Financing of Infrastructure Projects

IECD. No. 26/08.12.01/98-99

April 23, 1999

To

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

Dear Sir,

Financing of
Infrastructure Projects

Please refer to paragraphs 68 and 69 of the statement on "Monetary and Credit Policy for the year 1999 - 2000" enclosed to Governor's letter No. MPD.BC.185/ 07.01. 279/98-99 dated April 20, 1999 regarding credit for infrastructure.

2. As you are aware, the rapid growth of our economy critically depends on the state of infrastructure in the country. At the current juncture, the development of infrastructure in India, particularly in the key sectors like power, telecommunications, roads and ports, is critical. The Government of India and Reserve Bank of India have, therefore, accorded top priority for infrastructure development, with an enabling policy framework for participation by private sector. As a supplement to the Reserve Bank's policy in post-April 1997 period (viz. bestowing operational freedom to banks in the matter of credit dispensation) and in view of the national importance attached to infrastructure development, it is considered necessary to address important aspects involved in the financing of infrastructure projects and to set out operational guidelines which the financing banks/institutions should bear in mind while extending credit for such projects. These operational guidelines are enumerated in the following paragraphs .

3. Modalities of Financing
Infrastructure Projects

3.1 Coverage

Infrastructure in a sense would include sectors such as power, telecommunications, roads, ports, airports, water supply, waterways and urban transport system and sectors with similar characteristics.

3.2 Criteria for Financing

Banks/financial institutions (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 the Reserve Bank of India from time to time (please see paragraph 6.1 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 6.2 also).

(v) Banks/FIs should have the requisite expertise for appraising technical feasibility, financial viability and bankability of projects, with particular reference to risk analysis and sensitivity analysis (please see paragraph 5 also).

(vi) (vi) 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,

4. Types of Financing by Banks

4.1 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 financial institutions (some of the important features of the arrangements are given in Annexure 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.

4.2 Inter-institutional Guarantees

In terms of 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 presently are 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, it has been decided, in partial modification of the instructions contained in circular IECD.No.37/08.12.01 /94-95 dated February 23,1995, to give banks discretion in the matter of issuance of guarantees favouring other lending agencies, in respect of infrastructure projects alone, subject to the following:

(i) a bank would be permitted to issue the guarantee provided it also takes a funding share in the project and that the amount of such guarantees will not exceed twice the funding share assumed by it; and

(ii) the guarantor bank has a satisfactory record in compliance with the prudential regulations such as capital adequacy, credit exposure norms, norms relating to income recognition, asset classification and provisioning, etc.

5. Appraisal

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 Annexure 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 repetitive and sequential appraisals by several institutions are avoided.

6. Regulatory Compliances/Concerns

6.1 Prudential Exposure Norms

Infrastructure finance will continue to be governed by the instructions regarding exposure limits currently in force viz., exposure of a bank/FI to an individual borrower is restricted upto 25 per cent of its capital funds and that to a group of borrowers to 50 per

cent. Further, considering the large-scale financial requirements of infrastructure projects, banks/FIs have been allowed to exceed the group exposure limit by 10 per cent to 60 per cent, provided the additional exposure is on account of infrastructure projects in the four specified sectors, viz., roads, power, telecommunication and ports.

6.2 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.

In regard to FIs, the asset-liability guidelines would be issued separately in consultation with the institutions. Pending issuance of the same, FIs should internally lay down appropriate guidelines on ALM and ensure that financing of infrastructure is consistent with these guidelines.

7. 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.

Please acknowledge receipt.

Yours faithfully,
(V.G.Damle)
Chief General Manager

ANNEXURE 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. (Please see the attached chart). 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.

ANNEXURE 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 project, 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.

TAKE-OUT FINANCING PRODUCTS FOR COMMERCIAL BANKS - FEATURES

Product	Risk		Pricing				Benefits to	
	Until take-out	Post take-out	To co.direct* lending without take-out (A)*	Under take-out scheme (B)			Project	Bank
				Bank Interest **	IDFC charges @	Total chargeable to Co.(not to exceed) (A)		
1.Unconditional take-out	IDFC	IDFC	15-16.25%	12.75%(i.e. at MTPLR) - o/a exposure on IDFC-	2% take-out i.e. on principal	14.75%	Saving in interest by 0.25% - 1.5% i.e. (A) - (B)	Suitable for medium size banks with limited project appraisal skills, unwilling to take project risk-liquidity.
2. Conditional take-out								
a) Partial risk	IDFC - principal Bank - interest	IDFC - principal + int. Bank - overdue interest (till take-out, if any)	15-16.25%	12.75% (i.e. at MTPLR) - because of exposure on IDFC -	1.6% take out fee on principal + other charges	Varies from case to case depending on - risk involved	i) lower financing costs ii) longer tenor	Reasonable project appraisal skills willing to take on project risks-entirely or partly liquidity.
b) Performance linked - Subject to predetermined operating parameters	Bank	IDFC - if all performance indicies are met Bank - if perfor-mance indices are not met there will be no take-out.	15-16.25%	If the project is doing well, the banker can get premium from - IDFC on take-out	Take out fee min. 0.25% p.a.	Varies from case to case depending on - risk involved	i) lower financing costs ii) longer tenor	Having adequate project appraisal skils but asset-liability mismatch, exposure constraints-liquidity.
c) Partial credit linked to performance # Subject to certain level of achievement of predetermined operating parameters	Bank	Principal-IDFC Bank - Quantum linked to perfor-mance. Interest risk in same ratio	15-16.25%			Varies from case to case depending on - risk involved	i) lower financing costs ii) longer tenor	Same as above.

* Linked to the risk rating of the borrower.
** Linked to the risk rating of IDFC (likely to be AAA). IDFC will be in a position to provide long maturity funding after take-out.
@ Indicative - varies from project to project and are negotiable. Take-out can happen after a mutually agreed period and percentage of Loan amount.
# Take-out amount linked to performance criteria.