CHAPTER II

THEORY OF DEVELOPMENT BANKING.

2.1 Introduction:

In the 20th Century, especially after the second World War, Financial Institutions namely the Development Banks have been coming up as a catalyst for industrial development. A Development Bank is a financial institution engaged in providing medium and long term assistance to business units, in the form of Loans, underwritings, investment and guarantee operations.[1] In nearly every developing country development banks have been established. In the countries like India which are spurred by the objective of rapid economic development, the bank's have got a very important place, in the programme of development. The present work aims at the Study of working of one of these financial institutions in India. The Industrial Finance Corporation of India.

2.2 Importance of Development Banks:

The rate of growth of economic development depends upon many factors, among which the rate of capital formation is the most important, determinant. It is so because, although capital undoubtedly can not solve any problem of economic development in isolation of other factors, it certainly helps in acquiring those ingredients, which, if used in a judicious and balanced way, raise the rate of growth of the economy.[2] Financial intermediaries aquire unique importance in accelerating the process of capital formation and promoting economic growth. These financial intermediaries can be called as development banks when they play dual role i) Promotional role and ii) Financial role -

2.3 The development banks are gaining very much importance as an effective instrument of economic development. The governments of a large number of undeveloped countries, aspiring after a rapid rate of economic development, have either directly established such institutions or promoted their organisation. They have all been devised to provide at least a few, it not all the fundamental ingredients of economic development, the lack or inadequacy of which may be inhibiting an accelerated pace of progress. Thus a development bank is intended to provide the necessary capital, enterprise, managerial and technical knowhow where these are clearly inadequate or non-available and also assist in building up the financial and socio-economic infra-structure favourable to quick economic development[3].

2.4 Theory of Development Bankin-g:

The nature of financial arrangement varied from time to time depending on the stage of industrial development. The changes in the financial systems reflect the need of industries that were in existence[4]. Financial organisations influence the output through its influence on saving and investment. After examining the financial structure in advanced countries it can be argued that differences in financial structure have been an important contributing factor, in determining rate of growth of real national product. However it is not possible to isolate and measure the contribution of 'financial factors'. Apparently, however, no country has moved into the 'advanced' category without a banking system of substantial size. The forms of financing that can channel savings to the most productive types

of investments and thus foster the maximum economic growth are the most efficient and desirable ones. The Financial intermediaries are emerging in these areas successfully.

2.5 In old days before the industrial Revolution, financial intermediaries were almost absent. Barter financing has played an important role in the earlier stages of economic development. Most of the financing was internal. Agriculture was the predominant activity and pecuniary institutions had not come to play any important role. In those days internal savings acted as a limitation to the growth of individual companies, but with the establishment and expansion of financial intermediaries and financial markets the share of external financing showed rapid increase in the total capital formation.

2.6 Financial intermediaries are the institutions which collect savings from others, issuing in return claims against themselves, and use the funds thus acquired to purchase ownership or debt claims. There is a close relationship between the growth of financial intermediaries and economic development. If an economy lacks financial assets each spending unit invests all its saving in tangible assets. They can neither invest more, nor less than their savings. They would be forced to balance their budgets with saving equal to investment. Naturally this keeps a relatively low level of savings and investment and hence the rate of growth of output would be adversely affected. In the absence of financial assets, relatively inferior projects would be undertaken and there would be inefficient allocation of resources. Financial intermediaries, therefore, play a very important role in the saving - investment process

by raising the level of saving and investment and allocating more efficiently scarce savings among most productive investments.

2.7 The whole process can be explained in following way. Spending units in the economy can be divided into three parts 1) Spending units with balanced budget having saving equal to their investment i.e. they can not borrow or can not lend. Their budget is always balanced.

ii) Spending units with surplus budget having their saving more than their investment. Their financial assets increase more than their liabilities and they are the suppliers of loanable funds. So in the economy the spending units with surplus budget are ultimate lenders.

iii) Spending units with deficit budgets having saving less than their investment spending units with deficit budget spend more than their income, therefore they are receipients of loanable funds or they are ultimate borrowers.

2.8 In a developing economy there are more spending units with unbalanced budgets (i.e. either with deficit budgets or with surplus budget). In the case of spending units with balanced budgets, the expenditure is self financed. Their investments are financed from internal savings. In developing economy the importance of self financing gradually declines and external financing aquires important place.

2.9 External finance involves two methods i) Direct Finance ii) Indirect Finance. Under direct finance deficit units directly borrow from surplus units. Deficit units issue the

debts of their own and hold financial assets in the form af direct securities. Under direct finance, when capital formation takes place, debt tends to accumulate with wealth. So under direct finance there are no intermediaries in the economy. Under self finance and direct finance rate of economic development is very slow. But when financial intermediaries come into existance, they change entire structure of finance in the economy.

2.10 Under indirect finance financial intermediaries purchase primary securities from ultimate borrowers (deficit units), they transform primary securities into indirect securities and they sale indirect securities to ultimate savers (surplus units) under this method institutionalisation of saving and investment takes place. It quickens the growth rate of debt, relative to the growth rate of income and wealth. Under indirect finance financial intermediaries act as intermediaries between deficit units and surplus units. Financial intermediaries meet requirements of both, borrowers and lenders. Because borrowers and lenders get benefit. Borrowers get benefit through lower rate of interest and lenders get benefit through higher deposit rates. In this way financial intermediaries raise the level of saving and investment in the economy. They promote capital formation and through capital formation they promote economic growth to a great extent.

2.11 Financial intermediaries mobilise savings of the community by creating attractive financial assets suitable to different levels of wealth holders, to different time schedules and

different yields. They can also offer attractive rates of interest to attract more savings, because unlike the commercial banks they are not subject to interest rate ceilings. When the financial institutions play the role of allocating these savings efficiently in a desired manner they assume the role of development banks. In developing countries like India where planned economic development has been adopted, the development banks have been created as 'Engines of Economic Development'.

2.12 The growth of development banking is now a world wide phenomenon. These institutions emerged in developed countries to achieve post war reconstructional and in developing countries they were essential to achieve economic development. The industrial development of a country is impossible without the specialised institutions in the form of development banks. In a rudimentary economy, there were many obstacles in the way of industrial development which can be removed by these development banks.

2.13 <u>Defects in a Rudimentary Economy:</u>

In such an economy money is the only financial asset, Therefore its capacity for growth is limited, because money as such does not contribute to the economic development. There are restraints on savings and proper allocation of savings to investment Whatever savings are done, they had to be kept in the form of gold, landed property etc., due to the absence of financial assets. In urban areas, commercial banks attract these savings to some extent but because of the short term nature of their resources generally they do not participate in

the long and medium term loans needed by the business concerns. Thus an immature financial system is in itself an obstacle to economic progress. But financial intermediaries come into existence they change, the entire structure of finance in the economy. The importance of internal financing gradually declines and the share of external financing show rapid increase in the total capital formation. The activities of saving and investment become extremely diversified and complex during the process of economic growth and this causes the necessity of intermediation between these two important activities. The form of intermediate finance has definitely shown an upward trend in developed economies. In under-developed countries too, this form of capital formation has aquired great importance in present days. Thus indicates a very important change in the whole process - a transfer of choice of investment from individual saver to institutional agent. The nature and scope of financial intermediaries, their investment policies and operations affect the process of capital formation considerably.

2.14 Development Banking - Phases of Evolution.

Though the development banks are sometimes considered as of relatively recent origin, the origin of the development banks can be traced to as far back as 1822. When " The Societe Generale Pour Fevoriser 'Industrie Nationale' was founded in Belgium, with the specific object of financing and promoting industry. Another similar institution was established in 1852 in France with the name 'Credit Mobilier', which had aroused much greater interest throughout the world as a pioneering

effort towards building up an institutional structure of industrial finance. On this model Japan also founded in 1902, the 'Industrial Bank of Japan' For the purpose of financing her industrial development. Although the Japanese Bank played a significant part in financing the economic development of the country, it has to be distinguished from the modern concept of development bank in relation to underdeveloped countries. It was not a specialist institution designed to provide finance and enterprise for industrial development but a bybrid' institution combining in itself the functions of an issue house, an commercial bank and a mortgage institution. In Germany also the so called 'Industrial Banks were established for industrial development.

2.15 After the World War I, the enormous task of reconstruction, modernisation and development called for an adequate provision of long term industrial finance. They were pure mortgage banks.

2.16 Then in the post-depression period, in several countries, attempts were made to form suitable organisations for the provision of medium and long term finance, some of the institutional developments in the post depression period, however, showed an unmistakable, though not pronounced trend towards combining long term lending business with that of issue and underwriting and even of holding.

2.17 An entirely different phase in the institutional developments is to be observed in the years after World War II. In sharp contrast to the pure industrial mortgage banks of the period after World War I, and the hesitant policy of the post

depression industrial credit companies there could now be witnessed a remarkable trend in favour of a combination of the business of mortgage lending with that of underwriting and, in several important cases, participation in the equity capital of industrial companies as well,. In great Britain and several other countries in the commenwealth, such machineries were established. The Canadian Institution used for the first time the desi/nation of a development bank not familier in these days. But it had hardly any entreprenourial and promotional functions which characterise most of the development banks in underdeveloped countries today. These institutions established in the countries like British, Canada and Australia cannot be characterised as true development banks in the strictest sense of the word as understood in relation to underdeveloped economies. They were specialist machineries, set up in countries already in an advanced stage of economic development with the objective of broadening the existing sources of finance for the development mainly of small and medium sized industries during the process of transition from a War time to peace, time economy.

2.18 These institutional devices in the advanced countries provided the model for some underdeveloped countries which were in search of a suitable machinery for the financing of industrial development as an integral part of their overall economic development. The Industrial Finance Corporation of India and Pakistan are cases in point. They were intended to play a definite role in countries economic development.

2.19 The modern concept of a'development bank' is closely related to the urge on the part of a Back ward and underdeveloped country to achieve a quick rate of all round economic development and its search for an appropriate instrument through which such development can be promoted and financed. The countries like India, Pakistan, Burma, Ceylon, Chile, Mexico, Thailand etc. have all established development banks of their own.[5]

2.20 The Role of Development Banks -

The functions of the development banks differ from country to country as per the Socio-economic backgrounds in each country. In developed economy, the main objective of development bank is to increase the rate of growth of economy. They have no problem of 'take off. into the phase of self sustained growth'. In an advanced economy, save in some exceptional cases, the development banks are not required 'to fill up the gaps in the industrial structure of the economy.

2.21 On the other hand, the position of a development bank in an underdeveloped economy is much different. Because of the peculiar structural drawbacks from which an underdeveloped economy suffers, the responsibility of a development bank increase manifold. The progress has been impeded in most countries by lack or inadequancy of various ingredients of industrial development.

i) The First impediment is a shortage of capital for industrial investment. Some capital usually does exist in the form of private sayings but not enough, and only a small part of those savings is in any event readily available for investment in

industry, wealth is traditionally invested in land or commercial enterprises.

2) The Second bottleneck in the way of economic development is the lack of effective mechanism for channeling into productive investment a sufficiently large proportion of such savings as exists.

3) Finally many countries suffer from a limited initiative on the part of the industrial community. There is a dis-inclination to seek out and to venture into new areas of activity - and from limited or no opportunity to become acquainted with and to profit by technological advances achieved abroad[6].

In such a situation the function of the development banks in these countries is to help in overcoming these obstacles and in supplying the missing ingredients.

2.22 Financial Functions which development bank generally performs can be devided into two categories. Financial and Developmental. As a financial institution it provides loan assistance to industrial concerns. Loans are provided by certain development banks in both the currencies, local as well as foreign. The foreign currency loans play a very significant part in the economic growth of the relatively underdeveloped countries. For importing the necessary capital goods and know-how. They generally confine their lending operations to medium and long term loans only. As a financial institution a development bank undertakes the function of underwriting. They also subscribe to the shares, stocks, bonds, Debentures etc. of

industrial concerns and of other development banks. development banks assist industrial concerns also by providing guarantees of various types e.g. guarantees on behalf of the industrial concerns in respect of i) the loans raised by them in the open market or from the local/foreign financial institutions ii) the deferred payments due from such concerns arising out of the domestic purchaseor import of capital goods iii) the issue of clients's securities etc. Not only this, certain development banks are authorised to guarantee the obligations of various other financial institutions as well. This encourages other financial institutions to came forward and participate in industrial finance.

2.23 Developmental:-

The other types of functions of a development bank are called the developmental or fomento functions. These functions includes the promotion of new industries to fill up the gaps in the industrial structure, assisting in the formation of other development banks, provision of technical, managerial and administrative advice, conduct of techno economic surveys and market and investment research, arrangements of suitable capital structure, improving the investment opportunities,/climate to induce foreign capital participation, laying out of industrial estates, creation and stimulation of security market, acting on the management of industrial concerns, arranging the supply/ import of capital goods and industrial raw materials, provision of disaster loans for human welfare etc. These developmental functions are more important for a development bank to perform than the financial functions. To be useful as a potential instrument of economic growth, it is necessary that the

development banks should be very dynamic in the sphare of their operational techniques referred to above.[7]

2.24 Ownership:

Development banks as operating in the underdeveloped countries may be classified from the point of ownership as i) government owned ii) Central bank owned iii) Privately owned iv) mixed, being owned partly by government and/or nationalised central bank and partly by private interests.

The role of government in the economic development has considerably increased during these days. Development and efficient working of public financing institutions has been able to mobilise effectively savings and including forced savings and channel them into most productive types of investment.

But banks under private ownership and control have some distinct advantages over the public banks. They are likely to be free from political pressure and intervention by the countries parliament. Their investment decisions will be purely objective their methods flexible and their procedures businesslike.[8]

It must however be observed that the ownership factor is no criterion of efficiency.

2.25 Sources of funds:

The development bank ought to have sufficient capital to enable it to make an impact on industrial development, and to earn enough for expenses, the accumulation of adequate reserves and, in the case of private institution, payment of satisfactory dividend.[9]

Sources of funds of development banks may be either domestic or foreign or partly domestic and partly foreign, and may be derived from both equity and loans. Equity capital may be taken up by the national government, central bank and/or domestic private investors, institutional or individual. Apart from equity participation government have sometimes provided long term interest free loans. Some times there are foreign institutional investors . Resources are also largely raised through bond issues either in the domestic or in the foreign capital market. Apart from these external sources of finance the Development Banks' Chief internal source of finance consists of the repayment of principals and the reserve fund which they have built up. Some development banks have been authorised to receive term deposits from the Public.[10]

2.26 The Board of Directors:

Managerial pattern of the development banks normally depends upon the role of different agencies in its formation, financing and operation. In case of public Banks the board of directors generally consists of bureaucrafts, obviously nominated by the government/central bank of the country concerned.

In case of private banks, since most of the development banks have come into existance with government support, in some form or other, there is government representation on the Boards, till the government loan to the institution is repaid in full.

In case of development banks party state owned and partly private owned, the government reserves the right to nominate a certain number of directors.

Every development bank has to operate within the economic framework of its country, it becomes almost essential for it collaborate with the central bank in same firm or other.

Besides the board, these institutions form Executive Committees, advisory committees Adhoc committees etc. and recruit officers and staff members for day to day work.

2.27 Procedure:

Broadly the procedure adopted by the development banks with regard to the provision of financial assistance may be devided into three parts - Establishment of priorities, Project Appraisal, and follow up.

i) Establishment of priorities:

Each development bank has to evolve its priorities in the framework of government policies. The criteria for selecting a project may very between mere improvement in productivity or eligible borrowers and the consideration of a large number of factors viz. marginal capital co-efficient reinvestment co-efficient, capital labour ratio, balance of payment implications, employment potential, use of local human material resources, push to the growth of other industries, vertical integration and diversification, development of local latent, existance of any natural advantage and effective local/foreign demand etc.

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ii) Project Appraisal:

After the priorities are established and the bank's operational area defined in specific terms, there comes up the question of project appraisal which has two aspects; consideration of the application and techniques of appraisal. Generally the consideration of the application has this course: a preliminary discussion with the party, an informal application, its consideration by a small team of officers of the bank, communication of the decision on eligibility, formal application, collection of information/copies of documents from the party, visit to the project preparation of a summary for the Adhoc committee, consideration by the adhoc committee, preparation of a 'Memorandum' its consideration by the 'Central' or 'Executive' committee, assent of the Board of Directors and communication of the decision to the party. Technique of appraisal usually comprise consideration of economic, financial, technical and managerial feasibilities of the project, in brief its viability in the long run. Project appraisal is a very specialised work and requires specialised knowledge. The bank should have, therefore, a team of technical/financial experts to discharge this function.

iii) Follow-up.

Almost all the development banks possess a section to look after the project after the sanction and disbursal of assistance. This besides, keeping a close watch on the proper utilisation of the assistance, also helps the industrial concern which derives benefit from the expertise

of the bank's representatives in the Solution of problems coming up after the assistance is provided. In practice, however, much attention is not paid to follow up. But it is undesirable. Every development bank should possess trained follow up specialists.

Thus the development banks are the financial institutions, which help in accelerating the rate of economic development, by removing abstacles in the way of industrial development. The activities of these institutions are controlled by the government. Thus these are the effective instruments in the hands of the government to give proper direction and acceleration to the economic development.

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