

DRAFT

REPORT OF THE WORKING GROUP

ON

**CONSTRUCTION SECTOR
(INSTITUTIONAL FINANCING WORKING)**

FOR THE

12th FIVE YEAR PLAN

(2012-2017)

December 2011

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1.0 Preface

1.1 In the context of the formulation of the Twelfth Five Year Plan, Planning Commission has set up a Steering Committee on Construction to study and analyse the Indian Construction Industry to suggest policy framework and to recommend the measures for self-regulation for the constituents of the Construction Industry along with the mechanism for implementation of the recommendations.

1.2 For facilitating work by the Steering Committee, a Working Group on Construction (Institutional Financing Working) has been constituted as per CIDC Letter No.2253/12th-National Plan/WG2011 dated 23rd September, 2011 (Annexure-1). The final composition of the Working Group is as below:

- | | | |
|--|---|----------|
| 1. Shri V.P. Baligar, CMD, HUDCO | - | Chairman |
| 2. Dr. P.R. Swarup, DG, CIDC | - | Member |
| 3. Shri. S.P.S Bakshi, CMD, EPIL | - | Member |
| 4. Shri Chander Verma, Chairman, CCPL | - | Member |
| 5. Shri Gupta, L&T | - | Member |
| 6. Ms. Jyoti Gujral, Director (PPPI), IDFC | - | Member |
| 7. Dr. Akshaya Kumar Sen, AGM(Eco.), HUDCO | - | Member |
| 8. Shri Sunil Mahajan, Director, CIDC | - | Convenor |

1.3 This report of the Working Group has been prepared based on the discussions held during the working group meetings, base documents from CIDC & HUDCO and the study of similar initiatives being undertaken globally.

2.0 Overview of Construction Industry in India

2.1 Evolution of Indian Construction Industry

2.1.1 The evolution of the Construction Industry in India was almost similar to the construction industry evolution in other countries: founded by Government and slowly taken over by enterprises. After independence the need for industrial and infrastructural developments in India laid the foundation stone of construction, architectural and engineering services.

2.1.2 The period from 1950 to mid-60's witnessed the government playing an active role in the development of these services and most of construction activities during this period were carried out by state owned enterprises and supported by government departments. In the first five-year plan, construction of civil works was allotted nearly 50 per cent of the total capital outlay.

2.1.3 The first professional consultancy company, National Industrial Development Corporation (NIDC), was set up in the public sector in 1954. Subsequently, many architectural, design engineering and construction companies were set up in the public sector (Indian Railways Construction Limited (IRCON), National Buildings Construction Corporation (NBCC), Rail India Transportation and Engineering Services (RITES), Engineers India Limited (EIL), etc.) and private sector (M N Dastur and Co., Hindustan Construction Company (HCC), Ansals, etc.).

2.1.4 The construction sector remains largely unorganised. The Indian construction industry comprises around 250 large firms in the corporate sector, as can be seen from Table-1. In addition to these firms, there are about 1,20,000 class A contractors registered with various government construction bodies. There are thousands of small contractors, which compete for small jobs or work as sub-contractors of prime or other contractors.

Table-1: Market structure of construction contractors

Organized Industry Segment	Number of Employees	Number of Firms
Small	Less than 200	25,000-30,000
Medium	200-500	Greater than 500
Large	Greater than 500	250
Unorganized Industry Segment (Standalone contractors)		120,000
Source: Construction Federation of India "Gearing Construction for Growth, January 2005		

2.1.5 In the late 1960s government started encouraging foreign collaborations in these services. The Guidelines for Foreign Collaboration, first issued in 1968, stated that local consultant would be the prime contractor in such collaboration. The objective of such an imposition was to develop local design capabilities parallel with the inflow of imported technology and skills. This measure encouraged international construction and consultancy organisations to set up joint ventures and register their presence in India.

2.2 Construction Sector and Indian economy

2.2.1 The Construction sector has been contributing around 8% to the nation's GDP (at constant prices) in the last five years (2006-07 to 2010-11). As indicated by Table-2, GDP from Construction at factor cost (at constant prices) increased to Rs.3,84,629 crore (7.9% of the total GDP) in 2010-11 from Rs.2,84,798 crore (8% of the total GDP) in 2006-07. The increase in the share of construction sector in GDP has primarily been on the account of increased government spending on physical infrastructure in the last few years, with programmes such as National Highway Development Programme (NHDP) and PMGSY/Bharat Nirman Programme receiving a major fillip of late. The construction industry is experiencing a great upsurge in the quantum of the work load, and has grown at the rate of over 10% annually during the last five years. Although various steps have been taken to strengthen the construction industry, it is crucial to take necessary measures in order to prepare the industry to meet the challenges of growth.

Table-2: Construction Sector-Macro Aggregates

Macro Variable	2006-07	2007-08	2008-09	2009-10	2010-11
GDP from Construction (at Constant Prices) – Rs Cr	284798	315389	332557	355918	384629
Share of Construction in GDP(%)	8.0	8.1	8.0	7.9	7.9
Growth rate for GDP in Construction(%)	10.3	10.7	5.4	7.0	8.1

Source: Handbook of Statistics, RBI-2010-11

2.2.2 As per the principal findings of a study by IIM-Ahmedabad (July 2000) entitled “Impact of Investment in the Housing Sector on GDP and Employment in the Indian Economy”, the Construction Sector ranks higher than the important sectors like Transport and Agriculture (whose ranks are fifth and sixth respectively out of 14) in terms of additional income generated in the economy as a whole. A value of 4.71 for the Type-II Income Multiplier indicates that a unit increase in the final expenditure on the Construction sector would generate additional income in the economy as a whole which would be almost 5 times as high as the direct income generated within the construction sector itself.

2.2.3 Construction sector has huge employment generation potential. It ranks 5th and 7th in terms of employment multipliers of Type-I & II respectively. A value of 7.76 for Employment Multiplier of Type-II indicates that an additional unit of final expenditure in construction sector induces overall employment generation in the economy as a whole by an extent which is eight times the direct employment generated in the construction sector itself.

2.2.4 Today, India is the second fastest growing economy in the world. The Indian construction industry is an integral part of the economy and a conduit for a substantial part of its development investment, is poised for growth on account of industrialization, urbanization, economic development and people's rising expectations for improved quality of living.

2.3 Key drivers of growth of construction industry

Construction sector has two key segments: (i) Residential and Non-Residential Buildings (Residential, commercial, institutional, industrial); and (ii) Infrastructure. Infrastructure contributes roughly 50% to the construction sector and the remaining is through residential and non-residential building industry. The total market size for the period 2011 to 2016 is expected to be of the magnitude of INR 52,309 billion (Table-3).

Table-3 India: Construction Industry Estimates (INR Billion)						
	2012/13f	2013/14f	2014/15f	2015/16f	2016/17f	Total
Construction Industry Value, INR billion	7,668	8,875	10,316	11,860	13,590	52,309
Infrastructure Industry Value As % of Total Construction	49	50	50	51	52	
Infrastructure Industry Value, INR billion	3,723	4,413	5,204	6,059	7,017	26,417
Residential and Non-Residential Building Industry Value As % of Total Construction	52	50	50	49	48	
Residential and Non-Residential Building Industry Value, INR billion	3,945	4,461	5,112	5,800	6,574	25,893

Sources: BMI forecasts, Census and Statistics Department/ILO

The Key drivers of growth of construction industry are:

a. Growth in infrastructure:

- Approximately USD 1 trillion is to be spent in the next five years on infrastructure. While 50% investments in infrastructure will be done by the government through cash contracts, the remaining will be either pure private investments or PPP projects;
- At the minimum, 45% investment in infrastructure is towards construction & 20% of the infrastructure spend will be for modernization of the construction industry.

b. Growth in Building sector:

- Industrial growth: This sector sees a steady growth and contributes to the construction sector in the non-residential segment.
- Real estate commercial: A vibrant and growing service industry leading to a real estate and logistic boom contributing to the growth of construction in the non-residential sector: IT growth would continue to create a demand for commercial facilities. STPs and SEZ's are being built by real estate developers. Hospitality and tourism industry is driving the demand for hotels and resorts; Retail growth on account of increasing consumer disposable incomes is driving the demand for commercial area development on a large scale. Associated logistic services to service the supply chains require warehousing facilities.

c. Growth in housing:

- The current trend in real estate market is that after making investments in land the project construction is mainly retail financed i.e. through advances/milestone based payments from owners.
- The real estate developers traditionally employed contractors for construction of projects. Several large contractors are transitioning towards becoming real estate developers as well.
- In cases where private developers undertake affordable housing projects; retail financing would be a challenge as the ability of the retail investors would be very limited. One of the greatest challenges in the implementation of RAY is that there would be a need for addressing the housing loan requirements of this segment. For example the slum dwellers and EWS segments would find it challenging to pay the developers / contractors on a regular basis.
- In case of construction by government and its agencies in government housing or affordable housing (LIG and EWS segments), payments will be done by the government.

3.0 Flow of Funds to Construction Industry in India

3.1 The construction sector, including the residential & non-residential buildings and infrastructure sector, is attracting both domestic (government funding, institutional funding) as well as foreign direct investment. Before the year 2000, the deployment of gross bank credit in the construction sector was declining, e.g. from 2.13 per cent in 1990 to 1.37 per cent in 2000. In order to increase the flow of institutional credit to the construction sector, it was declared as an industrial concern under the Industrial Development Bank of India Act in March 2000. Table-4 shows the flow of bank credit to construction sector during 2006-07 to 2010-11. In the year, 2010-11, around Rs.50135 were lent by banks to the construction industry which was 1.4% of the gross bank non-food credit disbursed during the year. While this step was in the right direction, it is necessary now to encourage banks and lending institutions to develop lending norms and special funding instruments that could address both the requirements of the construction industry as well as the concerns of the bankers. The need for specialised financial may also be considered.

Table-4: Flow of Bank Credit to Construction Sector
(in Rs.Crore)

	2006-07	2007-08	2008-09	2009-10	2010-11
Gross Bank Non-Food Credit	1801240	2204801	2601825	3040007	3667354
Bank Credit to Construction Industry	19997	27945	38505	44219	50135
Percentage share (%)	1.1.	1.3	1.5	1.5	1.4

Source: Annual Reports, RBI

3.2 Construction activities including housing, roads and highways have also been attracting FDI inflows. Table-5 depicts the year wise and cumulative FDI flows into construction activities including roads and highways sector. The cumulative FDI inflows from April 2000 to August 2011 into construction activities stood at around US \$9417 million or Rs.42,072 crore, which is nearly 6% of the total cumulative FDI inflow into the country during same period.

**Table-5: Flow of FDI in Construction Activities
(including Roads & Highways)**

	2007-08	2008-09	2009-10	2010-11	Cumulative(April 2000 – Aug 2011)
In Rs. Crore	6989	8792	13469	4979	42,072
In USD million	1743	2028	2852	1103	9417 (6% of total FDI inflows)

Source: DIPP, MoC&I

3.3 Even though the construction sector is attracting both domestic (government funding, institutional funding) as well as foreign direct investment, more resources are needed for the sector to fulfil the ever rising pressures of enhancing the housing and infrastructure sectors in the country. Institutional financing of construction sector still remains an underdeveloped area in India.

3.4 The Indian construction industry is faced with high operation, maintenance, and financial costs. This aspect is further exacerbated by inadequate access to institutional finance, especially for small contractors who execute over 90% of the total construction works. The high cost of raising finance also translates into high costs, which again has a cascading effect on the economy. Appropriate measures and instruments should be formulated and implemented to reduce financing costs and ease the flow of funds to the industry.

3.5 Taxation: The construction sector experiences a very high incidence of direct and indirect taxes for construction and construction-related activities as compared to other sectors. The taxation and regulatory systems pertaining to construction should be reviewed with a view to rationalize the same and eliminate multisource taxation. Greater clarity needs to be brought out on the treatment of the sector as 'Industry' or 'Service' for taxation purposes. In addition, under the current fiscal regime developers can spend more than 18 per cent in taxes and levies on their activity. With the addition of stamp duty and other charges, the end user can pay up to 27 per cent above the cost of construction. When dealing in a price-sensitive market, these increments are particularly significant.

4.0 Existing Shortcomings in Institutional Financing for Construction Industry

4.1 The Indian construction industry is faced with high operation, maintenance, and financial costs. This aspect is further exacerbated by inadequate access to institutional finance, especially for small contractors who execute over 90% of the total construction works. Moreover, subsequent to the conferring of Industrial Concern Status on the construction industry, existing financial institutions, and banks have not adopted construction industry-specific lending norms and eligibility criteria for the borrowers from the construction sector neither introduced any special incentives or schemes for financing import of hi-tech construction equipment for infrastructure projects.

4.2 As the magnitude of housing shortage in the country is huge requiring substantial investments in housing and related infrastructure, the Banks, Financial Institutions and Housing Finance Companies have not lend to the poorer segments of the population for affordable housing segments. The priority sector lending by Banks for affordable housing loans up to Rs. 5 lakh constitute only 22.75%, as per the housing loan data received from the 26 leading public sector banks including SBI for the year 2010-11. Further, as per latest BSR report of RBI for the period ended March 2010, loan sizes up to Rs. 5 lakh constitutes 24.16% of the total outstanding housing loans of Rs.3, 06,307 crore.

4.3 The massive shortage for housing among the urban poor and the non-availability of any authentic data to substantiate the view that all the amounts which were lent by the banks in the category of less than Rs.5 lakh has actually not gone to EWS/LIG show that credit flow to these segments is meagre. This can also be substantiated from poor performance of schemes like Interest Subsidy Scheme for the Urban Poor (ISHUP) and 1% interest subvention, etc. It can thus be safely concluded that a very low proportion of the low ticket loans have actually gone to the EWS/LIG individuals.

4.4 The bulk of the potential buyers for affordable homes might not be able to access formal credit markets. Mortgage penetration is already low in India and mechanisms are only now developing to maintain credit histories. Informal sector workers in particular have variable income streams and in some cases, might not have access to a bank account.

4.5 Developers require both a down payment and assurance of regular EMIs to make the sale. Some buyers might not have the capital to make a significant down payment. Even for buyers who can afford the EMIs, the process of ensuring that they will be able to – given the problems described above – have proved to be time consuming and cumbersome for developers. Some non-profit developers like 'Janaadhar' have set up their own micro-finance institutions (MFIs) that make loans to clients to enable them to buy their homes. Similarly, Self Employed Women's Association (SEWA) makes loans to enable slum dwellers to participate in contribution-based slum upgrading efforts. Some commercial developers have tied up with external MFIs to enable financial access. McKinsey recommends the setting up of a mortgage guarantee fund to make such lending more secure, and expand the access of the lower to middle income groups.

4.6 The construction sector is characterised by lots of project delays which are due to lack of adequate credit, harassment, problems in approvals, bad image of the contractors/builders, etc. The construction industry also suffers from lack of transparency, lack of regular payment of bills to contractors, lack of appropriate lending & NPA norms, lack of corporatisation of construction industry and lack of a healthier partnership between government and the construction industry.

4.7 Key reasons for the reluctance on the part of banks/FIs to lend to the construction industry include: (i) lenders do not understand the working dynamics of the construction industry; (ii) lack of adequate safeguarding mechanisms to assure the banks about the credibility of the industry; and (iii) banks have better options to lend their precious money to sectors with assured returns at much lower risks. There is no appropriate institutional set up to absorb the flow of funds to the construction sector.

4.8 Apart from non-availability of credit for the sector, non-availability of bankable DPRs in the construction sector, huge time and cost overruns of the construction projects are some of the reasons for projects in the construction sector not taking off in a sustainable manner.

4.9 There is no uniformity in tax rates for different construction projects. The service tax is not payable on works contracts in respect of tunnels and dams whereas power projects are liable to pay service tax. A party who has constructed dam or tunnels and have nothing to do with construction of power house should not be charges any service tax as the same is exempt from payment of service tax.

4.10 Another shortcoming in the construction sector in India is that the state governments do not make funds available after they approve the projects. There is no law to ensure that a contract cannot be awarded unless finances are arranged. A programmatic approach for large construction programmes at the State level requiring a planned approach with resources tied up should be encouraged.

5.0 Strategies to improve Flow of Funds to Construction Industry

Although the industry is not fixed capital intensive, it is working capital-intensive in terms of gross working capital requirements with high payment receivable risk. However, several large construction companies are gradually transitioning to developer companies. The diversification is either as real estate developers or infrastructure developers. These projects are normally done as independent SPVs but quite often even done by the parent construction company. Some of the large construction companies are now setting up sectoral holding companies for developing projects and invest in multiple SPVs. Thus, there is an increasing need for long term debt and equity by these companies.

The flagship Bharat Nirman programme of the Government of India focuses on the provision of key rural infrastructure like irrigation, electrification, roads, drinking water supply and sanitation, affordable housing, and connectivity via community IT service centres. Similarly JNNURM has provided a boost for the urban infrastructure

projects. These programs would provide public funding for projects. Going forward these projects would need to be maintained by the local contractors. Therefore these contractors would grow and need venture capital funding. For the small contractors, it is largely working capital finance that is required by them. There are, thus, five types of financing requirements of the Construction Industry: (a) working capital requirements; (b) Capital requirements for Modernization of equipments and/or Expansion of industry; (c) Project specific bridge loans; (d) Loans for BOT projects; and (e) Equity for BOT and real estate project.

The construction sector remains in need of financial support while sizable funds available with Banks / Financial Institutions remain unutilised. Lenders do not have a reasonably sound and reliable system for risk assessment in the construction sector. The funds requirement of the construction industry is approximately USD 1 trillion with the modernisation requirements of the construction industry estimated to be to the tune of US \$ 150-200 billion. Further, as per the High Powered Expert Committee (HPEC) Report for estimating the investment requirement for urban infrastructure services, the investment requirement for urban infrastructure over the 20-year period (2012-31) is estimated at Rs 39.2 lakh crore at 2009-10 prices. In order to have a sustained and enhanced flow of credit to the construction sector, greater transparency, better corporate governance, sharing of experiences and specific regulations are required. Innovative financing methods/instruments are required to enhance the flow of funds and institutional credit to the construction sector. The Working Group recommends the following key strategies to improve the flow of institutional finance to the construction sector.

5.1 Enhancing flow of Finance through Grading of Construction Companies

Banks and Financial Institutions have been in search of a reliable, objective and comprehensive methodology for their assessing lending risks. Other Construction entities (Owners, Consultants and Contractors) also require a comprehensive, objective and reliable instrument for assessment in order to forecast the chances of success of a project. Insurance companies too will find a reliable risk assessment

system very useful for designing new types of risk covers for the construction industry. Therefore development and implementation of a grading system has a direct relationship with Construction Financing. The 11th Plan Working Group for Construction had suggested that an institutionalized system of grading of Construction Companies, Contractors, Project Owners, Consultants and projects should be adopted. CIDC with ICRA has developed a comprehensive and reliable system for assessing the performance potential of all entities involved in a project. An institutionalized system of grading of Construction Companies, Contractors, Project Owners, Consultants and projects should be adopted in order to enhance the confidence of financial institutions/banks in lending for the Construction sector. The FIs/banks can quantify the risks better and may lend at more reasonable rates.

5.2 Construction industry-specific lending norms

Existing financial institutions and banks should adopt construction industry-specific lending norms and eligibility criteria for the borrowers from the construction sector as well as introduce special incentives or schemes. Financing construction often involves lumpy investments and hence financing requirements are of higher order. The lending institutions may not be able to comprehend all type of risks and complexities involved in a construction project. It is for that reason many lending institutions fail to evaluate projects risks and gathers bad experiences in the sector in terms of bad loans or low returns on investments. These experiences make them risk averse to construction projects and as a result the sector faces paucity of funds. It is in this context the concept of “lender’s engineer” comes in, particularly for projects where long term loans are sought for project development. What is actually needed is an engineer who could deal with the financial aspects and several others such as contractual and legal, behavioural, social, historical, banking risk assessment, establishing & insurance related aspects. This engineer could be an individual for small value projects, or a group of engineers for large value projects. This could be a firm specializing in venture management.

Employed by the lending institutions a “lender’s engineer” would oversee the operations to protect the interests of lender, and therefore would play a very

important role to ensure the successful implementation of project. A “lender’s engineer” would thus ideally keep a check on the entire progress of the work, with a view to ensure that slightest impediments are immediately removed, and the work must continue as per schedule to ensure that the lender continues receiving his returns/dues. This type of an arrangement would go a long way in catalysing flow of institutional credit to the construction sector.

5.3 Credit Enhancement Product/Agency

Establishment of a ‘Credit Enhancement Product/Agency’ would provide bridge finance to the construction sector. For the infrastructure sector, IIFCL has recently launched a Rs. 300 crores partial guarantee facility that would be availed by the developer (or companies). For construction companies a liquidity support product would be useful in case of delayed payments particularly by the government to enable timely interest payments that would provide comfort to the other lenders. This would have to be taken by the Client to give comfort to lenders. However there could be issues if the Client is not making timely payments to contractor which means the credibility of client is suspect even with the lenders/guarantors. Financial risk Coverage policy may be more useful.

A **Credit Guarantee Fund** similar to the SIDBI Credit Guarantee Fund for providing collateral free loans may be envisaged for the small construction companies that need to modernise. This would facilitate the small construction companies.

5.4 Setting up of a Mortgage Refinance Company

With an aim to boosting large-scale construction activities in the country, the banks may facilitate development of financing products for developer and establish a Mortgage Refinance Company for construction activities. Such a Mortgage Refinance Company would be a financial institution owned by the banks with the sole purpose of supporting banks to do construction mortgage lending by refinancing banks’ mortgage portfolios. The Mission of the Company could be to source funds in the financial market as efficiently as possible and channel the same to member banks at a competitive rate. This will facilitate access to construction sector in general and

housing to the urban population, while contributing to the development of capital markets.

Mortgage Refinance Company would serve as a secure source of long-term funding at attractive rates while ensuring sound lending habits among banks. This will help in reducing any maturity mismatch risk for banks and increase available loan terms. This in turn helps improve the affordability of mortgages and extends the range of qualifying borrowers, resulting in the expansion of the primary mortgage market and thus home ownership in the country. Overall the key benefits of setting up a Mortgage Refinance Company can be summarized as:

- The provision of secure long term funding at attractive rates. Lowering the cost of funds, which can lead to a lowering of mortgage rates, thereby improving affordability and extending the range of potential borrowers.
- The availability of long term fixed rates can help provide a degree of certainty, which can help the markets develop with confidence.
- Allows for greater competition in the mortgage market. The introduction of such a Company means new institutions to enter a market which was previously restricted to those with either a good credit rating or to those who had invested in a branch network and had significant deposit collection capabilities. This will therefore enable a more diversified set of lenders to develop than just like large commercial banks, and can be a driving force for competition on the primary market, another factor promoting efficiency and affordability.
- By acting as a central refinancing platform, This Company can act as a force for standardization in the market, pushing Member banks to adhere to best practice. The Company will be able to set criteria for the types of loans it will refinance, including standardized documentation, processes, risk characteristics, etc. greater transparency, allows the creation of market information systems, which in turn can lead to better risk management better market and consumer regulations and an overall lowering of the risks associated with mortgage lending.

- This Company can act as an intermediate step on the path to a full secondary mortgage market. Whether it is the lack of adequate legislation, the absence of credit bureaus or the absence of rating agencies, many countries are not able to directly make the leap from funding mortgages through short term deposits to refinancing them on secondary mortgage markets using covered bonds or securitization.
- The Company can be a tool for delivering policy objectives such as the promotion of affordable housing in particular or the promotion of construction sector in India in general.

5.5 Setting up of a Construction Bank

There is a need for establishment of a Construction Bank especially dedicated to suit the sector's financial needs. Countries like China, Singapore, Ethiopia have established Construction Banks. The Construction Bank can offer a wide range of consumer, retail and commercial banking products and services to customers like retail housing finance, construction finance, trade financing, deposits, working capital and term lending, foreign exchange, leasing, insurance, investment, funds advisory and electronic banking services, etc. The operational modalities of setting up of the Construction Bank could be in the form of a Joint Venture with 51% Government share and 49% private sector stake.

5.6 Indian Infrastructure Equipment Bank

A major chunk of construction equipment owned by Companies remains unutilised for large parts of the year. The idle equipments require maintenance. Depreciation adds further to the unproductive costs of the Company, with the total equipment stocks of over Rs.1,35,000 crore in the country and with additional requirements of Rs.15,000 crore every year (as per CIDC estimates), efficient utilisation of construction equipment will result in huge savings to the economy. Keeping this in view, CIDC has prepared a general set of guidelines for the establishment of an Indian Infrastructure Equipment Trust Ltd.

5.7 **Compulsory Escrow accounting** for Construction Projects

An escrow is an arrangement made under contractual provisions between transacting parties, whereby an independent trusted third party receives and disburses money and/or documents for the transacting parties, with the timing of such disbursement by the third party dependent on the fulfillment of contractually-agreed conditions by the transacting parties. Escrow accounting is best known in the context of real estate (specifically in mortgages where the mortgage company establishes an escrow account to pay property tax and insurance during the term of the mortgage). Escrow accounting mechanism may be made compulsory in the construction projects of Governments in particular in order to provide credit cushion to the investors. It would also be beneficial from the lenders perspective, as it would ensure that the funds deployed for a specific project are spent for the same and repayment of principal is also timely.

Further, a **Letter of Credit** may be opened in the name of the contractor at the time of award of project by the Client to ensure that the payment is made as soon as the project milestone approval is received.

5.8 **Working capital advance**

Working capital advance may be provided to contractors in order to kick-start the construction project. Due to recent economic slowdown, delay in payments from clients, longer execution cycles, blockage of funds in the form of retention money and margin money required for availing the non-fund based limits and an increase in loans and advances/investments in subsidiaries, the working capital requirement for construction companies has been increasing. Moreover, given the market structure comprises mainly small contractors and the importance being placed on the development of infrastructure in the rural areas, there is an increasing need for facilitating the small contractors who would need working capital. It is suggested that for small contractors seeking working capital loan upto Rs. 10 lakhs the same may be made available as collateral-free working capital loan under the priority sector lending by Banks for contractors based on the letter of award of work. It

could be included under small business / enterprises. In addition to working capital advances, regulation may be made to release the funds which are blocked in the form of retention money.

5.9 'Delayed Payment Act' for Construction Projects

A 'Delayed Payment Act' may be formulated which would make it mandatory for the clients/big contractors to pay the small contractors the money along with the prevailing interest rate, the cases where contractors are not paid by the clients in time. Such kind of an Act is in place for Small Scale Industries sector which has a provision to charge penal rate of interest on outstanding payments if the same are delayed beyond the agreed or stipulated period of time. If a 'delayed payment Act' is formulated, It is expected to relieve the construction industries from shortage of working capital arising due to delayed payment against supplies made by them and will go a long way in alleviating the cash flow problems and provide a bulwark against bullying tactics of the big industry and protect the interests of the small contractors.

5.10 Lending and Non-Performing Assets (NPA) norms for construction sector may be reviewed and reformed.

5.11 Sector-specific (e.g. housing, real estate, Power, Roads, Ports, etc.) innovative financing instruments may be developed to enhance the flow of funds to the specific sectors. Innovative financing instruments/products like 'Insurance Product', 'Housing Warranty' and 'green construction finance' (and green rating other than LEED & GRIHA) may be explored for enhanced and orderly flow of institutional credit to the construction sector. The possible credit enablement mechanisms/financial instruments for affordable housing are given the Box-1.

BOX-1: Financing Instruments for Affordable Housing

1. **State Budgetary support** will have to be increased for affordable housing.
2. Credit enhancement mechanisms like Setting up of '**Credit Risk Guarantee Fund**' need to be expedited.
3. Dedicated fund for affordable housing and slum upgradation (e.g. **Urban Poor Fund or National Shelter & Livelihood Fund**) need to be created for financing affordable housing including slum housing programmes. Resources can be pooled to this Fund through contributions from Federal/State/Local Governments, HFCs, Banks, Financial Institutions/ Corporate Bodies, levy of labour cess / slum upgradation cess/ service tax on construction; and Multi-lateral/bi-lateral bodies.
4. There is a need to look at workable models for Social Rental housing which can be driven through private sector with conducive legal/regulatory environment. In this context, the options of issuing '**Rental Housing Voucher**' may be explored.
5. Set up Apex Institution by Govt of India for Financing/re-financing **Housing Micro finance** by MFIs.
6. Banks may be mandated to earmark certain percentage of **Banking Sector Fund** for Affordable Housing under priority sector lending.
7. Banks lending for affordable housing upto certain limit should be provided with **1% of the loan amount as incentive for covering their operational costs**.
8. Banks/HFCs may be permitted to **float tax-free infrastructure bonds** to raise cheaper funds and reserve for affordable housing so that they can reduce the lending rates for EWS/LIG housing loans.
9. Interest Subsidy may be enhanced and targeted for affordable housing. Other Subsidy methods like **interest-cum-capital subsidy** may also be worked out.
10. Incentives to private builders for creation of affordable/ rental housing stock through appropriate tax incentives, low cost credit and other incentives like **additional FAR/FSI/TDR**, etc. may be provided
11. **Pre-finance and start-up capital** may be provided to NGOs /CBOs for taking up affordable housing programme for the poor.
12. Substantial enhancement of **transfer of funds from Federal/State Govts to Local Governments**.
13. Enable Municipal Bodies to raise resources through tax-free bonds and transfer of Govt. land.
14. Greater Budget allocation by Local Governments: In line with the circular issued by the MoHUPA, GoI P-Budget having 25% share of municipal spending should be used to finance affordable housing including slum housing.
15. Municipal Governments should be given a part of the profit earned by the Development Authorities/Improvement Trusts as suggested by the 2nd Administrative Reforms Commission and 13th Finance Commission to create a revolving fund for affordable housing.
16. Specific dispensation for affordable housing at municipal level should be considered in the forthcoming Goods & Services Tax (GST).
17. Initiatives under service level benchmark for water, sanitation and solid waste, as per 13th CFC recommendations, should include specific coverage of affordable housing.
18. Short-term construction finance should be made available to municipal bodies to meet the immediate shortfall of funds due to delayed transfer of funds and receipt of beneficiary contribution.

5.11.1 Developing Housing Warranty Scheme

Housing Warranty Scheme, being offered to the consumers in the Developed Countries, (e.g. Japan, North America etc.), could be a potent instrument for covering risk elements at micro level for houses and buildings/structures. At micro level a property has several risks such as: a) whether it is free of encumbrances, b) What would be the longevity of the finishes and also the structure with and without the “routine repairs” c) What would happen to the investment, if the builder / contractor, abandons the work in an incomplete state, due to insolvency or any other extraneous reason?

A Housing Warranty Scheme would seek to mitigate such type of risks. The scheme, if introduced would benefit both the consumers and the Financial Institution for the new houses (both detached and attached houses) and also the property in secondary housing market, which presently is bereft of any support system. The scheme would have the following elements i) To provide a limited term defect warranty for the built houses and to set up and create a fund for the defect warranty for the houses constructed by small and medium sized builders who are rated, ii) To provide completion warranty programme for covering the risks arising out of bankruptcy of builders / contractors before completion of houses and to facilitate completion of the house with minimal additional cost to the buyer, iii) The Warranty Scheme for Houses shall provide a long-term warranty for quality and performance of housing with the maximum of 10 years, which would incorporate an insurance system to reinforce the defect warranty liability and shall establish a housing performance indication system. iv) As a part of this scheme, a Fund for Defect Warranty may be created.

5.11.2 Developing Insurance Products to mitigate construction business risks

The construction business poses a number of risks at various stages. These risks elements need to be covered appropriately by designing appropriate risk

mitigation products. Specific tailor-made insurance products need to be designed for construction sector. The possible products are outlined below:

a) Bidding Indemnity Policy(BIP)- Under BIP, a contractor is insured for an established SR(Success Ration) and variations positive or negative are reimbursed to or become payable by the contractor. The instrument if offered would help the construction companies to moderate their quoted price for a particular bid, allow the competent players to participate in business, thereby reducing the erratic bids which are one of the major reasons for contractual disputes resulting in time and cost overruns.

b) Delay in meeting obligation by client policy (DIMO Policy)- As indemnities, the contractor furnishes to the client Bank Guarantees (Earnest Money, Security Deposit, Performance guarantee, guarantee for advances). It has been observed that the clients, at times do not i) Pay the agreed dues in time ,ii) Return / Refund the indemnities thus accepted and iii) Meet other contractual obligations. In all the cases, both the contractors and the Bankers are sufferers. A Policy to cover such risks would be a welcome step.

c) Settlement of Claims Policy (SOC Policy)- During the tenancy of contracts, there arise a number of contractual claims. Delay in payments against these affect Cash flows and hence productivity. Indemnity, by way of ensuring justified payments, to the agency, whether from client or from Bankers as advance to the client, needs to be provided, until final reconciliation. SOC Policy is meant for such an eventuality.

d) Loss of Profit Policy (LOP Policy)- A construction company draws the cash flows & designs the profits on the basis of assessment of risks and other related exigencies. Realization of profits, in reality, is dependent on unforeseeable circumstances, however statistically established is terms of percentage of the value of business. Variations can be insured and thus the profits insured.

e) Transit Insurance Policy (TI Policy)- This could be on the lines of similar instruments already available with Insurance companies. The present

policies cover the risks related to the damage of the equipment and do not cater to the consequential losses such as productivity losses.

f) Loss of Performance of Construction Equipment (LOPCE Policy)-

Due to defective manufacturing or lack of effective maintenance systems, contractor faces losses on account of idle equipment. Loss in performance and erosion of efficiency of equipment may also be due to any other reason including natural calamity. Cover is needed for such eventuality.

g) Force Majeure Loss Policy (FML Policy)-

An instrument should be designed to cover the loss to the contractors due to termination of the contract on account of application of "*force majeure*" clause.

h) Financial Risk Coverage Policy (FRC Policy)-

It is an insurance instrument to cover the risks undertaken by the financiers for extending assistance to the construction industry related borrowers, which would enable them to come forward for full support to the contractors or to participate in the construction industry business. This should also cover the risk for non/delay in making payment on agreed dues and non-meeting of other contractual obligations by the contractors.

5.12 Fiscal incentives

Financial Institutions may be incentivised through fiscal incentives for lending to the construction sector by allowing resource mobilisation through tax-free bonds. Fiscal incentives to suppliers of construction materials and developers of the construction projects may be given to bring down construction costs. For example, all taxes paid (including VAT) for construction inputs for affordable housing may be reimbursed in the form of subsidy for builders to be passed on to the beneficiaries. Similarly, 100 per cent depreciation on capital expenditure on construction equipments for affordable housing may be allowed.

5.13 Uniformity in Tax Code

It is suggested that Uniformity in Tax Code should be adopted for all construction projects. Central Board of Direct Tax (CBDT) should have a consultative process to put up tax proposals on construction sector while deciding taxation on construction activity.

5.14 Workers welfare Schemes

Workers welfare activities should be taken up in right spirit and schemes like **Rashtriya Swasthya Bima Yojana (RSBY)** for construction workers may be implemented properly with the active participation of the industry.

5.15 Results Framework Document (RFD)

Results Framework Document (RFD) may be required for construction sector which will outline the mandate for the sector and the action plan for implementing the mandate. This document would contain not only the agreed objectives, policies, programs and projects but also success indicators and targets to measure progress in implementing them. The RFD seeks to address three basic questions: (a) What are department's main objectives for the year? (b) What actions are proposed to achieve these objectives? (c) How would someone know at the end of the year the degree of progress made in implementing these actions? That is, what are the relevant success indicators and their targets? The well-formulated RFD will ensure dedicated flow of institutional credit to the construction sector because of the clarify enshrined in the RFD.

5.16 Accessing International Financial Markets

Assistance may be extended to firms in construction sector in obtaining adequate financing through strengthening of domestic banking sector, and support to firms in tapping international financial markets. Liberal guidelines for accessing international capital market through External Commercial

Borrowings (ECB), Infrastructure Debt Funds (IDFs), Global Depository Ratios (GDR) and other debt instruments may be devised for firms in construction sector to access foreign funds for construction sector. Funds from multi-lateral/ bi-lateral agencies can be access by the firms involved in the construction sector.

5.16.1 Infrastructure Debt Funds (IDFs)

Infrastructure Debt Funds (IDFs) are expected to accelerate and enhance the flow of long term debt in infrastructure projects for funding the infrastructure investment requirements of USD 1 trillion (as per 12th plan estimates) which would require foreign investments – debt and equity - on a very large scale. The estimated shortfall in debt is approximately USD 280 billion at a conservative estimate. Currently despite it being an attractive option for the offshore investors, most foreign investors do not invest in corporate bonds. Current estimates suggest that the foreign investors hold approximately USD 21 billion worth of bonds (both gilts and corporate paper) of which not more than USD 11 billion is in corporate bonds. That too in bonds where there are no restrictions in tenure/duration of holding. Typically, Foreign Institutional Investors (FIIs) prefer to put their money in short-term paper and infrastructure bonds, which need to have a residual maturity of five years and are subject to a limit of USD 25 billion, are restrictive. The government would need to take steps to deepen the corporate bond market to make it attractive for these investors. IDF is one such instrument that is envisaged to help in creating a vibrant bond market.

IDFs provide additional benefits of bringing about financial reforms through correcting the asset liability mismatch in the financial system. India is soon likely to face a financial crunch vis-à-vis the equity and debt extended particularly as banks are reaching their exposure limits and on account of the asset liability mismatch. It is expected that the IDF would accomplish two key aspects:

- a. Provide long term debt to the project level SPVs; and

- b. Free the capital of domestic banks and Financial Institutions to pursue Greenfield projects.

IDFs would largely help the Project SPVs in accessing refinancing from long term investors and the construction companies which sponsor these projects can be assisted. IDF would raise long term loans from sources like pension funds and insurance companies (foreign and domestic).

5.16.2 Foreign Private Equity and Venture Capital Funds

Indian promoters have preferred to raise capital using a combination of debt and IPOs, but these modes have their limitations. There is a need to promote foreign PE and VC funds as well as long term domestic funds for VC. For the small companies and mid-sized contractors and developers to grow and expand their operations, a Venture Capital Fund is highly recommended. LIC has launched such a Venture Capital Fund for the Real Estate and Urban sector. Banks and Non-Banking Financial Companies (NBFCs) may be advised to set up similar Venture Capital Funds.

Over the last five years, PE funds have invested approximately US\$13 billion, equivalent to one-fourth of the total capital flows to India, into the infrastructure sector. PE funds mainly invest in construction companies at the holding company level or through holding company at a sectoral level than in individual infrastructure projects as they have more certain short-term margins and cash flows. The power sector has attracted the most interest from PE investors, increasing to 45 per cent of total investments. Telecom infrastructure has become the next biggest target for PE investment. Road sector too attracts PE investments. Water, wastewater and storage projects have seen a few deals. Ports and water sector remain promising. More than 82 per cent of PE-backed deals in the last five years have involved stakes under 25 per cent, and only 5 per cent have involved stakes greater than 50 per cent. Deal size will remain small—mostly in the US\$20 million to US\$30 million range—and acquisitions will be limited to minority stakes.

5.16.3 Regulatory reforms required for PE and VC

To facilitate PE and VC fulfilling their role as growth enablers, a host of regulatory changes will be needed to remove ambiguities about their treatment under Indian securities and tax laws. That requires policymakers to begin by recognising the importance of PE as a distinctive asset class with unique benefits and immense potential to propel growth. Three regulatory changes required are: First, PE and VC funds should be allowed to purchase at least 25 per cent of the capital of companies they target for investment without triggering an open offer. Under current law the threshold is set at just 15 per cent. Moreover, promoters should be permitted to share financial data about their companies with prospective qualified PE bidders, enabling the PE investors to conduct a thorough, well-informed due-diligence process and more accurately identify value-creation opportunities. A second set of rule changes that would vastly expand the pools of capital available for PE and VC investment would be to ease restrictions that bar deep-pocketed domestic institutional investors, such as pension funds, from investing in PE and VC. Additionally, removing barriers that limit insurance company investments only to funds that focus on infrastructure would draw more capital into PE and VC as an asset class. The Insurance Regulatory and Development Authority has recently circulated a proposal that would allow insurers to increase the proportion of their portfolio holdings they could invest in PE and VC funds, but only for those operating in the infrastructure space. Pension funds are prohibited from PE and VC entirely. Steps that would progressively allow them to participate would not only help mobilise capital but should enable the institutional investors better to diversify their portfolios and increase their returns. Tax simplification, in particular the broad reinstatement of straight pass-through of investment earnings, is a third regulatory reform that would make a significant difference.

5.16.4 Further, government may provide listing support to the construction companies seeking to list overseas to raise equity.

5.17 Incentivising Builders, Real Estate Developers/Corporates

Builders, Real Estate Developers/Corporates involved in construction sector may be incentivized, to take up affordable housing construction, through granting of additional FAR/FSI/TDR and appropriate fiscal incentives.

5.18 State Plan Document should have a Chapter on construction sector which would clearly mention the construction financing requirements in the state.

5.19 Single Window Clearance

In order to reduce the hassles and delays in the approval process resulting in delay in completion of projects, it is suggested that Single Window Clearance may be provided to the construction projects to avoid time and cost over-run. One of the major problems faced by the contractors pertains to land acquisition and other approvals. The government is in the process of finalising the new Act and enclosed note provides certain issues that need to be addressed urgently.

6.0 Way Forward

1. This Working Group Report reaffirms the significance of the flow of Institutional finance to the construction sector in the wake of massive investment requirement for the sector.
2. Obviously, such a vast financial requirement cannot be addressed by a single enterprise or institution and requires focused initiatives by the government in coordination with all the constituents of construction industry for dedicated flow of credit to the sector.
3. This Report suggests that workable Action Plans may be formulated to augment resources through various strategies, as outlined above, from the institutions for the construction sector.

Annexure-I

CIDC Letter: Working Group on Construction Sector (Institutional Financing Working)