Development Banks in India

Why in news?

The Union Finance Minster recently announced the setting up of a development bank. (Click here to know more on other announcements)

What are development banks?

- Development banks are financial institutions that provide long-term credit.
- They are also known as term-lending institutions or development finance institutions.
- It generally supports capital-intensive investments spread over a long period and yielding low rates of return.
- E.g. urban infrastructure, mining and heavy industry, irrigation systems
- Such banks often lend at low and stable rates of interest to promote long-term investments with considerable social benefits.

How do they work?

- To lend for long term, development banks require correspondingly long-term sources of finance.
- This is usually obtained by issuing long-dated securities in capital market.
- These are subscribed by long-term savings institutions such as pension and life insurance funds and post office deposits.
- The long-term investments associated here have notable social benefits as well as involve considerable uncertainties.
- Given this, 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.
- This is to help them invest in securities issued by development banks.

What is the recent proposal?

- It was proposed to establish an organisation to provide credit enhancement for infrastructure and housing projects.
- A development bank would enhance debt flow toward such projects.
- It comes in the context of India not having a development bank and also for the need to have an institutional mechanism in this regard.

- The overall aim is to improve access to long-term finance.
- The announcement could have far-reaching implications for India's financial system.

How did development banks evolve in India?

- 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).
- [This is the parent of the largest private commercial bank in India today, the ICICI Bank.]
- It was a collaborative effort between the government with majority equity holding and India's leading industrialists with nominal equity ownership.
- The objective was to finance modern and relatively large private corporate enterprises.
- In 1964, IDBI (Industrial Development Bank of India) was set up as an apex body of all development finance institutions.
- **Source** - As the domestic saving rate was low, and capital market was absent, development finance institutions were financed by -
    1. lines of credit from the RBI e. some of its profits were channeled as long-term credit
    2. Statutory Liquidity Ratio bonds, into which commercial banks had to invest a proportion of their deposits
- In other words, with government's role, short-term bank deposits got transformed into long-term resources for development banks.

How did they perform?

- Development banks got discredited for mounting non-performing assets.
- This was allegedly caused by politically motivated lending.
- Inadequate professionalism in assessing investment projects for economic, technical and financial viability was also a reason.
- 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 5 years.

How has it been for China?

- China's development banks include the Agricultural Development Bank of China, China Development Bank, and the Export-Import Bank of China.
- These have been at the forefront of financing its industrial prowess.
- After the global financial crisis, these institutions have underwritten China's risky technological investments.
- This helped it gain global dominance in IT hardware and software companies.
- Likewise, Germany's development bank, KfW, has been supporting long-term investment in green technologies and sustainable development efforts requiring long-term capital.

What is the way forward for India?

- The greater the backwardness of a country, the greater the role of the state in economic development.
- This is particularly true in providing long-term finance to catch up with the advanced economies in the shortest possible time.
- 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.
- The key one among them is the source of finance.
- If foreign private capital is expected to contribute equity capital (hence part ownership), such an option needs to be carefully analysed.
- The political and administrative leadership should carefully analyse the past lessons to lay a firm foundation for the new institution.

Source: The Hindu