Submission to the Reserve Bank of India on Draft Prudential Framework for Income Recognition, Asset Classification and Provisioning pertaining to Advances - Projects Under Implementation, Directions, 2024

This is in response to the release of Draft Prudential Framework for Income Recognition, Asset Classification and Provisioning pertaining to Advances - Projects Under Implementation, Directions, 2024 by the Reserve Bank of India. The Directions, hereon referred to as the draft framework or the framework, establish a unified prudential framework for financing projects in the Infrastructure, Non-Infrastructure, and Commercial Real Estate sectors by regulated entities (REs). They also introduce updated guidelines for changes in the start date of commercial operations (DCCO) for these projects, following a review of existing instructions and risk analysis. Issued under the authority granted by various sections of the Banking Regulation Act, 1949, the Reserve Bank of India Act, 1934, the Factoring Regulation Act, 2011, and the National Housing Bank Act, 1987, the Reserve Bank of India (RBI) deems these Directions necessary for public interest. Titled the "Reserve Bank of India (Prudential Framework for Income Recognition, Asset Classification and Provisioning Pertaining to Advances - Projects Under Implementation) Directions, 2024 (IRACP-PUIMP)," they take effect immediately. The Directions apply to Scheduled Commercial Banks (excluding Payments Banks, Local Area Banks, and Regional Rural Banks, but including Small Finance Banks), Non-Banking Financial Companies (NBFCs), Primary (Urban) Cooperative Banks, and All India Financial Institutions (AIFIs), collectively referred to as 'Lenders'.

The guidelines for project finance, as outlined, focus on the procedural and financial aspects necessary for the successful execution and management of projects through various phases: design, construction, and operation. The document provides detailed directives on financial closure, disbursement, monitoring, resolution of stress, and provisioning, aiming to ensure financial stability and mitigate risks associated with project financing. However, several critical areas are notably absent or insufficiently addressed, particularly concerning the propensity of project finance to run into losses, the desirability of making commercial retail banks do long gestation and risky 'development' project lending. environmental, social, and climate concerns, as well as mechanisms for public consultation and social audits.

Section 1

Key Points from the Guidelines:

a). Project Phases and Financial Oversight:

- The guidelines divide projects into three phases: design, construction, and operational.
- They mandate the presence of all necessary clearances before financial closure and proportional disbursement based on project completion stages.

b). Risk Management and Resolution:

- Lenders must have a board-approved policy for resolving stress and monitoring projects for credit events.
- A structured approach for resolution plans, particularly involving the extension of the Date of Commencement of Commercial Operations (DCCO), is detailed.

c). Provisioning and Financial Prudence:

- Specific provisioning requirements are outlined for different project phases and circumstances, including delayed implementation of resolution plans and non-performing assets.

Key Responses to the Draft Prudential Framework

a). The Draft Prudential Framework has left the reasons for cost overruns, Non performance unexamined

- An examination of causes and their classification would have allowed to evolve resolution plans attuned to the specific needs drawing on the learnings from the past experience.
- Major infrastructure, energy projects have faced huge cost overruns and fallen into NPAs, the project finance framework was an opportunity to address it.

b). Revisit the role of commercial banks

- Project finance usually deals with substantial, capital-heavy projects that come with considerable risks, such as those related to construction, operations, market fluctuations, and political factors. Development Finance Institutions (DFIs) are particularly suited to evaluate and handle these risks because of their specialised knowledge and extensive experience in funding intricate projects.

c). Critical absence of environmental and social safeguard measures at the level of financial institutions.

- The framework recognizes the necessity of obtaining mandatory environmental clearances in accordance with Indian law. However, they do not promote or mandate financial institutions to implement extra environmental, climate, and social safeguards on their own initiative.
- Big ticket project finance more often than not takes a toll on vulnerable communities, the framework misses the opportunity of incorporating free, prior

and informed consent as well as consultations with affected communities as a measure required by the financiers.

d). What more can be done to turn lending into sustainable financing

- Financial institutions can strive to achieve accountability for climate, environmental, and social issues by setting up thorough oversight and redressal systems. To ensure compliance with environmental and social standards at every project phase, from pre-approval to loan closure, it is essential to establish a permanent body within each financial institution.

Section 2

1. **Why Project Finance runs into losses and non performing assets?**

An explanation of immense non performing assets, write offs, and haircuts sustained by Indian banks and financial institutions was called for in order to suggest appropriate remedial action. The Draft Prudential Framework for Projects Under Implementation, 2024, however does not attempt to discover, discuss and address the underlying causes of projects turning financially unviable. This seems a glaring absence given the context of massive NPAs, haircuts and write-offs that the Indian banking system has witnessed in the last two decades.

The RBI's Statistical Tables Relating to Banks in India, released periodically, lack specific details on NPA and write-offs levels for the infrastructure sector and various types of financing like project finance, corporate finance, or asset finance. However, RBI's periodic statements reveal that NPAs in infrastructure project finance are notably high. Over the past five fiscal years, from FY 2018-19 to FY 2022-23, scheduled commercial banks have written off loans amounting to Rs 5.52 lakh crore linked to large industries and services.

The data shows a 1.6 times increase in the Gross Non-Performing Assets (NPA) accumulated across public sector banks since the 2014-15 level, reaching ₹54 lakh crore during 2019-2024.

Banks have written off a cumulative ₹14.56 lakh crore from 2014 to 2023, a figure that is more than three times higher than in 2015. This amount is also 2.5 times greater than the total spending by the Uttar Pradesh government in the 2023-24 fiscal year.

Yearly write-off amounts by public sector banks surged 17 times from 2013 to 2023, rising from ₹7,187 crore to ₹1.27 lakh crore. Among public sector banks, the State Bank of India has written off the highest total amount over the past decade, nearly ₹3 lakh crore by 2023. Similarly,

write-off amounts by private sector banks increased 20 times over the same period, from ₹4,115 crore to nearly ₹84,000 crore.

Although recovery from written-off loans has improved from 8% to 19%, the total recovery from written-off loans through various channels remains low at only 14% between 2017-18 and 2021-22, indicating a significant gap between the amounts written off and the amounts recovered.

The poor have the least responsibility for the rising NPAs. Historically, the main contributor to banks' NPAs was the priority sector, as banks were required to extend credit to agriculture and Medium Small Micro Enterprises. This trend continued through the 1990s and 2000s. However, in the 2010s, the share of priority sector NPAs in public sector banks grew much more slowly compared to NPAs in the non-priority sector. During the 2000s, the non-priority sector accounted for about 50 percent of NPAs in PSBs, but by 2019, its share had surged to around 80 percent. This shift highlights changing priorities in our economic policy, prioritising big players over the smaller and more numerous industries.

It is the citizen, whose money is deposited in the bank and whose tax money funds its running. Due to increasing losses for banks under the IBC and other factors, the amount of money provisioned for NPAs by banks increased almost ten-fold between 2010-2015 and 2017-2022. The profits of public banks were directly utilized to offset losses from IBC haircuts.

From 2016 to 2023, 7,325 default cases were processed under the Insolvency and Bankruptcy Code through the Corporate Insolvency Resolution Process (CIRP). As of December 2023, a total of ₹23.19 lakh crore was admitted, of which only ₹3.867 lakh crore has been recovered or is expected to be recovered.

For cases that went through the resolution process, the recovery rate was merely 32%. For those that ended in liquidation, the recovery rate was significantly lower at just 5%. A report by the credit rating agency CareEdge highlights that the overall recovery rate has been declining in recent years. The cumulative recovery rate dropped from 43% in the first quarter of FY20 to 32.9% in the fourth quarter of FY22, and further down to 32% in the first quarter of FY24.

The recovery rates appear even worse when excluding the 12 major cases initially announced by the RBI in 2016. Without these, the average recovery rate for resolved cases falls from 31.9% to 24.4%.

The prudential framework needs to understand the underlying causes of financial insolvency and unviability in case of project financing in order to formulate adequate guidelines.

It is important to highlight here that ‘profitability’ of investments is important because it is public money which is being invested by financial institutions. At the same time, it needs to

be emphasised that it is greater common good, as decided in an ongoing manner through public participation, that is the primary aim and not simply the profitability of financed projects.

Section 3

A case for revisiting the role of commercial banks as conduits of project finance

Project finance involves the long-term financing of infrastructure and industrial projects based on the projected cash flows of the project rather than the balance sheets of the project sponsors. This type of financing is highly specialised and has unique characteristics that make it more suitable for specialised development finance institutions (DFIs) rather than commercial banks. Here are several reasons why:

a). Risk Profile and Management

High Risk: Project finance typically involves large, capital-intensive projects that carry significant risks, including construction risk, operational risk, market risk, and political risk. DFIs are better equipped to assess and manage these risks due to their specialised expertise and experience in financing complex projects.

Risk Mitigation: DFIs often have access to risk mitigation tools such as political risk insurance, guarantees, and other financial instruments that are not typically available to commercial banks. These tools are crucial for managing the high risks associated with project finance.

The NPAs generated by the ultra-wealthy negatively impact the availability of credit for the poor. High NPAs lead to significant losses for banks, which in turn reduces their capacity to distribute credit. During the last decade, public sector banks saw a notable drop in their share of total credit disbursement among scheduled commercial banks. As NPAs increased, PSBs were able to fulfill a smaller portion of the credit needs of MSMEs. Consequently, it is the poor who suffer from the credit rationing caused by bad loans to the rich.

b). Long-term Financing Needs

Tenure of Loans: Infrastructure and industrial projects usually require long-term financing, often extending 15-20 years or more. Commercial banks typically have shorter-term lending horizons and might find it challenging to commit funds for such long periods due to regulatory and liquidity constraints.

Patience for Returns: DFIs are designed to support economic development and are often willing to wait longer for returns on their investments, which aligns with the long gestation periods of large infrastructure projects.

c). Development Focus

Economic and Social Objectives: DFIs often have mandates to promote economic development and social welfare in addition to financial returns. They are more willing to invest in projects that have high developmental impacts but might be less attractive to commercial banks due to lower or more uncertain financial returns.

Support for Unbankable Projects: Many projects that are crucial for development (e.g., in emerging markets or underserved sectors) might not be "bankable" by commercial standards due to high risks or low initial returns. DFIs can step in to provide the necessary financing for these projects.

d). Specialised Expertise

Technical and Sectoral Expertise: DFIs typically have specialised knowledge and expertise in various sectors such as energy, transportation, water, and sanitation. This expertise enables them to better understand the technical and financial aspects of projects, leading to more informed decision-making. At times, representatives of the DFI work closely with the board of the lender closely monitoring the decisions.

Structuring Complex Deals: Project finance deals are complex and require sophisticated structuring, including the creation of special purpose vehicles (SPVs), complex contractual agreements, and multi-layered financing arrangements. DFIs have the expertise to structure these deals effectively.

e). Regulatory and Capital Constraints

Regulatory Requirements: Commercial banks are subject to stringent regulatory requirements regarding capital adequacy, liquidity, and risk management, which can limit their ability to engage in long-term, high-risk project finance.

Capital Allocation: The capital-intensive nature of project finance means that it requires significant capital allocation. DFIs, with their focus on development finance, are more suited to allocate the necessary capital for such projects without the same constraints faced by commercial banks.

In summary, the specialized nature of project finance, with its unique risk profiles, long-term investment horizon, developmental objectives, and complex structuring requirements, makes it more suitable for development finance institutions. DFIs have the necessary expertise, tools, and mandates to effectively manage and finance these projects, which might be challenging for commercial banks to handle on their own.

Section 4

Critical Absences:

a). Environmental, Social, and Climate Safeguards:

- The guidelines acknowledge mandatory environmental clearances as per Indian law but fail to encourage or require financial institutions to adopt additional environmental, climate, and social safeguards at their level.
- There is no emphasis on climate risk assessments, sustainable practices, or measures to mitigate the long-term environmental impacts of financed projects.
- The present framework does not refer to or incorporate some of RBI's own guidelines for managing climate risk of its investments. For instance its own 'Survey on Climate Risk and Sustainable Finance' published in July 2022 showed the absence of governance systems in most commercial banks to address climate related financial risk. It showed that Board-level engagement on climate risk and sustainable finance was lacking. In about one-third of the surveyed banks, the responsibility for overseeing climate risk and sustainability initiatives had not yet been assigned. Moreover, only a small number of banks integrated climate risk, sustainability, or Environmental, Social, and Governance (ESG) Key Performance Indicators (KPIs) into the performance evaluations of their top executives. Most banks lacked a dedicated business unit or department for sustainability and ESG initiatives. Only a handful of banks had developed a strategy to integrate ESG principles into their operations, expand their sustainable finance portfolios, and incorporate climate change risks into their existing risk management frameworks.Should not the project finance framework mandate adequate board level capacity and requirement to incorporate climate risk?
- In its framework for green deposits released last year the RBI stipulates regulated financial institutions to build oversight mechanisms to assess, report and address environmental impacts of projects funded through green deposits. Why cannot the framework on project finance stipulate mechanisms to measure and address environmental, social and climate impacts arising out of its investments?
- In its Draft Disclosure framework on Climate-related Financial Risks, 2024, RBI speaks of monitoring scope 1,2 and 3 emissions for financial institutions throughout the time that loan is active, the draft prudential framework is an ideal occasion to put in place mechanisms for perpetual monitoring of not only the financial stress but climate, environmental and social stress engendered by the project.
- An official report revealed that by March 2024, as many as 449 infrastructure projects, each requiring an investment of Rs 150 crore or more, experienced a cost overrun exceeding Rs 5.01 lakh crore. The Ministry of Statistics and Programme Implementation (MoSPI), which oversees infrastructure projects valued at Rs 150 crore and above, indicated that out of 1,873 projects, 449 faced cost overruns and

779 were delayed. The delays, according to various project implementing agencies, were due to factors such as delays in land acquisition, obtaining forest and environmental clearances, and insufficient infrastructure support and linkages. The framework also stipulates that for public private partnership projects 'land availability to the extent of 50% or more can be considered sufficient by lenders to achieve financial closure.' The prudential framework does not attempt to examine why such factors matter. What are the lessons from previous land acquisitions, for instance? What should a financier's role be in case land acquisition is being challenged by local communities to protect their lifeworld and livelihood?

- Infrastructure, non-infrastructure, and commercial real estate projects can have substantial environmental and climate footprints. The lack of rigorous environmental and climate safeguards means potential long-term damage and increased project risks due to environmental non-compliance or climate-related disruptions.

b). Public Consultation and Social Audits:

- The guidelines do not mandate public consultations, free, prior and informed consent, which are crucial for transparency and community involvement in projects that may significantly affect local populations.
- Periodic social audits, which could help in assessing and addressing the social impact of projects, are also missing. These audits could provide ongoing oversight to ensure that projects do not adversely affect vulnerable communities.
- Projects can significantly impact local communities, particularly vulnerable groups. The absence of mandated public consultation and social audits can lead to social injustices, displacement, and community unrest. Ensuring that affected communities have a voice and that their concerns are periodically audited is essential for equitable development.

c). Broad Stakeholder Engagement:

- There is no framework for stakeholder engagement beyond the immediate financial and legal prerequisites. Effective project governance requires broader stakeholder input, including local communities, environmental groups, and independent experts.

d). Litigation Risk needs a far deeper understanding

The draft prudential framework states that a project finance account classified as 'standard' in the books of REs shall continue to be classified as 'standard' on account of extension of DCCO if it arises owing to litigation lasting upto one year. It is important to point out that litigation risk needs to be considered for the life-cycle of the project. Further, an understanding of causes - which could arise from environmental, climate, socio-economic concerns - of litigation need to be properly understood. Litigation is not only a financial concern but may require a response based on a financial institutions' commitment to environmental, climate and socio-economic commitments.

Section 5

Towards Sustainable Financing

a). Oversight and Redressal Mechanisms

The full accountability of financial institutions regarding climate, environmental, and social issues can be fully realised by establishing comprehensive oversight and redressal mechanisms within these institutions. A permanent body is necessary within each financial institution to ensure adherence to environmental and social standards throughout all project stages, from pre-approval to loan closure.

This dedicated body should encompass various functions, including due diligence, monitoring, and supervision to ensure compliance with environmental and social standards during the entire project lifecycle until the loan is resolved. Responsibilities should include conducting environmental and social assessments by independent third parties and internal representatives, maintaining transparency through public disclosure of environmental and social assessment reports, due diligence reports, records of consultations and meetings with impacted communities, loan status, and advising clients on best practices. It should also facilitate communication with the financial arm of the institution and operate a grievance redressal mechanism for reporting any potential violations by clients. The institution of Lenders' Independent Engineer too can be mandated to take on board environment, social and climate concerns and make periodical assessments and release the reports in public domain.

Role of the RBI

The Reserve Bank of India (RBI) is well-positioned to enhance and enforce a safeguards framework for financial institutions, preparing them for future challenges. This framework should include the following key actions:

- Making cumulative impact assessments mandatory, both upstream and downstream and over a period of time and in conjunction with other projects.
- Enhancing transparency.
- Involving the public as stakeholders.
- Building institutional capacity.
- Implementing effective grievance redressal mechanisms.

b). Integrating Climate, Environment, and Community Considerations

The current prudential framework is limited by its narrow focus on the bank's investment portfolio, neglecting the broader environmental and social impacts of financial institutions and their investments. This oversight is both ironic and a missed opportunity. It is ironic because the climate crisis is often exacerbated by industrial and construction activities financed by these institutions. It is a missed opportunity because the framework fails to adopt a holistic view that considers the interdependent relationship between climate, environment, and affected communities.

Expanding the framework to encompass this broader perspective is crucial. Internationally, there is a growing movement toward holding financial institutions accountable for all their impacts on the environment, climate, and society, including health, labor, land acquisition, and vulnerable communities. Implementing such a comprehensive disclosure framework could align Indian financial institutions with global standards and enhance their public accountability for all environmental, social, and climate impacts of their investments, beyond just carbon emissions.

Moreover, social and ecological impacts can lead to significant financial risks. By broadening their disclosure framework, financial institutions can avoid investments in projects likely to harm communities, the environment, and the climate, thus mitigating potential financial risks.

Encouraging financial institutions to implement additional safeguards can lead to more sustainable and resilient projects. It also aligns with global trends towards responsible investment and sustainable finance, which consider environmental, social, and governance (ESG) criteria as integral to financial decision-making.

c). Importance of an Impact Risk Perspective

The existing project finance framework lacks an 'impact risk' perspective, which is crucial for understanding the risks financial institutions pose to the environment and climate. This perspective considers both project-specific and cumulative impacts of investments, especially in large-scale projects.

Incorporating an impact risk perspective is beneficial not only for affected communities and the environment but also for financial institutions themselves. It helps them avoid investments that may face opposition due to negative environmental and social consequences. By assessing and disclosing impact risks alongside transition risks and climate-related financial risks, financial institutions can avoid poor investments and enhance accountability to the public, investors, and depositors.

d). Necessity for Comprehensive Investment Standards and Goals

A robust project finance framework should be complemented by clear investment standards, goals, thresholds, and mechanisms for redressal. Adopting a comprehensive set of standards like these would ensure that financial institutions not only address climate-related financial risks but also consider the wider environmental and social impacts of their investments.

Unique Environmental Challenges:

- **Biodiversity**: India is home to rich biodiversity, including numerous endemic species. Large projects can threaten these ecosystems, necessitating stringent safeguards tailored to local biodiversity.
- **Climate Vulnerability**: India is highly vulnerable to climate change impacts, such as extreme weather events, making it essential to integrate climate resilience into project planning and financing.

Social vulnerabilities:

- **Displacement and Livelihoods**: Big-ticket projects often require significant land acquisition, leading to displacement and loss of livelihoods and lifeworlds for local and indigenous communities. India-specific safeguards can ensure fair compensation, rehabilitation, and livelihood restoration.
- **Cultural Heritage**: India has a diverse cultural heritage, with many communities relying on traditional knowledge and practices. Safeguards must protect cultural sites and respect indigenous knowledge systems.

Regulatory Landscape:

- **Compliance with National Laws**: Indian financial institutions must align with national environmental and social regulations. However, existing regulations may not be comprehensive, requiring additional safeguards to fill gaps.
- **Global Standards Adaptation**: While international standards may provide a framework, they must be adapted to the Indian context to address specific local challenges effectively.

e). Importance of Transparency

Transparency is fundamental to any effort to ensure accountability in achieving climate goals. Publicly sharing project-related information enhances the accountability of both the client and the financial institution.

Effective accountability mechanisms rely on transparency, as it enables the participation and inclusion of various stakeholders. The government is also moving in this direction with the proposed National Financial Information Registry.

To begin with, in line with best international practices, banks can enhance accessibility to information by complementing existing disclosure mechanisms. This can include providing:

- The status of loans to individual corporate borrowers
- Assessment reports
- Closure reports

Conclusion

While the guidelines provide a comprehensive framework for financial management and risk mitigation in project finance, their lack of emphasis on environmental, social, and climate concerns, coupled with the absence of mechanisms for public consultation and social audits, represents a significant oversight. To ensure sustainable and equitable project development, it is crucial for financial institutions to adopt additional safeguards and engage in broader stakeholder consultation, aligning with global best practices and fostering long-term project viability and community trust.

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