India: Taken Over by Foreign Banks?

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On October 12, Raghuram Rajan, the new Governor of the Reserve Bank of India, announced that the RBI will soon issue new rules allowing a more liberal entry of foreign banks in India. "That is going to be a big opening because one could even contemplate taking over Indian banks, small Indian banks and so on," he stated in Washington at an event organized by the Institute of International Finance, a global banking lobby group.

The announcement of a reversal of long-standing regulatory policy for banking at an event organized by a lobby group is questionable as the wider developmental and regulatory concerns related to a liberalized entry of foreign banks are yet to be discussed in Parliament.

In the Indian context, the key policy issue is — do the benefits of foreign bank entry greatly outweigh the potential costs? Foreign banks have been operating in India for the past many decades and yet we find no evidence of the widely held notion that foreign banks add to domestic competition, increase access to financial services and ensure greater financial stability in the host countries. As witnessed during the global financial crisis of 2008, foreign banks reduced their domestic lending in India by as much as 20 per cent whereas the state-owned banks played a counter-cyclical role during the crisis.

Are Foreign Banks Discriminated in India?

It is widely believed that the entry of foreign banks in the Indian market is highly restricted and the regulatory framework discriminates against the foreign banks. Let us examine the ground realities. Currently, there are 41 foreign banks operating in India with 323 branches and 1414 ATMs. Another 46 foreign banks operate through their representative offices. It is often overlooked that even without branch licenses, foreign banks have been expanding business through off-site ATMs, non-banking finance companies and off-balance sheet exposures.

As per on-balance sheet businesses, foreign banks own 8 per cent of the total banking assets in India. However if one includes off-balance sheet businesses (e.g., forward exchange contracts and guarantees), then the ownership patterns dramatically reverse as foreign banks are the biggest players in the off-balance sheet businesses with a combined market share of 62 per cent in 2012. The total share of foreign banks as a percentage of the banking assets of India (both on- and off-balance-sheet items) was more than 40 percent in 2012.

As per India's commitment at the World Trade Organisation, licenses for new foreign banks may be denied when the share of foreign banks' assets in domestic banking system (including both on- and off-balance-sheet items) exceeds 15 per cent. Till date, India has not invoked the WTO commitments to deny the entry of foreign banks in the country. Rather, the number of branches permitted each year to foreign banks has been higher than the WTO commitments of 12 branches in a year.

In addition, foreign banks in India are free to undertake any banking activity (e.g., wholesale, retail, investment banking, foreign exchange, etc.) which is allowed to domestic banks. In Singapore, China and the US, strict restrictions have been imposed on the kind of businesses that could be carried out by foreign banks within their jurisdictions.

Where is Reciprocity in Market Access?

If India opens up its banking sector, how much market access Indian banks will get in return? The recent experience shows that market access to Indian banks is far from satisfactory. During 2003-07, India allowed US-based banks to open 19 branches (excluding the off-site ATMs). But, in the same period, the US did not allow a single Indian bank to open a branch or subsidiary or representative office in its territory despite many requests made by public and private sector banks.

Under the India-Singapore Comprehensive Economic Cooperation Agreement (2005), the RBI allowed market access to three Singaporean banks as per the agreement but the Monetary Authority of Singapore refused to fulfill its time-bound commitment for providing full bank license (Qualifying Full Bank status) to three Indian banks. The MAS had imposed higher qualifying standards in the form of Asset Management Ratio on the Indian banks compared to other international banks operating in Singapore. Whereas the RBI does not discriminate between foreign and domestic banks on prudential and regulatory norms.

The Urban-centric Foreign Banks

Till date, most of branches of foreign banks are located in metropolitan areas and major Indian cities where bulk of premium banking business is concentrated. As on March 2012, out of total 322 branches of foreign banks, 246 branches (76%) were located in metros, 61 (19%) in urban areas and the rest 15 (5%) in semi-urban and rural areas. It is distressing to note that foreign banks such as Standard Chartered Bank and BNP Paribas have not yet opened a single branch in the rural areas despite operating in India for more than 150 years.

Further, foreign banks are reluctant to serve the poor and low-income people residing in metropolitan and urban areas. There is no regulatory ban in India on foreign banks to serve the urban poor and low-income people.

The Niche Banking Model

Typically, foreign (and some big private banks) are averse to provide banking services to the poor people because they find such clients less lucrative. The foreign banks “cherry-pick” the most profitable businesses and affluent customers residing in the metros and urban areas.

They tend to follow “exclusive banking” by offering services to a small number of clients. The foreign banks are mainly interested in serving three niche market segments in India: up-market consumer retail finance, wealth management services and investment banking.

Several foreign banks and their lobby groups have publicly expressed their discomfort in fulfilling the mandatory priority sector lending requirements. Rather they prefer a niche banking model with no riders in terms of social and developmental banking. Hence, the real issue is not xenophobic hostility towards foreign banks but their niche business model in India devoid of social and developmental banking.

Financial Inclusion or Exclusion?

Given their business model oriented towards niche banking, will foreign banks augment the reach of the banking system to 500 million Indian citizens who do not have access to basic banking services? What specialization and international experience do foreign banks have when it comes to providing basic banking services to small farmers, landless workers and urban poor dwellers?

Recent studies have pointed out that 72 per cent of Indian farmers have no access to the formal banking system. One of the important factors behind rising farmer suicides in the countryside is lack of access to cheap credit from banks and institutional sources. Will the foreign banks open branches in the rural areas and compete with traditional moneylenders in the rural banking markets?

The contribution of foreign banks in the opening of "no frills" bank account under the financial inclusion program has been abysmal, as documented in various RBI reports. Can foreign banks be forced to meet the targets of financial inclusion for rural households, as suggested by the Committee on Financial Inclusion? Where would foreign banks open their branches in New Delhi? Friends Colony (an upmarket area of South Delhi) or Jahangirpuri (a low income group area of North Delhi)?

If the entry of foreign banks is allowed through acquisition of domestic banks, will it not lead to concentration of banking markets and loss of competition?

These are some of the important policy questions which need to be addressed before rolling out the red carpet treatment to foreign banks.

Learning from International Experiences

Research studies conducted jointly by SOMO and Madhyam (available at www.madhyam.org.in) on the impact of banking sector liberalization in South Korea and Uganda offer several important policy lessons. In South Korea, foreign bank played an eminent role in building of short-term foreign borrowings which induced financial fragility and risks in the Korean banking sector before and after the 2008 financial crisis.

In Uganda, a rapid entry of foreign banks through acquisitions and takeovers has led to a situation where rural areas remain under-banked and the bulk of bank credit goes to trade. With foreign banks controlling 87 percent of Uganda's banking assets, the rural households in Uganda are largely dependent on informal sources of finance to meet their consumption and investment needs.

In many Latin American countries such as Brazil, Mexico and Chile, there was a considerable decline in competition in the aftermath of liberal entry of foreign banks.

The global financial crisis has put a big question mark about the efficiency, "best practices" and state-of-the-art risk management models of big international banks.

The crisis has shown how many big international banks transmitted financial shocks across countries.

Several banks (including HSBC, UBS and Credit Suisse) have recently paid billions of dollars in fines for their alleged role in Libor rate-fixing scandal, money laundering and other corrupt practices. The JPMorgan Chase has been associated with several trading scandals in the recent past and has agreed to pay $5.1 billion to settle claims that it sold bad mortgages to two government agencies of the US (Fannie Mae and Freddie Mac) ahead of the financial crisis. According to media reports, JPMorgan may end up paying as much as $13 billion to settle all the pending claims over its reckless trading and market manipulative practices. Should India give such banks a free run?

Finally, we should not forget that the Indian banking system has remained insulated from global turmoil thanks to a limited presence of foreign banks, enlarged state ownership of the banking system, and a relatively strong regulatory framework.

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