**Guidelines on Partial Credit Enhancement to corporate bonds by banks**

## I. Purpose

1. The credit needs of the infrastructure sector in India are huge. Resources are generally raised through the bond market by corporates for project development. However, the Indian corporate bond market, being at a nascent stage of development, there is excessive pressure on the banking system to fund the credit needs of such projects thereby leading to greater asset-liability mismatch and exposing banks to liquidity risk. The insurance and provident/pension funds, whose liabilities are long term, may be better suited to finance such projects.

2. The regulatory requirement for insurance and provident/pension funds is to invest in bonds of high or relatively high credit rating.

3. With a view to enabling long term providers of funds such as insurance and provident/pension funds, as also other investors, to invest in the bonds issued for funding projects by corporates/SPVs, RBI, in its Second Quarter Review of Monetary Policy 2013-14, proposed to allow banks to offer Partial Credit Enhancement (PCE) to corporate bonds.

4. The objective behind allowing banks to extend PCE is to enhance the credit rating of the bonds issued so as to enable corporates to access the funds from the bond market on better terms.

5. It has been decided that, to begin with, banks can provide PCE to a project as a non-funded subordinated facility in the form of an irrevocable contingent line of credit which will be drawn in case of shortfall in cash flows for servicing the bonds and thereby improve the credit rating of the bond issue.

## II. Salient features of the PCE facility

6. The aggregate PCE provided by all banks for a given bond issue shall be 50 per cent of the bond issue size, with a limit up to 20 per cent of the bond issue size for an individual bank.

7. The PCE facility shall be provided at the time of the bond issue and will be irrevocable.

8. Banks are not expected to invest in corporate bonds which are credit enhanced by other banks.

9. Banks may offer PCE only in respect of bonds whose pre-enhanced rating is **BBB minus or better**.

10. Banks cannot provide PCE by way of guarantee.

11. Banks should have a board approved policy on PCE.

## III. Balance sheet treatment, capital requirements, exposure and asset classification norms for exposures arising on account of providing PCE

12. PCE facilities to the extent drawn should be treated as an advance in the balance sheet. Undrawn facilities would be an off-balance sheet item and reported under ‘Contingent Liability – Others’.

13. The aggregate capital required to be maintained by the banks providing contingent PCE for a given bond issue for their exposure on account of PCE provided will be computed, as if the entire bond issue was held by banks, as the difference between (a) the capital required on the entire bond amount, corresponding to its pre-credit enhanced rating and (b) the capital required on the bond amount corresponding to its post-credit enhanced rating, as per the risk weights applicable to claims on corporates in the Master Circular – Basel III Capital Regulations (as updated from time to time).

*To illustrate, assume that the total bond size is Rs.100 for which PCE to the extent of Rs.20 is provided by a bank. The pre-enhanced rating of the bond is BBB which gets enhanced to AA with the PCE. In this scenario –*

*a. At the pre-enhanced rating of BBB (100% risk weight), the capital requirement on the total bond size (Rs.100) is Rs.9.00.*
*b. The capital requirement for the bond (Rs.100) at the enhanced rating (AA, i.e., 30% risk weight)) would be Rs.2.70.*

*c. As such, the PCE provider will be required to hold the difference in capital i.e., Rs.6.30 (Rs.9.00 – Rs.2.70).*

14. On a review of the capital requirement for PCE, it has been decided that:
    a) To be eligible for PCE from banks, corporate bonds shall be rated by a minimum of two external credit rating agencies at all times;
    b) The rating reports, both initial and subsequent, shall disclose both standalone credit rating (i.e., rating without taking into account the effect of PCE) as well as the enhanced credit rating (taking into account the effect of PCE).
    c) For the purpose of capital computation in the books of PCE provider, lower of the two standalone credit ratings and the corresponding enhanced credit rating of the same rating agency shall be reckoned.
    d) Where the reassessed standalone credit rating at any time during the life of the bond shows improvement over the corresponding rating at the time of bond issuance, the capital requirement may be recalculated on the basis of the reassessed standalone credit rating and the reassessed enhanced credit rating, without reference to the constraints of capital floor and difference in notches.

15. In situations where the notional pre-enhanced rating of the bond slips below investment grade (BBB minus), capital must be maintained as per risk weight of 1250% on the amount of PCE provided.

16. The PCE providing bank will observe the following exposure limits:

    (a) PCE exposure to a single counterparty or group of counterparties shall not exceed 5 per cent of the bank's Single Borrower / Group Borrower limit to the counterparty to whom the PCE is provided,

    (b) The aggregate PCE exposure of a bank shall not exceed 20 per cent of its Tier 1 capital.

For more details on the guidelines, please refer to RBI circular RBI/2015-16/183 DBR.BP.BC.No. 40/21.04.142/2015-16 dated September 24, 2015; RBI/2016-17/43 DBR.BP.BC.No.5/21.04.142/2016-17 dated August 25, 2016 & RBI/2016-17/305 DBR.No.BP.BC.70/21.04.142/2016-17 dated May 18, 2017.