Infrastructure Financing: The Way Forward

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The global economy is going through turbulent times with the protracted war in East Europe and evolving geopolitical situation showing no signs of abatement. Thus, expectations of a recession in Europe and the USA are gathering momentum. At the same time, the zero Covid-19 policy in China, sharp spike in commodity prices and consequent monetary tightening by the US Fed is putting the global economy at risk. The global headwinds are impacting the countries across the world and India may not remain unscathed. In such a situation, creation of adequate and affordable infrastructure is critical to pump-prime the economy, rejuvenate demand and stimulate growth.

India's intensive infrastructure requirements, needed to bring dynamism to our development journey, are well known. Indeed, infrastructure development is considered as a prerequisite for realising our vision of reaching the milestone of US$5 trillion GDP by 2025 due to the multiplier effect it would have across sectors such as steel, cement, auto, real estate among others.

The country has currently succeeded in raising infrastructure spending to boost the growth drivers in the country. But this is not sufficient given the developmental priorities of the country. According to Economic Survey 2021-22, India needs to spend about US$1.4 trillion in infrastructure over this period to realize the vision of emerging as a US$ 5 trillion economy by FY25. Yet scaling up investment in the sector remains a challenge with demand for funds far exceeding supply. In fact, according to some estimates, India's infrastructure financing gap exceeds 5 per cent of GDP. The question is: What can be done to cover this huge infrastructure financing gap?

Unlike other emerging markets, India has relied primarily on the government budget for financing infrastructure projects, with nearly 70 per cent of funding coming from the government budget. This is followed by banks and NBFCs. Other sources of financing, such as, external commercial borrowings (ECBs), equity, FDI and insurance companies comprise a miniscule proportion of total infrastructure investment.

In view of the paucity of avenues for financing infrastructure investment, the government has recently stepped-up budgetary allocation to fund infrastructure investment. This has led to the allocation of Rs. 111 lakh crore (US$1.4 trillion), under the National Infrastructure Pipeline (NIP) in December 2019 for a five-year period between FY2019 and FY2025, covering diverse projects in roads, rail, ports, airports, power among others. The pipeline anticipates 80 per cent investment by the government and government entities and 20 per cent by the private developers.

Nevertheless, recognising that the fund allocation made under NIP is inadequate, other means for raising capital to finance the National Infrastructure Pipeline become inevitable. The government has proposed three ways to do this in the Budget 2021-22. These include the creation of institutional structures such as setting up the National Bank for Financing Infrastructure and Development for long term funding; National Monetisation Pipeline for monetising unused and underutilized assets and increasing the share of capital expenditure in Central and State budgets.

So far, the government has been taken a vanguard position for funding its infrastructure push, despite the limited fiscal space and the stretched nature of finances. Public investment in infrastructure would have a high spill-over impact on the economy and would crowd-in private investment. Already, there are early signs of private sector investing in infrastructure projects, especially in the roads and power sectors. This contribution would be scaled up to other sectors such as ports, railways, water and sanitation, coal, mines, etc as economic conditions improve. The government is also encouraging the private investor to participate by creating a pipeline of operating assets which would remove some of the riskier elements of investing in large projects.

At the same time, infrastructure projects in India are also attractive for global institutional investors due to high returns on investment and the steady revenue stream generated by such projects. Hence, the government is creating a framework where foreign institutional investors can participate in a wide range of sectors. The infrastructure investment trusts or InvITs have also gained traction in recent years for monetizing operational projects and freeing up capital for new projects.

While the government has done much to ease the funding constraints, more needs to be done to strengthen the regulatory ecosystem to encourage the private sector to invest. A credible and predictable regulatory and institutional regime, faster clearances, transparent bidding process, creating a level playing field, an effective dispute settlement mechanism for honouring contracts and a conducive tax regime should be paramount. In fact, a plug and play mechanism is needed whereby projects are awarded to the private sector only after securing key sovereign clearances, including land acquisition and removal of utilities, before issuing tenders for construction.

The government should also explore the possibility of establishing a 100% government-owned special purpose vehicle (SPV) for promoting PPPs. The SPV would be mandated to secure permissions, land acquisitions, and all other sovereign functions. The shares can subsequently be sold to the highest bidder who will be responsible for the future functions such as construction, etc. This should apply especially to big infrastructure projects such as power plants, airports and roads. This will not only help to mitigate risk and uncertainty associated with the project but would also help avoid project delays and cost over-runs.

Presently, the subdued demand conditions in the economy accruing from global factors dissuade the private sector from committing their resources in risky projects like infrastructure in a big way. Hence, the only option is that the government should continue using the EPC (Engineering, Procurement, and construction) model. However, the National Infrastructure Pipeline has started drawing the interest of the private sector. Besides, the twinning policy of the national infrastructure pipeline and the national monetisation pipeline, will eliminate the risk for the private players. Hence, there is a need for creating new and diverse avenues for raising funds by the private sector, going forward. Some such options are enumerated below.

Firstly, an active debt market for effective participation of institutional investors such as pension funds and insurance companies should be encouraged for providing long- term capital for funding infrastructure projects. This would help avoid asset-liability mismatches and risk of default as is the case with bank finance. However, the existing investment guidelines for insurance and pension funds limit the exposure of such funds to InvIT/real estate investment trust (REIT) assets. This would call for streamlining the limits for investment by insurance and pension funds in infrastructure investment trusts (InvITs) to promote active participation by investors to fund infrastructure projects, as suggested by NITI Aayog.

Besides, the issue of the Insurance Regulatory and Development Authority of India regulations not permitting investment of insurance funds in unlisted InvITs should be addressed. Pension Fund Regulatory and Development Authority (PFRDA) and Ministry of Labour and Employment via Employee Provident Fund Organization (EPFO) should consider routing a larger portion of the long term funds available to them under Pensions funds and EPFO towards either investing directly into long term infrastructure projects or use investment vehicles like InvITs and REITs. This could be done by implementing the NITI Aayog's suggestion of following a staggered approach for streamlining of investment guidelines and limits to keep pace with the growth in the InvIT market, starting with the allocation of insurance and pension funds towards unlisted InvITs,.

Secondly, infrastructure / corporate bond market, which is eminently suited to help infrastructure companies to raise resources, suffers from inadequate depth due to a variety of factors like regulations limiting investments from pension funds / insurance companies to instruments with a rating of AA or above etc. This in turn impacts the ability of infrastructure companies to raise resources. The deepening of corporate bond markets (including infrastructure bonds) should be contemplated through increase in tri-party repo transactions with AA rated bonds being accepted as collateral and increasing user friendliness of corporate bond trading platform.

Third, FPIs should be allowed to transfer their investments in IDF-NBFCs to domestic investors during the lock-in period thereby increasing the attractiveness of these instruments to FPIs.

Fourthly, the Budget 2019-20 had announced the setting up of the Credit Guarantee Enhancement Corporation as an NBFC for mobilising funds for infrastructure development. The fund is envisaged to provide guarantee to bonds issued by completed projects. The fund would be set up to increase sources of capital for infrastructure financing including that of the Rs. 111 lakh crore NIP and would help in augmenting the current credit guarantee facility offered by the NIIF-ADB combine, which is not adequate viz. a viz. the financing requirement. It is suggested that the Corporation should be operationalized in line with the guidelines notified by RBI.

Finally, developing Municipal Bond Market for financing Urban Infrastructure is also of critical importance in the context of rapid urbanization. Absence of the secondary market for municipal bonds, problems relating to rating of bonds, accounting practices followed by the municipal bodies, adequacy of user charges for generating cash flows for servicing of bonds, availability of escrow mechanism are some of the issues which require to be addressed to encourage investments.

In fact, the government has recently announced the setting up of the Infrastructure Finance Secretariat to rework the existing PPP policy and provide an impetus to private investment in infrastructure and also work on various infra-financing issues like deepening municipal bond markets, REITs and InvITs, dispute settlement etc. This should be made functional soon.

To conclude, a continued thrust on infrastructure spending will rekindle fresh investment, facilitate ease of doing business, improve the quality of life and give a boost to inclusive growth. Hence, development of a viable options for financing infrastructure development should be considered as an important element in the macro-financial policy toolkit for promoting growth.