



## On the Need for a National Development Bank

India's commercial banks are facing serious financial stress which has weakened the banking system. Non-performing Assets (NPAs), banking scams and scandals have become the norm in Indian banking sector. A trust deficit is developing in the banking sector as regulations and governance have not been able to arrest the decline.

This can be the right time to establish a National Development Bank (NDB) in India to re-industrialize India and de-stress the banking sector.

### Indian Banking Sector Deterioration: The Problem of NPAs

- NPAs or bad loans (which do not provide any income or profit for the banks) are rising constantly in India. Part of it is attributable to RBI's rigorous asset quality review based on its income-recognition and asset-classification norms.
- **The scale of the Problem:** RBI's **financial stability report** shows that for all commercial banks, gross NPAs as a proportion of total assets were 9.6% in March 2017 and an estimated 10.8% in March 2018. For public sector banks, these proportions were higher at 11.4% and 14.5%, respectively.
- Private banks fare slightly better than public banks but privatization is not necessarily the solution; the problems need systemic solutions.
- Lending at the political behest, the corrupt behavior of bank managers, lack of ability for risk assessment, lack of exercise of due diligence are some reasons for rising NPAs.
- A very large percentage of these NPAs are loans to corporates (and defaults by retail borrowers are small). *The banking system can be seen as being exploited by willful defaulters — mainly large borrowers — capable of "pulling strings".*

### Development Financial Institution (DFIs): What, Why?

- A DFI is defined as "*an institution promoted or assisted by government mainly to provide development finance to one or more sectors or sub-sectors of the economy.*"
- It distinguishes itself by a judicious balance between commercial norms of operation, as adopted by any private financial institution, and developmental obligations.
- The basic emphasis is on long-term finance and on assistance for activities or sectors of the economy where the risks may be higher than that the ordinary financial system is willing to bear.
- The principal motivation for developmental finance is to make up for the failure of financial markets and institutions to provide certain kinds of finance to certain kinds of economic agents.
- The vehicle for extending development finance is called Development Financial Institution (DFI) or Development Bank.
- The DFIs played a very significant role in the rapid industrialization of Continental Europe. The first government-sponsored DFI was established in the Netherlands in 1822.
- In Asia, the establishment of Japan Development Bank and other term-lending institution fostered rapid industrialization of Japan. The success of DFIs provided a strong impetus for the creation of DFIs in India.

### Usefulness of DFIs: the Indian Experience

- In countries that are latecomers to industrialization (such as India), the role of corporate financing has always been performed by development banks. They meet the investment financing needs of

new firms in underdeveloped manufacturing sectors that are not met by capital markets or commercial banks because the risk is too great.

- Starting around 1950, this model was adopted not only by several underdeveloped countries in Asia and Latin America seeking to industrialize, but also by Germany and Japan. India was a pioneer in establishing DFIs, its equivalent of development banks elsewhere, to kick-start industrialization.
- There were mainly three components in this process:
  - **long-term-lending institutions** Industrial Finance Corporation of India (IFCI, established 1948), Industrial Credit and Investment Corporation of India (ICICI, estb. 1955), and Industrial Development Bank of India (IDBI, estb. 1964), that were nationwide and provide long-term finance for private investment in the industrial sector, with funds from the Central government and RBI on concessional terms.
  - **State financial corporations (SFCs) and state industrial development corporations (SIDCs)** were set up in the 1950s to provide long-term finance for small and medium enterprises in the manufacturing sector of respective states.
  - **Investment institutions:** Life Insurance Corporation of India (LIC, 1956), Unit Trust of India (UTI, 1964) and General Insurance Corporation of India (GIC, 1973). They mobilized savings of households, by spreading insurance habits, and by opening up avenues of higher returns on the savings of individuals. They were a potential source of industrial finance being controlled by the government.
- With hindsight, it could be said that the DFIs made a significant contribution to the provision of industrial finance in India. As a proportion of gross fixed capital formation in the manufacturing sector, their total disbursements rose from one-tenth in 1970-71 to half in 2000-01.
- **The lendings of the DFIs was almost entirely to the private sector.** Some of it served a strategic purpose in kick-starting manufacturing sector activities and supporting innovative lending to an emerging services sector.
- The DFIs had their own limitations: due diligence for loans was limited; infrastructure was excluded from their portfolio; there was no coordination between their lending and industrial objectives and behest lending led to bad loans etc.
- **Premature closure of DFIs:** ICICI and IDBI were turned into commercial banks. SFCs and SIDCs stopped such lending. Investment institutions never had this formal lending mandate, and, except for LIC, withdrew from such lending.
- **The dilution of Development banks** in the early 2000s was in tune with the rising trend in developing nations (with exceptions like Brazil, China, Korea): progressive withdrawal of concessional funds made available by governments.
- Between 2000 and 2010, the outstanding loans of development banks as a percentage of GDP dropped from 7.4% to 0.8% in India, but rose from 6.4% to 9.7% in Brazil and 6.2% to 11.2% in China.
- The shutdown of DFIs despite all their problems was a mistake as commercial banks were not equipped for the task. DFIs began winding down in 2000 and were closed down in 2005.

## Experience of Development Financial Institutions (DFIs) vs. Commercial Banks

- DFIs had done much of the lending to corporate entities for investment in the manufacturing or services sectors until the early 2000s. After the closure of DFIs, borrowing from commercial banks emerged as an important alternative source of corporate financing.
- Commercial banks did not have the capability to assess credit risk on long-term investment lending because they have always been engaged in advancing short-term working capital.
- There was also a maturity mismatch for commercial banks because they borrowed short from depositors but had to lend long to investors.

## Need for a new National Development Bank (NDB) in India

- A new institution of NDB will start afresh without any baggage from the past while learning the lessons from the DFIs experience in India.
- It should have elaborate and institutionalized checks and balances to prevent collusion between government and firms leading to motivated lending.
- Meanwhile at least five **measures are needed to arrest bad loans in the banking**
  - revamp of selection and appointment of top banking officials

- skilling and training of senior staff for project appraisal
- strengthening vigilance in Public Sector Banks (PSBs)
- the time-bound probe, and
- raising accountability of government-appointed bureaucrats on bank boards and greater oversight by the RBI.

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