# Rediscovering Development Banks



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.”