From:	"Arun Chawla"
To:	"Komal Sharma" <komal.sharma@ficci.com>
Date:	2/9/2022 12:09:20 AM
Subject:	FW: Implementation of Expected Loss Method (ELM) rating for Indian infrastructure sector
Attachments:	IRDA circular.pdf SEBI Circular.pdf

Dear Komal

Here is the copy somehow it stayed in the outbox only.

Best Regards,

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From: Arun Chawla
Sent: 09 February 2022 11:38
To: secy-dea@nic.in
Cc: Jyoti Vij <jyoti.vij@ficci.com>; Manab Majumdar <manab.majumdar@ficci.com>; Anshuman Khanna <anshuman.khanna@ficci.com>; Abha Seth <abha.seth@ficci.com>; Neerja Singh <neerja.singh@ficci.com>
Subject: Implementation of Expected Loss Method (ELM) rating for Indian infrastructure sector

Shri Ajay Seth
Secretary
Department of Economic Affairs
Ministry of Finance
Government of India

Dear Shri Seth,

Hope you are doing well.

At the outset, we wish to place on record our sincere gratitude to the Government for a growth-oriented and forward-looking Budget. The measured announced would go a long way in bringing the Indian economy back on track and achieve sustained growth rates in future.

FICCI had the privilege of interacting with Hon'ble Finance Minister on the budget announcements yesterday and also had the opportunity to discuss certain key economic issues. Amongst all other issues discussed, we are writing to draw your attention to the significant issue of credit rating of infrastructure entities.

We are grateful that in recognition of infrastructure sector being an engine of economic growth, Government has been focused on infrastructure development in the country. This has had a high multiplier effect as growth in infrastructure creates demand for other sectors like steel, cement etc., besides providing large employment opportunities. Government's focus on infrastructure development through various initiatives such as National Infrastructure Pipeline (NIP), National Monetization Program (NMP), National Bank for Financing Infrastructure and Development (NaBFID) is quite encouraging.

As you would agree, infrastructure projects are beset with many challenges and complexities during construction, long gestation periods and dependency on multiple factors beyond the control of developers like natural resources allocation (coal and gas, land allotments), receivables/subsidies/grants from Government departments etc. One of the most critical challenges faced by infrastructure projects is the limited availability of bank finance on account of low investment grade rating. Generally, infrastructure projects have long project lifecycle of 40 to 60 years and Government also permits concession for a period of 40 to 60 years. Considering the specific challenges of infrastructure projects, they require different approach in respect of credit rating and interest payment intervals.

Currently, in line with RBI guidelines, Indian banks follow conventional rating system (probability of default based) under which credit rating agencies downgrade the Issuer rating to D (default) based on “one day, one rupee delay” principle resulting in account falling in the category of Special Mention Accounts or Non-Performing assets (SMA1, SMA2, SMA3 and NPA). Due to inherent challenges of infrastructure projects, specifically during construction phase and initial stabilisation phase, there is a likelihood of temporary delay in debt servicing owing to initial cash-flow mismatch though the project remains viable over long term. Therefore, PD rating may not be appropriate measure of risk involved.

In acknowledgement of these peculiar challenges of infrastructure projects, the Union Budget 2016 proposed development of a new credit rating system for infrastructure projects with an emphasis on various in-built credit enhancement provisions, instead of relying upon the standard perception of risk under conventional rating system. Relevant para 84 (iii) of Union Budget statement is reproduced hereunder:

“84. Our private sector plays an important role in the development of infrastructure, many of which are implemented in the Public Private Partnership (PPP) mode. I would like to announce three new initiatives to reinvigorate this sector.

….

(iii) A new credit rating system for infrastructure projects which gives emphasis to various in-built credit enhancement structures will be developed, instead of relying upon a standard perception of risk which often result in mispriced loans.”

Infrastructure projects have long economic life that is typically longer than the debt tenure financed by Banks. This leads to cash flow mismatches. Residual economic life of project presents an opportunity for the instruments to be refinanced over a longer period. ELM based rating considers project life-cycle based future cash-flows and thus provides a more holistic measure of creditworthiness of an infrastructure project.

In case of volatile cash flows, ELM based rating allows lender to distinguish between entities on the basis of project’s overall viability with favourable fundamentals and recovery prospects and those without, besides other features like termination payments, escrow mechanism, compensation due to Authority’s default, all of which help the infrastructure projects even beyond the loan tenure.

Globally, all the reputed international rating agencies (Moody’s, Fitch, S&P) have their own methodologies to assess the project viability in addition to conventional methods of rating which adequately takes care of project risks and its mitigation.

We wish to submit that adoption of ELM based rating will be equally beneficially for borrowers as well as lenders in the following manner:

Based on ELM rating, lenders can process working capital/term loan renewal of an infrastructure project, although “default based” conventional rating might be below investment grade. This additional working capital / term loan can help project in coming out of temporary stress caused due to cash flow mismatch.

Lenders can have risk-based pricing based on expected loss, & loss given default

Facilitates capital allocation based on expected loss, & loss given default

Serves as an input in decision on account exit, retention, or additional collateral requirements etc.

Ministry of Finance had constituted a committee to obtain inputs from credit rating agencies and various stakeholders including lenders, IDFs, regulatory authorities, infrastructure developers etc. to develop a new rating system for the infrastructure sector. Subsequently, in January 2021, Insurance Regulatory Development Authority of India (IRDAI) advised insurance companies to follow the ELM and similarly in July 2021, Securities and Exchange Board of India (SEBI) issued circular to rating companies to follow the ELM. Copies of IRDAI and SEBI circulars are attached as Annexure 1 and Annexure 2.

In view of the need and necessity to achieve faster growth of infrastructure in the country and considering the approach of international rating agencies as well as Indian regulators like IRDAI, SEBI to follow the ELM rating method, it may be deemed appropriate for Indian banks also to consider implementing the ELM based rating.

We, therefore, request that necessary policy guidelines be issued so that banks can also adopt and implement ELM rating method. This will go a long way in realising Government’s ambitious target of achieving faster infrastructure development in the country.

We look forward to favourable consideration of this submission and would be happy to provide further information that may be required.

Best Regards,

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