual default. So, if the CRAs fail to fulfil this function of providing an alert before the actual crisis, then the credibility of the CRAs will be in danger.

So, this will have a larger impact on the economy as a whole. It is with this reason that SEBI aims to tighten the disclosure guidelines for the CRAs.

With the Guidelines, SEBI has tried to change the retrospective approach that were mostly adopted by CRAs previously while rating the securities and debt instruments and has attempted to make the ratings more prospective. Further, by way of these Guidelines, SEBI has tried to improve the transparency and credibility of the ratings given by CRAs. Furthermore, SEBI has also tried to bring about uniformity in the ways that the different CRAs use to indicate different securities and debt instruments and their default rates for the ease and comfort of the investors. With these Guidelines, it is expected that the quality of the information provided by the CRAs will enhance and this will be made available to different stakeholders including the investors to promote better investment decisions.



STREAMLINING FINTECH INTO THE SECURITIES MARKET THROUGH REGULATORY AND INNOVATION FRAMEWORK

INTRODUCTION

The term ‘sandbox’ has now acquired a whole new meaning for innovators and regulators across the world. A sandbox mechanism is referred to an enabling framework where regulators, for a limited time, relax certain regulatory requirements (which may be in the form of compliance) or provide support in some other form to permit innovators to experiment with their ideas. The first ‘regulatory sandbox’ was launched in the year 2016 in the United Kingdom.² These sandboxes have gained traction and are already live or in the pipeline in over 50 jurisdictions across the world.³

The different types of sandboxes recently introduced in India are primarily by Reserve Bank of India (‘RBI’) and Securities Exchange Board of India (‘SEBI’), namely, (i) ‘Draft Enabling Framework for Regulatory Sandbox’ issued by RBI on 18th April 2019 (RBI Regulatory Framework); (ii) ‘Framework for Innovation Sandbox’ issued by SEBI on 20th May 2019 (SEBI Innovation Framework); and (iii) ‘Discussion Paper on Framework for Regulatory Sandbox’ issued by SEBI on 28th May 2019 (SEBI Regulatory Framework). The RBI Regulatory Framework and the SEBI Regulatory Framework are on the similar lines, providing for live testing of innovative products on limited customers with certain regulatory relaxations whereas the SEBI Innovation Framework provides for offline testing of products with the help of data provided by certain regulators which is not otherwise available to such entities.

I. Features of the RBI Regulatory Framework:

The RBI Regulatory Framework provides for a ‘sandbox’ which allows live testing of Fintech innovative products and services with limited customers and certain regulatory relaxations, decided on a case to case basis

²<https://www.whitecase.com/publications/alert/uk-regulatory-sandbox-foster-fintech-innovation>
³https://www.unsgsa.org/files/2915/5016/4448/Early_Lessons_on_Regulatory_Innovations_to_Enabling_Inclusive_FinTech.pdf

and upon satisfaction of the eligibility criteria. However, observance of some requirements such as customer privacy, data protection, and KYC will be mandatory. Upon exiting the sandbox, the applicants must fully comply with the relevant regulatory requirements before the product or service can be permitted for wider application. The participants selected will be allowed such relaxations to test their products for a specific time period and such products shall primarily focus on financial inclusion, payments and lending, digital KYC etc.

The eligibility criteria for Sandbox prescribes that the entity should have a minimum net worth of Rs. 50 lakhs and must qualify as a start-up. This means that any entity which has been incorporated for more than seven years is not eligible to participate. Moreover, the turnover of such an entity must not cross Rs. 25 crores and its minimum net worth should be Rs. 50 lakhs.

Drawbacks of RBI Regulatory Framework:

The RBI Regulatory Framework is a step towards the right direction, however it fails to solve certain problems:

- a) The eligibility criterion acts as an entry barrier to many smaller and established entities which might have the capability to introduce more innovation in the market.
- b) The RBI Regulatory Framework does not provide safeguards for intellectual property rights. Since a sandbox is often the first live test for a new innovation, participants may have legitimate fears regarding the escape of their technologies to the public domain.
- c) The RBI Regulatory Framework has failed to consider a grievance redressal mechanism among customers and participants. RBI must consider incorporating such a mandatory mechanism which would secure the legitimate interests of both the concerned parties.

II. Features of the SEBI Regulatory Framework:



The SEBI Regulatory Framework is majorly the same as the RBI Regulatory Framework with certain procedural changes along with certain variations in the eligibility criteria. In the early phases, only entities registered and regulated by SEBI will be eligible for testing within the sandbox, however, SEBI may subsequently consider permitting other entities (including start-ups) to participate depending on the responses received. Moreover, unlike the RBI Regulatory Framework, SEBI Regulatory Framework has a clearly defined grievance redressal mechanism for consumers and does not provide for any monetary entry barrier.

Drawbacks of SEBI Regulatory Framework:

Like the RBI Regulatory Framework, SEBI Regulatory Framework has certain drawbacks, such as:

- a) Failure to provide for any safeguards for intellectual property rights.
- b) Although SEBI provides for a grievance redressal mechanism for consumers, however it fails to provide for any scope of liability for the participants and does not provide for any grievance redressal for the participants.
- c) Since fintech innovations may be governed by both RBI and SEBI, there needs to be a clear coordination for delivering better and efficient environment for participants as well as the consumers.

III. Features of the SEBI Innovation Framework:

The SEBI Innovation Framework proposes an offline testing of innovative technologies in the securities market by fintech entities which are not regulated by SEBI. Unlike the regulatory sandbox, testing in SEBI's innovation sandbox takes place in isolation from the live market, without any participation from real customers. The testing is facilitated by providing a virtual environment where applicants can test their innovations by using market related data provided by stock exchanges, depositories and qualified registrar and share transfer agents, which data is not otherwise available to such entities. In this mechanism, the support provided by the regulator is in the form of providing data and infrastructure and not providing any regulatory relaxations as such.

SEBI has prescribed a subjective eligibility criterion for selecting an entity which includes all the fintech players intending to test innovative products in the securities market and having necessary resources to support the testing. For the purpose of testing, historical anonymized datasets will be made available to participants such as KYC data, transactions data, and mutual fund transactions data. The database will be provided through an Application Program Interface (API) and will be governed by a confidentiality agreement. Virtual machines may also be made available with configurations similar to the live environment. In an improvement from the RBI Regulatory Framework, the innovation sandbox proposes to formulate rules to ensure that all applicants can perform tests while protecting their intellectual property rights. It also provides for a grievance redressal mechanism to deal with any grievances of applicants in the innovation sandbox.

Drawbacks of SEBI Innovation Framework:

The SEBI Innovation Framework is a way forward towards an efficient framework however SEBI must keep certain parameters in check for better results, such as:

- a) As the success of this test largely depends on the accuracy of data provided to the participants, SEBI must ensure the ingenuity and authenticity of the data provided.
- b) The rules of participation in the sandbox should not be restrictive otherwise the framework would result in being counterproductive.

OVERALL BENEFITS:

The regulatory frameworks introduced by RBI and SEBI are enabling measures and if implemented properly, are expected to enhance the fintech innovations in India. The regulatory and innovation sandboxes are created with the expectation to benefit all stakeholders involved in the process:

- a) **Regulators:** This will allow regulators to develop an innovation-enabling framework after reviewing the empirical data generated from the sandbox testing.



- b) Fintech companies: They can test the viability and feasibility of an innovation without an expensive roll out, both in terms of customer satisfaction and regulatory amenability.
- c) Consumers: Consumers will benefit by getting access to a wider range of products and services at reduced cost.

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Introduction of a Complaint Management System (“CMS”) by The Reserve Bank of India (“RBI”)

The Governor of RBI, Mr. Shaktikanta Das, on 24th June 2019 launched Complaint Management System (“CMS”) which is a software application to facilitate RBI’s grievance redressal processes. The general public can access the RBI’s CMS Portal at the RBI’s website to lodge their complaints against any of the entities regulated by the RBI, including commercial banks, urban cooperative banks, Non-Banking Financial Companies (“NBFCs”), etc.

[Source: https://www.rbi.org.in/Scripts/BS_PressReleaseDisplay.aspx?prid=47383]

Waiver of charges for National Electronic Funds Transfer (“NEFT”) and Real Time Gross Settlement (“RTGS”) systems by RBI

The RBI on 11th June 2019 released a notification on its official website announced that in order to promote digital transactions in India, the RBI has decided to waive off the charges levied by RBI on the Banks for NEFT and RTGS transactions and have further advised the banks to pass off the benefits of such waiver to their customers, effective from 1st July 2019.

This waiver of charges has been done by the RBI in reference to the Second Bi-monthly Monetary Policy Statement on Developmental and regulatory Policies for 2019-20 as notified by the RBI, dated 6th June 2019.

[Source: <https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=11586&Mode=0>]

Revision of Employee State Insurance (“ESI”) Contribution

The Central Government, after consultation with the Employees’ State Insurance Corporation, on 13th June 2019, notified in the Official gazette of the Ministry of Labour and Employment, the amendment to the Employees’ State Insurance (Central) Rules, 1950, revising the rate of total contribution to the Employee State Insurance from 6.5% to 4%. This includes a reduction of 1.5% in employers’ contribution to 3.25% from 4.75% and 1% reduction in employees’ contribution to 0.75% from 1.75%.

[Source: <http://egazette.nic.in/WriteReadData/2019/205715.pdf>]

SEBI’s discussion paper on provision for Informant Reward Policy in the SEBI (Prohibition of insider trading) regulations, 2015

SEBI, on 10th June 2019, released a discussion Paper on amendment to the SEBI (Prohibition of Insider Trading) Regulations, 2015 (“PIT Regulation”) to provide for an informant mechanism to mitigate several challenges faced by



SEBI during the investigation process pertaining to cases of insider trading. The proposed Informant Mechanism will include a voluntary information disclosure form, wherein the informant would submit details of complete information relating to an act of insider trading, and the confidentiality of the identity of such informant and information provided shall be protected throughout as well as during any proceeding initiated by SEBI except where the evidence of the informant is required during such proceedings. SEBI has also proposed to reward an informant in case of disgorgement of atleast Rs. 5 Crores, and such reward will be 10% of the money collected but will not exceed Rs. 1 Crore, and such reward shall be paid from the Investor Protection and Education Fund.

[Source: https://www.sebi.gov.in/reports/reports/jun-2019/discussion-paper-on-amendment-to-the-sebi-prohibition-of-insider-trading-regulations-2015-to-provision-for-an-informant-mechanism_43237.html]

Filing annual return on Foreign Liabilities and Assets through shall now be done through a web-based system online reporting portal

RBI has issued a circular vide **RBI circular RBI/2018-19/226 A.P. (DIR Series) Circular No. 37 dated 28th June 2019** with respect to the filing of the annual return on Foreign Liabilities and Assets through the web-based system online reporting portal, discontinuing the existing mechanism of e-mail-based submission of FLA forms. In terms of the aforesaid circular, all the Indian reporting Companies which have received FDI and/or made FDI abroad (i.e. overseas investment) in the previous year(s) including the current year, are required to submit an Annual Return on Foreign Liabilities and Assets (FLA) in the prescribed Revised Foreign Liabilities and Assets Information Reporting System (FLAIR) with the concerned Department of RBI, by 15th July every year.

[Source: <https://www.rbi.org.in/scripts/NotificationUser.aspx?Id=11607&Mode=0>]

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