

# Need for Setting Up of a New Development Bank

**G. A. Tadas**

Discussion Paper # 254



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विकासशील देशों की अनुसंधान एवं सूचना प्रणाली



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# Need for Setting Up of a New Development Bank

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G. A. Tadas\*

**Abstract:** The development finance institutions (DFIs) like IFCI, IDBI and ICICI formed post-Independence contributed significantly towards India's industrialization. However, with financial sector reforms since 1991, access to low cost funds for DFIs gradually stopped and the pioneering institutions like IDBI and ICICI had to transform themselves into commercial banks, while IFCI has been undergoing financial strain. Development banks world over, whether in developed or developing countries, were formed in response to failures of the markets to provide the financing necessary for entrepreneurial activity to boost new or existing companies and in the process promote industrialization and infrastructure development. When India's development needs are enormous requiring huge financial resources, the closing down of the existing DFIs appears premature, especially in the context underdeveloped long-term bond market. Time has come to set up a nodal DFI to provide medium- and long-term credit to infrastructure and other long gestation projects, promote innovation and new technologies that are not supported by the banks and financial institutions as a gap-filling or market-creating mechanism. The innovative ways of raising resources may need to be explored by studying various approaches adopted by development banks across developed and developing countries. It is desirable to have periodic reviews of mandates assigned to DFIs and need to factor in changing priorities of the economy to ensure that they remain relevant.

**Keywords:** Finance, growth and development banks

## Evolution of DFIs in India

As India embarked on an ambitious industrial development programme post- Independence, it was felt necessary to set up separate long-term lending institutions, generally called development finance institutions or

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development banks (DFIs or DBs) to finance industrial development in the country. The Industrial Finance Corporation of India (IFCI) was set up as a fully owned Government of India (GoI) entity in 1948. The Industrial Credit and Investment Corporation of India (ICICI) was set up in 1955 in the private sector. The Industrial Development Bank of India (IDBI) was part of RBI from its inception in 1964 until it became a separate entity owned by GoI in 1976. In addition, a number of sector-specific DFIs/specialised institutions were set up to address specific requirements like National Bank for Agricultural & Rural Development (NABARD), Small Industries Development Bank of India (SIDBI), Power Finance Corporation (PFC), State finance institutions.

The DFIs were envisaged to provide medium- and long-term credit. They witnessed significant growth over the years aiding industrial development. The DFIs had access to cheap funds largely in the form of (i) National Industrial Credit Long Term Operations (NIC-LTO) Fund, which was created out of the profits of the RBI, and ii) bonds which were reckoned for computation of Statutory Liquidity Ratio (SLR) purposes for commercial banks subscribing to these bonds. This access to low cost funds was vital as it enabled the DFIs to lend long-term, directly or indirectly (through banks and other financial intermediaries by way of refinance) to corporates for setting up industrial projects at reasonable cost.

As banking reforms gathered pace since 1991 economic reforms, access to low cost funds for DFIs gradually stopped. This resulted in increased lending rates of the DFIs to a level where they were uncompetitive compared to commercial banks, which had also been foraying into project finance and term loans. The long-term portfolio of banks has grown significantly ever since. Apart from the asset-liability mismatch, banks were also breaching exposure limits. There was also increased access to external commercial borrowings (ECB) as well as capital markets that led to further decline of DFI lending. Further, RBI permitted the opening of banks by private sector. This resulted in new

private banks being set up (like IndusInd Bank, UTI Bank (now Axis Bank), Global Trust Bank (subsequently merged with Oriental Bank of Commerce), HDFC Bank). The term lending institutions such as IDBI and ICICI also set up commercial banks as separate subsidiary entities. As the business environment became more and more competitive, ICICI merged with its own subsidiary bank in 2001 and IDBI followed suit in 2004. IFCI has been striving to survive, without any significant lending for the past over a decade.

While the above transformation was taking place, there had also been initiatives to channel private capital into commercially viable projects by setting up Infrastructure Development Finance Company (IDFC) in 1997, founded on the recommendations of the ‘Expert Group on Commercialization of Infrastructure Projects’ (Rakesh Mohan Committee, 1996). Subsequently, India Infrastructure Finance Company (IIFCL) was set up in 2006 as a wholly-owned Government of India company, to provide long-term finance to viable infrastructure projects through the scheme for financing viable infrastructure projects (viability gap funding). In February 2015, the Government of India set up the National Investment and Infrastructure Fund (NIIF) to extend funding support to infrastructure projects. It has been acting as a collaborative investment platform for international and Indian investors looking for investment opportunities in infrastructure and other high-growth sectors. IDFC Infrastructure Finance Company is being taken over by NIIF. IDFC Bank set up in 2015 was merged with Capital First, a Non-Banking Finance Company (NBFC), in January 2018 and renamed as IDFC First Bank. IIFCL initially extended assistance to infrastructure projects in consortium with IDBI, ICICI, State Bank of India (SBI), that were mainly appraised by SBI, SBI Caps, IDBI Bank, ICICI Bank; however, there has not been much of traction in the recent years. In the last over 10 years there has not been much of long-term project finance activity being carried out by banks and financial institutions in the country.

## **Why Do We Need Development Banks?**

With the pioneering works of Goldsmith (1969), McKinnon (1973) and Shaw (1973), it has been increasingly recognised that financial development plays a crucial role in facilitating mobilization of financial resources and their efficient allocation across various productive activities. Subsequent studies have been able to move beyond simple correlations and establish causal link running from finance to growth. The financial intermediaries evaluate investment projects and entrepreneurs, mobilise resources to finance commercially viable projects and facilitate risk management. It is suggested that government policies toward financial systems may have an important causal effect on long-run growth (King and Levine, 1993). Also, studies on the linkage between financial markets and growth have brought out that well developed financial markets guide investors' funds to better uses by creating more information about investment projects and by inducing investors to shift their portfolios towards higher return investments (Atje and Jovanovic 1993). The research on the finance-growth nexus using industry-level data show that more developed financial markets decrease firms' cost of external capital and that industries that are relatively more dependent on external finance grow faster in countries with better developed financial intermediaries (Rajan and Zingales, 1998). It is also suggested by recent studies that the quality of financial intermediation plays a significant role in driving growth (Hasan, Horvath and Mares, 2018). It is now generally accepted that finance is not simply a by-product of the development process, but acts as an engine of growth.

Another issue that has been discussed a lot is whether we leave the financial development and economic development to be determined by market forces. It is by now well documented that economic development cannot be left to market forces alone given the market failures, externalities, public good nature of social and physical infrastructure projects and so on. As regards financial development, the relative merits of finance-led vs. market-based has been debated at length over the years (Gerschenkron, 1962; Goldsmith, 1969; Levine, 1997; Allen and



Gale, 1999; Stulz, 2000; Beck and Levine 2002). It has been argued that finance-led system has many advantages in better facilitating growth of new firms, expansion of existing firms, directing flow of credit to large projects which otherwise would have been ignored by market system. The ‘supply-leading’ role of financial development argues that financial deepening causes real economic growth (Patrick, 1966). A well-developed financial sector facilitates financial transactions, mobilises savings and transfers mobilised funds to developmental activities. In many developing countries, the poor quality and limited supply of infrastructure constitutes a major source of high costs for all producers and consumers. An economically efficient division of economic activity between the public and private sector would need to be based in part on the administrative and organizational requirements of the two alternatives. Government is a non-market organisation and it generally must do things on a large scale (Krueger, 1990). The finance-led growth should, however, be viewed within context of market failure situations so that sectors or people who otherwise are left out in a market-based system would get credit and in the process promote economic activity and growth. It is observed that unfettered financial sector growth or too much credit may cause increased volatility in GDP growth (Easterly, Islam and Stiglitz, 2000).

Infrastructure and heavy industries development projects typically involve high levels of initial financial investments with long gestation returns. As such mobilising and structuring financing of such projects is a complex proposition. Development banks or development finance institutions provide long-term credit to support capital-intensive investments in infrastructure projects, urban infrastructure, heavy industries. DFIs may often lend at low and stable rates of interest to promote long-term investments with relatively lower returns but with considerable social benefits. Development banks were formed in response to failures of the capital markets to provide the financing necessary for entrepreneurial activity to boost new or existing companies and in the process promote industrialization (Gerschenkron, 1962; Bruck, 1998;

Armendáriz de Aghion, 1999). They lend to companies that would not undertake projects if not for the availability of long-term, subsidised funding from a development bank. They have also tended to be market creating by supporting new ventures engaged in discovery of new technologies and productive processes (Hausmann and Rodrik, 2003).

To lend for long-term, development banks require correspondingly long-term sources of finance. This is usually achieved 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. Development banks are often supported by governments or international institutions in the form of tax incentives, lines of credit at concessional rates. Development banks are different from commercial banks which mobilise short-to medium-term deposits and lend for similar maturities to avoid duration mismatch. A well-developed debt market complements commercial banks in providing long-term finance. DFIs often provide services beyond loans and guarantees like venture capital, acting as business angels, leasing and factoring, securitisation as well as advisory services. Some are also active as long-term strategic investors. Historically, in the UK and the US, development of long-term debt market aided funding expansion of the market economy and colonial investments in the 19th century, such as financing of railways worldwide. DFIs have been a longstanding feature of banking and financial markets in Europe, helping to promote economic growth and support structural change in economies. There are DFIs at European, national and sub-national levels. These different levels and entities are often linked. For instance, the German Kreditanstalt für Wiederaufbau (KfW) as a national DFI provides funding to sub-national institutions in Germany. There is a 'European DFI' – the European Investment Bank (EIB) and there are area specific DFIs meant to promote small and medium enterprises (SME), economic and social infrastructure within the European countries.

Some enumeration of activities of European DFIs would reveal that they have endeavoured to remain relevant serving the changing needs of their countries : (i) KfW owned by the German government is

Germany's main DFI at the national level set up in 1948. KfW supports financing of infrastructure, SMEs, housing and environmental projects. It is also active in export and project financing as part of its international business and development cooperation. KfW has played an important role in financing reconstruction of the German economy following WWII. It has traditionally operated with a wide mandate and continues to support German economic policy via promotional activities. KfW was also active in implementing Germany's fiscal stimulus package 2009-10 and assumed EUR 15 billion of Germany's contribution to the loan package from Euro-area member states to Greece. (ii) Banque Publique d'investissement (BPI), owned 50 per cent by French state and balance by state-owned institutions was set up in 2012. It is a public group to support financing and development of companies, supporting public policies by the State and the regions. BPI has an investment and a participation arm and a separate entity to fund SMEs. BPI's main aim is to support growth, employment and competitiveness of the French economy and its prime responsibility is to safeguard state's economic interest. (iii) Instituto de Credito Oficial (ICO), 100 per cent owned by the Government of Spain, was set up in 1971. Its main purpose is to support and foster economic activities which contribute to growth and improved distribution of national wealth. Main activities are to support SMEs by extending loans channelled through other banks, long-term loans in sectors of national interest, managing export, promoting financial instruments. ICO also supports initiatives to develop less wealthy regions in Spain and can provide support in case of natural disasters and economic crisis. In addition, it operates concessionary lending programs for developing countries. ICO group also comprises a venture capital firm. (iv) Cassa depositi e prestiti (CdP), set up in 1850, is 80% owned by Italian Government. It aims to foster the development of public investment, local utility infrastructure works, and major public works of national interest. CdP supports publicly mandated lending activity, loans to state, regional and local governments and public law entities for financing of capital investments. CdP widened its scope of operations in recent years to include SME financing, additional support for exporters

and projects carried out via public private participation (PPP). CdP can also participate in investment funds and acquire equity holdings in companies of strategic interest (for details see Patricia, 2015).

In the Asian region, the China Development Bank (CDB) holds the key to understanding the working of China's state-led economic development model. The bank is at the center of the country's efforts to build a best in class network of highways, railroads, and power grids. It has been extending billion dollars credit lines to Chinese solar and wind power makers, who have grown to be global competitors by supplying cheap products. The credit line extended to the country's two biggest telecom equipment makers enabled them to win contracts around the globe (Sanderson & Forsythe, 2013). Apart from CDB, Agricultural Development Bank of China and Export-Import Bank of China have been at the forefront of financing China's development. After the global financial crisis, these institutions are said to have underwritten China's risky technological investments. This helped the country gain global dominance in IT hardware and software companies. CDB and the like have been continuously adapting to changing priorities of the economy from time to time to remain relevant and sustainable.

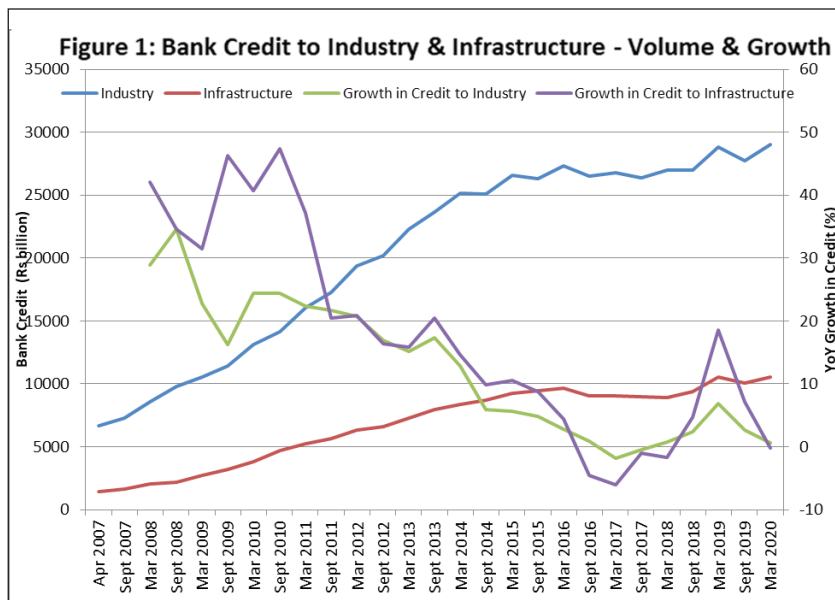
The experiences of countries across the world suggest that DFIs will continue playing an important role in the years to come in catalyzing structural change in economies by focusing on areas of market failure, facilitating market creating opportunities and extending critical support during times of financial crisis. During 2007-09 global financial crisis, private financial institutions shied away from supporting the fledgling industry. Further, the private financial sector has often ignored extending financial assistance to small firms, infrastructure and ventures engaged in innovation. The recent studies reveal that DFIs play crucial role in critical areas and situations: (i) counteracting pro-cyclical behavior of private financing, by providing counter-cyclical finance; (ii) promoting innovation and structural transformation; (iii) enhancing financial inclusion; (iv) supporting financing of infrastructure; and (v) supporting environmental sustainability (Griffith-Jones and Ocampo, 2018).

The development banks (DBs) have been used as important instrument by the governments to promote economic development. Regardless of their stage of economic development, countries have established DBs to finance construction of roads, highways, airports, energy plants, dams, and telecommunication infrastructure, small & medium enterprises (SMEs), and provide financial services to low-income households. While the catalyst role of DBs has been widely recognized, it is viewed that risks lie with potential ‘overburdening’ of DFIs and setting expectations too high on what they can achieve. DFIs can help to support economic policy goals but they are no substitute for reforms, which are in the domain of the governments. Similarly, having a DFI can be helpful in mitigating the impact of a crisis, but does not prevent it from happening (Patricia, 2015). It is desirable for DBs to have periodic reviews of mandates to ensure that they remain relevant. Changes in the economy need to be taken into account and adjustments in DB roles should be considered regularly (WB & World Federation of DFIs, 2017).

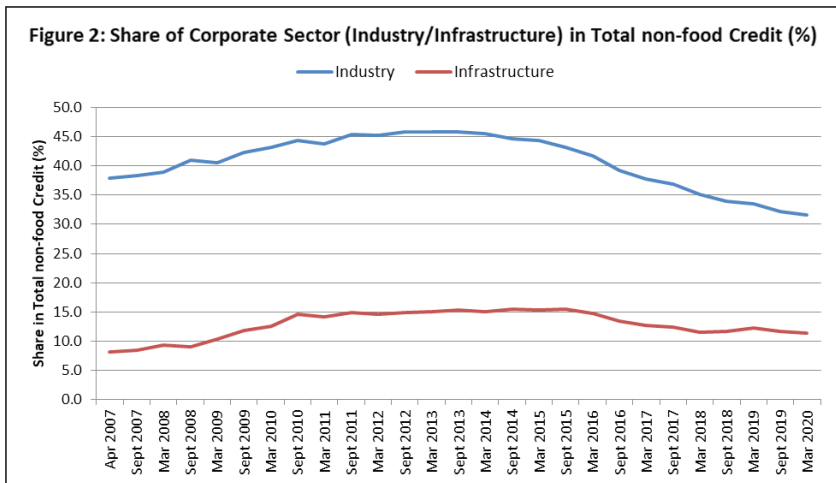
### **Need to Revive DFI**

One of the critical issues facing the economy is the stressed loan assets of the banking system. The RBI in its Financial Stability Report of July 2020 has stated that the gross non-performing assets (GNPA) ratio of the country’s scheduled commercial banks (SCBs) may increase from 8.5 per cent in March 2020 to 12.5 per cent by March 2021. The corresponding figures for the public sector banks (PSBs) are even more alarming. The PSBs may see their GNPA ratio increase from 11.3 per cent in March 2020 to 15.2 per cent by March 2021. With the gross bank credit of Rs.9.26 lakh crore as at end of March 2020, the GNPA at 8.5 per cent works to about Rs.7 lakh crore. This excludes the stressed assets of the banks which is also substantial and going to increase during the current year due to Covid-19 impact. The debate on the NPA issue has so far largely focused on resolving the stock of NPAs. This is no doubt important and but the resultant decline in fresh lending and the impact on private investment has not received much attention. A fall out of the stressed assets situation

is that banks have been wary of lending to corporate sector and making concerted efforts to reduce their exposure to the sector by focusing on retail lending aimed at diversifying risk and conserving capital. The bank lending to corporate sector (proxy industry) has declined significantly in the past over five years. After growing at steady rate till 2014, bank credit to industry has decelerated and in the more recent years (2016 to 2018) it has contracted in absolute terms or grown at a mere less than 1 per cent (Figure 1). The pace of infrastructure lending, which grew at a rate of over 35-40 per cent till March 2011, slowed thereafter to enter a negative zone during 2016 to 2018. The corporate lending as proportion of non-food credit that increased till 2010, has as result tended to stagnate in the subsequent years and has in fact consistently declined since mid-2015. The share of industrial credit increased from around 38 per cent in 2007-08 to over 45 per cent in 2011 and remained stagnant at this level through 2011 to 2014, only to decline in the years thereafter touching a low of 31.5 per cent in March 2020 (Figure 2). The share of infrastructure lending has dwindled more precipitously.



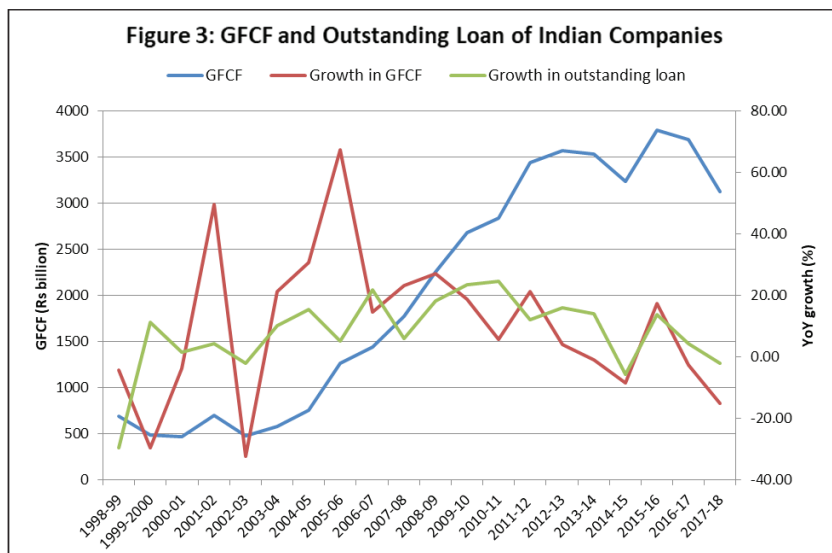
Source: Based on RBI data.



*Source:* Based on RBI data.

The decline in corporate lending may partly explain the stagnation or fall in fixed investment (fixed capital formation) by the corporate sector post 2011-12. The data based on Annual Survey of Industries covering the entire Factory Sector (comprising industrial units or factories registered under the Factories Act, 1948) in India indicate that gross fixed capital formation (GFCF) of the factory sector increased significantly during the period 2003-04 to 2011-12, post which it has increased only marginally. In fact, in the more recent years (2013-14 to 2014-15 and in 2016-17 to 2017-18) there was decline in GFCF in the factory sector (Figure 3). The outstanding loan to factory sector grew in the range of over 15% annually during 2003-04 to 2013-14, barring one or two years in between. There was loan degrowth in 2014-15, which although showed improvement next two years, declined again in 2017-18. GFCF also tended to decline in these years. The decline in corporate loan may not fully explain for deceleration in GFCF, as companies that are able to generate cash surpluses can plough back into business or raise equity through capital market. There could also be other business environmental factors (sluggish economy, policy and sector specific issues) that may not be conducive for further capital formation. It may be useful to study

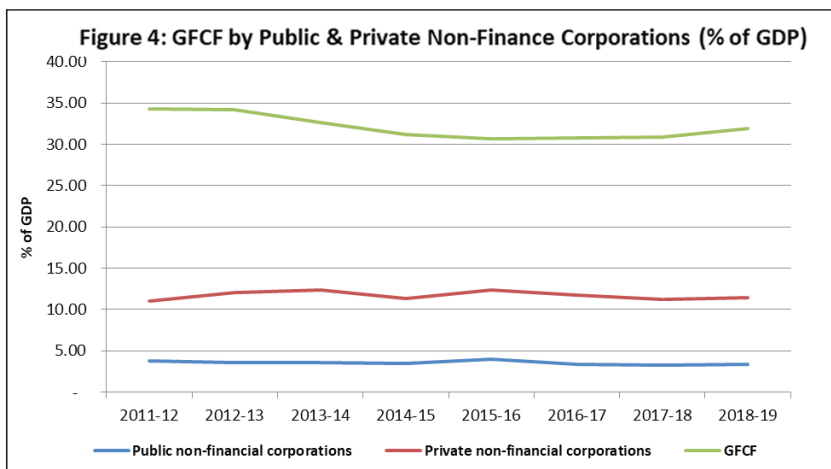
the inter-linkages between long-term credit or other sources of funds and GFCF of Indian companies through a detailed examination based on historical data.



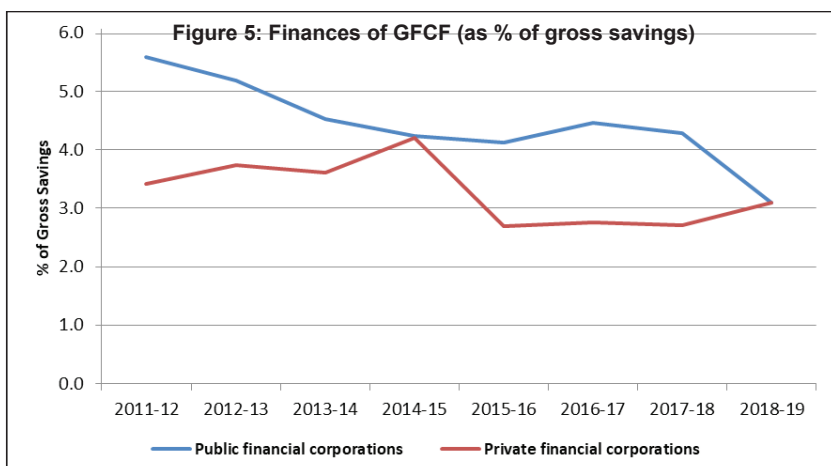
*Source:* Annual Survey of Industries data base.

At the macro-economy level, it may be noted that GFCF as per cent of GDP decelerated since 2011-12 from a little over 34 per cent to less than 32 per cent in 2018-19 (Figure 4). The GFCF in private non-financial corporations reached a peak of 12.4 per cent in 2013-14 and started dwindling in the range of 11-12 per cent thereafter. The share of public non-financial corporations in GFCF hovered around 3.3 to 3.9 per cent of GDP during the period, being more on the lower side of the range in the recent years. The finances for GFCF as percentage of gross savings similarly showed declining trend during 2011 to 2019 period (Figure 5), with the decline being more precipitous for public financial corporations (from 5.6 per cent to 3.1 per cent). Although the private financial corporations contribution to financing of GFCF as proportion of gross savings increased from 3.4 per cent in 2011-12 to 4.2 per cent in 2014-15, it started decreasing to levels below 3 per cent in the later years.





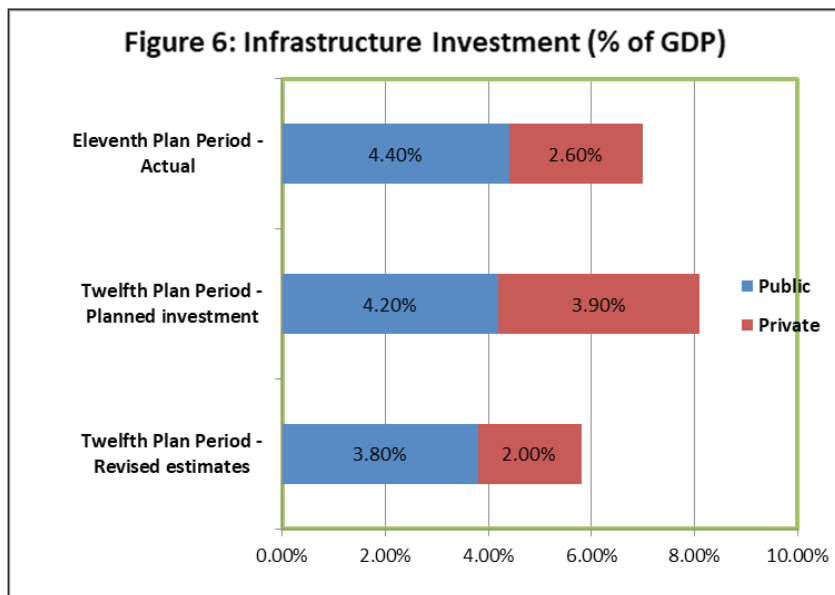
*Source:* Central Statistical Organisation data base.



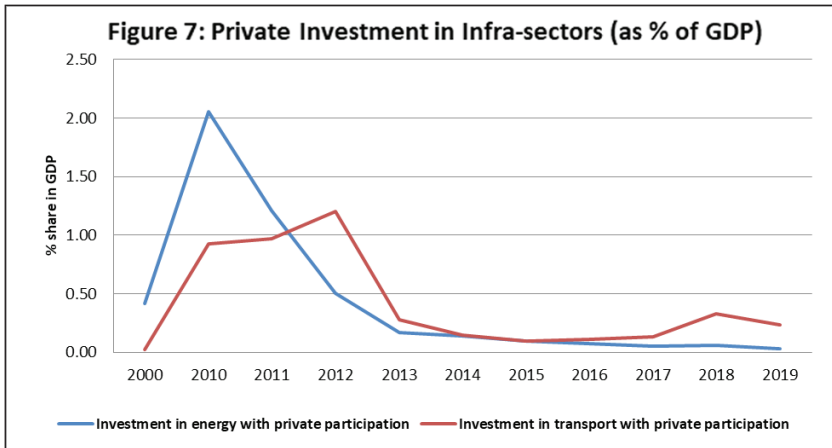
*Source:* Central Statistical Organisation data base.

The declining credit growth to corporate sector and in particular to infrastructure sector, coupled with uncertainties in regard to government policy and approvals has derailed infrastructure investment since 2010-11. The available data show that share of infrastructure investment in GDP during Eleventh plan (2007-12) was around 7 per cent, of which

public sector contributed 4.4 per cent , while private sector was at 2.6 per cent (Figure 6). The Twelfth plan (2012-17) envisaged infrastructure investment at 8.1 per cent of GDP (public sector at 4.2 per cent and private sector 3.9 per cent . However, the revised estimates throw-up much lower levels of infrastructure investment at 5.8 per cent (3.8 per cent for public sector and 2 per cent for private sector). More recent comparable data for infrastructure investment are not available to get an idea about latest position. The definitional and data problems (standardised time series data not available) pose hurdle for any meaningful comparative analysis of trends in infrastructure investment. Based on the World Bank data on private investment in certain infrastructure sectors, it is observed that the private participation in investment in energy as a percentage of GDP has continuously slid post 2010 (Figure 7). The share of private participation in investment in transport has been on the decline since 2012, with slight reversal of the trend towards 2018.



*Source:* Nikore, Financing Infrastructure gaps in India, Times of India, March 27, 2019.

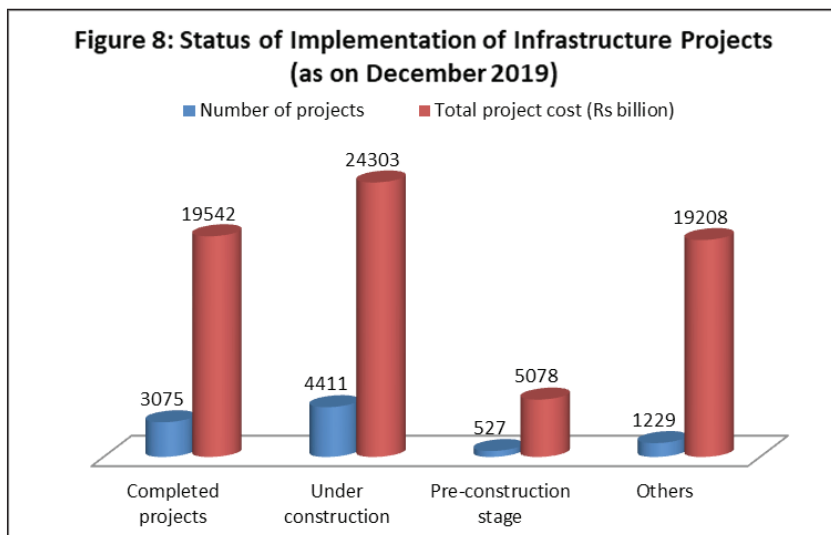


**Source:** Based on World Bank, World Development Indicators Data Series.

The decade of 2000s was marked by enhanced investment in infrastructure and increased private sector participation. Public Private Partnership (PPP) model was accepted as a preferred mechanism for the implementation of commercially viable long-term projects. The rollout of PPPs in early 2000s resulted in many projects being implemented in the areas of roads, ports, airports, power. While private sector participation witnessed significant increase supported by adequate funding by financial institutions and banks, over the years the pace decelerated due to adverse macro-economic factors, sectoral regulatory issues, bottlenecks faced in the implementation of the pipeline projects, non-realisation of expected revenue flows from the completed projects. The proportion of projects under implementation and in other stages is still high as compared to projects that are implemented (Figure 8).

It is estimated that India’s infrastructure financing requirement ranges between USD 150-350 billion per annum. The Twelfth Five Year Plan (2012-17) was formulated against the backdrop of a very good performance of the infrastructure sector during the Eleventh Plan. The Twelfth Plan projected an investment of about Rs.56 lakh crore in infrastructure during the Plan period, which was over twice the investment achieved during the Eleventh Plan. However, as noted

earlier, macro-economic developments in the late 2000s saw slowdown in infrastructure investment in general, including private sector projects in the years post 2010.



*Source:* Government of India, Department of Economic Affairs data base.

It may be noted that the Government had launched Smart Cities Mission (SCM) in the year 2015 for 100 smart cities across the country by 2022. Information Technology (IT) and digitisation are part of the smart cities development. However, implementation of the SCM has been tardy. There are also ‘Make in India’ schemes announced by the Government that need huge investments. Given the enormity of investment required and the limited availability of public resources for investment in physical infrastructure in India and fiscal constraints of the Government, it is imperative to encourage private sector participation and continue with the PPP mode of development of these projects. There is need to revive private sector confidence levels by putting in place clear long-term policy for infrastructure development, improvising regulatory frameworks, dealing with bottlenecks and creating an investment friendly climate for ensuring the long-term sustainability of PPP projects. In this

regard recommendations of the Kelkar Committee report of 2015 are worth noting. It is well recognised that a developed state of infrastructure facilitates economic growth by attracting investments. High transaction costs arising from inadequate and inefficient infrastructure can prevent the economy from realizing its growth potential regardless of the progress on other fronts. The pace of infrastructure development and quality of infrastructure services are critical for ensuring a sustainable economic growth at a healthy rate. It has been observed that time over-run and cost-over runs have impeded proper execution of infrastructure projects and that there is need for collaborative and agile planning, reforming procurement and strengthening contract management (PMI & KPMG, 2019). While project promoters can be expected to bear project execution and business risks, risks arising out of policy uncertainties and delay in government approvals are beyond their control, which need to be properly addressed. The past experience in regard to policy and approval risks has had adverse impact on the private sector initiatives to take up new and long-term infra-projects.

It goes without saying that promoting PPP mode of investment requires specialised long-term credit institutions with requisite experience in appraising projects and structuring financing. Unlike commercial banks, which are mainly geared towards short-term lending, development banks are by design providers of long-term finance. Their funding is predominantly in the form of long-term liabilities. They have technical expertise to take a leading role in the design and execution of development projects and they have the financial means to attract other players to co-financing (UNCTAD, 2016). There is complementarity in the role of development banks and commercial banks in the sense that while long-term credit is extended by the former for setting up of projects, the latter support running of the project unit post-implementation by providing working capital. The development needs of the country are enormous requiring huge financial resources and the support of a DB with requisite project finance and related advisory skills is critical at this juncture. In this context, the closing down of the existing DFIs

appears premature, especially in the context underdeveloped long-term bond market. It is felt that time has come to revive long-term credit institutions to provide medium- and long-term credit to manufacturing and infrastructure (Rangarajan, former Governor of RBI & others in an interview to CNBC-TV18's Latha Venkatesh, April 2017; Nagaraj, February 2020). The developments in the past over a decade have revealed that there has emerged a gap in institutional financing structure as also associated expertise in project finance. These long-term credit institutions can also facilitate faster development of the corporate bond market through credit enhancement. Finance Minister of India at a press conference on 23<sup>rd</sup> August 2019, announcing a slew of measures to boost the economy and financial market sentiments, had hinted at setting up of such an institution : “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.” In the Budget 2020-21, the Government has focused on infrastructure development and provided Rs.1.7 trillion for transport and highway infrastructure, apart from pushing for infrastructure projects launched earlier in December 2019 with an outlay of Rs.103 trillion spread over a period of 5 years. Now, with the ongoing covid-19 crisis and the impact of lockdown, many large companies as also MSMEs have been adversely affected. The economy is expected shrink in the current fiscal year as per estimates of International Monetary Fund (IMF), World Bank (WB) and many rating agencies. The government and RBI have initiated monetary and financial booster measures to mitigate the adverse consequences and aid affected sectors/companies to tide over the crisis. It is in this context that the role played by DBs during 2008-09 global financial crisis in many countries may be reckoned and existence of such a DB is a great comfort for the industry and country to address market failure issues during such times.

## **Ownership Structure and Resources Availability**

The UN (2005) defines DBs as “financial institutions set up to foster economic development, often taking into account objectives of social development and regional integration, mainly by providing long-term financing to or facilitating the financing of projects generating positive externalities”. National DBs around the world are seen in different shapes and sizes. They differ on ownership - public ownership can be full or partial. Some institutions have sub-national and national owners; others a mix of national, foreign, and multilateral ownership, involving for instance other DFIs as part of development cooperation (Patricia, 2015). Setting up of new development bank (DB) need not necessarily be copying of the erstwhile DFI structures. The ownership and organisation structure can be decided looking at experiences of successful DBs in other countries. It may also take the form of consolidating existing institutions and structuring them to suit the national priorities of creating best in class physical and social infrastructure. However, one needs to weigh pros and cons of a new DB vs consolidating existing institutions (the latter option may pose initial hurdles as are generally involved in consolidation with legacy assets, ownership and organisation structure and people).

There is need to do away with multiplicity of funds and institutions set up/supported by the government to deal with the same cause (of say, infrastructure development) and instead establish a single nodal institution that can be instrumental in channeling all long-term credit towards infrastructure and such other sectors in line with national priorities. The DB may also facilitate creation of financial infrastructure institutions facilitating development of long-term bond market, framework for proper appraisal and monitoring systems, rules and guidelines for long-term credit sanctions and disbursements, risk management, etc. The effectiveness of DBs is seen to depend on a range of factors, including a well-defined and sustainable mandate, use of innovative instruments to adapt to evolving circumstances and the adoption of best practices in corporate governance. A clear mandate including target sectors, positioning (vis-à-vis the private sector and other sector specific DBs

such as PFC, SIDBI), and financial sustainability objectives help to focus the activity of the DBs and avoid the common tendency of engaging in business that can be taken up by the private sector. The concept of ‘gap-filling’ should be central to the spirit of the DB mandates (Gutierrez, Rudolph, Homa & Beneit, 2011). The DB should also facilitate development of ‘market creating’ opportunities by encouraging venture capital, new technologies and products and entrepreneurship. In this context it is important to address certain questions that are often raised: whether private sector participation in the ownership structure of a DB significantly improves its effectiveness and what are the best governance arrangements to insulate DBs from undue interferences from the owners and make them more professionally driven entities.

The resources being provided to various funds/institutions for infrastructure by the government through Budget could be channelled through the nodal long-term credit institution. The capital/resources provided by the government can be further leveraged to raise resources from the market. There is also need to work out a mechanism to enable raising long-term funds at reasonable costs, including extending erstwhile enablers like SLR bonds, exemption from CRR, SLR, priority sector lending requirements. The DB may also plan raising resources through issue of special bonds targeted at promoting development of projects/sectors of national importance with tax exemptions so as to be attractive to retail investors. There could be large section of people who may be interested to invest for a national developmental cause (infrastructure bonds, green bonds, smart city development bonds, etc). This is one of the ways of channeling savings of the people to national developmental goals. The long-term resources available with pension funds, insurance companies, may be allowed to be channeled through this institution with adequate safeguards for timely debt servicing. The DB may explore tapping international market to raise low cost funds based on guarantee that may be extended by the government without impairing its fiscal position. Apart from extending long-term credit, these institutions may be allowed to undertake related businesses like structured credit, M&A



financing, promoting new technologies and products, advisory services that encourage innovation and make the model sustainable in the long-term.

## **Concluding Observations**

Development Banks (DBs) exist in most countries, developed or developing. The DBs in India have contributed immensely in the past towards industrial and infrastructure development. With the economic and financial reforms undertaken in 1991, there have been significant changes in the financial environment in the country over the years. The major DFIs like ICICI and IDBI have converted themselves into commercial banks and many new private sector banks have come up. While the older DFIs folded up their developmental role, the new institutions set up by the government (IIFCL, NIIF) are yet to make significant strides. Considering the huge resource requirements of infrastructure development and long-term finance to support long gestation projects, it appears that closure of then DFIs was premature and needs to be reviewed. Also, creating new institutions to support infrastructure development when the then existing DFIs were carrying out similar mandate needs an introspection. Instead of multiple institutions chasing the same goal, there could be a single nodal DB with clear mandate including target sectors and positioning (vis-à-vis the private sector and other sector specific DBs), and avoid the tendency of engaging in business that can be taken up by the private sector.

The DB may target sectors that are generally not supported by the private sector financial institutions, acting as gap-filling and market creating by extending support to industries and sectors where market fails to address due to high risk and low return syndrome, but projects that result in significant positive externalities and have economically and socially desirable consequences in the long-term. Initial focus could be on infrastructure development considering the needs of the country and this should be supported by a clear long-term policy on infrastructure development with a view to attract private sector participation. The nodal DB can be instrumental in channeling long-term credit and also facilitate

creation of financial infrastructure institutions that, in turn, can aid development of long-term bond market, risk capital and entrepreneurship, innovations. The nodal DB can also evolve a standard framework for appraisal and monitoring systems, rules and guidelines for long-term credit sanctions and disbursements and risk management. The DB mandate can be performed effectively based on financial sustainability objectives while focusing on the strategic goals, greater efficiency and driving performance, deriving lessons from past experience and best practices followed by the well performing DBs in other countries.

The resources being provided to various funds/institutions for infrastructure by the government under the Budget could be channeled through the nodal DB, which in turn can be leveraged to raise long-term resources. There is also need to work out a mechanism to enable raising long-term funds at reasonable costs, including extending erstwhile enablers like SLR bonds, exemption from CRR, SLR. The long-term resources available with pension funds, insurance companies, may be allowed to be channeled through this institution. The DB may also issue special bonds targeted at promoting development of projects/sectors of national importance with tax exemptions so as to be attractive to retail investors. There could be large section of people who may be interested to invest for a national developmental cause. The innovative ways of raising resources may need to be explored by studying various approaches adopted by DBs across developed and developing countries.

There is need to monitor and evaluate the developmental impact of the DB business operations. It is desirable to have periodic reviews of mandates to ensure that they remain relevant and need to factor in changing priorities of the economy. The design of governance structure should facilitate greater transparency, professionalism and accountability. There is need to look at some of well performing DBs in different countries so as to adopt best standards of governance and business practices.

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