ISSUE OF LONG TERM BONDS BY BANKS: FINANCING OF INFRASTRUCTURE AND AFFORDABLE HOUSING

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"...Long term financing for infrastructure has been a major constraint in encouraging larger private sector participation in this sector. On the asset side, banks will be encouraged to extend long term loans to infrastructure sector with flexible structuring to absorb potential adverse contingencies, sometimes known as the 5/25 structure. On the liability side, banks will be permitted to raise long term funds for lending to infrastructure sector with minimum regulatory pre-emption such as CRR, SLR and Priority Sector Lending..."[1]

- *Finance Minister Arun Jaitley, in the Budget for FY 2014-15*

1. Background

Technically, a bond is simply a loan which is taken by a government, a municipality or a company. Bonds generally are unsecured. The issuer pays the bond holder periodic interest ranging over the life of the loan. The secondary market for bonds in India is an over the counter market whereas the market for equities is a system-automated market.

The Modi government's main focus includes infrastructure development and strengthening India's infrastructure sector. Recently the Finance Minister Arun Jaitley in his budget speech announced various schemes relating to development of infrastructure sector such as introducing 'Infrastructure Investment Trusts' and 'Issue of Long Term Bonds by Banks for Financing of Infrastructural Projects'.

The authors have discussed about the Infrastructure Investment Trusts in a different paper. This paper will focus on the issue of long terms bonds by banks for financing infrastructure and affordable housing. This scheme is not entirely a new one but has been in place since 2004. Earlier, banks were allowed to issue long-term subordinated debt in the nature of unsecured redeemable bonds. As per the 2004 scheme, banks were allowed to raise long-term bonds with a minimum maturity of 5 years to the extent of their exposure of residual maturity of more than 5 years to the infrastructure sector. It was intended that banks should have first provided assistance to such infrastructure projects before raising resources through bonds.

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[1] Full text: Finance Minister Arun Jaitley's maiden Budget speech, http://ibnlive.in.com/news/full-text-finance-minister-arun-jaitleys-maiden-budget-speech/485007-3.html

After 10 years, the Reserve Bank of India (the "**RBI**") on July 15, 2014 came out with a circular on Issue of Long Term Bonds by Banks – Financing of Infrastructure and Affordable Housing" (the "**Circular**") pursuant to the Finance Minister's announcement.[2] The authors shall discuss the circular, its implications and criticism in the following parts of this paper.

2. THE CIRCULAR

2.1. Infrastructure Financing

The Circular addresses the liability side of the banks' balance sheets; raising long term funds for lending to key infrastructure. Apart from what is technically defined as infrastructure, affordable housing is another segment of the economy which both requires long term funding and is of critical importance. Government has stressed the importance of availability of cheap credit to make housing affordable for the Economically Weaker Sections, Lower Income Group and Medium Income Group segments of the population. Accordingly, the RBI intends to ease the way for banks to raise long term resources to finance their long term loans to infrastructure as well as affordable housing.

The Circular mentions various ingredients and issues relating to financing of infrastructure and affordable housing. Some of them are discussed below.

2.1.1. Exemption from CRR, SLR & PSL

RBI in order to encourage infrastructure development and affordable housing, exempted long-term bonds from the mandatory regulatory norms such as the Cash Reserve Ratio (the "**CRR**"), the Statutory Liquidity Ratio (the "**SLR**") and Priority Sector Lending (the "**PSL**") if the money raised is used for funding of such projects.

As per RBI regulations, banks are required to keep a portion of deposits as CRR with the central bank and park certain portion in government securities known as SLR. Banks are further required to provide certain specified lending to sectors classified as priority sector being agricultural, small scale industries, micro credits, education loans and housing loans. Additionally, the RBI issued instructions to banks specifying operational guidelines and incentives in the form of flexibility in loan structuring and refinancing.

Banks can issue long-term bonds with a minimum maturity of seven years to raise resources for lending to (i) long-term projects in infrastructure sub-sectors, and (ii) affordable housing.

2.1.2. 5/25 structure

The Finance Minister in his budget speech talked about introducing a 5/25 structure for providing long term loans to infrastructure projects.

As per the Circular, this structure will allow a bank to lend money to a developer for 25 years, with an option of rewriting the terms of the loan or transferring it to another bank or

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[2] Issue of Long Term Bonds by Banks – Financing of Infrastructure and Affordable Housing, RBI, http://rbi.org.in/scripts/NotificationUser.aspx?Id=9103&Mode=0

financial institution after five years. It is structured thus to allow the tenure of the loan to match the life cycle of the underlying asset.

However, there are some issues with 5/25 structure. Reset clauses may not work well because of interest rates that go up (which means the developer will be in a fix) or down (the banks will face a loss after having tied up resources required for the life of the project).[3] Banks ideally would not like to give loans for more than 15 years. This is the job of development finance institutions such as Industrial Development Bank of India. Transferring the asset to another bank poses its own set of difficulties. In case a bank cannot get another lender, then it will have to refinance the loan itself, which is a concern.

2.2. Housing Loans Eligible under Priority Sector Lending

The Circular defines lending to affordable housing as housing loans eligible under priority sector lending by the RBI, and also housing loans of upto Rs. 50 lakhs for houses of values upto Rs. 65 lakhs located in the six metropolitan centres viz. Mumbai, New Delhi, Chennai, Kolkata, Bengaluru and Hyderabad and Rs. 40 lakhs for houses of values upto Rs. 50 lakhs in other centres for purchase/construction of dwelling unit per family.

The updated provisions regarding housing loans eligible under priority sector lending are categorised as follows:

i. Loans to individuals up to Rs.25 lakhs in metropolitan centres with population above 10 lakhs and Rs.15 lakhs in other centres for purchase/construction of a dwelling unit per family excluding loans sanctioned to bank's own employees.
ii. Loans for repairs to the damaged dwelling units of families up to Rs. 2 lakhs in rural and semi-urban areas and up to Rs. 5 lakhs in urban and metropolitan areas.
iii. Bank loans to any governmental agency for construction of dwelling units or for slum clearance and rehabilitation of slum dwellers subject to a ceiling of Rs. 10 lakhs per dwelling unit.

2.3. Banks' Response to the Circular

Following RBI's incentive to raise long-term funds, private sector banks are chalking out plans to issue infrastructure bonds in the coming months. Recently YES Bank's board approved raising Rs 3,000 crore through long-term bonds. Even Axis Bank had earlier announced similar plans.

In a statement issued by Rajat Monga, group president- financial markets and chief financial officer, YES Bank, he said that "In accordance with the recent RBI guidelines on issue of long-term bonds by banks - financing of infrastructure and affordable housing - the board of

[3] Banks wary of budget's 5:25 plan for infra projects, http://www.livemint.com/Industry/9vVOjFOzmG9gPbb5ZJzUSL/Banks-wary-of-budgets-525-plan-for-infra-projects.html?utm_source=copy

YES Bank has approved raising Rs 3,000 crore of long-term bonds, and the bank now intends to seek shareholder approval for the same".[4]

On the same matter, Somnath Sengupta, executive director & head-Corporate Centre, Axis Bank, said that "We will look at the option of infrastructure bonds issuances as they look attractive".[5]

Till date only these two banks have shown their reactions towards the Circular and their responses are positive.

3. ANALYSIS

As more than Rs 4.5 lakh crore projects were held up across sectors in India for the last five to six years for issues ranging from land acquisition to environment to forest clearances and general government apathy, banks became even more cynical to fund these projects due to regulatory and other hurdles.[6]

However, the latest concession from the RBI to allow banks to raise long-term bonds exempt from mandatory priority funding regulations such as CRR and SLR, would help them bring down the cost of funding and improve the overall liquidity in the market.

Some of the major road, port, steel and power projects that are held up or have failed to take off are mega road projects like Kishangarh Udaipur project, Barwa Adda Panagarh road project, Shivpur Devas project and Agra Etawah bypass worth around Rs 18,000 crore.[7]

Steel projects like the Kendujhar steel project, Haveri integrated steel project, Kudathini steel project and Salboni steel project valued at Rs 1.25 lakh crore are held up. Other high value stalled projects are Kovvada nuclear power project, Dholera water front city town project, Haryana multi product SEZ, Hilligudi steel project and Raigad major innovation park project, valued at 1.90 lakh crore.[8]

RBI's measures would help bankers cut down on lending rates helping companies obtain loans that were difficult till now, and if obtained, difficult to pay back. The real traction will be seen only after some time, as treasuries will have to structure rates and the terms of lending as well as timelines.

Banks in the last five years have found it difficult to provide long-term financing for projects due to asset-liability mismatch.[9] They would invariably restrict their finance to a maximum 12-15 years period which resulted in higher loan instalments. This led to strain on the project and the ability of the promoters to raise fresh equity out of internal generation since the

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[4] Private banks gear up to issue infra bonds, http://www.smartinvestor.in/market/read-254969-readdet-Private_banks_gear_up_to_issue_infra_bonds.htm#.U9HtAvmSx6w
[5] Ibid.
[6] Long-term bonds may ease liquidity, http://www.mydigitalfc.com/news/long-term-bonds-may-ease-liquidity-522.
[7] Ibid.
[8] Ibid.
[9] RBI issues norms for long-term bonds for infra financing, http://www.moneycontrol.com/news/cnbc-tv18-comments/rbi-issues-norms-for-long-term-bonds-for-infra-financing_1127975.html

gestation period for such projects is very high.[10] This also led to higher user charges in the case of some infrastructure projects such as toll road and power generation projects, to ensure that greater cash flows are generated to service the loans. As a result of these factors, some long-term projects have been experiencing stress in servicing the project loan.

Lending under priority sector and participation of private players would be successful only if government balances the role of both public and private sectors. To initiate wider participation in Public Private Partnership (the "**PPP**") projects, the government should ensure it takes up the larger role in setting up infrastructure in areas infested by Naxalites and where it is difficult for private players to make returns. The PPP participation as sought under the budget and availability of funds for the projects would take off successfully only if concessionaires see better returns.

The division of risk between private sector and government authorities granting the concession agreement needs to be revised. The present structure of the official government contracts shifts most of the liabilities towards the private contracting parties and lesser burden on the government. Due to such structure, the foreign lenders mostly deny loans to the private contracting parties and if they grant the loan the terms of the loans are very strict. The government should shift most of the burdens, risks and liabilities towards itself as the government generally remains in a position to bear the risks and liabilities. Such structure will attract more private participation in the infrastructure sector and lending by the banks shall also get smoother.

4. CRITICISM

Public sector banks may not always have adequate expertise to appraise infrastructure projects. Some public sector banks may not have expertise to monitor such projects and assess their risks.

In the past year, between May 2013 and May 2014, banks' infrastructure loan portfolio has grown from Rs.7.7 trillion to Rs.8.6 trillion.[11] Out of this, the power sector accounted for around Rs.5 trillion in May 2014, up from Rs.4.4 trillion a year ago.[12] Incidentally, the asset quality of bank loans to infrastructure developers is deteriorating at a faster pace than that of loans advanced to any other sector. About 40% of total infrastructure loans are likely to be restructured by March 2015 as against 20% in March 2013, says a report by rating agency India Ratings and Research Pvt. Ltd.[13] Out of Rs.1.91 trillion infrastructure loans given by the State Bank of India, the nation's largest lender, as on 31 March, Rs.5,070 crore have

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[10] RBI OKs long term bonds of banks; cheap loans for infra cos., http://www.moneycontrol.com/news/economy/rbi-oks-long-term-bondsbanks-cheap-loans-for-infra-cos_1128158.html?utm_source=ref_article

[11] Infra financing: Barking up the wrong tree, http://www.livemint.com/Opinion/DIgGvPN7fuZu9KAUUUzPsI/Infrastrcture-financing-Barking-up-the-wrong-tree.html

[12] Ibid.

[13] India Rating & Research, http://indiaratings.co.in/research/allContentList.jsp?sectorCode=GLOBALINFRA&subSectorCode=GLOBALINFRA&secPage=issuer&page=1§orName=Infrastructure%20and%20Project%20Finance

turned bad.[14] Globally, the onus on funding the infrastructure sector is not on commercial banks alone. There are other agencies and long-term funds such as pension funds that support infrastructure. It may prove to be erroneous if we push our banking system to go the whole hog to support core projects before they build expertise.

Further, by exempting money raised for infrastructure loans from priority loan norms, RBI has made it official that priority loans are a drag on the banking system. In normal course, many banks miss the 40% priority loan target and 18% agriculture loan sub-target and are penalized for that. Now, exempting long-term bonds from SLR, CRR and priority loan targets, RBI is discouraging banks from giving loans to agriculture, small and medium enterprises and other business segments. If long-term bonds are exempted from these norms, why shouldn't long-term deposits get the same benefits?

5. CONCLUSION

From the above discussion it can be concluded that the step taken by the RBI is in the right direction. Though there are some criticisms to the scheme but it can only be evaluated gradually depending upon how the market reacts to this scheme. At this stage nothing accurate can be said but as of now it seems to be a good scheme.

Till the time the public sector banks get expertise in infrastructure financing, it is advisable for them to stay away from granting loans as there is a huge risk that the loan may go bad. Such financing should primarily be done by those expert infrastructure financing companies who have specialised experts to analyse the project, asses the risks and monitor the expenditure.

[14] Ibid.