CHAPTER - I

HISTORY OF DEVELOPMENT BANKING
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INTRODUCTION:

Walter Bagehot was right when he said that 'money will not manage itself'. In such a situation, the role of financial infrastructure in sustaining and promoting economic growth is well recognised. A network of financial institutions helps in efficient utilization of available investible resources. The vital question is: Should it be allowed to grow as a natural consequence of industrial growth where enterprise leads it or it should lead the enterprise per se planning? India, injected with socialist virus, choose the latter course in its endeavour to bring about structural transformation in the economy from agro-dominant to industrialised economy with a diversified industrial pattern with small, medium and large industrial units leading to wide dispersal of economic power through a mix up of public, private and joint sectors supported by suitable fiscal and monetary measures.

TERM FINANCING INSTITUTIONS IN INDIA:

A well-knit structure of term financing institutions, at the national and State levels, meets the
vital long-term financial needs of the growing industrial sector in India. At the national level, there are eight institutions, viz., Industrial Development Bank of India (IDBI), Industrial Finance Corporation of India (IFCI), Industrial Credit and Investment Corporation of India (ICICI), Life Insurance Corporation of India (LIC), General Insurance Corporation of India (GIC), Unit Trust of India (UTI), Industrial Reconstruction Bank of India (IRBI) and Export-Import Bank (EXIM Bank). These institutions cater to the term financial requirements of large scale units. The long-term financial requirements of small and medium scale industrial units are met by eighteen State Financial Corporations (SFCs), twenty six State Industrial Development Corporations (SIDCs), and commercial and co-operative banks with their extensive network of branches. A chain of Technical Consultancy Organisations (TCOs) sponsored by IDBI, IFCI and ICICI provide consultancy services to small and medium enterprises.

The significance of the state intervention in the market to give the desired direction to the economy has been accepted in the parlance of economic theory since the days of Adam Smith. But, the advance of Marxism, the 'great

depression' of the thirties and the vanishing colonialism are the three significant developments in the first half of the twentieth century which have brought about revolutionary changes in the scope of state authorities in economic sphere. The myth on full employment equilibrium had explored and Keynes gave a new direction to capitalism to face the new challenge. The doctrine of Laissez Faire was 'dead even in the countries where people talked about it must.' Writing about the future of the industrial system Prof. Galbraith has observed, "Given the deep dependence of the industrial system on the state and the nature of its motivational relationship to the state, i.e. its identification with public goals and the adaption of these to its needs, the industrial system will not long be regarded as something apart from government. Rather, it will increasingly be seen as part of a much larger complex which embraces both the industrial system and the state."³

BANKING SYSTEM AND ECONOMIC DEVELOPMENT:

In this context, the banking system of an economy has a special role to play. Schumpeter was of the view that

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credit is 'a phenomenon of development' and he considered the banking system along with entrepreneurship as being the pivotal agent in the process of economic development. The banker placed at the disposal of the entrepreneur the purchasing power which enables him to secure command over physical resources and thus push through his investment projects. Once the investment results in the increased production, the initial credit inflation disappears and the equivalence between money and commodity stream is restored. According to him, the credit created by the bank "enables the entrepreneur to proceed with his innovations in anticipation of savings".  

Gerschenkron's analysis also supports the view that the role of banking in economic development is not a passive or permissive one. Whether it makes a positive contribution in igniting the process of growth depends upon how banking policies are pursued and the pattern of evolution of the banking structure.  

Gurley and Shaw in their work have elaborately explained the role of banks in financial intermediation and the related aspects if widening the

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spectrum of financial assets available to the community in the process of development.\textsuperscript{6}

Both Kalecki and Keynes agreed with the above point of view and regarded the availability of finance as a key factor in ensuring independence of investment from saving. They regarded bank credit as a form of anticipated savings. Keynes stated categorically that the credit or finance required by ex-ante investment is not mainly supplied by ex-ante investment is not mainly supplied by ex-ante savings. He also writes, "It is to an important extent, the financial facilities which regulate the pace of new investment..... But if the banking system chooses to make the finance available and the investment projected by the new issues actually takes place, the appropriate levels of incomes will be generated out of which there will necessarily remain over an amount of savings exactly sufficient to take care of the new investment."\textsuperscript{7}

The arguments of Schumpeter, Kalecki and Keynes underestimated the time required for initial investment.

supported by increase in bank credit to result in necessary increase in income. They also ignored that investment themselves may be faulty and might not always increase income. This is more true in case of under-developed economies where huge capital investments are made on infrastructure and heavy basic industries. The recent experience in a large number of countries indicates that this method of initiating development through bank money has serious limitations and does not generate sustained growth. The initial credit inflation, instead of dying away, produces sustained inflation. This is, however, not to deny that the financial institutions can play a positive and catalytic role in economic development.

Hence, a distinction is drawn between the two types of development in relation to the growth of bank finance and financial infrastructure.

DEMAND FOLLOWING FINANCE:

Under this scheme, as trade and industry expand, the financial services needed by them are made available by the financial institutions. Thus, the growth of financial institutions is a consequence of industrial growth and finance follows where enterprise leads. It can be illustrated
with an example from our own country. Much of the banking development in India, prior to 1969, had been of this type. The commercial banks were associated with one or the other business house.

**SUPPLY LEADING FINANCE:**

In the supply leading scheme of finance, the financial institutions come into existence first. The provision of necessary financial services acts as a stimulant to economic development. But, this is possible only in those countries where the policy of State intervention exists. The banking development in India since the nationalisation of 14 major commercial banks in 1969 has been of this type.

Of these two types of finances, the latter one is more important in under-developed countries although it leads to inflation in the short-run. No doubt, consequently, the demand following finance will automatically increase in the long-run. Therefore, we shall be mainly discussing in this research project the problems relating to supply leading finance.

In the light of these development in economic thought, a number of developing countries set up special type
of institutions to provide the basic prerequisites for industrialization so that they may have rapid and smooth growth. These institutions differ widely in matters of their organisations, management and functions. In most of the cases, these institutions have come into existence wholly as a result of State effort, in some other cases they have come up as joint venture and in a few cases they are purely private institutions. Such institutions have come to acquire the name of 'development bank'.

**DEVELOPMENT BANK - WHAT IT IS:**

There is no finality as yet about the model of a development bank. These are diverse in their form and activities. At some places they are working as one of the departments of their Central Bank or the Government. In some cases, they shoulder the entire responsibility of the development plan of the economy whereas in some other cases they are designed to explore and exploit certain mineral resources only. In some countries they are exclusively meant for providing finance whole in some other countries they participate in equity capital and are also engaged in promoting and managing companies. The structure of a development bank will be greatly influenced by the social, political and economic milieu of the country where it
operates. Even then, there is something in common with the structure and functioning of all such banks. Diamond has defined a development bank on the basis of these commonalities in the following words:\(^8\)

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\text{Development bank is an institution to promote and finance enterprise in the private sector (emphasis added).}
\]

This definition is deficient in the sense that it fails to highlight the role of development banks in the mixed economies which is the popular model in the under-developed countries. The development banks act not only as the financiers of the private sector projects but they have to provide promotional and other related services as well. To the extent that development banks are involved in financing long-term industrial capital formation, the system of development banking is not unique. This role was earlier played by investment banks in the development of today's industrially advanced countries. Development banking in the second half of the twentieth century, thus parallels the investment banking of the nineteenth century in many ways. It is its focus and institutional arrangement which makes development banking unique. Particularly, it is oriented not

only towards free-economy and private sector dominated philosophy, it finances long-term capital formation in a manner directed and regulated in accordance with the development priorities of the country. The twentieth century development bank combines the functions of banking and development institutions. It is the promotional aspect of the functions of a development bank which makes it a real catalyst of development rather than a conduit of financial resources. Moreover, a development bank does not discriminate between the projects of private sector or public sector.

In the light of these two objectives, a development bank finances both profit oriented and development oriented projects since it functions as a banking as well as developmental institutions. Therefore, a development bank would invest in those development projects from which it is able to recover and revolve its fund without impairment. Thus, a development bank may be defined as:

A private and public institution, which provides promotional services and medium and long-term finance to public or private projects, which are development (economic) oriented and bankable.

10. Ibid., p.48.
Here it becomes necessary to distinguish between a development oriented project and a bankable project.

A development oriented project is that which fulfils one of the following objectives generally laid down by the governments of developing countries:

(i) helps the rapid economic growth and industrialization of the economy to create necessary climate for all-round development;
(ii) earns return on investment and thus generate resources for development;
(iii) promotes redistribution of income and wealth;
(iv) creates employment opportunities;
(v) promotes balanced regional development;
(vi) assists the development of small scale and ancillary industries;
(vii) promotes import substitution and helps in earning foreign exchange for the economy.

On the other hand, a bankable project is a self-financing project which generates enough earnings within a given period of time to:
(i) cover the cost of operation once the plan comes into action;
(ii) repay the principal of bank's loan;
(iii) pay the interest charges of the loan and leave a residual profit enough to reduce/induce the entrepreneurs to undertake and remain with the operations.¹¹

This conception of bankable projects, although applicable to some privately owned productive units, is narrow. Commercial banks in most countries, for example, finance a project provided the borrower's earnings, irrespective of the source, are sufficient to cover loan amortisation - principal and interest - according to an agreed time schedule. Development banks can adopt a similar view and define bankable projects broadly.¹²

ROLE, FUNCTION AND PURPOSE OF DEVELOPMENT BANKS:

A development bank must be an organic body that acts and reacts to the needs of its environment. It must strive to find its appropriate place in the economy and create a proper image for itself with government, industry,

agriculture and other sectors that it serves. This is, of necessity, a slow process. A development bank must proceed cautiously particularly during the initial years of its existence when mistakes or false moves can irreparably damage its reputation. The most important function of a development bank is to assist the process of development and the criterion for success is the extent to which it helps the process of development of resources: human, material, regional and financial.\textsuperscript{13}

Human resource development has qualitative and quantitative aspects. The number of new entrepreneurs a bank has assisted is, in itself, important. But of greater significance is the upgrading of the quality of the entrepreneurs that the bank has helped to bring about through improvement in skills, for example, in modern reporting methods and in the acquisition of financial discipline. The training thus afforded by the bank need not necessarily be formally be organised.\textsuperscript{14}

In the field of assisting a project that has become sick lies an important test of a development bank, since this is closely linked to management development. More


\textsuperscript{14} Ibid.
time should be spent than is usual in dealing with the difficult cases, in helping entrepreneurs put their projects back on rails, in identifying whether the problems are managerial, market or entrepreneurial. Managers may have to be removed, entrepreneurs encouraged and markets studied and analysed. These activities are the real test of the capability of a development bank.\textsuperscript{15}

More resources have been wasted as a result of poor management than from any other cause. As Hirschman says, "Among the proximate causes of economic development, the supply of entrepreneurial and management abilities now occupies in official documents a position of pre-eminence at least equal to that of capital."\textsuperscript{16} In developing countries waste has taken place even where companies were managed by foreign personnel. In the long-run, developing countries have to look for managers, who, once, appointed, should be allowed to learn, even at the expense of some mistakes. What has been said of managers holds true of consultants who, more often than not, are partners with machinery producers and/or raw material suppliers. A development bank plays a part in promoting the growth of both managerial and consultative talent through constant advice and assistance.\textsuperscript{17}

\textsuperscript{15}Ibid.
\textsuperscript{17}Asafa Demissie, \textit{Op.Cit.}
The advancement of backward regions in the economy is another area where a development bank can play a vital role. With assistance and co-operation of various government departments engaged in planning, infrastructure development and other services, it can harness human and financial resources for a more balanced growth and a more equitable distribution of developmental activities in the economy.\textsuperscript{18}

In addition to persuading potential investors to examine their projects critically, development banks can protect them from the skillful but unscrupulous salesmanship of foreign suppliers of machinery. They can help investors find suitable foreign partners and assist in negotiations with large multinational companies.\textsuperscript{19}

There are divergent views about the functions, duties and responsibilities of a development bank and no finality has yet been reached about it. There are some who are of the view that it has no function to perform beyond the functions of a bank while there are others who view it as the major promoter of projects. The entire spectrum of the activities in project promotion includes:

\textsuperscript{18} Ibid.  
\textsuperscript{19} Ibid.
identification of projects from an overall economic study of a country through area and sector surveys;
- conducting feasibility studies of projects;
- identifying entrepreneurs to manage the projects;
- undertaking full feasibility studies of projects either on its own or through consultants;
- appraising the feasibility studies and assisting the implementation and execution of the projects.

HISTORY OF DEVELOPMENTAL BANKING:

Development banks reflect the background, situation and needs of the country in which they appear.\(^\text{20}\) Since, Europe was the leader in modern economic development, the embryonic growth of banking as well as development banking emerged first in that region of the world. It started with France. In the French social structure, the businessman had always held an inferior place.\(^\text{21}\) Consequently, he had been trying to earn a respectable social status for himself by imitating the superior groups. Thus, the financial resources of the businessman were diverted towards conspicuous consumption which obstructed the smooth natural


growth of industries in France during the first half of the 19th century. The conditions in other countries of the continent were not much different from that of France. They were confronted with the shortage of capital and other factors of industrialization.\textsuperscript{22} As the birth pangs of the Industrial Revolution were first felt on this continent, these countries witnessed the birth of a number of new institutions and relevant legal codes. Corporate enterprises were born, capital markets developed, and their utilisation in building up overhead facilities (railways, canals and public utilities) provided the base for transforming their economies rapidly.\textsuperscript{23} In this process, the banks on the continent of Europe played an important role.\textsuperscript{24} From this background specialised financial institutions, a prototype of today's development banks, emerged on the European continent during the 19th century.\textsuperscript{25}

The Societe-Generale de Belgique, found in 1822 in Belgium, was the first development bank that came into existence to foster the development of industry. Its principal functions were to promote new industrial units.

\textsuperscript{23} P.N. Singh, Role of Development Banks in a Planned Economy, Vikas Publishing House Pvt. Ltd., Delhi, 1974, pp. 31-41.
\textsuperscript{25} P.N. Singh, Op.Cit.
establish financial subsidiaries and buy a considerable sum of shares of the companies promoted and established by it. The sources of its und were: (a) its own paid-up share capital; (b) saving bank deposits; and (c) sale proceeds of interest-bearing bonds. The Bank promoted many coal mining, railway, and canal companies and formed financial subsidiaries such as the Societe de Commerce Bruxelles, the Societe National pour Enterprises Industrielles et Commerciales, etc.²⁶

The Bank made indiscriminate use of funds. A considerable portion had been invested in unsecured loans. The result was that the Bank involved in serious financial difficulties. In 1851, its investment trust activities were limited and it was directed to pay more attention towards ordinary deposit banking business.²⁷ Thus, inspite of the intention to assist Belgian industrial development, the bank became in essence an ordinary commercial bank.

In France, the specialised institutions like Compteir d'Escompte, the Societe General pour Favouriser 1" Industries et le Commerce de la France and others were

²⁶. Ibid.
established in the mid 19th century. But the most important
was the credit Mobilier which was established in 1852 by the
Pereire brothers. It was through this institution that France
was exporting capital, and industrial and organisational
skills not only to Asia and the Near East but also to
European countries like Austria, Germany, Hungary, Romania,
Serbia, Spain, Switzerland, Italy and even Russia.  

The role of the Credit Mobilier in the economic
development of Europe was considerably great, perhaps the
most important of all its contributions to economic
development was the idea of development and the spirit of
enterprise which was implicit in its conception. Its direct
and immediate contribution to the mise en values of Europe
were considerable, but the indirect and tangible effects of
its activities were of greater importance and more lasting
benefits. The Credit Mobilier closed in 1867 because its
risks of involvement portfolios were not managed properly.

During the period after the Civil War, America
witnessed the growth of corporations as a form of large scale
business organisation. Towards the close of the 19th century,

29. Cameron, "The Credit Mobilier and the Economic Development of
Europe", The Journal of Political Economy, Vol. LXI, No. 6, 1953,
pp. 486-90.
a host of financial intermediaries appeared on the scene to mobilise funds for investment. The American capital markets acquired great efficiency to serve the ever expanding American economy. The banking system of America also showed a keen interest in the enterprises they financed.\(^{30}\)

The specialised financial institutions which had the feature of development banks no longer remained confined to the European countries during the twentieth century. The prototypes of such institutions appeared in other parts of the world as well. The first example of this trend was provided by the Industrial Bank of Japan which was established in 1902. The bank floated and underwrote government and municipal bonds, subscribed to the debentures of companies and granted loans to the industrial concerns on the security of real estates, land and factory premises, and to the small industrialists on their personal securities. The Government of Japan also utilised the Industrial Bank as a channel for extending financial assistance to small manufacturers. The achievements of this bank attracted the attention of some backward regions of Asia and provided a model for setting up their own development banks.\(^{31}\)


In the 20th century England, the question of industrial finance was examined by the Macmillan Committee which reported its findings in 1931. Before 1931, however, some efforts had been made to bridge the credit gap. In 1927, the Securities Management Trust Ltd. was set up as a private company entirely owned by the Bank of England. In 1930, the Bankers Industrial Development Company was formed. In 1934, the Credit for Industry Ltd. was established to assist small business firms. But all these attempts could not eliminate the "Macmillan gap".  

Therefore, during the post war period the Industrial and Financial Corporation was established in 1945, the Colonial Development Corporation in 1948, the Commonwealth Development Finance Company in 1952 and other specialised institutions came into existence. These institutions were similar to the development banks of today in many respects. 

Such institutions came into existence in almost every country of the world. The Industriekredit Bank was formed in 1949 in Germany to provide long-term finance for

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the reconstruction and improvement of German industries. In Italy, a few private institutions were set up for providing long-term finance: Mediabanka, Ente Finanziementi Italiani, and Centrobanka. Among the public institutions the most important are the Instituto per la Reconstructzione Industriale and Medio Credito.

The finance companies of Belgium - the Societe Generale de Belgique and Brufina, A.B. Industrikredit of Sweden and Norwegian Bank of Industry - are the other examples that are specializing in the provision of long-term credit for new and small scale industries on the continent of Europe. 33

Other specialised institutions that are important for the provision of industrial finance are: The Industrial Mortgage Bank of Finland Ltd., The National Hungarian Industrial Mortgage Institute Ltd., The Provincial Mortgage Bank of Saxony and the National Economic Bank of Poland. The Industrial Finance Department of the Commonwealth Bank of Australia and the Industrial Development Bank of Canada also played an important role.

In the United States of America, the efforts of the Reconstruction Finance Corporation, the Federal Reserve Bank and the Small Business Administration could not fully satisfy the needs of small industrialists. In this financial gap, it is interesting to note that 20 percent of small companies felt the shortage of finance in early fifties, some needing equity and others loans. But now a new kind of local institution, supported by individual communities and local governments in some cases, has come on the scene to assist small concerns. These are known as the Development Credit Corporations. Most of these are known as non-profit organisations obtaining their resources from the voluntary subscriptions or donations. Their functions consist of buying and building plants and building for sale or lease, lending or investing funds in industrial enterprises, rendering managerial, engineering and other advisory services to small concerns.

Technical factors inhibit the World Bank to help stimulate directly the expansion of private sector in underdeveloped countries however, it has evolved a new technique of sponsoring local development finance companies through

which the bank's funds could be made available to the private sector. The World Bank and the IFC have assisted in the promotion and establishment of private development finance companies in many under-developed countries. These companies are designed to stimulate sound economic growth by providing long-term capital and experienced management, and by establishing contacts with foreign business and investment institutions.

DEVELOPMENT BANKING IN INDIA:

The history of development banking in India dates back to the Swadeshi Movement period of 1906-13 during which many commercial banks were established to provide industrial finance. They remained confined particularly to the commercial function of those days and undertook several kind of business activities, including the provision of long-term credit to industry. They adopted methods of investment banking, deliberately departing from the traditional commercial banking practices. They subscribed to the share and debentures of industrial companies and freely advanced considerable sums on security of factories, machinery, plant, buildings and so on. These banks were, however, shortlived. Most of them failed during the banking crisis of 1913-15 and others had to close shortly thereafter.

The industrial banks once again revived in India immediately after the World War-I. A beginning was made by the establishment of the Tata Industrial Bank in 1917 followed by seven more industrial banks. The bank functioned very successfully but it went into voluntary liquidation in 1923 for the reasons similar to those of the Credit Mobilier. Whatever fate they might have met, these industrial banks were the precursors of the present Indian development banks.  

At the time of independence the Indian capital market was characterised by lack of institutions such as issue houses, investment trusts and unit trusts, for placing the shares or debentures issues on the capital market. It was felt that the existing financial institutions could go only part of the way in meeting the requirements of industrial finance. It was, therefore, necessary to devise new agencies for attracting long-term capital into both large scale and small scale industries.

In 1948, the Industrial Finance Corporation of India had come into existence to fill up the gap. But as late as 1950, the Indian capital market continues to exhibit the

37. Ibid., 119-24.
same weaknesses. The Report of the Committee on Finance for the private sector emphasised the need for more special institutional devices that would:

"...... add to the confidence of the investors and increase the marketibility of shares and debentures, attracting thereby new private investors into the field. As industrial expansion gathers momentum, new units will come into existence. Also, the operation of the units which are at present organised on a proprietary partnership or private limited company basis grew in size, the tendency to convert these into public limited companies will be strengthened and will lead to an increased resort to the capital market for procuring long-term finance. In such a contingency there will be room for several types of agencies for mobilising ingestable resources and promoting further growth.38

Recognising the importance of the development banks the Government of India set up four major institutions of this type after independence. These are:

(i) the Industrial Finance Corporation of India;
(ii) the National Industrial Development Corporation;
(iii) the Industrial Credit and Investment Corporation of India; and
(iv) the Industrial Development Bank of India.

The Government also helped to provide the Life Insurance Corporation of India Ltd., and the Unit Trust of India funds for investment in the private sector. In various states, the state level counter-parts of these institutions were set up. Over 60 development finance institutions in the industrial sector are presently operating in India with Industrial Development Bank of India as the apex development bank. Over these years, these banks have played a significant role in the industrial development of the country as well as states of India.

OBJECTIVES OF THE STUDY:

The proposed research investigation has been undertaken with the following objectives:

1. Assessment of the present pattern of availability of fund.

2. To determine whether the funds are available in time and in required quantity and at what cost.
3. To examine the suitability of current system of loans and advances.

4. How far the Industrial Development Bank of India has succeeded in achieving the task of providing industrial capital in this part of the country.

5. Suggesting improvements in the distribution system so as to ensure greater flow of assistance in proper time in sufficient order at standard rate of interest.

THE SCOPE AND IMPORTANCE OF THE STUDY:

The present study, therefore, intends to examine the role played by the development banks, in speeding up the process of industrialisation in the N.E. Region.

While looking at the performance of the all-India development financial institutions, we have also tried to investigate the role of the State level development institutions like the AFC, AIDC, etc.

The study, it hopes, will be beneficial both for the government and the public.
RESEARCH METHODOLOGY:

The study aims at analysing the impact of the development banking institutions, more particularly of IDBI, on industrialisation of the seven North-Eastern states during the period 1988-1993.

The main sources of secondary data for evaluating the performance of development banking institutions; are the Annual Reports of the respective institutions for the period, under review and their publications, Statistical Abstracts of the states of N.E. Region, Performance Budget of selected Departments of the respective Governments and the Reports on the working of Public Enterprises, published by the different states of the N.E. Region.

Primary data will be collected from the industrial units financed by the IDBI with the help of questionnaires and through personal contacts, with executives of the units as well as executives of the development financial institutions, namely - IDBI, ICICI, IFCI, NEITCO, etc.

Moreover a detail study of one of the units assisted by IDBI, but has been declared sick, will also be
undertaken in order to investigate the causes of its failure vis-a-vis IDBI's development role.

**HYPOTHESIS OF THE PRESENT STUDY:**

After going deep into the realm of development banking the following hypothesis are made and tested:

(i) Development Banking is an important infrastructure for economic development.

(ii) Development banks have helped funding entrepreneurs, but it has not necessarily helped in the industrial development of backward region.

(iii) Flow of credit of IDBI in the region and of other all-India financial institutions are not satisfactory.

The subject matter of the thesis has been spread over in eight chapters, which has been incorporated to the Preface.