To,
The Chief General Manager, Reserve Bank of India
Department of Non-Banking Regulation
2nd Floor, World Trade Centre, Centre 1
Cuffe Parade, Colaba
Mumbai – 400005;
Via email to: nbfcalmfeedback@rbi.org.in

Sub: Feedback – Draft Liquidity Risk Management Framework for NBFCs and CICs

At the outset, we, at Indian Association of Investment Professionals (IAIP), a member society of the CFA Institute appreciate the opportunity to submit our response to the LIQUIDITY RISK MANAGEMENT FRAMEWORK FOR NON-BANKING FINANCIAL COMPANIES AND CORE INVESTMENT COMPANIES

IAIP is an association of over 2000 local investment professionals who are CFA charter holders and about 4000+ professionals who have cleared exams, eligible and awaiting charter. The Association consists of valuation professionals, portfolio managers, security analysts, investment advisors, and other financial professionals, that; promote ethical and professional standards within the investment industry, facilitate the exchange of information and opinions among people within the local investment community and beyond, and work to further the public's understanding of the CFA designation and investment industry.

CFA Institute is a global non-profit association of investment professionals with over 155,000 members in over 152 countries. In India, the community of CFA charter holders is represented by the Indian Association of Investment Professionals.

Through our global research and outreach efforts, CFA Societies around the world endeavour to provide resources for policy makers, financial services professionals and their customers in order to align their interests. Our members engage with regulators in all major markets.

With regards to the above-mentioned consultative paper, we have proposed a few suggestions.

We would be happy to hear and discuss the merits / demerits of suggestions proposed by other practitioners and request to be included in the deliberation process.

Our responses to the specific questions as per the addendum to the consultation paper are mentioned below:

A. Details of our Organisation:
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C. Comments:

Specific Comments

1. **Funding Strategy** - Diversified Funding, Liquidity Risk Management Policy, Strategies and Practices (Annex A)

The guidelines prescribe a regular ‘market testing’ approach to assess fund raising capacity for a Non-Banking Financial Company (NBFC). However, without effective quantitative guideline, unscrupulous management can ‘game’ such recommendations.

This is primarily because, the ability of an NBFC to raise additional debt by a small amount is far easier than raising a higher amount. In other words, capacity to raise funds doesn’t scale linearly.

Hence, without a quantitative guideline, an NBFC may err on the side of testing the markets conservatively, rather than truly perform a quality test representative of normal business operations.

This can in turn send wrong signals to regulators, policymakers, its own ALCO (asset liability management committee), and its Board of Directors.

Additionally, as a banking entity’s LCR format shows operational and non-operational deposits explicitly, similarly the regulator should direct NBFC-D (deposit taking NBFCs) to start assessing their deposits from the perspective of ‘stickiness’ and thus, assess their behaviour under stress.

A certain degree of standardization is welcome here, so as to allow easier comparison and assessment across peers and time period.

While focus on qualitative dimension is necessary as the regulator has rightly observed, but companies should be ‘nudged’ to start the conversation with stakeholders on their assumptions about deposits and their associated outflows. An assessment of deposit characteristics is a good starting point for this end goal.


The guidelines appropriately mention about stress testing scenarios. However, instead of letting the companies decide for themselves, the regulator should direct the scenarios with which they will have to test. In short, the stance of the regulator in this case, is more of benevolent recommendation in the highest spirits of modern regulation. But in the light of recent cases of market failures, and owing to the novelty of such guideline, the regulator has to closely direct this exercise at least in the early years (see “Policy Recommendations” below for a detailed discussion)

The regulator should drive reporting quality by an NBFC by recommending their own scenarios. However, the scenarios may be designed, care should be taken to incorporate the following aspects of stress:
I. **Market Stress**: A scenario characterised by a price shock, volatility shock, market liquidity shock or an unexpected correlation between otherwise uncorrelated assets.

II. **Idiosyncratic Stress**: A scenario characterised by regulatory action, credit event on a counterparty, or other such scenarios, which are hard to anticipate.

III. **Combined**: A combination of one or many such events.

3. **Assets to be Considered for HQLA with a minimum haircut of 50%**, High Quality Liquid Assets, Annex B

In this category, common equity shares of non-banking/financial institutions included in S&P CNX NIFTY50, or BSE Sensex index is considered HQLA with 50% haircut.

We believe, this is a problematic consideration, especially since equity shares have a strong tendency to fall sharply during bear markets, in proportion often exceeding 50%.

It is not uncommon to witness shares of companies, like real estate and infrastructure which were part of S&P CNX NIFTY 50 composition before 2008 crisis, fall as much as 90% immediately after crisis begun.

In such cases, a haircut of 50% will prove to be extremely optimistic and can cause severe liquidity crisis in NBFCs who hold such ‘stock’ of assets.

4. **Subpoint (F), High Quality Liquid Assets, Annex B**

As like #1, where we discussed capacity of fund raising to be scale-dependent, similarly “market testing” the saleability of HQLA without a gauge of proportion is misleading. Especially since, at even moderate volumes, certain ‘liquid’ assets can turn illiquid.

As a result, to boost the LCR ratio of an entity, the management can choose to liquidate only a miniscule portion of HQLA, ensuring impact costs are small enough to warrant easy saleability.

For example, consider the case of “carbon credit certificates” sold through Clean Development Mechanism, a mechanism that carries the reputation of being promoted by United Nations (United Nations Framework Convention on Climate Change). While a NBFC holding these certificates are actively traded under this mechanism and may otherwise be considered zero risk owing to the large and active international markets, they may not always be ‘deep’ enough to ensure quick liquidation in high volumes.

While the above was a hypothetical blue-sky example, a real-life example occurred during 2007-08 where otherwise AAA rated mortgage bonds, suddenly found its market drying up.

A right policy prescription here would be the inclusion of the following words – “sufficiently representative sample”
5. **Public Disclosure on Liquidity Risk, Appendix I**

The regulator has rightly made it compulsory for NBFCs and CICs to disclose publicly on various aspects of their liquidity positions. This is an extremely encouraging step and goes one step forward in the ultimate goal of regulators partnering with free markets to ensure systemic stability.

However, the information that is to be disclosed to the markets is sparse and will require a significant amount of time, education and experience for market participants to interpret these tools in the right way.

Hence, we propose that the regulator should deepen public disclosure by also mandating NBFCs to disclose:

a. Statement of Structural Liquidity, otherwise known as Maturity Ladder
b. Tenure of Funding for Top 20 Significant Counterparties
c. Cost of Funding by Tenure
d. Outstanding Undrawn commitment facilities by facility type

The other tools like 20 large deposits, borrowings etc are excellent complimentary tools.

6. **Disclosure Methodology**

Disclosure of data in the government, RBI, by exchanges is increasingly turning towards machine readable formats like XBRL and otherwise Spreadsheets.

However, clubbing the market disclosure tools with annual financial report will lead to publishing of this data in PDF format, thus preventing easy analysis. The regulators must make it mandatory for the companies to include spreadsheet format as downloadable format for individual investors.

**Policy Recommendations**

The framework is extremely timely and hence welcome, given the current situation of NBFCs in India. The ‘arc’ of regulatory policy is long in our country, but has always bent towards greater quality reporting and disclosure.

Taking inspiration from the opt-repeated quote, by Warren E. Buffett, “Failure arises from a failure to imagine failure”, the regulators must force the NBFCs to actively discuss about their potential business failure.

In this spirit, the regulator should start pushing the organizations to frame and form a Reverse Stress Test, where each organization will come up with scenarios that will render their operations unviable.

Such an exercise done annually, will force the Board of an NBFC to turn their attention away from the good news, and instead focus on the painful but important aspects.

Regulator can collate such reports and disclose the findings without naming the institutions in the initial years (say starting from FY2023-26). Post the pilot phase, the regulator can offer an option to the NBFCs to disclose it to the public, should they choose to.
Such a step will be gradually be considered a statement of strength and not doing so would signal negatively. In the process, the regulators will ensure that the market is kept informed about impending crisis well ahead of time. This will offer flexibility to regulators to guide the ecosystem through any such crisis.

If you or your staff have questions or seek further clarification, please do not hesitate to contact Mr. Rajendra Kalur, CFA @ +91 98196 30042 or at advocacy@iaipirc.org

Sincerely yours,

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