Why RBI must rethink its draft guidelines for project financing

Its draft regulations will increase lenders' provisioning requirements. These warrant a relook

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On May 3, 2024, the Reserve Bank of India released draft regulatory guidelines for bank lending towards infrastructure projects. These guidelines apply to all commercial banks, non-banking financial institutions, urban cooperative banks, and financial institutions (such as NABARD and National Housing Bank) that engage in project finance lending. While these guidelines were released as a draft circular (with the RBI accepting comments till June 15), they were met with strong reactions. One market participant reportedly described the norms as "onerous". Banking sector stocks along with those of renewable energy firms fell sharply. As per reports, the Indian Banks' Association (IBA) is writing to the RBI to appeal against the proposed rules, and bank officials are reportedly planning to approach the Finance Ministry as well.

The draft guidelines constitute the RBI's first-ever attempt to provide a comprehensive regulatory framework for project finance in India. Typically, project finance involves the creation of a new special-purpose vehicle — a legal entity for developing a given infrastructure or industrial project. This entity raises funds (debt and equity) independently, and these are secured on the promise of future cash flows from the project, rather than the credit-worthiness of the sponsoring entities. Project finance is regularly utilised for infrastructure development, large-scale industrial undertakings and real estate projects.

The draft guidelines cover the entire life cycle of a project (from design to operation) and introduce several new requirements for lenders. These include, inter alia, (i) a board-approved policy for resolving stressed project finance assets, (ii) constant monitoring of the project's net present value (to ensure profitability), (iii) provisioning of non-stressed assets, and (iv) the creation and maintenance of project-specific databases.

At the core of the market's adverse reaction was an increase in lenders' provisioning requirements. The guidelines indicate that during an infrastructure project's construction phase, lenders should provision (set aside) 5 per cent of their funded amount. After the project's operational phase (when it starts generating cash flows), lenders can reduce this amount to 2.5 per cent. This can be reduced further to 1 per cent if the project generates cash flows sufficient to cover all repayment obligations, and if its long-term debt is on a downward trajectory. Banks are unhappy with this structure, instead preferring an initial provisioning requirement of 1 to 2 per cent, which represents a more modest increase over the existing requirement of 0.4 per cent as per reports.

For its part, the RBI has erred on the side of caution. Infrastructure projects, by their nature, are complex. They involve large capital outlays, significant gestation periods and involve many parties. They are, therefore, subject to multiple categories of risks — project-specific risks (such as delays, cost overruns), macroeconomic risks (financing availability, interest rate risk), and political/regulatory risks (cancellation of permits, change in regulatory measures), all of which can have cascading effects ('Infrastructure Financing Instruments and Incentives', OECD, 2015).

Such risks even manifest themselves in projects funded and undertaken by the government, which are generally considered less risky compared to private sector undertakings. As of March 2024, 42 per cent of the Union government's existing projects have reported delays, while 24 per cent have experienced cost overruns, as reported by the statistics ministry.

Given their large size and scale, failed projects can have a significant economic impact, something that India has already experienced in the 2010s in the form of the twin balance sheet problem. Rapid and exuberant lending by banks to firms in capital-intensive sectors such as infrastructure and power led to a proliferation of non-performing assets (NPAs) in the banking system ('The Origins of India's NPA Crisis', Columbia University SIPA Working Paper No. 2019-04). This resulted in firms curtailing investment and banks slowing down credit growth, both of which stymied economic growth. By stipulating strong prudential requirements, the RBI likely seeks to prevent such scenarios from occurring again.

On the other hand, lenders covered by the draft circular believe that RBI's proposed provisioning rules will adversely impact their profitability, given that loan provisions are recorded as an expense in their income statement. Lenders are likely to pass this "expense" to the infrastructure project in question, increasing costs. Low-profit margin sectors such as renewable energy will likely be hit the hardest. Direct costs aside, provisions that lenders perceive as being excessive, can have the effect of deterring them from financing such projects in the first place, therefore depriving them of crucial funding.

Moreover, the broader prudential requirements for banks, especially the Basel III framework, are possibly unfavourable for lending toward project finance. The Global Infrastructure Hub has noted how Basel III norms, (i) stipulate higher-than-warranted risk weights for project finance loans given their risk profile, (ii) do not allow flexibility for banks to avail credit-risk mitigation instruments (such as political guarantees) in project finance, and (iii) discourage long-term lending ('Banks are critical for closing infrastructure deficits, but banking regulations are not supportive', Global Infrastructure Hub, June 22,

2023). High project-specific provisioning requirements (as suggested in the draft guidelines) in addition to existing Basel III capital requirements, might have a compounding negative impact on bank lending for such projects.

Notably, market participants have not raised any issues with the RBI's draft guidelines other than the stipulation on provisioning norms. It is, therefore, crucial that the regulator and market participants work together towards a solution. In determining an appropriate provisioning figure for project loans, the RBI could commission a detailed empirical study, examining past records of infrastructure initiatives funded through project finance. Results from this study could be used to inform an appropriate provisioning figure. Such an initiative would go a long way in maintaining market confidence.

Even as the Union government has continued its thrust on infrastructure through numerous initiatives, total expenditure on infrastructure in 2022-23 stood at Rs 13 lakh crore, well below the Rs 20 lakh crore per annum figure required for implementing the National Infrastructure Pipeline of 2020 ('Infrastructure Investments — The Way Forward', Economic and Political Weekly). Private sector involvement, in particular, remains low. Well-regulated funding for infrastructure is necessary to generate investment at scale. Continued development of capital markets, along with facilitation of bank loans towards project finance, therefore, remain crucial for continued infrastructure development and broader economic growth.

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