WILL DEVELOPMENT FINANCE INSTITUTIONS REVIVE IN INDIA? SHOULD THEY?¹
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I. Introduction

Recent years have seen a resurrection of development banks worldwide. Their disbursements increased faster than those of private institutions. New national, regional and multilateral development banks were set up. FinDev in Canada (2017), Société de Financement Local in France (2013), PT Sarana Multi Infrastruktur in Indonesia (2008) and Development Bank of Nigeria (2013) are examples of new national development banks. Some others substantially increased their capital. The Asian Infrastructure Investment Bank, a multilateral development bank with a mission to improve social and economic outcomes in Asia commenced its operations in January 2016. The New Development Bank was established in 2014 to support infrastructure and sustainable development efforts in BRICS and other emerging economies. Policy-makers and academics reassess the evaluation of these institutions. This new wave is a reaction to the more pronounced failures of capital markets following the global financial crisis. Governments recognized that lending by state-owned banks was countercyclical, it helps to mitigate adverse effects of the crisis and plays a bridging role between savings and financing needs.

For a number of years now there has been intensified discussion of the need to establish a national development or long term credit bank in India. This move would open a new chapter in the eventful history of Indian development banks. There were times when they were considered essential in India’s catching up with more advanced economies. There were other times when it was believed that private sector actors could successfully take over functions from development institutions. This paper attempts to put the changes in appraisal in context and take a stand in the discussion on the establishment of a new long term finance institution in India. The second part of the paper gives a brief summary of the economic argument for development finance institutions in general. The third part deals with the hopeful start of these institutions following India’s independence. The fourth part discusses the demise caused by the financial reforms of the 90s. The fifth part is devoted to conclusions, lessons and recommendations.

II. The case for development finance

The economic logic for development finance policies is simple. Capital markets do not allocate resources to areas which are believed to be too risky and/or their payback time is believed to be too long. Reluctance of market-based financing affect two segments of business undertakings

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in particular: those in need of long term financing and the newcomers. The long time horizon and the long gestation lag may expose banks to an accrued risk they are often not prepared to take. The problem is often compounded by the mismatches in liquidity and maturity. The availability of long term sources represents a constraint to long term lending. As a result of scarcity of long term finance, investments in infrastructure and other specific capital intensive industries lack funding. New companies as well as small and medium scale enterprises in general find it exceedingly difficult to obtain bank financing because of the lack of past record and the foreseeable losses of their early learning period. Even in the advanced capital markets, availability of capital is a function of location, industry and presence of banks in the area. An undertaking in a remote village without bank branches has a very limited chance to have access to capital. (Seidman2005) These problems have particular importance in emerging countries with a low density of bank branches.

From a theoretical perspective, development finance policies can stem from market imperfections, more particularly from asymmetric information. Companies have superior (more, better, earlier) information about their future prospects than creditors or investors. Lenders are more unsure whether the borrower has the capacity and / or willingness to pay back its debt. If the company has better information about its investment returns than its potential investors, external finance may be expensive, a lender will charge a premium to compensate for the disparity in information or will not lend at all. (Greenwald B. – Levinson A. – Stiglitz J. (1993) In such a situation, some companies would not be able to obtain any credit even though they would be willing to repay the lender. They could earn profits if they were given access to credit. Financial institutions do not channel funds to profitable opportunities. (Stiglitz (1989) Credit rationing is a result of imperfection in capital markets or, in other words, financial market imperfections imply credit underprovision and lead to a suboptimal allocation of capital and other resources. (Esteva M. – Freixas X.(2018))

Governments can fill the vacuum left by market forces, and provide capital via development finance institutions (DFIs) especially to undertakings that might otherwise have difficulty attracting financing. Even if capital markets were perfect, their capital allocation would be limited by the size of domestic savings. In emerging economies this constraint – due to the lack of domestic saving and the lack of domestic capital – is more severe. DFIs can mitigate this constraint by intermediating various non market funds towards domestic firms. By doing so, they can expand the overall capital supply. These institutions do not measure their performance against profit objectives only. Their lending policy includes the pursuit of a social benefit objective, as well. This duality raises new and old questions. Do governments have additional information on companies' prospects that markets do not have? Is the problem of asymmetric information terminated? What is the optimal trade-off between pure profit-making and social impact? Can we expect the financing granted for non-remunerative projects markets rightly rejected? Is there a risk of subordination of lending policy to short term political interests? Hopefully, this paper will answer at least some of these questions.

III. THE RISE OF DEVELOPMENT FINANCE IN INDIA

The rationale for development finance in India was much the same as it was in other emerging economies: the aspiration to catch up through industrialization. Nayyar (2017) provides a good
summary of background and performance of development finance institutions. He points out that the accumulation of own capital was not sufficient, while there was almost no debt or equity market for long-term finance in the post-independence times. As a response to market insufficiencies, the Nehru government started the establishment of nationwide institutions. In parallel, state level institutions such as State Financial Corporations (SFC) and State Industrial Development Corporations (SIDC), with state governments being the sole owners, were also established. The Indian economy is traditionally a bank-based system. Because of scarcity of investable capital and the weaknesses of institutions in floating new issues, the government was right to focus on banking finance instead of institutions of redistribution of (hardly) existing capital. Nevertheless, emerging investment institutions such as insurance companies facilitated issuance of long-term loans by subscribing to bonds of DFIs. Their long term sources helped to match sources and long term assets.

This wave was followed by the creation of many refinancing and sector-specific or specialized institutions in the 80s. The mushrooming of DFIs is reflected in their business activity. Nominal annual growth of their disbursements was especially spectacular in the post 1970s. Their share in total bank lending or in gross fixed capital investments showed a dynamic rising trend until the turn of the century. (see Fig. 1). In 2000, DFI disbursements reached 30% of lending to industry, and constituted around 15% of gross fixed capital formation. These numbers are also results of the absence of competition in India’s banking market. Borrowers had no choice in the matter of selecting an institution for financing their projects. DFIs were the principal source of medium and long term finance for industries while commercial banks focused mostly on working capital finance.

However, it is fair to say that in conformity with the basic principles of their establishment, DFIs had an irreplaceable role in the industrialization process in India. Without DFIs the closing of the development gap with advanced economies would have been a more protracted process.

The composition of disbursements shows certain peculiarities. DFIs provided financing for small-scale industrial sector, agriculture, rural industrialization, village industries, power and railway sectors, or refinanced house loans. Infrastructure received less than 16% of total disbursements. Given the close linkage between industrial development and infrastructure, this figure is surprisingly low. An insufficient infrastructure is an obvious constraint to industrial and economic growth in general. Private capital may be reluctant to finance infrastructure projects because of their large funding need and long payback time. The data suggest that DFIs, contrary to their mandate, did not address the infrastructural obsolescence of the Indian economy adequately, either.

3 The three most important national institutions are the Industrial Finance Corporation of India (IFCI) set up in 1948, the ICICI (Industrial Credit and Investment Corporation of India (1955) and the IDBI (Industrial Development Bank of India) (1964).

4 As a belated response to this, newly created institutions were dedicated to infrastructure. The Infrastructure Development Finance Company (IDFC) was incorporated in 1997 as a private company to foster the growth of private capital flows for infrastructure financing. The India Infrastructure Financing Company Limited (IIFCL) was incorporated in 2006, as a wholly-owned government company, to provide long-term finance for viable infrastructure projects.
The spectacular growth of DFI lending from the mid-60s to the end of 90s was supported by high demand and abundant supply. Demand was constituted by companies with reasonable projects, but no access to market based financing. The credit supply was little limited by funding constraints. Numerous channels of funding were available to DFIs. However, concessional government and central bank sources, namely the Long-Term Operations (LTO) Fund of the Reserve Bank and tax-free government guaranteed bonds constituted the most important funds for DFIs. The bonds they issued were taken into account for Statutory Liquidity Ratio (SLR) computation purposes for commercial banks, who therefore showed interest to subscribe to these bonds.

DFIs had access to cheap funding from international institutions, too. Specific regulatory advantages also supported the supply side. DFIs were exempt from Statutory Liquidity Ratio rules. Commercial banks typically raised funding via short-term deposits, and faced high statutory liquidity requirements. Consequently, it was quite unviable from a pricing perspective for commercial banks to compete with DFIs and do large-scale long-term financing. The low cost of capital for DFIs allowed them to lend at rates that were lower than market rates and use longer grace periods. This further increased borrowers’ appetite for their credit.
The DFI funding came:

- directly from the government in the form of subsidized or interest-free loans,
- indirectly from the government through Reserve Bank of India (RBI) allocation on concessional terms. RBI allocations stemmed from its profits before they were transferred to the government.
- Government guaranteed bonds subscribed by commercial banks. Their yields stayed below the usual market rates due to the government guarantee and also because these bonds could be used to meet the statutory-liquidity-ratio requirements of commercial banks.
- off-budget transactions that relied upon public deposits in state-owned banks, post offices and pension funds.
- foreign loans from multilateral institutions such as the World Bank and the regional development banks.
- open market sources

Low cost government funding not only stimulated the business activity of DFIs but resulted in a dependency. DFIs were subject to political interference. “The government being an important source of finance, it was to be expected that it would exert control over the functioning of these institutions and in determining the leadership of these organizations. This did imply that some political and partisan considerations affected the functioning of the DFIs. It also implied that these institutions were partly protected from close scrutiny by members of parliament and other representatives of the people.” (Chandrashekar (2015) p9.) Political pressure could force managers into loss making credit decisions against their own will. DFIs operated as wings of government rather than as autonomous institutions. At the same time, political protection made irresponsible business behavior possible, too. Acts of mismanagement were rarely followed by sanctions. Should any loss be incurred, the political connections were available to provide rescue to the company and its managers. The anticipation of a government rescue increases the moral hazard of economically nonviable decisions. As a result, non performing assets built up and profitability of DFIs suffered. This is what Kornai calls soft budget constraint. Sengupta and Vardhan concluded that loan quality was worse at the term-lending DFIs. (Sengupta and Vardhan, 2017) In the absence of overall data for the DFI sector we can illustrate this by the case of IDBI bank, where the percentage of Gross NPAs between 1999 and 2003 ranged from 14.07% to 16.86% of total advances. (Chakrabarty, 2013). The entire banking sector had an approx. 10% NPA rate for the period of 2001-2003. “The share of non performing assets in loans as at end-

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5 In reality, these are government sources as well, as profits of RBI should be part of government revenues. RBI financing means that parliamentary scrutiny over these funds is not implemented.

6 In order to maintain the continuous operation of DFIs, when NPAs reached dangerous levels the government took over part of the infected loans. A framework for these interventions were first proposed by the Narasimham report of 1991: “…the Committee proposes the establishment if necessary by special legislation, of an Assets Reconstruction Fund (ARF) which could take over from the banks and financial institutions a portion of the bad and doubtful debts at a discount….” (Narasimham (1991) p.XIII

7 Kornai (1980)
March 2002 was at 24.1 per cent in case of India Investment Bank of India (IIBI), 22.5 per cent in case of Industrial Finance Corporation of India (IFCI), and 13.4 per cent in case of Industrial Development Bank of India (IDBI). (RBI (2003) (p.33)) For the same period, the ratio of gross NPAs to gross advances (of commercial banks) declined to 10.4 per cent from 11.4 per cent in 2000-01. (p.32) (RBI(2003))

The DFIs in conformity with their mandate were serving higher risk customers, as well. Consequently, it was to be expected that they would have lower profits and higher NPA rates than market institutions. However, the values cited above are signs of an unsustainable business model.

IV. The fall of development finance in India

India faced an economic crisis in 1990-91, which was manifested in an unmanageable balance of payments, high rate of inflation, unsustainably high fiscal deficit, melting foreign exchange reserves and growing profitability and portfolio quality concerns in the banking sector. Under the pressure of economic malfunctioning, the government of India launched massive macro-economic management reforms (with the primary objective of reducing the fiscal deficit); and structural and sector-specific reforms. The financial sector was a key area of these reform initiatives. The government established a committee under former RBI Governor M. Narasimham to provide an in-depth overview of the financial system. A few years later a second Narasimham committee was established. The reports of these committees had comprehensive recommendations for financial sector reforms including the banking sector and capital markets. The basic assumptions of this committee were that equity and bond markets as well as the banking sector made sufficient progress to better answer the external financing needs of the private sector. Commercial banks gradually improved their project appraisal skills, their risk management capabilities and developed interest in long term lending. Investment commitments to infrastructure projects with private participation increased significantly in the 1990s, from around US$20 billion at the start of the decade to more than US$140 billion by 1997. (Spratt-Collins, 2012) A higher retail deposit base aided a better asset-liability match. In addition, the development of the bond markets enabled commercial banks to raise long term funds. Due to these changes the DFIs lost some of their competitive edge in the long term finance market. At the same time, their non-performing assets reached dangerous levels and their profitability declined. In accordance with the findings of the Narasimham committee, the government launched far reaching liberalization reform(s) in the banking sector which affected the basic function and the institutional setup of DFIs. The advocates of the reforms were of the view that the problems of DFIs were attributable to a large extent to the absence of a competitive environment for project lending. The modifications aimed largely at enhancing the efficiency and productivity of the banking system through competition. It was felt that less barriers to entry and less constraining

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8 However, “this decline in profitability is not so much because of acceptance of social obligations of lending to some sectors at concessional rates of interest but because of deterioration in the asset quality.” (Narasimham (1991) p. 101 On the other hand, the deterioration of asset quality is a consequence of the acceptance of social obligations.
regulation would enhance competition. More freedom for commercial banks and less artificial competitive advantage for DFIs were supposed to ensure adequate long term lending by commercial banks. It is not an objective of this paper to provide a comprehensive assessment of the financial reform. We will focus only on specific aspects which had direct or indirect links with development finance institutions.

The major recommendations of the Narasimham committees with a special focus on DFIs are as follows:

- **Capital and financial market liberalization** -
  - development of new hedging tools (like Interest Rate Swaps, etc) for asset-liability mismatches opening the way for long term financing by commercial banks.
  - permission of issue of fresh capital to the public through the capital market. Subscribers to such issues includes actors of private sector, public sector undertakings, general public
  - No bar to new banks to enter the private sector. More permissive policy allowing foreign banks to open branches and joint ventures in India.
  - Gradual opening of the capital market to foreign portfolio investment

- **Interest rate deregulation** -
  - Regulation and control of interest rates by authorities is proposed to be replaced by interest rates determined by market forces. Concessional interest rates are proposed to be phased out.

- **Banking autonomy, policy and regulation** -
  - The over-regulated and over-administered banks including DFIs should be given operational flexibility and functional autonomy especially in matters of lending and internal administration. A healthy competition between banks and DFIs is desirable. There should not be any difference in the treatment between the public sector and the private sector banks. “The Committee also believes that commercial banks should be encouraged to provide term finance to industry, while at the same time, the DFIs should increasingly engage in providing core working capital.” (Narasimham (1991) (pXXV) The DFIs should obtain their resources from the market on competitive terms and their privileged access to concessional finance through the SLR and other arrangements should be phased out. This would lead to an actual increase in the cost of funds for DFIs.
  - A substantial decrease in the cash reserve ratio (CRR) and the statutory liquidity ratio (SLR) was proposed which would reduce the cost of funding for commercial banks. Consequently, the pricing advantage on the cost of funds would be reversed, with commercial banks gaining a large advantage over DFIs. Lower levels of CRR and SLR free up funds enabling commercial banks to provide both long term and short term industry lending

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9 The entry of private sector banks was not allowed until January 1993,
10 DFIs enjoyed exemption from CRR and SLR regulation.
11 Taken SLR and CRR together, banks needed to maintain 53,5% of their resources idle with the RBI. It was one of the reasons for their poor profitability. High SLR and CRR meant locking of bank resources for government use. DFIs exemption from CRR and SLR regulation ensured a competitive advantage vis-á-vis commercial banks. The removal of this exemption eliminated this advantage.
Non performing assets - An Assets Reconstruction 'Fund (ARF)' was established to take over bad and doubtful debts. This process was regarded as an emergency measure and not as a continuing source of relief to the banks and DFIs. “It should be made clear to the banks and financial institutions that once their books are cleaned up through this process they should take normal care and pay due commercial attention in loan appraisals and supervision and make adequate provisions for assets of doubtful realisable value.” (Narasimham(1991) (p.XIV).

Development banks were to be turned into commercial banks and as such they had to satisfy the prudential norms applicable to the banks. An RBI study argued in 2004 that the role of DFIs could be performed just as well by commercial banks and capital markets, therefore national term-lending institutions should be converted into banks or non-banking financial companies. (RBI, 2004)

The immediate consequence of the financial reforms on DFIs was their extreme marginalization in the development finance arena. This was caused by three factors:
- a sudden shrinkage of business activity of DFIs due to the sharp increase in their cost of funding
- a reformulation of their business policy
- a reduction in the number of DFIs

The most important single reform measure was halting the concessional funding of DFIs. Government guaranteed bonds were gradually phased out and access to the low cost funds of the Reserve Bank was also discontinued. DFIs could raise resources by way of raising debt and equity in the domestic and international capital market. As a result, their marginal cost of funds increased sharply. The old business model of development finance institutions was not sustainable without financial support from the government. Once funding was raised from the markets, DFIs had to operate according to market logic. The more expensive market funding made the use of under-the-market lending rates no longer possible and allowed substantially less lending. Their risk taking pattern had to be similar to that of any other commercial bank, i.e. higher risk customers could not count on credit decisions deviating from pure market considerations any more. As for the total disbursements of DFIs, the spectacular growth of the 1990s was followed by a sharp decline during the first half of the 2000s. This process is the most striking when their share in total bank credit, industry lending and gross fixed capital formation are considered. The total disbursements of DFIs as a percentage of industry lending plunged dramatically from the peak level of 30% to below 5% by the early 2000s. In gross fixed capital formation and bank credit, the share of DFI dropped from 15-17% to 3-5%.

12 Warnings have not proved to be sufficient. The RBI was forced to introduce a strategic debt restructuring (SDR) scheme in June 2015, which was a new version of the corporate debt restructuring (CDR) scheme of August 2001.
13 This transformation started with the Industrial Credit and Investment Corporation of India (ICICI) in 2002 and continued with the Industrial Bank of India (IDBI) in 2004.
The biggest drop in the share of DFIs took place in industry lending (-25% points), while the share of industry in total bank lending contracted significantly and was on a declining path since the early 70s. This suggests that neither DFIs nor banks provided sufficient support to industrial expansion in India.

The downsizing is another factor explaining the marginalization process of DFIs. According to the advocates of the financial reform, commercial banks were able and interested in providing term lending, therefore there was no need to maintain the same number of DFIs. Following the reform recommendations, the government shut down several development finance institutions. Those who remained reformulated their business policy. Their development financing activity faded away, but they made significant penetration into retail banking, and in particular to the personal loan market. Comprehensive data are not available, however, individual cases are in full consistency with the above statement. The evolution and the composition of the ICICI Bank’s gross advances clearly indicates both the headway of retail banking and a decline of classical development finance activity. While consumer loans represent half of total advances, infrastructure lending has a mere 11% share. ISBI Bank shows similar business characteristics. In its loan book, the share of retail advances increased to 43 per cent in March 2017 from 33 per cent at the end of March 2016. The announced strategy of IDBI Bank is to improve the share of retail business to 50% of book size over the next 3 years.

14 Two national DFIs (IFCI and IRBI) withered away. On state level, SFCs (State Financial Corporation) and SIDCs (State Industrial Development Corporation) Industrial Investment Bank of India were closed down.
Following the negative impacts of the financial reform, the DFIs did not disappear from view, but reemerged in a transformed suit. Their post-reform business priorities ensured economic survival but they were inconsistent with their original mandate. The new retail banking focus not only compensated for the drying up of project lending but helped to reach the earlier peak of disbursements.

The transformation of DFIs does not allow to conclude that development finance activity as such collapsed. The question is whether other actors could step in as good substitutes of DFIs in the development finance business. The available evidence is not convincing. Because of its capital intensive nature and the long payback period infrastructure is typical development financing target area. Based on the weakening and the transformation of DFIs one could expect a setback in infrastructure financing. This has not happened. While the long term lending of DFIs plummeted, the share of infrastructure in bank lending increased substantially. This suggests that commercial banks successfully stepped in and compensated for the withdrawal of DFIs. As industry lending grew slower than total bank lending, the share of infrastructure shows a more rapid improvement when compared to industry lending.
There are other indicators consistent with this. Prior to the financial reform, DFI disbursements amounted to 50% of gross fix capital formation. However, their plummeting in the early 2000s did not cause a break in the evolution of GFCF. A comparison of the average GFCF growth rates of the five years prior to (18.2%) and following (9.2%) the implementation of the financial reform, shows no break.\textsuperscript{15} The same holds for the 10 year comparison. Alternative sources of financing made an unbroken progress of capital formation possible. Commercial bank lending is one of these. Total bank lending visibly accelerated after the introduction of the financial reforms. Neither the GDP growth nor the inflation performance explain these developments. Both of them had slower growth in the post-reform years. The rapid growth of bank credit was mainly the result of commercial banks effort to fill the void left by DFIs

\begin{table}
\centering
\begin{tabular}{|l|c|c|c|c|}
\hline
 & Before financial reform\textsuperscript{*} & & After financial reform & \\
 & Preceding 5 years & Preceding 10 years & Following 5 years & Following 10 years \\
\hline
GFCF at current prices & 11,0\% & 13,7\% & 18,2\% & 17,4\% \\
\hline
Bank credit & 15,1\% & 16,1\% & 24,4\% & 22,8\% \\
\hline
GDP at market prices & 12,2\% & 14,1\% & 11,2\% & 13,6\% \\
\hline
CPI-IW & 6,8\% & & 4,1\% & \\
\hline
\end{tabular}
\caption{Evolution of selected financial and macro variables average annual growth rate}
\label{tab:financial}
\end{table}

\textsuperscript{15} The financial reforms consisted of various measures introduced at different points in time. Year 2002 is taken here as the dividing line of the pre and post reform period, as the most striking changes in the position of DFIs started that year.
Some other information contradicts the successful transition of development finance from DFIs to commercial banks and capital market institutions. According to Kumar (2015), banks were not able to meet the demand of industry for finance. The rapid growth in bank lending was accompanied by a declining share of industry lending. Undoubtedly, a rapid industrial catch-up is unlikely if industry is getting a smaller and smaller portion of bank credit.\textsuperscript{16}

![Fig. 7 Composition of bank lending, 1972-2016](source)

The inner structure of industry lending reveals additional weaknesses. The post-reform financing proved to be beneficial to urban districts and contributed to a further exclusion of rural areas. Banks closed their loss making rural branches and the tighter branch network caused a decline in the share of rural credit from 15\% (1990) to 9\% (2014). (Kumar (2015) pointed out, the share of long-term deposits in the total bank deposits declined sharply, posing severe limits on long-term lending. The domestic securities market was able to provide only constrained resources to commercial banks. The Indian primary bond market showed an appraisable growth only from 2004 but its size was still only about one third of that of Brazil or 10\% of that of China in the middle of 2010s. Therefore the Indian bond market does not represent an alternative source of funding either for banks or for the corporate sector. There were three peaks (2006, 2012, 2014) in the last decade, when banks’ issuances captured a higher share of the primary market. However, the amounts obtained were negligible (0,5-1,5\%) compared to

\textsuperscript{16} This erosion did not start with the introduction of financial reforms. The share of industry in bank lending dropped from 61\% to 48\% between 1972 and 1992, which were the flourishing years of DFIs. Consequently, even then, the DFIs were unable to compensate for the insufficient interest of commercial banks in industry lending. In the later years, the financial reform did not entail any change in this respect.
their deposits of the given year. Chandrasekhar points out that „between 2003-04 and 2006-07, which was a period when FII inflows rose significantly and stock markets were buoyant most of the time, equity capital mobilized by the Indian corporate sector rose from Rs.676.2 billion to Rs.1.77 trillion.” (Chandrasekhar (2015) (p.10) This latter figure represents 16% of total bank credit.

As for external sources, commercial borrowing is the most common way for Indian companies to raise money outside the country. This instrument after long years of sleep state embarked upon a rapid but short lived growth path beginning in 2004. First, the global financial crisis, after that the weak growth performance of the Indian economy caused a decline in commercial borrowing. All in all external commercial borrowing proved to be an insignificant source of corporate financing. Even at its peak, commercial borrowing represented a mere 3.5% of total bank deposits.
V. CONCLUSIONS, LESSONS, RECOMMENDATIONS

The financial reforms deprived DFIs of their regulatory advantages and of their access to concessional funding. As a result, they became unable to meet the demand of the corporate sector for long term financing, thereby their original role remained unfulfilled and their very raison d’être could be called in question. In order to survive, they developed a new business profile focusing on retail banking. With the closure and transformation of DFIs and in the absence of a deep and liquid corporate bond market, long term financing had to be carried out by commercial banks. Banks made significant progress to meet industry demands for finance, but they failed to become good substitutes for DFIs. The rapid exit of DFIs from project finance at the beginning of the 2000s did not produce a break in capital formation or infrastructure spending. Banks’ exposure to infrastructure has grown rapidly. However, the declining share of industry in total bank lending is an indicator of constraints to rapid industrialization. A greater boost to industry lending was not compatible with the banks’ profit goals. Some of the constraints are of general nature and not specific to Indian market developments. The asset–liability mismatch preventing long term lending is a feature of the banking business in general. Banks (and corporations) in advanced economies rely on the bond and equity markets and external borrowing to mitigate the negative impact of the mismatch. However, the underdevelopment of the Indian bond and equity market, the growing share of bank deposits (mainly short term) and claims on government in household savings and the irresolute movements of external commercial borrowings do not promise a quick improvement of the mismatch.

The catch-up with industrialization does not depend on long term finance only. New projects without access to finances will not materialize. At this point, the information asymmetry argument has to be reemphasized. Banks physically distanced from the lieu of prospective undertakings will likely have limited information on the prospects of new firms in rural areas and will likely reject many promising plans because of this. Indian commercial banks, too, amass a wealth of information on their clients, improved their project appraisal skills and their risk management capabilities but the unevenness of information and the resulting underprovision of credit continues to exist. As the establishment of new bank branches is guided by prospects of profitability, there will remain unserved (mostly rural) areas, where access to finance will be limited. The government is also unable to eliminate the information asymmetry. The government does not have any more information on the profit prospects of projects than the banks. Nor does it have any monopolistic additional knowledge in assessing their viability. There will, however, be projects that hold out less on profits but that verifiably increase social welfare and so can expect funding from state development institutions.

This paper concludes that it was a strategic mistake to enforce the transformation of development finance institutions into commercial banks and rely solely on market forces for long term industrial lending. Markets are not sufficient to deliver the highest possible social welfare in most advanced economies. They are less so in less advanced economies. Consequently, this paper joins those who recommend the reestablishment of special financing institutions promoting long term

17 Similar views are expressed by Nayyar (2017), Kumar (2015), Ray(2015)
industrial lending. It seems that central bankers of India are nuanced advocates of this approach. The Reserve Bank of India released a Discussion Paper on ‘Wholesale & Long-Term Finance Banks’ in April 2017. Former central bank governors Y.V. Reddy\textsuperscript{18} and C. Rangarajan\textsuperscript{19} expressed their open support for the proposal. The key arguments for and features of such institutions are the following\textsuperscript{20}:

- The proposed new bank(s) will lend to companies which would not get a loan from commercial banks because of the high risk and the long payback period of their project. Infrastructure projects are typically of this kind. High risk is associated with more defaults, therefore it is likely that these banks would be vulnerable to loan portfolio and lower profitability issues. However, the mission undertaken must not be an excuse for every portfolio problem. It is the responsibility of the independent management to take on risks only which do not result in a dangerous increase of NPAs and do not put the stability of the bank in jeopardy. High level of transparency and public accountability might be helpful to separate the impact of company objectives and that of (mistaken) management decisions, \textit{horrible dictu}, external political influence on asset quality. Lending decisions affect territorial, industry, etc. groups differently, and it can be predicted that winners and losers (mostly losers) will express their concerns. The new banks will be subject to public scrutiny and heated political discussions.

- Low cost resources are necessary conditions for competitiveness and for long term lending at reasonable rates. Low capital costs prevent higher client risk taken in conformity with the business policy of the new banks being reflected in higher lending rates. While resources should mostly originate from debt issuances in local and external markets in the form of bonds and asset securitization, special regulatory measures should ensure the marketability of those securities at a low yield level. Relaxations in respect of CRR, SLR, compliance with liquidity ratios, government guarantee for bond issuance are often mentioned as examples (see Reddy (2018)), RBI (2017) Direct budget transfers and central bank funding may put too much pressure on government finances and represent a vehicle for political interference. Therefore they need to be kept at a low level or fully avoided. Central bank profits are due to the budget, therefore their direct transfer to a particular economic actor prevents the public from deciding on the utilization of public resources. Therefore the earlier practice of transfer of central bank resources to DFIs is not to be reexercised. Access to low cost resources of multilateral and bilateral agencies should be permitted.

- Independent decision-making, the absence of political interference is a precondition of sound management. Words of the first Narashimam report of 1991 apply unchanged today, too. “We believe that ensuring the integrity and autonomy of operations of banks and DFIs is by far the more relevant issue at present than the question of their ownership.” (p.6) Autonomy can be ensured both in private and public ownership structure of these banks. In the latter case, the personal independence of the top manager is crucial. Appointment and dismissal procedures, income rules should be set in such a way as to ensure the independence of top managers. Mixed ownership is feasible only if several conditions are met simultaneously. Private capital takes ownership only if it has been ascertained that its profit expectati-

\textsuperscript{18} Y.V. Reddy: Development Banking – Way Forward - NSE-IEA Lecture on Financial Economics at Indian Economic Association 100th Annual Conference 2nd January, 2018
\textsuperscript{19} C Rangarajan - S Sridhar: We need a bank just for long-term credit in The Hindu Business Line April 09, 2017
\textsuperscript{20} These are similar to the points made when DFIs were established at the first place
ons will be met, i.e. its co-owner will not drive the bank to money loosing activities. On the other hand, the state will accept private capital as co-owner if it has been ascertained that their joint venture will pursue social objectives as well. Formal agreements or operational rules cannot, however, of themselves alone ensure the continuous implementation of these expectations. Therefore mixed ownership is a fragile structure.

At the time of the writing of this article it has not yet been determined whether development finance institutions will resurrect in India or not. This depends on the role the political decision-makers envisage for market and non-market forces in the socio-economic catch-up of the country. If the forces believing that market-based catching up would take longer than possible as a result of the inadequate operation of the capital markets gain ground, we may expect the reappearance of financial institutions similar to DFIs in India.

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