Wholesale and Long-Term Finance (WLTF) Banks:
Are these Reincarnations of the Development Banks?

Partha Ray

The RBI has released an important and timely discussion paper on April 4 2017 on the "Wholesale and Long-Term Finance" (WLTF) Banks.[1] This is in consonance with announcement made in the first Bi-monthly Monetary Policy Statement 2016-17 (of April 5, 2016) which had mentioned that the RBI would "explore the possibilities of licensing other differentiated banks ....and had identified custodian banks and banks concentrating on whole-sale and long-term financing, as two other classes of differentiated banks". Looking into cross-country experience, the present RBI proposal views extends that vision WLTF banks that would focus primarily on "lending to infrastructure sector and small, medium & corporate businesses." What is their genesis? Are these WLTF banks going back from the professed path of financial sector reforms whereby development banks like IDBI or ICICI banks were winded up? This short piece makes a speculative attempt to look into some such questions.

Genesis and Functions

As far as the genesis of WLTF banks is concerned, it can be traced in the Report of the RBI Committee on Comprehensive Financial Services for Small Businesses and Low Income Households (Chairman: Dr Nachiket Mor; June 2014) that envisaged a class of differentiated banks called "Wholesale Banks".[2] It noted:

> "Given the enormous cost and informational disadvantages that National Banks face in India it is possible that this may be an entirely acceptable and even a preferred strategy for a large, systemically important bank to follow, ... so that it is able to maintain an extremely high level of safety in its credit ratings and can therefore act as a high quality aggregator of both deposits and loans allowing smaller and more specialised banks and financial institutions to transfer their own systematic exposures to such a Wholesale Bank."

Taking a cue from the Mor Committee Report the April 2017 proposal of RBI has noted, "The Wholesale and Long-Term Finance (WLTF) banks will focus primarily on lending to infrastructure sector and small, medium & corporate businesses. They will also mobilize

[1] https://www.rbi.org.in/Scripts/PublicationReportDetails.aspx?UrlPage=&ID=866 (accessed on July 23, 2017).
[2] https://rbidocs.rbi.org.in/rdocs/PublicationReport/Pdfs/CFS070114RFL.pdf (accessed on July 23, 2017).

liquidity for banks and financial institutions directly originating priority sector assets, through securitization of such assets and actively dealing in them as market makers" (p.10).

It may be useful to note the following specific features of these WLTF banks:

a) **Activities**: The primary activities of WLTF banks will be deposits or loan products for wholesale clients and financing of infrastructure sector and core industries. These banks also act as "market-makers in securities such as corporate bonds, credit derivatives, warehouse receipts, and take-out financing etc" and will provide refinance to lending institutions. These banks may also offer investment banking services related to equity / debt investments and forex / trade finance. But unlike investment banks these services will be of ancillary interest to WLTF banks.

b) **Sources of Finance**: Primary sources of funds for WLTF banks could be a combination of "term deposits, debt / equity capital raised from primary market issues or private placement, and term borrowings from banks and other financial institutions".

c) **Deposits:** These banks may be permitted to accept deposits only "above a large threshold amount" and are expected to have negligible retail segment exposure. Deposits of these banks will have deposit insurance cover.

d) **Regulatory Requirements**: These banks are expected to have a higher level of initial minimum paid-up equity capital, say Rs. 1,000 crore or more. While these banks may be required to maintain CRR they would be eligible for exemption from CRR requirement for the liabilities under infrastructure bonds. Finally, some relaxation in respect of prudential norms on liquidity risk (e.g., Liquidity Coverage Ratio / Net Stable Funding Ratio) may be considered for WLTF banks. Opening of rural and semi-urban branches and compliance to priority sector lending norms would not be mandated for these banks

The Rise and Fall of Development Banks in India

But why does a country need WLTF banks? Are these not look-wise quite similar to the development banks? It is useful to turn to Nayyar (2015), who said:[3]

[3] Nayyar, Deepak (2015): "Birth, Life and Death of Development Finance Institutions in India", Economic & Political Weekly, August 15, pp. 51 -60.

> "The economic logic of development banks is simple. In countries that are latecomers to industrialisation, capital markets are imperfect. Therefore, new firms, which seek to enter the industrial sector, find it exceedingly difficult to obtain finance for their initial investment..... The problem is exacerbated when such investments are characterised by lumpiness and returns accrue only after a gestation lag. In these circumstances, firms might underinvest, or fail to invest, in the creation of manufacturing capacities that require learning capital. ... The problem is far more acute for long-term finance where there are indivisibilities in the capital needed by new firms, as the initial losses are high and the learning period is long. .... *Latecomers to industrialisation create development banks essentially to meet these financing needs of pioneering firms in a non-existent or infant manufacturing sector, which are not met by capital markets or commercial banks because, in their calculus, the risk is too great*" (p.51; emphasis added).

It may be useful to get a historical perspective of development banks here. India's first development bank, the Industrial Finance Corporation of India (IFCI) was set up in 1948. Within next five years, a number of state governments with the encouragement of the central government set up their own State Financial Corporations (SFCs). Later in 1954 the National Industrial Development Corporation (NIDC) was set up as an agency of the Central government to provide both entrepreneurship and finance to the industrial sector and functioned till early 1963. The Industrial Credit and Investment Corporation of India (ICICI) was floated as a public limited company with initiatives of the World Bank, the Government of India and representatives of Indian industry. While its primary objective was to provide medium-term and long-term project financing to Indian businesses, it emerged as the major source of foreign currency loans to Indian industry as well as for doing underwriting for the Indian corporates. Subsequently in 1964, the Industrial Development Bank of India was set up as an apex institution in the sphere of medium- and long term finance. It took over the business of the Refinance Corporation for Industry, which was set up in 1958 for SFCs. The control of the IFCI was transferred to the IDBI from the Central Government. The IDBI was constituted as a wholly owned subsidiary of the RBI and the RBI has created a new long-term fund known as the National Industrial Credit (Long-term Operations) Fund with an initial contribution of Rs 10 crore to which the RBI used to make annual allocations out of its surplus profits before these were transferred to the government (Ray, 2015).[4]

It is important to note that one of the key outcomes of the financial sector reforms in India has been the demise of the so-called development banks. This was in line with the

[4] Ray, Partha (2015): "Rise and Fall of Industrial Finance in India", *Economic and Political Weekly*, January 15, pp.61-68.

report of the Narasimham Committee II, which recommended that the IDBI should be corporatized and converted into a Joint Stock Company under the Companies Act on the lines of ICICI, IFCI and IDBI. In some sense, the Narasimham Committee II echoed the spirit reflected in the World Bank's *World Development Report*, 1989 which commented, "Nonbank financial intermediaries, such as development finance institutions, insurance companies, and pension funds, are potentially important sources of long-term finance.....most of the existing development banks are insolvent, however" (p. 4). Development banks were winded up in India primarily due to lack of sources of non-concessional finance which in turn emanated from a binding fiscal constraint. Put simply these development banks became unaffordable and their concessional sources of funds dried up. Accordingly in January 2001, the RBI permitted the reverse merger of ICICI with its commercial bank subsidiary. Later on October 1, 2004, IDBI was converted into a banking company and subsequently in April 2005 it merged its banking subsidiary (IDBI Bank Ltd.) with itself. With the demise of the IDBI and the ICICI, the term lending of the country had experienced a distinct transformation.

Need for the WLTF Banks

After a decade of the demise of development banks, there is a strong view that while winding up the development banks, India policy makers committed the folly of throwing the baby along with the bath water. After all, the death of development banks created a vacuum of term and infrastructure financing. Who filled up the void of terms-lending / wholesale funding? In an economy with well-developed financial markets, private corporate bonds could have come up. But despite various attempts, corporate bond market in India remained largely a private placement market catering primarily to blue-chap corporates. Thus, commercial banks had to come up to fill-up this void. But commercial banks have typically short term deposits as their main source of funds; hence any exposure to long term lending created a serious asset liability mismatch in their balance sheet.

Long-term loan to infrastructure is a major issue here. Such exposure to long-term infrastructure lending has been a key reason behind the accumulation of non-performing assets (NPAs) in commercial banks in India in recent times. The problem is a serious one as the RBI *Financial Stability Report* of June 2017 noted that the gross NPAs of scheduled commercial banks in India rose from 9.2 per cent in September 2016 to 9.6 per cent in March 2017 - it is anticipated to rise to 10.2 per cent by March 2018. Furthermore, their stress tests indicated that to loans to infrastructure could considerably impact the profitability of banks so much so that a severe shock (defined as 15 per cent of restructured standard advances and 10 per cent of standard advances become NPAs and move to the loss category) could completely wipe out the recorded profits of 2016-17. Faced with such a situation WLTF banks seem to be the right answer.

Way Ahead

Development of corporate debt market is not the only way to fund longer term financing needs – there are complementary approaches. It is in this context that the RBI Discussion Paper flagged the instances of a number of globally successful WLTF banks - Brazil, South Korea, Japan to name a few. When commercial banks in India are burdened with NPAs and infrastructural needs of the country are huge to reap the full growth potential, the proposal to set up WLTF banks is really opportune at the current juncture. However, it will be illusive to treat these WLTF banks as reincarnation of erstwhile development banks. It remains to be seen as to how far successful these WLTF banks will be in terms of getting access to non-concessional market based finance and still be viable.