Enabling Low Cost Financing to Renewable Energy in India

Supported by:

SHAKTI SUSTAINABLE ENERGY FOUNDATION

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Project Background & Need

Specific nature of RE projects makes arranging commercial debt difficult

Cost and terms of debt are driven by financial, economic and sector specific parameters

Need to channelize commercial debt at reasonable terms to RE through sector specific targeted interventions

Prior to that, imperative to understand present finance/banking regulations and areas where specific interventions may be required

Analysis to aid in determining mechanisms to increase availability and lower cost of finance to RE sector

Overall Approach & Methodology

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Task 1 – Understanding As-Is Scenario through Primary & Secondary Research

Task 2 – Secondary Research for International Experience

Task 3 – Qualitative Analysis through Analytical Framework

Task 4 – Industry Interactions & Stakeholder Consultation on Findings

Banking & Financing Sector Regulations

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Key Findings – Role in Sector Allocations & Exposures

- Banking regulations & RBI directives can direct credit to specific sectors by influencing lending terms & conditions **(Banking Regulations Act, 1949 and RBI Act, 1934)**
- Regulatory agencies can prevent overexposure to risky sectors to reduce overall systemic risk;
- Regulatory bodies **can't mandate** lending to a sector; Credit **decision ultimately lies with lender**.
- Bank's sectoral exposure = **function of (Regulatory directives, Banks internal policies, Demand for funds from companies / projects with acceptable risk profiles)**.
- Individual and group exposure norms set by RBI; **No sector level exposure limits mandated**; To be **set by banks internally** based on sector performance & perceived risks; **Not shared by banks.**

Key Findings – Role in Priority Sector Lending (PSL)

- **Preference to factor in cost for not meeting priority sector obligations** in overall cost rather than lending to risky sectors even if they are in priority sector.
  - In FY 12-13, 16 of 26 public banks, 10 of 20 private banks & 2 of 41 foreign banks not achieved PSL norms.
- **Categories under priority sector** – Agriculture, Micro and small enterprises, Education, Housing, Export credit and Advances to weaker sections.
- Percentage requirement – **40% of ANBC target for Domestic Commercial Banks / Foreign Banks > 20 branches** & **32% for Foreign Banks < 20 branches as per revised guidelines.**

Sector Allocations

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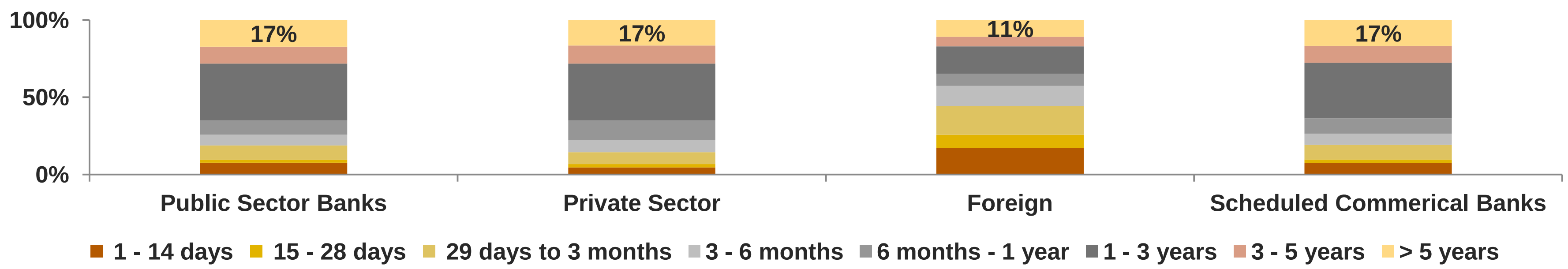
Key Findings – Analysis of Sector Exposure

- Lending to different sectors by banks is influenced by **Inherent risk or attractiveness** of a particular sector, Lender's **ability to assess risk** appropriately and **Lender's comfort** with the sector.

Key Findings – Tenure of Loans

- Most banks have **10-15% of advances from loans with maturity > 5 years**; 42% in case of Axis Bank; Breakup of **tenure beyond 5 years in not available.**
- Small proportion in long tenures is due to liability mix of banks i.e. **Majority of deposits & borrowings are short / medium term**
- **Refinancing (after commencement of operations) is not common** as **lenders prefer to keep good assets on their books after taking risk** during construction period



✓Capacity building exercises for financiers may result in lowering risk perception for RE projects

✓Tenure is not considered as a constraint for lending to RE projects as per banks

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Key Findings – Role in Cost of Funds

- RBI also **influences overall cost of funds** for banks by **altering Rates and Ratios.**
- Banks to provide loans based on Base Rate **(Base Rate System, July 2010)**; To be calculated by banks
- As per RBI, **lending rates for loans & advances ≥ Base Rate** with certain exceptions
  - Deposits and small-ticket borrowers under the differential interest rate (DRI) scheme
  - Loans to banks' own employees, and
  - Agricultural loans.
- Rate applicable for loan to particular borrower calculated by adding **Tenor premium, Risk premium** & **Product premium** to the Base rate
- Base rate regime is **not applicable for NBFCs**

✓ Cost of funds for banks and NBFCs are relevant as projects get funded by both.

✓ Cost of funds for banks have a cascading impact on ultimate cost of funds as some NBFCs borrow funds from banks for on lending purpose.

Sources & Costs of Funds

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- Sources of funds for banks include Deposits – CASA, Term deposits; Borrowings and Others.
- Cost of funds driven by cost of deposits as they account for 78% of total liabilities in FY 12-13;
- Within deposits, CASA has lowest cost; 33% of deposits in FY12-13; High CASA ratios = lower overall cost of funds;
- Domestic borrowings – Perpetual debt instruments, hybrid debt capital and subordinated bonds.
- Limited international borrowings as higher costs of hedging makes costs for international borrowing comparable to domestic sources.
- Overall cost of funds = Weighted average of the costs from different sources
  - Variation because of proportion of CASA deposits, credit profile of individual banks, government support, NPAs, capital base, etc.

✓ Cost of funds is just a component of bank's base rate.

✓ As per RBI's illustrative computation, Base rate = Cost of Deposits or Funds + Negative carry on CRR and SLR + unallocated overhead cost + average return on net worth.

✓ Final lending rate is determined by other factors (Risk premium, tenure premium, product premium).

Combining Non-commercial & Commercial Sources

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Key Findings – Refinancing Schemes from Sectoral Institutions

- **NABARD provides refinance facilities to:**
  - Commercial Banks (CBs), Regional Rural Banks (RRBs), State Co-operative Banks (SCBs), State Co-operative Agriculture and Rural Development Banks (SCARDBs), Scheduled Primary Urban Co-operative Banks and Non-Banking Finance Companies (NBFCs)
- **NHB (National Housing Bank) also offers refinancing facilities to:**
  - Housing Finance Company, Scheduled Commercial Banks, Scheduled Urban Cooperative Banks, Regional Rural Banks, State Level Apex Co-operative Housing Finance Companies, Agriculture and Rural Development Banks as well as other new Schemes
- **SIDBI (Small Industries Development Bank of India) provides refinancing facilities for:**
  - Setting up new small scale units or expansion, modernisation, diversification etc. of existing units;
  - Covers professional practice / consultancy venture and service sector units such as tourism related activities / hospitals / nursing homes / polyclinics / hotels / restaurants / marketing and industrial infrastructural projects;
  - All forms of organisations in the small scale sector.

✓ **Benefits of lower cost sources of funds can be passed on to specific sectors**

Risk Assessment of RE Projects

Key Risks associated with RE projects

- Regulatory risk and continuity of incentives;
- Non-uniformity in policy guidelines at Central and State levels;
- Uncertainty & divergence in FITs approved by SERCs;
- Lack of long-term RPO trajectory & its compliance;
- Lack of forecasting tools & grid management;
- Financial losses of distribution utilities & non-payment;
- Inadequate evacuation & transmission infrastructure;
- Operational risk such as CUF degradation;
- Land acquisition & forest clearances;
- Specific risk factors such as wind pattern changes, lack of database for solar irradiation, etc.

✓ **Absence of fuel supply issues, shorter gestation period & lower operational costs make RE projects better than conventional projects in terms of risk perception.**

✓ **Regulatory & policy risks critical for lowering cost of financing for RE projects**

Recommendations on Mechanisms for Lowering Cost of Finance

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Synthesized Products/ New Investors

- Allow **pension funds, insurance companies and sovereign funds** with long term horizons to **invest in RE projects**
- **Encourage securitization** and sell longer term tranches to such organizations.

Tax Free Bonds

- RE project financiers may be allowed to **raise capital from market via issuance of tax free bonds;**
- **Tax credit may be provided to investor** who could net it off against his tax liability.

Capital Tax Exempt Bonds

- Under Section 54, Bonds issued by REC and NHAI allow investors capital exemption – 6% interest rate, lock in of 3 years
- Similar provisions could be extended to IREDA/renewable energy financiers; option of higher interest rate for longer lock in

Reduction of sovereign guarantee fee

- **Sovereign guarantee fee** levied by GoI on funds from ADB and multilaterals **could be lowered for public sector entities / NBFCs** involved in financing RE projects.

Recommendations on Mechanisms for Lowering Cost of Finance

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Government/intermediary guarantees

- Accessing bond market directly by IPPs is difficult due of not sufficient credit profile
- Government agencies can provide guarantee for select RE projects in exchange for guarantee fees; will lead to lower financing costs due low perceived risks
- Entities having better understanding of RE sector can provide guarantee to qualifying projects after credit appraisal in exchange for guarantee fee.
- Currently IIFCL is giving partial guarantee

Infrastructure Debt Fund

- Allowing funding from Infrastructure Debt fund to RE projects meeting well defined criteria; or
- Create mechanisms to structure RE projects as PPP to enable funding from Infrastructure Debt Fund would allow longer tenure funds into renewable energy sector.

Improvement in soft loans scheme

- Certainty for developers on the availability of such soft loans,
- Improved payment timelines to utilize full allocation during financial year.
- MNRE can sign up with State Governments wherein every project selected under State policies would get a fixed loan via bank / NBFC.

Recommendations on Mechanisms for Lowering Cost of Finance

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Renewable Energy Development Fund

- Similar to the Rural Infrastructure Development Fund (IRDF) of NABARD
- REDF could be used for lending to priority sector renewable energy assets (i.e. off grid); considered towards priority sector requirements for banks investing in fund

Capacity Building

- To enable RE project lenders to understand the risks associated with renewable energy projects and lower the risk perception.
- Government / MNRE should empanel a set of agencies to appraise renewable energy projects to provide additional comfort for lenders who lack in-house capability to assess renewable energy projects.

Regulatory certainty and continuity of incentives

- Continuation of operational incentives such as preferential/ feed in tariffs, RPOs, RECs, 80IA benefits, accelerated depreciation, generation based incentives, etc.
- Harmonization and certainty of continuity to provide adequate comfort to the investors.

About the Study

The study has been supported by Shakti Sustainable Energy Foundation and carried out by CRISIL Risk and Infrastructure Solutions Limited

About Shakti Sustainable Energy Foundation (www.shaktifoundation.in)

Shakti Sustainable Energy Foundation works to strengthen the energy security of the country by aiding the design and implementation of policies that encourage energy efficiency as well as renewable energy.

About CRISIL Infrastructure Advisory (www.crisil.com)

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