Liquidity Risk Management Framework for NBFCs – Fixing the Broken House!

On 4th November, 2019, the Reserve Bank of India (RBI) revised the liquidity risk management framework for the Non-Banking Financial Companies (NBFCs) and Core Investment Companies (CICs). The guidelines earmarked the roles and responsibilities of NBFCs in managing their liquidity risks and implementing the Asset Liability Management (ALM) framework under normal as well as distressed liquidity market conditions. In the following paragraphs, the core components of the regulatory guidelines for liquidity risk management framework of NBFCs is discussed, along with their broad implications:

Governance of Liquidity Risk Management

The RBI regulatory guidelines placed significant emphasis on the governance of liquidity risk management by putting the responsibility for management of liquidity risk on (a) the Board of Directors, (b) Risk Management Committee, (c) Asset Liability Management Committee (ALCO) and (d) Asset Liability Management (ALM) Support Group. To further elaborate, first and foremost, the RBI guidelines placed the overall responsibility of managing the liquidity risk of NBFCs with their Boards, and in accordance, proposed that the Boards should decide the strategy, policy and procedures of the NBFCs as per the liquidity risk tolerance limits set by them.

Thereafter, the responsibility for evaluation of overall risks faced by the NBFCs including the liquidity risk was assigned with the Risk Management Committee, which would be comprised of the Chief Executive Officer (CEO), Managing Director (MD) and Heads of various risk divisions. In addition, the Asset-Liability Management Committee (ALCO) would be entrusted with the responsibility for adherence to risk tolerance limits as set by the Board as well as the implementation of the liquidity risk management strategy of the NBFC. As per the RBI directives, ALCO need to be comprised of top management of the NBFC, and would be responsible for making decisions on desired maturity profile and mix of incremental assets and liabilities, sale of assets as source of funding and overall structure and strategy of liquidity positions and liquidity risk management at each of the NBFC branch levels. Finally, the Asset Liability Management (ALM) Support Group would be consisting of operating staff to analyse, monitor and report the liquidity risk profile to the ALCO.

Product Pricing and Off-Balance Sheet Exposures Consistent With Liquidity Risk Tolerance

The RBI guideline emphasized the need for a NBFC to clearly articulate its liquidity risk tolerance which is consistent with its business strategy and product focus, such that it could identify, measure, monitor and control its liquidity risk in accordance with such risk tolerance and ensure sufficient liquidity during its daily operations, both under normal and stressed market conditions. In this regard, RBI urged the NBFCs to incorporate the liquidity costs and benefits in its internal product pricing mechanism and evaluate the trade-offs during the new product approval process for all of its product and services related business segments.

The guidelines further emphasized the need for careful evaluation of liquidity risks arising out of off-balance sheet exposures, contingent liabilities and Intra-group Transactions and Exposures (ITEs). In this regard, it was suggested that the NBFCs should develop a robust framework to estimate the cash flows arising from assets, liabilities and off-balance sheet items over appropriate time horizons, including the impact of risk exposures on account of Special Purpose Vehicles (SPVs), financial derivatives, guarantees and commitments on liquidity risk of NBFCs. In the same manner, the guidelines also suggested NBFCs to recognize likelihood of enhanced liquidity risks arising due to Intra-group Transactions and Exposures based on complexity, risk profile and scope of operations of companies affiliated to the business group. The greater scrutiny and heightened regulatory focus on Intra-group Transactions and Exposures (ITEs) of NBFCs could have emerged in the immediate aftermath of series of credit defaults by Infrastructure Leasing & Financial Services (IL&FS) Group of companies.

Introduction of Liquidity Coverage Ratio (LCR) for Liquidity Risk Management

In line with the Basel compliant norms for the banking sector, the RBI guideline mandated all Non-Deposit taking NBFCs with asset size of INR 100 billion and above, and all Deposit taking NBFCs to maintain a liquidity buffer in terms of Liquidity Coverage Ratio (LCR) to ensure that NBFCs have sufficient High Quality Liquid Assets (HQLA) to withstand any acute liquidity distress scenario lasting for 30 days. The LCR requirement would be binding on NBFCs from December 2020 onward, as the following progressive LCR requirements:

Regulatory Timeline	December 2020	December 2021	December 2022	December 2023	December 2024
Minimum LCR	50%	60%	70%	85%	100%

The Liquidity Coverage Ratio (LCR) is defined as the stock of High Quality Liquid Assets (HQLA) divided by the Total Net Cash Outflows over next 30 calendar days. HQLA refers to liquid assets, which can be easily converted into cash at close to its intrinsic value, or used as collateral to raise funding during a period of financial distress. Thus, the basic purpose of mandating the LCR requirement on the NBFCs is to ensure that NBFCs have adequate level of liquidity safeguards in the form of HQLA in order to meet its liquidity needs for a period of 30 calendar days, even under major market disruption scenarios.

As per the guidelines, HQLAs are required to be low credit and market risk instruments having low valuation uncertainty and pricing complexity, low correlation with valuation of risky assets and publicly listed on any recognized stock exchanges. Further, HQLAs are financial instruments with active and large secondary markets which have dedicated market makers, low level of market concentration and are likely to get benefited from flight to quality capital movements under situations of broad systemic crisis.

Assets such as cash, government securities and marketable securities which are assigned zero risk weight by banks under standardized approach for credit risk may be considered in the computation of HQLAs for a NBFC at their fair value without any haircut. However, for certain other securities such as Corporate Bonds, Commercial Papers and Common Equity shares, haircuts between 15% to 50% may be applicable, depending upon the risk weight by banks under standardised approach for credit risk, credit rating of the financial instrument and nature of liquidity in the traded market of the financial security during a relevant period of significant liquidity stress.

Diversified Funding Strategy and Contingency Funding Plan

Diversified funding strategy and Contingency Funding Plan (CFP) have been among the key focus areas of this RBI regulatory guideline for NBFC liquidity risk management. As per the RBI directives, the NBFCs are required to develop a funding strategy that is diversified across both source as well as tenor of funding, so that it can avoid over-dependency on a single source of funding. This is particularly important, as the NBFCs had been heavily dependent on Money Market Securities such as Commercial Papers (CP) or Certificate of Deposits (CD) for their funding requirements, thereby exposing themselves to significant liquidity risk factors emerging from Asset Liability mismatch particularly during distressed money market conditions.

In terms of Contingency Funding Plan (CFP), the NBFCs would be required to formulate contingency plans containing details of potential sources and estimated amounts of contingency funding, along with expected lead time required to raise additional funds under distressed liquidity conditions. Given the inherent uncertainty and significant volatility of the market conditions, NBFCs would require a robust stress testing framework to simulate short-term as well as longer-term NBFC-specific and systemic liquidity stress scenarios where in a wide range of assumptions about the strength of NBFC operating business, financial conditions and macro-economic factors could be taken into consideration. In future, it is plausible that NBFCs would require to engage in significant employee skill building and competency enhancement exercises for this purpose, either through in-house or externally supported training and management development programs conducted by academic experts and industry professionals in the banking domain.

Public Disclosure Requirements Related to Liquidity Position and Liquidity Risk Management

RBI mandated the NBFCs to publicly disclose the Liquidity Coverage Ratio (LCR) related details including the level of High Quality Liquid Assets (HQLA), and break-up of expected cash inflows and outflows over next 30 days on a quarterly basis to enable the market participants to make an informed decision about the quality of liquidity position of the NBFC, and the soundness of its liquidity risk management framework. The enhanced public disclosure requirements are likely to assist the Credit Rating Agencies (CRAs) in evaluating the credit instruments issued by the NBFCs, and enable the portfolio managers of the Asset Management Companies (AMCs) in making better investment decisions, thereby putting additional capital market induced disciplinary pressures and monitoring oversight on the NBFC Board as well as their Top Management.

Granular Maturity Profiling enabled by Robust Management Information System

The RBI guidelines have put down responsibilities on the NBFCs to develop a reliant Management Information System (MIS) which can provide timely and forward-looking information on the liquidity position of the NBFC and the Group to the Board and the ALCO, both under normal and stressed market scenarios, by capturing all possible sources of liquidity risks and gathering granular and time-sensitive information, particularly during stress events.

An important element of the granular, time-sensitive information is the granular maturity bucket, which can be used for maturity profiling to estimate cumulative surplus or deficit of funds at various maturity dates for measuring the future cash flows of NBFCs in different buckets. For example, the guidelines mandate the NBFCs to segregate the 1 to 30 day time bucket into granular buckets of 1 – 7 days, 8 – 14 days and 15 – 30 days. This is expected to enable the NBFCs to estimate their short-term liquidity requirements on the basis of their business projections and other commitments for planning purposes as well as monitor their short-term liquidity risk on a dynamic basis over next 1 day to 6 months. The guidelines also require the NBFCs to restrict the net cumulative negative mismatches in the maturity buckets of 1 – 7 days, 8 – 14 days and 15 – 30 days to a maximum of 10%, 10% and 20% of the cumulative cash outflows in the respective time buckets.

Liquidity Risk Monitoring Tools

The RBI guidelines have emphasized on three critical liquidity risk monitoring tools for the NBFCs: (a) The first measure would identify the level of concentration in the funding channel of the NBFC so that withdrawal of any dominant funding source does not pose as a major liquidity risk problem for the entity. (b) The second measure would identify the amount of available unencumbered assets which could be used as collateral to raise additional secured funding in secondary markets in the event of an unforeseen liquidity disruption event. (c) Finally, a high-frequency measure of market data would be adopted to monitor news and capture information related to financial leverage, shape of yield curve and even breach or penalty in respect of regulatory requirements to serve as early warning indicator for potential liquidity concerns for the NBFCs.

Summary of Causes and Consequences

The NBFC sector has recently witnessed a major liquidity turmoil, with potentially significant adverse cascading effects even for the real economic sector. Since the banks were already burdened with high level of Non-Performing Assets (NPAs), the credit growth required to boost the level of economic activity in the real sector was critically dependent on the shadow banking channels for financing the consumption demands of the retail consumers as well as the investment needs of the corporate entities, particularly in the real estate, infrastructure and consumer durables sector. Unfortunately, a series of credit defaults by the NBFCs beginning with Infrastructure Leasing & Financial Services (IL&FS) Group, and subsequently Dewan Housing Finance Limited (DHFL) and Altico Capital, triggered a major credit market disruption, which increasingly threatened to pose as a systemic risk factor both for the private consumption and corporate investments which are heavily dependent on NBFC financing channels. In turn, the slowdown in real economy along with asset quality deterioration in NBFC balance sheets would impact the core banking sector which had exposures to both the NBFCs as well as the consumer and corporate borrowing markets.

The RBI guidelines on the liquidity risk management framework of the NBFCs would serve to address some of the key shortcomings in the financial as well as operational strategies of the shadow banking sector. There are three major areas that can be highlighted in this respect: (a) The introduction of Liquidity Coverage Ratio (LCR) for liquidity risk management of NBFCs, in conjunction with public disclosure requirements related to liquidity positions and necessary diversified funding strategies and Contingency Funding Planning (CFP) to be adopted by the NBFCs are likely to significantly improve the status-quo, and force the NBFCs to manage their liquidity risks much better during future distressed liquidity market conditions. (b) While the regulatory onus of liquidity risk management has been rightly placed on the Board and Top Management of NBFCs, with the added support of Risk Management Committees, Asset Liability Management Committee (ALCO) and Asset Liability Management (ALM) Support Groups, the implementation of a prudent risk management culture and enforcement of the management responsibility in the event of corporate malpractices would continue to remain a challenge, particularly in the absence of an effective and time-bound Insolvency and Bankruptcy resolution process for the NBFCs. (c) The technical aspects of internal product pricing and estimation of off-balance sheet exposure consistent with liquidity risk tolerance of NBFCs, granular maturity profiling of estimated cash inflows and outflows enabled by management information systems adopted by the NBFCs, and the liquidity risk monitoring tools designed to pro-actively capture upcoming signs of firm-specific or market-wide distress factors would require significant investments in improving the knowledge and understanding of NBFCs around potential causes and consequences of the financial market and liquidity risk related factors. Academic experts and industry professionals may provide valuable guidance in upgrading the intellectual capital of NBFCs to manage this major transformation through various skill building exercises and in-house training and management development programs. For the time being, the Reserve Bank of India (RBI) deserves to be commended for proposing this time-bound and comprehensive regulatory framework that may go a long way in fixing the prevailing regulatory blind spots in the shadow banking sector, and eventually revive the recently observed sluggish growth in the domestic financial sector.

Sources of Reference Materials:

(a) Reserve Bank of India (RBI) Press Release dated 4th November, 2019.
(b) Bloomberg, NSE / BSE Websites.