

S S Mundra: Economic outlook and role of monetary policy in funding infrastructure projects

Address by Mr S S Mundra, Deputy Governor of the Reserve Bank of India, at “Citi’s Investor Summit: India poised for higher growth”, New Delhi, 17 November 2014.

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1. Delegates to the Summit, ladies and gentlemen! It is indeed a pleasure to be here this morning to interact with you. I thank Citibank and in particular, Mr. Pramit Jhaveri for inviting me to this summit. I must say that the theme for the summit is more topical than ever before in the aftermath of the Global Financial Crisis. We are seeing some positives towards recovery from the downtrend witnessed by the Indian economy since 2007–08. You have already heard the perspectives of two key stakeholders i.e. the Hon’ble Finance Minister, Shri Arun Jaitley and Shri Dinesh Sharma, Additional Secretary, DEA, who have a handle on the Indian economy.

2. I have been asked to speak on the topic “Economic Outlook for India and the Role of Monetary Policy, especially regarding funding of Infrastructure projects” and hence, in my address today, I would like to share RBI’s perspective on the prevalent economic landscape in the country and highlight some recent measures initiated by us towards flow of funds to the infrastructure sector. I would use this forum to also highlight some of the supervisory concerns that we have on infrastructure funding by banks.

(A) Economic outlook

3. As you are aware, amid slow growth and high inflation, the Indian economy had to contend with serious challenges to external stability emanating from an unsustainably high current account deficit (CAD), capital outflows and consequent exchange rate pressures over the last year. Measures initiated by Reserve Bank and the Government of India have since helped stabilise the economy. Improved political stability, a firmer commitment to fiscal consolidation, stronger monetary policy framework and better policy implementation are expected to improve the GDP growth rate to around 5.5 per cent in 2014–15 from the sub-5 per cent growth experienced in the preceding two years.

4. At the current juncture, Reserve Bank’s macroeconomic outlook is one of steady disinflation with growth gaining some momentum from Q4 of 2014–15 and improvement in macro-balances, particularly lower CAD on the back of commitment to fiscal consolidation. With revival in capital flows, there has been accretion to foreign exchange reserves after financing the CAD. The macroeconomic outlook is, however, subject to risks from both global and domestic uncertainties. Adverse global developments such as a slowdown in the pace of global recovery, financial market turbulence due to a faster than expected withdrawal of accommodative monetary policy in the advanced economies, hardening of commodity prices on geo-political tensions and/or weather-related supply disruptions, could have deleterious consequences for all emerging market economies.

Growth-inflation debate

5. Estimates of threshold inflation for India currently vary from 4 per cent to 6 per cent based on methodology used and time span of the study. Some estimates carried out in the Reserve Bank¹ using multivariate methods on quarterly data indicate that the level of

¹ [“Why Persistent High Inflation Impedes Growth? An Empirical Assessment of Threshold Level of Inflation for India”](#) (RBI Working Paper Series No. 17 for September 2011).

CPI-combined inflation (all India back-casted using the CPI-IW) above which it is harmful to growth is around 6 per cent.

6. Growth-inflation trade-off in India is complex, particularly when inflation is above the threshold level. Hence, our belief in RBI is that monetary policy possibly cannot spur growth by tolerating higher inflation. In turn, when inflation returns to below the threshold level on a durable basis, risks to inflation from addressing growth concerns may not be significant. Thus, we feel that it is important for India to ensure price stability as a necessary means to promote sustainable growth.

External sector

7. Net foreign assets of the Reserve Bank have expanded by nearly Rs. 1.2 trillion during the year so far. All categories of capital flows have been buoyant, particularly under FDI, FII, ECB and non-resident deposits. Notwithstanding these flows, in the absence of a strong demand for liquidity from the market, drivers of reserve money are compensating each other with the increase in net foreign assets largely offset by a reduction in net domestic assets.

8. An overall improved macroeconomic condition reflected in lower CAD, fiscal consolidation, upbeat market sentiment and an accretion to the foreign exchange reserves have enhanced the capacity of the country to manage external spillovers better. The recent surge of interest in India reflects the revived assessment about the country's underlying potential. RBI remains prepared to manage external spillover and India has the experience of managing phases of surges in capital inflows as well as phases of occasional sudden outflows as experienced in the aftermath of the global financial crisis and the taper announcement last May.

9. Let me finish this section of my remarks by outlining RBI's current focus areas. RBI's developmental measures during the past year have revolved around five major themes: strengthening of the monetary policy framework; strengthening the existing banking structure through entry of new banks and licensing new banks with niche focus; broadening and deepening financial markets; promoting financial inclusion and improving the financial system's ability to deal with corporate distress and financial institution distress. While RBI's developmental and regulatory policies continue to evolve around this five pillared approach, specific efforts are also directed at several other important initiatives like harmonisation of regulatory guidelines for non-bank finance companies, rationalising the priority sector lending guidelines, strengthening the fraud risk management and resolution of fraud cases in commercial banks, designing a charter of customers' rights, developing a framework for resolution of financial firms under distress and catalysing the state level coordination committee structure for better regulation, supervision and monitoring of the activities of firms indulging in promoting Ponzi schemes. In sum, RBI's resources are directed at fostering a competitive, vibrant and sound financial system for meeting the financing needs of a growing economy.

(B) Infrastructure sector: the engine for India's economic growth?

10. Let me now turn to the subject of infrastructure financing, which is the theme of this investor summit, and the potential positive impact that revival of investment in this sector can have for the growth prospects in the economy. Infrastructural development is one of the major determinants of economic growth in any developing country. Infrastructure refers to the support structures that facilitate production of goods and services, distribution of finished products to markets, as also basic social services such as schools and hospitals. In a sense, infrastructure is a catalytic agent for any economy.

11. Despite being the third largest economy in the world based on purchasing power parity calculations, India's position is undermined by a lack of world class infrastructure. India's average investment in infrastructure at 4.7 percent of GDP during 1992–2010

compared poorly to an average of 7.3 percent across China, Indonesia and Vietnam. India ranked 90th out of 144 countries, as per the World Economic Forum Global Competitiveness Report 2014–15, in terms of infrastructure quality with “inadequate supply of infrastructure” listed as the one of the most problematic factors for doing business.

12. Estimates suggest that the lack of proper infrastructure pulls down India’s GDP growth by 1–2 percent every year. To my mind, any sector to thrive and progress in the long run, most necessarily needs a continued demand and an enabling business environment. In the context of infrastructure sector this “enabling environment” has a wider connotation covering among others, the presence of well-documented and stable administrative and regulatory policies; a vibrant dispute resolution mechanism and a strong judicial system. Undoubtedly, the availability of long-term finance and the cost thereof are also integral to the success of the sector. Availability of finance for good profitable businesses has never been a problem and the statistics reveal that commercial banks’ exposure to the infrastructure sector has grown at a sustained pace. I would argue that if the infrastructure sector has failed to live up to the expectations, it is more on account of lack of an “enabling environment” and the quality of demand rather than due to monetary policy actions that have some bearing on the availability of funds or the cost of borrowing.

13. The availability/supply of goods and services in the market place presupposes the existence of demand by the consumers. The fast paced growth in the Indian economy witnessed in the past decade has placed increasing stress on physical infrastructure, such as electricity, railways, roads, ports, airports, irrigation, urban and rural water supply and sanitation, all of which already suffered from a “marked” deficit. The rapid urbanization has not only necessitated creation of new infrastructural facilities but also a need for upgrading the quality of existing infrastructure. Infrastructure development in new townships is a priority so as to redistribute the influx of growing population. Against this backdrop, new investments in creation of better all round infrastructural facilities such as irrigation, electrification, roads, drinking water, sanitation, housing, community IT service, integrated cold chain for agricultural and horticulture produce, ports, hospitals, etc., have the potential to significantly contribute to domestic growth. Likewise, the Delhi – Mumbai Industrial Corridor and the Chennai-Bangalore Industrial Corridor Projects have also been conceived with a view to developing new industrial cities as “Smart Cities” and converging next generation technologies across infrastructure sectors. These industrial corridors are expected to provide a major impetus to planned urbanization in India with manufacturing as the key driver and in the process create employment and accelerate the economic growth.

Pricing of infrastructural services

14. While the conventional wisdom is that the consumers require world class infrastructure in our country, a very important point to consider is whether the average potential user of these facilities is willing or in a position to pay for the world class infrastructure. There is a limitation on how much infrastructural capacity can a benevolent “State” create without stretching its own financials or without burdening its citizens with high user charges. Hence, the pricing for using infrastructure services, which may be exclusively built by the private sector, in a public-private partnership or exclusively by the public sector, assumes utmost importance for the viability of the projects. While the prices cannot be raised too high, it is important that the realizations for the service provider/operator are remunerative and based on commercial considerations. Also, there is a need to have an inbuilt mechanism in the services/pricing contract which provides for a pass-through of price hikes to the end users on account of increase in input prices. Therefore, managing the transition from state-subsidised services to market based pricing becomes an extremely important piece in the puzzle.

Enabling environment

15. As I mentioned earlier, a very crucial aspect for the success of any business venture is the availability of an enabling environment. At the cost of repetition, I would say that the lack of an enabling environment has been the biggest bane for the infrastructure sector in our country. The High Level Committee on Financing Infrastructure which submitted its second report in June earlier this year has lamented that a large number of infrastructure projects are stuck or delayed across various stages of award, construction and operation. The report mentions that debt constraints, fuel supply challenges for power plants, environmental clearances, land acquisition, etc., have held up a large number of projects, which can achieve commissioning within the short-term if these constraints are suitably addressed. The report also highlights that infrastructure projects are fraught with disputes that cause inordinate delays due to slow resolution processes. It adds that project implementation is another major concern in respect of infrastructural projects as on an average, projects suffer from 20 to 25 per cent time and cost over-runs, which rises to as high as 50 per cent in some sub-sectors.

16. There have been conscious attempts by the Government over the last two years to remove the various bureaucratic bottlenecks and regulatory hurdles which have impeded the progress of implementation of infrastructure projects and stalled them in a few cases. With a view to strengthen the investment climate in the economy, The Government of India had set up a Cabinet Committee on Investments (CCI) chaired by the Prime Minister, liberalized the FDI in multi-brand retail, aviation and broadcasting and took initiatives to fast track large investment projects in the areas of power, petroleum and gas, roads, coal, etc. The Government had also set up the Project Monitoring Group in the Cabinet Secretariat for monitoring the implementation of these high-value projects. The new Government has initiated measures to minimise tax litigation, loosened caps on foreign investment in railway infrastructure and defence manufacturing, speeded up regulatory approvals and reduced bureaucratic discretion; all of which are likely to further boost the investor sentiments in the infrastructure segment.

(C) Banks' role in financing of infrastructure projects

17. Let me now turn to the role of banks in financing of infrastructure projects in the country. In a bank dominated economy like India, the onus has always been on the banking system to finance the infrastructural needs of the economy and the sector as a whole and more specifically, the Public Sector Banks (PSBs) as a group, have been meeting those expectations. It is pertinent to note that outside of budgetary support, which accounts for about 45 per cent of the total infrastructure spending, commercial banks are the second largest source of finance for infrastructure (about 24 per cent).

18. Banks' exposure to the infrastructure sector as a percentage of total advances has gradually increased from 11.8% in March 2010 to 15.62% in September 2014 at the system level. For PSBs, this high share has moved even higher from 13.5% in March 2010 to 17.57% in September 2014. The share of private sector banks (PvtSBs) and foreign banks have also increased significantly from 7.6% to 9.59% for the former and from 2.8% to 12.13% for the latter during the same periods, albeit on a lower base.

19. In respect of PSBs, the level of gross NPAs in the infrastructure sector in June 2014 stood at 2.4% as compared to 1.36% for PvtSBs. However, if we were to look at the Stressed Asset Ratio (Gross NPAs together with Restructured advances as a % of gross advances) for the infrastructure sector in respect of PSBs, this ratio works out to a very high 22.58% on account of high level of restructured advances. For the banking system as a whole this ratio stood at 20.6%. When compared to the level of stressed advances for banking system as a whole at 10.39% at the end of June 2014, the levels of stressed assets in the "infrastructure" sector is significantly higher. There are a number of reasons for this diverse trend and I would dwell upon some of them shortly.

Major issues related to infrastructure financing

20. (i) The need for infrastructure financing in the country is huge. However, the non-bank sources (such as bond financing) have made insignificant contribution in this respect, forcing the banks to shoulder a large part of the burden of the financing needs. It needs to be appreciated that infrastructure financing pose some unique risks on the credit and liquidity fronts on account of long-gestation period involved. Appraising the credit proposal of infrastructural project in terms of necessary skill sets is distinctly different from credit appraisal of other types of loans that banks normally provide. Absence of these specific skill-sets has an important bearing on the quality of assets in this space, particularly in the PSBs.

(ii) While the higher level of stress in the “infrastructure” segment particularly in PSBs is a matter of concern, it must be noted here that out of total lending to the sector, a majority (about 85%) has been by the PSBs reflecting that these banks have increased their exposures to this sector in the post-crisis years.

(iii) As I mentioned earlier, several external factors such as delay in receipt of clearances/approvals, difficulty in coordination between agencies, unavailability of crucial linkages, etc., have been responsible for delayed completion of infrastructure projects thereby affecting the bank lending. There were also some structural/ legacy issues in the exposures to power sector/ discoms which adversely impacted lending to the sector. The recent Supreme Court order on the coal blocks may also create some additional stress on the coal dependent sectors in the short term, but a successful resolution of the issue would pave the way for a lasting solution.

(iv) On account of the higher level of stress in the sector, “risk averseness” could play a role in squeezing flow of further bank finance to the sector. Considering the tremendous financing needs of the sector, it is important that fund flows to the sector are uninterrupted; however, it needs to be achieved under viable modes of financing and appropriate structures with proper sharing of risks. With the experience of higher level of stress in PSBs, it is important that lending institutions using public deposits are not exposed to undue and unmanageable levels of risk from external factors and in the process jeopardizing financial stability.

(v) RBI has been engaging with all the stakeholders for creating a suitable environment to resolve the problem of NPAs in infrastructure sector. Some of the important measures taken are as under:

- Banks have been advised to carry out sensitivity tests / scenario analysis, for infrastructure projects, which should inter alia include project delays and cost overruns.
- The Reserve Bank has introduced a comprehensive Framework for Revitalising Distressed Assets in the Economy in January 2014 for early detection of sickness and remedial measures
- The Bank has set up the Central Repository of Information on Large Credits (CRILC) in April 2014 to collect, store and disseminate credit data to lenders to enable banks to take informed credit decisions.
- Disincentives have been proposed for: (i) wilful defaulters and non-cooperative borrowers, making their future borrowings more expensive, and (ii) for auditors, advocates and valuers who provide incorrect opinions about borrowers and their assets leading to deterioration in the asset quality of banks.
- Disincentives in the form of accelerated provisioning norms have also been proposed for the lenders for their failure to report the status of distress account to CRILC, for attempts to conceal the actual status of the accounts or upon failure to convene the JLF within the stipulated timeframe etc.

- RBI has issued guidelines to encourage sale of assets to Securitisation Companies (SCs) / Reconstruction Companies (RCs) at a stage when the assets have good chance of revival and fair amount of realizable value making it a supportive system for stressed asset management with greater emphasis on asset reconstruction rather than asset stripping.

(D) RBI initiatives to support infrastructure financing

21. Let me now briefly highlight some of the recent regulatory initiatives taken by RBI to facilitate flow of funds to the sector. In order to ensure adequate credit flow to infrastructure sector and to the affordable housing needs of the country, RBI's extant prudential guidelines were reviewed with a view to minimizing certain regulatory pre-emptions. Since July 2014, RBI has permitted banks to issue long-term bonds with a minimum maturity of seven years to raise resources for lending to (i) long term projects in infrastructure sub-sectors, and (ii) affordable housing. The instruments are exempted from regulatory requirements such as maintenance of CRR/SLR and priority sector lending.

Infrastructure debt funds for supporting take out finance

22. Recognizing the constraints in incremental financing by banks to the infrastructure sector, the banks have been permitted to enter into takeout financing arrangement. To augment debt resources for financing infrastructure, setting up of Infrastructure Debt Funds (IDFs) was permitted to refinance projects. By refinancing bank loans of existing projects, the IDFs are expected to take over a significant volume of the existing bank debt and thereby release funds for fresh lending by the banks for infrastructure projects. Thus far, three such IDF – NBFCs have registered with RBI and have become operational. Simultaneously, IDFs structured as trusts to be registered with SEBI, are also permitted to be set up to allow the investors to take direct risks and exposure to the infrastructure projects. One such trust-based IDF through the Mutual Fund route has also been set up.

Regulatory forbearance for infrastructure projects

23. There is a widespread acknowledgment that implementation of large projects is a complex proposition and unforeseen events have the potential to cause delays in achieving commercial operations on the original Date of Commencement of Commercial Operations (DCCO) fixed at the time of financial closure. Recognizing this fact, Reserve Bank has allowed certain relaxations to delayed projects, wherein DCCO of projects are allowed to be extended beyond the original DCCO. In terms of extant instructions, revisions of the DCCO and consequential shift in repayment schedule for equal or shorter duration (including the start date and end date of revised repayment schedule) will not be treated as restructuring provided that:

- (i) The revised DCCO falls within the period of two years from the original DCCO stipulated at the time of financial closure for infrastructure projects and
- (ii) All other terms and conditions of the loan remain unchanged.

24. Further, banks have been permitted to restructure and retain the "standard" asset classification if the fresh DCCO falls within a period of four years from the original DCCO on account of arbitration proceedings or a court case. Similarly, the standard asset classification can also be retained in case of infrastructure projects if the fresh DCCO falls within a period of three years from the original DCCO, if the delay is for other reasons beyond the control of promoters.

25. Reserve Bank has also clarified that multiple revisions of the DCCO and consequential shift in repayment schedule for equal or shorter duration (including the start date and end date of revised repayment schedule) will be treated as a single event of restructuring provided that the revised DCCO is fixed within the stipulated time limits and

other terms and conditions of loans remain unchanged. Thus, RBI guidelines provide sufficient flexibility to mitigate the impact of the delayed projects on the financial position of the banks.

26. The RBI has also allowed the banks to finance long term projects with an option to refinance them periodically. Under the scheme also popularly called the 5/25 scheme, banks can, for example, lend for a 25 year project with an option to rollover the loan every five year.

Conclusion

27. Let me conclude by trying to dispel some wrong notions which sometimes lead to criticism of RBI's policies on bank finance to the infrastructure sector. As I mentioned above, commercial banks have always been a large source of finance for the sector. It must be understood that the macroeconomic policies do play a very limited role in flow of funds to specific sectors. RBI's monetary and liquidity measures have an overarching objective of managing the inflation expectations and liquidity conditions in the market. The interest rate in the system is a function of an entire set of factors with inflation being one of the primary ones. Therefore, if the lending cost has not come down appreciably in the banking system, it is on account of persistent high levels of inflation.

28. Pinning entire expectations on an accommodative monetary policy and regulatory forbearance for financing of infrastructure sector would be overlooking the obvious. As I mentioned earlier, the banking system already has a high level of exposure to the sector and it cannot have infinite appetite towards a single sector. Obviously, the sector would need multiple originators of credit as also an efficient "originate and distribute" model to leverage capacity and expertise of each player in the act. It may also be mentioned here that any reference to infrastructure generally gets limited to commissioning of large new projects. There are, however, other equally important aspects which need consideration eg. constructing energy efficient building, minimizing transmission losses, providing cost efficient alternate energy sources to rural India etc. which can help the power sector. RBI's regulatory guidelines facilitate some of these alternate solutions.

29. I would also like to emphasize that the long-term funds available with the insurance and pension sectors can play a very critical role in funding investments in the infrastructure sector and immediate steps need to be taken in regard. There is also a need to upgrade the credit appraisal and monitoring capabilities of Indian banks, especially public sector banks, to face the challenges involved in project financing.

30. I would end by saying that the Indian economy is poised for higher growth with the infrastructure sector being a very critical component. The flow of investment in India can be accelerated significantly with a proper enabling environment comprising of sound regulatory policies, strong legal system and decisive administrative machinery being in place. I once again thank Citibank-India for inviting me to the Summit.

Thank you!