

# CAPITAL BUFFERS: RBI DRAFT NORMS TIMELY FOR NBFCS

Relevant for: Indian Economy | Topic: Issues relating to Growth & Development - Banking, NPAs and RBI

Non-banking financial companies, already reeling under a painful liquidity crisis, are up against a fresh challenge in the form of new regulatory norms set by the Reserve Bank of India. The central bank has released draft norms on liquidity risk management for deposit taking and non-deposit taking NBFCS. According to these proposed rules, NBFCS would have to comply with a higher liquidity coverage ratio (LCR), which is the proportion of assets that an NBFC needs to hold in the form of high-quality liquid assets that can be quickly and easily converted into cash. The new norms, which are expected to be implemented by the RBI over four years starting from April 2020, would likely put significant pressure on the margins of NBFCS. Under these norms, NBFCS would have to maintain their LCR at 60% of net cash outflows initially, and improve it to 100% by April 2024. If the norms are implemented, NBFCS may be forced to park a significant share of their money in low-risk liquid assets, such as government bonds, which yield much lower returns than high-risk illiquid assets. The strict norms have to be seen in the context of the present crisis where even prominent NBFCS are struggling to meet their obligations to various lenders.

While the profit outlook and other short-term financial metrics of NBFCS may be affected by the norms, there are good reasons to be optimistic about their long-term impact on the health of NBFCS and the wider financial sector. NBFCS, which are in the business of borrowing short term to lend long term, typically run the risk of being unable to pay back their borrowers on time due to a mismatch in the duration of their assets and liabilities. This is particularly so in instances where panic sets in among short-term lenders, as happened last year when lenders, worried about the safety of their capital, demanded to be paid back in full. In other words, NBFCS rely heavily on short-term lenders rolling over their loans without fail in order to avoid any kind of liquidity crisis. The new norms would discourage NBFCS from borrowing over short term to extend long-term loans without the necessary buffer capital in place. This could compel NBFCS to shrink the scope of their lending from what it is today, but it would save them from larger crises and significantly reduce the need for the government or the RBI to step in as the lender of last resort. Undeniably, NBFCS have done a tremendous job in recent years in widening and deepening access to credit by taking a share from the public sector banks, which have been severely affected by the bad loans crisis. However, the latest liquidity norms for NBFCS are still necessary to ward off systemic crises.

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As Prime Minister Modi returns to power, he must swear by the Indian civilisational ethos

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