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FINANCIAL INSTITUTIONS REFORM AND EXPANSION PROJECT

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SANITIZED VERSION

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I. OVERVIEW

India's economic recovery following the crisis of mid-1991 has been swift. This is due to good economic management and adherence to a sound stabilization program along with the introduction of broad ranging structural reforms and market liberalization. Real GDP, which dipped below two percent in 1991/92, is projected to grow at four percent in 1992/93. The continuation of this recovery is contingent upon good agricultural production, improvements in industrial production, growth in export earnings and improvements in infrastructure and financial services.

To raise its economic growth to 5 - 6 percent in the medium term, the government expects to raise investment from the present level of 24 percent of GDP to 27 percent and to improve the efficiency of that investment. Attaining its investment targets will require an increase in the domestic savings ratio, but immediate gains can be realized through more efficient allocation and utilization of existing savings. In order to do this, the government is liberalizing the financial market system by removing previous controls and creating a new environment in which the system can allocate resources more efficiently.

However, jettisoning antiquated controls is the easier half of market liberalization. Creating new regulatory and operational mechanisms and institutions to deal with the resulting new structure, especially in the capital markets sector, is more difficult. Liberalization places a great reliance on markets for achieving efficient resource allocation, and the markets can only do this if measures are taken to ensure that they function transparently, competitively and efficiently. Without a properly regulated environment, the capital market's true value as a tool for broad-based sustainable development remains constrained and distorted by non-competitive oligopolistic practices.

The Financial Institutions Reform and Expansion (FIRE) Project will address the development of India's capital market by providing $20 million in Development Assistance (DA) and $125 million in Housing Guaranty (HG) assistance over a seven-year period. The project will be structured around three components: 1) the operating environment of the capital market (including both equity and debt markets); 2) the development of the debt market portion of the capital market, with special emphasis on infrastructure project financing; and 3) capital market operations research.

The project will use DA funds to address problems found in the overall operational mechanisms of the capital market, to stimulate development of the debt market through concentration on the identification and testing of new and innovative debt instruments, and to research selected issues that are likely to affect the operations of India's capital market. Because of the importance that infrastructure finance has traditionally played in the development of debt markets world-wide (in most countries, infrastructure financing constitutes a large percentage of the total bond market), and because the economic liberalization process renders public financing of India's growing infrastructure needs impossible, HG loans will be used to demonstrate the practicality of raising private sector funds for infrastructure projects and thus will provide an important stimulus for broadening and deepening India's bond market.

In the medium to long-term, the project will reduce India's poverty by accelerating market-led growth through the more efficient allocation of the country's currently available savings. In addition, the infrastructure component will directly improve the standard of living and the environmental conditions in selected, poor, urban areas.

II. PROGRAM FACTORS

A. CONFORMITY WITH RECIPIENT COUNTRY STRATEGY AND PROGRAMS

1. BACKGROUND

a. The Equity Market

Stock markets are not new to India. Records show that transactions in government securities and East India Company loan securities took place in Dalhousie Square in Calcutta toward the end of the 18th century. The Bombay Stock Exchange (BSE) was founded in 1875, and since then Bombay has been known as the financial capital of India. Currently the BSE conducts about two-thirds of the equity trading volume in the country. There are 23 exchanges in India, including a very small over-the-counter exchange in Bombay. The other main exchanges are in Calcutta, Ahmedabad, Delhi and Madras.

India's long history of stock market trading has evolved independent of foreign participation and despite the consistent anti-market bias of post-colonial governments. Today India's equity market is surprisingly large, has considerable depth and in some respects is not an "emerging" market. For example, ten years ago India had a market capitalization of approximately five billion U.S. dollars and an annual turnover of approximately five billion U.S. dollars. At that time Taiwan, South Korea and Brazil had markets of approximately the same size while Turkey, Indonesia, and Thailand all had (in 1982) markets with capitalization of one billion U.S. dollars or less.

The decade of the 1980's witnessed dramatic growth in India's equity markets as a major source of finance for Indian industry. This growth, although not as dramatic as in other countries, was consistent with global trends and was the product of a more favorable, liberalized attitude of the GOI toward the market. Between 1980 and 1992, the number of listed companies increased tenfold; the number of share-holders soared from about two million to over 15 million; market capitalization increased from five billion U.S. dollars to $50 billion; and by the close of 1992 the annual volume of trading had reached $37 billion.

b. The Debt Market

Even though both equity and debt markets in India have grown in absolute terms, equities have clearly dominated. A review of a recent report by India's central bank, the Reserve Bank of India (RBI), reveals that debt has accounted for no more than 20 percent of the total resources mobilized in the capital market in any one of the past five years. India's debt market has been primarily driven by government demand for capital. Government securities still form a large portion of the market, but since the liberalization process began, the market is being increasingly opened up to private investment and market forces. The captive government debt market of institutions meeting the RBI's Statutory Liquidity Requirement (SLR), a system requiring Indian banks to invest a specified percentage of their liabilities (primarily their demand deposits) in government-designated instruments, is now being opened up by a phased reduction in the SLR and the auctioning of government debt.

The debt market is not a major source of debt finance for the Indian corporate sector. Historically subsidized long-term finance has been available to the corporate sector from the Development Finance Institutions (DFIs). This, coupled with low interest yields and lack of liquidity for the primary financial instrument used by the debt market (Non-Convertible Debentures - which are fixed rate, fixed term bonds backed by the credit standing of the issuer), have rendered the debt market unattractive to investors. Subsidized public sector long-term finance is being progressively curtailed as a result of the GOI's economic liberalization program, and this has created new demand in the debt market. However, because of the market's nascent stage of development and the relative paucity of instruments, it is proving difficult to meet this demand.

The 1980's witnessed some innovation in the debt markets in terms of the types of instruments available. In the mid-1980's, Convertible Debentures were introduced, and in 1989, Partially Convertible Debentures. The quasi-debt nature of these instruments offered investors the lure of access to equity, on conversion, and often at a price below the prevailing market price. Additional options are being tested in the market, e.g., Convertible Preference Shares - providing a fixed return during the first three - five years, followed by conversion to equity. The room for growth is enormous and has been only initially addressed by these innovations.

c. Infrastructure Finance

As the process of liberalization continues and government deficits are reduced, it will become increasingly necessary for infrastructure, especially urban infrastructure, to be financed outside of government budgetary resources. A failure to do so will negatively affect the economy and the liberalization process, since the urban services sector is a major contributing component of GDP. But infrastructure usually has a long gestation period and requires long-term financing. In a well-functioning capital market, funds of this nature are usually sourced from the debt markets. However, such funding is currently unavailable in India. The GOI is interested in assistance in mobilizing resources to finance urban infrastructure in the capital market, in promoting the privatization of municipal services (especially water supply schemes and solid waste management), and in facilitating public/private partnerships for infrastructure development. In order for funds to become available, improved capital market operations and commercially viable projects must be developed to attract the necessary investors.

d. GOI Actions

The debt and equity markets suffer from several generic deficiencies: a) a fragmentation of market control authority among various government entities; b) weak enforcement actions by those entities that have control authority; c) the lack of an adequate legal framework governing the markets; and d) the lack of transparency in the conducting of market transactions. The need for legal, regulatory and operational reforms to address these deficiencies has been evident to the GOI for some time. It has become more pronounced recently in response to the uncovering of significant market abuses and irregularities in securities trading. In order to counteract the deficiencies, the GOI established the Securities and Exchange Board of India (SEBI) in January of 1992 and gave it significant, but still insufficient, powers to perform its functions. Its powers range from inspections of mutual funds and stock exchanges to the registration of intermediaries (stockbrokers and sub-brokers) and the establishment of insider trading regulations. In late 1992, the Capital Issues (Control) Act of 1947 was repealed, which effectively meant that companies no longer had to obtain prior government approval to access the capital markets. The controls over pricing and premiums were also removed, so that most issuing companies are now free to set the price of their securities.

Other initiatives include: requiring greater disclosure by issuing companies in the primary market, including specific risk factors associated with their projects; and the establishment of the National Stock Exchange of India (NSEI), which is expected to serve as a model exchange by providing nation-wide stock trading facilities and electronic clearing and settlements.

Finally, the government has allowed foreign institutional investors (FIIs) such as pension funds, mutual funds, and investment trusts to invest in the Indian capital market provided they register with the SEBI. During the last 20 months, 18 FIIs have been registered to conduct business in India.

c. Other Donors

USAID will not be working alone in capital market development. The World Bank (IBRD) is developing a Financial Sector Program Loan that will focus on banking and is expected to begin implenentation in FY 93/94. The International Finance Corporation (IFC) has just completed a major study of India's capital market and also plans to participate in the market's development, most probably by taking an equity position in the securities industry. The Asian Development Bank (ADB) is in the process of finalizing a program sector loan of $250 million for capital market development. The ADB program will be the most closely linked donor activity to the planned FIRE intervention. FIRE will at a minimum closely coordinate with the ADB program. During Project Paper (PP) preparation, USAID will also explore the option of linking resources with the ADB as has been successfully accomplished in the Energy Management Consultation and Training Project.

Because of GOI recognition of the need to restructure the legal and regulatory framework of the capital market and because of the vast resources the above donors will bring to this process, it is expected that these donors will provide the major inputs in this area, while USAID through the FIRE Project concentrates on operational reforms and the creation and testing of new instruments in the debt market.

B. RELATIONSHIP TO THE MISSION STRATEGY

USAID/India strategy is to assist the GOI in its economic liberalization process through the acceleration of broad-based, market-led growth. This project directly supports that goal as well as the first of the Mission's main program focus objectives of an improved financial and regulatory environment.

The U.S. has one of the most highly developed and sophisticated capital markets in the world. This fact is universally recognized and is specifically cited by Indian officials in their requests for assistance in further developing the Indian capital market. The project will take advantage of the U.S. preeminence and comparative advantage in the field and will call upon the many sources of technical assistance and training in the U.S. capital market sector to provide the type and level of sophistication that India is seeking.

FIRE will complement major financial sector policy reform initiatives recently recommended by the GOI and supported by the World Bank, the IFC and the ADB. The project will build upon existing USAID-funded pilot projects which are assisting in the establishment of an over-the-counter stock market, a national stock depository and improved settlement and clearance systems for India's 23 stock exchanges. FIRE will also complement and diversify this effort by assisting in the creation of a long-term debt market. To do so it will build upon the existing successful HG program in India. The HG program has already made inroads into securitization and secondary mortgage markets (both of which are components of a secondary debt market) by providing Housing Guaranty funds to promote the issuance of project-based, urban infrastructure bonds.

FIRE will also build on the Mission's successful efforts in assisting the GOI to develop a consensus on essential urban policy reforms to increase investment in urban infrastructure. Over the past eighteen months, the Mission and RHUDO/Bangkok have collaborated with a group of key Indian policy-makers in a dialogue for essential urban policy reforms. Through a series of four regional policy seminars which brought together public sector participants from the center, state and local governments, together with senior representatives from private sector financiers and developers, 35 research papers on urban policy issues were presented for analysis and discussion. This dialogue resulted in an action plan for state and local governments to implement essential policy reforms, and a request by the GOI for loan and grant assistance from USAID to implement trial programs at selected localities. FIRE will continue this dialogue and will implement selected demonstration efforts aimed at increasing private investment in urban infrastructure.

III. PROJECT DESCRIPTION

A. General Problem

The capital market, as it now exists, is heavily asymmetrical, with the equity market more developed than the debt market. The capital market in general has several overarching structural problems that need to be addressed before it can efficiently mobilize capital. These problems, once addressed will benefit both the equity and debt components of the market. The debt component of the market, because of its incipient development, needs both the overarching assistance that will be provided to the capital market as well as specific assistance in developing instruments and infrastructure finance institutions that will attract greater levels of capital. In addition to structural reforms in the debt market, a stimulus upon which project-developed reforms can be demonstrated is needed. Because infrastructure financing traditionally constitutes the majority of the debt market in all countries, the HG-financed urban infrastructure component will be used as the stimulus and demonstration platform for project-developed instruments in the debt market.

L. Problems in the Overall Capital Market

There is an emerging consensus among informed observers regarding the major problems facing India's capital market. These problems include the following:

- There is a lack of an adequate legal framework for the capital market in general. The laws governing India's capital markets [principally the Companies Act, the Securities (Contracts) Regulation Act and the Securities and Exchange Board of India Ordinance] do not provide a comprehensive and consistent framework for regulation of the securities markets in accordance with international standards;

- In addition, there is fragmentation of the regulatory authority over the various components of the capital market. Although SEBI has been created to oversee the capital markets, significant overlap in authority remains among SEBI, the MOF, the Department of Company Affairs and the RBI. For example, the MOF regulates exchanges and approves SEBI regulations and other actions; the RBI oversees merchant banks that are operated by banks and regulates money market fund, whereas SEBI regulates other merchant banks and mutual funds; the Unit Trust of India's (UTI) market activities are not under the jurisdiction of SEBI; the Department of Company Affairs is involved in disclosure and other corporate matters that affect the securities markets and has authority for prosecution of any actions affecting corporations, including those that would normally be brought by a securities regulatory body;

- The fragmentation of regulatory authority has led to a virtual absence of enforcement efforts, which is compounded by the fact that significant powers generally associated with a capital markets supervisory authority have not been delegated to SEBI. For example, SEBI has no authority over prospectuses and corporate disclosure or the distribution of securities by issuers. Further, it does not have the authority to impose civil penalties or to participate effectively in the process of instituting criminal actions;

- There is an absence of transparency throughout the stock and emerging bond markets. Persons who deal with the market do not have access to appropriate information about the rules of the game, the issuers, the underlying activities (corporate disclosure) or the actual prices;

- An outdated settlement system which is grossly inadequate to cater to the growing volumes of business. This has lead to settlement, pay-out and delivery delays, "bad deliveries" (i.e. trades of bonds and stocks which fail) and a general loss in market liquidity;

- The lack of a single market due to the inability of the various stock exchanges to function cohesively, not only in terms of legal structure and regulatory framework, but also in terms of trading practices and settlement procedures. This lack of interconnected trading systems prevents the investors from exposure to the greatest number of buyers and sellers to compete for business;

- The lack of liquidity in most of the markets in terms of both depth and breadth, and in particular, the inability of exchanges to develop a market for debt instruments; and

- The lack of infrastructure facilities including effective computerization and telecommunication systems.

While the principal donors interested in India's capital market development (IFC, IBRD, ADB and USAID) and the top levels of the GOI are aware of, and addressing the above issues and constraints, powerful vested interests will have to be overcome to make real progress on these fundamental constraints.

In response to these problems, the government has promoted the concept of a National Stock Market System which would include an efficient regulatory system to be vested in SEBI and the promotion of a National Stock Exchange (NSE). It has also recommended the following support components:

- A National Clearing and Settlement System to administer the clearing and settlement functions at a national level, and arrange for payment against delivery as a counter guarantor to participating members (mandated to the Stock Holding Corporation of India Ltd. - SHCIL);

- A Central Depository Trust to eventually usher in scripless trading (mandated to SHCIL); and

- The creation of the Securities Facilities Support Corporation which would establish and maintain the network.

2. Problems in the Development of the Debt Market

The inability of exchanges to develop a primary and secondary market for debt underscores the very serious problem of the incapacity of the debt market to service the country's expanding needs. This is particularly true and acute now that budgetary expenditures are shrinking relative to the needs of India's population for basic urban infrastructure services. There are several constraints to the development of the debt market, other than the overall market deficiencies that affect both the equity and debt markets.

The essential components of a debt market are its supply, demand, and channel of distribution. Constraints to the development of India's debt market exist in all three components.

a. Supply

Traditionally in India debt has been traded in a distorted environment due to government restrictions and private, non-transparent transactions. For example, under the Statutory Liquidity Requirement of the RBI, Indian banks are required to maintain a certain percentage of their liabilities invested in securities specified by the government. These are usually either treasury bonds or public sector enterprise bonds. This practice creates a captive market for the sale of government securities and public sector enterprise bonds, and suppresses the development of a competitive debt market. Recognizing this fact, the GOI has announced and begun to implement a policy that will gradually reduce the percentage of liabilities required to be held under the rules of the SLR. This policy change will stimulate the development of the debt market, but, without a variety of instruments to meet the demand this stimulus will provide, the market may be unable to adequately respond.

b. Demand

The meteoric pace and volatility of the Indian equity market and government policy changes, such as the one identified above, are creating a demand for less volatile investment instruments. India has a relatively high household savings rate, much of which is invested in pension funds, mutual funds and life insurance. These institutional investors require the more stable yields provided through debt markets. The creation of competitive debt instruments will channel this demand by matching the terms and yields of the debt instruments with the investment needs of these institutions.

c. Channels of Distribution

Usually when government and industry (the users of capital) are in a position to issue debt and the investing public (the savers of capital) have the means and desire to buy debt, a market will form unless the channel of distribution impedes it. Distortions to this process can be external to the process, such as government policies, or internal such as the real and/or perceived risks investors face in entering the market. External distortions are being addressed primarily by GOI policy changes. The best method for addressing the internal distortions is to make the market more transparent, more efficient, and capable of providing multiple investment instruments that can address the multiple and unique risks of the multiplicity of investors needed to create the market. Improvements in the operational efficiency of the capital market and the creation of additional instruments in the debt market will address the internal distortions that are occurring in the Indian debt market.

B. Problems to be Addressed by the Project

For purposes of this project, the obstacles to the development of India's capital market will be grouped into two basic categories: 1) an inefficient operating environment for the capital market as a whole; and 2) an underdeveloped debt market, with special emphasis on infrastructure finance as a catalyst to the development of the debt market.

1. An inefficient operational environment

The present clearance and settlement systems are outdated and are not in line with internationally recognized standards. Because of this, the securities industry has reached a point of paper work grid-lock which is stifling the operational efficiency of the markets. The standard fortnightly settlement periods are too long by any measure, and the market suffers from pay out problems, delayed settlements, bad deliveries, and the tremendous paperwork related to the physical handling and movement of certificates.

However, the principal constraint is the lack of transparency for investor trades. In excess of an estimated 80 percent of individual investors must go through one or more sub-brokers in order to access a broker for their transactions. Sub-brokers are estimated to be in excess of 100,000 with member-brokers of recognized exchanges numbering only about 5,000 - 1 for every 170,000 people. Each one adds to the transaction cost in the form of an increased purchase price or a reduced sales price. These transaction costs are not transparent. The problems in the market are often further compounded by a system which allows and encourages brokers to speculate in transactions.

India has already established institutions commonly present in securities markets, including brokerage firms, merchant banks, venture capital firms, credit rating agencies, custodians, mutual funds, stock exchanges and accounting firms. However, there is an absence of several significant institutions, and deficiencies are evident in those that do exist. For example, the self regulatory organizations (SROs) are very weak and ineffective, and there is no national level group such as the National Association of Securities Dealers in the US. Without strong SROs, the superior knowledge of market practices and violations held by the persons in the market cannot be readily tapped by SEBI and the credit rating agencies, and regulatory efforts are restricted to external policing of the market.

A major problem in the development of the market is the lack of automated trading systems and the lack of interconnected automated trading systems. This prevents an individual order from being exposed to the maximum number of buyers and sellers and thus distorts the market and competition. It also makes it difficult to establish an audit trail that could help ensure investors a fair market price.

The major exchanges have delayed automation and serious reform efforts, including self regulation and the addressing of investor grievances. However, a National Stock Exchange has recently been put on a fast track by the Ministry of Finance (MOF). It is intended to avoid many of the deficiencies present in other exchanges and will provide competition to them. In spite of mounting pressure and resistance from other exchanges and broker groups, the National Stock Exchange is making rapid progress and is fully backed by the MOF, as is SEBI.

Another major problem is the lack of strong professional brokerage institutions and a weak distribution network. The brokerage industry has not developed adequately because corporate members have been excluded from the exchanges. Tax and bank lending policies have made it difficult for corporate brokerage firms to obtain and retain capital, and for individual brokers to transfer their memberships to corporations. The present commission structure also makes it disadvantageous for brokers to service retail investors in the secondary markets. Hence, to date there has been no development of a strong retail brokerage industry with the capability of directly servicing the needs of individual investors.

2. An underdeveloped debt market

The major problem to the full development of the Indian capital market is located in the channel of distribution. As noted above, both demand and supply are being addressed; however, the inability to buy and sell debt instruments in the marketplace and the inability to create additional instruments is currently the most serious impediment to debt market development. India's present bond market is uncompetitive and mostly limited to government debt and public sector enterprises. However, with the present and projected reductions in the SLR, there will be a much smaller captive source for SLR bonds which make up much of the market. Since it is the intention of the GOI to continue to reduce the SLR requirements over the next four years to 25 percent of liabilities, the presently underdeveloped debt market will be forced to become more competitive and market oriented.

The increasing market orientation of the debt market is reinforced by the GOI's recent decision to permit Indian enterprises to directly access international debt markets and by the report of the Nadkarni (the head of the National Stock Exchange) Committee on trading procedures for Public Sector Undertaking (PSU) bonds. Additionally, as the GOI reduces subsidies to India's state-owned banks, there will be an increasing need for these banks to raise capital from the market. Bankers are reportedly already lobbying the GOI to establish various debt securitization instruments, but constraints do exist.

Furthermore, when credit is not available in the banking system, long-term capital investment cannot take place in either the public or the private sector. The result is disinvestment in infrastructure and public services, and decapitalization in industry. The debt market offers the flexibility to create varying financial instruments to meet the needs of capital requirements for given projects. Flexibility to create financial instruments to fit specific needs is one of the most important features of debt instruments as opposed to equity. Barring bankruptcy or liquidation of the business entity, an equity participation is an investment in perpetuity, with infinite profits on the upside and losses up to the amount invested on the down side. In contrast, debt instruments have a predetermined time horizon, income stream, and value at the end of the contract. A debt instrument is a contractual arrangement which can be designed specifically to suit the requirements of the project. This flexibility promotes optimal intermediation in the financial system.

2a. The lack of viable basic infrastructure projects

The GOI has identified the impact of fiscal deficits and the consequent budgetary constraints as a problem in addressing infrastructure needs. They wish to promote the privatization of municipal services (especially water supply, sewage disposal schemes and solid waste management) and facilitate public/private partnerships for infrastructure development. Since infrastructure projects are in many instances only marginally profitable, it is important to keep the cost of capital as low as possible. This requirement is best met in the bond market. The most important advantage is the flexibility available in the bond market to satisfy the special requirements of infrastructure projects. These projects may take years from planning to completion, but in the debt markets the financial needs and risks associated with every stage and every player may be assimilated into special debt instruments and strategies.

In India the depth of the capital market can absorb large bond issues without creating market distortions. In the secondary market, which is not yet active in India, the main considerations are the term of the instrument and the holding period for the investor. For example, a 20-year bond becomes an investment with a one year horizon if it is sold after one year of the date of purchase. The liquidity offered in the secondary market is essential to the development of a bond market. One method of obtaining such viability is through well-structured, Build-Own-

Operate (BOO) or Build-Operate-Transfer (BOT) projects. (See Annex B for an explanation of BOOs and BOTs.)

B. PROJECT GOAL AND PURPOSE

The goal of the project is to broaden and deepen India's competitive debt and equity markets. The achievement of this goal will result in increased domestic and foreign investor participation in the debt and equity markets, and increased availability and trading of security instruments.

The project purpose is to improve the operating environment of the capital market and to assist in the development of the debt component of that market with special emphasis on infrastructure finance as a means for stimulating debt market development.

The achievement of project purpose will involve efforts to: improve transparency in trading practices; decrease time required for the settlement and clearing of transactions; improve disclosure norms for market participants; improve investor services; develop the debt market by mobilizing a significant portion of domestic savings for infrastructure financing; and increase the number of households below the median income level benefiting from infrastructure projects financed by the debt market.

C. EXPECTED OUTPUTS AND ACHIEVEMENTS

FIRE Project outputs will work toward the above goal and purpose by:

1) assisting in the establishment of a national depository system and a national system for clearing and settlement which will, among other things, reduce the average time required for settlement of trades;

2) supporting the efforts of debt and equity trading systems to attain greater levels of automation;

3) increasing the trading volume in the debt market by stimulating that market through the introduction of new debt instruments issued against HG-backed, urban infrastructure projects;

4) assisting in the development of the retail brokerage and mutual fund industries;

5) assisting in the development of technical capacities of personnel in securities trading, pricing and regulation through both overseas training and the development of indigenous training capacities in these areas;

6) increasing private sector participation in the delivery of municipal services; and

7) improving the capacity of local governments to plan, finance and recover the costs of basic urban infrastructure.

D. PROJECT OUTLINE AND DESCRIPTION

The project will have three components:

- The operating environment of the overall capital market;
- Development of the debt market portion of the capital market, with special emphasis on infrastructure project identification, financing and development; and
- Operations research.

1. The Operating Environment Component

FIRE will support India's transformation from its previously inward-looking and closely controlled and directed financial system to a more liberalized market-based system. This will be done through a package of technical assistance and training which will be targeted to the capital market to make it more transparent and efficient. To açcomplish this, the project will assist the GOI in its efforts to provide an adequate operational framework for the capital market.

The technical assistance and training provided under the project will assist in the development of systematic changes needed to provide more transparency and efficiency within trading and settlement system, and to facilitate the development of the debt market.

Operational areas of focus will include:

- Facilitating the development of a National Clearance and Depository System (NCDS);
- Assistance in automation and the development of a national market system;
- The development of new financial instruments (especially in the debt market);
- Facilitating the development of the distribution network by encouraging the establishment of professional brokerage institutions;
- Facilitating the development of the mutual fund industry;

- The development of an indigenous research and analysis capacity and systems for its dissemination to investors; and

- The upgrading of technical capacities of capital market personnel.

2. The Debt Market Development Component

The project will stimulate the development of the debt market through the use of demonstration projects in infrastructure finance. These projects will provide high quality and varied debt instruments sold through transparent and credible institutions. The project will support the linkage of infrastructure to the debt markets in two ways. Where projects are viable, such as well structured Build-Own-Operate (BOO) or Build-Operate-Transfer (BOT) projects (see Annex B for description), technical assistance will be provided to assist in directly accessing the debt markets with project-based revenue bonds. Where the viability is less obvious, an infrastructure finance institution will be utilized to serve as an intermediary and/or a guarantee may be utilized in order for these projects to access the market. In order to accommodate this market, which will include a majority of the projects targeted at below median income households, Housing Guaranty funds will be used to facilitate their access to funds through an institutional intermediary. However, the ultimate goal of all infrastructure interventions in FIRE will be to move infrastructure project financing into the debt markets, either directly or indirectly through an intermediary institution, and the project will have a bias toward using the discipline of the market to promote increased project viability.

2a. Infrastructure Project Identification and Development

In providing assistance to promote the growth and development of competitive debt systems, FIRE will make available Housing Guaranty funds to promote the issuance of project-based revenue bonds, particularly for the development of urban environmental infrastructure. Through the development of debt instruments, such as project-based revenue bonds, local public/private ventures will access the funds required to expand needed urban infrastructure and services (i.e. water and sewer schemes, solid waste management).

The HG program will have a demonstration effect. Two to four municipalities in one or two states will be selected to participate. The selection will be based on their willingness to promote three basic policies:

1) The development of a commercially viable infrastructure finance system;

2) Increased private sector participation in the delivery of municipal services; and

3) Improved local government planning designed to operate, maintain and recover the costs of basic urban projects.

2b. Demonstration and Replication

The specific purpose of a demonstration project is to encourage the supply of debt securities, to strengthen the channel of distribution, and to test the level of demand. A more general purpose is to establish a replicable system.

In a financial environment as complex and powerful as the one that exists in India, one of the few effective alternatives to initiate change in the immediate future is to influence by example. Demonstration projects which, if successful, could be replicated by others, are the best support that the Mission could offer to government reforms.

The implementation of demonstration projects involves several steps:

- the identification of potential issuing entities and viable infrastructure projects;
- the financial engineering, documentation, underwriting, rating and placement of instruments to finance the project;
- the construction, operation, maintenance and cost recovery of the project; and
- the promotion of its replication.

This is lengthy process. Nonetheless, it can be completed in progressive stages and adjusted according to new evidence as it becomes available.

Long-term technical assistance will be required for each of the components in the selected demonstration projects, and they will be supported by a flexible package of highly specialized, short-term technical assistance that can be made quickly available to maximize targets of opportunity as they are identified. An important and substantial component of the project will be formal and informal training for senior GOI financial policy makers, senior state and municipality officials, regulators, underwriters, brokers, and those involved in restructuring selected institutions. Significant technical assistance and training funds will also focus upon promoting innovative infrastructure financing methods such as the BOOs and BOTs options referred to earlier. Assistance will also be provided in the areas of public/private partnerships, and financially viable methods for local governments to operate, maintain and recover the costs of basic urban services. The training program will include short-term training, group study tours, workshops and conferences, both in the US and within India.

3. The Operations Research Component

In the rapidly changing environment of India's capital market, many of the parameters that influence and shape the operations of that market are likely to change over the seven-year course of the project. For example, the effect that the creation of the National Stock Exchange will have on the market's operating environment is unknown at this point. A second important unknown factor is the impact of the growing role of SEBI in market operations and SEBI's relationship to market participants and support providers, e.g., the Institute of Chartered Accountants. A third unknown is how the further development of a national brokerage industry will affect market operations.

In order to become informed of the impact that the above (and other as yet unidentified) factors are likely to have on India's capital market operations and to be prepared to make necessary adjustments in the project based on this information, FIRE will include an operations research component. This component will fund research on various aspects of India's capital market operations and ancillary issues. PP analyses will further define and identify relevant areas of research and proposed methods of implementing and funding it.

IV. FACTORS AFFECTING PROJECT SELECTION AND FURTHER DEVELOPMENT

A. SOCIAL CONSIDERATIONS

1. Socio-Cultural Context and Feasibility - FIRE is building upon a long-standing capital market which is part of the Indian culture. The need for such an intervention was recently underscored by an estimated $US 3 billion scandal in the markets. The GOI is determined to correct this situation and to insure that it does not recur. This project will support that initiative, as well as the GOI's desire to liberalize the markets.

This project will also complement recent efforts directed toward fiscal decentralization and deficit reduction, through the provision of assistance in the development of financially viable project-based urban infrastructure bonds to finance urban services benefiting below median income families. This will, in effect, be a method of utilizing the capital markets to serve, on a sustainable basis, the broad-based need for basic urban infrastructure services.

2. Beneficiaries - The beneficiaries will include: the 15 million investors in the markets; over 6,500 companies listed on the exchanges; the tax paying population who will benefit from the increased use of private sector funds to finance infrastructure; states and municipalities who will learn more viable techniques for the development and management of infrastructure; and the large number of below median income families who will benefit from improved urban environmental infrastructure services and hence an improved standard of living. These beneficiaries will be spread over the entirety of India but will tend to be concentrated in the urban areas. The only groups adversely affected should be those groups who have profited previously from ill-gotten gain.

3. **Participation** - The majority of beneficiaries will not be able to participate directly in the design, implementation and evaluation of this project. Instead, they will have to rely on those with the technical capacity to insure that their, and hence the country's, best interests are protected. Good proxies for their interests are the GOI, SEBI, and the more progressive states and municipalities. Key representative from these entities will be sought for input into the design, implementation and evaluation process at project forums, as will potential institutional participants and the more progressive elements of the exchanges, investor community and SROs.

4. **Impact** - Most importantly for India, the development of transparent and efficient debt and equity markets will help to increase the total volume of domestic savings and investment, and thereby will promote economic growth, infrastructure development and increased employment. Capital market development will also facilitate broader-based business ownership and hence promote democratic capitalism. Transparent and competitive markets also provide an enduring source of sustainable economic growth and ultimately reduce the necessity for external assistance. The financing of financially viable urban environmental infrastructure projects will also facilitate sustainable municipal infrastructure development and the growth of the debt markets.

B. FINANCIAL AND ECONOMIC CONSIDERATIONS

Capital markets provide long-term debt and equity finance for the government and the corporate sector. By making long-term investments liquid, capital markets mediate between the conflicting investment maturity preferences of lenders and borrowers. Competitive debt markets help allocate capital more efficiently by establishing fair market prices for securities and by minimizing the cost of buying and selling them. They also maximize financial intermediation through the reallocation of financial resources among corporations and industries. Most importantly for the development of India, they also help to increase the total volume of domestic savings and investment, and thereby promote economic growth and employment.

Capital markets facilitate the dispersion of business ownership and hence promote democratic capitalism. A sound and efficient debt market helps to promote the inflow of foreign capital for both portfolio and direct investment, and hence provide an added source of funding for long-term growth. However, for India, price transparency and settlement problems will have to be addressed before there will be any significant inflow from foreign institutional investors.

Most importantly, for capital markets to operate efficiently they must be guided primarily by market forces rather than government directives. India is now in the process of this transition, but there is a significant danger to the individual investor as the market is deregulated. Public sector institutions still control too much of the market and oligopolistic practices and a lack of transparency put the small private investor at a disadvantage.

India has recently begun moving from its old allotment system to a more market driven system where offerings are placed through underwriters, but the development of a retail brokerage industry could assist in this process and at the same time provide a higher level of investor service.

Recent GOI divestment of shares in the Public Sector Undertakings (PSUs) have also begun to facilitate the dispersion of ownership from the public to the private sectors and should continue to enhance the role of the capital markets. This fiscal year alone (1993-94), the GOI intends to raise in excess of $1 billion through the sale of shares in its PSUs. While this may be only 2-3% of present market capitalization, it could add another five percent to the market's trading volume and thus significantly increase its depth.

Recent liberalization efforts and macroeconomic trends also underscore the need for the development of a debt market. Gross capital formation of the Central Government, which was over 40 percent of the total expenditure in the first half of the 1980's, started to decline from 1986-87 onwards. This trend continued through 1991-92. The growth of gross capital formation shows a similar pattern. It averaged 18.8 percent per annum from 1982-83 to 1985-86 and 11.4 percent from 1986-87 to 1989-90. It fell further to an average of only 4.1 percent in 1990-91 to 1991-92. At issue here is whether the private sector can make up the shortfall, since any significant change from this pattern could slow or damage India's economic recovery and liberalization process.

However, while market capitalization and foreign investment in the equities markets have increased, bond markets have lagged behind in depth, diversity of instruments and yields. Yet, debt markets are essential to complete and efficient intermediation in the financial system. They provide a ready source of long-term debt, lower costs of capital, an efficient allocation of resources, and flexibility in the capital structure of enterprises, including the ability to secure financing without a dilution of the corporate equity base. Most importantly, debt markets provide the flexibility to create financial instruments which fit specific needs and thus promote optimal financial intermediation.

To develop a debt market, there will have to be a wider range of market-makers than the government bond oriented Unit Trust of India, and the public sector insurance companies and mutual funds. Presently, bonds are about to become tradeable through the Over-the-Counter Exchange (OTCEI). When it commences, assistance should be provided in order to help it develop and to assure that it is conducted within strict regulations. Screen trading should be utilized and broker participation should be on a fixed commission basis, rather than as investors.

Project Paper economic and financial analyses will focus on the extent to which the above elements will affect project implementation.

C. RELEVANT EXPERIENCE WITH SIMILAR PROJECTS

The FIRE Project will build upon existing USAID-funded, pilot projects in the capital markets. USAID has assisted the Over-The-Counter Exchange (OTCEI) and is contributing to the strengthening of its operational capability by providing key technical assistance support in the areas of regulation, compliance, surveillance, market administration and technology, and communications systems. The OTCEI was set up in 1990 and is India's first electronic stock exchange to operate as a nation-wide network. The exchange is also, for the first time in India, offering transparency in it's trading system and an expeditious settlement of trades.

USAID is also contributing to the development of a central security depository and national clearing system through support to the GOI and the Stock Holding Corporation of India (SHCIL). The technical assistance was directed to developing a blueprint for a central securities depository and an in-depth review of the required technology, structural and operational architecture needed to establish the dematerialized depository.

USAID, through its TASP Project, is also identifying opportunities for promoting research in the securities industry, including the development of new instruments and derivatives.

Additionally, FIRE will build upon current Mission and RHUDO efforts to assist in the creation of a long-term debt market. To do so it will build upon the previous and existing HG programs in India which have already made inroads into currency swaps, securitization and secondary mortgage markets, as well as training in the methodologies and structuring of BOO and BOT projects.

D. PROPOSED BORROWER, GRANTEE AND IMPLEMENTING AGENCIES

Housing Guaranty loan funds will be channeled through a national level financial institution as the "borrower" and will be used to further broaden and deepen the debt market through project-based urban revenue bond-financed demonstration projects. Two proposed "borrowers" for the Housing Guaranty funds are: the Housing and Urban Development Corporation (HUDCO), and Infrastructure Financing and Financial Services Limited (IL&FS). HUDCO is a public sector institution which is currently engaged in infrastructure finance and desires to expand that role. IL&FS is a joint public/private partnership (some foreign ownership) with significant experience in infrastructure development. Both of these "borrowers," as well as others, will be thoroughly examined during project design and a determination of the actual "borrower" made at that time.

DA funds in support of infrastructure project identification, financing and development will be channeled through a national level institution, such as the National Institute of Urban Affairs (NIUA), with no institutional interests in the projects. As an disinterested party, the institution will be responsible for developing annual work plans and allocating technical assistance and training resources among the national infrastructure finance institution, the private/public partnerships, and the state and local government agencies involved with demonstration projects. The institution will be identified during the Project Paper design process.

There are several possible grantees for the capital market operating environment component:

- The Industrial Development Bank of India (IDBI) - IDBI is a dynamic, government-owned organization that has taken the lead in establishing the National Market System. IDBI has also been a previous USAID grantee and is familiar with AID procedures;

- The Securities and Exchange Board of India (SEBI) - SEBI has been statutorily created and authorized by the GOI, has six board members appointed by the GOI and the RBI, a staff of about 75 persons, and is the primary securities industry regulator;

- The Stock Holding Corporation of India, Limited (SHCIL) - SHCIL is India's primary clearing and settlement organization for all capital market issues and as such has a major function to perform in the reform of the capital market operational environment;

- The Over the Counter Exchange of India (OTCEI) OTCEI conducts capital market transactions for stocks and bonds not listed in India's other exchanges;

- The Industrial Credit and Investment Corporation of India (ICICI) - ICICI is a public/private financial institution (approximately 85 percent of its publicly traded shares are owned by public sector financial institutions and 15 percent by private entities) which is currently successfully implementing four AID projects in various areas of private sector development; and

- The Unit Trust of India's Institute for Capital Markets (UTI/ICM) - UTI/ICM is India's leading institution for training investment bankers and capital market participants in operating procedures and practices of the market.

These potential grantees will be thoroughly examined during the Project Paper design and a determination of the actual grantee made at that time.

E. AID SUPPORT REQUIREMENTS AND CAPABILITY

There will be no additional U.S. Direct Hire or FSN staff required to manage the project. The designation of project management responsibility within the Mission will be carefully analyzed and decided during the PP preparation process.

F. ESTIMATED COSTS AND METHODS OF FINANCING

G. DESIGN STRATEGY

PP design will proceed immediately after the review and approval of the final PID. It will be managed by the Office of Program Development and Project Support (PDPS) and is anticipated to commence in early June 1993. Contracting for assistance in the PP design process will proceed concurrently with the PID review and approval process. The final PP is anticipated to be completed in late July 1993.

H. RECOMMENDED ENVIRONMENTAL THRESHOLD DECISION

According to the Environmental Procedures found in AID HB 3, the DA-funded portion of FIRE, as a technical assistance and training program, is categorically excluded from an Initial Environmental Examination, Environmental Assessment, and Environmental Impact Statement in accordance with the criteria included in Section 216.2(c)2(i). A Categorical Exclusion will be requested for the DA-funded portion of the project and its approval will be included in the final Project Paper.

Even though the projects to be developed either directly or indirectly with the HG funds are expected to have a very positive environmental impact, they may fall under the "Classes of Actions Normally Having a Significant Impact on the Environment." As such, it is recommended that the Environmental Threshold Decision be evaluated separately for the HG portion and addressed during the design of 386-HG-004 which will support this program.

I. AID POLICY ISSUES

This project is in full conformity with the AID Policy Paper on Financial Markets Development issued August 1988. FIRE "encourages the use of a variety of debt and equity instruments, promotes the growth of different kinds of institutions offering a wide range of financial instruments and services to potential investors and protects the interests of investors by reducing their risks." It promotes efficient and deep markets and incorporates the lesson that "financial liberalization should be accompanied by effective supervision of both public and private institutions to avoid fraud, circumvention of sound financial practices, and misuse of funds."

FIRE will promote "vertical" integration in the debt and equity markets in two ways: 1) by bringing the Indian capital markets more with line with international standards and hence encouraging increased levels of foreign investment, and 2) by encouraging the development of mutual funds and retail brokerage houses which will increase the investor base and improve the level of investor services. "Horizontal" integration will be promoted by assisting in the development and utilization of a reference rate for the debt market. Additionally, improvements in the equities market will "promote more widespread ownership of assets" in India.

FIRE will encourage the GOI and its states to "change restrictive tax laws and adopt tax policies that provide a suitable tax environment for financial markets development" by addressing: (1) the laws which encourage untraded equities being listed purely for tax reasons, and (2) discriminatory stamp taxes on debt transactions. This project will also follow the AID policy of "encouraging developing countries to develop new debt and equity instruments for directing scarce capital resources into productive investments" by developing debt instruments (project-based revenue bonds) for urban environmental infrastructure development.

The Housing Guaranty loan will be in conformity with the Financial Markets Development policy paper with respect to the management of foreign exchange risk. It will utilize a two-step loan that passes its financing through selected financial institutions before the funds are received by the ultimate borrower. The dollar loan will be guaranteed by the GOI, who will assume responsibility for its ultimate repayment, and the dollars or the local currency equivalent will then be onlent to the ultimate borrower. Furthermore, the use of a guaranty for the development of project-based urban environmental infrastructure bonds is justified because the "general policy and institutional environment is supportive" and the HG will "facilitate breakthroughs in new lending patterns (i.e. debt markets)."

J. GRAY AMENDMENT CONSIDERATIONS

Gray Amendment considerations have been incorporated from the outset of the project design process. A Gray Amendment firm contributed material for the PID design, and it is anticipated that Gray Amendment firms will have an opportunity to participate in the further design and eventual implementation of the FIRE Project.

ANNEX A

FINANCIAL INSTITUTIONS REFORM AND EXPANSION PROJECT (FIRE)

386–0531

LOGICAL FRAMEWORK

NARRATIVE SUMMARY	OBJECTIVELY VERIFIABLE INDICATORS	MEANS OF VERIFICATION	IMPORTANT ASSUMPTIONS
SECTOR GOAL To broaden and deepen India's competitive debt and equity markets	**MEASURES OF GOAL ACHIEVEMENT:** 1. Increased domestic and foreign investor participation in the debt and equity markets 2. Increased availability and trading of securities instruments 3. Increased private sector investment in urban infrastructure	1. SEBI statistics and records: a. An increased volume of securities traded (a measure of depth) b. An increased number of issues offered (a measure of breadth) 2. Ministry of Urban Dev. statistics 3. Project reporting	1. Political and economic stability 2. Continuation of liberalization 3. Major policy changes to be effected by the GOI and other donors working in capital markets
PROJECT PURPOSE To improve the operating environment of the capital market and to assist in the development of the debt component of that market with special emphasis on infrastructure finance as a means for stimulating debt market development	**END OF PROJECT STATUS: (EOPS)** 1. Improved transparency in trading practices 2. Decreased time required for the settlement and clearing of transactions 3. Improved disclosure norms for all market participants 4. Improved investor services 5. A developed debt market mobilizing a significant portion of domestic savings for infrastructure financing 6. Increased households below the median income level benefiting from infrastructure projects financed by the debt and equity markets	1. Stock exchange statistics 2. SEBI statistics 3. Project Reporting 4. Municipal records 5. Census statistics	1. India and the markets will continue current trends toward transparency 2. An organized debt trading structure will be established 3. Viable infrastructure projects that substantially meet the criteria for HG eligibility can be generated
PROJECT OUTPUTS 1. The establishment of a national depository system and a national clearing and settlement system 2. Greater automation of the debt and equity trading system 3. Increased trading volume and the introduction of new financial instruments 4. Development of the retail brokerage and mutual fund industry 5. Increased indigenous technical capacity in securities trading, pricing and regulation through both overseas training and the development of indigenous training capacities in these areas 6. Increased private sector participation in the delivery of municipal services 7. Improved capacity of local governments to plan, finance and recover the costs of basic urban infrastructure projects	**MAGNITUDE OF OUTPUT:** 1. Reduction by (X %) in the average time required for settlement 2. (X number) debt instruments utilized 3. (X $ value) debt instruments traded 4. Increased number of retail brokerage firms and private mutual funds 5. (X number) persons trained in securities trading, pricing and/or regulation; and (x number) of courses in those areas designed and offered in India through project interventions 6. (X $ value) investment in debt and equity funded infrastructure projects 7. (X number) below median income families benefiting from debt and equity funded infrastructure projects	1. Stock exchange statistics 2. SEBI statistics 3. Project Reporting 4. Municipal records 5. Census statistics	1. India and the markets will continue current trends toward transparency 2. An organized debt trading structure will be established 3. Viable infrastructure projects that substantially meet the criteria for HG eligibility can be generated
PROJECT INPUTS LOAN FUNDS: (US $ 000) HG GUARANTEED FUNDS NON–HG GUARANTEED TOTAL DA FUNDS: (US $ 000) TA TRAINING OPERATIONS RESEARCH AUDIT & EVALUATION CONTINGENCY TOTAL		• USAID & counterpart financial reports • Regular output monitoring records	• Timely funding and procurement by USAID and counterparts

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THE CONCEPT OF BUILD-OWN-OPERATE, BUILD-OPERATE-TRANSFER AND ITS APPLICATIONS FOR INFRASTRUCTURE DEVELOPMENT

In almost all countries, and especially developing countries, one of the most pressing requirements before new business investment will take place is the providing/upgrading of basic services such as energy, transportation, telecommunications, water supply, waste water disposal and the other facilities and activities delivered by the national infrastructure.

Whether in the process of economic development, or in the midst of transition from a centrally planned "command" economy to a market-based one, in most cases the state owned and operated facilities have been badly designed, have used outmoded or inappropriate technology, and are poorly managed. Public utilities are usually inadequately capitalized, burdened with redundant employees and excessive debt. Tariff structures are often set too low and/or haphazardly collected to provide sufficient revenue, and routine maintenance is often neglected.

Issues of overriding concern to political policy makers and the managers of these dysfunctional public utilities, ports, transport systems, etc. include the following: 1) how best to manage their conversion to meet the requirements of a competitive, cost conscious, market-driven economy; 2) what are the available ways to mobilize private investment and establish a new and effective public/private partnership; 3) what are the major constraints to start and accelerate private-sector led economic growth, and how can these problems be solved?

An approach that can address these issues is that of "Build-Own-Operate," and its variants including "Build-Own-Transfer" or "BOO/BOT."

The basic characteristic of BOO/BOT is the establishment of arrangements by the host government to grant long-term, irrevocable concession agreements or franchises to private investors, authorizing them to build, own, and operate needed infrastructure, in return for an exclusive contract to provide services over a time period sufficient to amortize the capital investment costs.

Included in such concession agreements should be government designation of the minimum performance parameters of the desired facility; and provision of reasonable and plausible guarantees to the investor that he will be able to capture and retain a revenue stream sufficient to service his capital loan, and provide funding for adequate operations and maintenance while still paying dividends to shareholders from the profits.

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Since all or most of the project financing would be non-recourse, or limited-recourse debt not supported by sovereign guarantees, there must be recognition that the cost of political and financial risks and the opportunity to earn a reasonable rate of return given the market conditions being faced, are legitimate components of the concession agreement.

The "architecture" of such a BOO/BOT framework should include but not necessarily be limited to:

- An approving public policy and institutional framework.
- A legal structure that minimally includes basic contract law; protection of property rights including intellectual property; some mechanism for dispute resolution; and information about corporate tax, import licensing, customs clearance, and related business practices.
- The existence of minimum financial and capital market structures required for the conduct of business activity including established Central Bank regulations and procedures for foreign exchange remittances.
- An authoritative and technically capable government mechanism for project identification and pre-feasibility determination, i.e., setting of priorities.
- A system for establishing agreed performance specifications to permit the conduct of a project solicitation, evaluation and competitive award process; and procedural arrangements for receiving, validating and assessing unsolicited proposals.
- A plan for confirming investor compliance with the conditions incorporated in his proposal, throughout the construction and thereafter, by performance monitoring.

Technical support for the design and installation of such a program may require experienced senior-level policy advisors, supported by legal, financial, engineering, and production experts fielded in multi-disciplinary teams to identify the most promising investment prospects; perform pre-feasibility analyses of a prospective portfolio of "BOO/BOT-able" projects; define the constraints; and develop remedies for their resolution. Attention should also be given to methods of increasing public awareness and acceptance.

A feature of BOO/BOT projects that should be kept in mind is their particular suitability for financing the capital construction cost of infrastructure projects for which technical, economic, and financial feasibility can be determined. Private investors will become interested in undertaking such projects to the extent of their capacity to generate a revenue stream that can be captured and applied to the amortization of the capital investment funding.

This would typically include such projects as bridges, tunnels, power plants, ports, airports, trunk highways, telephone systems, water treatment and waste water treatment plants, but need not be limited to the examples given. Another important feature of BOO/BOT is that it uses the credit worthiness, management capacity, corporate track record, and "financial stamina" of the private investor company; and often includes participation of the construction contractor. What is crucial is that the private investor is the borrower, not the host country ministry or statutory agency of the government.

Since the project is financed through non or limited-recourse credits, the lending institution needs to be assured that the owner/investor has been awarded a monopoly or an exclusive franchise or concession agreement to own and operate the facility for a time period at least long enough to permit amortization of the construction loan. Included in this franchise or concession must be the right of the private investor to capture all or most of the revenue in the form of tolls or tariffs paid by the users.

The principal appeal of this arrangement to a developing country or one in transition to a market system, especially one already heavily in debt to commercial banks or international donor agencies, is that the country does not have to assume any additional sovereign debt to get the project built. Another advantage to the country in addition to this avoided cost, is the greater likelihood - especially if the concession agreement is awarded on an open competitive basis - that the investor will utilize the latest "state of the art" technology, assuring optimum efficiency and cost effectiveness. Projects will be selected for implementation which meet clear economic and developmental needs, diminishing the possibility of "white elephants" or boondoggles. With performance parameters and cost containment built in to the selection and award process, the public is more likely to receive reliable services at high quality.

One way of characterizing BOO/BOT is that it is a way of re-apportioning the costs and benefits of providing socially necessary public services for which the government has the responsibility to assure, but for which it may lack the financial, managerial, or administrative capacity to deliver. Under BOO/BOT, there may be some sharing of the revenue with the government, or alternatively, the government may benefit from collection of corporate taxes or fees. There is also the assurance that the labor complement is likely to be appropriate in numbers and skill levels, to the performance needs of the facility, rather than the political requirements of the administration.

While BOO and BOT approaches to privatization, infrastructure development, and investment promotion are relatively new, their saliency and emergence are indisputable. The lessons of experience in countries that have "done it right" indicate that the clear identification of goals, in concert with the appropriate selection of the techniques to achieve successful transactions, are critical. The countries, programs, and projects that have invested in preparation on the "upstream" aspects of policy and project design have recorded tangible results in the downstream. While BOO and BOT and related variants represent no panacea, they provide policy-makers, investor/owners, and most importantly, users and consumers with another option in the process of transition to a competitive, market-based economy.