Infrastructure Financing through Bond Markets

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Background

A vibrant domestic corporate bond market can serve as a viable alternative to traditional debt financing for the infrastructure sector. Debt capital markets can potentially play a significant role in channelizing savings into the productive sectors of the economy and hence, has long been a policy priority for regulators, policy makers and market participants alike. A well-functioning corporate bond market can not only provide the much needed alternative to traditional bank financing, but can also help reduce borrowing costs for corporates through market based pricing of credit risk.

As aggregate annual debt private placements crossed the Rs. 10 trillion threshold for the first time ever in FY2024, there are concerns about domestic bond markets being increasingly dominated by the majority group of high rated or quasi sovereign borrowers. Thus, the debate about the ability of low rated, private sector borrowers from infrastructure sector, to access the domestic bond markets for debt financing continue to grow even louder.

Present state of Bond Markets

On the Supply side, infrastructure financing through domestic bond markets happen primarily through two distinct routes, as highlighted below.

Firstly, the Indirect Financing route, whereby entities involved in lending to the infrastructure sector raise funds through bond markets. This includes mostly AAA rated issuers like the Infrastructure Finance Companies (IFCs), Infrastructure Debt Funds (IDFs) and long-term infrastructure bonds issued by scheduled commercial banks. Such financial sector entities utilise the bond issuance proceeds to onward lend to entities executing infrastructure projects, while the bondholder assumes the credit risk of the financial sector entity.

Secondly, the Direct Financing route, whereby entities involved in executing infrastructure projects directly raise funds through bond markets. This includes the Infrastructure Investment Trusts (InviTs) and borrowers executing infrastructure projects. While InviTs are usually rated AAA, other infrastructure borrowers may be rated across the credit rating spectrum. In particular, the success story of InviTs raising debt from capital markets is worth emulating, as investors get attracted to this segment due to its regulatory oversight, capped leverage requirement, strong financial sponsors, as well as its robust and transparent governance framework.

On the Demand side, as per IRDAI Regulations, insurance companies are required to invest an aggregate amount of not less than 15% of the Investment Assets in housing and infrastructure sector categories. For retirement funds, while there is specific reference to infrastructure sector within corporate debt category, there is no minimum allocation requirement. Dedicated infra-focused lenders like wholesale NBFCs/IFCs, All India Financial Institutions and IDFs specifically look to invest in debt securities issued by infrastructure sector borrowers.

Key characteristics of infrastructure bonds

From the perspective of debt capital markets, bonds issued by borrowers involved in executing infrastructure projects have certain unique features, which make them different from traditional bank finance. For example, infrastructure bonds usually have bullet maturity unlike the amortising repayment schedule for bank loans. While markets had witnessed amortization in few infrastructure bonds, such amortizations are usually quite minimal and infrastructure bonds predominantly tend to have back-ended maturity structures. The bullet nature of repayment leads to concerns relating to refinancing risk for these infrastructure borrowers. Investors having short term investment horizon often insist on coupon reset structures or put/call options, which tends to reduce the effective maturity of the instrument.

Given the nature of infrastructure finance, borrowers tend to often raise debt funds through Special Purpose Vehicles (SPVs). Often, these SPVs are incorporated as private limited companies with weak or short track record of profitability and/or low net worth. While insurance companies are, regulatorily, not permitted to invest in private limited companies, the net worth constraints further lead to low maximum permissible investment limits per investor. These issues hinder the widening of the pool of potential investors for infrastructure bonds.

Analysis of investor profile and their preferences for infrastructure bonds

Infrastructure projects usually have moderate credit ratings, especially during project execution stages. The ratings improve significantly once the project becomes operational, achieves stability and starts generating cash flows. From the perspective of capital markets, investors tend to prefer higher rated, completed and revenue generating infrastructure projects.

Traditionally, insurance companies and retirement funds are the end investors in bond markets and manage significant pools of debt capital. As custodians of public money, insurers and pension funds cite their fiduciary role while prioritizing safety over returns as part of their risk-averse investment approach. In other words, capital preservation continue to remain a higher priority relative to portfolio yield enhancement. Given their liability profile, such long-only investors prefer investing mostly in high quality, long tenor assets of quasi-sovereign issuers.

As per extant regulations, EPFO and other exempted PF trusts are mandatorily required to invest only in bonds rated AA and above. For insurance companies and National Pension Schemes (NPS), there are regulatory restrictions for investment in bonds rated AA- and below. In view of the above, both insurance companies and retirement funds tend to invest in highest rated debt securities. Given the above rating thresholds for investments, infrastructure bonds continue to remain largely excluded from the vast pools of long term, patient capital available with insurance companies and retirement funds.

On the other hand, asset management companies or mutual funds adopt a fairly flexible investment approach, and are comfortable in assuming credit risk in their investment portfolios, based on the mandate of the relevant fund scheme. However, mutual funds usually have access to short-term funds, which skew their investment decisions towards short tenor instruments.

In summary, investor segments who have the investment appetite for higher duration risk (i.e., longer tenors) do not necessarily have the appetite for credit risk (i.e., lower rated bonds), and vice versa.

Further, RBI's recent draft guidelines relating to the Prudential Framework for Advances towards Projects Under Implementation aims to rationalise the extant guidelines and harmonise the same for all Regulated Entities (REs), which undertake project finance. Once finalised, the guidelines can have lasting impact on the manner and scope of infrastructure financing, as undertaken by REs.

Partial Credit Enhancement (PCE) for infrastructure bonds

As per extant regulations, banks are permitted to offer Partial Credit Enhancement (PCE) to corporate bonds in the form of a non-funded irrevocable contingent line of credit, without offering to guarantee the payment obligations. The aggregate exposure limit from the banking system towards the PCE has been capped at 50% of the bond issue size, with a limit of up to 20% of the bond issue size for an individual bank. Since banks have relatively better internal infrastructure and expertise for conducting due diligence and assessing the credit risk of complex infrastructure projects, the credit-enhanced bonds can potentially appeal to a wider category of bond market investors.

While PCE can significantly improve the market access for lower rated issuers, there are regulatory concerns about the resultant market distortions, since market participants may start trading the bank risk rather than corporate risk, thereby impeding the development of genuine corporate bond market.

In practice, the upper limit of 20% per individual bank usually results in marginal notch upgrade for most bonds, unless the cumulative PCE is enhanced to 50% across three or more banks. The notch-up can be lower depending on the extent of residual unsupported debt on the balance sheet, excluding the credit-enhanced debt, which can increase potential default risk of the Issuer. Further, investors insist on additional yield for credit-enhanced bonds compared to a plain vanilla instrument having the same credit rating, due to the complex, structured nature of the transaction. Also, banks are not permitted to invest in corporate bonds, which are credit enhanced by other banks, thereby leading to additional illiquidity premium for such bonds. The above cumulative yield premium, coupled with the PCE fees paid to the PCE provider(s), increases the effective borrowing cost for the issuer and reduces the attractiveness of the product for the borrower.

Recommended policy initiatives

a) Relaxation of investment norms for regulated entities

As per extant framework, there are regulatory restrictions for insurance companies and retirement funds for investment in bonds rated AA- and below. This skews the investment preference of end investors towards high rated bonds, thereby hindering the market access for lower rated borrowers.

To achieve greater participation from non-bank participants, the investment norms of regulated entities like insurance companies and retirement funds may be relaxed by the respective regulators. Enhanced participation of non-bank investors in corporate bond markets across the credit curve shall help increase the breadth of the market and will help bring down the funding costs for infrastructure borrowers.

b) Emphasis on EL-based rating framework

An alternative to relaxing the absolute rating thresholds may be to adopt a dual approach of taking into consideration both Expected Loss (EL) and Probability of Default (PD) in the context of infrastructure financing.

Infrastructure lending involves taking credit exposure to productive, physical infrastructure assets whereby the ultimate credit loss, post default, is usually expected to be lower when compared to similar rated corporate exposures. The conventional rating scale is based on the Probability of Default (PD) approach, whereby the emphasis is primarily on timely servicing of financial obligations. The traditional rating framework is, thus, unable to differentiate the entities based on the ultimate loss to be borne by the investors and tends to penalise infrastructure borrowers. Hence, there is a need to assess the risks by referring to a differential rating scale based on the Expected Loss (EL) approach.

As per guidance provided in 2021, IRDAI acknowledged the significance of the EL approach and permitted insurers to classify infrastructure investments, issued by Infrastructure Companies, rated not less than "A" along with an Expected Loss Rating of "EL1" as part of "Approved Investment". It may be noted that for non-infrastructure assets, IRDAI regulations stipulate a minimum credit rating of AA for classifying debt investments as part of "Approved Investment". It would hugely help widen the scope of infrastructure financing if other regulators adopt the EL approach for debt investments given the unique nature of infrastructure assets.

c) Relaxing NBFC classification for debt securities issued by IDFs

Infrastructure Debt Funds (IDFs) are important vehicles for facilitating infrastructure financing. As per extant regulations, Mutual Funds need to classify bonds

issued by IDFs under NBFC category for reckoning of sectoral limits. This skews the pricing, valuation, as well as the availability of investment limits, for such debt instruments. On the other hand, bonds issued by Infrastructure Investment Trusts (InviTs) are classified under the corporate category, based on the respective underlying industry, with regard to reckoning of sectoral limits.

Keeping in view the priority of vast funding requirements of infrastructure sector and to further encourage mutual funds for infrastructure financing, specific exemption from NBFC sector classification may be provided to debt securities issued by IDFs with respect to reckoning of sectoral exposure limits. Such instruments may be classified under a separate category altogether or under the infrastructure category. Alternatively, additional limits may be carved out under NBFC category for addressing exposures to debt securities issued by IDFs.

d) Incentivising the issuance of Green bonds

Providing easy access to climate finance is a policy priority for both domestic and global authorities. This includes raising funds for projects and/or assets relating to renewable and sustainable energy, clean transportation including mass/public transportation, sustainable waste management including waste to energy, climate change adaptation efforts, among other categories.

As on date, although there is no significant 'greenium' or yield reduction for issuers of green bonds compared to plain vanilla bonds, green bonds do have the potential to attract specific demand from climate-focused investors, including global funds and family offices, with a mandate to allocate resources to green investments. On the policy side, incentives like reduced issuance costs, including reduction in listing fees or exemption from other issuance costs/compliances, reimbursement of green certification costs upto certain caps, relaxation in sectoral limits and mandatory minimum allocation thresholds, may be introduced to help spur the demand for green debt securities.

Road Ahead

The target of making India a USD 5 trillion economy, as well as the ambitious roadmap for Viksit Bharat 2047, calls for significant investment by the corporate sector, including by companies involved in infrastructure activities. Access to capital for all productive sectors of the economy is a critical prerequisite in this regard. Traditional bank financing, on its own, may fall short in fulfilling this requirement. Bond markets help facilitate long-tenor, fixed-rate, debt financing from non-bank credit channels and helps provide a supportive role in financing the country's growth. Bond markets enable faster transmission of interest rates, raise overall corporate governance standards and ensure market-based pricing of credit risk. Efficient, transparent and deep corporate bond markets can immensely help channelize savings into debt capital markets and can complement the traditional banking sector lending, thereby helping realise the target of Viksit Bharat 2047.

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