INDIA

BANKING

SUMMARY

The State Bank of India (SBI), India's largest bank, and the other major public sector banks dominate the financial sector, but the government has allowed for the controlled entry of private sector and foreign competitors in banking and most other financial services. The public sector banks account for about 80 percent of India's banking activities. In a further move toward reform of the banking sector, government ownership in several public sector banks, including SBI, has been diluted. However, the Reserve Bank of India (RBI) still retains a majority shareholding in SBI of approximately 60 percent. In 1993, the government began to issue licenses for a limited number of private sector banks. There are currently 10 private Indian banks in operation, although these banks are still very small compared to the public sector banks.

The RBI is India's central banking institution and has sole authority for money supply management as well as administration of exchange controls and banking regulations. As the supervisory body for banking operations in India, it is also responsible for granting licenses for new banks and bank branches.

Interest rates have been largely freed from government control and banks are generally allowed to determine interest rates on domestic term deposits and lending rates independently. Cash reserve requirements for banks have been lowered progressively in recent years and now stand at 11 percent. The money market rates have been completely freed. Regulations governing loan syndication and credit for working capital purposes have been eliminated, allowing development financial institutions (FIs) and scheduled commercial banks to compete for both term and working capital loans. However, the RBI still requires that 40 percent of lending by locally-incorporated banks be directed to priority sectors of the economy.

Foreign banks face significant restrictions on entry and expansion. Foreign banks cannot establish bank subsidiaries. In addition, the number of foreign bank branches continues to be connected to the size and presence of Indian banks in the applicant's home country. The Narasimham Committee recommends that foreign banks should operate as bank subsidiaries rather than as branches, and that those foreign banks operating as branches should be encouraged to convert to bank subsidiaries. The report also recommends that foreign bank subsidiaries should have higher minimal capital requirements than locally incorporated banks.

India has introduced capital requirements based to some extent on the Basle Accord. However, branches of foreign banks must meet the capital requirements on the basis of locally held capital; parent capital is not taken into account. Additionally, legal lending limits are based on the locally held capital of the branch, in effect eliminating an important reason for establishing in branch form.

Foreign banks pay a basic corporate tax rate of 48 percent, compared to the 35 percent rate applied to local bank profits. In some respects, U.S. and other foreign banks receive better than national treatment, notably in lower directed lending requirements (32 percent for foreign banks) at concessional interest rates to priority sectors – small businesses, exporters, and the agricultural sector.

There are currently 42 foreign banks with 186 branches in India. Foreign banks control only 8 percent of total banking assets in India, of which U.S. banks hold nearly 35 percent.

DESCRIPTION OF THE MARKET

Structure of the Market

India's banking sector is dominated by the public sector banks, which accounted for approximately 82 percent of deposits and 79 percent of loans in the banking sector as of March 31, 1998. India's 27 public sector banks were all nationalized prior to 1980. One of the goals of Indian policy following the nationalization was the extension of financial services throughout the country, particularly to rural areas where branches might not be justified on a purely commercial basis. As a result, the number of public sector bank branches grew dramatically from 7,015 in 1969 (when 14 private banks were nationalized) to 56,998 by June 30, 1993 and 64,309 on September 30, 1998. Table I provides data on deposits and loans (in billions of rupees) for the locally incorporated public sector banks, locally-incorporated private sector banks, and foreign banks.

Table I – Broad Structure of the Industry
(in billions of rupees)

	Deposits		Loans	
Banks	March 31, 1997	March 31, 1998	March 31, 1997	March 31, 1998
Public Sector	4,493.29	5,046.82	2,202.51	2,595.12
State Bank of India (SBI)	*1,107.01*	*1,235.48*	*622.33*	*704.71*
SBI Associate Banks	*371.91*	*425.36*	*206.68*	*256.12*
Other Public Sector Banks	*3,014.37*	*3,385.96*	*1,373.49*	*1,634.28*
Foreign Banks	373.94	433.78	239.19	309.65
Private Banks	507.92	693.34	285.01	365.20
TOTAL	5,375.15	6,173.93	2,726.71	3,269.98

Source: RBI

The government's ownership share in public sector banks is being reduced slowly. In part due to pressure of funding requirements needed for the public sector banks to comply with India's new capital standards and to cover problem loans, the government has allowed the public sector banks to approach the capital market to sell equity to the public. The first public sector bank to take this step was India's largest bank, the State Bank of India, in which RBI ownership has been reduced to 60 percent. The Narasimham Committee has recommended that the government (RBI) holding in the SBI and other nationalized banks be reduced to 33 percent, a policy that would require amendment of the Banking, Nationalization and SBI Acts.

An important part of the liberalization process has been the government's policy of licensing new private banks and allowing additional branches of foreign banks to be established. The RBI granted "in principle" approval for 13 new private locally incorporated banks in March 1994. Two approvals were subsequently withdrawn in light of adverse circumstances. Thus far, 10 private locally incorporated banks have been granted licenses and started operations. Unit Trust of India Bank was the first of the group to begin operations in April 1994. New banks must provide paid-in capital of Rs1 billion (US$25 million), foreign banks and firms can hold up to 20 percent equity, and nonresident Indians can hold up to 40 percent of the equity in the new private banks. Multilateral institutions such as the International Finance Corporation and the Asian Development Bank can partake to the extent of the shortfall in nonresident Indian contributions. The introduction of these private banks has enhanced competition in the banking sector, especially since the new private and foreign banks have higher productivity levels based on newer technology and lower staffing levels. The private banks have generally reported higher levels of profitability than the public sector banks, due to advantages in lower overall staff costs, higher administrative efficiency and better managed asset portfolios. Although these changes represent a significant shift in government policy, the banking sector is still dominated by the public sector banks. Private banks accounted for only 11 percent of loans in the banking sector and 9 percent of deposits.

As of March 31, 1997, there were 42 foreign banks in India with 186 branches, most of which are located in metropolitan centers. These banks accounted for 9 percent of total banking sector loans and 7 percent of deposits. Since January 1992, 19 new foreign banks with a total of 47 branches have been allowed to enter the Indian market. Between April-May 1998, three more banks were permitted entry. The foreign banks are primarily involved in financing trade and extending loans to large business groups, and have a small exposure in the priority sector. Most foreign banks in the country have diversified their operations by opening merchant banking divisions, retail banking, mobilizing special deposits by nonresident Indians, security operations, and management consultant services. In addition, there were 28 representative offices of foreign banks in India as of March 1997. Foreign banks enjoy a positive reputation for customer satisfaction and innovation in the Indian market, and they continue to increase their business despite limitations on the number of branches they are allowed. They have higher productivity levels based on newer technology and

lower levels of manning. The net profit ratio for foreign banks was 1.4 percent as of March 31, 1997, far above the industry average.

Indian banks still hold large amounts of nonperforming loans, in large part due to directed lending by the government to priority sectors. Nonperforming loans represented about 17.5 percent of outstanding loans in the banking system as of March 31, 1997 (US$10.2 billion) as compared with 21.9 percent as of March 31, 1994. Banks have made provisions for roughly half of that figure. Rapid asset growth may mask the banking sector's asset quality problems. Commercial banks extended loans of Rs 330 billion (US$8 billion) for the fiscal year ended March 31, 1998, up sharply from Rs 175.48 billion (US$4.4 billion) the previous year. The government established special tribunals for speedy loan recovery in late 1993 and is pressing nationalized banks to recover bad debts. However, these tribunals have yielded disappointing results and policy makers are looking for other ways of addressing the problem of debt recovery. In the recent budget the government announced measures to strengthen the debt recovery tribunals and selectively encourage banks with high nonperforming assets (NPAs) to establish Asset Reconstruction Companies to facilitate better recovery of dues.

Regulatory Structure

The RBI is India's central banking institution and has sole authority for money supply management as well as administration of exchange controls and banking regulations. As the supervisory body for banking operations in India, it is also responsible for granting licenses for new banks and bank branches.

In April 1992, the RBI followed the Basle Group's recommendations in prescribing new risk weighted capital requirements. Indian banks had to reach a minimum ratio of risk weighted assets of 8 percent by March 1994 and those with an international presence were required to do so by March 1995. Foreign banks operating in India were required to meet the minimum capital ratio requirement by March 1993. The budget for the fiscal year ended March 31, 1998, proposes to raise the minimum capital adequacy ratio requirement for banks from the present 8 percent to 9 percent by March 31, 2000, and to 10 percent by 2002.

The Narasimham Committee on Indian banking sector reforms, set up in December 1997 to make recommendations for the second phase of financial sector reforms, presented its report to the Minister of Finance in April 1998. This report follows a 1991 report issued by the first Narasimham Committee, which made many similar recommendations. The latest report makes a case for strengthening India's banking system, particularly in view of plans to move toward capital account convertibility. Some of the major recommendations include:

- The merger of some strong public sector banks and the closure of some weak ones to comply with the greater integration of global financial systems.

- Separation of the regulatory and supervisory functions from the other responsibilities of the RBI. As the formulator and implementing agency of monetary policy, the RBI should not also be the owner of a bank due to possible conflicts of interest. The government should consider granting autonomous status to the Board for Financial Supervision, now part of the RBI.

- Reduction of the average level of net NPAs for all banks to below 5 percent by the year 2000 and to 3 percent by 2002. For those banks with an international presence the minimum objective should be to reduce gross NPAs to 5 percent and 3 percent by 2000 and 2002, respectively and net NPAs to 3 percent and 0 percent by these dates. Asset reconstruction funds should be established to tackle the problem of NPAs.

- An increase in the capital base of banks and a review of their capital adequacy ratios to improve the inherent strength of banks and their capacity to absorb risk. The minimum capital to risk-weighted assets ratio should be raised to 10 percent from the present level of 8 percent.

- Realignment of the roles of commercial banks and development financial institutions in India in favor of the concept of universal banking.

- Removal of the appointment of bank chairmen and board members from the realm of politics to encourage professionalism in bank management.

- Greater managerial autonomy for public sector banks and reduction in government ownership form the current 51 percent. The size of the work force at public sector banks should also be reduced to make them more efficient and competitive.

The Reserve Bank (RBI) has engaged in phased deregulation of interest rates over the past several years. All deposit rates have been deregulated except for savings deposits and FCNR(B) deposits. Rates for term deposits above 30 days have been deregulated and the maximum deposit rate for periods up to 30 days is linked to the "Bank Rate" established by the RBI. With regard to lending rates, banks are free to determine interest rates for loans above Rs 200,000. In the past two years, there has also been a significant reduction in the cash reserve ratio (CRR) and statutory liquidity ratio (SLR) requirements imposed by the RBI. The Cash reserve has been progressively reduced from 14 percent for the fiscal year-ended March 31, 1997, to 12 percent for the fiscal year-ended March 31, 1998, and is presently at 11 percent. Requirements of Statutory Liquidity Ratio (SLR) have been rationalized and banks must now maintain SLR at a reduced minimum of 25 percent of their entire net demand and time liabilities, compared to the 35 percent requirement for the fiscal year ended March 31, 1997.

The Indian banking sector has taken some important steps in recent years in upgrading service information technology, including the launch of an Internet banking service by Industrial Credit and Investment Corporation of India Bank. The Magnetic Ink Character Recognition (MICR) Check Processing Center, already in existence in the four metro areas (New Delhi, Mumbai, Chennai and Calcutta), has been extended to nine additional cities. Furthermore, the RBI has taken steps to set up a Very Small Aperture Terminal Network to provide reliable communication throughout the financial sector. The RBI is also encouraging greater use of the RBINet/BANKNET, a network to which all public sector banks, foreign banks and domestic private sector banks are connected. To provide extended working hours to the customers, many banks are establishing Shared Payment Network Systems (SPNS) and installing of Automated Teller Machines (ATMs) and Cash Dispensers. Other facilities that have been introduced are Electronic Funds Transfer Systems and Electronic Clearing Services for repetitive or low value transactions. Many foreign and domestic private sector banks are providing telebanking services and have become members of the Society for Worldwide Interbank Financial Telecommunications. In spite of these improvements, however, India's banking sector continues to lag behind its counterparts in Western countries and in many of its Asian neighbors in the use of technology.

U.S. PRESENCE IN THE MARKET

Citibank, Bank of America, American Express Bank, and Chase Manhattan Bank operate 17 branches in India and account for only 3 percent of total banking sector assets. The assets of these branches totaled US$4.5 billion on March 31, 1997, compared to US$3.5 billion in 1993. Morgan Guarantee Trust is in the process of opening a branch. Nations Bank is in the process of merging with Bank of America and is not seeking a branch. U.S. banks are leaders in consumer banking, retail services, custodial services, factoring, and other sophisticated banking services, and are among the most profitable banks in India. Bank of New York, Bankers Trust, Union Bank of California, Bank of Boston, and First Union National Bank have one representative office each.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Foreign banks can currently operate as branches in India, but cannot establish in bank subsidiary form. However, the Narasimham Committee recommends that foreign banks should operate as bank subsidiaries and not as branches, and that those foreign banks operating as branches should be encouraged to convert to bank subsidiaries. The report also recommends that foreign bank subsidiaries should have higher minimal capital requirements than locally incorporated banks.

The entry of foreign banks is based on economic, political, and bilateral relations with the applicant bank's home country. It is not strictly on a reciprocal basis, though it is roughly comparable to the presence of Indian banks in the applicant's home country. An inter-agency committee approves

applications for entry and expansion. Because Indian banks have not been major international players (98 overseas branches, 14 representative offices, 7 joint ventures, and 11 subsidiaries), not very many new foreign banks have been able to enter the Indian market since 1948. Liberalized policies since 1991 have opened the door for a number of additional foreign banks. The RBI fixes the number of branches both for new banks and existing banks taking into account WTO commitments and other factors. The RBI generally does not allow foreign banks to have both representative and branch offices at the same center.

Once approved for entry, foreign banks must capitalize their first two branches at US$10 million each; an additional US$5 million is required for a third branch. Subsequent branches do not require additional capital. The Narasimham Committee has recommended that the minimum start-up capital requirements for foreign branches must be higher than for Indian banks, and should be raised from US$10 million to US$25 million as a lump sum.

The RBI fixes the number of authorized branches upon granting an entry license, taking into account reciprocity and other factors, and does not usually allow foreign banks to have both representative and branch offices. The restriction on the number of branches applies only to foreign banks.

Foreign banks and firms can hold up to 20 percent equity in a private, locally incorporated bank, and nonresident Indians can hold up to 40 percent. Foreign banks and finance companies that do not have a presence in India are also permitted to invest up to 20 percent as a technical collaborator (within the overall 40 percent ceiling) in new private sector banks, subject to government approval. Joint ventures between foreign and domestic banks and nonbanking services are allowed in accordance with the foreign investment policy.

The RBI considers the capital base of a foreign bank as foreign funds deployed in India, including foreign currency loans extended to the branch by the parent, initial capital, and any subsequent increases in capitalization. Net funds deployed are required to be no less than 3.5 percent of aggregate liabilities, and no more than 25 percent of the capital base can be lent to any one borrower. The local capital of the foreign branch instead of the consolidated capital of the parent bank is used to compute the branch's minimum capital adequacy ratio requirement and legal lending limit.

India's 1997-98 budget reduced the basic tax rate from 43 percent to 35 percent for Indian banks and from 55 percent to 48 percent for foreign banks.

In some respects, foreign banks have advantages compared with locally incorporated banks. For instance, they are not required to open branches in rural areas, or to make loans to the agricultural sector. Locally incorporated Indian banks are required to extend 40 percent of their loans at concessional rates to the "priority sector, " consisting largely of the agricultural sector, exporters, and small businesses. Foreign banks are subject to slightly less rigorous requirements. Since July 1993, foreign banks have been required to extend 32 percent of their loans to the priority sector. Within

the target of 32 percent, two sub-targets for loans to the small scale sector (minimum of 10 percent) and exports (minimum of 12 percent) have been fixed. However, they are exempt from compulsory loans to the agricultural sector. Shortfalls in meeting the target can be balanced by depositing funds with the NABARD/Small Industries Development Bank of India (SIDBI).

Under the WTO Financial Services Agreement, the government has committed to licensing at least 12 new foreign bank branches per year (up from the present commitment of 8 per year).

The current levels of openness in the banking sector are not bound under GATS and actual practice is more liberal than Indian commitments. Continued reforms are expected that are likely to go further beyond India's commitments. One issue of national treatment is taxation, where foreign banks pay higher taxes than domestic banks, though this is balanced somewhat by the fact that foreign banks have lower levels of required lending to priority sectors. The other major issue is that foreign banks face a more restrictive policy on branching than do domestic banks.