Our Views

Differentiated business model for a private sector DFI

This year's budget proposed to create a regulatory framework to set up Development Financial Institutions (DFIs) with a mandate to act as a provider, enabler, and catalyst for infrastructure financing. Now that the Government has announced its intention to make an enabling regulatory framework for setting up of DFIs in private sector, the discourse has moved to the **structure and function of such DFIs.**

For a developing country like India, financing of greenfield infrastructure projects is indeed a challenge. Financing of such projects by DFIs is not a new concept in the Indian context - the earlier DFIs were created during the pre-economic liberalization era. During that period, given the controlled nature of the economy and a protected industry, lending to industry was relatively simpler. Business model of DFIs, in their previous avatar, was uncomplicated. On the liability side, they could raise low-cost long-term resources through various regulatory dispensations. On the lending side, since the industry was well protected, the financier's money was not at any risk.

With the changed business model post the economic liberalization, the DFIs had to compete in the market for raising liability funds. Post 1995, when the SLR status of bonds issued by DFIs were withdrawn, they struggled to stay competitive and relevant. There were challenges such as assets liability mismatch. Further, the industry also became more competitive and started focusing on alternate sources of fund raising. This led to a complete collapse of the DFIs concept. Hence, most of the DFIs converted into commercial banks over time.

However, today, due to ALM concerns, commercial banks are unable to fund large long-term infrastructure projects which is a prerequisite for economic growth. Hence, there is indeed a need for a long-term lending institution. With the growth in insurance and pension sectors, concerns about such institutions raising long-term liabilities are partly addressed.

Also, just one DFI would not be enough for the infrastructure aspirations of India. Therefore, it is expected that private sector would also set up DFIs. For private sector to consider long term infrastructure financing they need to have a differentiated business model. A conventional model of long-term lending may not work.

Credit enhancement/ First loss mechanism

Given that a private sector DFI will have limited availability of capital, its better that it supports infrastructure lending by way of providing credit enhancement support. Generally, infrastructure companies will have below investment grade rating and high cashflow mismatch in the initial years of construction or implementation. During this period, a DFI can provide a credit enhancement or a first loss support against a fee. Backed by this, commercial banks can fund these projects. Post construction phase, once the project starts generating cash flows, the credit rating of the project should improve, and a credit enhancement may not be required. Projects can then directly seek financing through the capital markets by way of bonds issuance. This would enable the lending institutions to churn their resources and will address the issue of asset-liability mismatch. It would be a win-win situation for everyone:

1. For DFIs – since they would have limited capital and not much ability to do project lending, a credit enhancement facility will work better. It will enable them to churn their capital as typically credit enhancement will be required only during the construction phase. Also, they can syndicate the risk with some other DFIs. It will help them earn a fee income – given that the spread between a below investment grade credit to an investment grade credit is very high, DFIs can charge a good fee. This will make the DFI model viable. DFIs can even consider pooling some of the credit enhanced assets and getting an insurance cover against them to reduce their risk.

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2. For Banks – they could appraise infrastructure projects but will not want to finance below investment grade projects. Also, asset-liability mismatch is a challenge for them. A credit enhanced structure will help them to reduce the risk. A take-out financing by way of capital markets once the project starts generating cashflow will help banks to match the tenure of the loan within their comfort zone. Given the deep domain and know-how, a bank would be best placed to carry out project evaluation based on cash flow analysis and financial risk assessment. Using this capability and supported by credit enhancement mechanism, it can provide credit to the project.

3. For the project company – credit enhancement will save them a lot of cost, some part of which can be shared as a fee income with the DFIs. Banks can lend to the projects during the construction period with a credit enhancement and finally now that there is a lot of focus on the development of corporate bond markets, capital markets can provide several options for creative structuring of financing particularly once the construction risk is over. Issuers will have several options through the capital markets to consider take out financing.

In conclusion, Also, a successful execution of a sovereign-backed DFI as proposed in the budget will re-instill confidence in the concept of DFI in India. This will open various financing avenues for the private DFIs including funds from sovereign wealth funds, insurance funds, pensions funds. In my view, a successful government backed DFI will induce set-up of private DFIs. However, **for a DFI in the private sector to succeed one will have to consider an innovative business model of partial credit guarantee scheme.**

https://economictimes.indiatimes.com/markets/stocks/news/what-would-it-take-for-private-sector-dfis-to-succeed-in-todays-india/articleshow/81214169.cms

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