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CONSTRUCTION FEDERATION OF INDIA

December 19, 2011

Shri Pranab Mukherjee
Union Finance Minister
Ministry of Finance
North Block
NEW DELHI-110 001.

Dear Finance Minister :

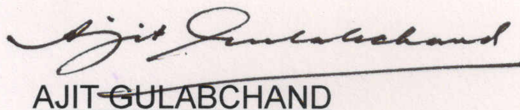
CFI Pre-Budget Memorandum 2012-2013 - "Infrastructure Finance"

On behalf of Construction Federation of India (CFI), I take this opportunity to submit a note on important issues relating to the infrastructure finance that need urgent attention in the ongoing process of formulation of the Union Budget 2012-13.

These issues have become particularly relevant in the wake of indications that there would be a substantial shortfall in the projected investments in the infrastructure sector during the XIth five year plan period. The current domestic as well as international economic scenario also necessitates a very focused effort for augmenting the fund availability if the ambitious targets being set for the XIIth plan are to be achieved.

We sincerely request that our submissions be given serious and positive consideration to help India achieve the desired growth in the Construction and Infrastructure sector.

With regards,



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Encl.: Pre-Budget Memorandum – Infrastructure Finance

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CFI PRE-BUDGET MEMORANDUM 2012-13

SECTION: INFRASTRUCTURE FINANCE

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Infrastructure Finance :

1. Market for long term debt:

CFI welcomes the steps taken by Union Government with regard to issuance of Infrastructure Bonds. This initiative needs to be further broadened and strengthened.

Suggestion:

- *The secondary debt market should be developed to a degree of breadth and depth required for funding the infrastructure projects. A developed market would lead to increased participation by insurance companies, pension funds and PFs etc. in infrastructure financing.*

- *Reserve Bank of India should be persuaded to categorize infrastructure bonds as eligible SLR investments.*

- *RBI should also be persuaded to reduce the SLR requirements and bring down the CRR requirements to the level permitted under the Banking Regulations Act for lending to infrastructure sector. This will improve the funds availability to the infrastructure sector. In the alternative, specialized institutions like IIFCL can issue instruments that can be subscribed to by Banks and this can form part of their SLR \ CRR requirements to ensure that the funding that has been raised for infrastructure development is used for this purpose to the maximum extent. This will also reduce the interest rates to be charged by the Banks as their yield on the overall lending will increase.*

- *When the Infrastructure Debt Fund is fully operational, it will also help create a secondary market for debt bonds.*

2. Norms for Insurance / Pension Funds:

At present, insurance and pension funds are mandated to invest 15% of their corpus in the infrastructure sector. The government Provident Funds invest entirely in government and approved securities. Private pension funds can invest only 5% of their corpus into equity, restricted to blue-chip stocks. Though they have access to long term funds, they do not have appraisal capability to take lead positions in funding infrastructure projects.

Suggestions:

- *The pension and insurance funds increase their risk appetite and add the lower credit rating projects to their basket.*

- *The sector is able to undertake co-financing on same lines as IIFCL (20% of project cost and on same terms as the Lead Bank).*

- *The investment by Insurance, PF and pension funds is based on minimum rating of AA+ and above. Most projects during construction and even during operations will not qualify for this kind of rating. These investment norms*

should be relaxed to make infrastructure project SPVs to avail this source of financing.

- *The investment limits and norms may be revised and redefined in discussion with regulator where applicable.*

3. **External Commercial Borrowing (ECB):**

With quite a few infrastructure projects through PPP route targeted to be awarded this year, domestic lending capacity may not be enough for the financing needs of these projects. Reforms on ECB would be critical from this perspective.

Though RBI has further liberalized the ECB policy for the infrastructure sector this year, the following suggestions may be considered:

The environmental clearances and the rehabilitation and resettlement related to land acquisition are not part of the scope of the infrastructure developers and this is a major impediment for obtaining funding from abroad. As most of the commercial banks overseas are signatories to the "equator principles," without the necessary clearances to their satisfaction, they will not be able to participate in the funding for infrastructure development. The government can certify the projects to this effect and should undertake to either convince the Banks to their satisfaction or to comply with the additional conditions that may be prescribed by the Banks to meet the requirements under the "Equator Principles."

Promoting ECB for infrastructure financing:

(i.) Removal of withholding taxes on ECB to make them competitive and to reduce overall cost of financing.
(ii.) Banks/ FI's should be allowed to provide guarantees to cover ECBs.
(iii.) 20 years benchmark
(iv.) Refinancing through ECB route for repayment of high interest loan should be permitted.

4. **IIFCL:**

(a) Limit of IIFCL Lending:

At present, IIFCL is allowed to lend up to 20% of the project cost. Also there are additional constraints/ limits for lending to projects other than PPP projects awarded under competitive framework.

Suggestion:

- *The limit of loan up to 20% of project cost may be increased to a higher level. The additional constraints/sub-limits applying to projects other than PPP awarded under competitive framework may be done away with.*

(b) Re-financing Scheme:

Suggestion:

- ***Enhance scope of refinance from IIFCL:***

The refinancing scheme of IIFCL for the road and port sectors stipulates that the tenor of refinance shall be limited to 10 years. Any extension of the tenor for the refinance facility requires an approval from the Government of India. It is proposed that the tenor of refinance may be stipulated at at least 15 years, as most of the projects in the road sector require lending for not less than 15 years. Besides, the scheme is applicable only for projects that have been bid-out after January 31, 2009. This limits the scope of refinancing projects that were awarded before January 31, 2009. The extension of scope of the refinance scheme to such projects will release the funds already disbursed by banks to existing projects for lending to forthcoming projects.

Further, banks availing the refinance scheme have to provide towards Cash Reserve Ratio and Statutory Liquidity Ratio. The refinance cost of funds from IIFCL have been stipulated as 7.85% at present and the CRR and SLR provisions increase the cost to the banks further by about 100 - 125 bps. It is proposed that refinance from IIFCL may be exempt from the CRR and SLR provisions as in the case of refinance from institutions such as NABARD, National Housing Board and Exim Bank.

5. Relaxation on Sectoral and Group Exposure Limits of Indian Banks:

Banks have an exposure limit for the Sector, individual groups and also individual entities. These limits are based on the capital of the banks and also on the prudential norms that they internally set for themselves – given the state of the economy and the sector in particular.

These limits have proved inadequate over a period of time as the funding requirements for infrastructure projects have been large and most banks have continuously been hitting their Sectoral Exposure limits as well as Group Exposure limits.

These limits have to be relaxed way beyond their current limits. Only this will enable Banks to increase their exposure to the Core sector and help them support the high capital outlay of infrastructure projects especially in the power sector.

In addition, what needs to be considered for computing exposure limits is the risk weighted capital allocation as defined by Basel norms, and not the actual capital allocated to infrastructure projects. This would be a fair representation of the Bank exposure, since risk weight allocated to an operational project would be lower than that allocated to a project under development, because of possibility of higher credit rating for operational projects having no construction risk.

6. Relaxation on Export Credit Agency requirements:

There is an Export Credit Agency in most exporting countries that provides insurance cover for political risk of the country of import and commercial risk of the transaction. Based on the backing of the ECA cover, commercial banks of exporting countries provide financing either to the Importer (Buyer's credit) or

Exporter (Supplier's credit). However, the ECA backing is generally limited to ~ 85%-90% of the value of imports, and the balance 10-15% risk is expected to be borne by the Commercial Banks of the Exporting country. Because of the reluctance of these Commercial banks to assume political and commercial risk, the ECA financing in most cases has been a non-starter.

ECA backed financing can become a reality in India if the reluctance of the external Commercial banks to assume 10-15% risk can be overcome. This would be possible if the Indian banks are permitted to provide Guarantees/ Standby Letter of Credit to external Commercial banks to cover this 10-15% risk. However, the ECB guidelines, as it exists today does not permit issuance of guarantee, standby letter of credit, letter of undertaking or letter of comfort by banks, Financial Institutions and Non-Banking Financial Companies (Nifco's) from India relating to ECB. It is, therefore suggested that this prohibitive provision be done away, especially for infrastructure projects so that cheaper foreign money is available to fund infra projects in India.

7. **Sector-Specific Financing Instruments:**

Government should introduce innovative financing instruments for sectors like power, roads, ports, housing etc to enhance the flow of funds to these specific sectors. Since these sectors play a vital role in creation of infrastructure developments in the country, such financial instruments/products can certainly enhance the flow of institutional funds/credit to the construction sector.

8. **Exclusive Banks for construction/infrastructure industry**:

There is a need for establishment of a Banks especially dedicated to suit the financial needs of construction and infrastructure sector which are facing dearth of adequate funds for the execution of their projects. The proposed Bank should provide flexible interest rate for the construction and infra projects and also include construction and infrastructure industry representatives in its Board. The sub-contractors who undertake a major part of the construction and infrastructure activities in the country need to be brought into the mainstream financial market.

9. **Compensation to Lenders in Concessionaire Event of Default situation during Construction:**

At present there is no compensation to the Lenders in the event of termination due to a Concessionaire Event of Default during the construction period. This acts as a dampener in infrastructure lending as Banks are left unprotected against this event. A provision in the Concession Agreement to enable protection to the Lenders upto a certain specified level or upto the amount expended may go a long way in improving the funding prospects for the infrastructure projects. Even in such an event, the authority is getting an asset on which the Lenders' money has been utilized and it will not be fair to assume that they have "zero" value.

10. **Uniform stamp duty on documentation for infrastructure financing:** At present, the stamp duty varies between States and a nominal and uniform stamp duty in the documentation for infrastructure financing will remove the complexities involved.

11. **Different bench mark Base Rate :**

    The base rate should be different for long term infrastructure financing as they are not affected by the short term volatility in the money markets and require a stable interest rate system.

12. Tax rebate for unlimited contribution on long term debt instruments for infrastructure financing and channelizing the individual long term savings through instruments, like PPF, will help in mobilizing the required resources for infrastructure financing.

13. Relaxation on fund raising from overseas for meeting working capital requirements of construction companies to meet their needs for execution of projects qualified under infrastructure financing will improve the overall funds availability and also ease the pressure on sectoral norms.