

From Commercial Banks to Category II AIFs:

Evaluating How Mid-Market Real Estate Developers Bridge Funding Gaps Post-NBFC Liquidity Tightening

Abstract

Since the 2018 collapse of a large infrastructure lender called IL&FS, Indian banks and Non-Banking Financial Companies (NBFCs, sometimes called “shadow banks”) have faced much stricter rules on how much they can lend to real estate developers. At the same time, a newer, faster type of investment vehicle called a Category II Alternative Investment Fund (AIF) has grown quickly, stepping in to help fill the financing gap that these tighter rules created. This paper asks a simple, practical question: when a mid-size real estate developer needs to borrow money, is it actually cheaper to take a slower, lower-rate bank loan, or a faster, higher-rate AIF loan? To answer this, we build an easy-to-follow, three-step calculation. Step one adds up the direct interest cost of each loan. Step two estimates how much money a developer saves by starting construction sooner rather than later. Step three combines the two into a single, comparable number: the effective cost of each financing option. Using a typical ₹80 crore (₹800 million) project, roughly the scale of a mid-rise residential development in a Tier-1 or Tier-2 Indian city, a 9% bank loan, and a 15% AIF loan, we find that the bank loan is still the cheaper option overall, but the gap between the two is much smaller than the interest rates alone suggest: a 600 basis point difference in interest rates narrows to an effective 375 basis points once the value of faster execution is counted. A follow-up test (a sensitivity analysis) shows that the AIF loan becomes the cheaper option once the monthly cost of construction delay rises above about 2.67%. We connect these results to existing academic research on shadow banking, non-bank lending, and the cost of project delays, and we discuss why developers might still prefer AIF debt even when it is not the cheapest option on paper. This paper is written to be a clear, step-by-step teaching example of how a simple financial model can answer a real-world capital-structure question.

Keywords

Category II AIFs; Shadow Banking; Real Estate Finance; Cost of Capital; NBFC Liquidity; Private Credit; Capital Structure; Cost Overrun

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1. Introduction

1.1 Why This Topic Matters

Building an apartment complex, an office building, or a housing development costs a lot of money, and that money almost always has to be borrowed. In India, real estate developers have traditionally borrowed from two main types of lenders: commercial banks, which offer lower interest rates but move slowly and demand heavy collateral, and Non-Banking Financial Companies (NBFCs), which move faster but charge more. This system worked reasonably well for many years. Then, in 2018, a large infrastructure lender called Infrastructure Leasing & Financial Services (IL&FS) defaulted on its debt, and the shock waves from that default changed Indian real estate finance for the next several years.

1.2 What Changed: Stricter Rules for Banks and NBFCs

The IL&FS default revealed a serious problem: some NBFCs had been borrowing short-term money and lending it out for long-term projects like real estate, a mismatch that left them exposed if short-term funding suddenly dried up. Academic researchers who studied this event describe it as a classic “shadow banking” crisis (Acharya et al., 2013), and later work confirmed that Indian NBFCs were tightly interconnected with banks and with each other, which meant that trouble in one part of the system could spread quickly to the rest (Chaturvedi & Singh, 2022; Mohanty et al., 2024). In plain terms: when NBFCs got into trouble, banks and regulators became much more cautious about how much money flowed into the sector, including real estate.

India's central bank, the Reserve Bank of India (RBI), responded with a series of new rules. The most important for this paper is the Reserve Bank of India (Project Finance) Directions, 2025, which took effect on October 1, 2025. This single set of rules replaced more than fifteen older, separate rules and made banks set aside more money (called “provisioning”) as a safety cushion against loans to real estate projects that are still under construction (Reserve Bank of India, 2025). A separate rule, the Non-Banking Financial Companies (Concentration Risk Management) Amendment Directions, 2026, tightened how much risk NBFCs can concentrate in any one sector or borrower (Reserve Bank of India, 2026a). And starting in January 2026, a new rule capped how much of any single AIF's fund a bank is allowed to invest in, at 10% of that fund's total size (Reserve Bank of India, 2026b). Together, these rules made it harder and more expensive for banks and NBFCs to keep financing real estate at the pace they once did.

The effect shows up clearly in the numbers: bank lending to the broader economy grew by 20.2% in the 2024 financial year but slowed to about 11% in the 2025 financial year, even as a completely different type of lender, private credit funds, grew their deal activity by 35% over the same period (EY, 2025).

Figure 1. Bank Credit Deceleration vs. Private Credit Expansion

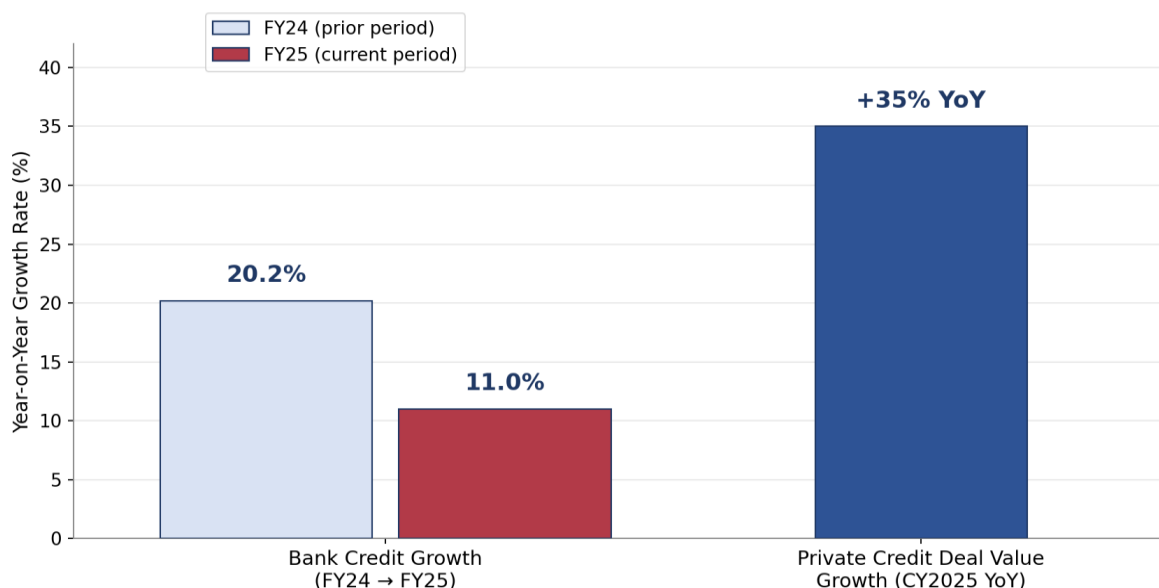


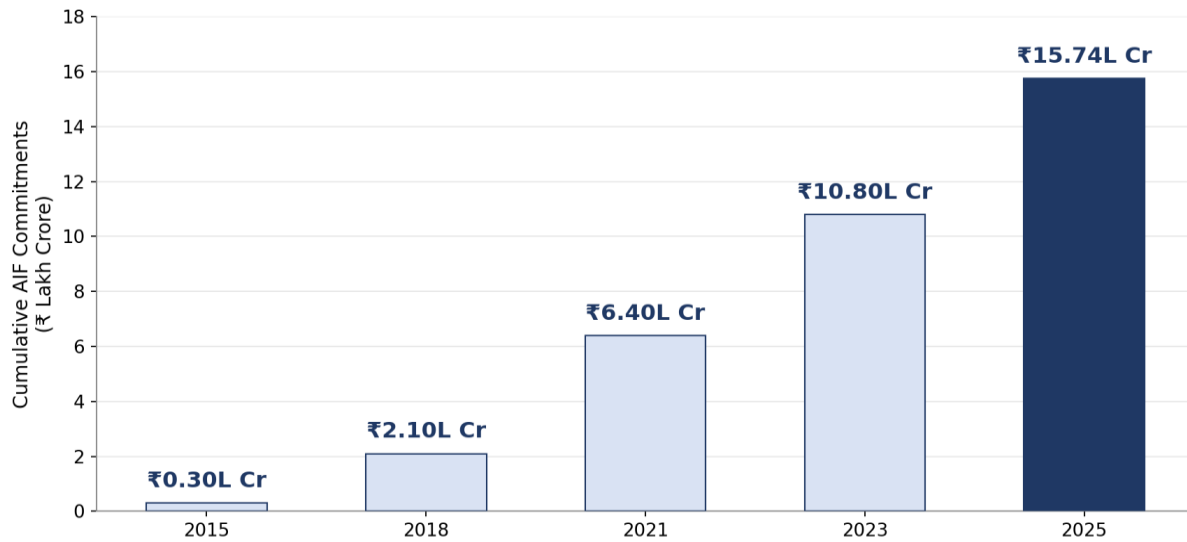
Figure 1. Bank credit growth decelerated from 20.2% (FY24) to 11% (FY25) even as private credit deal value expanded 35% year-on-year in CY2025. Sources: EY (2025); RBI sectoral credit data.

1.3 The Rise of Category II AIFs

Into this gap stepped a type of investment vehicle called an Alternative Investment Fund (AIF). AIFs are pools of money collected from wealthy individuals, family offices, and institutions, and are regulated in India under the SEBI (Alternative Investment Funds) Regulations, 2012 (Securities and Exchange Board of India, 2012). AIFs come in three categories; this paper focuses on Category II, the category that includes private credit and real estate debt funds. Because a Category II AIF is funded by capital that investors have already committed for years at a time, rather than by deposits that could be withdrawn on short notice, the fund does not face the same liquidity pressure that forced banks and NBFCs to pull back. This structural difference lets Category II AIF managers move faster and lend more flexibly, generally in exchange for a higher interest rate.

The growth has been dramatic. Total AIF commitments in India grew from under ₹30,000 crore in 2015 to approximately ₹15.7 lakh crore by September 2025, and Category II AIFs make up the largest and fastest-growing slice of that total.

Figure 2. Growth of Total AIF Commitments in India, 2015 to 2025



Source: SEBI AIF activity data as compiled in industry reporting; 2015 and 2025 endpoints are reported figures, intermediate years interpolated for illustration.

Figure 2. Growth of total AIF commitments in India, 2015 to 2025. Endpoints reflect reported SEBI-linked industry data; intermediate years are interpolated for illustrative trend purposes.

1.4 The Question This Paper Answers

Here is the puzzle this paper tries to solve. If a developer needs to borrow ₹80 crore, a bank might offer 9% interest but take six months to approve the loan. A Category II AIF might offer 15% interest, a much higher rate, but approve the loan in about six weeks. Simply comparing 9% to 15% makes the bank loan look obviously cheaper. But that comparison leaves out something important: every month a project sits waiting for loan approval is a month of extra construction-cost inflation, extra site-holding expenses, and lost time. In other words, speed has real, measurable economic value, and a fair comparison between the two financing options has to account for it. This paper builds a simple model to do exactly that, and it is written so that a reader with no finance background can follow every step.

2. Literature Review

Before building our own model, it helps to see what other researchers have already learned about the topics this paper touches: why non-bank lenders exist and grow, what went wrong in India's 2018 shadow-banking crisis, why some firms choose non-bank loans even at a higher price, why project delays are costly, and why the classic finance textbook idea of a single “cost of capital” is more complicated in practice. Each subsection below explains one idea in plain language and then points to the research behind it.

2.1 What Is “Shadow Banking,” and Why Does It Grow?

“Shadow banking” is simply the name economists use for lending that happens outside of traditional, deposit-taking banks. NBFCs and AIFs are both examples. A classic idea in finance, called delegated monitoring, explains why any lender, bank or otherwise, exists in the first place: it is expensive and difficult for many small savers to check up on a borrower individually, so it is more efficient to let one specialized institution do the monitoring on everyone's behalf (Diamond, 1984). Shadow banks exist because they can perform this same monitoring role while being funded, and regulated, differently than a bank. Recent research on the United States shows that shadow banking tends to grow specifically in the space that banking regulation leaves behind: firms that are too risky, too unprofitable, or too information-intensive for a heavily regulated bank to lend to often end up borrowing from non-bank lenders instead (Chernenko et al., 2022; Irani et al., 2021). This is a useful starting point for understanding India's experience, because it suggests that shadow banking growth is not random. It tends to expand precisely when and where regulation on banks tightens, which is exactly the pattern this paper documents for Indian real estate after 2018.

2.2 Lessons from India's Shadow-Banking Crisis

India has its own well-studied example of this dynamic. Acharya et al. (2013) showed, using data from before the 2018 crisis, that India's shadow banking sector had already grown large enough to matter for the whole financial system, and that it was closely linked to the regular banking sector rather than being a separate, isolated channel. When IL&FS defaulted in 2018, this close linkage turned out to be a serious weakness. Follow-up research using more recent data found that Indian NBFCs remained tightly interconnected even after the crisis, which meant that stress could still spread quickly from one institution to another (Chaturvedi & Singh, 2022). A broader review of the crisis concluded that the central, recurring challenge for India's NBFC sector is finding a healthy mix of funding sources so that the sector is not overly dependent on any single type of lender (Mohanty et al., 2024). This is directly relevant to our paper's topic: the regulatory response to these findings, tighter provisioning rules, tighter concentration limits, and caps on how much banks can invest in AIFs, is the same regulatory response that pushed real estate financing toward Category II AIFs in the first place.

2.3 Why Do Firms Borrow from Non-Bank Lenders?

If non-bank loans usually cost more, why would any borrower choose one? The most direct answer comes from a large study of U.S. companies, which found that roughly two-thirds of non-bank borrowing can be explained by regulatory constraints on banks rather than by borrower preference alone; firms that banks

are less willing or able to serve simply move to non-bank lenders, and they pay a meaningfully higher interest rate for the privilege (Chernenko et al., 2022). The same study found that non-bank loans often come with different, sometimes more flexible, contract terms than bank loans. This finding maps closely onto the Indian real estate case in this paper: Category II AIFs are not simply undercutting banks on service, they are stepping into a lending space that tightened bank regulation has made harder for banks themselves to fully serve.

2.4 The Hidden Cost of Delay

A second building block of this paper's model is the idea that delay itself is expensive. This is well established in the construction and infrastructure literature, not just in finance. In one of the most cited studies on the subject, Flyvbjerg et al. (2002) examined 258 transportation infrastructure projects worth a combined USD 90 billion (roughly ₹7.5 lakh crore) and found that cost estimates used to justify these projects were, with strong statistical confidence, systematically too low, in large part because delays and schedule slippage were not properly priced in at the outset. While that study focuses on public infrastructure rather than private real estate, its core lesson transfers directly: time is not a free variable in a construction project. Every month of delay carries a real cost, through rising material and labor prices, ongoing site-holding expenses, and the opportunity cost of capital that could otherwise be earning a return. Our model's "time-value savings" calculation is a simplified, real-estate-specific application of this same basic idea.

2.5 Basic Finance Theory: The Cost of Capital Is More Than the Interest Rate

Finally, this paper draws on a very old and very well-established idea in corporate finance: how a company (or a developer) chooses to finance a project is not just about finding the lowest interest rate. Modigliani and Miller (1958) first showed, under a set of simplified assumptions, that a firm's overall value should not depend on how it splits its financing between debt and equity, a result that later research spent decades testing and extending in more realistic settings. Myers (1984) built on this line of work to argue that in practice, firms weigh a range of costs and benefits, including flexibility, speed, risk, and financial distress, when they choose between financing sources, not simply the sticker-price interest rate. This is precisely the logic behind our paper's comparison: a 15% AIF loan and a 9% bank loan are not directly comparable numbers until the non-price differences between them, most importantly speed, are converted into dollar terms.

2.6 Where This Paper Fits In

Taken together, this literature explains why shadow banking grows (regulatory displacement), why India's shadow-banking sector became a policy concern (interconnectedness and funding mismatches), why borrowers accept higher rates from non-bank lenders (access and flexibility), why delay has a real cost (systematic evidence from infrastructure projects), and why the "cost of capital" question is more than a single number (capital-structure theory). What is missing from this literature, at least in the specific context of Indian mid-market real estate, is a simple, transparent, worked example that puts these ideas together into one calculation a student, developer, or credit analyst could reproduce by hand. That is the

gap this paper tries to fill: not new econometric evidence, but a clear applied framework that turns the qualitative insight “speed has value” into an actual number that can be compared, directly, against a nominal interest-rate spread.

3. Regulatory and Institutional Background

3.1 Tighter Rules on Banks and NBFCs

The regulatory story did not begin in a straight line. Right after the IL&FS default, in October 2018, the RBI actually loosened one rule temporarily, raising the limit on how much banks could lend to NBFCs, to prevent an immediate credit freeze. But over the following years, the overall direction has clearly been toward stricter, not looser, rules. The Reserve Bank of India (Project Finance) Directions, 2025 replaced more than fifteen older circulars with one harmonized rulebook and settled on a 1% “standard-asset provisioning” requirement for loans to projects still under construction (down from a stricter 5% that regulators had originally proposed, after banks pushed back), compared with a lower 0.4% requirement for loans to projects that are already finished and generating income (Reserve Bank of India, 2025). In plain terms, this means banks must set aside more of their own capital as a cushion when they lend to a project that is not yet built, which makes construction lending less attractive to banks relative to lending on completed buildings.

Two more rules followed in quick succession. The Non-Banking Financial Companies (Concentration Risk Management) Amendment Directions, 2026, which took effect January 1, 2026, changed how infrastructure-related lending is classified for the purpose of measuring how concentrated an NBFC's risk is in any one area (Reserve Bank of India, 2026a). And a separate rule, effective the same month, capped how much of any single AIF scheme's total fund size a bank is allowed to invest in, at 10% (Reserve Bank of India, 2026b). This last rule matters a great deal for this paper's topic: it is a direct, explicit attempt by regulators to stop banks from using AIFs as a side door back into the same real estate risk that the other new rules were designed to limit.

3.2 Category II AIFs: What They Are and How They Are Regulated

Category II AIFs are registered and supervised under the SEBI (Alternative Investment Funds) Regulations, 2012 (Securities and Exchange Board of India, 2012). Unlike a bank, a Category II AIF cannot use customer deposits and generally cannot borrow heavily to fund its lending (a restriction known as being “non-leveraged”); instead, it lends out money that investors have already committed for a fixed number of years. Because that money is locked in ahead of time, the fund manager does not have to worry about investors suddenly demanding their money back, the same problem that hurt NBFCs during the IL&FS crisis. This structural safety cushion is a major reason Category II AIFs have been able to keep growing and lending quickly even while banks and NBFCs have pulled back.

3.3 The Size of the Funding Gap

How big is the shortfall these AIFs are stepping in to fill? One industry estimate puts India's mid-stage residential construction funding gap at USD 15 to 20 billion (roughly ₹1.25 to ₹1.65 lakh crore), and describes this shortfall as structural, meaning it reflects a lasting mismatch between what projects need and what traditional lenders are willing to provide, rather than a temporary, cyclical dip (Sundaram Alternates, 2025). This is the backdrop against which the rest of this paper's comparison should be read: Category II AIF debt is not simply competing with bank debt for the same customers on price. In many cases, it is filling a gap that bank debt, under the new rules, may not be able to fill at all.

4. Research Objectives

This paper has three specific goals:

- To describe, in plain terms, how commercial bank loans and Category II AIF loans differ in speed, collateral requirements, and flexibility, against the backdrop of India's 2025 to 2026 regulatory changes.
- To build a simple, transparent, step-by-step calculation that compares the direct interest cost, the time-value savings from faster deployment, and the effective total cost of a representative bank loan against a representative Category II AIF loan for the same project.
- To identify, through a sensitivity analysis, the specific conditions under which a Category II AIF loan becomes the cheaper option, even though its stated interest rate is higher

5. Methodology

5.1 Research Design

This paper uses a worked numerical example rather than a statistical study of many real transactions. We made this choice deliberately: reliable, detailed pricing data for individual mid-market real estate loans in India is not publicly available in a large enough sample to run a formal statistical analysis. Instead, we build one clearly labeled, realistic baseline scenario, hold the project size and loan term constant across both financing options, and isolate the effect of the interest-rate and approval-speed differences on total project cost. Every input we use is calibrated against currently reported market rates rather than chosen arbitrarily, so the results reflect real, cited pricing conditions as of mid-2026 rather than an artificial example.

5.2 Data and Assumptions

Table 1 summarizes the baseline scenario. The 9% bank rate matches currently advertised construction-finance pricing (PNB Housing Finance advertises a rate starting from 9.25%); the 15% AIF rate sits within the 14% to 18% net return range that real estate-focused private credit funds currently target, and is consistent with reports of unlisted developers borrowing from high-net-worth individuals at 16% to 18% (Business Standard, 2025).

Parameter	Option A: Commercial Bank Loan	Option B: Category II AIF Debt
Principal Requirement	₹80,00,00,000 (₹80 crore)	₹80,00,00,000 (₹80 crore)
Nominal Annual Interest Rate	9.0%	15.0%
Approval / Processing Timeline	6.0 months	1.5 months
Collateral Requirement	100% fixed collateral	Flexible, milestone-linked security
Drawdown Structure	Rigid, lump-sum post-approval	Flexible, milestone-based
Assumed Loan Tenor (post-disbursement)	24 months	24 months

Table 1. Baseline scenario assumptions used in the comparative cost model, calibrated against currently cited market rate benchmarks.

5.3 The Model, Explained Step by Step

The full model has three steps. Before walking through each one, it helps to recall the basic idea of simple interest, since that is all Step 1 requires: if you borrow ₹100 for one year at a 10% annual interest rate, you owe ₹10 in interest for that year. Borrow the same ₹100 for two years instead of one, and the interest cost simply doubles, to ₹20. That is the entire idea; the rest of this section just applies it carefully.

Step 1: Direct Interest Cost

Direct Interest Cost = Principal × Annual Rate × Tenor (in years)

This measures the plain-vanilla financing cost of each loan over its full term, using the same principal amount and the same loan term (tenor) for both options, so the only thing driving a difference in this step is the interest rate itself.

Step 2: Time-Value Savings

Time-Value Savings = Principal × Monthly Carrying-Cost Rate × Months of Delay Avoided

This step puts a dollar figure on the benefit of starting construction sooner. Every month that a project's funding is delayed, the developer keeps paying for holding the land and site, keeps facing rising material and labor prices, and loses the opportunity to put idle equity capital to work. The “monthly carrying-cost rate” is simply an estimate, expressed as a percentage of the total loan principal, of how much all of these delay-related costs add up to for each month of delay. In our baseline case, the AIF loan approves 4.5 months faster than the bank loan (1.5 months versus 6.0 months), so this formula estimates how much money that 4.5-month head start is worth.

Step 3: Effective Cost of Capital (Net Differential)

Effective Net Cost Differential = (Interest Cost of Option B – Interest Cost of Option A) – Time-Value Savings

This final step nets the AIF loan's higher interest expense against the money saved by finishing faster. The result is a single number that tells us the true, apples-to-apples extra cost, or savings, of choosing the faster, higher-rate AIF loan over the slower, lower-rate bank loan, once both financing cost and the value of speed are counted.

5.4 What This Model Leaves Out

Like any simplified model, this one leaves some real-world complexity aside on purpose, so that the core comparison stays easy to follow:

- It applies one flat interest calculation to the full loan amount for the full loan term, rather than modeling a detailed month-by-month repayment schedule for either loan.
- It treats the monthly carrying-cost rate as constant over the delay period, rather than letting it change as a project moves through different construction phases.
- It does not model the possibility that either loan is not fully repaid on time (default risk) or needs to be extended past its original term.

These simplifications are revisited in the Limitations section, and they are exactly what a more advanced follow-up study could relax.

6. How the Two Financing Options Compare

6.1 Commercial Bank Loans

A commercial bank construction loan is built around a slow, thorough, front-loaded approval process: the bank checks the developer's title and collateral in detail, sets a fixed maximum loan-to-value ratio (meaning the loan usually cannot exceed a certain percentage of the collateral's value, and the required collateral is often worth as much as, or more than, the loan itself), and then releases most or all of the money in one lump sum once a credit committee gives final approval. After that, the repayment and drawdown schedule is generally fixed and can only be changed through a formal amendment process. In exchange for this rigidity, banks can offer a meaningfully lower interest rate, because they fund themselves with comparatively cheap deposits and, for well-collateralized, already-completed projects, benefit from lower regulatory provisioning costs under the new Project Finance Directions, 2025.

6.2 Category II AIF Debt

A Category II AIF loan is built around the opposite trade-off: speed and flexibility in exchange for a higher price. Instead of routing a loan through a multi-committee bank approval process, a small, dedicated deal team at the AIF conducts a more concentrated review, which lets the fund move much faster. Money is often released in stages tied to construction milestones (milestone-linked disbursement) rather than as one lump sum, which also means the developer is not paying interest on the full loan amount before it is actually needed. Some AIF loans also allow a moratorium period, a stretch of time at the start of the loan

during which the developer does not have to make principal or even interest payments, timed to match the project's own cash-flow needs.

6.3 Side-by-Side Comparison

Structural Dimension	Commercial Bank Loan	Category II AIF Debt
Underwriting Process	Multi-committee, standardized	Deal-team led, negotiated
Approval Timeline	Slow (months)	Fast (weeks)
Collateral Requirement	Full, fixed (often 100%+ LTV cover)	Flexible, structured security
Drawdown Schedule	Rigid, largely lump-sum	Milestone-linked, flexible
Pricing	Lower nominal rate (~9%+)	Higher nominal rate (14% to 18% IRR)
Cash-Flow Monitoring	Periodic, compliance-based	Continuous, covenant-driven
Typical Use Case	Stabilized, lower-risk projects	Time-sensitive, execution-heavy projects

Table 2. Structural comparison of commercial bank and Category II AIF debt facilities.

6.4 How AIFs Manage Risk Without Heavy Collateral

If Category II AIF managers are not leaning on the same heavy, fixed collateral that banks require, how do they protect themselves? Two mechanisms are especially common in mid-market Indian real estate lending:

- **RERA-Compliant Escrow Accounts:** under the Real Estate (Regulation and Development) Act, 2016, developers are already required to route a set share of customer payments into a project-specific escrow account. Private credit managers add their own extra controls on top of this existing legal requirement, which keeps project cash separate from the developer's other obligations and gives the lender ongoing visibility into how much money is actually coming in.
- **Automated Cash-Sweep Mechanisms:** a pre-agreed share of the money sitting in that escrow account is automatically swept toward paying down the loan before the developer can withdraw anything for other uses. This gives the lender a repayment mechanism that works on its own, without relying on periodic manual checks.

Together, these two tools let AIF managers rely less on large, static, upfront collateral and more on ongoing, cash-flow-based monitoring, which is part of what allows them to approve loans so much faster than a bank.

7. Results: Running the Numbers

7.1 Baseline Scenario Recap

Recall the baseline case from Table 1: a ₹80,00,00,000 (₹80 crore) mid-market project, financed either through Option A (a 9% commercial bank loan with a six-month approval timeline) or Option B (a 15% Category II AIF loan with a 1.5-month approval timeline), each carried for an assumed 24-month period after the money is disbursed. The 4.5-month gap between the two approval timelines (6.0 months minus 1.5 months) is the piece of the puzzle that Option A's slower approval process turns into extra, avoidable cost.

7.2 Step 1: Direct Interest Cost

Applying Direct Interest Cost = Principal × Rate × Tenor:

Facility	Calculation	Direct Interest Cost
Option A: Commercial Bank	₹80 crore × 9% × 2 years	₹14.40 crore
Option B: Category II AIF	₹80 crore × 15% × 2 years	₹24.00 crore
Nominal Interest Differential (B – A)	n/a	₹9.60 crore

Table 3. Direct interest cost comparison across financing options.

7.3 Step 2: Time-Value Savings

Our baseline case uses a monthly carrying-cost rate of 1.0% of the loan principal, built from three smaller pieces: about 0.40% per month from rising construction material and labor costs, 0.35% per month from site-holding and administrative overhead, and 0.25% per month from the opportunity cost of equity capital sitting idle while it waits to be deployed. Applying Time-Value Savings = Principal × Monthly Carrying-Cost Rate × Months of Delay Avoided over the 4.5-month gap between the two approval timelines gives:

Component	Monthly Rate (of Principal)	4.5-Month Value
Construction Cost Escalation	0.40%	₹1.44 crore
Site Holding / Overhead	0.35%	₹1.26 crore
Opportunity Cost of Idle Equity	0.25%	₹0.90 crore
Total Time-Value Savings (Option B benefit)	1.00%	₹3.60 crore

Table 4. Decomposition of time-value savings from a 4.5-month acceleration in capital deployment

7.4 Step 3: Net Project Outlay and Effective Cost of Capital

Because Option A's slower approval timeline is the source of the delay, its total project outlay is adjusted upward by the carrying cost that builds up during that delay; Option B avoids this extra cost entirely by deploying capital sooner. The resulting net project outlay for each option is:

Outlay Component	Option A: Bank Loan	Option B: AIF Debt
Principal	₹80.00 crore	₹80.00 crore
Direct Interest Cost	₹14.40 crore	₹24.00 crore
Delay-Related Carrying Cost	₹3.60 crore	₹0.00 crore
Total Net Project Outlay	₹98.00 crore	₹104.00 crore
Effective Annualized Cost of Capital	11.25%	15.00%

Table 5. Net project outlay and effective cost of capital under base-case assumptions.

Figure 3. Net Project Outlay Composition by Financing Option

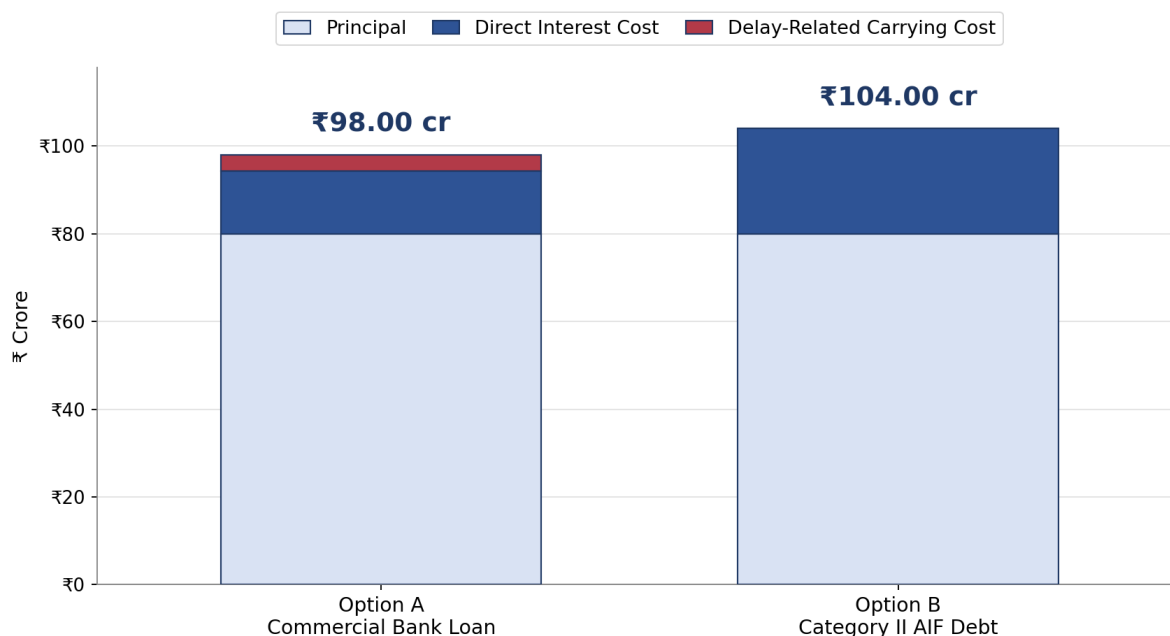


Figure 3. Net project outlay composition: principal, direct interest cost, and delay-related carrying cost, by financing option.

Under these baseline assumptions, Option A is still the lower-cost source of capital: total net outlay is ₹6.00 crore lower, and the effective annualized cost of capital is 11.25% versus 15.00% for Option B. But the time-value adjustment shrinks the effective gap between the two options considerably, from a nominal 600 basis points (15% minus 9%) to an effective 375 basis points (15.00% minus 11.25%). In plain

terms, once the value of speed is properly counted, the true cost penalty of choosing the faster private-credit option shrinks by 37.5%.

7.5 Sensitivity Check: What If the Cost of Delay Is Different?

Our 1.0%-per-month carrying-cost assumption is a reasonable estimate for a typical mid-market project, not a fixed law of nature, and it will genuinely vary across different project types, cities, and points in the economic cycle. Table 6 and Figure 4 recalculate the net cost difference across a wider range of possible monthly carrying-cost rates, to find the break-even point at which Option B stops being more expensive than Option A.

Monthly Carrying-Cost Rate	Time-Value Savings	Net Differential (B – A)	Lower-Cost Option
0.50%	₹1.80 crore	+₹7.80 crore	Option A
1.00% (base case)	₹3.60 crore	+₹6.00 crore	Option A
1.50%	₹5.40 crore	+₹4.20 crore	Option A
2.00%	₹7.20 crore	+₹2.40 crore	Option A
2.50%	₹9.00 crore	+₹0.60 crore	Option A
2.67% (break-even)	₹9.60 crore	₹0	Indifferent
3.00%	₹10.80 crore	–₹1.20 crore	Option B

Table 6. Sensitivity of the net cost differential to the assumed monthly carrying-cost rate.

Figure 4. Sensitivity of Net Cost Differential to Carrying-Cost Assumptions

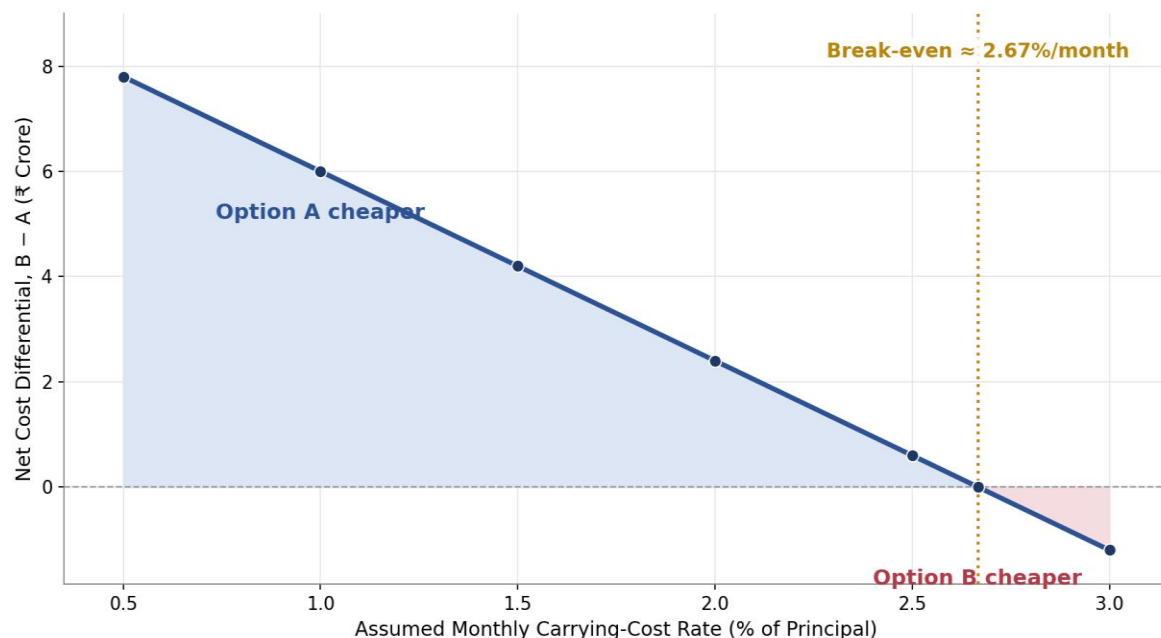


Figure 4. Net cost differential (Option B minus Option A) across a range of assumed monthly carrying-cost rates, showing the break-even threshold at approximately 2.67% per month.

The break-even carrying-cost rate of about 2.67% per month, which works out to roughly 32% on an annualized basis, is substantially higher than our 1.0% base-case assumption. That tells us something useful: under typical mid-market conditions, commercial bank debt keeps a real monetary cost advantage over Category II AIF debt in this baseline scenario. But projects with unusually high monthly carrying costs, for example a fast-moving urban land deal with a steep pre-sale revenue curve, or a project facing a sudden spike in construction-input inflation, could plausibly approach or exceed this threshold. At that point, the faster AIF loan becomes the better economic choice even before counting other, harder-to-quantify benefits like reduced execution risk.

8. Discussion

8.1 What the Break-Even Point Means

The main lesson of this paper is not that Category II AIF debt is always cheaper or always more expensive than a bank loan. It is that comparing the two options using only their headline interest rates, 9% versus 15%, is misleading. That simple comparison overstates the true economic cost of the AIF option because it completely ignores the dollar value of finishing 4.5 months sooner. The corrected, effective spread of 375 basis points is a far more useful number for a developer or a credit committee that is actually trying to decide between the two, because it reflects the real, net cash-flow consequence of the choice rather than just its sticker price.

8.2 Why Developers Might Still Choose AIFs Even When They Cost More on Paper

Even in cases where our model favors the bank loan on a strict cost basis, several real-world factors that the base-case numbers do not fully capture tend to push developers toward Category II AIF debt anyway:

- **Execution Certainty:** a 1.5-month approval window sharply reduces the risk of losing a time-sensitive land deal to a competing buyer while a bank's approval is still pending.
- **Collateral Flexibility:** some developers simply do not have collateral that meets a bank's strict requirements, or their project falls outside what banks are now willing to finance under the tighter Project Finance Directions, 2025. For these developers, the AIF loan is not a cost trade-off; it may be the only financing channel available at all.
- **Cash-Flow Matching:** because AIF loans are often released in stages tied to construction milestones, the average amount actually outstanding, and therefore the average interest actually paid, can end up lower than the full-principal, full-term calculation used in our conservative base case.
- **Optionality Value:** faster access to capital lets a developer respond quickly to shifting demand, pricing windows, or regulatory timing. Our time-value adjustment captures part of this benefit, but likely still understates its full value.

8.3 What This Means for India's Financial System

Stepping back, this shift from banks and NBFCs toward Category II AIFs is really a broader reallocation of financial risk: away from short-duration, deposit-funded institutions and toward long-duration, contractually committed private capital that is naturally better matched to a multi-year real estate project. The RBI's decision to cap bank investment in any single AIF's fund at 10% (Reserve Bank of India, 2026b) signals that regulators want to keep this reallocation clean, meaning they want to prevent banks from quietly re-entering the same real estate risk indirectly through AIFs, even while encouraging AIFs themselves to keep absorbing demand that banks are pulling back from. For mid-market developers specifically, the growth of a properly priced private-credit channel represents a real widening of the pool of available financing, arriving at exactly the point in the credit cycle when traditional channels have become the most constrained.

9. Limitations

This model is deliberately kept simple so that it is easy to follow, and that simplicity comes with some real trade-offs that should shape how its conclusions are used:

- **Single-Scenario Baseline:** the model uses one representative project size and one representative pair of interest rates, calibrated to currently cited benchmarks. Actual pricing for both bank and AIF loans varies with project risk, developer track record, city, and where the credit cycle happens to be at the time.
- **Constant Carrying-Cost Rate:** the 1.0% base-case monthly carrying-cost rate is a reasonable illustrative estimate, not a number measured directly from a large sample of real transactions, and it will vary by location, project stage, and how fast construction costs are rising at a given moment.
- **No Default or Extension Risk:** the model does not build in the probability-weighted cost of a loan default, a covenant breach, or a facility extension under either financing structure, any of which could meaningfully change the real, as opposed to the contractual, cost of capital.
- **Simplified Drawdown Treatment:** for comparability, the model applies one full-principal, full-term interest calculation to both facilities. In practice, an AIF's milestone-based drawdowns would likely make Option B's real interest cost somewhat lower than the conservative figure used here.
- **No Tax or Regulatory Capital Treatment:** differences in interest deductibility, stamp duty, and the regulatory capital treatment of bank- versus AIF-originated debt under the Project Finance Directions, 2025 are outside the scope of this model.

10. Conclusion

This paper set out to answer a simple, practical question in plain language: when should a mid-market Indian real estate developer choose a Category II AIF loan over a traditional bank loan, once the true cost of both options is properly measured? Using a baseline case calibrated to currently cited market rates (a ₹80,00,00,000 (₹80 crore) project financed at 9% over a six-month approval cycle versus 15% over a 1.5-month approval cycle), our model shows that commercial bank debt remains the lower-cost source of

capital under typical carrying-cost conditions. But the effective cost gap between the two instruments narrows substantially, from 600 to 375 basis points, once the rupee value of faster deployment is correctly built into the comparison. Our sensitivity analysis further identifies the specific condition, a monthly carrying-cost rate above approximately 2.67%, under which Category II AIF debt becomes the cheaper choice even on a strict, monetary basis.

Beyond the specific numbers, the broader lesson is that the shift from banks toward Category II AIFs in Indian real estate finance should not be read simply as a story about tighter regulation pushing borrowers elsewhere. It is better understood as a structural repricing of speed and flexibility, one that a properly built financial model, rather than a raw interest-rate comparison, is needed to evaluate correctly.

11. Future Research Directions

- Testing this model's carrying-cost assumptions against real, disclosed transaction data across different project types, city tiers, and points in the credit cycle.
- Extending the model to include the probability-weighted cost of default and loan extension under both bank and AIF financing structures.
- Comparing the realized, milestone-adjusted interest cost that AIF borrowers actually pay against this paper's more conservative, full-term assumption, to see how much the flexible drawdown structure narrows the effective spread in practice.
- Using a larger, panel-style dataset of developer financing choices to test whether this paper's break-even threshold holds up across different types of projects and sponsors, especially as the Project Finance Directions, 2025 and the January 2026 AIF investment caps mature into the credit cycle.

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