Rethinking Development Finance Institutions in India

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ABSTRACT

One of the key highlights of the Union Budget 2021 was the proposed resurgence of Development Finance Institutions (DFIs) to bolster an ailing infrastructure industry in the wake of the Covid-19 induced economic recession. The government aims to facilitate the long-term infrastructure-financing requirements via the DFIs under the National Infrastructure Pipeline, which aims to catalyze the financing and oversee completion of around 7400 projects by 2025.

India's tryst with Development Finance Institutions is far from a novice initiative, as the concept evolved post-independence to fuel indigenous industrialization that had been overtly neglected, and it was only in the latter half of the 20th century that significantly marked an end to the arduous processes of establishing specialized banking institutions for funding long-term infrastructure projects. However, a significant challenge that lies ahead is the paradigm shift in policies over the decades that has elicited the current scenario no longer conducive to a flourishing DFI-based financing model. This article aims to address the functioning of DFIs as well as highlight the regulatory concerns associated with the re-introduction of DFIs in India and stipulates pertinent measures that shall be undertaken to ensure their efficacy in meeting India's infrastructure financing requirements.

Keywords: Development Finance Institutions. Infrastructure Financing, Long-Term Infrastructure Projects, Project Financing

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Introduction

The world is slowly reeling back to normalcy following the catastrophic year that was 2020, the stakeholders in the Indian economy have once again turned to arguably its most stable sector in terms of revenue, i.e., infrastructure.[1] The Union Budget 2020-21 has laid down considerable emphasis on the infrastructure space, as the government aims to monetize its operational assets and further expand its threshold by instituting greenfield projects. An increased allocation of capital to the National Investment and Infrastructure Fund and an overall boost of additional Rs. 5.54 lakh crore chalked out to the sub-sectors such as Railways, Ports & Shipping, Roadways and Highways etc. is believed to lead the way for the infrastructure sector projects that have battled operational delays and force majeure claims due to Covid-19 induced lockdowns throughout 2020. To expedites instituted projects and to set up new ventures, the Indian government has decided to establish a Development Finance Institution (DFI) to complement the National Infrastructure Pipeline (NIP) that was instituted in 2019. The upcoming DFI will be instituted with a base capital of Rs. 20,000 crores and is anticipated to acquire a lending target of Rs. 5 lakh crores by 2024. A key objective of the DFI would be to act as a catalyst for meeting the country's long-term infrastructure financing requirements that are seemingly expanding as the nation hinges more towards rapid urbanization. The inability of banks to finance long-term projects over the years has aggravated the corporations and investors alike, and a DFI-based model is expected to fill in the void.

It is imperative to note that this will not be India's first rodeo with DFIs, and as history would suggest, the initial DFIs were phased out essentially to shift the reliance on India's capital markets to meet the financing requirements. Part-I of this article shall discuss the role of DFIs in shaping up Infrastructure Financing in a country and the issues that led to a switchover from DFI-based financing in the early 21st century, whereas Part-II deals with the regulatory obstacles that lie ahead for the upcoming DFI and suggests measures that shall be imbibed to eventually promote a pro-competitive environment between government and private sector DFIs to meet India's infrastructure-financing demands for the upcoming decades.

What are Development Finance Institutions?

DFIs was initially conceptualized as a mechanism to offset the delays in India's industrialization, and unlike other wealthier countries that inherited sovereign capital to fund development projects, India was left with inadequate capital post-independence. The urgency for establishing development institutions precisely to finance long-term infrastructure projects was further aggravated due to a lack of a free-market economy that could provide a bond-equity based market and the limited role of commercial banks to participate in financing projects that didn't guarantee shorter maturities. The riskier characteristic of financing long-term infrastructure projects is off-putting for the banks as well, since their primary customers are small to medium-ranged depositors that prefer their savings be liquidated for quicker withdrawal.

To bridge the gap of providing long-term financing options for projects, DFIs are set up by the government to finance projects affiliated to a sector or various sub-sectors. Since

[1]Tanya Thomas, *Infrastructure FY22 outlook rises to stable: India Ratings,* LIVEMINT (accessed om 06-03-2021) available at: https://www.livemint.com/industry/infrastructure/infrastructure-fy22-outlook-rises-to-stable-india-ratings-11614323702961.html

the risks associated with funding long-term infrastructure projects are higher and are prone to various conventional and non-conventional hindrances, DFIs are aided by the government for facilitating economic growth in sectors that are fraught with danger. Traditionally, DFIs or Development Banks are funded primarily through the capital markets via equity and bond offerings, annual budget and surplus capital of the RBI.[2] DFIs are generally created for financing projects since, unlike commercial banks, they offer low and stable interest rates for lending working capital and meticulously oversee the functioning of the projects they lend to under 'relationship banking'. Furthermore, Development Banks are not limited by their services to financing only and provide technical expertise, as well as project management, know-how. Unconventionally, DFIs also invest in the equity offerings of the firms they lend to, thus extending merchant banking facilities for underwriting and listing of the equity capital. Being associated with the development banks further enhances the credibility of the equities offered by the firms to the small and medium retail investors.[3]

Post-Independence, various DFIs such as Industrial Finance Corporation of India (IFCI); Industrial Development Bank of India (IDBI); National Bank for Agriculture and Rural Development (NABARD) and Industrial Credit and Investment Corporation of India (ICICI) and so on were incorporated with a majority holding of the RBI for long-term financing of projects and enabling the growth of their respective sectors. However, the role of DFIs began to curtail significantly after the 19991 LPG reforms, as public funding was incorporated for the DFIs, causing some firms to exit development banking altogether, whereas most DFIs failed to fulfil the credit requirements of small-scale sectors as they were restricted by inaccessibility to low-cost deposits.[4] The eventual transition and merger of two crucial DFIs (ICICI and IDBI) into Universal Commercial Banks marked the eventual decline of the DFI regime in India that culminated in 2011 with the merger of IDBI Home Finance and IDBI Gilts with IDBI Bank.[5]

The Past DFI Regime and Regulatory Challenges for NaBFID

An analysis of the issues persisting in the earlier DFI regime brought to light various reforms in their regulation as due to their credit creation capabilities, DFIs were bound to strict regulatory norms of the RBI. For instance, the RBI incorporated Chapter IIIB to widen its control over NBFC's[6] and to secure their stability via monitoring powers and regular inspection of FIs, as up until 1990, the existing DFIs were visibly functioning without any regulatory oversight. The subsequent reports by committees instituted for reforming the DFI regime, such as the 1st Narsimhan Committee[7] (August 1991); 2nd Narsimhan Committee[8] (April 1998), and the Khan Working Group[9] instituted in May

[2]C.P. Chandrashekhar, *Development Finance in India,* HEINRICH BÖLL STIFTUNG (accessed on 12-03-2021) available at https://in.boell.org/sites/default/files/uploads/2014/03/development_finance_in_india.pdf
[3]*Ibid*
[4]*Ibid*
[5]*About Us,* IDBI (accessed on 12-03-21) available at: https://www.idbibank.in/idbi-bank-history.asp
[6] RBI (Amendment) Act, 1997.
[7] Jayanth Verma & R Raghunathan V, *Narsimhan Committee Report – Some Further Ramifications and Suggestions*, IIM-A (accessed on 19-04-21) available at: http://www.iimahd.ernet.in/~jrvarma/papers/WP1009.pdf
[8]*Harmonising the Role and Operations of Development Financial Institutions and Banks*, Reserve Bank of India (accessed on 19-04-21) available at: https://www.rbi.org.in/scripts/PublicationsView.aspx?Id=225
[9]*Ibid*

1998, advocated for the adoption of Universal Banking in India and for transitioning of the existing DFIs into commercial banks over the years by either mergers or acquisition with their subsidiaries.

However, the Report of Working Group on DFIs[10] under the leadership of Mr. N. Sadasivan suggested multiple operational reforms to enhance the resources of long-term lending institutions, many of which have been seemingly incorporated under the establishment of the upcoming NaBFID. The Working Group primarily suggested that Banks shall be allowed to ameliorate the discrepancies in their asset to liabilities management by issuing development bonds for subscription by retail investors[11]. In order to identify the specific economic industry that requires strengthening, the working group suggested that a meticulous social cost-benefit analysis is performed, and only those industries that urgently require government intervention shall be allowed the aid of DFIs. Additionally, the committee laid impetus on strict governance of DFIs and recommended that they shall be governed in accordance with the RBI Guidelines for NBFC's[12] as they are actively involved in raising immense capital via various instruments such as bonds; provident funds, domestic lending, trusts and retail investors. Therefore. their failure could significantly harm the country's financial equilibrium and trigger a domino effect that may escalate to other NBFC's or FIs as well[13]. While the Working Group suggested a few more reforms to be incorporated within the DFI regime, a plethora of those were realized with the eventual conversion of DFIs into Commercial Banks. Moreover, since the upcoming NaBFID will also be India's first DFI to be established post -1991 reforms, it is believed that the government would consider the aforementioned recommendations to prevent the errors that mirror the earlier DFI regime.

The National Bank for Financing Infrastructure and Development (NaBFID) Bill 2021 is slated to be introduced in the Cabinet during the budget session[14], hence it will be a Non-Banking Institution that will be governed by its own statute and shall derive its powers from an enacted legislature, unlike other DFIs and FIs that are covered under the definition of Non-Banking Finance Companies and inevitably fall under the RBI's purview. Nevertheless, re-introducing the DFIs or Development Banks will involve amending the pre-existing statutes and regulations that are pertinent to the industry. Notably, provisions under the Banking Regulation Act, 1949 and Reserve Bank of India Act, 1934 are likely to be amended in order to extend regulatory control of the RBI over the NaBFID. Furthermore, it is essential that the regulatory mechanism for DFIs shall take into account all the pertinent concerns related to the protection of investors if DFIs utilize the capital markets via the public listing of their equities and bonds, thus centralizing over SEBI's role in ensuring no ill-practices are conjected with the securities of NaBFID as well, that shall be attained by either notifying a new set of regulations that shall deal with disclosure requirements of NaBFID or via an amendment to the existing Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015. The eventual collapse of the earlier DFI model is often

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[10] Report of the Working Group on Development Financial Institutions, Reserve Bank of India (2004) https://m.rbi.org.in/Scripts/PublicationReportDetails.aspx?UrlPage=&ID=387#4

[11]*Ibid*

[12] FAQ, Non-Banking Financial Companies, RBI (accessed on 19-04-21) available at: https://www.rbi.org.in/Scripts/FAQView.aspx?Id=92

[13]*Supra* note 10

[14]PTI, *Government to introduce DFI Bill in Lok Sabha next week*, MINT (accessed on 19-04-21) available at: https://www.livemint.com/politics/policy/government-to-introduce-dfi-bill-in-lok-sabha-next-week-11616146516201.html

attributed to a lack of adherence to appropriate corporate governance standards.[15] IFCI, IDBI and ICICI provided long-term credit facilities to companies for infrastructure financing and subsequently held an interest in those companies through substantial shareholding. The DFIs further manoeuvred representation in the Board of Directors of the companies, and with their implicit control, their lender companies regularly siphoned off the capital allocated for financing infrastructure projects[16], thereby constituting a system with non-existent supervision or appraisal of credit. Although, regulations to ensure appropriate corporate governance measures have evolved since strict adherence to the existing framework shall be mandated. Provisions in the Companies Act, 2013 related to the constitution of the board, board meetings under Chapter XII; appointment and eligibility of directors and their powers under Chapter XI as well as related party transactions under Section 188. Moreover, to ensure uniformity with the global best practices about financial information disclosures, the DFI shall be held to the accounting standards as issued by the ICAI, as is prescribed under Section 133 of the Act. Similarly, the DFI's compliance with the Secretarial Principals as specified by the ICSI with regards to General Meetings of the BOD and Meeting of the BOD shall ensure adequate corporate governance norms.

Additionally, an amendment under the Insolvency and Bankruptcy (Insolvency and Liquidation Proceedings of Financial Service Providers and Application to Adjudicating Authority) Rules 2019 is likely to safeguard the creditors in the event, a DFI is notified under Section 227 of the IBC, and a corporate insolvency resolution process is initiated by the appropriate regulator.

The government has further planned to incentivize the setting-up of NaBFID by offering various benefits such as assured reimbursement on hedging costs of ECB's by the development bank, sovereign guarantee over loans granted to their borrowers and a concessional rate of 0.1% over government guarantees.[17] Nevertheless, the proposed Income-Tax holiday over the NaBFID for a period of 20 years will require certain amendments in the Income-Tax Act, 1961 along with the Indian Stamp Act, 1899.

Strengthening India's next DFI

Given the socio-economic overhaul that has occurred since India's last spur at infrastructure financing via Development Banks/ DFIs, it is anticipated that the NaBFID is likely to encounter an unprecedented range of hindrances that must be dealt with beforehand to prevent the mistakes from the past from recurring. Correspondingly, the need for inculcating the current market scenario with the upcoming NaBFID cannot be overemphasized. There are certain measures that shall be taken to achieve the desired efficacy and the overall objectives of setting up the DFI.

- *Ameliorating Force Majeure Risks*–A core characteristic of long-term infrastructure financing is that its laden with capital expenditure (Capex) risks as

[15]Chakrabarti, Rajesh, Corporate Governance in India - Evolution and Challenges. (accessed on 20-04-21) SSRN: http://dx.doi.org/10.2139/ssrn.649857

[16]Renu Gupta & Prof. K.V Bhanu Murthy, Demise of Development Finance Institutions in India: A Critical Appraisal, ISBN: 978-81-923211-3-4

[17]KR Srivats, *Coming Soon; Tax, other fiscal sops for development financial institution*, THBL (accessed on 21-04-21) https://www.thehindubusinessline.com/economy/coming-soon-tax-other-fiscal-sops-for-development-financial-institution/article33990092.ece

and operational expenditure (opex) risks. The possibility of the developers facing these risks enhances manifold considerations once an infrastructure project is instituted, although a majority of such contingencies are covered by the developers and the lenders beforehand. However, the possibility of an unforeseeable circumstance deviating the course of a long-term infrastructure project shall not be ruled out, as the indefinite time frame of the event is only bound to result in both enhancing debts and litigation expenses to recover said debts. Moreover, the recent Covid-19 pandemic has re-ignited the debate on invoking Force Majeure claims to defer liability. With regards to the change in law along with force majeure litigations that are ensued, the law is succinct[18] as numerous claims are put forth by the party seeking relief. The precedents set out through a few single-judge bench orders have limited the scope of frustration of contracts due to Covid-19 as a force majeure event. In *S Haliburton Offshore Services v. Vedanta Limited & Anr.*[19] The Delhi High Court upheld the principles laid down in *Energy Watchdog* and refused Force Majeure exemption to a turnkey project that was eight months past its due date and was further of the view that force majeure claims have to be construed restrictively and that the petitioner should have a 'real reason' or 'real justification' for invoking force majeure as a defence. In the similar case of *Standard Retail Pvt. Ltd. v. M/s. G. S. Global Corp & Ors.*[20]**,** the Bombay High Court held that importing and distribution of steel is an essential service, and the petitioner cannot invoke force majeure under Section 56 of Indian Contract Act, 1872 to excuse itself from performing its due consideration caused by a temporary lockdown, thereby disposing of a Section 9 petition under Arbitration Act, 1996 seeking prevention of encashment of a Letter of Credit. Therefore, it is essential for the lender, in this case, the NaBFID, to ensure that the qualifying criteria for invoking force majeure clauses are illustrative and encapsulates all the probable events that could stymie a project.

- *Re-Enforcing Capital Requirements via InvITs/REITs*–Aside from being overly dependent on the government infused capital in the DFI, utilizing the recently proposed Infrastructure Investment Trusts (InvITs) and Real Estate Investment Trusts (REITs) could be realized as an alternative source of capital for financing long-term infrastructure projects and could mitigate the burden over NaBFID. The REIT/InvIT mechanism is structured around unit holders of commercial real estate as well as developers of long-term infrastructure projects to devise revenue from the commercial property holdings through their rent-structures or via revenue from operation and maintenance services for the developers of infrastructure projects. General InvITs/REITS undertakings include real-estate ventures, industrial parks, hotels and hospitality projects, special economic zones et cetera. Union-Budget 2021 has further allowed the InvITs/REITs to exploit funding from Foreign Portfolio Investors, making leeway for foreign capital into the infrastructure financing demands[21].

[18]Energy Watchdog v. CERC, Civil Appeal Nos.5399-5400 of 2016
[19]O.M.P (I) (COMM.) No. 88/2020 & I.As. 3696-3697/2020
[20] Commercial Arbitration Petition (L) NO. 404 OF 2020
[21]PTI, *Budget 2021: Govt. to allow FPIs to debt finance REITs, InvITs*, LIVEMINT (accessed on 21-03-21) available at: https://www.livemint.com/budget/news/budget-2021-govt-to-allow-fpis-to-debt-finance-reits-invits-11612180981392.html

- *Asset Monetization and Eventual Divestment* -With the government's strong push for divestment from state-run companies, its fixed shareholding[22] in NaBFID to 26% could be diluted over the decades once its objectives have been met. This would facilitate private sector investment in the infrastructure regime, with a potential DFI unblemished by government intervention and may lead the way for more since it is unlikely that one DFI can meet India's enormous infrastructure financing objectives. Monetizing the government-owned assets would aid the divestment regime and open up the sector for a more efficient interplay through PPP models. The decision to divest and monetize the stake in non-core sectors, beginning with oil and gas pipelines[23], will make headway and enable allotment of capital strictly towards infrastructure financing.

Conclusion

The Government's idea of re-instituting a Development Finance Institution as a catalyst to fund long-term infrastructure projects and refurbish the depleted financing resources is a welcome step for the industry. The ambitious outlook behind NaBFID has to counter various pitfalls, amidst a wave of discontent behind the infusion of 20,000 crores as paid-up capital and government's complete stake over the development bank as at the same time it is struggling to reduce its interest in the public sector undertakings. There are certain moot points with regards to the DFI harnessing funds as, unlike the earlier regime, the NaBFID will not be privy to specific privileges such as availability of cheap funds and instantaneous borrowing powers from the Reserve Bank of India, nevertheless on the bright side, the NaBFID will be capable of accessing the capital markets unlike its predecessors, and the sovereign backing will only aid in mass-subscription of its equities or bonds should it feel the requirement to list them sometime in the future.

Similarly, one other area of concern that has caused substantial impairment to the government's objectives in the past has been the consistent meddling of bureaucracy in granting clearance to pending project approvals. In order to prevent the mistakes of the earlier DFI regime from recurring, an anti-corruption oversight mechanism is imperative, as minimal red-tape is the sub-catalyst for the idea that is a Development Finance Institution.

[22]Gireesh Chandra Prasad, *Cabinet okays development finance institution for infrastructure*, LIVEMINT (accessed on 21-03-21) available at: https://www.livemint.com/news/india/cabinet-clears-setting-up-of-development-finance-institution-11615890140339.html

[23]Anshu Sharma, *Government finalizing roadmap for asset monetization: Report*, CNBC (accessed on 21-03-21) available at: https://www.livemint.com/news/india/cabinet-clears-setting-up-of-development-finance-institution-11615890140339.html