When risk is taken on prior to a project's completion, the borrowing rate will be higher for the part of the risk equivalent to whether the project will be completed or not. For social infrastructure projects for which a set period of operation has elapsed since completion, data on operability and profitability can be provided. In addition, because project continuity and accompanying future profitability can be readily judged to a certain extent, the high borrowing rate at time of the initial borrowing can sometimes be mitigated through refinancing.

In general, refinancing of project loans is done by means of additional project loans (with rates lower than the initial one). In Thailand, however, corporate bonds are sometimes issued for refinancing.

Cases in which refinancing through corporate bonds is possible are special ones in which contracts have been entered so that the risk can be regarded as sovereign, such as when the project's product is electric power and the other party to the sales contract is an electric power corporation which is wholly owned by the Government.

In terms of the period for issuing corporate bonds and repayment methods, various arrangements can be introduced such as layering of tranches in light of the project's cash flow prospects.

Even with project financing in India, as in cases like Thailand in which a project that prospers following completion can be regarded as a sovereign risk, refinancing through corporate bond issuance is possible. This could simultaneously expand the investor base, reduce interest on infrastructure funds and vitalize the bond markets

4. Methods for Japan's Cooperation

An overview of India's corporate-bond market would first reveal that the outstanding balance is extremely low in terms of ratio to GDP. Next, concerning secondary markets, stamp tax is levied against each trade. In addition, clearing systems are underdeveloped. These are issues that remain. For those who participate in the market, the life insurers and mutual funds limits on investing in corporate bonds is imposed, making such corporate bonds unattractive as investment vehicles. As long as this current state of the bond market prevails, it will be difficult to expect the corporate bond markets to function as the major supplier of funds for infrastructure investment.

So far, financial systems, whose role is to act as the financial intermediary, have depended heavily on banks and on the classic method of taking deposits and providing loans. However, keeping in pace with the growth of the Indian economy and manufacturing industry, funding demand from the manufacturing industry would increase. With the banks' credit-deposit ratio reaching a low of 49.9% in 1998 and then rising to 68.1% by 2005; in future, bank lending could become stringent.

It is natural to turn to the domestic bond market for long-term funds for infrastructure investment. Even among India's financial experts, efforts are underway geared to attracting life insurance, pension funds and private funds to the corporate bond markets. In particular, the modernization of settlement systems, the provision of trustee systems that operate from the perspective of protecting the bond holder's rights especially in the event of defaults and debt collection systems are some of the issues which need to be addressed.

Now, we would like to consider what Japan can do to supply funds for infrastructure development, with special focus on private banks, government-run financial institutions, such as JBIC and NEXI, and securities companies.

4.1 Private Banks: Long-Term Lending for IIFC

Japanese leading private banks and major regional banks have nearly completed the lengthy process of writing off bad assets. As a result, banks can be more positive about providing new financing. They are particularly interested in new lending to overseas borrowers. Despite India’s considerable economic growth, Japanese banks have had little involvement with its major financing projects up until now. Major growth in financing from Japanese banks will thus be possible henceforth.[7] Under the Japan-India Tax Treaty, when banks make direct loans from Japan, 10% withholding tax would be charged on interest. However, for the forthcoming loans from Japanese banks to IIFC, an exemption of the withholding tax rate is thought to be indispensable. In addition, when Japanese banks with branches in India make loans for IIFC from their branches in India, they must conform to local regulations such as single and group exposure limits. However, in view of the purpose of establishing IIFC and in consideration of the huge sums required for projects, measures that would ease the limits on single and group exposure would be desirable, at the very least.

4.2 Guarantees from JBIC and NEXI

In expectation of providing a complementary function to private banks, it would be desirable to have government-affiliated financial institutions such as JBIC and NEXI to provide guarantees to mitigate long-term investment risks to India that would be difficult for private banks to undertake. In particular, when IIFC engages in long-term funding, both parties would shoulder the sovereign risk for India over the long term that it is difficult for Japanese private bank to undertake. If guarantees were provided for loans to IIFC exceeding 5 to 7 years, private banks would be able to make active efforts in terms of loans for India’s infrastructure projects.

Similar efforts would also be possible in case of IIFC’s issuance of yen-denominated bonds in Japanese capital markets. If IIFC were to issue long-term (10-year) bonds in Japan, the existence of JBIC and NEXI’s credit enhancement will be the key to the successful placement to Japanese investors.

4.3 Securities Companies Functioning as Intermediaries

Envisioning that IIFC procures funds in capital markets with the Indian government’s guarantees, mention should be made on securities companies fulfilling the intermediary functions of bond underwriting and sale. In case of Euro or Global bonds, even with maturities exceeding 10 years, as long as the bond issued by IIFC is carrying the guarantee from the Indian government, they should be able to attract interest from a wide range of international investors. In the international markets, if bonds issued were indexed by credit rating with pricing done in line with spreads that should be paid,

[7] Japan’s domestic banks purchased about 1/3 of the sum of the Export-Import Bank of India’s Samurai bond issuance of February 2006.

they should be basically acceptable to investors.

On the other hand, for many investors in Japan, the criteria for judging whether or not bonds are attractive investment products, do not necessarily have a direct link to whether a fair level of return is procured in return to the risk that is undertaken by the investors. In Japan, whether the issuer is rated BBB or above is a major factor. If IIFC were to issue a Samurai bond with the Indian government's guarantee, we anticipate that wide acceptance by the investors may only be up to 7 years' maturity. On the other hand, for Japanese issuers, acquiring a BBB or above, will make it possible to procure funds at low cost that may not be possible in the international market. This means that if a Japanese issuer were down graded to below BBB, financing in the bond market will be difficult. Such distortions evident in Japanese bond markets are expected to be corrected somewhat through the briskness by which recent issues of Samurai bonds have been increasing.

Securities companies acting as intermediaries in Japanese financial market should make efforts to foster an environment where issuers with a rating lower than BBB could raise fund as long as spreads reflecting the issuer's credit standing is paid. While continuing to maintain close connections with issuers, providing opportunities in the form of road shows and giving investors detailed company overviews are considered to be necessary efforts.

4.4 Conclusion

Although the scale of India's bond market, and particularly its private bond market, is extremely small, bond market vitalization will be indispensable for procuring long-term funds from the private sector including infrastructure-related funds.

As presented in this report, countries in Asia have been aiming to vitalize their bond markets through the cooperation of international organizations and Japan's government-affiliated financial institutions.

In India, efforts to expand the investor base through the gradual improvement of bond-market systems and active composition of projects, in which private financial institutions can also engage in investments and loans, will likely be the most crucial element in vitalizing the bond market henceforth.

The enlightenment of issuers and investors through international organizations mentioned in this report and through the issuance of bonds with the credit enhancement of international organizations would likely be an apt beginning. If the products are appropriate, as demonstrated by the success of EXIM Bank's issuance of Samurai bonds, Japanese investors will be more than ready to accept such products.