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Infrastructure Development Financial Institution – Issue of Sustainability

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The various newspapers report about the intention of the government to set up an infrastructure-focused Development Financial Institution (DFI) to cater to the demand of the sector. The Prime Minister also called for a target of approximately Rs. 100 trillion for infrastructure investments over the 5-year period 2019-2024.[1] India certainly needs this investment as also highlighted by high powered committee on urban infrastructure some years ago. But given the current situation in infrastructure, the COVID-19 impact, and a diminishing headroom for more public expenditure, achieving this target could be daunting, especially in the absence of new avenues of financing these investments. DFIs dedicated to the sector could be considered a panacea for this.

The Central Government is already working on the structure of a new DFI – a specialized institution to offer long-term funds to the sector, where borrowers cannot get it from other sources.[2] We already have DFIs categorized as All-India or State / regional level institutions depending on their geographical coverage of the operation. Functionally, All-India institutions can be classified as (i) term-lending institutions extending long-term finance to different industrial sectors (some of which turned into commercial banks later on); (ii) refinancing institutions extending refinance to banking as well as non-banking intermediaries for finance to agriculture, Small Scale Industries and housing sector, respectively; (iii) sector-specific/specialized institutions; and (iv) investment institutions. Besides, we have state governments financed DFIs working at state levels.

All these DFIs have not been able to meet the specific needs of the infrastructure sector in a self-sustainable manner. Further, the operating model for infrastructure financing, such as Hybrid Annuity Mode, for private

[1] https://pib.gov.in/PressReleseDetail.aspx?PRID=1598055 Finance Minister Smt Nirmala Sitharaman releases Report of the Task Force on National Infrastructure Pipeline for 2019-2025, Posted On: 31 DEC 2019 4:11PM by PIB Delhi
[2] https://pib.gov.in/PressReleasePage.aspx?PRID=1693892 - Posted On: 01 FEB 2021 1:45PM by PIB Delhi

investors has undergone frequent changes in recent times, reflecting that developers are unable to sustain for long even when the public sector is taking a majority of the risks.

The long-term funding sources for infrastructure are turning scarce each day and new avenues are not opening. It is a well-known fact that in India, commercial banks have been primary sources of commercial lending as the Indian financial system is dominated by banks and the phenomenal growth in bank financing to infrastructure brought certain undesirable consequences like high stressed assets.[3] These infrastructure sector NPAs of the banking sector are sizable. Banks recognized nearly 8% of their total advances to the sector as gross Non-Performing Assets (NPA). As a whole, about 13% of banking sector's NPA were from the infrastructure. Furthermore, between the fiscal years ending March 2009-2016, infrastructure sector's stressed assets and restructured standard assets accounted for not only 17% of the banking sector's total exposure to the infrastructure sector but also 21% of the total stressed assets.[4]

Given this, it is natural to discuss the nature and model of such dedicated DFI before we move ahead with adding another monolith backed by typical government support and then finding it difficult to sustain its balance sheet. Infrastructure requires very long-term sources of funds, and scale of investment as in Prime Minister's vision statement certainly require a big DFI but the model cannot be like before. With commercial banks facing asset-liability mismatch in lending of resources for infrastructure, such need acquires more teeth.

There can be two basic models of such DFI: either government-backed or stakeholders supported with a private sector character. In the case of it being a government-backed institution, there is an advantage of the ease of fundraising. Further, the securities from such DFI could be made Statutory Liquidity Ratio (SLR) eligible and thus encourage banks and other financial institutions (FIs) to subscribe to such securities to meet Statutory Liquidity Ratio obligations. However, the moment it acquires government control, there is a heightened chance of oversight from 5Cs – Central Bureau of Investigation, Central Vigilance Commission, Controller & Auditor General, Chief Information Commission and Courts. Even most of the prudent decisions could be termed wilful mistakes in hindsight. A DFI with a private sector character would first require the political will to believe in the private sector and maintain a distance (i.e., an arm's-length relationship) from the institution, say in the form of directed lending or say priority-sector lending. For example, the government in such set up can keep its stake limited to 26% or 49%, i.e., not acquire a majority role.

[3] https://rbidocs.rbi.org.in/rdocs/Bulletin/PDFs/02SPF85BA0826CDB403C8A06274B13526AA0.PDF
[4] https://rbidocs.rbi.org.in/rdocs/Bulletin/PDFs/02SPF85BA0826CDB403C8A06274B13526AA0.PDF

Banks can also subscribe to the DFI's securities and this could be one source of funds for the DFI. Because of the absence of mature corporate bond markets in India, subscription of equity by the public, pension funds, private equity, other patient capital like sovereign wealth funds could be the other sources of funds for the DFI.

The question is to whom will the DFI lend: commercially viable (or so to say economic) infrastructure, social infrastructure, or both. Most of these investments are at the municipal level, and so it is imperative to look at the pattern of expenditure at this level. For example, the high-powered committee on infrastructure in its report projected urban infrastructure expenditure in 2021-22 at Rs. 3,30,242 Crores and in 2031-32 at Rs. 7,31,605 Crores. For the year 2021-22, the capital expenditure is around 54% of such investment, whereas Operation & Maintenance costs and establishment charges constitute 25% and 21%, respectively. This data clearly shows that about half of the investments are non-recoverable, as we already know in India, the focus is still on recovering Operating and Maintenance Cost than CAPEX. In such a scenario, will the DFI be willing to take such a sustainability risk? On the one hand, it would require lending at a sub-prime rate due to the under-pricing norms of credit lending to infrastructure sectors. On the other hand, it would invest money in avenues where two-third of the investments cannot be recouped.

The solution is not merely creating a DFI, a monolith like before. That would again land the institution at the same problems of funds mismatch. It is well established in finance that full cost recovery plus profit only can sustain an investment, support the related service level and avoid the asset-liability mismatch trap. If the government can think of outsourcing establishment costs and operating & maintenance costs in infrastructure projects to private entities, we can see potential savings in these costs due to entrepreneurial spirit and efficiency gains. The remaining part, the CAPEX, can be borne by the government at least in the short run.

Counter to this view could be that governments (including central or state or Urban Local Bodies, or municipal level organizations) do generate sufficient tax and non-tax revenues and so there is no need to worry about the sustainability of funding. But, for example if we see the revenue of municipal corporations, it shows stagnant behaviour (being only 1 per cent of GDP) during the period from 2007-08 to 2017-18.[5] Out of their total revenue, about 53% were earned by them, whereas the remaining were received from other sources (such as state government, central government, finance commission, etc.). Furthermore, of their total expenditure, three-fifth was revenue expenditure. After accounting for capital expenditure, their account deficit was nearly 6%.[6] A municipality's tax revenue (mostly property taxes) a major share of its own revenue, although the share is

[5] https://fincomindia.nic.in/writereaddata/html_en_files/fincom15/StudyReports/State%20of%20Municipal%20Finances%20in%20India.pdf

[6] https://www.nipfp.org.in/media/medialibrary/2013/08/IMFR_FINAL_REPORT.pdf

declining over time. Municipalities also earn non-tax revenues from charges for various services.[7] However, given the high degree of inefficiency in the provision of such services, municipalities could increase their non-tax recoveries by 39% and reach the Jawahar Lal Nehru Urban Renewal Mission (JNURM)'s 85% coverage level threshold.[8] The increase in non-tax revenue may be possible due to one-time events like land sales; however, most of charges levied on land sale is one-time revenue, lumpy and irregular. Further, this increase in revenue of municipalities on account of land sales is not sustainable.

The question then arises: how will this DFI be sustainable in its lending since most of the investments as per national infrastructure pipeline will be in sectors dominated by government expenditures wherein cost recovery of OPEX and Establishment Charges is still a question, the CAPEX recovery being far from thought? Is the government intention only in the rerouting of funds without an adequate return on investments? Will a DFI with a private-sector nature be willing to lend to a non-commercially viable project? If not, what is the solution? Certainly, creating a DFI cannot be a panacea if we want to solve the problem. The recovery of costs is something that the government of the day must ensure for the long-term sustainability of infrastructure projects, and so is the monetary environment. For example, we can no longer afford to fund the subsidy to a huge irrigation sector at the cost of marginal taxpayers and like so in other sectors. A DFI could be an approach and not a solution to the infrastructure financing problem unless the projects are self-sustainable. There is assumption that DFIs would operate with no mismatch in their asset liability management; but due to longer duration of borrowing raised by them, their cost of borrowing could rise. This would hit both ways, leading to lower profits to shareholders and cost of projects turning high or both. As DFIs are expected to fund projects on a large scale, this issue of lower profits or higher project costs can be significant and should not be ignored.

While talking of asset liability management risk, we mostly think of the maturity mismatch. But movement in interest rates heavily influence the real (as against contractual) maturity of a loan. Despite there being clauses for interest rate reset in most of the infrastructure projects, the benefit does not accrue equally between borrower and lender. While the borrowers get the benefit of lower interest rates, the increase in the rate is not easy to pass on to a borrower.

The public sector banks have under-priced the credit risk for infrastructure projects mainly on account of misaligned incentives and weak credit assessment mostly due to 'project finance' nature of infrastructure projects. Private sector lenders also under-priced the risk because of competition from the public sector banks.

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[7] Such services include water supply, sanitation and solid waste management, drainage and sewerage, slaughterhouses, marketplaces, etc.

[8] https://www.nipfp.org.in/media/medialibrary/2013/08/IMFR_FINAL_REPORT.pdf

Till 2004-2012, when the economy and the loan books kept growing fast, the negative effects of the mispricing of the risk was not visible. However, post global slowdown of 2008, the lenders became exposed to accumulated credit losses due to default in projects on account of falling revenues as compared to projected ones (for example, Delhi Airport Metro which failed merely due to lower passenger revenue being realised than was hyped), and increasing costs besides wilful mistakes being discovered like leakages of toll revenues in highways projects on

Build Operate Transfer (BOT) basis, poor project and debt structuring by banks without adequate guarantee or collateral. The result is a vast amount of infrastructure loans turned into non-performing assets as seen in paragraphs above.

To summarise, the setting up of DFIs is not the only way to solve our problem of project finance. It would effectively put the onus of financing on the government. The real problems of our financing sector are related to governance, contract adherence, project feasibility and risk management at both the macro and micro levels. The government needs to recognize project sustainability in longer run with full cost recovery as only option besides developing adequate framework of regulation, incentive and risk management.

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