# The India-EU Free Trade Agreement: Should India Open Up Its Banking Sector?

By Kavaljit Singh
Global Research, March 16, 2009
16 March 2009

Region: Asia, Europe
Theme: Global Economy

Since 2007, India and European Union (EU) are negotiating a free trade agreement (FTA). The negotiations not only cover trade in goods but also services, rules pertaining to intellectual property rights, cross-border investments, competition policy, government procurement and regulatory issues.

EU as a bloc is India's largest trading partner. EU accounts for around one-fifth of India's total trade (23 per cent in 2007) whereas India contributes around 1.8 per cent of the total EU trade and is its 10th largest partner. Services are an emerging area of EU-India trade. EU is also one of the largest sources of foreign direct investment (FDI) in India. Much of investments from EU have come in the energy, telecommunications and transport sectors. Of late, many Indian private companies are also undertaking substantial investments in several European countries.

EU initiative towards a FTA with India is a key component of its "Global Europe" policy framework based on several long-term economic and strategic goals. India currently leads the list of Asian countries with 30 FTAs, followed by Singapore with 26, China and Korea with 22 each and Japan with 19. Out of India's 30 FTAs, eight are within the Asian region, while the remaining 22 are outside Asia. Apart from closer economic ties, India sees potential geo-political gains in forging FTAs, particularly within the Asian region.

One of the major underlying themes in the ongoing negotiations on India-EU FTA is the liberalization of trade and investment in financial services. Financial services cover a wide range of services from banking to insurance to brokerage and asset management. The global trade in financial services has registered rapid growth in the past two decades on account of growing internationalization of trade and finance. Financial services firms see regulation as a biggest obstacle to their global ambitions. The liberalization of trade and investment in financial services is a part of wider financial sector liberalization which consists of domestic (e.g., interest rate deregulation) as well as external (e.g., capital account liberalization) reforms.

It has been observed that bilateral agreements have accomplished increased financial services liberalization commitments as compared to those made under the GATS negotiations of the WTO. For instance, take the US-Singapore FTA. Signing of FTA in 2003 led to deeper opening of cross-border trade and investment in financial services in Singapore. More importantly, the FTA incorporates strong disciplines on the use of capital controls during a financial crisis.

With the help of FTA with India, EU would like to achieve significant liberalization of India's banking sector, well beyond what has been achieved under the GATS framework. EU is seeking greater market access and export gains for its large banks through cross-border supply and direct investments. Through various foras, some of the key demands in the banking services emanating from EU include complete market access (commercial presence, cross-border supply and consumption) and national treatment commitments. It has sought removal of regulations pertaining to bank branches, numerical quotas, foreign ownership, equity ceilings, voting rights and investment by state-owned companies in foreign banks in India.

Since 2000, several European economies have registered a significant growth in their financial services net exports. Banking services are a key component of their financial services exports. The UK remains the leading exporter of financial services in the world. The UK’s financial sector net exports reached a record £38.8 billion in 2007, up from £29.8 billion in 2006. This is despite the turmoil in the credit markets which began in mid-2007. Banks were the largest contributor, with net exports of £23.2 billion in 2007.

In terms of UK’s balance of trade in goods and services in 2007, trade surpluses generated by financial services (£36.9 billion) managed to partially offset large deficits in goods (£89 billion) and travel (£17 billion).

According to RBI’s Annual Survey on International Trade in Banking Services (2006-07), the fee income of the Indian banks operating abroad was Rs.18,900 million in 2006-07. Whereas the total fee income generated by foreign banks operating in India was much higher at Rs.60,830 million. Thus, Indian banks were no match to foreign banks in generating income through trade in banking services.

The commercial motives behind entering banking markets in India are obvious as they provide immense profit opportunities to foreign banks. However, the big European banks are particularly interested in serving three niche market segments in India: up-market consumer retail finance, wealth management services and investment banking.

Despite wide-ranging asymmetries between India and EU, the negotiations in the banking services cannot be simply construed as one-way process. Apart from big European banks seeking greater market access to the Indian markets, a number of big Indian banks (both state-owned and private) are also seeking increased presence in the European countries (particularly in the UK and Germany) as they aim to serve the non-resident Indians (NRIs) based in these countries.

In India, the presence of foreign banks dates back to the pre-independence period. Since 1991, the entry of foreign banks has been liberalized. By asset size, out of top 10 foreign banks in India, 6 are EU-based. The 9 EU-based banks together controlled 65 per cent of total assets of foreign banks in India in 2008.

Under the WTO agreement, India has given commitments to offer 12 new licenses every year to foreign banks. However, the number of branches permitted each year to foreign banks has been higher than the WTO commitments. During July 2006-June 2007, India allowed seven established foreign banks (including ABN AMRO Bank, Barclays Bank and Deutsche Bank) to open 20 new branches and additional seven foreign banks to set up representative offices.

One of the key policy issues determining the market access is reciprocity. How much market access Indian banks are getting in return? In the case of India-Singapore CECA, the principle of reciprocity has not been followed. Though the RBI has allowed market access to Singapore banks as per the agreement but the Monetary Authority of Singapore (MAS) has failed to fulfill its commitments for providing full bank license (QFB status) to three Indian banks. Currently, the DBS Bank is operating 10 branches in India along with other Singapore banks whereas only State Bank of India has been given QFB status in Singapore. The other Indian banks (such as ICICI Bank and Bank of India) have been denied the QFB status.

There is a popular perception that the entry of foreign banks in the Indian market is very restricted and the regulatory framework discriminates against the foreign banks. A closer examination of current banking regulatory framework reveals that it is no longer discriminatory and in many important ways put foreign banks in the same footing as Indian banks. Unlike US, Singapore and China, foreign banks are free to undertake any banking activity in India (e.g., wholesale, retail, private banking, investment banking, foreign exchange, etc.) which is allowed to domestic banks.

The prudential norms applicable to foreign banks for capital adequacy, reserve requirements and asset classification are the same as for the Indian banks. Foreign banks also pursue independent staff recruitment policies. In fact, foreign banks are given undue favor when it comes to priority sector lending. The Indian authorities have imposed lower priority sector lending requirement at 32 per cent (of their adjusted net bank credit or credit equivalent amount of off-balance sheet exposures, whichever is higher) for foreign banks as against 40 per cent for Indian banks.

In the case of branch licensing policy, there is no regulatory prescription for foreign banks to open branches in rural and semi-urban areas. Foreign banks have the freedom to decide the location of their branches. While for new private banks, the licensing policy stipulates that while these banks need not necessarily open up branches in rural or semi-urban areas during the first three years of their operations. But once the moratorium is over, one out of four new branches would have to be opened in such centers.

This lopsided policy works in favor of foreign banks because rural branches generate less profit due to low value transactions. Most of the bank branches in the rural areas are operated by state-owned banks. On the other hand, foreign and private sector banks operate largely in urban and metropolitan areas and manage accounts of high-net-worth-individuals and large corporations.

In the case of EU-based banks operating in India, they have yet to open a branch in the rural areas. This is despite the fact that several EU banks (such as Standard Chartered, BNP Paribas and HSBC) have been operating in India for more than 140 years.

It is important to note that even without branch licenses, foreign banks have been able to expand business through off-site ATMs, non-banking finance companies and off-balance sheet exposures (e.g., derivatives).

The track record of European banks in promoting financial inclusion has been extremely poor in India. Since foreign banks have no branches in the rural areas, they are not obliged to serve the vast sections of rural households who are excluded from the formal banking system.

It is distressing to note that European banks are not serving the poor and low-income people residing in metropolitan and urban areas. There is no regulatory ban on foreign banks to serve the urban poor and low-income people.

Typically, foreign (and domestic private banks) are averse to provide banking services to the poor people because they find such clients less lucrative. In sum, as compared to foreign banks, state-owned banks have played a far greater role in promoting financial inclusion through various policy measures. Foreign banks tend to follow “exclusive banking” by offering services to a small number of clients, instead of “inclusive banking.” For instance, BNP Paribas maintains a strong clientele with large-sized companies only. It does not cater at all to small companies in India. Its wealth management service serves just 800 clients with net worth of above Rs.10 million.

It is well established that not only foreign banks charge higher fees from customers for providing banking services but maintaining a bank account requires substantial financial resources.

It is not the lack of market or regulatory discrimination which is hindering the delivery of banking services by European banks in India but primarily their business model and bias against the poor people in general.

One of the negative consequences of banking sector reforms is the decline in bank branches in rural areas even though the total number of bank branches in India has increased. The banks are reluctant to open branches in the rural areas in order to meet the profitability criteria. The banking sector under the post-liberalization period has witnessed a secular decline in agricultural credit.

The recent market trends suggest that huge losses suffered by European banks in their home markets may not deter them to enter India. Despite severe crisis at home, many European banks (including BNP Paribas, Barclays Bank, Crédit Agricole, Deutsche Bank, HSBC, Rabobank Group and the Royal Bank of Scotland) are seeking licenses to expand their businesses in India. Profit opportunities in India are much higher than mature European markets. In 2008, a number of European banks (such as BNP Paribas, Deutsche Bank and HSBC) registered huge growth in profits in India despite suffering losses in their home and other markets under the global financial crisis

It is a well-established fact that foreign banks tend to shift their focus to overseas markets (particularly those with strong GDP or income growth prospects) if their parent banks become weak because of crisis. As a counter weight to ailing domestic markets, the big EU-based banks would like to get out of recession by exploring newer markets, where the engines of economic growth are located. Indian economy is still in growth phase and is expected to grow in the coming years, albeit at a lower rate. Unlike Europe, credit growth is growing steadily in India.

Are big European banks going to augment the reach of the banking system to millions of Indians citizens who do not have access to basic banking services? Are EU-based banks going to meet the developmental needs of unbanked and underbanked regions of India? Can European banks meet the targets of financial inclusion for rural households, as suggested by the Committee on Financial Inclusion? In which location European banks would open their branches within metros? Dharavi or Nariman Point? Jehangirpuri or New Friends Colony? What extraordinary services European banks would provide to serve unbanked Indian people? What specialization and experience do European banks have when it comes to providing basic banking services to landless rural workers and urban poor dwellers? Do they have a success story?

The liberal entry of European banks may further constrict the access of banking services in the country: geographically, socially and functionally.

Also one cannot expect that big European banks would voluntarily open branches in rural and remote regions of India as part of altruistic motives or corporate social responsibility measures. This anomaly could only be addressed by branch licensing policy and strong regulatory and supervisory framework.

Since many big European banks are in the midst of turmoil and financial distress in the aftermath of the credit crunch, it raises serious questions about their strength and credibility. The global financial crisis has put a big question mark about their efficiency, "best practices" and state-of-the-art risk management models. The crisis has also exposed the poor corporate governance and transparency norms of several European banks.

In many important ways, the crisis has also exposed the fundamental weaknesses in the regulatory and supervisory regime of many EU member-states, particularly the UK, Germany and France. The regulatory issues become more important given the fact that many ailing European banks have large presence in the Indian markets.

In the light of these important developments, the agenda of enlarging the presence of European banks should be seriously reconsidered by policy makers.

In India, the much-touted benefits associated with European banks are yet to be materialized. The urban-centric European banks largely serve the niche market segments consisting of high-net-worth individuals and large corporations.

Keeping these important developments in view, the policy makers should rethink about the benefits of opening up of banking and financial services under the framework of India-EU FTA.

*Kavaljit Singh works with Madhyam, New Delhi. The above article is based on Special Report, "India-EU Free Trade Agreement: Should India Open Up Banking Sector?The full report is available for download at online: (www.madhyam.org.in)*





*Articles by:* Kavaljit Singh