NATIONAL LAW SCHOOL OF INDIA UNIVERSITY

PROJECT FINANCE IN INDIA: LEGAL CONCERNS AND ISSUES

(Under the guidance of Pro. (Dr.) N.L. Mitra)

Dissertation submitted in partial fulfillment of the requirements for the Degree of Master of Laws

SUBMITTED BY

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ID NO: 260,
LL. M FINAL YEAR,

2007-2009.

CERTIFICATE

This is to certify that this Dissertation **"Project Finance in India: Legal Issues and Concerns"** submitted by Mr. Amit (ID. No. 260) for the Degree of Master of Laws of the National Law School of India University is the product of bona fide research carried out under my guidance and supervision. This Dissertation or any part thereof has not been submitted elsewhere for any other degree.

(Prof.Dr.N.L.Mitra)

Date: 26-05-2009
Place: NLSIU, Bangalore

DECLARATION

I, Amit, do hereby declare that this dissertation, entitled **"Project Finance In India :Legal issues and Concerns "**, is the result of the research undertaken by me in the course of my LL.M. Programme at National Law School of India University, Bangalore, under the guidance of Prof. Dr.N.L.Mitra

This work is in the final semester and is my original work, except for such help taken from such authorities as have been referred to at the respective places for which necessary acknowledgements have been made.

I further declare that this work has not been submitted either in part or in whole, for any degree or diploma at any other University or institution.

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June 2009 Amit

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CHAPTER I

RESEARCH BACKGROUND:

Infrastructure is the backbone of any economy and the key of achieving rapid sustainable rate of economic development and competitive knowledge. Realizing its importance governments commit substantial portions of their resources for development of the infrastructure sector. However despite such focus, governments in developing economies face severe impediments due to their limited spending power. It is because of this reason that Project Finance acquires a very important role in the development of a country. Project Finance is complex and presents specific challenges that require specialist knowledge and understanding to create appropriate finance structures which will ensure that risks are dealt with effectively and efficiently. Under the project finance, banks provide finance for a single project and take a large part of the risk of the success or failure of that project. Project finance illustrates the most fundamental and

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beneficial objective of money and banks other than the use of money as a medium of exchange.

If we look at the legal frame work of project financing in India, we would notice that interestingly India in a fairly favourably placed, India and China rank about the same in terms of corruption[2], and India is perceived to be better than China in terms of the rule of law[3]. This way India is lucky to have a reasonably well developed framework of financial institutions. The liberalisation of financial sector and the capital markets has taken place in the last few years. However given the complexity of risks inherent in projects, lenders and investors may often perceive the project cash flow and collateral as not sufficient inducement to make up the financing risk. In such a situation, to gain the confidence of lenders and investors, special enhancement measures are required to be taken to improve the overall credit environment of the country.

The challenges confronting the project finance in India, have been continuously been highlighted in various committees like the Patil Committee in December, 2005, which concentrated on the micro issues of the corporate debt and securitised debt market; the Percy Mistry Committee report, February, 2007

[2] See Investment Climate Assessment Report prepared by the world bank in collaboration with the Confederation of Indian Industries, at http://www.worldbank.org ;

[3] Supra Note 2

which concentrated upon deeply interlinked bonds, currency and derivatives markets[4].

1.1. CHALLENGES CONFRONTING PROJECT FINANCING IN INDIA:

Still there are several regulatory constraints confronting project financing in India, which poses serious impediments to the atmosphere of project financing in India. To highlight some:

- One of the key constraints in Project Financing is the lack of availability of risk capital to support debt raising. There is a need for developing the market for other forms of risk capital such as mezzanine financing, subordinated debt and private equity[5].
- Further, with rising average size of projects, the problem is getting compounded. Indian lenders are increasingly facing a challenge based on their existing single-asset and single-industry exposure norms, which are meant for protecting the stability of the financing system. This emphasizes the need to improve the capacity as well as the sophistication of the financing system to distribute risks more widely and efficiently on one

[4] http://economictimes.indiatimes.com/articleshow/msid-3238786,prtpage-1.cms, Dated: June 1, 2009, Time of access: 16:30 PM.

[5] See S. Krishnamurthi's, "Project Financing: Policies, Procedure and Practice", 1998, pp. 79-152.

hand and to explore the possibility of making an exception for infrastructure as regards exposure norms in certain cases, on the other[6].

- Further, since Project Finance is generally long-tenored, they would not pose any threat to external viability. However, the economy's ability to absorb various capital inflows poses challenges with relation to monetary management. So far, the response to this challenge has been to either allow the rupee to appreciated, sterilize capital inflows, allow larger capital inflows, or impose restrictions especially on the inflow of debt capital.
- There are deficiencies in the exposure norms and which are preventing the commercial banks from meeting this challenge. Further the overall capitalisation for public sector banks is also a constraint for these banks to significantly increase their project financing portfolio.
- Further insurance companies are one of the eligible investors in project financing but till now there have been very limited participation by them. This can be attributed to regulatory restrictions, underdeveloped corporate bond markets and the absence of credit risk transfer mechanisms viz. securitization, credit derivatives, credit insurance etc.[7]

[6] Supra Note 5.

[7] Supra Note 5;

The endeavour of the researcher in this paper therefore is to undertake an analysis of these constraints and suggest ways in which the above mentioned deficiencies can be cured without much hassle.

1.2. RESEARCH METHODOLOGY:

For the purpose of convenience, the researcher has divided the paper into six parts. In the first part that is in chapter II, the researches shall be giving a brief introduction of Project Financing and its evolution. In the Second Part of the Dissertation that is in chapter III, the researcher shall be dealing with the fundamentals of Project Financing. In the third part that is in chapter IV, the researcher shall be dealing with the project finance, its structure, its funding alternative and the risk sharing methods. In the fourth part that is in chapter V, the researcher shall be dealing with the regulation on the project finance. In the fifth part that is in chapter VI the researcher is dealing with the deficiencies in the Indian regulatory frame work and final part researcher concluding this work with few suggestions

1.3. RESEARCH HYPOTHESIS:

- Project Finance is an important mechanism for stimulating the growth of the country.
- There are deficiencies in the Indian Regulatory Framework regarding Project Financing in India and there is a strong need to remove the deficiencies surrounding project financing in India.

1.4. RESEARCH QUESTIONS:

- Is Project Finance an important vehicle to stimulate the growth of a developing and fund starved Country like India?
- Has the present regulatory framework been able to keep pace with the changing trends of funding across the globe?
- What are the deficiencies in the regulatory framework of Project Financing in India?
- What should be done to best address the concerns of investors?

1.5. RESEARCH OBJECT:

The primary aim of the researcher in this dissertation is to undertake an analytical and comparative study of the legal issues and concerns relating to Project Finance. The researcher proposes to analyse the regulatory concerns and suggest ways in which the concerns can be taken care of. While doing so an attempt has been made to examine the overall conceptual framework and instruments of Project Financing.

1.6. SCOPE OF RESEARCH:

The researcher shall be touching upon the concept of Project Finance only to the extent necessary for the purpose of this paper. The purpose of this paper is only to highlight the legal concerns of project financing in India, and therefore the dissertation is concerned solely with the legal and regulatory issues arising from the information reviewed in the context of and for the purposes of this dissertation. The researcher has not undertaken any investigation as to administrative, accounting, financial and taxation aspects of Project Financing. In preparing this dissertation, the researcher has relied heavily upon the genuineness of the materials available at various sources quoted in this dissertation and has not therefore the factual accuracy of the findings.

1.7. METHOD OF WRITING:

The researcher has followed an analytical and descriptive style of writing. Finding of various authors have been used for the purposes of analysis and description. There has been an attempt to explain the concepts wherever necessary. Sincere endeavours have also been made to maintain the lucidity of the language.

1.8. SOURCES OF DATA:

Since the research is basically a doctrinal research, therefore the researcher has confined his research only to secondary sources of data, namely books, articles, committee reports and internet sources.

1.9. MODE OF CITATION:

The researcher has followed a uniform method of citation throughout the dissertation.

CHAPTER II

INTRODUCTION:

Infrastructure requirements for a country like India are massive, presenting enormous business potential for the private sector. How far can such business potential is tapped depends largely upon the availability of capital. Unfortunately there is an acute scarcity of capital in the country; the domestic savings also is not adequate to cater our developmental needs. Further with the growth of the economy, India's already inadequate and severely antiquated infrastructure is further overburdened to the point that it threatens to disturb the entire momentum of economic progress. This has prompted governments to open up the infrastructure sector to private sector and foreign investment and has increased reliance on Project Financing. The demand for project finance therefore has grown by leaps and bounds in the past decade.

2.1 NEED FOR PROJECT FINANCE IN A COUNTRY LIKE INDIA:

Traditionally, the Government of India has been the sole investor in the country's infrastructure facilities. In this regard, the Government of India financed and implemented the bulk of its infrastructure outlays and also managed the attendant risks thereto. Project financing historically was relatively simple. However, it also was quite inefficient and lacking accountability. Domestic funds were raised primarily through public sector banks and insurance companies, budgetary outlays as well as the issuance of bonds linked to infrastructure projects. Foreign loans and project-specific aid also were raised from multilateral financial institutions such as the Asian Development Bank and the World Bank.[8]

Notwithstanding, a growing budgetary deficit and the capital constraints of the Government of India led to a crisis situation in the early 1990s. As a result, the Government of India was forced to open the infrastructure sector to the private sector. This action constituted the first wave of liberalization of the Indian economy. Today, the public sector is moving towards privatization. It is increasingly looking towards the private sector to deliver through market-based mechanisms, corporate efficiency and viability-based practices. Since the Indian capital markets lack the sophistication of the similar markets in developed countries, foreign investors also

[8] See, Mark J. Riedy's, "Project Finance India, 2007—Overcoming Hurdles to Growth: Current Trends and Innovative Transactional Structures in India" , Practicing Law Institute Corporate Law and Practice Course Handbook series, February-March, 2007;

have had an increasingly more important role to play in the development and financing of India's infrastructure.

In a bid to increase the participation of the domestic private sector as well as foreign investors, the Government of India has relaxed regulations, reduced foreign investment restrictions, and introduced a number of tax, customs and other incentives for companies engaged in infrastructure-based activities.

It may be observed that India has a large external debt capacity. India could borrow an additional $ 120 billion in the next five years and yet maintain its external debt to GDP ratio at the current level (about 15 percent), which is considered sustainable. Even if a third of this capacity is used for financing infrastructure, it would cover about 10 percent of the infrastructure financing gap envisaged over the next five year period. Further, since infrastructure related debt is long-tenored, they would not pose any threat to external viability. In such a scenario, the Project Finance becomes an important toll to bring in money for various infrastructure projects. The basic characteristic of Project Finance is that it involves current outlay of funds in the expectation of future benefits. Project Finance in other words is an identified activity which correlates expenditure and work spread over a specified period of time having a specified objective.[9]

[9] http://www.thehindubusinessline.com/2002/12/03/stories/2002120300030800.htm, time of access: 13:55 PM, Dated: 26.05.09.

2.2 HOW DOES PROJECT FINANCE GENERATE FUNDS?

Project Finance involves an arrangement where the capital needs of a project is financed by utilizing the possible immovables like land, real property etc., tangible movables like goods and intangible assets like debt claims, commercial receivables, investments, intellectual property etc. is known as Project Finance. In such a case the lender looks towards the successful generation of revenues by the project in order to recover their money, the risk profile of the investment changes drastically along with the need to be protected".[10]

2.3 AN OVERVIEW OF THE BASIC STRUCTURE OF PROJECT FINANCE:

To give an overview the typical basic structure of project finance are set out below[11]:

- A single-purpose project company is found to build and operate the project. The shares in the project company are owned by the project sponsors, who enter into a share holders or joint venture agreement between themselves governing their rights and duties as shareholders[12].

[10] Supra Note 1.

[11] Phillip. R. Wood's "Project Finance, Securitisations, Subordinated Debt", Sweet and Maxwell, London, 2007, p. 3.

[12] Ibid.

- A syndicate of banks enter into a credit agreement to finance the construction of the project. The banks are paid out of the proceeds of the project product after completion. There may be several classes of lending banks, example international banks lending foreign currency; local banks lending domestic currency for local cost; export credit agencies lending or guaranteeing credits to finance suppliers to the projects of their national equipments; and international agencies lending or guaranteeing development credits (world bank, Asian development bank, European bank for reconstruction and development). The later are confidence-building. The agency may lend on a conduit basis so that the banks are sub-participants with a result that, although the banks takes the risk, the lender of record is the agency. Project sponsors (and governments) may be more reluctant to countenance default on a credit from an international agency than a commercial bank because of increased opprobrium in diplomatic corridors[13].

  The project company grants the finances the maximum security available locally over the assets. There may be an inter creditor agreement between the creditors.

[13] Supra Note 4.

- The balance of the finance needed is provided by the project sponsors either by way of equity subscription or subordinated debt or both[14].
- The project sponsors may guarantee the loans under full or limited guarantees during the high risk pre-completion period.
- The main commercial contracts that are required to be entered in to all construction contract, equipment supply contract, suppliers' agreement, purchase agreement, in maintenance agreement, interest hedge agreement (which may include currency hedging, independent expert agreement and other special contracts.[15]

The fundamentals of Project Finance have been dealt in more detail under Chapter III and Chapter IV of this dissertation. Before we move towards understanding the conceptual framework and working of Project Finance in detail, it would be proper to analyse its origin and development.

[14] Supra Note 4.
[15] Supra Note 4.

CHAPTER III

FUNDAMENTALS OF PROJECT FINANCE

There cannot be any universally accepted definition of project finance. A typical definition of project finance might be:

"The financing of the development or exploitation of a right, natural resource or other asset where the bulk of the financing is to be provided by way of debt and is to be repaid principally out of the assets being financed and their revenues."[16] Since the lender look towards the successful generation of revenues by the project in order to recover their money, the risk profile of the investment changes drastically along with the need to be protected".[17] The expressions "non-recourse finance[18]" and

[16] Graham D. Vinter, Project Financing: A Legal Guide,· Second Edition (1999), pp. xxxi, Sweet & Maxwell London

[17] Piyush Joshi, Law relating to Infrastructure Projects (2^{nd} ed., New Delhi: Butterworths , 2003).

[18] The full recourse finance and limited recourse loan can be defined as:

a) Full recourse finance refers to the right of the lender to take any assets of the borrower if repayment is not made. A limited recourse loan only allows the lender to take assets named in the loan agreement.

"limited recourse finance[19]" are often used interchangeably with the term "project finance". In strict terms, non-recourse finance is extremely rare and in most project finance transactions there is some (limited) recourse back to the borrower/sponsor beyond the assets that are being financed.

3.1. WHY CHOOSE PROJECT FINANCE?

Project finance is invariably more expensive than raising corporate funding. Also, and importantly, it takes considerably more time to organize and involves a considerable dedication of management time and expertise in implementing, monitoring and administering the loan during the life of the project. Also, Project funding can be obtained from various sources. There must, therefore, be compelling reasons for sponsors to choose this route for financing a particular project. The charts below demonstrate the difference between public, corporate and project financing, using an example of a water treatment project.[20]

b) Limited recourse finance has financing secured primarily by the project and by additional reassurances from sponsors.

[19] Limited recourse finance has financing secured primarily by the project and by additional reassurances from sponsors.

[20] See S. Krishnamurthi's, "Project Financing: Policies, Procedure and Practice", 1998, pp. 79-152.

In developing countries like India government fund projects by using existing surplus funds or by issued debt (government bonds) to be repaid over a specific period. However, governments have increasingly found this funding to be less attractive, as it strained their own balance sheets and therefore limited their ability to undertake other projects[21]. This concern has stimulated the search for alternative sources of funding. It can be explained through a diagram:

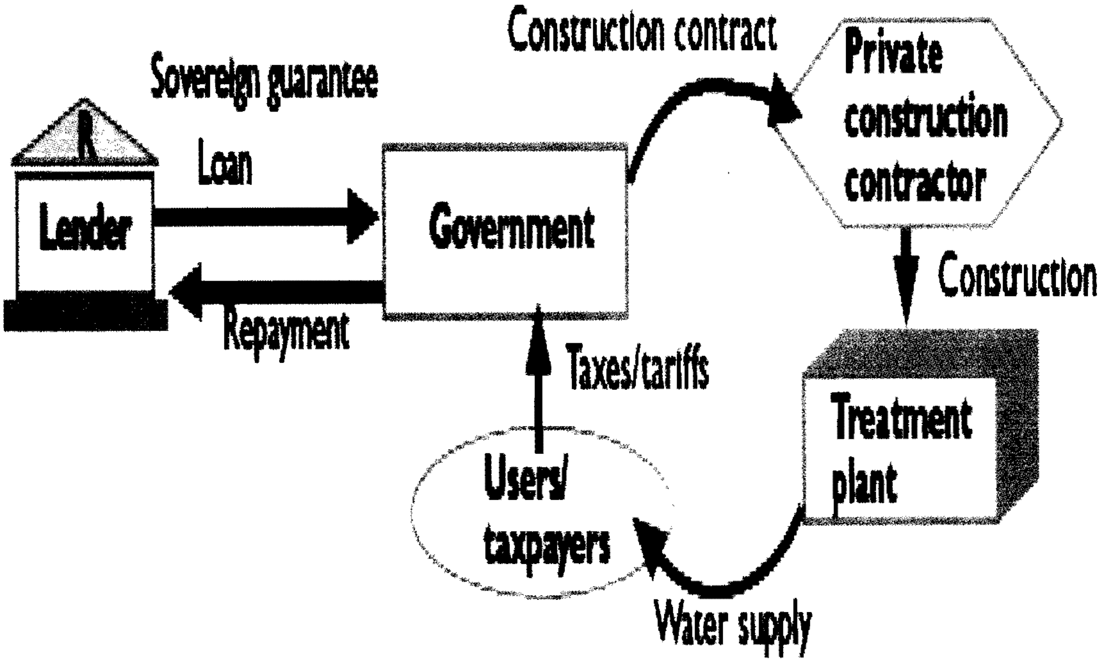

Construction contract
Sovereign guarantee
Private construction contractor
Loan
Lender
Government
Construction
Repayment
Taxes/tariffs
Treatment plant
Users/ taxpayers
Water supply

Figure 1

3.1.2 CORPORATE FINANCE:

[21] Supra Note 17.

This option is often used for shorter, less capital-intensive projects that do not warrant outside financing. However, as with government financing, private companies avoid this option, as it strains their balance sheets and capacity, and limits their potential participation in future projects.[22]

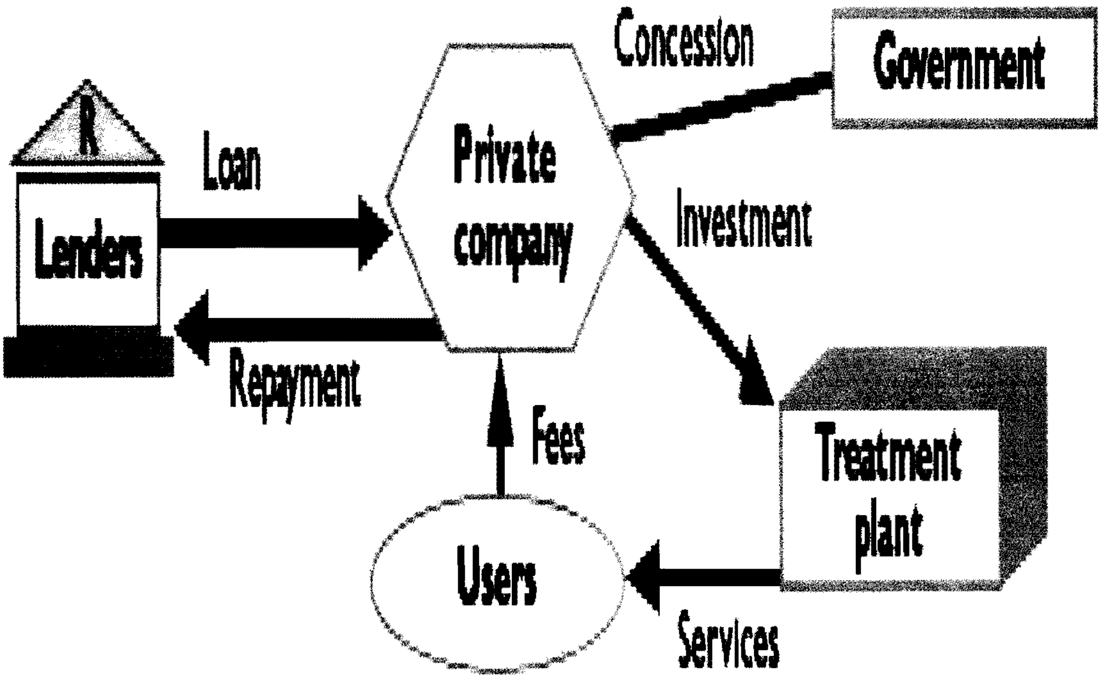

Concession
Government
R
Lenders
Loan
Private company
Investment
Repayment
Fees
Treatment plant
Users
Services

Figure 2

3.1.3 PROJECT FINANCE:

[22] Supra Note 17.

3.1.3 PROJECT FINANCE:

Project financing uses the project's assets and/or future revenues as the basis for raising funds. Generally, the sponsors create a special purpose, legally independent company in which they are the principal shareholders.[23]

A) A team or consortium of private firms establishes a new project company to build own and operate a specific infrastructure project. The new project company is capitalised with equity contributions from each of the sponsors.[24]

B) The project company borrows funds from lenders. The lenders look to the projected future revenue stream generated by the project and the project company's assets to repay all loans.

C) The host country government does not provide a financial guarantee to lenders; sponsoring firms provide limited guarantees. "Off-Balance-Sheet" financing.

The following are some of the more obvious reasons why project finance might be chosen:

[23] Phillip. R. Wood's "Project Finance, Securitisations, Subordinated Debt", Sweet and Maxwell, London, 2007, p. 3.
[24] Supra Note 23.

- The sponsors may want to insulate themselves from both the project debt and the risk of any failure of the project[25].
- A desire on the part of sponsors not to have to consolidate the project's debt on to their own balance sheets (subject to accounting and legal limitations). However, with the trend these days in many countries for a company's balance sheet to reflect substance over form, this is likely to become less of a reason for sponsors to select project finance.
- There may be a willingness on the part of the sponsors to share some of the risk in a large project with others. Smaller companies balance sheets are simply not strong enough to raise the necessary finance to invest in a project on their own and the only way in which they can raise the necessary finance is on a project financing basis
- A sponsor may be constrained in its ability to borrow the necessary funds for the project, either through financial covenants in its corporate loan documentation or borrowing restrictions in its statutes
- Where a sponsor is investing in a project with others on a joint venture basis, it can be extremely difficult to agree a risk-sharing basis for investment acceptable to all the co-sponsors. In such a case, investing

[25] Phillip. R. Wood's "Project Finance, Securitisations, Subordinated Debt", Sweet and Maxwell, London, 2007, pp. 33-67.

through a special purpose vehicle on a limited recourse basis can have significant attractions

- There may be tax advantages (e.g. in the form of tax holidays or other tax concessions) in a particular jurisdiction that make financing a project in a particular way very attractive to the sponsors and
- Legislation in particular jurisdictions may indirectly force the sponsors to follow the project finance route (e.g. where a locally incorporated vehicle must be set up to own the project's assets).[26]

[26] Supra Note 26.

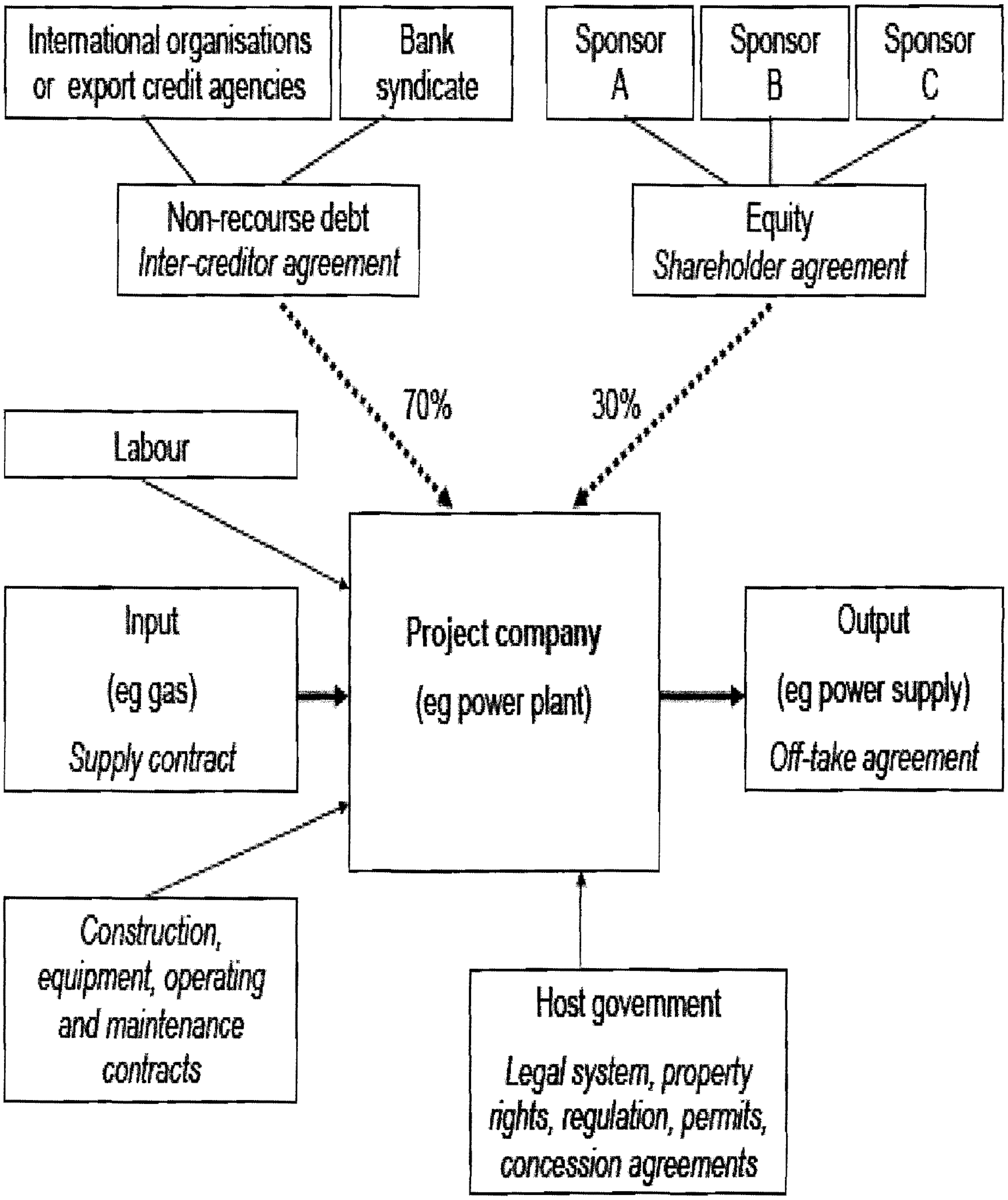

International organisations or export credit agencies
Bank syndicate
Sponsor A
Sponsor B
Sponsor C
Non-recourse debt
Inter-creditor agreement
Equity
Shareholder agreement
70%
30%
Labour
Input
(eg gas)
Supply contract
Project company
(eg power plant)
Output
(eg power supply)
Off-take agreement
Construction, equipment, operating and maintenance contracts
Host government
Legal system, property rights, regulation, permits, concession agreements

Figure 3

3.2 THE KEY CHARACTERISTICS OF PROJECT FINANCE:

A number of typical characteristics of project financing structures are designed to handle the risks illustrated above. In project finance, several long-term contracts such as construction, supply, off-take and concession agreements, along with a variety of joint-ownership structures, are used to align incentives and deter opportunistic behavior by any party involved in the project. The project company operates at the centre of an extensive network of contractual relationships, which attempt to allocate a variety of project risks to those parties best suited to appraise and control them: for example, construction risk is borne by the contractor and the risk of insufficient demand for the project output by the off-taker. Project finance aims to strike a balance between the need for sharing the risk of sizeable investments among multiple investors and, at the same time, the importance of effectively monitoring managerial actions and ensuring a coordinated effort by all project-related parties[27].

Large-scale projects might be too big for any single company to finance on its own. On the other hand, widely fragmented equity or debt financing in the capital markets would help to diversify risks among a larger investors' base, but might make it difficult to control managerial discretion in the allocation of

[27] Phillip. R. Wood's "Regulation of International Finance", Sweet and Maxwell, London, 2007, pp. 15-91.

free cash flows, avoiding wasteful expenditures. In project finance, instead, equity is held by a small number of "sponsors" and debt is usually provided by a syndicate of a limited number of banks[28]. Concentrated debt and equity ownership enhances project monitoring by capital providers and makes it easier to enforce project specific governance rules for the purpose of avoiding conflicts of interest or suboptimal investments.

The use of non-recourse debt in project finance further contributes to limiting managerial discretion by tying project revenues to large debt repayments, which reduces the amount of free cash flows. Moreover, non-recourse debt and separate incorporation of the project company make it possible to achieve much higher leverage ratios than sponsors could otherwise sustain on their own balance sheets. In fact, despite some variability across sectors, the mean and median debt-to-total capitalization ratios for all project-financed investments in the 1990s were around 70%. Nonrecourse debt can generally be deconsolidated, and therefore does not increase the sponsors' on-balance sheet leverage or cost of funding. From the perspective of the sponsors, non-recourse debt can also reduce the potential for risk contamination. In fact, even if the project were to fail, this would not jeopardize the financial integrity of the sponsors' core businesses.

[28] Supra Note 26.

One drawback of non-recourse debt, however, is that it exposes lenders to project-specific risks that are difficult to diversify. In order to cope with the asset specificity of credit risk in project finance, lenders are making increasing use of innovative risk-sharing structures, alternative sources of credit protection and new capital market instruments to broaden the investors' base[29]. Hybrid structures between project and corporate finance are being developed, where lenders do not have recourse to the sponsors, but the idiosyncratic risks specific to individual projects are diversified away by financing a portfolio of assets as opposed to single ventures. Public-private partnerships are becoming more and more common as hybrid structures, with private financiers taking on construction and operating risks while host governments cover market risks. There is also increasing interest in various forms of credit protection. These include explicit or implicit political risk guarantees,[30] credit derivatives and new insurance products against macroeconomic risks such as currency devaluations[31]. Likewise, the use of

[29] Supra Note 17.

[30] The explicit guarantee is a formal insurance contract against specific political risk events (transfer and convertibility, expropriation, host government changing regulation, war, etc) provided also by some commercial insurers. The "implicit guarantee" instead works as follows. The financing is typically divided into tranches, one of which is underwritten by the agency. The borrower cannot default on any tranche without defaulting on the agency tranche as well. The agency represents a G10 government or supranational development bank with a recognized preferred creditor status. Defaulting on the agency has additional political and financial costs that the host country would not want to incur since agencies are usually lenders of last resort for host countries in financial distress.

[31] Supra Note 26.

real options in project finance has been growing across various industries.[32] Examples include: refineries changing the mix of outputs among heating oil, diesel, unleaded gasoline and petrochemicals depending on their individual sale prices; real estate developers focusing on multipurpose buildings that can be easily reconfigured to benefit from changes in real estate prices.

Finally, in order to share the risk of project financing among a larger pool of participants, banks have recently started to securitize project loans, thereby creating a new asset class for institutional investors. Collateralized debt obligations as well as open-ended funds have been launched to attract higher liquidity to project finance.[33]

[32] Analogous to financial options, ie derivative securities which give the holder the right but not the obligation to trade in an underlying security, real options provide management with the flexibility to take a certain course of action or strategy, without the "obligation" to take it (in both cases options are exercised only if deemed convenient ex post).

[33] Among the new capital market instruments used for project financing: revenue bonds and future-flow securitisations are debt securities backed by an identifiable future stream of revenues generated by an asset; compartment funds offer to different types of investors shares with different levels of subordination and are dedicated to make equity investments.

CHAPTER IV

PROJECT FINANCE: STRUCTURE, FUNDING ALTERNATIVES AND RISK SHARING:

4.1 PROJECT FINANCE STRUCTURES:

There are a number of different structures available to sponsors for this purpose. The structures that the project sponsors will face in deciding how to finance a particular project will be how to invest in, and fund, the project.

4.1.1 A JOINT VENTURE:

A joint venture is a purely contractual arrangement pursuant to which a number of entities pursue a joint business activity. Each party will bring to the project not only its particular expertise but will be responsible for funding its own share of project costs, whether from its own revenues or an outside source. Practical difficulties may arise as there is no single project entity to acquire or own assets or employ personnel, but this is usually overcome by appointing one of the parties as operator or manager, with a greater degree of overall responsibility for the management and operation of the project.

4.1.2 A PARTNERSHIP:

Partnerships are, like joint ventures, relatively simple to create and operate but in many jurisdictions partnership legislation imposes additional duties on the partners, some of which (such as the duty to act in the utmost good faith) cannot be excluded by agreement. Liability is unlimited other than for the limited partners in a limited partnership, but these are essentially "sleeping" partners who provide project capital and are excluded from involvement in the project on behalf of the firm. Another option is limited partnership however it is a developing concept in India.

4.1.3 AN INCORPORATED BODY (LIMITED COMPANY):

In many cases it will not be convenient (or may not be possible) for the project assets to be held directly (whether by an operator or the individual sponsors) and in these cases it may be appropriate to establish a company or other vehicle which will hold the project assets and become the borrowing vehicle for the project. The sponsors will hold the shares in this company or other vehicle in agreed proportions. In most cases where this route is followed, the company or other vehicle would be a special purpose vehicle established exclusively for the purposes of the project and the use of the special purpose vehicle for any purposes unconnected with the project in question will be published. In addition to the constitutional documents establishing the vehicle, the terms on which it is to be owned and operated will be set out in a sponsors' or shareholders' agreement.

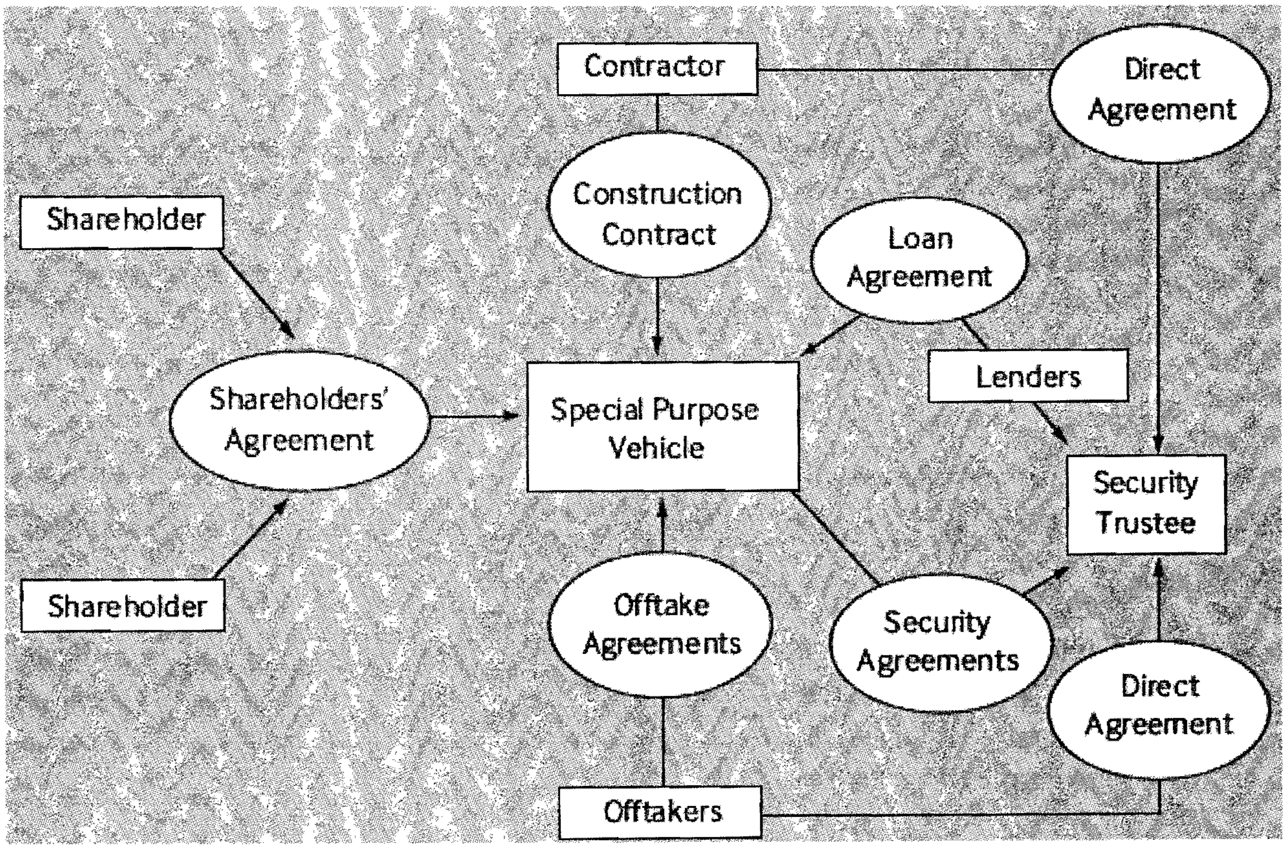
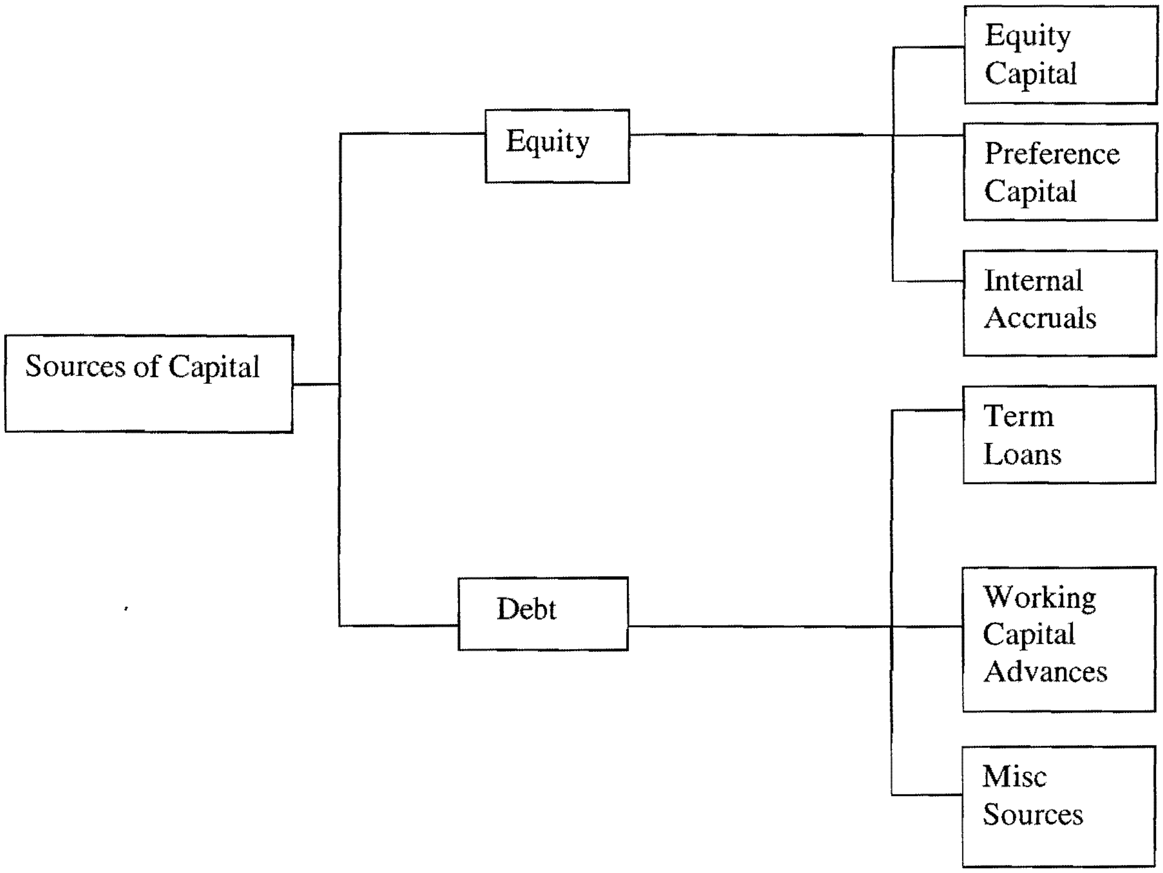

Contractor
Direct Agreement
Construction Contract
Shareholder
Loan Agreement
Lenders
Shareholders' Agreement
Special Purpose Vehicle
Security Trustee
Shareholder
Offtake Agreements
Security Agreements
Direct Agreement
Offtakers

Figure 1

4.2 PROJECT FUNDING ALTERNATIVES:

A capital project entails investment in land, plant, and machinery; miscellaneous fixes assets, technical know-how, distribution network, and working capital. The two broad sources of finance available to a firm are: shareholder's funds and loans funds. Shareholders' funds come mainly in the form of equity capital and retained earnings and secondarily in the form of preference capital. Loan funds come in a variety of ways like debenture capital, term loans, deferred credit, fixed deposits, and working capital advance

Equity and debt come in variety of forms and are raised in different ways. A firm can raise equity from both public and private sources. Capital raised from public sources is in the form of securities offered to the public through an offer document filed with the Securities Exchange Board of India. These securities can be traded on public secondary markets like the NSE or the BSE.


Sources of Capital
Equity
Debt
Equity Capital
Preference Capital
Internal Accruals
Term Loans
Working Capital Advances
Misc Sources

Private capitals comes either in the form of loans given by banks and financial institutions or in the form of securities like equity shares, preference shares, and debentures which are privately place with a small group of sophisticated investors like venture capital firms, financial institutions, insurance companies, mutual funds, and wealthy individuals.[34]

[34] Prasanna Chandra, Projects: Planning, analysis, financing, implementation and review, pp. 529, Fifth Edition, Tata Mcgrew Hill. India

4.2.1 TYPES OF SECURITIES THAT CAN BE USED FOR PROJECT FINANCING:

There various types of long-term securities that a project may issue in raising funds, it can be summarized as below:

4.2.1.1 Common equity represents ownership of the project. The sponsors usually hold a significant portion of the equity in the project[35].

4.2.1.2 Preferred equity also represents ownership of the project. However, the sponsors have a priority over the common equity holders in receiving dividends and funds in the event of liquidation[36].

4.2.1.3 Convertible debt is convertible to equity under certain conditions, usually at the option of the holder. This debt is generally considered subordinate and senior lenders regard it as pseudo-equity[37].

4.2.1.4 Unsecured debt can be either short- or long-term and, although not secured by specific assets, is senior to equity and pseudo-equity in receiving dividends and repayment of principal.

4.2.1.5 Secured debt may also be short -or long-term and is secured by specific assets or sources of revenues.

[35] http://financial-dictionary.thefreedictionary.com/Common+Equity

[36] http://www.investopedia.com/terms/p/perc.asp

[37] http://www.businessownersideacafe.com/financing/convertible_debt.php

4.2.1.6 Lease financing can vary in terms of structure and duration, although the lessor always retains the rights to the leased assets. Tax issues and the strength of the collateral are usually the driving forces behind a lease strategy. A lessor may be able to depreciate an asset for tax purposes, or the lessee may be exempt from taxes or expect losses in the early stages of the project.

4.2.2 PROJECT FUNDING OPTIONS AVAILABLE WITH THE BANKS:

Banks generally offer other short-term funding options. These are best described by their use of funds and carry specific conditions that will meet those requirements.

4.2.2.1 Construction financing, as the name suggests, is used for construction purposes and is usually very flexible with respect to draw-downs. When the construction is completed, it is generally replaced by one or more of the longer-term securities described above. The level of security required by the lender will vary. Construction financing lenders may require a designated long-term investor to commit to paying out the construction finance at a predetermined time. It is also not unusual for the lender of the construction financing to also be the long-term investor who will settle the construction financing.

4.2.2.2 Bridging finance is similar to construction financing but can be used for other purposes, usually during inception. This form of financing is also generally terminated when longer term funding is received. As with construction financing, bridge financing may require various levels of security, including a firm commitment on the part of a long-term lender to provide a facility for settling the bridging finance.

4.2.2.3 Line of credit funding is obtained and repaid on a regular basis throughout the life of the project. Credit lines are used as a cash management tool and are usually set up with various banks. Because a line of credit will not necessarily be used, the fee structure is based primarily on a commitment fee – a percentage (usually between 1 and 3 per cent) of the total line of credit committed by the investor. A standard short-term interest rate is charged on any amount drawn on the line of credit.

4.2.3 PARTIES TO PROJECT FINANCE:[38]

One of the complicating (and interesting) features of most projects is the considerable number of parties with differing interests that are brought together with the common aim of being involved to a greater or lesser extent

[38] Prasanna Chandra, Projects: Planning, analysis, financing, implementation and review, pp. 570, Fifth Edition, Tata Mcgrew Hill. India.

with a successful project. It is one of the challenges of those involved with a project to ensure that all of these parties can work together efficiently and successfully and co-operate in achieving the project's overall targets. With many projects, there will be an international aspect which will involve different project parties located in different jurisdictions and there will often be tensions between laws and practices differing from one country to another. No two projects will have the same cast of "players" but the following is a reasonably comprehensive list of the different parties likely to be involved in a project finance transaction.[39]

4.2.3.1 PROJECT COMPANY/BORROWER:

The project company will usually be a company, partnership, limited partnership, joint venture or a combination of them. The project company will in most cases be the vehicle that is raising the project finance and, therefore, will be the borrower. It will also usually be the company that is granted the concession or licence (in a concession-based financing) and who enters into the project documents.[40]

[39] Supra Note 38.

[40] See S. Krishnamurthi's, "Project Financing: Policies, Procedure and Practice", 1998, pp. 79-152.

4.2.3.2 PROJECT SPONSORS/SHAREHOLDERS:

The project sponsors are those companies, agencies or individuals who promote a project and bring together the various parties and obtain the necessary permits and consents necessary to get the project under way. They are invariably investors in the equity of the project company and may be debt providers or guarantors of specific aspects of the project company's performance.[41]

4.2.3.3 THIRD PARTY EQUITY:

These are investors in a project who invest alongside the sponsors. These investors are looking at the project purely in terms of a return on their investments for the benefit of their own shareholders. Many third-party investors are development or equity funds set up for the purposes of investing in a wide range of projects. Typically, they will require some involvement at board level to monitor their investment i.e private equity firms.

[41] Supra Note 40.

4.2.3.4 BANKS:

The sheer scale of many projects dictates that they cannot be financed by a single lender (bank) and, therefore, syndicates of lenders are formed in a great many of the cases for the purpose of financing projects.

However, participating in project financings is a much specialised area of international finance and the actual participants tend to be restricted to those banks that have the capability of assessing and measuring project risks[42].

4.2.3.5 FACILITY AGENTS:

As with most syndicated loans, one of the lenders will be appointed facility agent for the purposes of administering the loan on behalf of the syndicate. Usually, the role of the facility agent will be limited to administrative and mechanical matters as the facility agent will not want to assume legal liabilities towards the lenders in connection with the project.

4.2.3.6 TECHNICAL BANK: In many project financings a distinction is drawn between the facility agent (who deals with the more routine day-to-day tasks under the loan agreement) and a bank appointed as technical bank which will deal with

[42] Supra Note 38.

the more technical aspects of the project loan. It would be responsible for preparing (or reviewing) the banking cases and calculating the cover.

4.2.3.7 INSURANCE BANK/ACCOUNT BANK: In some of the larger project financings additional roles are often created for individual lenders. Two of these additional roles are as insurance bank and as account bank.

4.2.3.7.1 INSURANCE BANK: As the title suggests, will be the lender that will undertake the negotiations in connection with the project insurances on behalf of the lenders.

4.2.3.7.2 ACCOUNT BANK: Account Bank will be the lender through whom all the project cash flows flow. There will usually be a disbursement account to monitor disbursements to the borrower and a proceeds account into which all project receipts will be paid

4.2.3.8 MULTILATERAL AND EXPORT CREDIT AGENCIES: Many projects are co-financed by the World Bank or its private sector lending arm, the International Finance Corporation (IFC), or by regional development agencies. These multilateral agencies are able to enhance the bankability of a project by providing international commercial banks with a degree of protection against a variety of political risks.

Export credit agencies play the role of the agencies to assist exporters by providing subsidised finance either to the exporter direct or to importers (through buyer credits).

4.2.3.9 CONSTRUCTION COMPANY: In an infrastructure project the contractors will be one of the key project parties for design, procure, construct and commission the project facility assuming full responsibility for the on-time completion of the project facility - this is usually referred to as the "turnkey" model. In some large infrastructure projects a consortium of contractors is used[43].

4.2.3.10 OPERATOR: In most infrastructure projects, where the project vehicle itself is not operating (or maintaining) the project facility, a separate company will be appointed as operator for ensuring that the day-to-day operation and maintenance of the project is undertaken in accordance with pre-agreed parameters and guidelines[44].

[43] Phillip. R. Wood's "Law and Practice of International Finance", Sweet and Maxwell, London, 2007, pp. 39-187.

[44] Ibid.

4.2.3.11 EXPERTS: These are the expert consultancies and professional firms appointed by the lenders to advise them on certain technical aspects of the project.

4.2.3.12 HOST GOVERNMENT: The government in whose country the project is being undertaken is host government. The role of the host government in any particular project will vary from project to project and in some developing countries the host government may be required to enter into a government support agreement.[45]

4.2.3.13 SUPPLIERS: These are the companies that are supplying essential goods and/or services in connection with a particular project. Both the contractor and the operator would also fall under this category.

4.2.3.14 PURCHASERS: In many projects where the project's output is not being sold to the general public, the project company will contract in advance with an identified purchaser to purchase the project's output on a long-term basis.

[45] Supra Note 43.

In some projects essential supplies to the project and the project's output are purchased by the project company or, as the case may be, sold on "take-or-pay" terms, in which purchaser are required to pay for what it has agreed to purchase whether or not it actually takes delivery.

4.2.3.15 INSURERS: Insurers play a crucial role in most projects. If there is a major catastrophe or casualty affecting the project then both the sponsors and the lenders will be looking to the insurers to cover them against loss.

4.2.3.16 OTHER PARTIES: There will be other parties such as financial advisers, rating agencies, local/regional authorities, accountants, lawyers and other professionals that have a role to play in many projects to add to the complexity.

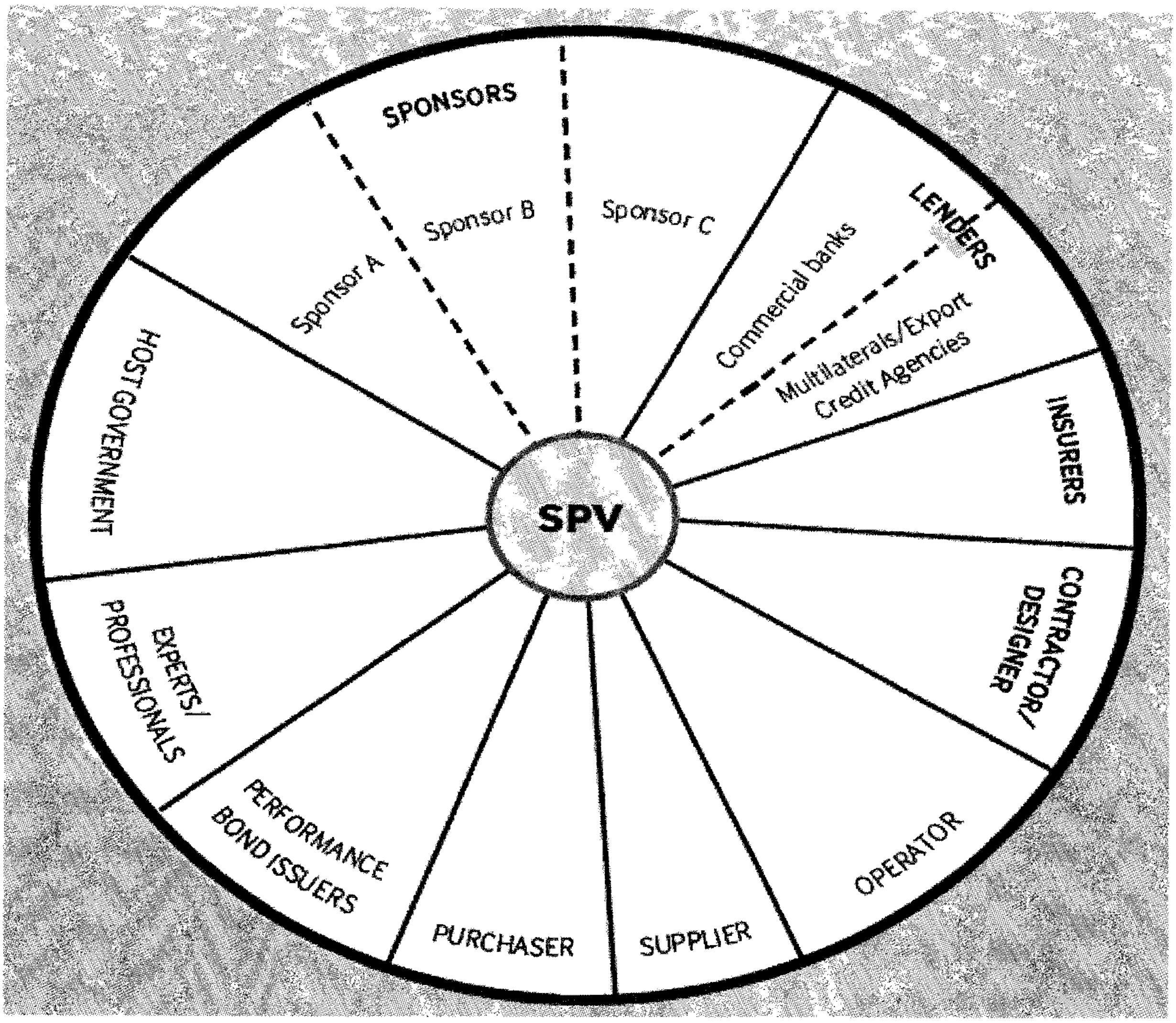

SPONSORS
Sponsor A
Sponsor B
Sponsor C
LENDERS
Commercial banks
Multilaterals/Export Credit Agencies
INSURERS
CONTRACTOR/ DESIGNER
OPERATOR
SUPPLIER
PURCHASER
PERFORMANCE BOND ISSUERS
EXPERTS/ PROFESSIONALS
HOST GOVERNMENT
SPV

Figure 2

4.3 SHARING OF RISKS:

4.3.1 INDICATION AND ALLOCATION OF RISKS: The essence of any project financing is the identification of all key risks associated with the project and the apportionment of those risks among the various parties participating in the project. Without a detailed analysis of these project risks at the outset the parties would not have a clear understanding of what obligations and liabilities they may be assuming in connection with the project and, therefore, will not be in a position to consider appropriate risk mitigation exercises at the appropriate time.

Thus, the sponsor's will be particularly concerned to ensure that they have identified and understood all risks that they will be assuming in connection with the project. They will want to be certain that they are able to manage and monitor these risks effectively and, where they are not able to do so, either to pass them on to another party involved in the project who is better able to manage any particular risks or, where this is not possible for any reason, perhaps to find some other way of managing the risk such as by taking out insurance or, more radically, altering the structure of the project to extinguish the risk or at least reduce it.

4.3.2 CONCERNS OF THE LENDERS: From the lenders' perspective, they will have similar concerns. Additionally, they will have the following concerns:

4.3.2.1 In assuming any risks associated with a particular project, they will need to be satisfied that there are no regulatory constraints imposed on them by any of the authorities that regulate their activities or pursuant to laws applicable to them.

4.3.2.2 They may have to report non-credit risks assumed by them in connection with their activities to their regulatory authorities and

4.3.2.3 Generally speaking, the more risk that a lender is expected to assume in connection with a project, the greater the reward in terms of interest and fees they will expect to receive from the project.

The task of identifying and analyzing risks in any project is likely to involve the project parties themselves, accountants, lawyers, engineers and other experts who will all need to give their input and advice on the risks involved and how they might be managed.[46]

4.3.3 GROUND RULES:

There are some ground rules that should be observed by the parties involved in a project when determining which party should assume a particular risk:

1. A detailed risk analysis should be undertaken at an early stage
2. Risk allocation should be undertaken prior to detailed work on the project documentation
3. As a general rule, a particular risk should be assumed by the party best able to manage and control that risk.

[46] Supra Note 43.

4. Risks should not be "parked" with the project company, especially where the project company is a special purpose vehicle.

4.3.4 CATEGORIES OF PROJECT RISKS:

The following is a list of some of the key project risks encountered in different types of projects. Of course, not all of these risks will necessarily be encountered in each project, but it is likely that most participants in projects will need to consider one or more of these risks and decide by whom these risks are to be assumed and how.

A) Construction/completion risk (Resource Risk)

B) Operating risk

C) Market risk (Interest Rate Risk, Currency Risk)

D) Political risk

E) Reserve/production risk

F) Counterparty risk

G) Legal and structural risks

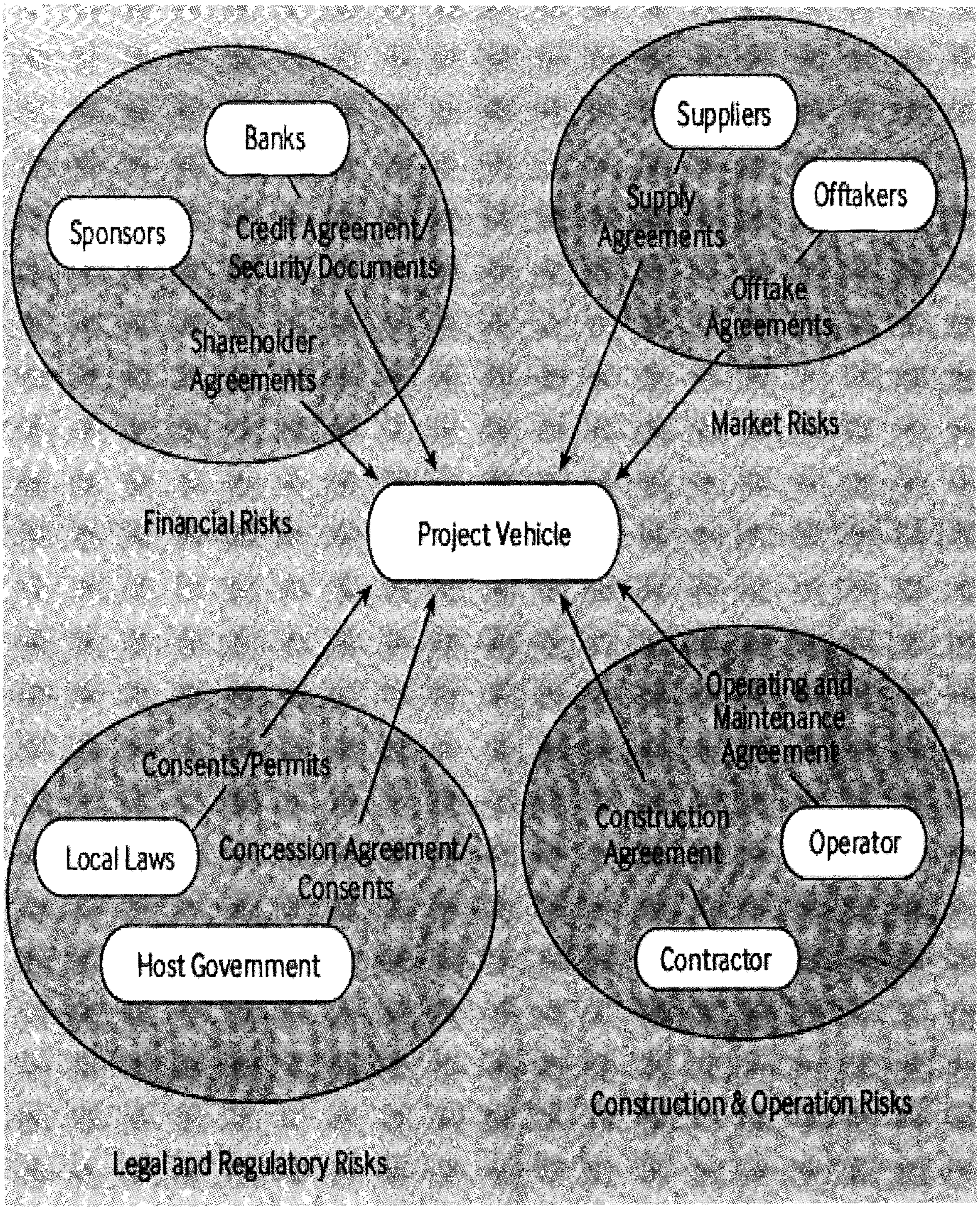

Banks
Sponsors
Credit Agreement/
Security Documents
Shareholder
Agreements
Suppliers
Offtakers
Supply
Agreements
Offtake
Agreements
Market Risks
Financial Risks
Project Vehicle
Consents/Permits
Local Laws
Concession Agreement/
Consents
Host Government
Operating and
Maintenance
Agreement
Construction
Agreement
Operator
Contractor
Construction & Operation Risks
Legal and Regulatory Risks

Figure 6

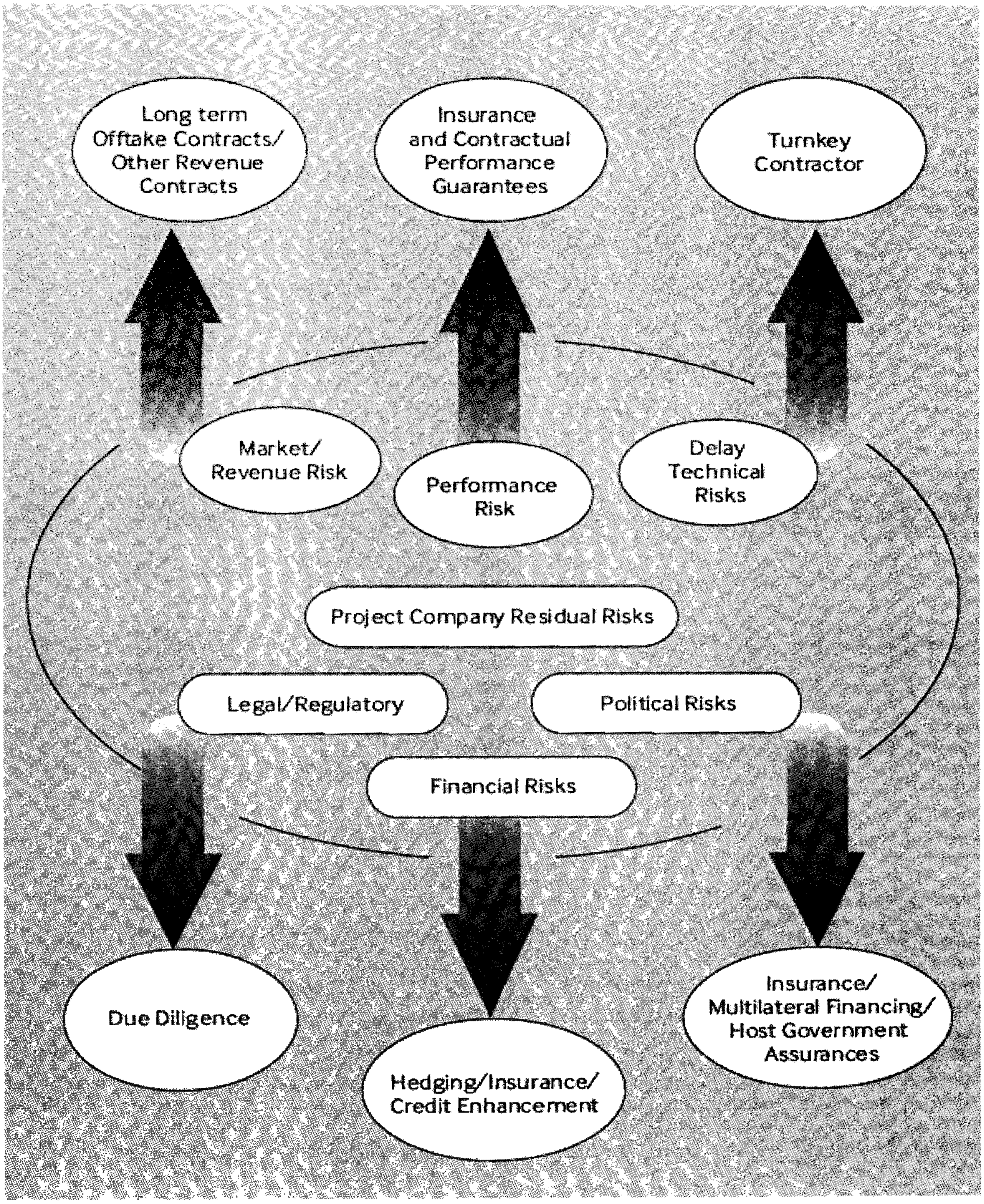

Long term Offtake Contracts/ Other Revenue Contracts
Insurance and Contractual Performance Guarantees
Turnkey Contractor
Market/ Revenue Risk
Performance Risk
Delay Technical Risks
Project Company Residual Risks
Legal/Regulatory
Political Risks
Financial Risks
Due Diligence
Hedging/Insurance/ Credit Enhancement
Insurance/ Multilateral Financing/ Host Government Assurances

Figure 7

CHAPTER V

REGULATION OF PROJECT FINANCE:

5.1 DISTINCTIVE CHARACTERS OF PROJECT FINANCE REGULATION: The regulation of Project Finance has three distinctive features:

5.1.1 ESTABLISHMENT OF OFFICIAL REGULATOR HAVING WIDE POWERS:

The establishment of official regulators with wide powers: A key feature of regulatory regime is the establishment of semi-governmental regulators, having wide powers viz. legislative power to make rules, executive power to implement a policy and judicial power to make decisions and enforce them by fines and other sanctions.[47] Often this is backed by the encouragement of private enforcement by investors of civil claims. Thus the regulation involves the concentration of legislative, executive and judicial powers in one entity. Regulation is a form of state intervention agencies.[48] Separate Regulators are established with the following objectives in mind:

[47] Phillip. R. Wood's "Project Finance, Securitisations, Subordinated Debt", Sweet and Maxwell, London, 2007, p. 3.
[48] Ibid.

- To decentralise government and to enhance independence so as to reduce day-to-day government cost and government interference;[49]
- To promote closeness to the regulated field and hence focus expertise and experience;[50]
- To distance the agency from central government, especially the risk of liability and opprobrium;[51] and
- To throw costs to the regulated firms who pay fees, thereby avoiding direct taxation.[52]

5.1.2 CRIMINALIZATION OF THE LAW:

Regulation tends to criminalize ordinary commercial law. The rules attract a criminal or quasi-criminal sanction, such as regulatory fines, public censure, and disqualification from working in the industry, asset freezes and investigative powers. Criminalization is the easy option. The punishments are often dressed up as administrative and therefore not criminal. The purpose of this is to evade the protections of the criminal law so that enforcement by the regulator is easier. One of the crucial differences between the civil and the criminal law is that the penalties of the criminal law are intended not as compensation for damages but as

[49] Supra Note 47.
[50] Supra Note 47.
[51] Supra Note 47.
[52] Supra Note 47.

punishment to deter violations. On this basis the administrative sanctions are essentially criminal in nature.[53]

5.2 MAIN HEADS OF FINANCIAL REGULATION:

There are six main heads of financial regulation whereby it seeks to achieve its objective of protecting public against investment losses by reason of fraud, negligence or insolvency:

5.2.1 OFFICIAL AUTHORISATION OF INVESTMENT BUSINESS:

Firms must be authorised by a regulator to undertake financial business. The licensing takes into account the competence, reputation and solvency of the applicant, its management and controllers. The aim is prevention rather than cure. The firms must continue to comply with the licence conditions.[54]

5.2.2 FINANCIAL SUPERVISION OF FIRMS:

Regulation seeks to protect investors from the insolvency of banks, who take deposits and of investment of firms who may hold client's money or client's securities.[55] The main rules are those which require banks and

[53] Phillip. R. Wood's "Project Finance, Securitisations, Subordinated Debt", Sweet and Maxwell, London, 2007, pp. 35-116.

[54] Phillip. R. Wood's "Project Finance", Sweet and Maxwell, London, 2007, pp. 123-134.

[55] Ibid.

investment firms to maintain prescribed levels of capital and to observe other insolvency safeguards such as adequate liquidity (ready cash or near-cash to pay current obligations).[56]

5.2.3 CODES OF CONDUCT ENHANCING AGENCY AND FIDUCIARY DUTIES:

These codify duties of due diligence by agents, duties to ensure that transactions are suitable for unsophisticated customers, mitigation of conflicts of interest, fair dealing and fair underwriting practices, disclosure of remuneration and record keeping.[57] The codes include rules which require investment firms to segregate client monies and assets from their own monies and assets to protect the assets in the event of the firm's insolvency.

5.2.4 MARKET FRAUDS:

The codes impose criminal liability, e.g. for fraudulent misrepresentation, market manipulation, false market and insider dealing. Less serious conduct-market abuse-attracts administrative fines.

[56] Supra Note 53.

[57] Phillip. R. Wood's "Comparative Law of Securities and Guarantees", Sweet and Maxwell, London, 2007, p. 79-91.

5.2.5 PROSPECTUS AND FINANCIAL PROMOTION:

The cornerstone of securities regulation is disclosure so that an investor can make informed investment decision. The policies for prospectus are achieved mainly by:

5.2.5.1 Prescribing that the information must be disclosed;[58]

5.2.5.2 Publishing of information such as by registration with a registrar of companies, a banking commissioner which may screen the prospectus;

5.2.5.3 Continuing disclosure that a holder of securities is kept informed about the status of his investment and the issuer during the currency of his investment as well as at its inception. This is achieved mainly by requirements imposed by securities regulation, by company law or embodied in a listing undertaking given to the stock exchange;[59] and

5.2.5.4 Enhancing misrepresentation law, e.g. the onus of proof of due diligence is shifted from the investor to the issuer, there is absolute liability on the issuer in some cases, a positive due diligence duty on the part of the issuers and their directors, additional liability of those involved other than the issuer, e.g. directors, auditors and other experts and sometimes, managers or underwriters, and wider damages and recession remedies.

[58] Supra Note 57.

[59] Supra Note 38.

5.2.6 INVESTOR COMPENSATION FUNDS:

These are usually central funds out of which compensation is paid to customers if a financial firm becomes insolvent. The compensation is normally subject to an upper limit per claim which usually covers only the small depositors or investor. The fund may be government-funded or funded by levies on firms.

5.2.7 OTHER HEADS OF REGULATION: Some other heads of regulation of Project Finance are as follows:

5.2.7.1 FINANCIAL STATEMENTS:

The content of financial statements for companies is at the heart of the disclosure concept. The principles and detailed rules are promulgated by accounting association in the effect of the professionals.[60]

5.2.7.2 CORPORATE GOVERNANCE:

Corporate Governance rules, especially for listed companies, seek to codify the fiduciary duties of directors. The basic fiduciary duties include such matters as a duty of due diligence, the avoidance of conflicts of interest and a duty not to take secret profits. Amongst the innumerable aspects of corporate governance regimes which lies at the centre of the

[60] See S. Krishnamurthi's, "Project Financing: Policies, Procedure and Practice", 1998, pp. 79-152.

company law, recent trends for listing companies have included the need for independent directors and separate committees for audit, nomination and remuneration.[61]

5.2.7.3 TAKEOVER REGULATION:

Most advanced states and many others too have detailed regulation covering takeovers. The regulation deals with such matters as the need to treat shareholders equally, and standards of disclosure, timetables, duties to ensure that financing is in place, mandatory duties to make a cash offer if the bidder acquires, say, thirty percent or more and other matters.[62]

5.2.7.4 LIMITATION ON ENTITIES ENTITLED TO RAISE MONEY FROM THE PUBLIC:

In most countries, closely held, small or private companies are prohibited from issuing securities to the public. The rationale is that, since these companies benefit from a more relaxed statutory regime imposing less burdens on family enterprises, they should be prevented from putting the public at risk by inviting public capital. Typical relaxations for the private companies are: exceptions form audited financial statements and prescribed disclosure at the companies or commercial register; no

[61] Supra Note 60.
[62] Supra Note 57.

minimum number of members, less stringent rules as to the amount or maintenance of share capital; no minimum number of directors and no two tear boards; and less red tape in the observance of corporate formalities.[63]

The object is to allow the use of the corporate privilege (no liability of owners on insolvency) by family and small business. In return for this weakening of creditor protections, these companies do not have access to public fund raising. They have to borrow privately from banks.

5.2.7.5 CONTROL ON THE TERMS OF SOCIETIES:

Where money is transferred in exchange for a piece of paper, it is fundamental that the piece of paper should constitute a valid legal claim. By reason of diversity of types of issue, securities regulation cannot in practice impose standards for the terms of bonds. In this respect reliance is usually placed upon the advisers to the managers. Regulatory regimes rarely go beyond a requirement of filing of copies of authorisations, constitutional documents, exchange control consents and sometimes legal opinions and leave it to the market practice to control the contractual

[63] Phillip. R. Wood's "Project Finance, Securitisations, Subordinated Debt", Sweet and Maxwell, London, 2007, p. 3.

terms, i.e. freedom of contract. The intervention in the case of actual terms of debt issues is extremely limited, but is more visible in case of shares. Thus for debt securities, common stock exchange requirements may be restricted to rules that, for example, any drawings must be made by lot; there must be the provision for replacement of lots or mutilated bonds;[64] prescription periods must be of a minimum duration; and (usually) the equal treatment of the holders of listed debt securities. But the law does not regulate, e.g. events of defaults or covenants.[65]

Nevertheless, in order to unite the interests of scattered bondholders, statute or stock exchange regulation may require the appointment of a trustee or, in civilian countries, a bond-holders representative. Bond holders may give the voting rights by statute or contract.

[64] Supra Note 63.
[65] Supra Note 63.

5.3 MICROECONOMIC REGULATION:

The types of financial regulation with which we are concerned are to be distinguished from microeconomic regulation. The main heads which actually fall with the province of central banks are as under:

5.3.1 Targeting the value of national currency, e.g. by buying and selling it. This used to be universally controlled by exchange controls and borrowing controls.

5.3.2 Controls of money supply, interest rates and credit such as by the purchase or sale of government securities which influence bank reserves, by imposition of reserve requirements on banks whereby banks must make interest free deposits with the central bank,[66] by discount rates (i.e. the rate at which the central bank will lend overnight to banks) and by direct controls on the amount of credit or interest which may be charger. However the later has become out of date.[67]

[66] Phillip. R. Wood's "Law and Practice of International Finance", Sweet and Maxwell, London, 2007, p. 3
[67] Ibid.

5.4 LAW AND INSTITUTIONS OF PROJECT FINANCING IN INDIA:

Financial regulation in the India is taken care of by two Regulators namely the Reserve Bank of India, the Securities and Exchange Board of India and the Insurance Regulatory and Development Authority.

5.4.1 Reserve Bank of India (RBI), which regulates the banking and the non-banking institutions, and is governed basically by the Reserve Bank of India Act, 1934 and the Banking Regulation Act, 1949. The Banking Regulation Act, 1949 as amended defines banking as the accepting of deposits of money from the public for the purposes of lending or investment, repayable on demand or otherwise and withdrawable by cheque, draft, order, or otherwise. Once authorised, a bank is allowed to engage in certain other forms of business such as borrowing or taking up of money, the lending or advancing of money with or without security, activities in relation to negotiable instruments, granting and issuing letters of credit and travellers cheque, selling and dealing in bullion and specie, receiving bonds and other valuables for safe custody and acting as agent for any government or local authority or any other person, affecting, ensuring, guaranteeing, underwriting, participating and managing and carrying out any issue of a company or a corporation. Banks are prohibited from engaging in any form of business other than those permitted under the Banking Regulation Act, 1949.

As far as foreign exchange is concerned RBI regulates the same through the power conferred to it under the Foreign Exchange Management Act, 1999. Local Banks can establish a branch office outside India subject to written permission from the RBI. Foreign Banks on the other hand are required to take a license from the same.

RBI regulates the entry of foreign exchange in India through various regulations formulated under the FEMA. As far as the question of Project Financing in India is concerned, the same can be done either through setting up a Joint Venture with an Indian entity or by a Wholly Owning a Company in India. There are two modes of bringing money into India: one is by investing in a Joint Venture or Wholly Owned Subsidiary as mentioned above or second as external commercial borrowing which are commercial loans with a minimum maturity of three years.

Under the FDI scheme, investment can be made by a Company in shares/convertible debentures and preference shares of an Indian Company; however in this regard the Indian entity is required to adhere to the pricing guidelines/valuation norms prescribed under the FEMA regulation for the issue of any of such shares. Further some other kind of preference shares can also be acquired by the a company which include non-convertible, optionally convertible or partially convertible preference shares, however issue of any such preference share by an Indian Company has to be in accordance with the guidelines applicable for ECB. It should be noted here that only those debentures which are fully and mandatorily convertible into equity, within a specified time would be reckoned as part of equity under the FDI policy. It is possible for an Indian Company to issue 'Right Shares' in favour of your Company with a specific prior permission from the Reserve Bank for such issue. This apart the Indian Companies have also been granted general permission for the conversion of External Commercial Borrowings into Shares/preference shares provided the activity is covered under the Automatic Route for FDI and the foreign equity after conversion of ECB into equity is within the sectoral cap[68].

Under the ECB scheme through the automatic route, commercial loans in the form of bank loans, buyers' credit, suppliers' credit, securitised instruments (e.g. floating rate notes and fixed rate bonds) available from

[68] Master Circular No. 02/2008-09 Dated July 1, 2008 on Foreign Investment in India, Master Circular No. 07/2008-09 Dated July 1, 2008 on External Commercial Borrowings and Trade Credits and Notification No. RBI/2008-09/343, A.P. (DIR Series) Circular No. 46 Dated January 02,

non-resident lenders with minimum average maturity of three years.[69] A foreign equity holder to be to be eligible as "recognized lender" under the automatic would require a minimum holding of 25 percent in cases where the ECB is for an amount upto USD 5 million, and a minimum equity of 25 per cent held directly and debt equity ratio not exceeding four times the direct foreign equity holding in cases where the ECB is for an amount more than USD 5 million.[70] The minimum lock-in in case of the later would be five year, compared to three year in the former. Investment through this route can only be made for the purposes of import, e.g., import of capital goods (as classified by the Director General of Foreign Trade in the Foreign Trade policy), by new or existing units, in the real sector – industrial sector including small and medium enterprises and infrastructure sector in India, which include Power, Telecommunication, Railways, Road including bridges, Sea port or Airport, Industrial parks and under infrastructure projects. Under this route, issuance of guarantee, standby letter of credit, letter of undertaking or letter of comforts by banks, financial institutions and non-banking financial institutions is not permitted. However the choice of security is left to the borrower. This therefore enables the pledging of shares of an Indian Company with an

[69] Ibid.
[70] Supra Note 68

investor company abroad. Suppliers of equipment are also one among the recognized lenders under the ECB scheme. The permissible ECB limit is USD 500 million per company per financial year under the Automatic route.[71]

5.4.1.1 INDIAN POLICY ON FOREIGN DIRECT INVESTMENT IN GENERAL:

India has among the most liberal and transparent policies on FDI among the emerging economies. FDI up to 100% is allowed under the automatic route in all activities/sectors except the following, which require prior approval of the Government:-

1. Sectors prohibited for FDI
2. Activities/items that require an industrial license
3. Proposals in which the foreign collaborator has an existing financial/technical collaboration in India in the same field
4. Proposals for acquisitions of shares in an existing Indian company in financial service sector and where Securities and Exchange Board of India (substantial acquisition of shares and takeovers) regulations, 1997 is attracted
5. All proposals falling outside notified sectoral policy/CAPS under sectors in which FDI is not permitted

[71] Supra Note 68.

Most of the sectors fall under the automatic route for FDI. In these sectors, investment could be made without approval of the central government. The sectors that are not in the automatic route, investment requires prior approval of the Central Government. The approval in granted by Foreign Investment Promotion Board (FIPB). In few sectors, FDI is not allowed. After the grant of approval for FDI by FIPB or for the sectors falling under automatic route, FDI could take place after taking necessary regulatory approvals form the state governments and local authorities for construction of building, water, environmental clearance, etc.[72]

5.4.1.2 PROCEDURE UNDER AUTOMATIC ROUTE:

FDI in sectors/activities to the extent permitted under automatic route does not require any prior approval either by the Government or RBI. The investors are only required to notify the Regional Office concerned of RBI within 30 days of receipt of inward remittances and file the required documents with that office within 30 days of issue of shares of foreign investors.

[72] Supra Note 68.

5.4.1.3 PROCEDURE UNDER GOVERNMENT APPROVAL

FDI in activities not covered under the automatic route require prior government approval. Approvals of all such proposals including composite proposals involving foreign investment/foreign technical collaboration are granted on the recommendations of Foreign Investment Promotion Board (FIPB). Application for all FDI cases, except Non-Resident Indian (NRI) investments and 100% Export Oriented Units (EOUs), should be submitted to the FIPB Unit, Department of Economic Affairs (DEA), Ministry of Finance.

Application for NRI and 100% EOU cases should be presented to SIA in Department of Industrial Policy and Promotion.

Application can be made in Form FC-IL. Plain paper applications carrying all relevant details are also accepted. No fee is payable. The guidelines for consideration of FDI proposals by the FIPB are at Annexure-III of the Manual for FDI.

FORM FC-IL - COMPOSITE FORM FOR FOREIGN COLLABORATION AND INDUSTRIAL LICENCE[73]

[73] http://siadipp.nic.in/download/il-form.doc

5.4.1.4 PROHIBITED SECTORS:

The extant policy does not permit FDI in the following cases:

- Retail Trading (except single brand product retailing)
- Atomic Energy
- Lottery Business
- Gambling and Betting
- Business of Chit Fund
- Nidhi Company
- Trading in Transferable Development Rights (TDRs)
- Activity/Sector not opened to private sector investment

5.4.1.5 GENERAL PERMISSION UNDER FEMA:

Indian companies having foreign investment approval through FIPB route do no require any further clearance from RBI for receiving inward remittance and issue of shares to the foreign investors. The companies are required to notify the concerned Regional Office of the RBI of receipt of inward remittances within 30 days of such receipt and within 30 days of issue of shares to the foreign investors or NRIs.[74]

[74] Supra Note 73.

5.4.1.6 INDUSTRIAL LICENSING:

With progressive liberalization and deregulation of the economy, industrial license is required in very few cases. Industrial licenses are regulated under the Industries (Development and Regulation) Act 1951.[75] At present, industrial license is required only for the following: -

1. Industries retained under compulsory licensing
2. Manufacture of items reserved for small scale sector by larger units
3. When the proposed location attracts locational restriction

5.4.1.7 INDUSTRIES REQUIRING COMPULSORY LICENSE:

Following are the industries for which a compulsory license is required:

a) Alcoholics drinks

b) Cigarettes and tobacco products

c) Electronic aerospace and defense equipment

d) Explosives

e) Hazardous chemicals such as hydrocyanic acid, phosgene, isocynates and di-isocynates of hydro carbon and derivatives

5.4.1.8 PROCEDURE FOR OBTAINING AN INDUSTRIAL LICENSE:

[75] Supra Note 73.

Industrial license is granted by the Secretariat for Industrial Assistance in Department of Industrial Policy and Promotion, Government of India. Application for industrial license is required to be submitted in Form FC-IL to Department of Industrial Policy and Promotion.

FORM FC-IL – COMPOSITE FORM FOR FOREIGN COLLABORATION AND INDUSTRIAL LICENSE

5.4.1.9 SMALL SCALE SECTOR:

Ministry of Agro and Rural Industries and Ministry of Small Scale industries have been merged into a single Ministry, namely, Ministry of Micro, Small and Medium Enterprises.[76]

5.4.1.10 LOCATIONAL RESTRICTIONS:

Industrial undertakings to be located within 25 kms of the standard urban area limit of 23 cities having a population of 1 million as per 1991 census require an industrial license. Industrial license even in these cases is not required if a unit is located in an area designated as an industrial area before

[76] Supra Note 73.

1991 or non-polluting industries such as electronics, computer software, printing and other specified industries.[77]

5.4.1.11 ENVIRONMENTAL CLEARANCES:

Entrepreneurs are required to obtain Statutory clearances, relating to Pollution Control and Environment as may be necessary, for setting up an industrial project for 31 categories of industries in terms of Notification S.O. 60(E) dated 27.1.94 as amended from time to time, issued by the Ministry of Environment and Forests under The Environment (Protection) Act 1986. This list includes petrochemicals complexes, petroleum refineries, cement, thermal power plants, bulk drugs, fertilizers, dyes, papers etc.

However where, investment in the project is less than Rs.1 billion, (appox. $ 22.2 million), such Environmental clearance is not necessary, except in cases of pesticides, bulk drugs and pharmaceuticals, asbestos and asbestos products, integrated paint complexes, mining projects, tourism projects of certain parameters, tarred roads in Himalayan areas, distilleries, dyes, foundries and electroplating industries.

[77] Supra Note 73.

Setting up industries in certain locations considered ecologically fragile (e.g. Aravalli Range, coastal areas, Doon Valley, Dahanu etc.) are guided by separate guidelines issues by the Ministry of Environment and Forests.

Other approvals/clearances at State level

Land, Water, Electricity, Registrations etc.

5.4.2 SECURITIES AND EXCHANGE BOARD OF INDIA (SEBI):

SEBI is the regulator of the securities market. SEBI is also responsible for stock exchanges, collective investment schemes and the take-over of companies under the Indian Take-Over Code. There is a Depositories Act, 1996 providing for the electronic registration and transfer of ownership of securities. SEBI is also the authority for the submission of prospectus and public issue. The Indian Take-Over code contains provisions for triggering mandatory open offers. Further the insider trading is regulated by the SEBI (Insider Trading) Regulations, 1992.[78] An insider is thus prohibited from dealing in securities of listed company on the basis of unpublished

[78] Phillip. R. Wood's "Project Finance, Securitisations, Subordinated Debt", Sweet and Maxwell, London, 2007, p. 3-15.

price-sensitive information to persons except as required in the ordinary course of business or under any law, or counselling or procuring any other person to deal in securities of any company on the basis of unpublished price sensitive information.[79]

There are many areas of Project Finance where the regulatory role of the above mentioned regulators overlap. The regulators therefore work in co-ordination with one another to ensure that financing does not become cumbersome and that the investment framework does not become prone to abuses.

[79] Supra Note 78.

CHAPTER VI

DEFICIENCIES IN THE INDIAN REGULATORY FRAMEWORK

In this part of the dissertation, basically aims to highlight the concerns of project financing in India. The basic aim is to nail down the regulatory concerns so that the remedial measures can be suggested. The concerns are basically based upon various books and committee reports, the endeavour of the researcher has been to analyse the systemic deficiencies and suggest improvements.

Coming to the topic, I think it won't be wrong to say that in India, Project Finance is proving to be somewhat difficult for there is an absolute lack of satisfactory legal framework regulating Project Finance. This is well manifest in the fact that there is no legislation on Hire-Purchase and Lease Financing in India.[79] Legislations like the Securitization Act cannot help the lenders because Project Financing is a limited recourse financing and the financier principally looks to the assets and revenue of

[79] The Hire Purchase Act, 1972 was enacted, but an account of objection by the 'transport lobby' and others is not notified till date). The law relating to hire purchase and equipment leases continues to be a branch of law of bailment, (part of the law of contract). There are obvious practical problems in recovery of lease rentals and for resuming possession of leased property in the event of the transaction becoming a default case. Except assets such as motor vehicles or other stand-alone items like computers, typewriters, etc., industrial equipment leases in relation to plant and machinery or other such items are most problematic for recovery of physical possession as are inextricably linked with the rest of the factory, and frequently also are special purpose assets, not easily saleable nor reusable by other lessees or hires.

the project in order to secure and service the loan and he has no other recourse than the project itself.

Further, it is difficult to finance large infrastructure projects in India. Since a majority of infrastructure projects in India inherently lack the capacity to generate earnings in foreign exchange, there is an inherent risk on relation to foreign exchange, debt, and the domestic debt market by itself does not have the capacity to provide adequate long-term maturity periods required to finance such project.

The incomplete markets in the Indian financial sector have been highlighted by several reports in the recent past. The most notable, and brilliant, among them, the Percy Mistry Committee report (Feb 2007), points a vacuous finger towards the deeply interlinked bonds, currency and derivatives (BCD) markets. Preceding the Percy Mistry report was the R H Patil Committee report (December 2005) which concentrated on the micro issues of the corporate debt and securitized debt markets and made a large number of recommendations.

These include creation of a reporting platform where off-exchange secondary trades in corporate bonds are mandatorily reflected, reduction of trading lot size, electronic fund transfer enablement and real time gross settlement, repeal of structural 'nanny' provisions prescribing minimum requirements like investment grade issues, maturity periods, put/call periods and restriction on conversions. Certain over-the-counter (OTC) trade facilitating platforms were given a no objection to make OTC trades more efficient, facilitating their movement from the phone to the electronic media. Certain other low hanging fruit like creation of a uniform day count were also prescribed so that everyone uses the same financial language in the markets.[80] Certain areas in the domain of the RBI and the government have been slower, though sometimes with justifiable cause. For instance, the finance ministry has to get all the states on board to reform the stamp duty levies. [81] Thus there are areas where the above mentioned recommendations have not been given effect. If we analyze the present Indian legal framework would reveal the following regulatory concerns would be highlighted:

6.1 LACK OF RISK CAPITAL TO SUPPORT DEBT RAISING:

One of the key constraints in infrastructure financing is the lack of availability of risk capital to support debt rising. Adequate flow of equity capital into infrastructure sectors has not been forthcoming, despite the fact that the domestic equity market is well developed. This underlines the need for developing the market for other forms of risk capital such as mezzanine financing, subordinated debt and private equity. Shortage of risk capital in

[80] See, Mark J. Riedy's, "Project Finance India, 2007—Overcoming Hurdles to Growth: Current Trends and Innovative Transactional Structures in India" , Practicing Law Institute Corporate Law and Practice Course Handbook series, February-March, 2007.

[81] http://economictimes.indiatimes.com/articleshow/msid-3238786,prtpage-1.cms, Date of access: 26.05.2009, Time: 00:44 AM;

the domestic market is also grounds for seeking larger FDI into infrastructure, which would not only narrow the risk capital gap, but also usher in requisite skills to implement and monitor projects in line with global best practices.

6.2 CHALLENGES RELATING TO MONETARY MANAGEMENT:

The economy's ability to absorb various capital inflows poses challenges with relation to monetary management. So far, the response to this challenge has been to either allow the rupee to appreciate, sterilize capital inflows, allow larger capital outflows, or impose restrictions specifically on the inflow of debt capital.[82] The last measure is especially blunt for it pre-supposes that all inflows of equity capital are necessarily superior to any kind of foreign debt capital. This actually ends up discriminating in favour of larger corporate borrowers, and against infrastructure projects. It is evident that until such time as we get to full capital account convertibility, there will necessarily remain a need for prioritization of capital inflows.

[82] See, Mark J. Riedy's, "Project Finance India, 2007—Overcoming Hurdles to Growth: Current Trends and Innovative Transactional Structures in India" , Practicing Law Institute Corporate Law and Practice Course Handbook series, February-March, 2007.

6.3 INSTITUTIONAL CONSTRAINTS: Apart from those mentioned above, there are certain institutional constraints that need to be addressed. They can broadly be summed up under the following heads:

6.3.1 LIMITED PARTICIPATION OF INSURANCE COMPANIES IN PROJECT FINANCE:

Eligible investors such as insurance companies have invested limited amounts in private infrastructure development. This can be attributed to regulatory restrictions, underdeveloped corporate bond markets and the absence of efficient credit risk transfer mechanisms (such as securitization, credit derivatives, credit insurance etc.). Furthermore, insurance companies' traditional preference for investment in public sector has meant that their contribution to infrastructure development by private sponsors is even less.

6.3.2 IMPROPER UTILIZATION OF SPECIALIZED NBFCS:

Though a relatively new entrant to infrastructure financing, NBFCs' share has been growing rapidly especially in the backdrop of a diminishing role of development financial institutions. In the future, NBFCs are expected to play a more critical role in infrastructure development. This is so, because such NBFCs:

- Have focused business models based on their deep knowledge of, and risk appetite for, complex and long gestation projects that are typical of the infrastructure sector;
- Are less likely to pose systemic risk and are easier to be created and expanded under private sponsorship.

Major constraints to the growth prospects of these NBFCs have been

a) Their inability to optimally utilize their capital and balance sheets through mechanisms like securitization; and

b) Their limited access to low cost financing options. Further, even more so than commercial banks, NBFCs are increasingly facing exposure norm constraints in Project Financing.

CHAPTER VII

CONCLUSION AND SUGGESTIONS:

Project financing needs a stable, transparent and effective Statutory, Regulatory and Financial framework in which the financer should get the returns of his investment, the government has to take necessary steps to increase the investor confidence in this sector. The present regulatory framework therefore needs to be strengthened keeping in the concerns of efficacy, stability and transparency. The new measures should aim for boosting the financers and investors confidence in project financing and then only we will be able to attract financers.

Keeping in mind the regulatory concerns highlighted in the previous chapter, I would like to suggest the following policy initiatives:

7.1 DEVELOPMENT OF DEBT CAPITAL MARKET: The creation of a deep and robust debt capital market is a key to making available long term debt instruments for infrastructure. To further develop the domestic debt capital market, which is currently at a nascent stage, the following initiatives would be necessary.

7.1.1 Patil Committee recommendations: There is a need to expedite the implementation of Patil Committee recommendations for the development of corporate bonds and securitization market. The key recommendations not yet implemented that need priority in implementation are listed below. These are considered critical initial steps as, a) they can be implemented broadly in isolation from other recommendations and, b) their impact on the bond market development will be quick and substantial, thereby creating a favorable ground for more comprehensive reforms.

7.1.2 Consolidation of all regulations pertaining to issuance of corporate debt securities under the aegis of SEBI to minimize multiplicity of regulators. Currently, guidelines relating to issue of debt securities are issued by SEBI, Company Law Board, stock exchanges and host of other entities. This makes compliance with the guidelines a difficult and cumbersome process. Also, multiplicity of regulators creates problems in effective supervision. Hence, it is desirable that a consolidated guideline and a single regulator be evolved. It is logical that SEBI be entrusted with this role given the fact that it is already responsible for all public and private placements of equity / equity linked instruments issued by corporates.

7.1.3 Removal of TDS on corporate bonds in line with GOI securities: Trading in corporate bonds becomes cumbersome due to tax deducted at source (withholding tax). At the end of the financial year, withholding tax on corporate bonds is deducted on accrued interest and a withholding tax certificate is issued to the registered owner. Interest payment, however, is made to the registered holder on the interest payment date, after deducting the withholding tax due. When trading takes place in a corporate bond, holders are forced to settle through physical exchange of cash. Further, investors who are not subject to withholding tax find it difficult to sell bonds to those who are subject to such tax (for example, insurance companies and mutual funds). It may be noted that a similar move in the case of government securities in the year 2000 had a tremendous effect on secondary trading in government securities.

7.1.4 Reduction and uniformity in stamp duty on issuance of debt instruments and on securitization transactions. The stamp duty applicable on debt instruments is not only high as compared to developed markets but also different across various states. Since stamp duty impacts heavily the cost of issue of the debt instrument, it makes debt less attractive vis-à-vis loans. Further, high variability in stamp duties across various states inhibits the development of a more broad based market.

7.1.5 Allowing repo transactions on corporate bonds in inter-bank repo market through a specialized clearing and settlement platform. Secondary market trading cannot take place unless there are enough dealers offering quotes in the market. Since dealers operate with funded portfolios, they are able to offer quotes at low spreads only if they can carry their stocks at a low cost. The success of government securities market is due to the availability of repos which enable the dealers to carry their stocks at a low cost. The absence of similar arrangement for corporate bond market puts it at a considerable disadvantage.

7.1.6 INCREASING THE EFFICIENCY OF PRIVATE MARKET:

To increase the efficiency of the private placement market for debt and bring it in line with global best practices:

❖ It is recommended that private placement be confined only to Qualified Institutional Buyers (QIBs) and the number restriction be done away with. In India, even non-QIBs are currently allowed to participate in the private placement market. Further, for an issue to qualify as a private placement, the number of investors is restricted to a maximum of 50. Globally, the investor base for private placement, which requires very little disclosure, is restricted to QIBs: a class of investors which characteristically is adequately aware of the risks associated with private issues.**6** Even in India, SEBI has put in a mechanism for development of private placement market for QIBs in equity/equity linked instruments through Chapter XIIIA of DIP guidelines.

❖ If the private placement market in India is restricted to QIBs in line with international practice, the number restriction would be redundant. It may be recalled that the 50-investor rule was imposed to curb a widespread tendency to pass off what would typically be public issues as private placements just to dodge the disclosure requirements.

7.2 Develop an OTC market for trading in privately placed debt securities. Further, an electronic trade reporting system should be devised to improve the transparency in the OTC market. Since large investors and QIBs generally drive corporate bond markets, development of a trading infrastructure for privately placed debt suited to the needs of such investors is critical. Since the investors in the privately placed debt market are small in number and are aware of the risks involved, ease of bilateral deals in the OTC market outweigh the benefits of an anonymous trade matching system. If transparency is a matter of concern, it can be taken care of by devising an electronic trade reporting system.

7.3 TAPPING THE POTENTIAL OF INSURANCE SECTOR:

In view of the recent introduction of private players into insurance business and the potential role of insurance companies in infrastructure, I am of the opinion that there is a need to:

(i) Make a comprehensive review of insurance regulations aimed at making them more modern, streamlined, unambiguous and well-understood and

(ii) Strengthen supervision, in the same manner that led to a transformation of regulation and supervision of commercial banks during the 1990s. While such a process may take some time, some immediate initiatives to stimulate infrastructure investment by insurance companies have been suggested.

There is a need to:

(a) Widen the scope of infrastructure financing by insurance companies in terms of sectors, and

(b) Liberalize the investment guidelines in terms of quality and types of eligible instruments, while relying more on management decisions. The first relates to the definition of infrastructure. The second relates to the rigidities of regulation and requires some elaboration of the context. Insurance investments other than in government securities can be classified as 'approved investment' and 'other than approved investment'. Investment in both debt and equity can be made in both these classes. The difference between the two categories, relevant for the current discussion, is that only approved investments are eligible for inclusion in 'Infrastructure and Social Sector', which requires minimum mandated investment on one hand and are not constrained by exposure norms on the other. There are, however, some provisions under the approved category that discourage the scope of both debt and equity investment in infrastructure. These restrictions need to be removed with respect to infrastructure sectors to provide the insurance companies greater flexibility in deciding appropriate portfolio and wider access to instruments.

7.3.1 RATIONALIZING BANKS' AND NBFCS' PARTICIPATION IN PROJECT FINANCING: Banks, FIs and large NBFCs play a vital role in infrastructure financing through originating, underwriting and distributing risk. While their significance is growing, they are likely to face increasingly severe resource constraint to maintain growth momentum. Although banks have had a rapid growth in their exposure to infrastructure sectors in the last few years, they will perhaps find it difficult to maintain similar growth in the years to come in the face of prevailing exposure norms and growing maturity mismatch, unless they are allowed to transfer risks from their balance sheets to other players in the financing system. Similar problems may be faced by FIs and NBFCs as well. In view of the enormous infrastructure funding requirement, larger financing by banks, FIs and large NBFCs needs to be facilitated.

7.3.2 FACILITATING EQUITY FLOWS IN PROJECT FINANCING:

In Project Finance, the buyback mechanism is used indirectly to finance suppliers in the following manner. Equity is allotted to the vendors, suppliers, etc at the initial stage as a consideration for the supply of raw materials / machines received from them. When the project becomes operational and the company begins to get sufficient cash to pay for these materials / machines, buyback of these equity shares becomes necessary to help the developer regain control over the company. In buying back share capital, companies face several restrictions (under Sec 77A of the Companies Act) including on a) the total amount of buyback that can be undertaken by the company, and b) the number of shares which can be bought back in a particular year. These restrictions discourage promoters to place sufficient equity with vendors/suppliers at the initial stage, and thereby compel them to infuse more equity than would have been the case under liberalized regulations for buy-back.

It is therefore recommended that in case of unlisted infrastructure companies, the buyback restrictions vis-à-vis vendors/suppliers be liberalized. Sec 77A of Companies Act also does not allow using borrowed funds for buyback of equity shares which implies that equity cannot be freed up during the course of a project even if the underlying risk profile improves. In certain infrastructure projects such as UMPPs, the initial equity contribution required by the lenders may be high (say 30 percent of project cost). However, the lenders may be comfortable with a lower equity base when the project gets commissioned and starts generating stable cash flows. In such situations, leveraged recapitalization, replacing equity with debt, should be allowed. This will free up part of the equity locked in the project, so that promoters can gainfully employ it in other infrastructure projects.

7.3.3 GAUGING PROJECT FINANCE THROUGH FOREIGN DIRECT INVESTMENT:

The existing guidelines do not permit domestic financial intermediaries to refinance existing rupee loans from external sources, although there is a potential market for it. It is recommended that refinancing of existing rupee loans through ECB should be allowed for *infrastructure* sector, because of the following benefits that it would yield:

- Some foreign financiers, who are not keen to participate in projects in early, risky stage, may show interest in the post-construction period when the risks subside.

- Indian lenders to infrastructure projects would like to have some of their loans refinanced in order to churn their asset portfolio, and at times, to limit their risks.

- Local promoters will benefit from greater diversity of funding sources as well as better price discovery. Refinancing from external sources would be particularly attractive in situations similar to the current one, when domestic interest rates are relatively high and the rupee is tending to appreciate.

The current ceiling of LIBOR+350 basis points for ECBs makes it difficult for the issuers to raise senior debt, subordinated debt, mezzanine financing or quasi equity as the maximum permissible return is not considered enough to match the perceived risk. Keeping in view the long term nature of infrastructure projects and the need for risk capital (in the form of quasi equity), this all-in-price ceiling on ECBs should be removed for senior, subordinated and mezzanine foreign debt for infrastructure projects. This suggestion is aimed at assuring liquidity for longer tenors, and in many cases, protecting promoters of infra projects from illiquidity in domestic loan markets due to seasonal factors.

7.4 CORPORATE GOVERNANCE SCANDALS: WHAT CAN BE THE REMEDY?

Incidents of corporate fraud like that of Satyam are there because so far it has not been possible to evolve a reliable method of recruiting the independent directors. The independence of such independent directors can be ensured by two ways; either by appointing a supervisory board to take care of the working of board of management as is the case in Germany or by making the appointment of independent directors subject to Extraordinary Annual General meeting or through postal ballot as is the case in USA. It would be difficult to infuse the German system of Corporate Governance through a Supervisory Board in India, because it would rather make the management of corporation complex and functioning difficult. A supervisory check is already there in the Indian system through the statutory auditors.

In such a case the question arises that can a director be appointed under section 257 of the Companies Act, 1956 in an extraordinary general meeting or through postal ballot, as the case is in USA? It is worth pointing out that under sub-section (1) of section 173 of the companies act, the appointment of directors in the place of those retiring is ordinary business of annual general meeting (AGM). This being the case the chance of appointing directors who are actually independent becomes grim. Thus going by the way of their appointment such directors cannot be expected to be independent. Thus this position deserves to be corrected either by empowering the regulator to appoint at least one or two independent directors or by making the appointment of director through an extraordinary general meeting or through postal ballot.

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