Long Term Infra Bonds For Indian Banking Sector: Future and Policy Ahead

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Abstract:

The empirically banks have various funding structures. Emerging market economy banks have safer funding structures than advanced economy banks. The central bank of India intends to ease raising long-term funds by banks for infrastructure. Also, there is cap on the quantum of long-term bonds to be issues by banks. The measures announced lead to an increase of market share for banks. Central government and the Reserve Bank of India have offered incentives for raising long-term bonds to fund infrastructure and affordable housing, investors' appetite for such instruments from insurance companies and pension funds seem limited. This would encourage banks to offer fixed rate loan products to keep interest rate risk under control, though the regulation allows issuance of bonds with fixed or floating rates of interest. Apart from Indian banking coming a full circle, it also raises the question of which is the right model. For the banking industry, long-term bonds appear to be the magic wand that will bring them out of the current disorder and set them on the path to eternal profitability. There are two issues that are raised here whether this will be a game-changer for banks and the infra sector and whether it is prudent to make such exceptions, somewhat an ideological consideration.

1. Introduction

The empirical investigation shows that banks have various funding structures and in general. Banks in emerging market economies also fund themselves primarily with retail deposits and are much more homogeneous in their use of various funding instruments than banks in advanced economy. Despite some movements in non-core versus core funding instruments, on average, bank funding structures change only gradually over time. In line with earlier studies, the empirical evidence suggests that bank funding is affected mainly by bank-specific factors and to a lesser extent by macro-financial and market variables. On average, countries with higher-quality regulations are associated with banks that have more deposit and less debt funding.

2. Infra bonds and India

In general, emerging market economy banks have safer funding structures than advanced economy banks. Emerging market economy banks are better capitalized, rely more on deposits and less on debt, and have lower loan-to-deposit ratios. In some economies, funding from a foreign parent bank could be a relevant source of bank funding, although in some cases subsidiaries provide funds to parents.

Current bank funding structures in emerging market economies appear to be less affected by regulatory reforms, although some cross-border effects pose concerns. Emerging market banks seem to be better to satisfy Basel-III requirements, on average, than their advanced economy. Basel-III capital and liquidity requirements are expected to be implemented on the same schedule for all Basel Committee on Banking Supervision member jurisdictions, including those in emerging market economies such as Argentina, Brazil, China, India, Indonesia, Mexico, Russia, Saudi Arabia, South Africa, and Turkey, and those in the European Union.

Key concerns of policymakers in emerging market economies are (1) how the reforms for global systemically important banks would affect their scale of operations and intermediation costs in host jurisdictions, and (2) whether benefits and costs of the reforms would be spread erratically across home and host jurisdictions, depending on where additional loss-absorbing capacity is held and which jurisdiction is permitted to trigger a bail-in.

3. RBI Guidelines for infra bonds

According to the RBI circular, the central bank intends to ease raising long-term funds by banks for infrastructure. Also, there is cap on the quantum of long-term bonds to be issues by banks. The long-term bonds of banks will not be considered under NDTL (Net Demand and Time Liability). The minimum maturity period of banks' long-term bonds to be seven years and will be exempted from CRR, SLR requirements. RBI has allowed banks to issue infra bonds via private, public placement. It has also eased priority sector norms for banks' long-term bonds. RBI says the long-term bonds of banks cannot have call or put option. Banks can issue infra bonds with fixed, floating interest rate. Long-term bonds of banks will not be eligible for deposit insurance. Banks must share data on long-term bonds soon after issuance. RBI says banks can only issue rupee-denominated infra bonds. The long-term bonds of banks will be exempt from priority sector lending. The instructions are in pursuance of Finance Minister Arun Jaitley's budget speech (Jul 15, 2014) in which he had said "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."

3.1 Structure 5:25

Under the 5:25 structure, bank may fix longer amortization period for loans to projects in infrastructure and core industries sectors, say 25 years, with periodic refinancing, say every five years. The RBI issued instructions to banks specifying operational guidelines and incentives in the form of flexibility in loan structuring and refinancing. It granted exemptions from regulatory pre-emptions, such as, the CRR, the SLR and Priority Sector Lending (PSL). 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.

3.2 Mitigating ALM problems

The objective of these instructions is to mitigate the Asset-Liability Management (ALM) problems faced by banks in extending project loans to infrastructure and core industries sectors, and also to ease the raising of long term resources for project loans to infrastructure and affordable housing sectors.

Banks have been seeking permission for longer tenor amortization of the loan, say 25 years, with periodic refinancing of balance debt, the RBI said. It further said, rupee denominated bonds should be issued in 'plain vanilla form' without call or put option with a fixed or floating rate of interest. Lending for affordable housing means loans eligible under the priority sector and loans up to Rs.50 lakh to individuals for houses costing up to Rs.65 lakh located in the six metropolitan centres. For other areas, it covers loans of Rs.40 lakh for houses with values up to Rs.50 lakh.

3.3 Long gestation period

The RBI said that while banks have been raising resources in a significant way, issuance of long-term bonds for funding loans to infrastructure sector has not picked up at all. Infrastructure and core industries projects are characterized by long gestation periods and large capital investments.

The long maturity of such project loans consists of the initial construction period and the economic life of the asset/underlying concession period. India is looking at investing $1 trillion in infrastructure development by 2017, half of which is expected to come from the private sector.

3.4 Realtors hail move

Realtors' body CREDAI, hailed the RBI's move to ease norms for banks to raise long-term funds for financing affordable housing, saying this would lead to cheaper credit for such projects. This will lead to lower interest rates for affordable housing projects. Another realtors' body NAREDCO said this would help developers to mobilize cheaper finance for development of affordable housing and will result into cutting in prices of housing in long term.

4. Benefits of using Infra Bonds

The Reserve Bank had issued the guidelines covering incentives for issuance of long term bonds by banks for financing of affordable housing and infrastructure after this declaration.

The measures announced lead to an increase of market share for banks beyond the current 63 per cent in the home finance market. The guidelines say banks can raise long term resources to finance their long term loans to affordable housing through minimum regulatory pre-emption like exemption in the mandatory government security holding and cash reserve ratio and priority sector lending. Once banks start hitting the street with offers, insurance companies and mutual funds, who typically invest in such securities, will get more options to invest their money. As banks are better rated and a safer bet, the housing finance companies will again have a difficult time raising the required resources for on-lending.

5. Investor's appetite

Though the central government and the Reserve Bank of India have offered incentives for raising long-term bonds to fund the infrastructure and affordable housing, investors' appetite for such instruments from insurance companies and pension funds seem limited. The reasons include the unsecured nature of these papers and current ratings of Indian banks.

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Though the central government and RBI have offered incentives for raising long-term bonds to fund infrastructure and affordable housing, investors' appetite for such instruments from insurance companies and pension funds seem limited reasons include the unsecured nature of these papers and current ratings of Indian banks. RBI says funds raised via these bonds will not be included in the computation of net demand and time liabilities. These bonds are unsecured in nature, due to which need to see how much appetite comes from the investors' side. These bonds will be of longer tenure and the demand for long-term bonds is not very high. Banks with lower credit ratings will find it difficult to raise funds through these bonds.

Insurance companies, pension and provident funds, foreign institutional investors and retail investors could be key investors in these bonds. This might be a constraining factor for long-term bond issuances by banks. Insurance firms would have the appetite for investing in long-term infra bonds in the initial stages. About 75-80 per cent of the total product portfolio in the industry is of traditional products that usually have 10-15 years duration. If there was a rise expected, a floating rate would be chosen.

The new guideline could also facilitate the development of a fixed interest rate market for infrastructure, as well as the affordable housing segment, as the Indian bond market is largely a fixed interest rate segment. This would encourage banks to offer fixed rate loan products to keep interest rate risk under control, though the regulation allows issuance of bonds with fixed or floating rates of interest. Though the central government and the Reserve Bank of India have offered incentives for raising long-term bonds to fund infrastructure and affordable housing, investors' appetite for such instruments from insurance companies and pension funds seem limited. The reasons include the unsecured nature of these papers and current ratings of Indian banks.

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Insurance firms say they would have the appetite for investing in long-term infra bonds, even up to Rs 100 crore in the initial stages. The fixed income head of a private life insurance company said though RBI has said these would have a minimum maturity of seven years, insurance companies would look at bonds of 10-30 year duration, since they have a long-term liability in insurance policies. About 75-80 per cent of the total product portfolio in the industry is of traditional products that usually have 10-15 years duration. If there was a rise expected, a floating rate would be chosen. These instruments would preferably be on a fixed rate of interest, since that is the case with infra projects.

6. Challenges ahead

There is near-unanimity that Indian interest rate cycle is at its peak now, and the only direction for rates is to head south. So, goading banks to borrow long term at current interest rates is something similar to what US Federal Reserve former chairman Alan Greenspan did to mortgage borrowers. Greenspan advised individual borrowers to shift to floating rates. Given the Indian financial tradition and the smartness of borrowers, the dice will be loaded against banks in the case of long-term bonds. At current interest rates, banks may be borrowing at near 10% without a call or put option. But they may be lending to someone who may have the choice of refinancing the loan at a lower rate when interest rates ease. Apart from Indian banking coming a full circle, it also raises the question of which is the right model. For the banking industry, long-term bonds appear to be the magic wand that will bring them out of the current disorder and set them on the path to eternal profitability. There are two issues that are raised here whether this will be a game-changer for banks and the infra sector, and whether it is prudent to make such exceptions, somewhat an ideological consideration.

Banks have been allowed in the past to raise bonds that go beyond the Tier-II capital. As banks see it, it is useful to pursue the issuance of such bonds, with a maturity of over 7 years, through public issues or private placement as per RBI's directive. The prospect of regulatory benefits is quite inviting though RBI has already warned banks in its Financial Stability Report that infrastructure was a problem area when it comes to stressed assets. Each bank has to draw a trade-off here. Banks cannot have cross-holdings, which means that one side of demand has been blocked. Long-term investors like insurance and pension funds would find them attractive but will have to revisit their own investment guidelines as these bonds are unsecured. If a tax benefit is not provided, then a household may not be interested as there are tax-free bonds providing an 8% return. If banks offer a 12% nominal return to match this 8%, the advantage of SLR and CRR exemption may get diminished. But for such bonds, there may be less liquidity, given the tenure. Even if retail interest is there, there could be substitution with deposits. With a 7-year bond providing acceptable yields, funds may move from long-term deposits to these bonds. Also, banks are already maintaining excess SLR, of 3-5%, which indicates that such concessions may not really work when the quality of assets are under pressure.

The payments bank concept is interesting because it will be a new initiative where banks take deposits and are not allowed to lend. In case of the payments bank, the bank would carry the cost. This is the classic concept of narrow-banking, where banks only invest in government paper and hence avoid the pitfalls of NPAs or capital adequacy. These banks will not be borrowing and hence will have only a cost of deposits. The spread between return on investment and cost of deposit would be around 100 bps which has to be managed by a bank to remain above the ground.

Now, the cost of intermediation would be lower for these banks as they would have lower expenses on most overheads given that they would be operating mostly in rural areas. Both these concepts are assuredly interesting and may be viewed as fairly innovative experiments that will be tested by the market. The success of bank bonds will provide a distinct fillip to the corporate debt market while that of a payments bank will work in furthering financial inclusion. On one hand the regulations may improve competitive position of banks, on the other; it may also lead to increase in cost of funds especially for higher rated HFCs as the traditional long term investors would have a limited corpus and larger number of high quality issuers to choose from.

Housing finance companies focused on the affordable housing segment, may get some relief as bank loans to such companies will get some regulatory relief and can benefit through improved fund availability and lower cost of funds, it said. The level of issuances from banks will be dictated by their ability to raise floating rate bonds as home loans are typically floating rate in nature which helps them manage interest rate risk and also find investors for the large issuances.

7. Policy ahead for Indian Banks

Banks in India are now allowed to structure infrastructure loans for up to 25 years by refinancing every five years on fresh terms. This can be done by the existing banks or even by a new bank. Since such restructuring will not be treated as traditional loan recast, the banks will not have to set aside money when they refinance infrastructure loans under the so-called 5:25 model. Earnings from investment in government bonds are less than those from corporate loans, and returns from priority loans are relatively low while the transaction cost of such small loans is high. There is slightly different take on RBI's two-pronged approach to prop up infrastructure financing and protect banks from asset-liability mismatches. Since there is no cap on maturity of bank loans and no bar on refinancing loans, there is nothing new about the 5:25 model. Banks are always encouraged to resort to take-out financing. So, RBI has tweaked it and allowed lending banks to keep the loan on their books and refinance it after every five years with new terms in case it is not taken over by another institution. It's hard to be convinced by the age-old asset-liability mismatch argument used by banks against infrastructure financing. This is simply because banks always have a steady flow of current and savings accounts (CASA). 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. Public sector banks don't have the expertise to appraise infrastructure projects. They sanction big loans to such projects simply because others are doing it and they don't regret such decisions, till the loans go bad. The growth in banks' exposure to the infrastructure sector over the past few years has been more than the average credit growth of the banking system. In the past year, the asset quality of bank loans to infrastructure developers is deteriorating at a faster pace than that of loans advanced to any other sector. Globally, the onus on funding the infrastructure sector is not on commercial banks alone.

8. Conclusions

A series of regulatory support has been extended to banks. Now, in conjunction with the government of India, the RBI has once again come to fore in resolving the macro concern of long term infra funding and addressing the ALM mismatch.

We believe the directive will benefit the banks (especially PSBs) with higher proportion of infra book and ALM mismatch. IDFC (Bank license holder) would be the key beneficiary as it would be improving its growth aspirations, maintaining NIMs and thus improve return ratios. However, it would be difficult to quantify the benefit for individual banks given the uncertainties over the quantum of eligibility and capability to raise funds.

The RBI directive to bring affordable housing under the current purview of long term funding would enable banks to future intensify the competition, especially in terms of spreads. In that case, the HFC's would be negatively impacted.

Taking cognizance of concerns of high capital requirement and asset quality issue in Infra space, both the RBI and the GOI have been incrementally supportive.

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