

8

DFIs IN TRANSITION— THE INDIAN EXPERIENCE

—A. P. PATI

The financial sector in India is in the midst of important structural changes. The initiation of reform process since early nineties has brought competition into force. The liberalisation-privatisation - globalisation combination has transformed the protected economy into a more vibrant, open and dynamic one. The metamorphosis has shown better prospects for growth rate through new opportunities, but side by side it has posed formidable challenges to the different constituents of financial system. The competitiveness in the financial system has put pressure on financial institutions to adopt and innovate. And as a major constituent of financial system the development banks, popularly known as development financial institutions (DFIs) have also experienced lot of changes. Further, the impact of the change on DFIs has been magnified by the globalisation of international financial markets, and by radical changes in information technology. These changes have made far-reaching impact on different functional aspects of DFIs; like resource mobilisation, product diversification, business strategy, disclosure norms etc. DFIs have started reorienting their operational goals and strategies to meet these challenges.

Considering the above transformations, in this article an attempt has been made to examine the impact of on going reform process on DFIs and how they have responded to these changes. In this article DFIs mean industrial DFIs operating at national level like Industrial Development Bank of India (IDBI), Industrial Financial Corporation of India (IFCI), Industrial Credit and Investment Corporation of India (ICICI), Small Industrial Development Bank of India (SIDBI), and Industrial Investment Bank of India (IIBI).

THE GENESIS OF INDIAN DFIs

In India, the humble beginning of industrial DFI started with the establishment of IFCI in 1948 to give a shape to the shattered economy left by British's. It was the first DFI after Independence. It was established because normal banking accommodation was inappropriate and the recourse to capital issue methods was impracticable. It was conceived as a public institution controlled by the Government of India. After IFCI, ICICI came into existence in 1955 as a private sector DFI with the help of World Bank. ICICI was created to channeling the foreign currency loan to the Indian industries. In 1964, IDBI was established as a wholly owned Government enterprise to function as the apex financial institution in the capital market so far as term lending to industries is concerned. It was established to supplement the activities of the existing development banks and also to provide dynamic leadership in the task of promoting a widely dispersed and diversified and yet viable process of industrialisation (Bhatt, 1974). After IDBI, IRBI came into existence in 1985 to look after the rehabilitation of sick and closed industries. But with the functioning of BIFR i.e. Board for Industrial Financial Reconstruction, it became a full-fledged term lending institution at par with other institutions in 1997 and renamed as (IIBI). The latest addition to this was SIDBI in 1990, came into being as a wholly owned subsidiary of IDBI, to

look after small scale industries. Besides, these national level DFIs, many DFIs like State Financial Corporations (SFCs), State Industrial Development Corporations (SIDCs) etc. came into existence in sixties and seventies.

THE ROLE AND FUNCTIONS OF DEVELOPMENT BANKS

As discussed in various literature development banks are the institutions to promote and finance enterprise in the private sector (Diamond, 1957). These are institutions, public or private, which have one of their principal functions, as the making of medium and long-term investment in the industrial projects (Boskey, 1959). These are financial intermediaries supplying finance to economic development of projects and providing related service (Kane, 1975). Development banks have two functions to perform i.e., banking and development. As banker the development banks are expected to finance those projects which are "Bankable" (Hook, 1976). A development bank must be an organic body that acts its appropriate place in the economy and create a proper image for itself with government, industry, agriculture and other sectors that serves.... The most important function of a development bank is to assist the process of development and the criterion of success is the extent to which it helps the process of the development of resources: human, material, regional and financial (Demissie, 1985).

These above observations revealed the pervasiveness of the nature of a development bank. The range of service varies from provision of medium and long-term loans to project appraisal and managerial and promotional assistance. However, despite their diverse nature, they have been devised to provide, at least a few if not all the fundamental ingredients of economic development, the lack or inadequacy of which may be inhibiting an accelerated pace of progress. Thus, a development

bank is intended to provide the necessary capital, enterprise, managerial and technical know-how where these are inadequate or non-available and also assist in building up the financial and socio-economic infrastructure, favourable to quick economic development (Basu, 1965).

CHALLENGES POSED TO INDIAN DFIs

In the present transitional phase Indian DFIs have changed their perception of business. DFIs are now driven by commercial objectives and market forces. The role of a development financier has been modified to a great extent in response to new challenges. Besides India there are other examples, such as the Development Bank of Singapore (DBS), the Korea Long Term Credit Bank (KCB), the Industrial Financial Corporation of Thailand (IFCT), and the China Development Corporation (CDC) (Diamond, 1989).

The various areas where DFIs have found new challenges are:

Resource Mobilisation

One of the challenging aspects of Indian DFIs is resource mobilisation. Their success and failure depend on the ability to cope up with the growing needs of the industry and the overall economy and as a corollary to this it is necessary on the part of DFIs to have adequate resources. Raising resources at a cheaper rate has become a cause of concern for them. Particularly, after the phasing out of Govt. guaranteed bonds (SLR Bonds) and drying up of low-cost Long-Term Operation (LTO) funds from RBI, DFIs are raising funds at market related rates. In this way, DFIs have been forced to go both domestic and international markets. They have also started raising short-term loans subject to certain conditions. Amidst these changes the average cost of fund has become more which ultimately affected the net margin (Table 1). The low rate of margin reveals the complexity of the environment and really these years have been a crunch time for DFIs. However,

DFIs have managed to live in this type of situation. During the later part of nineties many of them have issued rupee bonds to Indian public like Deep Discount Bonds and Flexi Bonds by IDBI, Family Bonds by IFCI etc. IDBI and ICICI have also made forays into foreign market with issue of Floating Rate Notes (FRNs) in European markets and Global Deposit Receipts (GDR) issues by ICICI. Recently, ICICI has listed in NYSE with an American Depository Receipt (ADR) of \$100 million as the first Indian DFI. The mobilisation of resources at market related rates forced DFIs to innovate new products/services and to shift from developmental objective to commercial objective.

Product Diversification

The nineties have envisaged the keenness among the DFIs to provide wide range of products and services to the clients. New products have become more fee-based than fund based. The existing fund based products have been basically channeled to infrastructure and sunrise industries with high growth potential like pharmaceuticals, information technology, food processing etc. However, the focus has been more on non-project finance like equipment leasing, bridge loan, short-term loans, underwriting, guarantees, direct subscription to equity and debentures, corporate loans, asset credit, venture capital finance etc. Table-2 reveals the shift of activities in the DFIs. Till the end of 31-03-1990 the share of project loan was 48 per cent but during the last five years it has grown to around 55 per cent on an average. Similarly, the underwriting and direct subscription has made a quantum jump from 1.8 per cent to an average of 10 per cent during the same period. On an average 5 per cent of total disbursement made through short-term and bridge loan which was nil till 1990. Among the fee-based services merchant banking, debenture trusteeship, forex services, financial restructuring, mergers and acquisitions, project counseling, credit rating, retail banking etc. These

activities are either carried on directly by DFIs themselves or by their subsidiaries (Chart-1). The IDBI and ICICI have also entered into new areas of business like commercial banking. Both of them have also tied with international insurance companies for insurance business in India. In 1996 ICICI even went one step ahead by establishing I- CREDIT, a non-banking finance company to create wide retail network to enter new areas like financing of automobiles, consumer durable, vendor lending and factoring services (IDBI, 1998-99). Thus it is found that the product portfolio has been restructured by DFIs for focused attention so that the deployment of scarce resources will properly fit to the market demand.

Shift in Basic Objectives

One of the important features of a development bank relates to the purpose for which funds are made available by it. The accent of these banks is on development so that its purpose is the provision of 'development finance', that is finance for new real investment on fixed assets (Om Prakash, 1957). By following an appropriate location policy, while assisting projects, they could help in reducing regional imbalance. In the initial years it was found that DFIs in India were disbursing almost 50 per cent of their assistance to backward areas. Till 1990 as shown in Table-2 the share of backward area was above 40 per cent. But during the recent years it has been gradually declining and reached merely at 26 per cent in 1996-97. It has also been found that a substantial portion of the assistance to the backward regions continues to flow to a small number of backward regions located conveniently nearer to the metropolitan or urban centers and having reasonably good infrastructure facilities and communications (Dave, 1983). Thus it seems that DFIs, are only interested in commercially attractive investments. It is also a fact that after the recommendation of the first

Narsimham Committee Report in 1992 to close the refinancing window, IDBI had made an attempt to do that. But the protest from SFCs and SIDCs halted that move. It is also a fact IDBI is saddled with refinance and lending commitments of thousand crore of rupees to SFCs which do not yield competitive returns. Table-2 reveals that till 1990 refinance was more than 38 per cent in total disbursement, which has gradually fallen down to around 8 per cent in 1998-99.

Prudential Norms

A major element of the financial sector reform in India has been the application of prudential norms and regulations introduced in 1992 aimed at ensuring safety and soundness of the financial system and at the same time encouraging markets to play increasing role. Prudential norms serve two primary purposes—first they reveal the true position of the bank's loan portfolio and secondly, they help arrest its deterioration. These norms introduced in India relate to income recognition, asset classification and provisioning for bad and doubtful debts and capital adequacy (RBI, 1997-98). Since 1993 Indian banks are required to adopt Basle Committee norms on capital adequacy by maintaining 8 per cent capital on the risk-weighted assets. But as per the acceptance of RBI, on the basis of the recommendation of Narasimham Committee Report II, now they have to maintain 9 per cent capital adequacy ratio by March 2000. Table-3 depicts the CAR of DFIs, which shows a declining, trend in last 3 years. This indicates that DFIs have to infuse more capital in future to maintain a comfortable ratio.

The quality of asset is also an important factor, which can not be ignored. The menace of non-performing assets, which reflects the asset quality, is a worldwide phenomenon. NPAs are nothing but the reflection of the economy and its performance. If the economy performs well, NPAs will be

less whereas NPAs tend to rise in a recessionary environment. Table-3 reveals a high percentage of assets are in the category of NPAs i.e. substandard, doubtful and loss assets. Among the DFIs, SIDBI has the lowest NPAs, whereas others have more than 10 per cent. Since any NPA is bad, such a high percentage is definitely alarming for DFIs. A high quality of credit management skill is necessary prerequisite for protecting DFIs' assets from contamination. To tackle the growth of NPAs a comprehensive package of measure is required of all parties involved- DFI management, governments and central banks, as well as DFI creditors, which in most cases are multilateral development banks (Golan, 1988). At the individual level there is need of establishing a separate cell to exclusively handle the problem of distressed borrowers and to set up portfolio management system. Thus DFIs should make adequate provisions for bad and doubtful debts, as well as reflect realistic income flows by not accruing interest on such debts. This would provide a cleaner picture of their capital structure and cash flows (IDBI, 1996-97).

Spawning new institutions in Capital Market

The role of DFIs in nurturing Indian capital market through underwriting, direct subscription etc. needs no elaboration. They are also helping the new assisted units through these activities. As shown in Table-2, till 1990 the share of under writing and direct subscription was only 1.8 per cent in total disbursements of DFIs. But in recent years it has increased to 12.2 per cent, which indicates the growing participation by DFIs in capital market. The DFIs also initially undertake and subscribe to the equity capital became the suppliers of industrial securities to the market which include both personal investors and saving institutions. This development helped greatly to develop the secondary market by augmenting greatly the volume of trading on the stock exchange (Parekh, 1984). Simultaneously DFIs in India are

also actively participating in sponsoring new institutions in capital market. In 1992 Securities and Exchange Board of India (SEBI) was established with active participation of DFIs to monitor the capital market activities and provide safeguard to investors. Similarly, in 1993 National Stock Exchange (NSE) was established for upliftment of debt/equity market through nation-wide screen based trading system. The much needed National Depository Limited was also came up in 1996 which usher an era of scripless on-line screen based trading with the help of IDBI and others.

Universal banking

In the post-financial sector reform era the DFIs in India have been gradually reorienting their focus from mere development banks to universal banks. The deregulation of interest rates, disintermediation and increasing participation by commercial banks in project finance has significantly altered the traditional operating environment for DFIs. Recently, they have entered into the realm of working capital or short term financing by breaking the "great divide" between commercial banks and DFIs. After the drying up of govt-guaranteed bonds and LTO funds from RBI, DFIs have targeted the same segment of commercial banks i.e. household sector. They are vying for lifting the ceiling on raising short-term funds from the market and remove the restrictions so as to bring them par with commercial banks. On the other side commercial banks are demanding statutory reserve requirements on DFIs in relation to short-term funds. This indicates that gradually the gap between them is narrowing down in both the fields of resource mobilisation and resource deployment. The Second Narasimham Report, 1998 and S.H. Khan, Working Group on harmonising the roles of banks and financial institutions, 1998 have recommended for convergence of activities between DFIS and Banks over a period of time which will be a gradual move towards universal banking (RBI, 1998).

VISION FOR TOMORROW

It is envisaged from the fact that Indian economy will continue to grow at a faster pace because the economy has shown resilience during the political instability phase. The growth will much faster when second phase of reform take a concrete shape. In the coming years it is thus expected that financial sector vis-a-vis the DFIs will undergo greater metamorphosis. The emphasis on commercialisation of activities will further dominate the developmental objectives of these DFIs. Developments like leasing of own assets, factoring of loan, merger and acquisitions among DFIs and commercial banks, issue of commercial papers, collaborations with commercial banks, loans to borrowers with profit sharing features etc. will take place. And most likely the information technology will dominate the operational activities. Networking of some of the key branches would be a vital area of importance. And in this process of transformation clearly the fast-movers will be always in the advantageous position. Among the DFIs in India ICICI is rising at faster rate than others. Perhaps the advantage of being in private sector helping it in quick decision making and to venture into new business.

REFERENCES

1. Bhatt, V. V., "A Decade Performance of IDBP", *Commerce*, Annual Number, 1974, p.151.
2. Diamond, William., *Development Banks*, Baltimore, John Hopkins Press, 1974, pp.4-5.
3. Boskey, Shirly., *Problems and Practices of Development Banks*, Baltimore, John Hopkins Press, 1959, p. 9.
4. Kane, Joseph. A., *Development Banking*, Laxington Books, D.C. Heath and Company, 1975, pp. 14-15.

5. Hook, J.T.D., *Financing and Problems of Development Banking*, New York, F. A. Prager Publisher, 1976, p.2.
6. Demissie, Asfa. "The Role, Function and Purpose of Development Banks", *The International Journal of Development Banking (IJDB)*, ICICI, Bombay, Vol.3, January 1985, pp.43-44.
7. Basu, S.K., *Theory and Practice of Development Banking*, Bombay, Asia Publishing House, 1965, p. 1.
8. Diamond, William, "Agenda for Development Financing in the 1990s", *ADFIAP Journal of Development Finance*, Asia-Pacific, December-89. pp.11-18.
9. Om Prakash, "Industrial Development Corporations in India and Pakistan", *Economic Journal*, Vol.1, No. xviii, 1957, p.40.
10. Dave, S. A., "Challenges of Development Banking", S.K. Monoranjan Memorial Lecture Delivered in Sydenham College of Commerce and Economics, 15-12-1983, Bombay.
11. IDBI, *Report on Development Banking*, 1996-97.
12. RBI, *Report on Trend and Progress of Banking in India*, 1997-98, p. 32.
13. Golan, Amon, "The World Bank Perspective", *ADFIAP Journal of Development Finance*, Special Issue, October 1988, p.9.
14. Parekh, H.T., "Development Finance: Retrospect and Prospect", *IJDB*, Vol.2, No.1, January 1984, pp.35.
15. RBI, *Supplement to RBI Bulletin*, November 1998, p.29.

Table 1
Average Cost of Fund

Year/DFIs	(In%)				
	IDBI	IFCI	ICICI	SIDBI	IIBI
1994-95	8.1	9.5	9.1	10.0	10.0
	<i>3.2</i>	<i>6.2</i>	<i>4.2</i>	<i>3.9</i>	<i>2.1</i>
1995-96	8.4	10.8	9.2	10.2	8.8
	<i>3.7</i>	<i>6.9</i>	<i>3.9</i>	<i>3.9</i>	<i>1.0</i>
1996-97	8.9	12.9	9.5	10.4	10.5
	<i>3.7</i>	<i>5.7</i>	<i>4.0</i>	<i>4.2</i>	<i>3.7</i>
1997-98	8.7	11.5	9.8	10.2	10.6
	<i>3.9</i>	<i>4.4</i>	<i>4.2</i>	<i>4.2</i>	<i>4.8</i>
1998-99	9.0	11.7	10.1	10.5	10.3
	<i>2.6</i>	<i>2.4</i>	<i>3.9</i>	<i>3.5</i>	<i>3.6</i>

Note: Figures in italic indicate net margin of DFIs.

Source: IDBI, Report on development banking in India, 1998-99.

Table 2
Share in total disbursement of DFIs

Year/Item	In%				
	Project Loan*	U'writing & D. Sub	Bridge/ST Loan	Backward Area Fin'g	Refinancing
1992-93	52.3	2.6	10.3	34.1	13.5
1993-94	46.6	4.7	15.1	30.0	12.4
1994-95	41.5	11.3	23.3	31.9	8.5
1995-96	59.7	10.0	4.5	32.3	9.9
1996-97	55.0	5.9	1.8	26.0	6.8
1997-98	60.6	13.7	8.2	NA	7.1
1998-99	60.9	12.2	5.3	NA	7.6
Till 1990	48.0	1.8	-	43.7	38.6

*Project loan includes Direct Rupee Loan and Foreign Currency Loan.

Source: IDBI Report on Development Banking in 1989-90, 1994-95, and 1998-99.