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Budget 2021 | Time to fuel long-term credit growth through Alternative Investment Funds

In order to promote investments in infrastructure and other sectors that require long-term capital, the government should reduce the tax rate for locked-in, closed-ended structures that invest in such key sectors. This can be our 'Atmanirbhar capital'

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Labourers work at the site of metro railway flyover under construction in Ahmedabad, India, March 31, 2016. India's infrastructure output grew an annual 5.7 percent in February, its fastest pace in at least 13 months, mainly driven by a surge in production of cement and fertilizers, government data showed on Thursday. REUTERS/Amit Dave - RTSCZAY

A look at the share of Gross Fixed Capital Formation (GFCF) in GDP does paint a picture of concern. It has reduced to 29.8 percent in FY20 **from 34.3 percent in FY12**. This reduction is partly attributable to poor transmission of long-term capital availability to fund long term capex.

Traditionally, banks, bond markets and mutual funds who are the primary credit providers, have provided short-term credit (and that also to the best rated borrowers). Insurance funds and pension companies are also limited in their ability to lend long-term to borrowers, despite having long-term liabilities to their pensioners. Transmission for long-term capital creation hence remains a pertinent issue.

Globally, things are a tad different. After the global financial crisis, a large part of banking moved to asset management companies who have increasingly started providing long-term capital for growth.

In India, this trend is steadily gathering pace with asset managers launching alternative investment funds (AIFs) to provide long-term credit to companies and projects. While currently, they account for less than 5 percent of the wholesale lending in India, this number is expected to increase to 12-15 percent by 2025. Asset management vehicles such as AIFs are best suited to provide long-term patient capital to borrowers as their assets and liabilities can be matched through long tenured closed ended funds.

Globally, ~45 percent of the operating infrastructure assets such as roads, transmission lines and renewable energy projects are owned and operated by asset managers and insurance companies. In India, this percentage is only 2 percent.

The AIFs in India have grown at a staggering **~65 percent since 2013**. The government and SEBI have taken several steps to boost the AIFs. However, given that the AIFs can take centre stage in the capital markets going ahead, providing much-needed long-term patient capital to borrowers, further rationalisation of tax and regulatory regime will help in a big way.

Given these, here is a five-point Budget wish-list:

Reduce tax on interest income: With gross savings rate over 30 percent of GDP since 2003-04, India has always had a large domestic savings pool. This largely goes into short-term investments or towards physical assets. Domestic savings need to be channelised to long-term capital formation. In mutual funds, the ELSS scheme has helped promote long-term equity capital formation. Similarly, in order to promote investments into infrastructure and other sectors that require long-term capital, the government should reduce the tax rate to incentivise long-term savings into locked in closed ended fund structures which invest in such key sectors. This can be our 'Atmanirbhar capital'.

Increase investment limits: Insurance and pension funds are allowed to invest only in higher rated and primarily listed securities. These securities issued by private players are allowed for investments to improve their returns while ensuring risks are low. To invest in these securities, there is a need to build capability to evaluate, invest and monitor these investments. Globally, insurance companies and pension funds allocate their capital to funds (AIF) managed by capable asset managers. This helps them to focus on their core business.

In India, pension funds are not allowed to invest in AIFs and the limits for insurance companies investing in AIFs are very low. The government can channelise this large pool of capital towards nation-building. It can allow insurance and pension funds to invest in such AIFs that primarily invest in approved underlying securities in compliance with the IRDA and the PFRDA regulations. This will help capacity (capital with insurance and pension) to come along with capability (the AIF by qualified asset managers) to help build India.

Bring parity in long-term capital gains tax for investments in listed and unlisted securities: Given that the AIFs (Category I and II) invest primarily in unlisted securities of portfolio companies and provide them with the much-needed risk capital pools, the capital gains tax treatment of such investments in unlisted securities should be at par with those of listed securities. Accordingly, the capital gains earned by investors through investments made in a SEBI registered Category I or II AIFs should be taxable at the rate of 10 percent. Further, the holding period for such unlisted securities in order to qualify as long-term should be reduced to 12 months.

Treat AIFs at par with IDFs: Infrastructure Debt Funds can be set up either as an IDF – MF or IDF – NBFC. In order to attract offshore-funds into IDFs, tax on interest payments on the offshore borrowings by the IDFs has been reduced to 5 percent. The same benefit should be extended to offshore investors willing to invest long-term in the infrastructure sector, but through an infrastructure AIF route. Currently, interest payments to offshore investors who come into India through the infrastructure AIF route is taxed at treaty rate.

Permit CSR investments through AIFs: The government can bring in regulations to channelise CSR funds through AIFs – Category I vehicle, which would be dedicated to sectoral allocation and would provide investments into social start-ups, social enterprises and MSMEs. Similarly, individual donors contributing funds/grants into Category I social venture AIFs can also be provided deduction under Section 80G.

While supply of credit has been constrained, we continue to witness growing demand for long-term, patient and flexible capital in India. This demand-supply discrepancy makes us very excited about the private credit opportunity as we enter 2021 and look forward to policy measures that will enhance commitments into AIFs. All eyes now on Budget 2021 which could provide an impetus to AIFs as a vehicle for long-term capital creation.

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