# Innovative Financing:
## The Case of India Infrastructure Finance Company

by Anna Roy

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OVERALL WINNER

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1818 H Street, NW
Washington, DC 20433
www.ppiaf.org
E-mail: ppiaf@ppiaf.org

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Cover photo: Lakshman Nadaraja/World Bank

# Innovative Financing

## *The case of India Infrastructure Finance Company*

*-Anna Roy*[*]

This case study has been written for the international short story competition organised by World Bank Group, as part of a larger effort to promote Public Private Partnership in pursuit of poverty alleviation and inclusive growth, especially in developing countries.

*India needs large investments in infrastructure for accelerating inclusive growth aimed at poverty alleviation and improvement in quality of life. Given the fiscal constraints that leave little room for expanding public investment at the scale required, Public Private Partnership (PPP) has emerged as the principal vehicle for attracting private investment in infrastructure. However, much of the private capital required for PPP projects has to be raised from domestic financial institutions that do not have the capacity or instruments to provide long-tenure debt for projects having a long payback period. While financial sector reform is a long-drawn process, this essay demonstrates how a well-designed intervention can help in bypassing the extant constraints without compromising on the integrity and prudence associated with debt financing. By setting up a government-owned financial institution with a mandate to provide about 30 per cent of the project debt, a large volume of long-term debt was mobilised while leaving the remaining 70 per cent to be financed by the normal banking system. This was perhaps, a first-of-its-kind financial institution which not only lent long-term funds, but also gave a strong signal to the banking system to participate proactively in the financing of infrastructure projects. As a result, private investments aggregating about US$ 114 billion have been facilitated without any dilution in the prudential norms of banking. This essay explains the evolution and success of this initiative.*

### Infrastructure deficit

1. Until recently, India's infrastructure was widely regarded as inadequate and inefficient. The power sector suffered from a peaking deficit of 14 per cent and an energy shortage of 11 per cent. Only 17 per cent of the total length of 70,548 km comprising the National Highways network was of four-lane standards, with 53 per cent being two-lane and the remaining 17 per

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[*] The author is currently a Joint Secretary in the Department of Financial Services, Government of India. The views expressed in this paper are personal and do not necessarily represent the views of the Government of India. For reviewing this paper and for providing useful insights, the author gratefully acknowledges Mr. Gajendra Haldea, who had authored this innovative financing mechanism and was instrumental in its adoption.

cent being single lane highways. Railways were plagued with old technology, saturated routes, low payload to Tare ratio of 2.5 and slow average speed of 22 kmph for freight and 50 kmph for passenger trains. A similar situation prevailed in other sectors like ports and airports where congestion and inefficiency were all-pervasive.

2. For several decades prior to the 1990s, India experienced a low and stable growth rate of 3 to 4 per cent per annum, famously termed as the Hindu rate of growth. Following the economic liberalisation coupled with dismantling of the licensing regime in the early 1990s, the economy recorded a high trajectory of growth ranging between 7 to 9 per cent throughout the decade of 1990. With this acceleration in growth rate, the pressures on a deficient infrastructure increased manifold, especially since the growth story of the 1990s was largely led by the manufacturing and services sectors while infrastructure development proceeded at a slower pace. As a result, infrastructure came to be regarded as a major constraint in sustaining the growth process and in attracting investment or doing business in India.

3. In the past, infrastructure projects were typically financed from the limited resources of the public sector, which was characterised by inadequate capacity addition and poor quality of service. Following the economic liberalisation of the 1990s, private investment began to flow in infrastructure with mobile telephony taking the lead. In power generation, private investment was initially aided by various forms of government guarantees, which were soon discarded as they came to be viewed as an unsustainable form of support for private sector projects. Other sectors, such as highways, railways, airports and ports witnessed piecemeal attempts at reforms which led to marginal outcomes.

4. Initial reforms predictably failed to mobilise private investment at the scale envisaged. The total investment in infrastructure during the Tenth Five Year Plan (2002-07) was thus limited to about US$ 240 billion, of which only 22 per cent came from private investment. Moreover, the total investment in infrastructure constituted only about 5 per cent of GDP, as compared to 9-11 per cent witnessed in the East Asian economies. As a result, there was a

growing realisation of the pressing need to accelerate the flow of private capital in infrastructure.

**Paradigm shift**

5. In order to mobilise private investment at the pace and scale necessary, the Government initiated concerted measures to create an enabling policy and regulatory framework for attracting private capital in infrastructure projects. A comprehensive architecture was, therefore, brought into effect for promoting Public Private Partnership (PPP) in sectors like power, highways, ports, airports and railways. The objective of this paradigm shift was to double the investment in infrastructure from about US$ 240 billion in the Tenth Five Year Plan (2002-07) to US$ 500 billion during the Eleventh Five Year Plan (2007-12), with greater emphasis on private participation.

6. The new architecture for promoting PPPs included several measures beginning from the constitution of the apex Committee on Infrastructure under the chairmanship of the Prime Minister. A streamlined mechanism for speedy appraisal and approval of PPP projects was also institutionalised. For projects which were economically justified but commercially unviable, the government introduced a scheme for providing capital grants of upto 40 per cent of project costs by way of viability gap funding.

7. A prominent feature of the PPP architecture was the adoption of model documents such as model concession agreements, model RFQ, model RFP and other bidding documents. The objective was to secure optimal sharing of risks and rewards while ensuring bankability of the projects coupled with efficient delivery of services at economic costs to be determined through a fair, transparent and competitive process of selection. It is noteworthy that in a study (Infrascope 2011) commissioned by the Asian Development Bank (ADB), the Economic Intelligence Unit (EIU) of the Economist (UK) has commended this PPP architecture while rating it among the best, by international standards.

8. The above initiatives, especially the standardisation of documents and processes, helped in a rapid roll out of PPP projects that caused India to be recognised as the largest recipient of PPP investments during 2008-12, as

reported by PPIAF. According to the data published by the erstwhile Planning Commission, the total investment in infrastructure over the Eleventh Plan period (2007-12) aggregated US$ 480 billion, which constituted 7 per cent of GDP as compared to 5 per cent during the Tenth Plan (2002-07). In particular, private investment increased from about 22 per cent of the total investment in infrastructure during 2002-07 to about 37 per cent during 2007-12, which implied a three-fold increase in absolute terms.

**Challenges of debt financing**

9. One of the main challenges in scaling up private investment was the mobilisation of debt financing for meeting the ambitious targets set by the Government. Since PPP projects are usually financed on a 30:70 ratio of equity and debt, mobilisation of the requisite debt resources seemed a herculean task. Moreover, infrastructure projects typically bear a long period of gestation, which needs to be supported by debt of a longer tenure. Inadequate availability of long-term debt from domestic financial institutions, therefore, posed an added challenge for sustainable financing of PPP projects.

10. Unlike the developed world where long-term debt can be mobilised from the capital markets, the bond market in India did not present such an option as it was characterised by lack of liquidity and depth. Listed corporate debt formed only 2 per cent of GDP, which was significantly lower as compared to other emerging economies, such as Malaysia, Korea and China. Further, quasi-government entities like banks, public sector oil companies and government sponsored financial institutions have remained the principal issuers in the corporate debt market, leaving virtually no appetite for new infrastructure projects that are perceived as risk-prone. As a result, there was little possibility of relying on the bond market for financing infrastructure projects.

11. Insurance and pension funds, which are also a source of long-tenure debt in the developed economies, offered a limited window in India, primarily due to various regulatory requirements associated with risk mitigation. As a result, these funds were not available for the Special Purpose Vehicles typically used for implementing infrastructure projects. Moreover,

insurance and pension funds in India were heavily invested in government securities which were difficult to displace.

12. Foreign debt, a comparatively cheaper option as compared to domestic borrowings, provided a limited elbow room for infrastructure companies, given the limits imposed by the Central Bank on external commercial borrowings with a view to preventing excessive capital inflows in order to maintain macro-economic stability.

13. In the above scenario, commercial banks and non-banking financial institutions became the principal source of debt funds for infrastructure projects. However, the banks faced their own constraints arising from the nature of their asset base, which primarily consists of short to medium term deposits. This implied a potential asset-liability mismatch in lending for the long term. Moreover, banks also lacked the experience and capacity to undertake limited recourse financing of infrastructure projects that typically do not provide much collateral security. Since the security for such debt primarily comprises the expected revenue streams of the respective projects, commercial banks were unlikely to show much appetite for such lending.

14. Given the various constraints, there was an urgent need to evolve and introduce an intervention that would enable mobilisation of long-term debt for PPP projects in different infrastructure sectors. Government intervention had also become necessary since the available sources of finance offered a limited scope for expansion. Without such an initiative, there was every possibility of a significant shortfall in the projected investment for infrastructure.

**Innovative financing vehicle**

15. To kick-start the process of private participation in infrastructure, the Government decided to create a new financing vehicle that would overcome the extant constraints. This new vehicle was meant to address the various regulatory and other restrictions; raise long-tenure funds from the market at economic costs and on the scale required; and on-lend to PPP projects while keeping the intermediation costs at the bare minimum.

16. In order to meet the above challenges, it was necessary to address several issues. Firstly, for mobilising funds on such a large scale, the proposed institution would have required a substantial contribution of equity, especially as the new entity would not have any net-worth of its own. Secondly, security of the on-lent debt had to be ensured through some form of a back-to-back arrangement that carried government support. Thirdly, the new entity had to be enabled to tap into insurance and pension funds besides raising external debt, including from multilateral development banks like the World Bank and the Asian Development Bank.

17. Thus an innovative vehicle, fully owned by the Government, was created with a mandate to provide long-term debt to PPP projects. It was called the India Infrastructure Finance Company Limited (IIFCL) and incorporated in 2006 as a non-banking finance company. To ensure that IIFCL delivered on its mandate, a detailed framework was set out to guide its functioning in mobilisation of resources, selection of projects, mode of lending and the approval processes.

18. IIFCL was allowed to raise funds from domestic and overseas markets on the strength of sovereign guarantees. This helped to keep the borrowing costs low. Moreover, such borrowings did not have to meet the net-worth and equity requirements as their repayment was backed by a sovereign guarantee. This arrangement was similar to the one followed by the World Bank which raises market borrowings on the strength of callable capital from its shareholders, without actual subscription of such capital.

19. IIFCL was tasked to provide financial assistance through multiple modes, viz. debt financing, subordinate debt and refinancing. Further, the exposure of IIFCL in any project was limited to 20 per cent of the project costs, which translated to about 30 per cent of project debt, assuming a debt equity ratio of 70:30. The guidelines also provided that upto one-half of IIFCL lending could be in the form of subordinated debt, which could serve as quasi-equity.

20. PPP projects in India typically carry a compulsory buy-back arrangement which requires the Government to take over a project in the

event of termination, primarily because such projects cannot be abandoned due to the public service that they provide. The buy-back arrangement requires the Government to repay the lenders, which in turn implied that lending by IIFCL would be secure.

21. In order to keep the intermediation costs low, IIFCL was visualised as a lean organisation. Therefore, all lending by IIFCL was to be undertaken through a consortium of lenders. Since 70 per cent of the debt was to be provided by commercial banks, the task of project appraisal and risk assessment was left to the banks while IIFCL lending was based on the premise that the principal lenders, especially the lead bank, would undertake the requisite due diligence. This allowed IIFCL to remain a lean institution with a clear focus and low costs.

22. Since many infrastructure projects required substantial imports, especially in case of power generation projects, IIFCL incorporated a subsidiary at London in 2008, to be known as IIFC (UK) Ltd in order to provide foreign currency loans to Indian infrastructure projects that were privately financed.

23. An important aspect of IIFCL lending was the longer tenure of its loans, which helped in extending the average maturity of the project debt and also encouraged the commercial banks to follow suit. Thus, IIFCL has become an important instrument in extending the average tenure of debt for infrastructure projects, making them more bankable and financially viable.

**Robust outcomes**

24. Upto March 2015, IIFCL has raised about US$ 6.5 billion from the domestic markets through a mix of instruments comprising taxable bonds, tax-free bonds and long-term loans from Life Insurance Corporation and National Small Savings Fund. It has also established a strong relationship with bilateral and multilateral institutions like ADB, World Bank and KfW who have committed lines of long-term credit to the extent of US$ 1.9 billion, US$ 195 million and Euro 50 million respectively. IIFCL has also entered into an agreement with the European Investment Bank for a loan of Euro 200 million.

25. Upto March 2015, IIFCL had approved 342 projects that would mobilise private investment of US$ 110 billion, of which IIFCL share would be about US$ 12 billion. It has so far disbursed US$ 7.6 billion to the aforesaid projects. A major chunk of loans has been sanctioned for the road sector (47 per cent), followed by the power sector (40 per cent). Till March 2015, IIFC (UK) has accorded cumulative sanctions of US$ 3.5 billion, of which disbursements of about US$ 1.4 billion have since been made.

26. IIFCL has so far contributed to the development of more than 19,000 Km of highways, creation of generating capacity of more than 40,000 MW of power, addition of about 50 million tons of port capacity, development of several urban infrastructure projects, including metro rail projects, and the development of Delhi and Mumbai International Airports which handle bulk of the air traffic in the country, besides several other projects.

27. The above initiatives have also spurred a rapid growth in infrastructure lending by banks, which increased from a level of about US$ 1.4 billion in 2000 to about US$ 173 billion in 2013, accounting for about 13 per cent of the total lending by banks in India. The term loans extended by banks also constituted more than half of the debt financing for infrastructure sector. It is noteworthy that during this period, bank loans for infrastructure projects grew at a compound annual grown rate of about 40 per cent.

**Learnings from the initiative**

28. The success of this initiative has demonstrated how an innovative arrangement helped in leveraging limited public resources for providing the much needed long-tenure debt for PPP projects on an unprecedented scale and at economic costs. IIFCL was perhaps, the first-of-its-kind Government-owned institution which borrowed extensively from the market without exposing the public exchequer to unmanageable risks. The guarantee exposure of the Government was strictly confined to the limits specified under the Fiscal Responsibility and Budget Management Act, 2003 while extension of sovereign guarantee for IIFCL borrowings was justified since the PPP projects it supported were meant to provide services that were hitherto provided by the Government.

29. During this entire process, the banks were encouraged to lend in a commercially prudent manner without any Government exposure or interference. Thus, the prudential norms normally applicable to lending by banks were not compromised. Yet, by combining IIFCL debt with the debt raised by project sponsors from other financial institutions, a mutually reinforcing arrangement was brought about.

30. This initiative should be regarded as a resounding success as it played a catalytic role in enabling a three-fold jump in the flow of private capital to infrastructure projects which not only helped in doubling the total investment in infrastructure between the two Five Year Plans but also increased its share in GDP from 5 per cent to 7 per cent. In effect, this initiative was one of the principal contributors to India being recognised as the highest recipient of PPP investments during the recent years.

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