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REDISCOVERING DEVELOPMENT BANKS

Relevant for: Indian Economy | Topic: Issues relating to Growth & Development - Banking, NPAs and RBI

Finance Minister Nirmala Sitharaman addressing a press conference in New Delhi on August 23.>Sandeep Saxen

Finance Minister Nirmala Sitharaman's press conference on August 23, announcing a slew of measures to boost the economy and financial market sentiments, had an interesting idea. It was about setting up a development bank.

Ms. Sitharaman said: "In order to improve access to long-term finance, it is proposed to establish an organisation to provide credit enhancement for infrastructure and housing projects, particularly in the context of India now not having a development bank and also for the need for us to have an institutional mechanism. So, this will enhance debt flow toward such projects." The announcement could have far-reaching implications for India's financial system. This article explains why.

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. To lend for long term, development banks require correspondingly long-term sources of finance, usually obtained by issuing long-dated securities in capital market, subscribed by long-term savings institutions such as pension and life insurance funds and post office deposits. Considering the social benefits of such investments, and uncertainties associated with them, development banks are often supported by governments or international institutions. Such support can be in the form of tax incentives and administrative mandates for private sector banks and financial institutions to invest in securities issued by development banks.

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. The capital market complements commercial banks in providing long-term finance. They are together termed as the Anglo-Saxon financial system. Historically, in the U.K. and the U.S., such a debt market took root to fund expansion of the market economy and colonial investments in the 19th century, such as financing of railways worldwide. This market was mostly sweetened by fiscal sops to promote Britain's global political and commercial interests.

Industrialisation of continental Europe and Asia was, however, financed under the aegis of German-type universal banks (providing long- and short-term credit) and state-sponsored (or guaranteed) development banks underwriting the risks of long-term credit. For instance, the earliest and ubiquitous saving institution, namely the post office bank (mostly government-owned and managed), mobilised national savings and channelled them into development banks for long-term investments whose social rates of return were higher than the assured interest rates for depositors. Alexander Gerschenkron, a Ukrainian economic historian at Harvard University, famously theorised that the greater the backwardness of a country, the greater the role of the state in economic development, particularly in providing long-term finance to catch up with the advanced economies in the shortest possible time.

In the context of the Great Depression in the 1930s, John Maynard Keynes argued that when business confidence is low on account of an uncertain future with low-interest rates, the government can set up a National Investment Bank to mop up the society's savings and make it available for long-term development by the private sector and local governments.

Following foregoing precepts, IFCI, previously the Industrial Finance Corporation of India, was set up in 1949. 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, IDBI was set up as an apex body of all development finance institutions.

As the domestic saving rate was low, and capital market was absent, development finance institutions were financed by (i) lines of credit from the Reserve Bank of India (that is, some of its profits were channelled as long-term credit); and (ii) Statutory Liquidity Ratio bonds, into which commercial banks had to invest a proportion of their deposits. In other words, by sleight of government hand, short-term bank deposits got transformed into long-term resources for development banks. The missing capital market was made up by an administrative fiat.

However, 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. After 1991, following the Narasimham Committee reports on financial sector reforms, development finance institutions were disbanded and got converted to commercial banks. The result was a steep fall in long-term credit from a tenure of 10-15 years to five years. The development of the debt market has been an article of faith for over a quarter-century, but it has failed to take off — as in most of Europe and industrialising Asia, where the bank-centric financial system continue to prevail.

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. Germany's development bank, KfW, has been spearheading long-term investment in green technologies and for sustainable development efforts requiring long-term capital.

In this light, the Finance Minister's agenda for setting up a development bank is welcome. However, a few hard questions need to be addressed in designing the proposed institution. How will it be financed? If foreign private capital is expected to contribute equity capital (hence part ownership), such an option needs to be carefully analysed, especially in the current political juncture. The design of the governance structure is fraught with dangers with many interest groups at work. One sincerely hopes that the political and administrative leadership carefully weigh in the past lessons to lay a firm foundation for the new institution.

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