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Financing reindustrialization: bring back development banks

Commercial banks simply do not have the capability to assess credit risk on long-term investment lending because they have always been engaged in advancing short-term working capital

DEEPAK NAYYAR
is emeritus professor of economics, Jawaharlal Nehru University, New Delhi. He served as chief economic adviser, government of India, from 1989-91, and as vice-chancellor, University of Delhi, from 2000-05.

ABHIJIT BHATLEKAR/MINT

Many commercial banks in India are under financial stress. This has imparted a fragility to the banking system as a whole. Scams and scandals surface from time to time, making headline news. There is also a quiet crisis that runs deep. It is not audible yet. But it is mounting, since recurring failures of regulation or governance have not led to any accountability or corrective action. Some erosion of confidence is no surprise. If the problem continues to be neglected, a trust deficit could develop over time.

The fundamental problem is the non-performing assets (NPAs) of commercial banks. An asset becomes non-performing when it ceases to yield any interest or income for the bank. Simply put, it is a bad loan. Such NPAs are rising rapidly. This rise is partly a consequence of the far more rigorous asset quality review by the Reserve Bank of India (RBI) based on its income-recognition and asset-classification norms. The RBI financial stability report shows that for all commercial banks, gross NPAs as a proportion of total assets were 9.6% in March 2017 and an estimated 10.8% in March 2018. For public sector banks, these proportions were higher at 11.4% and 14.5%, respectively. The problem is obviously serious in public sector banks. Even if private sector banks fare better, they also have the same problem. Hence privatization is no solution. The systemic problem of bad loans needs to be addressed.

The underlying factors are common. Lending at political behest plagues public sector banks but private sector banks are not immune either. Lending could be driven by corrupt behaviour if bank managers collude with corporate borrowers to collect margins for themselves without assessing risk before extending bad loans. Lending could also be inept if bank managers do not have the ability to assess risk or do not exercise due diligence. These reasons have always existed. The problem is not new. It has just grown rapidly over the past decade.

Until the early 2000s, development finance institutions (DFIs) had done much of the lending to corporate entities for investment in the manufacturing or services sectors. These began winding down in 2000 and were closed down in 2005. For a while, companies used retained profits or cash reserves, before turning to external commercial borrowing, the domestic bond market, or equity markets as sources of finance. It was not long before borrowing from commercial banks emerged as an important alternative source of corporate financing. Apart from behest, corrupt or inept lending, some systemic problems arose. Commercial banks simply did not have the capability to assess credit risk on long-term investment lending because they have always been engaged in advancing short-term working capital. Moreover, commercial banks were caught in a maturity mismatch, because they borrowed short from depositors but had to lend long to investors.

In countries that are latecomers to industrialization, this role has always been performed by development banks, which meet the investment financing needs of new firms in underdeveloped manufacturing sectors that are not met by capital markets or commercial banks because, in their calculus, the risk is too great. Starting around 1950, this model was adopted not only by several underdeveloped countries in Asia and Latin America seeking to industrialize, but also by Germany and Japan, which were seeking to reconstruct their economies. India was a pioneer in establishing DFIs, its equivalent of development banks elsewhere, to kick-start industrialization.

There were three components in this process: long-term-lending institutions that were nationwide, institutions for the states, and what came to be described as investment institutions.

The term-lending institutions were the Industrial Finance Corporation of India (IFCI), Industrial Credit and Investment Corporation of India (ICICI), and Industrial Development Bank of India (IDBI), established in 1948, 1955 and 1964, respectively. The essential objective of these national institutions was to provide long-term finance for private investment in the industrial sector, with funds from the Central government and RBI on concessional terms.

State financial corporations (SFCs) and state industrial development corporations (SIDCs) were set up in the 1950s to provide long-term finance for small and medium enterprises in the manufacturing sector of respective states, with funds from their respective governments on concessional terms.

The third component, investment institutions, was unusual in this role. It was made up of Life Insurance Corporation of India (LIC), Unit Trust of India (UTI) and General Insurance Corporation of India (GIC), established in 1956, 1964 and 1973, respectively. These institutions raised finances by mobilizing the savings of households, by spreading insurance habits, and by opening up avenues of higher returns on the financial savings of individuals. Obviously, their sources of finance, either households or individuals, were mostly small savers. The provision of long-term development finance, in the form of loans or equity, emerged as a secondary objective for these institutions, almost as a corollary. The nature of their business resolved the problem of maturity mismatches, while their ownership by the government made it a potential source of industrial finance.

In retrospect, it is clear that these DFIs made a significant contribution to the provision of industrial finance in India. As a proportion of gross fixed capital formation in the manufacturing sector, their total disbursements rose from one-tenth in 1970-71 to half in 2000-01. The public sector relied on resources allocated by the government to finance its investment. Hence, this lending was almost entirely to the private sector. Total disbursements, as a proportion of gross fixed capital formation in the private sector, rose from one-fourth in 1970-71 to three-fourths in 2000-01. In the absence of these institutions, such levels of private investment in the industrial sector would have been difficult to finance from alternative sources. The counterfactual is important. It shows that their contribution was essential. Some of it served a strategic purpose in kick-starting manufacturing sector activities and supporting innovative lending to an emerging services sector.

There were limitations too. Sometimes, the process of due diligence for extending loans was limited or incomplete. On occasions, even the debt servicing capacity of the borrower was not reviewed or monitored after the loan had been provided. Similarly, where the lending or investment institutions acquired equity in manufacturing firms, which entitled them to place their nominees on boards of directors, their role was often that of silent partners, essentially preserving the status quo rather than protecting the interests of the institutions they represented.

In addition, there were errors of omission. Infrastructure was excluded from their portfolios. By the time this was corrected, it was too little, too late. There was almost no coordination between their lending and industrial policy objectives or priorities, so there was no preferred access for pharmaceuticals, clothing, two-wheelers, auto components or information technology.

There were errors of commission as well. DFIs provided preferential access to some entrepreneurs, firms or business houses, so that the allocation of resources was shaped by the borrowers rather than the lenders. The DFIs and the government were both responsible for the behest lending that often led to bad loans. The most serious error of commission by the government was the deliberate winding down and premature closure of DFIs. ICICI and IDBI were turned into commercial banks. SFCs and SIDCs stopped such lending. Investment institutions never had this formal mandate, and, except for LIC, withdrew from such lending.

The shutdown of development finance institutions was a mistake, because their role was necessary and could not be dispensed with

The role of development banks was diluted during the early 2000s, not only in India but also in other developing countries. This was attributable to the progressive withdrawal of concessional funds made available by governments, which in turn was an integral part of deregulation and reform in the financial sector almost everywhere. It was hoped that the evolution of domestic capital markets would enable commercial banks to enter into long-term lending. This dilution did not happen everywhere. There were exceptions, such as Brazil and Korea in the developing world, or Germany and Japan among industrialized countries. In fact, the China Development Bank was established as late as 1994, and it performed a critical role in the industrialization surge that began in the mid-1990s. Between 2000 and 2010, the outstanding loans of development banks as a percentage of gross domestic product dropped from 7.4% to 0.8% in India, but rose from 6.4% to 9.7% in Brazil and 6.2% to 11.2% in China, and declined from 8.6% to 6.8% in Korea, while this proportion rose from 8.5% to 15.9% in Germany and from 3% to 7.2% in Japan.

The shortcomings of DFIs in India, highlighted above, obviously needed correctives. But their shutdown was a serious mistake, because their role was necessary and could not be dispensed with. It simply passed on the burden to commercial banks, not equipped for the task, which have accumulated NPAs as a consequence.

The time has come to establish a National Development Bank (NDB) in India. Such a new institution would start with a clean slate, without any baggage from the past. It must incorporate lessons from our past experience with DFIs to eliminate errors of omission and commission. It is just as important to introduce institutional control mechanisms that were missing from the conception and design of the erstwhile DFIs. Thus, it is essential to have an institutionalized system of checks and balances that can prevent collusion between governments and firms, or between development banks and firms, to capture rents by imposing discipline on the self-seeking behaviour of any one stakeholder, or even two stakeholders who wish to collude, by other stakeholders. The design and blueprint will need careful thought.

At this juncture, an NDB is both necessary and desirable. It would help reindustrialize India. It would also de-stress commercial banks.

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