# INNOVATIVE FRAMEWORKS FOR FACILITATING FINANCE INTO INFRASTRUCTURE SECTORS

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- Political will, fiscal compulsions and regulatory risks are extremely unfavourable for private investment in infrastructure
- However in last 3 years the GoI and RBI have initiated measures to resolve finance and non-finance issues facing such development - creating in NIIF, promoting InvIT and IDF to raise long term funds; clearly these measures remain inadequate
- Primary need is to mitigate risk in financing. Clarity in government policies, land acquisition strategies, improved environmental needs and regulations can create confidence among investors funding infrastructure projects.

## AN OVERVIEW:

### Need for Big Ticket Increase in Funding

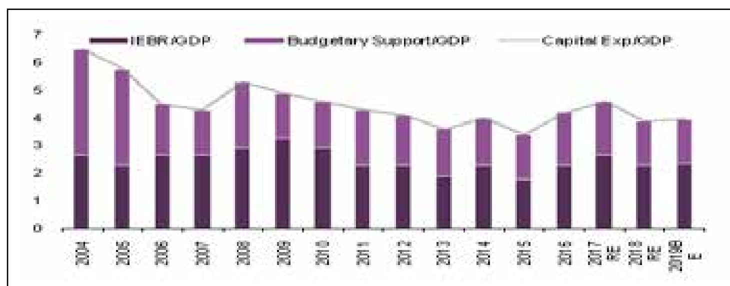
An S&P global research report The Missing Piece in India's Economic Growth Story: Robust Infrastructure, August 2016, has stated that a 1% additional spending out of real GDP is likely to boost India's GDP by at least 2%. Indeed India's poor infrastructure has been its bane for a significant period; even though some progress is evident, it continues to be the government's key bottleneck in the achievement of its ambition of 8% sustainable growth. This in turn affects the employment generating capacity of the manufacturing sector.

Among many issues that constrain infrastructure development in India (read political and regulatory risks, frequent changes in tax rules, revenue benchmarks etc.), financing of infrastructure in India has consistently remained a critical hindrance, despite attempts towards easing of flows through FDI, ECBs and other means.

## ANALYSIS & DISCUSSIONS:

Due to fiscal compulsions, the government has steadily been moving away from dipping directly into its budgetary resources (Exhibit 19) for infra-spending. We note the ratio of budgetary spend/GDP of 3.8% in FY2004 has dropped to around 1.6% as per FY2019 BE (budgeted estimates). It was expected that private participation in infrastructure development would rise. Also, the government had been thrusting infrastructure spend out of direct market borrowings by quasi-government entities (or extra budgetary support i.e. IEBR).

**Exhibit 19: Budgetary Support in Favour of Infrastructure Development**




*Source: India Budget documents: Various years*

Exhibit 20 highlights the major focus areas of expenditure of the government, wherein there appears to be an increased allocation towards the transport sector (railway, roadway etc).

**Exhibit 20: Outlay for Various Sectors in Budget 2017-18 (Rs billion)**

| | FY16 | FY17 | FY18 RE | FY19 BE |
|---|---|---|---|---|
| Agriculture and Allied Activities | 236.94 | 501.84 | 565.89 | 638.36 |
| % of GDP | 0.2% | 0.3% | 0.3% | 0.3% |
| Rural Development | 902.35 | 1138.77 | 1356.04 | 1380.97 |
| % of GDP | 0.7% | 0.7% | 0.8% | 0.7% |
| Energy | 211.23 | 309.64 | 416.82 | 411.04 |
| % of GDP | 0.2% | 0.2% | 0.2% | 0.2% |
| Transport | 874.13 | 1022 | 1070.92 | 1345.72 |
| % of GDP | 0.6% | 0.7% | 0.6% | 0.7% |
| Education | 672.39 | 720.16 | 818.69 | 850.1 |
| % of GDP | 0.5% | 0.5% | 0.5% | 0.5% |
| Health | 341.31 | 390.05 | 531.98 | 546.67 |
| % of GDP | 0.2% | 0.3% | 0.3% | 0.3% |
| Urban Development | 201.8 | 369.46 | 407.54 | 417.65 |
| % of GDP | 0.1% | 0.2% | 0.2% | 0.2% |

*Source: India Budget documents: Various years*

Funding for infrastructure projects has become risky since historically projects in India have suffered large time and cost overruns due to various factors such as delays in securing land and environmental clearances, fuel supply shortages, ineffective dispute resolution processes, rising input costs etc. The present government has diligently attempted a resolution to some of these stalled projects, but the scale of the problems has led to delays. This probably feeds back into the funding perspective as the risk of project implementation continues in India, despite best efforts.

**Effective Policy Responses for Risk Mitigation/Increasing Funds Flow to Infrastructure**

Over the last few years, the government and the RBI have initiated several measures to resolve financing and non-financing issues facing the infrastructure sector. These include measures such as creation of the National Investment and Infrastructure Fund (NIIF), promoting Infrastructure Investment Trusts (InvIT) and Infrastructure Debt Funds (ID F) to raise long term funds, as well as introducing reforms in PPP models and contracts to improve the enabling environment. However more needs to be done. To revive the investment momentum in infrastructure, government should expedite implementation of the various recommendations of the High Level Committee on Financing Infrastructure (2014), Committee on Revisiting and Revitalising the public private partnership (PPP) Model of Infrastructure (2015) and the NITI Aayog's Strategy for New India @ 75 (2018).

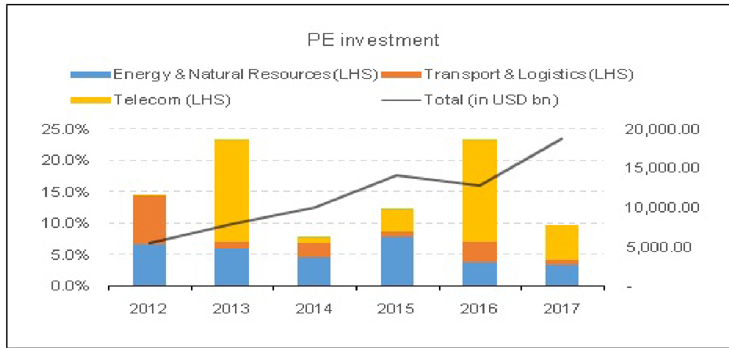
We review some of the steps taken and suggest measures below:

**Increasing Flow of Equity Capital**

The challenges faced by infrastructure projects for land acquisition, requisite approvals, forest and environment clearances are well documented, and have led to a number of stranded projects.

These stranded projects have increased the need to source equity required due to cost overruns and for new projects. Revenue risks from infrastructure projects (due to economic cycle or otherwise) have further constrained the flow of equity into infrastructure. Exhibit 21 highlights that despite an increase in private equity flows into the Indian economy, share of the same into infrastructure has been minimal. More importantly, if we set aside the Telecom sector, we note that funds flow into Transport and Logistics and Energy have been low. One reason is that PE investors are finding it difficult to exit from projects, which necessarily means that the overall sentiment has changed towards investing in operational assets rather than in greenfield infrastructure projects.

**Exhibit 21: Private Equity Investments in India (USD mn)**




*Source: Infrastructure Financing: Emerging options in India, FICCI & Centrum; Sept 2016*

**PRESENT SCENARIO**

Given the greater need for equity capital of infrastructure projects, the government has introduced several measures to accelerate equity capital flows to infrastructure projects –

(a) In 2015, the government permitted promoters to divest 100% of equity after two years of completion of construction for all BOT road projects. The main objective was to help existing promoters to unlock their capital and make additional funds available for investment.

(b) In the Union Budget 2014-15, the government announced creation of Infrastructure Investment Trusts (InvITs), an innovative structure to finance infrastructure projects. Since then, government has introduced several measures to promote InvITs such as rationalising the capital gains regime for sponsors, permitting foreign investments under the automatic route, providing a complete 'tax pass through' status etc. Although only three InvITs are functional currently, several players have shown interest in raising funds via this route.

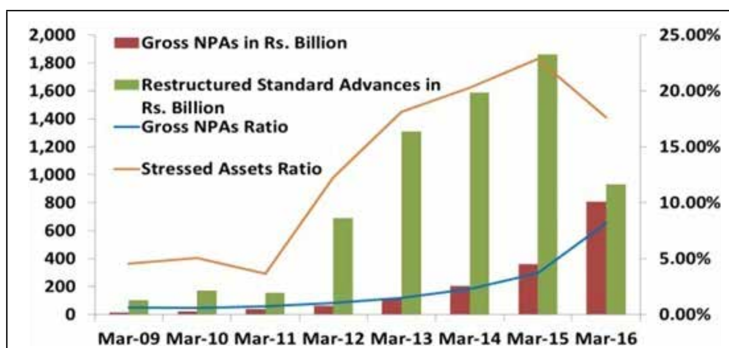
(c) Going forward the government should leverage IIFCL to provide subordinated debt to partly fulfill the equity needs of infrastructure projects. According to the High Level Committee on Financing Infrastructure recommendation, IIFCL should provide subordinated debt up to 10% of the approved project cost with a moratorium of at least 12 years for repayment of principal.

**Increasing Long-Term Debt Fund Flows**

Although a few specialised NBFCs did focus on infrastructure financing, commercial banks remain the predominant providers of finance to the infra sector. Outstanding bank credit to this sector which stood at Rs1.09 trillion in April 2006, increased to Rs9.9 trillion in February 2016 but dropped to around Rs9.6 trillion in October 2018. This is mostly owing to banks having to deal with NPAs on these infrastructure loans as well as the government having placed 11 banks on Prompt Corrective Action (PCA) to rectify their stressed balance sheets. YoY growth in infrastructure lending by banks is now at 8%, a far cry from the 20% in earlier years!

Since a major share of the liabilities (deposits) of banks is short term in nature, banks tend to provide loans for a much shorter tenor than what the infrastructure project requires. For instance, banks normally lend for a tenure of 12 to 15 years even when the concession period of PPP projects is beyond 30 years. Not aligning the compressed repayment schedules with the back loaded expected cash flows of the projects over the loan period was a key reason for the higher level of stressed assets in the infrastructure sector (Exhibit 22).

**Exhibit 22: NPAs and Stressed Assets in Infrastructure Sector**




*Source: N S Vishwanathan: Issues in infrastructure financing in India*

We note bond markets in India continue to remain underdeveloped, constraining the availability of long-term market financing for the infrastructure sector. On the other hand, while developed markets have a strong municipal bond market whereby local bodies can raise funds for their own infrastructure needs, the local entities in India are unable to do so as their financial conditions remain poor, also, they lack proper financial reporting, which hampers their credit rating.

In 2012, the government and the RBI created a framework to set up Infrastructure Debt Funds (IDF) with the objective of helping banks – the dominant source of debt capital – to refinance their infrastructure exposure.

(a) To enhance the flow of long-term debt funds into IDFs, regulators of domestic pension and insurance funds should incentivise channelling a larger proportion of their investible resources into these funds. Further, to accelerate the flow of foreign debt for financing infrastructure, India Infrastructure Finance Company (IIFCL) can provide guarantees for bonds issued by infrastructure companies in order to enhance their credit rating. With the availability of investment-grade paper, long-term foreign investors would be interested in making larger investments in infrastructure bonds.

(b) The general insurance companies in India are mandated to invest 5% of their corpus into infrastructure funding. On the other hand, the life insurance companies are mandated to invest 50% into government securities (G-Secs, both state and Centre) while the remaining investments are into approved and non-approved securities. Appropriate projects with requisite backstops should be structured to incentivise life insurance companies, with their access to longer term funds, to invest around 5-10% of their investible corpus into infrastructure space.

**Raising Public Investment to Crowd-in Private Sector Investments**

As indicated earlier, the government has increased public investment in infrastructure in the last few years. The total allocation for infrastructure development in 2017-18 stands close to Rs 4 trillion, including Rs 2.4 trillion for the transportation sector. In the Union Budget 2018, the government merged the Indian Railways' budget with the Union Budget; this is likely to facilitate multi-modal transport planning between railways, highways and shipping. Since 2015, the government has ensured a major boost to investment in the railways. Total capital outlay for the railways for 2017-18 has been pegged at Rs 1.3 trillion.

In August 2016, a Toll-Operate-Transfer (TOT) model was approved to monetise publicly funded national highway projects. The NHAI and other state agencies would be able to expedite the bidding process for operational projects that can be awarded under this model. This was expected to help attract long-term institutional investors globally who are generally averse to taking construction risks.

**Developing the Municipal Bond Market**

The infrastructure needs of local bodies have generally been met through grants and aids. For the interest of financing last mile infrastructure development, enablers should be built for the local bodies to raise funds themselves. In 2015 SEBI had indicated that the Urban Local Bodies (ULBs) with investment grade rating and with no default in the past 365 days can issue bonds. But it also says that these bodies need to have transparent accounting practices based on State Accounting Manual or the National Municipal Accounting Manual.

However, Local Municipal Bodies lack publicly available indicators such as fiscal performance, debt, contingent liabilities etc. which hinders proper credit assessment for such bodies. This has led to only limited issuances from the municipal bodies in India and a lack of critical size of issuances has also not encouraged the banking sector to participate in these issuances. There is probably an urgent need to set the accounting standards right for these local bodies as a first step towards developing Municipal Bond Markets.

**Building State Capacity for Project Preparation, Accelerating Policy & Contractual Reforms**

Inadequate project preparation by authorities not only results in delays but is often the cause of mid-course scope changes and disputes. Therefore, government authorities must ensure that robust Detailed Project Reports (DPRs) are prepared during the project development phase. Well developed projects can also help government agencies to curb aggressive bidding by establishing a range in which bids are likely to be viable and discourage extreme bids.

(a) The recommendation of the High Level Committee on Financing Infrastructure on the criteria of project bidding and awards must be considered to restore the practice of shortlisting of bidders to ensure competition and credible bids. The government must also work towards obtaining clearances during the preparation phase before placing the projects for bidding.

(b) The government must ensure that project authorities discharge their obligations in compliance with the conditions of the contract. Grants payable by the government to private developers which are not disbursed in a timely manner impose additional costs on the private sector and also undermine the sanctity of contracts, notwithstanding increasing disputes.

(c) A balanced and equitable sharing of risks is essential for PPP projects. Various committees have highlighted the need for reforming the provisions of PPP contracts, including flexibility to deal with unforeseen events. Provisions related to termination payments, exit and divestment clauses for concessionaires, cost escalations on account of delays in government approvals etc. may be revised based on extensive stakeholder consultations. Over the last few years, the government has introduced many amendments to improve the confidence of developers and lenders. For instance, premium payments to the authority from the developer now start only from the fourth year after the completion date as compared to first year previously.

(d) An independent and empowered institutional mechanism to expeditiously resolve disputes is needed. The government should expedite setting up of the 3P-India institute proposed by the Finance Minister in the Union Budget 2014-15 to foster an effective PPP environment. In addition, 3P-India could also develop suitable PPP models to attract private sector investments in sectors such as the Indian Railways and social infrastructure.

**Reinforcing Dispute Resolution Mechanisms**

Given the long term nature of infrastructure projects and involvement of multiple stakeholders in project execution, it is inevitable for projects to face challenges and roadblocks in execution that cannot be envisaged initially. Lack of an effective dispute resolution mechanism not only derails project timelines but also negatively impacts investor sentiments, thus deterring investments.

The number of disputes in PPP projects has shown a significant increase from 56 cases (pertaining to Rs 8 billion) in 2013 to 116 cases (Rs 115 billion) in 2015.As per available data, over Rs 210 billion worth disputes regarding 870 cases are pending for resolution in the roadways sector alone, concerning both PPPs and public funded projects. A key factor behind the difficulties facing the construction sector is the pendency of claims from government bodies. An estimated Rs 700 billion is tied up in arbitration. Over 85% of the claims raised against government bodies are still pending and the average settlement time for claims is estimated at more than seven years. Arbitration awards are almost invariably appealed against, resulting in long drawn disputes that often last three to 10 years

**CONCLUSIONS:**

In our understanding, risk mitigation in financing infrastructure is a primary need to attract long term funding into infrastructure projects. Clarity in government policies, clear land acquisition strategies, environmental needs and regulations can go a long way in creating confidence among investors to fund infrastructure projects.

http://www.vccircle.com/news/infrastructure/2016/11/24/infrastructure-investment-trusts-may-raise-around-3-bn-india-mid-2018 accessed on Feb 17, 2017.

**Other Key Suggestions to Enhance Funds Flow into Infrastructure are Summarised Below:**

(a) The GoI must focus on monetising operational projects which are generating revenues. This is particularly true for toll road projects, but may be considered for airports as well. It should encourage NHAI and other state agencies to expedite the bidding process for operational projects that can be awarded under the Cabinet approved Toll-Operate-Transfer (TOT) model. This could help attract long-term institutional investors globally who are generally averse to construction risks.

(b) Consider extending the increasingly successful Hybrid Annuity Model (HAM) structures to other infra segments.

(c) Explore options to provide credit enhancement, expanding scope of PCE mechanisms. To enable the flow of long-term non-bank credit to infrastructure, a suitable existing or de novo institution may focus on guarantee operations for bonds issued by infrastructure companies to raise their credit rating to 'AA' or 'AAA'. Institutions such as IIFCL may be renewed for this.

(d) Encourage regulators of domestic pension and insurance funds to channelise a larger proportion of their funds through IDFs, subject to prudential considerations.

(e) Utilise innovative financial structures, including mezzanine instruments, to increase the flow of equity finance into infrastructure projects.

(f) Create enabling atmosphere for local bodies to raise money for their own needs.

(g) GoI to set up an effective dispute resolution mechanism. It must expeditiously institute amendments in the Arbitration and Conciliation Act, 1996 as proposed in the Budget 2017-18. Government must also encourage project authorities to discharge their obligations in compliance with conditions of the contract.

(h) Government should expedite setting up of the 3P-India institute (to support Public Private Partnership) as proposed by the Finance Minister in the Budget 2014-15. 3P-India may be entrusted with the task of restructuring PPP contracts. It could also develop suitable PPP models to attract private sector investments in sectors such as the Indian Railways and social infrastructure.