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Indian Financial Markets

Draft proposals improve the cost benefit for PCE backed bonds; challenges, however, persist

APRIL 2025

Highlights

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Proposed framework by RBI aims to expand the partial credit enhancement (PCE) market and help entities raise funds via the bonds markets, by addressing some of the issues in earlier regulations, which had led to limited traction in the PCE bond issuances over the last decade

- The Reserve Bank of India (RBI) released draft directions on Non-Fund Based Credit Facilities (including partial credit enhancement, PCE) on April 9, 2025.
- The draft directions aim to expand the PCE market and help entities raise funds via the bonds markets, by addressing some of the issues in earlier regulations, which had led to limited traction in the PCE bond issuances over the last decade.
- Key proposals included expanding the scope of providing PCE to all regulated entities (RE; including scheduled commercial banks (SCBs), all India financial institutions (AIFIs), non-banking financial companies (NBFCs) in Top, Upper and Middle Layers, and housing finance companies (HFCs)) compared to the earlier mandate whereby only banks could provide PCE.
- PCE exposure limit by a single RE increased to 50% of the issue size, which is significantly higher than the previous capping of 20% of issue size.
- The capital required to be maintained by the PCE provider will depend on risk weights applicable to pre-enhanced rating of issuer for the quantum of PCE provided compared to the earlier formula of capital requirement as differential amount of capital calculated as per risk weights on pre- and post-enhanced rating for the total issue size.
- PCE shall be provided in the form of an irrevocable contingent line of credit at the time of bond issue and will be drawn in case of shortfall in cashflows for servicing the bonds. Drawn PCE facility would become payable within a period of 30 days to the PCE provider. If remain unpaid for 90 days, it will be classified as non-performing advance (NPA) by the PCE provider.
- Aggregate PCE exposure of an RE shall not exceed 20% of its Tier I capital.

Highlights

Proposed framework by RBI would lead to lower capital requirement for the PCE provider, which will eventually reduce borrowers' borrowing costs. In addition, higher credit enhancement can lead to higher notch upliftment in the credit rating.

- Lower capital requirement will make providing the PCE more commercially lucrative for REs as well as borrowers. For instance, as per ICRA's analysis, credit enhancement of 20% (same level as under earlier framework) leading to rating upliftment from BBB to A category, would lead to capital reduction by 60% and hence similar reduction can be expected in fee charged.
- Under the new proposed framework, a RE can extend PCE facility with maximum exposure to the extent of 20% of its Tier I capital. Accordingly, the public sector banks (PSBs)* cumulatively having a Tier I capital of ~Rs. 10.5 trillion as of December 2024 can support issuances of Rs. 4.4 trillion (10.5*20%*2). Similarly, AIFIs^ having a Tier I capital of ~Rs. 2.0 trillion can support issuances of Rs. 0.8 trillion, whereas large infrastructure NBFCs# cumulatively having Tier I capital of Rs. 2.5 trillion can support issuances of Rs. 1.0 trillion.

However, there remains a need for structural changes in the debt covenants for any meaningful upliftment of credit rating of PCE backed bond.

- While the PCE to a single bond issue is expected to be increased up to 50% of the issue size, the structuring of the bonds, which excludes cross-default and/or debt acceleration clauses, will be important for a meaningful upliftment of credit rating on these PCE backed bonds. With presence of cross-default and debt acceleration clauses with other borrowings of the borrowers, a meaningful upliftment will not be possible for PCE backed bonds despite a higher PCE, in ICRA's assessment.
- Further, continued availability of PCE for the bonds during the insolvency process will be critical for a rating upliftment of the PCE bonds.

*13 PSBs; ^6 AIFIs (NABARD, EXIM, SIDBI, NABFID, NHB and NABFID); #includes PFC, REC, IREDA, IRFC, HUDCO, IIFCL

Need for partial credit enhancement (PCE)

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PCE – Credit enhancement mechanism to enhance credit rating of bonds

- Bonds issued by infrastructure companies/their special purpose vehicles (SPVs) often factor in the inherent risk on account of higher gestation and cashflow concerns in the initial stages of a project. Additionally, there can be temporary mismatches in cashflows and debt repayment obligations in case of some disruption in the project. Resultantly, the investor interest for these issuances has remained low, given the higher risk perception, especially if the underlying assets are not diversified.

- With continued focus of the Government of India (GoI) towards infrastructural spending, given the prevalent lack of depth and liquidity in the corporate bond market for lower rated corporate bonds and keeping in mind the huge credit needs of the infrastructure sector, the RBI in September 2015, had released a framework to allow banks to offer PCE to corporate bonds.

- Given the limited traction in such PCE bond issuances over the last decade, the RBI has issued a draft circular in April 2025 to address some of the issues in earlier regulations.

Objectives of PCE

Enhances credit rating

- Higher rated RE providing partial/ limited credit enhancement can lead to improved credit rating for the borrower and resultantly lower cost of borrowing

Enables access to larger pool of investors

- Given the improved credit rating, issuance becomes attractive to a larger set of potential investors like insurance and pension funds who predominantly invest only in AA/AAA issuances

Addresses asset liability mismatch

- Given the requirement of insurance/ pension funds for longer tenured products, they are better suited for funding such products compared to banks who rely on short to medium term deposits

Benefits a variety of entities

- Projects with high predictability of cashflows but likely cashflow mismatches due to timing differences, given the nature of operations such as renewable energy projects, state government backed road annuity/ hybrid annuity (HAM) projects

Source: ICRA Research

Key proposals in draft framework^ for PCE

Draft guidelines expanded the scope of providing PCE to all REs (which includes all SCBs, AIFIs, NBFCs and HFCs) to the bonds issued by all corporates/SPVs and by NBFCs with asset size of at least Rs. 1,000 crore. This is in comparison to the earlier mandate whereby only banks could extend the PCE. Widening the scope to all REs reduces the dependence of issuers on banks. Given the sizeable net worth of other REs such as AIFIs and infra financing NBFCs that are higher rated, wider participation could be possible.

PCE exposure limit by a single RE increased to 50% of the issue size, which is significantly higher than the previous capping of 20% of issue size. An increase in exposure limit, whereby a single RE can provide PCE up to 50%, will lead to higher upliftment of credit rating of underlying borrower's bonds leading to lower borrowing costs and access to larger pool of investors. However, certain challenges need to be addressed, which are discussed later in this note.

Capital required to be maintained by the REs providing contingent PCE for an issuance shall be based on the PCE amount and the applicable risk weight corresponding to the pre-enhanced rating of the bond. This proposal will lead to reduced capital requirements for the RE when compared with the existing framework, which requires capital to be maintained as the difference between capital required on the entire bond amount corresponding to its pre-credit enhanced rating and capital required on bond amount corresponding to its post-credit enhanced rating. This shall eventually reduce the cost of availing such PCE and improve the cost-benefit analysis for the borrower.

^ RBI released draft framework titled 'Reserve Bank of India (Non-Fund based credit facilities) directions, 2025' on April 09, 2025

Existing framework and key proposed amendments

	Existing framework	Proposed framework	ICRA's comments
PCE provider	Only banks are permitted to provide PCE	All regulated entities including all SCBs, AIFIs, NBFCs and HFCs	▪ *Expanding the scope to all REs reduces dependence of issuers on banks and opens another avenue for other REs to support the infrastructure sector and earn fee income. Simultaneously, it increases competition for banks, although compensating them with capital release given the lower capital requirements.*
Higher exposure limit	PCE exposure limit for an issuance is capped at 20% of the bond issue size	PCE exposure limit for an issuance to be capped at 50% of the bond issue size	▪ *An increase in exposure limit will lead to higher upliftment of credit rating of underlying borrowers' bonds issuances leading to lower borrowing costs and access to a larger pool of investors. This will, however, be subject to addressing certain challenges, as discussed later in the note.*
Lower capital requirements	Capital to be maintained is the difference between capital required on entire bond amount corresponding to its pre-credit enhanced rating and capital required on bond amount corresponding to its post-credit enhanced rating	Capital required to be maintained by the REs providing contingent PCE for an issuance shall be based on the PCE amount and the applicable risk weight to the RE corresponding to the pre-enhanced rating of the bond	▪ *Lower capital requirement will make providing the PCE more commercially lucrative for REs as it will release capital. This will also enable REs to pass on the benefit to issuers by way of reduction in fee charged for providing PCE.* ▪ *For instance, under the new framework, if an issuance of Rs. 100 crore with a base rating of BBB is upgraded to A with a PCE of 20%, the capital requirement for the RE would be much lower at Rs. 1.8 crore (20%*9%*100%*100)# compared to the existing framework where the capital requirement is higher at Rs. 4.5 crore ((100%-50%)*9%*100)^. Similarly, release of capital is more for higher notch upliftment.* ▪ *However, the capital release for an instrument with a base rating in the A category, whose rating is being uplifted because of PCE, is expected to be limited. For instance, in case of rating uplift from A category to AA and AAA, the capital release will be nil and Rs. 0.9 crore respectively for a bond issuance of Rs. 100 crore and PCE of 20% .*

*# (% of PCE * required CRAR of bank * risk weight applicable to base rating * bond size)*
*^ (risk weight differential of base rating and enhanced rating * required CRAR of bank * bond size)*

Other salient operational features of the PCE facility

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PCE form	PCE shall be provided in the form of an irrevocable contingent line of credit at the time of bond issue and will be drawn in case of shortfall in cashflows for servicing the bonds.
Pre-enhanced rating	REs to offer PCE only to bonds that have a pre-enhanced rating of investment grade (i.e., not below BBB-).
Investors in PCE bonds	REs not permitted to invest in bonds that are credit enhanced by other REs.
Ringfencing	REs shall ensure that the project assets, created out of the bond issue for which PCE has been provided by them, and the cashflows from the project are ring fenced through an escrow account mechanism administered under a bond trustee arrangement.
Exposure limit for REs	Aggregate PCE exposure of an RE shall not exceed 20% of its Tier I capital.
Additional conditions for PCE to bonds of NBFCs/HFCs	PCE will be provided to bonds with a tenor of not less than three years. Proceeds from bonds backed by PCE from REs shall only be utilised for refinancing the existing debt of NBFCs/HFCs. The exposure of an RE by way of PCEs to bonds issued by each such NBFC/ HFC shall be restricted to 1% of capital funds of the RE within the extant single/ group borrower exposure limits.
Treatment on balance sheet	PCE facilities to the extent drawn will be treated as on-balance sheet advance on balance sheet whereas undrawn facilities would be an off-balance sheet item and reported under contingent liabilities.

Potential issuance of PCE backed bonds

Exhibit 1: Scenario analysis

Tier I capital (in Rs. crore)	Max PCE exposure (in Rs. crore) (maximum exposure capped at 20% of Tier-I of RE)	Max issue size (in Rs. crore) (corresponding to max PCE as 50% of the issue size)
20,000	4,000	8,000
40,000	8,000	16,000
60,000	12,000	24,000
80,000	16,000	32,000
1,00,000	20,000	40,000

- As seen in Exhibit 1, REs with Tier I capital of Rs. 1,00,000 crore, taking a maximum exposure of 20% of its Tier I capital, would be able to provide PCE for a maximum of Rs. 20,000 crore. Consequently, given the PCE capping at 50% of issue size, bond issuance of up to Rs. 40,000 crore can be supported by the RE.
- Extending the above calculation, the public sector banks* cumulatively having a Tier I capital of ~Rs. 10.5 trillion as of December 2024 can support issuances of Rs. 4.4 trillion (10.5*20%*2). Similarly, AIFIs^ having a Tier I capital of ~Rs. 2.0 trillion can support issuances of Rs. 0.8 trillion, whereas large infrastructure NBFCs# cumulatively having Tier I capital of Rs. 2.5 trillion can support issuances of Rs. 1.0 trillion. However, certain challenges need to be addressed, which are discussed later in this note.

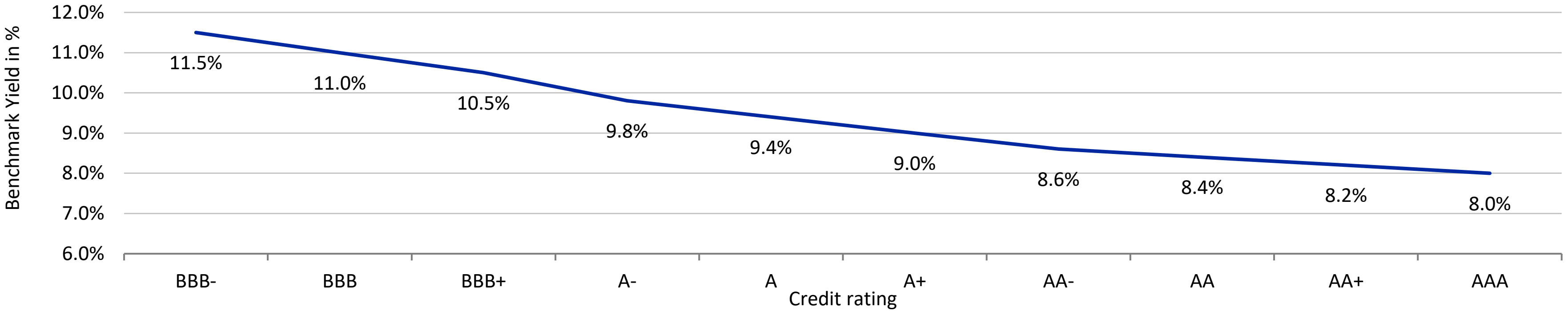
**13 PSBs; ^6 AIFIs (NABARD, EXIM, SIDBI, NABFID, NHB and NABFID); #includes PFC, REC, IREDA, IRFC, HUDCO, IIFCL*

Key challenges in the proposed regulations

Invocation and payment timelines	Drawn PCE facility would become payable within a period of 30 days to the PCE provider. If remain unpaid for 90 days, it will be classified as NPA by the PCE provider. This restriction makes the nature of PCE facility akin to a liquidity facility (providing only a liquidity cushion of 30 days) rather than a genuine long-term first loss credit enhancement facility. This feature limits the extent of rating enhancement possible on credit enhanced debt solely because of availability of PCE. Further, the timelines and mechanism for the invocation of the PCE should be clearly defined to ensure that the payments are made in a timely manner and there is no default on the supported bond (single day single rupee).
Cross-default and acceleration	In ICRA's opinion, there should not be a cross-default clause on the PCE backed bond, as the probability of default (PD) on the PCE backed bond would be the same as that of other lower rated loans on the same balance sheet of the borrower (current or future). Hence, a default on such loans could trigger debt acceleration on the PCE backed bond leading to a high likelihood of default on the latter (as the coverage in the event of acceleration of bond would only be partial).
Bankruptcy remoteness	The PCE facility should be available to cover the shortfall in servicing of the PCE backed bond even when the entity is under bankruptcy proceedings due to default on other loans. In ICRA's opinion, in a scenario where the borrower's cashflows are controlled by the resolution professional (RP) during bankruptcy, the PCE facility should cover the entire payment due on PCE backed bond, irrespective of whether the borrower's cash flows are available for debt servicing.

Annexure I: Typical corporate yield curve for investment grade issuances

Exhibit 2: Corporate yield curve



Source: ICRA Research; benchmark yields calculated for different rating levels for a tenure of 7-15 years as on Feb 2025

- A two-notch improvement in the BBB category rating can result in a benefit of up to 120 basis points (bps) reduction in the borrowing costs, whereas a two-notch improvement from an A category rating can result in a benefit of up to 80 bps reduction in the borrowing costs for the issuer.
- With the reduction in capital requirement, the RE can reduce the fee charged. Consequently, ICRA believes the proposed guidelines will be positive from a cost benefit point of view, provided the challenges highlighted earlier are addressed.
- For instance, under the new framework, if an issuance of Rs. 100 crore with a base rating of BBB category gets upgraded to the A category with a PCE of 20%, the capital requirement would be Rs. 1.8 crore under the proposed framework; and with a notional return on equity (RoE) of say 16% for the RE, the annual fee would be 30 bps of the bond issue, whereas the same is higher at 72 bps under the existing framework. This makes the cost of PCE significantly lower compared to a saving of up to 120 bps, as mentioned above.

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Thank You!