Regulatory reporting work done by Financial Services Global Capability Centres (FS GCCs) in India

Our perspective

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Background

As an extension to our previous publication on “Decoding Regulatory Reporting[1]”, this document highlights the key themes arising from specific regulatory reporting processes like EU Common Reporting (COREP) that is managed through the India shared services centers of global financial services firms.

Post the 2008 financial crisis, the regulators implemented new regulations governing the financial services industry at a breakneck pace. Within the financial services sector, various regulations were formulated to address regulatory expectations on consistency and transparency, resulting in exhaustive reporting and disclosures at regular intervals.

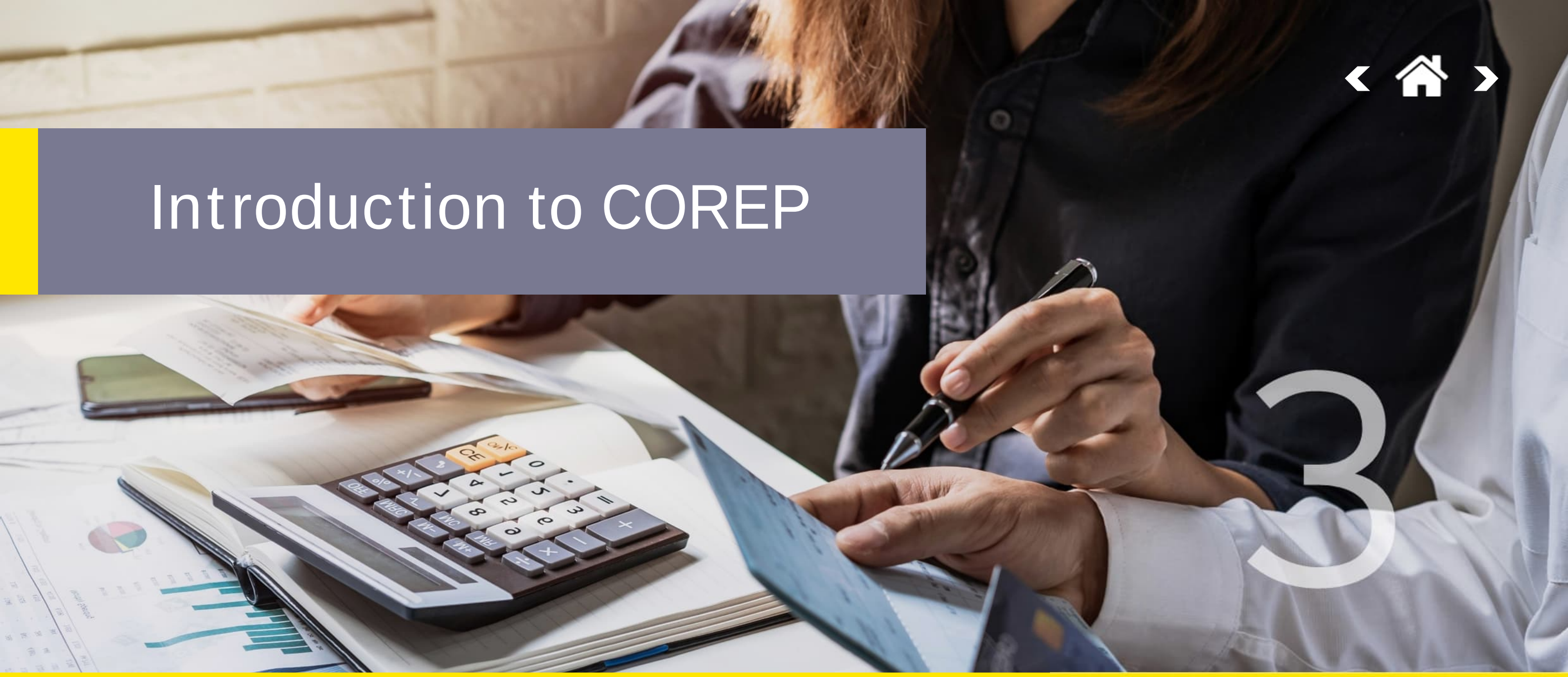
COREP is a standardized reporting framework introduced by the European Banking Authority (EBA) for all the Banking and Financial Institutions operating in the European Union. The EBA reporting framework is based on reporting to the competent authorities for the following areas:

1. Decoding Regulatory Reporting

Reporting done by FS GCCs in India

Over the past decade, various global financial services firms have set up their shared services centers in India to perform both production and change management initiatives covering various Regulatory and Financial reporting work. Our document analyzes some of the key themes and challenges arising from COREP reporting and our perspectives on the same.

Introduction to COREP



Common Reporting (COREP) is a form of supervisory reporting requirement prescribed in the Capital Requirements Directive (CRD IV) and issued by the European Banking Authority (EBA) to standardize the reporting of capital requirements and prudential regulatory information. It has been adopted by over 30 countries within Europe, including the UK PRA. This is applicable to all regulated financial institutions and banks in the European Union at a consolidated, sub consolidated and entity reporting level.

The Supervisory purpose of COREP implementation in the banking sector is:

- Standardization of reporting requirements across supervising authorities
- Analysis of standard information to predict trends and conduct peer reviews
- Sharing of data to governing regulators and authorities

COREP reporting covers:

- Own funds: A supervisor's aim is to ensure that financial institutions and banks have enough capital or 'own funds' to ensure their businesses remain stable and ensure that they can absorb losses in a going or in a gone concern situation.
  - Capital adequacy: Capital adequacy is the statutory minimum capital reserve that a financial institution and a bank must have available and regulatory capital adequacy guidelines, thus require relevant banks to maintain these minimum levels of capital, calculated as a percentage of their risk weighted assets.
  - Capital requirements: In order to calculate the capital requirements from the Supervisory point of view, the Financial Institution or a Bank can calculate the exposures either using the Standardized approach or specific internal approaches depending on the risk type. The various risk types on which minimum capital requirements are calculated as under:
    - Credit risk
    - Counterparty credit risk
    - Operational risk
    - Market risk
- Leverage: The leverage ratio is a measure which allows for the assessment of institutions' exposure to the risk of excessive leverage i.e., leverage being the proportion of an institution's liabilities to its own capital.
- Large exposures: Reporting of exposures which are 25% or above of the capital base of an institution. This caters to the need for mitigating concentration risk of the regulated entities.
- Liquidity coverage: Wherein institutions are required to keep a minimum amount of high-quality liquid assets to meet its short-term financial obligations within a 30-day period in stressed scenario.

- Net stable funding: The proportion of available stable funding via the liabilities of an institution to its required stable funding for the assets of an institution over a 12 months or longer-term horizon.

Our document specifically focuses on the COREP Credit Risk reporting templates C.07 (Standardized approach) and C.08 (Internal Ratings Based approach) as prescribed by the regulator.

C.07 return focuses on the standardised calculation of RWAs and on the other hand C.08 return focuses on the Internal Rating Based Models approach for RWA calculations.

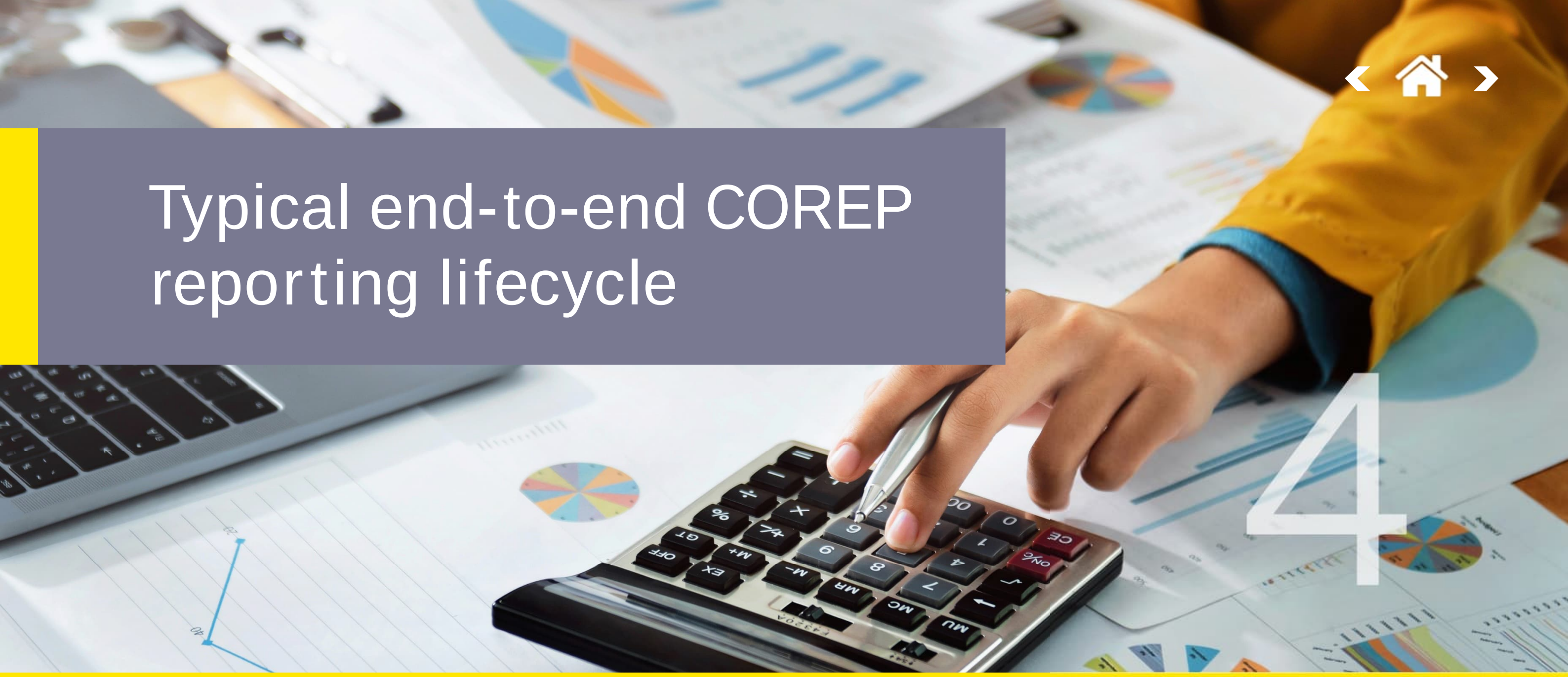
3.1. Key levers for COREP reporting (C07, C08):

COREP reporting being one of the major regulatory requirements for the financial services firms, involves various critical levers during the production process. Some of the essential areas that require a deep and thorough evaluation on a regular basis are:

- Flow of data from multiple source systems to the reporting system potentially leads to numerous data quality issues that may result in inaccurate reporting. Regular data control checks such as inter-system reconciliations, PD validation checks, variance analysis along with root cause analysis etc., need to be performed to provide comfort to senior management and regulators over the completeness and accuracy of data.
- Classification of exposures into various exposure types (Row 70 to 130 in C07, Row 20 to 60 of C08): The exposures reflected in these line items are classified into on balance sheet, off-balance sheet, Securities Funded Transactions (SFTs) and derivatives, etc.
- PD allocation based on obligor grades (Col 10 of C08): When following the internal ratings based approach, reporting institutions need to ensure accuracy through periodic reviews of PD assigned based on Obligor grades/ratings. Issues in PD allocations will result in inaccurate reporting to regulators.
- Breakdown of exposures by risk weight: risk weights need to be reviewed periodically to assess correct application of risk weights by exposure classes, credit ratings etc., as per the prescribed regulation.
- Provisions (Col 30 of C07): Institutions have dedicated teams that maintain control and supervision over the provisioning process as per the accounting framework (e.g., IFRS9). Under IFRS9 ECL staging requirement, there could be instances where inaccurate stages are being reported due to data sourcing issues with respect to performance of the exposures. This leads to inaccurate exposure calculation and has an ultimate impact on the institution's RWAs. This results in inaccurate regulatory submissions. Adequate governance over the staging process may help demonstrate accuracy in reporting to the regulator.
- Collateral measurement and consideration (col 50 to 140 of C07, col 40 to 210 of C08): Collaterals need to be correctly recorded in the source systems and periodic reconciliation between source system and reporting systems helps proper control over Credit Risk Mitigation (CRM) reporting.
- Correct classification of counterparties into SME (Row 20,30 of C07): often the turnover data, which is a key driver in classification of exposures into SME, is stale in the reporting institutions. There needs to be proper governance over the reference data on a periodic basis to avoid such data lapses.
- Permanent Partial use[2] (PPU) of standardized approach (Row 50 of C07): Permanent partial use of standardized approach for certain exposure classes needs to be approved by the regulator beforehand. A periodic review of compliance with the regulator's stringent criteria to use the PPU exception (for example exposures to immaterial business units, low-risk appetites) is required to be performed by the Institutions.
- Sequential IRB implementation (Row 60 of C07): Institutions can move the exposure classes from the calculation of standardized approach to IRB after required regulatory approvals. A strong control mechanism is required to review the reference data flags that indicate such transfer of exposures to ensure accurate reporting to the regulator.

2. PPU is an exemption given in the CRR guidelines by the EBA where Banks can permanently use Standardized approach for the calculation of RWAs for all the exposure classes and the business units where they have the approvals from the national competent authority.

Typical end-to-end COREP reporting lifecycle



1 Data sourcing and architecture

Standardization of data to a single golden source followed by a formal attestation of relevant source data from upstream owners.

2 Data validation

As part of data validation exercise, banks tend to focus on remediating the data quality issues through upstream source systems to standardize the returns.

3 Reconciliations

Inter-system, where required external reconciliations is typically done using automated tools/macros in most banks to identify the breaks above the set threshold limit which requires further investigation.

4 Adjustments

Includes standard adjustments due to legacy system issues and ad hoc adjustments due to issues related to system feeds or erroneous treatment given to certain trades. Such adjustments are typically posted manually or through the use of a workflow tool.

5 Review

Banks typically follow standardized templates for review purposes to maintain the audit trails, which is system driven or via emails. The required sign-offs and make checker reviews need to be evidenced from a governance perspective.

6 Variance analysis

Tool- based variance analysis is carried out using Tableau, Power BI, MicroStrategy.

Use of standardized templates to perform variance analysis with proper documentation over the root cause analysis.

7 Escalations

Set up escalation matrix based on pre-agreed thresholds as per risk appetite of the bank. Significant issues are highlighted and resolved through a pre-approved mechanism.

8 MIS and reporting

Removing complexity from reports to make them readily understandable to all stakeholders. A summary snapshot group reporting an assurance pack should include key items and movements with succinct explanations for senior management review.

9 Skilled resources

Ensure adequate upskilling and training inbuilding a fungible and stronger backup of resources for undertaking complex regulatory reporting work.

Challenges faced by GCCs in EU COREP reporting

Preparing high quality and error free reports for regulatory compliance usually comes with numerous challenges that banks and their shared services centers in India encounter. From a regulator's point of view, it is of paramount importance that an institution puts in place a robust governance framework to focus on completeness and accuracy of COREP reporting.

Along the end-to-end COREP reporting process, banks potentially encounter various specific challenges in their credit risk reporting (C.07 and C.08), as highlighted below, that could potentially lead to incorrect reporting.

No	Issue type	Challenge	Our perspective
1.	Inaccurate bifurcation and reporting of exposure classes	In the COREP reporting, sectoral classification of exposures plays a major role in RWA calculations. Customers are bifurcated based on exposure classes and credit ratings for the purpose of regulatory reporting. The pre-defined set of guidelines laid by out the regulators help arrive at such sectoral classifications. Inability to interpret the regulation correctly will lead to incorrect classifications and subsequently leading to inaccurate RWA reporting. This is more relevant where the underlying facts on exposure classes are not properly evaluated before concluding on their classifications e.g., issues in allocation of exposure classes under central government vs regional government, exposure classes arising from secured financing transactions (SFTs) vs loans. Additionally, these classifications need to be reviewed on a quarterly basis and inaccurate classification arising out of incorrect assessment of the business model of the customer will lead to inaccurate RWA reporting. Lack of SME skillsets and faulty data management predominantly at a reference data level are the primary contributors to the above issue, thereby leading to inaccurate regulatory reporting.	Emphasis on a robust reference data structure which ensures that the exposure classes are accurately mapped against each customer will facilitate a more effective reporting framework. Conducting periodic (say yearly) validation checks (through useful tools and enablers) of the detailed reference data tables across regions and legal entities will be a key enabler in ensuring high quality and accurate reporting outputs.

No	Issue type	Challenge	Our perspective
2.	Inappropriate allocation and access of credit limits	Credit limit of a facility refers to the maximum amount of credit a bank extends to a customer from which it can draw over an extended period without having to apply for a new loan each time, thereby giving rise to concentration risk. To mitigate concentration, economic sector and geographical risk on the bank and report in an orderly manner, the regulator has laid down guidelines to help an institution check if its exposures are well diversified and in line with regulatory RWA calculations. One of the major challenges faced by banks include the lack of adequate controls to capture credit limits accurately across group entities for a particular customer. Lack of a unified approach to capture the absolute limit at a group level due to geographical inconsistencies in reporting could potentially lead to misreporting of exposures and RWAs.	An operating model that facilitates consistent data lineage across regions to capture the overall credit limit of a customer at the group level is needed. This can be achieved through a coordinated attestation process by the group from all the regions to validate and confirm the appropriate credit limit for a customer. This effective operating model, along with performing periodic reconciliation of limits between source systems and reporting systems, would enable consideration of accurate limits while reporting.
3.	Use of the same collateral against multiple exposures	Banks use collaterals as a tool for mitigating risk against customer borrowings and traded securities. Banks also use very complex collateral mechanisms to ensure consumption of collaterals against its outstanding exposures. Often, lack of a synchronous co-ordination between different business units leads to the origination of multiple exposures against the same collateral. This also leads to operational redundancies and duplication of efforts from a reporting standpoint. The absence of an effective centralized, integrated, enterprise-wide collateral management solution is the major roadblock for reporting and calculation of accurate collateralized exposures. An ideal operating model should be efficient, flexible and should permit many-to-many mapping between collateral assets to risk exposures, thereby mitigating the risk and ensure correctness of the report.	Along with cross border collaboration, banks' operating model needs to involve collaboration within business units (BU) where different teams have the visibility of respective business activities of the customer through a centralized collateral management system. This will help avoid redundancies, which could lead to incurring additional risk for the bank.

No	Issue type	Challenge	Our perspective
4.	EBA validations	Extensible Business Reporting Language (XBRL) is a specific filing requirement for submission of the EU COREP returns to the regulators. The reporting and conversion of a manual data file into an XBRL template is carried out by external systems which possesses this niche expertise. These external systems used by the banks are inbuilt with specific taxonomy codes which in case of late adjustments are manually overridden. Such manual interventions are high risk for the firm and could potentially give rise to misstatements in reporting. Absence of expert knowledge in infrastructure taxonomy (e.g., Axiom) and insufficient data linkages with rule-based platform to validate the granular data requirement could pose challenges in finalizing the returns.	Presence of a control and governance framework that involves robust controls like four-eye checks, creation of EUCs, a centralized adjustment matrix with visibility of adjustments posted for various business functions and maintaining strict access controls will influence robust reporting.
5.	Partial Permanent Use and Sequential Implementation	Firms that are eligible to avail the PPU exemption must have exposures only in non-significant business units and the types of exposures must be immaterial in terms of size and risk profile. Lack of adequate skilled resources in drafting requisite policies for regulatory approvals to use these exemptions could pose a challenge for firms. Firms can conversely opt for the sequential implementation of the IRB approach under certain circumstances (e.g., improvement in credit ratings, material increase in size and risk profile of exposures) for exposure classes that were earlier subject to standardized approach provided they obtain the required regulatory approvals. The shift from standardised to IRB approach is a major challenge for firms given strict regulatory requirements of maintaining historical data models of the exposure classes for which they are seeking approvals. In absence of or failure to maintain any of these requirements could lead to misstatements and incorrect reporting to the regulator.	Maintenance of granular data dashboards on exposures subject to standardized and IRB approaches could be beneficial for firms to monitor any movement of its exposures from one approach to another. In addition to skilled SME resources that are experienced in such credit risk reporting, firms are expected to put in place adequate organizational arrangements through regular monitoring of data and clearly documented policies on timely application of PPU and sequential implementation.

Our point of view

On the back of the detailed COREP requirements, firms need to take a transformative approach to manage data, implement formal regulatory assurance programs across regulatory reports. Firms should to take into consideration the following key themes when working toward addressing the COREP reporting covering both end-to-end production and the required change management initiatives to remediate issues arising from such reporting:

1. Data and infrastructure: is a yardstick for implementing an effective regulatory reporting framework for a firm revolves around end-to-end data architecture and an enabling IT infrastructure. One of the major hurdles for global financial services firms is understanding the golden source of data, data lineages from various business lines and regions, and enrichment of data before it enters the report preparation phase. Firms could consider an infrastructure where data is stored in a centralized repository like on its dedicated cloud where data could be seamlessly sourced from each region and business lines for a robust COREP reporting.
2. Operating model: Regulatory reporting is an enterprise-wide activity with accountability by senior management functions within finance, risk, compliance and operations. For global firms that operate at a regional and legal entity level, there is a need to establish an integrated assurance framework within the second line of defence, covering such regions and legal entities, to establish uniform best practices across the global firm. Firms with global presence need to move away from a traditional approach where data was managed in siloes towards a more integrated approach that involves a well laid out data lineage and framework to manage such complex regulatory reporting like COREP.
3. Process and data quality: Banks continue to face challenges in maintaining adequate levels of data quality in their regulatory reporting framework. Sophisticated systems and comprehensive architectures throughout the data supply chain are the steppingstones to an efficient reporting process with high-quality data. An effective data quality framework typically has four major integrated pillars which are qualitative business rules, transaction testing, reconciliations and quantitative analysis. Firms are undertaking large-scale transformation programs through their shared services centers to streamline their regulatory reporting process across all major regions like the US, EMEIA and APAC. This includes use of cloud to centralize the storage of all key data needed for reporting along with use of improved analytical tools like QlikSense for creation of data mart, Tableau for variance analysis and visualization, Alteryx for automation of various workflows along with creation of centralized data warehouse using Hadoop.
4. Upskilling of resources: One of the common challenges across such global financial services firms, with large shared services centers in India, revolves around the lack of adequate technical knowledge and awareness of both policy requirements and regulatory expectations. Increased key person dependencies and concentration risk invariably become a bottleneck after a point in time if no suitable measures are undertaken to train the teams across various regulatory reporting areas in a fungible manner. The ability of firms to provide a differentiated experience to its staff by exposing them across various areas of reporting could also help contain attritions to some extent. Ensuring regular technical up-skilling of resources both in regulatory policy and assurance readiness, i.e., operation of controls and managing key person dependency risks along with adequate segregation of duties has become a necessity in such ever evolving regulatory landscape.

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