Ten tips to make the new DFI tick

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The budget proposal on setting up of a development finance institution (DFI) focused on infrastructure has fulfilled an important ask of many. National Bank for Financing Infrastructure and Development (NBFID) has been setup under the act of the Parliament. Its timing is propitious, too, given the need for a massive infrastructure build-out to make up for growth and livelihoods lost due to the pandemic.

But what form and shape should this new DFI take in order to avoid the pitfalls of some of the previously established ones? A lookback could offer answers.

As a concept, a DFI is an institution promoted or assisted by the government to provide development finance specifically to one or more sectors of the economy (infrastructure in this case) and to judiciously balance commercial and developmental obligations, which is not the remit of private commercial financial institutions.

The Industrial Finance Corporation of India (IFCI) was India's first DFI, set up in 1948. It was followed by the Industrial Credit and Investment Corporation of India (ICICI) in 1955, the Unit Trust of India (UTI) in 1963, and the Industrial Development Bank of India (IDBI) in 1964. The Export-Import Bank of India (1982), National Bank for Agriculture and Rural Development (1982), Small Industries Development Bank of India (1990), and various state financial corporations, were set up subsequently to cater to specific sectoral needs.

Till the early 2000s, DFIs such as ICICI, IDBI and Infrastructure Development Finance Corporation (set up in 1997) provided long-term finance to industry and infrastructure, demonstrating good credit appraisal skills in greenfield projects, and ensuring funding and development needs were met.

But over the past two decades, as the economy opened up, some of the major DFIs that had meanwhile set up banks to improve cost efficiencies, amalgamated into them (such as ICICI and IDBI), while others were reclassified as systemically important non-deposit taking NBFCs (such as IFCI). The remaining – primarily refinancing agencies – stayed focused on non-infrastructure sectors.

That transformation was necessitated by a bunch of challenges. Over time, DFIs were plagued with asset-liability mismatches as infrastructure projects needed long-term funding, which even these institutions found hard to come by. Banks, with lower cost of funds, looked better in terms of long-term business viability (and hence, to shareholders). The withdrawal of government guarantee on DFI bond issuances, rendering them ineligible under the statutory liquidity ratio (SLR) requirements, was another blow. Finally, high concentration risk and exposure to stressed sectors such as power generation, led to greater financial stress within DFIs.

So why a DFI now?

In ways, that's because we are back to square one. Currently, the infrastructure sector, which is vital for recovery and growth, is constrained by lack of funding as:

- Most banks have changed focus to retail lending due to better returns and asset quality, and asset-liability management
- Bond markets continue to lend only to AA/AAA corporates; while infrastructure projects are typically rated lower at around BBB in the construction stage
- There is increased risk aversion among lenders

Development finance, which targets economic activities that offer high returns socially, is hence the need of the hour.

Ten mantras to make the new DFI thrive

A strong DFI must have both, access to competitive cost of funds and strong project appraisal and credit monitoring skills, in order to offer superior risk-based pricing of long-term project loans. That, in turn, must rest on the following 10 pillars:

i. **Government ownership**: The new DFI should be led by the government, with 100% ownership initially. Later, as additional capital is needed over the next 5-10 years, it can move to a model where the government holds substantial majority and others like multilaterals the balance. Considering the DFI will play an important role over a long term, the commitment of shareholders to capitalise the company on a regular basis will be critical. Over a longer term, capital can also include long-dated sub-debt.

ii. **Sound capitalisation with access to long-term finance**: Making an impact without running into asset-liability mismatches would require solid capitalisation and access to long-term finance, such as bonds from capital markets, or deep and long-dated sub-debt of over 30 years tenure from the government and other multilateral/ sovereign funds. The government may also look at restoring statutory liquidity ratio (SLR) eligibility of DFI bonds to reduce cost of finance and improve project economics. Flexibility to issue longer-tenure tax-free bonds may be also be considered. Government's decision to provide guarantee for the borrowing of NBFID is a welcome step.

iii. **AAA rating**: As the DFI will leverage to on-lend, it must have a "AAA" rating. Rating agencies look at ownership and commitment of the parent to infuse funds at regular intervals and in case of exigencies. The government's commitment towards this demonstrated by setting up NBFID under the Act of the Parliament, along with good governance, can help achieve this.

iv. **Domain expertise and project appraisal skills**: Availability of manpower and a leadership skilled in project appraisal is a pre-requisite. The DFI will also need to have a strong risk management framework for continuous credit monitoring. Lending to projects which are not credit-worthy may reverse the whole process of setting up the DFI. Adoption of ESG principals in lending from the beginning would be critical.

    NBFID should also have an arm which works towards capacity building in the infrastructure sector and also provide policy inputs to the Government.

v. **Diversified asset, product and liability base**: A diversified asset base across sub-sectors will be critical. The DFI should offer a mix of loans, guarantees and maybe even look at equity. The DFI should also be open to subscribing to debentures of the infrastructure companies which could then be sold in the market subsequently, hence providing an impetus to the debt markets, an objective for setting up NBFID. Similarly liability side should have long term funding from diverse sources including loans, debentures, etc.

vi. **Sound pricing and lending behaviour**: A sound and rigorous risk/ pricing matrix is a sine qua non that would help rate each project. Risks should be appropriately priced and pricing should not be driven by market/ competition.

vii. **Partnerships**: Working in partnerships with other FIs/ banks in case of large loans can help diversify the risk. The DFI should look at churning its portfolio through securitisation as projects reach completion, to release capital and on-lend to new projects.

viii. **Strong governance architecture**: That's critical for success from inception. While the government as the owner should be part of the board and be part of strategic decisioning, the board must comprise majority of independent members with experience in infrastructure, risk and liability management. The DFI should lend based on independent policies and not under pressure from the government or other sources. NBFID could look at an investment committee which looks at all proposals and includes experts including external members.

ix. **Strong management team**: A professional, capable and highly motivated team with strong skill sets, having its own cadre and not being dependent on secondments from other banks/ FIs for short durations, will be critical in building ownership and accountability. Secondments does not bring commitment and accountability and hence must be avoided.

x. **Robust asset quality monitoring**: As infra assets run the risk of time and cost overruns, a robust asset quality monitoring system needs to be in place from inception. Such monitoring would enable timely interventions for mid-term corrections.

Surmounting challenges of raising long-term financing competitively, addressing asset-liability mismatches, monitoring asset quality, and working with lower returns in the short to medium term won't be easy in the current scenario. However, with these 10 pillars in place, the new DFI could thrive and help India achieve the USD 5 trillion economy goal quickly.

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