Financing of Large Infrastructure Projects

For Prelims: **Reserve Bank of India (RBI)**, **provisioning**, **fiscal deficits**, **Public-Private Partnerships (PPP)**, **CARE Ratings**, **corporate bond market**

For Mains: **National Infrastructure Pipeline (NIP)**, **National Bank for Financing Infrastructure and Development (NaBFID)**, **National Investment and Infrastructure Fund (NIIF)**, Financing issues faced by the large infrastructure projects in India.

Source: TH

Why in News?

Recently, the **Reserve Bank of India (RBI)** has proposed a new framework to improve the regulation of financing for **long-term projects** in infrastructure, non-infrastructure, and commercial **real estate sectors**.

- This is in response to the challenges these projects often face, such as delays and cost overruns.

What are the Key Provisions Proposed by RBI for Project Financing?

- **Mitigating Credit Events: The framework prioritises preventing credit events such as loan defaults, extensions of the project's commercial operation start date (DCCO), additional debt requirements, or a decrease in the project's Net Present Value (NPV).**

- **Increased Provisioning:** To build a buffer against potential losses, the framework proposes a significant increase in provisioning (setting aside funds) by banks.

- **Provisioning** is raised from the **existing 0.4% to 5%** of the loan amount during the **construction stage** (before the project launch).
  - The 5% provisioning will be implemented gradually with 2% in FY25, 3.5% in FY26, and reaching 5% by FY27.
  - The additional provisioning requirements are estimated to be 0.5-3% of banks' net worth and could impact the **CET1 (Common Equity Tier 1)** ratio.
- **Reduced Provisioning During Operations: If a project demonstrates a positive net operating cash flow (enough income to cover repayments) and reduces its total debt by 20% after starting commercial operations, provisioning can be lowered.**

- **Potential Impacts of the Proposed Framework:**

- **Impact on banks:**
  - Higher provisioning requirements **could impact bank profitability** in the short term. Additionally, loan pricing might increase slightly to reflect the perceived higher risk.

    - **State-owned banks** are cautiously optimistic, suggesting the impact on pricing might be moderate.
- **Impact on borrowers:**
    - Borrowers might face **stricter financing terms** and potentially higher interest rates. However, the framework aims to improve project viability and reduce overall risk in the long run.
    - **Rating agencies** predict a potential rise in funding costs by 20-40 basis points.

Classification of Bank Capital

- According to **Basel-III norms** banks' regulatory **capital** is divided into **Tier 1 and Tier 2,** while Tier 1 is subdivided into **Common Equity Tier-1 (CET-1) and Additional Tier-1** (AT-1) capital.
    - **Common Equity Tier 1** capital includes **equity instruments** where returns are linked to the banks' performance and therefore the **performance of the share price**. They have **no maturity.**
    - **Additional Tier-1 capital** are perpetual bonds that carry a **fixed coupon payable** annually from past or present profits of the bank. They have **no maturity**, and their dividends can be cancelled at any time.
- **Tier 2 capital** consists of **unsecured subordinated debt** with an **original maturity** of at **least five years**.

Provisioning Coverage Ratio (PCR)

- Under provisioning, **banks have to set aside or provide funds** to a prescribed **percentage of their bad assets.**
- It is essentially the **ratio of provisioning to gross non-performing assets** and indicates the extent of funds a bank has kept aside to cover loan losses.

What are the Financing Issues Faced by the Large Infrastructure Projects in India?

- **Fiscal Burden on Government: Traditionally, the government has been the primary source of funding for** infrastructure projects**, leading to high** fiscal deficits**. This limits spending on other social programs like education and** healthcare**.**
    - In 2022, the government's infrastructure spending was around 3.3% of **GDP**, a positive step but still below the desired level.
- **Asset-Liability Mismatch of Commercial Banks: Commercial banks, a key source of infrastructure financing, prioritise short-term loans with quicker returns. Long-term infrastructure projects with slow returns become less attractive.**
    - Many infrastructure projects **experience delays and cost overruns**, leading to **financial stress for banks** that provide loans. This discourages further lending for large projects.
- **Subdued Investments in** Public-Private Partnerships (PPP) **Projects: Private sector participation through PPPs hasn't met expectations. Uncertain regulatory environment, complex project structures, and land acquisition issues deter private investors.**
    - A **2023 report** by **CARE Ratings**, an Indian credit rating agency, states that private sector investment in infrastructure projects has been around **5% of the total requirement**.
- **Inefficient and Underdeveloped Corporate Bond Market: India's** corporate bond market**, a potential source of long-term financing for infrastructure, is still relatively small and lacks liquidity. This makes it difficult for infrastructure companies to raise funds through bond issuance.**
    - In 2023, the size of **India's corporate bond market** was approximately **USD1.8 trillion**, which is significant but still smaller compared to developed economies like the US at **USD51 trillion**.
- **Investment Obligations of Insurance and Pension Funds: Regulations often require insurance and pension funds to invest a significant portion of their funds in** government

securities. **This limits their ability to invest in riskier infrastructure projects, which could offer higher returns.**
    - According to the **World Bank,** only around 2% of Indian pension funds' assets are invested in **infrastructure projects**, compared to a global average of 5-10%.

What are the Government initiatives Related to Financing Large Infrastructure Projects in India?

- National Infrastructure Pipeline (NIP)

- **National Bank for Financing Infrastructure and Development (NaBFID)**

- National Investment and Infrastructure Fund (NIIF)

- Infrastructure Investment Trusts (InvITs) and Real Estate Investment Trusts (REITs)

- **Public-Private Partnerships (PPP) Model Reforms:** The government measures like **reducing legal complexities, simplifying the approval process** and streamlining dispute resolution processes.

    - **Example:** The Ministry of Finance has established a **dedicated PPP cell** and **model concession agreements** to **address the concerns of private investors** and facilitate faster project clearances.
- **Sovereign Wealth Funds (SWFs):**
    - The Indian government is actively engaging with **countries like UAE, Norway** etc. **with large SWFs** to facilitate their investment in Indian market.
        - SWFs can provide a stable source of long-term funding for infrastructure projects and help mitigate the risk burden on the government's budget.

What Measures can be taken to Improve Financing of Large Infrastructure Projects in India?

- **Enhancing Project Preparation and Risk Mitigation: Conducting extensive feasibility studies that accurately assess project viability, costs, and potential risks is crucial to attracting investors.**
    - Ensuring a fair and transparent risk allocation framework that balances the interests of both the public and private sectors.
- **Attract Private Sector Participation:** The government can **provide grants or subsidies** to bridge the gap between project costs and what private investors are willing to pay **(Viability Gap Funding),** making projects more attractive.
- **Diversifying Funding Sources:** Encouraging the creation of more **Infrastructure Investment Trusts (InvITs) and Real Estate Investment Trusts (REITs)** to attract investments from pension funds, insurance companies, and other institutional investors.
    - Creating a sovereign wealth fund in India to leverage the country's foreign exchange reserves for long-term infrastructure financing.
- **Streamline Approvals and Clearances:** Streamlining **land acquisition procedures** to ensure timely availability of land for project development, a major bottleneck currently.
    - Developing a more efficient system for environmental impact assessments and clearances, balancing environmental protection with project timelines.
- **Improve Project Execution and Efficiency:** Encourage the use of new technologies like **prefabrication** and **modular construction** to improve project efficiency and reduce costs.
    - Implementing stricter performance monitoring and accountability measures to ensure the timely completion of large projects and avoid cost overruns.

Drishti Mains Question:

Q. Discuss the key issues related to the financing of large infrastructure projects in India. What government initiatives have been taken to ease facilitation of large infrastructure projects in India.

UPSC Civil Services Examination, Previous Year Questions (PYQs)

Prelims

Q. Which of the following statements is/are correct regarding the Monetary Policy Committee (MPC)? (2017)

1. It decides the RBI's benchmark interest rates.
2. It is a 12-member body including the Governor of RBI and is reconstituted every year.
3. It functions under the chairmanship of the Union Finance Minister.

Select the correct answer using the code given below:

(a) 1 only

(b) 1 and 2 only

(c) 3 only

(d) 2 and 3 only

Ans: A

Q. If the RBI decides to adopt an expansionist monetary policy, which of the following would it not do? (2020)

1. Cut and optimize the Statutory Liquidity Ratio
2. Increase the Marginal Standing Facility Rate
3. Cut the Bank Rate and Repo Rate

Select the correct answer using the code given below:

(a) 1 and 2 only

(b) 2 only

(c) 1 and 3 only

(d) 1, 2 and 3

Ans: B

Mains

Q. The product diversification of financial institutions and insurance companies, resulting in overlapping of products and services strengthens the case for the merger of the two regulatory agencies, namely SEBI and IRDA. Justify. **(2013)**