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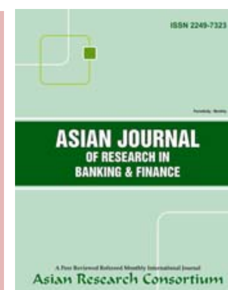

PRESENCE OF FOREIGN BANKS IN INDIA: NEED FOR GREATER CLARITY

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ABSTRACT

the approach taken by the RBI towards the entry of Foreign Banks has undergone changes. The RBI on entry of foreign banks in India has become more cautious and apprehensive and therefore changed its idea of the same. As foreign Banks in India are bound to follow the one mode presence criterion, the RBI, post the financial crisis has strongly advocated for the wholly owned subsidiary model over the branch form of presence. The Author proposes to examine this debate and analyse the stand taken by the RBI.

The paper is divided into three parts. The first part provides a picture of the Regulatory framework that governs foreign banks in India. This part gives an understanding of the licensing and procedural requirements that need to be carried out by foreign banks, for establishing their presence in India. The second part of the paper covers foreign investment in the Banking sector and analyses the debate on the mode of presence of foreign banks in India. It covers the stand of the RBI and the incentives taken by it, to provide for subsidiary model of presence. The third part of the paper provides the conclusion and recommendations of the Author.

KEY WORDS: Banking,Regulatory Framework

INTRODUCTION

The global financial crisis changed the role of the banking sector worldwide. The impact of the crisis on India brought the role of the Reserve Bank of India into limelight. Regarded as stringent and highly regulated, the Indian Banking sector emerged, to a very great extent unscathed from the clutches of the crisis that crippled the Developed Nations who were forced to bailout their

financial systems. Indian financial system, on the other hand witnessed the crisis with little impact. Learning lessons from the fate of other developed Nations, the Indian Regulator formulated strategies to avoid such ordeals in the future and make Indian financial system more resilient. Apart from taking measure like stricter implementation of Basel norms for the sector, the approach taken by the RBI towards the entry of Foreign Banks has also undergone changes. The RBI on entry of foreign banks in India has become more cautious and apprehensive and therefore changed its idea of the same. As foreign Banks in India are bound to follow the one mode presence criterion, the RBI, post the financial crisis has strongly advocated for the wholly owned subsidiary model over the branch form of presence. The Author proposes to examine this debate and analyse the stand taken by the RBI.

The paper is divided into three parts. The first part provides a picture of the Regulatory framework that governs foreign banks in India. This part gives an understanding of the licensing and procedural requirements that need to be carried out by foreign banks, for establishing their presence in India. The second part of the paper covers foreign investment in the Banking sector and analyses the debate on the mode of presence of foreign banks in India. It covers the stand of the RBI and the incentives taken by it, to provide for subsidiary model of presence. The third part of the paper provides the conclusion and recommendations of the Author.

1.1 REGULATORY FRAMEWORK

The presence of a large number of foreign banks in India is due to the liberal policy adopted by India towards them. Unlike many countries, India does not place undue restrictions on operations of foreign banks and therefore provides for a single class of banking license. The treatment given to foreign banks is at par with the Indian Banks. The procedure which is to be followed by foreign banks is similar to Private sector Banks.

They need to make an application before the RBI for opening their maiden branch in India.[1] Before a license is granted to a foreign bank, the RBI keeps certain factors in mind. These factors include the following:

i. the company is/or will be in a position to pay its present or future depositors in full as their claims accrue,

ii. the affairs of the company are not being, or are not likely to be conducted in a manner detrimental to the interest of its present or future depositors,

iii. the general character of the proposed management of the company will not be prejudicial to the public interest, or the interests, of its depositors,

iv. the company has adequate capital structure and earning prospects,

[1] Section 22, Banking Regulation Act, 1949.

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v. public interest will be served by the grant of a licence to the company to carry on banking business in India,

vi. the grant of licence would not be prejudicial to the operation and consolidation of the banking system consistent with monetary stability and economic growth, and

vii. Any other condition to ensure that the carrying on of banking business in India by the company will not be prejudicial to public interest or the interests of the depositors.

Apart from these factors, the RBI further needs to satisfy itself that the government or the law of the country in which it is incorporated does not discriminate against banks from India. The other factors it keeps in mind include soundness of the bank, its international presence; its rating by international rating agencies, ownership pattern and relations between India and the country of incorporation would be taken into account.

Foreign banks applying to the RBI for setting up their WOS/branches in India must satisfy RBI that they are subject to adequate prudential supervision in their home country. In considering the standard of supervision exercised by the home country regulator, RBI will have regard to the Basel standards. The setting up of WOS/branches in India should have the approval of the home country regulator.

Once a license is granted to a foreign bank it can carry on both wholesale and retail operations.[2] The Indian Law does not discriminate against foreign banks in any way. Therefore, deposit insurance cover is uniformly available to all foreign banks at a non-discriminatory rate of premium. The norms for capital adequacy, income recognition and asset classification are by and large the same. As per press note 2 of 2004, foreign banks can operate in India by establishing branches or subsidiaries. The requirements for the same are:

1.1.1 OPENING OF BRANCHES BY FOREIGN BANKS

After obtaining the license under Section 22 of the Banking regulations Act, 1949, foreign banks are subject to the branch authorization policy applicable to Indian banks [3] subject to the fulfilment of the following requisites:

Foreign banks are required to bring an assigned capital of US$25 million up front at the time of opening the first branch in India. Existing foreign banks having only one branch would have to comply with the above requirement before their request for opening of second branch is considered. They will be required to submit their branch expansion plan on an annual basis. In addition to the parameters laid down for Indian banks the following parameters would also be considered for foreign banks:

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[2] Technical paper on differentiated bank licenses, http://rbidocs.rbi.org.in/rdocs/Publications/PDFs/80798.pdf, accessed 28 November 2011.

[3] Master circular on branch authorization, section 23, Banking Regulation Act, 1949, http://rbidocs.rbi.org.in/rdocs/notification/PDFs/85480.pdf, accessed 27 November 2011.

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- Foreign banks and its group's track record of compliance and functioning in the global markets would be considered.
- Reports from home country supervisors will be sought, wherever necessary.
- The treatment extended to Indian banks in the home country of the applicant foreign bank would be considered along with due consideration to the bilateral and diplomatic relations between India and the home country.

The provisions of the Banking Regulation Act delineate the separate legal identity of the branches of foreign banks in India.[4]

1.1.2 CONVERSION OF EXISTING BRANCHES INTO WOS

Foreign Banks having branches in the Country will have to satisfy the norms applicable in case of wholly owned subsidiaries. Additionally, permission to convert into wholly owned subsidiaries will be guided by the manner in which the affairs of the branches are conducted, compliance with statutory and other prudential requirements and the overall supervisory comfort of the Reserve Bank of India. Such branches may also apply to the RBI for making investment in a private bank identified by the RBI for restructuring. However in such cases, the RBI will in addition to the general requirements for setting up WOS, examine the track record of the foreign bank in restructuring banks. It may also undertake enhanced due diligence to determine the status of shareholders. Also, in case of acquisition of a private bank by a foreign bank having presence in India, a maximum period of six months is given for conforming to one form of presence concept.[5]

1.1.3 WHOLLY OWNED SUBSIDIARIES

The licensing requirements for WOS will be similar to those applicable to private sector banks. It would be governed by the provisions of the Companies Act, 1956, Banking Regulation Act, 1949, RBI Act, 1934, and other relevant statutes and the directives, prudential regulations and other guidelines/instructions issued by RBI and other regulators from time to time. In

[4] Section 11(2): Banking companies incorporated outside India are required to maintain a certain amount of paid-up capital and reserves. Further, they are required to deposit with RBI, in cash or securities, an amount equal to their capital and reserves and 20 per cent of its each year's profit.

Section 11(4): Claims of all creditors of the company in India shall have first charge on the amounts kept deposited with the RBI under Section 11(2).

Section 25: Every banking company is required to maintain assets in India which shall not be less than 75 per cent of its demand and time liabilities in India.

[5] ibid;

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addition, a foreign bank must satisfy the RBI that it is subject to adequate supervision of the home country regulator.[6]

Even though they are to be treated as separate legal entities, wholly owned subsidiaries are to be treated as foreign owned and controlled as per the FDI policy 2011.[7] It is a consequence of this, that they would not be provided full national treatment on par with domestic banks.

The WOS are to have a minimum capital requirement of Rs.300 Crore and would need to ensure sound corporate governance. It is to be treated on par with the existing branches of foreign banks for branch expansion with flexibility to go beyond the existing WTO commitments of 12 branches in a year and preference for branch expansion in under-banked areas. The Reserve Bank had indicated that it may also prescribe market access and national treatment limitation consistent with WTO as also other appropriate limitations to the operations of WOS, consistent with international practices and the country's requirements.[8] In terms of priority sector lending, WOS have more obligations over foreign banks branches, however less onerous obligations than domestic banks branches.

1.2 FDI IN BANKING SECTOR

Foreign Investment in banks can be direct and indirect. Investment in Indian Banks can be made both by non-resident as well as resident Indian entities. Any non-resident investment in an Indian Bank is direct foreign investment. Investment by resident Indian entities could again comprise of both resident and non-resident investment. Thus, such an Indian bank would have indirect foreign investment if the Indian investing company has foreign investment in it. The indirect investment can be a cascading investment i.e. through multi-layered structure also.[9]

With the process of liberalization, the thoughts on entry of foreign investment in banks started grabbing attention. In the initial stages post liberalization, India witnessed a large number of mergers in the banking industry i.e. public-private and private-private. However, with time, the focus of the mergers in the Banking Industry shifted from "avoiding insolvency" to synergies and market efficiencies. It is then, that the Indian government came out with the road map for presence of foreign banks in India "laying a two track gradualist approach aimed at increasing the efficiency and stability of Banking Sector in India.

Till the year 2004, the cap on foreign investment in new and private sector banks was restricted to 49%. Press note 2 of 2004[10] raised the cap on FDI in banking. At present FDI in banking is capped at:

1.2.1 PRIVATE BANKS

[6] In considering the standard of supervision exercised by the home country regulator the RBI will have regard to the Basel Standards.
[7] DIPP press notes 2, 3 and 4 2009.
[8] Discussion Paper-Presence of foreign Banks in India, www.rbi.org, accessed 14 November, 2011.
[9] Press note 2 of 2009, http://siadipp.nic.in/policy/changes/pn2_2009.pdf, accessed 12 November 2011.
[10] DIPP, Press note 2 of 2004, www.rbi.org, accessed 12 November 2011.

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The FDI limit for private sector banks is 74% of which investment upto 49% is under the automatic route while beyond 49% investment can be made under approval route.[11] This cap includes investment by foreign institutional investors, FDI under portfolio investment scheme by FIIs, NRIs, OCBs prior to 2003, private placements, GDRs /ADRs and acquisition of shares from existing shareholders. At all times, at least 26% of the paid up capital of the bank would have to be held by resident Indian except in regard to a wholly owned subsidiary of a foreign bank.

Under the 74% cap, the FII limit is 49% under which individual FII holding is restricted to 10%, the aggregate limit for which cannot exceed 24% unless the bank concerned passes a special resolution by its Board of directors followed by passing of a special resolution to that effect by its general body, in which case the limit of 49% is acceptable. With respect to NRI holding, individual cap is 5% and the aggregate cap is 10% which can increase to 24% with the passing of a special resolution.

1.2.2 PUBLIC BANKS

In case of public sector banks, Presently, FDI and portfolio investment collectively in nationalized banks as also the State Bank of India and its associate banks are subject to overall statutory limits of 20 per cent as provided in Section 3 (2D) of The Banking Companies (Acquisition & Transfer of Undertakings) Acts, 1970 and of 1980. Further, the voting rights in them are restricted to 1% of the total voting rights. This leads to a disincentive amongst investors to invest in public sector banks.

1.2.3 FOREIGN BANKS

Apart from the licensing requirements imposed on foreign banks, press note 2 of 2004 provides for the entry mode for foreign banks in India. As per press note 2 of 2004, foreign banks may operate in India through one of the three channels viz.

- Branches,
- wholly owned subsidiaries or a
- Subsidiary with an aggregate foreign investment up to a maximum of 74 percent in a private bank.[12]

The Reserve bank of India unveiled the road map for the presence of foreign banks in India, which comprised two phases: During the first phase, foreign banks were permitted to establish presence by way of setting up a wholly owned banking subsidiary (WOS) or conversion of the existing branches into a WOS, following the one mode presence criterion.[13]

[11] FDI Policy 2012.
[12] DIPP, Press note 2 of 2004, www.rbi.org, accessed 12 November 2011.
[13] Discussion Paper-Presence of foreign Banks in India, www.rbi.org, accessed 14 November, 2011.

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Historically, the RBI appears to have had a preference for allowing foreign banks to operate in India as branches rather than separately incorporated subsidiaries. Consequently, most (if not all) foreign banks have been established as branches for the purposes of banking law as well as company law. Apart from the fact that a branch enjoys the support, creditworthiness, and solvency of the main entity, it was always an intriguing question as to why there was a preference for this form.[14]

In the last 5 years, however, RBI has revisited this position and has now expressed a preference for the subsidiary structure rather than the branch structure for foreign banks to operate in India. While doing this, RBI has not only looked at the experience of other countries, but has also closely monitored lessons from the financial crisis. In light of this shift, this section discusses the debate and incentives the RBI plans to give to

1.2.4 BRANCHES V SUBSIDIARIES

As opposed to the earlier trend of growing number of branches of foreign banks, the recent trend suggests otherwise. Even though the RBI believes that branch form of presence provides greater operational flexibility, increased lending capacity depending upon the parent banks capital and reduced corporate governance requirements, in its road map unveiled in the year 2005, it provides that while the branch form of presence can have its own advantages, trends from other countries forced it to think otherwise.

It recognised that branches do have certain advantages over subsidiaries, such as stronger support from the parent in situations of local adversity of the branch, internationally it is generally understood that with a branch it may be difficult to determine the assets that would be available in the event of failure of the bank to satisfy local creditors' claims and the local liabilities that can be attributed to the branch. As branches are part of the head office, assets attributable to it can easily be transferred by the branch to the foreign head office. Not only so but the management of a branch does not have a fiduciary responsibility to the branch's local clients.[15]

The RBI advocates the subsidiary form of presence for banks because international examples showing that holding companies do not prove a source of strength in times of crisis. International experience has shown that "comfort letters"[16] provided by the holding companies is

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[14] RBI's draft guidelines for private sector Banks, "http://indiacorplaw.blogspot.com/2011/08/rbis-draft-guidelines-for-private.html, accessed 12 November 2011.

[15] ibid;

[16] Letters of comfort are in the form of letters given by a parent company, in circumstances where it's subsidiary, or its board, needs written expression of the parent company's ongoing financial support. A parent company may give a letter of comfort instead of a formal guarantee, in the hope of achieving an outcome required by its subsidiary, without the risk of legal recourse. The parent is trying to avoid a legal obligation, whereas the recipient hopes the promise will be honored, even if it is not binding. When considering whether to rely on a letter of support, its recipient must face the reality that the parent has chosen not to enter into a formal legally binding guarantee. Further, if the recipient has sought a formal binding assurance from the parent and it has not been provided, then arguably it may no longer be reasonable for the recipient to expect to have received a legally enforceable document, when an informal letter is given instead.

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not a source of strength as their enforceability in times of stress is very often questioned. Another area of concern stems from the perspective of financial stability. The branches, not being locally incorporated entities may dominate the domestic financial system in the boom years, while at the same time they may withdraw or curtail their operations in times of crisis.

Its favouritism for subsidiarisation is evident, given the incentives it wishes to initiate for banks converting into subsidiary or opening subsidiaries at the entry point itself. It has gone ahead and advised on the presence of some category of foreign banks only in the form of subsidiary, at the entry point itself. The category includes:

- Banks incorporated in a jurisdiction that has legislation which gives deposits made/ credit conferred, in that jurisdiction a preferential claim in a winding up.

- Banks which do not provide adequate disclosure in the home jurisdiction.

- Banks with complex structures,

- Banks which are not widely held, and

- Banks other than those listed above may also be required to incorporate locally, if the Reserve Bank of India is not satisfied that supervisory arrangements (including disclosure arrangements) and market discipline in the country of their incorporation are adequate or for any other reason that the Reserve Bank of India considers that subsidiary form of presence of the bank would be desirable on financial stability considerations.

Also if any of the banks fulfils the above mentioned criteria, it would be mandatory for them to convert themselves into WOS or some banks which fall under the category of strategic banks.[17]

Post the global financial crisis, the RBI has shown its preference for the subsidiary form of presence over branch form. However, this enthusiasm of the RBI and the government is not shares by the banks. Foreign Banks in India which account for over 70 percent of foreign bank branches claim that they are awaiting the regulator's approval along with clarity on the branch licensing policy under the wholly owned subsidiary model before expanding their networks.[18] It is noteworthy that at present 41 foreign banks in India operate through their branches.[19]

Their apprehension to open subsidiaries or convert branches into subsidiaries stems from subsidiaries being locally incorporated entities. Banks are of the view that being locally incorporated entities, they entail obligations like priority sector lending over and above the

[17] Banks whose assets become 0.25% of total assets of all scheduled commercial banks in India.

[18] Foreign banks pause branch expansion, http://www.business-standard.com/india/news/foreign-banks-pause-branch-expansion/447618/, accessed 26 November 2011.

[19] http://rbidocs.rbi.org.in/rdocs/Content/pdfs/71207.pdf, accessed 1 August 2012.

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stipulated norms for branches and still would not be able to avail of the benefits of National Treatment. With a view to encourage banks to open subsidiaries over branches and encourage existing branches to convert into subsidiaries, the RBI has clarified that foreign banks seeking to convert their local operations into subsidiaries will not be required to pay taxes on the assets transferred to new entities.[20]

Several other incentives have been discussed by the Indian regulator in order to promote the growth of subsidiaries in India. A major area of concern for the foreign banks was the capital gains tax deductible on conversion. The RBI recently notified that banks converting their branches into subsidiaries would be exempt from this tax. By placing them in a better position over the branches, the RBI seeks to fulfil its objective of conversion. It has therefore elaborated upon each of the objectives mentioned hereinafter:

- Minimum capital Requirement: same as private banks
- At Present 200 crores/US$25 million for branches
- Licensing/prudential norms: same as private banks
- Allow them to raise rupee resources
- Less restrictive branch expansion policy for WOS on par with Domestic banks and
- Restricting opening of branches to WTO commitments
- Priority Sector lending: more stringent for WOS
- Comfort Letter by parent bank
- Allow remittance of profit in initial Years

However, as is evident from the approach of the foreign banks that the subsidiary model of operation does not seem to be their favourite, till date no single foreign bank has either established a subsidiary or converted its branch to a subsidiary. Apart from the plaguing tax concerns, larger banks are also wary of the cost impact they may have to incur on converting branches into wholly owned subsidiaries, which will be incorporated under the provisions of the Companies Act, 1956.[21]

1.3 ANALYSIS AND CONCLUSION

The banking sector in India has undergone gradual but in numerous transformations. In view of where it stands in the after math of the global financial crisis, these transformations can be

[20] Joel Rebello, Path clear for foreign bank subsidiaries, http://www.livemint.com/2012/05/07182622/ Path-clear-for-foreign-bank-su.html, accessed 1 August 2012.

[21] RBI makes it mandatory for foreign banks to adopt WOS route, may 8 2011, http://articles.economictimes.indiatimes.com/2011-05-08/news/29522710_1_foreign-banks-wos-discussion-paper, accessed 14 November 2011.

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said to be a way forward in the right direction. The regulating and governing institution, the Reserve bank of India has played a significant role in bringing the Indian banking sector in line with the global standards without letting the sector get affected as a consequence of the global turmoil.

The only area which raises concerns is RBI's stand which favours subsidiarisation over the branch form. Its concern seems legitimate in view of the plight the financial systems across the world are facing. However, reasons for the concern and the solution to the same raise questions in the mind of the author.

After analyzing the presence by way of branch and by way of subsidiary, the researcher is of the opinion that the benefits based of which the RBI furthers its claim of supporting subsidiary form stand true for the branch form too.

The advocates of this form base their argument on the fact that as a subsidiary is a locally incorporated entity, having its own capital base, and local board of directors, determination of its assets would be available in the event of failure to satisfy local creditor claims and local liabilities that can be attributed to a branch. However, as branches are part of their head office, assets attributable to it can easily be transferred by the branch to the head office.

This argument seems to hold little ground as firstly; every branch is required to bring in capital worth US$25 million at the time of its establishment. Not only so, but the Banking Regulation Act requires every banking company to deposit with the RBI, an amount equal to their capital[22] and 20% of its each year's profit. The act also makes provision for satisfying the claims of the local creditors as section 11(4) provides that in the event a bank ceases to carry on operations in India, the amount deposited and kept deposited with the RBI shall be a first charge on the claims of the creditors of the company in India. This in way makes them on par with locally incorporated subsidiaries which, though locally incorporated, are treated as foreign owned and controlled as per the FDI policy.

The only area where subsidiaries score over branch form is that apart from the ring fenced structure that the Banking Regulations Act provides for, the claim of depositors and creditors over other assets remains to be seen.

It must be kept in mind that Subsidiary form of presence is not free of risks. International trend shows that comfort letters provided by parent banks have enforceability issues, but in times of crisis in home country, they have withdrawn their operations from the host country leaving markets in a state of turmoil. That leaves them at par with the branches that withdraw their operations in times of turmoil.

RBI's stand at times seems somewhat paradoxical when it talks about the incentivising subsidiary mode of presence. The reason why the author feels so is because on the one hand it seeks to provide subsidiaries with less stringent capital requirements and more incentives as are available to domestic banks like branch licensing at par with them, less stricter prudential norms,

[22] In cash or in the form of unencumbered approved securities.

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allowing them to raise rupee resources available only to domestic banks, on the other this parity with domestic sector banks can lead to more stringent requirements in terms of priority sector lending as applicable to domestic banks and several other stricter norms which domestic banks have to adhere to.

These issues are of great importance in India from the point of view of the 41 foreign banks operating in India as of today. It is time we attained greater clarity on issue so as not to hinder a great source of foreign investment.

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