Partial credit enhancement to NBFC Bonds

Why in news?

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

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What is the importance of partial credit enhancement?

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- Credit enhancement means improving the credit rating of a corporate bond or in this case, that of NBFC.
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- 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.
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- This is done to provide an additional source of assurance or guarantee to service the bond.
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- 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.
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- Higher the credit rating, lower is the cost of raising funds.
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- Since these bonds are long-term in nature, they appeal to institutional investors like pension funds and insurers.
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- However, these investors, especially pension funds, invest mostly in investment grade securities which are at least AA-rated.
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- Credit enhancement makes the bonds more attractive by improving the

rating enough so that institutional investors become interested in adding these to their portfolios.
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- For the investor, the facility provides a sort of insurance in case of hard times.
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- Basically, the credit enhancement gets used only when there is a shortfall in either paying interest or repaying principal.
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- Hence, investors are more secure about repayment even if there is uncertainty regarding cash flows for some time.
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- Also, the bond market will benefit with more issues getting placed, which will help in developing the secondary market.
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What are the measures proposed?

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- 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.
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- This is because NBFCs and housing finance companies asked the government to make sure that confidence returns in the sector.
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- 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.
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- 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.
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- Also, banks shall introduce appropriate mechanisms to monitor and ensure that the end-use condition is met.
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- 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.
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- 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.
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- 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.
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- 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.
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What are the takeaways?

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- 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.
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- It is expected to help NBFCs and HFCs raise money from insurance and provident or pension funds who invest only in highly-rated instruments.
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- 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.
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