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A study on infrastructure financing in India

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ABSTRACT

Empirical research validates that the economic advancement of a nation critically hinges on the adequacy of infrastructure availability. It is evident that phenomenal transformation of some of the South-East Asian nations was essentially preceded by and later reinforced by quantum investments in physical and social infrastructure. This paper presents an analytical perspective on the pattern of infrastructure investment in select countries and also reflects on the Indian experience. The paper details means of financing of infrastructure in India and in this context dwells on the proactive role played by the Reserve Bank of India in the arena of infrastructure financing. The paper also examines the available financing tools, while at the same time attempts to underline innovative ways of addressing the problems for expanding avenues for timely and uninterrupted financing at competitive costs in India. The commercial aspect is also kept in view while exploring various options. The paper concludes that infrastructure financing must necessarily be provided by both public and the private sectors and emphasizes the role and scope for Public Private Partnership mode of financing to achieve the desired results.

KEYWORDS : Infrastructure, Finance, India, Government, Development.

Introduction

A major area of concern for sustaining the real gross domestic product growth in India has been lack of adequate infrastructure, which can support the growth process. The deplorably low levels of public investment have rendered India's physical infrastructure incompatible with large increases in the national product and clearly, without improving the rate of infrastructure investment, the overall growth rate at best would remain modest. Distinct from other large emerging market economies which are typically demand constrained, India has been, and will remain in the foreseeable future, a supply constrained economy. The biggest supply constraint is of infrastructure - physical, social and urban. The Global Competitiveness Report 2009-10 has stated that India rank an outstanding 76th in infrastructure. In view of criticality of the issue of infrastructure availability, the Government of India has taken effective measures.

Infrastructure financing in India has critical dimensions and contributes to increased investment and productivity, which is vital for an economy like India in order to sustain the uptrend in the cycle of growth. The Union Budget 2010-11 has provided resources amounting to Rs.1, 73,552 crore for upgrading rural and urban infrastructure. Several initiatives have been taken to accelerate the pace of project implementation. The policy framework, especially for the PPPs, has been modified by streamlining PPP approvals in the central sector through Public Private Partnership Appraisal Committee (PPPAC), introducing viability gap funding facility, providing finance through India Infrastructure Finance Company Ltd, standardizing contracts to regulate terminologies related to risk, liabilities and performance standards.

The Infrastructure Finance Industry in India Providers of Infrastructure Finance

The primary providers of infrastructure finance in India are financial institutions, public sector banks and other public sector institutions, private banks, foreign banks and multilateral development institutions.

Financial institutions

Financial institutions provide medium- and long-term financial assistance across various industries to establish new projects and for the expansion and modernization of existing facilities. These institutions provide both fund-based and non-fund based assistance in the form of loans, underwriting, direct subscription to shares, debentures and guarantees. Such long-term lending institutions include IIFCL, IFCI Limited, Industrial Development Bank of India Limited and Small Industries Development Bank of India.

State level financial institutions

State financial corporations, such as Maharashtra State Financial Corporation, Delhi Financial Corporation and Madhya Pradesh Financial Corporation, were set up to finance and promote small and medium term enterprises at a state level and they form an integral part of the institutional financing system. There are also state industrial development corporations operating at state level, which provide finance primarily to medium- to large-sized enterprises.

Public sector banks and other public sector institutions

Public sector banks make up the largest category of banks in the Indian banking system. Public sector banks operating in the infrastructure finance sector include IDBI Bank, State Bank of India, Punjab National Bank, Canara Bank and the Bank of Baroda. Other public sector entities, for example, the Life Insurance Corporation of India, also provide financing to the infrastructure sector.

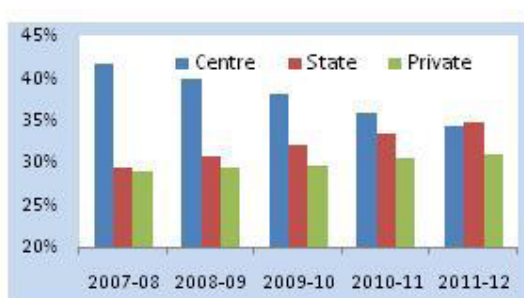
Private sector banks

After completion of the first phase of the bank nationalization in 1969, the majority of Indian banks were public sector banks. Certain existing private sector banks were merged with state-owned banks. In July 1993, as part of the banking reform process and to induce competition in the banking sector, the RBI permitted entry by the private sector into the banking system.

NBFC-Infrastructure Finance Companies ("IFCs")

In February 2010, the RBI introduced IFCs as a new category of infrastructure funding entities. Non-deposit taking NBFCs which satisfy the following conditions are eligible to apply to the RBI to seek IFC status:

Percentage of Contribution in projected investment in 11th 5-Yr Plan



Source: 11th 5 year plan document, planning commission

Challenges in Infra Financing
There a lot of hindrances in achieving easy financing for infra projects in India

1. Savings not channelized – Although India's saving rate may be as high as 37%, but almost one-third of savings are in physical assets . Also financial savings are not properly channelized towards infra due to lack of long term savings in form of pension and insurance.

2. Regulated Earnings – Earnings from projects like power and toll (annuity) may be regulated leading to limited lucrative options for private sector and difficulty for lenders. Also any increase in input cost over the operational life is very difficult to pass on to customers due to political pressures.

3. Asset-Liability Mismatch – Most of the banks face this issue due to long term nature of infra loans and short term nature of deposits.

4. Limited Budgetary Resources – With widening fiscal deficit and passing of FRBM act, government has limited resources left to meet the gap in infra financing. Rest of funds have to be met by equity / debt financing from private parties and PSUs.

5. Underdeveloped Debt Markets - Indian debt market is largely comprised of Government securities, short term and long term bank papers and corporate bonds. However, the policymakers face many challenges in terms of development of debt markets like; Effective market mechanism, Robust trading platform, Simple listing norms of corporate bonds, Development of market for debt securitization.

6. Risk Concentration – In India, many lenders have reached their exposure limits for sector lending and lending to single borrower (15% of capital funds) . This mandates need for better risk diversification and distribution

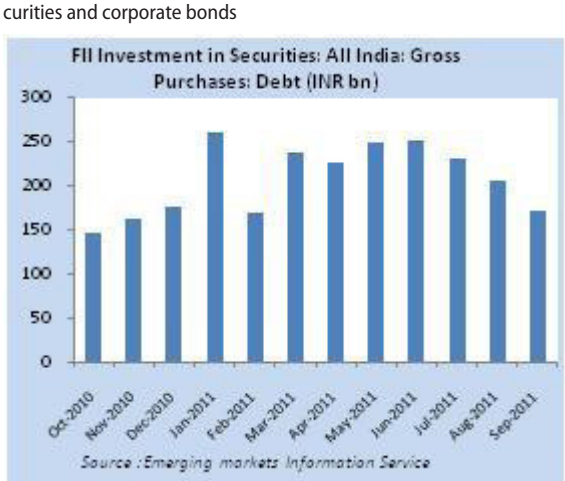
7. Regulatory Constraints – There are lot of exposure norms on pension funds, insurance funds and PF funds while investing in infrastructure sector in form of debt or equity. Their traditional preference is to invest in public sector of government securities.

Exploring Alternatives

To overcome these challenges and find a way for easy availability of funds for infra finance, we can explore following alternatives:

1. Developing domestic bond market, Credit Default Swaps & derivatives

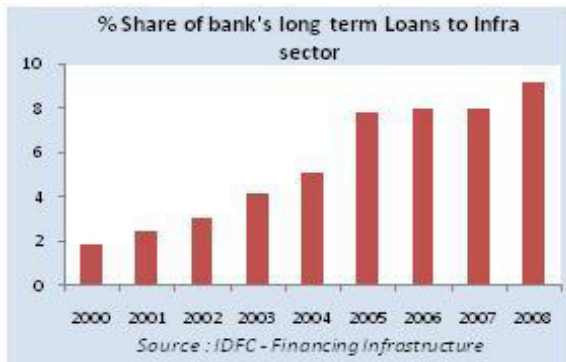
India receives substantial amount of FII investment in debt instruments. But most of this investment is concentrated in government securities and corporate bonds



FII investment limit in infrastructure bonds has been increased from USD 5 billion to USD 25 billion. However investments of only USD 109 million materialized till August, 2011 . This deficit in target investment levels need to be reduced.

2. Priority sector status to Infra
Hitherto, infrastructure financing doesn't come under the ambit of priority sector like agriculture, small scale industries, education etc. For every Rs 100 lent to non priority sectors, banks have to lend Rs 140 to priority sectors . Giving priority status will help banks to lend more to this sector.

3. Take out financing and loan buyouts
One major problem faced by banks while disbursing loans to infrastructure projects is the asset liability mismatch inherent with these projects. Therefore many such projects are denied financing by banks.



4. Rationalizing the cap on institutional investors
Rationalizing the cap on investment in infra bonds by institutional investors like pension funds, PF funds and life insurance companies will lead to more investment in this sector. Currently insurance companies face a cap of 10% of their investible funds for infra sector .

5. Tax free infrastructure bonds by banks
Currently only NBFCs can float tax free infrastructure bonds. If banks are also allowed to float these bonds, they can raise long-term resources for infrastructure projects, thus reducing the asset liability mismatch.

6. Fiscal Recommendations
The following fiscal policy medications can allow more funding of infrastructure projects.

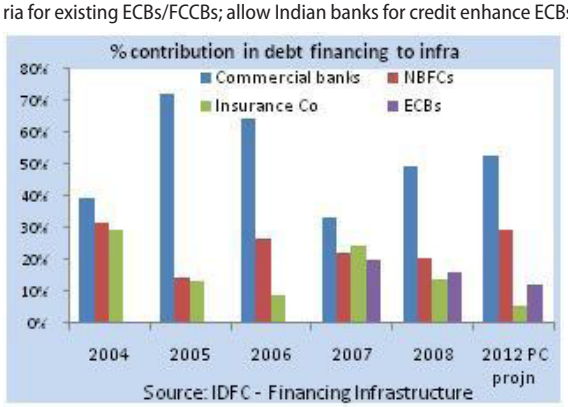
Reducing withholding tax
Currently foreign investors pay withholding tax as high as 20% depending on the kind of tax treaty. It increases borrowing cost as the current market practice is to gross up the withholding tax. So this recommendation would reduce the borrowing cost.

Tax treatment on unlisted equity shares

Unlisted equity shares attract larger capital gains tax than listed ones. Currently capital gains on unlisted equity shares are taxed at 20% instead of 10% for listed equity shares.

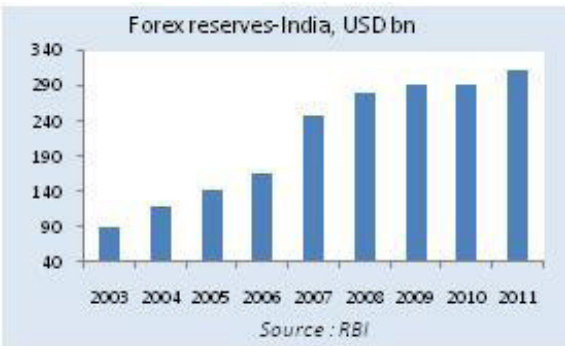
7. Foreign borrowings

With respect to foreign borrowings, several options are there like increasing the cap rate for longer tenure loans, relaxing refinancing criteria for existing ECBs/FCCBs; allow Indian banks for credit enhance ECBs.



8. Utilizing foreign exchange reserves

India's foreign exchange reserves stand at USD 311.5 bn .



These reserves are primarily meant to provide a buffer against adverse external developments. But they do not add value to any real sector as they are invested in foreign currency assets such.

9. Future cash flows as tangible security

The primary source of repayment of these loans is the future cash flows accrued from the project once they are completed and ready for public use. These cash flows can act as a security under certain conditions and debt covenants. For instance in case of road/highway development projects, RBI passed an order that a) annuities under build-operate-transfer (BOT) model and b) toll collection rights where there are provisions to compensate the project sponsor if a certain level of traffic is not achieved, be treated as tangible securities

Infrastructure finance in India opportunities and challenges

Among other things infrastructure development of a nation involves building of new roads, dams, bridges, powerhouses, railways, ports, airports and even network industry such as telecom. In Union budget 2011-2012 Rs. 2, 14,000 crore have been assigned for infrastructure development.

Eleventh Five Year Plan: The Agenda

Box 4: Infrastructure Deficit and Eleventh Plan Physical Targets

Sector	Deficit	Eleventh Plan Targets
Roads/Highways	65590 km of NH comprise only 2 per cent of network; carry 40 per cent of traffic; 12 per cent 4-laned; 50 per cent 2-laned; and 38 per cent single-laned	6-lane 6500 km in GQ; 4-lane 6736 km NS-EW; 4-lane 20000 km; 2-lane 20000 km; 1000 km Expressway
Ports	Inadequate berths and rail/road connectivity	New capacity: 485 m MT in major ports; 345 m MT in minor ports
Airports	Inadequate runways, aircraft handling capacity, parking space and terminal building	Modernize 4 metro and 35 non-metro airports; 3 greenfield in NER; 7 other greenfield airports
Railways	Old technology; saturated routes; slow speeds (freight: 22 kmph: passengers: 50 kmph); low payload to tare ratio (2.5)	8132 km new rail; 7148 km gauge conversion; modernize 22 stations; dedicated freight corridors
Power	13.8 per cent peaking deficit; 9.6 per cent energy shortage; 40 per cent transmission and distribution losses; absence of competition	Add 78577 MW; acess to all rural households
Irrigation	1123 BCM utilizable water resources; yet near crisis in per capita availability and storage; only 43 per cent of net sown area irrigated	Develop 16 mha major and minor works; 10.25 mha CAD; 2.18 mha flodd control
Telecom/IT	Only 18 per cent of market accessed; obsolete hardware; acute human resources' shortages	Reach 600 m subscribers- 200 m in rural areas; 20 m broadband; 40 m Internet

Source: Eleventh Five Year Plan Document, Planning Commission.

India Infrastructure Initiative

The India infrastructure initiative (III) is jointly promoted by IDFC and Feedback Ventures. The

IDFC, established by the Government of India in 1997 specialises in providing capital to commercially viable infrastructure projects, promotes public-private partnerships, and provides policy advice to encourage private financing in infrastructure. Feedback ventures is India's leading infrastructure development company with a 16-year-old track record of putting together infrastructure projects in core, social, and urban infrastructure. Feedback works with the leading Indian states to manage the process of creating PPP projects. Therefore the government and its agencies often require appropriate guidance and implementation assistance to:

- Design projects for PPP;
- Appreciate technical and engineering challenges;
- Master complicated capital-structuring issues;
- Meet the challenges of India's political economy, especially those relating to user charges, entrenched operators, and independent regulators, wherever they exist;

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