The upcoming new regulation regarding Capital Requirements & Shareholding for Foreign Banks in India

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1 Introduction

The Indian and global economy are back on track after the financial crisis. Now, in the aftermath, the Indian banking community needs to reconsider the structure of the financial sector for the immediate future.

Indian banks in general, have escaped the crisis. They were part of the highly regulated Indian environment and were hardly interwoven with the global financial economy—in terms of the risk sharing, in the trillions of dollars of straight and derivative financial products.

The winds of change are transforming the global banking landscape with incredible speed. Indian banks will become more visible among their international counterparts. The Indian banking sector will grow and will also be able to offer services on par with global players, and most important will have an appropriate infrastructure to manage: growth, financial stability, resilience, vision and social commitments.

In order to achieve this, the Ministry of Finance (MOF), and the Reserve Bank of India (RBI) intend to strengthen the banking sector by requiring higher levels of capitalization, to effectively implement the Basel II and III norms, and to fuel competition by issuing new banking licenses to private and foreign banks in India.

2 Foreign Bank Shareholding 2005-2010

In February 2005, the RBI released the ***Roadmap for presence of foreign banks in India***, laying out a two-track gradual approach, with the aim of increasing efficiency and stability of the banking sector in India. The first track pointed towards a consolidation of the domestic banking system, within the private and public sectors. The second track focused towards an enhancement of foreign banks in a synchronized manner.

Most foreign banks desirous of extending their business to India do not prefer the WOS route, which requires them to shell out more capital for the entry, with no commensurate benefit. Unless they are given national treatment, branch expansion in India would remain circumscribed, regardless of whether the branches-only or the WOS route is employed. What also worries them is an eventual listing on Indian stock exchanges that could be needed in case of domestic incorporation.

The roadmap was divided in two phases;

March 2005-2009

During the first phase, foreign banks, wishing to establish a presence in India could either choose to operate through 'branch presence' or set up a 100% Wholly Owned Subsidiary (WOS). This last option was offered for both existing foreign banks as well as for new foreign banks.

The WOS were to be treated on par with the existing branches of foreign banks for branch expansion in India. No foreign banks established itself as a WOS or converted to a WOS during this phase.. On June 30, 2010, a total of 32 foreign banks were present in India, of which more than 300 were foreign bank branches (0.36% of the total branch network in the country).

March 2009 onwards

The second phase began after a review of the first phase. However, in April 2009, the RBI stalled the plans for liberalizing the operations of foreign banks within the country, with respect to the global financial turmoil. But in August 2010 the RBI launched a discussion paper.

3 The Discussion Paper, August 2010

The RBI realizes the importance of a change in the economy; the move from a rural agrarian system to a post-industrial modern society. One of the prerequisites is a broad-based financial inclusion. A access to financial services, provides the under-privileged with the opportunity to build savings, make investments and avail credit.

The RBI has recommended that the District Consultative Committee draw up a roadmap to provide banking services in any form to every village with a population of over 2000 at least once a week on regular basis by March 2011.

After delaying the process of liberalization for foreign banks by over a year, the RBI released a discussion paper on 11 August 2010. The discussion paper focused on: ownership patterns, foreign shareholding regulations, capital requirements and the business model of new Private Banks.

The RBI is soliciting feedback from stakeholders by 30 September 2010. Based on this feedback, the RBI would then frame the policy (and as such the pending applications).

The RBI has taken a firm stance on key aspects for the issuance of new licenses:

- Licenses will only be issued whilst bearing in mind the larger mandate of Financial Inclusion (apart from the introduction of competition)
- Licenses will not be issued to any Non Banking Financial Companies (NBFC) or business housed engaged in the real estate activities
- The overseas holding has been capped at 50% for the first 10 years

The main issues examined in the discussion paper are listed below.

Capital requirements

The RBI proposed a few options outside the existing capital norms of ₹3 billion (approx. €50 million) for the new banks

- Have a minimum capital requirement at the higher side (approx ₹10 billion or €170 million) for new banks
- Have an initial minimum capital at some ₹5 billion (approx. €85 million) with a condition to raise the amount to ₹10 billion within a period of say 5 years

Financial inclusion

The RBI stresses the importance of strengthening the bank's capital base. However, the RBI also emphasises that banks will be able to take a more meaningful approach in the financial inclusion through their ability to invest in technology and cater to larger segments of unbanked populations.

The RBI highlights that shareholders who commit substantial amounts may be looking not only to the profitability niches, but also, based on their large size commercial banking capabilities, to financial inclusion.

Financial inclusion is the delivery of financial services at affordable costs to vast sections of disadvantaged and low income groups.

Financial Inclusion is about giving people an opportunity to build better lives, work towards contributing sustained improvements in the quality of life at the community level and foster overall growth at the national level.

Eligible shareholders

The discussion paper also raises the issue of the banking licenses for industrial holdings and conglomerates, who have access to sources of capital, management expertise and strategic direction. Conflicts of interest could arise as the firms misuse the bank for their own needs and restrict the credit flow to other competitors.

An option might be, that industrial holdings are required to acquire stakes in Regional Rural Banks (RRBs) before allowing them to set-up banks. In the present structure, RRBs are currently 50% owned by the Union government, 15% by the respective state governments and 35% by sponsored commercial banks.

The discussion paper also addresses the issue of converting Non-Banking Financial Companies (NBFCs) into full-fledged banks.

Ownership structure

Regarding the bank's ownership, the discussion paper suggests the following options:

- Retaining the current practise of requiring shareholders to bring in a minimum of 40% of the capital with lock-in clause for five years and a threshold for other significant shareholders to a maximum of 10% with the requirement to seek approval from the RBI on reaching 5% threshold and above. These shareholders too will have to dilute to the extent required in a time bound manner, five years after the lock-in period.
- Retain the general threshold for the shareholders at 5% of the capital but maximize shareholding for minority shareholders to 20% in the long run. Higher shareholding could be considered as exceptional and subject to stringent criteria.
- Allow shareholders to hold their initial shareholding of 40%, with the implication not to increase when the bank's capital grows.

Exhibit 1: Example

Percentage of Ownership	Bank's Capital (in INR)
Up to 40%	10 billion
30%	10-12 billion
20%	20 billion

Notes:

10 billion is equal to €170 million

20 billion is equal to €340 million

1 euro is approx. 60 INR

Business model

RBI wants to maintain the directive of 40% lending to agriculture and small loans, and 25% to rural branches, which all banks need to follow. New banks might be asked to focus on financial inclusion by opening branches in tier III-tier VI towns with population of less than 50,000.

Foreign banks are expected to move credit to priority sectors and ensure that these sectors advances (which include the Small Enterprises) constitute 32% of Adjusted Net Bank Credit (ANBC) or credit equivalent amount of Off-Balance Sheet Exposure, (whichever is higher.)

Within the overall target of 32% to be achieved by foreign banks, the advances to small enterprises sector should not be 10% of the adjusted net bank credit (ANBC) or credit equivalent amount of Off- Balance Sheet Exposure, (whichever is higher)

4 Implications

American Depositary Receipts (ADR) represent ownership in the shares of a non-U.S. company that trades in U.S. financial markets. The stock of many non-US companies trade on US stock exchanges through the use of ADRs.

A Global Depository Receipt or Global Depositary Receipt (GDR) is a certificate issued by a depository bank, which purchases shares of foreign companies and deposits it on the account. GDRs represent ownership of an underlying number of shares.

Foreign Banks that are planning to enter the Indian market might be allowed only a 50% stake in new banks that they propose to open and have to bring in a domestic partner. This means that they have to look for a domestic strategic partner for the remaining 50-51% stake.

There was an option under the Foreign Direct Investment Policy that, the foreign equity via Foreign Direct Investment (FDI) etc in a private foreign bank could be up to 74%, but the RBI is seems to intend to reduce this figure. Hence the new rule of 50% foreign equity is likely to be applied in the near future.

A reason for this change in policy is, that two of the largest private sector banks in India i.e. ICICI Bank and HDFC Bank, lost their "Indian-owned" status, as foreign investment in them exceeded 50%. This was as a result of the changes brought by the government in the way foreign direct investment is calculated including ADRs, GDRs and convertible bonds in the category.

Taking a leaf out of this scenario, The RBI is trying to ensure that new banks, do not lose their Indian-owned status, and as such propose the capping of: foreign investment, including FDI (Foreign Direct Investment), FII (Foreign Institutional Investment), and NRI holdings (Non Resident Indians), to remain below 50%.

The discussion paper has, in essence, put in to question the fate of 18 new foreign bank applications for bank licenses and representative offices, submitted to RBI before August 2010, which includes the likes of Goldman Sachs, National Australia Bank.

Some banks like Canada-based TD Bank have set up a representative office and are yet to apply for a license for commercial banking. Recently, Credit Suisse has received its license to operate in India, and Australia-based Commonwealth Bank has become operational with its first branch present in Mumbai on 25 Aug 2010, its primary focus being providing trade finance, remittance and foreign exchange to companies that trade between Australia and India.

5 Our View

The RBI's plans for new Foreign/Private Banks regulation are entering its final phase. It focuses on higher capitalisation, less foreign shareholding and more financial inclusion.

There are several scenarios possible for the new financial regulation with regards to foreign shareholding patterns such as:

- 50% Foreign Ownership only
- 74% Foreign Ownership (the present structure)
- Other Shareholder Ownership allowed (%)

We think the 50% holding limit for foreign banks will be the most likely outcome.

This will have negative effects; it will act as a deterrent towards the flow of foreign capital via the FDI route in the country. A limitation to 50%, is not encouraging to foreign capital owners at any point.

The other aspect that needs to be considered is the fact that foreign banks will have a bigger challenge ahead for them; to have a business model to carry out a host of activities with the right number of branches, diversified and strategically located to support various business sectors.

Foreign Banks planning to enter India need to have a business strategy, business model and an agile business plan in place, and to diligently and prudently work towards the various options they might have to counter under the new financial regulation.

RBI has already started stressing the need to open more branches on the existing new private banks (est. 1993) in order to create access to formal banking services to all segments of society.

The issue of industrial holdings to pick up a stake in RRB is no simple task. To change shareholding rules will require a change in the RRB Act 1976. This takes time. In the present scenario, there are 86 RRBs sponsored by 27 government-owned banks. Most of them are making losses, though some data suggests that the top five RRBs have a profitable business.

With regards to the issue of the ownership holding pattern, we believe that if the shareholder has a stake of 40%, they will have greater responsibility, which would then translate in the capacity of the bank to grow to a certain desired level and as a result instil confidence within the public of depositing in the bank. At a later stage this holding can be diversified to a lower level and the performance of the bank will not be affected.

The new bank license policy is the second wave, which in summary opened the gates to private banks in India in 1993, (when 10 new private banks were issued banking licenses to operate). Over the period of time only four banks still remain in the original shape (Size has increased X folds) as they were in 1993. Conversely, others were merged with these four original banks or some existing public sector banks.

The last license was issued in 2004 to Kotak Mahindra Bank, which was actually the only NBFC to be converted into a Commercial Private Bank and is currently successfully operational.

Some NBFCs have been well run for an over a decade and they have grown suitably to support the various priority sectors of the country. It is therefore imperative that they obtain a banking license.

The views and suggestions of the stakeholders will take some time to process. We expect the new legislation to become effective in 2011 12. It is unlikely that the RBI will enforce the new legislation in a short time frame.

Given the highly complex nature of the new legislation and its subsequent requirements, foreign banks are advised not to create a business plan without including the possible scenarios coming out of the new regulation.

Capgemini has been following these changes in policy and is well aware of all the facts and its implications. Therefore Capgemini has the capability to support foreign banks who want to enter or expand their activities in India by creating scenarios and indicating possibilities for capital and holding structure as well as help them structure and re-align their business model to comply with the new financial policy for market development.

6 How Can Capgemini Help?

Capgemini's extensive experience and in-depth knowledge of the Indian market can help banks to prepare for the challenges ahead. Capgemini has a number of services, each tailored to meet individual business requirements and operational needs:

- Scenario planning and business modelling. Development of possible scenarios, based on the most actual information regarding the outcome of the new regulation, for the most suitable business model to comply with regulation and the banks ambitions.
- Infrastructure model and architecture. Design and implementation of the local infrastructure as well as connecting to the national financial infrastructure.

Capgemini is able to deliver all necessary competences, both business and IT, to bring you up to speed in India.

How to start?

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