Partial Credit Enhancement - A push to the Corporate Bond Market

With a view to encourage corporates/SPVs to avail bond financing for infra projects which shall in turn provide a much needed thrust to the corporate bond market, the Reserve Bank of India(RBI) has introduced a new scheme of Partial Credit Enhancement (PCE) to corporate bonds. This scheme has been essentially designed bearing in mind particularly the large financial requirements of the infrastructure sector and the risks associated with it.

What does the new facility of Partial Credit Enhancement (PCE) offer?

It is known, that there prevail financial constraints in terms of funding the infrastructure projects with greater exposure of banks to such funding. Due to their ALM considerations, they are not in a position to provide such lending to infra projects. Besides, alternative sources such as insurance and pension funds are required to limit their investments to higher credit ratings. Presently few such projects have a high rating and hence cannot be a part of their investment portfolios. Consequently, the funding of such projects has become a concern.

In response to these constraints, the RBI has now proposed to provide PCE to various projects as non- funded subordinated facility in the form of an irrevocable line of credit which is to be drawn in case of shortfall in cash flows at the time of servicing the bonds. This facility is to be provided by the banks. The proposed enhancement facility will improve the credit rating of the bond issues. A BBB rated bond would be elevated to an A or AA category based on the enhancement, which would then make it investment worthy for institutions.

However, the total PCE to be provided by the banks for a given bond issue has been capped at permissible limit of 20% of the total bond issue size. Besides, this facility is to be availed at the time of issuance of bond and will be irrevocable.

What are conditions for availing this facility?

- Bonds whose pre-enhanced rating is BBB minus or higher.
- Banks cannot provide PCE by way of guarantee.
- Banks providing the facility to bonds issued by a corporate/SPV are not eligible to invest in those bonds. However, other needs based credit facilities can be provided to the corporate/SPV.
- So long as the exposure of a bank to a project loan is classified as standard and the borrower is not in any financial distress, providing a commercially priced PCE to enhance the rating of a bond issue, whose proceeds replace, in whole or in part, the bank's project loan, would not amount to restructuring.

- Banks are required to have an approved policy on PCE by the board covering issues such as quantum of PCE, underwriting standards, assessment of risks, settling limits, etc.
- The contingent PCE will be available only for servicing the bond and not for any other purpose irrespective of the seniority of claims of other creditors in relation to the bond holders.
- In case the PCE facility is partly drawn and interest accrues on the same, the unpaid accrued interest will be excluded from the calculation of the remaining amount available for drawing.
- The contingent facility may, at the discretion of the PCE providing bank, be made available as a revolving facility.
- In the event of the project failure / bankruptcy, in terms of repayment priority, the PCE must rank below the claims of the enhanced bond holders.

How is the PCE facility reflected in the books of accounts?

- PCE facilities to the extent drawn are to be indicated as advances under the balance sheet while the unwithdrawn facilities are to be indicated under 'contingent liabilities- others'.
- The provision to be created by the banks for providing the facility for a given bond issue is to be calculated such that as if the entire bond issue was held by banks as the difference between-
    a. the capital required on the entire bond amount, corresponding to its pre-credit enhanced rating and
    b. The capital required on the bond amount corresponding to its post-credit enhanced rating, as per the risk weights applicable to claims on corporates under Basel III Capital Regulations.

For instance, the total bond size is Rs.100 for which PCE to the extent of Rs.20 is provided by a bank. The pre-enhanced rating of the bond is BBB which gets enhanced to AA with the PCE.

In the above given situation-

1. At the pre-enhanced rating of BBB (100% risk weight), the capital requirement on the total bond size (Rs.100) is Rs.9.00.
2. The capital requirement for the bond (Rs.100) at the enhanced rating (AA, i.e., 30% risk weight)) would be Rs.2.70.
3. As such, the PCE provider will be required to hold the difference in capital i.e., Rs.6.30 (Rs.9.00 – Rs.2.70).

The above example is based on the assumption that the entire quantum of eligible PCE (20% of the bond issue size) is provided by a single bank. Where the PCE to a bond issue is provided by more than one bank within the overall limit, each bank will maintain capital as illustrated above in proportion to the quantum of PCE provided by it. Also the capital requirement is subject to change with the change in rating.

- In addition, the drawn tranche of the contingent PCE facility is required to be repaid within 30 days from the date of drawal which is the due date. In case it remains outstanding for 90 days the facility will be classifies as NPA.

- Also, the banks need to observe the following exposure limit-
    - PCE exposure to a single counterparty or group of counterparties shall not exceed 5 per cent of the bank's Single Borrower / Group Borrower limit to the counterparty to whom the PCE is provided,
    - The aggregate PCE exposure of a bank shall not exceed 20 per cent of its Tier 1 capital.

What would be the implications of such a facility?

1. As this facility would help enhance the rating of the bonds issued, the corporates especially for the ***infrastructure projects will have improved*** access to the corporate bond markets. Given the focus on such projects for our future growth this will be an effective tool for raising funds.
2. As the facility provides better access to the markets, ***exposure of banks to these projects will be reduced*** which in turn shall help improve business. Therefore, their balance sheets will be less pressurized, which is not the case today. Banks as of March 2015 had exposures of Rs 9.24 lkh crore with an increment of Rs 88,100 cr this year. If 20% this amount was diverted to the bond market, the same amount could have been fixed as the enhancement facility which would be a win-win situation for the banks and corporate bond market.
3. It shall also provide a significant ***boost to the corporate bond market*** as there will more paper floated and greater participation from institutions like insurance companies and provident and pension funds.
4. The enhanced facility also makes it suitable for market players particularly ***from pension and insurance*** industry to participate in funding of these projects and hence ***diversify their portfolio***.
5. More importantly it will provide a boost to investment and growth.

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