CIRCULAR

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To,
All Finance Companies' / Finance Units in the International Financial Services Centre (IFSC)

<u>Subject: Guidelines on Liquidity Risk Management for a Finance Company/Finance Unit.</u>

The Finance Companies/Finance Units may draw reference to sub-regulation (3) of regulation 4 on Liquidity Coverage Ratio (LCR), of the International Financial Services Centres Authority (Finance Company) Regulations, 2021 (herein referred to as 'Regulations') dated March 25, 2021 issued by the Authority.

2. The ability to fund assets and meet obligations as they come due, is critical to the viability of a financial institution. In this context the Liquidity Risk Management framework ensures that the Finance Company/Finance Unit(FC/FU) anticipates liquidity needs and is prepared to meet them. The Authority directs the FC/FU in the International Financial Services Centres (herein referred to as 'IFSCs') to adhere to the following guidelines on Liquidity Risk Management.

3. Applicability:

3.1 These guidelines shall be applicable to all FC/FUs registered with the Authority under regulation 3 of the Regulations and intending to undertake activities as mentioned in point 5 and point 6 of the Schedule therein, viz;

(i)Undertaking one or more core activities with or without non-core activities, and;

(ii) Undertaking specialized activities with or without core or non-core activities.

Further as per sub-regulation (3) of regulation 4 of the Regulations a FU may be allowed to maintain LCR at the parent entity level with specific approval of the Authority.

Section I
Liquidity Risk Management

4. The FC/FU shall have a liquidity risk management framework in order to ensure a sound and robust liquidity risk management system and ensure that it maintains sufficient liquidity. This framework shall be framed by the Board/Governing Body of the FC/FU and shall be in adherence to Basel document titled "Principles for Sound Liquidity Risk Management and Supervision" dated September 2008.

Further, the FC/FU shall adhere to the broad principles laid down by the above mentioned Basel document (to the extent applicable and in tune with the nature scale and complexity of their business) with respect to governance of liquidity risk management and measurement and management of liquidity risk. These principles shall be adopted in letter and spirit and whenever subject to supervisory review the FC/FU shall be in a position to demonstrate that the principles are adopted satisfactorily while managing its liquidity risk.

5. Maturity profiling

(a) For measuring and managing net funding requirements, the use of a maturity ladder and calculation of cumulative surplus or deficit of funds at selected maturity dates shall be adopted as a standard tool. The Maturity Profile should be used for measuring the future cash flows of the FC/FU in different time buckets. The time buckets shall be distributed as under:

(i) 1 day to 7 days

(ii) 8 days to 14 days

(iii) 15 days to 30/31 days (One month)

(iv) Over one month and upto 2 months

(v) Over two months and upto 3 months

(vi) Over 3 months and upto 6 months

(vii) Over 6 months and upto 1 year

(viii) Over 1 year and upto 3 years

(ix) Over 3 years and upto 5 years

(x) Over 5 years

(b) Within each time bucket, there could be mismatches depending on cash inflows and outflows. While the mismatches up to one year would be relevant since these provide early warning signals of impending liquidity problems, the main focus shall be on the short-term mismatches, *viz.,* 1-30/31 days. The net cumulative negative mismatches in the Statement of Structural Liquidity in the maturity buckets 1-7 days, 8-14 days, and 15-30 days shall not exceed 05%, 10% and 20% of the cumulative cash outflows in the respective time buckets. FC/FUs, however, are expected to monitor their cumulative mismatches (running total) across all other time buckets upto 1 year by establishing internal prudential limits with the approval of the Board/Governing body. FC/FUs shall also adopt the above cumulative mismatch limits for their structural liquidity statement for consolidated operations.

(c) The Statement of Structural Liquidity shall be prepared by placing all cash inflows and outflows in the maturity ladder according to the expected timing of cash flows. A maturing liability shall be a cash outflow while a maturing asset shall be a cash inflow.

(d) In order to enable the FC/FU to monitor their short-term liquidity on a dynamic basis over a time horizon spanning from 1 day to 6 months, The FC/FU shall estimate their short-term liquidity profiles on the basis of business projections and other commitments for planning purposes.

6. Measurement of Liquidity risk

The FC/FU shall monitor certain critical ratios in respect of liquidity risk measurement by putting in place an internally defined limit approved by the Board/Governing Body, for these ratios. The ratios and the internal limits shall be based on an FC/FU's liquidity risk management capabilities, experience profile and the nature, scale and complexity of their business. The ratios that FC/FU shall monitor shall include but shall not be limited to the following:

(a) short term[1] liability to total assets
(b) short term liability to long term assets
(c) Non-convertible debentures to total assets
(d) short term liabilities to total liabilities
(e) long term assets to total assets

[1] Less than one year

Section II

A. Liquidity Coverage Ratio

A.1 Definitions

7 For the purpose of this circular, unless the context otherwise requires, the terms herein shall bear the meanings assigned to them below:

(a) “High Quality Liquid Assets (HQLA)” shall mean liquid assets that can be readily sold or immediately converted into cash at little or no loss of value or used as collateral to obtain funds in a range of stress scenarios.

(b) Liquidity Coverage Ratio (LCR) shall represented by the following ratio:

$$\frac{\text{Stock of High Quality Liquid Assets (HQLAs)}}{\text{Total Net Cash Outflows over the next 30 calendar days}}$$

(c) “Unencumbered” shall mean free of legal, regulatory, contractual or other restrictions on the ability of the FC/FU to liquidate, sell, transfer, or assign the asset.

A.2 LCR framework

8. (a) A FC/FU shall maintain an adequate level of unencumbered HQLA that can be converted into cash to meet its liquidity needs for a 30 calendar-day time horizon under a significantly severe liquidity stress scenario, as specified in these guidelines.

(b) While the LCR is expected to be met in a single currency, FC/FU are expected to be able to meet their liquidity needs in each currency and maintain HQLA consistent with the distribution of their liquidity needs by currency.

(c) For the purpose of reporting, LCR shall be reported in USD.

9. The LCR shall be minimum 100% (i.e., the stock of HQLA shall at least equal total net cash outflows) on an ongoing basis. However, during a period of financial stress, the FC/FU shall have the option to use their stock of HQLA and thereby allow LCR to fall below 100%. The Authority shall be immediately reported with respect to use of such stock of HQLA along with reasons for such usage and corrective steps initiated to rectify the situation.

10. The stress scenario for LCR intends to cover a combined idiosyncratic and market-wide shock that would result in:

(a) a partial loss of unsecured wholesale funding capacity;

(b) a partial loss of secured, short-term financing with certain collateral and counterparties;

(c) additional contractual outflows that would arise from a downgrade in the FC/FU's credit rating;
(d) increases in market volatilities that impact the quality of collateral or potential future exposure of derivative positions and thus require larger collateral haircuts or additional collateral, or lead to other liquidity needs;
(e) scheduled draws on committed but unused credit and liquidity facilities that the FC/FU has provided to its clients; and,
(f) the potential need for the FC/FU to buy back debt or honor non-contractual obligations in the interest of mitigating reputational risk.

11. High Quality Liquid Assets

11.1 Liquid assets comprise of high quality assets that can be readily sold or used as collateral to obtain funds in a range of stress scenarios. They shall be unencumbered. Assets are considered to be *high quality liquid assets* if they can be easily and immediately converted into cash at little or no loss of value. The liquidity of an asset depends on the underlying stress scenario, the volume to be monetized and the timeframe considered. Nevertheless, there are certain assets that are more likely to generate funds without incurring large discounts due to fire-sales even in times of stress.

11.2 The fundamental characteristics of HQLAs include low risk (i.e. credit risk, market risk, legal risk or other associated risks); ease and certainty of valuation; low correlation with risky assets and listing on a developed and recognized exchange market.

11.3 The market related characteristics of HQLAs include active and sizeable market; presence of committed market makers; low market concentration and flight to quality (tendencies to move into these types of assets in a systemic crisis).

11.4 All assets in the stock of liquid assets must be managed as part of that pool by the FC/FU and shall be subject to the following operational requirements:

(a) must be available at all times to be converted into cash;

(b) shall be unencumbered;

(c) shall not be co-mingled/ used as hedges on trading position; designated as collateral or credit enhancement in structured transactions or designated to cover operational costs;

(d) shall be managed with sole intent for use as a source of contingent funds; and,

(e) shall be under the control of specific function/s charged with managing liquidity risk of the FC/FU.

11.5 Assets to be included in the computation of HQLAs are those that the FC/FU is holding on the first day of the stress period. Such assets shall be valued at an amount no greater than their current market value for the purpose of computing the LCR. Depending upon the nature of assets, they have been assigned different haircuts below, which are to be applied while calculating the HQLA for the purpose of calculation of LCR. The assets and the haircuts are as under:

(I) Assets to be included as HQLA without any haircut:

(a) Sovereign or central bank debt securities issued by the sovereign or central bank, provided that the sovereign has 0% risk weight.

(b) Marketable securities issued or guaranteed by foreign sovereigns satisfying all the following conditions:

(i) Assigned a 0% risk weight under standardized approach for credit risk;

(ii) Traded in large, deep and active repo or cash markets characterized by a low level of concentration; and proven record as a reliable source of liquidity in the markets (repo or sale) even during stressed market conditions.

(iii) Not issued by a bank/FC/FU/financial institution or any of its affiliated entities.

(II) Assets to be considered for HQLA with a minimum haircut of 15%:

(a) Marketable securities representing claims on or claims guaranteed by sovereigns, Public Sector Entities (PSEs) or multilateral development banks that satisfy all of the following conditions;

(i) assigned a 20% risk weight under standardized approach for credit risk

(ii) traded in large, deep and active repo or cash, markets characterized by a low level of concentration;

(iii) have a proven record as a reliable source of liquidity in the markets (repo or sale) even during stressed market conditions (i.e. maximum decline of price not exceeding 10% or increase in haircut not exceeding 10% points over a 30-day period during a relevant period of significant liquidity stress); and

(iv) provided that they are not issued by a bank/financial institution/FC/FU or any of its affiliated entities.

(b) Corporate debt securities (including commercial paper)[2] that satisfy all of the following conditions:

(i) In the case of corporate debt securities; not issued by a financial institution or any of its affiliated entities;

(ii) In case of commercial papers; not issued by a bank/FC/FU/financial institution or any of its affiliated entities

(iii) Either (a) have a long-term credit rating from a recognized external credit assessment institution/agency rated at least AA- (or any equivalent rating) or (b) in the absence of a long term rating; a short term rating equivalent in quality to the long-term rating;

(iv) Traded in large, deep and active repo or cash markets characterized by low level of concentration and;

(v) Have a proven record as a reliable source of liquidity in the market (repo or sale) even during stressed market conditions: i.e. maximum decline of price or increase in haircut over a 30-day period during a relevant period of significant liquidity stress not exceeding 10%;

(vi) Are denominated in any freely convertible currency.

(III) Assets to be considered for HQLA with a minimum haircut of 50%:

(a) Marketable securities representing claims on or claims guaranteed by sovereigns having risk weights higher than 20% but not higher than 50%, i.e., they should have a credit rating not lower than BBB- or equivalent.

(b) Common Equity Shares which satisfy all of the following conditions:

(i) not issued by a bank/financial institution/FC/FU or any of its affiliated entities;

(ii) included in an index on a recognized stock exchange;

(iii) exchange traded and centrally cleared;

(iv) traded in large, deep and active repo or cash markets characterized by a low level of concentration;

(v) have a proven record as a reliable source of liquidity in the markets (repo or sale) even during stressed market conditions, i.e. a maximum decline of share price not exceeding 40% or increase in haircut not exceeding 40 percentage points over a 30-day period during a relevant period of significant liquidity.

[2] Corporate debt securities (including commercial paper) in this respect include only plain-vanilla assets whose valuation is readily available based on standard methods and does not depend on private knowledge, i.e. these do not include complex structured products or subordinated debt.

(c) Corporate debt securities (including commercial paper)[3] and the securities having usual fundamental and market related characteristics for HQLAs and meeting the following conditions:

(i) not issued by a bank/FC/FU, financial institution or any of its affiliated entities;

(ii) have a long-term credit rating from an eligible credit rating agency between A+ and BBB- (or any equivalent rating) or in the absence of a long-term rating, a short-term rating equivalent in quality to the long-term rating;

(iii) traded in large, deep and active repo or cash markets characterized by a low level of concentration; and

(iv) have a proven record as a reliable source of liquidity in the markets (repo or sale) even during stressed market conditions, i.e. a maximum decline of price not exceeding 20% or increase in haircut over a 30-day period not exceeding 20 percentage points during a relevant period of significant liquidity stress.

(v) Are denominated in any freely convertible currency.

11.6 FC/FU's shall periodically monetize a proportion of assets through repo or outright sale to test the saleability of these assets and to minimize the risk of negative signaling during period of stress. FC/FU's are also expected to maintain liquid assets consistent with distribution of their liquidity needs by currency.

11.7 If an eligible liquid asset becomes ineligible (e.g. due to downgrade), FC/FU's will be allowed to keep the asset in their stock of liquid assets for an additional 30 calendar days in order to have sufficient time to adjust the stock / replace the asset.

12. Total net cash outflows

12.1 *Total net cash outflows* shall be defined as the total expected cash outflows minus total expected cash inflows for the subsequent 30 calendar days. Considering the unique nature of the balance sheet of the FC/FU's, stressed cash flows is computed by assigning a predefined stress percentage to the overall cash inflows and cash outflows. Total expected cash outflows (stressed outflows) are calculated by multiplying the outstanding balances of various categories or types of liabilities and off-balance sheet commitments by 115% (15% being the rate at which they are expected to run off further or be drawn down). Total expected cash inflows (stressed inflows) are calculated by multiplying the outstanding balances of various categories of contractual receivables

[3] Refer footnote 2

by 75% (25% being the rate at which they are expected to under-flow). However, total cash inflows will be subjected to an aggregate cap of 75% of total expected cash outflows. In other words, total net cash outflows over the next 30 days = Stressed Outflows - Min (stressed inflows; 75% of stressed outflows).

Items of Cash Inflows	**Items of Cash Outflows**
a. Maturing secured lending transactions backed by HQLA b. Margin Lending backed by all other collateral c. All other assets d. Lines of credit – Credit or liquidity facilities or other contingent funding facilities that the FC/FU holds at other institutions for its own purpose e. Other inflows by counterparty f. Net derivatives cash inflows g. Other contractual cash inflows	a. Unsecured wholesale Funding b. Secured Funding c. Additional requirements [(i)+(ii)+(iii)+(iv)+(v) +(vi)+(vii)+(viii)]: (i) Net derivative cash outflows (ii) Liquidity needs related to financing transactions, derivatives and other contracts where 'downgrade triggers' up to and including a 3-notch downgrade (iii) Market valuation changes on derivatives transactions (largest absolute net 30-day collateral flows realized during the preceding 24 months) based on look back approach (iv) Increased liquidity needs related to the potential for valuation changes in collateral securing derivatives (v) Increased liquidity needs related to excess non-segregated collateral held that could contractually be called at any time by the counterparty (vi) Increased liquidity needs related to contractually required collateral on transactions for which the counterparty has not yet demanded the collateral be posted (vii) Increased liquidity needs related to derivative transactions that allow collateral substitution to non-HQLA assets (viii) Currently undrawn committed credit and liquidity facilities (e) Other contingent funding liabilities (f) Any other contractual outflows not captured elsewhere.

Table 1: Items to be included in the cash inflows and outflows.

S No.	Net Cash outflows over the 30 days period	Amount
A	Total Cash Outflows	
B	Stressed Cash Outflows (A*115%)	
C	Total Cash Inflows	
D	Stressed Cash Inflows (C*75%)	
E	Total net cash outflows over the next 30 days = Stressed Outflows (B) - Minimum of (Stressed Inflows (D); 75% of Stressed Outflows(B)).	

Table 2: Computation of Net cash outflows.

12.2 FC/FUs shall not be permitted to double count items, i.e., if an asset is included as part of the “stock of HQLA” (i.e., the numerator), the associated cash inflows cannot also be counted as cash inflows (i.e., part of the denominator). Where there is potential that an item could be counted in multiple outflow categories (e.g., committed liquidity facilities granted to cover debt maturing within the 30 calendar day period), an FC/FU only has to assume up to the maximum contractual outflow for that product.

13. Disclosure on Liquidity risk management

The FC/FU shall disclosure the following information on liquidity risk from time to time:

(a) Institutional setup for liquidity risk management.

(b) Funding concentration based on significant counterparty.

(c) Funding concentration based on significant instrument / product.

(d) Critical ratios as specified in paragraph 6 of the guidelines as applicable to the FC/FU.

B. Liquidity Risk Monitoring tools

14. The liquidity risk shall be monitored via the Statement of Structural liquidity and the following metrics which capture specific information related to the FC/FUs cash flows, balance sheet structured, available unencumbered collateral and certain market indicators.

(a) Concentration of funding

This metric is meant to identify those significant sources of funding, withdrawal of which could trigger liquidity problems. The metric thus encourages diversification of funding sources and monitoring of each of the significant counterparty[4], significant product / instrument[5] and significant currency.

(b) Available unencumbered assets

This metric provides significant information on available unencumbered assets, which have the potential to be used as collateral to raise additional secured funding in secondary markets. It shall capture the details of the amount, type and location of available unencumbered assets that could serve as collateral for secured borrowing in secondary markets.

(c) Market-related Monitoring Tools:

(i) This includes high frequency market data that can serve as early warning indicators in monitoring potential liquidity difficulties at the FC/FUs.

(ii) The Board / committee set up for the purpose shall monitor on a monthly basis, the movements in their book-to-equity ratio for listed FC/FU's and the coupon at which long-term and short-term debts are raised by them. This also includes information on breach/penalty in respect of regulatory liquidity requirements, if any.

(d) LCR by significant currency

(i) While LCR is expected to be met in a single currency, in order to better capture the potential currency mismatches the LCR shall also be calculated in other significant currencies to identify the potential currency mismatches that could arise in a time of stress.

Foreign Currency LCR shall be represented by the following ratio:

$$\frac{\text{Stock of HQLA in each significant currency}^{6}}{\text{Total net cash outflows over a 30 day time period in each significant currency}}$$

[4] A "Significant counterparty" is defined as a single counterparty or group of connected or affiliated counterparties accounting in aggregate for more than 10% for a FC/FU.

[5] A "significant instrument/product" is defined as a single instrument/product of group of similar instruments/products which in aggregate amount to more 10% for FC/FU.

[6] A currency is considered "significant" if the aggregate liabilities denominated in that currency amount to 5% or more of the FC/FUs total liabilities.

(ii) The definition of the stock of high-quality foreign exchange assets and total net foreign exchange cash outflows shall be same as is considered for computation of LCR for common currencies[7]

15. Disclosure on LCR

FC/FUs shall disclose information on LCR in a format prescribed by the Authority including a sufficient qualitative discussion (in their annual financial statements under Notes to Accounts) around the LCR to facilitate understanding of the results and data provided in their annual financial statements.

16. All Finance Companies and Finance Units for which this circular is applicable, are directed to ensure compliance with this circular.

Yours faithfully

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[7] Cash flows from assets, liabilities and off-balance sheet items will be computed in the currency that the counterparties are obliged to deliver to settle the contract, independent of the currency to which the contract is indexed (or "linked'), or the currency whose fluctuation it is intended to hedge.