Rediscovering Development Banks

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The article is based on **Rediscovering Development Banks** that was published in The Hindu on 28th August. It talks about the need of development banks in long-term sustainable infrastructure financing.

Context

- Finance Minister recently announced a slew of measures to boost the economy and financial market sentiments.
- One of the measures was a proposal to establish **an organisation to provide credit enhancement for infrastructure and housing projects** with an aim to enhance fund flows towards such projects.
- The announcement can have far-reaching implications for India's financial system.

What are development Banks?

- Development banks are financial institutions that **provide long-term credit** for capital-intensive investments spread over a long period and yielding low rates of return, such as urban infrastructure, mining and heavy industry, and irrigation systems.
- Such banks often **lend at low and stable rates of interest** to promote long-term investments with considerable social benefits.
- Development banks are also known as **term-lending institutions** or development finance institutions **(DFIs).**
- Development banks are different from commercial banks which mobilise short- to medium-term deposits and lend for similar maturities to avoid a maturity mismatch-a potential cause for a bank's liquidity and solvency.

History of Development Banks in India

- Development banks formed the central piece of growth strategy in India too. Soon

after independence, the institutional framework for development banking began- IFCI (1948), IDBI (1964), IIBI (1972), **NABARD** and EXIM Bank (1982), SIDBI (1990), etc.
- IFCI, previously the **Industrial Finance Corporation of India,** was set up in 1948. This was probably India's first development bank for financing industrial investments.
- In 1955, the World Bank prompted the **Industrial Credit and Investment Corporation of India (ICICI) —** the parent of the largest private commercial bank in India today, ICICI Bank — as a collaborative effort between the government with majority equity holding and India's leading industrialists with nominal equity ownership to finance modern and relatively large private corporate enterprises.
- In 1964, **Industrial Development Bank of India** (IDBI) was set up as an apex body of all development finance institutions.
- According to an UNCTAD study (December 2016), development banks loans which formed 2.2% of the gross capital formation in the early 1970s reached 15.5% by the early 1990s.

Financing of Earlier Development Banks in India

As the domestic saving rate was low, and capital market was absent, development finance institutions were financed by

- lines of credit from the Reserve Bank of India (that is, some of its profits were channelled as long-term credit); and
- Statutory Liquidity Ratio bonds, into which commercial banks had to invest a proportion of their deposits.

Diluting the Role of Development Finance Institutions (DFIs)

- **Economic Reforms after 1990s** changed the role of DFIs. The Washington Consensus that guided reforms have put private markets in the forefront.
- According to the UNCTAD study, the proportion of DFIs loans accounted for over two thirds of total disbursals between the early 1970s and late 1980s, but declined to 30% in the early 1990s and early 2000s and after 2004, it declined further, to 1.7 %.
- After 1991, following the **Narasimham Committee reports on financial sector reforms,** development finance institutions were disbanded and got converted to commercial banks. ICICI in 2002 and IDBI in 2004 converted into commercial banks.
- Development banks got discredited for **mounting non-performing assets,** allegedly caused by politically motivated lending and inadequate professionalism in assessing investment projects for economic, technical and financial viability.

Development Banks in China and Germany: Example Setters

- **China's Development Banks-** the Agricultural Development Bank of China, China

Development Bank, and the Export-Import Bank of China- have been at the forefront of financing its industrial prowess.
    - After the global financial crisis, these institutions have underwritten China's risky technological investments, helping it gain global dominance in IT hardware and software companies.
    - Strong belief in development banking led China to create the **Asian Infrastructure Investment Bank** and the New Development Bank with its **BRICS** partners.
- **Germany's Development Bank,** KfW- Kreditanstalt für Wiederaufbau (Credit Institute for Reconstruction), has been spearheading long-term investment in green technologies and for sustainable development efforts requiring long-term capital.

What is the need for a Development Bank in recent times?

- **Global Financial Crisis of 2008** reignited the need of development banks globally.
    An IMF paper (2016) noted, "the initial hopes that the privatisation wave of the 1980s would fuel a private sector funded greenfield infrastructure investment boom have fallen well short of expectations".
- The World Bank devoted its Global Financial Development Report (2015) to the theme of importance of long -term finance.
- The UNCTAD study asserted "the time is ripe to promote development banks."
- India's **economic downturn** in recent quarters and the **high NPAs** of banks affecting their credit culture have forced the government to think about reviving the Development banks to boost the economy through infrastructure financing.

Way Forward

- The World Bank's new broad-based index of financial development placed India in 38^{th} place in regard to financial markets but 102 in respect of financial institutions, which reiterates that India needs to do a lot to strengthen domestic financial institutions.
- It would be wise to revive the concept of DFI if the government wishes to keep societal, regional, rural and environmental concerns intact while financing long term developmental projects.
- A strong national development bank is the need of the hour that will be in the forefront of funding India's strategic and long-term development.
- However, the financing structure of the proposed institution should be carefully analysed, especially if foreign private capital is expected to contribute equity capital (hence part ownership).

Drishti Input

"What are development banks? Discuss their significance in India's financial system in the backdrop of the recent economic downturn."