CHAPTER II

THEORY OF NON-BANKS

(1) The Non-Bank - its Nature and Evolution

The Non-Bank, Development Bank, Development Corporation or Development Finance Institution is an institutional device conceived of as an effective apparatus geared to the task of economic development after the Second World War. "It is a chosen instrument for facilitating and stimulating economic growth." 1 Development Banking is an instrumentality - and an important one - of development planning or economic development in the country." 2 The subject of economic development of under-developed countries did not draw much attention of the world leaders before the catastrophe. It was only during the forties that the economic and financial experts of the world started giving serious thought to this issue. They recognised that the political independence of the newly emerging nations would be meaningless in the absence of their economic emancipation. Following preliminary discussion at Atlantic City, the representatives of 44 nations attended a United Nations Monetary and Financial Conference convened at Bretton Woods, New Hampshire, U.S.A., on July 1, 1944. At this


conference they formally consented to the formation of International Bank for Reconstruction and Development (IBRD) - the premier Non-Bank Financial Institution of the world, on December 27, 1945.3

The European countries also went ahead with the task of establishing new institutions to tide over the problems of reconstruction and development resulting from the ravages caused by the catastrophic war.

The formation of International Bank for Reconstruction and Development gave strong incentive to the creation of many specialised financial institutions at national levels, besides the institutions set up directly by the World Bank itself.4 There are at present more than 400 development finance institutions spread over a hundred and odd countries in the world.5

The tempo of the formation of non-Banks did not stop at the national and international level; rather the idea started percolating to regional levels to serve the needs of composite geographical areas. The examples of such institutions are Inter-American Development Bank, the African Development Bank, the Asian Development Bank etc.

4The World Bank has initiated, sponsored and financed 68 development banks in forty-four countries (Parakh, op.cit.).
The Non-Bank financial institutions are not a totally new device introduced for the first time after the Second World War. The Societe Generale de Belgique founded in Belgium in 1822 was the first institution to come into being to finance and promote the rapid growth of industry. The Credit Mobilier of France established by the Pereire Brothers in 1852 was the second institution that followed suit. 'In the United Kingdom the merchant banking houses grew over the years to arrange long-term capital needed for economic growth, alongside the banks which functioned to provide working funds. In Germany, the banks combined both the functions of providing short-term and long-term capital and came to practice what has been termed universal banking'. However, the French example may be regarded as a pioneering effort for building up an institutional structure of industrial finance. It provided a great appeal throughout the 19th century to all countries anxious to develop suitable machinery for financing the rapid rate of industrialisation. During the early part of 20th century, the highly industrialized nations of the world like the U.S.A. also resorted to the formation of a development finance institution namely Reconstruction Finance Corporation for economic rehabilitation of the country ravaged by the depression of the thirties. However, it was during the last 35 years that the development finance institutions have gained tremendous popularity in the developing countries of Asia, Africa and Latin America.

Parekh, op. cit.
(2) **Definition**

The Non-bank encompasses institutions of diverse forms performing multifarious functions, often not similar in nature. So, it is really difficult to put forward an all-embracing definition of a non-bank. However, it will be illuminating and instructive to depict the views of different authors and experts in an effort to highlight the salient features of such institutions.

As a matter of fact, there is no dispute about the basic objective of non-banks which is to speed up the process of industrialisation in order to accelerate the rate of economic growth.

There are different types of non-banks such as Industrial Mortgage Banks normally making long-term loans to industrial enterprises; Industrial Finance Corporation making loans and providing equity capital as also undertaking of underwriting of shares and debentures; and Industrial Development Corporation undertaking promotion of industries, conduct of techno-economic surveys, market and investment research, provision of technical, managerial and administrative guidance to the entrepreneurs etc. Broadly speaking, the term non-bank includes all these institutions and many more that perform one or more or all the functions just mentioned. The significant point about a non-bank is that its principal function rests in financing economic activity though it may also undertake development functions.
A non-bank financial institution may be defined as an institution either wholly or partially owned by Government or by private interests (both domestic and foreign) primarily devoted to the provision of long-term capital (both loan and equity), to the stimulation and invigoration of the domestic capital market and to the supply of enterprise, including technical know-how and management to the private sector.

E.T. Kempier has tried to draw a line of demarcation between functions of commercial banks and non-banks. According to him, one of the primary responsibilities of a banker is concern for security and interest margins. He is expected to be conservative and to look with a certain suspicion on untutored ideas. A development finance company, on the other hand, must create for itself the image of an activist institution, interested in development and unafraid of change and fully aware that there can be no development without new ideas.

7 “Enterprise involves the willingness to assume risks in undertaking an economic activity, particularly a new one, though, not necessarily an unknown one. It may involve an innovation but not necessarily so. It always involves risk-taking and decision-making although neither risks nor decisions may be of great significance”. (See William Diamond, Development Banks, The John Hopkins Press, Baltimore, 1957, p.2).


They may be best regarded as the channel through which not only capital but also all the other ingredients of economic development flow under planned direction so as to irrigate and fertilise the arid regions and transform them into economically developed fruitful areas.  

The development banks constitute an important institutional machinery for accelerated and planned economic development, on account of lack of or inadequately developed capital markets and poor rates of voluntary investment, as a consequence of low per capita incomes.

According to William Diamond, an authority on development banking, it is an institution to promote and finance enterprises in the private sector.

Since development banks have emerged as multi-faceted institutions and a wide variety of functions and practices have come to be evolved all over the world, it would not be wrong to remark, "Development banking is an art - not a science".

12 Diamond, op. cit., pp.4-5.
(3) **Ownership**

Four types of non-banks are usually found in the developing countries:

(a) **Government-owned**, e.g., The Development Bank of Indonesia established in 1960.

(b) **Central bank-owned**, e.g., The Canadian Development Bank set up in 1944.

(c) **Privately-owned**, e.g., The Industrial Credit and Investment Corporation of India formed in 1955.

(d) **Jointly-owned** by Government and private interests, e.g., The Industrial Development Bank of Burma brought into being in 1961.

Majority of the non-banks, however, are owned by the Government or by the Central bank or by both in collaboration with each other. The number of privately owned non-banks is rather infrequent and rare.

The privately-owned non-banks have got certain advantages. They can follow businesslike procedures and can work objectively, flexibly and freely without political pressure or external interference.

The disadvantages are that it is difficult to establish private non-banks because of paucity of financial resources and lack of entrepreneurial spirit and ability. Even when private capital is available, they cannot be established on a sound financial basis unless the Government is prepared.
to extend generous financial support.\textsuperscript{14}

The Government/Central bank/Govt.-cum-Central bank-owned non-banks are also not without advantages. They command sufficient resources and can cover all types of industries, venture into new and pioneering fields and carry on extensive research and techno-economic surveys.

The allegation which is generally levelled against Government-owned non-bank is red-tapism. The drawback about central bank-owned non-bank is that its management and functioning may not receive adequate attention because of central bank's preoccupation with various functions of its own relating to the development and control of money market.

The non-bank with a mixed ownership may prove particularly useful in the context of a mixed economy where it may be called upon to finance the needs and requirements of both the private and public sector enterprises with even-handed justice.

The main disadvantage of this type of institution lies in the fact that each side may try to exert pressure to boost one sector and denigrate the other, thereby generating tensions and conflicts and hampering progress and prosperity of the institution itself.

It must, however, be remembered that the ownership factor is not the criterion of efficiency and it cannot by no means be generalised that privately-owned non-banks are operationally better than the ones by the Government.

Underdeveloped countries keenly desire to emulate the example of advanced countries by achieving a comparable rate of economic growth. But they have to be selective in their development approach because of resource constraints. So, without depending on market forces, the Governments of these countries take the initiative and establish non-banks to channelise financial resources to chosen fields and priority areas. Herein lies the rationale of the proliferation of Government-owned non-banks in underdeveloped countries.

(4) Sources of Capital

There are two sources of capital: external and internal. The external source is comprised of share capital, borrowings, long-term loan from the Government with nominal or no interest, bond and debenture issues and term deposits. The internal source includes repayment of principal and the reserve fund. The funds from these sources may be either domestic or foreign or partly domestic and partly foreign.

Of the sources mentioned, share capital and borrowings dominate the financial structure of many non-banks.

The non-banks have to keep sufficient amount of foreign exchange with them in the initial stage of industrialisation to finance imports of machinery, equipments and raw
materials. Foreign loans, however, entail exchange risk. The system of bearing exchange risk differs from institution to institution. But the broad logic is that it should be borne by the loanee himself.

The financial soundness of an institution is contingent on the relationship between equity and loan. Normally an equilibrium is required to be maintained between outstanding loans on the one side and total equity on the other. The borrowing is generally expressed as a certain number of times of paid-up capital or paid-up capital and surplus. Sometimes a ceiling is imposed on the amount of bond issues or total borrowings. The object of this statutory prescription is to ensure safety of borrowed funds.

According to Shirley Boskey, another authority on the subject under study, there is no single "correct ratio" that can be universally prescribed.\(^5\) As a matter of fact there are a variety of ratios maintained in actual practice. The Finance for Industry Limited of U.K. can borrow up to four times its capital (authorised capital: £100 million) and reserves to bring actual and potential resources to almost £500 million.\(^6\) The Industrial Finance Corporation of India has been empowered to borrow ten times its paid-up

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\(^5\) Ibid., p.24.

\(^6\) Central Office of Information (Reference Division), British Banking and Other Financial Institutions, a Pamphlet, London, November, 1974, p.33.
capital and reserves and the amount of total borrowings of Industrial Credit and Investment Corporation of India must not exceed Rs. 75 crore, i.e., Rs. 750 million. The borrowings of Industrial Development Bank of Canada cannot exceed five times the sum of its paid-up capital and reserve fund.¹⁷

The ratio between equity and loan should neither be too high nor too low. Because too high a ratio means lesser element of safety whereas too low a ratio may hinder progress for non-availability of required funds. So, the ratio should be set judiciously somewhere in between the two extreme positions.

(5) **Kinds of Financial Assistance Rendered by Non-Banks**

The central function of non-banks is the provision of finance. The assistance rendered by these institutions may take the following forms:

(a) granting of loans,
(b) subscription to shares and debentures,
(c) underwriting of shares, bonds and debentures,
(d) guaranteeing deferred payments for imported machinery and equipment, and
(e) guaranteeing of loans raised from domestic and foreign sources.

The majority of non-banks in the developing countries are equipped with twin functions, i.e., provision of loan and

equity capital. Though some charters authorize only conventional fixed-interest loans, most permit loans, equity investments or loans convertible into equity.\textsuperscript{18} The Industrial Finance Corporation of Thailand offers loans, equity participation, investment consultation and underwriting as forms of finance.\textsuperscript{19} Ever since its inception in 1959, the Nepal Industrial Development Corporation has tried to invest, finance and assist expansion, promotion and modernisation of industries by providing medium and long-term loans, equity participation, guarantees and technical as well as managerial advice.\textsuperscript{20} The forms of assistance of Industrial Credit and Investment Corporation of India include underwriting of shares and debentures, subscription to such securities, provision of loans, guaranteeing payments for credits and providing credit facilities to manufacturers for promoting sale of industrial equipments on deferred payment basis.\textsuperscript{21}

The assistance of Industrial Finance Corporation of India may take the form of long-term loans, underwriting of and direct subscription to securities, guaranteeing deferred

\textsuperscript{18} Boskey, op.cit., p.70.
\textsuperscript{21} Industrial Credit and Investment Corporation of India, \textit{The ICICI: A Source of Capital for Industry}, March, 1979, pp.5-6.
payments in respect of imported machinery and guaranteeing loans raised in foreign currency from foreign financial institutions.22

The capital market in the under-developed economies is sluggish, not so well-equipped as in the mature economies. There is also general paucity of financial resources in such economies due to low income levels and meagre savings. So, the non-banks of a less-developed economy should purvey at least two types of finance, i.e., loan and equity, since they are vital in the context of the situation of such an economy.

(6) Deposit Mobilisation and Working Capital Support

Many non-banks have been authorised to accept term-deposits. For example, the Industrial Credit and Investment Corporation of India has started accepting fixed deposits since 1978 to augment its rupee resources.23 The Industrial Development Bank of Burma and Pakistan also have been allowed by their charters to accept deposits. The Canadian Industrial Development Bank, Kreditanstalt (German Reconstruction Loan Corporation) and Japanese Development Banks are not allowed to augment their resources through this method. Some newly formed institutions (i.e., Industrial and Mining Development Bank of Iran, The Development Bank of Burma) have been allowed to carry on a wide range of commercial banking functions like opening Letters of Credit, discounting of bills etc.24

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24 Basu, op. cit., p.36.
The non-banks should not perform commercial banking business in countries where the banking system is well-developed. It would be wrong in principle for them to come into direct competition with commercial banks. Such competition is unhealthy, inadvisable and is likely to alienate commercial banks from the financial mainstream.

The activities of commercial banks in the developing economies being sparsely dispersed, a large majority of the population stay outside the umbrella of banking service. It means that much scope exists for the extension of their activities and functions. So, the receipt of term-loans by one or two non-banks with a few branches situated mostly in the big cities may pose no threat to the banking system.

**Working Capital Support:** There are two types of working capital: permanent and temporary. Permanent working capital is generally financed out of paid-up capital, temporary working capital being taken care of by the commercial banks. The non-bank basically entrusted with term-lending, normally does not feel the need of undertaking the financing of working capital needs more particularly so where banking system is well-founded. But the practice differs from institution to institution. The Industrial and Mining

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25 Permanent working capital consists of money blocked in various types of inventories such as raw materials, work-in-progress and finished goods and trade debtors. Temporary working capital is cash required for day to day operations of the business and to take advantage of any profitable opportunity that may arise. (See S.P. Jain and K.L. Narang, *Advanced Accountancy*, Kalyani Publishers, New Delhi, 2nd ed. 1980, p. 660.)
Development Bank of Iran, the South African Industrial Development Corporation and Nepal Industrial Development Corporation consider the provision of working capital as a part of their usual functions. On the other hand, the Industrial Development Bank of Burma and India do not provide it at all and the Industrial Development Bank of Canada and Pakistan carry out this function only under certain circumstances and in limited amounts.\textsuperscript{26}

It is a difficult task to combine these two functions. According to Shirley Boskey, different administrative problems may be created by an attempt to combine two types of financing, calling for different kinds of portfolio management and different staff qualifications.\textsuperscript{27}

The financing of working capital is basically a function of commercial banks. But where they are unable to meet the requirements, the non-bank should come to the rescue of the entrepreneurs. The provision regarding this activity should be flexible and it should be conducted on a limited scale.

(7) **Scopes and Coverage of Activities**

There are several separate fields of long-term investment, i.e., agriculture, small industry, large scale industry, mining, urban housing, transport and power. Which sectors of the economy should a non-bank attempt to cover?

\textsuperscript{26}Basu, \textit{op. cit.}, pp. 34-35.

\textsuperscript{27}Boskey, \textit{op. cit.}, p. 34.
There is no definite coverage which could be universally
prescribed as ideal. The level of development of an economy,
its size, socio-economic background, banking and financial
infra-structure, political philosophy of the Government and
credit policy pursued by it fixes the range and kind of
activities for a non-bank.

A single institution may handle all the fields of
activity or may specialise in one or more of them. For example,
the Philippine Rehabilitation Finance Corporation has been
empowered to provide credit for commerce, housing, agriculture,
industry, loans to reconstruct damaged property and to broaden
and diversify the economy. On the other hand, the Puerto Rico
Industrial Development Company has concentrated all its resources
on industry.28 The newly established non-banks are more
specialised in the scope of work than their old counterparts.

The nature of problems of large and small industry,
agriculture, housing, transport and power are different in
magnitude requiring different approaches and treatment. So,
it is desirable to have separate institutions for each segment
of the economy. The questions of resource constraints,
geographical expansion and work efficiency also suggest the same.
Specialisation in a particular field also enables an institution
to employ right quantum of funds and devote required attention on
the activity undertaken.

28 Diamond, op. cit., p.48.
The disadvantages of specialisation are that it may lead to the formation of many institutions putting undue strain on the already scarce administrative and managerial resources of the economy. The problem of financial overlappings is also there. It may also increase risk in putting together rather than diversifying resources. The problem of co-ordination of many institutions with each other and with Government policy may also arise.

The advantages of having broad scope of activities are that they minimise the number of institutions to be formed to take care of each function and as such economise the use of scarce managerial and administrative personnel resources available.

Too broad a scope may disperse resources too thinly to have much of an impact unless sufficient resource endowments are available.

In this age of specialisation it seems desirable that separate institutions be established to take care of the financial needs of agriculture, industry, housing etc.

The charter of a non-bank often asserts that it will not finance a project if the entrepreneurs can manage funds from normal banking channels or from the capital market. For example, the Industrial Finance Corporation of India, the Industrial and Commercial Finance Corporation of Britain, the Industrial Development Bank of Canada provide finance to a project provided that such credit would not otherwise be available on reasonable terms and conditions from any other
source. It is really problematical to determine whether an applicant can or cannot arrange funds from alternative sources. The Industrial Development Bank of Canada, among other queries, demands a certificate from the applicant that "he is unable to obtain loans from other sources on reasonable terms and conditions" to satisfy this criterion.29

There is no point in giving loan to an entrepreneur if he can arrange it from other sources. This stipulation sounds reasonable in the context of a developed economy where capital market is well established and a number of other visible and invisible sources of finance exist. But in an underdeveloped economy an entrepreneur has got very little scope of alternative choices. So, the provision may not sound appropriate in such an economy. But still there is no harm in incorporating this clause in the charter of non-banks in a developing economy provided that the institution does not put too rigid a construction on it.

Establishment of a System of Priorities: The non-banks have to work within the broad policy framework of the Government. So, formulation of its own independent system of priorities may not be possible. But the Government's direction in majority of cases is indicative and not exhaustive. So, a non-bank can evolve its own order of priorities which meshes adroitly with the broad policy framework laid down by the Government.

The fields of activity which draw the attention of

29Basu, op. cit., pp.47-49.
non-banks differ from country to country depending on the availability of human and natural resources and the stage of economic maturity achieved. So, no generalisation is possible in this respect. However, a modern non-bank attempts to do the following:

(1) emphasis on manufacturing activities,
(2) development of entrepreneurial base by inducing and inducting new faces into the industrial arena,
(3) development of expert-oriented and import-substituting projects,
(4) development of agro-based industries,
(5) mitigation of regional disparity,
(6) encouragement to projects using indigenous raw materials or local technology,
(7) encouragement to labour-intensive technology,
(8) more effort to channelise foreign currency to finance import of capital goods, i.e., machinery and equipments,
(9) rehabilitation of sick projects,
(10) promoting executive development, and
(11) innovative functions: identification of project ideas, financing the preparation of feasibility studies, providing technical consultancy services, organisation of seminars, research studies, publication of research findings, establishment of training institutes to develop functional skills, creation of chairs in the Universities.
for research in development banking, short-fellowships to the citizens of other countries for management training in developmental finance, invitation to leading development banking personalities of the world to deliver lectures on special occasions.

The Industrial Development Bank of India emphasises assistance to new entrepreneurs, enterprises located in relatively underdeveloped regions, projects which use indigenous technology and have greater employment potential, projects which earn or save foreign exchange and all other projects which are accorded national priority. The preferred areas of Industrial Finance Corporation of India and Industrial Credit and Investment Corporation of India may also be said to be along these very lines.

Development of backward areas, induction of new entrepreneurs, enterprises which earn or save foreign exchange, encouragement to labour-intensive technology and industries of national priorities may be said to be the preferred or priority areas for non-banks in the developing countries in general. But lending to priority sectors should not be at the expense of lending to industry in general and for other recognised purposes.31


(8) **Financing Procedures and Policies**

(1) **Loan Application**: It is the first link in the long chain of steps resulting in securing industrial finance. As regards the nature and quantum of information to be furnished in such questionnaires, practices differ from institution to institution. However, three methods can be observed in general:

(a) **Very detailed questionnaire**: The applicant has to fill it up as per detailed instructions. The nature and quantum of information is clearly stated.

(b) **Indicative questionnaire**: The general nature of data is stated. The extent and the form of data to be supplied is decided by the applicant.

(c) **Brochures are prepared to guide the general applicants regarding the type of information to be supplied in the initial application and if the institution is satisfied with the particulars contained in the initial reply, it gives special questionnaire tailored to the needs of a specific project.**

The Industrial Development Bank of Turkey, the Puerto Rico Industrial Development Company and three all-India financial institutions, i.e., Industrial Development Bank of India, Industrial Finance Corporation of India and Industrial Credit and Investment Corporation of India use detailed

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32 Boskay, op. cit., p. 121.
The advantage of detailed questionnaire is that it gives the applicant full idea of nature and quantum of information required. But the new entrepreneurs may be disheartened by the broad mass of complex data required to be supplied and scared by the problems associated with the collection of such data.

The indicative questionnaire is desirable but it may be difficult for a first timer to decide the extent of information to be supplied which will satisfy the institution.

The third system is a time-consuming procedure. However, it may save the applicants from undertaking unnecessary trouble by conveying institution's decisions at an early time.

The entrepreneurs of developing economies are not as competent as those of mature economies in view of the fact that the industrial experience of the former is much less than that of the latter. They are most likely to be unfamiliar with the thorny path of obtaining industrial finance. So, a simple application form with minimum particulars, i.e., name of the applicant, nature of project, location and financial capacity of the applicant may be useful. The remaining details should be collected by the institution itself to transform the proposal into a viable one. The institution may charge certain fee for this service.

(ii) Project Appraisal Criteria: Term-loans differ significantly from short-term loans. As the period of repayment

33 Indian Investment Centre, op. cit., p.141.
in case of term-loans is longer and funds are lent for the establishment of a new unit or expansion of an existing one, the degree of risk involved in term-lending is greater as compared to short-term lending. In fact, a term-loan is expected to be repaid not by liquidating the assets acquired but from the increased earnings accruing to the borrowing unit. The lending institution has, therefore, to assure itself that the borrowing concern shall be able to generate adequate profits in future years, so that the term-loan turns out to be self-liquidating. This requires a detailed procedure for the appraisal of a term-loan.

The points which are usually considered in appraising a project are:

(a) the background, experience and capital structure of the applying company;

(b) the basic soundness of the project, the availability of raw materials, power, labour and managerial personnel and quality of equipment;

(c) the cost of the project and reasonableness of the cost estimates both in terms of domestic and foreign currencies including appropriate provision for working capital and contingencies;

(d) the sources of finance, the contribution by the promoters, the relationship between debt and equity finance, security available for loans etc.;
(e) the size and prospective growth of the market, the nature of competition, the prospective prices, the degree to which the entrepreneur will have to depend on a protective tariff;

(f) experience and technical knowledge of all those who will set up and operate the projects;

(g) profitability of the project based upon examination of detailed estimates of output, costs, sales and annual profits, the capacity of the enterprise to repay loans, to build up reserves and to pay reasonable dividends.34

Some non-banks such as Industrial Development Bank of Turkey and the Industrial and Mining Development Bank of Iran employ different experts like accountants, economists, engineers, lawyers and financial analysts whereas others like Industrial Finance Corporation of India depend on government departments and advice of expert committees to look after the various aspects of appraisal.35 It would be desirable to have an internal organization of experts though it is expensive.

All 'bankable' projects are not necessarily economically important, nor is every economically important project necessarily 'bankable'.36 A development bank cannot continuously divert its financial resources to bankable

34 Basu, op. cit., p. 52.
35 Ibid., p. 53.
36 Bocay, op. cit., p. 50.
projects only and at the same time it cannot shut eyes to the financial basis of the enterprise. The happy marriage of banking and development criteria is essential. But utmost care should be exercised to ensure that no conflict or misconception about the structure and purpose of the project arises between the institution and the sponsor at a later stage (See Chart 2.1).

(iii) Documentation: Documentation is the stage that comes after sanction. The major work here is the preparation of different deeds and undertakings to be signed by the sponsor in order to make him legally liable for the debt and to establish his title to land and other fixed assets to ensure security of loan.

The non-banks of India, Nepal, Thailand, West Germany, United Kingdom, Canada and America go through this process to secure loan though with a degree of variation in the number of documents to be executed.

The number of documents to be signed by the sponsors should be kept as minimum as possible. Because the cumbersome formality of securing sponsor's commitment through a heap of documents may scare him out of the project altogether.

(iv) Disbursement: The process of obtaining industrial finance started with application theoretically ends with

37Development criteria incorporate benefits to the country's economy in the form of employment generation, effect of balance of payment, reduction of regional disparity, satisfaction of demand existing or future, the extent of technological improvement involved, the utilization of natural resources etc.
1. PROJECT SPONSOR'S PROPOSAL
2. AS SPECIFIED IN THE PROJECT REQUEST
3. AS PROPOSED BY THE CONSULTANT

4. AS SPECIFIED IN THE APPRAISAL REPORT
5. AS INSTALLED AT THE USER'S SITE
6. WHAT THE USER WANTED

Source: End-Use Department, Bangladesh Shilpa Rin Sangstha (Original Source: German Foundation for International Development (DSE), Federal Republic of Germany).
disbursement.

There are different methods of disbursement but the following are popular in practice:

(a) disbursement is made only when borrower presents acceptable evidence of expenditure, i.e., purchase of equipment or machinery, construction of building etc.;

(b) payment is made to the borrower's suppliers, rather than the borrowers directly;

(c) some non-banks insist that all or part of the borrower's share be actually invested before they themselves disburse; and

(d) borrowers are required to open a special account wherefrom withdrawals are adjusted against agreed contributions by the sponsors.

Disbursements are generally made in instalments at specified intervals or upon satisfactory submission of documents of expenditures incurred. It is a common practice to supervise the use of loan proceeds.\(^3\)

Disbursement should be made directly to the clients who are ultimately responsible for repayment unless misappropriation of fund is apprehended.

(v) **Interest Rate Policy** : There are three important questions about the interest rate policy: (a) should the rate of interest be higher or lower than market rate?

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\(^3\) Beskey, op. cit., p. 96.
Some experts are of the view that the rate should be higher than the market rate.\textsuperscript{39} The arguments are: (1) the quality of service and kind of financing rendered by non-banks is not available elsewhere; (2) the capital in underdeveloped countries is scarce and the rate should be related to scarcity factor; (3) the unrealistic interest rate may invite marginal projects which may not be financially or economically viable.

Another opinion is in favour of lower interest rate. The arguments are that in underdeveloped countries the pace of industrial development is slow and the entrepreneurial class itself is rather inadequately developed and cannot mobilise enough resources to invest in industry. So, to attract them into industry, and thereby quicken the tempo of industrial development, concessional or subsidised interest rate is necessary. It is also argued that the non-banks can borrow cheap money from the Government with nominal or no interest and from foreign sources with Government guarantee which other institutions cannot and the benefit of this cheap finance needs to be passed on to the clients.

It is the general feeling that the rate of interest in developing countries should be kept below market rate (but not abnormally low) to accelerate the pace of development and to promote the development of new entrepreneurial activity.

\textsuperscript{39}The market rate is difficult to define in a country with limited financing facilities. But the rate at which commercial banks are prepared to provide funds may be a convenient point of reference.
(b) Should the rate of interest be discriminatory or uniform?

There are advantages and disadvantages of both. The discriminatory rate is favoured on the ground that the projects where risk is greater and credit standing of the parties is not satisfactory, higher percentage may be charged by way of interest.

The institution has to face a lot of criticism if a policy of varying interest rates is pursued.

The benefit of uniform/flat rate of interest is that it does not expose the institution to charges of unwarranted and unjustified discrimination.

The main drawback of uniform rate is that a single flat rate is charged for all kinds of projects irrespective of the degree of risk involved in them. The flat rate also seems to subsidise riskier ventures unduly.

It is not advisable for public institutions to follow discriminatory rate of interest. If it wants to favour a particular type of industry, it can do the same through relaxation of margin requirements and waiving personal guarantees by the promoters/directors.

(e) What should be the spread between lending and borrowing rates of interest?

The spread depends on many factors - administrative expenses, cost of borrowed funds, margin for reserve and for profit. The interest rate in some countries is determined
externally and is not within the independent judgement of the non-banks. So, the spread between lending and borrowing rate of interest to be regarded as 'standard' or 'normal' is rather difficult to prescribe.

The general policy, however, is that a spread of 2.50 per cent to 3.00 per cent is reasonable.\(^{40}\)

(vi) **Commitment Charge**: There is wide variation regarding commitment charge on undrawn portion of loans. Some institutions make no commitment charge. Some are authorised but generally do not apply it. Some do not charge it on local currency loans but any such charge payable by them on foreign currency loans are passed on to the borrowers. Some charge 1.00 per cent commitment charge without any exception. The Industrial Finance Corporation of India charges a 1.00 per cent commitment fee but waives it where the borrowers are not responsible for delay.\(^{41}\)

If the financing institution has to pay commitment charge, it can realize the same from the borrowers. In other cases it should do so after signing of credit agreement. The charge should be waived if the clients cannot draw money for causes beyond their control.

(vii) **Security Policy**: The security taken is virtually a relationship between the amount of loan given and the estimated value of security offered. The non-banks generally


\(^{41}\) Boskey, *op. cit.*, p.81
try to take maximum security even when charters authorise unsecured loans in appropriate cases.

Mortgage of fixed assets may have very little resale value because of the problem of readily converting them due to location and design. But according to Beskey, the insistence on mortgage of such assets has its utility. The mortgage gives the financial institution sufficient strength to influence the policy of the leasee concern and to protect the viability of the project.42

The degree of coverage varies from institution to institution and the practice in this regard may be:

(a) some require mortgage on the entire industrial unit in case of loan for fixed assets and lien on all inventories including raw materials in process in case of loan for working capital (e.g. The Nacional Financiera of Mexico).

(b) some accept a uniform margin of 50.00 per cent as security which is also relaxable in case of need (e.g. The Industrial Finance Corporation of India).

(c) some require collateral equal to the amount of the loan plus the aggregate of interest charges (e.g. The Corporation de Fomento de la Produccion of Chile).

42 Ibid., p.62.
(d) Some require collateral valued at more than the amount of the loan, the margin being determined by the type of asset pledged and creditworthiness of the borrower (e.g. The Development Finance Corporation of Ceylon now Sri Lanka).

(e) Some have no uniformly applicable requirement (e.g. The Industrial Development Corporation of South Africa).

(f) A good personal guarantee is a preferred type of security in some countries because of the difficulty of executing foreclosure judgement in the court.

(g) The Bank of Japan does not refuse a loan simply on the ground of security.

(h) Some non-banks require in addition to their security, personal guarantee of the directors for the full amount of the loan (i.e., The Development Finance Corporation of Ceylon and Industrial Credit and Investment Corporation of Pakistan).

(i) Some institutions sometimes require that the life of the manager or proprietor of a small business be insured for its benefit, particularly in cases where the success of the company depends

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43 Ibid., p. 83.
44 Ibid., pp. 64–65.
essentially upon that person (i.e., The Industrial Development Bank of South Africa).

The types of assets acceptable as security also differ significantly between institutions such as:

(a) some want personal guarantees or liens on movables and require borrowers to assign to them accounts receivable (i.e., The Caisse Centrale of France).

(b) some want liens on lands as well as buildings, machinery and equipment; liens on inventories are also insisted upon in some cases.\(^{45}\)

(c) some do not accept mortgage on movables, raw materials or spare parts; only land, buildings and machinery existing and to be acquired while any part of the loan remains outstanding supported by a prohibition against the creation of any new debts or liens without its prior approval (i.e., The Industrial Finance Corporation of India).

(d) some prefer comprehensive mortgage initially but later proceed to release movables to enable the borrowers to obtain working capital support from the commercial bank (i.e., The Industrial Credit and Investment Corporation of Pakistan).

(e) some occasionally lend on the security of property unrelated to the business of the enterprise such

\(^{45}\)Imid., p. 83.
as borrower's house (i.e., The Puerto Rico Industrial Development Company).

The assets offered as security are valued on the basis of book value. Where book values understate market values and replacement cost because of inflation, valuation may be made by an independent assessor.

The non-banks should not take all the assets of the enterprise as mortgage if they do not lend short-term loan or working capital. On the other hand if they expect that commercial bank should supply working capital then they should leave sufficient assets unencumbered for this purpose.

Too much rigidity in security requirements may not be conducive to the healthy growth of industry. Relying on collateral as the sole criterion for loan decisions "tends to allocate financing according to applicant's relative wealth or even their relative liquidity. In practice this is likely to give a poor allocation for development purposes. Property ownership does not necessarily imply entrepreneurial drive and capabilities; indeed the wealthier borrowers are often more lacking in these qualities".\(^4^{6}\) On the other hand,

too much relaxation cannot be justified in this matter.

The present and future profitability, liquidity and capital base as well as the personal qualifications and integrity of the borrowers should be regarded as primary security for credits-collateral\textsuperscript{47} in the form of mortgages, hypothecation or institutionalised forms of guarantee to be considered secondary security.

It must, however, be acknowledged that relying exclusively on primary security by a bank that finances a large number of widely scattered small and medium-sized enterprises, would require intensification of evaluation and supervision to such an extent that only highly subsidised banks could afford to undertake it.

(viii) Repayment Period: Though some non-banks are authorised to make loans for a long period of 25 years, the period, in practice, has varied between 4 and 15 years.

The short period of repayment is beneficial for the institution from the viewpoint of quick cycling and minimisation of risk. But it may be difficult for the client to pay the instalment (both principal and interest) by earning surplus income within a short period, more particularly in the case of projects with a long gestation period.

\textsuperscript{47}In West Germany in many cases collateral is replaced by comprehensive appraisal of creditworthiness and intensive supervision of projects.
The long period of repayment, on the other hand, may encourage default and paralyse the working of the institution by impounding its financial resources for extended periods.

The following points require careful assessment in fixing an appropriate repayment:

(a) the anticipated earnings of the enterprise.
(b) the amount which may be required from earnings for strengthening working capital or replacement and modernisation besides regular instalment repayment.
(c) the depreciation aspect and economic life of assets forming a part of prime security.
(d) the intervening period between inception of a project and starting of its operations.
(e) the period between starting of operations and generation of sufficient cash.

The high rate of inflation that has plagued the world economy in general and developing economies in particular may not justify too long an amortisation schedule. The period should not also be too short. "Much care and judgement have to be exercised by a development bank in determining the appropriate period of repayment for a loan."

A repayment period of twenty to twenty-five years may be accepted as an ideal one in the light of the practice of development finance.

institutions in the developing economies.

(ix) **Institutional Relations**: Functioning in a consortium or syndicate has become a modern approach in the world of complex industrial financing. The non-banks of West Germany, Japan, U.K., Iran and India have been collaborating with commercial banks and other institutions in tackling ticklish problems of industrial finance since long and have achieved commendable success.

The factors which prompt close co-operation among financial institutions may be enumerated below:

(a) to meet massive financial requirements beyond the scope and resources of any single institution.

(b) to distribute investment risk.

(c) to economise management expenses.

(d) to cross-fertilise experience.

(e) to undertake techno-economic and industrial potential survey and organisation of technical consultancy service beyond the capacity of a single institution.

(f) to undertake common appraisal, supervision and follow-up.

To make the best possible use of available financial and human resources, the non-banks of the developing countries should co-operate with each other, pool together their resources and expertise and invite other institutions not
having proper machinery and experience for appraisal of applications to operate through them. 'Exchange of experience can suggest options and ideas not previously thought of and open the way to effective solutions tailored to the particular situation of a development bank'.

(x) **Follow-up and Inspection**: It is an essential part of the whole process of purveying industrial finance. Its object is to ensure that during the construction and operation stages of a project the matters go as per plan and projection and corrective action is taken if targets and expectations are impeded and distorted.

The non-banks carry out this function through regular inspection and insisting on the submission of periodical reports on physical and financial progress, production and sales and balance sheet and profit and loss accounts.

The non-bank should chalk out a clear-cut programme about loan supervision. The same persons who appraise a project should be sent out for inspecting its implementation because it is expected that they are likely to feel more responsible and serious and their early acquaintance with the project may help them to understand the problems quickly. It is also necessary to take utmost care while evaluating progress reports. Because in many of the less-developed countries it is common for enterprises to keep several sets

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49. **IPCI Silver Jubilee Memorial Lecture, Welcome address by C.D. Khanna, New Delhi, March 1973, p. 3.**
of books and to present to outsiders, including the Government, information which amounts to considerably less than a full and accurate disclosure of their financial condition and operating results'.

Most of the banks carry out supervisory activities at their own expense though funds and staff at their command are a limiting factor.

(xi) **Size of Investment**

Generally the charters of non-banks do not specify lower and upper limit of an individual investment. Many institutions do not have any lower limit and a few of them have flexible upper limits.

Both the limits have got their own merits. The upper limit helps to diversify investment and the lower limit helps to prevent flooding of uneconomic proposals.

The limits of investment are essential for the economic and meaningful canalisation of funds to projects particularly in the private sector. The upper limit is necessary to prevent concentration of wealth into a few hands and the lower limit is necessary to avoid comparatively smaller proposals generally expensive to process and manage.

(xii) **Sponsors' Contribution**

It is the general feeling of non-banks that the applicant's involvement in the project be secured by requiring them to put up substantial matching funds towards the financing of the project cost.

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50 Boskey, op. cit., p.95.
51 Ibid., p.99.
52 Ibid., p.66.
The non-banks are normally prepared to finance no more than 50.00 per cent of the total capital requirements though in some cases they have gone up to as much as 90.00 per cent.

The International Finance Corporation expects the private investors to put up at least half the required capital in the case of a new enterprise. For expansion of an existing enterprise it is willing to consider a higher proportion of the new investment, but nevertheless requires that the total private investment in the expanded enterprise should exceed the amount of its own investment.

The non-banks of developed countries deal with entrepreneurs who are deemed to be financially sound. So, they can demand substantial involvement of the sponsors in the project cost. But in the developing and stagnant economies the vicious circle of poverty impedes the flow of adequate investible resources towards the entrepreneurs. So, the institutions in such economies should finance comparatively bigger portion of the project cost to fill up the gap between the need for investible resources and the actual availability of funds.

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\[3\] Capital requirements are not calculated by all non-banks in the same way. Some include working capital requirements in it and some exclude the same from its purview.

\[4\] Boskey, op. cit., p. 68.
(xiii) **Restrictive Conditions**: The non-banks normally incorporate certain conditions in the financing contract to ensure effective and purposeful utilization of funds extended and to secure standard financial behaviour from the loanee concern. Some such conditions are:

(a) restriction on payment of dividend.

(b) retention of secured and/or unsecured loans provided by the management/their friends in the business.

(c) restriction on any change in the capital structure, security and material contracts.

(d) to undertake to provide additional capital in given circumstances and to agree that it will not dispose of its shares without prior consent.

(e) limitation on further borrowing and on capital expenditures which may be incurred without the prior consent of the institution.

(f) limitation on pledges of assets.

(g) condition of accelerated amortization with the increase in gross sales.

(h) condition of insuring borrower's properties.

(i) consultation before embarking on a new project.

(j) limitation on remuneration of directors and managers and prior consultation about any intended changes.

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The Industrial Development Bank of Turkey feels that its insistence has materially aided in raising accounting standards in Turkey. This is one of the most useful achievements of a development bank.
Too many restrictions sometimes spoil the initiative of the sponsors. So, judicious blending of the element of liberality and financial prudence is necessary.

(9) Organisation Structure

There are two broad patterns of organisational structure: function-oriented and expertise-oriented.

The organisation under function-oriented pattern is structured according to functional areas of the institution such as project appraisal, legal scrutiny, disbursement, accounting, follow-up, project promotion and development and training. The Market and Economic Research and Statistics Departments are also organised to aid the other departments. Each department is manned by people suited to its own functional specialisation and help from other departments can also be obtained in case of need.

The individual disciplines on the basis of which expertise-oriented pattern operate are: Technical, Financial Analysis, Legal, Economic Research etc. One department known as Operations Department normally co-ordinates various functions such as evaluation, follow-up and supervision of projects and project development and promotion. Documentation and disbursement works are separately performed.56

The object of both the systems is to sift proposals closely before the loans are granted and to ensure that the projects are brought to successful fruition. So, either of the systems can be applied with advantage.

Most of the non-banks organise branch or regional offices to cover wide geographical areas. The branch offices are not equipped to perform all operational tasks and have normally to serve as windows of the institution in the area, entertain requests for assistance and serve as channels of communication between the entrepreneurs and the central office.

The regional offices are adequately staffed and in some cases regional managers are empowered to scrutinise and evaluate projects up to a certain amount subject to ratification by the central office. In those cases where regional offices are non-existent, the branch offices need to be geared up to the task of processing proposals up to a certain limit.

Appraisal Methods

(a) Appraisal by Generalist: A single professional aided by relevant service departments investigates all aspects of the project and makes a comprehensive evaluation report. This practice can be adopted to keep the operating costs to the minimum, more particularly in cases where the nature of the project is found to be repetitive. The disadvantage is that after all there is a limit to one's capacity and
capability and if quite a new project comes up, the generalist may find himself handicapped.

(b) **Composite Appraisal by a Team**: The appraisal is done by a team and each member remains liable for aspects related to his training, background and experience. This is favoured when the aim is to develop inter-disciplinary expertise among the personnel.

(c) **Single-aspect Specialist Appraisal**: Independent project report is prepared by each specialist on aspect related to his expert knowledge and an integrated report is prepared by any of the participating departments or by a co-ordinating department. Allocation of departmental responsibility is the main aim of this system.

We are living in an age of specialisation. So, project appraisal, being a highly technical job, needs to be attended to by persons of specialised knowledge. Single-aspect specialist appraisal may be applied successfully in a developing economy with advantage since it leaves little room for evading responsibility.

(10) **Methods of Fostering Capital Market**

Though a non-bank cannot significantly alter volume of private voluntary savings at a given income, it can redirect it easily to more productive uses. The main objective of developing capital market is to provide incentives and means to invest savings in industrial securities and not to impede the growth of this market by approving assistance to a sponsor
who can manage the same from other channels.

The methods for this purpose may include:

(a) **Sale of Investments From Own Portfolios**: It enlarges the supply of marketable securities, broadens future base attracting new buyers and releases fund for new investments. The sale also helps non-banks to reduce their interest in projects directly established by them. The basic thing in this effort is the quality of initial investment and willingness to hold the investment until it becomes seasoned;

(b) **Sale of Industrial Securities With Bank Guarantee**: The investor gets additional protection from bank guarantee but it may narrow the market for its own obligations;

(c) **Sale of Bank's Own Obligations**: These normally carry redemption privileges and special guarantee from the Government. It is good for the investors from the view point of liquidity, safety, and attractive yield. But capital market is not broadened by it though it is a device for enlarging bank's resources; and

(d) **Participation**: It is a joint venture between private investors and a development finance institution. The success of this method depends on investors' confidence in institution's judgement and wide contact with potential investors. It provides an opportunity to the average investor to invest in industry without going into difficult task of project appraisal.

The sale of investments from its own portfolio may be applied in a developing economy. Because under this method, the
financial institution performs two roles: one as a developer of securities and the other as a developer of market. It is helpful to revive a moribund capital market.

(11) Promotional Role

There are two extreme paths in the pursuit of promotional functions. The minimum way is to help to transform a half-baked inadequate proposal into well-conceived, well-planned, financially well-disciplined enterprise so that it becomes profitable and can contribute to national income and high level employment. The maximum promotional function involves the formulation and development of a proposal, the mobilisation and organisation of the various elements that are needed to give life to it, and actively assisting in its execution.

Between these two paths the following promotional activities are undertaken by most of the non-banks of the developing countries:

(a) to suggest improvements in projects submitted to them for approval.
(b) to assist in finding technical and entrepreneurial partners.

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97 William Diamond prefers the word innovation for wide range of activities undertaken in the name of promotion. Because few development banks are involved in real promotional activities but many are involved in innovative activity.

98 Basu, op. cit., p.83.

99 William Diamond, "Inter-play between Financial Institutions and Economic Development", Commerce, Annual Number, 1974, Bombay, p.21 (Originally this was the author's lecture in the Second IFCI Silver Jubilee Memorial Lecture, New Delhi).
(c) to assist in finding funds for large projects.
(d) to arrange for the preparation of both industrial surveys and feasibility studies for specific projects.
(e) to make equity investments and carry-out underwriting operations.

Two important promotional functions for a developing economy should be: identification of suitable projects and the identification and development of the right entrepreneurs. The expansion of industrial infrastructure and major industries are useless if there are no people to take advantage of the forward and backward linkages and to materialise spread effect actually.

The non-bank financial institutions of developing countries, normally with little or no industrial experience, must give due weightage to promotional functions as the traditional concept of development banking is not applicable here. They should not forget that their business goes far beyond the daily bread and butter of providing capital on a 'yes' or 'no' basis to entrepreneurs who apply for it.

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60 Entrepreneurs fight with problems and find solutions. They set targets and work towards them. They have initiative and intelligence. Entrepreneurs are calculated risk-takers (Management Development Institute, Identification, Promotion and Implementation of Industrial Projects (North-Eastern States), ed. K.L. Varshneya and S.P. Valavade, New Delhi, May 1976, p.22)


62 All the resources needed for investment are available, finance is a limiting factor. Once the financial resources are made available, investment will be automatically stepped up.

63 See f.n.59, p.76.