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Demise of Development Financial Institutions in India: A Critical Appraisal

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Abstract

The emerging economies in post colonial era faced a difficult choice of appropriate mechanism of channelising the resources into development effort. Many of them had inherited capital starved primitive financial systems. Such systems could not be relied upon to allocate resources among competing demands in the economy. The task of institution building was too important to be left at the mercy of the market forces at the budding stage of development. In such a situation, several governments in Continental Europe and East Asian economies decided to take the matter into their hands and established institutions specifically to cater to the needs of financial resources for developmental effort. Such institutions were called Development Financial Institutions.

Development financing is a risky business. It involves financing of infrastructure and industrial projects which usually have long gestation period. The long tenure of such loans has associated with its uncertainty as to performance of the loan asset. The repayment of the long term project loans is dependent on the performance of the project and cash flows arising from it rather than realisability of the collaterals. The project could go wrong for a variety of reasons, such as, technological obsolescence, market competition, change of government policies, natural calamities, poor management skills, poor infrastructure etc. The markets and banking institutions were highly averse to such uncertain outcome, besides without possessing enough information and skills to predict with any certainty the outcome. There were also cost considerations associated with such risky ventures. The long term loan comes with a high price tag due to the long term premium loaded into the pricing.

In such a condition, long term financing would be scarce as well as costly so as to render the project financially unviable. DFIs were established with the government support to indemnify their losses as also the commitment for making available low cost resources for lending at the lower rate of interest than that demanded by the market for such risky projects. This arrangement worked well in the initial years of development. As the infrastructure building and industrialization got underway the financial system moved higher on the learning curve and acquired information and skills necessary for the appraisal of the long term projects, it also developed appetite for risk associated with long term projects. The intermediaries like banks and bond markets became sophisticated in risk management and also have certain advantages over the traditional DFIs such as low cost funds and benefit of diversification of loan portfolios. The government support to DFIs, in the meanwhile, was also declining either for fiscal reasons or in favour of building market efficiency. Therefore, towards the end of twentieth century, existence and role of DFIs began to be questioned.

In several economies, having attained their developmental goals, DFIs were either restructured or repositioned, or they just faded away from the scene. The Indian experience has also traversed the same path. Although, India cannot be said to have achieved developmental goals yet, the government fiscal imperatives and market forces have forced for a reappraisal of policies and strategy with regard to the role of DFIs in the system. Therefore, it has also become the need of the hour to identify not only the nature and magnitude of requirement of development finance but also the various resources of long-term finance other than DFIs in Indian economy. Furthermore, sources of the supply of development or long term finance in the absence of DFIs are needed to be examined in terms of their availability and sufficiency. This paper aims at highlighting the issues and implications emerging out of demise of Development Financial Institutions in India by evaluating the views in favor and against the DFIs.

Keywords*: Development Financial Institutions, Universal Banking, Commercial Banks, Capital Markets*

INTRODUCTION

A typical structure of the financial system of any economy is constituted of financial institutions, financial markets, financial instruments and financial services. The functional, geographic and sectoral scope of the activity and type of ownership are some of the criteria which are mostly used to categorise the large number

and variety of financial institutions which exist in an economy. In its broadest sense, the term financial institutions would include banking institutions and non-banking financial institutions. The banking institutions may have quite a few things in common to non-banking ones. However, to make distinction between the two, it is said that the former are "creators" of credit whereas the latter are mere "purveyors" of credit. This distinction arises out of the fact that the banks, which are a part of the payment system, can create deposits or credit but the non-banking institutions which are not part of the payment system, can lend only out of the resources put to their disposals by the savers.

An efficient and robust financial system acts as powerful engine of economic development by mobilizing resources and allocating the same to their productive uses. It reduces the transaction cost of the economy through provision of an efficient payment mechanism, helps in pooling the risks and making available long-term capital through maturity transformation. By making funds available for entrepreneurial activity through its impact on economic efficiency and growth, a well-functioning sector also helps in alleviating poverty both directly and indirectly.

In a developing country, however, the financial sectors are incomplete in as much as they are in lack of full range of markets and institutions that meet all the financing needs of the economy. For example, there is generally a lack of availability of long-term finance for infrastructure and industry, finance for agriculture and small and medium enterprises (SME) development and financial products for certain section of the people. The role of development finance is to identify the gaps in institutions and markets. In a country's financial sector, it acts as "gap-filler".

The principal motivation for developmental finance is, therefore, to make up the failure for financial markets and institutions to provide certain kinds of finance to certain kinds of economic agents. The failure may arise because the expected return to the provider of finance is lower than the market-related return (notwithstanding the higher social return) or the credit risk involved cannot be covered by the high risk premium as economic activity to be financed becomes unviable at such risk-based price. Development finance is, thus, targeted at economic activities or agents, which are rationed out of markets.

The vehicle for extending development finance is called Development Financial Institution (DFI) or development bank. A DFI is defined as "an institution promoted or assisted by government to provide development finance to one or more sectors or sub-sectors of the economy. The institution distinguishes itself by a judicious balance as between commercial norms of operation, as adopted by any private financial institution, and developmental obligations; it emphasizes the "project approach" – meaning that the viability of the project to be financed – against the "collateral approach"; apart from provision of long-term finance, equity capital, guarantees and underwriting functions. A development bank normally is also expected to upgrade the managerial and the other operational pre-requisites of the assisted projects. It insurance against the default is the integrity, competence, resourcefulness of the management, the commercial and technical viability of the project and above all the speed of implementation and efficiency of the assisted projects. Its relationship with its clients is of a continuing nature and of being a "partner" in the project than that of a mere "financier".

Thus, the basic emphasis of a DFI 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. DFI may also play a large role stimulating equity and debt market by (i) selling their own stocks and bonds; (ii) helping the assisted enterprises float or place their securities and (iii) selling from their own portfolio of investments.

Concept of Development Banking

Development includes not only economic change but also social and institutional changes leading to upliftment. Development is a continuous process which requires structural adjustments, innovations and new institutions to fulfill the aspirations of the people as well as national objectives. For more than four decades, there has been growing awareness for development process related to certain aspects of economic growth. The challenges of persistent poverty, degradation of natural resources are leading to radically new ways of assessing economic development.

Economic development depends upon a multiplicity of factors and the rate of capital formation is one of the most important determinants of rate of growth of an economy. Financial resources for development come

through mobilization of savings, foreign investment and their judicious use to uplift the rate of growth of the economy i.e., developing agriculture, industry, infrastructure and trade.

Industrialisation is widely considered as not only one of the important means to bring in the socio-economic transformation and achieving industrial self-sufficiency but also for the accelerated development of agriculture, transport, trade, services and other sectors through the forward and backward linkages. Jawaharlal Nehru had emphasized that "Real progress must ultimately depend upon industrialisation. Throughout the world, industrialisation has become the magic word of mid-twentieth century." Industrialisation has become one of the methods by which we can realize social and economic change which would lead to higher standard of living and greater equality of opportunity. (Desai, 2008)

The economic development of a country further depends upon its financial structure. In the long run, the larger the proportion of financial assets to real assets, the greater the scope for economic growth and for which precondition is investment. A more efficient composition of the real wealth is obtained by the promotion of financial assets which provide incentives to savers to hold a large part of their wealth in financial form. An increasing rate of savings correlates with the increase in the proportion of savings held in the form of financial assets relative to tangible assets.

A major function of financial institutions, whether short-term or long-term, is to provide the maximum financial convenience to the public. This can be done in following three ways: (i) Promotion of the overall savings in the economy by a deepening and widening of the financial structure;(ii) Purveying the existing savings in a more efficient manner so that those are in greater need, from social or economic point of view, get priority in allotment; and (iii) Monetary financial institutions assist by creating credit and deposit money and facilitating transactions in trade, production and distribution in the economy.

Meaning of a Development Bank: development banks are those banks engaged in the promotion and development of industry, agriculture and other priority sectors. These banks differ from commercial banks in one regard that they do not mobilize savings of the people but they invest the resources in a productive manner. Additionally, these banks provide all the developmental services, so as to accelerate the growth of the economy. Thus, the aforesaid views about development banking clarify that task of a development bank

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is not restricted to just industrial development; rather it is to facilitate all-round development/progress/growth or welfare of a nation whether it is related to agriculture or infrastructure, society's health or education, eradication of unemployment or poverty etc. Therefore, DFIs or development banks assume a particular responsibility since the very beginning of their inception which makes them different from others and to justify their existence, they are required to be cautious, visionary and conscientious while pursuing their goals.

Characteristics of Development Banks: Banks are required to develop their multilateral character; however, the distinctive feature of development bank lingers on stimulating or encouraging development in one sector or the other. They modify the environment in which they operate and provide finance for it. They are the institutional entrepreneurs engaged in enterprise creation. Hence, characteristics of development banks are; visionary, promoter, technical competent, mobiliser of resources, innovative, creative, leader as well as entrepreneur. Some other categorising features of development banks are: (a) multi-purpose specialised financial institution (b) strives for promoting economic development (c) makes refinance available to other financial institutions (d) provides number of services from project identification to project management (e) arranges package of incentives to entrepreneurs (f) brings in institutional innovations to accelerate the process of growth and (g) a link that spurs all-round development.

Types of DFIs: In the post world war, development banks have emerged as a model agency of economic development. The development banks have made their way in many economic activities inter alia they have made their presence felt in areas where development is a key issue. According to the types of economic activities carried out by them, development banks can be grouped into seven heads; big industry, investment, insurance and credit the guarantee, export-import trade, capital market, agriculture and housing. Development banks can further be divided into two groups; all India level institutions and regional or state level institutions, on the basis of area of operation.

Functions of DFIs: The promotional activities of the development banks cover a wide range of functions including identification and training of new entrepreneurs through institutes of entrepreneurship development and other accredited agencies, self-employment/ wage employment in industrial sector for weaker section of society through voluntary agencies, support to science and technology entrepreneur's parks, energy

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conservation, provision of consultancy services, etc. Apart from providing support to these specific schemes and programmes, it has been the Endeavour of development banks to strengthen and upgrade institutional infrastructure for undertaking promotional activities. There are around 555 DFIs all over the world and a study of a sample of these DFIs (2001a and 2001b) indicate that motive behind setting up of these DFIs bear resemblance to what has been stated above. Besides, commercial banks, mutual funds, merchant banks, financial companies, leasing companies, technical consultancy organisations extend support to development in their unique way.

Development Bank vs. Commercial Bank: Though, developmental goals are also facilitated by a commercial bank in one way or another but a basic difference between a commercial bank and development bank is that a commercial bank mainly lends funds for a short period of time and entrepreneur uses these funds to satisfy working capital needs from such a loan, while the development bank lends money for a long period and entrepreneur invests these funds to buy fixed assets. An institution where 51 per cent of the shares are held by the Central Government or State Government or jointly by the Centre and the State is called a Public Financial Institution (PFI). The stature of a PFI gives the institution certain benefits like easier tax treatment of bad debts, favourable credit ratings etc. Now when a PFI is primarily involved in long term financing, it is called a Development Financial Institution (DFI) (Shahani, 2008).

In commercial banking terms, credit is a business, needs to be repaid, has a price, and required to be covered by collateral. In development finance, credit is means to achieve other ends. It has a social outlook of creating externalities and social infrastructure, which can co-exist with market. The business of a DFI, among other things, aimed at financial inclusion.

However, the terms “DFI” or “development bank” have not been specifically used either in RBI Act, 1934 or in Companies Act, 1956 or various statutes establishing DFIs. As RBI has defined the term “Financial Institutions” (FIs) whereas some of the institutions have been classified as public financial institutions (PFIs) by Companies Act, 1956. Although various FIs including PFIs differ from each other in respect of their business specifications, some of them perform the functions of DFIs in broadest sense of the term. Even though, there is no specific definition of the term “Development Financial Institution” (DFI), it is identified as a category and DFIs are characterized by following functions: (i) Financing the sectors of the economy where the risks involved are beyond the acceptance limits of commercial banks (ii) Provide long-term

assistance mainly. (iii) Meet the credit needs of the riskier but socially and economically desirable objectives of the state policy generally.

Evolution of Development Financial Institutions

The origin of the development banks lie in the 19th century when the countries of Europe were themselves in the early stages of industrial development. In the U.K., the Merchant Banking Houses grew over the years to arrange long-term capital needed for economic growth, alongside the banks which functioned to provide the working funds. Many of the DFIs were sponsored by national government and international agencies. The first government sponsored DFI was created in Netherlands in 1822. In France, significant development took place in long-term financing after establishment of DFIs such as Credit Foncier and Credit Mobiliser over the period 1848-1852. In Asia, establishment of Japan Development Bank and other term-lending institutions fostered rapid industrialisation of Japan.

In the earlier part of the twentieth century, the industrially advanced countries, such as the USA and UK, also resorted the variance of development finance institutions for various purposes, such as for the economic rehabilitation out of the depression of the thirties (Reconstruction Finance Corporation in USA) and to fill the gap in their conventional financing pattern as in UK. However, it is only in the last thirty years, since the end of World War II that the institution of development bank has got world-wide acceptance and popularity and has come to be known as an instrument for speeding up economic growth, especially industrial development, in the newly developing nations of Asia, Africa and South America. At the international level, the establishment of the International Bank for Reconstruction and Development (IBRD or the World Bank) and the International Monitory Fund (IMF), their evolution over the years, as also their dynamic law enforcement and approaches, can be regarded as the most important single factor to promote world development.

Success of these institutions provided a strong impetus for creation of DFIs in India after independence, in context of the felt need for raising the investment rate. The Report of the Reserve Bank of India (RBI) Working Group for Harmonising the Role of DFIs and Banks (May 1998) states that DFIs in India were created for broad based industrial development as the existing institutional framework was not adequate to address the long term financial needs of Indian industry. These DFIs evolved since 1948 as largely

government owned specialized financial institutions. RBI was interested with the task of developing an appropriate financial architecture through institution building so as to mobilize and direct resources to preferred sectors as per planned priorities. While the reach of the banking system was expended to mobilize resources and extend working capital finance over an ever-increasing scale, to different sectors of the economy, the DFIs were established to cater to the long-term finance need of the industrial sector. The first DFI established in India in 1948 was Industrial Finance Corporation of India (IFCI) followed by setting up of State Financial Corporations (SFCs) at the state level after passing of SFCs Act, 1951.

The Root of DFIs in India: Historically, the idea of establishing special institutions for the provision of finance for industry was put forth in strong terms, as far back as 1931 by the Central Banking Enquiry Committee. The committee recommended the creation of Provincial Industrial Credit Corporations and an all-India institute for the purpose of catering to the financial needs of regional and national importance respectively. Very little action was taken on these recommendations till the beginning of 1945.

In pursuance of the suggestions of the General-Purposes Sub-Committee appointed by the Department of Planning and Development of the Central Government that the question of adequate arrangement for the provision of industrial finance to be examined by Finance Department, In consultation with the Reserve Bank of India, a detailed study was made by Reserve Bank in May, 1945. The study proceeded on the basis that the specialized institutions should be set-up at the both the all-India level and regional levels. It also indicated, very elaborately, the respective fields of operations of all-India and regional level institutions. The proposal of establishing all-India institutions went through several stages and modifications were made in the directions of broadening the institution's range of functions. The first step towards building the structure of a development finance institution was taken with establishment in 1948, of the Industrial Finance Corporation of India with a view to providing medium and long-term credit to the units in the corporate sector and the industrial co-operatives. A wide variety of financial institutions have been incorporated at national as well as state level in India since its independence to satisfy the thirst of distinct priority sectors and industries of the country for long-term or development finance[1].

[1] The list of various DFIs set up in India since its independence can be referred from Report of the WG on DFIs 2003-2004 along with their objectives.

Operating Environment of DFIs in India

Development financing emerged in India since its independence and from the very beginning; low-cost funds were made available to DFIs to ensure that the spread on their lending operations did not come under pressure. DFIs had access to soft window of Long Term Operation (LTO) funds from RBI at concessional rates. They also had access to low-cost funds from multilateral and bilateral agencies duly guaranteed by the government. They were also allowed to issue bonds, which were qualified for SLR investments by banks. For deployment of funds, they faced a little competition as the banking system mainly concentrated on the working capital finance. The working environment remained supportive for the DFIs till the adoption of policy of liberalization by the country in 1991.

With the initiation of financial sector reforms, the operating environment for DFIs changed substantially. The supply of low cost funds was withdrawn forcing DFIs to raise resources at market related rates. On the other hand, they had to face competition in the areas of term-finance from the banks offering lower rates. The change in working environment coupled with the high accumulation of non-performing assets due to a combination of factors caused a serious financial stress to term-lending institutions. As a result, the two AIFIs known for term-lending; ICICI and IDBI have already sought the way of transition to banks through back merger and IFCI and IIBI are also passing through a difficult time.

Regulatory Framework for DFIs till 1990: The responsibility and associated regulatory and supervisory powers are conferred upon RBI in Banking Regulation Act, 1949 in respect of banks and in RBI Act, 1934 in relation to non-banking institutions. RBI regulation covering financial intermediaries is based upon two primary factors – protecting depositors interest, in case of public deposits is accepted, and the systematic stability considerations. As banks are a part of the payment system and are the "creators" of credit, RBI's regulation over them has historically been far more comprehensive than that over non-banking institutions (NBIs), which include FIs established by statutes and NBFCs.

The comprehensive legislation and regulation concerning banks have been in place for a long time under the BR Act, 1949. The regulation on NBIs were introduced comparatively late in 1964 when by an amendment to RBI Act, 1934, a new Chapter III was inserted in the Act to give necessary powers to the RBI to regulate the deposit accepting activities of the NBIs. Significant amendments to Chapter IIIB have been effected in

1974 and 1997 vesting the RBI with more powers to exercise the control over the NBIs, in particular over NBFCs.

Under Reserve Bank of India Act, the terms, "Non-Banking Institution" (NBI), "Financial Institution" (FI) and "Non-Banking Financial Company" (NBFC) have been defined as follows: "Non-Banking Institution" means a company, corporation or a co-operative society. The term "Financial Institution" means a non-banking institution which carries on as its business or part of its business any of its activities such as the financing of any activity other than its own; acquisition of marketable securities; letting or delivering of goods under a hire-purchase agreement; insurance business; chits or kuries business or running schemes involving collection of monies and awarding prizes or gifts or disbursing money in any other way. However, the term does not include any institution, which carries on as its principal business, agricultural operations; or industrial activity; or the purchase or sale of any goods (other than securities) or the providing of any services; or the purchase, sale or construction of any immovable property. The term "non-banking financial company" means a financial institution which is a company; a non-banking institution which is a company and which has as its principal business the receiving of deposits, or under any scheme or arrangement or in any other manner, or lending in any other manner; and such an non-banking institution as RBI may specify.

Thus NBIs including DFIs and NBFCs have been under the control of RBI especially by virtue of certain powers granted to it by RBI Act since 1964. However, till about 1990, the thirst of RBI regulatory action remained confined to the deposit taking activities of the NBIs. There was practically, no regulation of FIs other than NBFCs till 1990s. Around 1990, the significant growth and diversification of Indian financial system coupled with its development from short end to the long into a continuum for few preceding years, made RBI to take an integrated view of the operations of the banks and select all India FIs for providing more comprehensive bases to the monetary and credit policies. Accordingly, RBI took certain measures to widen the scope of its oversight beyond banks, so as to gradually encompass the broader financial system.

As a part of the decision to undertake active monitoring and regulation of FIs, in 1990, RBI had a close look at the powers available to it under RBI Act, 1934 in relation to FIs. It was found even though the provisions of Chapter IIIB were introduced in the context of NBIs receiving deposits, the provisions of RBI Act have empowered RBI to require the FIs, independent of their deposit taking activity, to furnish information to the

RBI and it was also sufficiently empowered to carry out inspection of FIs. Further, it was noted that RBI had also powers to give directions to FIs not only in relation to acceptance of public deposits but also in matters related to conduct of business of FIs provided RBI was satisfied that it was necessary to do so for the purpose of regulating the credit system of the country to its advantage and in issuing such directions to FIs, RBI has due regard to conditions in which, and objects for which, the FI has been established, its statutory responsibility, and the effect of the business of such FI likely to have on trends in the money and capital market.

Regulation and Recommendations regarding DFIs since 1991 till Millennium: During 1990-91, as an adjunct to monetary and credit policy, RBI had started monitoring the activities of select large size financial institutions, viz., IDBI, IFCI, ICICI Ltd., IRBI, EXIM Bank, NABARD, NHB, SIDBI, LIC, GIC and UTI. Accordingly, to know the size and nature of financial flows, particularly the total debt and investment instruments which go to finance the non-financial sector of the economy, a system called Financial Institution Information System (FIIS) was introduced.

Subsequently, the committee on Financial System (Narasimham Committee, I) had recommended, in its report released in 1991, a quasi –autonomous Banking Supervisory Board might be set up under the aegis of RBI and it should have supervisory jurisdiction not only over the banks and NBFCs but also over the FIs. Near about the same time, the committee appointed by governor, RBI enquired into the securities transactions of the banks and FIs (Janakiraman Committee) had brought out several serious irregularities in these securities transactions in its first report. Following the recommendations of the above two committees, the approach of RBI regulation and supervision towards the select FIs monitored by it underwent a change. Beginning from issuance of guidelines in 1992 relating to transactions in securities held in the investment portfolio by the select FIs (one of the follow up measures on Janakiraman Committee), RBI started issuing regulatory instructions to the FIs. RBI also extended prudential norms relating to income recognition, asset classification and the provisioning as also the capital adequacy to the select DFIs, in faces, since 1994. Besides, since 1995, after setting up the Board of Financial Supervision (BFS) in keeping with the recommendations of the Narasimham Committee-I, RBI also started conducting periodical inspection of these DFIs.

Later, in 1997, in the wake of certain adverse developments in the NBFCs sector, RBI Act, 1934 was further amended extensively and RBI regulation over NBFCs was made quite comprehensive. Some of the select FIs already being regulated and supervised by RBI e.g. ICICI Ltd. and IFCI Ltd., which were constituted as companies, got covered by the definition of NBFCs as given in the amended RBI Act, 1934. RBI, however, on the case to case basis and for specific periods roled over, did not apply guidelines for NBFCs to them and instead continued to regulate and supervise them only as DFIs.

Because of the liberalisation of the Indian economy in 1990s, arguments started taking place that the development financial institutions or term lending institutions did not have much role to play. Moreover, it was no longer considered desirable that these institutions should depend on authorities for concessional funds. Many of them were suffering with high level of NPAs. Therefore, there was a need of harmonization of role of banks and DFIs in India. It was in this context that discussions on Universal Banking initiated at official level in India through three documents: (a) Report of Narasimham Committee-II (NC-II) on Banking Sector Reforms (April 1998), (b) Report of Khan Working Group (KWG) (May 1998), and (c) Discussion Paper by RBI (January, 1999). The major points put forth by each of these were as follows: (L.M. Bhole, 2006)

* According to NC-II, (i) Following the trends abroad, a move towards up is visible in India also. (ii) Development Financial Institutions (DFIs) should convert themselves to banks over the years. (iii) These banks should be subject to regulatory discipline which is applicable to commercial banks. (iv) Only banks and Non-Bank Financial Companies (NBFCs) henceforth should exist in India. (v) Those DFIs which do not convert themselves into banks would be classified as NBFCs.

* The ideas of KWG were more or less similar. It suggested that there should be a progressive move towards Universal Banking[2] in India. An enabling framework should be put in place for this purpose. Meanwhile, DFIs may be permitted to have banking subsidiaries with their holding upto 100 percent.

[2] In practice, the term "Universal Banking" refers to those banks that offer a wide range of financial services, beyond the commercial banking functions like mutual funds, merchant banking, factoring, credit cards, retail loans, housing finance, auto loans, investment banking, insurance etc.

* Recognising the importance of the role played in India by DFIs in RBI's Discussion Paper released in January 1999, a cautious and slow approach was adopted by RBI. It was of the view that international experience and domestic requirements should guide our approach and policies towards UB in India. The banks and DFIs should become UBs over a period of five years. UBs can develop through mergers/acquisitions or subsidiaries as conglomerates. UBs should be subject to RBI regulation as applied to commercial banks. Ultimately, banks and NBFCs would exist in India.

Thus, in late 1990s, role and existence of DFIs in the country began to be questioned in terms of the advantageous position of commercial banks in raising low cost funds against DFIs. As banks enjoy the natural benefit of low cost funds and are, therefore, capable of providing low cost funds at lower rates despite higher intermediation cost and can derive at the same time, the benefit of risk diversification across a wide spectrum of assets of varying maturities, subject to limitation imposed by their asset liability management (ALM) considerations. With the change in the operating environment, supply of low cost funds has dried up for DFIs forcing them to raise resources at market related rates. DFIs are unable to withstand the competition from banks due to their higher cost of funds. Consequently, ICICI[3] and IDBI[4], the two all-India long-term financial institutions have transformed themselves into universal banks in years, 2002 and 2004 respectively.

Report of the Working Group on DFIs (2003-04)

In order to address the regulatory and supervisory issues relating to the term lending and refinancing institutions and for improving the flow of resources to them, RBI in terms of the review of mid term review of the monetary and credit policy for the year 2003-04 set up a Working Group (WG) under the chairmanship of Mr. N. Sadasivan for examining, within the broader framework of NBFCs, various regulatory and supervisory aspects including access to short term resources for DFIs as a separate category. The Working

[3] Industrial Credit and Investment Corporation of India Ltd. (ICICI) was established in 1955 as a company formed under Companies Act, 1913 and with the primary objective to promote the industries in the private sector and meeting their foreign exchange requirements.

[4] On July 1, 1964, IDBI was established under Industrial Development Bank of India Act, 1964 as the principal institution for industrial development in the country to co-ordinate the working of the institutions engaged in financing, promotion and development of industry in conformity with national priorities and assisting the progress of such institutions to extend credit and other facilities for the betterment of the industry.

Group on the Development Financial Institutions made various operational suggestions; some of the important ones are as given under:

1. In light of the banking system having acquired the skills in managing risks in extending finance to different sectors of the economy including the long-term finance and capital market, (both equity and debt taken together) providing larger significant resources to the corporate sector, the need for the DFIs as an exclusive provider of the development finance has diminished. The banks may be encouraged to extend high risks projects with suitable government support with a view to distributing risks and funding resources as also developing credit appraisals and monitoring skills across the financial system. Banks may also be permitted to raise long term resources through issuance of development bonds for the purpose of long term project finance so that problem of asset liability management can also be taken care of.

2. In a purely market driven situation, the business model of any DFI which raises long term resources from the market at the rates governed by the market forces and extends only very long term finance to fund capital formation of long gestation is unlikely to succeed on account of threat to its spreads from high-cost of funds and high propensity to accumulate NPAs owing to exposures to very high credit risks. DFIs are, therefore, crucially dependant for their existence on government commitment for continued support. Central Government need to decide after a detailed social cost benefit analysis on the areas of activities which require development financing and only those DFIs which Central Government decides to support, for the time being, can continue as DFIs. Rest of the DFIs should be converted either to a bank or a NBFC as recommended by Narasimham Committee and should be subject to full rigour of RBI regulations as applicable to respective categories. Further, no DFI should be established in future without the Central Government support.

3. Many of the institutions notified as PFIs under Section 4A of the Companies Act, 1956, have become financially weak and act without any assurance of government support. The bonds issued by these PFIs and their certain other liabilities are treated as eligible investment for insurance companies, PFs, mutual funds and RNBCs. Such exposures on PFIs also qualify for concessional risk weight of 20 percent for banks, FIs, NBFCs and RNBCs under RBI guidelines. The eligibility of resources raised

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by these entities as "approved investments and concessional risk weight of 20 percent for banks, FIs, NBFCs and RNBCs is based upon the perception of safety merely on account of PFI status being conferred on them and same should be done away with.

4. As SFCs have outlived their utility and should be faced out in a definite time frame. The credit gap, if any, created by the exit of SFCs from the market can be filled up by banks and by suitably repositioning SIDBI[5].

5. The DFIs which convert themselves to banks are expected to follow all the regulations to which banks are subjected from the date of conversion. However, the entities may need exemptions in terms of certain norms relating to equity holdings and priority sector lending for a period of 3-5 years after conversion depending on the situation in which they are placed. No relaxation should be granted unless mandated by statute in respect of requirements such as minimum capital, asset classification, income recognition, provisioning, capital adequacy, maintenance of CRR and SLr, drawing of accounts and building of reserves, permissible banking business etc.

6. The DFIs being non-banks are more akin to NBFCs and, hence, should as a general rule be subjected to NBFCs guidelines. Though, NBFC guidelines are basically meant for protection of the depositors interest and affixing the liabilities of NBFCs for that purpose and such type of regulatory framework is much lesser in case of DFIs as most of the DFIs do not accept public deposits and even if they do, public deposits constitutes a very little portion of their total resources raised. Yet, failure of any of the larger DFIs could have adverse effect on the entire financial system as these entities raise resources on a large scale, by issuance of bonds, from domestic banks, PFs, insurance companies, trusts as also the general public. The regulation of these DFIs should, therefore, be so designed as to ensure that the regulatory framework along with the government support available to DFIs works towards ensuring their financial soundness so that the overall systematic stability is not endangered.

[5] SIDBI was formed in 1990 under an Act of Parliament (SIDBI Act, 1989) as a wholly owned subsidiary of IDBI.

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7. Considering the systemic importance of the four all India DFIs established by statute via, EXIM Bank[6], NHB[7], NABARD[8] and SIDBI as instruments of public policy; RBI may continue to regulate the financial and related aspects of these DFIs irrespective of whether they accept public deposits or not. All the recommendations made for the regulation of a Development Finance Company (DFC) should be made applicable to these DFIs except the regulation relating to registration with RBI, entry-points norms and composition of board of directors. Further, RBI may divest its ownership stakes in NHB and NABARD to avoid any scope for conflict of interest.

8. RBI may ensure that the standard of regulation and supervision exercised by NHB, SIDBI and NABBARD for the institutions falling under their respective domains are broadly are at par with that maintained by RBI. Till the state level DFIs are established by the statute such as SFCs are faced out, suitable regulatory or supervisory powers may be vested in SIDBI in respect of these entities.

9. DFIs which have been constituted as companies and are performing developmental roles should be classified under the new category of NBFCs called "Development Financial Companies" (DFCs) and subjected to uniform regulation. Further, all the DFIs that may be set up in future should be formed as companies and required to be registered with RBI as NBFCs. Moreover, the entry norms for DFCs should be kept sufficiently high at the NOF of Rs. 100 crore. The public deposits accepting DFCs should be required to maintain liquid assets as NBFCs under Section 45-IB of RBI Act and the condition of transfer of certain portion of annual profits to reserve funds under Section 45-IC should also be made applicable to DFCs.

10. The guidelines laid down by RBI for select FIs relating to their investment credit portfolio, income recognition, asset classification, capital adequacy, provisioning, single and group exposures and supervisory process established for DFIs suggested by recommendations of the Informal Advisory

[6] EXIM Bank, wholly owned subsidiary of GOI established under EXIM Bank Act, 1981 with a view to promoting India's international trade and all matters connected therewith.
[7] NHB was set up in accordance with the provisions of the National Housing Bank Act, 1987 and began to function on July 9, 1988.
[8] NABARD was established in December, 1981 under Agriculture and Rural Development Act, 1981 as an Apex institution at the national level to provide credit for the promotion of agriculture, small scale industries, cottage and village industries, handicrafts, other rural crafts and other allied economic activities in rural areas.

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Group for Regulation and Supervision of FIs should also be extended to DFCs in light of their systemic importance. DFCs may also be required to submit their audited annual accounts to RBI every year and seek prior permission of RBI before appointing, reappointing and removing statutory auditor/auditors. RBI should also have powers to prescribe the composition of Board of Directors of DFCs so that professionals having special knowledge and practical experience in finance, accounting, management, industry or any other area of importance can be included which RBI might consider useful to the DFCs.

Thus, the report of the WG on DFIs, 2003-04 also supported the views of Narasimham Committee-II, 1998 and Khan Working Group, 1999 to an extent with a further proposal of formation of DFCs in future subject to the guidelines of NBFCs.

Transition of DFIs into Banks

Pursuant to the recommendations of Khan Working Group on Harmonisation of Role and Operations of Development Financial Institutions and Banks, a discussion paper was prepared outlining the issues arising out of the Narasimham Committee-II and Khan Working Group. In the light of the issues brought out in the paper, a broad policy framework was outlined in the mid term review of the monetary and credit policy of 1999-2000 of RBI. Accordingly, principle of Universal Banking was considered as a desirable goal as initiatives had already been taken by allowing banks to diversify into investments and long-term financing and DFIs to lend for working capital. As banks possess certain special features, any dilution from RBI's prudential and supervisory norms for conduct of banking business was inadvisable and any conglomerate in which banks were present should be subject to consolidated approach to supervision and regulation.

Though, it was also recognised that DFIs would continue to play a special role in Indian financial system until debt markets demonstrate substantial improvement in terms of liquidity and debt. Further, any DFI which wish to convert into a bank should have options, provided the prudential norms applicable for banks are fully satisfied. To this end, a DFI would need to prepare a transition path in order to fully comply with the regulatory regulations of a bank. Finally, operational guidelines for enabling a DFI to convert to universal bank were issued in 2001, following the policy pronouncement by RBI on 'Approach to Universal Banking'. DFIs were advised that those who choose to convert into a bank may formulate a roadmap for transition path

and strategy for smooth conversion, over a specified time frame. It was also advised that the plan should specifically provide for full compliance with prudential norms, as applicable to banks over the proposed period and should be submitted to RBI for consideration and further discussion, if necessary.

The GOI in mid-year review, 2002 also announced that "financial sector reforms, involving interest rate deregulation, increased competition from banks, and lack of concessional funds have rendered the business models of development financial institutions (DFIs) unsustainable. Various expert committees have recommended measures to transform the DFIs. With the RBI's policy in this regard crystallising last year, ICICI transformed itself into a bank. The Government proposes to address the problems of IDBI and IFCI. It is proposed to repeal the IDBI Act and facilitate its transformation into a bank. With regard to IFCI, the government proposes to take measures keeping in mind the interest of the retail investors and the government guaranteed lenders."

Out of the ten DFIs then being regulated and supervised by RBI only two DFIs i.e. ICICI Ltd. And IDBI submitted the transition path to RBI and government, respectively, for consideration. Two DFIs expressed their intention to submit the roadmap, but sought more time to concretize their plan by appointment of consultants, etc. One DFI forwarded a broad road map for conversion to a structured NBFC by 2005, also seeking support from government, which was considered crucial for the envisaged conversion. The proposal was forwarded by RBI to government for their consideration. The remaining five DFIs did not show any inclination to consider the option, as no proposal was received from them. Nothing further was heard from the DFIs who had sought time for formulating a plan for conversion. The transition plan for IDBI, which involved long winded legislative process and is finally at the stage of fructifying now, the roadmap submitted by ICICI Ltd. Was successfully implemented and conversion, was achieved in 2002. (Report of the Working Group on the Development Financial Institutions, 2003-04)

Reasons for Conversion of DFIs into banks: There is no consensus, as to the reason why development financial institutions were converted into banks. The reasons given by financial institutions are different from the reasons given by financial analysts in this respect. The reasons given by financial institutions include (i) the benefit of low cost funds which they could access once they become a bank, e.g., the average cost of funds for IDBI was 2-3% higher than that of IDBI Bank in year 2002-03, (ii) it offers the benefit to the

customers not only in form of one roof banking but also certain value added services (iii) the gradual opening up of the economy which has made far-reaching changes in the field of banking and finance like deregulations of interest rates, flexibility in spreads, more the opportunities in credit cards and consumer finance etc and (iv) financial reforms are more oriented towards banks rather than institutions.

On the contrary, the reasons for the conversion of DFIs into banks according to financial analysts are (i) there is a strong signal from RBI to these institutions to either convert themselves to a bank or a Non Banking Finance Company (NBFC) and the obvious preference has to a bank, (ii) fall in the demand from corporates who have now easier access to alternative roots of financing like capital markets, commercial paper, foreign currency loans private placements etc and (iii) the cost of financing through most of these roots is cheaper as against long term financing through DFIs.

Furthermore, one of the reasons (emergence of alternate sources of finance for corporates) for conversion of DFIs into banks can also be examined with the help of following Table 1 as given in the study made by Hanson and Kathuria on Indian financial sector. The data set out in the Table over a twenty-five-year period (1971-72 to 1995-96) reveals that the relative importance of domestic equity capital (consisting of both promoter's contribution and external equity) in project expenditure steadily increased, from 28.5 percent in 1970s to almost 41 percent in first half of 1990s. The proportion of project financing obtained through debentures and bonds increased sharply to 18.2 percent in 1980s from 4.5 per cent in 1970s. Loans (which include in addition to bank loans, loans given by DFIs, investment institutions, state-level corporations, and other domestic and foreign sources) remained the most dominant source of funds in 1970s but their importance declined significantly in 1980s when the capital market boomed and the large amount of capital was mobilized in the form of debentures and equity. This decline in the loan capital was more pronounced in later half of 1980s.

Table 1: Financing of Project Cost of Companies

Period	**1971-2 to 1980-1**	**1981-2 to 1990-1**	**1991-92 to 1995-6**
No. of companies (average)	83	319	530
Share capital (Indian)	28.5	37.5	41.1
(a) Equity	26.5	37.5	41.0

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(b) Preference	2.0	0.1	0.1
Share capital (foreign)	0.2	0.1	5.5
(a) Equity	0.2	0.1	5.5
(b) Preference	0.0	0.0	0.0
Reserves and surplus	11.8	3.4	1.6
Subsidy from central gov!	0.5	0.9	0.2
Debentures/bonds	4.5	18.2	6.1
Deferred payments	1.2	0.4	0.2
Loans	53.3	39.6	45.3
(a) DFIs (IDBI, ICICI, IFCI)	24.1	22.5	12.1
(b) UTI, LIC and GIC	4.0	1.7	0.3
(c) SFCs and SIDCs	5.3	1.6	1.4
(d) Banks	15.5	66	10.0
(e) Promoters, directors & friends	0.6	1.0	8.7
(f) Other sources (foreign & Indian)	3.9	6.3	12.8
Total	100.0	100.0	100.0

The proportion of the All India Financial Institutions (AIFIs), the DFIs, investment institutions, state-level financial corporations, declined somewhat (under the loan component) in 1980s and sharply after liberalization. This, however, does not truly reflect the total contribution of these institutions in project financing. In addition to loans, the AIFIs also offer assistance by way of underwriting or direct subscription of shares and debt securities. This assistance by FIs has not been featured in Table 1 under "loans" category, rather this assistance extended by FIs to projects is included in "domestic share capital" and "debentures/bonds" categories.

While some analysts give other reasons for conversion of DFI into a bank and these include (a) fall in demand of the projects requiring long term financing as it has been found that more and more entrepreneurs

are shying away from big projects. The reason for this is the poor success rate of existing projects and prospects of cost overruns in these projects. Then, premium charged on insurance too on these projects have gone up and this has only happened after the mishappening of WTC fall in USA. (b) Fall in the important source of income for the DFIs like public issue of bonds. Most of the DFIs used to raise enormous funds through their public issue of bonds (e.g., ICICI raised funds through ICICI Safety Bonds and IDBI issued Flexi Bonds). Since most of these bonds were driven by their tax benefit status, these had to die after these concessions had been withdrawn by the Government. (c) Further, advancement in it is now gone to the extend that customer want their bank to go beyond Universal Banking and now are asking for Virtual Banking Services where the customer gets all the facilities electronically without going to the bank personally. Hence there is a general feeling amongst these DFIs if they do not act now they might be left behind in the race.

Advantages of Long Term Financing through DFIs: Long term financing through DFIs has some specific benefits like the loan can be tailor made to suit the specific need of the borrower and this can be in terms of number of installments, moratorium period, loans on soft rate of interest, repayment schedules and rescheduling debt (if the circumstances so desire) etc. This kind of fine tuning is not possible in case of other sources of finance. Moreover, DFI also acts as a catalyst agent in promoting the unit it has advanced loan. This may be in form of helping the entrepreneur with new project ideas, undertaking feasibility studies etc.

Limitations of Other Sources of Finance: Most of the alternative roots of financing have their own limitations like commercial paper provides loans for short periods that too only to rated corporates, capital markets work well only in good times, private placements are available only to reputed corporates while the venture capital financing has now become choosy after the meltdown in the technology sector in early 2000. External Commercial Borrowing works when the home currency markets are strong and the rate of interest in the overseas markets is less than the domestic markets.

Now since long term financing given by DFI is relatively unaffected by changing economic cycle, it may be concluded that there is no real substitute for this line of financing (Shahani, 2008).

Critical Appraisal of the Role of DFIs

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As stated in Economic Survey, 2004-05 "with the progress of blurring of functions between banks and financial institutions, the FIs (All India Financial Institutions) are fast loosing ground and adopting a business model of a bank to remain viable in the long run." In connection with transforming Industrial Development Bank of India (IDBI) into a commercial bank, the Survey states "migration to new business model of commercial banking, with its access to low cost current/savings deposit is expected to enable it (IDBI) to overcome most of the limitations of the current model of development finance.". As household savings naturally flows to Provident Fund(PF) for post retirement requirements; to insurance for death or accident related events; to Commercial Banks for liquidity and payment settlements; To the Housing sector for shelter; and then to Capital Market and Mutual Funds for higher returns. DFIs are not naturally placed for financial resources and have to mostly rely on these institutions for resources. Their cost of funds would be higher and they find it difficult to compete with Commercial Banks for acquisition of assets.

Economic Survey 2005-06 notes" consolidation in banking sector has also encompassed the Development Financial Institutions, which have been the traditional providers of long term finance. DFIs like ICICI and IDBI merged with commercial banks and in a sense lost their original identity. DFIs like SIDBI, NABARD, EXIM Bank and IDFC continue to retain their identity and are operating profitably. Does the above discussion imply that there is no further role of a general DFI in India? Even if they exist, are DFIs likely to remain niche players? Further, can commercial banks and capital market shoulder the responsibility of industrial development of the country? This discussion reveals four things. First, it has been accepted that general DFIs are no longer required in India. DFIs like IDBI and ICICI have merged with commercial banks and a major reason for that has been the need to access public deposits which the major source of low cost funds. Second, the financial performance of niche players like SIDBI and EXIM Bank has been better than general DFIs like IDBI, IFCI and IIBI. Third, access to low cost funds is essential for efficient and profitable financial intermediation. Forth, strategic options in terms of expansion/diversification have to be continuously explored to remain in the market (, 2006). An attempt has been made to judge the relevance of DFIs in current time by compiling distinct views in their favour and against.

Charges against DFIs: Chakrabarti in one of his papers, "Corporate Governance in India – An Evaluation and Challenges" expresses his views as "In the absence of a developed stock market, the three all-India

development finance institutions (DFIs), the Industrial Finance Corporation of India, Industrial Development Bank of India and Industrial Credit and Investment Corporation of India – together with state financial corporations became the main providers of long-term credit to companies. Along with government owned mutual fund, the Unit Trust of India – they also held large blocks of shares in companies they lent to and invariably had representations in their boards. In this respect, the corporate governance system resembled the bank-based German models where these institutions could have played a big role in keeping their clients on the right track. Unfortunately, they were themselves evaluated on the quantity rather than quality and thus, had a little incentive for either proper credit appraisal or effective follow-up and monitoring. Their nominee directors served as rubber-stamps of the management of the day. With their support, the promoters of businesses could actually enjoy managerial control with very little equity investment of their own. Borrowers therefore routinely recouped their investment in a short period and than had a very little incentive to either repay the loans and run the business. Frequently, they bled the company with impunity, siphoning the funds with DFI nominee director's mute spectators in their boards. This sordid but increasingly familiar process usually continued till the company's net worth was completely eroded. Given this situation, it is hardly surprising that the banks flush with depositors funds routinely decide to lend only to blue chip companies and park their funds in government securities."

Bhandari et al evaluated the role of DFIs in India for the period 1989-97 by examining how firm investment decisions are affected by their ability to access DFIs. They find that the firms that had prior access to DFIs continue to receive funds from these sources only if they can be classify as priori more financially constrained. Access to DFIs for funds spurs investment. These results suggest that DFI lending is not governed by considerations of lobbying, precedence or even to sponsor particular types of projects that might be socially desirable but not privately profitable. Rather, the primary role of DFIs has been to reduce financial constraints faced by firms. They also find that the drastic contraction of long-term bank lending to industry in India in the early nineties had adverse consequences for firms that were particularly bank-dependent, but only if these firms could be classified as a priori more financially constrained.

Report of WG on DFIs, 2003-04 states that India has historically, followed a financial intermediation-based system where banks, DFIs and other intermediaries have played a dominant role. However, in recent years, resources are increasingly mobilized through capital markets (both debt and equity) and hence, DFIs have come of age in India also. Furthermore, this has been attempted to be proved by the report with the help of

Table 2 how the role of capital market (debt and equity) in allocation of resources to real sector is enhanced conspicuously especially during 1990s. However, one can also interpret that credit from banks and DFIs has not declined even after facing adverse situations.

Table 2: Sources of Resource Mobilisation

(Percent of GDP)

Period	**1971 to 1992**	**1992 to 2000**
A. Credit from Bank and DFIs	3.9	4.3
B. Capital Market (debt & equity excluding private placement)	0.6	1.7

Source: Report on Currency and Finance, 2000-01

In accordance with Desai (1999), over the years, the development banks have failed in these crucial areas: (i) DFIs have financed industrial groups rather than new entrepreneurs (ii) Entrepreneurship development lacked commitment in innovation (iii) Inordinate delay in sanction and disbursement (iv)Emphasis on plurality of instructions assisting the same project (v) Dilution of the standard of scrutiny of project proposals (vi) Absence of project monitoring and implementation (vii) Inability to build up adequate staff, both technical and financial (viii) Their Incapacity to advise the entrepreneurs on various matters from project idea, formulation, execution and implementation (ix) Distortion in the growth of a developed capital market (x) The development financial institutions in India lack in vision, innovation and enterprise. In the process, they have inherited a bureaucratic attitude.

Judged in these terms, although the quantity of funds flowed through these channels are huge, but it failed to generate sources of savings to retain the qualitative tempo of industrial development on a sustainable basis. It is right time to reorganize development institutions to accelerate the process of equitable and healthy industrial development in the future.

Views in Support of DFIs: The history of the economic development of different countries of the world suggests that financial development of the country start from the banking financial institutions followed by

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the non banking financial institutions. But in the later stage, the contribution of the non-banking financial institutions becomes more eminent than the BFIs. Actually both types of institutions are needed and competitions within and between banks and non-banks could enhance economic development and improve their expertise.

There are three different approaches to the question of Universal Banking. First is through DFIs: What exactly is their future? If they are having any role in future, how are they going to be funded? The Khan committee looked upon from DFIs point of view. The second which the Narasimham committee examined, is the institution place in the totality of the financial systems: What should be the nature of relationship between NBFCs, DFIs and banks? So, there we have a system's point of view. The third approach is through planning or developmental angle. How we insure that funds are available for long-term corporate needs? The views in support of DFIs can be segregated on three grounds: (i) achievements and performance of DFIs (ii) undesirability of Universal Banking and (iii) scarcity of long term lending.

An Achievements and Performance of DFIs: In spite of mentioning weaknesses of DFIs, Desai (2008) also states that it is difficult to imagine the course of economic growth which has taken place in the world without the significant contribution made by these financial institutions. Their catalyst importance should not be underestimated. They have been able to make an impact on employment and have stimulated small scale and medium enterprises. As experience is gained by these agencies, they are themselves evolving and are able to take new initiatives to further the wider cause of development, as may suit the growing needs of their respective economies. Cumulatively, till end March 2000, the development banks have sanctioned 6, 18,175 crore and disbursed 4, 35,406 crore to diversified industrial projects and entrepreneurs. Looking back on past 50 years, the development banks can take pride in varied achievements, which present the best evidence of their usefulness in the context of economic growth.

Bhole (2006) also highlights the role and performance of DFIs as "Let us note the developments in the development sector during 1990s. First, even though concessional funds for them were phased out, they were not adversely affected during the first half of 1990s. They took advantage of flexibility provided to them in the matter of raising and deploying external commercial borrowings and raised substantial amounts of funds from the international markets. They also took advantage of booming conditions in the domestic capital

market and raised significant amount of debt and equity at handsome premia. On the asset side, they enjoy good demand of funds due to acceleration of economic activity in general and industrial sector in particular. In this process, they did reorient their operations by offering innovative products and diversifying their activities into new areas of business."

Gupta (1999), "Quantitatively, term finance provided by banks to medium and large scale industry in India is hardly one-tenth of that is provided by all-India DFIs. Almost everybody, including the RBI has recognized that DFIs are far better equipped than commercial banks with regard to long-term financing of industry. I believe that we should preserve the role which DFIs are playing currently as it will continue to be important even in the future as the economy grows."

Strong institutional support is necessary for development of the capital market which is the core of economic development in the market economic system. NBFIs around the world provide institutions support to the capital market (Monzur Hossain - MD Shahiduzzaman).

Hanson and Kathuria in their study on financing of Indian firms also acknowledge the contribution of DFIs or AFIs in improvement of capital market and gross fixed capital formation of the private corporate sector, which has been shown with the help of Table 3 as given below.

Table 3: AFIs Capital Market Contribution and Role in Gross Fixed Capital Formation (GFCF) of the Private Corporate Sector

Period	**1971-2 to 1980-1**	**1981-2 to 1990-1**	**1991-2 to 1996-7**
Percentage share of underwriting, direct subscription etc in disbursements	6.7	11.0	20.2
Percentage share of disbursements in GFCF	45.8	54.5	48.0

Sources: CSO, National Accounts Statistics, various issues; RBI, Report on Currency and Finance, vol.II. various issues; and IDBI. Report on Development Banking, various issues.

As the capital market expanded to provide support to projects, FIs also channeled their funds increasingly via the capital market by raising their share of assistance through underwriting and direct subscribing of issues for project construction in the 1980s And the 1990s. The share of this assistance in total assistance of FIs raised from below 7 per cent in 1970s to 11 per cent in 1980s to 20.2 per cent in post-reform period. The contribution of FIs to gross fixed capital formation of the private capital sector is also reflected by Table 3 as their average share increased by 9 percentage points, from 45.8 per cent in 1970s to 54.5 per cent in the 1980s. In spite of the heightened competitive pressures in the financial sector and the resultant improve in the mechanisms for resource pooling, The FIs have financed on an average around 48 per cent of gross fixed capital expenditure of the private corporate sector in the first six years of the post-liberalisation period. The following Tables indicate the financial performance of some of the important DFIs in India since 1999-2000 and onwards when the arguments for the transformation of DFIs into banks were picking height. ICICI Ltd. has not been included as it was converted into a bank in 2002.

Table 4: Profit after Tax to Average Assets (percent)

DFIs	1999-2000	2000-2001	2001-2002	2002-2003	2003-04	2004-05
IDBI	1.3	1.0	0.6	0.6	0.5	Na
IFCI	0.3	-1.2	-4.0	-1.2	-17.2	-v
IIBI	0.8	2.8	1.5	-15	-4.8	-v
SIDBI	2.9	2.8	1.6	1.2	2.0	1.7
NABARD	0.5	0.4	0.3	0.3	0.7	1.8
IDFC	6.2	5.2	5.9	5.2	5.2	4.3
EXIM BANK	2.6	2.1	2.2	2.0	1.7	1.5

Table 5: Average Cost of Funds (percent)

DFIs	1999-2000	2000-2001	2001-2002	2002-2003	2003-04

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IDBI	9.2	9.3	9.2	8.5	7.4
IFCI	12.6	12.6	12	9.3	7.9
IIBI	9.9	10.1	10.8	12.1	11.7
SIDBI	10.4	10.5	10.3	9.4	6.4
NABARD	3.5	3.9	4.5	4.5	4.5
IDFC	5.7	8.5	9.9	9.4	6.8
EXIM BANK	5.8	6.3	5.5	4.8	4.5

Table 6: Margin (percent)

DFIs	1999-2000	2000-2001	2001-2002	2002-2003	2003-2004
IDBI	1.9	1.6	1.2	1.3	1.0
IFCI	1.1	1.6	-.07	-1.6	-0.7
IIBI	3.3	3.8	2.2	-4.1	-1.8
SIDBI	3.0	2.4	1.7	2.4	1.8
NABARD	1.0	1.2	1.9	1.8	2.1
IDFC	6.2	3.1	3.0	3.9	6.1
EXIM BANK	4.1	3.3	3.2	3.0	2.5

Table 7: Capital Adequacy Ratio (percent)

DFIs	1999-2000	2000-2001	2001-2002	2002-2003	2003-2004	2004-2005
IDBI	14.5	15.8	17.9	18.7	18.3	Na
IFCI	8.8	6.2	3.1	1	-v	-v
IIBI	9.7	13.3	9.2	-v	-v	-v
SIDBI	28.0	28.0	45.0	44.0	51.6	50.7
NABARD	44.4	38.5	36.9	39.1	39.4	38.8
IDFC	-	84.1	56.7	51.3	37.0	28.6
EXIM BANK	24.4	23.8	33.1	26.9	23.5	21.6

A glance on the Tables 4,5,6 and 7 shows that the profitability of the general DFIs like IDBI and especially IFCI and IIBI began to decline in latter half of 1990s and beginning of the millennium and their average cost was higher in comparison of the niche players, i.e., SIDBI, NABARD and EXIM Bank. Still, the Capital Adequacy Ratio (CAR) remained more than 9 per cent, as required by RBI in all cases excepting IFCI. Still, elimination of DFIs is not justifiable in view of the following: (a) DFIs were established to further the cause of development and not for earning profits (b) India has not met its developmental goals as yet (c) Alternate sources of development finance are not capable enough to replace DFIs.

(B *Undesirability of Universal Banking:* The experience from abroad shows that UBs have not existed in all the countries all the time. In USA, during 1930-80, the creation of UBs was discouraged under Glass-Steagal Act. Even today, many experts abroad are in favour of narrow banking rather than universal banking. Although their has been a recent trend towards establishment of UBs in countries like US, UK, Canada, the authorities and social scientists in those countries are worried about the emergence of this “brave new world” of conglomerates. Similarly, in developing countries like India, Bangladesh and others, the model of Universal Banking is not being welcomed by financial experts as expressed with the help of following views: Bangladesh Bank, Financial Institutions Department (BB, FID): One important arena of NBFIs is the deployment of funds in the long term financing. By definition, banking financing institutions should not involve in long term financing and they are the institutions related to money market instruments and are

allowed to make only fully collateral short term lending. Bank business is based on the depositor's money. Lending long is risky because it creates least accountability to the borrowers. Borrowing short and lending long by the BFIs create a mismatch in the financial system and hamper the macroeconomic stability.
Gupta (1999), "I don't think that the DFI's role can be entirely taken over by commercial banks. Of course, banks do some amount of term lending but they cannot match the skills and experience in assessing long-term earning capacity of borrowing companies as opposed to assessing the liquidity position. The banks hesitate to go into the riskier area such as, financing the long-term capital requirements of new firms.

Monzur Hossain - MD Shahiduzzaman observed banking has the multifaceted own activities so that for bringing more efficiency in their own efficiency as well as the efficiency of the financial system they should not be involved with the activities that NBFIs can do.

Vaidyanathan claimed that FIs can access relatively cheaper funds by becoming banks but given the CRR and SLR and priority sector requirements, it is going to be difficult task to meet the term lending requirements. One possibility is for the waver of the CRR/SLR requirements to these new entities but that would be opening the Pandora's Box in our context. The form of organization is only a minor part of the solution; the major issue is regarding flexibility and autonomy given to these institutions. Some of the most successful entities have adopted the Universal Banking mode. But the success or otherwise is not a function of organizational structure but more due to management practices. In other words, Universal Banking per se is not a sufficient condition for success. After all the individuals who are running them and are not based on inanimate structure.

Hitherto the business of financial institutions has been confined to only 'credit' with attendant forex business (with limitations). Apart from the proportion of existing NPAs in their balance sheets the FIs have to reckon with other important variables while moving towards commercial banking. Looking at the existing size of financial institutions as compared to the bank with which merger is intended, the relatively short gestation period available to bank to establish itself amidst turbulent market/competition is quite challenging. One might well ask what is the input from a financial institution, in a merger, to a relatively less asset based bank. FIs have had a crucial role in the years following Independence: in the then prevalent conditions, financial institutions built up infrastructure contributed to a better industrial climate. The expertise in these fields may

be sub served or enlarged appropriately. However, is such expertise relevant for say small, for retail loans- which are promising avenues for banks of today? Are we looking at another type of mismatch? (The Hindu, Thursday Nov 22, 2001)

C Scarcity of Long Term Lending: There is no perfect substitute available for the type of long-term or development financing provided by DFIs as implied by following discussion:

Bhole (2006) stated that the “emergence of competitive financial system and financial sector reforms” can lead to changes in DFIs, but it need not result in their disappearance as development finance institutions. It is true that these institutions were set up when the capital markets were relatively underdeveloped and were incapable of meeting the long-term financing needs of the economy adequately. This rationale for the existence of DFIs has not disappeared at all even now. The capital market in India is still utterly incapable of meeting the long-term financial requirements of even the corporate sector. The old financial markets imperfections still continue to exist. The SSI sector, agricultural and other priority sectors do not have access to capital market, and they need adequate supply of long-term funds, if the required rate of capital formation is to take place in the economy. Put it differently, a very big “unsatisfied fringe of long-term borrowers” in the corporate and many other vital priority sectors which existed and prompted the setting up of DFIs in 1950s and 1960s, exists now also, and it defines the continued role for them at present too. If the emergence of competitive financial system has not rendered the corporative banks irrelevant, why should it make DFIs irrelevant?

Recent years have witnessed a blurring of traditional distinction between banks and financial institutions. In keeping with this development, there has also been relaxation in project financing norms for infrastructure lending by banks. Similarly, banks have been allowed to have two-tier PLRM, one for working capital and loans upto three years and other for loans exceeding three years period. In this context, the recommendations of the Working Group set up by the RBI for harmonizing the role and operations of DFIs and banks and the RBI initiative to prepare draft proposals on the respective roles of banks and financial institutions, as announced in the monetary and credit policy for the first of 1998-99, also assume significance. These developments, however, fall short of measures needed to facilitate financing of infrastructure projects. (Outlook, http://indiabudget.nic.in/es97-98/chap35.pdf.)

Since the Indian economy is moving away from the public sector, it implies a correspondingly larger role for private corporates. But where will these corporates raise long-term debt finance if ordinary investors continue to have little confidence in private corporate bonds? In a developing economy like India, many of these corporates will be new and their promoters unknown. As a result, the need for DFIs will remain almost as strong for many years to come as at present (Gupta, 1999).

Therefore, we observed that views in favor of DFIs are much stronger than views in against DFIs.

Implications and Possible Solutions

Bhole's argument in favour of DFIs is very relevant as he claims that the sanctions and disbursements by FIs have declined significantly only in and after 2000-01, and it has been so due to: (a) a reduction in number of project proposals seeking assistance; (b) restructuring of assets portfolios by DFIs; (c) week financial position of IDBI and IFCI and (d) spread of universal banking, particularly the merger of ICICI and ICICI bank. The problem of IFCI and IDBI have been more due to non-economic factors of mismanagement, corruption, heavy investment in a thoroughly corruption afflicted project namely, Enron. It would be sad if such factors would be made the basis for taking away the role of these institutions as development bodies. DFIs are facing the problems due to industrial recession also. Their problems do not mean that they have become unviable organizations as a suppliers of medium-term and long-term development funds. Their problems do not justify to allow them to disappear or to wind up their activities. In fact, it is too important a group of institutions to disappear in the near future. Similar observations of other financial experts in this respect have been enlisted as follows:

1. Monzur Hossain - MD Shahiduzzaman (in context of Bangladesh): NBFIs are suffering from high cost and scarcity of funds. At present, with high cost of funds non-banks are forced to compete with the banks those have relatively low cost of funds. This situation somewhat hampers the growth and development of NBFIs. For rapid growth and development of this sector, fund problem should be solved on a priority basis. Opening of a refinancing window even for a limited period of time may be considered after a strategic evaluation.
2. James A. Hanson and Sanjay Kathuria: Pension and insurance reforms are keys to mobilizing long-term funds. India's pension system is still in its infancy. A shift towards a more fully funded, transferable pension system would provide more long-term, investible resources for capital markets and good income

for retirees. But, high fiscal deficits are needed to be reduced to undertake pension reform. Similarly, liberalisation of insurance industry would provide more resources for the long-term capital market provided, of course, a reduced fiscal deficit decreases the government's funding needs.

3. Outlook: In view of long gestation period, infrastructure projects require funds with long maturity, which can be provided by insurance and provident funds. The financial savings of households held by these institutions are long term liabilities which can be converted into long term assets. Further steps aimed at developing the domestic debt market should be designed to facilitate the flow of contractual savings for infrastructure financing.
4. R. Vaidyanathan: The options, (either in case of DFIs or Universal Banks) which should be considered in context of changes both in domestic and global scenario are as follows: (i) Grant them greater autonomy – only then they will be able to stand up to the competition from the domestic as well as international players (ii) Reduce government stake over the period of time and make them private (iii) Make them more market driven both from lending practices as well as compensation packets (iv) Allow for external expert to be inducted at senior levels (v) Introduce strict risk management practices and internal controls (vi) Have to enter in to the global financial system through more sophisticated financial instruments (vii) A proper succession planning, without leaving these institutions headless for months.

Therefore, eliminating the role of such an important category of the financial institutions is not favorable rather endeavors on the part of government and authorities are required to protect and strengthen this class of financial intermediaries? Furthermore, other sources of long-term finance like infrastructure bonds issued by ICICI Bank and deep discount bonds issued by commercial banks earlier, fix deposits, provident funds and life insurance should be encouraged, of course, keeping in view their limitations.

Conclusion

It can be concluded from the discussion that all the credit of making the world so wonderful goes to these development finance institutions as neither capital markets and nor the commercial banks were capable enough to bear the risk of supporting undertaking huge projects. Though, DFIs have not also been remained aloof of charges of mismanagement and corruption but it never implies their unviability or irrelevancy in

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present context especially in case of our country where other sources of long-term finance are still not developed to replace them.

Former finance minister, Yashvant Sinha has also recently said on CNBC Awaz during an interview on 8 March, 2012 that we need to develop our infrastructure and housing finance to raise investment demand and consumption demand in view of fiscal deficit and slow market to improve economic growth. Therefore, the recommendation of Narasimham Committee, Khan Working Group, RBI Discussion Paper and Report of the Working Group on Development Financial Institutions (2003-04) for the transition of DFIs into banks has not been found acceptable at least for the time being until the developmental targets of the country are achieved and other possible sources of developmental finance become so strong to replace DFIs. Hence, it has become the need of the hour to find out the answers of the following: (a) what are the development targets yet to be achieved? (b) What are the sources other than DFIs to fulfill those development needs? (c) To what extent, the other sources of development finance are capable meeting set objectives?

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