FOREIGN BANKS AS WHOLLY OWNED SUBSIDIARIES: RBI'S NEW POLICY

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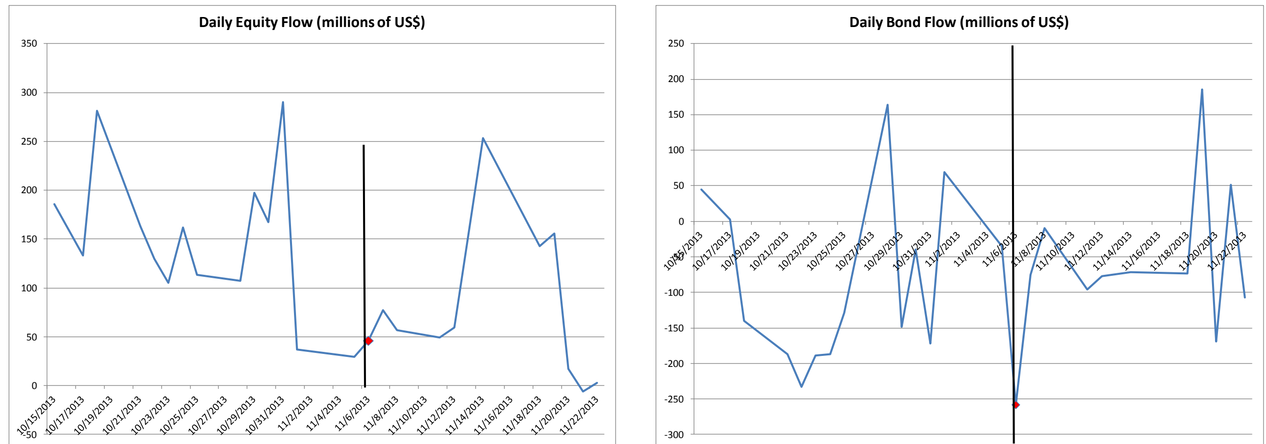
The new policy on foreign banks is a step in the right direction but likely to have little short-run impact as discussed below.

RBI's new policy for setting up of wholly owned subsidiaries (WOS) of foreign banks – is indeed a welcome step towards modernization of the Indian banking system. It is an important component of the Pillar 3 of the plan laid down by the RBI to reform the financial system. The announcement surely signaled a "confidence effect" for investors. Bond and equity flows picked up after the announcement (see figure below).



This article tries to dig deeper into the policy and asks the following questions: What objectives is it trying to fulfill in principle? What will the announcement really mean in practice?

We consider the following three objectives, and discuss the role the new policy might play in moving towards each of these: (i) efficiency, (ii) financial stability, and (iii) inclusion.

Efficiency

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The objective of encouraging foreign banks' participation in India has been essentially 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).

Table
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.

What does the new policy likely to imply in practice? Will the entry of foreign banks through the WOS route provide any *new* incentives to foreign banks to increase significantly their share in banking assets?

The 2005 policy initiative already allowed entry of foreign WOS' with freedom of branch expansion, but did not yield desirable results – no foreign bank came forward to set up or convert branches into WOS. What is different in the new policy? The new policy guarantees "near national treatment" to foreign banks – with essentially two new features -- branch expansion at par with domestic banks (the 2005 policy allowed treatment only at par with existing branches of foreign banks) and freedom to raise non-equity capital beyond the initial paid up capital. Whether these two new features of the policy will sufficiently incentivize foreign banks to expand substantially remains to be seen.

More 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.

Importantly, foreign banks are likely to take into account a number of other perhaps more important considerations – like taxation issues, and political and economic uncertainties rather than regulatory incentives alone- before deciding whether and when to expand business in India.

To summarize on efficiency, although the announcement has some new features that may be particularly attractive for banks trying to expand retail business in India, the policy is fairly similar to the one announced in 2005, and by itself may do little to incentivize foreign banks. Some changes to the current scheme may however play a more meaningful role in attracting foreign banks. For example, greater clarity on allowing the subsidiaries to grow through mergers and acquisitions (a feature mentioned in the scheme (para 17)) could provide a large incentive for foreign banks to expand business in India.

Financial stability

The accepted wisdom 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, subsidiarization 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 (Paragraph 4). The mandatory feature to convert into WOS is line with the wisdom on branch versus subsidiarization after the crisis and can in principle help toward achieving the stability objective.

Will the new policy really make a significant difference for financial stability in practice? Notably, foreign bank "branches" in India are already subject to regulations similar to WOS such as assigned capital, and standalone supervision. Branches can also voluntarily have advisory boards (they were actually mandated to do so until a few years ago). In this respect, we do not see the policy to be bringing about a significant change in practice.

Also, the bigger question might be whether these stability concerns are a policy priority at the moment when foreign banks in India constitute only 7% of total banking assets, with no individual foreign bank comprising more than 2%? In comparison, foreign bank assets comprise

more than 30% on average for Latin America, and are as high as 86%, 68%, and 65% for some OECD countries like Czech Republic, Poland, and Finland respectively.

To summarize, the new policy is a step in the right direction towards achieving financial stability, and is in line with global wisdom, but we do not perceive it as bringing about any big change at the current juncture when foreign banks still have a small presence, and even branches of these banks are subject to a certain degree of supervision and regulation.

Financial inclusion

Like domestic banks, WOS of foreign banks will be mandated to comply with priority sector lending requirements in terms of lending to agriculture 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. That they will grow by themselves and innovate in lending to MSMEs and other under-served markets – is less likely, unless the policy changes are able to attract banks from emerging markets like Brazil and South Africa, which have led inclusion efforts in these countries.

To summarize, the new policy in our view 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.

Conclusion

Overall, the new policy to allow and mandate foreign bank to enter through WOS' is in the right direction to enhance efficiency, stability, and inclusion. But in our view, it is likely to have little impact over the short run given that foreign bank presence is low and is less likely to increase significantly with these measures itself; and we do not see foreign banks as innovating on the rural and MSME end. The gains of subsidiarization for financial stability may however fructify over the medium term as foreign banks occupy a greater presence in the country.

Notably, while a greater presence of foreign banks can promote competition, and enhance efficiency of domestic banks – not all countries with well functioning financial systems have depended on foreign banks to flourish. Take the example of Canada, which largely escaped the great recession. Like India, Canada's banking system is large – constitutes 60 percent of total financial system assets. Moreover, the system is highly concentrated with five big domestic banks comprising 85% of total banking assets. Foreign banks constitute roughly only 5% of the banking assets. Importantly, the banking system is predominantly privately owned. The example

of Canada among others illustrates that the objectives of competition and efficiency can as well be achieved by allowing a much larger role for well-capitalized private banks, whether domestic or foreign. While foreign ownership brings benefits to borrowers in terms of diversification and new products, it also exposes the host country to external funding shocks and vulnerabilities in the home country. Therefore the real challenge and difficult reform that remains for India is to provide a much greater role for private banks in the largely state owned banking system.