Rajeshwar Rao: Managing the challenges in financing infrastructure - the road ahead for NaBFID

Keynote address by Mr Rajeshwar Rao, Deputy Governor of the Reserve Bank of India, at the Infrastructure Conclave, organised by the National Bank for Financing Infrastructure and Development (NaBFID), Mumbai, 12 September 2024.

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Distinguished guests, ladies, and gentlemen,

It is a pleasure to be here today at 'NaBFID's Infrastructure Conclave' which provides an excellent opportunity to interact with the participants who play a critical role in India's infrastructural journey.

Infrastructure can be thought of as the framework of facilities and systems that enables an economy to function efficiently that can then make possible optimal outcomes for the society at large. It is, therefore, a critical catalyst in fuelling a country's economic expansion and holistic development. It lays the foundation for a prosperous and equitable society by enhancing productivity, attracting investment, expanding markets, and improving quality of life. India is the fastest growing major economy in the world and as it embarks on an ambitious journey towards emerging as a global economic powerhouse, the role of solid and reliable infrastructure is becoming paramount. Recognizing this, India has made and committed substantial infrastructural investment during recent years via policy measures such as the National Infrastructure Pipeline (NIP), PM Gati Shakti National Master Plan, Bharatmala Pariyojana and Sagarmala Pariyojana. An allocation of 11.11 lakh crore for capital expenditure in the union budget this year, which is 3.4 per cent of GDP, seeks to reinforce this commitment.

Historically, public expenditure has been the cornerstone of infrastructure development in India. However, considering the limits up to which we can depend on public expenditure, the involvement of the private sector becomes crucial in funding the expansion of infrastructure, fostering industrial competitiveness, broadening access to a diverse talent base, and optimising the use of resources. It is in this context that a specialized institution like the National Bank for Financing Infrastructure and Development (NaBFID) with a specific mandate to support long term infrastructure financing in India, can play a transformative role in bridging the funding gap to catalyze participation of the private sector. Against this backdrop, let me briefly reflect on the challenges in infrastructure financing in general and the critical role that can be played by NaBFID in overcoming these challenges. I would also like to flag a few emerging issues that NaBFID should navigate to effectively deliver on its mandate.

Development Finance Institutions

Just to set the context, let me begin by sharing a brief perspective on the concept of development finance institutions (DFIs). In the immediate aftermath of the World War II, when the war-ravaged nations and newly independent countries embarked on the path of rapid industrial development, they quickly realised that the financial systems of the era were not equipped with the necessary skills in pricing and managing risks

associated with financing projects with long gestation periods. To address these shortcomings, Development Finance Institutions (DFIs) were set up across the globe by governments to cater to the requirement of financial resources for the developmental effort. These institutions enjoyed government support for underwriting their losses and had access to cheap funds from multilateral and bilateral agencies that were guaranteed by the governments. However, as the governments eventually found it difficult to support them given budgetary constraints and considerations of market efficiency, many of these DFIs were repurposed[1].

Journey of Indian DFIs

The Indian DFIs too traversed a similar path as their global counterparts. It started with the establishment of IFCI in 1948 along with an eco-system of State Finance Corporations (SFCs), followed by the establishment of other term lending and re-finance institutions such as ICICI and IDBI to support development in various sectors of the economy. By providing long-term industrial finance, these organisations played an instrumental role in stimulating capital formation and supporting investment activities within the country for over four decades. However, elevated NPAs coupled with the increased competition from commercial banks, forced DFIs to re-align their strategies. As they found their business model to be unviable, some DFIs converted to commercial banks.

Challenges in Infrastructure Financing

Financing infrastructure presents a unique set of challenges requiring specialised expertise. To begin with, there is a need to have a consensus on the definition of infrastructure itself. The Rangarajan Commission (2001)[2] identified six characteristics of infrastructure sectors: natural monopoly, high sunk costs, non-tradability of output, non-rivalness in consumption up to congestion limits, the possibility of price exclusion, and bestowing externalities on society. Some of these characteristics stem from the inherent challenges of financing the infrastructure sector rather than the nature of the infrastructure itself. High sunk costs coupled with long gestation periods further complicate the financing of infrastructure projects and lead to asset-liability mismatches. Delays in approvals, clearances, land acquisition challenges, and breaches of agreements also add to the risks of project financing and cause further issues like cost overruns.

The interdependence of infrastructure projects further complicates financing, as unlocking the true potential of an infrastructure project is often contingent upon the availability of complementary infrastructure. This interconnectedness or interdependence can convolute the financing process, as impediments or delays in one project can trigger a cascade of causal effects, impacting all interconnected projects. Consequently, the successful fruition of an infrastructure project often hinges on the availability of synergistic infrastructure, comprehensive planning, meticulous synchronization, and proficient execution. This underscores the necessity for having an integrated approach to infrastructure development, where projects are not perceived in isolation but as components of an interconnected matrix.

The long lifecycle of infrastructure projects necessitates the involvement of different financial entities specializing in various phases of the project aiding the process by refinancing, transferring, and taking over of projects between these entities. A comparatively underdeveloped financial system, and a market for raising debt for the infrastructure sector, had made the sector reliant upon banks and NBFCs for its financing needs. However, the spike in the non-performing assets in the banks in the last decade and the debt default by a systemically important NBFC engaged in infrastructure finance, reduced the appetite of these financial intermediaries towards infrastructure financing. The recent downward trajectory of Non-Performing Assets (NPAs) for banks, coupled with the enhanced resilience of Non-Banking Financial Companies (NBFCs), signifies a positive shift for the sector.

Measures by RBI to Support Infrastructure Finance

Recognizing the importance of infrastructure financing for economic development, the Reserve Bank of India (RBI) has implemented several significant measures within the framework of prudential regulations:

NBFCs[3] are permitted to exceed the specified credit exposure limit to a single borrower by an additional 5 percent, if the extra exposure is allocated to infrastructure projects.
While the banks are currently asked to ensure that promoter's contribution towards equity capital should come from their own resources and that they should not typically provide advances for purchasing shares of other companies. exceptions are made for financing the acquisition of promoters' shares in infrastructure projects.
Banks are also allowed to issue long-term infrastructure bonds to raise market funds. These funds are exempted from Priority Sector Lending requirements and are not subjected to CRR/SLR requirements.
Bank's lending to Infrastructure Investment Trust (InvITs) was permitted since 2019.
With a view to enable long term providers of funds to invest in the bonds issued for funding projects by corporates/SPVs, banks are allowed to offer Partial Credit Enhancement (PCE).
Further, banks, All India Financial Institutions (AIFI) and select NBFCs[4] can act as market makers in credit derivatives as part of RBI's efforts to put in place a market-enabling regulatory framework for the corporate bond market.

Notwithstanding the efforts taken by the Government and the regulatory framework enabled by the Reserve Bank, it is evident that more needs to be done to meet the country's infrastructure needs over the next few decades as we move on the path of aspiration to become a developed economy by 2047. Here an institution like NaBFID can, undoubtedly, play a pivotal role.

Role of NaBFID and Navigating the Challenges Ahead

National Bank for financing Infrastructure and Development or NaBFID was established to support the long-term non-recourse infrastructure financing in India including the development of the bonds and derivatives markets necessary for infrastructure financing. I would like to highlight some areas where we believe NaBFID should focus given its mandate.

Equity structure and funding

NaBFID has taken promising strides by sanctioning more than 1 lakh crore[5] by the last financial year, along with a substantial increase in the actual disbursal. The initial capital of 20,000 crore supplemented with the additional grant of 5,000 crore[6] should support loan book growth in the near term. Further, the growth in scale of large institutional investors such as life insurance companies, pension funds etc., presents an opportunity for NaBFID to secure reliable long-term funding for their financing needs, offering a 'natural fit'. Consequently, it should also strive for a strong credit rating which will help it to tap both domestic and global sources of funding in future.

It is also necessary that over the medium-term, plans for self-sustainable operations, under a business model that is not reliant on continuous government support, or regulatory dispensations would need to be in place. The dynamic nature of our times necessitates agile strategies for institutions with focus on sectors prioritized by the government, thereby complementing overall governmental efforts, while retaining the required flexibility to pivot its strategies as per the changing needs of the economy.

Governance

In this context the role of Governance is crucial. RBI has increasingly underscored the significance of governance and assurance functions within financial institutions for the long-term sustainability and growth. The role of the Board is critical in guiding the future path of the institution and attracting long term potential institutional investors. An independent, skilled, and professional management is important enabler for this. As NaBFID is still in its formative phase, the focus must be on equipping itself with the necessary resources, skills and knowledge through concerted efforts on human capital development, institutional strengthening, and adoption of best practices. As with any other entity in the financial services sector, NaBFID must particularly look to strengthening of risk management and the establishment of robust assurance systems from the outset, fostering a sound risk culture going forward.

Developing expertise and reputation in project appraisal and evaluation

While NaBFID Act provides various enabling features to attract the best talent and get the best expertise, NaBFID would need to quickly develop project appraisal expertise and establish itself as a leader setting benchmarks in the market for its project selection, appraisal and monitoring to give comfort to lenders and stakeholders.

Learning from past mistakes

The absence of a strong post-disbursal monitoring of credit utilization was perhaps a key design failure in the erstwhile DFIs which resulted in sub-optimal outcomes[7]. There is a need to learn from the past episodes and set up dedicated units tasked with the ongoing monitoring and evaluation of funded projects through comprehensive and frequent surveys and assessments, which will not only enable dynamic appraisals for subsequent disbursements but also ensure that the finance and tangible progress in

projects are in sync with each other. Furthermore, necessary mechanisms must be put in place for dealing with the liquidation & resolution of the bad assets and sufficient expertise must be built internally towards this end.

Sustainable finance as good practice

There cannot be a more pertinent time than this to stress the importance of the climate risks and the required mitigation. We are witness to the risks that are manifesting and affecting various facets of the economy. The biggest challenge faced by EMDEs, and more so India, is the availability of adequate financing for the development of technologies and requisite infrastructure to cater to the issue of climate change and build a sustainable economic system. Technology and infrastructure will be the fulcrum for driving the crusade against climate change and fostering sustainable growth in the future. Low-Carbon Climate Resilient (LCCR) infrastructure is the way ahead, and the world is looking forward to it in terms of dealing with the climate-related risks.

Specialised financing institutions like NaBFID can contribute significantly to climate finance[8] and LCCR infrastructure development in the economy by facilitating the investment of public and private funds towards these projects. Specifically, these institutions can provide access to capital through concessional and non-concessional lending, equity investment, climate-specific funds, public-private partnerships, risk-sharing instruments, specific grants and assistances, and technical assistance.

Given the need for supporting technology-enabled ecosystem across the life cycle of infrastructure projects, there is also a requirement to develop specific expertise and focus on fostering an ecosystem of sustainable finance in the country. It can specifically work towards mainstreaming the LCCR development and enable the country to meet its emission targets. It can also aid in symbiotic infrastructure development that has beneficial after-effects on mitigating climate change.

Developmental role

Let me reflect a bit on as developmental role for the NaBFID as a new age DFI. In addition to its financial objectives, NaBFID can play an important role in several crucial developmental objectives viz., bond market development and the provision of technical assistance/ consultancy services for infra projects. It can strive to become a market maker and provide adequate liquidity to the investors. Further, to ensure that the custodians of the long-term funds viz. pension and insurance funds derive comfort in lending to the infra-sector to match their long-dated liabilities, it can think of offering innovative solutions like providing partial credit enhancements through rating upgrades or providing first-loss default guarantees. It could play a critical role in facilitating loan syndication for large ticket loans and a lead role in supporting the SLMA in development of credit markets as well. As NaBFID develops its internal rating model for credit appraisal, it may also be able to offer products such as credit default swaps (CDS) which would go a long way in ushering confidence in the bond market space.

Conclusion

As Indian economy continues to grow, it is imperative that infrastructure is seen as a factor of production like labour and capital to attract necessary focus considering its

multiplier effects in capacity building, developmental outcomes, and societal well-being. While the historical challenges and lessons are instructive, I feel that NaBFID has a unique opportunity to play a transformative role in shaping India's infrastructural landscape. The journey ahead necessitates a delicate balance between financial prudence, developmental impact, and long-term vision. As a new generation DFI, NaBFID must strive to remain at the forefront for the task of driving innovation and ensuring that infrastructure development is inclusive and sustainable. I am sure during today's conclave; the delegates will have fruitful discussions on some of these issues.

I extend my best wishes for the success of the conclave.

Thank you and Namaskar.

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[1] Examples include China Development Bank (CDB), African Development Bank (AfDB), International Finance Corporation (IFC), Korea Development Bank (KDB), Brazilian National Bank for Economic and Social Development (BNDES), Development Bank of Singapore (DBS) which have shifted focus from industrial development to include private sector development, regional integration, commercial banking in their mandates.

[2] A Commission set up by the Government in January 2000 under the Chairmanship of Dr. C. Rangarajan reviewed the statistical system and the entire gamut of Official Statistics in the country. As part of report, it presented its notion of infrastructure to differentiate from other sectors. (https://www.mospi.gov.in/82-notion-infrastructure)

[3] For entities outside NBFC-UL, all NBFC (other than NBFC-IFC) have exposure limit of 25 percent of their Tier-1 Capital while NBFC-IFC can have exposure up to 30 percent of their Tier-1 Capital. For NBFC-UL, exposure is capped at 20 percent and 25 percent of its eligible capital base for NFBC (other than NBFC-IFC) and NBFC-IFC respectively.

[4] Master Direction – Reserve Bank of India (Credit Derivatives) Directions, 2022

[5] NaBFID Annual Report

[6] Source: PIB Press Release dated Feb 29, 2024 on review of NaBFID's performance by Hon. Minister of Finance.

[7] Source: EAC-PM Working Paper Series (EAC-PM-Wp/08/2022) NaBFID - A Vehicle of Infrastructure Financing: Challenges and Opportunities

[8] UNFCC (United Nations Framework Convention on Climate Change) defines climate finance as local, national, or transnational financing-drawn from public, private and alternative sources of financing-that seeks to support mitigation and adaptation actions that will address climate change.