RBI addresses medium term viability for NBFCs; short-term concerns still remain.

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Brickwork Ratings, Mumbai: The Reserve Bank of India (RBI) on May 24, 2019 through a draft circular on “Liquidity Risk Management Framework for Non-Banking Financial Companies (NBFC) and Core Investment Companies (CIC)” has tried to address the liquidity concerns faced by NBFCs in the recent past. Though the draft addresses the viability concerns in the medium term, concerns relating to liquidity, profitability continues to be unaddressed for the short term.

The draft proposed by the central bank includes introduction of Liquidity Coverage Ratio (LCR) for all deposit taking NBFCs; and non-deposit taking NBFCs with an asset size of INR 5000 crore and above. With a view to ensure a smooth transition to the LCR regime, the proposal is to implement it in a calibrated manner through a glide path over a period of four years commencing from April 2020 and going up to April 2024.

The draft guidelines also cover application of generic Asset Liability Management (ALM) principles, granular maturity buckets in the liquidity statements and tolerance limits, liquidity risk monitoring tool and adoption of the “stock” approach to liquidity.

Commenting on the development, **Rajat Bahl, Chief Analytical Officer & Head - Financial Institutions at Brickwork Ratings** opines, “RBI’s recent draft circular are steps in the right direction in bringing back confidence in the risk management of NBFCs in the medium term, however short-term measures still needed to overcome near-term confidence deficit leading to liquidity drought. There would be negative impact on the profitability on NBFCs where the LCR calibration would entail such adjustments, though for most large NBFCs the impact would be marginal.”

Introduction of granular maturity buckets of 1-7 days, 8-14 days and 15-30 days will ensure closer focus and better management of liquidity by NBFCs. However, the most effective tool being proposed is the introduction of Liquidity Coverage Ratio (LCR) for the mid-sized and large NBFCs. The proposed LCR guidelines require NBFCs to hold at any time High Quality Liquid Assets (HQLA) equivalent to 100% of net stressed cash outflows over the next 30 days. The LCR requirements will translate to the NBFCs having to hold a minimum of 28.75% of total cash outflows over the next 30 days. This liquidity requirement from NBFCs will provide a good cushion against any liquidity squeeze in the economy.

RBI recently had also mandated mid-sized and large NBFCs (assets more than INR 5000 crore) to appoint an independent Chief Risk Officer (CRO) reporting directly to CEO/Board, clearly highlighting the importance of risk management at senior most levels of NBFCs.

The draft guidelines could be enhanced further to link the liquidity requirement to also extend to the maximum gearing for NBFCs. The current capital guidelines theoretically allow NBFCs a gearing of between 6.5 times to 19 times. While NBFCs rarely go beyond a gearing of 10 times, NBFCs that maintain high liquidity, compute net gearing (subtracting the liquid investments from the borrowing) and hence tend to have a higher overall gearing. Therefore, an increased liquidity requirement might see NBFCs increasing their gross gearing level, unless the LCR guidelines are complemented with stricter guidelines for gearing.

While the guidelines aim to instil confidence in the risk management by NBFCs in the medium term, measures are required to erase the confidence deficit currently prevalent in the management of NBFCs. The current issue whether germinating from a solvency issue or a liquidity issue of a few large NBFCs issue has now led to lenders becoming wary of taking or extending their exposure, driving NBFCs to resort to securitizing their assets to improve liquidity. The interest in buying assets from NBFCs clearly indicates that the issue is not brewing from asset quality problems, however, dependence by NBFCs on securitization for an elongated period with higher than usual pricing could eventually convert the issue to one of solvency."

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