CAU Asia Focus

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INDIAN BANKING REFORMS: A CHANGING LANDSCAPE FOR STATE-OWNED AND FOREIGN BANKS

In the past few months, the Indian government announced a series of banking reforms that were designed to give state-controlled banks greater autonomy and to provide guidelines for foreign bank expansion. To the disappointment of many analysts, the measures did not materially change how foreign banks can operate. Significant restrictions on foreign banks remain and the Reserve Bank of India (RBI) retains wide discretionary power over the timing and implementation of reforms.

STATE-OWNED BANK REFORMS

The primary beneficiaries of the announced reforms are the state-owned banks, which control over three-quarters of total assets in the financial system. In late February, the central government gave state-run banks significantly greater operational and managerial freedom, including the rights to: establish overseas branches or subsidiaries; exit non-profitable ventures; set human resource policies; and acquire domestic and foreign banks.

These measures were intended to level the playing field for state-controlled banks to compete with private banks by increasing their efficiency and helping them to expand into new business lines and geographies. The Ministry of Finance expects that these measures will move the financial system towards “competition, consolidation and convergence” and eventually create Indian banks that are truly global players.

In addition, as part of the 2004-05 budget unveiled on February 28, 2005 by Finance Minister Palaniappan Chidambaram, banks will be permitted to issue preferred shares, thereby allowing state-owned banks to raise capital without diluting the government’s minimum 51 percent stake. The Finance Minister also announced the removal of the limits on banks’ statutory liquidity and cash reserve ratio requirements, and in doing so, gave the central bank greater flexibility to set the limits.

ROADMAP TO FOREIGN BANK INVESTMENT

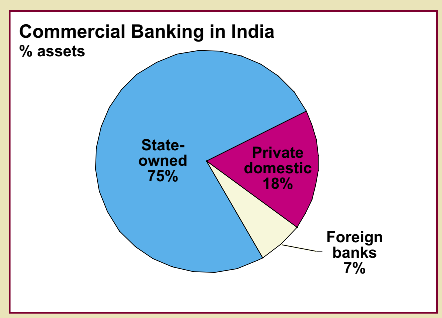
The two phase roadmap for foreign bank investment, unveiled by the RBI in tandem with the budget, does not offer material changes to how foreign banks can operate in the near future. In the first phase, between March 2005 and 2009, foreign banks will be allowed to establish a wholly-owned subsidiary or to convert existing operations into a subsidiary. In addition, the RBI raised the limit of foreign direct investment in private banks to 74 percent from 49 percent and plans to amend the Banking Regulation Act to allow for the voting rights of foreign banks to reflect their ownership level, eliminating the current 10 percent cap.

On the surface, the central bank appears to have taken important steps in opening the sector to foreign banks. However, the restrictions around these measures are significant and the RBI maintains considerable discretionary powers to direct the extent

BACKGROUND

Total banking sector assets in India as of March 18, 2005 were INR 20,830 billion ($478 billion), representing less than six percent of total U.S. banking assets. The Indian banking system continues to be dominated by government banks, with public sector banks accounting for three-quarters of total commercial banking assets. The banking system, however, is fragmented; with the exception of the State Bank of India, no one bank holds more than ten percent of total system assets. As a point of reference, the combined assets of India’s five largest banks are less than the assets of the largest Chinese bank.

The financial condition of the Indian banking system has somewhat improved in recent years. The booming Indian economy and low interest rate environment have allowed banks to increase earnings by expanding lending, widening interest margins and increasing gains from trading government securities. Asset quality has also improved, with nonperforming loan (NPL) levels of 7.2 percent in FY04, down from 8.8 percent in the prior year, despite tightened loan classification standards (from 180 days to 90 days). However, analysts estimate that the actual NPL ratio could be approximately 3 percentage points higher if restructured loans are taken into account.



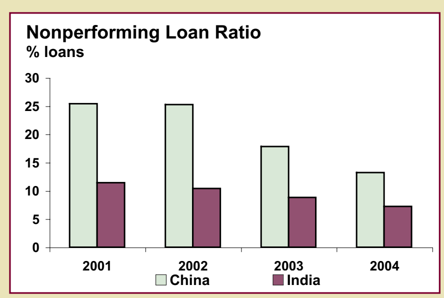


FIGURE 1: REFORM TIMETABLE

ANNOUNCED REFORMS	PRIOR TO MARCH 2005	2005-2009	2009 THEREAFTER
Structure of foreign bank presence in India	Branches Only	Branches or wholly-owned subsidiaries	Full national treatment, including IPO, subject to 26% of paid-in capital being held resident Indians
Aggregate foreign direct investment limit in private banks	49%	74% for banks identified as distressed by RBI	74%
Foreign voting rights limit	10%	Proposed amendment to allow voting rights to reflect ownership level	
Branching limit per year	12	> 12 subject to RBI approval	
UNCHANGED			
Five percent foreign investment limit in private banks by individual foreign banks			
Ten percent foreign investment limit in private banks by foreign institutional investors or individual corporate entities.			

and timing of reforms. Before 2009, foreign banks will only be allowed to acquire up to 74 percent ownership of *distressed* private banks identified by the RBI for restructuring, and only "in a phased manner." In addition, wholly-owned foreign subsidiaries must have a minimum capitalization of approximately $70 million and their ability to open branches will be subject to the same rules as those that apply to existing branches of foreign banks. However, with the permission of the RBI, foreign banks now will be able to expand beyond the current 12 branch per year limit.

After March 2009, foreign banks *may* be allowed to acquire any private bank, depending on a review of the outcome of the first phase. At that point, wholly-owned subsidiaries will be allowed to list or dilute their stake to 74 percent through an IPO or offer for sale.

These measures also leave the RBI with considerable discretionary powers to approve or reject foreign holdings. For private banks which are not identified by the RBI as distressed, the RBI must approve any acquisition by a foreign bank of 5 percent or more, "taking into account the standing and reputation of the foreign bank and the desired level and nature of the presence of the foreign bank." As a result, those foreign banks which currently own more than 5 percent of an Indian bank will either have to seek RBI approval or scale back their investment to the 5 percent limit.

While foreign bankers expressed disappointment that the reforms did not go far enough, the roadmap removes a measure of uncertainty from the market. This development, combined with the growth of the Indian consumer and corporate credit market, are expected to attract more foreign players. Thirty-three foreign banks currently operate in India, but account for a mere 6.9 percent of total assets. Only three U.S. banks have banking operations in India: Citigroup, Bank of America and JP Morgan Chase. Since the government announced reforms, however, global consumer finance giant, General Electric (GE), declared its intention to enter the retail banking business in India. UBS, the world's largest private bank, has applied for a banking license and there is speculation that large international securities firms such as Merrill Lynch, Goldman Sachs and Lehman Brothers may enter the private banking market.

LARGEST FOREIGN BANKS IN INDIA BY ASSET SIZE (US$millions)

1. Standard Chartered Bank	$7.9
2. Citibank	$6.8
3. HSBC	$5.8
4. ABN Amro	$2.4
5. Deutsche Bank	$2.0

Source: Reserve Bank of India as of 03/31/04

CONCLUSION

The announced reforms are expected to increase efficiencies by loosening restrictions on state-owned banks and reduce uncertainty by providing a roadmap for increased foreign bank participation. However, while the reforms are steps in the right direction, little has in fact changed for foreign banks, which continue to be hampered in their ability to become full market participants. Although the roadmap holds the promise of full national treatment for foreign banks four years from now, it remains to be seen if political and economic considerations allow these promises to be realized.

— Susan Chan
Financial Analyst

Questions or comments may be directed to the Country Analysis Unit, (415) 974-3353.