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Non-banking Financial Companies – Infrastructure Finance Companies

Draft guidelines aim to strengthen balance sheets; near-term profitability to be impacted

MAY 2024

List of abbreviations and definition of select terms

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NBFC	Non-banking finance company
RBI	Reserve Bank of India
RE	Regulated entity
DCCO	Date of commencement of commercial operations
RoMA	Return on managed assets
Endogenous risks	Risks that are endogenous to a specific project, and mainly arise from deficiencies in planning/execution capability of the project sponsor/concessionaire. These may lead to cost overruns, time overruns, change in ownership, etc.
Exogenous risks	Risks that are exogenous to a specific project and may adversely impact some or most of the entities in the economy or in a specific sector or in a specific geographic region. These factors may be natural calamities, pandemics, changes in government policy/regulation/law, etc.
HAM	Hybrid annuity model
Project finance	Project finance refers to the method of funding wherein the lender looks primarily to the revenues generated by a single project, both as the source of repayment and as a security for the loan.
CRE	Commercial real estate
NBFC-IFC	Non-banking finance company – Infrastructure finance company
Credit event	A credit event shall be deemed to have occurred if there is a default; and/or lenders determine a need for extension of the originally envisaged DCCO of the project or any subsequent extension of already amended DCCO; and/or lenders determine a need for infusion of additional debt; and/or if there is a diminution in the net present value (NPV) of the project.
Review period	30 days from the date of credit event

Highlights

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Draft regulations focused on more robust underwriting and information sharing among lenders.

Higher provisioning requirement for projects under implementation to impact profitability for REs; though impact to be spread over a three-year period.

Project finance cost would go up as lenders build in extra provisioning cost in lending rates; viability of projects could be impacted.

- On May 03, 2024, the RBI issued the draft guidelines, "Prudential Framework for Income Recognition, Asset Classification and Provisioning pertaining to Advances - Projects Under Implementation, Directions, 2024". These have been issued to rationalise the extant guidelines and harmonise the same for all regulated entities (REs), which undertake project finance.
- The draft guidelines propose more robust underwriting by project finance lenders and emphasise the need for all key approvals being in place before loan disbursement. Similarly, the DCCO needs to be spelt out clearly and documented at the time of financial closure. Any subsequent change in the DCCO could be treated as a credit event, indicating vulnerability in the project credit profile.
- The draft guidelines harmonise the provisioning requirement in case of DCCO deferrals across REs and proposes a higher provision requirement for under-construction projects under implementation, which is proposed to be applied gradually over a three-year period. Maximum permissible DCCO deferral while maintaining standard asset status is proposed to be reduced to 3 years.
- The impact of the proposed higher provisioning for under implementation projects would be significant. Per annum impact on RoMA during the glide path provided is estimated at 100-150 bps for the lenders. Alternatively, some entities could directly create the impairment reserve and hence Tier I capital could be accordingly impacted. DCCO deferrals beyond 1/2 year would attract further higher specific provisions.
- The guidelines also provide a roadmap for gradual reduction in provisioning requirement based on the project's performance; however, would still be higher than the current norm of 0.4% of the loan amount.
- In ICRA's view, project finance ability could get impacted in some cases since the funding cost could go up by 20-40 bps as lenders build in an additional risk premium in their loan pricing.
- Some of the other requirements like maximum permissible moratorium and loan tenure being limited to 85% of the economic life of a project could be constraining for specific sectors like roads etc., which have long implementation period.

Key areas covered in the draft guidelines

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Prudential Conditions for Project Finance

- Aimed at more robust underwriting and exposure norms

Resolution of Stress

- Harmonisation of recognition of stress and increased data sharing among lenders
- Resolution process and conditions applicable for DCCO extension

Income Recognition and Provisioning for Standard Assets

- Prudent accounting of income
- Enhanced provisioning requirement for projects under implementation

Prudential conditions for project finance – key points

Measures directed at more prudent underwriting and risk mitigation

All mandatory pre-requisites (e.g. availability of land, legal clearance, regulatory clearance) to be in place before final closure

Limit the number of lenders, which can ease the subsequent consortium decision making and resolution process, if required

Financial closure to be achieved and DCCO to be clearly spelt out and documented before disbursement of funds. Disbursement to be in proportion to stages of project completion

For consortium lending, the exposure floor for each lender would be as follows:

Aggregate lender exposure	Lender floor amount
Up to Rs. 1,500 crore	10% of aggregate exposure
Greater than Rs. 1,500 crore	5% of aggregate exposure or Rs. 150 crore, whichever is higher

Generally, no moratorium on repayments beyond DCCO. In specific cases, moratorium beyond DCCO not to exceed six months. Repayment structure to be realistically designed to factor in lower cash flows initially

Could be stringent in case of some projects where the first annuity is received as late as after 6 months of DCCO

Original or revised repayment tenor, including moratorium period, not to exceed 85% of the economic life of the project

May be a constraint in some HAM projects where annuity payment available after loan tenures is limited

Resolution of stress

Conditions for an account to continue to be classified as 'Standard' post DCCO deferment

Reasons for extension of DCCO			
	Exogenous risks	**Endogenous risks**	**Litigation (court cases)**
Allowable deferment of DCCO from originally envisaged DCCO in the financing agreement	Up to 1 year (including CRE projects)	Up to 2 years for infrastructure projects	Up to 1 year (including CRE projects)
		Up to 1 year for non-infrastructure projects (excluding CRE projects)	

Occurrence of credit event, during the construction period, with any of the lenders in project financing arrangement, within or outside the consortium, shall trigger a collective resolution

Maximum permissible DCCO deferment reduced to 3 years for infrastructure loans (from 4 years earlier) and 2 years for non-infrastructure loans

If the resolution plan involving change in DCCO is not successfully implemented within 180 days from end of review period, then account will be downgraded to NPA

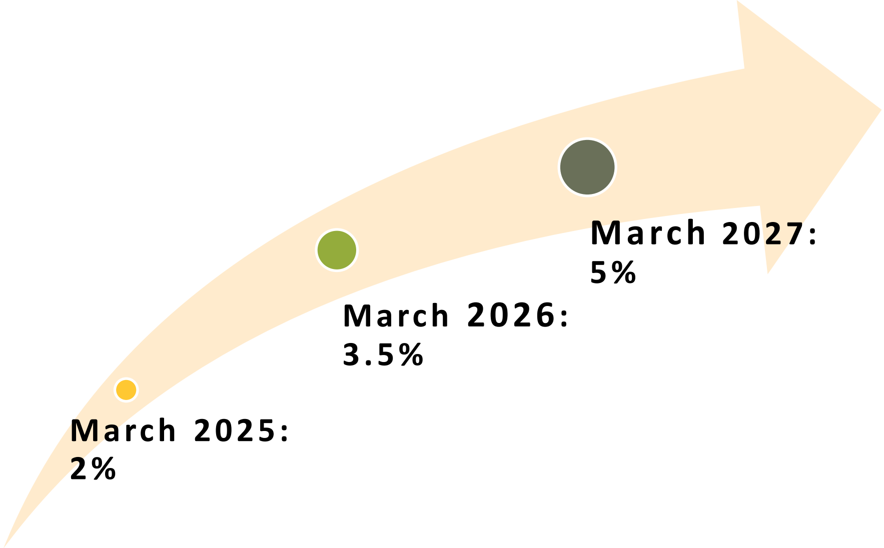
Income recognition and provisioning for standard assets – key points

- In case of DCCO deferred accounts, where account classification is standard and there is moratorium on payment of interest and principal, the lenders are to book income only on cash basis.
- Proposed changes in provisioning requirement for standard assets under implementation

		Existing requirement for standard asset provisioning		Proposed standard asset provisioning
	Status	**Banks**	**NBFCs**	**All lenders***
Under construction	All under implementation projects including projects where revised DCCO is within two years from the original DCCO prescribed during financial closure	0.40%	ECL	5%
	If the DCCO is extended beyond two years	5%	5%/ECL	5% + 2.5% = 7.5%
Operational phase	Operational project	0.40%	ECL	2.5%
	Operational project (after DCCO deferral) with positive net operating cash flow sufficient to cover current payment obligations and at least 20% decline in long-term debt of the project outstanding at the time of the DCCO	0.40%	ECL	1%

**Note: For NBFCs, higher of IRAC or ECL provisioning would apply*

Phased provision build-up required for projects in under-construction phase with DCCO deferment



- Applicability of these guidelines to existing stock of project assets could mean the provision on existing books would also need to be significantly increased. As per ICRA's estimates, the current stage 1 provision for NBFC-IFCs is ~0.60% which would need to be increased gradually to meet the proposed requirements.

- Even after DCCO achievement and meeting the other stipulated requirements, the provisioning for the account would need to be at least 1% (over 0.25% or 0.4% today), despite satisfactory performance

Increased provisioning requirement would be passed on to borrower and, thus cost of borrowing for projects could go up by 20-40 bps as per ICRA's estimates

Expected impact on profitability for REs – an illustration

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Exhibit: Expected reduction in RoMA (in bps) for NBFC-IFCs per annum (over a three-year period)

Share of under construction portfolio										
0%	**10%**	**20%**	**30%**	**40%**	**50%**	**60%**	**70%**	**80%**	**90%**	**100%**
64	72	80	89	97	105	114	122	130	139	147

Note: This calculation is based on current portfolio mix of NBFC-IFCs and has not been adjusted for portfolio growth and any subsequent movement from under construction projects to operational projects. Also, impact on RoMA is assumed to be equally spread over a three-year period.

Current NBFC-IFC RoMA is ~2.2% per annum

Sector-specific impact – Power sector

Impact will be more prominent for higher gestation projects such as thermal power and hydro, followed by power transmission (to a lesser extent), wherein the risk of delays is prominent. This would increase the IDC component of the project cost and also impact the debt metrics, post the DCCO.

Most of the thermal projects currently under development are by the Central/state public sector utilities, which typically follow the balance sheet funding route and have the cost-plus tariff structure. This is also true for the hydro segment.

In the case of power transmission projects awarded through the bidding route, the higher cost of debt funding will impact the project debt metrics. For every 50 bps increase in interest rates, the cumulative DSCR of the project will be impacted by 2-3 bps.

The risk of delays / deferment of DCCO is relatively lower for solar and wind projects compared to the thermal, hydro and transmission segments. Also, IDC forms a small component of the project cost, given the lower gestation period. Nonetheless, the increase in cost of funding will have an impact, post the DCCO. For the wind and solar projects as well, every 50 bps increase in interest rate will impact the cumulative DSCR of the project by 2-3 bps.

Sector-specific impact – Roads

For a hybrid annuity mode (HAM) road project of the National Highways Authority of India (NHAI), the annuity becomes due for payment after 180 days of COD (commercial operations date) and the authority (NHAI) has 15 days for making the annuity payment, as per the concession agreement. To address these timelines, HAM project sanctions generally have seven months' (or higher) repayment moratorium from the COD date, which provides a cushion of more than one month in case of administrative delays in annuity receipt. However, the proposed RBI regulations will have practical challenges in implementing as the maximum moratorium period allowed is six months, thereby providing no headroom in case of delays in annuity receipt.

The operational period for a HAM project is 15 years and sanctions generally have 13.5-14 years as repayment period, translating to a repayment tenor at above 90% of the economic life of the project. The draft regulations specify the repayment tenor, including the moratorium period not exceeding 85% of the economic life of the project, and would require revision in sanction terms for new HAM projects to align with the modified regulations. The compressed timelines for repayment are likely to increase the equity requirements for the developers for maintaining a similar credit profile.

The increase in provisioning norms for under-construction and operational projects is likely to result in higher borrowing costs. For operational HAM road projects, every 50 bps increase in interest rate will result in the cumulative DSCR of the project declining by 2-3 bps. This, coupled with the revision in the repayment tenor to 85% of the economic life of the project, is likely to result in a material decline in the cumulative DSCR by 7-10 bps.

To summarise

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1. Legacy issues faced by lenders have largely been addressed; however, retrospective application of guidelines would lead to higher provisioning requirement on the existing book as well.

2. Lenders would need to build in adequate buffers while underwriting project finance loans as subsequent changes would construe increased riskiness in the loan book

3. Lenders with exposures to relatively lower gestation projects, such as solar and wind, would be less impacted than in sectors such as roads.

4. Tier I capital for lenders could be impacted by 100-250 bps due to lower profitability. However, lenders might pass on some of the cost to borrowers to mitigate the impact, subject to project viability permitting such actions.

5. Going forward, credit flow to project loans could get hampered as lenders will have to allocate higher capital for such loans.

ICRA-rated infrastructure financing entities

Company	Long Term*	Outlook	Short Term
Aseem Infrastructure Finance Limited	[ICRA]AA+	Stable	[ICRA]A1+
Housing and Urban Development Corporation Ltd	[ICRA]AAA	Stable	[ICRA]A1+
India Infradebt Limited	[ICRA]AAA	Stable	[ICRA]A1+
India Infrastructure Finance Company Ltd	[ICRA]AAA	Stable	
Indian Renewable Energy Development Agency Ltd	[ICRA]AAA	Stable	[ICRA]A1+
Indian Railway Finance Corporation Ltd	[ICRA]AAA	Stable	[ICRA]A1+
Kotak Infrastructure Debt Fund Limited	[ICRA]AAA	Stable	[ICRA]A1+
NIIF Infrastructure Finance Limited	[ICRA]AAA	Stable	[ICRA]A1+
Power Finance Corporation Limited	[ICRA]AAA	Stable	[ICRA]A1+
PTC India Financial Services Limited	[ICRA]A+	Negative	[ICRA]A1
REC Limited	[ICRA]AAA	Stable	[ICRA]A1+

*Source: ICRA Research; *Senior-most debt ratings; Note: Data as on March 31, 2024*

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Thank You!