R Gandhi: Structure of foreign banks for emerging nations – Indian case

Keynote speech by Mr R Gandhi, Deputy Governor of the Reserve Bank of India, at the ASIFMA (Asia Securities Industry and Financial Markets) Annual Conference 2014 "Developing Asia's Capital Market", Singapore, 6 November 2014.

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Ladies and Gentlemen!

1. It is a pleasure and privilege to be among the banking and finance industry participants and fellow regulators in this ASIFMA Annual Conference on Developing Asia's Capital Market. The theme of the Conference is very contemporary. Though the theme relates to Capital Market, I also find that you had included credit and banking in the discussions. And I find that one of the panel sessions was specific to India, besides many other sessions which also have direct relevance to the Indian context. That panel discussed opening up Indian capital market. I intend to talk about opening up foreign banking in India.

2. The foreign banks play a transformational role in influencing the host country economies. On the one hand they act as a key vehicle in channelizing foreign investments; on the other hand they bring in efficiencies and boost competitive spirit amongst the financial sector entities, thereby, raising the efficiency bar of the domestic players. Structure of foreign banks in a geography, which is a sub-set of banking structure, will be influenced by the desirable form of financial architecture in an economy. The extent to which foreign banks are allowed to play a role in the domestic sector depends upon the unique market needs of each economy. The important consideration will be the confidence of the host regulator to maintain resilience in the wake of destabilizing cross border capital flows. In the process, it always remains a challenge to marry the expectations of international banks entering into a developing economy and the expectations of the host country authorities on the role of and deliverables from the foreign banks, while maintaining financial resilience. To an extent, this challenge could be partly met by the authorities by devising an appropriate structure for foreign banks and review the same at each stage of economic development to ensure that opportunities are not lost for either side. Equally important is to put in place appropriate policy responses to insulate the domestic economy from destabilizing capital flows.

3. India has a real long history of banking. According to the Indian Central Banking Enquiry Committee (1931), money lending activity in India could be traced back to the Vedic period, *i.e.*, 2000 to 1400 BC. The existence of professional banking in India could be traced to the 500 BC. Kautilya's Arthashastra, dating back to 400 BC contained references to creditors, lenders and lending rates. After the independence of the country in 1947, keeping in tune with the then economic policy, banking sector was highly regulated. In the aftermath of a balance of payment crisis situation in 1991 and with the advent of economic reforms India embarked upon financial sector liberalization in a phased manner. Banking industry was deregulated by way of allowing entry of new private sector banks; ten new private Indian banks were set up in 1993, followed by two banks in 2003. Other notable features towards deregulation of banking sector included allowing 74% foreign investment in private sector banks, doing away with licensing of branches of domestic scheduled commercial banks in a phased manner, deregulation of interest rates, widening and deepening of financial markets, etc.

4. Indian banking sector comprises of different types of institutions to cater to the divergent banking needs of various sectors of the economy. There are typical commercial banks which operate on all India basis. There are government owned banks, privately owned banks and foreign owned banks. There are also small banks with limited areas of operation. Credit cooperatives were created to cater to the credit, processing and marketing needs of small and marginal farmers organised on cooperative lines. Cooperatives expanded also in

urban and semi-urban areas in the form of urban cooperative banks to meet the banking and credit requirements of people with smaller means. Regional Rural Banks were created to bring together the positive features of credit cooperatives and commercial banks and specifically address credit needs of backward sections in rural areas. Further, there was an experiment of establishing Local Area Banks, *albeit* on a smaller scale, to bridge the gap in credit availability and strengthen the institutional credit framework in the rural and semi-urban areas. Notwithstanding the development of various types of banks, Indian banking sector is yet to meet the desired banking penetration and inclusion as witnessed in most advanced and some of the emerging economies.

5. A cross-country comparison using the World Bank Financial Sector Database with several other economies, which have bank-dominated financial systems, reveals that banking sector in India is yet to match the size and outreach of the banking sector as prevailing in various other comparable economies. According to this World Bank report,[1] India has around 11 ATMs and nearly 11 bank branches per 100,000 people as compared to 119 and 47 in Brazil; 182 and 38 in Russia; 38 and 8 in China; 60 and 10 in South Africa; 58 and 10 in Singapore; 124 and 24 in UK as against the world average of 34 ATMs and 12 branches per 100,000 people. But by other matrices such as ATMs/GDP, we are probably better.

6. Structural changes in the banking sector have been periodically examined by various expert committees in India. The committees favoured consolidation in the Indian banking structure to create well-capitalised, automated and technology-oriented banks through mergers and acquisitions; fostering competition in the banking structure through permitting more private sector banks; setting up of small banks with local character to cater to the requirements of rural and unorganised sectors; more active foreign banks participation; strengthening of the existing structure through enhancing appropriate risk management capabilities; and putting in place legal, insurance, resolution and prudential measures to enable the banking structure to discharge its core functions in an efficient and inclusive manner.

7. In India, the universal banking model is followed. As regards the structure of universal banks, the conglomerate structure is bank-led, *i.e.*, banks themselves are holding companies which operate certain businesses through Subsidiaries, Joint Ventures and Affiliates. The general principle in this regard is that para-banking activities, such as credit cards, primary dealer, leasing, hire purchase, factoring etc., can be conducted either inside the bank departmentally or outside the bank through subsidiary/ joint venture /associate. Activities such as insurance, stock broking, asset management, asset reconstruction, venture capital funding and infrastructure financing can be undertaken only outside the bank. Lending activities must be conducted from inside the bank. Investment banking services are provided by the banks as an in-house departmental activity or through subsidiary. However, limits on equity investments, by a bank in a subsidiary company, or a financial services company including financial institutions, stock and other exchanges, depositories, etc., which is not a subsidiary restrict expansion of investment banking services and insurance business by the universal banks. Consequently, India does not have large investment banking and insurance activity within the banking groups.

8. Some countries have a differentiated bank licensing regime where differentiated licenses are issued specifically outlining the activities that the licensed entity can undertake. The criterion for differentiation for the purposes of issuing differentiated licenses could be on account of capital conditions, as is practiced in Indonesia or to the activity as is the case in Australia, Singapore and Hong Kong.

[1] World Development Indicators: Financial access, stability and efficiency – World Bank Report (2014).

9. With the broadening and deepening of financial sector, a need is felt that banks move from the situation where all banks provide all the services to a situation where banks find their specific realm and mainly provide services in their chosen areas. As the economy grows and becomes more integrated with the global economy, need would be felt for sophisticated financial services and products which will require the presence of different types of banks. Accordingly, differentiated banks serving niche interests are also contemplated for India.

10. Much of the Indian population is still outside the purview of formal financial sector and there is need to spruce up the institutional mechanism in this regard. Reserve Bank had, accordingly, issued draft guidelines on small banks and payment banks in June 2014. Both, payments banks and small banks are "niche" or "differentiated" banks; with the common objective of furthering financial inclusion. While small banks will provide a whole suite of basic banking products, such as, deposits and supply of credit, but in limited size, payments banks will provide limited range of products, such as, acceptance of demand deposits and remittances of funds, but will have a widespread network of access points particularly in remote areas, either through their own branch network or through Business Correspondents or through networks provided by others. The final guidelines on small and payment banks will be released shortly.

11. The presence of foreign banks in India is seen to be one of the drivers to increase competition, promote efficiency of the local banking system and also for bringing in sophisticated financial services and risk management methodologies which can be adopted by the domestic banks. Based on cross-country experience, some of the main drivers of foreign banks would be the desire of banks to follow their home customers abroad, opportunities in the host countries, the attractiveness of local profit, the absence or elimination of barriers to foreign bank entry etc.

12. The share of foreign banks in total assets of the banking sector in India is 6.5 per cent. The operations of foreign banks are skewed and mainly concentrated in urban and metropolitan areas. Out of the total of 318 foreign bank branches, 315 are in urban and metropolitan areas. Foreign banks account for less than one per cent of total branches of commercial banks in India.

13. Currently, foreign banks presence in India is in the form of branches or representative offices. For the branch form, Reserve Bank of India issues a single class of banking licence for conducting all type of banking business, ranging from retail, wholesale, forex and derivative products, credit cards, etc. There is no restriction as to the type of business to be conducted through branches unlike in some other countries where restrictions are placed on acceptance of retail deposits, conducting business in local currency, types of clientele, region, availability of deposit insurance, access to clearing and settlement systems etc. As on October 31, 2014, there are 44 foreign banks in India operating through a network of 318 branches. Also, 45 foreign banks have presence in India in the form of representative offices.

14. Foreign banks are present in India in the branch mode since mid-nineteenth century. Also, foreign banks were allowed to set up a wholly owned subsidiary (WOS) in India. To operationalise the FDI guidelines, the Reserve Bank released the roadmap for presence of foreign banks in India on February 28, 2005. The roadmap was divided into two phases – the first phase spanning the period March 2005 to March 2009 and the second phase beginning after a review of experience gained in the first phase.

15. In the first phase, foreign banks already operating in India were allowed to convert their existing branches to WOS while following the 'one-mode presence' criterion and the WOS was to be treated at par with the existing branches of foreign banks for branch expansion in India. During the first phase no foreign bank came forward to set up or convert their branches into WOS in the absence of adequate incentives. As the time came to review the experience gained in the first phase, global financial markets were in turmoil and there

were uncertainties surrounding the financial strength of banks around the world. At that time it was considered advisable to continue with the current policy and procedures governing the presence of foreign banks in India.

16. Building on the lessons from the financial crisis, Reserve Bank issued a Discussion Paper in January 2011 on the mode of presence of foreign banks in India. Taking into account the feedback received on the Discussion Paper, the framework for setting up of wholly owned subsidiary (WOS) by foreign banks in India was released in November 2013. Those foreign banks which have commenced banking business in India through a branch mode after August 2010 shall convert into a wholly owned subsidiary if they meet the set conditions and prescribed regulatory thresholds. The conditions would be, such as, foreign banks incorporated in a jurisdiction having legislation giving a preferential claim to deposits of home country in a winding up proceedings; foreign banks that do not have adequate disclosure requirements in their home jurisdiction; foreign banks with complex structures; foreign banks which are not widely held could have maiden presence only by way of WOS. Also, if the Reserve Bank of India is not satisfied with the adequacy of supervisory arrangements (including disclosure arrangements) and market discipline in the country of their incorporation or Reserve Bank of India considers necessary for subsidiary form of presence of the bank or if a foreign bank, which has set up its presence in India through branch mode after August 2010, is considered by RBI as being systemically important by virtue of the size of its business, such banks would have to operate through a WOS. However, in case of foreign banks which are operating in India before August 2010 shall have the option either to continue their banking business through the branch mode or to convert those branches into a WOS.

17. Foreign banks have evinced interest on WOS structure in India and are deliberating internally their strategy on form of banking presence. The initial minimum paid-up voting equity capital for a WOS shall be INR 5 billion (nearly USD 82 million). In the case of an existing foreign bank having branch presence in India, which desires or is required to convert into a WOS shall have a net worth of INR 5 billion. WOS would be permitted to open branches in any centre, except at certain sensitive locations from the perspective of national security, without having the need to take prior permission from Reserve Bank of India in each case, subject to their opening 25% of branches in a year in unbanked centres. In the case of foreign bank branches, they may have to seek prior approval of Reserve Bank for branch expansion in India.

18. Financial intermediation in India mainly happens through banks. With a view to improve upon the credit disbursement to certain sectors of the economy which requires stimulus through support from formal financial sector, priority sector lending was introduced in 1970s. The objective was to achieve a wider spread of bank credit, prevent its misuse, direct a larger volume of credit flow to priority sectors and to make it an effective instrument of economic development. The definition of priority sector has evolved over a period of time. Priority sector includes those sectors of the economy which in the absence of inclusion in the priority sector categories would not get timely and adequate finance, such as, small loans to small and marginal farmers for agriculture and allied activities, loans to micro and small enterprises, loans for small housing projects, education loans and other small loans to people with low income levels. Currently, the definition is under a review.

Foreign banks' operations in India – Issues flagged often and RBI's take

Priority sector lending

19. Presently, the domestic scheduled commercial banks are required to achieve priority sector lending target of 40 per cent of the aggregate bank advances. The same would be applicable for new WOS of foreign banks. Foreign banks with 20 or more branches in the country are being brought on par with domestic banks for priority sector targets in a phased

manner over a five year period starting from April 1, 2013. For foreign banks with less than 20 branches the overall target is fixed at 32 per cent.

20. Foreign banks have from time to time raised the issue of fully or partially exempting them from the need to undertake priority sector lending on account of their limited geographical presence and expertise in areas like agro / small scale lending. These are the sectors where formal flow of credit is necessary to create equitable development. Reserve Bank has tried to facilitate bank lending to these sectors by ensuring that the pricing of credit is made free. Foreign banks on their part are expected to bring in innovation and develop new models through their global experience to deliver credit to needy sectors of the economy in a cost effective manner. Foreign banks had to a large extent pioneered in the areas of technology banking, ATMs in India which was followed by the domestic players and has today changed the landscape of banking in India. As regards foreign banks with 20 and more branches required to undertake priority sector lending at par with domestic scheduled commercial banks, it may be noted that many of these banks are present in India for more than 100 years and are present even before some of the public sector banks were born. These foreign banks, therefore, not only know the Indian economy well but are also well versed with the culture and psyche of the local populace. Therefore, it should not be an insurmountable problem for them to comply with the priority sector requirements.

21. It is to be appreciated that different jurisdictions, including advanced countries, have been requiring the concept of mandated lending for identified sectors, communities and programmes.

Opening of branches in unbanked and underbanked centres

22. WOS of foreign banks are freely allowed to open branches in any centre with a stipulation that at least 25 percent of the total number of branches opened during the financial year must be in unbanked rural (Tier 5 and Tier 6) centres, i.e. centres which do not have a brick and mortar structure of any scheduled commercial bank for customer based banking transactions. Tier 1 comprises metropolitan and urban centres, Tiers 2, 3, and 4 comprise semi-urban centres and Tiers 5 and 6 comprise rural centres.

23. Incidentally, foreign banks operating as branches are not governed by these stipulations, although, for opening a branch they need to seek prior approval from Reserve Bank on case to case basis. However, keeping in view the concentration of foreign bank branches in urban and metropolitan areas, it is expected that foreign banks when desiring to expand presence may also like to open branches in underbanked centres, measured in terms of average population per branch office in a district / state. I understand that there are similar stipulations in other jurisdictions which have been laid down after factoring the specific needs of their economy and the extent of banking penetration.

24. Currently, foreign banks have around 99% of their branches in urban and metropolitan centres of the country. For increasing banking penetration and financial inclusion, there is a need to open branches in centres that are unbanked. With a liberal branch expansion policy, WOS would have access to the hinterland, which hitherto remained unexplored by foreign banks in India. Thus, there is ample growth opportunity for foreign banks under the WOS set up. In the case of foreign bank branches, there are again plenty of prospects by way of opening branches in underbanked centres. Incidentally, underbanked centres do not necessarily constitute rural areas and many of the centres are located in the fringes of metropolitan and urban areas. Further, with the Government of India's plans to develop hundred smart cities across India, there is ample opportunity to open branches in these centres and in fact I believe many existing foreign banks in India would by now have started to strategize to foray into such centres so as to have the first mover advantage.

Niche banking vs. universal banking

25. Foreign banks have often sought to do niche banking like corporate / wholesale banking, investment banking rather than undertaking a bouquet of activities as would be required of a commercial bank. The rationale for such request stems from the limited geographical reach, stymied business model for foreign branch operations, lack of expertise in local market, etc.

26. Reserve Bank of India issues universal banking licence to foreign banks for conducting all type of banking business. There is no restriction as to the type of business to be conducted through branches unlike in some other countries where restrictions are placed on foreign bank branches on acceptance of retail deposits, conducting business in local currency, types of clientele, availability of deposit insurance, access to clearing and settlement systems etc. Once established, the regulation is non-discriminatory in India, as foreign banks enjoy near national treatment in the matter of conduct of business. As indicated earlier, on account of the typical requirements of the economy, it is our desire and expectation that the foreign banks offer commercial banking with a view to ensure further penetration of banking activities. Needless to indicate that in the process foreign banks could diversify their risks and also it helps to tap the available latent opportunities.

Growing the inorganic way

27. There have been requests on whether Reserve Bank would allow foreign banks to expand inorganically to explore possibilities for acquisition of banks operating in India. In this regard, the stance of Reserve Bank has already been conveyed in the framework of WOS of foreign banks in India. To repeat, it has been stated that once WOS are in operation for a while and after a review is made with regard to the extent of penetration of foreign investment in Indian banks and functioning of foreign banks, WOSs may be permitted to enter into mergers and acquisitions with private sector banks in India, subject to the overall foreign investment limit of 74 per cent. Since mergers and inorganic growth are natural phenomena, it is likely that over a period of time a number of small institutions may look in for such possibilities to reap benefits of economies of scale and the attendant gains. At the same time, as the population needing basic financial services increases and more opportunities unfold, more entities would like to establish presence within the gamut of policy on entry of new banks and the existing foreign banks would be making exploratory inroads into hinterland to seize the opportunities. However, depending upon the developments in the banking system and the needs of the economy, Reserve Bank would review the policy on the presence of foreign banks in India at an appropriate point of time.

Conclusion

28. To conclude, India has a long history of welcoming foreign banks, while cautiously allowing its expansion, keeping the country's needs in perspective. India offers ample scope for growth for the foreign banks in universal banking, more specifically in the highly sophisticated and profitable markets of trade finance, investment banking, treasury banking and personal banking. The permitted and desired structure of foreign banks is in effect as per the current international ethos. The regulatory and supervisory approaches are, by and large, common and non-discriminatory. Welcome to India.

29. Thank you all for patient listening.