Analytically speaking

VINOD KOTHARI & COMPANY

Infrastructure Debt Funds:

The mutual fund route and the NBFC route[1]

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[1] This article builds on an earlier article by the authors at http://india-financing.com/Article%20on%20IDFCs-will%20this%20new%20vehicle%20garner%20infrastructure%20financing-Vinod%20Kothari%20&%20nidhi%20ladha.pdf

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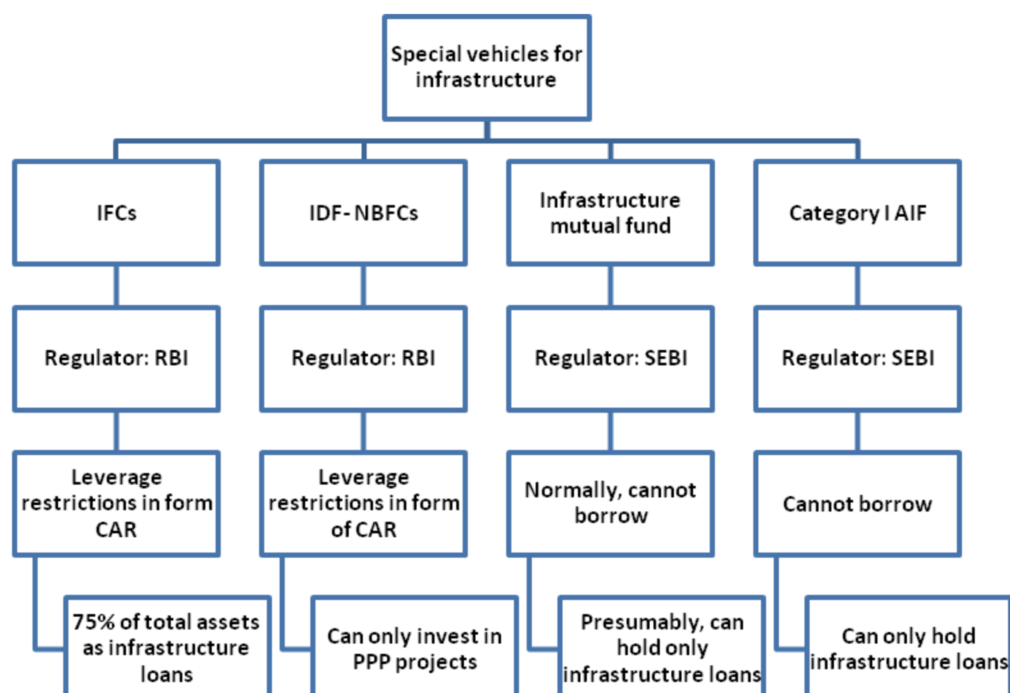
Unarguably, one of the most critical needs to restart the Indian economy is infrastructure spending. It is common knowledge that lots of infrastructure investments are running dry of funds – partly because of lack of policy decisions, and partly because of government's inaction on several fronts. Infrastructure bonds were talked about in the Budget 2010 – after good one and half years, the RBI came with guidelines for infrastructure debt financing companies (IDFCs) in September 2011. Post this, even the SEBI's Alternative Investment Fund Regulations in 2012 contain provisions for forming Category I AIFs focused on infrastructure sector.



Infrastructure debt funds and infrastructure debt finance companies:

It may be noted that Infrastructure Debt Funds (IDFs) can be set up either as mutual funds (trusts) or as companies (NBFCs). If the IDF is set up as a mutual fund (IDF-MF), it would come under SEBI's regulatory ambit, while if it is set up as an NBFC (IDF-NBFC), it would come under the regulatory ambit of the Reserve Bank India.

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Amendments in SEBI's mutual fund regulations had already been made permitting mutual funds to come with schemes for infrastructure debt financing. The RBI came with a notification dated September 23, 2011, which provides for IDFs to be sponsored by all NBFCs, including Infrastructure Finance Companies (IFCs) either in the Mutual Funds format, or in the NBFC format. As regards mutual funds, the same may be sponsored by any NBFC, including an infrastructure finance company (IFC). However, if it is in company or NBFC format, only IFCs can sponsor IDF-NBFCs.

In essence, the scope for floating IDFs now stands as follows:

- All SEBI-registered mutual funds may come up with schemes for infrastructure debt financing.
- All NBFCs may sponsor infrastructure debt financing mutual funds.
- IFCs may sponsor infrastructure debt financing companies.

Infrastructure mutual funds:

Mutual funds desiring to launch Infrastructure Debt Fund Schemes are required to abide by Chapter-VI-B of SEBI (Mutual Funds) Regulations, 1996[2]. The Chapter (Regulations 49L to 49T) lays down specific requirements to be fulfilled by Infrastructure Mutual Funds, in addition to the broad guidelines issued by SEBI for all mutual funds in general.

1) Eligibility Criteria for launching the Scheme:

If a mutual fund proposes to launch only Infrastructure Debt Fund schemes, a Certificate of Registration (CoR) is to be obtained and it is to be ensured that:

- The sponsor has been carrying on activities or business in infrastructure financing sector for a minimum period of 5 years
- The sponsor fulfills the eligibility criteria as laid down under Regulation 7 of the SEBI (Mutual Funds) Regulations

[2] Regulations amended by SEBI (Mutual Funds) (Amendment) Regulations, 2011

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An existing mutual fund is eligible to launch infrastructure debt fund scheme provided it has an adequate number of key personnel having adequate experience in infrastructure sector.

2) Conditions imposed by SEBI:

- The Scheme is to be launched either as close-ended scheme maturing after more than 5 years or interval scheme with lock-in of 5 years and maximum interval period of 1 month
- Units of the Scheme, after being made fully paid-up, are to be listed on a recognised stock exchange
- Indicative portfolio of the scheme may be disclosed to the potential investors
- Minimum of five investors required. A single investor cannot hold more than 50% of net assets of the scheme.
- Minimum acceptable investment from an investor is Rs. 1 crore.
- Minimum unit size should be Rs. 10 lakhs
- Each scheme requires a firm commitment from the strategic investors for contribution of a minimum amount of Rs. 25 crores before the allotment of units of the scheme are marketed to other potential investors.
- Partly-paid units may be issued to the investors provided that:
  - ✓ The asset management company shall call for the unpaid portions depending upon the deployment opportunities
  - ✓ The interest or penalty deductible in case of non-payment of call money within time is to be disclosed in the offer document
  - ✓ The amount of interest or penalty shall be retained in the scheme

3) Investments –Permissions and Restrictions

- Minimum 90% of the net assets of the scheme in the debt securities or securitized debt instruments of infrastructure companies or projects or special purpose vehicles which are created for the purpose of facilitating or promoting investment in infrastructure or bank loans in respect of completed and revenue generating projects of

infrastructure companies or special purpose vehicle. The limit is 30% for all the infrastructure debt fund schemes taken together under a Mutual Fund-however, the limit may be extended upto 50% subject to the prior approval of the board of trustees and the board of asset management company.

- Balance may be invested in equity shares, convertibles including mezzanine financing instruments of companies engaged in infrastructure, infrastructure development projects, whether listed or not; or money market instruments and bank deposits.
- Restrictions are applicable on the life-cycle of the Scheme
- Ineligible investments:
  - ✓ Investment in unlisted security of the sponsor or its associate or group company
  - ✓ Preferential allotment of listed security by the sponsor or its associate or group company
  - ✓ Investment exceeding 20% of the net assets of the scheme in listed security of the sponsor or its associate or group company or bank loan in respect of completed and revenue generating projects of infrastructure companies or special purpose vehicles of the sponsor or its associate or group companies. Any investment within the limit is subject to approval of trustees and full disclosures to investors
  - ✓ Investment exceeding 20% of the net assets of the scheme in any asset or securities owned by the sponsor or asset management company or its associates not below investment grade. Investment within the limit is subject to approval of trustees and full disclosures

The Regulations also specify requirements as to valuation of assets, duties of Asset Management Company, transactions by employees and disclosures.

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Eligibility Parameters for NBFCs as Sponsors of IDF-MFs

Sponsoring of IDFs by NBFCs would require prior approval of RBI and compliance with the following parameters in addition to those prescribed by SEBI

1. The NBFC should have a minimum Net Owned Funds (NOF) of Rs. 300 crore and Capital to Risk Weighted Assets (CRAR) of 15%;
2. Its net NPAs should be less than 3% of net advances;
3. It should have been in existence for at least 5 years.
4. It should be earning profits for the last three years and its performance should be satisfactory;
5. The CRAR of the NBFC post investment in the IDF-MF should not be less than the regulatory minimum prescribed for it;
6. The NBFC should continue to maintain the required level of NOF after accounting for investment in the proposed IDF and
7. There should be no supervisory concerns with respect to the NBFC

Eligibility Parameters for IFCs setting up IDF-NBFCs

The following would require to be complied with by the IFCs along with prior approval of RBI

1. Sponsor IFCs would be allowed to contribute a maximum of 49 percent to the equity of the IDF-NBFCs with a minimum equity holding of 30 percent of the equity of IDF-NBFCs,:
2. Post investment in the IDF-NBFC, the sponsor NBFC-IFC must maintain minimum CRAR and NOF prescribed for IFCs
3. There are no supervisory concerns with respect to the IFC

Regulatory Directions to IDF-NBFCs

To regulate the functioning of IFCs sponsoring IDF-NBFCs, RBI[3] has prescribed the 'Infrastructure Debt Fund-Non-Banking Financial Companies (Reserve Bank) Directions, 2011' (the Directions) which shall come into force with immediate effect.

The Directions have defined "IDF-NBFC" as a non-deposit taking NBFC that has Net Owned Fund of Rs 300 crores or more and which invests only in Public Private Partnerships (PPP) and post commencement operations date (COD) infrastructure projects which have completed at least one year of satisfactory commercial operation and becomes a party to a Tripartite Agreement.

The above definition is laying three conditions to be fulfilled by an NBFC to be categorized as IDF-NBFC:

1. It should have a NOF of at least Rs.300 crores
2. It should be investing in PPP which have completed at least one year of satisfactory commercial operation, and
3. It should be a party to a Tripartite Agreement

The highlights of the Directions are:

1) Credit Rating

a) A minimum grade of 'A' of CRISIL or equivalent rating issued by other accredited rating agencies is required

2) Eligible Investors

a) Domestic and off-shore institutional investors, especially insurance and pension funds which would have long term resources

3) Fund raising

a) IDF-NBFCs can raise resources through issue of either Rupee or Dollar denominated bonds of minimum 5 year maturity.

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[3] Vide notification RBI/2011-12/268 DNBS.PD.CC.No.249 /03.02.089/2011-12 dated November 21, 2011

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4) **Capital Adequacy**
    a) A minimum CRAR of 15 percent is must
    b) Tier II Capital of IDF–NBFC shall not exceed Tier I

5) **Credit Concentration norms**
    a) Maximum exposure on individual projects will be at 50 percent of its total Capital Funds (Tier I plus Tier II)
    b) An additional exposure up to 10 percent could be taken at the discretion of the Board of the IDF-NBFC
    c) Additional exposure up to 15 percent (over 60 percent) may be permitted by RBI on an application

6) **Risk Weights for calculating capital adequacy**
    a) bonds covering PPP and post commercial operations date (COD) projects in existence over a year of commercial operation shall be assigned a risk weight of 50 percent
    b) All other assets shall be risk weighted as per the extant regulations as given in para 16 of the Non-Banking Financial (Non-Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007

7) **Other Prudential Norms**
    a) Other norms like income recognition, asset classification, provisioning requirement etc are applicable as specified in Non-Banking Financial (Non-Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007

Our Analysis

I. Mutual funds vs. NBFCs

Regulations permit an IDF to be set up either as a company (IDF-NBFC) or a mutual fund (IDF-MF). The broad differences between the two are as follows:

1. **Who can sponsor**: IDF –MF can be sponsored either by an NBFC or by an IFC. However, IDF-NBFC can be sponsored only by an IFC.

2. **Leverage:** Going by the general feature of mutual funds, mutual funds issue units which are in the nature of beneficial interest certificates. Mutual funds don't issue debt paper or bonds. IDF-NBFCs, however, are explicitly allowed to issue bonds, and hence can leverage themselves. In fact, given the risk weights for infrastructure assets and the required capital adequacy norms for IDF-NBFC s, the leverage may be several times of equity of the IDF-NBFC. Leverage provides higher returns on equity in case of IDF-NBFCs.
3. **Tax transparency:** Going by the general tax exemption under sec 10 (23D), an IDF-MF will have only one-point tax on the distributed income of the fund, thereby achieving full tax transparency. However, in case of IDF-NBFCs, the company itself will remain liable to pay taxes on its income
4. **Capital adequacy:** Capital required in case of IDF-NBFCs is 15% of risk weighted assets. In case of IDF-MFs, question of capital adequacy does not arise as mutual funds only issue units, which is effectively capital only.
5. **Applicable regulations**: in case of mutual funds, SEBI's mutual fund regulations will be applicable. In case of IDF-NBFCs, the above mentioned Directions issued for IDF-NBFCs, Companies Act and the RBI regulations in case of NBFCs apply. Most of the prudential regulations have been extended in case of IDF-NBFCs as well. For IDF-MFs, new chapter VI-B has been introduced[4] in the MF Regulations which provides for setting up and operating of IDF-MFs.
6. **Eligibility:** IDF-MF schemes may be launched by the existing MFs if it has an adequate number of key personnel having adequate experience in infrastructure sector. IDF-NBFCs would require minimum NOF of Rs. 300 crores
7. **Permissible Investments:** For IDF-MFs, at least 90 per cent of the net assets of the IDF scheme shall be invested in debt securities or securitized debt instruments of infrastructure companies. On the other hand, IDF-NBFCs has been allowed to invest 100% only in PPP and post COD infrastructure projects which have completed at least one year of satisfactory commercial operation and are a party to a Tripartite Agreement.

[4] Amended Regulations notified on 30th August, 2011

8. **Minimum amount for raising funds:** The IDF schemes to be issued by IDF-MFs should have an upfront firm commitment of INR 250 million, however, IDF- NBFC would raise resources through issue of either Rupee or Dollar denominated bonds of minimum 5 year maturity. No minimum amount has been prescribed for IDF-NBFCs.

II. *Credit rating:*

The regulations lay down minimum rating requirement – 'A' or better. The regulations leave several things open to interpretation, and in fact, speculation:

a) First, it is not clear what is the rating of? Rating of the IDF-NBFC, or rating of the bonds issued by the entity? Usually, ratings refer to an instrument, as there is no rating of an entity. A single entity may have different instruments carrying different ratings. Obviously, the RBI seems to have used the public deposits template where ratings were to be assigned to the public deposit scheme of the NBFC. Logical answer to the question is – it is rating of the bond, and not rating of the IDF-NBFC itself. However, one would have expected the regulator to draft the rules in unambiguous language, not to leave readers perplexed.
b) If the first question is answered, then the next question becomes easy to answer – when does the rating have to be obtained? Is it rating at the time of start of business, or rating only at the time of issue of bonds? Once again, logically, there is no way any entity can expect to get an A rating at the very start of business. So, as we taken the view above that the rating is only rating for the bonds, the rating has to be obtained whenever the IDF-NBFC comes up with its bond issue.
c) A third and critical question is - what if the rating gets downgraded? There is no answer to that in the guidelines at all. Once again, our interpretation that the rating pertains to the bonds, and to the entity, comes to rescue. If an entity bonds already in issue get downgraded to below A, there is nothing that the issuer can do about it. However, any new issue of bonds, rated less than A, cannot be sold to investors. It is quite possible that there is an existing bond issue which has been

downgraded, and yet the entity continues to issue further bonds, if the further bonds have an A rating.

On the key question of whether it is possible to have infrastructure bonds, if issued by a single entity, having different ratings – the possibility seems quite clear. Though the bonds are the unconditional obligation of the issuer, the bonds may be backed by cash flows from a particular project.

III. *What all business can an IDF do?*

There is only a vague statement as to what business can an IDF-NBFC do – Rule 7 says that IDF-NBFCs shall invest only in PPP and post COD infrastructure projects which have completed at least one year of satisfactory commercial operation and are a party to a Tripartite Agreement with the Concessionaire and the Project Authority for ensuring a compulsory buyout with termination payment. This may be seen as laying down a qualifying condition for the projects that the IDF-NBFC finances. That is to say, IDF-NBFC shall only in such projects as are backed by a tripartite agreement, and compulsory buyout with a termination payment. But it is not clear as to what is the business that can IDF-NBFC do, pending investment in qualifying projects. Surely enough, an IDF-NBFC cannot correlate the issue of infrastructure bonds with its own investments in infrastructure financing.

It is possible to get one indirect hint from the language of Reg 9 – this provides a risk weight of 50% in case of qualifying project investments, and 100% in other cases. If the assets of the IDF-NBFC were limited only to qualifying projects, the question of a risk weight of 100% in case of other assets would not arise at all.

Hence, it may be logical to conclude that there is no bar on IDF-NBFC making investments other than for qualifying projects – however, these should be passive investments, no designed constitute the business of the IDF-NBFC.

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IV. Tax benefits to investors

Under sec 80CCF, individuals and HUFs making investment in infrastructure bonds as may be notified from time to time. Hence, investments in infrastructure bonds are expected to have a tax appeal for retail investors.

As tax oriented schemes try to hit the capital market typically towards the year-end, it is high time that NBFCs and IFCs interested to sponsor IDFs quickly prepare themselves for launch.

A new instrument: Infrastructure AIFs:

SEBI recently came up with Alternative Investment Fund (AIF) Regulations, 2012[5] under which "Infrastructure Fund" has been defined as an AIF that invests primarily in unlisted securities or partnership interest or listed debt or securitized debt instruments of investee companies or special purpose vehicles engaged in or formed for the purpose of operating, developing or holding infrastructure[6] projects. Infrastructure Funds have been included under ***"Category I Alternative Investment Fund"***. Category I AIFs are under specified investment conditions, as listed below:

- Investment in investee companies or venture capital undertaking or in special purpose vehicles or in limited liability partnerships or in units of other Alternative Investment Funds is permitted.
- Fund of Category I Alternative Investment Funds may invest in units of Category I Alternative Investment Funds of same sub-category. However, such funds are permitted to only invest in such units and not in units of other Fund of Funds. The investment restrictions stipulated for Infrastructure funds do not apply to such fund of funds.
- Category I AIFs are not permitted to borrow funds directly or indirectly or engage in any leverage except for meeting temporary funding requirements for a maximum of 30 days, on not more than four occasions in a year and not more than 10% of the corpus.

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[5] http://www.sebi.gov.in/cms/sebi_data/attachdocs/1337599839661.pdf

[6] The term "infrastructure" is to be defined by the Government of India from time to time.

In addition to the above, Infrastructure Funds are subject to some specific conditions:

- Minimum 75% of the corpus is be invested in unlisted securities or units or partnership interest of venture capital undertaking or investee companies or special purpose vehicles, which are engaged in or formed for the purpose of operating, developing or holding infrastructure projects
- However, investment is also permitted in listed securitized debt instruments or listed debt securities of investee companies or special purpose vehicles, which are engaged in or formed for the purpose of operating, developing or holding infrastructure projects.

Market activity in IDFs so far:

Reportedly, the papers for the first IDF in the NBFC mode were filed only in March 2012[7].

IDFC is also reportedly floated plans to set up an IDF in the mutual fund route[8] – however, this is yet to become operational.

Thus, the activity in setting up IDFs has just begun to pick up; probably because of the delay in ramping necessary guidelines by the RBI – though the proposal dates back to Budget 2010.

Budget 2012 proposals:

Proposed section 194LC reduces withholding tax on ECBs for infrastructure companies. These provisions are not intended for infrastructure debt funds. That is to say, if an infrastructure company, operating in the sectors specified below, raises ECBs, then the withholding tax rate is reduced from 20% to 5%:

(i) generation or distribution or transmission of power; or

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[7] http://www.thehindubusinessline.com/industry-and-economy/banking/article2964281.ece?homepage=true
[8] http://moneylife.in/article/idfc-plans-indias-first-infrastructure-debt-fund-through-mutual-fund-route/24212.html

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(ii) operation of aircraft; or
(iii) manufacture or production of fertilizers; or
(iv) construction of road including toll road or bridge; or
(v) construction of port including inland port; or
(vi) construction of ships in a shipyard; or
(vii) construction of dam; or
(viii) developing and building affordable housing projects.

Notably, ECBs are allowed under the automatic route in case of infrastructure companies. The definition of "infrastructure" under ECB Circular includes the following sectors:

(i) power, (ii) telecommunication, (iii) railways, (iv) roads including bridges, (v) sea port and airport, (vi) industrial parks, (vii) urban infrastructure (water supply, sanitation and sewage projects), (viii) mining, exploration and refining and (ix) cold storage or cold room facility, including for farm level pre-cooling, for preservation or storage of agricultural and allied produce, marine products and meat.

Quite obviously, the definition of infrastructure as given by the FM in the Budget proposals is materially different from that of the ECB circular. Airlines have been included in infrastructure sector – there may be contentions that this has been done to help ailing airlines of the country. The FM in course of his Budget speech did refer to a harmonized definition of "infrastructure" – currently, definitions are contained in the ECB Circular, Income-tax Act, RBI rules for infrastructure finance companies, and so on.

Will Budget 2012 impact infrastructure debt funds?

There are two points to observe in relation to the impact of the Budget proposals on IDFs.

First, the scheme for IDFs as it stood before the Budget 2012 was attractive enough – tax incentives for investors, lower withholding tax for the fund itself, and so on.

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However, despite all this, no IDFs have, in fact, been launched still. Practitioners say that the way infrastructure operating companies are ailing under a pile of debt and stuck operations, what is needed is business, and not so much another line of funding. The infrastructure investment story is not attracting international investors, at least for the time being.

Second, with the direct ECB window made attractive to the infrastructure operators, an opinion may be that it makes the case for IDFs only weaker. After all, if international investors may invest in infrastructure sector directly, rather than through IDFs or IFCs, it may only lead to disintermediation.

It would take some time to see the impact of the Budget on the infrastructure finance sector in general, and on IDFs and IFCs in particular.