5:25 Flexible Structuring Scheme: Aligning Benefits

I. Genesis

The development of core industries and infrastructure sector is pivotal for developing countries like India. Development in infrastructure sectors like power, road, port and core industries like coal, cement, steel, natural gas, etc. would act as a catalyst for overall socio-economic development of the nation. However, many factors viz. fuel supply constraints, land acquisition issues, delay in regulatory approvals and clearances have stalled the progress of these critical sectors. From the financing perspective, the biggest challenge for banks to fund these long-gestation projects is the limited availability of long-term funds. Due to the asset-liability mismatches, the banks have restricted their finances to a maximum of 12-15 years, as against the economic life of around 25 years for large-sized infrastructure and core industries projects. This timing variance negatively impacts both, the borrower as well as the lender. It also affects the consumers in terms of higher user charges.

II. The 5:25 flexible structuring scheme

As per the 5:25 flexible structuring scheme, the lenders are allowed to fix longer amortization period for loans to projects in the infrastructure and core industries sector, for say 25 years, based on the economic life or concession period of the project, with periodic refinancing, say every 5 years. The repayment at the end of each refinancing period would be structured as a bullet repayment, with the intent specified upfront that it will be refinanced and such bullet repayment shall be allowed to be considered in Asset Liability Management (ALM) of banks. The repayment may be taken up by the same lender / a set of new lenders / a combination of both / by issue of corporate bonds as a refinancing debt facility and such refinancing may repeat till the end of the amortization schedule.

Conditions for 5:25 flexible structuring scheme

- Term loans to projects, in which the aggregate exposure of all institutional lenders exceeds Rs.500 crore, in the infrastructure and core industries sector will qualify.
- Banks may fix a fresh amortization schedule for the existing projects loans, once during the life time of the project, after the Commercial Operations Date (CoD) without it being treated as restructuring subject to:
    - The loan is standard as on date of change of loan amortization schedule
    - The Net Present Value of the loan remains same before and after the change in the amortization schedule.

- The Fresh loan amortization schedule should be within 85% of the initial concession period / life of the project.

- In case of accounts which are already classified as NPA, banks are allowed to extend the flexible structuring scheme. However, it shall be considered as 'restructuring' and such accounts would continue to remain classified as NPAs.

II.A. Beneficiaries

The 5:25 flexible structuring scheme is applicable to projects in the Infrastructure and Core Industries sector. New projects or projects which have achieved CoD are eligible under the scheme. However, under-implementation projects which have not yet achieved CoD are eligible for extension of moratorium period up to 2 years in infrastructure sector and 1 year in other sectors under separate guidelines of RBI without being considered as restructuring and subsequent to CoD announcement, such projects would be eligible under the extant scheme.

Figure 1 Issues faced by projects at various stages of the life-cycle and eligibility for flexible structuring scheme

New Projects where loan has not been sanctioned	Under Implementation projects which have not achieved CoD	Operational Projects which have achieved CoD
-On account of large number of projects being held up there are no major fresh proposals	-Delay in approvals and clearances -Delay in land acquisition -Ambiguity on input fuel -Cost Overrun	Stressed financial position due to: -Cost Overrun -Higher input fuel cost -Less than envisaged revenue -Concentrated debt repayment schedule
ELIGIBLE	**NOT ELIGIBLE**	**ELIGIBLE**

Infrastructure sector is as defined under the Harmonized Master List of Infrastructure of RBI. Core industries sector are the sectors included in the Index of eight core industries published by the Ministry of Commerce and Industries, Government of India.

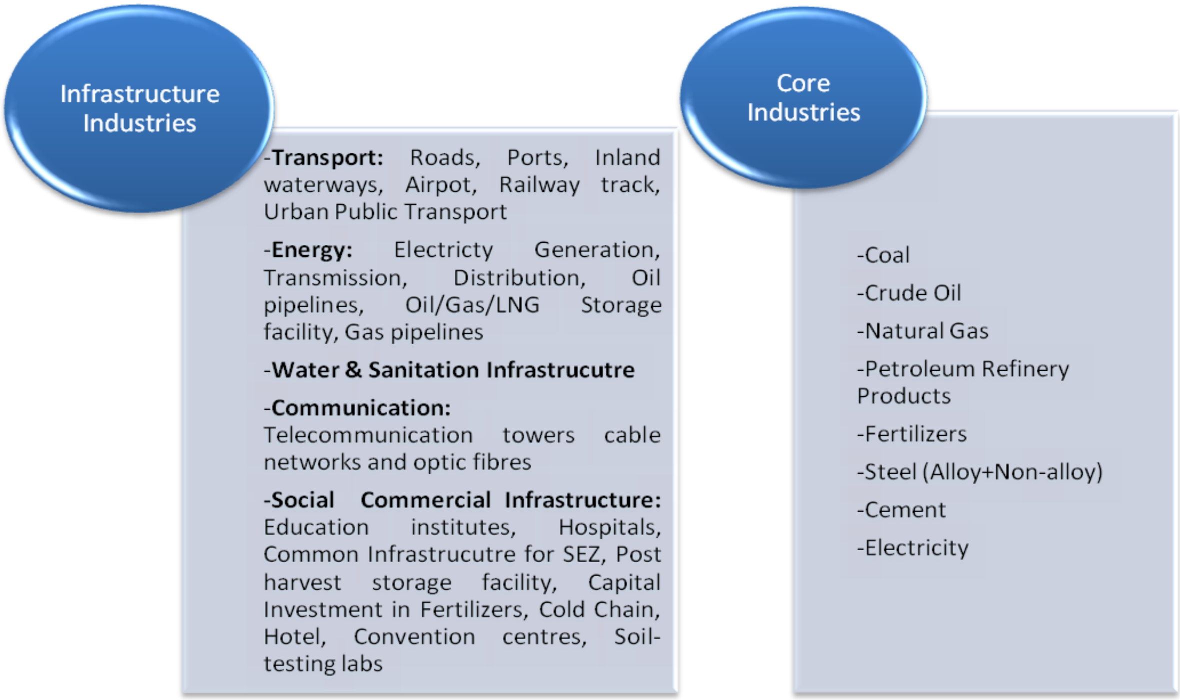


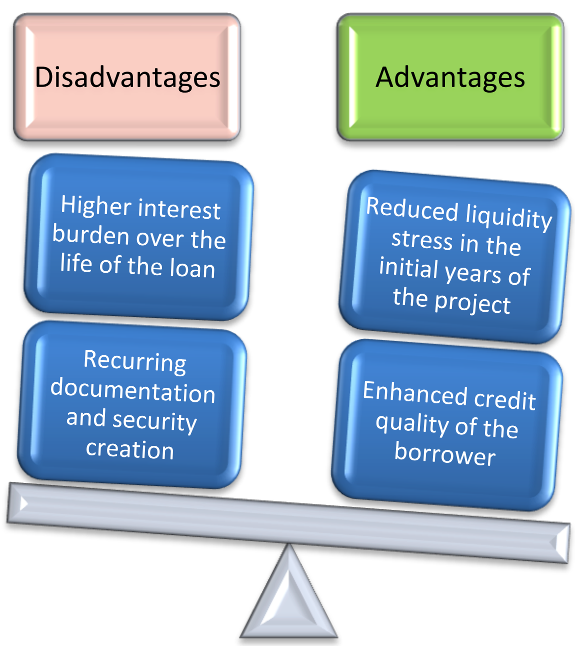
Figure 2 Beneficiary sectors

II.B. Perspectives

The flexible structuring scheme is envisaged to impact all the stakeholders;

Borrower / Company

Figure 3 Borrower's Perspective



Reduced financial stress in the initial phase of the project

The flexible structuring scheme would spread out the repayments based on the economic life of the project, hence smoothen the probable cash flow mismatches in the initial years wherein stress level is high due to stabilization phase of the project. This would improve the liquidity position of the borrower.

Enhanced credit quality of the company

The spread out repayment schedule would lead to improvement in the credit profile of the company. Upon improvement in the credit profile, the company could possibly access the corporate bond market thereby reducing their cost of borrowings. This would further enhance the viability of the project and incentivise the investor for such projects which would lead to development of the infrastructure and core industries in the country.

Higher interest burden

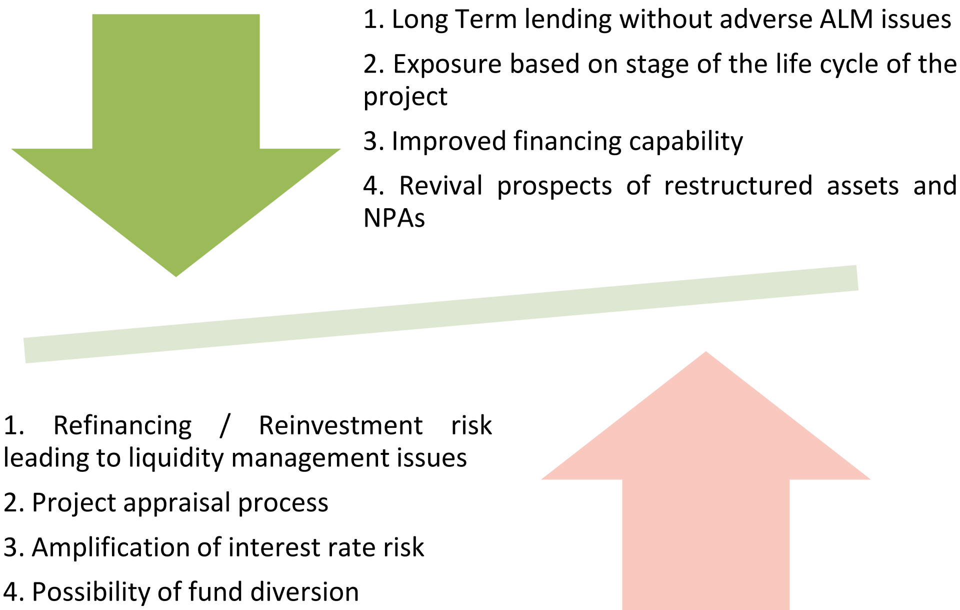
As per the restructuring scheme, principal amortization of the term loan is spread over a longer period compared to existing repayment schedule. It results in slower amortization of principal and hence higher interest outflow for the borrower. Over entire tenure of term loan, interest outflow as per restructuring scheme will be substantially higher compared to existing repayment schedule of loan. However, present value of the interest outflow as per restructuring scheme shall be on a lower side.

Recurring documentation and security creation

The flexible restructuring scheme is a boon from the perspective of a borrower; however, it comes along with one disadvantage. Since the loan would be refinanced at the end of every 5 years, the borrower would require undertaking documentation and security creation at the time of every refinancing which entails some cost.

Lenders

Figure 4 Lender's Perspective



Long-term lending without adverse ALM issues

As the project loan would be refinanced at the end of every 5 years and banks would be allowed to consider the bullet repayment at the end of every 5 years as a part of their ALM, the banks would be able to extend finance to long gestation infrastructure projects and core industries without getting adversely impacted by ALM issues. However, there is possibility of ALM issues still persisting if new lenders do not refinance the loan at the end of 5 years.

Exposure based on stage of the life cycle of the project

The banks would be able to take up or shed their exposures at different stages of the life cycle of the project depending on bank's single/group borrower or sectoral exposure limits.

Improved financing capability

On account of reduction in the project risk, spread out repayment burden and option of refinancing, credit ratings of such borrowers could potentially improve thereby allowing lower capital provisioning for the banks. The shorter amortization schedule of 10-12 years led to stressed cash flows in the initial years of the project, leading to higher need for restructuring and higher probability of the account becoming a Non-Performing Asset (NPA). These issues would be resolved by the flexible restructuring scheme and hence reduce the provisioning and stress creation for the banks. These, along with the improved ability of the borrower to access bond markets, would result into improved financing capability of the banks.

Revival prospects of restructured assets and NPAs

The flexible financing scheme is also applicable to infrastructure and core industries projects which have been restructured or classified as NPAs, hence, enhancing the prospects of their revival. (However, in such cases of flexible financing, the account would continue to be classified as NPA).

Refinancing / Reinvestment risk leading to liquidity management issues

Though theoretically, there won't be ALM issues, but in spirit ALM mismatches shall prevail as there would be refinancing risk at the end of 5 years if other lenders are not ready to take over the loan. Banks would face difficulty in estimating the liquidity needs because the cash flows from refinancing would not be certain. Also, in case of taking over of loan by other lenders at the time of refinancing, bank will have to face reinvestment risk as it shall be vested with excess liquidity and will have to find avenues for its effective deployment at a short notice.

Project appraisal process

Re-pricing of the loans at each stage of the sanction commensurate with the risk at each phase of loan is difficult since it requires fresh appraisal at the time of refinancing.

Amplification of interest rate risk

The flexible structuring scheme could amplify the magnitude of the interest rate risk and potentially impact profitability of the lenders if the borrower prepays part or entire facility. Impact of interest rate risk to the net present value of the loan to the lender, under normal scenario and flexible structuring scenario is depicted in the Scenario Analysis below.

Possibility of fund diversion

It would be critical for banks to develop a robust due-diligence and escrow mechanism as borrowers may misuse this scheme and divert funds to other projects in case of availability of excess cash accruals during initial phase of the project.

Consumers and economy

The flexible structuring scheme would spread out the repayment burden and debt servicing shall be in consonance with the project life. Accordingly, there would not be unusual high revenue requirement in initial period of operations which could lead to relatively lower usage charges for the consumers. Also, better viability of the project would incentivise the companies to invest further in infrastructure segment leading to higher economic growth. Also, the large-sized core industries and infrastructure projects which have presently stuck up would be revived and in turn, positively impact the economy.

II.C. Scenario Analysis

In order to deduce the impact of the 5:25 flexible restructuring scheme, Present Value (PV) of total payout [for impact analysis on the borrower] and Net Present Value (NPV) of the loan [for impact analysis on the lender] have been calculated, respectively.

Assumptions

Particulars	Normal Scenario	5:25 Scenario
Loan amount (Rs. Crore)	5,000	5,000
Repayment terms (No. of Equal quarterly installments)	32	72
Rate of Interest of bank loan	13.50%	11.90%
Return on Equity for borrower	15.00%	15.00%
Discounting rate used for calculation of NPV of loan from lender's perspective (i.e. Base rate)	10.00%	10.00%
Discounting rate used for calculation of PV of total payout to lenders from borrower's perspective (i.e. Average cost of capital for the borrower)	13.95%	12.83%
(Debt : Equity) Ratio assumed for calculation of Average cost of capital for the borrower	70:30	70:30

Outcome

For Borrower	PV of total payout to lenders (Rs. Crore)
Normal Scenario	5,033
5:25 Scenario	4,913
For Lender	**NPV of the loan (Rs. Crore)**
Normal Scenario	617
5:25 Scenario	617

On analysis, we can deduce that in order to meet the criteria for having NPV of the loan remaining same before and after the change in loan repayment schedule from the lender's perspective, the rate of interest is required to be reduced by the lenders. In that scenario, from a borrower's perspective the PV of total payout to the lenders is marginally lower.

However, in order to comprehensively analyse the impact of the flexible structuring scheme, it is critical to compare the impact of the interest rate risk on the lender if the borrower prepays the loan. Analysing the scenarios above for prepayment at different stages of the life-cycle of the project led to the following outcome;

NPV of the loan for lender (Rs. Crore)		
Prepayment	**5:25 Scenario**	**Normal Scenario**
No Prepayment	617	617
Entire Prepayment after 5 years	390	551
Entire Prepayment after 10 years	555	-
Entire Prepayment after 15 years	610	-

The magnitude of the interest rate risk to the lender is significantly higher under 5:25 Scenario as compared to Normal Scenario if the borrower prepays the loan. Hence, flexible financing scheme could potentially impact the profitability of the lender in case of prepayment at the time of refinancing.

III. Extrapolating the benefits: Refinancing scheme

The 5:25 flexible refinancing scheme is applicable only to projects in the infrastructure and core industries. In order to extend the similar benefit to other sectors, RBI decided that banks may refinance loans of existing projects and fix a longer repayment period, and same shall not be considered as restructuring in the books of the existing as well as taking over lenders, subject to the following conditions;

- The aggregate exposure of all the institutional lenders to such projects should be minimum Rs.1,000 crore.
- The project should have started commercial operations.
- The total repayment period should not exceed 85% of the initial economic life / concession period of the project.
- Such loans should be ‘standard’ in the books of the existing banks at the time of refinancing.
- In case of partial take-out, a significant amount of loan (minimum 25% of the outstanding loan by value) should be taken over by the new set of lenders from the existing financing banks.
- The promoters should bring in additional equity, if required, so as to reduce the debt to make the debt-equity ratio and Debt Service Coverage Ratio (DSCR) of the project loan acceptable to the banks.
- The above said facility will be available only once during the life of the existing project loans.

IV. Conclusion

In its effort to address one of the major issues affecting the growth of the infrastructure and core industries, RBI has rolled out the 5:25 flexible structuring and refinancing schemes. It is likely to bring along several advantages for the borrower and revival of several large scale projects. For a lender, though it has few potential disadvantages, the scheme has an overall positive impact. In addition, the scheme would benefit the consumer and also bolster the development of infrastructure and core industries which, in turn, would lead to socio-economic development of the nation. Hence, the 5:25 flexible structuring / refinancing scheme is a win-win situation for all the stakeholders. However, if the scheme is not implemented in its true spirit and without appropriate monitoring mechanism, in terms of wilful diversion of funds by the promoters, it could potentially paralyse the critical sectors of the Indian economy.

V. Credit Rating Perspective

If a borrower avails the flexible financing scheme / refinancing scheme, following are the key points from the perspective of credit rating:

- On account of spread out principal repayment obligations, the Debt Service Coverage Ratio (DSCR) shall improve during initial phase of the project life compared to original repayment schedule resulting in to improved liquidity position of the company / reduction in cash flow stress.
- There would be reduction in the rate of interest for the borrower; however, on account of relatively slower amortization of the term loan, the relative impact on the finance cost needs to be analysed.
- The capital structure improvement velocity shall reduce on account of slower amortization of the term loan.
- On account of lower principal repayment in initial phase, borrower would be left with additional cash and its effective utilisation shall be critical.
- For the safety of lenders, the creation of Debt Service Reserve Account (DSRA) and its impact on the credit profile of the company needs to be analysed.

References

I. RBI circular DBOD.No.BP.BC.24/21.04.132/2014-15 dated July 15, 2014 on 'Flexible Structuring of Long Term Project Loans to Infrastructure and Core Industries'

II. RBI circular DBOD.BP.BC.No.31/21.04.132/2014-15 dated August 07, 2014 on 'Refinancing of Project Loans'

III. RBI circular DBR.No.BP.BC.53/21.04.132/2014-15 dated December 15, 2014 on 'Flexible Structuring of Existing Long Term Project Loans to Infrastructure and Core Industries'

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