FOREIGN INVESTMENT IN BANKING IN INDIA

DISSERTATION SUBMITTED IN PARTIAL FULFILMENT FOR THE AWARD OF

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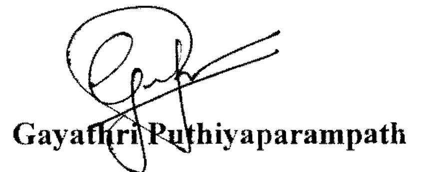
DECLARATION

I declare that this dissertation titled "**Foreign Investment in Banking in India**", which is submitted in partial fulfilment of the Degree of Master of Laws, is the outcome of my research carried on under the guidance of Prof. (Dr.) N.L. Mitra. The extent of information collected from existing literature has been indicated and fully acknowledged at the appropriate places by footnoting. I further declare that this dissertation, wholly or in part, has not been submitted to this or any other University for the award of any Degree.



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CERTIFICATE

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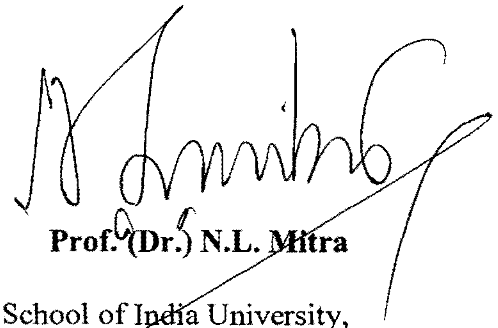
This dissertation or any part thereof has not been submitted here or elsewhere for the award of any other degree.



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LIST OF ABBREVIATIONS

AD – Authorized Dealer

ADR- American Depository Receipt

CCI- Controller of Capital Issues

CFSA – Committee on Financial Sector Assessment

CRAR – Capital to Risk – Weighted Asset Ratio

DCA- Department of Company Affairs

FCNR- Foreign Currency Non- Resident

FDI-Foreign Direct Investment

FEMA- Foreign Exchange Management Act

FERA- Foreign Exchange Regulation Act

FII –Foreign Institutional Investor

FIPB- Foreign Investment Promotion Board

GATS- General Agreement on Trade in Services

GDR – Global Depository Receipt

HO – Head Office

IMF- International Monetary Fund

IPO- Initial Public Offering

IRDA- Insurance Regulatory and Development Authority

JV – Joint Venture

MCI- Ministry of Company Affairs

NBFC – Non-Banking Financial Company

NRE – Non Resident (External)

NRI- Non-Resident Indian

PIO-Person of Indian Origin

RBI- Reserve Bank of India

SBI- State Bank of India

SIA- Secretariat of Industrial Affairs

US- United States

WOS – Wholly Owned Subsidiary

WTO- World Trade Organization

"Banks remain special in terms of the particular functions they perform - as the repository of the economy's immediately available liquidity, as the core payments mechanism, and as the principal source of non-market finance to a large part of the economy. And they remain special in terms of the particular characteristics of their balance sheets, which are necessary to perform those functions – including the mismatch between their assets and liabilities which makes banks peculiarly vulnerable to systemic risk in the traditional sense of that term"

-Sir Eddie George, Former Governor, Bank of England

RESEARCH METHODOLOGY

SCOPE OF THE RESEARCH

The topic for research is "**Foreign Investment in Banking in India**". In this the researcher proposes to analyse the concept of foreign investment in banking in India. The researcher proposes to analyse international commitments of India in relation to foreign investment in banking, the legal and regulatory framework in relation to foreign investment in banking and the requirement and demerits of foreign investment in banking.

HYPOTHESES

- India has a liberal legal and regulatory regime on foreign participation in its banking sector;
- Status quo has to be maintained in foreign investment in banking considering the financial crisis that is still affecting the global economy.

RESEARCH QUESTIONS

- What is foreign investment?
- What is the background of foreign investment in banking in India?
- What are the Indian commitments on banking under the GATS?
- What are the statutory provisions affecting a bank with foreign investment and a foreign bank in India?
- What are the channels through which and modes in which foreign investment and participation can be made in Indian banking sector?
- What are the important legal. regulatory and tax aspects that are to be considered by a proposed foreign investor in banking and a foreign

bank in India and is there any differentiation in treatment as compared to domestic banks?

- What is the need and demerits of foreign investment in banking in India?

RESEARCH METHODOLOGY

The researcher has adopted a descriptive and analytical method of research.

RESEARCH DESIGN

In the course of the research the researcher has relied on primary sources of data like the Policy Statements, Notifications, Circulars and Reports from the RBI, DIPP etc. as well as secondary sources of data including books, journals and web sources.

CHAPTERIZATION

The paper is divided into seven chapters. The first chapter deals with the concept of foreign investment and the evolution of the policy on foreign investment in the Indian banking sector. The second chapter summarizes the commitments of India under the GATS and the Revised Offer of 2005 in relation to banking under the GATS. The third chapter focuses on the statutory provisions that are relevant in relation to foreign investment in both public as well as private sector banks, as also foreign banks. The third chapter deals with the regulatory framework in relation to foreign investment in banking, cap on foreign investment in banking, modes of foreign participation in Indian banking, including that by foreign banks and the current position on the presence of foreign banks in India. The fifth chapter deals with important requirements that are to be considered by a foreign investor as well as a foreign banker for participating in Indian banking. The sixth chapter analyses

the pros and cons of foreign investment in banking. The seventh chapter is the suggestions as well as summarization of the treatment of banks with foreign investment and foreign banks in India.

LIMITATIONS

The research would be restricted to the legal and regulatory framework on foreign investment in banking in India. The researcher has not ventured into a detailed comparison of the position in India with other jurisdictions though there are a few such incidental references.

METHOD OF CITATION

A uniform method of citation would be followed throughout the project.

CHAPTER I

INTRODUCTION

The life-blood of every economy is circulating through the banking sector of that economy, especially in countries like India where strong reliance is placed on bank-based financing rather than market-based financing. Without an efficient and transparent banking system the economy will suffer. Banking sector performs three primary functions in an economy: the operation of the payment system, the mobilization of savings and the allocation of savings to investment projects.[1] Apart from this, banks also have the role of transforming various risks. Failure of even one of the constituents of the financial sector of an economy can lead to panic and several serious problems. A slight carelessness with respect to the regulation and various requirements in banking can lead to great financial crisis, as had happened in the case of Asian financial crisis of 1997-1999 or the Argentine crisis (1992-2002). or the sub-prime mortgage crisis in the US banking sector which spread to the economies of the whole world. Apart from that the domestic banks have to attain certain minimum levels which make them capable of facing the tough competition introduced in the markets by foreign participation, before the opening up of the banking sector to foreign participation. This involves reforms in capital adequacy, interest rates, use of technology, risk management practices etc. Banks are considered to be special. Liberalization and introduction or enhancement of the limits of foreign capital in banking is not a task which can be accomplished suddenly. But it requires phases of reforms in the domestic

[1] Roland Christian, Banking Sector Liberalization in India – Evaluation of Reforms and Comparative Perspectives on China, Physica Verlag-A Springer Company, http://books.google.co.in, accessed on 16.04.09

banking sector. This explains the reluctance on the part of several countries to completely open up their financial sector which includes banking.

1.1 MEANING OF FOREIGN INVESTMENT

Foreign investment in banking is thus a very delicate issue that can have long term implications on the whole economy. Foreign investment involves the transfer of tangible or intangible assets from one country into another for the purpose of their use in that country to generate wealth under the total or partial control of the owner of the assets.[2] Foreign investment can take various forms, the major types being, Foreign Direct Investment (FDI) and Portfolio Investment.

Foreign Direct Investment is investment that is made to acquire a lasting interest in an enterprise operating in an economy other than that of an investor, the investor's purpose being to have an effective choice in the management of the enterprise.[3] Portfolio investment is passive investment for the sole purpose of deriving income, as opposed to participating in the management of the investee firm under a direct investment.[4] In India, Foreign Institutional Investors (FIIs), Non-Resident Indians (NRIs) and Persons of Indian Origin (PIOs) are allowed to invest in the primary and secondary capital markets in India through the portfolio investment scheme. Under this scheme, FIIs/NRIs can acquire shares/debentures of Indian companies through the stock exchanges in India.[5]

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[2] Sornarajah M., The International Law on Foreign Investment, Cambridge University Press, UK, 2nd Edition (2004), p. 8

[3] IMF Balance of Payment Manual (1980), para. 408

[4] http://www.businessdictionary.com/definition/portfolio-investment.html, accessed on 17.04.09

[5] http://www.rbi.org.in/advt/FIINRI.html, accessed on 17.04.09

1.2 EVOLUTION OF INDIAN POLICY ON FOREIGN INVESTMENT IN BANKING

Though, the approach of India in the pre-liberalization era was also not much liberal, foreign banks are not nascent to the Indian soil. Many of the big foreign banks had come to India in some form or the other as far back as a century and a half ago. But it was only in 2005 that the Reserve Bank of India (RBI) drew the first clear roadmap on how they could operate here.[6] Though not in the form of foreign investment, foreign participation was there in Indian banking, through the opening of offices of foreign banks. Banking sector in India has also gone through several phases of development since independence depending on the economic policy adopted at different phases.

Pre-independence Era: The modern commercial banking system has its origin in India in the period prior to independence, with the establishment of British owned foreign banks in India.[7] This was followed by the establishment of foreign banks in India by other countries like France, Germany, Japan, Holland and US.[8] However, as observed by the Indian Central Banking Enquiry Committee Report of 1931, foreign banks were predominantly engaged in the financing of foreign trade and the entire foreign exchange business was a virtual monopoly of these banks.[9] However, the operations of foreign banks were confined to select major cities. The operations and the deposits of these foreign banks were progressing well until it was adversely hit by the global depression of the late 1920s, which was followed by the

[6] Rosen Rana and Roy Saumya, 'Foreign Banks await RBI's green signal to branch out', http://www.livemint.com/2007/06/29003816/Foreign-banks-await-RBI8217.html, accessed on 29.04.09

[7] Karunagaran A., Foreign Banks in Historical Perspective, Economic and Political Weekly. March 18, 2006, p.1087

[8] ibid

[9] ibid

recession, decline in foreign trade and the outbreak of the Second World War. However, even before independence, the relative share of the foreign banks in aggregate deposits of credit became less, in spite of their good performance in terms of deposit and credit.

Post-independence before liberalization: At the wake of independence India had a well developed commercial banking system. The Reserve Bank of India was already in place in 1935 and there were over 600 commercial banks in India at the end of the year 1947.[10]

In this period as such there was no ban on foreign banks operating in India. But they were highly regulated by strict entry norms and licensing requirements. One of the important development which is pertinent to be noted is the enactment of the Banking Companies Act, 1949, which treated both the foreign and domestic banks on an equal footing. Under the Banking Regulation Act, as amended in 1959, RBI was conferred with the power to inspect foreign banks. The RBI also issued directives to foreign banks to maintain a certain portion of the assets and liabilities in India. An important feature in the Indian banking sector in the 1950s and 1960s until the nationalization of banks was the progressive expansion of healthier banks and the large-scale amalgamation/consolidation or liquidation of smaller and unviable banks.[11] The cash balance of the foreign banks at that point of time was very low.

Though apparently the economic atmosphere was open to FDI, there was a latent air of nationalism prevailing at that point of time. As Kidron has put it, the initial period after independence between 1947 and 1957, an uneasy

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[10] Supra note 1
[11] ibid

triangle prevailed among individual businesses, industry associations and the government.[12] Apart from that there was also a belief that the banks established in the pre-independence era were biased against small scale enterprises, agriculture and ordinary citizens.[13] There was demand for a State partnered commercial bank, which demand was materialized in 1955 with the transformation of the Imperial Bank of India into the State Bank of India by way of shifting of ownership of the new bank to the Government of India. This was followed by other reforms as setting up of new subsidiaries to the SBI and other reforms. Still there were several apprehensions that the connection of the commercial banks with commercial and industrial houses made them biased towards the corporates.[14] Though there was an emphasis on industrialization in the Second Five Year Plan and there were consequent efforts on the part of the Government, they subsided with the onslaught of shortage of foreign exchange, deficit in Balance of Payments and devaluation of rupees in the late 1960s. All these culminated in the enactment of the Nationalization Act of 1969. During this period, as the Report of the Banking Commission of 1972 noted: "......... the relative importance of foreign banks in the banking system declined....." [15]

It was during this period[16] that the infamous FERA which strictly regulated the flow of foreign equity into the Indian economy was enacted. In the early 1980s there was the next phase of bank nationalization. With this the share of deposits of public sector banks went up to 92%. However, this does not mean

[12] "Das P. Satya, An Indian Perspective on the WTO Rules on FDI"- Mattoo Aditya, Stern M. Robert, India and the WTO, Co-publication of the World Bank & Oxford University Press (2003), p.
[13] Supra note 1
[14] ibid
[15] Supra note 2
[16] In 1973

that there were no non-nationalized private banks or foreign banks in India at that point of time.

However, in the period after nationalization foreign banks began to gain an edge over the domestic banks in areas like extending of foreign currency loans through loan syndications, investment banking, consultancy related to investment activities, portfolio management, and in general capital market related and derivative market related areas. In retail banking, they were active in services to high net worth customers. They were of great help to the corporates in raising foreign currency resources with the help of their overseas presence. The profitability of the foreign banks remained above the average in the banking system, which is generally attributed to their higher efficiency as compared to the domestic banks.

However in this period the inefficiencies that have crept into the Indian banking system began to be felt and as a consequence in the latter half of the 1980s attempts of deregulation in the banking sector began to be made. All these paved the way for more comprehensive reforms in the banking sector which began from early 1990s.

Post-liberalization era: Liberalization of the banking sector did not occur abruptly. But several necessities paved the way for it as the tackling of shortage of foreign exchange as result of the exodus after the Kuwait war, the balance of payment crisis etc. This move was strengthened by the release of the Report of Narasimham Committee on Financial System of 1991. One of the recommendation of the Committee was the liberalization of the policy with regard to allowing foreign banks to open offices in India. This was followed by a step-by-step deregulation in the Indian banking sector, which

passed through various phases including the permission for the entry of domestic private banks. Thus there has been a change in the operating environment of banks in India after 1991, when there arose an urge for profitability and efficiency in banking. Entry of new private banks was permitted by the Reserve Bank of India in January 1993 and guidelines was issued to effectuate the same. The guidelines allowed the new private banks, with prior approval, to raise capital from foreign institutional investors of up to twenty percent of total capital and to raise capital from non-resident Indians up to forty percent. However, the guidelines also provided that the total capital raised from both the sources had to be less than forty percent of the bank's total capital and the voting rights of a single shareholder was limited to ten percent.[17]

In order to achieve the capital adequacy ratio of six percent by March 1995 and eight percent by March 1996, provision was made through an amendment in the Banking Companies Act, 1970 facilitating nationalized banks to tap the capital market for private equity.[18] As per the amendment Government had to retain ownership of at least fifty one percent. Voting rights of individual shareholder was limited to a maximum of one percent and the foreign ownership in nationalized banks was limited to twenty percent. Foreign banks and financial institutions were allowed only 20 percent ownership stakes in Indian banks.[19]

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[17] Phani B.V., Ghosh Chinmoy, Harding John -The Effect of Liberalization of Foreign Direct Investment (FDI) Limits on Domestic Equity Prices: Evidence from the Indian Banking Sector, August 2004, http://www.isb.edu/caf/docs/PhaniGhoshHarding.pdf, accessed on 12.12.08

[18] ibid

[19] ibid

The reforms and entry deregulation in the banking sector got boost with the dawn of the era of the World Trade Organization in the year 1995. India got itself committed to the General Agreement on Trade in Services in 1995, with respect to the liberalization of its services sector. This helped in relaxing the requirement of shielding the priority sector from equity participation.

From the period between 1995 and 2000, banks were not allowed to raise FDI via the automatic route. But it required the private bank to make special application to the RBI to raise capital from foreign sources. In 1997, the MCI published guidelines indicating the conditions that were generally required for approval of such applications. The guidelines did not make any changes in the permissible quantitative limit on FDI. But it included all private banks. On September 1, 1998, the MCI clarified that foreign financial institutions were considered eligible foreign investors for FDI purposes and could thus invest up to twenty percent of a bank's total capital. The MCI also indicated that higher amounts, up to the overall FDI limit of forty percent, would be considered when there was a shortfall in other sources of FDI such as FDI from NRIs. The automatic route remained closed to banks and any bank that wanted to raise FDI had to go through a case by case review and approval process.[20]

The next remarkable development in foreign entry deregulation in the Indian banking sector was the introduction of foreign investment via automatic route in Indian banking in 2001. This facility was made available to all private sector banks and the quantitative limit on FDI from all sources in private banks was raised to forty nine percent, subject to the guidelines issued by the

[20] ibid

RBI. [21] This cap included both FDI and FII and foreign majority ownership of Indian banks was not permitted. This cap of 49% FDI under "automatic route" in respect of public sector banks included the following categories of shares:

- IPOs;
- Private placements;
- ADRs/GDRs and
- Acquisition of shares from existing shareholders.[22]

However the acquisition of shares from the existing shareholders under the automatic route did not involve transfer of existing shares in a banking company from residents to non-residents and it required the approval of the FIPB followed by "in principle" approval by the Exchange Control Department (ECD) of the RBI.

This was followed by subsequent ventures for the liberalization in respect of foreign participation in banking. In 2004, the FDI in private banks under automatic route was enhanced to 74%.[23]

As per the Guidelines for Foreign Direct Investment (FDI) in the Banking Sector[24], FDI and portfolio investment in nationalized banks are subject to overall statutory limits of 20% as provided in Section 3 (2D) of the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970/80. The same ceiling also applied in respect of such investments in State Bank of India and its associate banks.

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[21] Press Note No.4 (2001 Series)

[22] Guidelines for Foreign Direct Investment (FDI) in the banking sector, http://siadipp.nic.in/policy/policy/app_c.htm , accessed on 18.04.09

[23] Press Note 2 of 2004

[24] ibid

This was followed by further opening of the banking sector for foreign capital by the increase of cap on FDI to 74% in 2004, which cap included investment by FIIs as well.[25]

Consistent with the fact that India is an emerging super power, many of the foreign banks have shown an interest in the Indian banking sector. According to Wharton professor of finance Krishna Ramaswamy, "The fact that there are very profitable private banks since the liberalization in such a short order – between 1993 and 2005 – is a testimonial to the fact that people will get very sophisticated in the banking services they demand and receive, whether at the retail or corporate level."[26] Many of the foreign banks were interested in acquiring stakes in Indian bank, once it is made permissible in the second phase of liberalization which was to commence on 01 April 2009. However, no such move has not yet been announced by the regulator. RBI. This can be attributed to the financial crisis which has spread over economies across the globe.

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[25] Supra n. 23

[26] 'Why Global banks are banking on India' http://knowledge.wharton.upenn.edu/india/article.cfm?articleid=4145# , accessed on 22.12.2008

CHAPTER II

COMMITMENTS OF INDIA UNDER THE GATS

The spark of liberalization in Indian banking that was ignited in early 1990s was strengthened with the establishment of the WTO as an international body. Services sector began to gain importance in the trade arena with the rapid advances in technology and the globalisation spree that hit the major economies of the world in the early 1990s. Liberalization and deregulation in the financial sector of different national economies encouraged international trade in financial services as well. GATS is the international legal framework governing international trade in services.

Trade in services is a part of the Uruguay Round of multilateral trade negotiations. However, an agreement on trade in services was not reached with the conclusion of the Uruguay Round. The unfinished negotiations on services reached an interim agreement in December 1997. As per the agenda in the GATS requiring the Members to enter into successive rounds of negotiations aimed at progressive liberalization in the services sector, within five years after the entry into force of the WTO Agreement, the services negotiations commenced again in January 2000 which is popularly known as the 'GATS 2000 Negotiations'.

In March 2001, the modalities for the services negotiations, referred to as the "Negotiating Guidelines and Procedures" was adopted. It stipulated for a bilateral "request-offer" approach as the main method of negotiating new "specific commitments" on market access, national treatment and additional commitments. The wide agenda of the Doha Development Agenda was later on subsumed by the 'GATS 2000 Negotiations'. Deadlines of 30 June 2002

and 31 March 2003 were set for the submission of "initial requests" and "initial offers" respectively at the Doha Development Agenda.

Consequent to the failure of the Cancun Ministerial Conference, negotiations continued in Geneva. This along with other efforts led to the adoption of the "July 2004 Framework Agreement". It reaffirmed the Members' commitment to progress in the area of services negotiations in line with the Doha Mandate and it set May 2005 as the deadline for the submission of the "revised offers". At the Hong Kong Ministerial Declaration on Services, agreement was reached to begin plurilateral negotiations, which would be complementary to the bilateral Request-Offer process.[27]

2.1 OVERVIEW OF THE GATS

The GATS comes in two parts: firstly a framework of rules, principles and concepts which underlie obligations regarding measures affecting international trade in services that affects across the board to measures affecting trade in services, and secondly, the specific negotiated commitments listed in countries' schedules for service sectors.[28] The first category of obligations includes provisions in relation to the Most Favoured-Nation (MFN) Treatment, transparency and domestic regulations. The MFN treatment under the GATS is not as rigid as in the case of GATT since there is a possibility to make reservations to the MFN obligation under the GATS, which has to be listed in the Annex on Article II Exemptions. However, it should not exceed a period of ten years[29].

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[27] WTO Negotiations on Trade in Services (A Backgrounder), http://commerce.nic.in/trade/backgrounder_services.pdf, accessed on 21.04.09

[28] Cornford Andrew, The WTO Negotiations on Financial Services: Current Issues and Future Directions, United Nations Conference on Trade and Development, Discussion Paper No.172, June 2004, http://www.unctad.org/en/docs/osgdp20046_en.pdf, accessed on 02.01.09

[29] Annex on Article II Exemptions, para. 6

Services like financial services are likely to be highly regulated by domestic regulations. GATS framework provides sufficient freedom for Members to adopt and maintain domestic regulations as well. GATS imposes on Members an obligation to ensure that in sectors where specific commitments have been taken, measures of general application affecting trade in services are administered in a reasonable, objective and impartial manner.

Specific commitments apply only to those services sectors, which are scheduled by a Member in its GATS commitments and not to all services sectors covered by the GATS.[30] In respect of specific commitments, the obligations of National Treatment[31] and Market Access[32] are applicable. There is no explicit obligation to grant access to foreign suppliers or to accord them national treatment. WTO Members are free to decide which financial services will be subject to market access and national treatment disciplines. A Member is free to decide which service sectors are to be scheduled for undertaking liberalization commitments under the GATS rules and is referred to as the 'positive list approach' or 'bottom up approach'.[33]

National Treatment is defined as treatment no less favourable than that accorded to like domestic services and service suppliers. Under Article XVII measures entailing deviations from national treatment are also to be included in a country's schedule. Market Access is not defined in the GATS. However it lists six categories of measures which are prohibited unless specified in a country's schedule (for each of the four modes of delivery). The categories cover the following: (a) limitations on the number of service suppliers; (b)

[30] Das Kasturi, GATS 2000 Negotiations and India: Evolution and State of Play, Journal of World Trade 41 (6): 1185-1236, 2007.
[31] Article XVII, GATS
[32] Article XVI, GATS
[33] Supra n. 30

limitations on the value of service transactions or assets; (c) limitations on the number of service operations or on the quantity of service output; (d) limitations on the number of natural persons who may be employed; (e) limitations on the type of legal entity through which a service is supplied; and (f) limitations on the permissible size of participation of foreign capital either in terms of maximum percentage limit on foreign shareholdings or in terms of the total value of an individual entity's or of aggregate foreign investment.'[34]

There are four modes of supply of service under the GATS, namely,

1. ***Cross-border supply***
2. ***Consumption abroad:*** Supply through movement of consumers to the location of the supplier;
3. ***Commercial presence:*** Supply through the establishment in a country of the commercial presence of legal entities from another country;
4. ***Presence or movement of natural persons:*** Supply through natural persons of one country in the territory of another.

2.2 GATS AND FINANCIAL SERVICES

'Financial services' is one of the services covered under the GATS, the essential purpose of which is the reduction of barriers in trade in services. GATS does not define what a service is. Service includes any service in any sector, except services supplied in the exercise of governmental authority. Financial services have been defined in the GATS as including any service of a financial nature offered by a financial service supplier, including all insurance and insurance-related services (e.g., direct insurance, reinsurance, insurance intermediation, and auxiliary insurance services), as well as all

[34] ibid

banking and other financial services (e.g., deposit taking, lending, financial leasing, asset management, trading in securities, and financial advice).[35] Negotiations on financial services did not reach a conclusive position at the end of the Uruguay Round. So the time period to arrive at an agreement was extended to six months which was further extended till July 1995. Though an agreement was reached in July 1995, it was without the participation of the United States. So it was decided to apply only on an interim basis. Finally, an agreement with the participation of the United States was reached on 13 December 1997. From then onwards, trade in financial services was effectively brought under the umbrella of the GATS. The Fifth Protocol to the GATS was then adopted. As a result of negotiations, US and Thailand decided to withdraw their broad MFN exemptions based on reciprocity. Only few countries submitted limited MFN exemptions or maintained existing broad MFN exemptions.[36]

In addition, and specific to financial services, WTO Members have the option of scheduling their commitments pursuant to the Understanding on Commitments in Financial Services. This document which forms part of the schedule of Members adopting it provides a standardised list of liberalisation commitments in financial services.[37]

2.2.1 Annex on Financial Services

The GATS has an Annex on Financial Services which is binding on all WTO Members and is also an integral part of it. The Annex applies to "measures

[35] Foreign Banking: Do Countries' WTO Commitments Match Actual Practices? http://www.wto.org/english/res_e/reser_e/ersd200611_e.pdf, accessed on 21.04.09

[36] Raju K.D., Financial Services Negotiations under the General Agreement on Trade in Services (GATS): A Case Study of Indian Banking and Insurance Sectors, http://works.bepress.com/kdraju/15/, accessed on 12.02.09

[37] ibid

affecting the supply of financial services"[38]. Broadly, 'financial services' cover insurance and banking services. Banking comprises all the traditional services such as acceptance of deposits, lending in foreign exchange, derivatives, securities underwriting, provision and transfer of financial information, and advisory and other auxiliary financial services.[39] An important aspect is that any natural or juridical person of a Member wishing to supply services is also included within the purview of the definition of "financial service supplier".

The GATS does not prevent Members from adopting and maintaining measures for prudential reasons.[40] According to the GATS provisions, even though a measure is taken for prudential reasons, thus is a priori covered by the exception, it "shall not be used as a means of avoiding a Member's commitments or obligations under the Agreement."

2.3 COMMITMENTS OF INDIA UNDER THE GATS

Financial service under the GATS broadly covers insurance and banking sectors. There are horizontal as well as vertical commitments under the Schedule of Commitments, the former of which is applicable to all the sectors that are covered under the Schedule and the latter applies only to the specific sectors or subsectors.

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[38] Annex para 1 (a)

[39] Pathak Shubhangi, Liberalization of Financial Services under the WTO, http://www.igidr.ac.in/~money/mfc_08/Liberalization_of_Financial_Services...%20Subhangi %20Pahak.pdf, accessed on 14.01.09

[40] Annex on Financial Services, para 2 (a): "Notwithstanding any other provisions of the Agreement, a Member shall not be prevented from taking measures for prudential reasons, including for the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed by a financial service supplier, or to ensure the integrity and stability of the financial system. Where such measures do not conform with the provisions of the Agreement, they shall not be used as a means of avoiding the Member's commitments or obligations under the Agreement."

both on and off balance sheet of the banking system exceeds 15 per cent.[44] Foreign banks are subject to non-discriminatory resource allocation requirements as well.

So far as the limitations on National Treatment to foreign banks are concerned, it is provided in the Schedule of Specific Commitments that foreign banks are required to constitute Local Advisory Boards consisting inter alia of professionals and persons having expertise in areas such as small scale industry and exports. The Chairman and members of Local Advisory Board must be resident Indian nationals except for the Chief Executive Officer who may be a foreign national. The appointment of the Chairman and the Board requires the approval of the Reserve Bank of India. However India has offered to replace the Local Advisory Board requirement with the guidelines on the composition of the Board of Directors.

Further in the horizontal commitments it is provided that public sector enterprises can invest surplus funds in term deposits only with scheduled commercial banks incorporated in India.[45]

In respect of these services, it is provided in the Schedule of Specific Commitments that Services in Mode 4 are unbound, except as indicated in the horizontal section. In this regard, the Horizontal Commitments say that it is open to the extent provided there and are only for measures affecting the entry and temporary stay of natural persons who fall in the categories of business visitors, persons who visit India for the purposes of business negotiations and for the preparatory work for establishing a commercial presence in India and

[44] ibid

[45] http://tsdb.wto.org/simplesearch.aspx , accessed on 21.04.09

who will not receive any remuneration from India. Entry of such persons is for a period of not more than 90 days.[46]

In the case of intra-corporate transferees at the level of managers, executives and specialists who have been in the employment of a juridical person of another member for a period not less than one year prior to the date of application for entry into India and are being transferred to a branch or a representative office or a juridical person owned or controlled by the aforesaid juridical person. Entry and stay in this category shall be for a maximum period of one year extendable with permission for a maximum of three months.[47]

In case of collaboration with public sector enterprises or government undertakings as joint venture partners, preference in access will be given to foreign service suppliers/entities which offer the best terms for transfer of technology as per the commitment.[48]

It is pertinent to note that India has submitted a revised offer on trade in services in August 2005.[49]

It stipulates for compliance with the minimum capitalization norms. In the revised offer the commercial presence by a foreign bank is scheduled to include branch operations as well as a Wholly Owned Subsidiary of a foreign bank licensed and supervised as a bank in its home country, subject to regulations of the Reserve Bank of India. The limit on the number of licences has been raised from 12 to 20 in the Revised Offer by India. Further, provision is inserted in the Revised Offer stipulating that foreign banks can

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[46] ibid
[47] ibid
[48] ibid
[49] http://commerce.nic.in/trade/revised_offer1.pdf , accessed on 21.04.09

invest in private sector banks through the FDI route subject to foreign equity ceiling of 49 percent and subject to the condition that in the case of foreign investors having prior collaboration in that specific service sector in India, FIPB approval would be required. Further, in the case of transferable securities, presence is permitted through the establishment of locally incorporated joint venture company with foreign equity not exceeding 74 per cent. Here the foreign equity participation is limited to recognized foreign stock broking companies.[50]

As far as limitations on National treatment under the Revised Offer is concerned, modification is made to the effect by adding that the investment of surplus funds in term deposits with scheduled commercial banks by public sector enterprises, such investment in term deposits with Wholly Owned Subsidiaries would be subject to guidelines by the Reserve Bank of India. The requirement for the constitution of the Local Advisory Board has been dispensed with under the Revised Offer.[51]

In so far as the horizontal commitments under the Revised Offer is concerned, it is provided that in the case of collaboration with public sector enterprises or government undertakings as joint venture partners, preference in access will be given to foreign service suppliers/entities which offer the best terms of transfer of technology.[52]

It is not only the commitments under Mode 3 that are relevant to India. Even the provision of services through Mode 4 also is relevant, because persons who visit India temporarily for the sale of services or entering into agreements for such sales for that services supplier and/or employees of a juridical person

[50] ibid
[51] ibid
[52] ibid

for the purpose of setting up a commercial presence of that juridical person in India are subject to certain market access conditions namely,

- Representatives of such services suppliers or employees of such juridical persons will not be engaged in making direct sales to the general public or in supplying services themselves
- Will not receive any remuneration from a source located within India
- Entry of persons of this category is limited to a period of not more than 180 days.

Further, in the case of managers, executives and specialists in the employment of the juridical person of another Member and are being transferred temporarily to a branch or a representative office or a juridical person owned or controlled by the aforesaid juridical person in the context of provision of a service in India, is limited to a maximum period of five years. Along with that the required visa and conditions attached to entry and temporary stay have to be complied. In the case of intra-corporate transferees and contractual service suppliers proof of contract and possession of requisite educational and professional qualifications is also required, as per the Revised Offer.

CHAPTER III

STATUTORY FRAMEWORK GOVERNING BANKS IN INDIA

Unlike many of the usual instances of foreign investment, foreign investment in banking is a concern not only of the policy making arm of the Government, but also of the regulator of the sector, the RBI, not as the regulator of the foreign exchange market alone, but also as the regulator of banking as well. Thus the central bank has a very important role to play in the moulding and implementation of the policy on foreign investment in banking. This is an area where there is mounting external pressure for further liberalization of norms and is also an area which is of great strategic significance. The framework for foreign investment in banking is embodied in statutes, policies of Government, regulations, circulars and guidelines of different regulators like RBI, SEBI, IRDA and Ministry of Company Affairs. The framework differs on the basis of the type of banking entity as well as the nature of entity to be formed through the foreign investment.

"The Indian financial system consists of commercial banks, co-operative banks, financial institutions and non-banking financial companies (NBFCs). The commercial banks can be divided into categories depending on ownership pattern, viz, public sector banks, private sector banks and foreign banks. While the State Bank of India and its associates, nationalised banks and Regional Rural Banks are constituted under the respective enactments of the Parliament, the private sector banks are banking companies as defined in the

Banking Regulation Act."[53] As at the end of March 2007, there were 82 scheduled commercial banks comprising of 28 state-owned public sector banks, which accounted for more than 70% of the total assets of the sector, 25 privately owned Indian banks accounting for 22% of the assets and 29 foreign banks operating in India accounting for 8% of the assets of the banking sector.[54]

The law governing the banking companies, with respect to regulation of banking business in India is the Banking Regulation Act, 1949. In other aspects, the Companies Act, 1956 will apply. Prior to the enactment of the Banking Regulation Act, 1949, the applicable law in relation to banks also, was Part XA of the Indian Companies Act, 1913. The Banking Companies Act, 1949 applies to all banking companies in India, irrespective of whether it is Indian or foreign in constitution or origin. The provisions on the business, licensing, management, acquisition, restructuring and resolution, including winding up of banking companies are governed by this enactment.

The public sector banks are exempted from some of the provisions of the Banking Regulation Act in view of the separate statutes governing them. The public sector banks are governed by the statutes under which they were created, namely, the State Bank of India Act, the State Bank of India (Associate Banks) Act and in the case of nationalized banks, the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970/80.

[53] 'Technical Paper on Differentiated Bank Licences', www.rbidocs.rbi.org.in/rdocs/Publications PDFs/80798.pdf, accessed on 03.01.09

[54] India's Financial Sector-An Assessment (Vol. IV), Advisory Panel on Financial Regulation and Supervision, Committee on Financial Sector Assessment, March 2009

3.1 Scheduled and Non-Scheduled Banks

In India there are two categories of banks, namely, scheduled banks and non-scheduled banks. Scheduled Banks in India constitute those banks which have been included in the Second Schedule of Reserve Bank of India (RBI) Act, 1934. RBI in turn includes only those banks in this schedule which satisfy the criteria laid down vide section 42 (6) (a) of the Act. The conditions are that the bank must have paid up capital and reserves of an aggregate value of not less than five lakhs of rupees, satisfaction of the RBI that the affairs of the bank are not being conducted in a manner detrimental to the interest of the depositors and it is either a State co-operative bank or a company as defined in the Companies Act or an institution notified by the Central Government in this regard or a corporation or a company incorporated by or under any law in force in any place outside India.[55] Thus licensed foreign banks as well as Indian incorporated banks can be scheduled banks under the RBI Act.

Being a part of the Second schedule confers some benefits to the bank in terms of access to accommodation by RBI during the times of liquidity constraints. At the same time, however, this status also subjects the bank to certain conditions and obligation towards the reserve regulations of RBI.[56]

Such banks have to maintain with the Reserve Bank an average daily balance the amount of which shall not be less than three percent[57] of the total demand and time liabilities in India of such bank as shown in the return. The RBI can by notification increase this rate and it cannot be more than twenty per cent of the demand and time liabilities.[58]

[55] Section 42 (1), Reserve Bank of India Act, 1934
[56] http://www.banknetindia.com/board/784b.html
[57] The present CRR is 5%
[58] Section 42 (1), Reserve Bank of India Act, 1934

The Reserve Bank can by way of notification in the Official Gazette direct scheduled banks to maintain an additional average daily balance in addition to the balance prescribed as above, an additional average daily balance which is calculated with reference to the excess of the total demand and time liabilities of the bank as shown in the return over the total of its demand and time liabilities at the close of business on the specified date.

However, a scheduled bank need not maintain with the RBI any balance which shall be more than twenty per cent of the total of its demand and time liabilities.[59]

A non-scheduled bank has to maintain a sum equivalent to at least three percent[60] of the total demand and time liabilities in India as on the last Friday of the second preceding fortnight, a cash reserve.[61]

When the scheduled bank maintains such amounts with the RBI, the RBI has to pay interest on the amount by which such balance is in excess of the balance which the scheduled bank would have to maintain, if no such notification was issued.[62]

If the RBI does not demand the payment of penalty, it may pay interest on the amount actually maintained with it irrespective of whether it is less than the balance required to be maintained in pursuance of the notification.

The RBI can specify any transaction or class of transactions as liability in India of the scheduled bank.

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[59] Proviso to section 42 (1), Reserve Bank of India Act, 1934
[60] The current CRR is 5%
[61] Section 18, Banking Regulation Act, 1949
[62] Section 42 (1B), Reserve Bank of India Act, 1934

Scheduled banks have to send to the RBI such fortnightly returns as are specified in the RBI Act.[63]

These regulations and requirements are applicable both to branches of foreign banks operating in India as well as banks which are incorporated in India.

3.2 Framework under the Banking Regulation Act

Banking Company' means any company[64] which transacts the business of banking in India.[65] The Banking Regulation Act defines "banking" as accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise, and withdrawal by cheque, draft, order or otherwise.[66] In addition to the business of banking, a banking company can engage in many other activities as well, as per the Act.[67] The activities of banks are thus not confined to traditional acceptance of

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[63] Section 42 (2), Reserve Bank of India Act, 1934

[64] This includes companies incorporated outside India and having a place of business in India.

[65] Section 5 (c), Banking Regulation Act. 1949

[66] Section 5 (b), Banking Regulation act, 1949

[67] **Section 6:** In addition to the business of banking, a banking company may engage in any one or more of the following forms of business, namely: —

(a) the borrowing, raising, or taking up of money; the lending or advancing of money either upon or without security; the drawing. making, accepting, discounting, buying, selling, collecting and dealing in bills of exchange. hoondees, promissory notes, coupons, drafts, bills of lading, railway receipts. warrants, debentures, certificates, scrips and other instruments and securities whether transferable or negotiable or not; the granting and issuing of letters of credit, traveller's cheques and circular notes; the buying, selling and dealing in bullion and specie; the buying and selling of foreign exchange including foreign bank notes; the acquiring, holding, issuing on commission, underwriting and dealing in stock, funds, shares, debentures, debenture stock, bonds, obligations, securities and investments of all kinds; the purchasing and selling of bonds, scrips or other forms of securities on behalf of constituents or others, the negotiating of loans and advances; the receiving of all kinds of bonds, scrips or valuables on deposit or for safe custody or otherwise: the providing of safe deposit vaults; the collecting and transmitting of money and securities:

(b) acting as agents for any Government or local authority or any other person or persons; the carrying on of agency business of any description including the clearing and forwarding of goods, giving of receipts and discharges and otherwise acting as an attorney on behalf of customers, but excluding the business of a 1[managing agent or secretary and treasurer] of a company;

(c) contracting for public and private loans and negotiating and issuing the same; (d) the effecting, insuring, guaranteeing, underwriting, participating in managing and carrying out of any issue, public or private, of State, municipal or other loans or of shares stock, debentures,

the profits of the business transacted through the branches that year also has to be deposited with the RBI.[69]

Indian incorporated banks: In the case of other banking companies, that is Indian incorporated banking companies, the aggregate value of the paid up capital and reserves must not be less than five lakhs of rupees if it has place of business in more than one State and if any place of business is in Calcutta or Mumbai, then it should be minimum ten lakh rupees. But if all the places of business are in one State and not in Bombay or Calcutta, the minimum is one lakh rupees, plus ten thousand rupees in respect of each of its other places of business situated in the same district in which it has its principal place of business, plus twenty-five thousand rupees in respect of each place of business situated elsewhere in the State otherwise than in the same district.[70] But such a banking company cannot be required to have a paid up capital and reserves exceeding an aggregate value of five lakhs of rupees. A banking company with only one place of business cannot be required to have a paid up capital and reserves exceeding fifty thousand rupees.

If all the places of business of the bank are situated in one State, one or more of which is in Bombay or Calcutta, it is five lakhs of rupees and twenty five thousand rupees in respect of each place of business situated outside Bombay or Calcutta.

3.2.2 Licensing of banks: A company can carry on banking business in India only if it holds a licence issued by the Reserve Bank of India, irrespective of whether it is a foreign bank or an Indian bank.[71] India does issue only a single class of bank licence. The application of foreign banks to open their maiden

[69] ibid

[70] Section 11 (2A), Banking Regulation Act, 1949

[71] Vide section 22, Banking Regulation Act, 1949

branch in India is considered under section 22 of the Banking Regulation Act. Licence for banking can be granted to a company incorporated outside India as well, on the satisfaction of certain conditions and on being satisfied that the carrying on of banking business by such company is in public interest and the Government or the law of its home country does not discriminate in any way against banking companies registered in India and also that the company complies with all provisions applicable to banking companies outside India under the Act. The other common conditions that are applicable to banks incorporated in India as well as foreign banks are the following:

- The company must be or will be in a position to pay its present or future depositors in full as their claims accrue;
- The affairs of the company are not being, or is not likely to be, conducted in a manner detrimental to the interests of its present or future depositors;
- The general character of the proposed management of the proposed bank must not be prejudicial to the public interest or the interest of the depositors;
- The company must have adequate capital structure and earning prospects;
- Having regard to the banking facilities available in the proposed principal area of operations of the company, the potential scope for expansion of banks already in existence in the area and other relevant factors the grant of the licence would not be prejudicial to the operation and consolidation of the banking system consistent with monetary stability and economic growth;

3.2.3 Branch Expansion: Once an entity has become a banking company in India, then for the further expansion of its number of branches, through opening of new place of business in India or change the existing place of business situated in India, it has to approach the Reserve Bank for its prior permission.[72] Before granting permission for the new place of business, the financial condition and history of the banking company, the general character of management of the banking company, the adequacy of capital structure an earning prospects and public interest issues will be considered by the RBI, irrespective of whether it is a foreign bank or a domestic bank.[73] While considering the application of Indian banks, the RBI will take into consideration, the nature and scope of banking facilities provided to common persons in under banked areas, actual credit flow to the priority sector, efforts for promoting financial inclusion, policy on minimum balance requirements, need to induce enhanced competition in banking sector, compliance with regulations, relationship of the bank with its subsidiaries, affiliates and associates, quality of corporate governance, risk management systems and internal control mechanisms.[74] This is in fact discriminatory towards the Indian banks.

3.2.4 Regulation on the capital of banks: For a banking company to carry on banking in India, irrespective of whether it is an Indian or a foreign bank, the subscribed paid up capital must not be less than one-half of the authorised capital and the paid-up capital must not be less than one-half of the subscribed capital[75].

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[72] Section 23, Banking Regulation Act, 1949
[73] Section 23 (2), Banking Regulation Act, 1949
[74] Master Circular – Branch Authorisation, July 01, 2008
[75] Section 12 (1), Banking Regulation Act, 1949

3.2.5 Ownership and voting rights in banks: Though there has been liberalization in the cap on FDI in the private banking sector, there is no actual fructification of the purpose of such increased cap unless the foreign investor is able to exercise voting rights proportionate to his/its share holding in the banking company. Despite the enthusiasm shown by the Ministry of Finance which even reached to the extent of introduction of a Bill in the Lok Sabha, the serious infirmity of lack of proportionate voting rights worries the prospective and present foreign investors in both public and private sector banks. The status quo is backed by the RBI.

As regards private sector banks, the deterrent provision in the Banking Regulation Act makes provision to the effect that whatever may be the number of shares held by a person in a banking company, no person holding shares in a banking company shall, in respect of any shares held by him, exercise voting rights in excess of ten percent of the total voting rights of all the shareholders of the banking company.[76] If any provision in the memorandum or articles of the banking company stands contrary to this, it will be void to the extent of such repugnancy.[77]

In the case of State Bank of India (SBI), no shareholder, other than the Central government is entitled to exercise voting rights in excess of 10 percent of the issued capital.[78] In the case of SBI Associates, no shareholder, other than the Central Government, is entitled to exercise voting rights in excess of 10 per cent of the issued capital.[79] Further, there is restriction to the effect that no person can be registered as a shareholder in respect of any shares held by him

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[76] Section 12 (2), Banking Regulation Act, 1949
[77] Vide Section 5A, Banking Regulation Act, 1949
[78] Section 11, State Bank of India Act
[79] Section 19 (2), SBI (Subsidiary Bank) Act, 1959

in excess of two hundred shares.[80] Similar provision is there in respect of other nationalized banks as well which provides that other than the Central Government, no shareholder is entitled to exercise voting rights in excess of 1 per cent of the total voting rights of all the shareholders of the bank.[81]

3.2.6 Other regulations on banks

Under the Banking Regulation Act, a requirement is imposed on banking companies incorporated in India that such Indian companies have to maintain a Reserve Fund out of the balance of profit of each year and before the declaration of dividend a sum of 20 % of the profit of the banking company has to be transferred to such fund.[82] Such requirement is not applicable in the case of a foreign bank which comes as a branch in India.

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[80] Section 19 (1), SBI (Subsidiary Bank) Act, 1959

[81] Vide section 3 (2E), Banking Companies (Acquisition and Transfer of Undertakings) acts, 1970 & 1980

[82] Section 17, Banking Regulation Act, 1949

CHAPTER IV

FOREIGN INVESTMENT IN BANKING IN INDIA –THE REGULATORY FRAMEWORK

4.1 REGULATORY POLICY ON FOREIGN INVESTMENT

In India the inflow and outflow of foreign exchange is governed by the Foreign Exchange Management Act and the regulations framed under it. The issue or transfer of security to or by person resident outside India is governed by Foreign Exchange Management (Transfer or Issue of Security by a Person resident outside India) Regulations, 2000.

4.1.1 Foreign Direct Investment: In FDI investments are usually held directly or through offshore holding company structures. Investment in equity shares is considered as FDI. Investment in fully and compulsorily convertible debt instruments is also treated as equity investment for FDI purposes[83]. Though there is no cap on dividend that can be distributed on equity shares there is limit in the case of interest that can be paid on debentures.[84]

An entity incorporated outside India, which includes foreign banks or a person resident outside India can purchase shares or convertible debentures of an Indian company, which includes an Indian bank under the Foreign Direct Investment Scheme, up to the limits and extent provided.[85] In case the foreign investor is a collaborator or is acquiring the entire shareholding of a new Indian company, he should obtain the prior permission of the Central

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[83] Circular of the RBI on 'Foreign Direct Investments (FDI) – Issue of shares under FDI and refund of advance remittances', dated December 14, 2007, RBI/2007-08/213, A.P. (DIR Series) Circular No. 20

[84] http://www.bmrtax.com/PDF/452TPSR0209_tif_goradia.pdf, accessed on 12.05.09

[85] Regulation 5(1) (i), Foreign Exchange Management (Transfer or Issue of security by a person resident outside India) Regulations, 2000 r/w Regulation 1, Schedule I, Foreign Exchange Management (Transfer or Issue of security by a person resident outside India) Regulations, 2000

Government, if he has a previous venture or tie-up in India through investment in shares or debentures or a technical collaboration or a trademark agreement or any investment in the same or allied field in which the Indian company issuing the shares is engaged. It is also provided that if a company which includes a private banking company wants to issue shares beyond the sectoral limits provided[86], it can issue it to foreign investor only with the prior approval of the SIA or the FIPB.

4.1.1.1. Routing of funds: The Indian company issuing the shares or convertible debentures under direct investment route has to receive the amount of consideration for the shares or convertible debentures by inward remittance through normal banking channels or by debit to NRE/FCNR account of the person concerned maintained with an authorized dealer/authorised bank. In case the shares or convertible debentures are not issued within 180 days from the date of receipt of the inward remittance, such amount has to be refunded to the person concerned by outward remittance through normal banking channels or by credit to his NRE/FCNR (B) account as the case may be.

A report of the details of the foreign investor, a report in Form FC-GPR with a certificate of the Company Secretary on the satisfaction of the requirements under the Companies Act, terms and conditions of Government approval, eligibility of the company to issue shares and the possession of all the original certificates from the authorized dealers evidencing the receipt of amount of consideration also has to be filed with the RBI.

[86] 74% in the case of private banking

4.1.2 Issue of shares through ADR/GDR: A registered broker in India has to purchase the shares of the Indian company on behalf of the person resident outside India, for the purpose of converting the shares so purchased into ADRs/GDRs subject to the satisfaction of certain conditions namely, that the shares are purchased on a recognized stock exchange, the Indian company has issued ADRs/GDRs, the shares are purchased with the permission of the custodian of ADR/GDR of the Indian company and are deposited with the custodian, the number of the shares purchased does not exceed ADR/GDR converted into underlying shares and is as per the sectoral cap and the non-resident investor, broker, custodian and overseas depository comply with the provisions of the Scheme for Issue of Foreign Currency Convertible Bonds and Ordinary Shares (Through Depository Mechanism) Scheme and guidelines.

4.1..2.1. Routing of funds: The Indian company issuing the shares through the ADR/GDR mechanism has to receive the amount of consideration either by inward remittance through normal banking channels or by debit to NRE/FCNR account of the person concerned maintained with the authorized dealer/authorised bank. In case the shares or convertible debentures are not issued in 180 days from the date of inward remittance or debit into NRE/FCNR (B) account, it has to be refunded by outward remittance through normal banking channels or by credit to the NRE/FCNR (B) account of the foreign investor.

4.1.3 Foreign Institutional Investment: The term FII has been defined to mean an institution established or incorporated outside India which proposes

resolution by its Board of Directors followed by the passing of a special resolution to that effect by the shareholders in the General Body meeting.[90]

The amount of consideration for the shares is paid out of remittance from abroad through normal banking channels or out of funds held in an account maintained with the designated branch of an authorized dealer in India.

A registered FII can purchase the shares or convertible debentures of the Indian company through offer/private placement, subject to the ceiling applicable to FII investment. In the case of Public Offer, the price of the shares to be issued is not less than the price at which the shares are issued to the residents. In the case of private placement, the price must not be less than the price arrived at in terms of the SEBI guidelines or the guidelines of the CCI.

FIIs and sub-accounts need to open a bank account in India and also need to appoint a custodian to keep custody of their cash and securities. They also need to obtain a Permanent Account Number (which is like a tax identification number) and appoint a tax advisor in India.[91]

4.1.3.1. Routing of funds: The routing of the amount for the transaction of purchase of shares by an FII is through opening a Foreign Currency Account and/or a Special Non-Resident Rupee Account with a designated branch of an authorized dealer. This account is to be funded by inward remittance through normal banking channels or by credit of the sale proceeds (net of taxes) of the shares/convertible debentures sold on stock exchange. The funds from the Foreign Currency Account of the registered FII may be transferred to a Non-Resident Rupee Account of it or vice versa. The designated branch of the

[90] Schedule 2, Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000

[91] Supra n. 82

authorized dealer may allow remittances of the net sale proceeds (after payment of taxes) or credit the net amount of sale proceeds of shares/convertible debentures to the foreign currency account or a Non-resident rupee account of the registered FII concerned.

However, because of the lack of lasting interest in the equity of any particular company, the sudden inflow and outflow of funds by the FIIs, in accordance with the general trends in the capital market can lead to highs and lows. FIIs' net outflows have been Rs 47,706.2 crore till March 30 in the financial year 2008-09 as against huge inflows of Rs 53,000 crore in the previous fiscal.[92]This general trend triggered by the global financial crisis was reflected in the banking sector as well.

4.1.4 NRI Investment: A Non-resident Indian can purchase the shares or convertible debentures of an Indian company on repatriation as well as non-repatriation basis as well under portfolio investment scheme But in private sector banks, an NRI can invest only under the portfolio investment scheme. In such a case the purchase has to be done through a registered broker on a recognized stock exchange. It has to be through an Authorized Dealer for the purpose and duly approved by the RBI. The paid up value of the shares of the Indian company purchased by each NRI must not exceed 5 per cent of the paid up value of the shares issued by the company concerned. The paid up value of each series of convertible debentures purchased by each NRI must not exceed 5 per cent of the paid up value of each series of convertible debentures. The aggregate paid up value of shares of any company purchased by all NRIs must not exceed 10 per cent of the paid up capital of the company

[92] 'FII outflow close to Rs. 50,000 cr in FY09', March 31, 2009, http://www.business-standard.com/india/news/fii-outflow-close-to-rs-50000-cr-in-fy09/57723/on, accessed on 11.05.09

and in the case of purchase of convertible debentures the aggregate paid up value of each series of debentures purchased by all NRIs must not exceed 10 per cent of the paid up value of each series of convertible debentures. However, this aggregate ceiling can be increased to 24 per cent if a special resolution to that effect is passed by the General Body of the company concerned.

4.1.4.1. Routing of funds: The payment for purchase of shares or convertible debentures is to be made through inward remittance in foreign exchange through normal banking channels or out of funds held in NRE/FCNR account maintained in India if shares are purchased on repatriation basis and by inward remittance or out of funds held in NRE/FCNR/NRO/NRNR/NRSR account of the NRI concerned maintained in India where the shares/debentures are purchased on non-repatriation basis.

The net sale/maturity proceeds of shares and/or debentures of an Indian company purchased by NRI has to be through the designated branch of an authorized dealer which is to be credited to NRO account where the purchase was made out of funds held in NRO account or where shares or debentures were purchased on non-repatriation basis or at the option of the NRI investor to be remitted abroad or credited to his NRE/FCNR/NRO account of the NRI, where the shares and/or debentures were purchased on repatriation basis.

4.2 STRUCTURING OF FOREIGN INVESTMENTS THROUGH TAX HAVENS

There is a rampant practice among the foreign investors to route their foreign investment to India via, offshore holding companies. The favourite havens of foreign investors to base the offshore holding companies generally are

Mauritius, Cyprus, Singapore etc., of which the most popular is investment through Mauritius. The main reasons for it are that capital gains earned by a resident of Mauritius is not taxable in India or Mauritius. Further, dividends earned by Mauritius companies (held at a 10% stake) in Indian companies are taxed at a concessional rate of 5 %. However, the capital gains exemption is available only when the Mauritian entity does not have a permanent establishment in India. This structure of investment is more popular among investment funds or FIIs investing into India's private equity and stock market.

4.3 POLICY FRAMEWORK ON FOREIGN INVESTMENT IN BANKING

4.3.1 Cap on FDI in private sector banks

Foreign Investment in private sector banks is under the automatic route, meaning that no prior approval is required for FDI. Only post-facto filing of data relating to the investment is to be made with the Reserve Bank of India.[93] The investors are required to notify the Regional office concerned of RBI within 30 days of receipt of inward remittances and file the required documents with that office within 30 days of issue of shares to foreign investors.[94]

The cap on FDI in private sector banks is 74%.[95] This cap has to be maintained in all cases of foreign investment in private banking, except in the case of setting up of Wholly Owned Subsidiary. This provision precludes the foreign investor from carrying through a special resolution, since a special resolution requires the affirmative support of three fourths of the voting

[93] http://www.investmentcommission.in/policies_and_laws.htm, accessed on 26.09.08
[94] http://www.apind.gov.in/bg_fdipol.html, accessed on 01.05.09
[95] Press Note 2 of 2004

strength. This is a serious hurdle to control that can be exercised by the foreign investor.

The 74% FDI comprises not only foreign investment through which a lasting interest is acquired in a domestic bank by a foreign entity as in the case of IPOs, private placements, GDRs/ADRs and acquisition of shares from existing shareholders, but also investment for the purposes of returns, through portfolio investment by the FIIs, NRIs and shares acquired prior to September 16, 2003 by OCBs.[96] There had been considerable debate on whether FII investment can be included in the FDI cap, before proper clarification was made.

4.3.2 Cap on foreign investment in public sector banks

FDI and portfolio investment in nationalised banks are subject to overall statutory limits of 20% of the paid-up capital of the bank as provided under Section 3 (2D) of the Banking Companies (Acquisition and Transfer of Undertakings) Acts, 1970/80.[97] The same ceiling would also apply in respect of such investments in State Bank of India and its associate banks.[98] This is limit is inclusive of investment from all sources, including FII investment. Quite distinct from the fixation of FDI cap by policies in the case of private sector banks, the cap is fixed by the statute. It is difficult to change this, as compared to Policy which can be altered by successive governments.

Though there were efforts to bring down the Government stake in public sector banks and not to mix FII investment with FDI investment, it has not materialized.

[96] ibid
[97] Proviso to section 3 (2D), Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970/80; http://siadipp.nic.in/policy/policy/app_c.htm, accessed on 02.05.09
[98] ibid

4.3.3 Calculation of Foreign Investment in Indian banks

Concerns over the acquisition of certain Indian companies engaged in activities with sectoral caps prompted the Department of Industrial Policy and Promotion to bring in certain guidelines and restrictions on the transfer of shares from residents to non-residents. These are embodied in Press Notes 2, 3 and 4 of 2009. Private sector banking is also thus affected by the same. The Reserve Bank has pointed out to the Finance Ministry that it could impact seven Indian private sector banks.[99] The effect of the new policy is that any downstream investment by a firm with more than 50 per cent foreign equity will be treated as FDI. According to the provisions of these Press Notes, ICICI Bank, ING Vysya, YES Bank, HDFC Bank, Development Credit Bank, IndusInd Bank and Federal Bank are foreign owned Indian controlled banks. As per the new Policy, foreign investment through investing Indian company will not be considered for calculation of indirect foreign investment in the case of Indian companies which are 'owned[100] and controlled[101]' by resident Indian citizens/Indian companies which are owned and controlled by resident Indian citizens. In the other case. the investment by such companies will be considered as indirect foreign investment. If a declaration is made by persons under section 187C of the Indian Companies Act about a beneficial interest

[99]New FDI norms may be revised for banking sector, http://news.in.msn.com/business/article.aspx?cp-documentid=2998556, accessed on 11.05.09

[100] **"owned"** by resident Indian citizens and Indian companies, which are owned and controlled by resident Indian citizens, if more than 50% of the equity interest in it is beneficially owned by resident Indian citizens and Indian companies. which are owned and controlled ultimately by resident Indian citizens;

[101] **"controlled"** by resident Indian citizens and Indian companies, which are owned and controlled by resident Indian citizens, if the resident Indian citizens and Indian companies, which are owned and controlled by resident Indian citizens, have the power to appoint a majority of its directors .

being held by a non resident entity, then even though the investment is made through a resident Indian citizen, it has to be considered as foreign investment.

Confusion prevails among the bankers since such a situation will affect the domestic investment by such banks. DIPP feels that since banking is a regulated sector, it may need some additional provisions on FDI.[102] The new regulations will be applicable only after they are notified under the Foreign Exchange Management Act (FEMA)[103], which is not yet done.

4.4 MODES OF FOREIGN PARTICIPATION IN THE INDIAN BANKING SECTOR

The modes of introducing foreign equity and participation in the private banking sector are contained in the Press Note 2 of 2004 issued by the Department of Industrial Policy and Promotion. Accordingly, foreign capital can make its way to the Indian private banking sector through various channels, namely, IPOs, private placements, GDRs/ADRs, acquisition of shares from existing shareholders, FDI investment under Portfolio Investment Scheme by FII[104]s, NRIs and shares acquired prior to September 16, 2003 by OCBs. It is not only banks that can make foreign investments in private banking sector. Other entities as well can make it. Foreign banks can enter the Indian private banking market through branches and Wholly Owned Subsidiaries or by investing in existing private sector banks within the prescribed limits. Foreign banks registered as FIIs can invest under the portfolio investment scheme as well. Entities which are not registered

[102] Supra n. 97
[103] ibid
[104] SEBI (Foreign Institutional Investors) Regulations, 1995, Regulation 2 (f): 'Foreign Institutional Investor' means an institution established or incorporated outside India which proposes to make investment in India in securities;

FIIs/NRIs can make investment in private banking through the direct investment route.

4.4.1 Requirements to be satisfied for foreign investment in private banking sector

The aggregate foreign investment that is permitted in private banks from all sources is 74 per cent and 26 per cent of the paid up capital always has to be held by resident Indians, except in the case of Wholly Owned Subsidiary. This requirement of 74% FDI ensures that the foreign investors on themselves cannot effect the passing of a special resolution.

The policy makers were not oblivious of the existence and emergence of universal banking as also the limits of FDI in different financial sectors, in which different financial services are offered by a bank, as also the limits of FDI in different financial sectors, which is evident from the provision in the Press Note which provides that applications for foreign direct investment (FDI route) in private banks having joint venture/subsidiary in insurance sector may be addressed to the RBI for consideration in consultation with the IRDA, so as to ensure that the 26 per cent limit of foreign shareholding applicable to the insurance sector is not being breached.[105]

4.4.2 Transfer of Shares: The transfer of shares under FDI from residents to non-residents requires the approval of the FIPB under FEMA. The Foreign Exchange Management (Transfer or Issue of Security by a Person resident outside India) Regulations, 2000 stipulates that in the case of transfer of any share or convertible debenture from residents to non-residents, through direct

[105] ibid

investment route, of an Indian company engaged in private banking, such transfer has to be with the prior approval of the Government and the RBI.[106]

Persons resident outside India other than NRIs or OCBs, can transfer by sale or gift the shares or convertible debentures held by him to any person resident outside India. An NRI can do such transfer only to NRIs.[107] However, the transferee has to obtain the prior permission of the Central Government to acquire the shares, if he has previous venture or tie-up through investment in shares or debentures or a technical collaboration or a trademark agreement in the same or allied field in which the Indian company whose shares are being transferred is engaged.[108]

A Person resident outside India holding the shares or convertible debentures of an Indian company can sell it on a recognized Stock Exchange in India through a registered broker. A person resident outside India. can transfer the share or convertible debenture of an Indian company, without the prior permission of the RBI by sale to a person resident in India subject to adherence to pricing guidelines, documentation and reporting requirement for such transfers as specified by the RBI.[109]

In private sector banking Government approval/FIPB approval will be required in the following cases where[110],

- The Indian company is being established with foreign investment and is owned by a non-resident entity or

[106] Regulation 10A (b), Foreign Exchange Management (Transfer or Issue of Security by a Person resident outside India) Regulations, 2000.

[107] Regulation 9, Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000

[108] ibid

[109] Regulation 10B (2), Foreign Exchange Management (Transfer or Issue of Security to any Person resident outside India) Regulations, 2000

[110] Press Note 3 of 2009

- An Indian company is being established with foreign investment and is controlled by a non-resident entity or
- The control of an existing Indian company, currently owned or controlled by resident Indians and Indian companies, which are owned or controlled by resident Indians, will be/is being transferred/passed on to a non-resident entity as a consequence of transfer of shares to non-resident entities through amalgamation, merger, acquisition etc. or
- The ownership of an existing Indian company, currently owned or controlled by resident Indians, will be/is being transferred/passed on to a non-resident entity as a consequence of transfer of shares to non-resident entities through amalgamation, merger, acquisition etc.

4.4.3 Acquisition of control over 5 per cent in a private bank: If any foreign investor acquires and thereby owns or controls 5 per cent or more of the paid up capital of the private bank, then the RBI guidelines relating to acquisition by purchase or otherwise of shares of a private bank will apply, whether it is through the direct investment route or portfolio investment route.[111] These are measures to protect the interest of depositors and the integrity of the financial system.

Accordingly, there has to be provision in the Articles of Association to the effect that no transfer or acquisition of shares by an individual or a group to a level of 5 per cent or more of the total paid up capital of the bank takes place unless there is prior acknowledgement by the RBI. In the case of such transfers of shares exceeding 5 per cent or more of the paid up capital of the bank, the bank has to approach the RBI for the acknowledgement of

[111] Supra n. 23

transfer/allotment of shares after the Board makes the review. This Guideline will apply if the direct or indirect holding, beneficial or otherwise of any person exceeds five percent or more. Such transfer cannot be registered in the books of the bank unless it is acknowledged by the RBI. The RBI can stipulate that for any subsequent acquisition at any higher threshold also this requirement has to be satisfied. However, in case of restructuring of problem/weak banks or in the interest of consolidation in the banking sector, the Reserve Bank may permit a higher level of shareholding, including by a bank.[112]

In considering an application for the grant of acknowledgement for the transfer of shares, RBI can take into account all matters that it considers relevant to the application, including the fitness and propriety of the concerned shareholders. However, it can include other factors as considered relevant by the RBI.

Some of the factors which the RBI can take into account for considering whether the applicant is fit and proper to hold the position of the shareholder are the integrity, reputation and track record of the applicant in financial matters, compliance with tax laws, history of proceedings of a serious disciplinary or criminal nature or any such impending proceedings or any investigation which may lead to such proceedings in respect of the applicant, record or evidence of previous business conduct and activities where the applicant has been convicted for an offence under any legislation designed to protect members of the public from financial loss due to dishonesty, incompetence or malpractice, whether the applicant has achieved a

[112] India's Financial Sector- An Assessment, Advisory Panel on Financial Stability Assessment and Stress Testing (Vol. III), Committee on Financial Sector Assessment, March 2009

satisfactory outcome as a result of financial vetting, the source of funds for the acquisition and in the case of applicants who are body corporates, the track record of good corporate governance, financial strength and integrity, in addition to the assessment of the individuals and other entities associated with the body corporate.

The RBI stipulates for enhanced precautions, if the acquisition raises the shareholding of an investor to a level of 10 per cent or more and up to 30 per cent. At such a juncture, the RBI can take into account factors including, source and stability of the funds for the acquisition and the ability to access financial markets as a source of continuing financial support for the bank, the business record and experience of the applicant including any experience of acquisition of companies, the extent to which the corporate structure of the applicant will be in consonance with effective supervision and regulation of the RBI and in the case of applicants which are financial entities, whether the applicant is widely held entity, publicly listed and a well established regulated financial entity in good standing in the financial community.

A higher level of precaution through further additional conditions is imposed if the shareholding through acquisition or investment is to exceed 30 per cent which includes the conditions as to whether the acquisition is in public interest, the desirability of diversified ownership of banks. the soundness and feasibility of the plans of the applicant for the future conduet and development of the business of the bank and the shareholder agreements and their impact on the control and management of the bank.

In addition and more importantly, the acknowledgment by the RBI will be subject to compliance by the applicant with other applicable laws and

regulations as those issued by the SEBI, DCA and IRDA. The applications will be considered on the basis of recommendations made by an independent Advisory Committee.

However, it is pertinent to note in this context that certain private banks in India have a very high percentage of foreign shareholding, like the ICICI Bank, ING Vysya bank etc.

4.4.4 Restriction on shareholding by different entities in a private sector bank: Concerns about the diversified ownership of banks have prompted the RBI to put in checks in the shareholding pattern and limits in the private sector banks in India.[113] These guidelines will be applicable to the foreign banks which are making investment in Indian private sector banks. Acquisition of shares of five per cent and above of the paid up capital of the private sector bank requires the acknowledgment from the RBI.[114] The objective of the Guidelines is to ensure that no single entity or group of related entities has shareholding or control, directly or indirectly, in any bank in excess of 10 per cent of the paid up capital of the bank.

In the case of ownership by a corporate entity, no single individual/entity has ownership and control in excess of 10 per cent of that entity. In the case of ownership by a financial entity, it has to be ensured that it is a well established regulated entity, widely held, publicly listed and enjoys good standing in the financial community. [115]

Large industrial houses will be allowed to acquire, by way of strategic investment, shares not exceeding 10 per cent of the paid up capital of the bank

[113] 'Guidelines on Ownership and Governance in Private Sector Banks' dated February 28, 2005, http://www.rbi.org.in/upload/content/images/guidelines.htmlb, accessed on 28.08.08
[114] ibid
[115] ibid

subject to the approval of the RBI. This limitation can, if considered necessary be extended to important shareholders with other commercial affiliations.[116]

Banks (including foreign banks having branch presence in India) / FIs should not acquire any fresh stake in a bank's equity shares, if by such acquisition, the investing bank's / FI's holding exceeds 5 per cent of the investee bank's equity capital.[117]

However, such limitations on shareholding will not apply in the case of restructuring of problem/weak banks or in the interest of consolidation in the banking sector; RBI may permit a higher level of shareholding.[118]

4.4.5. Norms of corporate governance in private sector banks:

As recommended by the Ganguly Committee, the roles and responsibilities of the directors of banks are to be well defined. There must be representation in the directors from the sectors specified in the Banking Regulation Act.[119]They must also fulfil the corporate governance norms as well as 'fit and proper' status of important shareholders. There is also restriction as to more than one member of family or close relative or associate being on Board of Directors.

4.4.6. Presence of foreign banks in banking in India

Foreign banks are permitted to make their presence in Indian private banking either through branches or subsidiaries. A foreign bank can operate in India only through one of the three channels, viz, (i) branch/es, (ii) a WOS and (iii)

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[116] ibid

[117] RBI/2004-05/21 DBOD. BP. BC. No. 3/21.01.002/2004-05, Prudential Norms on Capital Adequacy –Cross holding of capital among banks/ financial institutions, as incorporated in the Guidelines on Ownership and Governance in Private Sector Banks

[118] Supra n. 111

[119] According to Section 10A (2) of the Banking Regulation Act, at least 51% of directors must have special knowledge or practical experience in accountancy, agriculture and rural economy, banking, co-operation, economics, finance, law, small scale industry etc.

a subsidiary with aggregate foreign investment up to a maximum of 74 per cent in the private bank.[120]

The initiative of the RBI in the operationalization of Press Note 2 of 2004 as regards the presence of 'foreign banks' in private banking market in India, is contained in the ***'Roadmap for the Presence of Foreign Banks in India'***. A gradualist two track approach has been adopted by the Roadmap for the implementation of the Policy on the presence of foreign banks in private banking, where the first track is the consolidation of the domestic banking in both public and private sectors and the second track is the gradual enhancement of the presence of foreign banks in a synchronised manner. India's commitments under the WTO are also given importance in this two track approach. It has divided the implementation into two phases, the former being the period March 2005 to March 2009 and the latter being the period beginning from April 2009.

The first phase for the presence of foreign banks in India has already expired. In this period, the presence of foreign banks could be in the following forms:

1. Branch
2. Wholly Owned Subsidiary
3. Acquisition of shareholding in select Indian private sector banks identified by the RBI for restructuring

4.4.6.1 PHASE I

a) Wholly Owned Subsidiary: The setting up of subsidiaries by foreign banks was one of the moves that was recommended by the Narasimham

[120] Supra n. 23

Committee on Banking Sector Reforms.[121] It was recommended that foreign banks may be allowed to set up subsidiaries or joint ventures in India which should be treated on par with other private banks and be subject to the same conditions with regard to branches and directed credit as the latter.[122]

Foreign freshers in Indian private banking sector can make their debut as a Wholly Owned Subsidiary of the parent foreign bank. A foreign bank is permitted to establish a WOS either through conversion of the existing branches into a subsidiary or through a fresh banking licence.[123] Foreign banks regulated by banking supervisory authority in the home country and meeting the licensing criteria prescribed by the RBI is allowed to hold 100 per cent paid up capital to enable them to set up a WOS.[124] "A foreign bank or its wholly owned subsidiary regulated by a financial sector regulator in the host country can now invest up to 100% in an Indian private sector bank. This option of 100% FDI will be only available to a regulated wholly owned subsidiary of a foreign bank and not any investment companies. Other foreign investors can invest up to 74% in an Indian private sector bank, through direct or portfolio investment."[125]

A foreign bank has to apply to the RBI for the setting up of WOS and has to satisfy the requirements as provided in the 'Annexure to Roadmap for the Presence of Foreign Banks in India'. Adequacy of the prudential supervision of the applicant foreign bank in the home country is a primary factor considered by the RBI, when considering the application of the foreign bank

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[121] Kakkar Vaibhav, 'Foreign Banks in India: Present and Future Perspective', [2005] 60 SCL 97
[122] www.rbidocs.rbi.org.in/rdocs/AnnualReport/PDFs/31197.pdf, accessed on 15.04.09
[123] Supra n. 23
[124] ibid
[125] http://www.banknetindia.com/banking/0426.htm, accessed on 26.09.08

to establish WOS. This assessment will be made in the light of the Basel Standards. Approval of the regulator of the home country of the foreign bank is also required for the grant of approval for establishing WOS by a foreign bank in India. Other factors that will be considered by the RBI in giving approval for the setting up of WOS are the economic and political relations between India and the country of incorporation of the foreign bank, financial soundness of the foreign bank, ownership pattern of the foreign bank, international and home country ranking of the foreign bank, rating of the foreign bank by international rating agencies and international presence of the foreign banks. Since the list of factors is inclusive, other factors as well can be considered by the RBI.

The minimum start up capital for the WOS of a foreign bank is Rs.3 billion and the capital adequacy ratio is 10 per cent or as may be prescribed from time to time on a continuous basis, from the commencement of operations of the WOS[126]. In view of the implementation of the Basel II[127] norms, specific CRAR has been specified in respect of Tier I and Tier II capital for both foreign as well as domestic banks. The difference between foreign and domestic banks in this case is that the former has started its implementation in March 2008, whereas the latter has to start the implementation from March 2009. The current prevailing rate of minimum CRAR is 9 per cent, according to the Basel II accord. The parent of the foreign bank is required to hold 100 per cent equity in the Indian WOS for a minimum prescribed period of operations.

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[126] Annexure to the Roadmap for the presence of foreign banks in India, http://www.rbi.org.in/upload/content/pdfs/Annexure.pdf, accessed on 28.08.08

[127] *Infra* Chapter V

As regards licensing of the wholly owned subsidiary of a foreign bank, it is provided that the WOS will be subject to the licensing requirements and conditions broadly consistent with those for the new private sector banks. It is pertinent to note that provision does not stipulate for pure parity between WOS of foreign bank and new private sector bank in this regard. However, India does not as of now follow the policy of differential bank licensing. Though the 'Technical Paper on Differentiated Bank Licensing' elaborately spoke about graded licensing and it was proposed by Governor Y.V. Reddy[128] as well, finally the Technical Paper recommended for the maintenance of the status quo, ie, single class of bank licences. "India issues a single class of banking licence to foreign banks and does not place any limitations on their operations. All banks can carry on both retail and wholesale banking. 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. Other prudential norms such as exposure limits are the same as those applicable to Indian banks."[129] "This would essentially mean that the single class of licence would place them virtually on the same track as Indian banks and would not place any restrictions on the scope of their operations, either on the wholesale or retail segment."[130] Banks in India, both Indian and foreign, enjoy full and equal access to the payments and settlement systems and are full members of the clearing houses and payments system.

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[128] Annual Policy Statement for the Year 2007-08 by Dr. Y. Venugopal Reddy, Governor, Reserve Bank of India, April 24, 2007, http://rbi.org.in/scripts/NotificationUser.aspx?Id=3445&Mode=0#185, accessed on 04.05.09

[129] Technical Paper on Differentiated Bank Licensing, http://www.rbi.org.in/scripts/PublicationsView.aspx?id=9795, accessed on

[130] http://www.financialexpress.com/news/foreign-entrants-will-improve-banking/355613/, accessed on 3rd May 2009

For the purpose of branch expansion, the WOS will be treated on par with existing branches of foreign banks and there is flexibility go beyond the existing WTO commitments of 12 branches in a year and preference for branch expansion in under-banked areas. However, there is a catch that the Reserve Bank may also prescribe market access and national treatment limitation consistent with WTO as also other appropriate limitations to the operation of the WOS, consistent with the international practices and the country's requirements. This has created some confusion among foreign banks.[131]

There are certain requirements on the front of corporate governance of the WOS of a foreign bank. There are certain limitations on the composition of the Board of Directors.[132] Not less than 50 per cent of the directors of the WOS should be Indian nationals. Further, not less than 50 per cent of the Directors will be non-executive directors. A minimum of one-third of the directors should be totally independent of the management of the subsidiary in India, its parent or associates. The directors have to conform to the 'Fit and Proper' criteria[133] as laid down in RBI guidelines

A WOS can be formed by a foreign bank also through the conversion of existing branches of foreign banks into a WOS. But it can be done only on the basis of one-mode presence criterion, i.e., when such a WOS is to be formed, the existing branch licence has to be given up. All the requirements which apply in the case of formation of a new WOS will apply in this case as well. However, there are some additional requirements as well. The permission for

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131 'RBI unveils Roadmap for Presence of Foreign Banks in India and Guidelines on Ownership and Governance in Private Banks', Press Release, February 28, 2005

132 Supra n. 124

133 Available at http://rbidocs.rbi.org.in/rdocs/Notification/PDFs/54648.pdf, accessed on 04.05.09

the opening of the WOS through this route will inter alia be guided by the manner in which the affairs of the branches of the bank are conducted, compliance with the statutory and other prudential requirements and the overall supervisory comfort of the Reserve Bank.[134]

While reckoning the minimum net worth of the WOS which is formed from the conversion of a branch into WOS, the local available capital including remittable surplus retained in India, as assessed by the RBI will be qualified.[135] The RBI will also inspect/audit the financial position of the branches operating in India and arrive at the aggregate net worth of the branches.[136]

Converting a bank into a WOS will require it to be registered as a company under the Companies Act, 1956. For the formation of a fresh WOS of a foreign bank also incorporation of a company under the Companies Act, 1956 is required.

The WOS will be governed by the provisions of the Companies Act, 1956, Banking Regulation Act, 1949, Reserve Bank of India Act, 1934, other relevant statutes and the directives, prudential regulations and other guidelines/instructions issued by RBI and other regulators from time to time. So the provisions of the Companies Act, 1956 will apply in the formation of the Wholly Owned Subsidiary, except in situations in which specific provision is made in the Policy or the Banking Regulation Act, 1949.

Though it can be said theoretically that 100% shares can be held by a foreign company, practically, Indian law does not permit one man companies. So there has to be a nominal shareholder as well.

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[134] Supra n. 124
[135] ibid
[136] ibid

However, the truth is that no foreign bank has as of now resorted to the WOS route for establishing their presence in India.

b) Acquisition of holding in private sector banks identified by the RBI for restructuring

In the first phase till 2009, foreign banks would only be allowed in a phased manner to acquire up to 74 per cent ownership in distressed private sector banks identified by the Reserve Bank for restructuring. In other private sector banks, no bank can have a stake in excess of 5 per cent.[137] Thus, there is a limitation on foreign banks to make investment in the private banking sector. During this phase, eligible foreign banks converting can be permitted to acquire shareholdings in Indian private sector banks, which would be limited to banks in need of restructuring.[138] Between March 2005 and March 2009 foreign banks will be permitted to take equity only in private banks that the RBI identifies for restructuring and be allowed to acquire a controlling stake in phases.[139]

In the first phase of the Roadmap, foreign bank will be permitted to establish a subsidiary through acquisition of shares of an existing private sector bank provided that at least 26 percent of the paid up capital in the private sector bank is held by residents at all times. However, such acquisition of holding can be made only in private sector banks identified by the RBI for restructuring by eligible foreign banks. In such an acquisition by a foreign bank of a private sector bank also the Reserve Bank must be satisfied about the adequacy of the prudential supervision in the home country, economic and

[137] Supra n. 110

[138] India's Financial Sector- An Assessment, Advisory Panel on Financial Stability Assessment and Stress Testing (Vol. I). Committee on Financial Sector Assessment, March 2009

[139] http://www.domain-b.com/finance/banks/rbi/20050301_fdi.html, accessed on 26.09.08

political relations between both the countries, the financial soundness of the foreign bank, ownership pattern of the foreign bank, international and home country ranking of the foreign bank, rating of the foreign bank by international rating agencies, international presence of the foreign bank etc. The RBI can in this case undertake enhanced due diligence on the major shareholders to determine their 'Fit and Proper status'. The track record of the foreign bank in restructuring is a relevant factor considered by the RBI. The eligibility of foreign bank and requirements as to minimum required capital will be same as in the case of setting up of WOS by a foreign bank.[140]

"The Reserve Bank may, if it is satisfied that such investment by the foreign bank concerned will be in the long-term interest of all the stakeholders in the investee bank, permit such acquisition. Where such acquisition is by a foreign bank having presence in India, a maximum period of six months will be given for conforming to the 'one form of presence' concept."[141]

None of the foreign banks have yet set up an Indian subsidiary. They have also not been allowed to buy any local banks, even though quite a few weak banks were up for grabs. At least three old private banks were placed under moratorium, freezing all banking activities, over the last two years before their mergers. These were all offered to local players even though foreign banks were eager to buy them. In all these cases, foreign banks' proposals did not find favour with RBI as they wanted to conduct detailed due diligence before firming up their plans. The banking regulator, however, was in no mood to

[140] Supra n. 124
[141] Supra n. 110

give them time as it wanted to lift the moratorium on the weak banks fast and protect depositors from any discomfort for long.[142]

c) Branches: Though not investment in the strict and legal sense of the term, one of the options that are available before the foreign banks for establishing their presence in India is the establishment of branches. This is the most widely used mode by the foreign banks for ensuring their presence in India. Branch of foreign banks are a part of the same legal entity as the foreign bank. This is most preferred mode of entry for foreign banks. Branches, being entities dependent on the parent foreign bank have more access to financial strength from the foreign banks. Such a benefit is not available in the case of subsidiaries which are Stand-Alone entities. This mode does not require the complexities associated with the establishment of a local company and acquisition of reputation and goodwill.

Though, as per the WTO Commitments of India in force now commits only for twelve branches of foreign banks in a year, including both new and existing foreign banks, the number of branches of foreign banks permitted to be established is far above the level. The Roadmap envisages for a more liberal approach in the licensing of foreign banks in under-banked areas.

Branch under the Banking Regulation Act: The establishment of branch offices of foreign companies in India is generally regulated by the Foreign Exchange Management (Establishment in India of Branch or Office or Other Place of Business) Regulations, 2000. Though it is stipulated under the Regulation that a person resident outside India cannot open branch office in India without the approval of the RBI as provided under the Regulation, an

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[142]http://www.livemint.com/2007/06/29003900/Foreign-banks-jostle-for-footh.html?pg=2, accessed on 02.05.09

exception has been made in respect of banking companies which have obtained the necessary approval under the provisions (sections 22 and 23) of the Banking Regulation Act, 1949.[143] It is pertinent to note that if the intention of the foreign bank is to carry on banking business in India, it has to obtain a licence under the Banking Regulation Act. Therefore the banking companies take recourse to the provisions under the Banking Regulation Act, according to which certain conditions are to be satisfied by the foreign bank.[144]

Liaison office under the FEMA: An approval of the RBI to set up a liaison office or branch office under the Foreign Exchange Management (Establishment in India of branch or office or other place of business) Regulations will not equip the foreign bank to do the banking, since under the Regulation, there are certain limited activities that can be carried on by the branch office or liaison office of any person resident outside India, namely, rendering of professional/consultancy services, carrying out research work, in which the parent company is engaged, promotion of technical and financial collaborations between Indian companies and parent or overseas group company, representing parent company as buying/selling agent in India, rendering services in Information Technology and development of software in India, rendering technical support to the products supplied by parent/group companies etc.[145]In case of liaison office, the activities are representing in India the parent company/group companies, promotion of technical/financial collaboration between parent/group companies and companies in India and acting as a communication channel between the parent company and Indian

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[143] Proviso to Regulation 3, Foreign Exchange Management (Establishment in India of Branch or office or other place of business) Regulations, 2000
[144] Supra pp. 29-30
[145] Schedule I, Foreign Exchange Management (Establishment in India of Branch or Office or other Place of Business in India) Regulations, 2000

companies. Many of these services are either not relevant in the context of banking companies or will not serve the purpose for which the branch is to be established. For the establishment of branch office under the Regulation, the person resident in India has to apply to the RBI in Form FNC 1.[146]

Branch Authorization in the case of foreign banks: Along with the conditions that are applicable to the authorization of branches of Indian banks, certain additional requirements are there for the authorization of branches of foreign banks. At the time of opening of the first branch foreign banks are required to bring an assigned capital of US$25 million upfront. In the case of foreign banks which just have one branch, it has to satisfy this condition before the opening of the second branch as well. The conditions which the RBI will take into account in the granting of authorization to foreign banks to open branches are the track record of the group of compliance and functioning in the global financial markets, report of the home country supervisors, treatment extended to Indian banks in the home country of the applicant foreign bank, bilateral and diplomatic relations between India and the home country and the commitments of India under the WTO.[147] Weightage will also be given to even distribution of home countries of foreign banks having presence in India.[148]

Foreign banks which establish branches in India have to submit annual branch expansion plan to the RBI.[149]

[146] Regulation 5 (i), Foreign Exchange Management (Establishment in India of Branch or Office or other Place of Business in India) Regulations, 2000
[147] Master Circular on Branch Authorization, July 01, 2008
[148] ibid
[149] ibid

4.4.6.2 PHASE II

Phase II of the 'Roadmap for the presence of foreign banks in India' commenced from April 2009. Foreign banks were initially eagerly waiting for the Phase II of the Roadmap to grab the opportunities that might arise. After a review of the experience in the Phase I and after due consultation with the stakeholders, Phase II envisages the removal of limitations on the operations of the WOS and treating them on par with the domestic banks to the extent possible.[150]

Another measure envisaged in the Phase II of the Roadmap is the dilution of stake of the foreign banks in WOS after minimum prescribed period of operation so that resident Indians will get a stake of at least 26 per cent. Further, these banks will be allowed to get listed as well. The dilution of stake can be either by way of Initial Public Offer or as an Offer for Sale.[151]

The most luring of all the plans in the second phase of the Roadmap to the foreign banks is the part which stipulates for mergers and acquisitions of foreign banks with any private sector banks in India. According to the Roadmap, after a review of the extent of penetration of foreign investment in Indian banks and functioning of foreign banks, mergers and acquisitions of foreign bank with any private sector bank can be permitted, subject to the overall investment limit of 74 per cent.[152]

4.4.6.3 FOREIGN BANKS ADOPTING THE NBFC ROUTE

Phase I of the Roadmap for the presence of foreign banks has elapsed. In that phase, three options were there before the foreign banks, namely, branches,

[150] Roadmap for the Presence of Foreign Banks in India, http://www.rbi.org.in/upload/content/images/RoadMap.html, accessed on 28.08.08
[151] ibid
[152] ibid

WOS, acquisition of shareholding in private sector banks identified by the RBI for restructuring. However, due to the restrictions and limitations faced by foreign banks inter alia, in making entry, branch expansion and tax issues through some of these routes, many of the foreign banks opted for the NBFC route, either for entry or for further expansion.

NBFCs can also provide services which a bank cannot provide through the banking route. Another advantage of NBFCs cited by foreign banks is the reduced cost of operations. A bank's NBFC subsidiary which grants retail loans such as consumer loans, vehicle loans, housing loans etc. coupled with a bank ATM can circumvent the branch authorization restrictions imposed on the bank by extending its outreach substantially. The customer can deposit or withdraw cash at the bank ATM. obtain a loan from the NBFC and make repayments into the loan account by using the bank ATM. Thus, the bank together with its NBFC subsidiary can perform more or less all the functions which a bank branch undertakes.[153]

NBFCs are of two types, namely. Non-Deposit taking NBFCs and deposit taking NBFCs, for the former of which there is minimal regulation. Further, NBFCs can undertake activities that are not permitted to be undertaken by banks or which the banks are permitted to undertake in a restricted manner, for example, financing of acquisitions and mergers, capital market activities, etc. The differences in the level of regulation of the banks and NBFCs, which are undertaking some similar activities, gives rise to considerable scope for

[153] Financial Regulation of Systemically Important NBFCs and Banks' relationship with them, http://www.rbi.org.in/scripts/NotificationUser.aspx?Id=3206&Mode=0, accessed on 07.05.09

regulatory arbitrage.[154] Also, 100 per cent FDI under automatic route is permitted in the case of 19 activities of NBFCs.[155]

The level of foreign ownership in the non-banking financial companies (NBFCs) is much higher in India than many other developing countries. Many foreign banks extensively use the NBFCs to expand their businesses in the country due to relaxed regulations, low capital requirements and less stringent policies on branch expansion and credit delivery.[156] A foreign bank can set up a wholly owned non-banking subsidiary if it brings in $50m. Unlike banks, there is no regulation on NBFCs setting up branch networks.[157]

There is certain regulatory arbitrage in the case of NBFCs-ND, namely:[158]

i) The NBFCs -NDs are exempted from CRAR requirement.

ii) The NBFCs-NDs are exempt from credit and investment concentration norms.

iii) The Non-deposit taking NBFCs are not subject to restrictions on investment in land and building and unquoted shares.

iv) The NBFCs-NDs are subject to less supervisory rigour in the sense that normally they are not subjected to any inspection.

v) The banks with a limited branch network may find the NBFC route as convenient for business expansion by circumventing the branch licensing requirements.

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[154] Financial Regulation of Systemically Important NBFCs and Banks' relationship with them, http://www.rbi.org.in/scripts/NotificationUser.aspx?Id=3206&Mode=0, accessed on 07.05.09
[155] Press Note 7 of 2008
[156] Kavaljit Singh, India – EU Free Trade Agreement: Should India open up banking sector? – Special Report
[157] 'RBI asks foreign banks to give details of local arms', http://portal.bsnl.in/intranetnews.asp?url=/bsnl2/content%20mgmt/html%20content/business/business35248.html, accessed on 12.05.09
[158] Supra n. 132

vi) The foreign bank sponsored NBFCs generally have a high credit rating such as AAA, etc. which enables it to raise low cost debt resources with ease. This obviates the need for further infusion of funds by the parent for their activities in India.

So many foreign banks opted for the NBFC route for the expansion of their business in India. The capital market exposure limits for NBFCs are nil in certain cases and in other cases it is high. However they have to follow the consolidated prudential norms now[159]. This has put a curb on the presence of banks in the NBFC sector. These restrictions and regulations are applicable only in the case of Deposit taking NBFCs.[160]

4.4.7. REPORT OF THE COMMITTEE ON FINANCIAL SECTOR ASSESSMENT AND THE CURRENT POSITION ON THE PRESENCE OF FOREIGN BANKS IN INDIA (ANNUAL POLICY STATEMENT FOR THE YEAR 2009-10)

The dreams and aspirations of many of the foreign banks have been shattered by the spectre of the global financial turmoil which was triggered by the sub-prime crisis. The year 2009 was expected to be the year when mergers and acquisitions between Indian and foreign banks will take place. Uncertainty is now shrouding over the financial strength of banks all over the world.

4.4.7.1. Report of the CFSA

The Committee on Financial Sector Assessment (CFSA) constituted by the Government of India in consultation with the Reserve Bank in September 2006 to undertake a comprehensive self-assessment of India's financial sector has come up with its report in March 2009 and has made certain

[159] *Infra* 5.7

[160] Vide DBOD. No. FSD BC.46/24.01.028/2006-07 dated December 12, 2006

recommendations on the future course of action to be adopted in respect of the *Roadmap for the Presence of Foreign Banks in India.*

The CFSA is of the opinion that the entry of foreign banks needs to be gradual and consistent with the overall financial policy strategy and the transition should happen smoothly without causing any imbalances. According to the CFSA Report, foreign banks can operate in India either as branches or under the subsidiary route, but subject to reciprocity. Further, it recommends that though the branch licensing policy could be broadly structured as per the WTO commitments, the licensing of branches would continue to be based on reciprocity. [161]

"When the foreign banks adopt the subsidiary route, the foreign shareholding should not exceed 74 per cent and in that case all the regulatory guidelines and norms applicable to private sector banks could be made applicable to them. The Indian subsidiaries of these banks should be listed in the Indian stock exchanges. The Report further recommends that there is a need to have independent directors on the board of directors for Indian subsidiaries of foreign banks to protect the interest of all the shareholders. The expansion in operations of foreign banks should not affect the credit flow to the agriculture and small and medium enterprises. If there is a policy-mandated requirement of funding such entities, there should be no discrimination between foreign and domestic banks, as exists at present. Subsidiaries of foreign banks would be subject to all requirements that the Indian banks are subject to."[162]

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[161] Supra n. 54

[162] ibid

4.4.7.2. Annual Policy Statement for the Year 2009-10[163]

Taking into account the snowballing effect of the global financial crisis, the RBI in its Annual Policy Statement has adopted a cautious approach. The recommendation of the CFSA is not adopted. At present uncertainty is looming around the financial sector and the regulatory and supervisory policies at national and international levels are under review. So the RBI has in effect extended the timeline for further liberalization of banking sector as contemplated in the Phase II of the Roadmap for the presence of foreign banks. The status quo continues to be maintained until after due consultation with the stakeholders, once there is greater clarity regarding stability, recovery of the global financial system, and a shared understanding on the regulatory and supervisory architecture around the world.

[163] http://rbi.org.in/scripts/NotificationUser.aspx?Id=4936&Mode=0, accessed on 07.05.09

CHAPTER V

FOREIGN INVESTMENT IN BANKING – ALLIED REQUIREMENTS

Foreign investment in banking and entry of foreign banks to India touches various nodes of Indian legal and regulatory framework. Apart from the conditions and provisions as to the forms of entry, cap on foreign investment etc. there are several factors which are to be considered before a foreign investor makes investment in Indian private banking sector.

5.1 REQUIREMENTS UNDER THE COMPANIES ACT, 1956

One of the most important factors that are to be considered when a foreign investor plans to invest in India is the type of legal entity that is suitable for the intended purpose.

Branches: Foreign companies which are companies incorporated outside India have to comply with certain formalities for the establishment of a place of business in India, namely, compliance of the Indian Companies Act and compliance of Reserve Bank of India's rules and regulations. Under the Companies Act, it has to make certain filing of documents with the Registrar of Companies.[164]

Incorporation of company in India (WOS/JV): When the chosen legal entity is a company, which is the case in the setting up of WOS and JV, the provisions of the Companies Act, 1956 will be applicable in as much as it is not governed by the Banking Regulation Act, 1949.

As per the provisions of the Companies Act, if a company or association or partnership with more than ten persons wants to carry on the business of

[164] u/s 592, Companies Act, 1956

banking, either it has to be registered as a company under the Companies Act or it has to be formed in pursuance of some other Indian law[165]. In the case of private banks, it has thus to be registered under the Companies Act. In addition to this it must obtain licence from the RBI.

Under the Companies Act, there are two main types of companies, namely, public limited companies and private limited companies. Among them, public limited companies which deal with public money have more requirements to be satisfied under the Companies Act than private limited companies. One more category of companies is companies which are deemed to be public companies.

In the case of banking, the nature of the company in the case of foreign investment essentially depends on the type of entity used. In the case of WOS of foreign banks, they can incorporate it as private or public companies. But the treatment of private subsidiary of a foreign public company is a bone of contention in India. WOS later on have to dilute their stake to divest 26% shareholding to resident Indians after the minimum prescribed period of operation as per the ***Roadmap for the presence of foreign banks in India.*** As per the latest report of the CFSA, such companies can be allowed to be listed as well. This means that at that stage the company has to go public, if that move is adopted by the RBI in Phase II of the Roadmap.

The Companies Act says that if the entire share capital is held by one or more foreign bodies corporate even though they may be public companies as per the definition of the Act, it will not be treated as subsidiary of a public company but will be treated as a private company which is not the subsidiary of a public

[165] Section 11, Companies Act, 1956

company for the purposes of the Act.[166] If any portion of its share capital should be held by one or more individuals anywhere, or by an Indian company however small a fraction the shareholding may be, the private company will be treated as a subsidiary of a public company. As a company requires at least a minimum of two members, it is necessary for a private company not being considered as subsidiary of a public company that its shares should be held by at least two foreign bodies corporate as its members, though one of them may be a nominee.[167]

In the case of private companies which are subsidiaries of public companies, a number of provisions of the Companies Act like sections 269, 295 etc. will be applicable.

So the company has two options before it, namely, incorporation of a public company or a private company. In the case of private companies, there is restriction on the right of members to transfer shares, number of members, prohibition of invitation to public to subscribe shares and prohibition of invitation or acceptance of deposits from or to person other than its members, directors or their relatives[168]. However, such kind of limitations is not there in the case of public companies. But in the case of WOS in banking, it is advisable to incorporate as a private company and later on go public.

There is no bar on the appointment of foreign directors in Indian banks. This does not require the approval of the RBI also. In the case of WOS, 50% of the directors must be Indian nationals. However, directors must have expertise in the fields as provided in the Banking Regulation Act.

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[166] Vide section 4 (7), Companies Act, 1956

[167] Ramaiya A, Guide to Companies Act, Treatise – Part I, 15th Edn, Wadhwa and Company, p. 115

[168] Section 3 (1) (iii), Companies Act, 1956

Stamp Duty: In the case of setting up of a Wholly Owned Subsidiary of foreign banks, relevant stamp duty has to paid under the applicable laws. The Memorandum of Association and Articles of Association are required to be stamped adequately in the prescribed manner and mode. Rules 10 and 39 of Schedule I of the Indian Stamp Act, prescribe the rates of stamp duty payable on the Memorandum of Association and Articles of Association. The different States prescribe different rates of stamp duty applicable to the companies incorporated in their respective territories.

Concerns over stamp duty is one of the factors that has deterred foreign banks in setting up WOS.

5.2 ACQUISITION OF IMMOVABLE PROPERTY

Though the Banking Regulation Act [169]provides that a banking company must not hold any immovable property acquired by it for a period exceeding seven years, the holding of property for its own use is provided as an exception to this requirement.

In the case of private sector banks and foreign banks, the norms and procedures to be followed for acquisition of accommodation on lease/rental basis by these banks for their use should be determined by the banks themselves, as per the policy laid down by the Board of Directors. Banks have to ensure that all their branches/offices are operating from premises which have a subsisting valid lease agreement, free of any disputes between the bank and the landlords.[170] If any such disputes are pending, the same has to be reported to the Regional Director.

[169] Vide section 9, Banking Regulation Act, 1949

[170] 'Acquisition of Accommodation on Lease/Rental basis by Commercial banks for their branches/offices – Liberalisation of Guidelines', RBI/2008-09/132 DBOD.No.BL.BC.

The acquisition of immovable property in India by a person resident of India who is not of Indian origin is difficult in India. The provisions of the Foreign Exchange Management (Acquisition and Transfer of Immovable Property in India) Regulations, 2000 governs the situation. Such a person can at the most take immovable property on lease provided the period of lease does not exceed five years. This creates an obstacle for foreigners to be employed in the branch office of a foreign bank in India. There has been constant demand from the trading partners of India for the removal of such a restriction. In addition to this there may be requirements under the state laws as regarding reporting of the stay of the foreigner to Police etc.

As regards foreign companies which have established in India in accordance with the Foreign Exchange Management (Acquisition and Transfer of Immovable Property Outside India) Regulations, 2000, a branch office can acquire immovable property in India which is necessary for or incidental to the carrying on of such activity.[171] This will be applicable in the case of branch offices of foreign banks.

As regards subsidiary in India, which is incorporated in India or Wholly Owned Subsidiary of a foreign bank in India, they being companies incorporated in India will not have such obstacles.

5.3 PRUDENTIAL MEASURES IN RELATION TO EXPOSURE NORMS

No distinction is made between foreign and Indian banks on exposure norms. It is equally applicable to all scheduled commercial banks.

32/22.01.03/2008-09, http://www.rbi.org.in/scripts/NotificationUser.aspx?Id=4424&Mode=0, accessed on 12.05.09

[171] Regulation 5, Foreign Exchange Management (Acquisition or Transfer of Immovable Property in India) Regulations, 2000

Generally, the exposure ceiling limit for credit exposure is 15 per cent of capital funds in case of a single borrower, which can exceed by an additional 5 per cent if it is on account of extension of credit to infrastructure sector and 40 per cent of the capital funds in the case of a borrower group.[172]

The aggregate exposure of a bank to the capital markets cannot exceed 40 per cent of its net worth. In the case of consolidated bank, it must not exceed 40 per cent of the consolidated net worth.

Banks' investment in equity shares, preference shares eligible for capital status, subordinated debt instruments, hybrid capital instruments and any other instrument approved as in the nature of capital, which are issued by other banks/FIs cannot exceed 10 per cent of the investing bank's capital funds. Further, banks/FIIs should not acquire any fresh stake in a bank's/FIs equity shares, if by such acquisition, the investing bank's/FIs holding exceeds 5 per cent of the investee bank's equity capital.[173]

5.4 MEASURES ON CAPITAL ADEQUACY AND MARKET DISCIPLINE – BASEL II

Foreign banks operating in India and Indian banks having presence outside India were to migrate to the standardised approach for credit risk and basic indicator approach for operational risk under Basel II with effect from March 31, 2008. This has been successfully implemented. But in the case of other banks, the deadline for the adoption of the norms was March 31, 2009.

Under the Revised Capital Adequacy Framework implementing the Basel II Norms of the BIS[174], foreign as well as domestic banks are to maintain a

[172] Master Circular – Exposure Norms, dated July 01, 2008
[173] ibid
[174] Master Circular – Prudential Guidelines on Capital Adequacy and Market Discipline – Implementation of the New Capital Adequacy Framework. July 01, 2008, RBI 2008-09/68

minimum Capital to Risk-weighted Assets Ratio (CRAR) of 9 per cent. However, under Pillar II, the RBI can prescribe higher level of minimum capital ratio based on the risk profiles and risk management systems of each bank. The banks are expected to operate at a level well above the minimum requirement.

At the Tier I CRAR of at least 6 per cent has to be maintained by banks. The components of Tier I capital vary for foreign and domestic banks.

In the case of Indian banks, Tier I capital includes, paid up equity capital, statutory reserves and other disclosed free reserves, capital reserves representing surplus arising out of sale proceeds of assets, eligible innovative perpetual debt instruments, eligible perpetual non-cumulative preference shares or any other instrument generally notified by the Reserve Bank.

In the case of foreign banks, Tier I capital includes interest free funds from HO kept separately for maintaining the capital adequacy, statutory reserves kept in Indian books, remittable surplus retained in Indian books which is not repatriable so long as the bank functions, capital reserve representing surplus arising out of sale of assets in India held in a separate account and which is not eligible for repatriation so long as the bank functions in India, interest free funds remitted from abroad for the purpose of acquisition of property, HO borrowings in foreign currency by foreign banks operating in India for inclusion in Tier I capital and any other item allowed by the RBI.

Foreign banks have to give an undertaking to the RBI that it will not remit abroad the 'capital reserve' and 'remittable surplus retained in India' as long as they function in India to include it in the Tier I capital. These funds are to

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DBOD.No.BP.BC. 11 /21.06.001/2008-09

be retained in a separate account named 'Amount Retained in India for meeting Capital to Risk-weighted Asset Ratio Requirements'. The net credit balance, if any, in the inter-office account with Head Office / overseas branches will not be reckoned as capital funds. However, any debit balance in the Head Office account will have to be set-off against capital. An auditor's certificate to the effect that these funds represent surplus remittable to Head Office once tax assessments are completed or tax appeals are decided and do not include funds in the nature of provisions towards tax or for any other contingency may also be furnished to Reserve Bank.

Tier II capital comprises of Revaluation Reserves, general provisions and loss reserves, hybrid debt capital instruments, subordinated debt, innovative perpetual debt instruments (IPDI) and Perpetual Non-Cumulative Preference Shares (PNCPS) and any other type of instrument notified by the Reserve Bank. Upper Tier 2 instruments along with other components of Tier 2 capital cannot exceed 100 % of the Tier I capital. Subordinated debt instruments eligible for inclusion in Lower Tier 2 capital will be limited to 50 per cent of Tier I capital after all deductions.

In the case of banks in India, they are allowed to recognise funds raised through debt capital instrument which has a combination of characteristics of both equity and debt, as Upper Tier 2 capital provided the instrument complies with the regulatory requirements. Indian banks are also allowed to issue Perpetual Cumulative Preference Shares, Redeemable Non-Cumulative Preference Shares and Redeemable Cumulative Preference Shares as Tier 2 capital. This facility is available only to Indian banks and not foreign banks. A

bank incorporated in India will have access to capital with the choice of raising Tier 2 capital in the local market like the Indian banks.

A bank's aggregate investment in all types of instruments, eligible for capital status of investee banks / FIs / NBFCs / PDs as prescribed, should not exceed 10 per cent of the investing bank's capital funds (Tier 1 plus Tier 2, after adjustments). Any investment in excess of this limit shall be deducted at 50 per cent from Tier 1 and 50 per cent from Tier 2 capital. Investments in equity or instruments eligible for capital status issued by FIs / NBFCs / Primary Dealers which are, within the aforesaid ceiling of 10 per cent and thus, are not deducted from capital funds, will attract a risk weight of 100 per cent or the risk weight as applicable to the ratings assigned to the relevant instruments, whichever is higher. As regards the treatment of investments in equity and other capital-eligible instruments of scheduled banks, within the aforesaid ceiling of 10 per cent, will be risk weighted as per paragraph 5.6.1. Further, in the case of non-scheduled banks, where CRAR has become negative, the investments in the capital-eligible instruments even within the aforesaid 10 per cent limit shall be fully deducted at 50 per cent from Tier 1 and 50 per cent from Tier 2 capital.

The investments made by a banking subsidiary/associate in the equity or non equity regulatory-capital instruments issued by its parent bank, should be deducted from such subsidiary's regulatory capital at 50 per cent each from Tier 1 and Tier 2 capital, in its capital adequacy assessment on a solo basis. The regulatory treatment of investment by the non-banking financial subsidiaries / associates in the parent bank's regulatory capital would,

however, be governed by the applicable regulatory capital norms of the respective regulators of such subsidiaries / associates.

The revised Capital Adequacy Framework, assigns risk weights on claims to different kinds of entities.

Pillar 2 and 3 of the Basel II which is implemented through the Revised Capital Adequacy Framework are the Supervisory Review Process and Market Discipline, which envisages suitable risk management systems in banks and their review by the supervisory authority as well as guidelines on market discipline to complement the requirements under the other two pillars, through appropriate disclosures, interaction with accounting disclosures etc. Banks are required to have a process for assessing their capital adequacy in relation to the risk profiles and also must have a strategy for maintaining capital levels. Supervisors must review, monitor and ensure its compliance with regulatory capital ratios. Banks are to have capital in excess of regulatory minimum level of capital. Supervisors must expect banks to operate in that manner. Supervisors should intervene at an early stage to prevent capital from falling below the minimum.

Though the minimum CRAR is stipulated at 9 per cent, the capital adequacy of scheduled commercial banks is above that level. At the end of March 2008, the overall CRAR of banks improved to 13.0 per cent from 12.3 per cent a year ago.[175]

5.5 LENDING TO THE PRIORITY SECTORS

"The Government of India through the instrument of Reserve Bank of India (RBI) mandates certain type of lending on the Banks operating in India

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[175] Operations and performance of Commercial Banks 2007-08, Part 2 of 3, www.rbi.org.in, accessed on 12.05.09

irrespective of their origin. RBI sets targets in terms of percentage (of total money lent by the Banks) to be lent to certain sectors, which in RBI's perception would not have had access to organised lending market or could not afford to pay the interest at the commercial rate. This type of lending is called Priority Sector Lending."[176]

Under the regulatory regime distinction has been made between Domestic commercial banks and Foreign Banks in respect of priority sector lending. The total priority sector advances for the domestic commercial banks and foreign banks are 40 per cent and 32 per cent respectively.[177] For foreign banks no target has been specified as agricultural advances, 10 per cent for small enterprise advances, same target as domestic commercial banks for micro-enterprises within Small Enterprises sector, 12 per cent for export credit and no target has been stipulated in respect of advances to weaker sections and differential rate of interest scheme.[178]

This is considered to be a factor which diminishes the lustre of establishment of branch office of a foreign bank in India, according to many foreign banks. Removal of the requirement of priority sector lending has been one of the factors that have been demanded by trading partners and foreign service providers to India.[179]

Indian subsidiaries of foreign banks will therefore be governed by the 40 per cent priority sector lending norm requirement and branches of foreign banks in India will be governed by the 32 per cent priority sector lending requirement.

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[176] http://www.banknetindia.com/banking/psl.htm, accessed on 07.05.09
[177] Master Circular on Priority Sector Lending, July 01, 2008
[178] ibid
[179] www.commerce.nic.in, accessed on 06.05.09

5.6 TAX IMPLICATIONS OF INBOUND INVESTMENTS IN BANKING IN INDIA

According to the Indian Income Tax Act, 1961, taxation will be done on the income earned by the foreign companies which has accrued, is received or is deemed to accrue in India. In India. taxation is based on residential status.

Where India has entered into tax treaties with the home country of the foreign investing entity, the investor has the option to be governed by the beneficial among the two, i.e, tax treaty or the Income Tax Act.

A subsidiary or a wholly subsidiary of a foreign bank will be resident in India as it is incorporated in India and will be taxed on its global income, like any other Indian bank. Dividend/interest paid by an Indian company will be taxed in India.

However, foreign banks which come as branches will not be residents and they will be taxed on income earned in India or from a source/activity in India. The provisions of the DTAA if any, also has to be taken into account.[180]

Rates of taxation: In India, domestic companies (Joint Ventures/subsidiaries/WOS) are taxed at the rate of 30 per cent of the total income.[181] In the case of foreign banks which are foreign companies, the rate is 40 per cent.[182]In addition to this the applicable surcharge also has to be paid.

In ascertaining taxable income, all expenditure incurred for business purposes are deductible. This includes interest on borrowings paid in the financial year and depreciation on fixed assets. In the case of domestic companies, there is a

[180] Section 90 (2), Income Tax Act, 1961
[181] Finance Bill, 2009
[182] ibid

flat corporate tax of 30%.[183] In the case of foreign companies, the rate of corporate taxation excluding the tax on royalties and technical fees is 40 per cent.[184]

Securities Transaction Tax: Every transaction relating to the purchase and sale of equity shares on a recognized stock exchange will be subject to Securities Transaction Tax.

Dividend Tax: Under Section 115-O of the Income Tax Act, any amount declared, distributed or paid by a domestic company by way of dividend shall be chargeable to dividend tax. Only a domestic company (not a foreign company) is liable for the tax. Tax on distributed profit is in addition to income tax chargeable in respect of total income. It is applicable whether the dividend is interim or otherwise. Also, it is applicable whether such dividend is paid out of current profits or accumulated profits.[185]It is paid as Dividend Distribution Tax by the Indian company. The current rate of dividend distribution tax is fifteen per cent.[186] Amounts declared, distributed or paid as dividends are totally exempt from income tax in the hands of shareholders.[187] Thus this will not be applicable in the case of branch of foreign companies, but only in the case of subsidiaries or WOS of foreign banks in India. This will apply if an Indian bank has foreign investors as well.

Taxation of investment income of Non Resident: In the case of companies, unless the company is an Indian company or one the control and management of which is situated wholly in India, it will not be considered as resident.[188]

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[183] Finance Bill, 2009
[184] ibid
[185] http://business.gov.in/taxation/different_taxes.php, accessed on 12.05.09
[186] Section 115O, Income Tax Act, 1961
[187] Sapan Vipool, Parekh Shah, 'Inward and Outward Investment: India and the UK',
[188] However, provisions of individual DTAA also have to be taken into account.

Where the non-resident income has only investment or income by way of long term capital gains or both, the Non-Resident will not be entitled to any deduction under Chapter VIA of the Act and also will not be eligible to claim indexed cost of acquisition/improvement.[189] A Non-Resident who earns long-term capital gains on shares of an Indian company is exempt from such capital gains if he re-invests the entire sales proceeds within six months in a new 'specified asset'. If he does not re-invest, the resulting long term capital gains will be taxed at 10.2%. Investment income on specified assets is taxed at 20.4%.

Taxation of FII: Section 115AD of the Income Tax Act deals with taxation of investment income on securities and capital gains arising on eventual transfer of such securities held by FII. The controversy is whether the security held as stock-in-trade and is taxable as business income or is it held as an investment and hence taxable as capital gains. At present, the gains made by some FIIs in Indian capital markets are treated as business income and are not taxable on the grounds that these institutioms do not have permanent establishments in India. However. there has been contrary view in the case of Fidelity Advisory, where it was held that the income of FII will be taxed as capital gains and not as business income.

Taxation of interest on borrowings from or to HO of foreign banks: The question whether the Indian branch of the foreign bank and the parent bank are one and the same or separate legal entities arises when considering the payment of interest by the Indian branch on the sums borrowed from the parent bank. This was addressed in a decision of the Special Bench of the

[189] Vide section 115D, Income Tax Act. 1961

ITAT Kolkata, where it was held that both are the two wings of the same person and are not separate and independent taxable entities and that there was no question of deduction of tax at source.[190]

In computing the income of the foreign bank, deduction is allowed for expenses incurred in earning such income including a portion of the head office expenses. The head office and overseas branches of foreign banks usually lend monies to the Indian branch or borrow monies from the Indian branch. Thus, interest is either paid or received by the Indian branches to or from head office or other overseas branches. The taxability of such interest in India is a bone of contention in India. The foreign banks borrow money from the parent offices and repatriate interest earned on such profits as advances, which is termed as head office expenditure. The Mumbai Income Tax Tribunal has ruled in the cases of Degremont International, Banque Indosuez and Banque National de Paris that the expenditure incurred by a foreign parent company for its operations in India will be taxed if it exceeds 5 per cent of the profit. However, there is no such taxation in respect of Indian entities. As per the provisions of the Income Tax Act, in case of a non-resident, head office expenditure is allowed to be deducted from total income at the rate of 5% of the adjusted total income or expenditure actually incurred by the taxpayer, whichever is less.[191]

However, as regards the receipt of interest from the head office outside India, by the branch office of the foreign bank, it was held by the Mumbai Tribunal that it was a taxable income in India and the Indian branch and the head office

[190] ABN Amro Bank NV v. Assistant Director of Income Tax, [2006]280ITR117(Kol)
[191] Vide section 44C, Income Tax Act, 1961

of the bank outside India cannot be considered as the same entity for the purpose.[192]

The Divisional Bench of the Mumbai Tribunal, in the case of American Express Bank Ltd.[193], it was held that income received/receivable by the Indian branch from the head office is not chargeable to tax in India. The Tribunal observed that since there was no Tax Treaty between India and USA during 1991-92 Assessment Year (1991-92), the provisions of the Income Tax Act would be applicable.

Thus there is no settled position of law as to the taxability of the interest paid/received by the Indian branch of a foreign bank. The decisions of the Kolkata and Mumbai Tribunals were admitted to be incongruent and it was held to be applicable only in the case of accrual of income through profits from the Head Office of the foreign bank. The position remains a bit nebulous until it is settled by a higher authority.

Discriminatory tax provisions: Foreign banks are discriminated against in some aspects under the Income Tax Act, 1961. In India, domestic companies (Joint Ventures/subsidiaries/WOS) are taxed at the rate of 30 per cent of the total income.[194] In the case of foreign banks which are foreign companies, the rate is 40 per cent.[195]In addition to this the applicable surcharge also has to be paid.

With respect to deductions in respect of any provision for bad and doubtful debts, a scheduled or non-scheduled bank, other than a bank incorporated by or under the laws of a country outside India, is entitled to deductions at the

[192] Dresdner Bank AG v. ACIT, [2007] 11 SOT 158 (Mum)
[193] American Express Bank Ltd. v. DCIT ITA No. 2770/Mum/1996 and DCIT v. American Express Bank Ltd. ITA No. 2439/Mum/1996 (Mumbai Tribunal)
[194] Finance Bill, 2009
[195] ibid

rate of 7.5 % of the total income (computed before making Chapter VIA deductions) and 10% of aggregate rural advances.[196] The applicability of this provision is excluded in respect of banks incorporated by or under the laws of a country outside India. Further such banks also have an option to claim deduction up to 10% of the doubtful assets/loss assets as on the last day of the previous year as per the guidelines of the Reserve Bank of India. Banks incorporated outside India are entitled deduction at 5 % of the total income (before Chapter VIA deductions) for provision for bad and doubtful debts.[197] In keeping with the Report of the Task Force on Direct Taxes, the Report of the Working Group on Non Resident Taxation had recommended that foreign banks should be allowed deduction in accordance with the prudential guidelines issued by the RBI.[198]

Another discriminatory provision in respect of foreign companies is regarding the deductions in respect of the proportionate amounts of VRS payments in the event of business reorganization by way of amalgamation, demerger, acquisition, or succession of business, which is available only to the amalgamating and amalgamated Indian companies.[199] This seems to be an anomaly as section 35DDA (1) extends the benefit of amortization of VRS expenditure to all assesses.

5.7 EXPOSURE OF BANKS TO NBFCs

Due to the widespread practice of foreign banks resorting to the NBFC route for gaining advantage of the few regulations in that sector, RBI has introduced

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[196] Section 36 (viia) (a), Income Tax Act, 1961
[197] Section 36 (viia) (b), Income Tax Act, 1961
[198] Report of the Working Group on Non Resident Taxation, January 2003, www.necbookpalace.com/nec/index.php?target=products&product_id=15986, accessed on 23.04.09
[199] Section 35DDA (2), Income Tax Act, 1961

limits on the exposure of banks to NBFCs. However, only deposit taking NBFCs have been made subject to prudential regulations. The main intent of it is the protection of the interest of the depositors.

Banks in India, including foreign banks operating in India, shall not hold more than 10 % of the paid up equity capital of an NBFC – D.

NBFCs promoted by the parent / group of a foreign bank having presence in India, which is a subsidiary of the foreign bank's parent / group or where the parent / group is having management control would be treated as part of that foreign bank's operations in India and brought under the ambit of consolidated supervision. Consequently, the concerned foreign banks should submit the consolidated prudential returns (CPR) prescribed by the above guidelines to the Department of Banking Supervision and also comply with the prudential regulations / norms prescribed therein to the consolidated operations of that bank in India. Where a foreign bank is holding between 10% and 50% (both included) of the issued and paid up equity of an NBFC, it will be required to demonstrate that it does not have a management control in case the NBFC is to be kept outside the ambit of consolidated prudential regulations.

The exposure (both lending and investment, including off balance sheet exposures) of a bank to a single NBFC / NBFC-AFC should not exceed 10%/15% respectively, of the bank's capital funds as per its last audited balance sheet. Banks may, however, assume exposures on a single NBFC/NBFC-AFC up to 15%/20% respectively, of their capital funds

provided the exposure in excess of 10%/15% respectively, is on account of funds on-lent by the NBFC /NBFC-AFC to infrastructure sectors.[200]

The structural requirements imposed are that investment by a bank in a financial services company cannot exceed 10 per cent of the paid-up share capital and reserves and investments in all such companies, financial institutions, stock and other exchanges put together should not exceed 20 per cent of the banks' paid up share capital and reserves. Further, banks in India have to obtain the prior approval of the RBI before being granted Certificate of Registration for establishing an NBFC and for making a strategic investment in an NBFC in India. However, foreign entities, including the head offices of foreign banks having branches in India may, under the automatic route for FDI, commence the business of NBFI after obtaining a Certificate of Registration from the Reserve Bank.[201]

5.8 BORROWING LIMIT

Without making any distinction as between foreign banks and domestic banks, all AD Category-I banks can borrow funds from their Head Office, overseas branches and correspondents and overdrafts in nostro accounts up to a limit of 50 per cent of their unimpaired Tier I capital as at the close of the previous quarter or USD 10 million (or its equivalent), whichever is higher.[202] There are certain category of borrowings that are outside the limit of 50 per cent of unimpaired Tier I capital or USD 10 million, whichever is higher:

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[200] Master Circular – Exposure Norms dated July 01, 2008, RBI/2008-2009/80 DBOD No. Dir. BC. 19/13.03.00/ 2008- 09

[201] 'Financial Regulation of Systemically Important NBFCs and Banks' Relationship with them', Dec 12, 2006, RBI/2006-07/205 DBOD. No. FSD. BC.46 / 24.01.028/ 2006-07

[202] 'Overseas Foreign Currency Borrowings by Authorized Dealer Banks – Enhancement of limit', RBI/2008-09/227 AP (DIR Series) Circular No. 23, dated October 15, 2008

- Overseas borrowings by AD Category – I banks for the purpose of financing export credit subject to the conditions prescribed in IECD Master Circular dated July 1, 2003 on Export Credit in foreign currency;
- Subordinated debt placed by head offices of foreign banks with their branches in India as their Tier II capital;
- Capital funds raised/augmented by the issue of Innovative Perpetual Debt Instruments and Debt Capital Instruments, in foreign currency;
- Any other overseas borrowing with the specific approval of the RBI.

Both foreign banks as well as domestically incorporated banks cannot borrow or lend in foreign exchange under the automatic route.[203] However, they can borrow under the approval route, subject to the limitations and restrictions as to the lenders, purpose, maturity etc. of the borrowing.[204]

5.9. REMITTANCE OF PROFITS

Indian branches of foreign banks operating in India may remit to their Head Offices outside India net profit/surplus (net of taxes) arising out of their Indian business after finalisation of the accounts for the respective year, in accordance with the provisions of the Banking Regulation Act, 1949 and directions issued by Reserve Bank in this regard[205]. Foreign banks operating in India may remit net profits/surplus (net of tax) earned in a quarter year in the normal course of business arising out of their Indian operations on a quarterly basis, to their Head Offices without prior approval of RBI provided the accounts of the bank are audited on a quarterly basis and appropriate transfer

[203] Foreign Exchange Management (Borrowing or Lending in Foreign Exchange) Regulations, 2000

[204] ibid

[205] http://www.rbi.org.in/SCRIPTs/ECMUserParaDetail.aspx?Id=582&CatID=14, accessed on 13.05.09

to statutory reserves are made as per the provisions of Section 11(2)(b)(ii) of the Banking Regulation Act, 1949 and the other relevant provisions of the Banking Regulation Act, 1949 and directions issued by RBI in this regard are complied with. In the event of excess remittance, Head Office of foreign banks should immediately make good the shortfall.[206]

[206] 'Remittance of profit by foreign banks operating in India', DBOD.No.IBS.BC. 46/16.13.100/2003-04, http://www.rbi.org.in/scripts/NotificationUser.aspx?Id=1407&Mode=0, accessed on 15.04.09

CHAPTER VI

NEED AND THE DEMERITS OF FOREIGN INVESMENT IN BANKING

6.1 NEED OF FOREIGN INVESTMENT IN BANKING

According to Stultz, opening markets to foreign investors reduces a country's cost of capital by decreasing systematic risk. Stulz identifies two primary reasons for the decline – the potential for reduced systematic risk resulting from better diversification of risk and the potential for lower agency costs resulting from alignment of manager and shareholder interests due to improved monitoring of management and the threat of takeover.[207]

The introduction of foreign investment in banking is a part of globalization of finance that has been adopted by the many nations of the world. These moves are adopted by nations on the belief that it leads to greater profitability, more efficient allocation of resources and diversification of risk. It is a part of the initiatives to introduce a nation's banking into the arena of global competition, which is required taking into account the broader process of political and economic integration. The policy of liberalisation that has been adopted by the Indian economy since 1991 is an effort to raise Indian economy to a level where it can compete globally. In that effort foreign investment and participation has been permitted in almost every sector, except a few prohibited ones. This increases the demand for high quality banking services and more innovative financial products for facilitating foreign participation in Indian economy as well as the flow of funds from inside India and outside India. The expertise of foreign banks and Indian banks with foreign

[207] Supra n. 17

participation in this regard is better as compared to local Indian banks with domestically sourced capital.

Foreign participation in various methods including through foreign investment in banking is means to raise enough capital by the banks. The Bank for International Settlements which has come with Basel II norms, prescribes certain levels of capital adequacy for banks. So far as India is concerned, the foreign banks present in India and Indian banks having overseas presence were mandated to migrate to the standardized approach for credit risk and basic indicator approach to operational risk under Basel II from March 31, 2008 and in the case of Indian banks, the due date has been March 31, 2009. The minimum stipulated CRAR for Tier I capital in India is 9 per cent. Similar measures when adopted by foreign countries, also necessitates the requirement of capital in the banking sector. In India, the following had been the estimates of ICRA, "In ICRA's estimates, Indian banks would need additional capital to the extent of Rs. 120 billion to meet the capital charge requirement for operational risk under Basel II. Most of this capital would be required by the public sector banks (Rs. 90 billion), followed by the new generation private sector banks (Rs. 11 billion), and the old generation private sector banks (Rs. 7.5 billion). In ICRA's view, given the asset growth witnessed in the past and the expected growth trends, the capital charge requirement for operational risk would grow 15-20 percent annually over three years, which implies that the banks would need to raise Rs. 180-200 billion over the medium term[208]."

Another need that is often cited as a factor which supports foreign investment in banking is the recapitalisation of problem/weak banks. This had been a part

[208] Chandrasekhar C.P. and Ghosh Jayati, 'Basel II and India's Banking Structure', accessed on http://www.macroscan.org/fet/mar07/print/prnt030307Basel_II.htm 13th January 2009

of the agenda of the RBI as well, since the Roadmap for the Presence of Foreign Banks in India provides that within the ceiling of 74% FDI foreign banks can acquire in a phased manner shares in private sector banks identified by the RBI for restructuring. In economies of nations which have suffered from recent financial crisis where banks are thirsty for capital, foreign banks can be a good solace.

The popular justification of foreign investment in banking revolves around the role of foreign investment as a source of non-debt inflows and its role as a means of attaining competitive efficiency by creating a meaningful network of global interconnections[209]. This argument gains ground because inefficiency had crept in the Indian banking sector after the era of nationalization of major banks. The resultant public sector banks had poor lending practices and did not have an internal risk management system[210].

Introduction of competition in the banking market is another factor that is often cited as a favourable factor associated with the liberalization of the banking sector. It has brought about greater competition among banks, both domestic and foreign. This is squeezing banks profitability and is forcing the banks to work efficiently. This is favourable to banks' customers. This increases the choice that is available to consumers and the level of sophistication and the diversity of products being offered. Increase in the level of technology used is another positive fall out of foreign participation in the Indian banking sector. Efficiency can be gained through through adoption of

[209] Badade Kunal, Katkar Medha, 'Foreign Direct Investment in banking Sector – A Boon in Disguise', http://www.indianmba.com/Faculty_Column/FC499/fc499.html, accessed on 19.04.09

[210] Shirai Sayuri 'Assessment of India's Banking Sector reforms from the perspective of the governance of the banking system'

new technologies, products and management techniques which are brought in by foreign investors.

However, there is a counter argument to justification of foreign investment in banking as a promoter of efficiency in the banking sector that now domestic private sector banks are utilizing such facilities.

Other factors which necessitate foreign investment in banking are mainly to do away with the problem of inefficient management, Non-Performing assets, Financial Instability, poor risk management practices, poor capitalization and also to cope up with the changing financial market conditions. Also it is useful in transfer of technology from overseas countries to the domestic market. Host countries benefit from the technology transfers and innovations in products and processes commonly associated with foreign bank entry.

In general, more efficient allocation of credit in the financial sector, better capitalization and wider diversification of foreign banks along with the access of local operations to parent funding, may reduce the sensitivity of the host country banking system and lead towards financial stability.

6.2. REVERSE SIDE OF THE COIN – DEMERITS OF FOREIGN INVESTMENT AND PARTICIPATION IN BANKING

Foreign banks have a tendency to concentrate their activities in serving corporate clients rather than financing activities that expand local production capacities and employment. So there are chances of the foreign banks from getting detached from local economy with large scale foreign participation.

Instead of the purported target of financial inclusion, it can lead to financial exclusion. Such situations have been reported from countries like Mexico.[211]

The need of increased presence of foreign banks in India has been questioned on the ground that in many countries that have a high foreign bank presence, it was a sequel to a banking crisis, when banks were sold to foreign banks because of shortage of capital to do the banking business.[212] Consequently, the improvement in efficiency is considered to be so great only due to the fact that the banking system was in the throes of crisis prior to the entry of foreign banks. It is just due to injection of capital into moribund banking systems.[213]

Doubts have been expressed as to whether foreign banks will bring in efficiency for individual banks or to the banking sector as a whole. The danger in relation to foreign banks is that foreign banks will "cherry-pick" the best relationships in the system leaving the domestic banks enfeebled.

Argument goes to the effect that on the front of competition, if the foreign banks come through acquisition of stake in existing private sector banks, it will not have any positive impact on competition. But such an effect will be there only when the foreign banks enter through Greenfield route.

The most important of the various factors listed by the opponents of foreign banks is the ability and taste of the foreign banks to cater to the greater social requirements of the Indian economy, including financial inclusion, development of agriculture and the financial stability.

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[211] Biles J. James, 'Globalization of Banking and Local Access to Financial Resources – A Case Study from Southeastern Mexico', igeographer.lib.indstate.edu/biles.pdf, accessed on 21.05.09

[212] Ram Mohan T.T., 'Is it time to open up to foreign banks?', Economic & Political Weekly, July 12, 2008, p. 12

[213] ibid

Higher foreign participation in the banking sector either in the form of investment or through the entry of foreign banks would expose the Indian economy to the shocks from the international financial system. In the case of presence of foreign banks, they may react to erosion of capital in their parent economies by cutting down on balance sheet size. Credit standards can be tightened by them due to slow down in the global economy.

Foreign banks' presence may weaken monetary policy transmission because foreign banks have access to a large pool of funds beyond the control of monetary authority. Foreign banks also pose significant challenges to regulation as well.

CHAPTER VII

CONCLUSION AND SUGGESTIONS

Foreign investment in banking. a great policy question in India had been a bone of contention among the political parties since the opening up of the sector to foreign participation. Always considered to be a strategic sector, this feeling is natural.

Though WTO had been a strong driving force in the liberalization of foreign investment in banking, it can be seen that India has been showing greater enthusiasm and was ahead of the Roadmap for the presence of foreign banks in India.

The list of eligible investors in banking is quite large and is incomparable to the position in other jurisdictions. In addition to banks and other financial institutions, corporates and individuals are free to make investment in Indian banking. Further foreign investment in Indian banking can take the form of FII as well as FDI. The conditions to be satisfied by a foreign bank investor in Indian banking does not require it to have previous presence in India, as is the case with China.

India issues a single class of bank licence, irrespective of the ownership or holding of the banking company. Indian law accords equitable treatment to banks with foreign shareholding. domestic banks and foreign banks, as to the business that can be carried on by them. All banks can carry on the business of banking as also any of the permissible activities as stipulated under the Banking Regulation Act. Such treatment is not meted out in jurisdictions like China or the United States of America. Foreign and domestically incorporated

banks are treated equally in relation to deposit insurance, prudential norms, asset classification, provisioning etc.

Some of the few checks that can be found only in relation to foreign banks in India are taxation of branches of foreign banks at a higher percentage, access for domestically incorporated banks to go to local market for raising Tier II capital etc. All these can only be considered as necessities in an economy like India which relies heavily on bank based financing. On a closer analysis it can be found that in certain aspects a positive discrimination is shown towards foreign banks, which is especially evident in the case of norms in relation to priority sector lending and the conditions and factors in relation to branch expansion by Indian banks.

WOS of foreign banks have the further advantage that it is treated on par with domestic banks on branch expansion. Though Indian law permits the establishment of WOS of foreign banks in India, no WOS of foreign bank exists as of now in India. Among the investors, there is an air of lack of clarity as to the treatment of WOS of foreign bank. This is because there is no compulsion in Phase I of the Roadmap for the presence of foreign banks that National Treatment must be given to WOS of foreign banks. However, apparently, except certain requirements like the one as to the composition of Board of Directors, according to which not less than 50% of the Directors of a foreign bank is to be Indian nationals etc., WOS of foreign banks is treated like Indian banks. However, when the RBI has directed for the continuance of the status quo on the presence of foreign banks in India, necessary clarification has to come from the RBI on the treatment of WOS of foreign banks, since

still now any market access and national treatment limitations can be imposed on them.

There are strong advocates of proportional voting rights in banks, which is essentially affecting those foreign banks who go for a phased acquisition of a private sector bank and other categories of foreign investors. However, it does not have any effective impact on foreign banks which establish WOS in India. However, given the present financial situation, it is not the right time to take away this cap and provide proportional voting rights to investors. In such a situation, the growing economy which relies on many activities which require special consideration will be seriously affected. The motive of foreign investors and foreign banks is not the development of Indian economy, but sheer profit. They can drive companies to a destiny which satisfies their motives of profiteering if proportional voting rights is allowed. Concentrated shareholding in banks controlling huge public funds does pose issues related to the risk of concentration of ownership because of the moral hazard problem and linkages of owners with businesses.

The year 2009 is a critical year in the Roadmap for the Presence of Foreign Banks in India. Anticipating India as an emerging super power, many eyes had been on Indian banking sector until recently hoping for a positive nod from the RBI permitting acquisition and merger and acquisition by foreign banks of Indian banks. As usual India being on the moderate side has not gone for an aggressive liberalization in foreign investment in banking even after April 2009. This is attributable partly to the financial turmoil that hit the markets world over following the sub-prime crisis in the US. Everywhere regulators have tightened the locks of the doors of investment and foreign participation.

Banks which were more exposed to foreign participation had to taste the bitterness of the turmoil. Indian regulator following a moderate approach did not leave Indian banking sector to suffer. In addition to this the Government ownership in the public sector banks also placed India in a safe position.

An analysis of the Indian policy on foreign participation in banking reveals that it is more towards the lenient side.

India has foreign investment in banking in the form of direct as well as portfolio investment. FII investments have the effect of a double-edged sword. At times of boom there will be huge influx of FIIs, but when the markets are down there will be depressing outflow of foreign exchange. So there has to be effective monitoring of the transactions of the FIIs.

Another very important factor that has to be considered by the RBI is the cold welcome received by the Indian banks when trying to establish their presence in other countries. This is despite the Indian policy of granting more branch licences than required under the WTO Commitments. The holding of ING in ING Vysya Bank is another evidence of the enthusiasm shown by Indian regulators in opening up the banking sector to foreign participation. Despite the fact that there are almost 52 branches of US banks in India, India just has around a dozen branches of Indian banks in the US. Applications from SBI and ICICI Bank for opening branches in the US are still pending.[214] Therefore, as has been highlighted in the Report of the CFSA, reciprocity has to taken into serious consideration when formulating the policy on the presence of foreign banks in Phase II of the Roadmap for the presence of foreign banks in India.

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[214] Gupta Shishir, 'India to US: Your banks coming in, you need to allow ours as well', http://www.indianexpress.com/news/india-to-us-your-banks-coming-in-you-need-to-allow-ours-as-well/223880/, accessed on 11.05.09

Considering the impact the Press Notes of 2009 can have on foreign investment in banking, appropriate clarification has to be brought in by the DIPP on the applicability of the provisions as to the calculation of foreign investment in the banking sector.

Considering the importance and significance of banking to the economy, there has to be strict supervision of the entry of foreign investors into the banking sector and has to be closely monitored by the regulator. Implementation of Basel II will also bring in more security in the dealings.

It is judicious to follow the gradual approach in adopting the Roadmap at the present juncture. Indian banks must also must be in a position to stand the rigors of foreign competition through adoption of Basel norms and consolidation in the local banking market. Once it has been achieved and the effects of the financial turmoil has subsided the India can open up the banking sector for foreign mergers and acquisitions. However, such requirements as priority sector lending cannot be dispensed with and has to be an integral part of Indian banking.

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