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The World and the Indian Banking Industry

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26 August 2006

Online at https://mpra.ub.uni-muenchen.de/1266/
MPRA Paper No. 1266, posted 28 Dec 2006 UTC

The World and the Indian Banking Industry

Introduction

The Indian banking industry is presently in a situation of great flux. There are various developments, changes within the Indian economy and deregulations occurring that have the potential to drastically change the way this industry functions in the future. As per the changes envisaged by the Reserve Bank of India (RBI), a roadmap has been laid down to gradually deregulate this sector to the foreign banks.

Some of these regulations include the following proposals:

- Lifting the ceiling on voting rights in banks
- Smoothen mergers and acquisitions of private banks
- Permit foreign banks to set up subsidiaries in India.
- A tentative nod to banks to permit trading in commodities and commodity derivatives

The major changes would be through removal of Section 12(2) of Banking Regulation Act, allowing voting rights in proportion to the shareholding. This was not the case earlier and was a major hindrance to the entry of foreign banks in India.

The banking industry caters to the following broad categories of products/services:

- Retail banking
- Retail products such as credit cards, debit cards etc.
- Portfolio Management: Mutual Funds etc.
- Corporate lending and project financing (including loans)
- Investment banking
- Foreign exchange trading

All of these areas have attracted substantial foreign interest in the event of the opening up of the Indian economy. Traditionally, Indian banks have used very conservative risk managing strategies, shying away from derivatives, commodities and real estate. However as the appetite for credit and newer banking products is increasing, this sector is no longer limited to Private Sector banks (PSBs). This also implies that there is a scope for consolidation,

amongst various sectoral banks as well as financial institutions so as to be able to provide these newer products and services to customers.

Issues

The fact that this sector is being deregulated has thrown up several issues, several of which have been debated both by the financial and the political experts:

Issue 1: Household savings, their investment and returns

According to a McKinsey report, the current Indian savings pattern is highly inefficient. This is because even though Indian households save 28% of their disposable income, they invest only half their savings in financial assets. The rest goes towards buying gold, housing, and buying/maintenance of equipment for the various small Indian enterprises. It is observed that "India's bank deposits, equities, and bonds represent just 160% of GDP, compared with 220% in China and 420% in Japan". More inefficiency is seen in the fact that regulations have traditionally required banks to hold 25% of their assets in government bonds. Government policy also requires banks to direct 36% of their loans to agriculture, household businesses etc., which have higher transaction costs and default rates. Due to this kind of a conservative policy, India's banks lend only 60% of their total deposits, one of the lowest lending ratios in the world. Hence there is a vast potential offered by this sector that the foreign players seem to be keen to tap [Diana Farrell, 2006].

Issue 2: Permissible risk appetite and risk-management instruments

As discussed before, banks have been pressurized into investing in the traditionally 'safe' assets such as low-yielding Government bonds. However with RBI giving a nod to banks to invest into credit derivatives and perhaps commodity derivatives in the future, it is likely that the risk-return profile shall undergo a drastic change. To pass on the benefits of this change to consumers, banks shall have to devise new instruments and products. It is here that there is an opportunity for foreign banks, not only to target the existing gap but also to infuse a new culture and of course, fresh funds.

Issue 3: Regulation pertaining to foreign banks

This mainly deals with the permission to be extended to foreign banks to set up subsidiaries and transact in bank buy-outs. Even though the FDI ceiling in a bank was raised to 74%, the ceiling of 10 per cent on voting rights irrespective of the shareholding in a bank was preventing foreign banks from venturing into India.

The RBI has now proposed to do away with this ceiling on voting rights in banks, to smoothen mergers and acquisitions of private banks and to permit foreign banks to set up subsidiaries in India.

Politics Views

The Left has claimed that these regulations shall benefit only those banks that intend to make a quick buck by providing high-profile corporate service, as opposed to those who wish to intensify their rural operations. They have further stated that since foreign players could on a yearly basis keep on increasing their holding size in a particular bank, this would lead to an imbalance of power.

Concerns

1. Effect on domestic banking banks, especially PSBs. These have opposed the acquisition of domestic banks by foreign players, primarily since this would give these new players a direct advantage in terms of an already existing banking structure, complete with a national presence in terms of branches, ATM networks, and of course skilled personnel knowledgeable of local needs and consumer behavior.

2. Will Government achieve its objectives of reaching the rural masses, a large majority of which are still oblivious to banks and their advantages? Although banks such as the SBI have built a massive footprint, it is said that foreign banks are here to attract profitable businesses from large business houses by acting as one-stop financial

service supermarkets, as opposed to providing core-banking services to the masses. An obvious bone of contention is that why incentives should be given for something that doesn't help a larger part of the country and at the same time might affect the profitability of PSBs that have expansive services and have greatly improved with the times.

These various benefits and pitfalls of RBI's decision can best be assessed by looking into the examples of other countries that have undergone similar transformations by opening up this sector to the world.

The Foreign Experience

One of the primary reasons for allowing foreign banks to enter in a country is to improve the quality and the efficiency of banking services and to bring more efficiency and transparency in the financial sector. Across the world, the entry of foreign banks in a country has usually been found to benefit the end consumers as it has led to increased credit availability, more efficient banking and a higher rate of economic growth. The entry of foreign banks has especially benefited developing countries where the foreign entrants are more efficient than the local banks and raise the overall level of competition. However, the implications of foreign bank entry on the stability of the domestic banking sector have been widely debated. This is especially the case for developing countries where the financial sector is still not very robust and economic crisis have occurred in the past. Foreign banks are considered detrimental to the stability of the economy because they expedite capital flight during troubled times and worsen economic crisis scenarios. During the South East Asian crisis, these banks were the first to withdraw from the market. They are also accused of "cherry picking" or choosing only the more attractive clients for doing business with, leaving the domestic banks to deal with the more risky ones [Victor Murinde , 2002]. The examples of some countries is discussed in the following sub-sections

1. South Africa

Before the entry of foreign banks, the four big local banks in South Africa, Standard, Nedcor, FNB and Absa had 80-85% of the domestic market share. After the restriction on this entry were removed, firms like Deutche, Merill Lynch and ABN Amro entered the higher end of the market in corporate, investment and private banking by acquiring local players in some

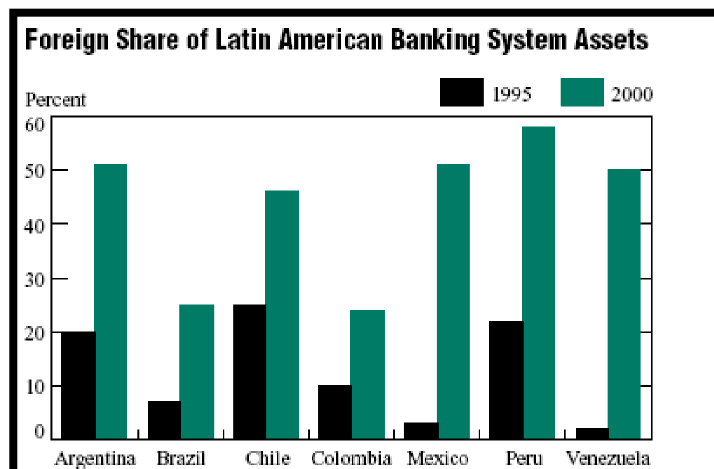
cases and now, have become the country's top equity houses. The local banks have been relegated to the retail market which they still dominate. The entire sector has become more competitive with incidences of mergers and the emergence of niche players.

The local banks have been unable to compete with the foreign owned banks on price parameters owing to the latter's lower cost of funds and have also been forced to decrease their cost-income ratios. At the same time, they have superior local knowledge and the advantage of an established customer base and are still favored by some local corporates. To reduce their costs, the domestic banks have started cutting down their branch networks and exploring alternative less-costly delivery channel like phone banking and net banking. For instance, Nedcor has reduced its branched by 36 % and have reduced their cost-income ratio to 58.7% form 70%. Absa has consolidated its operation and increased focus on its core competencies instead of being all things to all people.

The increase in competition has also led to higher attrition rates of about 35% among the employee base of domestic banks. Salaries of the employees with local experience are increasing as foreign banks offer their recruits e-sops and generous bonus [Can the local banks hold on]

2. Latin America

The entry of foreign banks in Latin American occurred in the post 1995 period when regulatory limitations of foreign ownership were eased after a severe banking crisis. Today, foreign banks own a majority of assets in almost all the Latin American countries (except Brazil). The entry of the foreign banks also led to sector-wide financial reforms, better regulations and better accountability through increased disclosure requirements.



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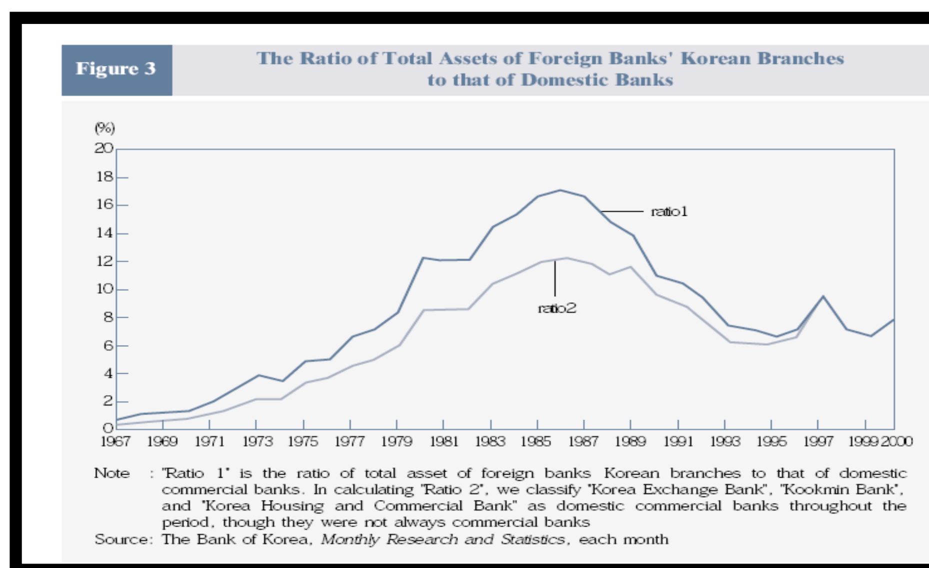
During 1995-2000, both the foreign and domestic private banks outperformed the state owned banks. Also, the local banks that had been acquired by the foreign sector banks did not substantially outperform the ones that were under domestic control. This indicates that both domestic and foreign markets can co-exist in the market.

However, in terms of other financial parameters, foreign banks had more asset liquidity and a higher rate of loan growth than domestic banks. They also relied less on deposit financing and had better loan recovery records, which made them more efficient then the latter.

3. South East Asia - Korea



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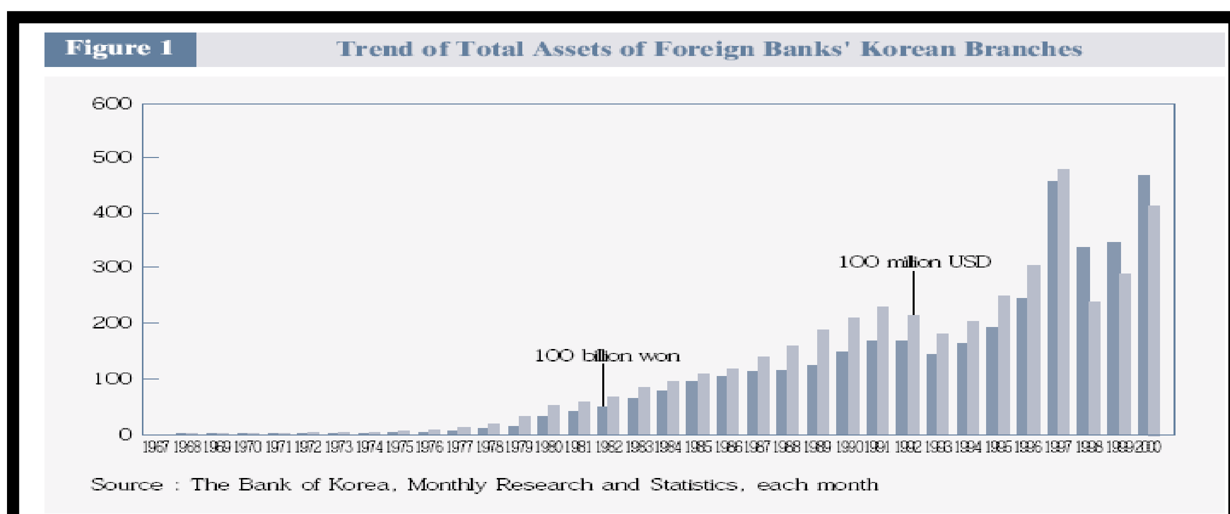
Though foreign banks had entered the Korean market as early as1967, substantial foreign investment in Korea however, began only in the mid-1990's after the relaxation of entry restrictions by the government. By 2000, 43 banks from 16 countries had established Korean branches and the total assets of these branches rose to 41.5 billion dollars in 2000 from a mere 6.5 million dollars in 1967. According to a study by Byungyoon Lee, the entry of the foreign banks helped the domestic banks to improve their cost efficiency due to competitive pressures, without affecting their profitability [Byungyoon Lee , 2006].



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4. Central and Eastern Europe (CEEC)

In a study of short term effects of foreign bank entry in ten selected CEEC countries, the consequences of foreign bank entry were found to be dependent on factors like degree of foreign bank ownership, development of the banking market and the economic development of the country. It was found that in the short term, the competition in the banking sector increased and there was an associated decrease in the before-tax profits, non-interest income, average loan interest rate and loan loss provisions of the existing domestic sector banks. This decrease in income and loan loss provisions and increase in overhead costs of the banks due to the entry of the foreign banks was more pronounced for the less developed markets than for the more develop ones. Also, the impact of foreign bank entry in terms of non-interest income and loan loss provisions was lesser on the domestic banks which had a greater market share [Uiboupin, J., 2005].

Conclusion

From the preceding examples, it is clear that allowing foreign entry is helpful if not essential for the development and betterment of the financial markets. Though, in the short term the profitability of the domestic banks takes a hit (as seen by the CEEC example) and there are incidences of mergers and acquisition, in the long term, the domestic banks are able to effectively compete with the entrants. Increased competition would only weed out the inefficiencies in the domestic sector and force the incumbents to become more profitable either by cost cutting and consolidation or through a renewed focus on their core competencies as is successfully being done by the South African banks.

An analogy could also be taken of other sectors that have been deregulated such as power, telecom and automobile. All of these sectors have seen competitiveness go up, their extent of service increase with an increase in profitability. However, deregulation and easing of restrictions introduces a lot of initial instability in the financial sector and the success of such measures is largely dependent of the performance and the foresight of the regulators. In this regard, sometimes a strategy of gradual deregulation accompanied by intensive stakeholder communication is advocated so as to smoothen the transition. Also, it is recommended that PSBs be treated on the same platform as the entrants; any discrepancy here will put them on a

back foot and jeopardize their services. Another point which became evident from the examples was of timing. If the domestic arena is opened up too soon when the local banks are still in their nascent state, the sector would be completely overrun by the foreign banks. Similarly, if deregulation is delayed too much, the foreign entrants would be at a high disadvantage as the local banks will have their roots firmly entrenched and it would be very difficult to enter. Considering the success of the other deregulation efforts in India in various sectors, the time for allowing foreign banks to enter Indian market seems to be just right. Thus, as with other contentious issues such as capital account convertibility, the path that RBI has chalked out seems to be prudent, and a resurgent India should be able to take full advantage of this envisaged deregulation.

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