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CRISIS IN DEVELOPMENT FINANCE

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Crisis in Development Finance

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Foreword

Development financial institutions (DFIs) are at the crossroads today. Denied their traditional sources of long-term government funding, they have no option but to rely on short-term deposits to meet their funding requirements. At the same time, they continue to fund infrastructure and other long-term projects. The result is a maturity mismatch that threatens the viability of these institutions. Moreover, since financial institutions in India spearheaded the drive towards industrialisation in the days of licence-permit raj, they have vast exposures to companies and industries which, in the age of globalisation and open economy, have little competitive advantage.

The upshot is a staggering weight of non-performing assets. Besides, banks are also increasingly trespassing into areas hitherto reserved for the DFIs. Their lower cost of funds makes them formidable competitors. Faced with this situation, the model of DFI-led growth, which has been the preferred model for many late industrialising countries, such as Germany, Japan, South Korea, is fast losing its gloss. There is no longer a felt need for specialised financial institutions, and the trend is clearly towards universal banking.

This change in development finance gives rise to several questions. For example, what effect will the failure of the DFI-led model have on a country's economic growth? Now that long-term lending is being generally avoided, does it mean that infrastructure financing will suffer? In this monograph, Manas Chakravarty attempts to find answers to these and other related questions. He then goes on to examine the alternative models of infrastructure financing in the changed circumstances. I hope the monograph will contribute towards better understanding of the role of development finance, particularly in the context of the urgent need for large-scale funding for infrastructure development.

K. L. Thapar
Director

Introduction

The Indian financial system is going through a process of massive change. Long divided into watertight compartments, various segments of the system are merging into one another, and financial conglomerates have made their appearance on the scene. Commercial banking, insurance, investment banking, asset management, leasing, housing finance, credit card issuance, lending for infrastructure development, and lending to the stock market, are all activities that are increasingly being carried out by single institutions, or a group of affiliated firms. Liberalisation has freed participants in this sector from many of the restrictions of the past, and, as a result, they have diversified into new products and services, on the one hand, while venturing into new areas of activity, on the other.

These developments in the Indian financial services are part of a worldwide trend towards consolidation in the industry, the essence of which can be summed up in two words – universal banking. The main driver of this change has been the extremely rapid change in technology that has taken place in the last decade. Walter Wriston, a prominent banker, who had witnessed this change, candidly observed: "The new system was not built by politicians or economists. It was built by technology. In some respects the new world financial system is the accidental by-product of communication satellites and of engineers learning how to use the electromagnetic spectrum upto 300 gigahertz." The growth in telecommunications was complemented by an explosive growth in computing, a power which transformed the industry, enabling it to use information in many new ways, and also making possible the design of innovative products.

But it was not technology alone that was the reason for this change. As a matter of fact, globalisation of finance was also a product of underlying trends and pressures in the economies of the advanced countries, one of which was the increasing importance of finance capital. The power of finance capital was a major reason for the breaking down of barriers to the free flow of international capital, on the one hand, and of removing the fetters on its expansion within national economies, on the other. Add to that a change in the intellectual climate, which led to the freeing of markets, and the withdrawal of many restrictions on private initiative.

However, the transformation of the industry was not immediately accompanied by a concomitant change in the method of regulation. Consolidation has resulted in firms in the industry getting bigger, and this trend, together with the introduction of new products, such as derivatives, has increased risk in the financial system. It is not just banks that are too big to fail these days, but some securities firms as well – the best example being that of Long Term Capital Management, the high-profile securities firm set up by Nobel Prize winning economists, a rescue for which was arranged by the US Federal Reserve. The threat of contagion has since increased manifold. Also, the increasing reliance on the market has led to the scrapping of direct controls, making it all the more necessary for a new kind of regulation to be put in its place.

A debate on the kind of regulation best suited to the new environment is raging throughout the world – in finance ministries, in central banks, and in international institutions, such as the Bank for International Settlements. Several countries have veered round to the view that the only way to effectively supervise the financial system of a country is to have a single regulator for all financial services. There are many arguments for and against such a super-regulator, which have been brought out in this monograph, but the simplest one in favour is that if firms in the sector diversify into various activities, the regulator must be enabled to regulate all those activities. Only then will the regulator be able to take a holistic view of the risk the firm is bearing. More importantly, it is now recognised that there is a need for an agency that is able not only to keep abreast of the changes in the sector but also to anticipate and plan the regulation of change, so that there are no regulatory loopholes that can be a source of risk.

In India, the picture is complicated by the fact that the financial system is still dominated by huge public sector institutions, and recent events have shown that some of them have feet of clay. Such a structure lays the system open to moral hazard, as lending to or entrusting funds to them is perceived by the public as having a kind of implicit sovereign guarantee. In order for such a system to work, the relationship between the government and public sector institutions not only needs to be at an arm's length, but must also be seen by all concerned to be so.

This monograph is an attempt to address all these issues. It looks at the systems of financial regulation in vogue, the advantages and disadvantages of the super-regulator concept, and argues that there are certain critical regulatory functions in today's complex and networked financial systems that only a super-regulator can tackle. The example of the Financial Services Authority in the UK is examined in some detail.

The monograph also probes the arguments against having such a regulator in developing countries, and the related contention that the central bank is best suited for such a task in a developing financial system. However, it concludes that both these arguments are flawed, and a super-regulator is essential for taking a holistic view of the entire financial system and for dealing with the grey areas on the regulatory map.

Manas Chakravarty

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Introduction

Development financial institutions (DFIs) were once de rigueur for any developing country. Long held to be part and parcel of any development strategy, their reputation had soared after the successes of Japan and South Korea's state-led growth. Specialised financial institutions, channelling savings into sectors that could trigger high economic growth, were supposed to be the catalyst that sparked rapid late industrialisation. Country after country set up these institutions, India being no exception. Even for those sceptical of directed credit, there was hardly any alternative. Developing countries had underdeveloped capital markets, both for equity and debt, and the long-term capital needs of companies could only be met by the term lending institutions. The policy was very simple – long-term funds at concessional rates were made available to the term lenders, who lent it out cheaply to the corporate sector in an effort to boost rapid capital formation.

In India, as in other countries, the strategy was contingent upon a system of financial repression, with administered interest rates, a financial sector divided into watertight compartments, directed credit, and pre-emption of bank resources by the government. Development financial institutions were set up not only by the central government, but by every state government. Different categories of DFIs came into being – for agriculture, for small-scale industries, for the power sector, for housing and for exports.

However, liberalisation has brought about a sea change in the conditions in which DFIs could flourish. The scale of pre-emption of resources has fallen, banks have been allowed to trespass into territory hitherto reserved for the DFIs, and interest rates have been freed to a large extent. The upshot has been that DFIs no longer have access to long-term low-cost funds. At the same time, the bulk of their assets continue to be long-term in nature. This has given rise to a maturity mismatch.

Furthermore, the opening up of the economy has resulted in a transformation of the country's corporate sector. The protective walls under which many industries flourished have been breached, and competition today is far more severe than it was during the eighties. As a result, many companies, indeed many industries, are no longer competitive. Loans granted to these industries have become non-performing assets. Moreover, the euphoria after liberalisation has also resulted in easy access to finance by the Indian companies, and setting up of large capacities in anticipation of increased demand that has failed to materialise. Many of these loans too have gone bad. Non-performing assets have burgeoned. At the moment, DFIs have their back to the wall.

What options are open to the DFIs? Has the DFI-led model of development failed? If so, will the long-term funding in general, and financing for infrastructure in particular, suffer as a result of such failure? These are the questions that this monograph attempts to answer. The answers are far from easy, but they must be found, for time is running out for the DFIs. If the country's financial system is to be strengthened, a solution must be searched for the problems faced by these term-lending institutions. The experience of other countries in this area, new modes of financing and new institutions that fund infrastructure have been examined. Securitisation, structured debt obligations, subordinated debt and the need to develop long-term bond markets have been discussed. The conclusion: transformation into banks is the way to survive for the DFIs, but that in itself will not solve the problem of finding funds for long-term finance. For that to happen, banks and DFIs need to look at the new and innovative financing methods, and the government must do its bit to remove impediments in the development of new markets and instruments. Most importantly, reform must ensure that projects become bankable enough to attract private finance. There is no dearth of money available for infrastructure development; dearth is of bankable projects.

In its discussion paper on Harmonisation of Roles of DFIs and Banks, the RBI has pointed out that the cross-country experience related to DFIs (Industrial Bank of Japan, Korean Development Bank and the Development Bank of Singapore) from the East-Asia region shows that declining involvement in the term business by DFIs did not adversely affect the availability of finance for projects. The paper goes on to say, however, that it is necessary to appreciate that in these countries the transition in their role took place against the background of very high rates of growth in the GDP and domestic savings, strong inflows of foreign capital and rapid expansion of capital markets. In India, savings rate and FDI inflows are not as high and capital market, particularly for debt finance, is yet to be developed. Thus, there are gaps in the long-term finance which could be met by the DFIs. At the same time, it has to be recognised that over longer term, DFIs may have to adapt to the changing needs and move either towards greater specialisation or greater universalisation – a process that may involve mergers, acquisitions and diversification.

One way in which DFIs can contribute towards funding infrastructure without getting into a maturity mismatch is by subscribing to readily tradeable bonds of the special purpose vehicles set up to implement the infrastructure projects. For instance, a number of flyovers in Mumbai have recently been built by the Maharashtra State Road Development Corporation (MSRDC) by issuing bonds. Tax benefits have been accorded by the centre on subscriptions to bonds issued for such infrastructure development projects. DFIs subscribe to such bonds in a big way. If there is a ready market for such bonds, they can be unloaded by the DFIs, and no maturity mismatch need occur. In other words, when there is a well-developed debt market, there is no risk of a maturity mismatch. That's true of the liabilities side of DFIs' balance sheets as well. When a deep and broad market exists for corporate paper, DFIs can meet their funding needs from this market, instead of depending on high-cost retail deposits.

The lack of development of bond markets in developing countries is a big constraint in providing infrastructure finance. One of the reasons why government guarantees and other forms of government support were needed in North America and in the European countries in the nineteenth century for funding infrastructure was that at that time bond markets in these countries were still in the process of development. It is significant that UK – the country with the best financial markets and institutions – did not find it necessary to provide any financial support for infrastructure development at all. Thus, the extent of public support reflects the state of development of the financial sector even more than the unique characteristics of infrastructure projects. As for direct lending through DFIs, they are only a non-transparent way of (quasi) sovereign credit enhancement. If credit enhancement is indeed required, it is far more prudent that it would be done directly by the government, rather than routed indirectly through a DFI.

A simpler solution would be to merely shift the burden of financing infrastructure projects from DFIs to banks. However, financing of infrastructure by banks and financial institutions gives rise to three different kinds of regulatory issues. First, many infrastructure projects require long-term financing. When banks provide such funding, they are exposed to a maturity mismatch, as most of their funding is through short-term deposits. In other words, merely shifting the burden of infrastructure financing from DFIs to banks doesn't solve the main problem, that is the maturity mismatch which is partly a liquidity risk and partly an interest rate risk. The interest rate risk can be minimised if the lending is done on a floating rate basis. However, there are two problems with such an approach. In developing countries, sometimes it is difficult to have a benchmark to which the floating rate is linked. But that should pose no problem in a country like India, where the market for government securities is well-developed. Lending on a floating rate basis can mitigate the interest rate risk for the bank but at the cost of creating the same risk for the project. Capital-intensive infrastructure projects are, however, not well positioned to handle this risk. Second, because of their long maturity and unique risks, credit appraisal of infrastructure projects is quite different from the credit appraisal that banks do for providing short-term credit facilities to the industrial borrowers. As a result, only a relatively small number of banks have the skills required for appraising infrastructure projects. And third, major infrastructure projects may breach banks' exposure limits for individual borrowers or industries. This problem arises when banks attempt to fill the gap created by the project's inability to tap other sources of finance. The problem also gets aggravated when only a limited number of banks have the willingness and ability to engage in infrastructure financing. This is, however, not to deny that banks have a significant role to play in infrastructure financing. The point rather is that they cannot be the sole or even the dominant providers of funds for these projects.

Yet another source of funds for infrastructure development can be the bond markets. Many East Asian countries have been very successful in using their pool of high savings (for instance, Singapore's central provident fund) as a source of developmental finance. East Asian countries like Malaysia and Singapore mobilized large savings through contractual savings schemes. Governments in these countries were able to use these funds quite effectively in financing industrialization and infrastructure development. However, while trying to replicate this success in India, we must remember that apart from prudent investment policies, the viability of this model was facilitated by rapid economic growth and favourable demographics in the said countries.

Here it may be pointed out that the government can destroy the potential for a debt market by pursuing wrong macroeconomic policies and creating regulatory obstacles. In India, governments have done much to impede the growth of the debt market: some state governments have imposed crippling stamp duties on secondary market transactions in bonds and on securitisation transactions. It may be noted that securitisation too is also a means by which DFIs can overcome the problems related to maturity mismatch. But for securitisation to be successful, presence of markets in long-term corporate debt is essential.

Distortionary policies pursued by the government inhibit the development of bond markets. For example, the access of the state governments at more or less equal rates of interest (with only a small variation permitted) distorts the market. Further, some of the tax incentives for small savings have the effect of segmenting the fixed-income market. For example, the post-tax yield on the public provident fund scheme, the interest payable on post office deposits, and on other instruments such as RBI relief bonds is so high that bond market instruments become unattractive. This inhibits the flow of funds to the bond markets. The lack of a retail investor base for bonds is yet another problem that makes the market one-sided.

There are also constraints on supply of long-term funds. Household sector is the major source of savings which constitute the largest reservoir of long-term funds for the industry in industrial countries. However, most of the savings through the long-term instruments, such as, LIC policies, pension and provident funds are still subjected to heavy pre-emption by the Government of India.

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Issues in Development Finance

Indian development financial institutions (DFIs), once the crème de la crème of the state-owned financial sector, have fallen on hard times. Burdened with non-performing assets and maturity mismatches, long-term lending has become an unviable proposition for the DFIs. No wonder they are desperately keen to convert themselves into commercial banks. Originally conceived as a key element in the country's drive towards industrialisation, these organizations are today eager to get rid of the DFI tag. ICICI Ltd has already announced its merger with ICICI Bank, and has forwarded an application to the Reserve Bank in this regard. The Industrial Development Bank of India (IDBI), once the country's apex long-term financing institution, is making all-out efforts to find out a bank with which it can merge. The irony is that banks seem to be equally keen on avoiding IDBI's overtures. To the commercial banks, IDBI's massive burden of non-performing assets and its maturity mismatches are indeed a deterrent. The only reason why IFCI hasn't yet mooted the idea of merging itself with a bank is that the institution is widely seen as a basket case, dependent on bail-outs for its survival. The wheel has come full circle – development banking, once trumpeted as the key that would unlock the gateway to economic development, no longer enjoys that pride of place.

It isn't only in India that DFIs are in a bad shape. There is no doubt that after the Second World War, these institutions did occupy a significant place in the area of state-led economic development. However, with the renaissance of free-market economics, and the manifest failure of state-led models, the wheel has turned full circle, and DFIs all over the world have fallen from grace.

Schumpeter gave German Kreditbanken immense credit for taking an entrepreneurial attitude and fostering the rise of large industries. He along with other economic historians clearly saw a link between rapid industrialisation and the financing of industry by private banks.

The same model of financing industrial development through specialised financial institutions was later adopted in Japan and South Korea. Before the Asian crisis, this was the model being followed by the so-called 'tiger' economies. Although censured as a product of 'crony capitalism' by the West, there was a clear economic rationale for the model. The East Asian economies had high savings rates. In such a system, where households and governments are non-borrowers, the borrowers must be firms and other investors. Hence, the system is biased towards high ratios of debt to equity in the corporate sector. The trouble is, firms with high levels of debt to equity are vulnerable to shocks that disturb cash flow or the supply of (bank or portfolio) capital, because debt requires a fixed level of repayment, unlike equity which requires a share of profits. The higher the debt-to-equity ratio, the more likely it is that any depressive shock will cause illiquidity, default and bankruptcy (This is exactly what happened during the Asian crisis). Therefore, banks and firms must cooperate to buffer systemic shocks, and government must support their cooperation. The need for government support gives the government a powerful instrument for influencing the behaviour of both firms and banks. This is the economic rationale for the pattern of 'alliance capitalism', dubbed as 'crony capitalism', that is often said to characterize East and Southeast Asia.

In the developmental states of Japan, South Korea and Taiwan, the state coordinated, directed and collaborated with firms entering major world industries. In some of the new industries, the state assisted firms with cheap credit, tax breaks and other forms of subsidy, helping them to mobilize resources on the scale needed

Subsequently, in its 1993 Blueprint for Financial Reform, the government outlined a five-year programme of gradual financial sector deregulation. Under the plan, all interest rate controls, except those on demand deposits, were scheduled to be removed by 1997. Other principal measures of the Blueprint included reducing controls on short-and long-term capital flows, giving banks greater autonomy in managing their business, and reducing policy loans from the central bank. Immediate reforms included widening the margin of fluctuation for the exchange rate to plus or minus 1% and raising the ceiling on long-term foreign portfolio inflows.

The timetable for liberalising capital movements was subsequently expedited with the 1995 'Revision to the Foreign Exchange Programme'. Foreign portfolio outflows for purchases of securities and overseas deposits were to be completely liberalized by the end of 1998. By the end of 1999, the restrictions on the amount of domestic securities that might be issued overseas were to be done away with. Foreign loans used by South Korean firms to finance capital goods were scheduled to be liberalised by 1999. Controls on the flow of short-term capital were to be removed gradually.

South Korea's 1996 accession to the Organisation for Economic Corporation and Development (OECD) was contingent upon its acceptance of the obligations of the OECD Codes of Liberalisation of Capital Movements and Current Invisible Operations. The codes are binding on OECD member countries and require them to remove specific restrictions on the movement of capital and invisible operations. Critics of the liberalisation measures point out that South Korea's retreat from the state-and-DFI-led model of development, and, in particular, the opening up of its capital markets and exposure to short-term overseas capital was responsible for that country's collapse during the Asian crisis. The opening up of the short-term markets also sounded the death-knell for the earlier high-debt DFI-led model.

The Unravelling of the DFI-led Model

The current stagnation in Japan and the Asian crisis have been widely held to be the result of the unravelling of 'crony capitalism'. It has been pointed out that explicit structural weaknesses – the result of a non-market economy – lurked beneath the aura of success that Korea was able to project. The economy was characterised by government-directed, uneconomic lending, supported by implicit guarantees. Excessive leverage supported growth but not profits. In fact, as Korea had virtually no meaningful capital market, one of the interpretations of the crisis in the Korean economy was that market mechanisms needed to be introduced into the Korean economy.

institutions." He says that there is a "Big Push from international organisations, backed by governments and corporations in the rich countries, to institute a world-wide regime of capital mobility that allows easy entry and exit from any particular place. If the agreements are ratified and enforced, they will ratchet up the power and legitimacy of the owners and managers of international capital in the world at large. This will in turn help to secure the predominance of the Anglo-American system. That system, based on maximizing returns through the optimal allocation of the existing stock of capital and savings, is better suited to maintaining stability when incomes are high and growth and inflation low. The Asian system, focused on the accumulation of capital and deliberate creation of Schumpeterian rents through the acquisition of new technology, is better suited to fast growth. As long as the Asian system operates on the basis of long-term relationships and capital, Anglo-American capital is at a disadvantage in these markets. Therefore the Asian system must be changed."

There is, therefore, a strand of opinion that continues to see the building up of development financial institutions, together with their low-cost loans, their support from the government, and other such measures as helpful for rapid economic growth. While that may indeed be true, the point is that in today's milieu of globalism and the empowerment of multinationals, it is impossible to re-create an environment conducive to DFI-led growth. Even in the countries where DFIs have proved most effective, there is now no alternative to change.

Problems of the Indian Financial Institutions

After independence, India too started its own development banks (see Annexure1). A well-knit structure of Financial Institutions (FIs) has developed over the years. These FIs were started not only at the national level but by every state that wanted to industrialise. DFIs, both at the centre and in the states, were supposed to be the magic wands that would industrialise the country. The Industrial Finance Corporation of India (IFCI) was trade. National Housing Bank was set up in 1988 under the National Housing Bank Act as the principal agency to promote housing finance institutions and to provide financial and other support to such institutions. In January 1997, Infrastructure Development Finance Company (IDFC) was incorporated under the Companies Act, 1956 to provide impetus to the infrastructure sector.

There are, however, some significant differences among the DFIs. While most of them extend direct finance, IDBI extends direct finance as well as refinance. Thus, IDBI has a sizeable share of indirect finance (refinance of industrial loans, loans and investments in shares and bonds of other FIs, etc.), which ICICI and IFCI do not have. SIDBI, NABARD and NHB are mainly refinancing institutions. SIDBI's activities include refinancing of term loans granted by SFCs/SIDCs/commercial banks and other eligible institutions and direct discounting/rediscounting of bills arising out of the sale of machinery/capital equipment/components by manufacturers in the small-scale sector. Two of the above refinancing institutions, *viz.*, NABARD and NHB have a supervisory role – NABARD supervises Regional Rural Banks and other institutions engaged in financing agriculture and rural sector, while NHB supervises housing finance companies.

The mission of the DFIs was rapid industrialisation of the country. The primary purpose for setting up the FIs was to build up fixed assets in the country by using financial intermediaries skilled in handling that kind of lending. Long-term lending is a very different game from short-term lending to corporates because of the number of associated uncertainties traceable to unreliable information and unexpected developments. Typically, the farther ahead one looks, the less relevant the current information becomes. Also, financial institutions have historically played a very significant role in financing the long-term requirements of funds in an environment where alternative sources of long-term funds, such as the capital markets, particularly the debt segment of the markets, were not available due of lack of development of failed in India. Hence, the need for a change can be justified on simple empirical grounds.

After liberalisation, it was decided to end the regime of repression that characterised the country's financial system. Among other measures of market liberalisation, the government decided to free the interest rates. It decided to pay the market rate for the pre-emption of bank reserves as a step in this direction and in an indirect effort to limit government spending. The result was that it was no longer possible for the government to provide cheap funds to the DFIs. After cheap government funding sources were withdrawn in the early 1990s, DFIs started raising resources from the capital market largely by way of debt. In order to provide them with some flexibility in their resource management, DFIs were given access to term deposits, certificates of deposit and the term money market within the limit stipulated for each institution and under some other terms and conditions.With concessional funding drying up, DFIs had no option but to start tapping the retail market for funds. They had remarkable success in tapping these retail sources of finance, thanks to their public image as being extended arms of the government and hence enjoying an implicit government guarantee, but unfortunately these funds were acquired at a much higher cost than the concessional terms these institutions were used to. These funds were also for much shorter tenures than the earlier low-cost borrowings from the government.

At the same time, commercial banks were allowed to lend long-term, thus paving their way for entering the territory hitherto reserved for the DFIs. Commercial banks had access to cheap current and savings bank deposits, a facility denied to the DFIs. At one stroke, therefore, the DFIs were exposed to competition from commercial banks, to whom funds were available at much cheaper rates. They were also exposed to a maturity mismatch, because while they were required to lend for longer terms, their sources of funding were short-term in nature. The spreads between their lending rates and their cost of funds were also squeezed.

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Present Position of DFIs in India

All-India Financial Institutions (AIFIs)

During 2000-01, financial assistance sanctioned and disbursed by AIFIs stood at Rs.1,17,667 crore and Rs.72,528 crore, respectively. Sanctions increased by 16.2% and disbursements by 7.3%, respectively, as compared with 23.6% and 20.1%, during 1999-2000. All-India development banks' (AIDBs) sanctions grew by 16.7% and disbursements by 9.2%, during 2000-01.

Among the major financial institutions, namely, IDBI, ICICI and IFCI, both IDBI and IFCI witnessed a decline in their income during the year 2000-01, reflecting primarily a fall in interest income (in the case of IDBI) and a sharp drop in other income (in the case of IFCI). However, the rise in expenditure was more pronounced in the case of all the three institutions, the largest increase being in the case of ICICI, which recorded a rise of 20.7% in 2000-01 due primarily to a rise in provisions. Consequently, the net profits of IDBI and ICICI posted declines during the year 2000-01, while IFCI posted a net loss (see Annexure 4).

The ratio of net NPA to net loan as on March 31, 2001, in respect of ICICI, SIDBI and EXIM Bank was below 10% that of IFCI, IDBI, IIBI and TFCI ranged between 14.0% and 23.0% (see Annexure 2).

In December 1998, the minimum Capital Adequacy Ratio (CAR) to be achieved by FIs was enhanced from the then existing 8% to 9%, with effect from the year ending March 31, 2000. Thus, as at end-March 2001, all financial institutions (except IFCI) were well above the 9% benchmark figure. The CAR of IDBI, SIDBI, IIBI, NHB and TFCI witnessed significant improvements. EXIM Bank, NABARD, IFCI, ICICI and IDFC showed a decline in their CAR as compared with the previous year's position. The CAR of IFCI was 6.2% which was lower than the required level of 9% as at the end of March 2001.

State-level Financial Institutions

And if that is true for the all-India DFIs, it is all the more true for the state-led development financial institutions. After independence, every state government followed the example of the centre in setting up industrial development banks and financial corporations to ensure speedy industrialisation of their respective state. It didn't take long, however, for these institutions to become the fiefdoms of political satraps. Loans were granted on political considerations and recruitment too was sometimes made on political grounds. Small wonder that these institutions soon got bogged down in a quagmire of bad debts.

After liberalisation, with the economies of almost all states facing a severe resource crunch, the problems of the state financial corporations (SFCs) assumed alarming proportions. A committee was appointed under IDBI chairman GP Gupta for suggesting ways to revive and revamp them. The Committee came to the conclusion that there had been a significant erosion in the net worth of these corporations. As on March 2000, about 50% of the total equity in eighteen state financial corporations had been eroded, and the total non-performing assets of these institutions amounted to a huge Rs. 5577 crore. Although the recovery rate for loans granted by them varied widely between the states, it was much higher compared to banks, and ranged between 66% in the better-run states to a mere 3% for the Bihar State Financial Corporation. Four SFCs have achieved capital adequacy ratio (CAR) above 8%, five have registered CAR between 2.06% and 6.25% and the rest have shown negative CAR. The Committee suggested a cash infusion of Rs.3600 crore in the SFCs to enable them to clean up their balance sheets and start on a new slate.

Earlier, the Khan Committee report on harmonising the role and operations of development financial institutions and banks had suggested the gradual reduction of state governments' stake in these corporations below 50%. The Committee had also suggested restructuring and reorganisation of strong SFCs and transfer of the existing shareholding of IDBI in these corporations to SIDBI (Small Industrial Development Bank of India).

The Committee also stated that in order to enable SFCs to adapt to the emerging changes, it was necessary for them to restructure their organisations and management, broaden their resource base and carry out financial restructuring. It also recommended that the agenda for the reform of the state-level institutions (SLIs) should incorporate the following:

(i) There should be eventual merger of State Financial Corporation and State Industrial Development Corporation in each state into a single entity. While the consolidation of state lending institutions (SLIs) should form part of the short-term agenda of reforms in the financial sector, an immediate-term imperative is the corporatisation of these entities to improve their competitive efficiency.

(ii) Following restructuring/reorganisation, strong SFCs could be encouraged to go public by making initial public offerings (IPOs). In the process, the state government's holding in these corporations may be allowed to be brought down to below 50%.

(iii) As the credit requirements of small-scale industries are being taken care of by SIDBI since its establishment in 1990, it would be desirable to transfer the present shareholding of IDBI in these SLIs to SIDBI. It should be vested with the overall responsibility for enacting policy and procedural guidelines with regard to the operations of SFCs.

(iv) SIDBI should be accorded the same role and status as the nodal/co-ordinating agency for financing of small (and medium) industries as is now available to NABARD in the field of agricultural development. Ownership in SIDBI should, as a logical corollary, stand transferred to the RBI/government on the same lines as NABARD.

(v) SIDBI's role in the state-level institutions should be both as stakeholder and as resource provider. For this purpose, SIDBI should have access to assured sources of concessional funding from the RBI.

The problem that faces these SFCs is the same that plagues the all-India DFIs: they don't have cheap funding sources. Also, they are totally dependent on cash-strapped state governments for funds, which makes them worse off than the all-India DFIs.

Emerging Change in the Structure of DFIs

Unfortunately, the DFIs themselves took some time in understanding the new situation. In the initial euphoria of liberalisation, it was widely expected that India, with its cheap labour, would become a manufacturing base for the world. This belief coincided with the opening up of finance, such as foreign loans and foreign equity. Companies tapped the GDR market and investors lapped up their issues. Much of these funds went into increasing the manufacturing capacity. For a time, pent-up demand also exploded, leading to high rates of growth for industry. Soon, however, it was realised that the explosion of domestic demand was a temporary phenomenon, and much of the Indian industry was not globally competitive. The newly created capacities remained unutilised. Indeed, in an environment of falling tariff barriers and with the entry of multinationals, it was realised that large segments of Indian industry would suffer a setback. For the DFIs, which had lent liberally for the expansion of capacity, and which had large exposures to many of the earlier uncompetitive industries, the fear was that they would be dragged down with these industries into a sea of non-performing assets.

The upshot of all this is that a number of loans made by the FIs in the mid-1990s have gone bad because of changes in the industrial environment. The outcome is a worrying level of non-performing assets (NPAs) on the books of all the FIs. In this context, it may be mentioned that the level of disclosed NPAs does not carry much credibility. First, the prudential norms are still not up to international standards, which means that, if internationally accepted standards for classifying NPAs are imposed, the NPA figure for DFIs would increase substantially. Second, the DFIs have taken advantage of the RBI norms to 'restructure' their loans. Needless to add that while part of such restructuring may be genuine, its usual effect is to bring down the level of NPAs. What will happen once the restructured loans are also not repaid, is obvious.

Faced with the impending doom if they continued with their old ways, the DFIs started to restructure their operations. ICICI was the first to start searching for ways to survive. The initial impulse was to lend to the second rung of companies, where higher spreads were available. But that was soon realised to be a risky proposition, because the higher spreads merely reflected higher risks. Soon, ICICI turned to short-term lending to corporates, in an effort to lower the maturity mismatch. These short-term loans became the fastest growing component of the overall portfolio. Moreover, realising that the business of long-term lending to the manufacturing sector was no longer viable, ICICI decided to branch out into other areas of finance – it set up a bank, a housing finance company, a securities arm, a brokerage, a merchant bank and even an infotech company. It started describing itself as a 'virtual universal bank.' IDBI and IFCI followed in its wake. Financial entities, such as ICICI, IDBI and HDFC now follow a system that classifies them as near universal banks because all these institutions have promoted commercial banks. However, the problem they face is that they cannot use the cheap funds raised by their group companies that act as commercial banks.

The DFIs are also abandoning their concentration on big ticket lending to focus on retail finance. The big push by the ICICI into retail finance is expected to diversify its income stream even while reducing the risk associated with incremental lending. ICICI made its presence felt through a high-pitch advertising campaign to familiarise people with its brand name. IDBI decided to follow suit and set as its long-term objective a 'one-stop financial supermarket'. The broad imperative of moving into retail finance is very clear – while big-ticket lending carries a big default risk, retail lending, with smaller-sized loans, reduces the impact of default.

Advances in information technology have made possible the thrust into retail lending for the FIs which have traditionally been catering to corporate borrowers. The shrinking of boundaries and the breaking down of barriers, thanks to IT, have triggered a revolution in financial services the world over. India is no exception. ICICI has been the most aggressive, among all the financial intermediaries, in breaking into the retail market. The company made its presence felt in housing and automobile finance by capturing a significant share of the market. Although the share of retail lending in ICICI's balance-sheet is still very low, yet in a relatively small market, ICICI's thrust has heightened competition among lenders and brought benefits to consumers in the form of more innovative products and lower interest costs.

ICICI has been able to move into the market by capitalising on the progress in back-office automation and using the 'spare' distribution capacities of other financial intermediaries. It is the possibility of scaling-up retail operations at limited incremental cost that excites the financial intermediaries, which is where ICICI has made its presence felt.

ICICI has, in fact, spelt out its strategy by pointing out that, over time, retail assets were expected to comprise about one-third of the portfolio. Any significant step-up in retail assets would contribute greatly to reducing volatility in ICICI's income and earnings stream. That also seems to be the strategy IDBI is seeking to adopt to become a one-stop-shop of financial products.

IFCI, however, is for now out of the race to build retail assets. The company's attention is focussed on overcoming its NPA problems and augmenting its fee income. Nevertheless, the Basu Committee – appointed by the IFCI to suggest ways out of the mess – recommended that the IFCI should cut back its exposure to project finance and balance its portfolio through a suitable re-mix. Long-term finance may yield high returns, but, at present, it is the high risk that has come to the forefront and needs to be addressed.

As for IDBI, the country's largest development financial institution, all indications are that it could be headed for serious trouble. A revised set of figures placed by the institution before the Ministry of Finance has indicated a cash requirement of Rs.7,000 crore over the next three years, much of which it is finding difficult to tie up. Besides, it has also put in a request for a Rs.3,000-crore equity infusion from the government. At an earlier meeting, IDBI had placed its capital infusion requirement at Rs.2,500 crore and immediate fund requirement at about Rs.5,500 crore. Officials in the Ministry of Finance have been particularly concerned over IDBI's admission that it has been struggling to raise resources from the market due to the rating downgrade (recently, IDBI's rating was downgraded by Crisil from AAA to AA+) despite its massive requirements. It has also admitted to the Ministry that it may be heading for losses during the current fiscal. The institution is reported to have admitted that the losses could spill over to the subsequent year unless assistance comes at an appropriate time.

IDBI has clarified that the capital infusion of Rs.3,000 crore is being sought to write off a portion of the institution's huge portfolio of non-performing assets (NPAs), which at the end of the fiscal 2000-01 stood at over Rs. 9,000 crore in gross terms. The institution has argued that only a massive NPA write-off would enable it to get back its rating, which would help it to tie up its funds requirement from the market.

Today, the DFIs are at a critical juncture. Faced with problems arising from rosy projections of demand in the country a few years ago and the opening up of new avenues to deploy resources, the healthier ones have sought to diversify into new channels. However, it is their historical role, that of providing long-term funds, which will be of significance in the foreseeable future. It is also the fate of the long-term loans made by them in the past that will determine their near-term future.

In the circumstances, both IDBI and ICICI now want to convert themselves into commercial banks. ICICI has already decided on a merger with its group institution, ICICI Bank. The Narasimham Committee had also suggested that, with the increasing convergence of activities between banks and DFIs, DFIs should, over a period of time, convert themselves into banks. According to the Committee, there would then be only two forms of financial intermediaries, *viz*., banking companies and non-banking finance companies.

The RBI, while supporting the DFIs' desire to convert themselves into 'universal banks', nevertheless has sounded a note of caution. It has said that "improved access to short-term resources through the traditional banking route helps diversify DFIs' business but would not necessarily add to the long-term resource base. The problems faced by the DFIs now or in the immediate future do require attention but their conversion into universal bank, by itself, is neither a necessary nor a sufficient option to overcome the difficulties." The reason for the RBI's reticence is simple – DFI's conversion into a bank will not give it access to long-term resources, and it will not, therefore, change the existing maturity mismatch.

Some other problems also result from converting the DFIs into banks. There are two practical impediments viz., (a) backlog of liabilities in a DFI on which reserve requirements have not been provided; and (b) the relatively high reserve requirements, particularly Cash Reserve Ratio (CRR) (For different regulatory regimes applicable to banks and DFIs, see Annexure 3). The CRR has, however, already been brought down, thus lessening the problem for DFIs. Nevertheless, ICICI has sounded a warning that its conversion into a bank and the need to invest in low yielding government securities will lower its profitability.

The DFIs' current problems may be solved by turning themselves into commercial banks and by giving up long-term lending. However, they will continue to suffer so long as the historical baggage of long-term loans remains on their books, resulting in high non-performing assets. It is also possible that, given the increasing globalisation of the Indian economy, more and more corporates would crumble, increasing their NPAs even further. The trend towards tighter prudential norms would also have a dampening effect on their financial performance.

The bigger question, however, is : what will happen to long-term lending if the DFIs shun it? There need not be much of a worry so far as loans to the manufacturing sector are concerned. The Indian corporate sector is currently more in need of consolidation than capacity addition. The brownfield expansion programmes and debottlenecking are activities that can very well be supported by long-term lending by banks, without serious maturity mismatches. Greenfield capacities too could be financed by the banks. Armed with expertise in project appraisal and long-term instruments, the personnel in the FIs, who will shift to the banks, would be best placed to finance big, long-gestation projects. An indication of this is already available – there is no dearth of finance available for manufacturing projects.

But what about infrastructure lending, much of which is long-term in nature? The crisis in Indian infrastructure has often been attributed to the fact that while the state has withdrawn from funding infrastructure projects, the private sector has not stepped in to fill the gap. The result has been a steep deterioration in infrastructure. Needless to say that this is extracting its toll on the economy. The magnitude of infrastructure financing required, according to the India Infrastructure Report, is considerable. Infrastructure investment will account for 22 to 25% of the GDI, rising from about Rs. 60,000 crore in 1995-96 to Rs. 1,07,000 crore in 2000-01; Rs. 1,80,000 crore in 2005-06; Rs. 4,30,000 crore in the next five years, and Rs. 7,40,000 crore in the subsequent five years.

To meet the country's growing needs for infrastructure financing, it was felt that a specialised lending agency may be established. Accordingly, Infrastructure Development Finance Company Ltd. (IDFC) was set up in 1997 to address the financial requirements of the infrastructure sector. IDFC offers customised financial products to its clients and also provides advisory services. Besides, it is mandated to rationalise the policy, legal and regulatory framework to stimulate the flow of private capital for commercially viable infrastructure investments in the country.

Since its inception, IDFC has been active in the energy, integrated transportation, telecommunications and urban infrastructure sectors. Its initial paid up capital is Rs.1000 crore. Together with Rs. 650 crore by way of subordinated debt from the Government of India and the Reserve Bank of India, its total capitalisation stands presently at Rs. 1650 crore (see Appendix for a case study of IDFC). The operational highlights of IDFC for the financial year 2000-01 have been presented in the Table alongside.

Infrastructure Development Finance Company Ltd. (IDFC)
Operational Highlights - FY 2000-01

(Rs. in crore)

	Approvals	Disbursements
Energy	1041	222
Telecommunications and I.T.	860	494
Integrated Transportation	539	42
Urban infrastructure	27	4

4

Project Financing

Project finance is an effective means of financing infrastructure. Project finance can be defined as limited or non-recourse financing of a project through the establishment of a project company formed to construct, operate and maintain the facility. The financing for the new investment is structured around the project's operating cash flow and assets.

Project financing can either be limited recourse or non-recourse financing. Limited recourse financing is the more common form of project financing. Under limited recourse project financing, the creditors and investors have some recourse to the sponsors of the project. Under non-recourse project financing, on the other hand, creditors and investors do not have recourse to the sponsors. Bonds floated by special purpose vehicles, both government as well as private, have been subscribed to by the DFIs. The use of put and call options in such bonds, and the use of credit enhancement and other forms of structured finance, have also helped such bonds to be subscribed.

Role of Infrastructure Leasing and Financial Services (ILFS)

In this context, the role played by the Infrastructure Leasing and Financial Services (ILFS), established in 1989, illustrates the kind of contribution that DFIs can make in the new environment. It is a private sector financial intermediary in which the Government of India owns a small equity share. Its activities have, more or less, remained confined to the development of industrial townships, roads and highways. It basically undertakes project feasibility studies and provides a variety of financial as well as engineering services. Its role, therefore, is that of a merchant banker rather than of a mere loan provider so far as infrastructure financing is concerned, and its share in the total infrastructure finance in the country remains limited.

ILFS has helped local bodies, parastatal agencies and private organisations to prepare feasibility reports of commercially viable projects, to spell out the pricing and cost recovery mechanisms, and to establish Special Purpose Vehicles (SPVs). Further, it has become an equity holder in these companies along with other public and private agencies, including the operator of Build-Operate-Transfer (BOT) projects . The role of ILFS may thus be seen as a promoter of a new perspective of development and a participant in project financing.

Financial Institutions Reform and Expansion Programme

Mention must be made here of the Financial Institutions Reform and Expansion (FIRE) Programme, launched under the auspices of the USAID. Its basic objective is to enhance resource availability for commercially viable infrastructure projects through the development of a domestic debt market. Fifty per cent of the project cost is financed from funds raised in the US capital market under the Housing Guaranty Fund. This is being made available for a period of thirty years at an interest rate of 6%, thanks to the guarantee from the United States Congress. The risk involved in the exchange rate fluctuation due to the long period of capital borrowing is being mitigated by a swapping arrangement. The funds under the programme are being channelled through ILFS and HUDCO who are expected to raise a matching contribution for the project from the domestic debt market.

A detailed agenda for policy reform pertaining to urban governance, land management, pricing of services, etc. has been proposed for the two participating institutions. In order to provide loans under the Programme, these organisations are supposed to examine the financial viability or bankability of the projects. This, it is hoped, will ensure financial discipline on the part of the borrowing agencies, such as private and public companies, municipal bodies, parastatal agencies, as well as the state governments that have to stand guarantee for the projects.

ESI Scheme and Employers' Provident Fund

Funds are also available under the Employees' State Insurance Scheme and Employers' Provident Fund. These have a longer maturity period and are thus more suited for infrastructure financing. However, there are regulations requiring investment to be channelled into government securities and other debt instruments in a 'socially desirable' manner. The government, however, is seriously considering proposals to relax these stipulations so that the funds can be made available for infrastructure financing, in accordance with the principle of commercial profitability.

Municipal Bonds and Structured Debt Obligations

A major source of infrastructure financing in developed countries has been through the issue of municipal bonds to which institutions like DFIs can subscribe. Unfortunately, among the urban infrastructure projects in India, which have been perceived as commercially viable, few can have municipal bonds issued in the market. The weak financial position and constrained revenue sources of the urban local bodies make this difficult. But problems sometimes bring with them their own solutions. A new type of credit instrument has been designed to enable the local bodies to tap the capital market. 'Structured debt obligations' (SDOs) are arrangements through which bonds are issued on the condition that the borrowing agency pledges or escrows certain buoyant sources of revenue for debt servicing. This is a mechanism by which the debt repayment obligations are given utmost priority and kept independent of the overall financial position of the borrowing agency. It ensures that a trustee would monitor the debt servicing and the borrowing agency would not have access to the pledged resources until the loan is repaid.

Cash Flow Financing

One of the innovative infrastructure financing concepts is cash flow financing. In cash flow financing, the lenders estimate the cash flows of a project over its lifetime to see what kind of debt burden it can support and at what rate. Then, the amount of debt, financing rate and the mode of repayments can be tailored to fit the cash flows of the project. This helps both the lender and the project promoter. Cash flow financing is usually linked to the attainment or completion of several milestones. For instance, since the initial stages of a project are more risky than the later stages, guarantees may be required in the beginning, but can be progressively done away with as the project comes on stream.

Escrow Mechanism

Escrow mechanism has been developed in the case of independent power projects (IPP) which are built by private parties out of private funds and supply electricity to State Electricity Boards (SEBs). Essentially, it ensures that out of the revenues of the SEB, the debt obligations of the financing institutions will be paid first of all. This is done by having some identified revenues being passed through a separate account called the escrow account to which the lenders also have a right to appropriate the funds in case the SEB defaults in making payments. By having the power to be assigned those funds in case of default gives an added comfort to the lender and allows the IPP to raise financial assistance. However, escrowable amounts are limited in each SEB and once these funds are appropriated the SEB may not have much assured revenue flows for its other expenses.

Take-out Financing

Take-out financing allows banks to finance 15-year projects through five to seven-year money, thus addressing the main problem of maturity mismatch faced by India's banks and financial institutions. In India, Infrastructure Development Finance Company (IDFC) offers this facility to banks and institutions. It offers to take out the loan from the bank's books after an initial period, say five years. IDFC can then keep the loan in its own books, or lend it to another bank, for, say, another five years. While the project promoter has got the loan for 15 years through this mechanism, banks can participate in loans on a part-to-part basis which they could not do earlier.

In another variant, the take-out financier could offer a refinance facility to the original lender at the end of five years instead of taking out the loan from its books. This means that the take-out financier will infuse funds in the bank in case the bank faces any liquidity problems at the end of five years. With this assurance, the bank could keep the loan on its own books for a period longer than five years and earn interest thereon.

Subordinated Debt

Institutions have also been thinking of funding infrastructure projects through a quasi-equity instrument called 'subordinated debt' which could have flexible maturity and payment terms. In this case, the borrower gets money which has a longer tenor, and has the comfort of paying it after he has met the secured debt obligations. The payment terms can also be made flexible. Such loans could even be converted to equity at a later date, if desired. Though these loans will be more expensive than secured debt, they will at least ensure that a project starts up.

Ultimately, the development of a deep and liquid debt market with diversification of investor base will help in evolving products that can help banks manage such a risk and unbundle the credit risk from the liquidity and interest rate risk. The Reserve Bank has been encouraging banks and other financial institutions to securitise the receivables, repackage them and offer to investors at various stages of the infrastructure project. One immediate hurdle, however, appears to be the current applicability of stamp duty.

One of the specific proposals made for hedging liquidity risk and interest rate risk is a take-out facility and market-making in project debentures, say after a pre-determined period of five years, to give comfort to commercial banks which are willing to deploy their funds in infrastructure. Also, the provision of a 'liquidity back stop' by the RBI for supporting market-making at the end of the predetermined period has implications for monetary management.

At present, less than 10% of annual infrastructure investment is privately funded, and some of this has indirect government participation. But it is expected that over the years the share of privately funded infrastructure would increase significantly. Some are of the view that a substantial share investment in the power and transport sectors may in future originate in the private sector. It may be pointed out that in Indonesia, Malaysia and the Philippines, more than half of all infrastructure investment is likely to be undertaken by private consortia. Even in the People's Republic of China, there are now encouraging signs of movement towards private sector involvement in this area. Many Chinese road and power projects have recently been listed on the Hong Kong Stock Exchange in order to tap international capital markets. The increasing private sector involvement in infrastructure projects opens up opportunities for the DFIs.

Despite all their problems, DFIs in India remain a favourite source of funds for companies. A recent survey by the Society for Capital Market Research and Development has revealed that, among corporates, the most favoured source of long-term debt finance are term loans from DFIs. In particular, about 70% of relatively new and small companies preferred term loans from credit markets rather than bond issues in the capital market. About two-thirds of the respondents said 'Yes' when asked whether DFIs were needed any more. Also, an all-India survey of household investors conducted by the Society for Capital Market Research and Development in late 1997 revealed that 85% of the respondents regarded private sector corporate bonds as unsafe. In contrast, DFIs' bonds were considered safe by around 80% of the respondents. DFIs have, thus, a crucial role to play in the development of the private debt market.

The Malaysian Experience

In Malaysia, there has been an effort to fit DFIs into the new, liberalised economy. Like many other countries, DFIs in Malaysia have also been established and funded by the government to develop and promote certain strategic sectors of the economy, and to achieve social goals. Malaysian DFIs are expected primarily to fill in the gaps in the supply of financial services that are not normally provided by the banking institutions. Such development institutions generally specialise in the provision of medium and long-term financing of projects, which require specialised skills and focus, and may carry higher credit risks or market risks due to the longer investment tenures. In some cases, the mandated roles of the DFIs include the promotion and achievement of government's specific social and economic objectives.

The DFIs have contributed in varying degrees to the development and growth of the targeted industries and strategic sectors of the economy. They are expected to provide support to these sectors without making losses or resulting in a direct cost to the government. To enable them to perform these functions, such DFIs have generally been accorded special benefits in the form of funding at lower rates, implicit government guarantee to the institutions' debts, special status for their debt instruments and favourable tax treatment. But Malaysian DFIs are small in size, compared to their Indian counterparts. At the end of 1999, the share of assets of the large DFIs in Malaysia was only 3.8% of the total assets of the banking sector. Total loans extended by the large DFIs as a group represented a mere 2.9% of the total loans of the banking sector. Of the total amount of loans extended by the DFIs, 31% was channelled to the manufacturing sector, 17% to the construction sector, 13.4% to agriculture, 12.1% to transport and storage, and 10.3% to the real estate sector.

A blueprint for changing the DFIs has been worked out in Malaysia. This involves: development and evolution of specialised DFIs dedicated to financing infrastructure projects, agriculture sector, capital intensive and high-technology industries and the services sector; and emergence of DFIs as lead advisers, consultants and/or management service providers to the targeted sectors of the economy. The blueprint says that in order to ensure that the DFIs complement the existing banking institutions effectively in providing financial services to the activities not serviced by the banking institutions, the role of the DFIs should be clearly outlined and defined. It is proposed that the focus of the DFIs should be as follows:

– As development institutions, DFIs should continue to meet the socio-economic and developmental goals set by the government;

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- As financial intermeidaries**,** the DFIs should not be involved in sectors that have matured and are able to obtain financing on their own from the banking system or the capital market. DFIs should complement the banking sector through extension of credit in priority and/or new growth areas specified and identified by the government, such as, information technology and high technology ventures, infrastructure development, services and agriculture.

The blueprint further says that a systematic framework to ensure adequate funding for DFIs' operations should be introduced. The framework should comprise the following elements:

- Funds obtained from the government for development and social programmes should be allocated through a budgetary process, where funds are allocated and accounted for in the government's annual budget;
- The government funds intended for development and social programmes should be kept separate from the DFIs' own funds and administered separately as is done in the case of trust funds;
- Government support should be extended to facilitate DFIs to raise funds from the capital market for their own lending activities; and
- DFIs should be encouraged to raise funds from the capital market for their lending activities when possible.
- Government funding support for development and social programmes should be protected with a system of close supervision and controls, together with strong corporate governance to ensure that these funds are used for their stated purposes. DFIs' access to the capital market needs to be enhanced to provide an efficient means of financing capital-intensive and long-gestation projects. Government support may be needed to enable DFIs to obtain favourable funding rates, which ultimately would make the projects more viable.
- Lastly, it is necessary to set up a unit to ensure coordination with relevant ministries, authorities and agencies, as well as to facilitate achievement of government objectives.

For DFIs to successfully meet their objectives, government support and effective coordination among relevant ministries is essential. This can be achieved through the following measures :

- Consultative approach should be adopted to facilitate coordination and communication among the regulatory and supervisory authority, the government, the DFIs and industry experts through regular meetings and consultation to ensure smooth transmission and implementation of government policies. This process would

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promote coordination among government agencies for effective policy development and its efficient implementation by the DFIs;

– Relevant ministries should clearly specify the role and objectives of DFIs in line with the changing needs of the nation and developments in the economy;

– Annual budgetary allocation processes should be applied as tools to determine DFIs' scope of activities and funding sources;

– Measures should be adopted to address ad-hoc development and social projects which are not budgeted for in government allocation to DFIs and also to incorporate performance review and accountability criteria; and

– Performance plan, targets, benchmarks and measurement criteria for DFIs' operations should be formulated and agreed upon.

In this context, it may be pointed out that the Malaysian experience is no longer relevant for India, where government support for DFIs is not forthcoming (except in the case of bail-outs, where financing may have to be provided by the government). The route adopted by the DFIs in India is now clear – they have adopted the univeral banking model: all of them are intent on transforming themselves into commercial banks. There are several parallels for such a change internationally. In Korea, for example, specialised banks, created in the 1960s to direct resources to specific sectors, have since expanded into commercial banking.

5

Conclusion

This monograph has attempted to find answers to the following questions: (a) What is the role for the development financial institutions in an environment of liberalised finance?; (b) How will the present problems faced by the financial institutions viz. those of lack of access to cheap financing sources, on the one hand, and of a maturity mismatch, on the other, be solved?; (c) If the DFIs convert themselves into banks, as they seem to be very keen on doing, what effect will their withdrawal from long-term lending have on the development of infrastructure and the setting up of greenfield capital complexes in this country?

The RBI, in its discussion paper on "Harmonising the Role and Operations of DFIs and Banks" had no doubt about the role that DFIs should play. It said : "Capital markets also cannot be relied upon to provide project finance adequately due to lack of a well-developed long-term debt market in the country. All of this is likely to lead to significant under-supply of term-lending activity in the event of DFIs moving away from it prematurely." And further, "Drastic changes in their respective roles at this stage may have serious implications for financing requirements of funds of crucial sectors of the economy. Given the unique position of DFIs in relation to term-lending at this stage, it is desirable that they remain engaged in term-lending activity even as they diversify into new opportunities opened to them by progressive desegmentation of the sector." In short, the central bank recognises that DFIs continue to have a role to play to fund the long-term requirements of the Indian industry.

The problem is that the DFIs themselves have a different perspective in this regard. From their point of view, their very survival is at stake unless they can convert themselves into banks. That is why they are willing to take on onerous reserve requirements that the central bank has stipulated to be fulfilled if they are to convert themselves into banks.

However, it is possible to evolve a via media that will allow DFIs access to low-cost resources, as well as enable them to fund long-term projects. That can be done through innovative financing mechanisms mentioned in the preceding discussion, such as take-out financing, securitisation, convertible bonds, funding of bond and other hybrid instruments floated by SPVs, structured finance involving milestones and credit enhancements. Most importantly, we need to develop our corporate bond markets, making them broad and deep, and extending them to the retail level. The World Bank and other multilateral lending agencies have been traditional lenders to infrastructure projects. Their assistance needs to be tapped in new ways, with partnerships between them and domestic DFIs. Similar ways of providing long-term finance can be conceived in partnerships between banks and long-term investors, such as insurance companies and pension funds. And if the policy environment is conducive, there is no dearth of foreign project finance for infrastructure projects.

The opening up of the insurance sector to private players has resulted in many new players coming into the sector. The amount of resources flowing into this sector has increased dramatically. Insurance companies are natural candidates for financing infrastructure, because they need long-term assets that can match their long-term liabilities. The same holds true for pension funds. As the rules for pension fund investment are liberalised, and as infrastructure bonds backed by credit enhancements (to make them eligible for investment by such funds) are issued, insurance and pension funds can be a large source of infrastructure finance. At the very least, they can be institutions to whom initial investors in infrastructure projects such as banks can sell down their investments.

In any case, continuing to remain DFIs without having access to cheap funds is certainly not an option. In the circumstances, there can be two approaches to DFIs. One of them, which can be applied to many of the state-level institutions, is to simply close them down, after transferring their assets to an asset reconstruction and recovery company. Any developmental role that is still being played by the state-level institutions could with ease be assumed by the banks. So far as the refinancing institutions, such as SIDBI, NABARD, and HUDCO are concerned, their survival depends on being able to access funds at rates cheaper than those offered to their borrowers. The same arguments against interest subsidies that apply to the other DFIs also apply to these institutions. Nevertheless, they have not been exposed to the same pressures as the other DFIs. The selling off of assets to a reconstruction company can also be a route as has been followed by IFCI, whose NPA problem is very large.

As for the other institutions, they are simply too large to fail. For them, there is no alternative but to convert themselves into commercial banks. Though it will not solve the entire problem, it will at least help the DFIs to survive till they can adopt the new ways of doing business. This option will remove the maturity mismatch for these institutions, lower their cost of funds, and enable them to restructure their business. The IDFC, for instance, has tried to reinvent itself to fit the new market realities.

To sum up, there is an imperative need in this country to forge new partnerships between the public and private sectors in order to finance infrastructure. New ideas, such as the Private Finance Initiative, that has worked satisfactorily in the UK, should be tried here. The DFIs, even in their new incarnation as commercial banks, must take the lead in adopting such innovative ideas.

Most importantly, although the DFIs need to convert themselves to commercial banks in order to survive, that will not mean the drying up of funds for infrastructure. Unfortunately, the whole approach so far has been to throw money at the problem in the hope that it will go away. That is why IDFC was capitalised at such a high level. Recently, the 2002-03 budget has talked about setting up a new Infrastructure Fund for funding equity in infrastructure projects. As a matter of fact, if good projects are available, there is no dearth of finance. Consider the success of the telecom sector in attracting funds, now that a framework for reform has been established in that sector. At the same time, consider the flight of capital from the power sector, where the reforms necessary for attracting private investment have not been pursued. The problem in Indian infrastructure today has nothing to do with projects and programmes, nor, for that matter, with funding. Rather, it is about systemic policy changes. Get the policy right, and funds will flow in.

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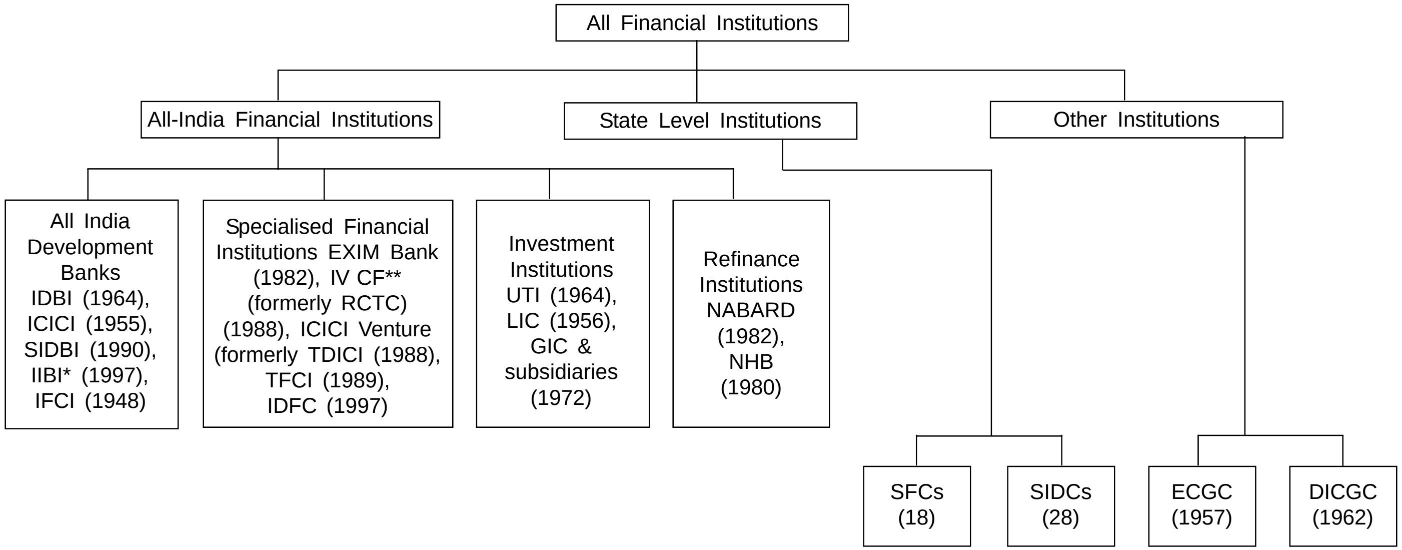
Annexure I

Organisational Structure of Financial Institutions



* The erstwhile Industrial Reconstruction Bank of India (IRBI), established in 1985 under the IRBI Act, 1984, was renamed as Industrial Investment Bank of India Ltd. (IIBI) with effect from March 27, 1997.

** IVCF-IFCI Venture Capital Funds Ltd.

Notes:
(i) Figures in brackets under respective institutions indicate the year of establishment or incorporation.
(ii) Figures in the brackets under State Financial Corporations (SFCs)/State Industrial Development Corporations (SIDCs) indicate the number of institutions in that category.
(iii) ECGC: Export Credit Guarantee Corporation of India; DICGC: Deposit Insurance and Credit Guarantee Corporation.

Source: RBI, Trend and Progress of Banking of India.

Asset Classification of Select Financial Institutions
(As at end-March)

(Amount in Rs. crore)

Institution	Standard		Sub–standard		Doubtful		Loss		Net Loans Outstanding#		Net NPA/Net Loans (per cent)	
	2000	2001	2000	2001	2000	2001	2000	2001	2000	2001	2000	2001
1	2	3	4	5	6	7	8	9	10	11	12	13
IDBI	49,424	48,107	4,055	3,014	3,620	5,356	–	–	57,099	56,477	13.4	14.8
ICICI	48,382	54,525	1,793	885	2,166	2,097	–	–	52,341	57,57	07.6	5.2
IFCI	15,738	14,818	2,177	934	1,926	2,963	–	–	19,841	18,715	20.7	20.8
SIDBI	14,613	13,934	115	61	82	113	–	–	14,810	14,108	1.3	1.2
NABARD	29,031	35,771	833	–	218	–	–	–	30,082	35,771	3.5	–
NHB	3,668	N.A.	–	N.A.	–	N.A.	–	–	3,668	N.A.	–	N.A.
IIBI	3,286	2,108	380	201	278	424	–	–	3,944	2,733	16.7	22.9
EXIM Bank	4,231	4,562	200	236	174	171	–	–	4,605	4,969	8.1	8.2
IDFC	895	1,199	–	–	–	–	–	–	895	1,199	–	–
TFCI	746	604	101	81	28	75	–	–	875	760	14.7	20.5

N. A. : Not available – : Nil
: Net of provisioning and write-offs.
Notes: (i) NPA in any year is the aggregate of the amounts under sub-standard, doubtful and loss categories.
(ii) IDFC has been included since 1999.
Source: Published balance sheets of respective institutions.

Annexure III

Comparative Position of Banks and FIs with respect to Select Regulatory Parameters

	Particulars	Norms for Banks	Norms for FIs
1.	*NPAs*	An asset would be treated as a NPA when (i) Interest and/or instalment of principal remain overdue for a period of more than 180 days in respect of a term loan; (ii) The account remains out of order for a period of more than 180 days, in respect of Overdraft/Cash Credit(OD/CC); (iii) The bill remains overdue for a period of more than 180 days in the case of bills purchased and discounted; (iv) Interest and/or instalment of principal remains overdue for two harvest seasons; in respect of short-term agricultural loans for production and marketing of seasonal agricultural crops such as paddy, wheat, oilseeds, sugarcane, etc. (v) Any amount to be received remains overdue for a period more than 180 days in respect of other accounts;	An asset would be treated as NPA for the following reasons: (A) *Record of recovery* (i) The change to 180 days for instalment of principal/ interest is applicable from the year ending March 31, 2002. (ii) Not applicable. (iii) A bill purchased/ discounted/ rediscounted shall be treated as NPA if it remains overdue and unpaid for a period more than 180 days; (iv) Not applicable; (v) Any other credit facility (including deposits placed with the corporate sector or debentures subscribed on private placement basis) would need to be treated as NPA, if any amount to be received in respect of that facility remains overdue for a period more than 180 days. (vi) Government guaranteed advances shall be treated as NPAs only if concerned state government repudiates its guarantee.
		The 90 day norm shall be adopted by banks from the year ending March 31, 2004.	The 90 day norm has not been made applicable to FIs. (B) *Time overrun* In case of the projects under implementation, an asset becomes NPA where the time overrun has exceeded

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Particulars	Norms for Banks	Norms for FIs
		more than 50% of the time period initially contracted for completion of the project. Based on valid grounds, however, the Board of the FI can treat an asset as standard even if the time overrun has been in excess of the above limit of 50% and pass a resolution as to what the permitted time overrun would be, but there can only be a one-time refixing of the time period of the project.
		(C) *Take-over/OTS/Merger of units*
		(i) In case of sick units (under nursing program or otherwise) which are taken over by 'standard' category borrowers, the credit facilities extended to the transferee and the merged units are permitted to be classified separately for not more than three years from the date of take-over. Thereafter, the conduct of the facilities by the combined entity determines the asset classification.
		(ii) In case of one-time settlement (OTS) entered into between a FI and the new management of a sick unit after its merger with a healthy unit, the assets in respect of the merged (sick) unit are permitted to be treated as standard without waiting for the three year period, if the payments are being made as per the OTS scheme.
		(iii) In case of reverse merger too, where a sick unit takes over a healthy unit, the respective facilities of the two units are permitted to be classified separately for a period of three years; thereafter, the performance of the combined entity determines the classification.

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Particulars	Norms for Banks	Norms for FIs
2. *Income Recognition*	*Advances* (i) The banks should not take to income account, the interest on any NPA; (ii) Interest on advances against term deposits, National Savings Certificates, *Indira Vikas Patra, Kisan Vikas Patra,* and Life policies may be recognised, provided adequate margin is available in the accounts; (iii) If government guaranteed advances become NPA, the interest on such advances should not be taken to income account unless the interest has been realised.	*Advances* (i) in respect of any NPA, the FI should not take to interest income, fees or any other charges unless actually realized. (ii) Not applicable to FIs. (iii) Same as in case of banks.
	Investments (i) Where interest/principal is in arrears, the banks should not reckon the income on the securities; (ii) Banks may book income on accrual basis on securities of corporate bodies/public sector undertakings in respect of which the payment of interest and repayment of principal have been guaranteed by the central government or a state government, provided interest is serviced regularly and as such is not in arrears; (iii) Banks may book income from dividend on shares of corporate bodies on accrual basis, provided dividend on the shares has been declared by the corporate body in its Annual General Meeting and the owner's right to receive payment is established; (iv) Banks may book income from government securities and bonds and debentures of corporate bodies on accrual basis, where interest rates on these	*Investments* (i) Same as in case of banks. (ii) Generally the same, except that the words' public sector undertakings' are not mentioned in case of FIs. (iii) Same as in case of banks. (iv) Same as in case of banks. (v) Not applicable to FIs

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Particulars	Norms for Banks	Norms for FIs
	instruments are pre-determined and provided interest is serviced regularly and is not in arrears; (v) Banks should book income from units of mutual funds on cash basis. *Reversal of Interest* If any advance including bills purchased and discounted becomes NPA during any year, interest accrued and credited to income account in the previous year should be reversed or provided for, if the same is not realised. This is applicable to Government guaranteed accounts and non-performing investments also.	Same as in case of banks.
3. *Asset Classification*	All NPAs in the advances portfolio (except State Government guaranteed advances, where guarantee is not invoked) and central government advances, where the central government has not repudiated the guarantee, are to be classified into three categories (a) Sub-standard asset - NPA for a period less than or equal to 18 months, (b) Doubtful asset-NPA for a period exceeding 18 months; and (c) Loss asset-Asset where loss has been identified by the bank/internal/external auditor, but the amount has not been written off wholly.	Generally, the same as in case of banks.
4. *Provisioning*	*Advances* Standard asset-0.25% on global portfolio basis. Sub-standard asset-10% of the outstanding balance. Doubtful asset (DA)-Unsecured portion 100% *plus* the following% on the secured portion: 20%, if DA <1 year 30%, if DA is of 1-3 years	*Advances* Generally, the same as in the case of banks. However, in case of doubtful/loss assets which are subsequently classified as sub-standard consequent to rescheduling/ renegotiation, the provision made or the amount written off cannot be reversed till the asset becomes eligible to be classified as performing asset.

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Particulars	Norms for Banks	Norms for FIs
	50%, if DA>3 years Loss asset-100% of the outstanding to be provided for.	The provision for government guaranteed account which has become NPA should be made only if the concerned state government repudiates its guarantees.
	Investments Where the interest/principal is in arrears, the bank should make appropriate provisions for depreciation in the value of investment.	*Investments* Same as in case of banks.
5. *CRAR*	9% of risk-weighted assets (RWA) on an ongoing basis. Capital Funds would include the following elements: *Tier-I capital* (i) Paid-up capital, statutory reserves and other disclosed free reserves, if any; (ii) Capital reserves representing surplus arising out of sale proceeds of assets; Equity investments in subsidiaries, intangible assets and losses in the current period and those brought forward from previous periods, should be deducted from tier-I capital.	Generally, the same as in case of banks, except that the under noted instruments are also permitted to be treated as tier-I capital: (i) Grant equivalent implicit in the 20-year preference shares with original maturity of 20 years; (ii) Government of India grant received in perpetuity in respect of KfW line of credit as portion of Interest Differential Fund; (iii) Certain 20-year bonds of FIs subscribed by Government of India that fulfill prescribed conditions; (iv) Reserves held under Section 36 (1) (viii) of the Income Tax Act, 1961.
	Tier-II capital: (i) Undisclosed reserves and cumulative perpetual preference shares; (ii) Revaluation reserves (at a discount of 55%); (iii) General provisions and loss reserves, including general provisions on standard assets (not more than 1.25% of RWA). (iv) Hybrid debt capital instruments;	Gap in provisioning also deducted for Fis. The same as in case of banks, except that redeemable, cumulative, non-convertible preference shares having initial maturity not less than 5 years will be eligible for inclusion in tier-II capital on the same footing as 'sub- ordinated debt' and will be subject to the progressive discounting and the ceiling applicable to subordinated debt.

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Particulars	Norms for Banks	Norms for FIs
	(v) Subordinated debt (eligible to be reckoned as tier-II capital will be limited to 50% of tier-I capital); Tier-II elements will be reckoned as capital upto a maximum of 100% of total tier-I elements. *Capital Adequacy for Subsidiaries* Banks to voluntarily build in the risk- weighted components of their subsidiaries into their own balance sheet on notional basis, at par with the risk-weights applicable to the bank's own assets. The additional capital is to be built up in the bank's books in phases from March 2001.	Same as in case of banks. Not applicable to FIs.
6. *Investments*	*Classification* The entire investment portfolio of banks (including SLR and non-SLR securities) should be classified into three categories, *viz*., Held to Maturity (HTM), Available for Sale (AFS) and Held for Trading (HFT) categories. Holding period under HFT not to be more than 90 days. The investments under HTM should not exceed 25% of bank's total investments. Banks have the freedom to decide the extent of holdings under AFS and HFT categories. *Valuation* HTM - not necessary, unless book value is more than face value, in which case the premium is to be amortised over the period remaining to maturity. AFS-annual or more frequent (net appreciation in each classification to be ignored, net depreciation to be provided for). HFT-monthly or more frequent (net appreciation and net depreciation can be taken to Profit and Loss account).	*Classification* Generally, the same as in case of banks, except that the under-noted norms apply to equity shares. Investments in equity shares as part of project finance are to be valued at cost for a period of two years after commencement of production or five years after subscription, whichever is earlier. In respect of other investments in equity shares, valuation may be done as per market value which would be the market price of the scrip as available from the trades/quotes on the stock exchange. Those scrips for which current quotations are not available or where the shares are not quoted on the stock exchanges, should be valued at break-up value (without considering revaluation reserves, if any) which is to be ascertained from the company's latest balance sheet (which should not be more than one year prior to the date of valuation). In case the latest balance sheet is not available, the shares are to be valued at rupee one per company.

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	Particulars	Norms for Banks	Norms for FIs
7.	*Exposure Norms*	The exposures to individual and group borrowers are 20% and 50% of the capital funds[5], respectively; and 60% in case the exposure is on infrastructure sector. The maximum exposure to (with effect from March 2002)[6]: Individual borrowers-15% of capital funds; Group borrowers-40% of capital funds (can be exceeded by an additional 10% if the exposure is for financing infrastructure projects alone). Components of exposure would comprise 100% of funded and non-funded exposure. With effect from April 2003, forward contracts in foreign exchange and other derivative products like currency swaps, options, etc., at their replacement cost are to be included, while determining exposure.	Same as in case of banks, except (i) investment exposure not reckoned for FIs, (ii) in respect of term loans, the exposure limit is reckoned on the basis of undrawn commitments. In cases where disbursements are yet to commence, exposure limit is reckoned on the basis of sanctioned limit or the extent to which the Fis have entered into commitments with the borrowing companies in terms of agreements, as the case may be. In respect of all other facilities (other than term loans), exposure limits shall continue to be reckoned on the basis of sanctioned limits or outstandings, whichever are higher.
		Ceiling for investment in shares is 5% of bank's total outstanding advances as on March 31 of the previous year (including commercial paper).	Not applicable.
8.	*Disclosure Requirements*	The following information is to be disclosed as 'Notes on Accounts' in the balance sheet by public sector banks: (i) Percentage shareholding of the Government of India; (ii) Percentage of net NPA to net advances; (iii) Amount of provisions made towards NPAs, depreciation in the value of investment and income tax, separately; (iv) capital adequacy ratio (tier-I and tier-II capital), separately; (v) sub-ordinated debt raised as tier-II capital; (vi) gross value of investments in and outside India; aggregate of provisions for depreciation and net value of investments:	Generally the same as in case of banks, except that items (i), (iii), (vi), (xi) and (xviii) are not applicable to FIs. (iii) Same as banks. However, investments include only those items which are other than those in the nature of an advance. The undernoted additional disclosures have been prescribed for FIs. (i) Risk-weighted assets-for on and off-balance sheet items separately; (ii) The shareholding pattern as on the date of the balance sheet;

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Particulars	Norms for Banks	Norms for FIs
	(vii) interest income as percentage to average working funds; (viii) non-interest income as percentage to average working fund; (ix) Operating profit as percentage to average working fund; (x) Return on Assets; (xi) Business per employee; (xii) Profit per employee; (xiii) Maturity pattern of loans and advances; (xiv) Maturity pattern of investments in securities; (xv) Foreign currency assets and liabilities; (xvi) Movements in NPAs; (xvii)Maturity pattern of deposits and borrowings; (xviii) Lending to sensitive sectors. Additional disclosure in the 'Notes on Accounts' from the accounting year ended March 31, 2001 (i) Treatment of restructured accounts; (ii) Investment in shares, etc: (a) Investments in shares, (b) Investments in convertible debentures, and, (c) Units of equity oriented mutual funds. Additional information in the 'Notes on Accounts' in the balance sheet from the accounting year ending March 31, 2002: (i) Movement of provisions held towards NPAs, (ii) Movement of provisions held towards depreciation on invesments.	(iii) Amount and percentage of net NPAs under prescribed asset classification categories; (iv) Credit exposure as percentage to capital funds and as percentage to total assets, in respect of: (a) the largest single borrower (b) the largest borrower group (c) the 10 largest single borrowers (d) the 10 largest borrower groups (v) Detailed disclosures on forward rate agreements and interest rate swaps. (vi) Credit exposure to the five largest sectors/ industries as percentage to total loan assets.

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Particulars	Norms for Banks	Norms for FIs
9. *Asset Liability Management (ALM) Guidelines*	ALM guidelines were introduced for banks in February 1999. Banks were to ensure coverage of 60% of their liabilities and assets initially, and subsequently cover 100% of their business by April 1, 2000.	ALM guidelines for FIs were issued in December 1999 and implemented since April 2000. The guidelines envisages preparation of periodical Liquidity Gap Statement and Interest Rate Sensitivity statement in accordance with the detailed prescriptions contained in the guidelines.
	The prudential norms prescribed are only for negative liquidity mismatches in the first two time buckets (*viz.*, 1-14 days and 15-29 days) at 20% each of the cash outflows in these time buckets.	The prudential norms prescribed are only for negative liquidity mismatches in the first two time buckets (*viz.*, 1-14 days and 15-29 days) at 10% and 15% of cash outflows in these time buckets. The FIs are expected to fix their own prudential limits with the approval of their Board/Asset Liability Committee (ALCO) for cumulative negative gaps. In the case of interest rate gaps, the Board/ALCO will have to fix the prudential limits for each FI.
10. *Resource Raising*	Not applicable to banks.	Regulation has been laid down regarding the total borrowing of the FIs and the quantum of resources they can raise through the umbrella limit (i.e., term-money borrowings, certificate of deposits, term-deposits, inter-corporate deposits and commercial paper). At present, their total borrowings are required to be within a ceiling of 10 times of their NOF, while borrowings through the aforesaid umbrella limit for the said instruments are required to be within the ceiling of one time of their NOF.

Source: Trend and Progress of Banking in India, RBI

Annexure IV

Financial Performance of Select Financial Institutions*

(Rs. crore)

	Item		1999-2000	2000-01	Variation of Col. (3) over Col. (2)	
					Absolute	Percentage
	1		2	3	4	5
A.	Income (i+ii)		24,410.41 (100.00)	25,867.15 (100.00)	1,456.74	5.97
	(i)	Interest Income	22,152.18 (90.75)	23,519.05 (90.92)	1,366.87	6.17
	(ii)	Other Income	2,258.23 (9.25)	2,348.10 (9.08)	89.87	3.98
B.	Expenditure (i+ii+iii)		21,147.73 (100.00)	23,748.09 (100.00)	2,600.36	12.30
	(i)	Interest Expended	18,244.60 (86.27)	19,567.24 (82.40)	1,322.64	7.25
	(ii)	Provisions	686.64 (3.25)	1,578.77 (6.65)	892.13	129.93
	(iii)	Other Expenses	2,216.49 (10.48)	2,602.08 (10.96)	385.59	17.40
		of which : Wage Bill	362.27 (1.71)	476.35 (2.01)	114.08	31.49
C.	Profit					
	(i)	Operating Profit	3,949.32	3,697.83	(-)251.49	(-)6.37
	(ii)	Net Profit	3,262.68	2,119.06	(-)1,143.62	(-)35.05
D.	Total Assets		2,32,043.02	2,46,518.00	14,474.98	6.24
E.	Financial Ratios (per cent) @					
	(i)	Operating Profit	1.71	1.50	(-)0.21	–
	(ii)	Net Profit	1.41	0.86	(-)0.55	–
	(iii)	Income	10.52	10.49	(-)0.03	–
	(iv)	Interest Income	9.55	9.54	(-)0.01	–
	(v)	Other Income	0.97	0.95	(-)0.02	–
	(vi)	Expenditure	9.11	9.63	0.52	–
	(vii)	Interest Expended	7.86	7.94	0.07	–
	(viii)	Other Operating Expenses	0.96	1.06	0.10	–
	(ix)	Wage Bill	0.16	0.19	0.04	–
	(x)	Provisions and Contingencies	0.30	0.64	0.34	–
	(xi)	Spread (Net Interest Income)	1.69	1.61	(-)0.08	–

@ Ratios to Total Assets.

* IDBI, ICICI, TFCI, EXIM Bank, NABARD, SIDBI, IDFC, IFCI, NHB and IIBI.

Notes: (i) Figures in brackets are percentage shares to the respective total.

(ii) NHB data is as on June 30, 2001.

Appendix

INFRASTRUCTURE DEVELOPMENT FINANCE COMPANY LTD.: A CASE STUDY

It is a well-established fact of infrastructure development that it requires large volumes of long-term investments that are not only lumpy but are also risky. In India, in the absence of a proper bond market, such investments had not been forthcoming via the capital market. Instead, the country had had to depend on funds generated through taxation. The reforms of 1991, however, sought to give up this route and shift the focus towards the capital market as a source of capital for long-term investment in infrastructure. The reason partly was the inability of the exchequer to undertake large capital investments owing to the burden of current expenditures. It was in this context that, five years ago, the IDFC was created. At the time of its establishment, there was a mood of great optimism about the prospects for its success. That expectation has, however, not been met in any significant measure. There are many reasons for this, some valid others not.

The case against the IDFC is that India does not need another financial institution, since it is now widely conceded that the DFI model has proved to be unviable. The criticism is not without merit. Even a cursory glance at IDFC's balance sheet for the year ended March 2001 shows that while outstandings on account of loans for infrastructure amount to Rs. 1174 crore, investments (mainly in bonds, debentures and income funds) amount to Rs. 902 crore. This low level of advances is all the more disturbing when viewed against the fact that IDFC's paid-up capital is a huge Rs. 1000 crore and its reserves amount to another Rs. 382 crore. It is evident that IDFC's scale of operations is certainly far below the potential implied by its huge capitalisation. This means an unacceptably high level of waste of resources. In addition, IDFC also has a subordinated debt of Rs. 650 crore contracted from the government and the Reserve Bank of India. These are long-term loans repayable in 2012, but the tenor of these loans is being extended to 50 years.

In 2000-01, IDFC's income from infrastructure loans was only Rs. 127 crore, out of a total income of Rs. 314 crore. Most of IDFC's income for the year was from investments and profits from other sources. This inevitably leads to questions about the size of the IDFC's capital base. Clearly, it is imperative that there should be growth in IDFC's balance sheet. It is encouraging to note that there has indeed been some growth during 2000-01. For example, outstandings on account of infrastructure loans increased by Rs. 412 crore, while outstanding investments went down by Rs. 17 crore. This implies that IDFC is finally concentrating more on lending than on treasury operations, that is, investing in government bonds and other sources of interest income. In the financial year 2000-01, the pace of disbursements seems to have picked up somewhat, with disbursements amounting to Rs. 2000 crore by end-December 2001.

IDFC's performance has no doubt been a disappointment for those who expected it to disburse large sums of money for infrastructure development in its first few years. But it needs to be realised that even institutions like ICICI and HDFC had a lot of treasury operations in the first two years of their existence though they had a much smaller capital base. In contrast, IDFC had been provided a huge capital base, which it could not spend in two years. With the benefit of hindsight, it can be said that capitalisation was wrong, and perhaps IDFC should have had callable capital. In this context, however, one should not lose sight of the fact that with the government's reforms going ahead at full steam, it was expected that infrastructure development would take place at a faster pace. If this has not turned out to be the case, it is as much to do with the slow pace of reforms in other sectors.

It is also important to recognise that there is a crucial difference between IDFC and other DFIs. IDFC's business plan clearly states that it is not a DFI, in the sense that it does not depend upon fiscal crutches for funds. In contrast, DFIs depend upon government guaranteed debt and SLR (statutory liquidity ratio) securities. IDFC's mission is not only to be an intermediary in the finance function, not merely to provide capital for infrastructure, but to lead private capital towards commercially viable infrastructure projects. This would involve offering guarantees, credit enhancements, etc. In essence, IDFC has to conceive a project, make it bankable and take it to the market. This requires it to redefine its role all the time in view of the market conditions and the nature of the project in question.

The reality of infrastructure funding in this country is that there is no dearth of funds – actually, there is a dearth of bankable projects. The story of infrastructure development in India in the past five years is one of short-term solutions to long-term problems. For instance, now that many of the issues in telecom liberalisation have been sorted out, telecom players have no dearth of financing available to them. Consider, for instance, the success of Bharati Telecom's public issue floated at a time when the appetite for new issues was very low indeed.

Viewed from this perspective, IDFC's role has to be re-defined from being a mere provider of infrastructure finance to an institution dedicated to finding solutions that facilitate infrastructure financing, including the arranging of finance. IDFC is trying to reinvent a business – new structures for financing are being worked out, new private-public partnerships are being explored. However, it will take some time before its ideas get accepted.

The New Initiatives

In India, the problem is that 99% of infrastructure here is owned by the government. Given the scarcity of financial resources available both to the central and state governments, if we have to depend on the government alone for infrastructure, performance will continue to be well below promise. That is why IDFC is pushing for a public-private partnership. This initiative is known as the Private Finance Initiative (PFI) which is a means of using private finance and skills to deliver capital investment projects traditionally provided by the public sector. These include capital projects, such as schools, hospitals, roads, and water facilities. Instead of the public sector body directly procuring capital assets and subsequently owning, operating and regulating them, PFI generally involves the private sector in owning and operating these assets and the public sector having a larger role in regulation.

The public sector body enters into a contract with the successful private sector consortium to deliver some or all of the services associated with the investment over a period of time. Part of the contract specifies that the private consortium must take on a considerable degree of the risk associated with the project. The risk includes possible cost overruns, lower than expected usage, etc.

IDFC's efforts towards pushing the PFI idea in India have borne fruit in the annuity-based schemes of road financing under the NHAI road projects. Under this programme, the private sector is to build and maintain roads for 15 years through annuity payments by the government. The service delivery is the starting point and the government will pay for the service i.e. availability of lane kilometres over time. If the service is not provided, the government can penalise the winning bidder. If the road has to be repaired a number of times, it will be at the expense of the bidder, not the government.

In UK, PFI model has been used across a broad spectrum of sectors, such as roads, hospitals, government accommodation, low and medium level defence projects, and prisons. Among developing and emerging sectors, progress in PFI has been made in trams, court buildings, schools, information technology projects, environmental projects, social housing and urban traffic control.

From the foregoing discussion, it seems justified to conclude that since IDFC does not see itself as a mere provider of loans for infrastructure, it needs to build up a framework which creates projects that it can finance. The idea is to make IDFC not merely a lender, but a merchant banker too for infrastructure projects; in fact, it already has a merchant-banking licence. Besides, it can also become a major arranger of funds, or can form a syndicate or even securitise. And once infrastructure projecs starts fructifying, it will mean more business for IDFC.

As things stand, it would be rather premature to classify IDFC as just another development financial institution, and predict that it will go the way of the DFIs. However, its success would depend on the speed and success of infrastructure reforms in India, and also on the success of its attempt to extend the PFI model from roads to other infrastructure sectors. Much also would depend on whether its merchant banking and marketing skills are equal to its expertise in ideation and project appraisal.