CHAPTER IV
EVOLUTION OF DEVELOPMENT BANKING
IN INDIA

In financial intermediation, institutions play a significant role in as much as they issue or make available both the financial instruments as well as loans, and thus by their intermediation bring about the separation of the production and ownership of social surplus.

The technique of accelerating the rate of economic growth of the country by furnishing industries with medium and long term capital/financial resources through state aided and/or state sponsored specialised financial institutions (or Development Banks as they are popularly known) is not of recent origin in India. Suggestions have
been offered and recommendations made at different points of time in India for the establishment of development banks.

An attempt is made in this chapter to present a synoptic review of the setting of the development Banks in India.

The Capital Market

In underdeveloped countries, the capital market should perform two primary functions to assist economic development. These are: (1) promotion of savings and investment, and (2) efficient allocation of funds among competing uses. These functions are performed through the services of the financial institutions which are in touch with the parties in possession of disposable capital on one hand and with the parties eager to employ it on the other. If there exists an effective long term capital market in which individuals and institutional savers come forward to pursue long term securities, most of the problem is solved. However, it is most unlikely that strong individual participation in the capital market can be achieved during the development process in underdeveloped countries, so the necessity of financial intermediation is more felt in discharging the functions of the capital market.

The financial institutions constituting the capital market can affect the stock of capital for growth purposes
in three ways. Financial institutions can encourage a more efficient allocation of a given total amount of capital by bringing about changes in its ownership and composition through intermediation among various types of asset holders. They can encourage a more efficient allocation of new investments from relatively less to relatively more productive uses, by intermediation between savers and investors and lastly they can induce an increase in the rate of capital accumulation by providing increased incentive to save, invest and work.  

The major determinant of aggregate saving is, of course, national income but the provision of certain incentives and facilities for investment can enhance total savings out of a given level of national income. The capital market provides such incentives.

Where economic growth is brought about by the process and social priorities, the financial institutions could achieve their aims without impairing saving motivation. Largely for these reasons the post-war period has witnessed an impressive growth in financial institutions in both developed and developing economies.

As economic development progresses the extent and depth of financial intermediation increases and the spectrum of financial instruments widens, there would be the 'laying effect' in the sense that one type of financial
intermediaries may transfer funds available with it to another type which in turn may pass them on to some investing sectors.

Institutional Set up in India

In underdeveloped countries which are aiming at a high rate growth through rapid industrialisation, the availability of finance is appearing as the bottleneck. While on the one hand there is increasing need of flow of finance as the development process gathers momentum, on the other hand the capital markets are ill-equipped to provide for the needs of long term finance.

After the commencement of the planned economic development, the very concept of industrial financing has changed. In the pre-planning period the problem was conceived essentially in terms of specific gaps indicated by the financial difficulty faced by small and medium sized enterprises and less known entrepreneurs - a concept analogous to the Macmillan Gap. Although the gap is still there, the aspect of industrial financing task which acquired predominance in the planned development process is the overall problem of securing for industrial investment a sufficiently large share of the total annual flow of savings, and of ensuring simultaneously its distribution over different branches and sectors of industry in accordance with the socially determined priorities.
As indicated earlier, the specialised financial institutions are needed to divert the existing funds into productive channels, and when a country has a definite plan priorities they are acquired to see how and when the funds are invested. This need is greater in the private sector, because the allocation of funds in the public sector is done by the Government in the manner determined by the State. But in the private sector, the proper allocation of funds among various industrial projects needs to be regulated by some specialised financial institutions and this job can very well be entrusted to what is called the development banks.

**Historical Background**

The need for financial agencies was felt as far back as 1918, when the Industrial Commission recommended setting up of a development bank analogous to the Industrial Development Bank of Japan (1902) through the active intervention by the Government in economic affairs. Between 1917-23 certain private industrial banks were set up e.g. Tata Industrial Bank but because of their wrong investment policies, they could not make an impact and had to be closed down. The Central Banking Inquiry Committee (1931), inspired by various Provincial Banking Inquiry Committees, favoured the idea of routing State aid to industries through the industrial finance corporation at the provincial level but nothing materialised then.
Some economists like Prof. S.K. Basu and Dr. P.S. Loknath suggested that for providing financial assistance to industries an all-India lending body should be established which should have its branches in provinces. Prof. Basu suggested the creation of an all-India Bond Issuing Institute with a number of credit granting Provincial bodies affiliated to it but having no bond issuing power. The national body was conceived to provide finance to the Provincial bodies which in their turn, were to lend to industries. Thus, the emphasis was on provision of term loans only and not on provision of underwriting facilities, equity capital, etc. During the forties, emphasis gradually shifted from the setting up of Industrial Mortgage Banks to Finance Corporation.

Most of the fixed assets of industries in India during the Second World War become depleted, crippled and obsolete. This added to the urgency of finding out a suitable via-media for providing term finance to industries which were badly in need of repairs, replacements, re-equipment, modernization and rehabilitation etc.

Here in this connection the need for Government financial assistance became acute. The Government of India made it clear in the Industrial Policy Statement (1945) that the question of setting up Industrial Investment Corporation was
under active consideration. Consequently, the Industrial Finance Corporation Act was passed in March 1948.

Pre-Independence Organisation

The principal features of the pre-independence industrial financing were, narrow-based entrepreneurial finance, a semi-organised and narrow industrial securities market devoid of issuing institutions and virtual absence of participation by intermediary financial institutions in the long term financing of industries. As a result, industry had a very limited access to external savings and had to depend primarily on internal savings i.e. the financial system was not responsive to opportunities for industrial investment. Such a system was clearly incapable of initiating a high rate of industrial growth.

In the absence of an adequate arrangement for raising external finance, the growth of industry depended in the main on the accumulation of capital in entrepreneurial hands, or on the existence of a close nexus between the sources of entrepreneurship and the sources of finance. The Managing Agency System was to some extent instrumental in creating this nexus. The system had led over the years to 'Group Management' and 'Group Finance' under which the internal savings of a group as a whole were utilized for
expansion within the group. The obvious outcome of this situation is that the industrial expansion took the form of increasing managerial and financial concentration.

Post-Independence Organisation: A Synoptic View

In the post-independence period there has taken a phenomenal growth in the financial institutions. India is now well-served by a network of specialised financial institutions at all-India level and in the States. These institutions have been sponsored by the Government for providing medium and long term financial assistance to industry. They have acquired such an importance within about 30 years that they can be properly described as the corner stone of the modern industrial financial system in India. The establishment of these institutions is really the most outstanding development in the sphere of industrial finance since independence and has a far-reaching effect on the entire industrial financing system.

Industrial Finance Corporation of India

The first special financial institution to be set up in India viz., the Industrial Finance Corporation of India (IFCI) was established in July 1948 under the Industrial Finance Corporation Act, 1948, with a view to providing medium and long-term credit to industry, particularly in
circumstances where accommodation from normal financial sources is inappropriate or recourse to capital issue method is impracticable.

Any public limited company or co-operative society incorporated and registered in India engaged in manufacturing, preservation or processing of goods or in the shipping, mining or hotel industry or in the generation and distribution of electric power or any other form of power is eligible for assistance. As a result of an amendment of IFCI Act in December 1972 it can extend assistance also to public sector undertakings incorporated as private limited companies.

Section 23 of the IFCI Act authorises the Corporation to provide financial assistance by (a) granting loans or advances to or subscribing to the debentures of industrial concerns repayable within 25 years, (b) guaranteeing loans floated in the open market by industrial concerns repayable within 25 years, (c) underwriting of stocks, shares, bonds or debentures issued by industrial concerns subject to the stocks etc. acquired as a result of underwriting being disposed of in the market within a period of seven years, and (d) guaranteeing deferred payments in respect of imports of capital goods by approved industrial concerns which are able to make such arrangements with foreign manufacturers.
The Corporation was originally prevented from subscribing directly to the shares or stocks of any company having limited liability, but IFCI (amendment) Act 1960, empowers the Corporation to subscribe directly to the share capital of industries.

The Corporation was also prohibited from accepting deposits but an amendment to the IFCI Act passed in November 1957 empowers the Corporation to accept deposits from the State Governments and also from local authorities, repayable after the expiry of a period which shall not be less than 5 years from the date of making the deposit. The finances of the IFCI are available for setting up of new industrial projects as also for renovation, modernization, expansion or diversification of existing ones. Small scale industrial units and industrial enterprises organised on the basis of proprietary or partnership basis are ineligible for financial assistance from the IFCI.

At the time of the starting of the Corporation it was decided that in view of the then situation in the money market and the stock exchanges, the Corporation for the time being should not undertake underwriting operations and guaranteeing loans floated in the public market. This policy continued for a full decade. The Corporation turned to underwriting and guarantees only in June 1958. There
does not appear to have been much satisfaction for its view in the earlier years that it did not underwrite because conditions in the capital market were not favourable for underwriting, which is on par with a doctor's statement that he would not attend on a person so long as that person was ill.\textsuperscript{7} The fact of the matter is that in the beginning the Corporation wanted to play safe, which one can appreciate, though not the reason that was given out for underwriting. In actual practice the Corporation concentrated exclusively on its lending functions, mostly of rupee resources. However, loans in foreign currencies are granted only for the import of capital goods and not for financing raw materials and maintenance imports or payment of royalties, interest and dividends etc.

The IFCI adheres to the priorities laid down by the Government from time to time in its Five Year Plans. It gives priority to industries that (1) facilitate agricultural development, (2) increase export earnings, and (3) substitute imports.\textsuperscript{8}

\textbf{State Financial Corporations}

The setting up of IFCI was followed by the creation of regional institutions known as State Financial Corporations (SFCs) by the State Financial Corporations Act, 1951. The
SFCs are unique set of institutions bearing close resemblance to development banks set up in other countries, though there are significant differences mainly in the environment in which they are to function. The idea of establishing the finance corporations in each State goes back to the early thirties, when the Central Banking Inquiry Committee recommended (in 1931), to set up Provincial Industrial Corporations. The scheme of their operation was generally confined to small and medium sized industries though large scale industries were not to be denied assistance.

The SFCs are closely modelled on the line of IFCI but there are certain departures. The definition of 'industrial concern' is much wider so as to include not only public limited companies, but also private limited companies, partnerships and proprietary concerns. Also the SFCs are authorised to give guarantees and make loans and advances for a period of not more than 20 years as against the limit of 25 years for IFCI. 9

Thus all types of industrial concerns can approach SFCs for accommodation and in this sense the scope of activities of SFCs is wider than that of IFCI. The SFCs can (a) guarantee loans raised by industrial concerns which are repayable within 20 years and which are floated in the public market, (b) underwrite the issue of stocks, shares and bonds or debentures of industrial concerns, (c) grant loans or
advances to industrial concerns repayable, with a period not exceeding 20 years, (d) subscribe to debentures floated by industrial concerns.

A SFC is prohibited from subscribing directly to the shares or stocks of any company having limited liability except for underwriting purpose and granting any loans or advances on the security of its own shares.

In all there are 18 SFCs now, of which 17 have been set up under the State Financial Corporations Act, 1951. Tamil Nadu Industrial Investment Corporation Limited (TIIC), was set up as early as 1949 under the Indian Companies Act. However, in a number of respects, its operations are similar to those of SFCs and some of the sections of SFCs Act apply also to the TIIC.

Need for Dynamic Approach

It was expected that these statutory corporations (i.e. IFCI & SFCs) will provide a solution to the long standing complaints of inadequate long terms financing facilities for both large and small scale industrial enterprises. In actual practice these institutions failed to make any significant impact on the availability of long term industrial finance. Their methods and policies were characterized by excessive caution, their procedures were dilatory, they concentrated on traditional industries and more stress was laid on security rather than on prospects. This attitude was reflected in
their concentration in lending activity to the exclusion of underwriting activity.

It was, therefore, felt to have a more dynamic approach than that followed by the IFCI and SFCs if the requirements of the private industrial sector were to be met effectively. This led to the creation of two new institutions, viz., the National Industrial Development Corporation and the Industrial Credit and Investment Corporation of India.

**National Industrial Development Corporation**

The National Industrial Development Corporation (NIDC) which is a full-fledged Government institution, was set up by the Government of India in October 1954 for the promotion and development of industries in India. The Corporation is conceived mainly as an instrument of Government for securing a balanced and integrated development of industries in both the public and private sectors, particularly the development of those industries which are necessary to fill up the gaps in the industrial structure of the country. The Corporation is required to plan and formulate projects for setting up new industries or developing new lines of production. The Corporation is not conceived to be primarily a financing agency, this form of assistance being confined to a few special industries. It is primarily a development corporation.
Although the NIDC was set up with the objects mentioned above, it began operating as a highly specialised agency for granting loans for the modernization and rehabilitation of the jute and cotton textile industries. In 1958 the Government promoted the Corporation to advance loans to machine tool manufacturing industries. The amount of loans sanctioned to cotton and jute textile industries up to the end of March 1964 aggregated Rs. 28.2 crores, against which an amount of Rs. 14.9 crores was disbursed. The corresponding figures at the end of March 1963 were Rs. 26.4 crores of loans sanctioned and Rs. 12.6 crores disbursed. As regards the machine tool industry, the total amount of financial assistance sanctioned at the end of March 1964 was the same as at the end of March 1963 - Rs. 1.00 crores while the actual withdrawal stood at Rs. 88 lakhs as against Rs. 54 lakhs at the end of March 1963.

The Estimates Committee in its report presented to the Lok Sabha on 1st April 1961 has severely criticised the working of the NIDC and suggested that the NIDC should be divested of its functions as a financial agency. At present it has been converted into a Consultancy organisation and has no concern with the financing of the private industry.
The Industrial Credit and Investment Corporation of India Limited (ICICI) was established in January 1955 as one of the development banks which World Bank actively sponsored in a number of countries in co-operation with the respective Governments. The ICICI was to be the private sector financial institution i.e. without any contribution to its share capital from the Government, the Reserve Bank etc. But the Corporation was to have the Government's full support including provision of loans. The setting up of ICICI represents a landmark in the diversification of development banking in India in so far as it was a pioneer in many respects of the provision of foreign currency loans and underwriting. The latter function was sadly neglected by the IFCI. ICICI was to be an issuing-cum-lending institution from its very inception. Its operations are designed to be flexible in general. The Corporation will (a) assist in the creation, expansion and modernization of private enterprises, (b) encourage and promote participation of private capital both internal and external, in such enterprises, and (c) encourage and promote private ownership of industrial investment and the expansion of investment markets, in particular by (a) providing finance in the form of long and medium term loans or equity participations; (b) sponsoring and underwriting new
issues of securities, (c) guaranteeing loans from other private investment sources, (d) making funds available for re-investment by revolving investments as rapidly as prudent, and (e) furnishing managerial, technical and administrative service to Indian industry.

The ICICI, being a privately owned corporation has certain advantages over other Corporations like the IFCI. It is independent of direct Government Control and free from its interference in small matters. Thus it enjoys sufficient independence and flexibility which other corporations do not have.

A distinguishing feature of ICICI's functioning was that it sought to emphasis underwriting function which was neglected by the previously established institutions. It did pioneering work in the underwriting field and became a rallying point for other financial institutions in this field.

Refinance Corporation for Industry

The Government of India in June 1958 decided to introduce a scheme of term lending by commercial banks and set up the Refinance Corporation for Industry Ltd., (RCI) for the purpose of refinance to banks against term loans granted by them. In 1962, the RCI was empowered to provide refinance to SFCs also in order both to solve the problem of slow utilisation
of RCI's funds by banks and to help the SFCs by augmenting their resources. RCI did not involve in direct industrial finance. RCI was merged with Industrial Development Bank of India from September 1, 1964.

**Industrial Development Bank of India**

With the establishment of Industrial Development Bank of India (IDBI) in July 1964 as a subsidiary of the Reserve Bank of India, a major re-organisation and strengthening of the structure of special financial institution took place. In terms of its conception as an 'appex institution' it has been assigned functions in the spheres of medium and long term finance. Thus, the IDBI is meant to (a) co-ordinate the activities of the other financial institutions (including commercial banks), (b) supplement their resources, (c) plan and promote industries of key significance to the industrial structure and, (d) adopt and enforce a system of priorities in promoting further industrial growth. 12

IDBI's assistance to the financial institutions takes the form of refinancing of loans granted by them or of subscription to their shares and bonds or of rediscounting of usance bills arising out of sales of locally produced machinery on deferred payment basis.
In addition to the above indicated functions, IDBI also engage in the direct financing of industrial concerns by granting loans, underwriting new issues, subscribing to shares and debentures, and guaranteeing loans on deferred payments. However, the special feature of its activities is the refinancing of loans and export credits extended by other special financial institutions and commercial banks.

Apart from assistance, IDBI also performs other developmental functions, such as promotion of new projects and provision of developmental services. IDBI, as indicated earlier was started as wholly-owned subsidiary of the RBI. In terms of Public Financial Institutions Laws (Amendment) Act, 1975, it has been delinked from the RBI with effect from 16th February 1975. The primary objective of delinking is to enable the RBI to devote on proper discharge of its central banking functions on the one hand, and to enable the IDBI to grow into a developmental agency on the other. The ownership and control of IDBI passed on from RBI to the Central Government.

IICs/SIDCs.

In a number of states, there are also special Government owned financial institutions known as Industrial Investment Corporations (IICs), for the purpose of granting loans and underwriting assistance, besides promoting industrial units and locating entrepreneurs. In many States these corporations co-ordinates their activities with the industrial
financing operations of SFCs, all-India development banks and commercial banks.

In addition to the institutional infrastructure for industrial development, the emergence of State Industrial Development Corporations (SIDCs) and State Industrial Investment Corporations (SIICs) is of relatively recent origin. The first SIDC was set up in Bihar in November 1960. Over the years all the states have realised the importance of SIDCs/SIICs as catalyst in the industrialisation process. SIDCs mainly give all help to entrepreneurs in regard to the supply of infrastructure facilities. They acquire land, put up industrial estate for a number of units to work in the same area, construct roads, and arrange for the supply of water and electric power. They also introduce the entrepreneurs to the State level financial institutions. Thus promoting industrial development is a common objective of all these corporations.

**Industrial Reconstruction Corporation of India Limited.**

The latest institution was to be set up was the Industrial Reconstruction Corporation of India Limited (IRCI), in 1971. The primary objective in setting up the IRCI was to revive and revitalise industrial units which have closed down or are likely to face closure but show promise of being operated economically with suitable
assistance. In attempting to achieve this objective, the IRCI functions not merely as a lending institution but also as a reconstruction agency. This role includes restructuring of management providing technical and managerial guidance either through its own staff or by helping in procuring suitable personnel and acting as a catalyst in securing assistance from other financial institutions, banks, and Governmental agencies. Although the scope of IRCI is fairly very much wide, its primary responsibility has been to provide financial and technical assistance and guidance to sick industrial units which are unable to obtain assistance from normal financial and banking channels. One of the important functions of the Corporation is to provide technical and managerial assistance to units in trouble.

Investment Institutions

From the above discussion it can be concluded that there is now quite a wide variety of what one might call development banks proper to provide finance to industry in diverse forms. From a modest beginning in 1948 the institutional machinery has been strengthened and diversified from time to time, both by the addition of newer institutions with more flexible structures and by enlarging the resources and scope of functions of the existing institutions. In addition, there are two all-India investment institutions,
which also play a role in the provision of finance for
industry in the form of loans and underwriting and investment
in addition to the primary role of buying (and selling)
securities of already established industrial units.

The one is the Life Insurance Corporation of India (LIC)
established in 1956 through the nationalisation of life
insurance companies. This monolithic State owned institution
has brought about a concentration of funds which has led
to command over enormous resources. LIC has been very much
influenced in the industrial securities market in India.
Because of a continuing flow of insurance premium funds, it
comes to the market frequently and also in a bigger way than
other institutions. It has emerged as a leading underwriter
of corporate issues and a shareholder massive importance.
LIC's operations in the capital market have beneficial effect
on the functioning of the financial system. In particular
its purchases of corporate securities have price stabilizing
effect on the market and they strengthen the influence of
investment consideration in the determination of share market
prices. Its contribution in the area of underwriting has
the effect of improving the allocative efficiency of the
financial system. The investments of the LIC are regulated
by the Section 27A of the Insurance Act, 1938, though from
time to time some modifications are made in this regard.
Another measure taken by the Government of India in the direction of strengthening the organisation of the financial system for developmental purpose is the establishment of the Unit Trust of India (UTI) in 1964. The ultimate aims of the establishment of UTI were to enable small investors to share in the industrial prosperity through indirect holding of equities on the one hand and to mobilize the savings of relatively small investors who form the major section of the saving population for economic development on the other. It has been introducing innovative forms of financial assets to suit the preferences of different classes of investors. In order to encourage unit holdings by the people the Government of India has given certain fiscal concessions.

UTI mobilises public savings through the sale of 'units' under different unit schemes and saving plans operated by it. In investing its resources, UTI's primary concern is the profitability of the investments so that its basic objective of ensuring reasonable, and growing returns to unit holders is fulfilled. The investment operations are done mainly through purchase and sale of corporate securities in the stock market. UTI also provides underwriting of, and direct subscriptions to shares and debentures of companies in participation with other all-India financial institutions.
Table 3.1
Sales, Repurchases, Outstanding of UTI units since inception up to June 30, 1980.
(Rs. in crores)

<table>
<thead>
<tr>
<th>Year (July-June)</th>
<th>Sales</th>
<th>Repurchases</th>
<th>Outstanding</th>
</tr>
</thead>
<tbody>
<tr>
<td>1964-69 (First Five Years)</td>
<td>63.0</td>
<td>6.4</td>
<td>56.7</td>
</tr>
<tr>
<td>1969-74 (Second Five years)</td>
<td>109.7</td>
<td>14.5</td>
<td>151.9</td>
</tr>
<tr>
<td>1974-75</td>
<td>17.2</td>
<td>20.4</td>
<td>148.8</td>
</tr>
<tr>
<td>1975-76</td>
<td>29.0</td>
<td>11.0</td>
<td>166.8</td>
</tr>
<tr>
<td>1976-77</td>
<td>34.6</td>
<td>8.0</td>
<td>193.3</td>
</tr>
<tr>
<td>1977-78</td>
<td>73.3</td>
<td>11.2</td>
<td>255.4</td>
</tr>
<tr>
<td>1978-79</td>
<td>101.5</td>
<td>9.5</td>
<td>347.5</td>
</tr>
<tr>
<td>1979-80</td>
<td>57.8</td>
<td>14.4</td>
<td>390.9</td>
</tr>
</tbody>
</table>

Total: 486.1 95.4

Before the establishment of the UTI, the LIC was by far the most dominant buyer of industrial securities in India as well as single most institutional underwriter of capital issues. The UTI now stands the largest buyer of industrial securities. In a sense, therefore, the establishment of UTI can be said to have relieved the LIC of the responsibility to support the industrial securities market.

LIC and UTI are a class by themselves. Though both in the public sector, they are financial intermediaries in the real sense as they intermediate between the ultimate lenders and ultimate borrowers. While the specialised financial institutions in the public sector intermediate between the Government and the Corporate sector. They look like more as distributors of term loans and long term finance. Their operations are not determined by market forces but are a matter of policy.13

Since the nationalisation of the general insurance business in the country in 1973, the General Insurance Corporation of India (GIC) and its four subsidiaries have been participating on a consortium basis with the other all-India financial institutions, in the financing of industrial projects. The participation of GIC and its subsidiaries in such projects takes the form of underwriting of new issues, direct subscriptions to privately placed debentures or granting of term loans.14
Commercial Banks

Commercial banks are the oldest financial intermediaries. Like the UTI and LIC they also intermediate between the ultimate lenders and ultimate borrowers and in this sense they are also real financial intermediaries. We shall deal separately with this aspect.

Conclusions

From the above presentation it is observed that a battery of development banks has come into being in India so that with a variegated structure they are able to provide finance to industry in diverse forms. From a beginning in 1948 the machinery has been strengthened and diversified from time to time both by the addition of new institutions with more flexible structure and by enlarging the resources and the scope of functions of the existing institutions. Some of these institutions are all-India, others are State level in scope of operations and between them cover the whole range of industry. There is, thus, a fairly wide variety of development banks.
References


3. Basu, S.K., in (Industrial Finance in India) and Loknathan, P.S., in (Industrial Organisation in India).


5. This limitation can be waived with the permission of the Central Government.


8. NCAER, Capital Market in a Planned Economy, New Delhi, 1966, p. 17.


