

Infrastructure Debt Funds (IDFs)

The Finance Minister of India, Mr. Pranab Mukherjee, in his budget speech for 2011-12 had announced setting up of Infrastructure Debt Funds (IDFs) in order to accelerate and enhance the flow of long term debt in infrastructure projects for funding the government's ambitious programme of infrastructure development. To attract off-shore funds into IDFs Finance Minister had also announced that withholding tax on interest payments on the borrowings by the IDFs would be reduced from 20% to 5%. Income of the IDFs has also been exempt from income tax.

For finalizing the structure of the proposed IDFs wide-scale consultations were held with potential investors, infrastructure companies and regulators and experts. The following broad structure has emerged based on these consultations.

- i. An IDF may be set up either as a Trust or a company. A trust based IDF would normally be a Mutual Fund (MF) that would issue units while a company based IDF would normally be a form of NBFC that would issue bonds;
- ii. An IDF would have to be registered in India and regulated by one of the financial regulators. A trust based IDF (MF) would be regulated by SEBI; and an IDF set up as a company (NBFC) would be regulated by RBI.
- iii. The investors would primarily be domestic and off-shore institutional investors, especially Insurance and Pension Funds who have long term resources. Banks and FIs would only be allowed to invest as sponsors of an IDF.
- iv. In case of an IDF that issues bonds, credit enhancement inherent in Public Private Partnership (PPP) projects would be available. Such IDFs would refinance PPP projects after their construction is completed and they have successfully operated for at least one year. Such projects would involve a lower level of risk and consequently a higher credit rating. Such a structure would enable flow of Insurance and Pensions funds at competitive costs in order to channelize low cost long term debt in PPP projects in infrastructure sectors such as roads, ports, airports, railways, metro rail etc.
- v. In case of IDFs that issue units, greater credit risk would be borne by the investors who will be free to seek correspondingly higher returns. MFs would be especially useful for non-PPP projects.

Infrastructure projects given their long pay-back period require long-term financing in order to be sustainable and cost effective. However, banks which have been the main resource of funding these projects are unable to provide long-term funding given their asset-liability mismatch. Moreover, banks are also approaching their exposure limits. IDFs through innovative means of credit enhancement is expected to provide long-term low-cost debt for infrastructure projects by tapping into source of savings like Insurance and Pension Funds which have hitherto played a comparatively limited role in financing infrastructure. By refinancing bank loans of existing projects the IDFs are expected to take over a fairly large volume of the existing bank debt that will release an equivalent volume for fresh lending to infrastructure projects. The IDFs will also help accelerate the evolution of a secondary market for bonds which is presently lacking in sufficient depth.

Thus the IDFs would enable sourcing of funds through alternate sources which would help in bridging the likely debt gap.

Details of the structure of the IDFs approved by the competent authority is given below.

Structure of IDF

IDF being a pass-through vehicle is easily workable if set up as a Trust. However, since a Trust cannot issue bonds or undertake credit enhancement and cannot get withholding tax benefits, an IDF would also have to be allowed as a company.

(A) IDF as a Trust:

- If set up as a Trust, an IDF would be **regulated** by SEBI.
- Any domestic entity regulated by a financial sector regulator could be the **sponsor**. The role of the sponsor will be to responsibly deploy the investor funds into viable assets and ensure highest returns for the investors and to manage all associated functions like book-keeping and maintaining a DSRA.
- It would raise resources through issue of rupee denominated **units** of minimum 5 year maturity, which would be listed in a recognized stock exchange and trade-able among equivalent (domestic vs. foreign) investors.
- It would have to **invest** minimum 90% of its assets in the debt securities of infrastructure companies or SPVs across all infrastructure sectors, projects stages and project types.
- The returns on assets of the IDF will pass through to the investors directly, less the management fee.
- The **credit risks** associated with the underlying projects will be borne by the investors and not by the IDF.
- Apart from the less risk averse off-shore institutional investors the domestic institutional investors could be the potential **investors**.
- An infrastructure debt fund scheme on the Trust route can be launched either as close-ended scheme maturing more than five years or an Interval scheme with lock-in period of five years. It would have minimum 5 investors, each holding not more than 50% of net assets of the scheme. Minimum investment would be one crore rupees with Rs.10 lakh as minimum size of the unit.

SEBI has formulated a draft chapter VI-B, which on insertion in the existing **Mutual Fund Regulations**, shall permit setting up of IDFs on this route by registered MFs as a scheme.

The Board of SEBI will announce the scheme separately after due process.

(B) IDF as a Company

- If set up as a company, an IDF would be **regulated** by RBI.
- It would be set up by one or more sponsors, including NBFCs, IFCs or banks.
- It would be allowed liberal prescription of risk-weightage (50% instead of 100%), net owned funds (minimum Tier I equity of Rs.150 crore) and exposure norms (not as a %age of net-owned funds).

- It would raise resources through issue of either rupee or dollar denominated **bonds** of minimum 5 year maturity, which would be tradeable among equivalent (domestic vs. foreign) investors.
- It would invest in debt securities of only PPP projects which have a buy out guarantee and have completed at least one year of commercial operation. Refinance by IDF would be upto 85% of the total debt covered by the concession agreement. Senior lenders would retain the remaining 15% for which they could charge a premium from the infrastructure company.
- The **credit risks** associated with the underlying projects will be borne by the IDF.
- Potential **investors** would include the more risk averse off-shore institutional investors, off-shore High Net-worth Individuals (HNIs), NRIs and domestic institutional investors.
- Credit enhancement of IDFs to AA level with the above investment restrictions is feasible.

RBI will issue Regulations for setting up of IDFs on the company route.

IDF is a novel attempt to address the issue of sourcing long term debt for infrastructure projects. The structure of IDFs would be closely reviewed for its efficacy and further refinement.