Development Financial Institutions

This article is based on **“Why DFIs have regained relevance today”** which was published in The Hindu Business line on 22/06/2021. It talks about the role of Development financial institutions in infrastructure building.

Development financial institutions provide long-term credit for capital-intensive investments spread over a long period and low yielding rates of return, such as urban infrastructure, mining and heavy industry, and irrigation systems.

They act as critical intermediaries for channelling long-term finance required for infrastructure and realising higher economic growth.

In India, after the 1991 reforms, major DFIs were converted into commercial banks. However, after these there were few institutions in the country which could take care of industrial or infrastructure development.

Therefore, in order to plug the infrastructure deficit, the government has taken a positive step by making a proposal to re-establish the DFIs in India.

DFI: Background & Present Status

- Development banks are different from commercial banks, which mobilize short- to medium-term deposits and lend for similar maturities to avoid a maturity mismatch.
- In India, the first DFI was operationalized in 1948 with the setting up of the Industrial Finance Corporation (IFC).
- DFIs in India like Industrial Development Bank of India (IDBI), Industrial Credit and Investment Corporation of India (ICICI) and IFCI did play a significant role in aiding industrial development in the past with the best of the resources made available to them.
- However, after 1991 reforms, the concessional funding they were getting from **Reserve Bank of India (RBI)** and the government was no longer available in the subsequent years.
    - As a consequence, IDBI and ICICI had to convert themselves into universal banks.
- While these DFIs disappeared, a new set of institutions like IDFC (1997), IIFCL (2006) and more recently, **National Investment and Infrastructure Fund (NIIF) (2015)** emerged to focus on funding infrastructure.
- In budget 2021, with the initial capital base of ₹20,000 crore as committed by the government, the new DFI, assuming a leverage of around 7 times, can lend up to ₹1.4 trillion.

Need for DFI

- **Infrastructure Building:** Inadequate and inefficient infrastructure leads to high transaction costs, which in turn stunts an economy’s growth potential.
    - Therefore, DFIs makes sense as the Centre government envisages mobilizing nearly ₹100 lakh crore for the ambitious **National Infrastructure Pipeline.**
- **International Precedent:** Irrespective of the level of development, countries across the world

have set up development banks to finance key infrastructure and manufacturing projects.
    - For instance, the European Investment Bank (EIB) acts like a DFI for Europe.
- **Lack of Finance for Infrastructure:** Although India has a long-term debt market for the government securities and corporate bonds cut, it is still out of reach of retail investors and unable to meet the large infrastructure financing needs.
- **Economic Crisis Triggered By Covid-19 Pandemic:** The Covid-19 pandemic has exacerbated inequality, the poverty gap, unemployment, and the economy's slowing down.
    - Thus, infrastructure building through DFIs can help in quick economic recovery.

Way Forward

- **Mobilizing Capital For DFI:** To lend for the long term, DFI requires correspondingly long-term sources of finance.
    - In this context, the government may allow equity investment by institutions having a long term horizon like insurance companies, pension funds to augment the capital.
    - Further, DFI can be adequately capitalized by the sovereign-backed funds, alternative routes such as capital gains/tax-free bond issues, external borrowings, and loans from multilateral agencies.
- **Administration of DFI:** The ownership and organisation structure are critical and require greater clarity as this would have bearing on the functioning, flexibility, governance of the institution and its long-term sustainability.
- **Functionality of DFI:** It is critical to hire experts with a good understanding of infrastructure, policies, financing and risk management to work with the institution by offering market-driven lending packages.
- **Reaching Out Retail Investors:** The government needs to set up institutions and network platforms to reach retail investors and incentivise and structure the bonds/instruments so that they are attracted to invest long-term in those instruments.
- **Periodic Review of DFI:** Periodic reviews are necessary to ensure that the DFI remains relevant by taking into account changing priorities of the economy and making consequential adjustments in the role.

Conclusion

For a developing country like India, it is desirable that the new DFI remains viable and sustainable to be able to cater to the long-term development financing requirements.

Drishti Mains Question

Development Financial Institutions (DFIs) are critical intermediaries for channelling long-term finance required for infrastructure and realising higher economic growth. Discuss.