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INDIA–EUFTA

Foreign Banks are Coming

Kavaljit Singh

Since 2007, India and EU have been negotiating a free trade agreement (FTA)—covering trade in goods and services, investments, intellectual property rights and government procurement - that is fraught with problems. Till now, ten negotiating rounds have been held. The agreement is expected to be finalized by mid-2011.

One of the major underlying themes in the ongoing negotiations is the liberalization of trade and investment in banking services. With the help of FTA with India, European Union is seeking greater market access and export gains for its banks through cross-border supply and direct investments. Some of the key demands emanating from Europe include removal of all barriers to market access (commercial presence, cross-border supply and consumption) and grant of national treatment commitments.

The EU banks and powerful lobby groups such as European Services Forum (ESF) have put forward a slew of demands including removal of all restrictions pertaining to branch licenses, foreign ownership (of both public and private banks), numerical quotas, equity ceilings, differential taxation, and voting rights. The ESF is seeking removal of priority sector lending on locally incorporated EU-owned banks besides removal of current restrictions under which branch licenses may be denied if foreign banks' aggregate share of the banking market exceeds 15 percent.

Another key demand of ESF relates to the removal of restrictions on foreign banks to participate in exchange traded commodity products. The ESF has also demanded free access to deposits made by the state-owned companies.

By asset size, six out of top 10 foreign banks in India are EU-based. The 9 EU-based banks together controlled 65 percent of total assets of foreign banks in India in 2008. Hence, the policy implications of opening up of Indian banking sector under the India-EU FTA would be markedly different from other FTAs such as India-Singapore Comprehensive Economic Cooperation Agreement.

Though there are 27 member-states of the EU, the banking services agenda is aggressively pushed by the UK and Germany under the proposed India-EU FTA. The UK is one of the leading centers for global banking with the largest share of cross-border banking lending (18 percent) in the world. The financial services alone account for 8.3 percent of its GDP.

The UK remains the leading exporter of financial services in the world. According to IFSL estimates, the UK's financial sector net exports were £41.8 billion in 2009 despite the global financial crisis. Banks were the largest single contributor, with net exports of £25.3 billion. The bulk of UK banks' net exports were generated through spread earnings (£10.6 billion) with the largest contribution by derivatives.

In terms of UK's balance of trade in goods and services in 2009, trade surpluses generated by financial services (£40.2 billion) managed to partially offset large deficits in goods (£82 billion). The UK's financial services trade surplus with India was £206 million in 2007, with banks contributing £197 million. Over the years, Germany and Ireland have also registered significant trade surpluses in financial services.

A number of Indian banks (especially big private banks) are also striving for increased presence in Europe. It is interesting to note that Indian banks are not aiming at capturing the highly competitive domestic banking markets in Europe. Rather their aim is to tap the non-resident Indians (NRIs) based in EU member-states. Since India is the largest remittance recipient country in the world ($55 billion in 2010), Indian banks are keen to serve this lucrative business segment by increasing their presence in the European banking markets.

Of late, some domestic banks are also facilitating acquisition of European companies by big Indian corporations. For instance, ICICI Bank co-financed United Spirits' takeover of Scotch whisky distillers, Whyte & Mackay, in 2007 and Tata Motors' $2.3 billion takeover of Jaguar and Land Rover in 2008.

The motives of EU-based banks behind entering Indian banking markets are obvious due to immense profit opportunities and a stable banking system. For London-headquartered Standard Chartered, India became the largest contributor to the bank's global operating profits in 2010. The bank's profits in India reached $1.2 billion in 2010. For UK-based HSBC Holdings, Europe's largest bank by market capitalization, India was the seventh largest contributor to its global profits in 2008.

By and large, European banks are interested in serving three niche market segments in India: up-market consumer retail finance, wealth management services and investment banking. Several European banks (such as Societe Generale and BNP Paribas) are keen to expand their presence in niche markets such as private banking. The big ticket mergers and acquisitions (particularly in cross-border segment) taking place in corporate India require investment banking, underwriting and other advisory services where big European banks have a competitive edge over domestic banks.

To date, most of bank branches of EU-based banks are located in metropolitan areas and .major Indian cities where bulk of premium banking business is concentrated. As on March 2010, there were 9 EU-based banks operating in India with a network of 213 branches. Out of which, 163 branches (76.5%) were located in metropolitan areas, 45 (21%) in urban areas and merely 5 (2.3%) in semi-urban areas.

It is distressing to note that EU-based banks have not yet opened a single branch in the rural areas. This is despite the fact that several EU banks have been operating in India for more than 150 years. Established in 1858, Standard Chartered Bank is the oldest foreign bank in India. BNP Paribas and HSBC began their operations in India in 1860s.

Not surprisingly, European and other foreign banks are not serving the poor and low-income people residing in metropolitan and urban areas. There is no regulatory ban on foreign banks to serve the urban poor and low-income people.

In India, financial exclusion has strong linkages with poverty and is predominantly concentrated among the poor and marginalized sections of society. Various studies have measured the extent of financial exclusion in India. The National Sample Survey Organisation of the Ministry of Statistics and Programme Implementation carried out All India Debt and Investment Survey (AIDIS) 2002-03 to assess the indebtedness of Indian farmers. The Survey revealed that 45.9 million farmer households in the country (nearly 51%) do not have access to credit, either from institutional or non-institutional sources.

One of the negative consequences of banking sector reforms is the decline in bank branches in rural areas even though the total number of bank branches in India has increased. The total number of bank branches of all scheduled commercial banks (including regional rural banks) increased from 72,752 at end-June 2007 to 76,518 at end-June 2008 but the share of rural branches declined to 40.7 percent at end-June 2008 from 42.1 percent at end-June 2007. In 1991, the share of rural branches was the highest (58.5 percent). In other words, the recent spurt in bank branches has worsened the rural-urban ratio.

In August 2005, the RBI issued a list of 391 underbanked districts in India with population per branch more than the national average of 16,000. The underbanked population is higher in the North Eastern and Eastern regions.

Since the 1990s, the banking sector has witnessed a secular decline in agricultural credit. This is in sharp contrast to the 1970s and 80s when a significant shift in bank lending in favor of agricultural sector took place. The state-owned banks contributed 77.3 percent of total credit to agriculture at end-March 2007 while the remaining was contributed by private sector and RRBs.

Besides, there is a significant decline in banking lending to small- and medium-sized enterprises (SMEs) since the 1990s. The SMEs account for almost 40 percent of India's total production, 42 percent of exports and are the second largest employer after agriculture. The SMEs produce over 8,000 value-added products and are involved in several services sector.

Since European banks have no branches in the rural areas, they are not obliged to serve the vast sections of rural households who are excluded from the formal banking system. Their contribution in the opening of "no frills" bank account under the financial inclusion program has been abysmal.

Typically, foreign (and big domestic private banks) are averse to provide banking services to the poor people because they find such clients less lucrative.

In particular, foreign banks tend to follow "exclusive banking" by offering services to a small number of clients. Several EU-based banks and their lobby groups have expressed their discomfort in fulfilling the mandatory priority sector lending requirements. Rather they prefer a niche banking model with no riders in terms of social and developmental banking.

It is well established that not only foreign banks in India charge higher fees from customers for providing banking services but maintaining a bank account requires substantial financial resources. Given the fact that the average up-market retail banking customer can be ten times more profitable than the average mass-market retail customer, it is highly unlikely that the commercial interests of European banks would match with the developmental needs of unbanked population. Rather the liberal entry of European banks may constrict the access of banking services in the country : geographically, socially and functionally.

In the context of proposed India-EU trade agreement, the following questions need to be put before the trade negotiators:

Will European banks augment the reach of the banking system to millions of Indians citizens who do not have access to basic banking services? Will EU-based banks undertake social and developmental banking? Can European banks meet the targets of financial inclusion for rural households, as suggested by the Committee on Financial Inclusion? Would European banks open their branches in low-income neighborhoods? What extraordinary services European banks would provide to serve unbanked population? What specialization and experience do European banks have when it comes to providing basic banking services to landless rural workers and urban poor dwellers?

GLOBAL FINANCIAL CRISIS

Several European banks had acquired US-based mortgage and "toxic" financial assets whose value plummeted sharply during 2007-08. This contributed to a sudden loss of confidence within the European banking system as banks became reluctant to lend to one another, thereby causing a dramatic loss of liquidity.

The highly leveraged EU-based banks (particularly in the UK, France, Germany and Ireland) sought billions of euros of state help to rebuild their balance sheets battered by the financial meltdown.

The European governments provided more than €3 trillion through guarantees and recapitalization schemes to save the ailing banks. Since the financial crisis badly infected the real economy, the EU economies are not out of the woods yet as there are renewed worries about rising unemployment.

Post-crisis, serious questions have been raised about the strength and credibility of European banks. The global financial crisis has put a big question mark about their efficiency, "best practices" and state-of-the-art risk management models. The crisis has also exposed the poor corporate governance and transparency norms of several European banks.

Given the higher degree of interconnectedness among EU banks, problems in one country quickly put the entire financial system at risk. Without doubt, the EU is facing unprecedented challenges in maintaining financial stability and strengthening banking regulations.

In contrast, Indian banking system has largely remained insulated from global turmoil, thanks to limited presence of foreign banks, negligible exposure of domestic banks to US sub-prime markets and related financial instruments, and enlarged state ownership of banking system. Often criticized as "inward-looking" and "conservative," India's regulatory framework also acted as a key determinant in protecting the domestic banking system from the global financial turmoil.

The proponents of banking services liberalization tend to overlook the potential costs associated with the entry of foreign banks in host countries. If the entry of foreign banks is allowed through acquisition of domestic banks, it may lead to concentration of banking markets and loss of competition.

The foreign banks can be a source of cross-border contagion from adverse shocks originated elsewhere. A large presence of foreign banks originated in crisis-ridden countries could lead to rapid transmission of financial shocks in the host countries.

The parent bank may also reduce exposure in a host country or move out completely due to losses suffered in home or other countries. Post-crisis, foreign banks have drastically reduced lending in India. During 2009-10, the loan portfolio of foreign banks contracted by 9.7 percent. The UK's Royal Bank of Scotland has decided to exit from or shrink its operations in 36 countries (including India and China) due to problems at its parent bank.

In addition, it is highly debatable whether foreign banks' presence has a stabilizing role in the case of a systemic crisis. In Argentina, for instance, several foreign banks chose to leave the country when a financial crisis erupted in 2001.

Furthermore, the entry of foreign banks poses new challenges to regulation and supervision. The regulatory and supervisory authorities are restricted to their national borders while foreign banks can easily cross national borders and operate internationally. The overall responsibility for the parent bank remains with the regulatory authorities in the home country. But there is little coordination and sharing of information among the regulatory authorities of home and host countries.

The global financial crisis has proved beyond doubt that increased financial integration can transmit financial shocks across countries. Financial innovation in certain unregulated products and markets can also augment financial shocks. The crisis has highlighted the risks associated with the presence of large financial conglomerates in the domestic banking system. Post-crisis, several proposals for enhanced regulation and supervision of financial conglomerates (which operate in different segments such as banking, insurance, securities and private equity) are under consideration at various levels.

Keeping these new developments in view, the policy makers should rethink about the benefits of opening up of banking services under the framework of India-EU FTA. □□□

[Kavaljit Singh (kavaljit.singh@gmail.com) works with Madhyam. New Delhi (www.madhyam. org.in). This article is an excerpt from a Beiefing Paper published by Madhyam]