FDI IN INDIAN BANKS AND FOREIGN BANKS IN INDIA; STUDY OF THE RECENT CHANGES AND THE IMPLICATIONS

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I. Abstract

As per the last FDI policy (Consolidated FDI Policy of Department of Industrial Policy and Promotion, ministry of Commerce & Industry, effective from 05-Apr-2013), FDI is permitted through 4 distinct channels namely maximum of 74% equity in private sector banks, maximum of 20% equity in public sector banks, branches of Foreign banks and wholly owned subsidiaries of foreign banks. The maximum caps seems to be just figures but the figures mentioned assumes importance when we find that the government is battling Current Account Deficit for which any layman would say that Foreign investment into India would help reduce it; Indian banking and banks can be used as soft baits to attract foreign currency. On the other hand, foreign banks have close to the 5% range contribution to the banking sector's most important metrics namely deposits and advances. Thus it is important that FDI in the banking industry and the working of foreign banks becomes very important.

This paper tries to correlate the Indian banking industry with the other industries from the investment point of view and also tries to study the futuristic dimensions of the things to come because of the recent changes declared by the banking regulator i.e. Reserve Bank of India.

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II. Importance of the study

Few aspects make the study critical and important namely

Current Account Deficit

Off late, India has been facing a crisis with respect to its international balance of payments. Current Account Deficit has touched a high of 4.8 percent of the GDP; the last report of RBI however projects the same to be contained to 3 percent in the current financial year.

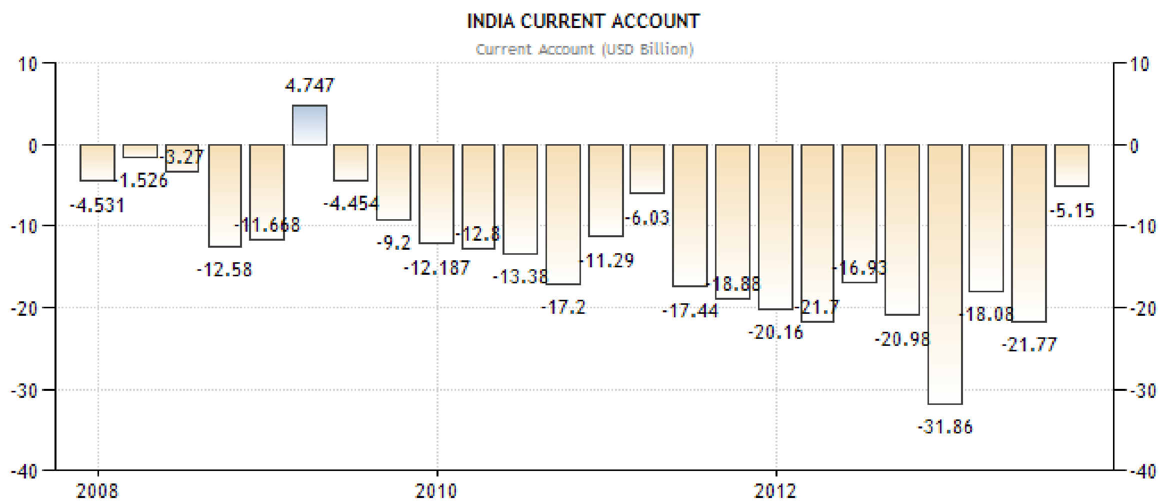

Table1: Current Account picture: Source RBI

So every money which comes into the Indian economy from any foreign shore shall help reduce the deficit to some extent. FDI in banking is covered under the Service Sector as

Amount in Rs. crores (US$ in million)

Ranks	Sector	2011-12 (April - March)	2012-13 (April-March)	2013-14 (April-October, 2013)	Cumulative Inflows (April '00-October'13)	% age to total Inflows (In terms of US$)
1.	SERVICES SECTOR **	24,656 (5,216)	26,306 (4,833)	7,920 (1,360)	180,195 (38,595)	19 %

measured by RBI. One can clearly observe that there has been a great dip in terms of inflows in this segment in comparison to the previous years. There has been a dip in the inflows in this segment from 2011-12 to 2012-13 but the figures (updated till Oct'13) for this FY is nowhere close to even half of the previous year's figures.

RBI can use increase in forex inflow in this sector to reduce some bit of Current Account Deficit.

Allowance of increased FDI in few sectors

Government of India has allowed increase in FDI cap across many sectors. There has been a marked increase Telecom sector (74 percent to 100 percent), Insurance sector (49 percent from 26 percent), Credit Information companies (74 percent from 49 percent) and has allowed higher allocation in FDI in key sectors like defense through Cabinet's interference.

Since the momentum has been set, there is every chance that government might relax norms for direct investments in banking also.

Growing importance of foreign banks

As per the last updated figures for different types of banks, foreign banks have now a sizeable chunk of the entire Indian banking. If we were to consider only the important parameters namely Deposits and Credits, the figures for foreign banks stands at 4.2 percent and 5.2 percent respectively as on Jun-12. The percentage may seem much lower in comparison to those of SBI & Associates, nationalized banks and private sector banks; however this is not insignificant either when we are talking of the size of Indian banking.

III. Recent changes w.r.t. policy of RBI towards foreign banks

On 06-Nov' 2013, RBI released the framework for setting up of wholly owned subsidiaries by foreign banks. The policy is guided by the two cardinal principles of (i) reciprocity and (ii) single mode of presence.

As a locally incorporated bank, the Wholly Owned Subsidiaries shall be given near national treatment which means they would be allowed to open branches anywhere in the country like other Indian banks. This activity would be restricted to sensitive areas where RBI's approval would have to be necessarily taken. Besides, they would also be able to participate fully in the development of the Indian financial sector. As a caution, to ward off the possibility of Indian banking system being dominated by foreign banks, the framework has certain measures to contain their expansion if the share of foreign banks exceeds a critical size.

Since this is going to be a guiding beacon for all foreign banks, it is essential that the features should be dissected and discussed in details. Key notable points are as follows

- Priority Sector lending requirement would be 40 per cent for Wholly Owned Subsidiaries (WOSs) in lines with other scheduled commercial banks with adequate transition period for existing foreign bank branches converting into WOS.

- The subsidiaries (WOS) would be permitted to use parental guarantee / credit rating but it would be allowed only for the purpose of providing custodial services and for their international operations. However, WOS should not provide counter guarantee to its parent for any such support.
- WOSs may, at their option, dilute their stake to 74 per cent or less in accordance with the existing FDI policy of the government of India. In the event of dilution, they will have to list themselves.
- Banks with complex structures (holding and cross holding), banks which do not provide adequate disclosure in their home jurisdiction, banks which are not widely held (not closely held by individuals or few corporates), banks from jurisdictions having legislation giving a preferential claim to depositors of home country in a winding up proceedings, etc., would be mandated entry into India only through the WOS mode.
- Foreign banks which commenced banking business in India before August 2010 (many foreign banks fall into the bracket) shall have the option to continue their banking business through the branch mode. However, they will be incentivised to convert into WOS (if they chose to) because of the attractiveness of the near national treatment afforded to WOS.
- To prevent domination by foreign banks over Indian banking system, restrictions would be placed on further entry of new WOSs of foreign banks / capital infusion, when the capital and reserves of the WOSs and foreign bank branches in India exceed 20 per cent of the capital and reserves of the banking system.
- The initial minimum paid-up voting equity capital for a WOS shall be INR 5 billion for new entrants. Existing branches of foreign banks desiring to convert into WOS shall have a minimum net worth of INR 5 billion.
- The parent of the WOS would be required to issue a letter of comfort to the RBI for meeting the liabilities of the WOS on the lines and style as demanded by RBI from time to time.
- Corporate Governance – (i) not less than two-third of the directors should be non-executive directors; (ii) a minimum of one-third of the directors should be independent of the management of the subsidiary in India, its parent or associates; (iii) not less than fifty per cent of the directors should be Indian

nationals / NRIs /PIOs subject to the condition that not less than 1/3rd of the directors are Indian nationals resident in India.

- The branch expansion guidelines as applicable to domestic scheduled commercial banks would generally be applicable to WOSs of foreign banks except that they will require prior approval of RBI for opening branches at certain locations that are sensitive from the perspective of national security.

IV. Comments on the proposed structure

a. The objective of encouraging foreign banks' participation in India's growing story has been probably to enhance efficiency of local banking. The idea is that efficiency would be driven by more competition in the sector. Foreign banks can also enhance efficiency by encouraging innovation, and bringing global expertise and technology transfer into local banking practices. Table below presents the performance of foreign banks vis-à-vis public and private sector banks in the country. Foreign banks tend to lend more, have higher returns, lower costs, and better credit quality. Interestingly domestic private banks have lower NPAs compared to foreign banks; this may be probably due to their large exposure in credit cards. Cost of funds is a major problem for these banks as their access to low cost funds i.e. Current and Savings account is less.

As on 31 March 2013 (in %)

	Foreign banks	Public sector banks	Private sector banks
Credit-deposit ratio	91.6	77.9	81.9
Return on assets	1.9	0.8	1.6
Return on investments	8.1	7.6	7.3
Cost of funds	4.1	6.3	6.1
Gross NPA ratio (as a percent of total advances)	3.0	3.8	1.9

Source: RBI. Cost of funds is the interest paid on deposits and borrowings as ratio of total deposits and borrowings.

Generally, while a foreign bank with significant wholesale operation might prefer the centralized branch model with flexibility to transfer funds, a global retail bank, may prefer a more decentralized subsidiary operation because of its business focus on serving local retail clients and its reliance on local deposits and guarantees. Therefore global banks aiming for example, to tap the lucrative largely untapped rural markets in India might be incentivized by the new policy. But is also true that global banks have been rethinking their business models after the crisis and a few have already signaled their retreat from some foreign retail markets.

b. The general thought after the global financial crisis seems to be that WOS' are easier to govern, regulate, supervise, and resolve. In good times, WOS' are subject to the full suite of local laws, regulations and supervisory practices and in crisis episodes, can more easily be subject to "ring fencing" by the host country. Ring fencing targets the subsidiary's ability to transfer assets abroad and might be beneficial to achieve stability and protect the domestic banking system. Despite the accepted wisdom, subsidiarisation is still quite uncommon in Asia, where the number of foreign bank branches is more than double that of subsidiaries, unlike Latin America where foreign subsidiaries dominate.

RBI's policy announcement on WOS introduces a new feature whereby all "systemically" important foreign bank branches, which commenced business after August 2010, or any new one gaining entry, will be mandated to convert into WOS. The mandatory feature to convert into WOS is line with the wisdom on branch versus subsidiarisation after the crisis and can in principle help toward achieving the stability objective. This is somewhat similar to the existing practices in the Indian banks. Thus, this policy will not affect the general fabric of Indian banking. The old foreign banks (which includes the major names) are as such following the same procedures.

c. Like domestic banks, WOS of foreign banks will be mandated to comply with priority sector lending requirements in terms of lending to agriculture, education and micro and small enterprises. In that sense, if new foreign banks come, access to the underserved borrowers will be increased.

Importantly, foreign banks in India have played a role in leading product innovation in the corporate segment and have been active in derivative trading and other off-balance sheet activities. The new policy is not likely to make a significant stride towards achieving inclusion other than through priority sector lending requirements. In fact, priority sector lending is often mentioned by foreign banks to be a constraining factor in expanding their lending activity to India.

V. Conclusion

The undermining fact with regards to bringing in FDI for countering the current account deficit shall be the major factor behind any decision of RBI and Govt. of India in allowing flexibility of foreign banks. It will be a matter of time by which the banks shall respond to the call and the policies of RBI (some changes have already come). One should also wait to see the benefits which trickle down to the individuals at large and the nation's economy. Notably, while a greater presence of foreign banks can promote competition, and enhance efficiency of domestic banks, it is to be mentioned that not all countries with well-functioning financial systems have depended on foreign banks to flourish.

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