Special Report



India-EU Free Trade Agreement: Should India Open Up Banking Sector?

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Madhyam



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Acknowledgements: A number of individuals and organizations have provided support in the research and publication of this report. In particular, I would like to thank CIVIDEP, EED, FERN, Laura Ceresna, Myriam Vander Stichele, Public Interest Research Centre, S. L. Shetty, SOMO, Sophie Powell and The Corner House. Thanks are also due to all those whose writings and data I have drawn upon in the preparation of the report. In particular, I would like to thank Reserve Bank of India for using its data and various reports. Thanks are also due to Ranjeet Thakur for the layout and designing of the publication.

Published in 2009 by:

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Acronyms

AIDIS	All India Debt and Investment Survey
ANBC	Adjusted Net Bank Credit
ASEAN	The Association of Southeast Asian Nations
ATMs	Automated Teller Machines
CAR	Capital Adequacy Ratio
CDS	Credit Default Swap
CECA	Comprehensive Economic Cooperation Agreement
CIS	Commonwealth of Independent States
CRR	Cash Reserve Ratio
DFIs	Development Finance Institutions
DRI	Differential Rate of Interest
EU	European Union
FDI	Foreign Direct Investment
FII	Foreign Institutional Investor
FTA	Free Trade Agreement
GATS	General Agreement on Trade in Services
GCC	Gulf Cooperation Council
GDP	Gross Domestic Product
HDFC	Housing Development Finance Corporation
HNWI	High Net Worth Individual
HSBC	The Hongkong and Shanghai Banking Corporation
IDBI	Industrial Development Bank of India
IFSL	International Financial Services, London
IMF	International Monetary Fund
IPO	Initial Public Offer
LABs	Local Area Banks
M&As	Mergers and Acquisitions
MFIs	Micro Finance Institutions
MSE	Micro and Small Enterprise
NABARD	National Bank for Agriculture and Rural Development
NAFTA	North American Free Trade Agreement
NBFCs	Non-Banking Financial Companies
NGOs	Non-Governmental Organisations

NIM	Net Interest Margin
NPAs	Non-Performing Assets
NPL	Non-Performing Loan
NREGS	National Rural Employment Guarantee Scheme
NRFIP	National Rural Financial Inclusion Plan
NRIs	Non-Resident Indians
OBE	Off-Balance Sheet Exposures
RBI	Reserve Bank of India
RIDF	Rural Infrastructure Development Fund
RoA	Return on Assets
RoE	Return on Equity
RRBs	Regional Rural Banks
SAFTA	South Asian Free Trade Agreement
SBI	State Bank of India
SCBs	Scheduled Commercial Banks
SHGs	Self-Help Groups
SIDBI	Small Industries Development Bank of India
SME	Small and Medium Enterprise
SSI	Small Scale Industry
UCBs	Urban Cooperative Banks
UK	United Kingdom
WOS	Wholly Owned Subsidiary
WTO	World Trade Organisation

Data Notes

Million is 1,000,000.

Billion is 1,000 million.

Trillion is 1,000 billion.

Dollars are US dollars unless otherwise specified.

1 US Dollar ($) = Indian Rupees (Rs.) 50 (As on February 20, 2009).

Indian Financial Year: April-March.

The Background

The proposed trade and investment agreement between India and the European Union (EU) is an outcome of an institutionalized bilateral process initiated in June 2000. The first India-EU Summit, which took place in Lisbon in June 2000, is generally considered to be a watershed in the evolution of strong economic, political and technological ties between India and EU. Here, a decision was taken to hold annual summits.

It was at The Hague Summit (2004), India and EU agreed to forge a "Strategic Partnership." This was a result of an earlier EU publication in December 2003 when it identified India (along with several other countries such as the US and China) as the ones with whom it should develop a long-term "Strategic Partnership."

At the 2005 Summit, both parties adopted the India-EU Strategic Partnership Joint Action Plan and agreed to enhance bilateral trade and economic relations and remove barriers inhibiting trade and investment flows. In this regard, a High Level Trade Group was set up to study and suggest measures for strengthening bilateral trade and investment relationship.

In 2006, EU launched, "Global Europe," a new framework under which open trade policy was given a new impetus with special focus on market access to European suppliers.

At the 7th India-EU Summit held in Helsinki in 2006, both parties endorsed the recommendations of the High Level Trade Group to initiate negotiations for a bilateral trade and investment agreement. Following the agreement, negotiations for India-EU trade agreement were launched in June 2007 in Brussels, expected to be over in two years.

Already, several rounds of formal negotiations on the modalities of the agreement have taken place in New Delhi and Brussels. The signing of agreement has been delayed as differences have cropped up between India and EU over certain issues which would be kept off the agreement.

However, the scope of bilateral negotiations is not merely restricted to trade in goods and services but also covers cross-border investments, non-tariff barriers and rules pertaining to intellectual property rights, competition policy, customs procedures, government procurement, regulatory transparency and state aid.

EU is India's Largest Trading Partner

EU as a bloc is India's largest trading partner. EU accounts for around one-fifth of India's total trade (23 per cent in 2007) whereas India contributes around 1.8 per cent of the total EU trade and is its 10th largest partner. EU provides a substantial market for India's export (mainly textiles and clothing) and has always been an important supplier (mainly machinery and chemical products) for India's imports. Since 2001, bilateral trade between the two entities has seen 11 per cent annual growth. Services are an emerging area of EU-India trade.

EU is also one of the largest sources of foreign direct investment (FDI) in India. The key EU-member states for FDI are UK, Germany, the Netherlands, France, Italy and Belgium. Much of investments from EU have come in the energy, telecommunications and transport sectors. Of late, many Indian private companies are also undertaking substantial investments in several European countries.

EU initiative towards a free trade agreement (FTA) with India is a key component of its "Global Europe" policy framework based on several long-term economic and strategic goals. India and EU have signed a number of bilateral agreements including Science and Technology Agreement (signed on 23 November 2001) and Customs Cooperation Agreement (signed on 28 April 2004). A Maritime Agreement is also under negotiation.

India has already signed a free trade agreement with Singapore in 2005 and with other SAARC member-countries (SAFTA). India has also initiated several negotiations for bilateral trade agreements with Thailand, Japan, South Korea, Chile, Mercosur, Gulf Cooperation Council (GCC) and ASEAN.

India currently leads the list of Asian countries with 30 FTAs, followed by Singapore with 26, China and Korea with 22 each and Japan with 19. Out of India's 30 FTAs, eight are within the Asian region, while the remaining 22 are outside Asia. Apart from closer economic ties, India sees potential geo-political gains in forging FTAs, particularly within the Asian region.

Services Take the Cake

Services are important for both India and EU. Since the 1990s, the rapidly expanding services sector has been contributing more to economic growth than any other sector. The services sector contributes nearly three-quarters of gross domestic product (GDP) for EU and nearly 55 per cent of GDP for India. Over three-quarters of EU jobs are in the services sector alone. In India, services provide employment to 28 per cent of total workforce.

Over the years, the share of agriculture and manufacturing in India's GDP is declining while the share of services is rapidly increasing. Financial services, tourism, transport and communication services have been experiencing double-digit growth since 2002. It is estimated that the share of services in country's GDP would reach 59 per cent in 2010.

EU has consistently pursued the liberalization of the global trade in services both at multilateral (e.g., GATS negotiations in the WTO) and bilateral levels.

Given the slow progress of Doha round negotiations at the WTO, EU is becoming increasingly focused on bilateral and regional trade agreements with an objective of gaining immediate market access. In particular, provisions pertaining to trade in services have been included in a number of bilateral and regional agreements such as the Association and Stabilization Agreements, Partnership and Cooperation Agreements with Russia and other CIS countries and agreements with Mexico and Chile. Such provisions are also included in the ongoing negotiations with India as well as Mexico, Gulf Cooperation Council, Korea and ASEAN.

The rapid growth of services sector in India is not limited to domestic markets. Of late, India has emerged a major services exporter, particularly in the arena of information technology (IT) and IT-enabled services, telecommunications and construction. In 2007-08, India's services exports were worth $86 billion, almost 40 per cent of country's total exports of goods and services. The country's share in the global trade of services has improved from 2 per cent in 2004 to 2.7 per cent in 2006.

The main destinations of India's services exports are developed countries, with US and the EU together accounting for over 45 per cent of services exports. The services sector has been attracting substantial amount of foreign investments.

India has liberalized its cross-border trade in services with significant market access granted in sectors such as telecommunications, financial services, retail trade and courier services. India's major interests depend on cross-border supply of services through outsourcing and movement of short-term service providers.

At present, transport, travel and business services account for the bulk of services trade between India and EU. Through FTA with India, EU is seeking market access in financial services, professional services such as accounting and legal services, courier services and telecommunication services. While India is keen in IT, medical services, tourism and some components of financial services.

Financial Services: The Modes and Models of Liberalization

One of the major underlying themes in the ongoing negotiations on India-EU FTA is the liberalization of trade and investment in financial services.

Financial services cover a wide range of services from banking to insurance to brokerage and asset management. The global trade in financial services has registered rapid growth in the past two decades on account of growing internationalization of trade and finance.

Financial services firms see regulation as a biggest obstacle to their global ambitions. The main objective of liberalization of trade in financial services is to provide enhanced market access and remove regulatory barriers to foreign competition.

The main barriers to financial services cross-border trade include administrative rules and regulations that restrict the supply of services by foreign suppliers. While the barriers to domestic presence of foreign services firms include limits on foreign ownership, restrictions on branches and business operations, numerical quotas, equity ceilings, differential tax treatment, etc.

The liberalization of trade and investment in financial services is a part of wider financial sector liberalization which consists of domestic (e.g., interest rate deregulation) as well as external (e.g., capital account liberalization) reforms.

The liberalization of financial services can occur under three ways: unilateral domestic reforms; commitments made under the auspices of the WTO and other international organizations; and commitments made under preferential trade agreements (bilateral or plurilateral).

Broadly speaking, there are two models of services trade and investment liberalization under the FTAs.

The first model, popularly known as "GATS" model, differentiates various modes of cross-border supply of services. Under GATS framework, financial services could be provided through mode 1 (officially known as "cross-border supply" such as domestic consumers taking a loan from a bank located abroad), mode 2 (officially known as "consumption abroad" such as domestic consumers buying financial services while traveling abroad), mode 3 (officially known as "commercial presence" such as foreign banks setting up subsidiaries or branches in host countries to provide banking services) and mode 4 (officially known as "movement of natural persons" such as business visas or temporary entry of foreign individuals in host countries to supply financial services). Except mode 3 which directly involves investment in a host country, modes 1, 2 and 4 are related to different forms of cross-border supply of services.

The "GATS" model follows a "positive list" approach under which countries list sectors and sub-sectors in which liberalization commitments are to be made. The EU-Chile FTA is a shining example of "GATS" model. The EU is seeking market access and national treatment commitments under mode 3 for financial and other services under the FTA negotiations with India.

The second model, popularly known as "NAFTA" model, follows the NAFTA approach under which commitments related to "commercial presence" (GATS mode 3) are dealt separately in the investment chapter. The "NAFTA" model follows a "negative list" approach under which liberalization commitments cover all sectors (and sub-sectors) unless specifically exempted by the submission of a negative list by the member-country. The US-Singapore FTA is based on "NAFTA" model.

In the case of EU-Mexico free trade agreement, a "Hybrid" model of services trade liberalization (with a mix of both models) has been noticed. In a few trade agreements (such as Mercosur), measures related to harmonization of financial regulatory frameworks have been incorporated.

It has been observed that bilateral agreements have accomplished increased financial services liberalization commitments as compared to those made under the GATS negotiations of the WTO. For instance, take the US-Singapore FTA. Signing of FTA in 2003 led to deeper opening of cross-border trade and investment in financial services in Singapore. More importantly, the FTA incorporates strong disciplines on the use of capital controls during a financial crisis.

In a typical North-South bilateral trade agreement, it is the developed countries which are the main "demandeurs" of financial services liberalization given their strong strength in financial services exports.

EU's Wish List

With the help of FTA with India, EU would like to achieve significant liberalization of India's banking sector, well beyond what has been achieved under the GATS framework. EU is seeking greater market access and export gains for its large banks through cross-border supply and direct investments. Though there are 27 member-states of the EU, only three (the UK, Germany and France) are aggressively pushing the agenda for banking services liberalization. EU's strong demands on banking services liberalization in India are backed by influential lobbies of big banks and financial institutions.

Through various foras, some of the key demands in the banking services emanating from EU include complete market access (commercial presence, cross-border supply and consumption) and national treatment commitments. It has sought removal of regulations pertaining to bank branches, numerical quotas, foreign ownership, equity ceilings, voting rights and investment by state-owned companies in foreign banks in India.

Under the Doha negotiations at the WTO, the EU (along with the US) has set high benchmarks to improve access for commercial presence and cross-border supply in various financial services. It has included strong disciplines on transparency, licensing and other regulatory issues. With other countries having similar commercial interests, EU has also pushed for a plurilateral approach to seek greater liberalization of financial services in India.

Many European banks have also demanded removal of priority sector lending requirements, borrowing limits and other regulatory measures.

The Burgeoning Financial Services Trade

Since 2000, several European economies have registered a significant growth in their financial services net exports. Banking services are a key component of their financial services exports.

To illustrate, take the case of the UK, one of the most vocal proponents of banking services liberalization in India. The financial and professional services account for 11 per cent of its GDP.[1] The UK is the world's largest source of bank lending with total banking assets of £7.5 trillion in September 2008.[2]

Table 1: Financial Services Trade Balance ***($ billion)***

	2000	2004	2005	2006
UK	20.6	37.4	34.7	46.3
Ireland	0.4	4.8	3.9	5.1
Germany	1.1	0.0	-0.4	3.8
France	1.5	-1.6	-2.1	-3.9
of which:				
Bank & Other Financial Services				
UK	17.7	29.8	33.3	41.6
Ireland	0.6	2.5	2.7	3.1
Germany	1.5	1.7	2.2	3.0
France	-0.2	-1.0	-1.0	-2.4

Source: IMF; IFSL, 2008.

London is the leading financial center with over 350 banks, much ahead of New York, Paris and Frankfurt. London accounts for an estimated 41 per cent of EU's financial services.[3] Almost a half of European investment banking is conducted in London. London also accounts for over 30 per cent of world foreign exchange trade and 40 per cent of the over-the-counter derivatives market.[4]

The UK remains the leading exporter of financial services in the world. According to IFSL estimates, the UK's financial sector net exports reached a record £38.8 billion in 2007, up from £29.8 billion in 2006[5] (Table 2). This is despite the turmoil in the credit markets which began in mid-2007. Banks were the largest contributor, with net exports of £23.2 billion in 2007.

Table 2: UK Financial Sector Net Exports ***(£ million)***

	2005	2006	2007
Banks	14929	17662	23216
Fund Managers	2105	2625	4124
Insurance	1652	4132	5529
Securities Dealers	2266	2983	4785
Baltic Exchange	735	706	769
Other Financial Services	2696	1716	417
Total Net Exports	24383	29824	38840

Source: IFSL, 2008.

The bulk of UK banks' net exports were generated through spread earnings (£9.5 billion), FISIM[6] (£7.8 billion) and net fee income (£4.5 billion). Derivatives alone accounted for over two-thirds of total spread earnings.

In terms of UK's balance of trade in goods and services in 2007, trade surpluses generated by financial services (£36.9 billion) managed to partially offset large deficits in goods (£89 billion) and travel (£17 billion) (Table 3).

Table 3: UK Sector Trade Balances *(£ billion)*

	Financial Services	Business Services	Transport	Travel	Goods
1997	13.74	8.02	-2.09	-3.64	-12.34
1999	14.47	10.87	-2.42	-8.87	-29.05
2001	18.01	12.42	-3.51	-13.27	-41.21
2003	21.52	15.01	-3.79	-15.48	-48.61
2005	20.22	16.79	-2.08	-15.91	-68.59
2007	36.98	17.87	-2.47	-16.90	-89.25

Source: Office for National Statistics, UK, 2008.

In 2007, the UK recorded a trade surplus in financial services with most countries including US (£8.8 billion), Japan (£1.7 billion) and the EU (£12.2 billion) as a bloc. The FDI net earnings by the UK financial services firms jumped from £2.6 billion in 2001 to £11 billion in 2007 (Table 4).

The UK's financial services trade surplus with India was £206 million in 2007, with banks contributing £197 million. No wonder, a deeper market access to the Indian banking system would boost the services exports of the UK-based banks and financial institutions.

Table 4: FDI Net Earnings of UK Financial Services *(£ bn)*

	Total Credits	Total Debits	Net Earnings
1997	5.55	2.79	2.77
1999	7.09	3.60	3.49
2001	8.31	5.71	2.61
2003	12.32	5.64	6.68
2005	19.02	11.99	7.22
2007	20.08	9.77	11.03

Source: Office for National Statistics, UK, 2008.

In 2008, the Reserve Bank of India (RBI) carried out an Annual Survey on International Trade in Banking Services (2006-07) to find out the quantum of cross-border trade in banking services in the context of India.[7] The Survey covered banking services provided by 12 Indian banks operating abroad and 25 foreign banks operating in India.

The RBI Survey found that the fee income of the Indian banks operating abroad was Rs.18,900 million in 2006-07. Whereas the total fee income generated by foreign banks operating in India was much higher at Rs.60,830 million. Thus, Indian banks were no match to foreign banks in generating income through trade in banking services.

The RBI Survey found that the amount accrued to India by Indian banks' operations in foreign countries was Rs.14,250 million during 2006-07 whereas the amount accrued to abroad by foreign origin banks' operations in India was Rs.60,830 million during the same period.

The amount accrued to India by Indian banks' operating in the UK, Germany, the Netherlands and France was much lower than the amount accrued abroad by banks from these countries operating in India (Table 5). For instance, the fee income generated by 84 branches of UK-based banks was Rs.8,553 million in 2006-07 compared to the fee income of Rs.1,893 million generated by 22 branches of Indian banks operating in the UK. The amount accrued to India was greater than the accrued to Belgium and Singapore.

The RBI Survey noticed that Indian banks generated major share of fee income by rendering credit related services, trade finance related services

Table 5: Banking Services Trade: Accrual of Amounts to Abroad and to India (2006-07) ***(Rs. million)***

	Foreign Banks Operating in India Accruals to Abroad	Indian Banks Operating Abroad Accruals to India
Belgium	69.4	339.6
France	929.1	406.5
Germany	3403.5	353.4
Netherlands	1595.8	NA
UK	8553.3	1893.3
All Countries	60831.2	14253.5

NA: Branch is not available.
Source: Reserve Bank of India, 2009.

and money transfer services. On the other hand, foreign banks in India generated major share of fee income by rendering derivatives, stock, securities and foreign exchange trading service activities.

The Survey observed that Indian banks generated major share of fee income (69.4 per cent) by rendering banking services to non-residents while foreign banks generated major share of fee income (91 per cent) from residents.

The Lure of Niche Banking Markets

The commercial motives behind entering banking markets in India are obvious as they provide immense profit opportunities to foreign banks.

For London-headquartered Standard Chartered, India is the second largest contributor to the bank's global operating profits after Hong Kong. The bank's Indian operations posted 71 per cent increase in operating profit to $690 million in 2008 from $403 million in 2006.[8] In 2008, its operating profits touched an all time high of $943 million.[9] In wholesale banking business, India is now Standard Chartered's largest contributor in global revenues.

For UK-based HSBC Holdings, Europe's largest bank by market capitalization, India was the seventh largest contributor to its global profits in 2008. Its Indian operations witnessed a 25.9 per cent jump in profit before tax to $666 million in 2008 against $529 million in 2007.[10]

However, the big European banks are particularly interested in serving three niche market segments in India: up-market consumer retail finance, wealth management services and investment banking.

The growth potential for consumer finance products in India is enormous. Consider the following statistics. India has only 22 million credit cardholders as against 200 million mobile phone subscribers. The domestic credit card market is growing by 35 per cent annually. The share of housing mortgage to the GDP is a mere 6 per cent as compared to China's 11 per cent. India's household savings invested in financial products is just 18 per cent of the GDP.

The country's favorable demographics (60 per cent of India's population is below 30 years) also offer the prospect of greater spending power in the hands of working youngsters.

For Deutsche Bank and Barclays, India has become a launch pad for retail banking services. Both banks have started off with India in the Asia-Pacific region. Other European banks such as Societe Generale and Royal Bank of Scotland are also keen to enter niche markets such as private banking.

For the past few years, India is creating millionaires at the fastest pace in the world. According to *World Wealth Report 2008*, India led the world in the high-net-worth-individual (HNWI) population growth at 22.7 per cent, driven largely by market capitalization growth of 118 per cent and real GDP growth of 7.9 per cent.[11] India added another 23,000 more millionaires in 2007 to its 2006 tally of 100,000 millionaires holding at least $1 million in financial assets excluding their primary residence and consumables.

According to *Barclays Wealth Insights Report*, India will be the eight largest nation of wealthy individuals in the world by 2017, with 411,000 millionaires having an aggregate wealth of $1.7 trillion. As the newly wealthy grapple with their riches, wealth management and advisory services have become a booming business in India. The HNWI community is a key market segment for wealth management services. In 2009, the Royal Bank of Scotland launched Royal Wealth Management which exclusively offers services to wealthy Indians. Several international banks have created specific products and launched specialized branches to serve the HNWI segment.

The demand for specialized financial products and services (such as structured products, tax and real estate planning, etc.) is rising at an unprecedented pace. Market estimates suggest that the contribution of financial products and services to India's GDP would be close to 19 per cent by 2012.

During 2003-08, the investment banking business experienced a boom under the buoyant market conditions in India. In terms of market capitalization, India's two stock exchanges, the Bombay Stock Exchange and the National Stock Exchange of India, were ranked among the world's top 12 exchanges in 2007. Much of market capitalization growth in the stock markets was contributed by financial services, real estate and infrastructure sectors.

The buoyancy in the Indian stock markets has helped foreign banks to consolidate their underwriting and advisory businesses. In 2007, 103 companies raised $9.3 billion through initial public offerings (IPOs) in the Indian stock markets. Six out of ten top underwriters were foreign banks.

Big European banks are the leading issue managers and underwriters in India. For instance, take the case of Deutsche Bank. Apart from retail banking services launched in 2005, Deutsche Bank provides a complete range of products and services in the areas of investment banking and asset management in India. Its Indian operations had a balance sheet size of over $4.2 billion in 2007.[12] The Deutsche Bank has been a leader in mergers and acquisitions, with the bank involved in Tata Steel's acquisition of Corus.[13] During 2006-07, Deutsche Bank was the leading manager of bonds and equities offerings in India.

In sales and trading, Deutsche Bank is among India's leading foreign exchange dealers. The bank ranks among the top three in derivatives sales. In 2008, Deutsche Bank was the top holder of Indian stocks among foreign institutional investors in the country.[14]

The surge in demand for corporate financial products has attracted the attention of international banks. Indian companies are increasing the scale of their operations for which they require capital and advisory services.

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. The large-scale infrastructure projects in power, roads and ports also need financial intermediation which opens up new business opportunities for foreign banks.

In addition, the share of foreign banks in foreign exchange market in India is also growing at a tremendous speed. During January-June 2007, the share of foreign banks in the total foreign exchange turnover stood at 52 per cent.[15]

The private equity (PE) business has witnessed rapid growth in recent years. The total PE investments in India hit a record $17 billion in 2007. European banks play an important role in the financing of leveraged buyouts.

Banking Services Market Access: A One-way Street?

Despite wide-ranging asymmetries between India and EU, the negotiations in the banking services cannot be simply construed as one-way process.

Apart from big European banks seeking greater market access to the Indian markets, a number of big Indian banks (both state-owned and private) are also seeking increased presence in the European countries (particularly in the UK and Germany) as they aim to serve the non-resident Indians (NRIs) based in these countries.

It has been estimated that there are over 150,000 millionaire NRIs in the world and a substantial number of them reside in Europe. The Indian banks are increasingly focusing on servicing this niche market of NRI millionaires.

As India is the largest remittance recipient country in the world with inflows of US$ 24 billion annually, Indian banks want to increase their market share in this segment by increasing their presence abroad.

In addition, Indian banks are facilitating acquisition of European and other foreign companies by big Indian corporations. The domestic banks have been allowed to extend financial support to Indian companies for acquisition of equity or strategic investments overseas. Due to increasing number of Indian corporations accessing the international equity and debt markets, a larger presence of Indian banks in the overseas markets is being planned.

To illustrate, take the case of ICICI Bank, the second largest bank and largest private sector bank in India. The ICICI Bank operates in 19 countries (including the UK and Belgium) in the form of full-fledged branches, wholly owned subsidiaries, offshore banking units and representative offices. The ICICI Bank has over 25 per cent share in the Indian remittance market. The bank's global assets account for about 25 per cent of its total assets. The ICICI Bank has expanded into corporate and advisory services in foreign markets. The 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 ICICI bank suffered a loss of $264 million on account of its exposure to credit derivatives and investments made by its subsidiaries in the UK and Canada in 2008.

ICICI Bank is not the only Indian bank seeking greater international presence. Several large state-owned banks (such as State Bank of India, Bank of India and Bank of Baroda) are also interested in having a strong overseas presence. Many of them have recently begun operations in the UK, China, Singapore and South Africa. Despite the severe banking crisis in the Western countries, Indian banks plan to expand their operations there.

In 2008, 18 Indian banks (13 state-owned and 5 private) were operating a network of 203 offices abroad. The network included 131 branches, 22 subsidiaries, 7 joint ventures and 43 representative offices in 51 countries.

India: A Bank-Based Financial System

India follows a bank-based financial system with a multilayered network consisting of large state-owned banks, old private banks, new private banks (established in the post-1991 period), foreign banks, regional rural banks, cooperative banks, non-banking finance companies (NBFCs) and development financial institutions.

The share of banking assets in India's financial sector assets is around 75 per cent. Therefore, the contribution of banking sector is very vital for economic growth and poverty reduction strategies.

Of late, niche players such as microfinance institutions have become active in the Indian banking sector. However, India's banking landscape is still dominated by commercial banks which control a majority of the banking assets in the country. As of March 2008, there were 79 commercial banks with diverse ownership.

The government-owned – State Bank of India (SBI) and its associated banks – along with other state-owned and regional rural banks were established by the enactments of the Indian Parliament.

Under the Banking Regulation Act of 1949, the Reserve Bank of India, country's central bank, has the power and responsibility to regulate and supervise all banks. No bank can carry out business in India without a license issued by the RBI.

Foreign Banks in India

In India, the presence of foreign banks dates back to the pre-independence period. Established in 1858, Standard Chartered Bank is the oldest foreign bank in India. BNP Paribas and HSBC began their operations in 1860s.

Since 1991, the entry of foreign banks has been liberalized. The number of foreign banks in India increased from 24 in 1990 to 41 in 2000 but their number declined to 29 in 2005 largely due to mergers and acquisitions in the global banking industry.

The number of branches of foreign banks increased from 138 in 1990 to 207 in 2003 and further to 277 in 2008. The foreign banks' share in total banking assets also increased from 5.6 per cent in 1990 to 8 per cent in 2008. In 2008, 30 foreign banks were operating in India with a network of

Table 6: Foreign Banks in India

Year	Foreign Banks (No.)	Number of Branches	Share in Total of Commercial Banks Operating in India (Per cent)	Share in Total Assets of Commercial Banks (Per cent)
1980	14	129	9.5	3.9
1990	24	138	8.8	5.6
1995	29	156	10.2	7.3
2000	41	186	13.9	7.5
2003	36	207	12.9	6.9
2005	29	251	13.6	6.5
2006	29	262	16.5	7.2
2007	29	272	16.5	8.0

Source: Reserve Bank of India, 2008.

277 branches and 765 off-site ATMs. These banks originated from 21 countries. Besides, 41 foreign banks have also opened representative offices in India.

The 9 EU-based banks operating in India are ABN-AMRO Bank (acquired by a consortium led by Royal Bank of Scotland in 2007), Antwerp Diamond Bank, Barclays Bank, BNP Paribas, Caylon Bank, Deutsche Bank, HSBC, Societe Generale and Standard Chartered. Table 7 provides the list of EU-based banks with their branch network in India. By asset size, out of top 10 foreign

Table 7: EU-based Banks Operating in India

Name of Bank	Country of Incorporation	No. of Branches in India
ABN-AMRO Bank	Netherlands	28
Antwerp Diamond Bank	Belgium	1
Barclays Bank	United Kingdom	5
BNP Paribas	France	9
Calyon Bank	France	6
Deutsche Bank	Germany	10
HSBC Holdings	United Kingdom	47
Societe Generale	France	2
Standard Chartered Bank	United Kingdom	90

As at end-March 2008.
Source: Reserve Bank of India, 2008.

banks in India, 6 are EU-based. The 9 EU-based banks together controlled 65 per cent of total assets of foreign banks in India in 2008.

The Rationale Behind Nationalization of Indian Banking Sector

The nationalization of privately-owned banks was a major development in the banking sector in the post-Independent India. India nationalized its banking sector with the promulgation of the Banking Companies Ordinance on July 19, 1969. Under the Act, 14 of the largest privately-owned banks were nationalized. In 1980, 7 more private-sector banks were nationalized under the same Act.

Prior to nationalization, the entire banking system was in the hands of private sector. Most of privately-owned banks were in the form of joint stock companies controlled by big industrial houses. For instance, Tatas were the major shareholders of Central Bank of India which was established in 1911. The Birla family, one of the leading corporate houses of India, controlled United Commercial Bank. More importantly, there were several bank failures due to imprudent bank lending in the absence of regulatory safeguards. During 1947-58, for instance, as many as 361 banks of varying sizes failed in India. The failed banks were either amalgamated or ceased to exist.

In those times, the limited outreach of banks coupled with weak regulatory framework represented a classic case of market failure in the Indian banking sector.

Before nationalization, privately-owned banks were located in metropolitan and urban areas. The population covered per branch was 1,36,000 in 1951. Much of bank lending was concentrated in a few organized sectors of economy and limited to big business houses and large industries. Whereas farmers, small entrepreneurs, laborers, artisans and self-employed were totally dependent on informal sources (mainly traditional moneylenders and relatives) to meet their credit requirements. The share of agriculture in total bank lending was a meager 2.2 per cent during 1951-67.

To reverse this trend, the Indian government introduced the policy of social control over banks in 1967. The objective of this policy framework was to bring structural changes in the management of banks by delinking the nexus between big business houses and big commercial banks. Under this policy, new guidelines on the management of banks were issued to ensure that persons with specialized knowledge and experience could join the board of directors of a bank. The RBI also got new powers to appoint or sack senior management in a bank. Another policy objective of social control was to improve the distribution of credit towards agricultural and developmental sectors.

Despite such laudable policy measures implemented under the social control framework, a large segment of the population (particularly in rural areas) had not access to the institutionalized credit. Based on this experience, it was realized that the nationalization was the only option to channelize banking resources to the neglected sectors of economy and rural areas. In 1969, the Government nationalized 14 banks with deposits of over Rs.500 million.

There were several policy objectives behind the bank nationalization strategy including the transformation of "class banking" into "mass banking," expanding geographical and functional spread of institutionalized credit, mobilizing savings from rural and remote areas and reaching out to neglected sectors such as agriculture and small scale industries.

Another policy objective was to ensure that no viable productive business should suffer for lack of credit support, irrespective of its size. In sum, the bank nationalization drive was inspired by a larger social objective so as to subserve national development priorities.

The Positive Outcomes of Bank Nationalization Regime

Before nationalization, banks were reluctant to open small accounts as these were not considered profitable. Between December 1972 and June 1983, as many as 212 million new bank loan accounts were opened up, out of which nearly 93 per cent were small loan accounts (Rs.10,000 or less).

At the time of nationalization, scheduled commercial banks had 8,187 branches throughout the country. But in 1990, the branch network increased to 59,752. With such a rapid increase in bank branches across regions, the population covered per branch, which was 65,000 in 1969, also decreased to 13,756 in 1990 (Table 10).

In 1990, out of 59,752 bank branches in the country, 34,791 (58.2 per cent) were located in the rural areas. In contrast, the share of rural branches was 17.6 per cent in 1969. Such a massive expansion of bank branches in the rural and unbanked areas was the result of 1:4 licensing policy of 1977 under the nationalization regime.

Prior to nationalization, branch licenses were issued on the financial strength of the banks. The 1:4 licensing policy changed the focus to providing banking services throughout the country, particularly in remote and unbanked areas. Under the 1:4 licensing policy, banks were given incentive to open one branch in metropolitan and one branch in urban areas, provided they open four branches in the rural areas.

This policy led to rapid growth of bank branches in the rural and remote regions of the country and thereby helped in correcting the urban bias of the banking industry. Between 1977 and 1990, more than three-fourths of bank branches were opened in the unbanked areas.

Even the supporters of banking sector liberalization cannot deny that such a rapid expansion of bank branches, after nationalization, was unparalleled among developing countries.

The rapid expansion of the branch network led to large deposit mobilization by banks, which in turn, contributed to higher saving rate. The household financial savings increased manifold as nationalized banks enhanced public confidence in the banking system. For instance, household sector financial savings increased from Rs7950 million in 1969 to Rs.60810 million in 1980. Similar trends were witnessed in bank credit too. The bank credit-GDP ratio witnessed a sharp rise, from 10 per cent in 1990 to 24 per cent in 1991.

Apart from licensing policy, the establishment of regional rural banks (RRBs) in 1976 also widened the reach of banking services. The mandate of RRBs was to serve small and marginal farmers, agricultural laborers, artisans and small entrepreneurs in the rural and remote areas.

In rural areas, there was significant rise in bank deposits and credit. According to official data, the share of rural deposits in total deposits increased more than five times, from 3 per cent in 1969 to 16 per cent in 1990. The share of credit to rural India in total credit jumped from 3.3 per cent to 14.2 per cent during the same period.

In addition, banks were directed to maintain a credit-deposit ratio[16] of 60 per cent in the rural and semi-urban branches in order to ensure that rural deposits are not used to increase urban credit. The credit-deposit ratio in rural areas increased from 37.6 per cent in 1969 to over 60 per cent in the 1980s and 1990s.

To a large extent, these policy measures helped in reducing the dependence on rural population on non-institutional sources such as traditional moneylenders and landlords.

The Introduction of Priority Sector Lending

The bank lending to priority sectors and weaker sections of society received a major boost under the nationalized regime. In the early 1970s, the concept of priority sector lending (also known as directed lending) was evolved to ensure that adequate credit flows to the vital sectors of the economy and according to social and developmental priorities.

Under this policy, specific targets were imposed on the banks to meet the priority sector credit requirements. Slowly, the definition of priority sector has acquired new meaning but broadly it includes bank lending to agriculture, small and medium-sized enterprises (SMEs), weaker sections of society and exports.

Under priority sector lending, bank loans to students, retail traders, farmers, small businesses, food and agro-industries, exports and other activities were made available often at concessional rates.

The Differential Rate of Interest (DRI) Scheme was also launched in 1972 to provide bank loans at concessional rates of interest to low income groups (such as landless laborers, handicapped persons, scheduled castes and scheduled tribes who did not have tangible assets) for productive purposes.

The nationalization regime witnessed substantial flow of credit to all sectors, including the neglected sectors of the economy such as agriculture and small- and medium-enterprises (SMEs). The share of agriculture credit in the total bank credit increased from 2.2 per cent in 1968 to 13 per cent in 1980 and further to 15.8 per cent in 1989. The share of small-scale industry in the total bank credit which was negligible before nationalization reached 15.3 per cent in 1989, a significant achievement by international standards.

There is no denying that the banking system under the nationalization regime was not perfect as it could not reach out to each and every household but at least a serious effort was made to spread banking services: geographically, socially and functionally. No one can deny that there were cumbersome lending procedures, inadequate supervision, corruption and political interference which affected functional efficiency and profitability of the banking system. Nevertheless, nationalization regime made the entire banking system subservient to the needs of the real economy. Besides, the unholy nexus between the banks and big corporate houses was dismantled to an extent.

In sum total, nationalization changed the orientation of commercial banking in India from “class banking” to “mass banking.” The state ownership was used as a tool to exert social and democratic control over the banking system.

There are very few parallels in the history of banking in the world where such large-scale geographical expansion and functional diversification of the banking system (with social and developmental orientations) took place.

Banking Sector Liberalization in India

Banking sector liberalization is a process in which allocation of bank resources is determined by market forces rather than the state and public institutions. It minimizes the role of the state in the financial sector by encouraging market forces to decide who gets and gives credit and at what price.

Implemented in conjunction with other macroeconomic policy reforms, banking sector liberalization has remained one of the most controversial policy issues in India. Since the launching of liberalization and globalization policies in 1991, a series of important developments have taken place in the Indian banking sector, ranging from a liberalized regime for the entry of foreign banks to divest in state-owned banks to interest rate deregulation to dismantling of developmental financial institutions to the mushrooming of microcredit programs and non-banking financial institutions. The stated objective of banking liberalization has been to make banks more competitive, efficient and profitable.

The processes involved in the banking sector liberalization in India are very dynamic and complex. The pressure to open up the banking sector in India has come from various sources (domestic and foreign).

Since 1991, the entry of foreign banks has been liberalized. Several official committees have recommended opening up of India’s banking sector on the grounds that the entry of foreign banks would enhance competitive efficiency of the banking sector and would encourage domestic banks to adopt “best practices” and new technology.

To enlarge the presence of foreign banks in the Indian banking markets, RBI announced a roadmap entailing sequencing of banking reform measures in 2005.

The roadmap consists of two phases. In the first phase, between March 2005 and March 2009, foreign banks will be allowed to establish a 100 per cent wholly owned subsidiary (WOS) or conversion of the existing branches into a WOS. Besides, the WOS will be treated on a par with the existing branches of foreign banks for branch expansion. To date, surprisingly, no foreign bank has opted for a WOS route. During this phase, foreign banks will also be allowed to take over ailing private sector banks identified by the central bank.

In the second phase, starting from April 2009, foreign banks will be given the "National Treatment" under which they would be treated on par with domestic banks and the remaining restrictions on foreign ownership and investments will be removed.

As a part of financial sector reforms, the successive political regimes have undertaken partial privatization of state-owned banks, reducing the government stake to 51 per cent. In 2008, the Planning Commission's High Level Group on the Services Sector recommended that the government stake in public sector banks should be further reduced to 33 per cent.

For many years, foreign investors have been demanding the removal of 10 per cent ceiling on voting rights in the Indian banks. They are seeking voting rights in commensurate with their ownership in the private Indian banks. To remove this ceiling, the government introduced a bill in the Indian Parliament in 2008.

A further boost for global integration could come if India undertakes capital account liberalization which, in turn, would further expand cross-border trade and investment in the banking and other financial services.

Trade Agreements and Banking Sector Liberalization

Under the WTO agreement, India has given commitments to offer 12 new licenses every year to foreign banks.

The trade agreement such as India-Singapore Comprehensive Economic Cooperation Agreement (CECA), which came into effect in 2005, is an example of opening up banking sector on a bilateral basis. Under the CECA, three Singapore banks are allowed to open 15 branches in India and three Indian banks would be given the Qualifying Full Banking (QFB) status in Singapore. The QFB status allows banks to undertake all banking activities, including retail and wholesale banking, in Singapore. Besides, banks with QFB status can also transact business in Singapore dollars.

The CECA provides special privileges to three Singapore banks (DBS Bank, United Overseas Bank and Overseas-Chinese Banking Corporation) as they are allowed to set up a wholly-owned subsidiary (WOS) in India to enjoy treatment on a par with domestic banks in terms of branch licenses, places of operations and prudential requirements. In case these three banks choose to set up as branches in India, CECA provides a separate quota of 15 branches (for all three banks) over four years, over and above the quota for all foreign banks.

Despite the much-touted roadmap for banking sector liberalization, the Indian authorities are violating it to accommodate commitments made under the CECA. In principle, the commitments made by India under the CECA are in conflict with domestic regulations related to foreign ownership. For instance, two sovereign wealth funds owned by the Government of Singapore (Temasek Holdings and Government of Singapore Investment Corporation) have been allowed to acquire 10 per cent stake each in ICICI Bank.

As per existing rules, no single foreign institutional investor can own more than 10 per cent equity in a listed company in India. The different foreign institutional investors owned by a common entity are classified as a group and are subject to the 10 per cent limit. Instead of treating both Singapore funds as a single entity because of their common state ownership, the Indian authorities have allowed them to hold up to 20 per cent of shares in ICICI Bank.

No Reciprocity in Market Access

Contrary to popular perception, Indian authorities are opening up its banking markets, far exceeding the international commitments. The RBI has gone beyond the existing international commitments to give greater market access to foreign banks.

The number of branches permitted each year to foreign banks has been higher than the WTO commitments of 12 branches in a year. During July 2006-June 2007, India allowed seven established foreign banks (including

ABN AMRO Bank, Barclays Bank and Deutsche Bank) to open 20 new branches and additional seven foreign banks to set up representative offices. During July 2007-June 2008, 3 existing foreign banks were allowed to open 18 branches. Besides, 5 new foreign banks (including Dresdner Bank) were given permission to open one branch each.

One of the key policy issues determining the market access is reciprocity. How much market access Indian banks are getting in return?

The recent experience shows that market access to Indian banks is far from satisfactory. During 2003-07, India allowed US-based banks to open 19 branches (excluding the off-site ATMs). But, in the same period, the US did not allow a single Indian bank to open a branch or subsidiary or representative office in its territory despite many requests made by Indian banks.

In the case of India-Singapore CECA, the principle of reciprocity has not been followed. Though the RBI has allowed market access to Singapore banks as per the agreement but the Monetary Authority of Singapore (MAS) has failed to fulfill its commitments for providing full bank license (QFB status) to three Indian banks. Currently, the DBS Bank is operating 10 branches in India along with other Singapore banks whereas only State Bank of India has been given QFB status in Singapore. The other Indian banks (such as ICICI Bank and Bank of India) have been denied the QFB status.

Are Foreign Banks Discriminated in India?

There is a popular perception that the entry of foreign banks in the Indian market is very restricted and the regulatory framework discriminates against the foreign banks. A closer examination of current banking regulatory framework reveals that it is no longer discriminatory and in many important ways put foreign banks in the same footing as Indian banks.

As pointed out by V. Leeladhar, former Deputy Governor of RBI, India issues a single class of banking license to foreign banks which means that there are no restrictions on the scope of their activities.[17] In many countries including the US, Singapore and China, strict restrictions have been imposed on the kind of businesses (e.g., foreign-country related business) that could be carried out by foreign banks. But in India, foreign banks are free to undertake any banking activity (e.g., wholesale, retail, private banking, investment banking, foreign exchange, etc.) which is allowed to domestic banks.[18]

Owing to single class license policy, foreign banks are having a field day. They are handling bulk of their home-country trade and investment businesses. A substantial portion of foreign institutional investments and foreign exchange business is also handled by the foreign banks thanks to this liberal policy. Foreign banks also enjoy comparative advantage in undertaking off-balance sheet activities, such as forward exchange contracts and guarantees owing to their foreign exchange positions and relevant expertise.

In India, there are also no restrictions on the establishment of non-banking financial subsidiaries by foreign banks. Unlike many other developed and developing countries, deposit insurance cover is uniformly available to both foreign and domestic banks in India. If any bank (domestic or foreign) fails, a payment of up to Rs.1,00,000 to each depositor is guaranteed under the Indian regulations.

Further, the prudential norms applicable to foreign banks for capital adequacy, reserve requirements and asset classification are the same as for the Indian banks.[19] Foreign banks also pursue independent staff recruitment policies.

Foreign banks often complain that they are not allowed to manage state-owned company term deposits. According to rules, state-owned companies can only park their funds with any scheduled commercial bank (irrespective of ownership) incorporated in India. Since foreign banks are incorporated in their home countries, they are not eligible for accessing these funds. However, this curb will not be valid if the foreign banks incorporate subsidiaries in India. As pointed out by Mathew Joseph and Rupa Rege Nitsure, this restriction will not longer be valid if the foreign banks incorporate subsidiaries in India.[20] Similarly, foreign banks can get equal tax treatment by incorporating subsidiaries in India.[21]

Despite the RBI permission, no foreign bank has converted their existing branches into WOS, till date. The possible reason could be once they opt for a WOS route, they would have to follow priority sector lending guidelines, which are applicable to domestic banks.

Domestic banks complain that foreign banks are given undue favor when it comes to priority sector lending. The Indian authorities have imposed lower priority sector lending requirement at 32 per cent (of their adjusted net bank credit or credit equivalent amount of off-balance sheet exposures, whichever is higher) for foreign banks as against 40 per cent for Indian banks.

Within the overall target of 32 per cent, foreign banks are required to lend 10 per cent to micro and small enterprises and 12 per cent to export credit. But no target has been prescribed for foreign banks to lend money to agricultural sector and weaker sections of society.

In addition, foreign banks are also exempted from Differential Rate of Interest (DRI) scheme under which loans are offered to people below the poverty line, particularly to scheduled caste and tribal people, at a much lower rate of interests with easy repayment rates and no margins.

In contrast, within the overall target of 40 per cent, it is mandatory for domestic banks (both state and private) to lend 18 per cent to agricultural sector and 10 per cent to the weaker sections of the society besides meeting the requirements under the DRI scheme. Moreover, state-owned banks are required to lend at least 5 per cent of their net bank credit to women.

In other words, this lopsided policy framework has ensured that foreign banks can remain insensitive to the requirements of the agricultural sector and the weaker sections of society.

The RBI statistics reveals that since 2000, state-owned banks, as a group, have been meeting the overall priority sector lending targets, despite steep shortfall in agricultural lending. The priority sector lending by state owned banks was 39.6 per cent during 2006-07, marginally short of mandatory 40 per cent.[22] At end-March 2008, aggregate credit to women by state-owned banks was 6.12 per cent of their net bank credit with 24 banks reaching the target.[23] Eight state-owned banks have also opened 19 specialized women branches.[24]

The private sector banks, as a group, are failing to meet the priority sector targets. For instance, no private bank has achieved the 10 per cent sub-target lending to weaker sections during 2006-07. In order to avoid penalties, often private banks buy such loan assets from their state-owned counterparts.

While foreign banks, as a group, have been achieving the overall lending target of 32 per cent, but largely only on the account of export credit, in tune with their priorities. In fact, the share of export credit in total net bank credit of foreign banks was 18 per cent in 2006-07, much higher than the prescribed target of 12 per cent.

At the individual bank level, some foreign banks have been unable to meet the priority sector lending targets and sub-targets. But there are glaring loopholes leading to some foreign banks missing the lending targets. Those foreign banks which are unable to meet the priority sector lending targets are required to deposit amounts equivalent to the shortfall with the Small Industries Development Bank of India (SIDBI) for three years. In return, foreign banks earn interest on such deposits. Aggregate amounts of Rs.10,580 million and Rs.10,310 million were deposited by the foreign banks with SIDBI for 2006 and 2007 respectively as they could not meet the stipulated targets.[25]

The Branch Licensing Policy Favors Foreign Banks

In the case of branch licensing policy, there is no regulatory prescription for foreign banks to open branches in rural and semi-urban areas. Foreign banks have the freedom to decide the location of their branches. While for new private banks, the licensing policy stipulates that while these banks need not necessarily open up branches in rural or semi-urban areas during the first three years of their operations. But once the moratorium is over, one out of four new branches would have to be opened in such centers.

This lopsided policy works in favor of foreign banks because rural branches generate less profit due to low value transactions. Most of the bank branches in the rural areas are operated by state-owned banks. On the other hand, foreign and private sector banks operate largely in urban and metropolitan

Table 8: Distribution of Bank Branches in India ***(in Per cent)***

Bank Groups	Rural	Semi-Urban	Urban	Metropolition
State-owned Banks*	35.0	25.9	20.5	18.6
Old Private Banks	18.2	33.5	28.6	19.4
New Private Banks	6.3	25.4	32.3	36.0
Regional Rural Banks	77.9	17.6	4.0	0.4
Foreign Banks	0	0.7	17.9	81.4

As at end-March 2008.

* Includes nationalized banks, SBI Group and IDBI Ltd.

Note: Population group wise classification of branches is based on 2001 Census. The "Rural" group includes all centers with population of less than 10,000. The "Semi-Urban" group includes centers with population of 10,000 and above but less than 100,000. The "Urban" group includes centers with population of 100,000 and above but less than 1 million. The "Metropolitan" group includes centers with population of 10 lakhs and above.

Source: Reserve Bank of India, 2008.

areas and manage accounts of high-net-worth-individuals and large corporations.

To date, most of bank branches of foreign banks are located in metropolitan areas and major cities where bulk of premium banking business is concentrated. As on June 2008, there were 30 foreign banks operating in India with a network of 279 branches and 765 off-site ATMs. Out of 279 branches, 227 (81.4 per cent) were located in metropolitan areas, 50 (17.9 per cent) in urban areas and just 2 (0.7 per cent) in semi-urban areas (Table 8). Not a single foreign bank has opened a branch in rural areas.

Since foreign banks have no branches in the rural areas, they are also not obliged to fulfill the agricultural loans commitments under the priority sector lending policy.

In the case of EU-based banks operating in India, they have yet to open a branch in the rural areas. This is despite the fact that several EU banks (such as Standard Chartered, BNP Paribas and HSBC) have been operating in India for more than 140 years.

Barclays Bank is the only European bank which opened a branch in the semi-urban center, Nelamangala, near Bangalore in 2007 (Table 9). Nelamangala is not a typical semi-urban center as it is situated next to Peenya Industrial Estate, one of the largest industrial hubs in South Asia. Close to 3,000 industrial units of all sizes are located there.

Table 9: Branches of EU-based Banks in India ***(in Per cent)***

Name of Bank	Rural	Semi-Urban	Urban	Metro-polition	Total
ABN-AMRO Bank	0	0	9	19	28
Antwerp Diamond Bank	0	0	0	1	1
Barclays Bank	0	1	2	2	5
BNP Paribas	0	0	0	9	9
Calyon Bank	0	0	0	6	6
Deutsche Bank	0	0	4	6	47
HSBC	0	0	9	38	10
Societe Generale	0	0	0	2	2
Standard Chartered	0	0	12	78	90

As at end-March 2008.

Source: Reserve Bank of India, 2008.

Box 1: Are Foreign Banks More Efficient than Domestic Banks?

It is often claimed that the increased presence of foreign banks enhances the efficiency of the domestic banking system. It is also claimed that foreign banks introduce new technology and offer better customer services which improves the overall quality of banking services.

There is a popular perception that foreign banks perform better than domestic banks (both state-owned and private) on efficiency and productivity levels in India. However, the analysis carried out by RBI suggests domestic banks no longer lag behind their foreign peers on efficiency indicators. On several parameters, state-owned banks outperform both foreign and private banks despite the fact that state-owned banks run a huge branch network in the rural and semi-urban areas and undertake substantial social and developmental banking activities.

The Reserve Bank of India has measured efficiency of different bank-groups in India using both accounting and economic measures.[64] Based on its rigorous analysis, the RBI observed that "ownership has no definite relationship with efficiency."[65]

Let us begin with accounting measures. The intermediation cost is the standard benchmark of bank efficiency. The intermediation costs refer to administration and operational costs incurred by banks while offering services. The higher the intermediation cost, the lower is the efficiency

Some Efficiency Parameters *(2006-07) (in Per cent)*

Bank Group	Operating Cost to Total Assets	Net Interest Margin	Inter-mediation Costs	Return on Equity
State Bank Group	1.98	2.79	2.97	15.30
Nationalized Banks	1.67	2.58	3.32	14.65
Old Private Banks	1.88	2.74	3.63	10.32
New Private Banks	2.11	2.36	3.61	13.57
Foreign Banks	2.78	3.74	5.51	13.86

Source: Reserve Bank of India, 2008.

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of a bank. In contrast to domestic banks, intermediation costs of foreign banks were much higher in India during 2006-07. The high intermediation costs have negative welfare and distributional outcomes.

In the case of net interest margins (the difference between interest earned on investments and interest paid out to depositors), foreign banks have higher ratio than domestic banks. However, this is largely due to large proportion of current accounts which has allowed foreign banks to raise low cost deposits in India.[66] As pointed out by the RBI, foreign banks are not passing the benefits of low cost of funds to customers.[67]

Two other accounting indicators, return on assets (RoA) and return on equity (RoE), measure the overall profitability of banks. RoA indicates how much profit a bank earns for every unit of its assets. RoE indicates how efficiently a bank is using shareholder equity to generate profits. The higher the ratios, the better the profitability and productivity of banks. Undoubtedly, foreign banks have higher RoA as compared to domestic banks, largely on account of profits generated by off-balance sheet businesses in India. However, RoE of state-owned banks was higher than both foreign and private banks in 2006-07 (see Table on the previous page).

There is no denying that the average business done in a branch of a foreign bank is much higher in comparison with domestic banks. But this is largely due to the fact that foreign banks operate in metropolitan and urban areas and usually serve HNWIs and large corporations. Whereas state-owned banks maintain 60 per cent branches in the rural and semi-urban areas where the transaction size is small.

The RBI has also used a non-parametric methodology called Data Envelopment Analysis (DEA) which has become popular in measuring bank efficiency in many European countries. The DEA method calculates efficiency by incorporating numerous factors affecting banks' performance. The DEA measures efficiency of a bank relative to the constructed benchmark.[68] Closer the rank to the benchmark (with rank = 1), the more efficient is the bank.

Based on this methodology, the RBI found that during 2006-07, the

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government-owned State Bank group was the most cost efficient with efficiency level of 0.85, followed by new private sector banks (0.83), nationalized banks (0.80), foreign banks (0.66) and old private sector

Bank Group-wise Efficiency Levels

Bank Group	Efficiency Levels	2006-07
State Bank Group	Cost	0.85
	Technical	0.95
	Allocative	0.89
Nationalized Banks	Cost	0.80
	Technical	0.93
	Allocative	0.86
Old Private Banks	Cost	0.59
	Technical	0.72
	Allocative	0.81
New Private Banks	Cost	0.83
	Technical	0.95
	Allocative	0.88
Foreign Banks	Cost	0.66
	Technical	0.79
	Allocative	0.83

Source: Reserve Bank of India, 2008.

banks (0.59). The RBI analysis further found that out of 10 most efficient banks, top 5 were state-owned banks, followed by 3 private sector banks while the remaining two were foreign banks.[69]

Over the years, domestic banks have upgraded technology to provide better services to customers. Services such as internet banking, mobile banking and ATM banking are no longer exclusive to foreign banks.

The RBI established Banking Ombudsman in 1995 to solve customer complaints relating to banking services. During 2007-08, the number of complaints per branch received at the offices of Banking Ombudsman was the highest among the foreign banks (22.1), followed by private sector banks (1.7) and public sector banks (0.5). Most of complaints were pertaining to credit cards, deposit accounts, remittances and loans.

Nevertheless, the pursuit of higher efficiency levels cannot be an end in itself. As observed by T. T. Ram Mohan, “Ever increasing levels of efficiency cannot be the sole objective for the banking sector. We need a level of efficiency that is consistent with other objectives – financial inclusion, development of agriculture and, not least, financial stability.”[70]

It is important to note that even without branch licenses, foreign banks have been able to expand business through off-site ATMs, non-banking finance companies and off-balance sheet exposures (e.g., derivatives). In particular, the number of off-site ATMs operated by foreign banks far exceeds the number of their branches. For instance, Citigroup operates 412 off-site ATMs with only 40 bank branches (more than 10 times of its branches) in India. The ABN-AMRO Bank operates 83 off-site ATMs with 28 bank branches.

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.

Undoubtedly, foreign banks are generating handsome returns in India in comparison with domestic counterparts and international benchmarks. The balance sheets of foreign banks, as a group, expanded 39.5 per cent in 2007 as compared to 24.3 per cent increase in the balance sheet of entire banking sector.[26] Similarly, the net profits of foreign banks increased 49 per cent in 2007 as compared with 27 per cent of entire banking sector in India.[27]

However, it needs to be reiterated that the faster growth and higher net profits by foreign banks have been at the cost of rural and social banking in India.

The Stark Anomalies in Banking Assets Ownership

As per on-balance sheet businesses, domestic banks (both state and private) own 92 per cent of the total banking assets in the country while the foreign banks own the remaining 8 per cent as on March 2008.

However if one includes off-balance sheet businesses[28], then the ownership patterns dramatically reverse as foreign banks are the far the biggest players in the off-balance sheet businesses with a combined market share of 67.9 per cent in 2007. As a result, the total share of foreign banks as a percentage of the assets of India's banking system (both on- and off-balance-sheet items) was 49 per cent in 2007, far above the commitments given by India at the WTO.

According to India's commitment at the World Trade Organisation, licenses for new foreign banks may be denied when the share of foreign banks' assets in domestic banking system (including both on- and off-balance-sheet items) exceeds 15 per cent.

But it is important to note that the Indian authorities have not invoked the WTO commitment to deny the entry of foreign banks in the country. The reason is plain and simple. It is a reciprocal gesture by India in response to growing ambition of domestic banks to venture abroad. In the words of V. Leeladhar, "Our (Indian) banks are aggressively trying to go abroad. If we are restrictive, our banks will face a problem in getting their proper share of branches abroad. So we have been a little liberal so that we (our banks) may also get adequate number of branches."[29]

As end-March 2008, the total off-balance sheet exposure of all commercial banks in India was more than three times the size of their consolidated balance sheet as compared with more than two times at end-March 2007.[30]

However, domestic banks are lagging behind the foreign banks in terms of off-balance sheet activities. As on March 2008, the off-balance sheet exposure of foreign banks was at 2,830.5 per cent of their total assets, followed by new private sector banks (301.8 per cent), public sector banks (61.5 per cent) and old private sector banks (57.1 per cent).[31] Among the bank groups, foreign banks constituted the largest share (70.8 per cent), followed by new private sector banks (15.6 per cent) and public sector banks (12.9 per cent) in the total off-balance sheet exposure of commercial banks.[32]

The global financial crisis, started in 2007, has clearly proved beyond doubt that banks are ultimately accountable for both on- and off-balance sheet assets (and liabilities). The banks cannot wish away their off-balance sheet exposures. The banks will have to honor the commitments if the clients fail to do so. The HSBC, for instance, had to shift its $35 billion liability from "off-balance sheet" status to "on-balance sheet" status in the aftermath of sub-prime mortgage crisis.

The technical divisions between "on-balance sheet" and "off-balance sheet" items are largely used by banks to avoid prudential capital requirement norms and diversify their sources of income. Therefore, the true ownership of domestic banking assets by foreign banks should be assessed by combining both on- and off-balance sheet exposures.

The off-balance sheet items could pose liquidity risk to the banks if not supervised properly. In the light of recent incidence of losses suffered by Indian exporters on account of foreign exchange derivative products (an off-balance sheet business) sold by foreign banks and domestic new private sector banks, the central bank should issue new regulations to limit banks' off-balance-sheet exposures.

Despite the restrictions on voting rights, foreign ownership in India's private sector banks continues to increase rapidly. As per policy directive issued in March 2004, foreign banks can acquire up to 74 per cent equity in Indian private banks. Though ICICI Bank and HDFC Bank are incorporated in India but their foreign ownership is close to 74 per cent due to listing in the international markets as well as large investments by strategic and foreign institutional investors (FIIs). As on March 2008, the shareholding of FIIs was more than 60 per cent in four new private sector banks.[33]

The Extent of Financial Exclusion in India

Though there is no universally accepted definition of financial inclusion, in simple terms, it means providing affordable services (such as bank accounts, credit, remittance and payment services) to those sections of society who are not part of formal financial system.

Since financial exclusion has strong linkages with poverty, it is predominantly concentrated among the poor and marginalized sections of society. From an economic development viewpoint, financial exclusion denies opportunities to poor people to come out of poverty.

It is well acknowledged that financial exclusion is not merely restricted to rural population. A large number of urban dwellers, migrants and informal sector workers also lack access to banking and other financial services.

In the case of India, financial exclusion is largely concentrated among landless laborers, small farmers, urban poor, migrants, lower castes, tribal communities, senior citizens and women.

Some of the important barriers to financial inclusion include lack of bank branches, vast spread of population in hilly and remote areas, high service charges and penalties, cumbersome procedures, risk perception and class biases, lack of physical infrastructure, low income, unemployment, lack of assets, financial illiteracy, etc.

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.[34] The AIDIS brought out several new insights into the extent of financial exclusion in India. The Survey revealed that 45.9 million farmer households in the country (approx. 51 per cent), out of a total of 89.3 million, do not have access to credit, either from institutional or non-institutional sources.[35] Further, merely 27 per cent of total farm households are indebted to institutional sources. In other words, 73 per cent of farmer households have no access to formal sources of credit.

Even though the share of private moneylenders in the credit of rural households has declined substantially from 69.7 per cent in 1951 to 17.5 per cent in 1991, the AIDIS found that the share of moneylenders increased to 26.8 per cent in 2002.

The Survey found large variations in financial exclusion across regions, social groups and land holdings. Geographically, financial exclusion is more widespread in the North-East and Eastern India. According to the Survey, the proportion of farm households not having access to credit from formal sources is higher in the North-Eastern region (95.91 per cent) followed by the Eastern region (81.26 per cent) and Central Region (77.59 per cent). Around 87 per cent of non-indebted farm households belong to the marginal and small farmer categories.

Furthermore, the spread of financial exclusion is much higher in non-cultivator households such as agricultural laborers and artisans. Out of 59.6 million non-cultivator households, 46.6 million (about 80 per cent) are estimated to be financially excluded.

Among the social groups, farmer households belonging to tribals, lower and backward castes have very little access to credit from formal sources. In particular, dalit rural households face greater marginalization in terms of access to credit from commercial banks.[36]

A recent study by Pallavi Chavan reveals that lack of access to banking services is widespread among women, especially poor women.[37] Women contribute about one-fifth of the individual savings mobilized through bank deposits but receive only around one-tenth of the total individual credit from banks.[38] According to Chavan, overall women's access to banking services has not improved despite the mushrooming of microcredit programs in India.

Several other estimates also highlight the higher levels of financial exclusion in India. One of the commonly used methods in assessing financial inclusion is the number of deposit accounts (both savings and current) in proportion to the adult population of the country. It has been estimated that only 59 per cent of adult population in India have bank accounts while the remaining 41 per cent is unbanked.

Further, 61 per cent of adult Indian population is unbanked in the rural areas against 40 per cent in the urban areas. The unbanked population is higher in the North Eastern and Eastern regions.

In contrast, over 90 per cent of adult population has bank account (savings or current) in Belgium, Sweden, France, UK and Germany. In Belgium, banks are required to open "call deposit account" which offers affordable services related to basic transactions such as money transfers, deposits and withdrawals.

In Sweden and France, the right to access basic banking services is enshrined in law. Under Sweden's Banking Business Act of 1987, banks cannot refuse a customer to open a saving account.

In France, residents have the right to open an account with any bank under the provisions of the Banking Act of 1984. In case a bank refuses, resident can approach the Banque de France (central bank of France) which will designate a bank to open an account. In the UK and Germany, voluntary codes and charters have been established to provide access to basic banking services. In India, no such legal and policy measures are in place.

Under the nationalization regime, the number of savings accounts opened by banks increased rapidly. In fact, the rise in savings accounts was much higher than the population growth. The rise in savings accounts was witnessed in both rural and urban areas. However, the number of savings accounts per 100 persons/adults declined sharply between 1991 and 2002.

The number of total credit accounts per 100 persons/adults is another indicator of credit delivery services. Compared to many European countries, loan accounts per 100 persons/adults are much lower in India. The number of loan accounts constituted only 14 per cent of adult population in India.

Another indicator for measuring banking services access is the population covered per bank branch. In the post-liberalization period, the population covered per branch increased in rural areas while it declined in the urban areas (Table 10).

One also finds that there is a huge difference between India and European countries in terms of population per branch. In India, one bank branch caters to 16,129 individuals but a bank caters to 4,807 individuals in the Netherlands, 4,484 individuals in the UK, 2,315 in Belgium, 1,945 in Germany and 1,587 in France. The Indian banking system requires more bank branches (particularly in the unbanked regions) and other channels to improve the ratio.

Since the early 1990s, the share of small borrowers in the total number of bank accounts as well as bank credit has been steadily declining despite upward revisions in the credit limit over the years. For instance, the share of small borrowal accounts (credit limit up to Rs.25,000) in the total number of accounts declined from 95 per cent in 1992 to 90.3 per cent in 2006. In contrast, the number of bank accounts with higher credit limits of Rs.25,000-Rs.200,000 witnessed a jump during this period.

According to the Survey of Small Accounts (2006), carried out by the RBI, the share of small borrowers in gross bank credit was 25.4 per cent in 1989 but it declined to 16.4 per cent in 2006.[39] The RBI survey underlines that the present-day banking system discriminates against all types of small borrowers who seek credit for productive and consumption purposes.[40] The Survey further found that even among small borrowers, banks tend to favor relatively better-off sections of society. The majority of small borrowal accounts are managed by state-owned banks of India which accounted for 36.9 per cent of the total bank accounts and 43.9 per cent of the total bank credit to small borrowal accounts as on March 2007.[41]

Table 10: Population Per Bank Branch in India

(in Thousands)

End-March	Rural	Urban	Total
1969	82	33	63
1981	20	17	19
1991	14	16	14
2001	16	15	16
2007	17	13	16

Source: Reserve Bank of India.

Not long ago, banks used to collect small low-cost deposits directly from customers as part of their door-to-door deposit collection schemes. These schemes played an important role in mobilizing domestic savings. Instead of dismantling, such schemes should be further strengthened to encourage small savings, particularly in the rural areas.

Financial Inclusion and Foreign Banks

The track record of foreign banks in promoting financial inclusion has been extremely poor in India. As discussed earlier, most of branches of foreign banks are located in metropolitan areas and major cities where bulk of premium banking business is concentrated. Since foreign 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.

It is distressing to note that 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. Rather, India's approximately 190 million urban poor provide a huge untapped market that could be reached by foreign banks. The potential market size cannot be overlooked given the saturation of retail banking markets in the developed countries.

Concerned with the widespread financial exclusion, the RBI launched several policy initiatives since 2005. In November 2005, the RBI advised all banks to make available a basic "no-frills" savings account either with nil or low minimum balances to weaker sections of society. To facilitate "no-frills" accounts, Know Your Customer (KYC) procedures were simplified. The Table 11 delineates the progress made by different banks in opening such accounts. Not surprisingly, the overwhelming numbers of "no frills" accounts have been

Table 11: Number of 'No-Frills' Accounts Opened in India

Category	End-March 2006	End-March 2007	End-December 2007
State-owned Banks	332,878	5,865,419	11,026,619
Private Sector Banks	156,388	856,495	1,560,518
Foreign Banks	231	2,753	30,260
Total	**489,497**	**6,724,667**	**12,617,397**

Source: Reserve Bank of India.

opened up by the state-owned banks (87 per cent as on December 2007), followed by domestic private banks (12 per cent). The contribution of foreign banks has been minimal (0.23 per cent), despite the fact that they control 8 per cent of India's banking assets.

Typically, foreign and domestic private banks are averse to provide banking services to the poor people because they find such clients less lucrative. It has been found that state-owned Syndicate Bank, which opened the largest number of "no-frills" accounts, had no negative impact on its financials.[42] Opening such accounts may appear to be a costly affair in the beginning, however, it makes good business for banks in the medium-and long-term basis. The Dharavi model is a case in point (Box 2).

In addition, several districts in the country were taken up for achieving 100 percent financial inclusion. Considerable progress was made under this

Box 2: The Dharavi Model

Situated in Mumbai, Dharavi is Asia's largest slum. After the unprecedented success of EU supported movie, *Slumdog Millionaire*, Dharavi has been catapulted to the status of most celebrated slum. Most of the inhabitants of Dharavi are involved in informal sector of the urban economy through vast network of small home-based production units producing leather goods, garments and jewellery. Dharavi's thriving home-based economy produces goods worth over $500 million a year.

It has been estimated that nearly 400,000 residents of Dharavi have no access to formal banking system. Under the "no-frills" account initiative, three state-owned banks (Union Bank of India, Canara Bank and Indian Bank) have opened bank branches in Dharavi since 2007. They provide a wide range of banking services to the inhabitants of Dharavi at a lower cost. Besides ATM facility, Indian Bank also provides doorstep banking transactions to the residents of Dharavi. Since a large number of migrant people live in Dharavi, many of them are using banking services to send money to their families in their native places.

The spread of banking services in Dharavi counters the popular perception that poor people are "unbankable." Based on the success of this model, Indian Bank has also extended similar banking services to urban poor living in Andhra Pradesh and Chennai.

initiative as well. But only state-owned banks came forward and achieved the desired results.

Despite considerable progress made under these policy measures, it has been found that a large number of bank accounts are no longer operational due to higher transaction costs and access constraints. Location of bank branches is also vital. In case of far away location, a villager may lose half a day's wage in conducting a transaction. Therefore, it is imperative that banking services should be easily accessible.

In sum, as compared to foreign banks, state-owned banks have played a far greater role in promoting financial inclusion through various policy measures.

In 2006, the Committee on Financial Inclusion was constituted by the Government of India under the chairmanship of C. Rangarajan to suggest policy measures for financial inclusion. In its Report submitted on January 4, 2008, the Committee has recommended the setting up of a National Rural Financial Inclusion Plan with a clear target to provide access to financial services to at least 50 per cent (55.77 million) of the excluded rural households by 2012 and the remaining by 2015.

The Committee has suggested that the rural and semi-urban branches of commercial and regional rural banks "may set for themselves a minimum target of covering 250 new cultivator and non-cultivator households per branch per annum, with an emphasis on financing marginal farmers and poor non-cultivator households."[43] Given the fact that foreign banks have negligible presence in the rural and semi-rural areas, it is only the state-owned commercial banks and RRBs which can meet the targets for financial inclusion.

Foreign Banks: More Frills, Less Banking

In terms of providing banking services and products, foreign banks (and big domestic private banks) have a bias towards wealthy and affluent customers in India. Some foreign banks also provide "lifestyle benefits" such as access to exclusive clubs, concierge services and leisure activities to their wealthy clients in India.

Foreign banks tend to follow "exclusive banking" by offering services to a small number of clients, instead of "inclusive banking."[44] For instance, take BNP Paribas, the 10th biggest foreign bank in India. In 2008, BNP Paribas' total assets stood at Rs.75,868 million.[45] The bank maintains a strong clientele with large-sized companies only. It does not cater at all to small companies in India. The bank is a leading player in assisting Indian companies to raise debt and equity from international markets. It has considerable market share in trade finance and structured products. BNP Paribas's wealth management service serves just 800 clients with net worth of above Rs.10 million.

It is well established that not only foreign banks charge higher fees from customers for providing banking services but maintaining a bank account requires substantial financial resources. This has been corroborated by a recent survey conducted in the state of Karnataka by an independent researcher.[46]

Several foreign banks have expressed their discomfort in fulfilling the mandatory priority sector lending requirements. Many foreign and private banks would prefer only to have a niche banking model with no riders in terms of social and developmental banking.

However, given the widespread financial exclusion in India because of poverty and unemployment, it should be made mandatory for the banks to provide services to the poor and marginalized sections both in rural and urban areas. Specific targets in terms of lending to agriculture and weaker sections of society should be stipulated for the foreign banks. Strict penalties should be imposed if the foreign banks are unable to meet the prescribed targets.

In the US and South Africa, banks have started giving attention to the unbanked market as their "mainstream" already-banked market has become highly saturated.[47] In India too, there is a huge untapped market of more than 500 million (almost the size of total EU population) which lack access to basic banking services. More than altruistic reasons, such a big market size should be attractive to European banks. No denying that this market is different from others and requires a separate business model. The banks would have to tailor specific products at lower costs to serve this population. But the potential market size cannot be overlooked given the saturation of retail banking markets in Europe.

Therefore, it is not the lack of market or regulatory discrimination which is hindering the delivery of banking services by foreign banks in India but primarily their business model and bias against the poor people in general.

Decline in Bank Branches in Rural India

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 RRBs and LABs) 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 per cent at end-June 2008 from 42.1 per cent at end-June 2007.[48] In 1991, the share of rural branches was the highest (58.5 per cent). In other words, the recent spurt in bank branches has worsened the rural-urban ratio.

The decline in bank branches in rural areas is the consequence of dismantling of branch expansion program in 1995. As pointed out by S.L. Shetty, former Deputy Governor of the RBI, the approach of totally dispensing with branch expansion program, or one of assigning it to individual banks based on their own commercial perceptions, is sure to arrest the territorial spread of banking in the country, particularly in rural areas.[49] The banks are reluctant to open branches in the rural areas in order to meet the profitability criteria.

However, there are several regional and economic disparities. The poorer states such as Uttar Pradesh and Bihar as well as the entire North-Eastern region have witnessed a major decline in the number of bank branches in the post-liberalization period. On the other hand, relatively better-off states (with significant urbanization) such as Delhi, Haryana, Punjab and Maharashtra have witnessed a steep hike in the number of bank branches. Delhi, for instance, witnessed a jump of more than 30 per cent in bank branches, from 1,256 branches in 1997 to 1,639 in 2004.

The declining share of rural bank branches has led to a fall in deposits, credit and credit-deposit ratios in the rural areas. There are other alarming trends such as decline in rural borrowers' accounts.

What is also perturbing is that cooperative banks have lost their dominant position in the post-liberalization period. The share of cooperative banks declined almost half from 62 per cent in 1992-93 to 33 per cent. While the share of commercial banks increased from 33 per cent to 68 per cent during the period. In addition, regional rural banks (RRBs) were set up with a specific mandate to meet the credit needs of the small and marginal farmers, agricultural laborers, artisans and small entrepreneurs operating in the rural and remote areas. Under the market-led reforms, however, many RRBs have been amalgamated and their operations have been drastically reduced.

In terms of deposits and credit, banking services are getting increasingly concentrated. According to statistics provided by the RBI, the top hundred centers (arranged according to the size of deposits) accounted for 69.7 per cent of total deposits, while the top hundred centers (arranged according to the size of bank credit) accounted for 77.8 per cent of total bank credit at end-March 2008.[50] The six cities (namely Mumbai, Delhi, Chennai, Kolkata, Bangalore and Hyderabad) accounted for over 46 per cent of deposits of all scheduled commercial banks in September 2008, as compared to 38.5 per cent in September 2003.[51]

The Rise in Unbanked and Underbanked Regions

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 state-wise list of underbanked districts is given in Table 12.

The list was part of a policy advice (non-binding in nature) issued by the central bank to all commercial banks asking them to work out their branch expansion strategies "keeping in mind the developmental needs of unbanked regions." The advice called for greater emphasis to be given to unbanked regions while seeking licenses for bank branches.

According to the RBI list, states such as Uttar Pradesh, Madhya Pradesh and Bihar have the maximum number of underbanked districts in the country while states and union territories such as Goa and Chandigarh do not have any underbanked districts. Interestingly, some of the underbanked districts also include prominent industrial cities such as Surat in Gujarat.

Table 12: Number of Underbanked Districts in India (2005)

Andhra Pradesh	13	Karnataka	7	Orissa	22
Arunachal Pradesh	11	Kerala	1	Pondicherry	1
Assam	22	Madhya Pradesh	43	Punjab	1
Bihar	37	Maharashtra	26	Rajasthan	25
Chhattisgarh	15	Manipur	8	Sikkim	1
Gujarat	12	Meghalaya	3	Tamil Nadu	14
Jammu & Kashmir	4	Mizoram	2	Uttar Pradesh	63
Jharkhand	18	Nagaland	11	West Bengal	16

Source: Reserve Bank of India, 2005.

According to the RBI statistics, out of total 1,250 bank branches opened between July 2004 and June 2005, only 15 were located in unbanked areas. The proportion got further worsened next year. Out of 1,331 total branches during July 2005-July 2006, only 2 were opened in the unbanked areas. During 2006-07, only 36 branches opened in the unbanked areas out of a total 2,366 branches. During 2007-08, the proportion improved marginally, with 160 branches in unbanked areas out of a total 3836 new branches.

In total, merely 264 bank branches (1.5 per cent) were opened in unbanked areas out of a total 6804 branches during 2002-07 (Table 13). This development has serious negative consequences for promoting inclusive development across regions.

For the next decade or so, there is no alternative to expanding bank branch network in unbanked and underbanked regions in the country. The RBI should revive the bank expansion program with a special focus on the unbanked regions.

Of late, there has been greater emphasis on the promotion of technological channels (e.g., biometric ATMs) as a substitute for brick-and-mortar bank branches in the rural areas. At best, such channels can complement brick-and-mortar bank branches as certain transactions (e.g., loans) require physical bank branches. There are several other advantages of bank branches. Not only bank branches could be used to provide other financial products and services (such as insurance) but they could also assist in the distribution of wages and financial assistance under the National Rural Employment Guarantee Scheme (NREGS) and other developmental schemes.

Table 13: The Neglect of Unbanked Areas

Year	Total New Branches Opened	Branches opened in Un-banked Areas
2002-03	844	45
2003-04	923	8
2004-05	1340	13
2005-06	1331	2
2006-07	2366	36
2007-08	3836	160

Source: Reserve Bank of India.

Sharp Decline in Agricultural Credit

Agriculture still remains the largest source of livelihood for Indian people. Despite the decline in the share of agriculture in the GDP from 36 per cent in the 1980s to 18 per cent in 2006-07, agriculture provides livelihood support to about two-thirds of the country's 1.3 billion people.

The banking sector under the post-liberalization period 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.

From a mere 1.3 per cent in 1969, the share of direct lending to agricultural and allied activities reached around 16 per cent in the 1970s and 14 per cent in the 1980s. Since the mid-1990s, the share has ranged between 9-11 per cent of the total bank lending. In 2007, the share stood at 11.8 per cent (Table 14).

The state-owned banks contributed 77.3 per cent of total credit to agriculture at end-March 2007 while the remaining was contributed by private sector and regional rural banks. To some extent, decline in agricultural lending over the past decade has happened due to the weakening of regional rural banks and rural cooperative banks.

Under the priority sector lending norms, domestic banks (both state-owned and private) should provide 18 per cent of adjusted net bank credit (ANBC) to the agriculture sector, of which 13.5 per cent should be disbursed as direct credit and 4.5 per cent as indirect credit. Direct credit means banks

Table 14: The Share of Agriculture Credit in Total Bank Credit

Year	(in Per cent)
1980	15.7
1990	15.9
1995	11.8
2000	9.9
2001	9.6
2002	9.8
2003	10.0
2004	10.9
2005	10.8
2006	11.4
2007	11.8

Source: Reserve Bank of India, 2008.

giving loans to farmers for crops, seeds, agricultural equipments, etc. Whereas indirect credit refers to a wide range of activities such as loans to commission agents, agricultural traders, agri-business companies and even state electricity boards. Not all public and private sector banks have been able to meet the stipulated targets for agricultural lending.

According to the Standing Committee on Finance (constituted by the Indian Parliament), the shortfall in bank lending to agriculture was Rs.218,180 million during 2007-08.[52] This is despite the fact that the recovery of agricultural loans has improved from 74.5 per cent in 2004 to 80.1 per cent in 2006 in the case of public sector banks.[53]

Any shortfalls in agricultural sector lending are required to be deposited with the Rural Infrastructure Development Fund (RIDF) of the NABARD. RIDF provides loans to state governments and state-owned companies to for rural infrastructure projects. The Standing Committee observed that banks are allocating only a part of shortfall to RIDF. For instance, from the total outstanding credit in 2005-06, the shortfall was Rs.366,280 million whereas the amount allocated to RIDF was Rs.140,000 million only.[54]

Even among the farming community, the small and marginal farmers (who constitute 84 per cent of total farming community) and agricultural laborers are discriminated in bank lending. In 2001, there were 127 million farmers and 107 million agricultural laborers in India. In certain states such as Andhra Pradesh and Tamil Nadu, the number of agricultural laborers exceeds the number of farmers. The banks tend to favor big farmers who can offer collaterals. Lately, domestic private banks are financing corporate participation in agriculture through contract farming, traders and other market intermediaries in the value chain.

Table 15: Bank Group-wise Credit to Agriculture in India

(End-March) (in Per cent)

Bank Groups	2000	2002	2004	2006	2007
Nationalized Bank	51.5	49.9	53.2	56.0	52.9
State Bank of India	28.9	30.5	26.3	24.7	24.4
Regional Rural Banks	13.8	13.7	12.7	10.9	11.4
Private Banks	5.5	5.6	7.2	8.0	9.6
Foreign Banks	0.3	0.3	0.7	0.4	1.7

Source: Reserve Bank of India, 2008.

As a consequence of these developments, small farmers and agricultural laborers have no alternatives but to seek credit from non-institutional sources such as traditional moneylenders and landlords who lend money with exploitative terms and conditions.

The increasing number of farmers' suicides in the countryside is a reflection of neglect of rural and social banking in India. According to official statistics, as many as 1,82,936 farmers committed suicide in India since 1997. In other words, one Indian farmer committed suicide every 30 minutes since 1997.

One of the important factors behind farmer distress is lack of access to cheap credit from banks and institutional sources. Heavy indebtedness has been a common factor for most suicides by farmers in the country. In Bidar district of Karnataka, it has been noticed that cases of farmers' suicide were mostly related to loans taken from private moneylenders at exorbitant rates of interest.[55]

A recent study into the causes of farmers' suicide in the state of Andhra Pradesh found 76 to 82 per cent of the victim households had borrowed from non-institutional sources and the interest rates charged on such debts ranged from 24 to 36 per cent.[56] It needs to be emphasized that most farmers had taken loans for productive purposes such as buying agricultural inputs and equipments.

Decline in Bank Lending to SMEs

In the post-liberalization period, the share of credit to industry in the total bank credit has been declining. It declined sharply from 53 per cent of the total bank credit in 1990 to 36.2 per cent in 2007. However, the decline in bank lending is more pronounced in the case of small- and medium-sized enterprises (SMEs).

There are 13 million SME units in the country that together account for 90 per cent of all companies in India. Like many European countries, SMEs are the engines of India's economic growth. The SMEs contribute 40 per cent of India's total production, 34 per cent of exports and are the second largest employer after agriculture. The SMEs produce over 8,000 products and are involved in several services sector.

Unlike large firms which can tap domestic and international capital markets for funds, SMEs are entirely dependent on the bank finance. Therefore, the growing neglect of bank lending to SMEs can have adverse implications on economic growth and employment.

As on March 31, 2007, the share of SME credit in the total bank credit was measly 3.9 per cent (Table 16). Though the decline in bank lending to SMEs has been observed across all bank groups, it is more pronounced in the case of private banks (Table 17). The share of the SME sector in total credit was the lowest in the case of foreign bank.

Within the SME segment, the share of credit to the micro and small enterprises (MSEs) is declining sharply. The number of loan accounts of micro and small-scale units with commercial banks has declined from 5.8 million at end-March 1992 to 1.9 million at end-March 2007. In terms of total credit, the micro and small enterprises in India received Rs.1,486,510 million (96 per cent) from state-owned banks, Rs.460,690 million (2.9 per cent) from private banks and Rs.154,890 million (1 per cent) from foreign banks as on March 2008.[57]

The major obstacle faced by SMEs in securing bank finance is the lack of collateral and insufficient information. Foreign and private banks are generally reluctant to lend money to SMEs due to higher risk perception. They tend to serve less risky business segments such as big corporates.

As part of priority sector lending requirements, foreign banks are required to allocate 10 per cent of net bank credit to micro and small enterprises. Any

Table 16: The Share of SME Credit in Total Bank Credit

Year	(in Per cent)
1980	12.0
1990	12.4
1995	10.8
2000	8.2
2001	7.2
2002	5.7
2003	5.7
2004	4.9
2005	4.6
2006	4.1
2007	3.9

Source: Reserve Bank of India, 2008.

Table 17: The Share of SME Credit in Total Credit
(Bank Group-wise) (in Per cent)

Year	SBI and its Associate Banks	Nationalised Banks	Private Banks	Foreign Banks
1996	10.5	12.6	9.8	2.4
1997	10.4	11.6	9.5	2.4
1998	9.7	10.4	9.7	2.0
1999	10.6	9.1	9.2	1.9
2000	10.0	8.6	7.6	1.6
2001	9.1	7.4	6.5	2.4
2002	7.1	6.3	4.1	1.5
2003	6.3	7.1	3.3	1.4
2004	5.6	6.3	2.4	1.1
2005	5.8	5.4	2.2	2.8
2006	5.5	4.8	1.8	1.4
2007	5.0	4.6	2.3	1.2

Source: Reserve Bank of India, 2008.

shortfall in meeting this target has to be deposited with the Small Enterprise Development Fund with the SIDBI. It has been found that in certain years (such as 2005-06), a number of foreign banks failed to achieve the prescribed targets of lending to micro and small enterprises.

The introduction of new regulatory norms (Basel II) in the financial year 2009-10 will also pose new challenges to SMEs. Since majority of SMEs in the country are unrated and rating costs are substantial (Rs.300,000 upwards), they would have to bear the higher cost of borrowings from banks.

In the absence of lending from formal sources, a large number of SMEs in India rely on informal sources of lending and pay higher interest rates. A number of SME are facing imminent closure on account of lack of cheap credit and unfavorable policy environment.

Steep Rise in Bank Lending to Retail and Sensitive Sectors

Since the early 1990s, the retail credit has witnessed a phenomenal growth, from 6.4 per cent of total bank lending in 1990 to 22.3 per cent in 2007. The retail credit includes housing loans, lending for consumer durables, credit cards and educational loans.

With favorable demographics and rise in income levels of salaried class borrowers, much of the retail credit boom is concentrated in the urban India. Since foreign and new private banks are largely concentrated in urban and metropolitan cities, their share has been highest in retail lending among all bank groups.

As it is well-known that consumer retail loans are vulnerable to price shocks, large-scale exposure by foreign and new private sector banks could induce systemic risks in their entire banking system.

In India, loans given to capital market, commercial real estate (such as office buildings, retail space, industrial space, etc.) and commodities sectors are classified as "sensitive" as they are sensitive to asset price fluctuations. In the post-liberalization period, a glaring fallout has been the tremendous growth in bank lending (particularly by foreign and new private banks) to risky and speculative businesses such as stock market, commercial real estate, derivative trading and commodities.

As on March 2007, the exposure of all commercial banks to the sensitive sectors constituted 20.4 per cent of the total bank lending (comprising 18.7 per cent to real estate, 1.5 per cent to the capital market and 0.1 per cent to commodities).[58]

Among bank groups, new private banks had the highest exposure to the sensitive sectors (34.5 per cent of the total loans), followed by foreign banks (28.7 per cent), private banks (26.6 per cent) and state owned banks (16.6 per cent) in 2006-07.[59]

Table 18: The Share of Personal Loans in Total Bank Credit

Year	(in Per cent)
1980	3.4
1990	6.4
1995	9.0
2000	11.2
2001	12.2
2002	12.6
2003	15.1
2004	20.3
2005	22.2
2006	23.3
2007	22.3

Source: Reserve Bank of India, 2008.

Box 3: Exotic Derivatives Trap Small Exporters

During 2006-07, the depreciation of the US dollar against most global currencies coupled with rupee appreciation hit the Indian exporters badly. In particular, small and medium-sized exporters located in export zones such as Tirupur, Ludhiana, Panipat and Karur began to lose their competitive advantage due to currency appreciation.

Taking undue advantage of the situation, banks, particularly new private banks (e.g., ICICI and Yes Bank) and foreign banks (e.g., ABN Amro), aggressively pushed exotic currency derivative products to exporters ostensibly to hedge their losses from a rising rupee.

The unwary exporters entered into derivative contracts largely on the advice of the banks without realizing the potential risks involved in these products.

In many instances, the full implications of these risky complex products were not explained to the buyers. Many buyers of these complex products in Tirupur were small exporters (ex-farmers with little education and awareness to understand these complex products).

Some banks offered sample deals to buyers in order to clinch bigger deals in the future. After gaining the confidence of the exporters, private and foreign banks pushed derivative products which were grossly irrelevant and unsuitable. For instance, banks sold derivative products in multiple, cross-currencies (such as Swiss franc and Japanese yen) despite being fully aware that most Indian exporters bill their exports in US dollars.

Apart from the alleged breach of trust by banks, the currency derivative contracts were also in violation of existing derivative regulations. For instance, regulations allow only those banks with whom exporters have a credit relationship to offer such products. Derivative transactions that do not hedge any underlying exposure are not allowed.

continued on next page...

Further, the regulations specify that the value of derivative products should have some relationship with the business turnover of the export company.

In practice, all such regulations were violated by banks while offering derivative products to small and medium-sized exporters. No due diligence was undertaken by the banks to assess the suitability of the derivative product to a small exporter.

However, these speculative contracts went haywire when the Swiss franc and Japanese yen began to rise suddenly against the dollar in early 2008. As a result, several exporters incurred huge losses as their derivative contracts multiplied their foreign exchange risks. The Tirupur-based Plywin Exports, for instance, incurred a loss of Rs.80 million on the currency derivatives sold by ABN Amro Bank.

It has been estimated that the total losses suffered by Tirupur-based exporters on account on derivative contracts were above Rs.4000 million, almost the net-worth of all exporters based in Tirupur.

Many exporters have accused the banks for concealing the risk inherent in these contracts. Some exporters have taken the matter to the court alleging that the banks sold them exotic derivatives contracts for purely speculative purposes.

The banks too are sitting on the massive piles of non-recoverable debt. The losses are so huge that the banks cannot recover them by even selling the assets of the export firms.

Some small-sized exporters are on the verge of closure with serious negative implications on employment and exports. In Tirupur, there are over 6,250 factories, which provide direct employment to 350,000 people (mostly rural women) and indirect employment to about 150,000 people. After this incident, small exporters have become wary of such exotic derivative products.

This episode has clearly revealed how the aggressive selling of exotic derivative products by banks could badly damage the business prospects of vibrant SME segment of Indian exporters.

In the real estate lending, which constituted 91.9 per cent of the total lending to the entire sensitive sector, new private banks (with 32.3 per cent of the total loans) and foreign banks (26.3 per cent) were the leading players during 2006-07.

While the foreign banks had the highest exposure to capital markets, followed by new private banks, old private banks and state-owned banks.

In 2007, the RBI conducted a supervisory review process and identified 10 banks as "outliers" having a real estate and capital market exposure in excess of 200 per cent and 25 per cent of their net worth, respectively.[60] Such large exposure in risky businesses is a matter of serious concern. To contain reckless lending by banks in the wake of speculative bubble in the real estate markets, the RBI took several policy measures including the tightening of risk weights and lending norms to real estate sector.

Another perturbing development is the massive increase in unsecured loans by Indian banks in recent years. The unsecured loans increased almost five-fold in 5 years, from Rs.11,06,960 million in 2003-04 to Rs.50,42,660 million in 2007-08. The unsecured loans (without any collateral security) are considered high-risk assets and more prone to default. But foreign and private banks find unsecured segment very lucrative because the interest rates are much higher (40 per cent and above).

The big private banks (such as ICICI Bank and HDFC Bank) have a greater exposure to unsecured loans as compared to other bank groups. The top three banks in private sector have more than 15 per cent of their portfolios in unsecured loans and advances.

Table 19: Bank Lending to Sensitive Sectors ***(in Per cent)***

Bank Group	Capital Markets*	Real Estate^	Commodities	Total Advances
State-owned Banks	1.8	15.3	0.0	17.2
Old Private Banks	2.0	16.5	0.4	18.9
New Private Banks	5.6	28.5	0.0	34.1
Foreign Banks	3.3	23.1	0.1	26.4

As at end-March 2008.
* Exposure to the capital markets is inclusive of both investments and advances.
^ Exposure to real estate sector is inclusive of both direct and indirect lending.
Source: Reserve Bank of India, 2008.

The Limitations of Microcredit Programs

Since the mid-1990s, the official policy response has been to promote microcredit institutions to serve the credit needs of rural and informal sectors. There is no denying that micro finance institutions (MFIs) have spread over the past few years due to weakening of formal financial institutions, particularly in the rural areas.

Though initially started by women's groups and NGOs in the country, micro finance institutions are nowadays dominated by corporate structures with the large-scale funding by big commercial banks, venture capital and private equity groups.

However, it is very important to stress here that much-touted microcredit programs launched by self-help groups (SHGs), NGOs and micro finance institutions are no substitute to the formal banking system in India. The majority of SHGs and microfinance institutions rely heavily on funding from commercial banks.

With just 15 million clients (the second largest in the world after Bangladesh with 16 million), MFIs have only reached a fraction of underbanked population in India. The penetration of MFIs is skewed towards a few Southern states in India. The top 25 players accounts for as much as 75 per cent of the total microcredit business in India.

Several studies have questioned the developmental impacts of microcredit programs as it has been found that their transaction costs are very high and often much of credit is used for consumption purposes rather than investment in productive activity.[61]

There are several recent instances of aggressive lending by MFIs with negative outcomes. In 2005, many poor borrowers (mostly women) landed themselves in a spiral of indebtedness in Andhra Pradesh. For these borrowers, MFIs were no better than traditional moneylenders as they charged exorbitant rates of interest (100 per cent and above). Some MFIs are also believed to have used coercive methods of loan recovery. So lending by MFIs could also be counter-productive if not properly regulated.

At best, microcredit programs can complement, not substitute, the formal banking system to meet the growing credit needs of farmers, rural entrepreneurs, small enterprises and informal sectors of Indian economy.

Global Financial Crisis and India-EU FTA

The global financial crisis has badly hit EU banks resulting in massive losses and bailout packages running into trillions of euros. Almost every major European economy is struggling with the banking crisis. The highly leveraged EU banks have sought billions of euros of state help to rebuild their balance sheets battered by the crisis. Ultimately, the European taxpayers' will have to foot the bill.

EU banks hold balance sheet assets of €41.2 trillion. The rising levels of banks' toxic debts may pose a systemic risk to the entire EU banking system. According to a recent report by Bank for International Settlements, Europe's banks face a $2 trillion dollar shortage as they borrowed heavily in local currencies to make dollar investments and loans.[62]

The weakening of East European economies may further damage the big EU banks which had invested more than €1.6 trillion in these countries. Austrian and Italian banks have lent heavily in Eastern Europe.

Will the turmoil in the banking sector coupled with severe recessionary conditions in several European countries halt the process of India-EU FTA? Will ailing European banks put a hold on their expansion in India?

The recent market trends suggest that huge losses suffered by European banks in their home markets may not deter them to enter India. Despite severe crisis at home, many European banks (including BNP Paribas, Barclays Bank, Crédit Agricole, Deutsche Bank, HSBC, Rabobank Group and the Royal Bank of Scotland) are seeking licenses to expand their businesses in India.

It is a well-established fact that foreign banks tend to shift their focus to overseas markets (particularly those with strong GDP or income growth prospects) if their parent banks become weak because of crisis. As a counter weight to ailing domestic markets, the big EU-based banks would like to get out of recession by exploring newer markets, where the engines of economic growth are located.

Indian economy is still in growth phase and is expected to grow in the coming years, albeit at a lower rate. At present, there are very few growth spots in the world and India is still counted among one of them. Though there has been a slowdown in the economy because of the global contagion, analysts have predicted that the medium-and long-term growth prospects of India remain strong.

In contrast, India banks have largely remained insulated from global turmoil thanks to their limited exposure to US sub-prime markets, enlarged state ownership of banking system and relatively strong regulatory framework.

Unlike Europe, credit growth is growing steadily in India. The strong growth in the domestic banking markets is not an insignificant development in the current unfavorable international environment. Despite pressures emanating from slowing domestic economy, state-owned banks have outperformed both foreign and private banks in terms of reduced lending rates, credit growth and net profits.

As explained earlier, profit opportunities in India are much higher than mature European markets. In 2008, a number of European banks (such as BNP Paribas, Deutsche Bank and HSBC) registered huge growth in profits in India despite suffering losses in their home and other markets under the global financial crisis (Table 20).

The market for banking services and products in India is expected to remain buoyant in the coming years since there is a greater need for financial intermediation in many fast growing sectors including infrastructure and services.

Furthermore, the Indian authorities are unilaterally pushing ahead the agenda

Table 20: Operating Profits of EU-based Banks ***(in Rs. million)***

Banks	2007	2008	% change
ABN Amro	10383	9151	-11.8
Antwerp Diamond Bank	183	190	4.1
Barclays Bank	1556	1759	13.0
BNP Paribas	1382	2835	105.0
Calyon Bank	1454	2556	75.8
Deutsche Bank	4139	8660	109.2
HSBC	19223	29348	52.6
Societe Generale	432	371	-14.0
Standard Chartered Bank	23379	29492	26.1

Note: Operating Profit = Net Profit + Provisions and Contingencies.
Source: *Banking Annual 2008*, Business Standard, December, 2008.

of banking sector liberalization by inviting greater presence of foreign banks in the domestic markets.

Given these developments, the agenda of banking sector liberalization under the India-EU FTA framework will remain high under bilateral negotiations. Commenting on the prospects of India-EU FTA in the aftermath of global financial crisis, Peter Mandelson, former EU Trade Commissioner, said, “The downturn does not reduce the value of a bilateral trade deal, it raises it.”[63]

Some Pertinent Questions

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

Are big European banks going to augment the reach of the banking system to millions of Indians citizens who do not have access to basic banking services?

Are EU-based banks going to meet the developmental needs of unbanked and underbanked regions of India?

Can European banks meet the targets of financial inclusion for rural households, as suggested by the Committee on Financial Inclusion?

In which location European banks would open their branches within metros? Dharavi or Nariman Point? Jehangirpuri or New Friends Colony?

What extraordinary services European banks would provide to serve unbanked Indian people?

What specialization and experience do European banks have when it comes to providing basic banking services to landless rural workers and urban poor dwellers?

Do they have a success story?

Will the principle of reciprocity in market access be observed?

Will the India-EU FTA reduce the domestic regulatory space?

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 regions of India.

The liberal entry of European banks may further constrict the access of banking services in the country: geographically, socially and functionally.

Also one cannot expect that big European banks would voluntarily open branches in rural and remote regions of India as part of altruistic motives or corporate social responsibility measures. This anomaly could only be addressed by branch licensing policy and strong regulatory and supervisory framework.

Since many big European banks are in the midst of turmoil and financial distress in the aftermath of the credit crunch, it raises serious questions about their strength and credibility. 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.

In many important ways, the crisis has also exposed the fundamental weaknesses in the regulatory and supervisory regime of many EU member-states, particularly the UK, Germany and France. The regulatory issues become more important given the fact that many ailing European banks have large presence in the Indian markets.

In the light of these important developments, the agenda of market-driven reforms and large presence of foreign banks should be seriously reconsidered by policy makers.

Rethinking Banking Sector Opening Up

In the wake of global financial crisis, there should be serious rethinking on banking sector liberalization and deregulation at both India and EU levels. Though the crisis erupted in the US in mid-2007, the contagion effects have badly affected several big banks in many European countries including France, Germany and the UK.

Though there are some worrisome trends in the Indian banking system, but, by and large, it has remained untouched by the global financial tsunami. Often criticized as “outdated” and “conservative,” India’s relatively inward focused regulatory framework acted as a key factor in protecting the domestic banking system from the global financial turmoil.

The series of banking crises experienced in several countries in the past several decades highlight the dominating role played by liberalization and deregulation processes in precipitating the crises. Time and again, these crises have exposed banking market failures and regulatory shortcomings.

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. In many Latin American countries such as Brazil and Chile, there was a considerable decline in competition in the aftermath of liberal entry of foreign banks. The foreign banks can be a source of cross-border contagion from adverse shocks originated elsewhere. As illustrated by the ongoing financial crisis, 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 due to losses suffered in home or other countries.

In the light of recent experience, 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.

In addition, 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.

In India, the much-touted benefits associated with the liberal entry of foreign banks are yet to be materialized. As discussed earlier, urban-centric foreign banks largely serve the niche market segments consisting of HNWIs and large corporations in India. Time and again, many European banks have demanded removal of priority sector lending requirements and other riders related to social and development banking in India.

Keeping these important developments in view, the policy makers should rethink about the benefits of opening up of banking and financial services. In particular, the Indian authorities should reconsider the roadmap for the entry of foreign banks.

The ongoing negotiations on the proposed India-EU free trade agreement raise several policy issues which could only be addressed through wider public consultation, debate and participation. The terms, conditions and contents of ongoing negotiations should be placed before the public at large and there should be an actively involvement of citizen's groups, labor groups, farmers' organizations, parliamentarians and people's representatives.

Who Benefits? Who Loses?

To conclude, there are always losers and gainers of free trade and investment agreements. Therefore, it is very important for policy makers to analyze the potential distribution effects of such agreements on different types of economic activities and strata of society.

The policy issues run much deeper than the superficial debate whether in-principle India and EU should sign a bilateral trade agreement. Rather the debate should be around questions such as: Free Trade Agreement for Whom? Who Benefits? Who Loses?

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