

Partial credit enhancement to NBFC Bonds

Why in news?

\n\n

The Reserve Bank of India has permitted banks to grant partial credit enhancement (PCE) to bonds issued by NBFCs and housing finance companies recently.

\n\n

What is the importance of partial credit enhancement?

\n\n

\n

- Credit enhancement means improving the credit rating of a corporate bond or in this case, that of NBFC.

\n

- For example, if a bond is rated BBB, credit enhancement, which is basically an assurance of repayment by another entity, can improve the rating to AA.

\n

- This is done to provide an additional source of assurance or guarantee to service the bond.

\n

- Through the credit enhancement facility, the existing rating can be improved at an early stage, which enables the issuer to raise funds at a relatively lower yield.

\n

- Higher the credit rating, lower is the cost of raising funds.

\n

- Since these bonds are long-term in nature, they appeal to institutional investors like pension funds and insurers.

\n

- However, these investors, especially pension funds, invest mostly in investment grade securities which are at least AA-rated.

\n

- Credit enhancement makes the bonds more attractive by improving the rating enough so that institutional investors become interested in adding these to their portfolios.

\n

- For the investor, the facility provides a sort of insurance in case of hard times.
\n
- Basically, the credit enhancement gets used only when there is a shortfall in either paying interest or repaying principal.
\n
- Hence, investors are more secure about repayment even if there is uncertainty regarding cash flows for some time.
\n
- Also, the bond market will benefit with more issues getting placed, which will help in developing the secondary market.
\n

\n\n

What are the measures proposed?

\n\n

- The credit crunch that followed the IL&FS crisis saw the RBI providing special incentives to banks to enable the flow of funds to NBFCs.
\n
- This is because NBFCs and housing finance companies asked the government to make sure that confidence returns in the sector.
\n
- Hence RBI has allowed banks to grant PCE to enable NBFCs to obtain funds from the bond market on favourable terms and to improve their bonds' credit rating.
\n
- However, it says that the occupancy of these bonds should not be less than three years and shall only be used to refinance existing debt.
\n
- Also, banks shall introduce appropriate mechanisms to monitor and ensure that the end-use condition is met.
\n
- The RBI has also increased banks' limit for offering their capital to a single non-infra funding NBFC from 10% to 15% till the end of this year.
\n
- It has permitted banks to use government-issued securities as high-quality level 1 liquid assets equal to the bank's incremental offering to NBFCs and housing finance companies.
\n
- However, the RBI limited the exposure of a bank through PCEs to bonds assigned by each NBFC or housing finance company to 1% of bank's capital funds within the current borrower exposure limit.

\n

- Also, banks are permitted to give PCE as the non-funded subordinate in the form of conditional credit only used in case of cash flow shortfall for maintaining the bonds.

\n

\n\n

What are the takeaways?

\n\n

\n

- The move is aimed at enhancing the credit rating of the bonds and enabling these NBFCs to access funds from the bond market on better terms.
- It is expected to help NBFCs and HFCs raise money from insurance and provident or pension funds who invest only in highly-rated instruments.
- Thus the PCE can serve as a contingent line of credit to service the bonds in case of shortfall, thereby improve the credit rating of the bond issue.

\n

\n\n

\n\n

Source: Livemint

\n\n

\n\n

\n\n

\n