RBI Proposes Liquidity Norms for NBFCs

RBI in its draft circular on **"Liquidity Risk Management Framework for NBFCs and Core Investment Companies (CICs)"** (to be adopted by all deposit-taking and non-deposit taking NBFCs with an asset size of Rs 100 crore and above and all CICs registered with the RBI) has **proposed certain guidelines for dealing with the Liquidity and IL&FS type of debt crisis in NBFCs**.

About IL&FS Debt Crisis

IL&FS Financial Services, a group company, defaulted in payment obligations of bank loans (including interest), term and short-term deposits and failed to meet the commercial paper redemption obligations.

- Consequent to defaults, rating agency ICRA downgraded the ratings of its short-term and long-term borrowing programmes.
- The defaults not only adversely affected hundreds of investors, banks and mutual funds associated with IL&FS but also resulted into Liquidity Crisis in NBFCs.

RBI Guidelines

- **Introduction of Liquidity Coverage Ratio:** Liquidity Coverage Ratio (LCR) rule would be introduced in all deposit taking Non-Banking Financial Companies (NBFCs) and non-deposit taking shadow banks with an **asset size of Rs 5,000 crore** and above.
    - **LCR** is a requirement under Basel III whereby banks are required to hold an amount of **high-quality liquid assets (HQLA)** that's enough to fund cash outflows for 30 days.
    - **HQLA** are liquid assets that can be **readily sold or immediately converted into cash** at little or no loss of value or can be used as collateral for borrowing purposes.
- **Mandatory holding of Government Securities** by NBFCs in the form of high quality liquidity assets.
- **Comprehensive Risk Mitigation Policies:** Board of all NBFCs with assets of more than 5,000 crore are required to ensure an **Asset liability management committee, asset risk management committee, and an asset-liability management support group in NBFCs** for implementing Liquidity risk mitigation policies.
- **Asset-Liability mismatch** can not be more than **10% of the total outflows** of NBFCs.
- NBFCs are required to formulate their **Contingency Funding Plan** as a liquidity crisis management tool that will help them with **alternative sources of funding** in liquidity crisis and will **prevent over reliance on single source** of funding like it is suspected that over reliance of NBFCs over commercial papers can bring them to default of over 1 lakh crore commercial papers issued by them in the past.

Commercial papers are short term debt instruments issued by companies to raise funds for a time period of up to one year

- **A granular maturity bucket system** has been proposed to keep a check on mismatches across tenures. Unde new norms, the 1-30 days bucket would be bifurcated into 1-7 days, 8-14 days, and 15-30 days buckets. Also, NBFCs will need to monitor their cumulative mismatches (running total) across all other time buckets up to 1 year by establishing internal prudential limits with the approval of their boards.