Financing of Infrastructure Projects

IECD.No. /08.12.01/2001-02

February 20, 2002

The Chairman/Chief Executive Officer
(All commercial banks/
All India Financial Institutions)

Dear Sir,

<u>Financing of Infrastructure Projects</u>

Please refer to our circular IECD.No.26/08.12.01/98-99 dated April 23, 1999 regarding financing of infrastructure projects.

2. In the light of paragraph 71 of the Mid-Term Review of Monetary and Credit Policy for the year 2001-2002 announced by Governor on October 22, 2001 and after a review of the matter, some of the instructions relating to criteria for financing, inter-institutional guarantees and Group Exposure Limit for infrastructure projects contained in the above IECD circular have been modified and banks/financial institutions are advised as under :

<u>Criteria for Financing - Finance for infrastructure projects undertaken by government owned entities</u>

3. In respect of infrastructure projects, where financing is by way of term loans or investment in bonds issued by government owned entities, banks/Financial Institutions should undertake due diligence on the viability and bankability of such projects to ensure efficient utilization of resources and creditworthiness of the projects financed. Banks should also ensure that the individual components of financing and returns on the project are well defined and assessed. Lending/investment decisions in such cases should be based solely on commercial judgment of banks/Financial Institutions. There should be no compromise on proper credit appraisal and close monitoring of the projects financed and banks should ensure that only projects that are intrinsically viable are financed. State Government guarantees may not be taken as a substitute for satisfactory credit appraisal

and such appraisal requirements should not be diluted on the basis of any reported arrangement with the Reserve Bank of India or any bank for regular standing instructions/periodic payment instructions for servicing the loans/bonds.

4. As indicated in paragraph 3.2 (item vi) of our circular IECD.No.26/08.12.01/98-99 dated April 23, 1999, in respect of projects undertaken by public sector units, term loans may be sanctioned only for public sector undertakings registered under the Companies Act or a Corporation established under the relevant statute. Further, such term loans should not be in lieu of or to substitute budgetary resources envisaged for the project. The term loans could supplement the budgetary resources if such supplementing was contemplated in the project design. While such public sector units may include Special Purpose Vehicles (SPVs) registered under the Companies Act set up for financing infrastructure projects, it should be ensured by banks and financial institutions that these loans/investments are not used for financing the budget of the State Governments. Whether such financing is done by way of extending loans or investing in bonds, banks and financial institutions should undertake due diligence on the viability and bankability of such projects to ensure that revenue stream from the project is sufficient to take care of the debt servicing obligations and that the repayment/servicing of debt is not out of budgetary resources. Further, in case of financing SPVs, banks and financial institutions should ensure that the funding proposals are for specific monitorable projects other than those being implemented by State Governments in view of the fact that the borrowings of State Governments for budgetary purposes are met by banks and financial institutions by contributions to their approved market borrowing programmes.

Inter-Institutional Guarantees

5. In respect of infrastructure projects, banks would be permitted to issue guarantees favouring other lending institutions, provided the bank issuing the guarantee takes a funded share in the project at least to the extent of 5 per cent of the project cost and undertakes normal credit appraisal, monitoring and follow up of the project.

Group Exposure Limit

6. The additional exposures of 10 per cent in Group Exposure limit presently restricted to projects in four specified infrastructure sectors, viz., roads, power, telecommunications and ports may be extended to projects in all infrastructure sectors as defined in circular IECD.No.11/08.12.01/1999-2000 dated March 2, 2000.

7. The guidelines on financing of infrastructure projects as currently applicable are set out in Annexure.

Please acknowledge receipt.

Yours faithfully,

(Smt.R.K.Makhija)
General Manager

Encl.

Annexure

Guidelines for Financing of Infrastructure Projects

Modalities of Financing
Infrastructure Projects

1.1 Coverage

The coverage under "infrastructure " would be the same as defined under Section 10 (23 G) of the Income Tax Act, 1961. Accordingly, infrastructure would include sectors such as power, roads, highways, bridges, ports, airports, rail system, water supply, irrigation, sanitation and sewerage system, telecommunication, housing, industrial park or any other public facility of a similar nature as may be notified by CBDT in the Gazette from time to time (please see circular IECD.No.11/08.12.01/1999-2000 dated March 2, 2000).

1.2 Criteria for Financing

Banks/FIs are free to sanction term loans for technically feasible, financially viable and bankable projects undertaken by both public sector and private sector undertakings subject to the following conditions:

(i) The amount sanctioned should be within the overall ceiling of the prudential exposure norms prescribed by RBI (please see paragraph 4.1 also).

(ii) Banks/FIs should satisfy themselves that the projects financed by them have income generation capacity sufficient to repay the loan together with interest. Banks/FIs should also satisfy themselves that the project financed is run on commercial lines i.e. involving commercial considerations such as identifiable activity, cash-flow considerations and that they do not run into liquidity mismatch on account of lending to such projects.

(iii) Banks should evolve an appropriate debt-equity ratio for each project, if necessary in consultation with FIs.

(iv) Banks/FIs are free to decide the period of loans keeping in view, *inter alia,* the maturity profile of their liabilities (please see paragraph 4.2 also).

(v) Banks/ FIs should have the requisite expertise for appraising technical feasibility, financial viability and bankability of projects, with particular reference to the risk analysis and sensitivity analysis (please see paragraph 3 also).

(vi) In respect of infrastructure projects undertaken by Government owned entities, where financing is by way of term loans or investment in bonds issued by government owned entities, banks/Financial Institutions should undertake due diligence on the viability and bankability of such projects to ensure efficient utilisation of resources and creditworthiness of the projects financed. Banks should also ensure that the individual components of financing and returns on the project are well defined and assessed. Lending/investment decisions in such cases should be based solely on commercial judgment of banks/Financial Institutions. There should be no compromise on proper credit appraisal and close monitoring of the projects financed and banks should ensure that only projects that are intrinsically viable are financed. State Government guarantees may not be taken as a substitute for satisfactory credit appraisal and such appraisal requirements should not be diluted on the basis of any reported arrangement with the Reserve Bank of India or any bank for regular standing instructions/periodic payment instructions for servicing the loans/bonds.

(vii) In respect of projects undertaken by public sector units, term loans may be sanctioned only for corporate entities (i.e. public sector undertakings registered under Companies Act or a Corporation established under the relevant statute). Further, such term loans should not be in lieu of or to substitute budgetary resources envisaged for the project. The term loan could supplement the budgetary resources if such supplementing was contemplated in the project design. This is in relaxation of the earlier instructions on the subject contained in circular IECD. No. 15/08.12.01/94-95 dated October 6, 1994. While such public sector units may include Special Purpose Vehicles (SPVs) registered under the Companies Act set up for financing infrastructure projects, it should be ensured by banks and financial institutions that these loans/investments are not used for financing the budget of the State Governments. Whether such financing is done by way of extending loans or investing in bonds, banks and financial institutions should undertake due diligence on the viability and bankability of such projects to ensure that revenue stream from the project is sufficient to take care of the debt servicing obligations and that the repayment/servicing of debt is not out of budgetary resources. Further, in case of financing SPVs, banks and financial institutions should ensure that the funding proposals are for specific monitorable projects other than those being implemented by State Governments in view of the fact that the borrowings of State Governments for budgetary purposes are met by banks and financial institutions by contributions to their approved market borrowing programmes.

2. <u>Types of Financing by Banks</u>

2.1 In order to meet long-term financial requirements of infrastructure projects, banks may, *inter alia*, take recourse to the following:

(a) Finance through funds raised by way of subordinated debt, subject to the terms and conditions stipulated in circular DBOD.No.BP.BC.5/21.01.002/98-99 dated February 8,1999.

(b) Entering into take-out financing arrangement with IDFC/other financial institutions or availing of liquidity support from IDFC/other FIs (some of the important features of the arrangement are given in Appendix I).

(c) Direct financing through rupee term loans, deferred payment guarantees foreign currency loans, etc., keeping in view the ability to manage asset- liability profile.

(d) Investment in infrastructure bonds issued by project promoters/FIs.

2.2 Inter-institutional Guarantees

In terms of the extant RBI instructions, banks are precluded from issuing guarantees favouring other banks/lending institutions for the loans extended by the latter , as the primary lender is expected to assume the credit risk and not pass on the same by securing itself with a guarantee i.e. separation of credit risk and funding is not allowed. These instructions are presently not applicable to FIs. While Reserve Bank is not in favour of a general relaxation in this regard, keeping in view the special features of lending to infrastructure projects viz., high degree of appraisal skills on the part of lenders and availability of resources of a maturity matching with the project period, banks would be permitted to issue guarantees favouring other lending institutions in respect of infrastructure projects, provided the bank issuing the guarantee takes a funded share in the project at least to the extent of 5 per cent of the project cost and undertakes normal credit appraisal, monitoring and follow up of the project.

3. <u>Appraisal</u>

Infrastructure projects are often financed through Special Purpose Vehicles and are structured on a limited/non-recourse basis (important features of this arrangement are given in Appendix II). Financing of these projects would, therefore, call for special appraisal skills on the part of lending agencies. Identification of various project risks, evaluation of risk mitigation through appraisal of project contracts and evaluation of creditworthiness of the contracting entities and their abilities to fulfil contractual obligations will be an integral part of the appraisal exercise. In this connection, banks/FIs may consider constituting appropriate screening committees/special cells for appraisal of credit proposals and monitoring the progress/performance of the projects. Often, the size of the funding requirement would necessitate joint financing by banks/FIs or financing by more than one bank under consortium or syndication arrangements. In such cases, participating banks/FIs may, for the purpose of their own assessment, refer to the appraisal report prepared by the lead bank/FI or have the project appraised jointly. Banks/FIs should, however, ensure that the appraisal in all cases is completed within a time bound period and that repetitive and sequential appraisals by several institutions are avoided.

4. Regulatory Compliance/ Concerns

4.1 Prudential Exposure Norms

Infrastructure finance will continue to be governed by the instructions regarding exposure limits currently in force. As regards Group Exposure Limit, the additional exposures of 10 per cent in the limit presently restricted to projects in four specified infrastructure sectors, viz., roads, power, telecommunications and ports may be extended to projects in all infrastructure sectors as defined in paragraph 1.1 above.

4.2 Asset-Liability Management

The long - term financing of infrastructure projects may lead to asset – liability mismatches, particularly when such financing is not in conformity with the maturity profile of a bank's liabilities. Banks would, therefore, need to exercise due vigil on their asset-liability position to ensure that they do not run into liquidity mismatches on account of lending to such projects. In this connection, banks may refer to the guidelines on Asset-Liability Management (ALM) System issued vide circular DBOD.No.BP.BC.8/21.0400/98-99 dated February 10, 1999 and, as advised therein, put in place an effective ALM system within the stipulated timeframe. FIs are also advised to put in place an effective ALM System as stipulated in circular DBS. FID. No. C.11/01.02.00/99 – 2000 dated December 31, 1999.

5. Administrative Arrangements

Timely and adequate availability of credit is the pre-requisite for successful implementation of infrastructure projects. Banks/FIs should, therefore, clearly delineate the procedure for approval of loan proposals and institute a suitable monitoring mechanism for reviewing applications pending beyond the specified period. Multiplicity of appraisals by every institution involved in financing, leading to delays, has to be avoided and banks should be prepared to broadly accept technical parameters laid down by leading public financial institutions. Also, setting up a mechanism for an ongoing monitoring of the project implementation will ensure that the credit disbursed is utilised for the purpose for which it was sanctioned.

APPENDIX-I

Take-out financing/liquidity support

(a) Take-out financing arrangement

Take-out financing structure is essentially a mechanism designed to enable banks to avoid asset-liability maturity mismatches that may arise out of extending long tenor loans to infrastructure projects. Under the arrangements, banks financing the infrastructure projects will have an arrangement with IDFC or any other financial institution for transferring to the latter the outstandings in their books on a pre-determined basis. IDFC and SBI have devised different take-out financing structures to suit the requirements of various banks, addressing issues such as liquidity, asset-liability mismatches, limited availability of project appraisal skills, etc. They have also developed a Model Agreement that can be considered for use as a document for specific projects in conjunction with other project loan documents. The agreement between SBI and IDFC could provide a reference point for other banks to enter into somewhat similar arrangements with IDFC or other financial institutions.

(b) Liquidity support from IDFC

As an alternative to take-out financing structure, IDFC and SBI have devised a product, providing liquidity support to banks. Under the scheme, IDFC would commit, at the point of sanction, to refinance the entire outstanding loan (principal+unrecovered interest) or part of the loan, to the bank after an agreed period, say, five years. The credit risk on the project will be taken by the bank concerned and not by IDFC. The bank would repay the amount to IDFC with interest as per the terms agreed upon. Since IDFC would be taking a credit risk on the bank, the interest rate to be charged by it on the amount refinanced would depend on the IDFC's risk perception of the bank (in most of the cases, it may be close to IDFC's PLR). The refinance support from IDFC would particularly benefit the banks which have the requisite appraisal skills and the initial liquidity to fund the project.

APPENDIX-II

Features of limited/non-recourse financing
structure of infrastructure projects

Infrastructure projects are characterised by large size, huge capital costs, long gestation and extended pay back period thereafter and high leverage ratios. Financing of infrastructure projects is different from the traditional method of financing based on the balance sheet support. These projects are often financed through Special Purpose Vehicles (SPVs) and are structured on a limited/non-recourse basis. The approach to such projects is to properly identify and allocate various elements of the project risks to the entities participating in the project. Accordingly, the residual risk borne by the project company is a small percentage of the entire risk. Some of the other important features of the limited/non-recourse financing structure are briefly given below :

(a) Sponsor support obligation

In a limited/non-recourse financing structure, the sponsor group commits to provide standby support for cost-overruns in the projects, provided the quantum of such support has crystallised prior to financial closure. In the event of any cost overrun in the project, it is met from such standby support. In case the overrun exceeds the amount of such support, while there will be no obligation on any party in view of the exposures already taken, all the players can negotiate the quantum and terms of additional funding requirement. After satisfactory completion of the project, no recourse would be available to the project sponsors for any shortfall in the revenue projections unless specifically agreed to between the parties.

(b) Security structure

SPVs have a security structure which is generally more stringent than that for normal projects. The security package generally includes a registered mortgage/hypothecation of all assets, besides pledge of sponsor holdings in the SPV and an assignment in favour of institutions of all the project contracts and documents as also charge on the future receivables.

(c) Trust and Retention Arrangement (TRA)

The cash flows of the SPV are captured by way of a TRA arrangement. such an arrangement provides for the appropriation of all cash inflows of the company by an independent agent (acting on behalf of the security trustee). This is then allocated in a pre-determined manner to various requirements including debt servicing and it is only after all requirements are met that the residual cash flow is available to the project company. Thus, the lender would have the security of cash flows in addition to the assets of the company.

(d) Guarantees

The payment risk in some of the infrastructure projects is further mitigated by way of a guarantee from the State or Central Government.