Opportunities and Challenges of Foreign Banks in India

Dr. Durga Madhab Mahapatra
Post Doctoral Fellow, Department of Commerce , Berhampur University, Odisha, Email:durgagreaternoida@gmail.com

Prof. Ashok K. Mohanty
Professor and Head, Department of Commerce, Berhampur University, Odisha.

Abstract

The operational history of foreign banks started with Standard Chartered bank that set up its first branch in Kolkata in April 1858, a year after the so-called First War of Independence in which sepoys of the British East India Company's army rebelled against the rulers. Hong Kong and Shanghai Banking Corp. Ltd, or HSBC, has been in India even longer. Its origin can be traced back to October 1853, when Mercantile Bank of India, London and China was founded in Mumbai with an authorised capital of Rs.50 lakh. By 1855, Mercantile Bank had offices in London, Chennai, Colombo, Kandy, Kolkata, Singapore, Hong Kong, Guangchow and Shanghai. It was acquired by HSBC in 1959. With close to a Rs. 1 trillion asset book, HSBC has 47 branches and three new branch licences in India. Citibank NA, which has the biggest asset base among all foreign banks in India, is 107 years old. It has 42 branches across 29 centres. Among other foreign banks, ABN AMRO Holding NV, which came to India in 1920 (again, Kolkata was the first port of call), has 31 branches and Deutsche Bank AG, 30 years old in India, is present in 12 centres through 13 branches. Barclays Bank Plc, which launched its India operations in November 2006, has seven branches. This paper discussed the opportunities and challenges of foreign banks in India.

Keywords : SME Growth, microfinance business, Trade flows

Introduction

India has a better banking system in place vis-à-vis other developing countries. The structural changes in the banking industry and reforms in the regulatory regime have the potentials for the improvement in the performance of the industry. To feature among the top banks in the world, it has been universally acknowledged that the key drivers for the future will be competition, consolidation and convergence. Following the Union Budget 2005-06, the Reserve Bank of India (RBI) released the roadmap for presence of foreign banks in India as well as guidelines on ownership and governance in private sector banks.

The RBI's roadmap has envisaged two phases. In the first phase, between March 2005 and March 2009, foreign banks are permitted to establish presence by way of setting up a WOS or conversion of the existing branches into WOS. Also, during this phase, permission for acquisition of share holding in Indian private sector banks by eligible foreign banks is limited to banks identified by RBI for restructuring. The second phase has commenced in April 2009 after a review of the experience gained and after due consultation with all the stakeholders in the banking sector. The foreign banks were focussing on their corporate fee-based business, customer-centric approach and superior use of technology. In this paper, an attempt has been made to present the opportunities and challenges of foreign banks in India.

Opportunities of Foreign Banks in India

Demographic Dividend: India, the second most populous country in the world with roughly 50 per cent of Indians below 25 years age, offers a great deal of opportunities for foreign banks. Foreign banks are more tech-savvy and attract younger generation more than the traditional banks of India. The foreign banks have been characterized as better earning with prosperity for higher spending and less focussed on savings.

Economy's Condition: To hedge against the US economy's slowdown, India's trade is likely to increase with China, Western Europe and South-East Asia/Japan. The slowdown is potentially a double-edged sword while a rising rupee against the dollar might impact our exports. A slowdown in the US economy may result in other benefits such as larger push to outsource jobs to India and increase in the inflow of investment funds. With its booming economy, consistent growth in GDP and higher per capita income of the people, India can be looked upon as an encouraging opportunity for investment by the foreign bankers.

SME Growth: The growth in manufacturing sector in India thrives on its gigantic SME base. While the largest manufacturers may increasingly globalize through acquisition and probable sacrifice in short-term profitability, the huge SME base in India is expected to unleash itself through better credit or FDI inputs,

technology upgradation, better distribution and integration with global supply chain that paves the way for alluring opportunities for the foreign banks.

FDI Inflows: Like fuel to fire, FDI accelerates growth in numerous sectors, particularly in retail, financial services and all areas of infrastructure. Moreover FDI inflows will allow these sectors to scale to globally efficient levels. This may open up a new vista for the foreign banks.

Internationalization of Indian Business: Foreign banks are also preparing for internationalization of Indian business. As Indian companies go global, they need banking support and it is not possible for Indian banks to be present all over the world. The presence of foreign banks can promote competition and enhance efficiency of domestic banks.

Trade Flows: Foreign banks are also looking to tap into the opportunities arising from greater trade flows. Actually, the growing local economy will require a massive amount of capital and domestic banks alone will not be able to meet that demand. Foreign banks will then be well placed to bridge this gap.

Product-Centric: The opening of the economy in the 1990s brought fresh attention to foreign banks for their role in facilitating trade flows, introducing new products and helping capital formation. But most of the local banks are not very product-savvy and have no global connectivity. The foreign banks have cutting edge top-notch products and as a consequence they tend to be product-centric and they are product-organized with customer-centricity.

Rural Branch Licensing Policy: 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. But for new Indian private banks, one out of four new branches has to be opened in rural or semi-urban areas. In terms of market share of the banking sector in India, foreign banks have a noticeable presence.

Emerging Financial Services: The foreign banks help to enhance financial intermediation and reduce the cost of financial services. The foreign banks also increase the credit risk and the potential for capital flow volatility and cross-border contagion. Moreover, foreign banks are more likely to be exposed to the risk of a sharp slowdown or reversal in bank-intermediated capital flows. Considering all this, the RBI policy is an indication of welcome pragmatism based on new lessons learnt from the global crisis, specifically on the role of foreign banks in developing countries.

No Agricultural Lending Targets: There are no agricultural lending targets for foreign banks operating through branches. The guidelines of RBI place a 10 per cent agricultural lending target for foreign banks. Most of the Indian banks have struggled to meet their agricultural lending targets of 18 per cent. But foreign banks have no domain expertise of direct lending to agriculture.

Table-1: Priority Sector lending (% of Adjusted Net Banking Credit)

Category	Domestic Bank/ Foreign Banks (With more than 20 Branches)	Foreign Banks with less than 20 Branches
Total Priority Sector Lending	40	32
Contribution to Agriculture	18	No Specific Requirement
Contribution to Weaker Section	10	No Specific Requirement

Source: Report on Trends and Progress of Banking in India, RBI Publication.

Acquisition and Value-Creation: Foreign banks entering India will have to be innovative in their approaches to win the largest customer base, and to build a value-creating customer franchise. At the same time, foreign banks need to be an active player in the game for potential acquisition opportunities, need to sustain and maintain long-term value-creation mindset.

Microfinance Business: In fact, the profitability of the microfinance business has captured the attention of some of the world's largest and wealthiest commercial banks such as Citigroup, HSBC, ING, ABN AMRO, Commerz Bank and Deutsche Bank. Some successful instances of commercial banks sponsoring microfinance initiatives include Sogsesol, a service company model adopted by SOGEBANK (Haiti) and Real Microcreditor, a microfinance-focussed subsidiary of BANCO ABN AMRO Real, Brazil. These, among others can prove to be useful guides for the implementation of commercial microfinance principles in India.

No Restrictions on Banking Activities: In developed countries like the US, Singapore, China, etc. strict restrictions have been imposed on the kind of business that could be carried out by foreign banks within their jurisdiction. Foreign banks in India are free to undertake any banking activity i.e. wholesale, retail, investment banking, foreign exchange, etc., which are allowed to domestic banks.

Takeovers of State Owned Bank: The takeovers of banks are a landmark in banking history. There are several lessons to be learnt from takeover i.e. (i) smaller state-owned banks should be allowed to amalgamate so that their lending books are substantial enough to make large loans for big corporate or infrastructure deals; and (ii) India as a seriously under-banked country that needs more banks and financial inclusion. The Reserve Bank of India (RBI) needs to clear banking licenses continuously with flexible norms for different lenders. This

is an opportunity for foreign banks to merge with state-owned banks.

The entry of foreign banks and adoption of new technology have thrown open new opportunities. These banks are unveiling new innovative and customized products and services on every other day posing a challenge to the existing players. The role of foreign banks in the Indian system is one of the most important issues that the RBI has had to grapple with in the post-liberalization scenario. If the foreign banks accept the challenge thrown to them, it could result in a win-win situation. It will give them an opportunity to grow. Now, it is up to the banks as to how well they leverage the opportunities to meet the challenges to the best of their capacities. Foreign banks participation can enhance efficiency of local banking by introducing more competition, innovation, global expertise and technology transfer into local banking practices.

Thus, foreign banks are given undue favour when it comes to priority sector lending. The Indian authorities have imposed lower priority sector lending requirements at 32 per cent for foreign banks as against 40 per cent for Indian banks. The foreign banks can perceive it as a goodwill gesture from the government.

Challenges of Foreign Banks in India

Consolidation: Consolidation is expected to take place in India among the public sector banks resulting in the formation of 6 or 7 larger banks. These consolidated banks would share their balance sheets and would be better positioned to allocate risk capital under the Basel II capital adequacy norms. This consolidation would further improve the risk profile of the banking industry and the Indian economy by substantially reducing the threats of weak bank failures and better corporate governance. These larger banks would be able to ensure higher shareholder returns, subject to re-vitalising their human resource management models and efficiently managing merger-linked issues. Consolidation would help the merged entity share its capital base and achieve economies of scale. While consolidation creates a better and sustainable scope for the domestic banks in India, foreign banks with its less number of branches across the country would definitely perceive it as a challenge for its operation.

Mergers: Post April 2009, when restrictors on operations of foreign banks were relaxed, the Indian banks, would perforce to have to consolidate and strengthen themselves for greater breadth of products, depth in delivery channels and efficiency in operations. The synergistic benefits of mergers include enhanced market share, augmented clientele base, increased geographical spread, technological automation, global reach and compliance with global benchmarks.

Limited Accessibility : The presence of well developed foreign banks would definitely drive the introduction of world class practices and capabilities that would come to the industry. But their influence on the industry in this context is at present very small due to the limited reach that they currently have in India. The inadequate accessibility on the part of the foreign banks creates a gap of financial inclusion and thus stands as an impediment for its smooth functioning.

Banking Legislations: Indian banking legislations are complex. The nationalized banks are governed by the Banking Companies (Acquisition and Transfer of Undertaking) Acts 1970 and 1980. Private sector banks come under the purview of the Companies Act, 1949. Foreign banks which have registered their documents with Registrar under Section 592 of the Companies Act are also banking companies under the Banking Regulation Act. Similarly, some provisions of the RBI Act too are applicable to nationalized banks, SBI and its subsidiaries, private sector banks and foreign banks. Needless to say, almost all the statutes have had to be amended from time to time to reflect changes in circumstances and context. Actually, this wide array of legislations of varying vintage is a challenge to foreign banks operation in India.

Financial Inclusion: In fact, foreign banks are mostly present in the metropolitan regions, and as such, their role in furthering financial inclusion especially by extending banking services to the unbanked regions is limited. The banking sector is a key driver of inclusive growth. Banks and other financial service players largely are expected to mitigate the supply side processes that prevent poor and disadvantaged social groups from gaining access to the financial system. However, demand side factors, such as a lower income/ or asset holdings also have a significant bearing on inclusive growth. Thus, the disparity on the basis of connectivity between the foreign and domestic banks brings out a new challenge for the former.

Opening New Foreign Banks: Historically; the framework for licensing of new banks in the private sector was formed in January 1993. Ten new banks were set up in the private sector. The norms were revised in January 2001. Two new banks come on the horizon after that. Out of the four banks promoted by individuals in 1993, only one has survived with muted growth. Among the remaining six banks, one bank voluntarily amalgamated itself with another private sector bank within five years of operations. Four banks promoted by financial institutions were either merged with the parent or rebranded and achieved growth. The bank that was converted from a cooperative bank is endeavouring to stabilize itself. Two banks i.e. Kotak Mahindra Bank and YES Bank licensed after 2001 are doing well. Considering this position, a total of 31 foreign banks are in the queue to seek the RBI's permission to start their operation in the domestic market by opening of branches or representative offices in India. The subsequent failure by the domestic banks in the past puts an obstacle in disguise to disturb the confidence of the RBI for the foreign banks.

Parent Bank's Turmoil and India's Restrictive Policy: Foreign banks in India have dominant presence in the niche areas and operate in highly profitable segments of the banking industry. The banks like Citi Group, Standard Chartered and HSBC have a substantial presence in the country, but over the past decade, competition has been

far more intense with public sector and private sector banks in India. However, the turmoil faced by the overseas parents of these foreign banks in Europe or the US also had an impact on the India growth plan. Quite a few foreign banks including Deutsche Bank, Barclays and Royal Bank of Scotland are selling their retail portfolios or exiting the business. Recently, HSBC called off its proposed acquisition of the India's retail and commercial banking operations of Royal Bank of Scotland as part of a cost-cutting drive globally. Further, RBI's restrictive policy on opening new branches is a challenging time for foreign banks in India.

Weak Governance and Audit Compliance Issues: The violation of anti-money laundering case and scams by a couple of established foreign banks in the past raise questions on transparency and credibility of its governance. For instance, Citi Bank is wealth management scam of Rs. 300 crores and HSBC, paying a penalty of $ 1.9 billion in US for violating anti-money laundering case are two grave scams in the foreign banking history. This may be further challenges to prove their transparency and robust governance.

Implementation of Basel III: The Basel-I Committee has decided to introduce a capital measurement system in 1988. Since 1988, this framework has been progressively introduced not only in member countries but also in virtually all other countries with the active support of international banks. Basel-II accord was introduced with the aim of correcting most of the deficiencies in Basel-I. The first version of Basel-II came out in 1999, followed by two other versions on 2001 and 2003. A revised framework was issued by the Basel Committee on banking supervision in June 2004. This goal is accomplished through the introduction of "three pillars". The first pillar represents a significant strengthening of the minimum requirements set out in the 1988 accord, while the second and third pillars represent innovative additions to capital. But the challenges to implementing Basel-II norms in India because of issues of cross-border capital will particularly affect foreign banks (current foreign banks are statutorily required to maintain local capital). In the first week of March 2005, the RBI announced detailed draft guidelines on how banks have to implement the new rules which determine how much capital banks have to set aside as a cushion against default on loans. Further, Basel-III aims to plug the gaps in the existing Basel-II guidelines. The new norms were made effective in a phased manner from January 1, 2013 and will be implemented fully from March 31, 2018. Thus, the delay in implementation of Basel-III can be looked upon as a deterrent in the functioning of the foreign banks.

Conclusion

It is a common belief that entry of any competitor in the given business space poses some challenges to the existing players in the field. The major challenges posed by new banks to the existing bankers will be on two fronts: (i) Business share (ii) Human Resources. Foreign banks in India are focussed on corporate fee-based business, more customer-centric approach, adoption of new technology, new innovative and customized products and services. All this create new opportunities and pose a challenge to the existing players. The foreign banks have a number of opportunities in the LPG era. These opportunities are concerned directly or indirectly with the overall profitability of the banking industry. There is a huge demographic landscape for better earnings. SME growth is expected to better credit and FDI inputs with technology upgradation, better distribution and integration with global supply chain, internationalization of Indian business, etc. Foreign banks will then be well-placed to bridge this gap between trade flows and introducing new product-centric approach. As per new branch licensing policy, foreign banks have a noticeable presence in rural and semi-urban areas in India. Further, foreign banks help enhance financial intermediation and reduce the cost of financial services. In a nutshell, foreign banks need to be active players in the game for potential acquisition opportunities. They need to sustain and maintain a long term value creation mindset. Apart from these opportunities foreign banks are concentrating in highly specialized and profitable areas of business. Foreign banks mostly operate in metropolitan centers and target exclusive groups of customers including the multinational corporations (MNCs), large Indian companies, non-resident Indians (NRIs), professionals, etc.

References

- "Reforms in the Right Direction", Capital Market, Vol. XX/02, March 28-April 10, 2005, pp. 19-20.
- Kumar, Shinjini (2012) "Foreign Banks face Bharat Challenges", Business Line, New Delhi, June 29, 2012, p. 19.
- Adhikari, Anand (2011) "Foreign Banks: Not Impressed", Business Today, Vol. 20, No. 7, March 21-April 3, 2011, pp. 44-47.
- Diwanji, Abizer (2010) "Indian Banking Sector 2010: Opportunities and Challenges", Chartered Financial Analyst, February, pp. 55-57.
- Ghosh, Somak (2008) "Next Big things for Indian Banks", Chartered Financial Analyst, Indian Banking: 2007-08, Vol. XIV, Issue 10, October, pp. 85-87.
- Singh, Kavaljit (2013), "Should India Ease Entry Rules for Foreign Banks?" Mainstream, Vol. LI, No. 47, November 9.
- Neither too big nor too small", The Economic Times, Bhubaneswar, 22nd November 2014, p. 8.
- Mishra, Prachi (2013) "Big Change for Foreign Banks?" The Economic Times, 31st December 2013, p. 14.
- "Creating a Competitive Banking Industry", Mint, New Delhi Edition, Vol. 8, No. 84, April 9, 2014, p. 22.
- Bharathi, Y Bala and De, Sanjoy (2009) "Entry of Foreign Banks: Shelved for Now", Chartered Financial Analyst, Vol. XIV, Issue 6, pp. 39-43.

- Diwanji, Abizer (2010) "Indian Banking Sector 2010: Opportunities and Challenges", Chartered Financial Analyst, February 2010, pp. 55-57.
- "A Prerequisite to Survival", Chartered Financial Analyst, Vol. XV, Issue 2, February 2009, pp. 72-76.
- Madhavan, N. (2012) "Fresh off the Boat", Business Today, December 9, 2012, pp. 86-88.
- Parera, R. and Gridhar, A. (2006) "Open Markets 2009 Opportunities and Challenges", Business Today, Vol. 15, No. 4, February 26, pp. 68-76.
- Report on Trend and Progress of Banking in India (2010-11), RBI, Mumbai, p. 6.
- Khedekar, S. (2010) "New Bank Licenses: Opening Attraction", Capital Market, Vol. XXV/14, September 6-19, 2010, pp. 17-21.
- Bhoir, Anita (2012) "Growth is still Foreign to these MNC Banks here", The Economic Times, New Delhi, 12th December 2012, p. 15.
- Ram Mohan, T.T. (2011) "Foreign Banks: RBI gets the Balance Right", Economic and Political Weekly, Vol. XLVI, No. 5, April 9, 2011, pp. 10-12.
- "Banking in Consolidation", Business Line, New Delhi Edition, Vol. 18, No. 55, 25th February 2011, p. 10.
- Raja, M. and Sudharhar, J. Clement (2009) "Implementation of Basel-II Accord in India", Journal of Commerce and Trade, Vol. 4, No. 2, October 2009, pp. 25-30.
- "Basel-III & Indian Banks", The Economic Times, New Delhi Edition, 4th May 2012, p. 6.