CHAPTER III

THEORY OF DEVELOPMENT BANKING

The demand for medium and long term industrial finance has grown by leaps and bounds, much beyond the capacity of the traditional sources of finance and hence emerged the need for the special financing agencies to meet the gap between the demand for and supply of such finance. In a developing economy, institutional arrangements for the mobilization and channelling of financial resources should be continuously expanded and adapted to the growing and varied needs of the economy. It is not nearly a question of the total quantum of financial flow but also a matter of sectoral flow. The different sectors have different problems. The setting up of special financial institutions is also increasingly felt by developed economies, though
perhaps the aggregate assistance channelled through them is small in relation to what is provided by the capital market mechanism.\(^1\) But the need for such institutions in developing economies is much greater and in this matter, a great deal of initiative and assistance is called for by the Government and its agencies.

Considering the growing needs of industrial finance under rapid industrialisation programmes in developing economies, the establishment and development of specialised financial institutions becomes an important and inevitable step in the solution of this problem. The selling up of special financial institutions, more appropriately styled in the economic literature as 'development banks', as an integral part of deliberate and conscious attempt by the government to orient the financial system to the needs of planned economic development, has been an outstanding institutional development in the emergence of the financial machinery in India.

In the present chapter we shall try to analyse the theoretical and historical aspects of development banks and their evolution in India will be dealt with in the next chapter.
Historical Background

Development banks, however, are not a new institutionalised device introduced for the first time in the years after World War-II. Prototypes of these banks could be witnessed even before World War-I and their origin could be traced back to the middle of the 19th century when the Societe Generale de Belgique was founded in Belgium in 1822 with the specific object of financing and promoting industries. But it was the "French Credit Mobilier" set up by Pereire Brothers in 1852 that aroused much greater interest throughout the world as a pioneering effort towards building up an institutional structure of industrial finance. Its main object was to function as a financing institution which would sell the shares of the undertakings it promoted when they were ripe for the market and thus obtained the means of financing new enterprises. Throughout the 19th Century the Credit Mobilier provided a great appeal to all countries which were eager to erect a suitable machinery for financing a rapid rate of industrial progress.

Japan had chosen Credit Mobilier as a model when it founded the Industrial Bank of Japan in 1902 for the purpose of financing her industrial development. The Japanese bank can be distinguished from the modern concept of a development bank in relation to underdeveloped countries. It was not a specialised institution designed
to finance and enterprise for industrial development but a 'hybrid' institution combining in itself the functions of an issue house, a commercial bank and a mortgage institution.

Since the days of the above indicated pioneering institutions there may be observed several interesting phases in the institutional development of these financing and promoting devices, the accent of activity shifting from pure financing to promoting and developing or a combination of the two at the same time. These developments have occurred in the private as well as in the public sector, in the national as well as the international field.

Phases of Development of Development Banking

The different phases of institutional development in the 20th century can be classified into three main phases: (a) post-World War-I development, (b) post-depression institutions and (c) post-World War-II institutions. In tracing the various phases of the institutional finance a reference has to be made to the Industrial Bank of Germany. German banks passed through various phases of evolution. In the first stage of their development, they assumed the character of investment trust companies. In the next stage of their development, they began to foster the growth of deposit business. The deposit business of this period came to be
combined with the investment trust business of the former period. Their business became mixed and they were known as 'mixed' banks. Their evolution did not stop here. In the years after First World War their tendency was to switch over to deposit banking. In the post-depression years it was sought to bring about the separation of investment banking from the deposit banking by the enactment of the German Credit Act of December 5, 1934.

Post-World War-I Development

After the conclusion of the First World War a large number of European countries came to be confronted with the task of economic reconstruction, modernization and development. This enormous task called for an adequate provision of long term industrial finance. To solve this financial problem the type of machinery that was chosen was provided by the device of the industrial mortgage banks. The device made a powerful appeal to these countries and the machinery was adopted to provide long term loans to industry. During this period a number of financial mortgage banks came to be established in several countries of Central and Eastern Europe. The largest of these banks were the Industrial Mortgage Bank of Finland Ltd., the National Hungarian Industrial Mortgage Institute Ltd., and the Provincial Mortgage Bank of Saxony (Germany). These mortgage banks played an important role in the reconstruction and
development of the war-shattered economies by providing long term amortisation loans to various categories of industries, large and small, against the mortgage factory building, plant and equipment etc. Unfortunately they were affected adversely by the Great Depression and hence their financial achievement can not be correctly assessed.\(^3\)

**Post-Depression Institutions**

In several countries attempts were made to form suitable organisations for the provision of medium and long term finance to small and medium sized industries. The post-depression institutions, however, were in many respects different from the financial machinities evolved in the years after World War-I. The industrial mortgage banks of the nineteen-twenties never combined issue and underwriting business with that of mortgage lending, nor did they ever make it their business to provide initial capital to industrial concerns by subscribing to their shares. They were pure mortgage banks and did not even accept deposits, short or long term. The British Credit for Industry Ltd., formed in 1934, was one such institution which was no doubt a lending rather than an investment institution. However, several other specialised institutions formed at that time are found to have combined underwriting and holding business with that of mortgage lending. The Industrial Credit Company
of Ireland was an example of such inter-mixture of functions. Netherlands Company for Industrial Financing is another example of the type. The Swedish Industrial Credit Company, (1934) was empowered to grant term credits and to issue bonds but was not permitted to accept deposits. The Belgian Societe National de Credit Industriel, empowered to issue bonds of five years maturity, was expressly allowed to receive time deposits and which, thus, broke the tradition for the first time in this respect.

Post-World War-II Institutions

The third phase witnessed the phenomenal progress in the institutional financial development. In sharp contrast to the pure industrial mortgage banks of the period after World War-I, and the hesitant policy of the post-depression industrial credit companies there could now be witnessed a remarkable trend in favour of a combination of the business of mortgage lending with that of underwriting and, in several cases, participation in the equity capital of industrial concerns as well. From 1944 onwards remarkable developments had taken place in the machinery for financing and promoting post-war industries in Great Britain and in the other Commonwealth Wealth Countries. Notable examples are: The Industrial Development Bank of Canada (1944), the Finance Corporation for Industry Ltd., and the Industrial and Commercial Finance
Corporation Ltd. of Great Britain (1945) and the Industrial Finance Department of the Commonwealth Bank of Australia (1946) are important examples of such machineries being established in developed countries.

The designation of 'development bank' not popular in earlier days has been for the time used by the Canadian institution i.e. the Industrial Development Bank of Canada. But it has hardly discharged any function of the development such as entrepreneurial and promotional, which characterise the nomenclature in developing countries. It seems to have been designed to provide only financing services. In sharp contrast, the Industrial Finance Department of the Commonwealth Bank of Australia, though not expressly described as a development bank, was intended to provide not only industrial finance but also to assist in the development of industrial undertakings.

These institutions differed from one another with regard to their scope, methods and organisation, but they have followed the uniform pattern with regard to their basic functions and their set objectives. As earlier indicated, they have provided financial assistance for industrial enterprises for which such assistance was not readily available through the channels of ordinary banking and the stock exchanges, or it was of a type which no bank could furnish. The British and the Canadian institutions were
entirely financing agencies, while the Australian Industrial Finance Development was envisaged to function also as a development bank, for, the law authorised it to provide finance for the establishment and development of industrial units.

The British, Australian and Canadian institutions were closely similar in the sense that they have made not only term loans but also provided risk capital, by subscribing to the share capital of the companies. But these financial institutions can now, however, be characterised as development banks in the true spirit of the term as understood in relation to underdeveloped economies. However, these institutions have furnished a model for some underdeveloped countries which were in search of suitable financial infrastructure for providing finance for industrial development as an integral part of their overall strategy for economic development. The Industrial Finance Corporation of India and that of Pakistan are cases in point.

The Significance of Development Banking

Development banks are in fact a reflection of the increasing urge for rapid economic development and of the search for machinery to use where development does not appear to be proceeding of itself with the desired speed.
The term 'development bank' itself involves the banking or financing functions and secondly, it indicates the nature of such finance as being primarily developmental or long term. The word development in itself includes the functions of promoting industries, cherishing entrepreneurial abilities and setting up of new units.

It is really a difficult task to define a development bank. This is so because of the diversity in their forms and heterogeneity of their functions. There is of course no universal model of a development bank. Each country has tended to adopt a design suitable for the peculiar socio-political and economic framework in which the institution has to work. But there is obviously no dispute about the target of the development banks, which is to accelerate the rate of economic growth through speeding up of the process of industrialisation and introducing a qualitative change in the pattern of investment.

Development banks generally are intended not only to provide long term capital for the private industrial sector but also mobilize savings, enterprise and skills for productive investment in that sector. William Diamond has described a development banks as financial institutions devoted primarily to stimulate the private sector of the economy. They have been set up as catalysts for investment in the private sector to provide injection of capital.
enterprise and management and not merely as administrative
device to handle the Government's own investment.

Such institutions were designed to be the means of
mobilizing resources and skills and of channeling them into
approved fields under private auspices rather than the public
ones. Thus a development bank by its very nature is intended
to provide necessary capital, enterprise, managerial and
technical know how where these are inadequate or non-available
and also to assist in building up the financial and socio-
economic infrastructure conducive to expedite economic
development. The stress of its various activities has shifted
from one country to another according to its peculiar needs
and circumstances. In some countries the emphasis has been
on finance, in some others on promotion, in yet others on
technical skill and advice and again elsewhere on economic
planning itself.7

Sometimes a distinction is made between 'development
bank' providing long term loan capital and a 'development
corporation' seeking to participate in equity capital and
promoting and managing specific companies as well as providing
financial support. However, if one combines the functions
of providing long term capital and promoting and managing
corporate enterprises, into an integrated function such as
may be essential to supply the needed capital and management
in underdeveloped economies, the distinction between the two kinds of development institutions gets blurred.

Need for the Development Banks in LDCs.

After World War-II, the Less Developed Countries (LDCs) came out with the determination to accelerate the pace of their economic development. This determination has been manifested by an increasing emphasis on industrialisation and by the hope that industrial expansion can be speedily achieved. However, the progress has been constrained in most countries by the lack or inadequacy of various ingredients of industrial development. The first is the shortage of capital. The LDCs, spurred by the rapidity of their political advancement during recent years, feel it a necessity to achieve their economic growth at a faster pace. But their resources do not permit the accumulation of earnings sufficient to finance the rate of growth satisfactory to them. The second ingredient of industrial development is the absence of an effective mechanism for channeling into productive investment a sufficiently large proportion of saving; that is, that is lying idle with saving units. The absence of capital market means in turn that there is little familiarity with investment financing techniques, and lastly many countries suffer from a limited initiative on the part of industrial community – a disinclination to seek out and to venture.
into new areas of activity - and from limited or no opportunity to become acquainted with and to profit by technological advances achieved abroad. 9

The concept of the 'Vicious Circle' of underdeveloped economies has become a familiar one and is generally explained by making reference to the shortage of capital, which is owing to the low level of income and to its low growth rate. This condition leads to low purchasing power of the people resulting in low profitability and low investment. This again may be because of low productivity. It may be noted that this vicious circle continues in LDCs trapping them in a low level income stagnation. What is required for coming out from these conditions is to raise the level of investment in order to achieve the desired rate of growth. Economic growth largely depends on the rate of capital formation and when a country plans to attain high rate of growth, particularly through industrialisation, the availability of industrial finance appears to be a major bottleneck in the process. On the one hand, there is increasing need for more and more finance as the development process gathers momentum and on the other hand the capital markets are ill-equipped to provide adequate financial requirements. This situation leads to serious problems. A way to come out from this is sought in the establishment of new institutions with one of their main purpose being to provide long term finance for industries.
Mixed banking experiment was tried in Western countries and particularly in Germany. In this experiment both commercial banking as well as long term financing functions were combined under the same institution and it enabled the latter to play a vital role in the industrial development of those countries. The situation in underdeveloped countries, however, are different. The commercial banks are showing a tendency towards providing medium term finance to industries through term lending, though they can not undertake the huge responsibilities of catering to the increasing needs of growing industrial sector and hence can at the most, act as a supplementary source and not as the main purveyors. This problem becomes more acute in the case of small industries. Even a developed country like the U.K. faced the problem of the 'Macmillan Gap', culminating in the establishment of the Industrial and Commercial Finance Corporation in 1945.

Special financial institutions are also necessary for the purpose of channeling the available funds in the most desired manner. The rate of economic growth depends on how and where the funds are invested. The specific task needs to be handled by specially trained personnel. The development banks can be more useful in this respect. The need for the development bank is felt more in the private sector rather than in the public sector because of the fact that in the
public sector, the allocation of funds is done by the Government machinery and managed in a method planned by the State while in the private sector the allocation of funds to proper industries in most suitable manner needs to be controlled by some special financial institutions and this job can be entrusted to development banks.

One more point to be noted in this context is that the development banks are more convenient channels through which foreign capital and skills can flow into the national economy and reach the enterprises that are unable to attract these sources by themselves. One of the main tools of development banks is the maintenance of contacts with foreign business, investment institutions and international financing agencies. Such as World Bank, International Finance Corporation and International Development Association. Thus, in addition to possibly stimulating capital imports, the establishment of development banks in a particular country for disposing of capital funds will be necessary to augment and complement the work of private investors. The development banks, with collaboration of other international institutions can manage to have the services of foreign experts for their benefits and train their own staff.
Ownership and Management

The managerial pattern of development banks normally depends upon the role of different agencies in its formation, financing and operation. Development banks as operating in the underdeveloped countries may be classified from the point of view of ownership as (1) Government owned (2) Central Bank owned, (3) Privately owned and (4) Mixed ownership i.e., partly owned by the Government and/or Central bank and partly by the private interests. By far the larger number of these institutions belong to the first and second categories.

Privately owned development banks are very difficult to establish in underdeveloped countries where the entrepreneurial talents are generally lacking. Where the environment is inflationary and the demand is for long term credits, it may likewise be difficult to establish a private bank.

Owners of capital hesitate to lend directly at long term when the value of money is falling, and may therefore not be willing to do so indirectly, by investing in the equity of an institution whose principal activity is one of providing loan capital.\textsuperscript{12}

Even when the private capital is forthcoming, a private development bank cannot be given a sound financial basis without some Government support such as the guarantee of the principal and/or interest of the Banks' capital and bond issue.
an interest free loan or some kind of subsidy. It is a
debatable issue whether a development bank under private
ownership and control have some distinct advantage over a
public development bank or vice-versa.

It is said that the privately owned development banks
are likely to be free from political pressures and inter­
ventions by the country's Parliaments to which a public bank
is subject by reasons of its public accountability. The
investment decisions of a privately owned bank will be purely
objective, its methods flexible and its procedures business
like.

The development banks owned by government and/or central
banks either wholly or with a majority interest are also not
without their advantages. The coverage of their activities
may be wider and extend to both large, medium and small
industries, they can venture into new and pioneering fields.
Moreover, they can carry out extensive research and techno-
economic surveys beyond the financial resources of private
banks.

But it must be observed that ownership factor is no
criterion of efficiency. Private banks are not necessarily
efficient and well managed and public banks not necessarily
susceptible to political pressures and bureaucratic influences
or rigid and unbusinesslike in their methods and procedures.13
By far the majority of the institutions have a mixed ownership with a majority share in the hands of the Government or its agencies. There are two very rare instances of cent per cent central bank ownership viz., the Industrial Development Bank of Canada and that of India.*

There are many instances of development banks wholly owned by the State. Among them the Industrial Development Bank of Nepal and that of Indonesia, the National Development Bank of Brazil, and Libyan Industrial and Real Estate Bank, the Development Corporation of Chile, the Industrial Bank of Iraq and the Industrial Development Companies of Puerto Rico may be mentioned.†

Instances of mixed ownership are also in quite a good number. Among them are the Industrial Finance Corporation of India, the Pakistan Industrial Development Bank, the National Investment Bank of Ghana, the National Bank for Economic Development of Morocco, the Industrial Development (Finance) Corporation of Malaysia, the National Financiera of Mexico, the Industrial Development Bank of Nigeria, and the Industrial Bank of Sudan belong to this group.

There are many cases where the development banks are wholly under private ownership. Some prominent examples in

* The Industrial Development Bank of India has been delinked from the Reserve Bank of India with effect from 16th February 1975.
This respect are provided by the Industrial Credit and Investment Corporation of India and Pakistan, the Industrial and Mining Development Bank of Iran, the Development Corporation of Ceylon, the Industrial Development Bank of Turkey and the Industrial Finance Corporation of Thailand.

**Twin Roles: Financing and Promoting**

The development banks are intended to provide not simply capital whether equity or loan, but also technical, managerial and entrepreneurial talents whenever required and to help in erecting the financial infrastructure conducive to the rapid economic growth of the respective countries. In other words, development banks have a two fold role to perform. By far the more important role is that of a financing institution, providing finance to industrial enterprises in various ways. Equity participation, provision of term loans, subscription to bonds and debentures of companies, underwriting of their stocks and guaranteeing of loans raised from domestic or foreign sources are the usual forms in which finance is provided by the development banks.

Apart from this, these institutions have a promotional role to play. In some cases the promotional role is more significant than that of financing. The problem of industrial enterprises, the provision of technical and managerial guidance, undertaking research and conducting survey work, feasibility studies and fostering of capital
market, etc., constitute the main features of the promotional role of development banks. Promotion is the process of enterprise creation. It involves the formulation and development of a proposal, the mobilisation and organisation of various elements that are needed to give life to it and finally to its execution.

The development banks should not be satisfied by providing term loans to industrial units and also by assisting it in its establishment i.e. promotional role. The assisted units should not be left all alone. Their real work starts thereafter. Their day to day business, the hard core of their activity is evaluating the investment proposals and, if investments are made, looking after them. These tasks may some times seem routine and humdrum but to Dr. William Diamond, doing this job well is a creative and not a routine.

Sound appraisal requires the development bank to go through virtually the same kind of examination of a proposal that the entrepreneur himself goes through. The constructive banker thus finds himself in the posture of moulding, modifying and advising on the proposal before him, so as to minimise the risk of failure of the business. A client finds in his banker a constructive partner, at the least, he gets a second diognostic opinion from one whose critical view can be trusted because it is an outside disinterested opinion.
In the appraisal process development banks can ask their clients to re-examine their plans, to spell them out in explicit detail and to understand more clearly their implications and the available options.

Moreover, the creative role of development bank does not end with the decision to finance a project. Its relations with its clients becomes more intimate thereafter, if it is discharging its job effectively. Supervision involves keeping a finger on the pulse of the enterprise, scanning the environment for factors and situations which might affect the client, sensing problems even before they become self-evident, and coming with proposals to deal with them. It leads the way to improving clients accounting, auditing and budgeting systems, to improving management, to identifying possibilities for economies of scale in production and marketing. Constructive follow-up is one of the most delicate task of a development bank. The development bank that perseveres in the course and becomes effective in its critical task of appraisal and follow-up, safeguards its portfolio and profit and loss account, assures its clients a constructive partnership and can justifiably consider that it is making an important contribution to the development of its country.16
Sources of Funds

How large should a development bank's resources be and where should they come from? There is no categorical answer to this question and no formula to determine the proper magnitude of a given bank's capitalisation. Both the size and origin of its resources have a direct bearing on its purpose and activities. The development bank ought to have sufficient capital to enable it to make an impact on industrial development, and to earn enough to meet the expenses, the accumulation of adequate reserves and in the case of private institutions, payment of a sufficient dividend. On the other hand, resources should not be so large that they greatly exceed what appears reasonably necessary for the fulfillment of its purpose. The actual resources at the disposal of a development bank can be determined by practical considerations.

Where should the capital come from? Generally, three types of resources constitute the capital structure of a development bank, viz., Government, private and foreign and/or international. Governments of most of the countries perform an important role in the formation, financing and operation of the development bank. Role of the Government vis-a-vis the capital structure of a development bank may take several forms, viz., contribution to the share capital of the bank (sometimes providing even the entire (initial) share capital). Contribution to the bonds, debentures and other
securities floated by the bank, guaranteeing the repayment of the principal amount invested by the investors in the shares, bonds, etc. of the development bank, guaranteeing the payment of dividend at a certain minimum rate on its shares by the bank and the payment of interest on its bonds and debentures, provision of long term loans (at low rate of interest and some times interest free) to the development bank, guaranteeing the loans raised by the development bank from foreign investors/financial institutions, providing the development bank at periodical intervals a slice from the budget revenues, placing at the disposal of the development bank some special funds/receipts etc. Coupled with the role of the Government is the part which the central bank play. They generally contribute the share capital of the development banks and/or private long term loans. In some cases (like that of the IDB of India) central banks have also created special funds/reserves for meeting the capital requirements of the development banks.

Private financial resources comprise the capital contributed by financial institutions and/or the investing public, reserves, if any, accumulated by the development bank, loans raised in the market and the deposits received. So far as the capital contribution is concerned different development banks presents different models. Keeping in view the objectives of development banks in underdeveloped
countries, at least, all private individuals, and financial institutions (both local and foreign) should be allowed to subscribe to the capital of the development banks in order to maximise the rate of capital formation and productive investments are maximised. The development banks should also be allowed to accept deposits. In the context of the principal problem of resources of the development banks it is suggested that they could not rely on the Government or the World Bank to continue to provide the quantity of capital needed to finance its business in the private sector of the country.  

Development banks as a rule have been authorised to issue their own bonds and debentures to supplement the resources obtained from equity capital and loans from the Government, Central bank and international financial institutions. Indeed as their role in the financing of the countries economic development becomes more and more significant they have to place greater reliance upon this source of funds. The relative preference differs between borrowed funds and equity capital. Borrowed funds impose fixed charges, while equity capital imposes no fixed charges but at the same time it may be more costly in the long run. But it is also true that some limitations has to be placed on the bond issues and borrowings of the development banks. Their total borrowings should be made to bear some fixed proportion to their share capital and reserves. Here
in this connection a question arises that what should be the reasonable ratio of debt to equity?

**Debt/Equity Ratio**

There can be no precise answer to this question. A great deal will depend upon the types of assets accepted as security for their loans and upon their loan and investment policies, in other words upon the risks of investment, where the risks of investment are greater, the capital structure of the development bank should not be made up of a high proportion of borrowed funds. Thus if the development bank is intended to provide equity capital to its industrial customers rather than loan capital, it will not be advisable to provide for a preponderance of borrowed funds in its capital structure. On the other hand, if it is contemplated that the development bank should mainly be a provider of loan finance rather than equity finance, a relatively greater proportion of debt in its capital structure may not be wrong.

Taken together, these considerations can translate into a variety of debt-equity ratios in practice. There is no single 'correct' ratio. The World Bank suggested a 3:1 ratio for the banks in Turkey, India, Pakistan and Iran, which it helped to establish. The debt:equity ratio of
5:1 has been prescribed for the IDB of Pakistan. The Industrial Bank of Japan was able to borrow up to 10 times its capital. The IFC of India has been empowered to borrow from the Central Government and the Reserve Bank and through debenture issues up to 10 times its paid up capital and reserves, as against 5 times as originally provided. The Turkish Industrial Development Bank has no statutory limit on its borrowings, and special legislation exempts it from the severe restrictions on borrowings imposed by the Turkish Commercial Code. Nevertheless, its borrowing is narrowly limited by the provisions of its loan contracts with the World Bank. In some cases the same objective has been sought to be achieved by imposing a ceiling on total borrowings. The Indian ICIC provides an instance of such prescription of an overall ceiling. The absence of any statutory limit on the amount of bonds and debentures to be issued by the IDB of India is contrary to established convention in this respect. In this connection, the fact must not be lost sight of that the IDB of India has been conceived as an 'Apex Institution' to fill up the gaps in the industrial structure of the country and to undertake development banking functions.

The solution of the question of determining a suitable debt-equity ratio limit for the development banks should be found with reference to the expectations and risk-bearing
capacity of the subscribers to the banks' capital, the type and scope of the banks' activities, the pattern of the banks' portfolios, etc. No scientific hard and fast rules can be prescribed in this regard for the development banks. Even if some ceiling is prescribed, it should be flexible.

Objects and Scope

So far as objects and scope of development banks are concerned, they differ widely from one country to the other. This is manifested by the fact that development banks have been established in countries which differ widely from each other in their socio-economic backgrounds. Each development bank is modelled on a pattern which is best suited to economic, social, cultural and industrial setup of the country/region in which it operates. Some of the development banks confine their activities to the industrial sector only, whereas some other development banks also provide financial assistance for agricultural development. Further some development banks provide financial resources for housing, fisheries, commerce, tourism, deep-sea fishing, crafts, slaughter houses and meat packing plants etc. Whereas most development banks confine their activities to investment in the country, certain development banks take interest in investment in other countries also. Generally, development banks do not interfere with sectors other than the industrial
sector. This is in conformity with the principles put forth by the Second Working Party of Experts (on Mobilisation of Domestic Capital) of the U.N. Commission for Asia and Far East (1953) which suggested that as a rule separate organisations should be set up for agriculture and industry. The trend in some countries is to have different development banks for different types of industries and purposes. Most development banks provide financial assistance only to industries in the private sector while some other are also empowered to extent financial assistance to the public sector industrial undertakings. By and large it is being acknowledged that one single institution should not finance both the sectors i.e., public and private. Few development banks are established to provide financial assistance to the small scale industries only. Further, while certain banks provide financial assistance only for the small sized or large sized industries, many development banks offer financial assistance to all size groups.

**Fostering Capital Market**

The other important function of development banks is the fostering of the capital market. In underdeveloped countries, the prospects for rapid development of the capital market are limited. The volume of private voluntary savings is relatively low and is, at any given income level not likely to be changed significantly by institutional innovations or
new savings media. But the proportion of savings that may be redirected to more productive uses is in most countries quite large. The immediate objective of efforts to develop a capital market is to provide the incentives and means for investment of savings in new ways, which will make financing more readily available for productive projects requiring more funds than entrepreneurs can readily provide. Development banks can assist in the growth of capital market. They can help directly to bridge the gap between savers and investors by selling their obligations to the public. They can engage in portfolio sales. They can underwrite the issues of new securities. Besides pooling savings, development banks can also attract direct investor participation in their own functioning, thus providing still another means for channeling liquid savings to worthwhile investments. The presence of development banks in the above context gradually reduces the shyness of capital and accelerate the rate of capital formation.

In the countries where the nucleus of a private capital market exists, development banks have been concerned to support and not to impede the growth of this market in search for profitable projects and in the formation of operational policies. Most development banks are required by their charters to satisfy themselves, before approving an application, that financing is not available through
other channels, and this is generally their policy, even in the absence of charter requirements.

**Development Banks and Commercial Banking Business**

As indicated earlier, development banks are specialised financial institutions with the prime objective of providing long and medium-term capital and other facilities for promotion and expansion of industries as well as to stimulate the capital market by mobilisation of funds lying idle through the exercise of underwriting and issue house functions.

The hotly debated issue that arises here is that whether the development banks should combine commercial banking business with development banking or not? The debatable issue in this connection is the type of finance to be advanced to the industrial concerns. In some cases, distinction is made between financing for fixed assets and financing for working capital, and it is emphasised that the development banks should look to the needs of financing fixed assets only and leave the working capital financing to the care of commercial banks and such other short-term sources. However, this distinction is very subtle. Most banks distinguish between permanent and temporary working capital requirements. The general view is that permanent working capital needs should be financed out of the paid-up capital of the company, while temporary working capital requirements should
be met by the commercial banks. Particularly where banking and credit facilities are well developed and industry can have recourse to commercial banks for its necessary working capital finance, development banks need not enter this field of activity. But in underdeveloped countries where the banking system is immature and ill-organised and credit facilities are inadequate, development banks may have to come forward to fill the gap and provide short term credit to their customers for working capital purposes. A case in point is furnished by IDC of Nepal which provides short-term credit to its industrial customers for commercial banking is still undeveloped in the country.

There are, however, differences in the readiness of development banks to finance working capital and the ways in which they do so. Some development banks, like the Industrial Development Corporation of South Africa (IDC) finance permanent working capital where an enterprise's operations require that substantial inventories or stocks of raw materials be on hand all times. IDC takes these needs into account in determining total capital requirements. National Financiers of Mexico finances permanent working capital where it is also lending for fixed assets, if funds for working capital are not otherwise available. The Corporacion de Fomento de la produccion of Chile distinguishes between established and new enterprises for this purpose,
it normally does not provide funds for working capital needs to the former but may in the case of new ventures. The IDB of Canada does not as a rule provide funds for financing inventories or receivables as an alternative to borrowing from banks. But where a growing business is short of working capital, purchases of equipment having reduced it to an unsatisfactory level and there is a basis for a term loan secured by mortgage, it is prepared to supplement current financing from other sources.

Moreover, in cases where the development banks supply funds by acquiring the first mortgage right of all the fixed assets, it may not be possible for the loanee concern to obtain huge funds needed for financing working capital. It should, therefore, be incumbent on the part of the development banks and in the interest of both the parties, to supply funds in such cases. Hence, for practical purposes, there is nothing wrong if a development bank provides finance for working capital requirements, although it should be only in special cases. The IFC of India in its earlier stages was not inclined to furnish working capital, but it has now come to appreciate the problems faced by the loanee companies in meeting their working capital requirements when their liquid assets are already mortgaged to the Corporation. The ICIC of India considers the providing of working capital as competing with the business of the ordinary banks and, therefore, as a rule does not provide working capital.
Neither the IDE of Burma nor the IDE of India has been expressly authorised to furnish such short term finance for working capital requirements.

Other development banks, like the Banco Nacional do Desenvolvimento Economico of Brazil, the ICIC of Pakistan and Caisse Centrale of France, prefer not to finance working capital needs directly. Where funds for permanent working capital can not be raised elsewhere, these banks on occasion provide such funds indirectly, by financing a somewhat larger proportion of fixed assets capital requirements than is their normal practice.

Working capital is as much an essential part of a project as its fixed capital. But the resources of development banks are not unlimited. They should use their funds to assist as many enterprises as possible. The financing of working capital is basically a function of commercial banks. But where they are unable to meet the entire requirements the Industrial and Mining Development Bank of Iran thinks that development banks should step in.22

Apart from the provision of working capital, the other more important commercial banking business is accepting deposits, mostly of more than one year maturity. Some development banks have been permitted by their charters to
accept deposits (Indian IFC, SFCs and IDB, Burmese and Pakistani development banks). But neither the Japanese Development Bank nor the German Kreditanstalt is authorised to receive deposits. The Canadian IDB is also prohibited from accepting deposits, except as security for due discharge of obligations under the loan or for the due performance of an agreement with the development bank. From the point of view of principle, it is clear that institutions whose resources are to be locked up in long term investments, should not accept deposits of a short term character.

Receiving deposits from the public even for periods of more than one year is not an appropriate function of a development bank. When there is a well developed banking system and there is keen competition among the banks, it will be wrong in principle for the development banks in their privileged position and enjoying Government support to enter into competition with the commercial banks.

The other forms of commercial banking business i.e., discounting of bills and opening letters of credit are also undertaken by development banks, but there is no uniform practice. The classic intermixture of mortgage and commercial banking is the Industrial Bank of Japan. But development banks established in recent years in the under-developed countries have not always been expressly
authorised to perform such types of commercial banking business. In some cases development banks authorised by their charter to undertake such kinds of commercial banking business are gradually limiting or abandoning it altogether. A typical case is furnished by the Industrial Bank of Iraq. Commercial Banking functions such as opening of letters of credit previously handled by the Bank were curtailed in 1953. Although they were resumed to some extent in 1961, their volume is quite limited. But the Industrial Development Banks of India (Art. Sec. 91(6) and Pakistan (Arts. 14-17) and Burma (Art. 36) and Industrial Credit and Investment Corporation of India (Art. 38) have been given a wide coverage of functions including the opening of letters of credit and accepting, discounting, or rediscounting bills of exchange and promisory notes of industrial concerns.24

Conclusions

Development banking is an art. Therefore, each development bank will have to be modelled on a pattern and adopt operational strategy which is in consonance with the economic, social, political and cultural environment of the country or area in which it operates. A development bank is created for the special task of stimulating economic development. The provision of finance must remain the hard core of a development banks' activity. It must use its capital well if it is to survive financially and if it is to
live up to its objectives. A development bank has the opportunity to promote enterprises, i.e. to conceive investment proposals and to stimulate others to pursue them or itself to carry them through from conception to realisation. In practice, a development bank is well suited to assume this kind of role.
References


3. Ibid., p. 6.


11. Singh, Prabhu N., op. cit., p. 22


16. Ibid., pp. 29-35.


