Infrastructure Financing through Capital Market – Challenges Ahead

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Under the Eleventh Five Year Plan, Govt. of India had planned an investment of USD 514 bn[1] in the infrastructure sector (2.3 times the level in Tenth Plan). The investment has been planned with a view to sustain and facilitate a GDP growth rate of above 8%. The infrastructure sector has attracted substantial investments after the government came out with guidelines on Public Private Partnership (PPP) route. However, the ongoing crisis in financial markets has dented the investment scenario. While the financial crisis is expected to wither away in due course, the Government needs to address issues concerned with success of PPP model to sustain investments.

The success of PPP model is generally dependent on (i) allowing private investor to earn reasonable returns commensurate with the level of risk; (ii) policy support from Government to enable investor to maintain schedules for implementation of the project; (iii) assurance of adequate service quality to users for a longer period of time at affordable cost; (iv) bankable project models, which facilitate fund raising from markets; and (v) development of robust, long term and deep financial markets to fund the projects.

The aspects, which would enable PPP model to continue to attract investments through capital markets may be classified as under:

A) Authority and policy related issues;
B) Structure of projects – investor friendliness, returns and bankability; and
C) Financing of projects – Indian financial and debt markets.

A) Authority & Policy Issues:

PPP initiative is not only for the private parties to contribute equity but also to bring expertise, innovation and efficiency into the system. However, the goal is subverted due to:

- Long drawn and often painful bidding exercises, leading to demand surpassing planned capacity;
- Frequent delays in project conceptualization and implementation, leading to burgeoning costs and resulting rise in user charges;
- Involvement of a plethora of departments & authorities inspite of single window clearance mooted by the government to facilitate infrastructure projects;
- Lack of proper planning coordination, leading to multiple agencies handling projects, duplication of infrastructure and resultant lack of viability.

A more pragmatic approach is needed in the areas of process simplification and planning.

B) Structure of Projects:

In order to attract private capital and especially foreign capital into India, the following issues need attention:

- Major changes in policies and project models with a change in government. Political insulation and consistency is absolutely necessary.
- While continuous improvement is a good mantra, tinkering with well-established and successful concession and contract formats is not advisable, as observed in sectors like roads. A successful formula should be employed for long term to enhance acceptability among all stakeholders.
- Regulation of tariff and usage charges should be based on global and domestic cost-benefit studies to eliminate over/under-charging users.
- Upside caps in many sectors like roads act as disincentives to investors and lead to poor bankability of projects. The objective of regulatory bodies like National Highway Authority of India (NHAI) should be timely, efficient and quality service delivery rather than profit management & distribution.
- A rigorous assessment of private bidders' capacity to execute multiple projects should be carried out before allowing them to qualify in multiple projects. Similarly, the bid should be critically examined to assess the viability of bids, which are quoted substantially higher than expectations.

C) Financing of Projects:

While it is expected that the Government would have a free hand in implementing key policy reforms, there is a need for well developed financial markets in debt and equity to generate large funds required for implementation of infrastructure projects. Planning Commission estimates the debt and equity requirement under XIth plan at USD 201 bn and USD 228 bn respectively. Private debt is pegged at USD 74 bn while private equity at USD 30 bn.

	Private	Public: PSUs and commercial enterprises of govt.	Public: Budgetary government bodies	
EQUITY	30	56	142	228
DEBT	74	88	39	201
	104	144	181	

figures in USD billion   Source – Planning Commission & McKinsey&Co

Some of the challenges that affect raising of resources for infrastructure projects are as under:

a) Absence of a robust, deep and long-term debt /bond market to cater to the long term funding need
b) Weak securitization mechanism and market
c) Absence of take-out financing market
d) Asset Liability mismatch in banking sector, hampering long term lending
e) Few public loan guarantee and credit enhancement schemes
f) ECB funding restrictions
g) Low interest rate requirement of infrastructure and back-ended financing cost structures not possible under present interest rate regimes and cost of funds of lenders

Most of the equity investment in infrastructure happens on the back of good policy, good structure and good debt funding availability. Strengthening these three pillars discussed would help in securing requisite equity for financing projects in India.

a) Long-term Debt/Bond Markets:

Infrastructure financing globally is generally done through very long duration infrastructure bonds. However, India lacks a strong, deep and long term debt market. While the government and regulators have been trying to develop such a market in India, the reasons and challenges that obstruct the development are summarized as under:

- Onerous paperwork and standards for issuance, particularly disclosures
- Thin, un-diversified investor base
- Regulatory restrictions on large insurance and pension institutions that house huge domestic savings of India
- Lack of liquidity in secondary market

In the absence of support from the main markets, issuers tend to flock to alternative markets. Issuers in India have shown marked preference for private placement of bonds than public listings. The listing requirement as well as cost of public issue are key drivers for this behaviour. But this weakens secondary markets in bonds and debt. However, Securities Exchange Board of India (SEBI) has now simplified the disclosure requirements for issuers of debt securities. The documentation requirement for a company with listed equity is much lower now.

The investor base in India for bond issuance is thin. This is due to the fact that large institutions like the Insurance companies and Pension Funds housing the huge savings are under strict government restrictions regarding investment avenues. If the same are relaxed and insurance and pension entities in India are allowed to channelize the domestic savings into long term infrastructure projects, it would allow domestic savings to create more productive assets instead of locking investments in Government Securities.

Historically, pension fund returns in India have been pegged at around 8% p.a. However, the Funds are finding difficult to generate this kind of return by investment in only Government Securities. Hence, the continuance of these rates of return by pension and insurance funds is uncertain. This, along with the entry of private pension funds necessitates other investment avenues to enhance return opportunities. In contrast, good quality infrastructure projects can provide a return of 9-10% p.a. on long-term basis. Such returns will perfectly suit the Pension and Insurance Funds and attract investors.

The policymakers have traditionally been averse to allowing foreign capital into sovereign debt. But present scenario demands a broadening of the investor base and FII's could be given higher limits for investments in bonds in India. The Government. has recently raised the limit of FII investment in Indian corporate bonds to USD 15 bn. This is a welcome change and might generate interest of big global players. The equity markets in India have scripted their success story primarily on the back of this investor class. The G-Sec market can thus be opened to foreign capital, while keeping the domestic savings dedicated for infrastructure and nation building.

The secondary market for debt securities in India has never really taken off and remains a low preference option for domestic savings and foreign capital. While the equity stock markets have surged ahead in the past 6 years,

attracting huge domestic savings and foreign money, the debt market has been facing poor liquidity due to the restricted returns and the lack of information and awareness. Also, the recent credit crisis has hurt investor confidence in debt securities and has dried up liquidity in secondary debt market.

b) Weak Securitization Market:

Securitization is an important tool in providing exit routes to investors and developers with specific skills of project implementation. This allows structuring of projects where the developer exits after implementing the project and re-finances / securitizes the project receivables to allow a more efficient operator to run the show. This addresses issues of investor lock-in as well as the difficulty of finding construction/implementation developers with adequate skills and willingness to operate projects for long periods. There is a need to develop this market.

c) Absence of Take-out Finance market

Take-out finance refers to a system wherein a bank/FI agrees, through a contract, to take-over the outstanding loan liability of another lender to an infrastructure project company at the end of a pre-agreed period. This transfer (take-out) of the loan liability from the books of the first lender may happen unconditionally or with conditions to be satisfied. The process helps smoothen the ALM problem that banks in India face when financing long-term infrastructure projects with tenures of 10-15 years using deposits that they raise for an average term of 3 years. Thus, a consortium of lenders can effectively finance a long-term project by issuing medium term debt and signing take-out contracts with each other.

Ambiguity exists on the risk weight and provisioning norms on such assets by banks that have signed the take-out contract but have actually not taken the loan on their books. Along with this, absence of uniform stamp duty across states also creates a hurdle for such arrangements as multiple agreements are signed for funding a single project.

d) Asset-Liability Mismatch in Banks:

Infrastructure projects are long gestation projects and financing these entirely through bank loans is not feasible. Banks typically raise deposits for 1-3 years and thus cannot provide 15-20 year loans without creating asset liability mismatch. However, the banking sector would be comfortable buying a 20-year bond if a liquid market exists to provide a ready exit route. Similarly, an insurance firm or a Pension Fund would be comfortable holding on to a long tenure bond with the flexibility to sell/trade in secondary markets.

e) Loan Guarantee & Credit Enhancement:

Globally, the funding of infrastructure, especially in segments with low viability and bankability like water distribution, sewage treatment and irrigation has been helped through public loan guarantees and other credit enhancement mechanisms like pooled finance development fund (PFDF) scheme. Typically in India these projects are funded under Viability Gap Funding (VGF) Scheme, wherein the Central and State Government put together can fund maximum up to 40% of the project cost. VGF Scheme has not been very successful and needs a re-look.

f) ECB Funding Restrictions:

Raising of funds through ECB route is regulated by RBI. There are restrictions on amount of funds, interest rates payable (LIBOR + 500 bps for 5 years plus tenure) and end-use (restricted to purchase of goods and services from abroad only). Since infrastructure projects require a lot of rupee spending and large size debt, RBI restrictions does not allow ECB funds to be used for infrastructure financing. In January 2009, Reserve Bank of India (RBI) has done away with some of these restrictions. The limit on quantum of funds is now raised to USD 500 mn, the interest rate cap has been removed till December 2009 and rupee end-use has been allowed. These waivers would need to be continued for some more time.

g) Funds at Low Interest Rates:

The current bank credit system is not tuned for financing long gestation infrastructure projects at reasonable rate of interest. This leads to projects of 10-15 year tenure financed at interest rates in the range of 10-13%. Such a pricing structure leads to front ending of user charges and optimistic appraisals to cover the debt service burden. However, an infrastructure project will typically not start making money until 2-3 years of construction and another 2 years of operations stabilization are over.

The Indian Government initiated the process of providing low interest long-term funds to infrastructure by creation of the India Infrastructure Finance Company Ltd. (IIFCL) in 2006. The company has a mandate of raising low cost long-term funds through tax-free bond issues in India and abroad, and funding infrastructure projects on case-to-case basis at low interest rates (current tranche of Rs. 10,000 cr allows for interest not above 10.35%). IIFCL has completed the process of raising Rs. 10,000 crore through issue of tax-free bonds in India and plans to raise further Rs. 30,000 crore through issue of similar bonds in the domestic market. While IIFCL has been instrumental in providing funds to infrastructure sector, it has not been successful in providing funds at lower rate of interest and of longer maturities. In addition to IIFCL, banks and FIs are also allowed to issue tax-free infrastructure bonds to mobilize long-term funds.

Addressing these concerns relating to policy, structure and financing of infrastructure should be the top priority of the Government. However, the larger body of corporates, bankers, consultants, bureaucrats, regulators and investors should contribute in this nation building process, each in their own way. As articulated earlier, the crisis blowing over the global economy will wither away soon, but it is essential that we as a nation use this time, this temporary pause in the rush, to tweak and strengthen the structures of infrastructure development and financing, remove these inherent anomalies and prepare ourselves for a bolder thrust ahead.

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[1] Planning Commission of India – on basis of 1 USD = INR 40