LEARNING OBJECTIVES:
After studying the chapter you should be able to understand:
- Overview of development financial institutions in India
- Role of DFIs in Indian economy

Introduction
A Development Financial Institution (DFI) is defined as “an institution endorsed or supported by Government of India primarily to provide development/Project finance to one or more sectors or sub-sectors of the economy. The institution differentiates itself by a thoughtful balance between commercial norms of operation, as adopted by any financial institution like Commercial bank and developmental responsibilities. It emphasizes the long term financing of a project rather than collateral based financing apart from provision of long-term loans, equity capital, guarantees and underwriting functions, a development institution normally is also expected to upgrade the managerial and the other operational requirements of the assisted projects. Its association with its clients is of an on-going nature and of being a companion in the project than that of a plain lender like banks. Hence, the basic stress of a DFI is on long-term finance and support for activities to the sectors of the economy where the risks may be higher that may not be feasible for commercial banks to finance them. So role of DFIs is not just long term financing but more of development of significant sectors of our economy for hastening growth. These DFIs are also known as Development banks.

After independence the role of commercial banking was limited to working capital financing on short term basis so thrust of DFIs was on long term finance to industry and infrastructure sector in India. India’s first DFI was operationalised in 1948 and it set up State Financial Corporations (SFCs) at the State level after passing of the SFCs Act, 1951, succeeded by the development of Industrial Finance Corporation of India (IFCI).
Financial Institutions

<table>
<thead>
<tr>
<th>Development Banks (National)</th>
<th>Specialized/Sectoral Financial Institutions</th>
<th>Investment Institutions</th>
<th>State Level Institutions</th>
</tr>
</thead>
<tbody>
<tr>
<td>IDBI</td>
<td>TFCI</td>
<td>UTI</td>
<td>SFCs</td>
</tr>
<tr>
<td>ICICI</td>
<td>TDICI</td>
<td>LIC</td>
<td>SIDCs</td>
</tr>
<tr>
<td>SIDBI</td>
<td>RCTC</td>
<td>GIC (with subsidiaries)</td>
<td></td>
</tr>
<tr>
<td>IFCI</td>
<td>EXIM BANK</td>
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<td></td>
</tr>
<tr>
<td>SCICI</td>
<td>NABARD</td>
<td></td>
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<td>IRBI</td>
<td>and other</td>
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Source: RBI report on DFIs on its website www.rbi.org.in

DFIs can be classified in four categories of institutions as per their functions:

1. National Development Banks e.g. IDBI, SIDBI, ICICI, IFCI, IRBI, IDFC
2. Sector specific financial institutions e.g. TFCI, EXIM Bank, NABARD, HDFC, NHB
3. Investment Institutions e.g. LIC, GIC and UTI
4. State level Institutions e.g. State Finance corporations and SIDCs

The role of DFIs was to recognize the gaps in institutions and markets in our financial sector and act as a gap-filler which was made due to incapability of commercial banks to finance big infrastructure projects for long term and support them to attain growth and financial steadiness. Therefore, Govt. of India set up specialized DFIs in India to fulfil long term project financing requirements of industry and agriculture. The financial institutions in India were set up under the full control of both Central and State Governments. The Government used these institutions for the achievements in planning and development of the nation as a whole.

**Role of DFIs in Indian Economy**

Specialized development financial institutions (DFIs), such as, Industrial Finance Corporation of India (IFCI), Industrial Development Bank of India (IDBI), National Bank for Agriculture and Rural Development (NABARD), National Housing Board (NHB) and Small Industry Development Bank of India (SIDBI), with majority ownership of the RBI were launched to meet the long-term financing needs of industry and agriculture in India for driving growth in our economy post-independence. There have been three phases in the evolution of DFIs in India. The first phase began with Independence
and spreads to 1964 when the Industrial Development Bank of India was set up. The second phase stretched from 1964 to the middle of the 1990s when the role of the DFIs grew in importance, with the funding disbursed by them amounting to 10.3 per cent of Gross Capital Formation in 1990-91 and 15.2 per cent in 1993-94. In third phase after 1993-94, the prominence of development banking declined with the decline being particularly severe after 2000-01, as liberalization resulted in the exit of some firms from development banking and in a waning in the resources mobilised by other firms.

**Evolution of DFIs in India**

The process started instantly after Independence, with the setting up of the Industrial Finance Corporation (IFCI) in 1948 to embark on long term term-financing for industries. State Financial Corporations (SFCs) were formed under an Act that came into effect from August 1952 to endorse state-level, small and medium-sized industries with industrial finance. In January 1955, the Industrial Credit and Investment Corporation of India (ICICI), the first development finance institution in the private sector, came to be set up, with backing and funding of the World Bank. In June 1958, the Refinance Corporation for Industry was established, which was later taken over by the Industrial Development Bank of India (IDBI). Other DFIs that were launched included the Agriculture Refinance Corporation (1963), Rural Electrification Corporation Ltd. and HUDCO. Two other major steps in institution building were the setting up of IDBI as an apex term-lending institution and the Unit Trust of India (UTI) as an investment institution, both starting operations in July 1964 as subsidiaries of the Reserve Bank of India. There were new initiatives at the level of the states as well in the 1960s. State governments setup State Industrial Development Corporations (SIDCs) to inspire industrial development in their territories.

Declining role of DFIs post-liberalization

In the second phase extending from the start of liberalization to the transformation of the ICICI and IDBI into commercial banks (2002-2004), the share of DFIs fell from two-thirds to just 30 per cent. Indian Govt. soon understood that development banking was not in itself suitable to deal with all its needs. This is because the financial system must not only back to growth by directing investment to crucial investment projects, but it must render development broad-based by delivering credit to sectors that may otherwise be ignored by the financial sector. Credit to support agricultural operations that are seasonal in delivery of produce and subject to much volatility is vital. But providing credit in small volumes to isolated and often remotely located borrowers surges transaction costs substantially. DFIs failed in providing cheaper loans to small scale sector and rural farm sector. As DFIs were not having low cost deposits in form of current and saving accounts like commercial banks in India, they were not able to provide low cost finance to priority sector for long term. Although access to state funding prior to the reforms in 1991 meant that the development financial institutions were in a position to raise resources at interest costs that were much lower than if they had relied on market sources. This also allowed them to lend at rates that were rational from the point of view of industry and the infrastructural sectors. That made them the first choice for finance for Indian business, which did considerably benefit from the financial support provided by the government, in the years before the 1990s. But Govt. after 1991 reforms reduced public funding in these DFIs responsible for their decline in India. Therefore, there are a variety of ways in which the gap created by the transformation of development finance was filled. There was a shift towards bank credit and external commercial borrowing. There was improved reliance on internal resources and there was a growing role for external commercial borrowing & private equity in corporate financing.

Universal banking replacing DFIs in India

Now there is very thin line between role of DFIs and Commercial banks due to overlapping of their functions. After merger of two important DFIs ICICI and IDBI with its banking units in 2004 most of DFIs functions are being performed by commercial banks and these commercial banks are actively involved in project financing like DFIs. Therefore, Commercial banks are called universal banks which provide all kind of financial services under one roof.

But the DFIs were central to the industrialization and the development effort till the onset of liberalization cannot be denied. Their resources
were crucial and the choice of areas to which they were willing to finance, which was linked to the pattern of development prescribed by the Five Year Plans, ensured that the allocation of investment was moved in directions warranted by larger development goals.

**Summary**

Private financial institutions and banks focused on profit are likely to be less willing to take on board environmental concerns, especially if they result in the loss of profit opportunities or reduction in profitability as well as societal goals while providing project financing which is major concern from holistic and equitable regional development point of view of our economy. India’s experience with development banking suggests that it would be inclined to promoting greater private participation in financing the bank’s activities and favour lending to projects that directly or indirectly ensure private profit rather than social benefit. Moreover, it is unlikely to emphasize environmental and social concerns when lending and investment decisions are made. Hence, our Govt. need to revive DFIs concept again to keep societal, cultural, regional, rural and environmental concerns intact while sanctioning credit to long term infrastructure projects.

**Review Questions**

**Q. 1** State the objective of development financial institutions.

**Q. 2** What is universal banking? Why Govt. of India is encouraging DFIs to convert into universal banks? Do you think that it is good to shift focus on universal banks rather than strengthen DFIs from long term soundness of our economy?

**Q. 3** Discuss important role of DFIs for our Indian Economy.