Reimagining Development Banks
A Comment on RBI's 'Discussion Paper'

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The RBI's "Discussion Paper on Wholesale and Long-term Finance Banks" is a welcome initiative for its familial resemblance to development banks—an indispensable institution in most late-industrialising economies. The success of development banks critically hinges on: (i) access to assured sources of low-cost, long-term funds; (ii) public ownership and/or management; and (iii) the quality of institutional governance. As development banks invariably incur quasi-fiscal costs with potential social benefits, their operations often are kept off-budget, insulating the investments from short-term budgetary negotiations.

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The Reserve Bank of India's (RBI 2017) "Discussion Paper on Wholesale and Long-term Finance Banks" needs to be seen in the current macroeconomic context, summarised in the following four trends: (i) deceleration in annual economic growth from 8%–9% until 2011–12, to around 7% last year (2016–17), accepting the official gross domestic product (GDP) estimates to be true; (ii) a nearly 10 percentage point decline in the rate of domestic capital formation, to about 29% of GDP, from its peak in 2008–09; (iii) declining capacity utilisation in manufacturing and electricity generation since 2011–12, and an unprecedented fall in bank credit growth, especially for industry; and (iv) a surge in corporate bad debts, raising the banking sector's non-performing assets (NPAs), and thereby undermining its financial viability.

Reasons and Antecedents

In developing economies, non-inflationary financing of capital-intensive sectors such as industry and infrastructure is a critical constraint as domestic savings are usually low (mostly from the household sector), and much of it in short-term bank deposits. As infrastructure (or, social overhead capital) is capital-intensive, yielding low rates of return spread over a long period, it warrants long-term credit at low interest rates. Historically, capital markets in the United Kingdom (UK) and the United States (US) have performed this function—known as the Anglo–Saxon model of finance. For instance, London's capital market financed much of the 19th century railway construction worldwide, though often with implicit government subsidies and guarantees to mitigate the risks of long-term investment (Eichengreen 1996).

To overcome the constraint, bank-centric financial systems got evolved—as an institutional device to fill the gap of missing and imperfect capital markets—initially in continental Europe, followed by rapidly industrialising Asia in the 20th century. State-sponsored development banks—variously called policy banks, development finance institutions (DFIs), term-lending institutions—helped mobilise domestic and external resources for investing in national priorities, as Gerschenkron (1962) has shown. In many instances, development banks, such as Germany's KfW or Brazil's BNDES, helped create markets where none existed, by investing in newer technologies and innovative activities (Mazzucato 2013).

In contrast to commercial (or deposit-taking) banks, development banks provide credit by mobilising long-term contributions from pensions, provident funds, or post office savings, all of which are long-term savings requiring a strong state's presence to ensure the safety of the deposits, and their socially productive use. Development banks are also often financed from national budgets, or (indirectly via) the central bank, or external, multilateral development agencies. Ample evidence exists to show how development banks have underwritten accelerated capital formation not just in late-industrialising countries, but even among the advanced economies such as Germany (Ray 2015; Nayyar 2015).

Interestingly, when the Cold War ended—at the zenith of free-market triumphalism, and even as the Bretton Woods institutions were espousing financial liberalisation among developing countries—Western nations set up, in 1990, the European Bank for Reconstruction and Development (EBRD), a development bank, to supply long-term credit to augment fixed investment and promote market-based institutions in the East European and Central European nations that emerged out of the Soviet economic system. It just illustrates the need for pragmatic public intervention in financial provision, when the markets fail, or fail to respond with the desired speed and effectiveness to meet societal needs.

In the planning era, as the state's agency, the RBI spearheaded institution-building by setting up a range of specialised

development banks with a clear division of labour among them—from the Industrial Finance Corporation of India (IFCI) in 1948, to the Export–Import (Exim) Bank of India in 1982—as is well summarised in the RBI's discussion paper. Similarly, under the State Financial Corporation Act, 1951, most state governments established term-lending institutions for small- and medium-sized enterprises, refinancing (or rediscounting) national level development banks' credit.

The sources of funds for the development banks were: (i) equity capital from the central (or state) government and RBI; (ii) debt obtained by commercial banks' mandated subscription to "SLR bonds" priced at less than the market interest rate (which, by bureaucratic sleight of hand, turned short-term bank deposits into long-term credit); and (iii) lines of credit from RBI's profits from printing money, that is, seigniorage—known as the National Industrial Credit (Long-term Operations) Fund. With assured sources of finance, these institutions were tasked with the responsibility of acquiring expertise in credit appraisal, monitoring projects, assessment of technology and markets, and for modernising corporate governance (away from family-controlled managing agency houses). The performance of development banks was judged by the development targets achieved, not by their financial returns.

Changing Discourse

After 1991, however, the liberal economic reforms changed the narrative. The Indian financial system was reported to be repressed, adversely affecting banks' profitability, "crowding out" private investment, and hence contributing to poor economic growth—as theorised by Ronald McKinnon (1973) and Edward Shaw (1973). Though this view gained wide currency, the extent of financial repression and its economic effects remained debatable, since the rates of gross domestic savings (GDS) and gross capital formation (GCF) rose steadily, especially after bank nationalisation, to 23% and 24% of GDP respectively by 1990–91. Moreover, annual economic growth accelerated to 5.5% in the 1980s, from 3.5% during the previous three decades with a steady financial deepening (Reserve Bank of India 1985).

Nevertheless, the Narasimham Committee reports of 1991 and 1998 that scripted the financial sector reforms—broadly in line with the policy templates outlined in the *World Development Report 1989*—sought to: (i) move to market-determined interest rates; (ii) introduce greater competition in credit supply; and (iii) reduce government's pre-emption of bank credit and directed lending. Development banks' long-term lending (as part of the state's pre-emption of bank credit) at low interest rates was said to have contributed to a misallocation of resources by the substitution of capital for labour, and rising capital intensity of production, thus adversely affecting output and employment growth. Moreover (as state-owned entities), political and bureaucratic interference in the functioning of development banks, it is claimed, adversely affected credit appraisal and credit quality leading to inefficiency of resource use, and contributing to industrial "sickness" (or non-performing assets for the development banks) (Joshi and Little 1996).

Interestingly, the Narasimham Committee's first report in 1991 opined that the time was not yet ripe for getting rid of development banks.[1] However, it changed its stance in the second report. Thus, Industrial Credit and Investment Corporation of India (ICICI) was merged with its commercial banking subsidiary, and the Industrial Development Bank of India (IDBI) was converted into a commercial bank, after amending the relevant act in Parliament.

Expectedly, bank credit tenor got shortened with the demise of development banks, but the corporate debt-market failed to take off in its place. An opaque private placement market has emerged instead, between banks and large borrowers (Ray 2015). But the need and demand for term-lending has resurfaced periodically. This is perhaps why, when the IDBI Act, 1964 was amended to convert it into a commercial bank, a caveat was added in the legislation to retain the option for the bank to perform development banking functions (if and when needed), as is evident from the official history:

> For the purpose, Industrial Development Bank (Transfer of Undertaking and Repeal) Act, 2003 [Repeal Act] was passed repealing the Industrial Development Bank of India Act, 1964. In terms of the provisions of the Repeal Act, a new company under the name of Industrial Development Bank of India Limited (IDBI Ltd) was incorporated as a govt company under the Companies Act, 1956 on 27 September 2004. Thereafter, the undertaking of IDBI was transferred to and vested in IDBI Ltd with effect from the effective date of 01 October 2004. *In terms of the provisions of the Repeal Act, IDBI Ltd has been functioning as a bank in addition to its earlier role of a financial institution* (emphasis added). (IDBI Bank 2013)

In the words of the *Economic Survey, 2004–05*, this meant:

> Taking into account the changing operating environment following the initiation of economic reforms in the early 1990s, the Government decided to transform IDBI into a commercial bank *without eschewing its traditional development finance obligations* (emphasis added).

In response to the felt needs, a variety of hybrid (public–private) development bank institutions came up, such as the Infrastructure Development Finance Company (IDFC), Infrastructure Leasing and Financial Services (IL&FS), India Infrastructure Finance Corporation (IIFC), etc. In 2015, IDFC dissolved itself to become a commercial bank.

In the financially globalising decade of the 2000s, surging foreign private capital inflows eased the credit constraints for large borrowers, permitting policymakers to aggressively pursue public–private partnership (PPP) projects, substituting PPP for public infrastructure investment (to comply with the fiscal deficit target set by the Fiscal Responsibility and Budget Management (FRBM) Act) (Nagaraj 2013). As per World Bank data, India accounted for the second-largest share of PPP projects among developing countries (Pratap 2014), and its share in infrastructure investment shot up from a quarter in the Tenth Plan (2002–07), to one-half in the Twelfth Plan (2012–17). The PPP appeared to be a compelling option when interest rates were low, exchange rates stable, and the economy and exports were booming.

The short-sighted policy ignored the potential currency and maturity mismatches of the capital inflows, under the wishful belief that sustained output and

exports would pay itself off. After the financial crisis in 2008, however, the chickens came home to roost—leaving behind a severe hangover of corporate bad debts, turning into the banking sector's (ever-growing) NPAs, that is, still haunting policymakers. To appreciate the gravity of the problem, according to Care Ratings, gross NPAs of 13 public sector banks, as a proportion of their credit, more than doubled in just two years since 2015, to 12% in the fourth quarter of 2016–17 (*Financial Express* 2017). This now calls for a lasting solution, including public infrastructure investment requiring long-term credit (Nagaraj 2017; Ministry of Finance 2017), which is perhaps the subtext of RBI's discussion paper.

After the Global Financial Crisis

Interestingly, the renewed interest in development banks seems to echo a significant strand of policy discourse in the advanced economies after the financial crisis (Turner 2015). As credit (and output) growth failed to pick up measurably despite interest rates being close to zero on account of quantitative easing (QE), development banks are seen by some as a way of stepping up investment demand. For instance, the LSE Growth Commission 2013, a London School of Economics initiative, has urged the British government to set up an infrastructure bank. To quote the report (at length), to understand the underlying reasoning:

> An Infrastructure Bank (IB) to facilitate the provision of stable, long-term, predictable, mostly private sector finance for infrastructure. There are good theoretical reasons for the creation of such a bank: it can help to overcome key market failures in capital markets in a direct and constructive way. In particular, it can help to reduce policy risk and, through partnerships, to structure finance in a way that mitigates and shares risk efficiently. This will require a whole range of financial instruments including equity and structured guarantees. There are good practical examples that show the advantages of a bank with this sort of mandate, such as Brazil's BNDES, Germany's KfW, the European Bank for Reconstruction and Development and to some extent the European Investment Bank. The IB would develop banking and sector-specific skills in new and important areas. It would use its special ability to make investments that could then provide powerful examples with catalytic effects on private investment through its partnerships. It could have a very strong multiplicative impact so that its investments have effects much larger than the amount of capital it puts in. The IB would be governed by an independent board with a clearly defined mandate and access to capital markets. (Aghion et al 2013)

The foregoing is quite in line with Keynes's idea—as Robert Skidelsky has recently been advocating for the developed economies—of setting up a national investment bank with the treasury providing the equity capital, leveraging which the proposed bank could borrow from the capital market to create a low-cost infrastructure fund to boost investment demand. Writing in 2011 at the depth of the crisis, before the then UK Chancellor presented his budget, Skidelsky and Martin argued:

> What is the best way out of the current dilemma? In his June 2010 emergency budget Mr Osborne proposed a green investment bank ... the Bank's funding was postponed and made dependent upon privatisation receipts. The revival and radical scaling-up of this idea can provide a way forward. The chancellor's budget should expand on existing plans, and consult on establishing a new UK National Investment Bank. This should have a mandate to finance not only "green" projects, but also others that can contribute to the rebalancing of the economy—particularly transport infrastructure, social housing, and export-oriented small and medium-sized enterprises.
>
> There are two main arguments for establishing such a venture. The first is the traditional rationale for public development banks. Private capital markets are prey to short-termism and other market failures, and tend to provide less finance than is optimal to projects that generate economic benefits to the wider economy in excess of their private returns. A public development bank can circumvent these shortcomings by taking a longer-term view, and by including these external benefits in its project appraisals. (Skidelsky and Martin 2011)

Finance and Lending Principles

From the foregoing, evidently, development banks have three prerequisites: (i) stable and low-cost sources of long-term funds; (ii) a strong and proactive state's role; and (iii) governing the institution in line with long-term national interests. Experience suggests that there have been a variety of institutional forms in meeting these requirements.

Historically in Japan, for instance, post office savings by households—the most ubiquitous and trusted institution offering government-guaranteed, tax-free, returns—was the principal source of low-cost funds for the Development Bank of Japan, amounting to as much as 10% of GDP during 1991–93. A symbol of Japanese nationalism, post office savings is often called the second budget, whose resources went into the "Fiscal Investment and Loan Plan" set up in 1952. It has remained an off-budget item, to ensure that these resources are used only for long-term investment, and not subjected to short-term budgetary scrutiny. Japan's post office bank is perhaps the world's largest savings institution, despite various attempts to undermine it (Garon 2011). Table 1 shows that Japan's total public expenditure has all along been much higher than that reported by the International Monetary Fund, and it was as high as 50% of GDP during 1991–93, if the off-budget items are included.

Table 1: Japan's Government Spending as a Percentage of GDP

Year	General Government Expenditure (A)	Fiscal Investment and Loan Program (B)	Total (A+B)	IMF	Central Government
1956–60	28.90	3.67	32.32	–	21.75
1961–65	26.53	4.59	30.90	–	19.20
1966–70	26.20	5.13	31.20	–	18.85
1971–75	29.43	6.48	35.84	13.07	19.92
1976–80	38.25	6.98	45.21	16.97	27.04
1981–85	41.86	7.00	48.85	18.11	30.36
1986–90	39.34	7.63	46.95	16.48	27.91
1991–93	40.41	9.74	50.13	22.04	27.45

(1) General government equals central government plus local government minus duplication between general account of central government and local government. Central government equals general account of central government plus special account of central government minus duplication between both accounts. "Total" equals central government plus Fiscal Investment & Loan Program (FILP) minus FILP funding through the Industrial Investment Special Fund. Deficit/surplus of FILP equals FILP funding through government-guaranteed bonds and government-guaranteed borrowings. Deficit/surplus of central government equals net increase in the central government debt outstanding except short-term (financing) bills.
(2) There was a change in classification after 1991. Other data are from the Japanese Ministry of Finance, and Statistics Bureau.
Sources: Amsden (2001: 134); IMF, *Government Finance Statistics*.

Similarly, in Singapore, a high and compulsory central provident fund scheme for workers—for instance, in 2011, workers contributed 20% of their salary and employers 15.5%, for a total of 35.5% of workers' salary—was the instrument for mobilising domestic savings for long-term domestic capital formation, especially for

housing in the city state. Like in Japan, the post office bank collected voluntary household savings to mandatorily channel them into government-designated bank securities meant for long-term investment (Huff 1995; Blöndal 2006).

More recently, China's historically unprecedented investment-led growth is known to be propelled by three policy banks—Agricultural Development Bank of China (ADBC), China Development Bank (CDB), and the Export–Import Bank of China (Chexim)—to funnel resources into the targeted industries and sectors. Lessons of the contrasting patterns of institutional development between China and India in the 1990s—with divergent outcomes for industrialisation—are perhaps hard to miss (especially considering that both the economies avowedly claimed to be wedded to "market-friendly policies").

Thus, many Asian economies have followed the same principle with some variations in detail, pursuing similar long-term goals (Amsden 2001). To quote Amsden:

> The public finance behind the "rest's" development banking (and other dimensions of industrial policy) was often "off-budget" and related to non-tax revenues. It derived from foreign sources, deposits in government-owned banks, post office savings accounts, and pension funds (as in Brazil). In East Asia especially, these transactions typically occurred outside the general government and parliamentary political process. "Off-budget" items were under the control of the bureaucracy rather than the legislatures, even if the legislature was popularly elected. This greatly strengthened the hands of professional bureaucrats in the ministries responsible for planning, finance, and industry. (2001: 133)

Comparing financial development in Japan, Korea, and Taiwan, Hugh Patrick also arrived at a similar conclusion:

> all three countries made finance the handmaiden of development policy—albeit in rather different ways and to substantially different degrees—to achieve similar objectives: to promote exports, to make long-term funds available at relatively low cost to finance business fixed investment (primarily heavy industry), to build infrastructure (power, water, transport, communications) ... All three countries grew rapidly while repressing their financial system, so it was easy to believe that these policies were having the intended positive, causal effect. (1994: 334)

Hence, the principal message from the foregoing detailed quotations from varied sources seems obvious: development banks were the Asian economies' pragmatic response to speed up domestic investment for rapid industrialisation. They helped overcome the missing and imperfect markets for long-term finance. Their operations were kept off the public gaze, by keeping them outside the normal budgetary process.

Governance Issues

Reimagining development banks would, however, have to contend with the earlier criticisms of misallocation of resources and poor accountability due to political and bureaucratic meddling, as was evident from rising NPAs and industrial sickness, giving rise to the popular quip: "Industries (or firms) get sick, but industrialists prosper!" The recent corruption scandal that has engulfed Brazil's BNDES—the world's largest development bank—is a cautionary tale in this respect (Leaty 2015).

There seems to be no getting away from the governance issues that often bedevil such an institution. The idea that well-functioning and regulated markets result in the desired financial discipline on the participants has now been widely belied, as the reforms are found to be business-friendly than market-friendly (Kohli 2006). With the rise of crony capitalism and pro-business reforms, many a cynic might contend that state capitalism (of the earlier era) has been replaced by crony capitalism lately—with far less public accountability and transparency (*Economist* 2014a, 2014b). To appreciate the import and magnitude of the change, one only has to try figuring out the structure of large PPP contracts—with enormous opacity in their ownership and control, carefully designed to keep them off the regulatory gaze.

Therefore, the potential criticism against reimagining the role of development banks cannot be simplistically posed as reverting to state intervention in financial markets, but as a practical response to the felt needs of finding low-cost, long-term resources to overcome critical development bottlenecks. There would be a need to devote considerable attention to development banks' institutional design—in terms of ownership, control and public oversight—to built-in checks and balances to ensure managerial autonomy, yet maintaining room for independent and credible reviews and audits.

Perhaps a way to go about designing a development bank is to have multiple "owners" with overlapping governance jurisdictions over the institution. Such an arrangement could, in principle, allow for a wider disclosure of information to multiple owners with varied perspectives, without any single "principal" dominating the governance structure, thus leaving greater functional autonomy to the institution. Importantly, the yardsticks for a development banks' performance need to be development or strategic goals, not mere financial targets and profits.

Conclusions

The RBI's "Discussion Paper on Wholesale and Long-term Finance Banks" is a welcome initiative, as the concept seems similar to development banks. Perhaps the proximate reason for the initiative is the poor domestic investment climate, as commercial banks are saddled with mounting NPAs caused by lending for private corporate infrastructure investment during the boom years.

Historically, development banks have played a crucial role in overcoming low domestic savings rates and the lack of well-functioning capital markets in most successful late-industrialising economies of continental Europe and Asia. Ample support exists for development banks, in theory and in comparative experience, as briefly discussed in this article.

Theoretically, development banks have a close resemblance to Keynes's concept of a national investment bank as Skidelsky and Martin have shown. When monetary policy is ineffective at interest rates close to zero, Keynes argued for stepping up aggregate demand via a national investment bank to finance long-gestation infrastructure projects.

The critical requirements for the success of development banks are: (i) secure sources of low-cost, long-term funds; (ii) public ownership and/or management; and (iii) quality of institutional governance. The sources of funding for development banks vary across countries, but

their underlying principles, and their overarching objectives have remained the same. Development banks necessarily incur quasi-fiscal costs, and they are mostly kept off-budget to insulate their investments from budgetary bargaining.

After the dissolution of ICICI and IDBI in the late 1990s, bank credit tenor expectedly declined. Several attempts to recreate development banks under PPP without a secure source of funding met with little success. The IDFC—perhaps the most serious effort in this direction—got converted into a commercial bank in 2015. With the corporate debt market failing to take off, it is perhaps imperative now to take a fresh look at the problem—which probably is the subtext of the RBI's discussion paper. If policymakers accept the idea, details of the proposed development bank could be worked out by examining quantitatively the capital requirement, the feasibility of alternative sources of financing it, and designing its governance structure—drawing upon the Asian experience.

However, the critical challenge in reimagining development banks would be to avoid past mistakes, and have built-in checks and balances in its governance structure to safeguard managerial independence without compromising on the need for periodic, independent public scrutiny.

NOTE

1 The report said: "The first major issue that arises for consideration in any contemplated reform package is ... the examination of the continued relevance of the DFIs in the contemplated scheme of things. As industrial development proceeds, the economy acquires greater sophistication ... the need for specialised financial institutions focusing their attention on a promotional developmental role is likely to diminish, though it should be added that in the present stage of development of the Indian economy *this situation has not arisen. There is, therefore, a significant role to be played by the DFIs in the acceleration of industrial development and hence their continued relevance*" (emphasis added) (Reserve Bank of India 1991: 70).

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