

**The Report**

**of**

**The Committee on Infrastructure Financing**

**May, 2007**

**New Delhi**

## Table of Contents

<b>PREAMBLE</b> .....	3
<b>1) Macro-economic constraints</b> .....	8
<i>A. Nature of savings</i> .....	8
<i>B. Fiscal discipline</i> .....	9
<i>C. Availability of risk capital</i> .....	10
<i>D. Concentration of risk</i> .....	10
<i>E. Capacity to absorb capital inflows</i> .....	11
<b>2) Institutional constraints</b> .....	13
<i>A. Commercial Banks</i> .....	13
<i>B. Insurance companies</i> .....	13
<i>C. Specialized NBFCs</i> .....	14
<i>D. Infrastructure focused central PSUs</i> .....	15
<b>3) Policy Initiatives</b> .....	16
<b>A. Development of domestic debt capital market</b> .....	16
<i>i) Patil Committee recommendations</i> .....	16
<i>ii) Efficiency of private placement market</i> .....	19
<i>iii) Regulatory asymmetry between loans and bonds</i> .....	20
<i>iv) Introduction of credit derivatives</i> .....	21
<b>B. Tapping the potential of insurance sector</b> .....	22
<i>i) Harmonizing the definition of Infrastructure</i> .....	25
<i>ii) Liberalizing investment guidelines for debt instruments</i> .....	26
<i>iii) Liberalizing investment guidelines for equity instruments</i> .....	27
<b>C. Enhancing participation of banks, financial institutions (FIs) and large NBFCs in infrastructure financing</b> .....	28
<i>i) Asset side management</i> .....	29
▪ Securitization.....	29
▪ Modifying NBFCs’ exposure norms.....	30
▪ Rationalizing exposure norms of financial intermediaries.....	31
<i>ii) Liability side management</i> .....	33
▪ Foreign borrowing for on-lending to infrastructure sector.....	33
▪ SLR requirements on long term funds.....	33
▪ Gold Deposits.....	34
<b>D. Fiscal recommendations</b> .....	35
<i>i) Withholding tax</i> .....	35
<i>ii) Rationalization of Dividend Distribution Tax (DDT)</i> .....	36
<i>iii) Tax rebate on investment in UMPPs</i> .....	36
<i>iv) Tax treatment on unlisted equity shares</i> .....	37
<b>E. Facilitating equity flows into infrastructure</b> .....	38
<i>i) Liberalizing buyback regulations</i> .....	38
<i>ii) Change in initial bidders</i> .....	39
<i>iii) Venture or Private Equity funds as bidding partners</i> .....	40
<b>F. Inducing foreign investments into infrastructure</b> .....	40

i)	<i>Steps for improving FII participation</i> .....	41
ii)	<i>Separate treatment for infrastructure holding companies</i> .....	42
iii)	<i>Refinancing through ECBs</i> .....	43
iv)	<i>Relaxing the all-in-price ceiling for subordinated and mezzanine debt</i> .....	43
<b>G.</b>	<b>Utilizing foreign exchange reserves</b> .....	44
i)	<i>Externally focused investment arm</i> .....	45
ii)	<i>Monoline credit insurance company backed by foreign exchange reserves</i> .....	46
4)	<b>Conclusion</b> .....	48
	<b>Annexure – A : RBI Circular on Definition of Infrastructure</b> .....	50
	<b>Annexure – B : Rationalization of RBI’s guidelines on securitization</b> .....	52
	<b>Annexure – C : Office Memorandum on Establishment of Committee to make recommendations on Infrastructure Financing</b> .....	54

## PREAMBLE

To sustain GDP growth rate at 9 percent per annum in the medium term, investment in infrastructure would have to be substantially augmented. According to the Government, India would need about \$ 320 billion investment (at 2005/06 prices) in various infrastructure sectors during the Eleventh Five Year Plan (2007-12). The sector-wise requirements of funds for sectors for which estimates are publicly available are as follows:

**Table 1 - Current Overall Target and its Composition (at 2005/06 prices)**

Sector	Amount	
	USD billion*	INR Crores
Power	130	616,500
Railways	66	300,000
National Highways	49	220,000
Civil aviation	9	40,000
Ports	11	50,000
<b>Sub Total</b>	<b>265</b>	<b>1,226,500</b>
Residual sectors	55	223,500
<b>Total</b>	<b>320</b>	<b>1,450,000</b>

\*Assuming exchange rate of INR 45.30 to one USD

**Note:** There is no formal consensus on what constitutes infrastructure. Therefore, the scope of 'Residual Sectors' varies depending on what definition of infrastructure is adopted. A conservative definition of infrastructure would imply that Residual Sectors include telecom, SEZs, supporting urban infrastructure, water and sanitation, state and rural roads, logistics, pipelines etc.

The Committee believes that for all sectors except residual sectors, the figures given in Table 1 are based on capacity expansion needs identified by the Government for the Eleventh Plan and provide realistic estimation of the required investment. For the residual sectors (including state highways, rural roads, urban infrastructures, pipelines, SEZs, telecommunication etc.), however, the (implied) investment needs appear to have been significantly underestimated, considering the continuing exponential growth in some sectors (e.g., telecommunication), huge investment backlog in certain others (e.g., state highways), ambitious access expansion programs (e.g., rural roads) currently being pursued and large potential investments entailed by new initiatives (e.g., SEZs and pipelines).<sup>1,2</sup> The implication is that the overall amount (\$320 billion) is underestimated to the same extent as the residual sectors.

Further, the Government itself envisages that the investment in infrastructure would rise gradually from 4.7 percent of GDP in 2005/06 to 8 percent by 2011/12, the last year of the Eleventh Plan. This translates to an investment of USD 384 billion (at 2005/06 prices) during the Eleventh Plan, assuming that the real GDP grows at 9 percent per annum and annual inflation remains at 5 percent.

In the view of the Committee, therefore, the infrastructure spending target should be revised from USD 320 billion (at 2005/06 prices) to USD 384 billion at 2005/06 prices (which translates to USD 475 billion at current

---

<sup>1</sup> According to the Working Group on Rural Roads, set up by the Planning Commission, the financial requirement for PMGSY during the Eleventh Plan is Rs 790 billion (at 2005/06 prices) or US\$ 17 billion.

<sup>2</sup> In the five years ending 2005/06, capital spending on telecom was Rs 1367 billion (in 2005/06 prices) or US\$ 30.4 billion. It would be reasonable to assume that capital spending in the five year period 2007-2012 would be 20 percent higher or about \$36 billion.

prices), as it would meet more adequately the fund requirement of all sectors, particularly the residual sectors. It is the achievement of this revised target and its individual sector components that the Committee will address its recommendations to.

What are the challenges in achieving this? Not only are the total investment needs enormous, but the bulk of them will have to be in sectors such as power, roads and urban infrastructure, where levy and collection of adequate user charges have proved to be difficult. Further, the Government spending on infrastructure will be constrained by FRBM laws at a time when infrastructure spending is sought to be significantly expanded. This means the emergence of two challenges. First, infrastructure in the coming years will have to be progressively financed by user charges. Second, the share of private sector in infrastructure investment would have to rise substantially from the current levels. The Committee believes that meeting these two challenges would require:

- important changes in the way the sectors are governed, and
- addressing the constraints in the financing system.

While the scope of the committee's recommendations relates only to the latter, it needs to be emphasized that unless the governance issues (such as those relating to competition in service provision, collection of user charges, institutional capacity, regulation and dispute resolution) are adequately addressed, neither would the most efficient financing system be able to

mobilize the required resources, nor will we be able to create a large enough pipeline of bankable projects.

We now turn to the financing system, which is the focus of the Committee's report. It may be useful to note that the revised target entails a financing gap of USD 129 billion (at 2005/06 prices). [Financing gap is the difference between target investment and baseline investment. The latter is estimated by maintaining the current level of spending (as percent of GDP) during the Eleventh Plan.]

**Table 2 - Financing Gap for 2007-2012 (dollar billion), Using Revised Target (\$384 billion at 2005/06 prices)**

---

	<b>Target</b>	<b>Base-line</b>	<b>Gap</b>
At 2005/06 prices	384	255	129
At current prices	475	313	162

---

Given that Gross Domestic Savings are anticipated to rise by 1 percentage point of GDP in each year of the Eleventh plan, to achieve the target infrastructure investment level of 8 percent of GDP by 2011/12, and thereby bridge the gap stated above, half of the incremental domestic savings will have to be intermediated into the infrastructure sectors. This is a huge challenge. The Committee believes that the financing system, in its current form, will constrain the economy from achieving the target, because of its limited ability to meet the specific requirements of infrastructure investment, such as long-term funds, a certain kind of risk appetite on the part of investors and large and lumpy investment. The challenge therefore lies in raising significantly the financial sector's capability for intermediating

financial savings into infrastructure from the current level of 15-20 percent to 50 percent at the margin. Identifying the relevant constraints and recommending initiatives to overcome them constitutes the aim of this Committee.

The Committee believes that in this pursuit, the financing system will be constrained by two sets of factors: macroeconomic and institutional. Following is an explanation of how these constraints work and their implications.

## 1) Macro-economic constraints

### *A. Nature of savings*

As stated earlier, it is envisaged that Gross Domestic Savings (GDS) will rise by 1 percentage point of GDP in each year of the Eleventh Plan and that achieving the target investment would involve channeling half of the incremental savings to infrastructure. This is under the assumption that physical savings (as a percentage of GDS) does not increase in keeping with the current trend (Table 3). If, however, the GDS rises as envisaged,<sup>3</sup> but is accompanied by an increase in physical savings (as a percent of GDP) from the current level, the degree of financial intermediation required will have to be even higher, because physical savings are not available for intermediation; only financial savings are.<sup>4</sup> The tenor composition of savings is a related issue, because while overall financial savings may be large, there has been a shortage of long term savings, which may persist in the medium term. Renewed attempts to increase pension and insurance penetration will help in mobilizing larger long-term savings, but such attempts can materialize only in the long run. Clearly, in the medium term, additional access by infrastructure sectors to external finance both in the form of foreign equity capital and long term debt finance (including from multilateral agencies) would be necessary,

---

<sup>3</sup> It would be over-optimistic to expect GDS to grow by more than 5 percentage points of GDP in five years.

<sup>4</sup> Currently about a third of gross domestic savings are in physical assets.

more so if the share of financial savings in GDP does not rise as envisaged.

Table 3 : Projections of India's Gross Domestic Savings (% of GDP)

	Actual			Projected			
	1999/00	...	2005/06	2006/07	2007/08	...	2011/12
Gross Domestic Savings	25		32	34	35		39
of which							
Household sector	21		22	23	23		24
Financial savings	11		12	12	12		13
Physical savings	11		11	11	11		11
Private Corporate sector	5		8	9	9		11
Public sector	-1		2	2	3		4
Memo items							
Total physical savings	11		11	11	11		11
Total financial savings	14		21	23	24		28

Source: CSO Estimates and Committee's projections

### *B. Fiscal discipline*

Within the constraints of the FRBM laws, there will be limited scope for central and state governments to raise their support – budgetary as well as guarantees – to infrastructure (as share of GDP) in the coming years. The implication is that the Government per se can finance only a small part of the financing gap; the predominant part of the gap has to be bridged by private sector and PSUs (through extra-budgetary resources). The challenge for the government, with limited budgetary resources at its command, would be to improve the efficiency of its spending on

infrastructure (capacity creation and subsidy) on one hand and leverage private and non-budgetary PSU investments on the other. In this context, the challenge will be to encourage private companies and PSUs which have strong cash surpluses and access to private financing to take up an increasing share of the burden for developing the country's infrastructure. One option is to design some well targeted and sustainable fiscal incentives to specific infrastructure sectors for stimulating non-government investment (i.e., investment by the private sector and PSUs).

### *C. Availability of risk capital*

One of the key constraints in infrastructure financing is the lack of availability of risk capital to support debt raising. Adequate flow of equity capital into infrastructure sectors has not been forthcoming, despite the fact that the domestic equity market is well developed. This underlines the need for developing the market for other forms of risk capital such as mezzanine financing, subordinated debt and private equity. Shortage of risk capital in the domestic market is also grounds for seeking larger FDI into infrastructure, which would not only narrow the risk capital gap, but also usher in requisite skills to implement and monitor projects in line with global best practices.

### *D. Concentration of risk*

The financing risks of some of the infrastructure sectors, especially the ones that require large amounts of funds, have tended to get concentrated in the hands of few financiers. With rising average size of projects, the

problem is getting compounded. Indian lenders are increasingly facing a challenge based on their existing single-asset and single-industry exposure norms, which are meant for protecting the stability of the financing system. This emphasizes the need to improve the capacity as well as the sophistication of the financing system to distribute risks more widely and efficiently on one hand and to explore the possibility of making an exception for infrastructure as regards exposure norms in certain cases, on the other.

#### *E. Capacity to absorb capital inflows*

It may be observed that India has a large external debt capacity. India could borrow an additional \$ 120 billion in the next five years and yet maintain its external debt to GDP ratio at the current level (about 15 percent), which is considered sustainable. Even if a third of this capacity is used for financing infrastructure, it would cover about 10 percent of the infrastructure financing gap envisaged over the next five year period. Further, since infrastructure related debt is long-tenored, they would not pose any threat to external viability.

However, the economy's ability to absorb various capital inflows poses challenges with relation to monetary management. So far, the response to this challenge has been to either allow the rupee to appreciate, sterilize capital inflows, allow larger capital outflows, or impose restrictions specifically on the inflow of debt capital. The last measure is especially blunt for it pre-supposes that all inflows of equity capital are necessarily superior to any kind of foreign debt capital. It also ends up

discriminating in favour of larger corporate borrowers, and against infrastructure projects, the latter typically being developed by SPVs. It is evident that until such time as we get to full capital account convertibility, there will necessarily remain a need for prioritization of capital inflows. In this context it is essential to ensure that the needs of the infrastructure sector get the priority they deserve relative to the needs of the wider corporate sector such that the Planning Commission's GDP growth targets are not jeopardized.

## 2) Institutional constraints

### *A. Commercial Banks*

Commercial banks have registered a high growth in their exposure to infrastructure (57 percent CAGR) in last five years (2001/02-2005/06), which has been possible partly due to a small starting base. With the impending constraints on government spending (including on infrastructure) due to the FRBM laws at a time when infrastructure spending is sought to be accelerated, the banking system's exposure to infrastructure would have to rise significantly as a percent of GDP. It is possible that sector exposure norms and maturity mismatches may prevent banks from meeting this challenge. Further, the overall capitalization for public sector banks is also a constraint for these banks to significantly increase their infrastructure financing portfolio.

### *B. Insurance companies*

Eligible investors such as insurance companies have invested limited amounts in private infrastructure development.<sup>5</sup> This can be attributed to regulatory restrictions, underdeveloped corporate bond markets and the absence of efficient credit risk transfer mechanisms (such as securitization, credit derivatives, credit insurance etc.). Furthermore,

---

<sup>5</sup> During the period 2003/04 to 2005/06, mandated investment by insurance companies in infrastructure grew by 13.7 percent per annum (against 17 percent CAGR for overall insurance investment), while commercial banks' credit to infrastructure grew by 70 percent per annum (against 34 percent CAGR for overall bank credit). Of course, part of the difference is due to relatively slower growth of overall insurance assets.

insurance companies' traditional preference for investment in public sector has meant that their contribution to infrastructure development by private sponsors is even less.

### *C. Specialized NBFCs*

Though a relatively new entrant to infrastructure financing, NBFCs' share has been growing rapidly especially in the backdrop of a diminishing role of development financial institutions. In the future, NBFCs are expected to play a more critical role in infrastructure development. This is so, because such NBFCs:

- have focused business models based on their deep knowledge of, and risk appetite for, complex and long gestation projects that are typical of the infrastructure sector;
- are less likely to pose systemic risk and are easier to be created and expanded under private sponsorship.

Major constraints to the growth prospects of these NBFCs have been a) their inability to optimally utilize their capital and balance sheets through mechanisms like securitization; and b) their limited access to low cost financing options. Further, even more so than commercial banks, NBFCs are increasingly facing exposure norm constraints in financing infrastructure.

#### *D. Infrastructure focused central PSUs*

It may be noted that these PSUs already play a significant role in infrastructure financing (accounting for nearly 40 percent of India's infrastructure spending) and would have to continue to do so in future. But, several PSUs, especially those in roads, transport and communication, have not adequately leveraged the strength of their balance sheets to raise resources from the market and some have large amounts of idle cash. This is ironical considering that there is a general shortage for equity/risk capital for infrastructure projects in the country.

On the basis of the observations made above regarding the constraints, it is inferred that financing a rapid development of infrastructure would require India to embark on a strategy that aims at:

- Improving intermediation of domestic financial savings so that they are channeled to meet the specific requirements of infrastructure investment such as those relating to risk, tenor and scale
- Facilitating targeted access to foreign financial savings
- Distributing financial risk more widely and efficiently across the domestic financial system and abroad, to avoid excessive concentration
- Making infrastructure financing--especially in sectors where it has not been traditionally forthcoming--relatively more attractive for a wide spectrum of investor/ financier classes by providing more liberal regulatory regimes for infrastructure vis-à-vis non-infrastructure sectors and in some cases, offering well-designed fiscal incentives.
- Achieving all the above through a facilitating (rather than directive)

framework for each class of financing institution, *while ensuring that accelerated investment in infrastructure does not jeopardize fiscal discipline, financial stability and external viability.*

### **3) Policy Initiatives**

To advance these objectives, the Committee proposes several initiatives which are classified under the following major heads.

- A. Development of domestic debt capital market
- B. Tapping the potential of insurance sector
- C. Rationalizing banks' and NBFCs' participation in infrastructure financing
- D. Fiscal recommendations
- E. Facilitating equity flows into infrastructure
- F. Inducing foreign investments into infrastructure
- G. Utilizing foreign exchange reserves

#### **A. Development of domestic debt capital market**

The creation of a deep and robust debt capital market is a key to making available long term debt instruments for infrastructure. To further develop the domestic debt capital market, which is currently at a nascent stage, the following initiatives would be necessary:

##### *i) Patil Committee recommendations*

There is a need to expedite the implementation of Patil Committee

recommendations for the development of corporate bonds and securitization market. The key recommendations not yet implemented that need priority in implementation are listed below. These are considered critical initial steps as, a) they can be implemented broadly in isolation from other recommendations and, b) their impact on the bond market development will be quick and substantial, thereby creating a favorable ground for more comprehensive reforms.

- Consolidation of all regulations pertaining to issuance of corporate debt securities under the aegis of SEBI to minimize multiplicity of regulators.

Currently, guidelines relating to issue of debt securities are issued by SEBI, Company Law Board, stock exchanges and host of other entities. This makes compliance with the guidelines a difficult and cumbersome process. Also, multiplicity of regulators creates problems in effective supervision. Hence, it is desirable that a consolidated guideline and a single regulator be evolved. It is logical that SEBI be entrusted with this role given the fact that it is already responsible for all public and private placements of equity / equity linked instruments issued by corporates.

- Removal of TDS on corporate bonds in line with GOI securities.

Trading in corporate bonds becomes cumbersome due to tax deducted at source (withholding tax). At the end of the financial year, withholding tax on corporate bonds is deducted on accrued interest and a withholding tax certificate is issued to the registered owner. Interest payment, however, is made to the registered holder on the interest payment date, after deducting the withholding tax

due. When trading takes place in a corporate bond, holders are forced to settle through physical exchange of cash. Further, investors who are not subject to withholding tax find it difficult to sell bonds to those who are subject to such tax (for example, insurance companies and mutual funds). It may be noted that a similar move in the case of government securities in the year 2000 had a tremendous effect on secondary trading in government securities.

- Reduction and uniformity in stamp duty on issuance of debt instruments and on securitization transactions.

The stamp duty applicable on debt instruments is not only high as compared to developed markets but also different across various states. Since stamp duty impacts heavily the cost of issue of the debt instrument, it makes debt less attractive vis-à-vis loans. Further, high variability in stamp duties across various states inhibits the development of a more broad based market.

- Allowing repo transactions on corporate bonds in inter-bank repo market through a specialized clearing and settlement platform.

Secondary market trading cannot take place unless there are enough dealers offering quotes in the market. Since dealers operate with funded portfolios, they are able to offer quotes at low spreads only if they can carry their stocks at a low cost. The success of government securities market is due to the availability of repos which enable the dealers to carry their stocks at a low cost. The absence of similar arrangement for corporate bond market puts it at a considerable disadvantage.

*ii) Efficiency of private placement market*

To increase the efficiency of the private placement market for debt and bring it in line with global best practices, the Committee makes the following recommendations:

- It is recommended that private placement be confined only to Qualified Institutional Buyers (QIBs) and the number restriction be done away with.

In India, even non-QIBs are currently allowed to participate in the private placement market. Further, for an issue to qualify as a private placement, the number of investors is restricted to a maximum of 50. Globally, the investor base for private placement, which requires very little disclosure, is restricted to QIBs: a class of investors which characteristically is adequately aware of the risks associated with private issues.<sup>6</sup> Even in India, SEBI has put in a mechanism for development of private placement market for QIBs in equity/equity linked instruments through Chapter XIII A of DIP guidelines.

If the private placement market in India is restricted to QIBs in line with international practice, the number restriction would be redundant. It may be recalled that the 50-investor rule was imposed to curb a widespread tendency to pass off what would typically be public issues as private placements just to dodge the disclosure requirements.

---

<sup>6</sup> Globally, regulators have evolved regulations for issue of debt securities in the private placement market based on the class of investors. For example: debt securities to be issued in the private placement market are governed by Sec 144A if issued to US based QIBs or by Regulation S if issued to non US based QIBs.

- Develop an OTC market for trading in privately placed debt securities.<sup>7</sup> Further, an electronic trade reporting system should be devised to improve the transparency in the OTC market.

Since large investors and QIBs generally drive corporate bond markets, development of a trading infrastructure for privately placed debt suited to the needs of such investors is critical. Since the investors in the privately placed debt market are small in number and are aware of the risks involved, ease of bilateral deals in the OTC market outweigh the benefits of an anonymous trade matching system. If transparency is a matter of concern, it can be taken care of by devising an electronic trade reporting system.

*iii) Regulatory asymmetry between loans and bonds*

The regulations relating to investments in bonds are far more restrictive compared to granting of loans. For example:

- Banks cannot invest in unrated debt instruments. Nor can they invest in unlisted debt papers beyond a certain limit (10% of their total non-SLR investments). No such restrictions are applicable for loans.
- Banks grant loans with no mark to market implications. But their bond investments are subject to mark-to-market regulations since banks are not allowed to classify any part of their bond portfolio under the held-to-maturity (HTM) category.

---

<sup>7</sup>Under the aegis of SEBI, a trading infrastructure with essential features of the OTC market is being attempted. Eventually, however, a system of anonymous order matching is being envisaged.

It is recommended that

- Banks should be allowed to invest in unrated and unlisted bonds issued by at least the infrastructure companies.
- Banks need to be given an option to classify their bond holdings under either the trading category (with mark-to-market implication) or HTM category (subject to only ALM norms). At a minimum, long term infrastructure bonds (with maturity more than 5 years) held by banks should be allowed to be classified under HTM category up to 5% of their total liabilities.

There is no valid logic for having an asymmetry in regulations between instruments when the underlying risks associated with the corporate raising the resources, are the same. The current asymmetry with a bias in favor of loans makes banks averse to investment in corporate bonds and hence keeps a potentially important class of investors out of the corporate bond market.

*iv) Introduction of credit derivatives*

The current regulatory framework does not allow dealing in credit derivatives, even though the RBI had issued draft guidelines governing credit derivatives in 2003.<sup>8</sup> The Committee recommends the introduction of credit derivatives and granting of permission to foreign investors to trade in them.

Introduction of credit derivatives will yield the following advantages:

---

<sup>8</sup> RBI has issued draft guidelines in May 2007 for introduction of credit default swaps to be entered into between banks and primary dealers.

- Since India has a narrow investor base for debt instruments, credit derivatives can potentially serve as an efficient risk transferring instrument and thereby widen the investor base.
- Can help address the limitation of exposure norms.
- Special skills required for infrastructure financing, which may be limited, would be used efficiently as credit derivatives facilitate efficient risk distribution.
- Allowing foreign investors to participate in credit derivatives market will help in distributing the risks even more widely without significantly adding to capital inflows.

## **B. Tapping the potential of insurance sector**

The world over, long-term liabilities have been used to finance long term assets, underlining the relative importance of insurance companies in infrastructure development vis-à-vis banks. By global comparison, Indian insurance companies, however, have not played a significant role in financing infrastructure projects, particularly those sponsored by private companies.

For several years, insurance was provided exclusively by public sector companies, with LIC playing a dominant role in the insurance space. In the last few years, many insurance companies have come up in the private domain. The private insurance companies, although small in size, are growing and can potentially be important players in infrastructure financing. As of March 2006, the gross investment by insurance companies was Rs

529,484 crores, out of which the mandated investment in infrastructure sector was Rs 54,620 crores (10.3 percent of total).<sup>9</sup>

**Table 4 - Investment by Insurance Companies (Rs crore)**

	<u>At end of period</u>		
	<u>2003/04</u>	<u>2004/05</u>	<u>2005/06</u>
<u>Non-life</u>			
Total investment	34,075	37,412	42,333
of which:			
Infrastructure and Social Sectors	3,600	4,390	4,982
<u>Life</u>			
Total investment	352,625	428,452	487,151
of which:			
Infrastructure and Social Sectors	38,637	45,521	49,638
<u>All insurance companies</u>			
Total investment	386,700	465,864	529,484
of which:			
Infrastructure and Social Sectors	42,237	49,911	54,620

Source: IRDA Annual Reports

Currently, both public and private insurance companies are looking for long-term investment opportunities including in infrastructure sector but are not finding enough avenues and instruments that match their investment policy. This is due to their risk-averse attitude and preference for public sector on one hand and (partly) restrictive regulations on the other. This is indicated by the fact that insurance companies have consistently invested much more in government securities than they are required to as per regulations, but not so in infrastructure. Further, their infrastructure investment portfolio is

<sup>9</sup> 90.9 percent of the total insurers investment in infrastructure and social sector was accounted for by life companies as against and 9.1 percent by non-life companies.

dominated by public sector companies.

**Table 5 - Insurance Companies' Performance (2005/06) Vs Regulation (% of total investment)**

	<u>Government securities</u>		<u>Infrastructure &amp; Social sectors</u>	
	Performance	Regulation	Performance	Regulation
<u>Life</u>		Not less than		Not less than
Public	61.9	50	12.4	15
Private	56.5	"	18.8	"
Overall	61.8	"	12.5	"
<u>Non-Life</u>		Not less than		Not less than
Public	39.3	30	11.5	10
Private	41.8	"	14.9	"
Overall	39.6	"	11.8	"

Source: IRDA annual report

In view of the recent introduction of private players into insurance business and the potential role of insurance companies in infrastructure, the Committee emphasizes the need to (i) make a comprehensive review of insurance regulations aimed at making them more modern, streamlined, unambiguous and well-understood and (ii) strengthen supervision, in the same manner that led to a transformation of regulation and supervision of commercial banks during the 1990s. While such a process may take some time, some immediate initiatives to stimulate infrastructure investment by

insurance companies have been suggested.<sup>10</sup>

The Committee's recommendations have two broad aims: (a) widen the scope of infrastructure financing by insurance companies in terms of sectors, and (b) liberalize the investment guidelines in terms of quality and types of eligible instruments, while relying more on management decisions. The first relates to the definition of infrastructure. The second relates to the rigidities of regulation and requires some elaboration of the context. Insurance investments other than in government securities can be classified as 'approved investment' and 'other than approved investment'. Investment in both debt and equity can be made in both these classes. The difference between the two categories, relevant for the current discussion, is that only approved investments are eligible for inclusion in 'Infrastructure and Social Sector', which requires minimum mandated investment on one hand and are not constrained by exposure norms on the other. There are, however, some provisions under the approved category that discourage the scope of both debt and equity investment in infrastructure.<sup>11</sup> These restrictions need to be removed with respect to infrastructure sectors to provide the insurance companies greater flexibility in deciding appropriate portfolio and wider access to instruments.<sup>12</sup>

*i) Harmonizing the definition of Infrastructure*

It is recommended that the definition of infrastructure under various

---

<sup>10</sup> A committee in IRDA is currently examining the issues regarding the investment policy of insurance companies to bring them in line with global best practices.

<sup>11</sup> Such restrictions are absent in 'other than approved' category.

<sup>12</sup> For example, this will give greater flexibility to insurance companies channel larger investment under the 'Infrastructure and Social Sectors'.

regulations (such as those relating to banks and insurance) be harmonized and the RBI's definition provided in its circular dated October 10, 2006 be adopted (See Annexure A), with the only exception that the definition should explicitly include pipelines.

By bringing greater clarity to definition of infrastructure on one hand and widening its scope on the other, a harmonized definition will:

- Create new avenues for infrastructure investment by insurance companies.
- Facilitate design and implementation of special regulations and fiscal incentives for infrastructure.
- Assist consistent tracking of spending on infrastructure in national accounts.
- Improve trading in infrastructure papers across investor classes.

Compared to the IRDA definition, the RBI definition is preferred as it is more comprehensive in terms of the sectors covered. The RBI definition is also clear about what activities within the given sectors are eligible for financing, while such an approach is absent in the IRDA definition.

*ii) Liberalizing investment guidelines for debt instruments*

- Minimum credit rating:

It is recommended that the minimum rating requirement for bonds, hybrid instruments (such as convertible bonds) and securitized paper issued by infrastructure companies (including holding

companies) be lowered to investment grade (BBB-) to qualify as approved investments under the category of ‘Infrastructure and Social Sector’.

The current IRDA investment guidelines allow investment in assets/instruments under approved category for consideration under ‘Infrastructure and Social Sector’, only if they have a minimum credit rating of AA (or A+ in exceptional cases with investment committee approval). Since infrastructure companies typically do not enjoy high credit rating at least in the initial years, the recommendation will expand the avenues of investment in the infrastructure space. It may be noted that this is only a facilitating measure, the actual investment portfolio would depend on the commercial judgment and risk appetite of the insurers’ investment committees.

*iii) Liberalizing investment guidelines for equity instruments*

▪ Dividend payment history:

As per current regulations, to qualify as approved investment, the investee company should have a dividend payment record (of not less than 4% including bonus) for at least seven out of nine immediately preceding years for life companies. There are similar restrictions for non-life companies as well.

It is recommended that dividend payment history as a

consideration for equity investment be relaxed. This recommendation is based on the premise that infrastructure development, especially by the private sector companies, is a relatively new phenomenon with most of these companies being or having been set up only recently and hence do not have a dividend payment record. Also, several existing infrastructure companies, although stable in operations, may not have a dividend payment track record. Relaxing this requirement will widen the spectrum of infrastructure companies that can be potentially included in the insurers' investment portfolio.

- Inclusion of new instruments:

To further facilitate investment in equity of infrastructure companies, it is recommended that all equity investments in listed infrastructure companies be considered as approved investments. Also, to allow insurance companies to take advantage of the mutual funds with schemes targeted at investment (including equity) in infrastructure companies, investment in these schemes may also be considered as approved investments. This will enable insurance companies to seek higher return while maintaining liquidity and at the same time, benefit from the experience of professional managers.

### **C. Enhancing participation of banks, financial institutions (FIs) and large NBFCs in infrastructure financing**

Banks, FIs and large NBFCs play a vital role in infrastructure financing through originating, underwriting and distributing risk. While their significance is growing, they are likely to face increasingly severe resource constraint to maintain growth momentum. Although banks have had a rapid growth in their exposure to infrastructure sectors in the last few years, they will perhaps find it difficult to maintain similar growth in the years to come in the face of prevailing exposure norms and growing maturity mismatch, unless they are allowed to transfer risks from their balance sheets to other players in the financing system. Similar problems may be faced by FIs and NBFCs as well. In view of the enormous infrastructure funding requirement, larger financing by banks, FIs and large NBFCs needs to be facilitated. In this respect, the Committee makes the following recommendations:

*i) Asset side management*

▪ Securitization

Securitization helps transform loans to tradable debt securities, and thereby facilitates financial institutions to not only address the exposure norm constraints, but also distribute risks more efficiently even among those who do not have the skills to appraise them. To further facilitate securitization of existing infrastructure assets by banks, FIs and NBFCs to other domestic and overseas investors, the following key steps need to be taken:

- a. Inclusion of Pass Through Certificates (PTCs) under the definition of ‘security’ as per SCRA, will enable the listing of these PTCs and thereby help in increasing the transparency of

the market and tradability of the instrument.<sup>13</sup>

- b. Rationalization of RBI's guidelines on securitization in line with international best practices: The guidelines issued by RBI for securitization of standard assets are a welcome move towards creating a more transparent and better regulated securitization market in India. However, there are certain areas where these guidelines are not in line with international best practices (see Annexure B) and hence may need amendments to stimulate the growth of securitization market.
- c. To increase the investor base, IIFCL should be allowed to invest at least in the senior tranches of securitized papers relating to infrastructure companies. (IIFCL which can be a potentially large investor in securitized paper in infrastructure is currently not allowed to invest in such papers.)

▪ Modifying NBFCs' exposure norms

The current exposure norms for lending by NBFCs are given below:

**Table 6 – NBFC's Exposure Norms**

	Single Borrower Limit		Group Borrower Limit	% of
	General	Additional with Board approval		
NBFCs	20%	Nil	35%	Only Tier I

These need to be modified for infrastructure lending as follows:

- a. Single borrower limit should be allowed to be increased by

<sup>13</sup> The Securities Contracts (Regulation) Amendment Bill 2007 (Bill 98 of 2007) is passed by the Lok Sabha on May 14, 2007 and has been tabled in the Rajya Sabha.

- further 5% with their Board's approval;
- b. The group borrower limit should be increased; and
  - c. The capital funds for NBFCs should include both Tier I and Tier II and not only Tier I capital.

With the infrastructure companies growing rapidly and their funding requirements being enormous and lumpy, NBFCs' ability to lend to such infrastructure projects is being constrained by the exposure norms and hence the recommendation.

- Rationalizing exposure norms of financial intermediaries
  - a. Underwriting: Currently financial intermediaries are constrained by exposure norms in underwriting and originate-to-sell transactions. The exposure norms should not be applicable to such transactions where the intention is to sell off the exposure within a short period of time, say 6 months. Should the intermediaries fail to sell the exposure within the stipulated period, they may be asked to raise additional capital or write off the excess exposure from their capital or prohibited from taking further exposures. This will help these financial intermediaries in maintaining confidentiality, managing timing mismatches and accelerating deal closure.
  - b. Step-down subsidiary: The current regulatory policies treat lending to step-down project SPVs floated by infrastructure companies under the group borrower limits even if the lending is without recourse to the parent company. This provision does

not add to stability of the banks but restricts their ability to lend. Hence, lending to step-down subsidiary (without having recourse to the parent) should be exempt from the group exposure limit.

The group exposure limits were prescribed to ensure that banks do not suffer due to cross holding of ownership among various corporate group entities. The step-down subsidiaries--created to execute a particular infrastructure project without any dependency on the parent whatsoever--do not involve cross holdings. Additionally, the lenders escrow the subsidiaries' revenues and funds can flow back to the parent or other step-down subsidiaries of the same parent only after the repayment of debt or on meeting of the prescribed financial covenants. Hence, the banks' lending to these subsidiaries is not vulnerable to the bankruptcy of the parent. There is thus a strong case for removal of exposure to such subsidiaries from group exposure limits.

- c. Take out financing for infrastructure projects: At present, conditional take out financing is subject to 100 percent risk weight for provision of capital by both the entities involved simultaneously (with the take-out financier using a credit conversion factor of 50% till the take-out happens), which results in i) maintenance of excess capital, thereby restricting take-out financier's lending ability and ii) increase in the lending costs. The latter occurs because the take-out financier

charges a fee for maintaining capital. Hence, it is recommended that the credit conversion factor be reduced to 0% till the take-out happens for infrastructure sector.

ii) *Liability side management*

To enable banks/NBFCs to mobilize sufficient resources of suitable tenor and nature for infrastructure financing, the following recommendations are made:

▪ Foreign borrowing for on-lending to infrastructure sector

The existing guidelines do not allow financial intermediaries such as banks, financial institutions and NBFCs to raise foreign currency borrowings for on-lending to infrastructure sector. It is recommended that these intermediaries should be allowed to raise long term resources (say minimum 10 years) from overseas market.

There is a dearth of long term resources in the domestic market, but not so in the international market. Since it is difficult for infrastructure companies to directly access foreign markets in view of the projects being sub-investment grade, intermediation of foreign funds by domestic financial intermediaries is imperative.

▪ SLR requirements on long term funds

Currently, banks are required to maintain 25% of their demand and time liabilities as SLR regardless of the tenor of the liabilities. It is recommended that the resources, whether domestic or foreign, raised

by banks for a long tenor (say at least 10 years) by way of bonds/term deposits for investment in infrastructure assets should have no SLR requirement.

This will reduce the cost of intermediation for infrastructure and hence, induce banks to have a relatively larger exposure to infrastructure than other sectors. In addition, this will encourage banks to use long term funds for long term lending.

It may be noted that the ongoing fiscal correction has resulted in steady reduction in Government's borrowing program in relation to deposit growth of banks.<sup>14</sup> Hence, the Committee feels that such a recommendation will ensure that infrastructure fills a larger share of the space created by reduced bank financing of government expenditure.

▪ Gold Deposits

Banks may be allowed to raise long tenor gold deposits which will be used for the purpose of infrastructure financing. Currently, consumption of gold in India is largely for the purpose of household investment in the form of jewellery / gold bars to either meet future needs or purely as a long term investment. Therefore, the savings in gold take the form of physical savings not available for intermediation by the financial sector. To convert these physical savings into financial savings, households need to be encouraged to hold their gold

---

<sup>14</sup> In 2007/08, for example, the RBI expects aggregate deposit growth to be about Rs 5,00,000 crore, implying SLR investment of Rs 125,000 crore.

exposure in a form which does away with the need for physical holding of gold. One such product could be fixed tenor long term gold deposit certificates issued by banks. Banks, in turn, could hedge the risk of such gold liabilities in the forward or futures market thereby generating financial liabilities for themselves. Such long tenored liabilities could then be used for financing infrastructure projects.

#### **D. Fiscal recommendations**

##### *i) Withholding tax*

It is recommended that the foreign borrowings by *infrastructure companies or project SPVs* may be exempted from withholding tax requirements. Similar withholding tax exemptions should be provided to FIIs and their sub accounts investing in rupee denominated infrastructure debt instruments.

Currently withholding tax rates can be as high as 20 % (depending on the lender's domicile), which adds to the borrowing cost as the current market practice is to gross up the withholding tax. So, the recommendation would reduce the borrowing cost. The recommendation would also weaken the incentives for corporates to raise funds in currencies in low interest rate regimes without hedging their exposures.

ii) *Rationalization of Dividend Distribution Tax (DDT)*

Infrastructure development business often entails a multi-tier corporate structure with a holding company at the top which is generally a listed entity. The holding company makes investments in various step-down subsidiaries which are involved in the actual execution of the infrastructure project. The step-down subsidiaries are created so as to comply with either the guidelines set out by agencies like NHAI or the mandates given by the lenders (to avoid mingling of cash flows from various projects).

These step-down subsidiaries pay DDT <sup>15</sup> on distribution of dividends to its holding company, which in turn is required to pay DDT while distributing dividends to its shareholders. This reduces the return of the equity investors in the holding company, making investment in infrastructure sector less attractive. It is, therefore, recommended that the administration of DDT be rationalized to remove its cascading effect.

iii) *Tax rebate on investment in UMPPs*

The power sector, a critical sector determining the growth of the economy, has attracted far less investment than required in the past, primarily due to deficiencies in the distribution segment. Reforms in the distribution end are gradually picking up momentum, but may take 4-5 years to show significant results. Meanwhile, 9 UMPPs (of 4000

---

<sup>15</sup> DDT is levied @ 16.995% (15% plus 10% surcharge plus 3% education cess).

MW each) have been planned to give a significant boost to power generation. The total project cost of these UMPPs is going to be enormous (estimated to be USD 36 billion) with the equity component being about USD 12 billion. Considering the general shortage of risk capital, this is going to be a huge challenge, which will be compounded by the fact that these projects would not generate dividends at least during the initial years.

The Committee believes that fiscal incentives for a limited period will be an appropriate solution. Incentives can be provided to individuals investing in equity of such projects through IPOs or in specific schemes floated by mutual funds to invest in listed equity of these projects. It is recommended that a tax rebate of 20% on the amount invested by individuals could be given for investments locked-in for at least 5 years. Investments by individuals in long term bonds specially raised for the power sector by financial intermediaries should also be eligible for similar fiscal incentives. This will help in not only attracting risk capital but also distributing the risk more widely. As compared to the potential benefits, the fiscal cost will be negligible (around USD 0.24 billion or INR 1000 crores by rough estimates).<sup>16</sup>

*iv) Tax treatment on unlisted equity shares*

Currently, capital gains on sale of unlisted equity shares are subject to much higher tax rates than listed equity shares, putting unlisted equity

---

<sup>16</sup> Assuming that the retail investors will subscribe to a third of the total equity issued, i.e., USD 4 billion. Tax rebate of 20% works out to USD 0.8 billion and hence the tax loss to the exchequer will be USD 0.24 billion assuming a tax rate of 30%.

at a considerable disadvantage. It is suggested that investment in unlisted equity capital of infrastructure companies--operating or holding company--should get the same tax treatment as listed equity investment, i.e., short term capital gain being taxed at 10% and long term capital gain tax being nil.

Since private entry into infrastructure is a relatively new phenomenon, there are only a few private companies capable of raising equity capital through public issues, implying that unlisted equity would be the dominant source of equity capital at least in the medium term. Similar tax treatment for listed and unlisted equity will make the providers of risk capital indifferent between the two, from a tax perspective.

## **E. Facilitating equity flows into infrastructure**

### *i) Liberalizing buyback regulations*

In many infrastructure projects, the buyback mechanism is used indirectly to finance suppliers in the following manner. Equity is allotted to the vendors, suppliers, etc at the initial stage as a consideration for the supply of raw materials / machines received from them. When the project becomes operational and the company begins to get sufficient cash to pay for these materials / machines, buyback of these equity shares becomes necessary to help the

developer regain control over the company. In buying back share capital, companies face several restrictions (under Sec 77A of the Companies Act) including on a) the total amount of buyback that can be undertaken by the company, and b) the number of shares which can be bought back in a particular year. These restrictions discourage promoters to place sufficient equity with vendors/suppliers at the initial stage, and thereby compel them to infuse more equity than would have been the case under liberalized regulations for buy-back. It is therefore recommended that in case of unlisted infrastructure companies, the buyback restrictions vis-à-vis vendors/suppliers be liberalized.

Sec 77A of Companies Act also does not allow using borrowed funds for buyback of equity shares which implies that equity cannot be freed up during the course of a project even if the underlying risk profile improves. In certain infrastructure projects such as UMPPs, the initial equity contribution required by the lenders may be high (say 30 percent of project cost). However, the lenders may be comfortable with a lower equity base when the project gets commissioned and starts generating stable cash flows. In such situations, leveraged recapitalization, replacing equity with debt, should be allowed. This will free up part of the equity locked in the project, so that promoters can gainfully employ it in other infrastructure projects.

*ii) Change in initial bidders*

Currently, in transportation, port and power sector, it is very difficult

to replace one or more initial bidders with new partners. This jeopardizes the prospect of the project by reducing the flexibility in the constitution of management. Hence, it is recommended that all the bidding documents for infrastructure projects should provide a clause for dropping the initial bidder(s) or replacing them by a new entity, if agreed to by all the parties to the contract through a deed of adherence. The deed of adherence will bind the new entity to the terms of the original contract. This provision should be included in model concession agreement.

*iii) Venture or Private Equity funds as bidding partners*

Currently, SEBI registered venture funds / private equity funds cannot be taken as bidding partners, as these funds do not meet conventional qualification criteria such as gross revenue, net worth or net cash accruals. Considering the shortage of risk capital in the country, it would make sense to allow these funds to become bidding partners. To facilitate their participation, it is recommended that the criteria to qualify as bidding partners should be not the net worth of the private equity or venture investment manager, but the uncommitted investible funds managed by these entities and available for deployment.

## **F. Inducing foreign investments into infrastructure**

To attract foreign funds into India's infrastructure sector, the following

facilitating measures are suggested:

*i) Steps for improving FII participation*

The existing debt FII/sub account limits (in USD billion) have some anomalies (Table 7).

**Table 7 – Existing debt FII/sub account limit**

	100% Debt Scheme	70:30 Scheme	Total
G-Sec/T Bills	2.0	0.6	2.6
Corporate Debt	1.0	0.5	1.5
Total	3.0	1.1	4.1

Currently, in 100 percent debt schemes, individual limits are allocated to FIIs in a manner that results in low absolute limits for each FII, weakening their incentive to actively utilize their respective limits. Whatever little trading that takes place under these limits is largely motivated by arbitrage. To ensure that the limits get better utilized and to attract genuine long term investors as opposed to arbitrage traders, the following recommendations are made:

- Replace the existing allocation process (of individual limits) with a first come first serve rule for the 100 percent debt scheme, as in the case of 70:30 schemes.
- Once the limits start getting sufficiently utilized, additional limits (for investment in long term debt instruments issued at least by infrastructure companies) should be considered.

*ii) Separate treatment for infrastructure holding companies*

At present, most developers such as L&T, Gammon, GMR Infrastructure, etc., house all their infrastructure investments in a holding company as a separate business from that of the parent company. These holding companies get classified as NBFCs under RBI guidelines due to their income and asset patterns being largely financial in nature. This puts several restrictions on the holding companies as enumerated below:

- Compliance with stringent regulatory requirements applicable to regular lending NBFCs
- Limits on bank borrowing by these companies
- ECBs not allowed under the automatic route
- FDI investment in these companies not allowed without RBI approval
- Investment in these companies by registered venture capital funds is subject to regulatory approval

Since the holding company corporate structures (such as L&T Infrastructure Development Project Limited) facilitate infrastructure development, they need to be treated as a separate class of NBFCs (say infrastructure NBFCs) that are exempt from these restrictions. Specifically, the infrastructure holding companies should be allowed to raise FDI under the automatic route.

iii) *Refinancing through ECBs*

The existing guidelines do not permit domestic financial intermediaries to refinance existing rupee loans from external sources, although there is a potential market for it. It is recommended that refinancing of existing rupee loans through ECB should be allowed for *infrastructure* sector, because of the following benefits that it would yield:

- Some foreign financiers, who are not keen to participate in projects in early, risky stage, may show interest in the post-construction period when the risks subside.
- Indian lenders to infrastructure projects would like to have some of their loans refinanced in order to churn their asset portfolio, and at times, to limit their risks.
- Local promoters will benefit from greater diversity of funding sources as well as better price discovery. Refinancing from external sources would be particularly attractive in situations similar to the current one, when domestic interest rates are relatively high and the rupee is tending to appreciate.

iv) *Relaxing the all-in-price ceiling for subordinated and mezzanine debt*

The current ceiling of LIBOR+350 basis points for ECBs makes it difficult for the issuers to raise senior debt, subordinated debt, mezzanine financing or quasi equity as the maximum permissible return is not considered enough to match the perceived risk. Keeping in view the long term nature of infrastructure projects and the need for risk capital (in the form of quasi equity), this all-in-price ceiling on

ECBs should be removed for senior, subordinated and mezzanine foreign debt for infrastructure projects. This suggestion is aimed at assuring liquidity for longer tenors, and in many cases, protecting promoters of infra projects from illiquidity in domestic loan markets due to seasonal factors.

### **G. Utilizing foreign exchange reserves**

There has been a considerable debate about the use of foreign exchange reserves for infrastructure development, but the idea has not made any headway. Meanwhile, India's foreign exchange reserves continue to grow rapidly. These reserves, while providing a buffer against adverse external developments, do not contribute directly to the real sector, as they are invested in foreign currency assets such as government bonds. The financial return on these reserves is small. In fact, it is well known that the cost of sterilization that the reserve accumulation entails exceeds the return on these investments.

It may be pointed out that rapid accumulation of reserves in recent years has happened not only in India, but also in emerging Asian economies such as China, Korea, Singapore, Thailand and Philippines. In fact, the foreign exchange reserves in Asia exceeded USD \$ 3 trillion by the end of 2006. Recognizing that the reserves are in excess of what is needed for 'liquidity purposes and cushions against external shocks' some of these countries (China and Korea) have moved towards allocating a part of the reserves to 'aggressively managed portfolios' along the lines adopted by Singapore.<sup>17</sup>

---

<sup>17</sup> China has recently moved in this direction, while Korea has already launched Korean Investment Corporation. See Regional Economic Outlook, Asia and Pacific, April, 2007, IMF

The Committee recognizes that there is a case for similar initiatives in India too. The model to be adopted, however, has to be designed to suit India's specific constraints and needs. An important concern that needs to be addressed is that its operation should not add to the already high rate of domestic monetary expansion. Further, keeping in view the real risks of disruptive reversals of capital flows, the Committee is in favor of allocating only a small fraction of total reserves for this purpose. Within these constraints, the challenge is to balance the objectives of the RBI in its reserve management (safety, liquidity and return) against the needs of the infrastructure sector. Trade-offs are bound to occur in any structure that can be devised to implement this. So, structures that entail acceptable tradeoffs need to be chosen. In the view of the Committee, the following structures provide starting points for exploring such a mechanism:

*i) Externally focused investment arm*

A company can be set up in a foreign country with the Government of India (through say IIFCL) being the sole contributor of funds to this company. This company can borrow a small fraction of India's reserves (say US\$ 10 billion) from the RBI.<sup>18</sup> The loan can be benchmarked to 30-year US Government bond. The RBI will get a premium over this by way of compensation for the loss of liquidity.

The mandate of this company will be to invest in infrastructure

---

<sup>18</sup> In addition, the company could raise 10 percent of net accretion to foreign exchange reserves from the RBI.

development outside India, only of the kind that would either supplement India's infrastructure needs or help in sourcing raw materials / importing machinery for domestic development. For example, the company can invest in power projects in Bhutan/Nepal with an understanding that they will supply part of the power generated to India, or invest in gas pipelines construction up to the Indian border. Also, the company can provide support to Indian oil and gas companies to acquire assets overseas, which would facilitate India's infrastructure development.

The main risk of this model is that it would entail some loss of liquidity in the asset portfolio of the RBI and the funds set aside for the proposed company may not qualify as reserves. This risk would, however, be manageable, since the corpus of the company is small in comparison to total reserves. While the return will almost certainly be higher than what it is at present, the safety of these assets can be ensured by deploying them judiciously by professional managers.

*ii) Monoline credit insurance company backed by foreign exchange reserves*

Monoline credit insurance companies are basically credit enhancement agencies that offer "credit wraps" for a one-time upfront fee. A monoline insurance company can be set up by IIFCL with a thin capital in a foreign country. The company can then raise long term foreign currency bonds which would be subscribed by RBI out of its foreign exchange reserves. The funds so raised will be deployed

in highly rated collateral securities (e.g. US Government bonds). Backed by such collateral, the insurance company can provide credit wrap--for an appropriate market-determined fee--to infrastructure projects in India for raising resources from international markets. The provision of credit wrap will improve the credit rating of such projects which in turn will help the issuers in (i) having access to longer tenor funds, (ii) raising higher amount of debts and (iii) expanding the investor base. Access to long term funds will be the most important benefit of this route. It may be noted that there would be no net cost advantage for the borrowers, as the advantage of improved rating will be offset by market-determined fees they have to pay.

In this model, safety of assets of the new company will be high, given the portfolio envisaged. As in the previous model, there will be a loss of liquidity and on this count; the return for RBI can be expected to be more than at present. Since the corpus of the fund will be small (USD 5-6 billion), the loss of overall liquidity will be marginal. The project companies will use the funds raised with the help of the credit wrap, to finance project-related imports.

#### **4) Conclusion**

The committee recommends that in order to sustain and improve upon the current high GDP growth rate, significant amount of infrastructure investment is required. The target of infrastructure spending over the next five years needs to be revised upwards to USD 384 billion at 2005-06 prices (equivalent to USD 475 billion at current prices) from the current estimate of USD 320 billion at 2005-06 prices.

An investment target of this size poses significant challenge from availability of financial resources perspective. The committee, however, believes that channeling the flow of domestic and foreign financial savings of this scale to infrastructure sector requires a judicious mix of policy interventions which balance the growth and stability objectives. The key is to ensure that the financial system is in a position to effectively intermediate a large proportion of incremental domestic savings while the savings rate increase from current 34% to 39% of GDP by FY2012. At the same time, access to foreign savings to bridge the financing gap is crucial, though the same needs to be achieved without compromising monetary stability. Adhering to these objectives, the committee has framed its recommendations to develop the domestic debt capital market, to tap the potential of the insurance sector and to enhance the participation of banks, financial institutions and large NBFCs specializing in infrastructure financing.

Implementation of the recommendations requires a few enabling policy changes related to withholding tax, rationalization of dividend distribution tax and tax treatment of (i) investment in Ultra Mega Power Plants and (ii) unlisted equity shares. The Committee has also made recommendations to

facilitate equity flow into infrastructure projects, to induce foreign investments into infrastructure and steps required to utilize foreign exchange reserves to accelerate capacity expansion of infrastructure projects in India.

In committee's view, strong domestic growth and equally supportive global macro-economic environment provide a unique window of opportunity for building world class infrastructure in the country and the country should not miss such an opportunity. The task may be overwhelming but it is within the reach and the speedy implementation of recommendations made in this report is critical to achieve the objective of enhancing flow of investment from private sector into infrastructure sector in the medium term.

## **Annexure – A : RBI Circular on Definition of Infrastructure**

Any credit facility in whatever form extended by lenders (i.e. banks, FIs or NBFCs) to an infrastructure facility as specified below falls within the definition of "infrastructure lending". In other words, a credit facility provided to a borrower company engaged in:

- developing or
- operating and maintaining, or
- developing, operating and maintaining any infrastructure facility that is a project in any of the following sectors, or any infrastructure facility of a similar nature:
  - i. a road, including toll road, a bridge or a rail system;
  - ii. a highway project including other activities being an integral part of the highway project;
  - iii. a port, airport, inland waterway or inland port;
  - iv. a water supply project, irrigation project, water treatment system, sanitation and sewerage system or solid waste management system;
  - v. telecommunication services whether basic or cellular, including radio paging, domestic satellite service (i.e., a satellite owned and operated by an Indian company for providing telecommunication service), network of trunking, broadband network and internet services;
  - vi. an industrial park or special economic zone ;
  - vii. generation or generation and distribution of power
  - viii. transmission or distribution of power by laying a network of new transmission or distribution lines.
  - ix. construction relating to projects involving agro-processing and supply of inputs to agriculture;

- x. construction for preservation and storage of processed agro-products, perishable goods such as fruits, vegetables and flowers including testing facilities for quality;
- xi. construction of educational institutions and hospitals.
- xii. any other infrastructure facility of similar nature.

## **Annexure – B : Rationalization of RBI’s guidelines on securitization** <sup>19</sup>

- a. Definition of the Originator: Any group entities of the originator cannot participate in the securitization transactions of the originator. As a general rule, since all securitization transactions are conducted on an arm’s length basis, this deprives group entities of the originator from profitable investment opportunities. In particular, some group entities which are regulated separately by distinct regulatory bodies like IRDA, SEBI, etc. and which deals with funds raised from public could well be exempted from the ambit of the definition of “originator”.
- b. Capital adequacy: Under the current guidelines, an originator may be required to maintain more capital than it would have, had the assets not been securitised. Hence, the total capital to be held by the originator against securitised exposures including for first loss, second loss and liquidity facility, should be capped at the capital required to be maintained had the assets not been securitised. This is also in line with the regulations prevalent in Singapore and paragraph 610 of Basel II.
- c. Profit recognition: RBI guidelines require that any profit arising on account of sale of assets under securitisation program should be amortised over the life of the securities issued. This treatment of profits is inconsistent with the accounting treatment prescribed by ICAI’s Guidance Note, FAS 140 and IAS 39. All these regulations require gain on assets sold to be booked at the time of completion of sale.

---

<sup>19</sup> In its guidelines on capital adequacy issued in line with Basel II norms, RBI has already acknowledged gain on sale (for the purpose of deduction from Tier 1 capital, if permitted to be realized) and capital treatment on securitisation exposures including liquidity and credit enhancement facilities on a rating based approach.

- d. Release of credit enhancement: RBI guidelines require that no portion of the credit enhancement should be released to the provider during the life of the securities issued by the SPV. It is a well-accepted international practice across the developed markets to gradually release credit enhancement provided in a securitisation transaction.
- e. Underwriting: Any underwriting devolvement, of securities issued by the SPV, on the originator in excess of 10% (RBI vide letter dated October 4, 2006 to the Indian Banks Association has increased this limit to 20%) of the original amount of the issue has to be fully deducted from the capital. There is no economic rationale for such deduction as these investments do not create any additional risk on the originator over and above what would be the case had the assets not been securitised. This treatment, in general, is also not in line with other regulatory jurisdictions and Basel-II framework.
- f. Put Options: RBI guidelines prohibit the securities issued by the SPV from having any put options provided either by the originator or by third parties. RBI vide letter dated October 4, 2006 to the Indian Banks Association has allowed third parties to provide put options. Put option by originators should also be allowed and the capital treatment for such options should be similar to as applicable to take-out financing.

**Annexure – C : Office Memorandum on Establishment of Committee to  
make recommendations on Infrastructure Financing**

No. 2/31/2006  
Ministry of Finance  
Department of Economic Affairs  
(Infrastructure Division)

North Block, New Delhi  
December 26, 2006

OFFICE MEMORANDUM

Subject: Establishment of Committee to make recommendations on  
Infrastructure Financing

1. The undersigned is directed to communicate the establishment of a Committee to make recommendations on Infrastructure Financing.
2. The Committee has been constituted as follows:

Shri Deepak Parekh - **Chairman**  
Chairman  
HDFC

**Members**

Shri T.S. Bhattacharya  
Managing Director  
State Bank of India

Mr. S.S. Kohli  
Chairman and Managing Director  
India Infrastructure Finance Company Limited

Mr. Sanjay Nayar  
CEO - India

Citibank

Mr. Nachiket Mor  
Deputy Managing Director  
ICICI Bank Limited

Mr. Hemendra Kothari  
Chairman  
DSP Merrill Lynch

Mr. Rajiv Lall  
Managing Director & CEO  
IDFC Limited

3. The Terms of Reference of the Committee are as follows:

- (i) Overview the current systems of infrastructure financing in India (instruments/institutions/players). Develop a vision for private financing of infrastructure in the medium term.
- (ii) Identify and estimate the need for different kinds of capital including debt financing (especially long term); sub-debt financing; equity capital; mezzanine and other quasi-equity classes of capital.
- (iii) Assess the existing challenges to, and potential for mobilizing long term debt financing from the domestic banking system for infrastructure development.
- (iv) Recommend steps to improve the availability of long term debt capital for infrastructure financing. Specifically:
  - a) Draw attention to those recommendations of the Patil Committee report that have a bearing on the infrastructure sector
  - b) Supplement these recommendations as necessary
  - c) Suggest measures to enhance the ability of provident funds and insurance companies to finance infrastructure projects.

- (v) Recommend changes in existing regulations and policies to facilitate the availability of non-debt capital for infrastructure development. In particular, examine the factors constraining the availability of:
  - a) Mezzanine financing
  - b) “financial” equity (As distinct from “strategic” equity) from both domestic and foreign investors.
- 4. The Committee shall submit an interim report containing its findings and recommendations to the Ministry of Finance, Department of Economic Affairs within six weeks. The final report of the Committee shall be submitted before March 31, 2007.
- 5. IIFCL shall act as Secretariat to the Committee and shall bear the expenditure incurred on the same.
- 6. This has the approval of the Finance Minister.

Sd/-  
(Shyamala Shukla)  
Director (Infrastructure)  
Telephone: 2309 3513

Fax:2309 2477

**Copy for information and necessary action:**

Shri Deepak Parkeh, Chairman, HDFC

Shri T.S. Bhattacharya, Managing Director, State Bank of India

Mr. S.S. Kohli, Chairman and Managing Director, India Infrastructure Finance Company Limited.

Mr. Sanjay Nayar, CEO -India, Citibank

Mr. Nachiket Mor, Deputy Managing Director, ICICI Bank Limited

Mr. Hemendra Kothari, Chairman, DSP Merrill Lynch

Mr. Rajiv Lall, Managing Director & CEO, IDFC Limited

**Copy for Information:**

Shri Vinod Rai, Secretary, Financial Sector, Department of Economic Affairs

Shri Rajeev Ratna Shah, Member Secretary, Planning Commission.

Shri. A.K. Mohapatra, Secretary, Department of Shipping.

Shri Ajay Prasad, Secretary, Ministry of Civil Aviation

Shri Vijay Singh, Secretary, Department of Road Transport and Highways

Shri. D.S. Mathur, Secretary, Department of Telecommunications

Shri. J.P. Batra, Chairman, Railway Board.

Shri. R.V. Shahi, Secretary, Ministry of Power

Shri Gajendra Haldea, Advisor to Deputy Chairman, Planning Commission

Dr. D.P. Krishnan, Joint Secretary, Capital Markets Division, Department of Economic Affairs

Dr. Jayanthi Anand, DGM, Reserve Bank of India

Sr. PPS to Finance Secretary, Department of Economic Affairs

PPS to Additional Secretary, Department of Economic Affairs

PS to Joint Secretary (Infrastructure)

**Forwarded to**  
**Shyamala Shukla, Director, DEA**  
e-mail: shyamala.shukla@nic.in