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RBI'S DRAFT PRUDENTIAL FRAMEWORK FOR PROJECTS UNDER IMPLEMENTATION 2024 - WILL IT USHER IN A NEW ERA IN PROJECT FINANCING?

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Introduction

On 3 May 2024, the Reserve Bank of India (RBI) released draft regulatory guidelines, titled 'Draft Prudential Framework for Income Recognition, Asset Classification and Provisioning pertaining to Advances - Projects Under Implementation, Directions, 2024' (Draft Framework). The Draft Framework applies to all commercial banks, non-banking financial Companies, urban cooperative banks, and financial institutions like NABARD and National Housing Bank. The Draft Framework proposes to establish a comprehensive regulatory framework for project finance in India for the infrastructure, non-infrastructure and commercial real estate sectors.

KEY PROPOSALS OF THE DRAFT FRAMEWORK

Increased Requirements for Lenders

The Draft Framework covers the different phases of a project (from design to construction to operation) and introduces several new requirements for lenders. These include, amongst others:

(i) a board-approved policy for resolving stress in projects;

(ii) yearly monitoring of the project's net present value (to ensure profitability);

(iii) provisioning of non-stressed assets;

(iv) extension of the date of commencement of commercial operations (DCCO) as part of resolution plan upon occurrence of any credit event; and

(v) the creation and maintenance of project-specific databases.

The Draft Framework also provides that where the aggregate exposure of the participant lenders to the project is up to INR 1,500 crores, no individual lender should have an exposure less than 10% of the aggregate exposure of the consortium. For projects with higher lender exposure, the individual exposure floor is set at 5% or INR 150 crores, whichever is higher.

Additionally, the Draft Framework also stipulates that the repayment structure for project loans should be designed realistically, considering the likelihood of lower initial cash flows, and that financing agreements should not provide moratorium on repayments beyond the DCCO. However, if granted in specific cases, a moratorium beyond the DCCO should not exceed 6 months.

Increased Provisioning on Financing Infrastructure Projects

The revised provisioning requirement under the Draft Framework stipulates that during the construction phase of a project, lenders would need to set aside a provision of 5% of the outstanding loan amount. This is a significant increase from the current provisioning requirement of 0.4% for all 'standard assets'.

However, the provisioning requirement would decrease to 2.5% once the project is operational, and would further reduce to 1% once the project has: (a) a positive net operating cash flow that is sufficient to cover current repayment obligation to all lenders; and (b) the total long-term debt of the project with the lenders has declined by at least 20% from the outstanding, at the time of achieving the DCCO.

This provisioning requirement will apply to all existing outstanding exposure of lenders to infrastructure projects and is required to be achieved in a phased manner to be achieved within 31 March 2027.

Resolution of Stress

As per the Draft Framework, occurrence of any credit events (which are situations of a borrower defaults), or when lenders determine a need for extension of the DCCO, or the lenders identify a need for infusion of additional debt, or when there is a decrease in the net present value of the project, must be promptly reported to the Central Repository of Information on Large Credit (CRILC) and to members of the consortium or multiple banking arrangement by the lenders.

Lenders are expected to continuously monitor projects and upon occurrence of any credit event during the construction period (together with other lenders for such project finance arrangement) initiate a resolution in terms of the RBI's Prudential Framework for Resolution of Stressed Assets dated 7 June 2019 (RBI Prudential Framework). As per the Draft Framework, the lenders are required to conduct a review of the debtor account within 30 days of such credit event (Review Period), and where required, are required to implement a resolution plan in accordance with the RBI Prudential Framework.

Resolution Plans involving extension of the DCCO

Where a resolution plan involves an extension of the DCCO, it will only be implemented if:

(i) all necessary documentations are completed, including execution of necessary agreements between lenders and the debtor, creation of security charges and perfection of securities;

(ii) the lenders and the debtor update their financial records to accurately represent the revised terms of the financing agreement; and

(iii) post implementation of resolution plan, financial parameters like debt-to-equity ratio, debt service coverage ratio etc., and external credit rating (if any) shall remain unchanged or enhanced in favour of lenders.

However, if a resolution plan involving a change of the DCCO is not successfully executed within 180 days following the end of the Review Period, then as per the Draft Framework, the account must be immediately downgraded to a non-performing asset (NPA).

Key Concerns of Stakeholders

Increased Provisioning on Financing Infrastructure Projects:

The proposition for lenders to allocate higher provisions for all infrastructure projects currently under construction could have several implications:

(i) Increased provisioning could lead to a rise in the cost of lending and could impact lenders' profitability, and consequently the lenders may decide to pass through any additional costs arising from increased provisioning directly to the borrower. This in turn would increase

the financial burden on the borrowers and may potentially affect the feasibility of certain projects.

(ii) Increased provisioning could lead to diminishing returns for lenders involved in the project finance and may reduce their appetite for such exposure.

(iii) It could lead to lenders becoming more selective in their project financing, making it more expensive or difficult for borrowers to secure financing.

Stricter Norms for Consortium Arrangements

As mentioned above, the Draft Framework stipulates that for projects financed under consortium arrangements, each lender should have a minimum exposure of 10% of the aggregate exposure, where the aggregate exposure of the participating lenders is up to INR 1,500 crores, and for projects where aggregate exposure of participating lenders is more than INR 1,500 crores, the individual exposure floor shall be 5% or INR 150 crores (whichever is higher).

This could limit the ability of smaller lenders to participate in large project financing consortiums; however, this could also potentially limit the number of lenders, thereby simplifying the consortium decision-making and resolution process, if necessary.

Concerns Over Compliance and Operational Challenges

As a result of the revised provisioning requirement, stricter norms for consortium arrangements, and the new data maintenance requirements (e.g., electronic maintenance and updating of project-specific data by the lenders, including updating of changes within 15 days through a system to be put in place within 3 months) could increase the compliance burden and operational costs for lenders and increase information covenants / requirements on the borrower and as a result potentially diverting resources away from efficient project financing.

Conclusion

While the proposed Draft Framework aims to strengthen risk management in project financing in the country, it remains to be seen if it would increase lending costs and create operational inefficiencies. The increased provisioning requirements and stricter norms for consortium arrangements could tighten funding for project finance.

Accordingly, the Draft Framework requires careful consideration from market participants, and deliberations with the RBI on the potential impact of the Draft Framework, before the same is notified.

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