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Theme 227

INFRASTRUCTURE FINANCING

PART I

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SIB STUDENTS' ECONOMIC FORUM

OCTOBER 2010

THEME 227 : INFRASTRUCTURE FINANCING- PART I

The economic advancement of a nation depends on the adequacy of infrastructure. The extent of the infrastructure and its quality determines the total factor productivity and the aggregate output of goods and services in the economy. Both physical and social infrastructures are required for producing more of goods and services in the economy and also for uplifting standard of living of the population. The physical infrastructure by way of basic services like roads, transportation, communications, power, roads, highways, bridges, ports, airports, rail system, water supply, irrigation, mining etc. facilitates production of capital goods and consumer goods in the economy. This directly results in the increase in gross domestic product (GDP) or the national income of the country. Social infrastructure by way of education, research and development, healthcare, housing, sanitation, entertainment facilities etc. helps in enhancement in the human welfare and human development by way of increase in standard of living of the people. Thus infrastructure provides a stable enduring platform for enhancing economic growth. The development stage of the economy can be judged by the availability of infrastructure in the system. The rapid economic advancement of the developed economies is attributed to the establishment of infrastructure in those economies and the slow pace of economic development in the less developed economies is stated to be owing to poor infrastructure facilities. The miraculous growth of the South-East Asian economies such as Japan, Hong Kong, Republic of Korea, Singapore, Thailand, Malaysia, the People's Republic of China and Taipei also vindicates that infrastructure development is essential for overall economic growth. Therefore a planned, balanced and long-term economic development necessitates creation of requisite infrastructure and this is considered to be a *sine qua non* for economic development.

What is the status of infrastructure facilities in developed and developing economies?

There exist significant demand supply gaps in availability of infrastructure

both in the developed and developing economies. In the developing economies, there is need for augmenting infra facilities due to high economic growth and burgeoning population. Thus, there is a structural deficiency in infra facilities. The developed economies face the problem of high cost of re-investment to replace or modernize the ageing infrastructure. In emerging economies such as India, China and Brazil, rapid growth and urbanization has necessitated strengthening and supplementing infrastructure services. In the developed economies, a substantial part of the existing infrastructure was built in 1960s and 1970s. These have now reached a point of their life cycle where replacement is imperative. Thus globally investments required for rebuilding and developing infrastructure are huge. However, the need for bridging infrastructure deficit in developing countries is more urgent. There are also wide divergences in infra spending by the countries. India spends just 6 percent of its GDP annually on infrastructure, whereas China spends 20 percent of GDP annually on infrastructure.

What are the distinguishing features of the infrastructure projects?

Infrastructure projects will be large in size and will require huge capital costs. Such projects have fairly longer gestation periods as the time required for completion of the project is long. The yield from the project is available only after its completion. The returns from the projects will be consistent for quite a long period. They will require extended payback periods i.e. initial and subsequent investments will be recouped over a longer period of time compared to normal types of commercial ventures. There is also high risk involved in infrastructure projects. As large amounts are invested for a longer period, many uncertainties may arise during the process of construction leading to high risk factors. Very often, the returns from the infra projects may also be low in the initial periods.

What is meant by infrastructure lending?

Infrastructure lending includes credit facilities extended by lenders such as banks, financial institutions (FIs) or non banking financial companies (NBFCs) for developing, operating and maintaining any infrastructure facility. In the past, the government was the sole financier to the infra projects in India. The government had also taken up responsibility for implementation, operation and maintenance of the projects. The amount of funds required has become too huge to be funded by budgetary allocations alone. Also fiscal prudence and

consolidation demand that there should be limits to deficit financing even for long term projects owing to the implication on inflationary tendencies in the economy. Therefore it is very much required to reach out to the private sector and private savings and other mechanisms available in the market for funding infrastructure projects. In the past, leading development financial institutions like IDBI, ICICI had a major role in funding infra projects in the country. Infra financing through issuance of long-term bonds is a viable method of attracting investment from the public and corporate segments.

What are the different forms of infrastructure finance?

There are three principal forms of financing infrastructure projects - Public finance, Corporate finance, and Project finance. Public financing consists of government providing equity financing through budgets, loans at concessional rates and issuing guarantees. Corporate finance consists of equity financing by shareholders' equity and retained earnings, and debt financing in the form of commercial bank borrowings. Project finance consists of government, corporations and public – private partnership (PPP) financing investments by way of equity or debt fully secured by the revenue stream of the infrastructure project.

What are the specialized institutions in India in the sphere of infrastructure financing?

In recent years, the government has taken initiatives to provide long term infrastructure finance through creation of Infrastructure Development Finance Corporation (IDFC) and India Infrastructure Finance Company Limited (IIFCL).

IDFC was incorporated in 1997 for promoting private participation in infrastructure financing in India. It provides finance through various instruments like debt, mezzanine and private equity investments. It also provides advisory services and plays an important role in the formulation of the infrastructure policy of the country. IDFC identifies infrastructure development projects across the country and promotes PPPs for building infrastructure.

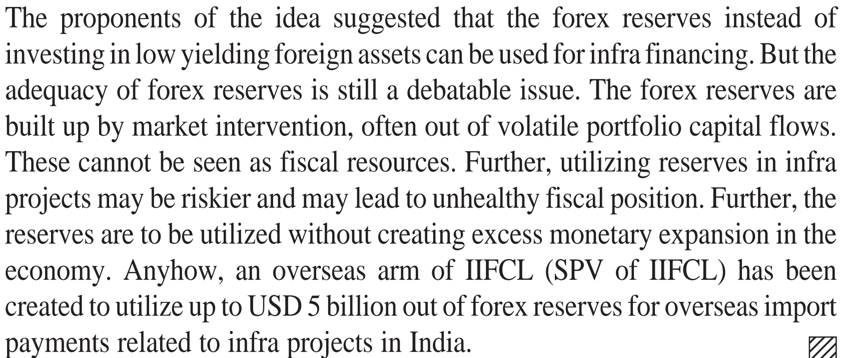
IIFCL was incorporated by the government. The sources of funds are equity, long-term debt in the open market, debt from institutions like World Bank or Asian Development Bank as well as from external commercial borrowings

(ECBs). Its borrowings are controlled and guaranteed by the Indian government. The IIFCL funds infrastructure projects by way of long-term debt, refinance to banks and financial institutions. The IIFCL accords preference to projects under PPP and in such cases, it lends directly to the project executing company.

What are the international and multilateral sources for infrastructure financing?

There are international institutions such as World Bank and ADB (Asian Development Bank) providing infra finance in developing economies. IFC (International Finance Corporation), the private sector arm of the World Bank Group, finances private sector infrastructure. The World Bank is one of the largest funding organizations for infrastructure projects in the world. India has got a good share of assistance from the World Bank. Apart from institutional funds, infrastructure projects also use External Commercial Borrowings (ECBs) to raise funds. FDI (Foreign Direct Investment) is another source for Greenfield projects. FDI norms are being liberalized in India to increase the share of foreign investment in infra sectors.

Is the proposal to utilize foreign exchange resources of India for infra financing acceptable?



The proponents of the idea suggested that the forex reserves instead of investing in low yielding foreign assets can be used for infra financing. But the adequacy of forex reserves is still a debatable issue. The forex reserves are built up by market intervention, often out of volatile portfolio capital flows. These cannot be seen as fiscal resources. Further, utilizing reserves in infra projects may be riskier and may lead to unhealthy fiscal position. Further, the reserves are to be utilized without creating excess monetary expansion in the economy. Anyhow, an overseas arm of IIFCL (SPV of IIFCL) has been created to utilize up to USD 5 billion out of forex reserves for overseas import payments related to infra projects in India.

Characteristics of Infrastructure Projects / Finance

Infrastructure projects differ significantly from other commercial projects in manufacturing and services sector.

Longer Maturity: Infrastructure finance tends to have maturities between 5 years to 40 years. This reflects length of the construction period of the infra projects as well as life-span of the underlying asset that is created. A hydro-electric power project may take some 5 years for completion of construction, but once constructed, it has a longer life-span.

Large Investment: Infrastructure projects involve huge outlay of investment as resource cost. Resources are to be mobilized from domestic and foreign centers.

Higher Risks: Since larger amounts are invested for longer durations, underlying risks are also quite high, such as demand uncertainty, environmental transformations, technological obsolescence and also uncertainties relating to political and policy matters.

Fixed and Low Returns: Higher pricing of infra services and facilities will have inflationary impact in the economy. Therefore higher rate of return from the investment for short-term periods cannot be expected. Very often, due to general price increase, the real returns could be fixed or low for longer periods.

The main theme of the 11th Five Year Plan (2007-08 to 2011-12) is development of infrastructure in India with a proposed investment of INR 20,56,150 crore (at 2006-07 prices) to be shared between the centre, states and the private sector in the ratio of 37.3: 32.6 : 30.1 percentages respectively. It is projected that the investment requirements for infrastructure during the Twelfth Plan (2012-13 to 2017-18) will be to the extent of INR 50,00,000 Crore. (USD 1 trillion)

Your comments and feedback on this publication may be sent to Staff Training College, The South Indian Bank Ltd., Thrissur 680 001 or by E.mail: ho2099@sib.co.in

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