K C Chakrabarty: Transformation of DFIs into commercial banks – the case of the IDBI and the role of employee unions

Special address by Dr K C Chakrabarty, Deputy Governor of the Reserve Bank of India, at a Seminar on "IDBI's role as Development Financial Institution" organised by the United Forum of IDBI Officers & Employees, Kolkata, 27 September 2013.

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1. Shri Basudeb Achariya, Hon'ble MP, Lok Sabha; Comrade Rajen Nagar, President, AIBEA; Shri B.P. Kanungo, Regional Director for West Bengal and Sikkim, Reserve Bank of India; Shri Samir Ghosh, General Secretary, All Indian Reserve Bank Employees Association; Principal office bearers of the United Forum of IDBI Officers and Employees; officers and employees of IDBI and other delegates to the seminar; ladies and gentlemen! I am pleased to note that the United Forum of IDBI Officers and Employees has taken this initiative to organize a seminar on the subject of "IDBI's role as Development Finance Institution for the Social and Economic Development of the Country" in commemoration of the Golden Jubilee of IDBI.

2. I observe that there is lot of confusion and misconception about the role of Development Finance Institutions (DFIs) not only in India but also across the globe, especially in the post reform period. In fact, there is a feeling among the public that in the post reform period, regulators and policymakers are not encouraging the role of financial institutions as developmental agents and have oriented their policies towards a market led economy by sacrificing the developmental role, whereas, the fact is that policymakers and regulators in India continue to have a firm belief that the role of finance is to encourage development and that the financial institutions must promote this basic role. The objective of developmental finance, thus, continues to remain the same and only the outer cover in the form of the institutional structure needs to undergo a change from time to time.

3. I am extremely happy to be here to address the delegates to this important seminar in this historic city of Kolkata which has always been the nerve centre of the all types of movements in the country – be it the freedom movement, the labour movement, the trade union movement or any other movement related to financial sector or politics. I am sure, befitting the glorious traditions of this historic city, this seminar would also throw up pertinent issues/challenges and actionable ideas in the important area of developmental role of finance, thereby justifying the organizing of this seminar in the city of Kolkata.

4. Let me begin by congratulating IDBI and all its employees on completing 50 years of glorious existence. Occasions such as Golden Jubilees are not just reasons for celebration for the organization, but also a moment of joy for the foot soldiers who have put their heart and soul into building the institution and seeing it through the initial teething phase. Hence, my warm wishes are also due to the Union and to the present and past employees of IDBI Bank.

5. Though there is little doubt that DFIs, in general and IDBI, in particular, have made immense contribution in the economic growth of the country in the post-independence era, overtime, especially in the post-reform period , they have lost their relevance due to certain structural changes that have taken place in the banking and financial system in the country. I thought it apt to use this occasion to share my perspectives on the role of DFIs in India's economy and the path they should look to traverse following their transition to full-fledged commercial banks. In my address today, I would also briefly reflect on the context for setting up of DFIs, trace their history and their relevance in the modern day.

What are Development Finance Institutions?

6. A DFI is defined as "an institution promoted or assisted by Government mainly to provide development finance to one or more sectors or sub-sectors of the economy". The institution distinguishes itself by a judicious balance between commercial norms of operation, as adopted by any private financial institution, and developmental obligations. DFIs adopt the "project approach" – emphasizing the viability of the project to be financed – against the "collateral approach". Apart from provision of long-term loans, equity capital, guarantees and underwriting functions, a development bank normally is also expected to upgrade the managerial and the other operational pre-requisites of the assisted projects (Scharf and Shetty, 1972).

7. Thus, the basic emphasis of a DFI is on long-term finance for industrial and infrastructure projects and on assistance for activities or sectors of the economy where the risks are higher than what the other traditional financial institutions like banks may be willing to assume. In fact, in the olden days, banks were only meeting the short term working capital needs of trade and business and were generally averse to lending for the long term. The risk aversion of banks primarily stemmed from the repayment of project loans being contingent upon performance of the project and cash flows arising from it over a long period of time. The project could go wrong for a variety of reasons like technological obsolescence, market competition, change of Government policies, natural calamities, poor management skills, poor infrastructure, etc. Naturally, the risk premium on the long gestation projects was substantially higher which not only resulted in creating a scarcity of finance for the long term projects, but also raised the finance cost thereby rendering the project financially unviable. It was precisely to overcome the twin problems of scarcity and high-cost of finance for the long term projects that the DFIs were established almost exclusively under Government ownership. Importantly, these institutions were also expected to develop requisite expertise on project appraisal and risk management in long term lending and complement private financial lending entities.

Genesis of Development Finance Institutions

8. As I mentioned earlier, the DFIs were mostly established as special financial institutions for promoting and supporting national economic development agenda. They have, indeed, played a catalytic role in the socio-economic development across the globe. In Europe, the advent of development finance can be traced back to the mid-nineteenth century when these institutions were established primarily to meet the increased demand for medium to long-term capital by new and emerging enterprises during the industrial revolution. In France, long term finance institutions were set up in the late 1840s for giving impetus to the industrial and infrastructural development. In the developed economies, DFIs were also established because of external developments like war, etc. DFIs in Continental Europe, in fact, played a major role in reconstruction of the war-ravaged economies.

9. In the post-colonial era, the emerging economies faced the challenge of evolving an appropriate mechanism for channelizing resources into the development effort. Many of them had inherited capital starved, primitive financial systems. Such systems could not be relied upon to allocate resources among competing demands in the economy. The task of institution building was too important to be left to the mercy of the market forces, which themselves were at a nascent stage of development. Besides, the markets and traditional financial institutions were generally averse to lending for the long-term as such lending would be characterized by uncertain outcomes. Facing such a scenario, several governments in Europe and East Asia decided to establish institutions specifically to cater to the requirements of financial resources for long term developmental efforts.

International experience

10. Having seen the context in which the DFIs were set up, let me now give you some global perspective on the DFIs. Two distinct models of development financing have been followed internationally. At one end of the spectrum is the Anglo-American model, which is purely market based with financial markets playing an important role in allocating resources for competing uses, including the industry and long term projects. At the other end is the model adopted by Continental Europe and South East Asian Economies, in which financial savings were channelized and allocated through financial intermediaries like banks and DFIs. The DFIs played a very significant role in the rapid reconstruction and industrialization of Germany and Japan after the 2nd World War by providing long-term credit. In Japan, the government owned Japan Development Bank was established in 1951 for reconstruction of the economy. In Korea and Singapore also DFIs were set up in 1960s with the main aim of rapid industrial development. The emergence of DFIs in the then developing economies also coincided with a period when the capital market, as a source of long term funding, was yet to stabilize. Based on the European model, the success of the DFIs in the overseas territories provided strong impetus for creation of DFIs in India after independence.

11. The initial mission for which the DFIs were set up in the developed economies were complete by the 1980s and most of them have since been wound down or their roles have been redefined. Most of the surviving DFIs now operate in niche segments of financial market where the entry barriers are relatively very stringent. India has also witnessed several structural changes in the banking and financial system, especially in the post reform period which has undermined the objectives for which the DFIs were established. Commercial banks, which traditionally refrained from lending for the long term or infrastructure projects gradually improved their project appraisal skills, their risk management capabilities and slowly developed appetite for long term lending. The stable retail deposit base built by the banks also aided their asset-liability management function. Further, the development of the bond markets also enabled commercial banks to raise long term funds from the insurance and pension funds. These structural changes in the economy meant that the DFIs lost their competitive edge in the long term finance market and started facing challenges on solvency and liquidity fronts. The non-performing assets started to grow while the profitability subsided. In a contemporaneous development, following liberalisation in the Indian Economy during the 1990s, there was an increasing clamour for reduced Government ownership and involvement in the financial institutions mainly from efficiency, accountability and moral hazard perspectives. I would return to some of the problems faced by the DFIs in India a little later in my address. In essence, since the DFIs were no longer in a position to meet the objectives for which they were set up in an efficient and transparent manner, they were given an option of transitioning into a universal bank.

Establishment of IDBI

12. The desire to promote rapid economic development and to be self-reliant in industrial output led to the establishment of several DFIs to finance industrial/infrastructure projects in the post-independence India. IFCI was the first DFI to be set up in 1948, which was followed by ICICI in 1955 and other State Finance Corporations under various Acts with the specific objective of providing long-term finance to industry. IDBI was set up in 1964 as a subsidiary of RBI by an Act of Parliament. I must compliment you for being a part of an institution which, for over 40 years, played a key role in nation building as an apex DFI (between July 1, 1964 and September 30, 2004). You must be proud of the fact that as a DFI, the erstwhile IDBI stretched its canvas beyond mere project financing to cover an array of services that contributed towards balanced geographical spread of industries, development of identified backward areas, emergence of a new spirit of enterprise and evolution of a deep and vibrant capital market. The role of IDBI as an institution builder is also laudable in light of the fact that EXIM Bank and SIDBI, two of the vibrant development finance institutions of the day, were carved out of IDBI.

Indian experience

13. As I mentioned earlier, in several economies, having attained their developmental goals, the DFIs were either restructured or repositioned or they just faded away from the scene. The Indian experience has also more or less traversed the same path. Although the developmental goals cited as the primary reasons for setting up of DFIs in India have not been achieved yet, the Government's fiscal imperatives and market dynamics has forced a reappraisal of the policies and strategies with regard to the role of DFIs in the system. The commercial banks have now taken over the mantle of agents of development from the erstwhile DFIs.

14. Let me now return to the problems faced by the DFIs in India. The DFI concept in the Indian context suffered from some inherent structural infirmities. As the DFIs were set up as public sector enterprises, the market perceived the borrowings made by them as having implicit government guarantee. This induced a sense of profligacy in the behaviour of the DFIs while borrowing. Further, in the absence of a competitive environment for project lending, the entities became quite complacent and disregarded the viability of the projects financed, while pricing. The crossholding of shares amongst the DFIs also led to a contagion effect in creating NPAs. The slower development of the capital markets also did not help matters as in several instances, the promoters failed to raise equity from the market after the DFIs had made the initial disbursements. The DFIs received low cost funds from National Industrial Credit (Long Term Operations) Fund from RBI under concessional terms and through government guaranteed bonds in the beginning. However, these were subsequently withdrawn, leading to a spike in their borrowing cost. Post the reforms programme launched in the early 1990s, the DFIs had to contend with increased competition from banks, which were also allowed to undertake project financing. Despite a significant increase in their cost of funds, the DFIs were forced to lend at very competitive rates, which resulted in a decline in their spread and profitability. The cumulative effect of all these developments was that the operations of the DFIs became increasingly unsustainable, at the turn of the century and they gradually lost their distinct identity as a vehicle for providing long term funding for industrial and infrastructural purposes.

15. Following the recommendations of the Narasimham Committee II and publication of the RBI Discussion Paper on "Harmonising the Role and Operations of Development Financial Institutions and Banks" released in January 1999, Reserve Bank announced its regulatory approach for the DFIs in the annual policy statement of April 2000. It was decided to allow an option to any DFI which wished to convert into a commercial bank, provided the prudential norms applicable to the banks were fully satisfied. This paved the way for conversion of the DFIs into commercial banks. The GOI in the Mid-Year Review, 2002 also categorically announced that "financial sector reforms, involving interest rate deregulation, increased competition from banks, and lack of concessional funds have rendered the business models of development financial institutions (DFIs) unsustainable". Specifically for IDBI bank, the percentage of Gross NPAs between 1999 and 2003 ranged from 14.07% to 16.86% of total advances and the Net NPAs ranged from 11.64% to 14.82% of net advances.

16. It was in this background that the Government repealed the IDBI Act in 2003 and converted IDBI Limited into a Banking company (as Industrial Development Bank of India Limited) for undertaking the entire gamut of banking activities. In view of the tough emerging competitive scenario in the Indian financial sector, the managements of ICICI Limited and ICICI Bank had already merged their operations in 2002 to pursue a universal banking strategy.

Where does IDBI bank go from here?

17. Having seen the history of DFIs and the gradual progression of IDBI from a DFI into a commercial bank, let me now focus on the challenges that the bank is facing in its new avatar and what contribution can the unions make in helping the institution regain its primacy

amongst the financial institutions of the country? Before I go any further let me quote former RBI Governor, Dr. Bimal Jalan who aptly captured the thought process behind the conversion of DFIs into universal banks. Dr. Jalan said “the move towards universal banking would not provide a panacea for the endemic weaknesses of a DFI or its liquidity and solvency problems and/or operational difficulties arising from under-capitalization, non-performing assets, and asset liabilities mismatches etc. The overriding consideration should be the objectives and strategic interests of the financial institution concerned in the context of meeting the varied needs of customers, subject to normal prudential norms applicable to banks”.

18. That brings us to the question what objective has IDBI Bank set for itself and how is it geared to achieve it? It is been around a decade since you became a commercial bank. Are you satisfied with your performance? Following conversion of the DFIs into banks, the mantle of leading the developmental agenda has fallen on the commercial banks. With years of experience in developmental banking behind it, your institution was in a perfect position to lead this agenda. How do you view your achievement vis-à-vis the expectations the society has of you? Here, I would like to remind that as unions, there is an onerous responsibility cast on you to help your institution fulfill this social agenda. While I would leave it upon all of you to dispassionately evaluate your performance over the years, let me, on my part, delve into some of the key areas in which I believe IDBI Bank has huge opportunities which, if properly exploited, would benefit the bank no end, going forward.

19. An immediate goal which you must focus is on spurring your financial inclusion initiatives. There are vast untapped areas in India’s hinterland where banking services are yet to reach. Even after implementation of our first round of Financial Inclusion Plans by banks, close to three and a half lakh villages remain unserved by banks. The exclusion is not only limited to rural areas but also to select pockets in the urban/ metropolitan centres. According to World Bank Findex Survey (2012), only 35% of Indian adults had access to a formal bank account and 8% borrowed formally in the last 12 months. Remember the alternate cost of funds for this segment of borrowers is extremely high. Against this backdrop, it is beyond comprehension why the commercial banks do not find enough viable business propositions for growth. I must warn you that it is this most ‘creamy’ layer of customers that the new banks would be looking to tap and therefore, it is in your own interest to capture this vast customer base before others do so. For a bank which has one of the lowest NIMs in the industry, I do not know why you should not pursue this agenda actively.

20. In a scenario where Government of India is implementing transfer of benefits and subsidies through direct benefit transfers to the bank accounts in order to plug the leakages in the system, you must look to open as many customer accounts as you can. Remember, whosoever acquires the customers initially will be the winner in the longer run. As you are aware, the bank can use a combination of physical branch network and Business Correspondents for providing banking services to geographically dispersed areas. Therefore, the lack of a large number of physical braches can also not be considered as a constraint for reaching out to the masses. You should look to leverage technology and build a cost-efficient business delivery model to attain maximum penetration into the unbanked areas and seek to offer innovative products and services to customers at an affordable price. As employees of the bank, all of you need to play a pivotal role in bringing about this focus on financial inclusion.

21. I also observe that IDBI Bank has been unable to achieve the Priority Sector Lending targets and worryingly, its performance on this front has been falling. This is despite the merger of a primarily rural focused bank like United Western Bank. The system of Priority Sector Lending has been introduced mainly to ensure easier access of credit to those deserving sectors and people, who otherwise, do not receive adequate credit. Moreover, RBI has freed the pricing of products under PSL; therefore, banks should not have any inhibition in lending to this segment. Please remember that the banks who do not meet their PSL targets have to contribute funds to the RIDF, the returns from which are quite less

remunerative, may be lesser than your cost of funds. The bank also needs to take up financial literacy campaigns to educate the potential customers on high interest charged by the informal credit channels and wean them away from money lenders.

22. I have also observed an increasing trend in the Gross NPA and restructuring of standard advances in the banks which reflects deficiencies in the appraisal and risk management standards. You have to work with the Top Management in acquiring the necessary skills and upgrading the Credit Risk Management system and initiate necessary steps to arrest this disconcerting trend.

Role of employee unions

23. Let me now turn specifically to the responsibility that you have, as unions, in ensuring that IDBI Bank attains its true potential in its role as a full service bank. You must appreciate the new operating environment that exists today and must realize that in this highly competitive market, no longer would the corporate chase you. For most of your members who have cut their teeth in an era when IDBI was a DFI with limited competition and a small universe of customers to deal with, the transition to commercial banking might be difficult, but remember, if you wish to survive as an institution in this new avatar, you must be willing to change. What is, in fact, needed is a change in mindset and you, as responsible union, have to oversee a smooth transition among the employees. Retail banking is a customer centric business and hence, you would need to develop the passion, compassion and grace to deal with customers. In my opinion, IDBI had a great opportunity to leverage upon the relationship it had built over the years with big corporate/ public sector enterprises and could have got the salary accounts of staff of these organizations with the bank. This would have given you access to a stable and low cost fund. It is unfortunate, however, that this has not happened.

24. Employee productivity and efficiency, especially in the public sector banks, remains at abysmally low levels. I do not know how many of you have gone through the speech I recently made at a FICCI – IBA event. I have given detailed statistics on the productivity and efficiency parameters of Indian banks and more so, the PSU banks vis-à-vis their counterparts in rest of the world. If you peruse them closely, you would be note that we are not only doing badly vis-à-vis our counterparts in the developed world but also against developing countries and emerging markets in Asia and elsewhere. I have also argued that though some productivity and efficiency gains have happened in Indian banks, they have happened at the cost of compromising on the allocational efficiency. The society at large has not benefited from the operational efficiency gains that the banking sector has seen and there is no perceptible cost reduction for the customers in general. I would say the only saving grace for us is that we are virtually at the lowest ebb and our performance can only improve from here on. As banking community, we need to change and very quickly at that, to remain relevant to the society.

25. It is in this context that the ability of the unions to influence employee behavior becomes very important. Not for a single moment, I mean to undermine the role that IDBI has played, in its initial role as a DFI. Along with the other development financial institutions, IDBI has significantly contributed to economic prosperity of the country during the initial plan periods; but in a liberalized economy and in an era of universal banking, role of DFIs as specialized financial institutions has certainly diminished. It is for the unions, through seminars/interactive sessions like these, to sensitize their members about the changed ground realities. As I said earlier, for you to be able to compete in the tough existing environment, you need to veer away from preset rigidities and be willing to change.

Conclusion

26. In sum, I would like to mention that for all economies, development is necessary and finance has a central role in facilitating that. The soul of the DFI has to remain intact in a developing economy. The structural changes in the financial system have, however, blurred

the boundaries between the DFIs and the commercial banks, in terms of areas of operation. The DFIs do not hold any competitive advantage over banks and hence the compulsion to tag institutions as DFIs to enable them to pursue development finance, no longer exists. I feel that commercial banks are in a perfect position to fulfill the objectives which were originally intended for the DFIs.

27. Your institution has inherited the soul of a DFI from IDBI Limited. What is required is a transformation in the mindset of the employees to see through this period of transformation. I strongly believe that rather than seeking any reversal of status for your institutions as a DFI, the management and the unions of IDBI Bank should look ahead to the future. As responsible unions, you have a very constructive role in motivating the employees of your institution. Rather than resting on past laurels, you have to gear up to face the future. The achievements over the past 50 years should only be used for drawing inspiration and motivation for the hard work that you have to do in the next 50 years. As employees, all of you have to update yourselves with the latest skills, technology, etc. to be able to deliver up to the optimum level. The Management and the unions have to collectively strive to ensure that the impressive legacy that the institution has inherited is sustained even in its new avatar as a commercial bank. There is enough scope for commercial banking in the country, if the interest for new bank license despite some of the onerous requirements on capital, financial inclusion, PSL is anything to go by. The need for the bank is to identify the available opportunities and apply your collective might towards attaining it. IDBI is a well reputed brand which does not need any introduction. Going forward, you must look to leverage upon your brand and broaden your customer base before new banks poach them.

28. You may have to unlearn and relearn few new things to succeed in the even more competitive business environment that is likely to unfold shortly. It is imperative for the Top Management and for the employees to work collectively for the progress of your institution. I am sure the able leadership of the United Forum of IDBI Officers and Employees would ensure that the staff is motivated to handle new challenges and the institution can retain its glorious tradition in perpetuity.

29. I thank you for inviting me on this occasion and giving me a patient hearing. I wish you all the very best for all your future endeavors.