Development Financial Institution

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This article is based on **"Return of DFIs"** which was published in The Hindu Businessline on 09/02/2021. It talks about the government's proposal of re-establishing the idea of a Development Finance Institution (DFI).

The **budget 2021** has signaled that the Centre Government is banking on long-term infrastructure creation to lift India's economic growth rate sustainably. In this pursuit, the government has proposed to go back to the Development Finance Institution (DFI) idea.

Further, DFI makes sense as the Centre government envisages mobilizing nearly ₹100 lakh crore for the ambitious **National Infrastructure Pipeline**. The idea of DFI looks good in the context of the looming NPA crisis of Banks.

However, many economists have pointed out that India should keep the failed experiment with DFI, such as ICICI and IDBI, which leads to the conversion into universal banks.

DFI & Background

- 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.
- Development banks are different from commercial banks, which mobilize 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).
- In India, the first DFI was operationalized in 1948 with the setting up of the Industrial Finance Corporation (IFCI).
- Subsequently, India's Industrial Credit and Investment Corporation (ICICI) was set up with the World Bank's backing in 1955.
- The Industrial Development Bank of India (IDBI) came into existence in 1964 to promote long-term financing for infrastructure projects and industry.

- However, during the 1970-80s, DFI 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.
- Due to these factors, Narsimhan Committee (1991) recommended disbanding of the DFI, and the existing DFI were converted into commercial banks.

Need for DFI

- **NPA Crisis:** The surge in NPAs in the banking sector, and the need to augment financing of infrastructure for kick-starting the growth cycle have led to a renewed policy attention on setting up DFIs.
    - The gap between banks' assets and liabilities, already increased by bad debts will become unsustainable in infrastructure investment, given the long funding periods of such projects.
- **Economic Crisis Triggered By Covid-19 Pandemic:** Alexander Gerschenkron, a Ukrainian economic historian, famously theorized 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.
    - 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.
- **Achieving the Target of $5 Trillion Economy:** The government has envisaged attaining the target of becoming a USD 5 trillion economy by 2025.
    - However, this goal will depend on world-class infrastructure across the country.
    - NITI Aayog has estimated that US$4.5 trillion will be needed by 2030 to fund infrastructure. DFI is a step in the right direction towards this goal.
- **International Examples:** DFIs in China, Brazil, and Singapore has been successful in both domestic and international markets.

Way Forward

- **Mobilizing Capital For DFI:** To lend for the long term, DFI requires correspondingly long-term sources of finance.
    - DFIs of the earlier era were over-reliant on cheap government funds and today's commercial banks ran into asset-liability mismatches due to their reliance on retail deposits to fund long-term projects.
    - Therefore, it may be best for new-age DFIs to focus on diversified sources of funding.
    - Presently, 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.

- **Specialized DFIs:** Specialised project lenders focussed on specific verticals tend to do better at building project appraisal skills and managing risks than 'supermarket' lenders who fund any project that comes their way.
    - The Centre must therefore be open to the idea of multiple specialized DFIs modeled on the success of refinancing institutions such as NHB and NABARD.
- **Ensuring Good Governance:** While freeing a DFI from political interference or crony lending is necessary, merely having private shareholders or professional managers on board isn't sufficient to ensure good governance.
    - This has to be backed by a robust system of external checks and balances such as supervision by RBI and proper due diligence by auditors and rating agencies.
- **Ensuring Ease of Doing Business:** In the past, ambitious highway and pipeline projects have been continually held up by local protests and land acquisition woes, retrospective taxes, and poor contract enforcement.
    - The success of DFIs is contingent on ironing out such issues and removing on-ground impediments to the ease of doing business.

Conclusion

While boosting investment in the infrastructure sector is imperative for sustained growth, the need for the hour is to resolve persistent issues in the debt market that impede long-term financing flow.

Drishti Mains Question

Establishing Development Financial Institutions is a good idea for infrastructure creation and to lift India's economic growth rate. Critically Analyse.