

**MANAGEMENT RESPONSE TO THE PROJECT PERFORMANCE EVALUATION
REPORT FOR THE PRIVATE SECTOR INFRASTRUCTURE FACILITY IN INDIA
(Loans 1480/1481-IND)**

On 29 November 2006, the Director General, Operations Evaluation Department, received the following response from the Managing Director General on behalf of Management:

A. Overall Comments

1. Management finds that the OED report is well written and covers major relevant aspects of the loan projects. We take note that the overall rating of Loan 1480-IND is successful and that of Loan 1481-IND is partly successful and that there is no specific follow-up action identified for ADB or the Borrowers. We appreciate the key issues and lessons that the OED report identified and will utilize them in our future relevant projects.

B. Specific Comments

2. The report suggests that the modality of the Private Sector Infrastructure Facility (PSIF) was not fully appropriate in achieving its secondary market objective of corporate debt market development and using a program loan might have been more appropriate (para. 35). However, we would like to point out that ADB did provide a program loan on capital market development, Loan 1408-IND: Capital Market Development Program (approved on 28 November 1995) that included debt market components right before the PSIF was conceived. This program was rated successful. The PSIF was designed to complement the program. Furthermore, when it was clear that while a primary market was active, a liquid and deep secondary debt market was not developing in spite of earlier efforts, ADB provided technical assistance to India (TA 3473-IND: Development of a Secondary Debt Market, approved in July 2000). Subsequently, a follow-up program on capital market development focusing on long-term debt market development was included under the country assistance program. Due to political economy considerations, this was, however, not pursued at the time at the request of the Indian Government.

3. Furthermore, the promissory notes issued by sub-borrowers were securitized under the PSIF to allow the participating financial institutions (PFIs) the flexibility to float these securities in the Indian capital market to help develop the debt market in securities. This instrument was chosen because the timing for issuance of these securities could not be determined precisely due to the fact that the point of commercialization of the subprojects nor the conditions prevailing in the capital market could not be determined in advance, but a credit rating was needed for the securities to be issued in the market. Consequently, a corporate bond was not possible for sub-borrowers to issue as suggested in the report (para. 35), at the time when the loan was contracted. Credit rating agencies in India were consulted regarding what instrument would be appropriate to utilize under the project.

4. It may be important to clarify why subloans under the PSIF were denominated in Indian rupees instead of US dollars (para. 82). The purpose for the rupee conversion of foreign exchange loans from ADB by the PFIs to the subloan borrowers was to insulate the subloan borrowers from foreign exchange risk. In the past, under development financial institution (DFI) loans, the foreign exchange risk was invariably passed on to subloan borrowers by PFIs, sometimes with disastrous consequences as subloan borrowers were not in a position to hedge themselves. Consequently, under the PSIF, the onus of the responsibility to hedge the foreign exchange risk was passed on to the PFIs who were better able to cover themselves. There is no currency mismatch as the subloan borrower simply purchases foreign exchange (about equal to the inflow from ADB's loan in foreign exchange), with the proceeds of its rupee loan to finance its importations, that were also readily available in the market due to the large inflows that India was experiencing after it opened its current account and the improving currency reserves of the country, while keeping its liabilities in Indian rupees. The PFIs, on the other hand, hedged their positions by either entering into a commercial foreign exchange swap or switching the foreign exchange to finance exporters. Under the Innovation and Efficiency Initiative (IEI), ADB does the swap or raises local currency through a local bond issue itself.

5. On para. 85, quote "5Had the floating interest rate lending been more actively used, there might have been less instances of prepayment under the PSIF." unquote. It should be noted that the prepayments occurred mainly because interest rates for Indian rupees declined rapidly in the domestic market following the economic slowdown in India. The reverse could have equally happened under a different economic scenario. Borrowers opt for fixed rates for long-term loans to avoid the interest rate risk. Consequently, the downside of unhedging their positions is exposing themselves to possible losses from interest rate fluctuations. Moreover, the choice between the floating and fixed rates of interest was at the option of the subloan borrower. Nonetheless, if the point is for India to have used the floating rate system more extensively in practice at the time, then the point is well taken. This reflects more critically the broader lesson for India to have allowed the introduction of hedging mechanisms and of more innovative instruments to be used in practice in parallel, in order to help mitigate market risks at a time when it was undergoing financial markets' liberalization. The introduction of options and futures (derivative instruments) and deregulation of the insurance industry were policy components of ADB's Capital Market Development Program in India and the subject of continuing dialogue with the Government. The phenomenal growth of the options and futures market and liberalization of the insurance industry as well as pension and provident funds in India are proofs that India has heeded these lessons well.