Opening the vault

India's banking sector is on the verge of a second wave of liberalization. Coming amid a global financial crisis, how will domestic and international banks – and their legal advisers – respond to the challenge?

Barney Reynolds and Aatif Ahmad report

Despite opening up vast areas of the economy to foreign investment, the Indian government has continued to exercise tight control over the banking and financial services market.

Prior to the reforms of 1991, the banking sector was subject to detailed micro-management. Having nationalized the industry in 1969, the government imposed financial control through bureaucratic price-fixing and planned resource allocation, resulting in a substantial amount of resources being directed towards financing fiscal deficits rather than more productive uses.

The main tools of financial control included administered interest rates, statutory pre-emptions and directed credit policies. Deposit and lending rates were determined by India's central bank and banking regulator, the Reserve Bank of India (RBI). Legislation imposed demanding statutory liquidity ratios (SLRs), which required banks to hold a certain minimum percentage of assets in the form of government securities, and equally tough cash reserve ratios (CRRs).

In addition, directed credit policies required banks to channel at least 40% of their credit into priority sectors such as agriculture and small scale industries.

Administered interest rates have since been replaced by more market-determined ones, although some price distortion still persists. The SLR, although reduced to 24% of the net demand and time liabilities, remains high by international standards and has been criticized for creating a captive market for government securities and crowding out productive private investment. Furthermore, banks are still expected to meet targets for credit to priority sectors even though more than half of all bad loans tend to arise from such lending.

The most important feature of recent reforms has been the reduction of entry barriers to foreign and private sector players. As a result, seven new private banks entered the market between 1994 and 2000 and over 20 foreign banks followed after 1994. The market, however, continues to be dominated by public sector banks (PSBs) which are majority owned by the Indian government (although many are listed on stock exchanges with substantial equity in the hands of foreign investors).

In March 2008 PSBs accounted for 69.9% of the aggregate assets and 72.7% of the aggregate advances of the scheduled commercial banking system. Nevertheless, the importance of foreign and private banks cannot be ignored. These institutions have developed solid businesses in niche areas such as foreign exchange and investment banking services. Non-banking financial companies (NBFCs) are also playing an increasing role in meeting the financing demands of the Indian economy.

Throwing open the doors

On 28 February 2005, the RBI announced a new two-phase roadmap to further facilitate the entry of foreign banks into India. The first phase, from March 2005 to March 2009, enables foreign banks to enter the market via the foreign direct investment (FDI) route, either by opening a branch or by setting up a wholly owned subsidiary in India. Once a foreign bank has obtained its banking licence, in theory it enjoys the same status as an Indian bank and is permitted to conduct the same activities. In fact, foreign banks enjoy a lower priority credit requirement than their domestic peers (32% as against 40% required for Indian banks).

Further expansion by existing and new foreign banks is possible, but subject to rigorous branch licensing procedures. The RBI considers, among other things, a foreign bank's and its group's track record of compliance and functioning in the global markets before authorizing any branch expansion.

The RBI has, nevertheless, agreed to exceed its existing World Trade Organization commitment to allow 12 new foreign branches a year, especially if branches are targeted towards under-banked areas.

Expansions through acquisitions offer limited prospects, however, as foreign investors still encounter restrictions when purchasing stakes in Indian banks. Investment by foreign institutional investors (FIIs) in PSBs is subject to an overall statutory limit of 20%. Foreign banks are permitted to acquire controlling stakes only in those banks that have been earmarked by the RBI for restructuring.

There are also limits on portfolio investment in shares issued by private banks. FIIs are permitted to acquire up to 10% of the capital of a private sector bank, with an aggregate limit of 24% for all FIIs in any individual bank (which can be raised to 49% if a resolution is passed by the bank's board of directors followed by a special resolution of its general body). The aggregate foreign investment in existing private banks from all foreign sources (FDI, FIIs and non-resident Indians) cannot exceed 74% of the private bank's paid-up capital.

The second phase of liberalization

The second phase of reforms envisaged by the RBI is set to commence in April 2009. In this phase, wholly owned subsidiaries of foreign banks will be regulated in much the same way as PSBs, allowing them to expand without facing undue restrictions.

The second phase also paves the way for foreign banks to engage in M&A transactions with any private sector bank, subject to an overall foreign investment limit of 74% in the private sector bank acquired.

After completing a minimum prescribed period of operation, wholly owned subsidiaries of foreign banks will be permitted to obtain a listing on Indian stock exchanges so long as at least 26% of the paid-up capital of the subsidiary is held by Indian residents at all times.

Bucking international trends

Most observers believe that foreign participation in India's banking sector must be seen in the context of broader proposals to reform India's financial sector as a whole. Business leaders have thus called for a comprehensive agenda for reform to address issues across the entire financial sector. Such an agenda would encompass the adoption of full capital account convertibility, the liberalization of foreign investment in banking, the enforcement of Basel II capital adequacy norms, the introduction of credit derivatives, the development of markets for asset-backed securities (ABSs) and corporate bonds, the liberalization of the insurance industry and the removal of investment restrictions on pension funds and insurance companies.

In response, the Planning Commission of India constituted a high level committee on financial sector reforms on 17 August 2007. Professor Raghuram Rajan of the University of Chicago was appointed as the committee's chairman. Despite the growing backlash against lax regulation in Western countries, the tenor of the Rajan report, published in April, is to push for even greater liberalization and deregulation, covering many aspects of the RBI's roadmap.

The report notes the growing international sentiment against deregulation, but insists that regulators must "find the right balance between attenuating risk-taking and inhibiting growth". It also warns India's regulators that regulatory overkill in one sector (retail banking, for example) may not mitigate burgeoning risks in other areas, pointing to the example of Indian corporations that recently suffered huge losses on currency bets, or the strong growth in lending by the softly regulated NBFCs.

Some of the key recommendations of the Rajan report include liberalizing foreign investment in rupee-denominated corporate and government bond markets after a clear monetary policy framework is in place (focused solely on inflation targeting and eschewing exchange rate management); liberalizing banking correspondent regulations so that a wide range of local agents can serve to extend financial services; and liberalizing the interest rates financial institutions can charge, ensuring access by the poor to credit.

Other proposals include selling small underperforming public sector banks, possibly to other banks or to strategic investors; permitting the takeover of Indian banks or domestically incorporated subsidiaries of foreign banks, so long as issues do not arise in relation to excessive concentration or stability; removing licensing requirements for branch expansion, while retaining the right to impose restrictions on the growth of certain banks for prudential reasons; and encouraging the introduction of exchange-traded interest rate and currency futures markets in tandem with the move towards full capital account convertibility.

Unleashing a wave of consolidation

The new phase of reforms could very well lead to locally driven consolidation in the Indian banking industry. Comparably smaller than their global counterparts, Indian banks may be tempted by the economies of scale offered by mergers. The Rajan report supports such endeavours, advocating the entrance of strategic private investors to assist in improving governance and eliminating political interference in PSBs.

Much will depend on the degree to which the Indian government is prepared to relinquish control over PSBs, but once the second phase of reforms begins, we may see a wave of M&A activity involving overseas investors such as sovereign wealth funds (assuming they are permitted to invest by the Indian government) and private equity funds.

If the Rajan recommendations are implemented, NBFCs are likely to play an increasingly important role. Capital markets activity is currently dominated by these entities, especially the Indian subsidiaries of major Western broker-dealers and investment banks. If the markets for ABSs, corporate bonds, interest rate futures and currency futures take off, NBFCs are likely to emerge as the major players given their experience and ascendancy elsewhere. That said, a number of major Indian banks have set up their own capital markets divisions that are attracting growing volumes of business.

Regulators will certainly be alive to the risk of NBFC activity circumventing prudential regulations imposed on banks and fuelling the kind of excessive risk-taking that caused the sub-prime crisis in the West. Indeed, one of the most important lessons of the current crisis is the need for regulators to apply prudential norms across all areas of the financial industry. Excessive leverage by broker-dealers without access to a stable base of insured deposits was partly to blame for the demise of Bear Stearns and Lehman Brothers.

India's regulators will no doubt be revisiting the regulation of NBFCs in the light of recent events on Wall Street.

Bracing for foreign competition

Many commentators have dismissed the RBI's second phase of reforms as half-hearted and fraught with unnecessary complexity. Foreign investors are understandably dismayed by the multiple discretions conferred on regulators and the red tape that still exists.

Indian regulators have been reluctant to permit unrestricted access by foreign banks due to concerns over the impact such access would have on PSBs and private Indian banks. Despite their extensive branch networks and local knowledge, anxiety among domestic banks continues to linger since unhindered competition from foreign banks with deeper pockets and better productivity may be detrimental to their prominence and financial health.

The threat of foreign competition has prompted PSBs to engage in frantic efforts to cut costs, improve services and meet the corporate governance standards that come with stock market listings.

Threats on the horizon: Public sector banks are gearing up for greater competition.

In spite of these fears, the robust capital position of India's indigenous banks (existing regulations prevented them from exposing themselves to the sub-prime market to the same extent as many foreign banks) may shield them from competition and discourage forays into the Indian market by foreign banks.

The advantage accrues from the strong capital position of India's banking system compared to the rapidly depleting capital of Western banks. At a time when Western banks were, and are still, facing the prospect of decapitalization and nationalization, India continues to profit from the strength of its commercial banks, which collectively boasted an overall capital adequacy ratio of 12.7% in October – well above the regulatory minimum of 9% and the Basel II requirement of 8%. Given this large capital cushion and a very low proportion of non-performing assets, Indian banks, unlike their Western counterparts, are unlikely to suffer any serious solvency issues in the present economic downturn.

Indian banks are also well placed to deal with any domestic liquidity stresses, given their high SLR of 24% and the fact that credit-deposit ratios are extremely low by international standards.

Acting out of extreme caution, the RBI has even imposed prudential limits to regulate the development of the inter-bank call money market and ensure a limited reliance on purchased funds and other inter-bank liabilities to fund asset growth. Thus, on a fortnightly basis, outstanding call market borrowings must not exceed 100% of tier I and tier II capital. In addition, purchased inter-bank liabilities of a bank must not exceed 200% of its net worth. This can be compared with the loose control that enabled a British bank, Northern Rock, to source 75% of its funding from the wholesale markets, enabling it to pursue an aggressive lending policy.

Economic woes temper reform

While Indian banks may exploit their solid positioning to consolidate domestically and focus on improving governance and productivity, foreign financial institutions continue to work on stabilizing their recovery from the financial collapse.

Massive capital injections into stricken Western banks by their governments are likely to slow down any expansion plans these banks might have had for countries like India. In many cases governments have extracted promises from the assisted institutions to direct lending to local economies. Even banks that have not relied upon state support, such as Barclays or HSBC, are likely to rethink any expansion plans in the midst of the current uncertainty and the pressure on bank earnings and assets.

Furthermore, Indian regulators worried about the impact of exotic products and lax regulation in the West, appear to be rethinking their liberalization policies. Written prior to the collapse of Lehman Brothers in September, many of the reforms envisaged by the Rajan report seem likely to face major new hurdles.

In a statement made in October, the deputy governor of the RBI, Dr Rakesh Mohan, attributed the resilience shown by emerging market economies, in part, to the "smaller presence of foreign banks" in those economies. Furthermore, the RBI has decided not to introduce credit derivatives, despite having issued draft guidelines for credit default swaps in May and October 2007, due to "adverse developments in international financial markets".

A tight grip on the finances: India's banking sector is dominated by public sector institutions.

'Big Bang' for lawyers

India's financial depth continues to remain very low. The total financial stock represented a mere 137% of GDP in 2003 compared to 272% for China and 400% for the US. If a comprehensive financial reform programme is ultimately adopted, it is likely to unleash another period of healthy economic growth. Deregulation may produce a "Big Bang" for India's financial sector, similar to the growth in financial services experienced by Britain after the reforms of the 1980s.

In the event of such an occurrence, the legal profession will have to undergo profound restructuring in tandem with the financial sector to meet the demands of a deep, liquid and diverse financial system. Both Indian and international corporates would be increasingly wary about consulting local boutique firms, demanding instead, advice from large full-service firms that meet global standards. An increasing need for lawyers specializing in regulatory matters, debt capital markets and M&A may well outstrip supply, leading to further calls for the liberalization of India's legal market.

In the short term, domestic and overseas law firms servicing India will play a key role in influencing the shape of the financial industry as it undergoes internal consolidation and migrates to international capital adequacy norms. Lawyers will have to become conversant with Basel II norms, initially using the standardized approach and later, advising on the implementation of an internal ratings-based approach. M&A in the financial sector involves more complex negotiations than in many other industry sectors, given the regulatory regimes that govern financial institutions and their systemic and public importance.

Lawyers will have to factor in more than just legal considerations when advising clients on mergers, restructurings and acquisitions. There may also come a time when India's banks seek acquisitions overseas. In such situations, law firms will be required to formulate and manage cross-border teams at short notice, a task which foreign institutional firms have special expertise in achieving.

No sign of stalling

The RBI has stated it will introduce reforms in a gradual manner, attuned to the performance of the real economy and its readiness to accept financial innovation. Nevertheless, there are many areas of reform such as the development of a corporate bond market that will be on the regulators' agenda in the years to come.

There is no sign yet of any deviation from the roadmap issued by the RBI which indicates that the next phase will begin on time in April 2009. Quite what this new phase leads to in terms of foreign bank expansion is another matter and subject to the vagaries of international developments.

For the moment, continued weakness in the Western financial system will severely curtail the ability of Western banks to expand in emerging markets like India. However, the current period offers domestic banks the chance to improve their services before opportunities are snapped up by foreign financial institutions. ■

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