Grant Thornton

#GTBharat
SHAPING A VIBRANT INDIA

Role of foreign banks in shaping a vibrant Bharat

February 2022

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Foreword

In a world besieged with numerous issues, countries must have the courage to lead, and India has taken cognisance of this responsibility.

For India, national and international responsibilities are complementary, and they have never been a trade-off. Perhaps, this is why we see India distributing vaccines globally and conducting robust national vaccination initiatives. It is this outlook that is driving everyone towards self-reliance, a collaborative policy for the greater good, something that India has devotedly followed. The vision of an Aatmanirbhar Bharat, outlined in May 2020, is a thread that intends to bring self-reliance to everyone in India and to enable the nation to play a larger role in the global economy and be an engine for growth.

Capital and enterprise are the key elements for growth and making them available in abundance will help India achieve this vision. The government has been working hard in developing a conducive investment climate in the country and has always welcomed suggestions from the industry in its endeavour. At a recent conference organised by the finance ministry on creating synergies for seamless credit flow and economic growth, the honourable Prime Minister of India Narendra Modi stated that Indian banks are strong enough to play a major role in imparting fresh energy to the country's economy, for giving it a big push and making India self-reliant. The Prime Minister stressed on the role that the banking sector needs to play to achieve the vision of a self-reliant India by thinking big and being innovative.

This report by Grant Thornton Bharat is an initiative that attempts to throw light on how we can leverage the foreign banking community within the country to help enhance the achievement of the goals of capital and enterprise. The report makes an objective assessment of how providing an enabling environment for the foreign banks in India can help achieve the mission of Aatmanirbhar Bharat. There have been many suggestions that the report has outlined, and it may be worthwhile to look at the same and consider them for deliberation to arrive at a consensus for the greater good of everyone. This report is a welcome initiative as it makes us realise that re-looking at some of our existing structures and making incremental changes can bring great benefits.

We hope that many organisations continue to do such good work to aid the government in their endeavour of national greatness and continue to share perspectives and thoughts on how to get closer to the goals of international and national development.

Amitabh Kant
Chief Executive Officer
NITI Aayog

Note from the CEO

At Grant Thornton Bharat, it is our purpose to shape a vibrant India and foreign banks have been, for decades, contributing to the economic progress of the country by bringing necessary investments, knowledge, innovation and advanced technologies.

The genesis of foreign banks in India dates back to the 19th century with the need for establishing banks that catered to foreign exchange business, foreign trade-related financing and bill discounting. As India's interconnectedness with the global economy increased, many foreign banks entered the space and started viewing India as an emerging global market.

Foreign banks have been the pioneers in introducing new products, segments and state-of-the-art technologies, thereby promoting greater economic efficiency and banking sector reforms. They have been instrumental in supporting the growth agenda, backed by a strong export and import position, as well as heightened foreign direct investment (FDI) and foreign portfolio investment (FPI) inflows in the country.

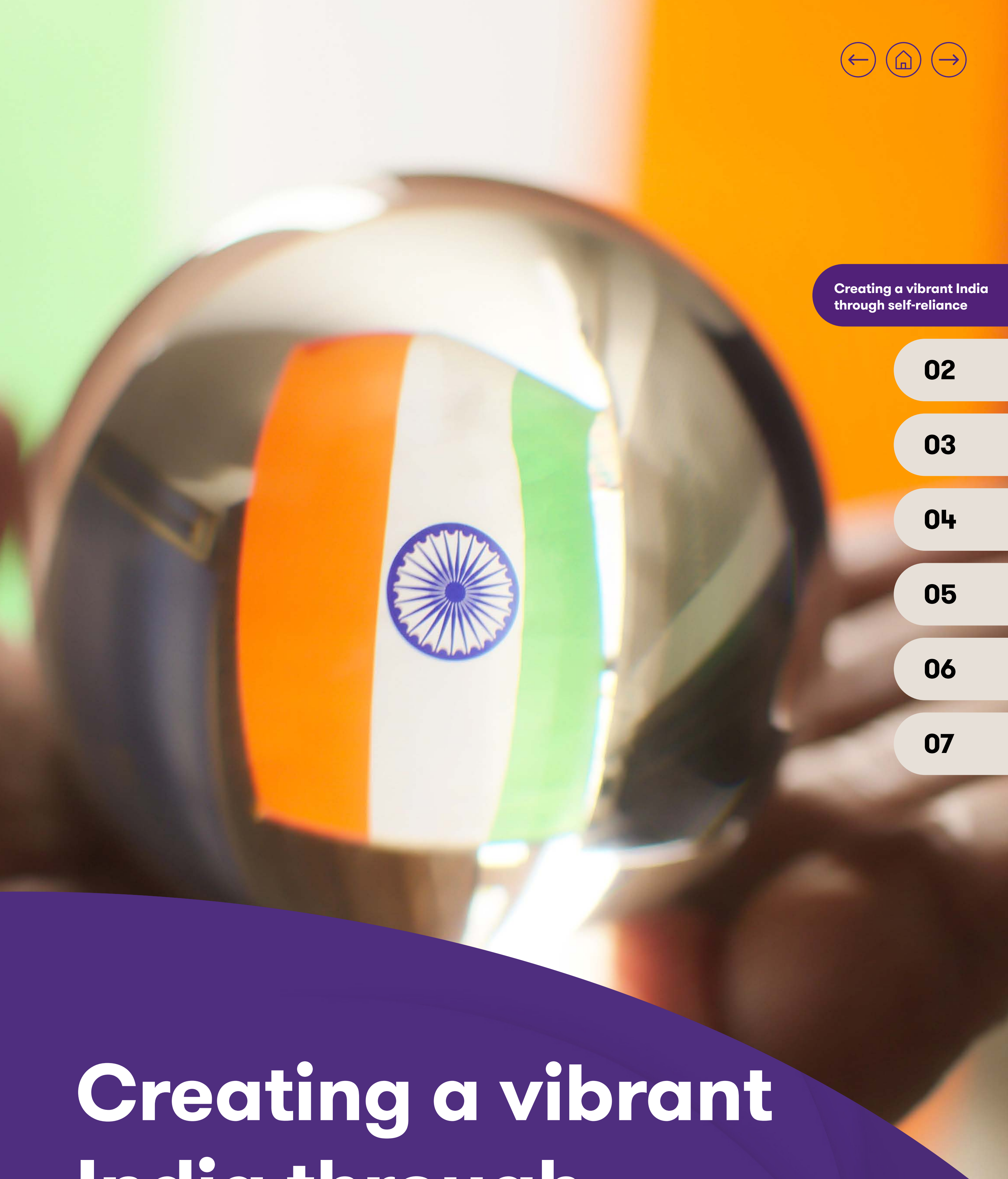
However, while foreign banks are essential to bringing in the necessary global practices in India, the recent exits of a few foreign banks have highlighted the need to rethink and reshape the financial services ecosystem and make it more friendly for foreign banks to operate in.

With an intent to bring in a fresh perspective of how foreign banks are contributing towards shaping a vibrant and better India, this report deep dives into the history, importance and the meaningful contribution of these banks in growth of the country. The report also highlights the key operational challenges that foreign banks face and the possible interventions that the RBI and government could do to ease some of these challenges.

A collaborative platform, where regulators, governments and foreign banks could come together, would provide an impetus to the Indian economy and we are confident that this report will lay the groundwork for the same.

We hope to facilitate such a collaborative platform and will look forward to your participation to continue to help Shape a more Vibrant Bharat.

Vishesh C. Chandiok
Chief Executive Officer
Grant Thornton Bharat



Creating a vibrant India through self-reliance

Empowering foreign banks to play a vital role in India's growth story

The vision for a self-reliant India was conceived in May 2020 when the world was hit by the COVID-19 pandemic. The movement intends to revive the economy that has been grappling with the effects of the pandemic.

The five pillars that will constitute Aatmanirbhar Bharat

- While achieving these pillars, it is intended to develop a self-reliant economy that is looking at quantum leaps rather than incremental changes, a modern infrastructure that becomes the identity of a progressing modern nation like India, a technology-driven system in line with the aspirations of the 21st century, a vibrant democracy and a strong demand-supply chain.
- The financial services industry and banks, particularly, have a great role to play in supporting the Aatmanirbhar Bharat mission. The main components contributing to strengthening the above pillars include foreign capital flows, trade flows that strengthen the supply chain and strategic investments, technology know-how and advanced systems, advanced and compliant risk infrastructure and access to global knowledge capital.
- The vision of Aatmanirbhar Bharat is an inclusive one, aiming to move in tandem with the world economy and placing India as a market leader in a variety of subjects.

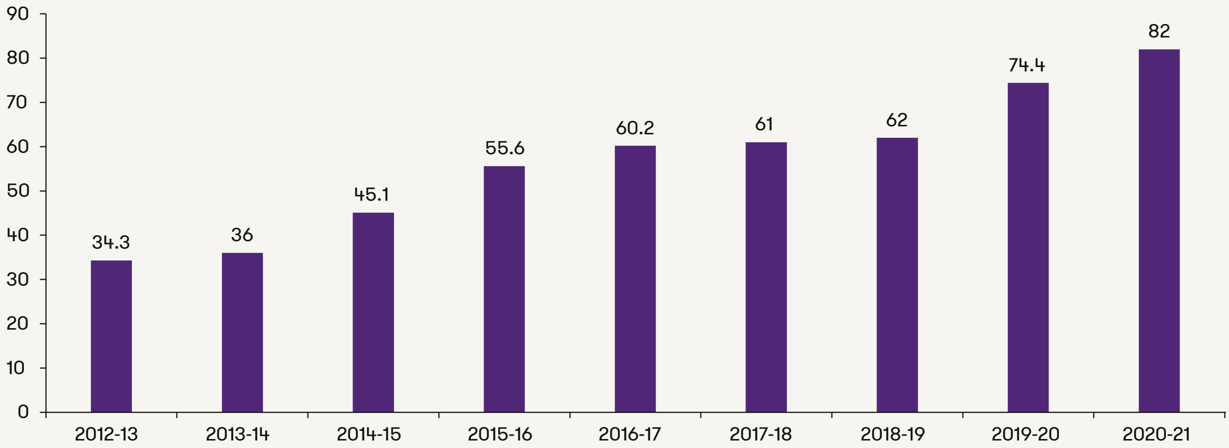
Aligning foreign banks with India's vision of self-reliance

Foreign banks have been contributing to the above components since inception. The onset of **advanced technologies** as well as **capital, trade flows and advanced global practices** were primarily driven by foreign banks. The **growth and advancement of the Indian banking industry** has also largely been driven by foreign banks.

As per the World Investment Report 2021 released by the United Nations Conference on Trade and Development (UNCTAD), India has been ranked as the fifth largest recipient of foreign direct investments (FDI) flows accounting for USD 64 billion in 2020. Such a high volume of foreign investments has been possible due to the conducive financial services ecosystem and government policies promoting foreign capital inflows.

Foreign banks have been instrumental in supporting the four pillars of a global India, supported by a strong export and import position as well as heightened FDI and FPI inflows in the country, which has contributed greatly to India's position in terms of the balance of payments.

Total FDI flow (USD) bn



Source – DPIIT | figures for FY 2019-20 and 2020-21 are on provisional basis.

Foreign banks have been supporting MNCs and promoting foreign investments in a great way

Pillars of foreign investments supported by foreign banks

GICs

Supply chain
Foreign banks have enabled global supply chain migrations and India is now becoming a hub for global processing centres

Working capital

Capital needs
Foreign banks have supported global centres for their onshore working capital needs

Setting up base

Infrastructure
Foreign banks have also enabled MNCs to set up a base in India by supporting capital raising, external commercial borrowings (ECB), raising funds in rupee-denominated bonds (masala bonds)

Hence, it is crucial to recognise the sustained contribution of foreign banks to make India a global leader. A level playing field is essential to ensure foreign banks thrive in a competing economy like ours and enable our economy in shaping a Vibrant Bharat. Moreover, providing an enabling environment by relooking at some of the regulatory and supervisory frameworks applicable to foreign banks will be considered as a step in the right direction.

Through this report, we intend to capture some of the aspects that the government and the RBI can evaluate to create an enabling environment for foreign banks. A small pivot in creating the right enablers for foreign banks can help achieve a big momentum in the Aatmanirbhar initiative.

Executive summary

Genesis of foreign banks in India

The genesis of foreign banks in India dates back to the 19th century with the need for establishing banks that catered to foreign exchange business, foreign trade-related financing and bills discounting. Foreign banks have contributed to a large extent to the economic development of the country and have been pioneers in introducing new products, segments, advanced technologies, thereby promoting greater economic efficiency and banking sector reforms.

The need for modern banking services was felt as early as the colonial era which led to the establishment of the earliest banking institutions in the form of agency banks, joint-stock banking companies and presidency banks. The British administration established the first joint-stock bank, that is, the Bank of Calcutta (later, Bank of Bengal) which went on to merge with the other presidential banks, the Bank of Madras and the Bank of Bombay to form the Imperial Bank of India in 1921. The Imperial Bank of India was later established as the current day State Bank of India (SBI).

The presidency banks established in the British era were instrumental in introducing new banking products and technology prevalent globally and catered to discounting of bills of exchange, other negotiable instruments, maintaining cash accounts, accepting deposits and giving out small ticket secured loans.

Over time, India's interconnectedness with the global economy increased and India came to be seen as a part of the global supply chain. As trade flows increased, many foreign banks started seeing India as an emerging global market and decided to set up branches here.

Over the years, the banking sector witnessed various reforms along with the evolution of the economy at large. The passing of the Reserve Bank of India Act in 1934 and commencement of operations by the RBI, as India's central bank, from 1 April 1935, were milestone events for the banking sector. The nationalisation wave in 1969 and subsequently in 1980, leading to nationalisation of 14 commercial banks, controlling approximately 85% of bank deposits and further six banks in 1980 led to the government controlling around 91% of the banking business in India. However, foreign banks responded positively to these reforms and continued to be the pioneers of innovation in the banking sector, bringing in the required technology, global practices, products and capital from their country of origin.

The economic reforms in 1991 opened up an era of change for foreign banks. Some of the key events that provided an impetus to the growth of foreign banks in India include:

Financial sector reforms

- Reduction in the high statutory liquidity ratio (SLR) and cash reserve ratio (CRR) over a period of time on the recommendations of the Narsimham Committee
- Interest rate liberalisation that permitted banks to decide interest rates on deposits and bank loans which until then were decided by RBI provided a competitive advantage to banks and enabled them to manage the funds transfer and asset liability position in the most optimal manner
- Liberalisation of the bank branch licensing policy enabled rationalisation of the existing branch network of banks
- Autonomy provided to banks to open new branches and specialised branches enabled banks to operate with greater efficiency
- Introduction of new accounting and prudential norms for asset classification and provisions for non-performing assets on the recommendations of the Narsimham Committee

Industrial policy reforms

- The New Industrial Policy, 1991 was introduced with an objective of opening up the domestic industrial sector to promote growth and create a competitive industrial economy
- Abolishment of industrial licensing, repealing of the Monopolies and Restrictive Trade Practices (MRTP) Act, promoting private participation in industrial areas reserved for public sector were reforms in the right direction to promote industrial growth and position India as a global economy

Trade policy reforms

- Introduction of a limited negative list for imports and exports opened up avenues for foreign trade and curtailed restricted items
- The tariff structure was rationalised, resulting in reduction in import duties and removal of quantitative restrictions
- The reforms permitted setting up of trade houses with 51% foreign equity for export promotion

Foreign investment policy reforms

- Setting up of Foreign Investment Promotion Board (FIPB) to regulate direct foreign investment
- Increasing FDI limits in priority areas from 51% to 74% and also up to 100% in certain cases

Over the years, as India began establishing itself as a global economy, foreign banks found it conducive to thrive in the Indian economy and consider India as a global market with great potential. They have adapted to changing geo-political situations, economic challenges as well as changing regulatory dynacmics. However, while foreign banks are essential for bringing in the necessary global practices in India along with advanced technology and innovation, the recent exits by foreign banks from India prompts one to rethink the manner in which the financial services ecosystem has been shaping up, especially for foreign banks. The RBI and the government could consider working together to ease some of the challenges that foreign banks have been facing in order to provide a further impetus to their growth in the context of the Indian economy.

Some of the considerations that the RBI and the government can evaluate are stated below and are further detailed in the report:

- Easing licensing and capital requirements
- Providing KYC portability for opening NRI accounts
- Rationalisation of priority sector lending (PSL) norms
- Rationalisation of current account guidelines
- Rationalising large exposures framework
- Potential to consider amendments to the Banking Regulation Act, 1949
- Easing the tax burden on foreign banks
- Potential to include for-eign banks as agency banks for government services
- Easing norms for data localisation
- Evaluate reduction in deposit insurance premium that foreign banks pay

1 Potential to include foreign banks as agency banks for government services

A differentiated licensing structure may be evaluated to provide adequate focus to the business model of foreign banks that primarily focuses on niche segments. The timeframe for providing licenses to foreign banks may be rationalised and on-tap licensing norms can be looked at for foreign banks too.

The capital adequacy norms for foreign banks may be rationalised in the light of the business model that foreign banks have and the riskiness of their exposures.

2 Rationalising priority sector lending (PSL) norms

The RBI could potentially look at deepening the market for PSL certificates to reduce volatility and develop a framework to regulate the PSLC market. It can also look at providing fungibility across PSL targets such that foreign banks can focus on their niche expertise. Further, emerging sectors, such as ESG, sustainability, renewable energy, financing electric vehicles and health infrastructure, could also be considered for inclusion within the ambit of PSL.

3 Rationalising large exposures framework

The RBI can look at exempting derivatives from the LE framework or alternatively postpone implementation of the regulation until enabling regulations are in place such as those for variation margin, SA-CCR, etc. The RBI shall also look at permitting CRR maintenance in foreign currency, notifying the standardised approach for counterparty credit risk and allowing principle of local regulatory capital to apply to credit risk mitigation.

4 Rationalisation of current account guidelines

Revision in the current guidelines, done with an objective to devise a framework against funds diversion and money laundering, only seem to be stifling competition among banks. The RBI can consider evaluating a framework for data sharing between banks to address the issue of end-use monitoring as well as look at enhancing the governance framework for such monitoring. Use of SupTech and other technology tools as enablers to monitor end-use and funds diversion could also be looked at.

5 Evaluate reduction in deposit insurance premium that foreign banks pay

Under the deposit insurance framework, currently a flat rate based premium charge is levied on all banks, irrespective of the risk profile of banks. Foreign banks have advanced risk management systems and policies which make them less risky as compared to their domestic counterparts. However, they are also required to pay the same amount of insurance premium. A differential premium structure may be evaluated instead of a uniform premium structure, which is risk agnostic.

6 Providing KYC portability for opening NRI accounts

The RBI may consider evaluating a framework for providing KYC portability for NRIs, who constitute a large proportion of foreign bank clientele and contribute to maintaining the balance of the payments position.

7 Rationalising tax structures for foreign banks

Foreign banks now pay tax at a rate ranging 41%-44% depending on their net income earned during the year as against 25.17% paid by domestic banks. Rationalising the tax structure is an important measure to ensure fair and equitable treatment and creating a level playing field for foreign banks.

8 Potential to consider amendments to the Banking Regulation Act, 1949

Given the evolution of the banking industry since the introduction of the Act, there have been new businesses introduced such as insurance, mutual funds, pension fund management, and such other businesses. The ambit of services that a bank is allowed to carry out may be broadened to include a host of services that foreign banks provide in other advanced jurisdictions.

9 Potential to include foreign banks as agency banks for government services

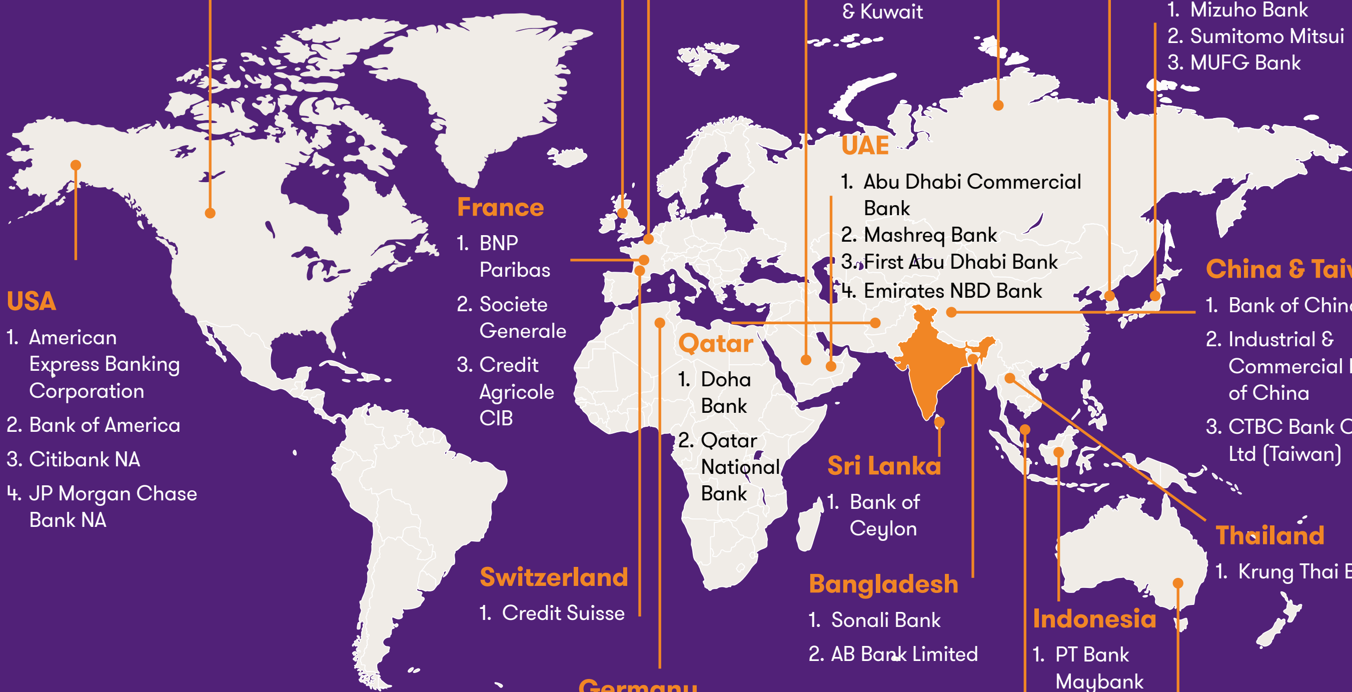
The RBI may consider including foreign banks as agency banks to provide services such as tax collection, pension disbursements, collection of other statutory dues, etc., given the level of customer service quality and convenience that foreign banks bring to the table.

10 Easing norms for data localisation

Local borders around storage of data defeat the purpose of cross border collaboration. To ease data localisation challenges, discussions are necessary at global forums such as G-20 summits to ensure member nations adopt an enabling framework, globally.

Foreign banking landscape in India

Foreign banks operating in India



Canada
1. Bank of Nova Scotia

United Kingdom
1. Standard Chartered Bank
2. HSBC Bank
3. Barclays Bank
4. RBS Bank

Netherlands
1. Cooperatieve Rabobank

Bahrain
1. Bank of Bahrain & Kuwait

Russia
1. Sberbank
2. JSC VTB Bank

South Korea
1. Shinhan Bank
2. Woori Bank
3. KEB Hana Bank
4. Industrial Bank of Korea
5. Kookmin Bank

Japan
1. Mizuho Bank
2. Sumitomo Mitsui
3. MUFG Bank

USA
1. American Express Banking Corporation
2. Bank of America
3. Citibank NA
4. JP Morgan Chase Bank NA

France
1. BNP Paribas
2. Societe Generale
3. Credit Agricole CIB

UAE
1. Abu Dhabi Commercial Bank
2. Mashreq Bank
3. First Abu Dhabi Bank
4. Emirates NBD Bank

China & Taiwan
1. Bank of China
2. Industrial & Commercial Bank of China
3. CTBC Bank Co. Ltd (Taiwan)

Qatar
1. Doha Bank
2. Qatar National Bank

Sri Lanka
1. Bank of Ceylon

Thailand
1. Krung Thai Bank

Switzerland
1. Credit Suisse

Bangladesh
1. Sonali Bank
2. AB Bank Limited

Indonesia
1. PT Bank Maybank Indonesia TBK

Germany
1. Deutsche Bank

Singapore
1. United Overseas Bank
2. DBS Bank

Australia
1. ANZ Banking Corp
2. National Australia Bank

44 banks from **21** nations are operating in India

Source - https://rbi.org.in/scripts/banklinks.aspx
First Rand Bank has closed down India operations and hence not included above
SBM Bank (India) Limited has been set up as a wholly owned subsidiary in India

Assessing the contribution of foreign banks to the Indian economy through the years

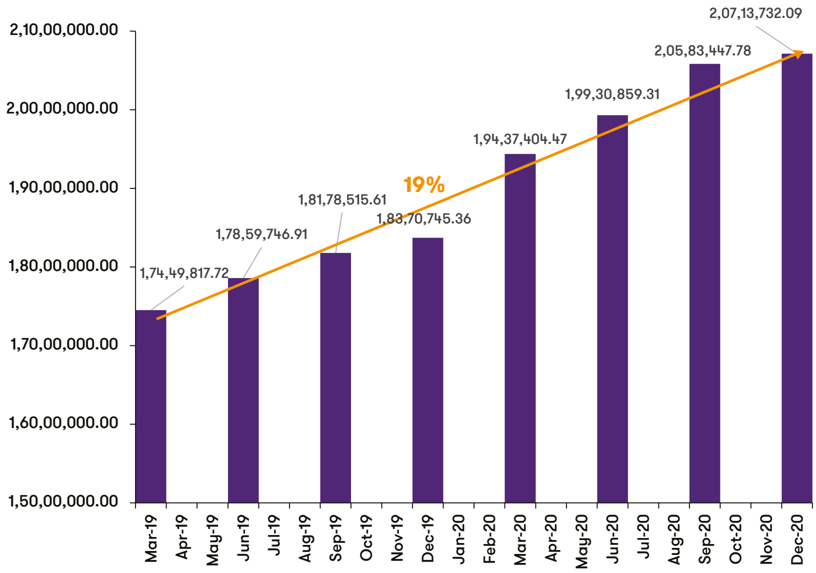
Foreign banks have been contributing greatly to the Indian economy for the last few decades. They are growing increasingly relevant to the steady progress of the Indian economy. Foreign banks have contributed to this economic progress by bringing necessary investments, knowledge, innovation and advanced technologies.

	Foreign banks	Public sector banks	Private sector banks
Number of banks	45	12	22
Number of branches#	284	89,316	27,085
Share of deposits	5%	64%	31%
Share of assets	7%	60%	34%
Share of profits#	23%	-	77%

- Data as on 31 December 2020 – RBI OSMOS returns
- # Data as on 31 March 2017

From the table above, it is evident that foreign banks have approximately 0.24% of the total branch network. However, they account for 6% of the share of assets and 23% of the share of profits. With increasing income and profit share, the contribution of foreign banks to the banking industry is also on the rise.

Increase in the paid up capital and reserves of foreign banks (INR)



Data as on 31 December 2020 – RBI OSMOS returns

Key contributions of foreign banks to the Indian economy

- Foreign banks have increasingly contributed to the growth of priority sectors, specifically export credit
- They have displayed a consistent growth in their return on assets, which has prompted Indian banks to adopt better practices and enhance efficiency
- Foreign banks have contributed towards technological enhancements to drive business growth and meet strategic objectives
- Foreign banks have adopted superior risk management frameworks leveraging global practices and have been able to maintain stable NPA ratios despite increasing priority sector lending
- Foreign banks are key partners towards foreign currency lending and contribution to exports and foreign trade
- They have been responsible for driving new-age banking in India through adoption of advanced technologies, virtual banking through digital banking, the onset of blockchain technology

Assessing foreign banks' contribution as pioneers of digital advancement and innovation in India

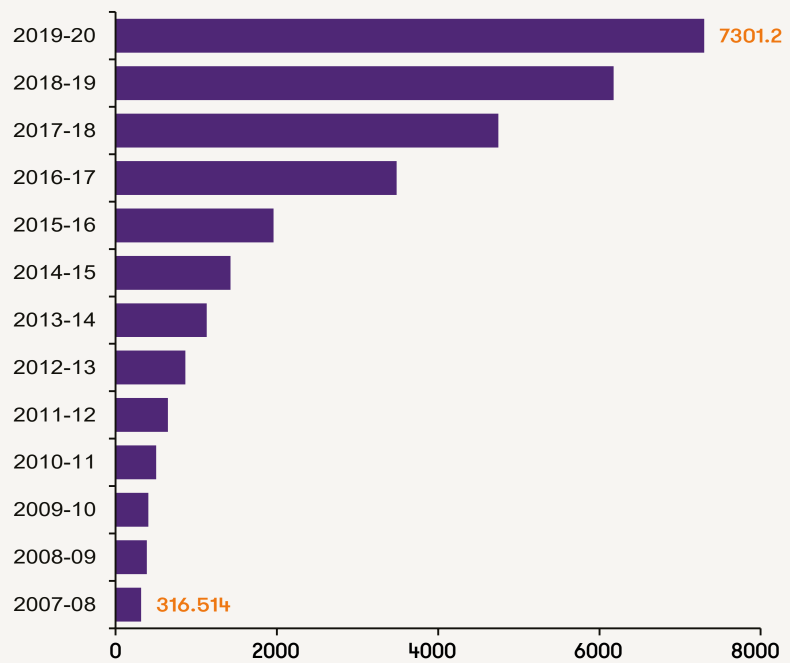
Introduction of ATMs and commissioning the first ATM in India

Automated teller machines or ATMs were invented as early as 1967 when the first cash machine was commissioned by Barclays Bank Enfield branch in North London in the UK. The earliest technology primarily allowed cash dispensation. Over the years, ATM technology evolved across the globe.

However, ATMs were introduced in India 20 years later in 1987 when HSBC Bank commissioned the first ATM in Mumbai. Over time, public and private banks in India also established their ATM centres taking a cue from their foreign counterparts. Foreign banks were thus instrumental in introducing the ATM innovation to the Indian banking industry which now benefits from ATM services such as cash withdrawal, balance inquiry, PIN updates, mini statement, funds transfer, utility payments, etc.

The volume of card transactions has substantially improved over the years

Total card transaction volumes (million)



Source – RBI annual reports (Includes all card transactions, except PPI transactions)

Contributing to setting up the regulatory framework for internet banking

Internet banking services were introduced by one of the leading private sector banks in India in 1996 to enable online banking services in its branches. Various other banks followed suit, including leading foreign banks operating in India.

The RBI constituted working groups to deal with matters concerning regulation and supervision of internet banking services. The CXOs of various foreign banks such as ABN Amro Bank and Deutsche Bank contributed substantially to the sub-group on regulatory and supervisory issues and were instrumental in setting up the regulatory framework in India. The regulatory framework was based on leading international practices introduced in India, including international practices on operational and internal control issues introduced by the efforts of foreign banks.

Introducing innovation through global centres of excellence

Foreign banks have been instrumental in driving innovation and introducing cutting-edge technology through their global in-house centres (GICs).

Key statistics related to GICs

>1,000
Number of GICs in India

USD 21.5 bn
Revenues

>7.45 lakh
Number of employees

While the above statistics pertain to GICs established across sectors, a major part of the GICs have been established across the banking, financial services and insurance (BFSI) sector, with leading foreign banks, such as JP Morgan Chase and Co., Goldman Sachs, Deutsche Bank and Morgan Stanley occupying a large share.

GICs were set up by foreign banks primarily as a means of achieving cost efficiency through outsourcing operations to emerging economies. Over a period of time in the early 1990s, MNCs set up GICs in nations, such as India, China, Malaysia, Thailand, Philippines, Mexico and Brazil, to outsource their business functions. However, with time, there was a need to not only look at driving cost efficiencies through GICs, but also ensure quality operations and enhance productivity. With this objective, GICs started introducing innovation and technology as prevalent in their home jurisdictions.

GICs have evolved from performing routine back-office operations to becoming centres of excellence, offering strategy and product innovation, leveraging their global expertise and introducing leading practices through their parent organisations.

To meet this objective, GICs have increased dependence on talent available in India, creating employment opportunities locally as well as creating a pool of top-quality talent in India.

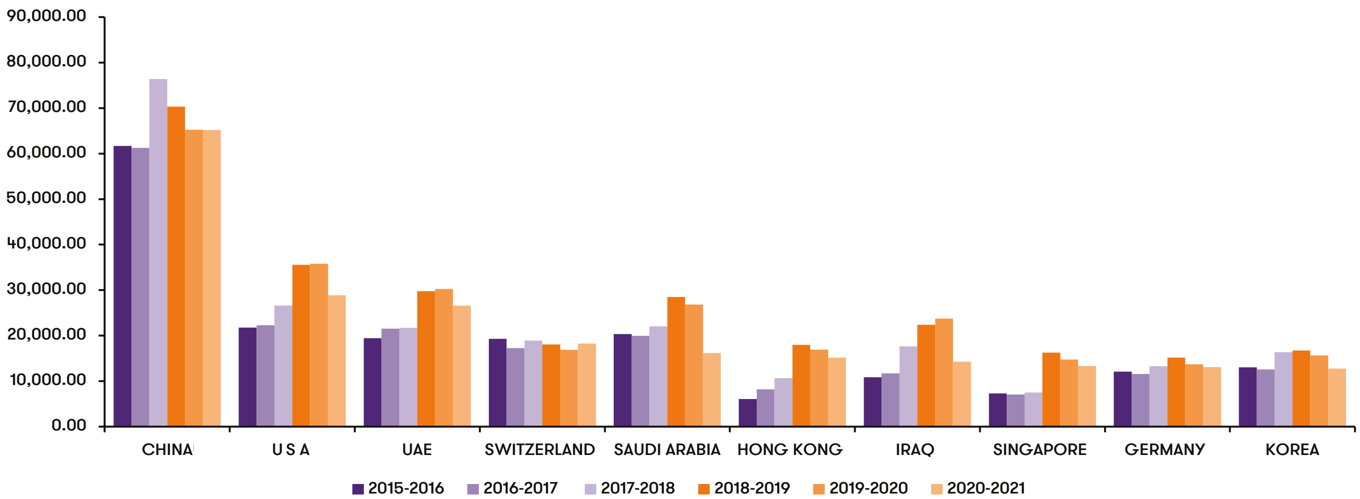
Additionally, GICs have also been instrumental in introducing technological innovations, such as blockchain technology, big data analytics, machine learning and the likes of it, which has resulted in redefining the manner in which the banking industry has traditionally operated and banks are now looking at remodeling their business operations with the onset of disruptive technology.

The above has led to positioning India as a global leader in the BFSI ITES space.

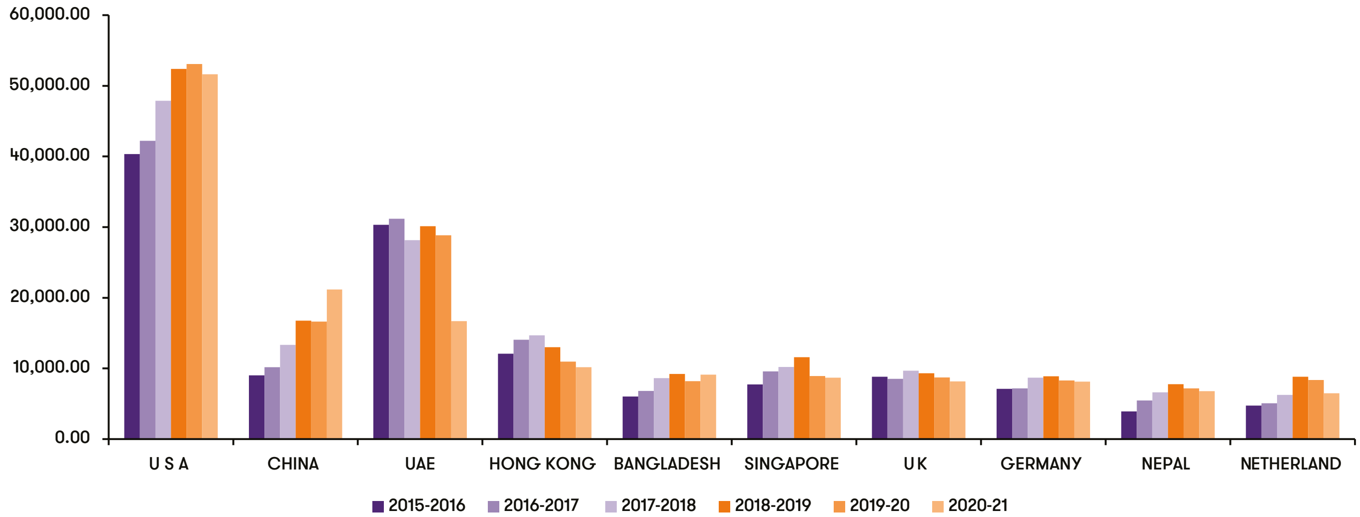
Assessing the contribution to foreign trade

The overall international trade operations have a significant impact on the growth and expansion of the Indian economy. The trade policies and government reforms have developed the import-export market over the years and the Indian market is one of the most sought-after locations for conducting trade activities. As depicted in the above charts, the highest volumes of imports are from China, USA, the UAE, Switzerland and Saudi Arabia. Further, the countries with the highest export volumes are the USA, China, the UAE, Hong Kong and Bangladesh.

Top 10 countries with highest imports (USD million)



Top 10 countries with highest exports (USD million)

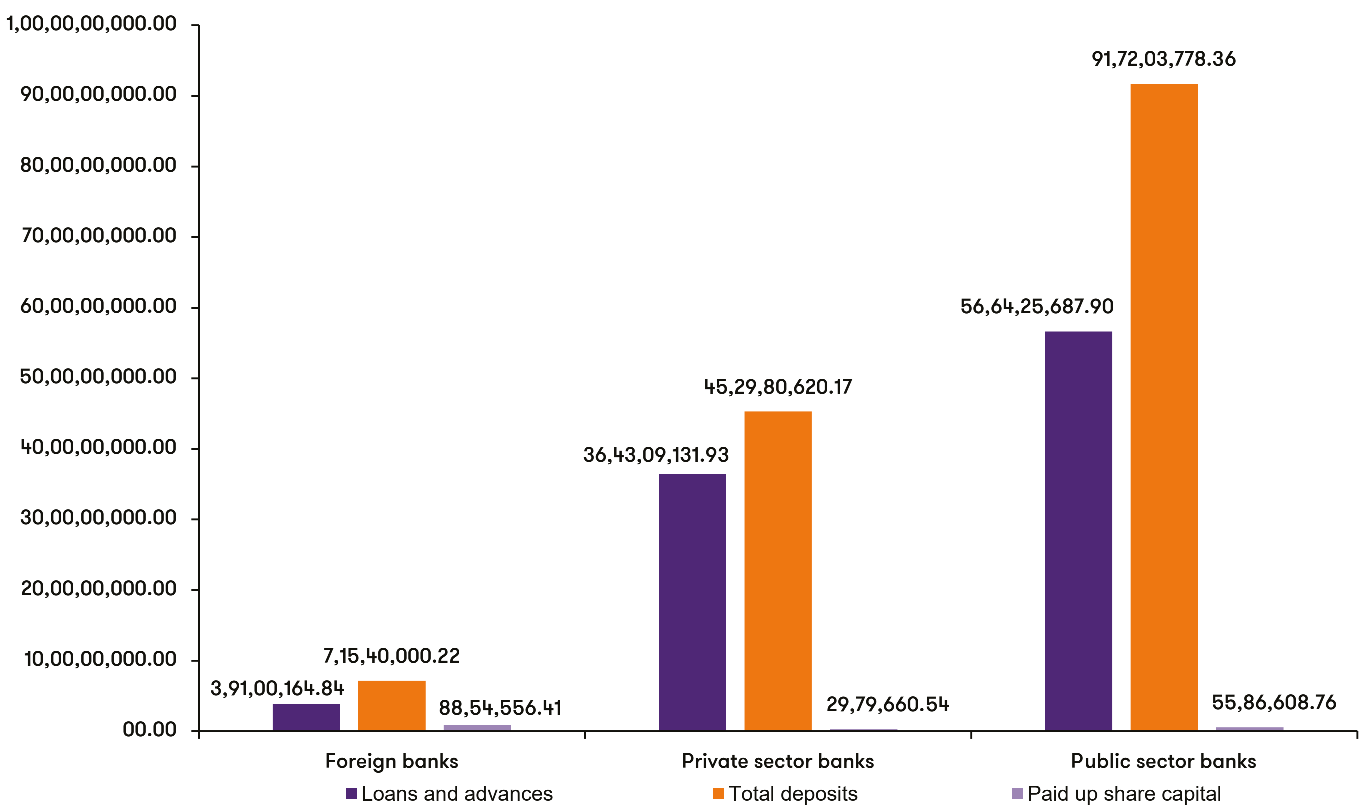


With the steady growth in trading activities, banks in different countries are encouraged to set up branches or subsidiaries in India to ease transactions and provide banking facilities to the customers.

Source: tradestat.commerce.gov.in/eidb/default.asp

Evaluating foreign banks' contribution compared to domestic banks

Key financial indicators (in lakhs)



Source : Offsite returns (OSMOS) collected at Department of Banking Supervision, RBI

Although the trading activities flourished over the years, the growth of foreign banks was not significant. As of December 2020, there are 45 foreign banks, 22 private banks and 12 public sector banks in India. Although the number of branches of foreign banks is high, the market share of foreign banks is low as compared to the private and public sector banks in India. As of December 2020, the total loans and advances of foreign banks was 4% of the total loans and advances when compared to 38% in private sector banks and 58% in public sector banks. Further, there is also a stark difference that is observed in deposits across the banks which was 5% of the total deposits in foreign banks, 31% in private sector banks and 64% in public sector banks. However, 51% of the total paid-up share capital is in foreign banks and 17% and 32% in private and public sector banks, respectively.

The difference in operations is quite significant and this is owing to the challenges that are faced by the foreign banks which restricts their expansion and growth in India.

It is important, both for the government and the RBI, to consider steps to resolve the challenges currently faced by foreign banks and create an enabling environment to help foreign banks contribute to the growth of the Indian economy.

The above thought process also works well with India's vision for an Aatmanirbhar Bharat. Foreign banks can contribute considerably to this agenda if a level playing field is provided along with an enabling environment with ease to do business in India.

Decoding the structure of foreign banks in India

Framework for foreign banks in India

Foreign banks are institutions that have their headquarters outside the country and run their offices in another country as per the regulations stated by the host supervisor, in this case, the RBI. Earlier, in India, foreign banks had their presence solely through branches. However, in November 2013, RBI introduced a framework to structure the presence of foreign banks in India.

RBI's scheme for structuring the presence of foreign banks in India

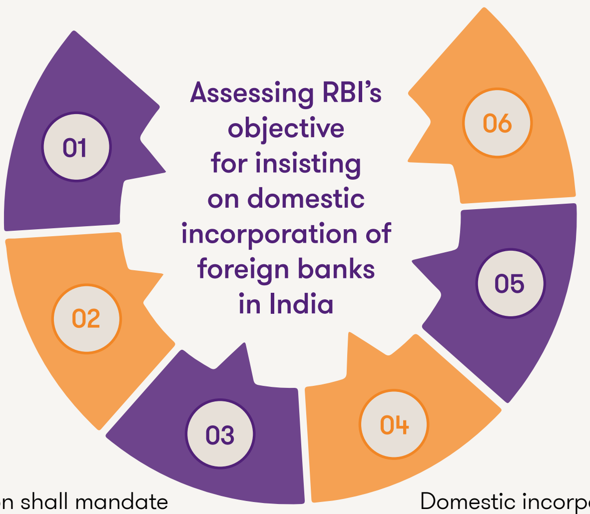
The RBI developed a scheme for setting up of Wholly Owned Subsidiaries (WOS) by foreign banks in India, which would allow the foreign banks in India to operate via a branch mode or a wholly owned subsidiary mode.

Foreign banks established before August 2010

Foreign banks which commenced banking business in India before August 2010 had the option to continue their banking business through the branch mode or to convert those branches into a wholly owned subsidiary if they met the conditions.

Foreign banks established after August 2010

Foreign banks which commenced banking business in India from August 2010 onwards were required to furnish an undertaking that they would convert their branches into wholly owned subsidiaries if required by the RBI.



01 Domestic incorporation shall ensure a separate legal entity structure within India and enhance legal and regulatory prowess

02 The structure provides for ring fencing of capital and assets within the home country and delineation of the same vis-à-vis that of the foreign parent

03 Domestic incorporation shall mandate a local board and management in India that shall act in the best interests of the stakeholders of the local entity

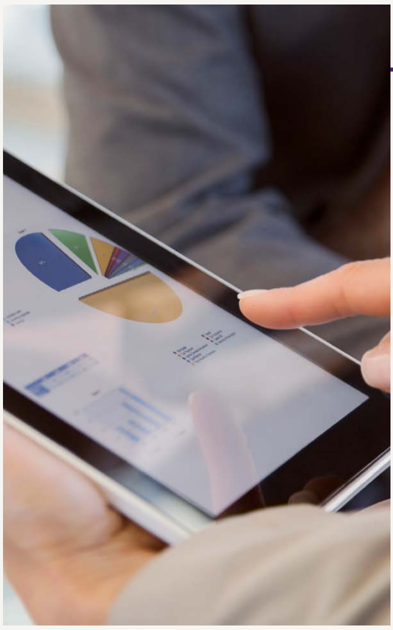
04 Domestic incorporation shall enhance the regulatory and supervisory framework of RBI and ensure supervisory autonomy

05 Domestic incorporation shall ease the resolution process

06 The structure shall promote and protect interests of local retail depositors

Considering the geopolitical and other downside risks, the RBI has been cautious in recent times. The regulator aims to ensure that the wholly owned subsidiaries and foreign bank branches do not, at any point, dominate the Indian financial system.

Eligibility for setting up a wholly owned subsidiary structure in India



Approval of home country regulator/supervisory as a pre-condition to obtaining RBI approval for setting up WOS structure in India.

Adequacy of prudential supervision as per internationally accepted standards including consolidated supervision in home country.

Other factors taken considered for assessing eligibility

- Economic and political relations with the country of incorporation of the parent bank
- Reciprocity with home country of the parent bank
- Financial soundness
- Ownership pattern
- International and home country ranking of the parent bank
- Home country/parent bank rating by a rating agency of international repute
- International presence of the bank
- Adequate risk management and internal control systems

Conditions for the foreign banks to carry out business as wholly owned subsidiaries

01 Banks incorporated in jurisdictions that have a legislation that gives a preferential claim to deposits of home country in winding up proceedings

02 RBI is not satisfied with the adequacy of supervisory arrangements (including disclosure arrangements) and market discipline in the country of incorporation of the foreign banks

03 Banks with complex structures

04 Banks which are not widely held

05 Banks that do not have adequate disclosure requirements in their home jurisdiction

06 For any other reason that the RBI considers necessary for subsidiary form of presence of the bank

Apart from the six conditions mentioned above, if a foreign bank that has set up its presence in India through branch mode after August 2010, is considered by the RBI as being systemically important by the virtue of the size of its business, they will have to convert into the wholly owned subsidiary structure as stated by the RBI.

The scheme for the setting up of WOS by foreign banks in India laid out by RBI mentions certain conditions as stated below:

Eligibility for setting up a WOS

Requires an approval from the home country regulator/supervisor, satisfying RBI that it is subject to adequate supervision as per internationally accepted standards in its home country. RBI also considers factors like economic and political relations with the country of incorporation, financial soundness, ownership structure.

Conditions requiring presence only as a WOS

There are six conditions prescribed by the RBI, which if applicable and are met by the foreign banks, they are required to operate via a WOS in India. These conditions have been mentioned in the previous slide.

Minimum capital requirement

The initial minimum paid-up voting equity capital as stated by RBI for the WOS of the foreign bank is INR 5 billion. The amount is required to be brought up front.

Corporate governance

Captures the criteria that the WOS of the foreign banks should meet with respect to the composition of board of directors and appointment of Chairman and CEO.

Statutory, regulatory, prudential and other requirements

The scheme lays down the targets and the sub-targets to be followed by the WOS of the foreign bank. The same are in accordance with the RBI's Master Circular RPCD.CO.Plan. BC.9/04.09.01/2013-14 dated 1 July 2013.

Raising of non-equity capital in India

The WOS of the foreign banks are allowed to raise rupee resources by issuing non-equity capital instruments. This is in similar lines with what has been permitted for domestic banks.

Branch expansion/ authorisation

The branch authorisation policy applicable to a domestic scheduled commercial bank is applicable to the WOS of the foreign bank. This mentions the requirement of opening branches in unbanked rural areas, authorisation for expansion, etc.

Priority sector lending requirements for WOS

The scheme lays down the targets and the sub-targets to be followed by the WOS of the foreign bank. The same are in accordance with the RBI's Master Circular RPCD.CO.Plan. BC.9/04.09.01/2013-14 dated 1 July 2013.

Use of credit rating and parent/head office support

The parent of the WOS is required to issue a letter of comfort (LOC) to the RBI for meeting the liabilities of the WOS. The WOS is also allowed to use the parental guarantees/credit rating only for the purpose of providing custodial services and for international operations.

Declaration of dividends

The WOS of foreign banks in India are allowed to declare dividends like domestic banks and are subject to criteria laid down in RBI circular DBOD. No. BP.BC. 88/ 21.02.067/2004/05 dated 04 May 2005 which may be repatriated as per the provisions of FEMA 1999.

Investment by the WOS in subsidiaries and other companies

Captures the instructions and the regulator guidelines which the WOS must follow for the investment in subsidiaries and other companies.

Business model

The WOS of the foreign banks are required to submit the business model including the plans to achieve financial inclusion, retail banking and a branch expansion plan for one-year along with its application. The plan should be realistic and viable.

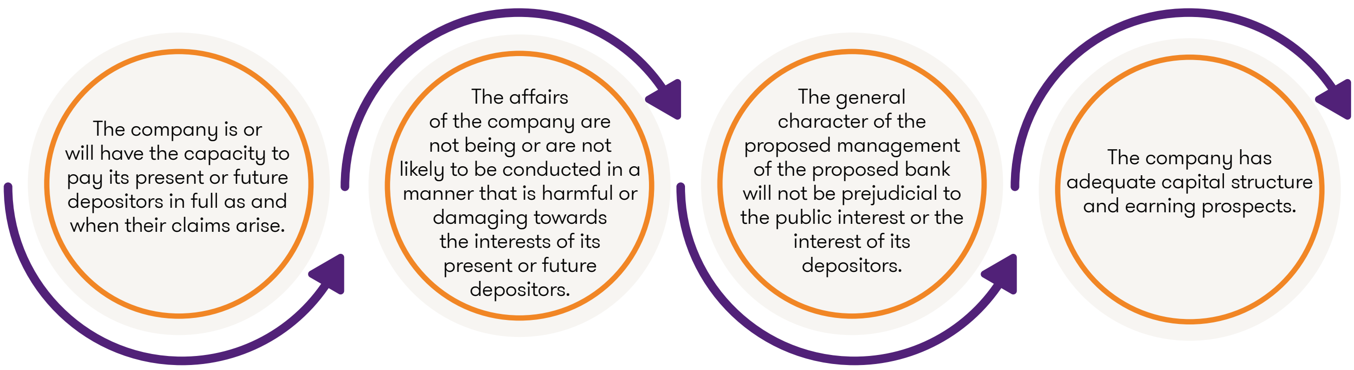
Apart from these, conditions for national treatment, process on use of group resources, procedure for conversion of existing branches of foreign banks into WOS, procedure for mergers/acquisitions, application procedure, other conditions, etc. are also captured.

Licensing of foreign banks and opening of branches by foreign banks

License to open a foreign bank in India

India issues a single class of banking license to banks. There are no restrictions on operations of foreign banks. Before granting the Banking license to any of the banks, including foreign banks, the RBI is required to be satisfied with certain conditions as mentioned below.

Conditions that RBI needs to be satisfied with



License to open branches of foreign banks in India

The branch authorisation policy applicable for the Indian banks has been made applicable to foreign banks.

Conditions for foreign banks

01 Foreign banks are required to bring an assigned capital of USD 25 million upfront at the time of opening the first branch in India.

02 Existing foreign banks having one branch would have to comply with the above requirement before their request for opening of second branch is considered.

03 Foreign banks are required to submit their branch expansion plan on an annual basis.

04 Foreign banks and their groups' record of compliance and functioning in the global markets will be considered. Reports from home country supervisors will be sought.

05 Weightage would be given to even distribution of home countries of foreign banks having presence in India.

06 The treatment extended to Indian banks in the home country of the applicant foreign bank would be considered.

07 Due consideration would be given to the bilateral and diplomatic relations between India and the home country.

08 The branch expansion of foreign banks would be considered keeping in view India's commitments at World Trade Organisation (WTO).

Exit of key foreign banks over the years

Given the challenges inherent in the ecosystem for foreign banks in India, the country has witnessed exits of a few foreign banks in the recent years while some others have curtailed their operations in India

Timeline of key events

Dresdner Bank
September 2008
Commerzbank which acquired Dresdner Bank AG gives up the banking license

Deutsche Bank
March 2011
Discontinued credit card business

Morgan Stanley
January 2013
Surrendered banking license

UBS AG
June 2013
Surrendered commercial banking license

Morgan Stanley
May 2014
Discontinued wealth management business

Deutsche Bank
August 2015
Discontinued asset management business

HSBC Bank
November 2015
Discontinued private banking business

Barclays Bank
January 2016
Discontinued equities broking and capital markets business

Royal Bank of Scotland
May 2016
Wound up corporate, retail and institutional operations

First Rand Bank
October 2016
Discontinued Retail and SME Lending business

Deutsche Bank
July 2019
Discontinued equities trading business

Abu Dhabi Commercial Bank
September 2019
Exited India operations

BNP Paribas
June 2020
Shuts down wealth management business

Westpac
October 2020
Exited India operations

First Rand Bank
April 2021
Exited India operations

Citibank
April 2021
Discontinued retail business

Assessing causes for exit of foreign banks over the years

Foreign banks have often faced a challenge with respect to the scale of operations compared to domestic banks and public sector banks operating in India. Given their scale of operations, profitability also becomes a cause of concern.

Foreign banks often face a challenge in managing the NPA situation in its Indian operations and this is one of the common reasons for exit/curtailment of foreign banking operations in India.

Divestment or curtailment of retail businesses is often accompanied by the decision to focus on niche markets and core segments where foreign banks have demonstrated expertise historically.

Regulatory dynamics also have a role to play and the past exits have taken place as a result of foreign banks reassessing their business strategies in the light of stringent regulatory norms and complex capital regulations.

Supervisory framework for foreign banks

Off-site supervisory process

As a part of its supervisory framework, the RBI conducts various exercises to monitor the health of all the banks in India. These activities are carried out through on-site supervision and off-site surveillance mechanisms.

Off-site supervision

As a part of conducting off-site supervision processes, the RBI looks at majorly two processes

Regular returns to be submitted

The RBI has set up various rules, regulations and guidelines which requires the banks in India to submit various returns to it. RBI requests these returns at a set frequency and has also defined the format in which the return has to be submitted. The returns requested by RBI are applicable for foreign banks as well as other scheduled commercial banks, mainly comprising reporting around frauds, inflow/outflow of funds, numbers and value of transactions via various mediums, forex transactions, deposits, liabilities, positions in the market, etc.

Information requests

Apart from the defined returns, the RBI also requests the banks to provide ad-hoc information for the purpose of reviewing the same.

- Off-site supervision is conducted through Off-site Monitoring and Surveillance System (OSMOS), Prompt Corrective Action (PCA) [based on pre-determined trigger points on Capital-to-Risk Weighted Assets Ratio (CRAR), Net Non-Performing Assets (NPA) and return on Assets (RoA), Risk Profile Templates etc.].
- The primary objective of the off-site surveillance is to monitor the financial well-being of the banks between the two on-site inspections. This helps in identifying banks which show financial deterioration and can be a source for supervisory concerns. This also helps in triggering a timely rectification mechanism to handle any potential problems in the bank.

On-site supervisory process

Annual supervision of banks

The RBI conducts annual supervision of the commercial banks in India. The supervisory processes include evaluation of banks' performance by way of an on-site annual financial inspection broadly with reference to the following:

1. Banks' financial condition and performance
2. Management and operating conditions focusing on management
3. Systems and internal controls, including risk management strategies
4. Compliance to regulations

Based on the above evaluation, a summary assessment is made which mainly highlights the supervisory concerns and identifies areas for corrective action. The foreign banks operating in India are rated under the CALCS (i.e., capital adequacy, asset quality, liquidity, compliance and systems and controls) model.

Risk-based supervision (RBS)

The RBI conducts Risk-Based Supervision of Banks (RBS). Its an ongoing process where the risks of the banks are evaluated, and appropriate supervisory plans are designed and implemented.

The RBS framework consists of six steps:

1. Understanding the bank
2. Assessing risks faced by bank for supervisory purposes
3. Scheduling and planning supervisory activities
4. Defining examination activities, on-site reviews and on-going monitoring
5. Inspection procedure
6. Reporting findings and recommendations and follow-up

RBI has developed the risk assessment matrix by identifying risk groups, risk weights to arrive at the net risk and they have developed Impact Rating Matrix by creating various impact parameters, indicators, rating scale, significant weight to arrive at the final impact rating for the bank.

Thematic reviews

Thematic supervision is a process where thematic methods are applied to perform risk identification, detection, assessment and management. Under RBS regime the areas for conduct of thematic study would be guided by the process of risk identification.

Risks to be identified for thematic study may come from different sources, including the following:

1. Supervisory findings of individual banks
2. Nature and trend of customer complaints
3. Trends observed from consumer protection angle which may include new products offered, feedback from consumer protection organisations, etc.
4. Market data and market intelligence
5. Emerging trends from macroeconomic and banking sector analysis
6. Information gathered from meetings with banks management especially with those having below average rating
7. Information received from law enforcement agencies, peer international and domestic supervisors; etc.

Supervisory policy measures

As a part of its supervisory framework, the RBI conducts various exercises to monitor the health of all the banks in India. These activities are carried out through on-site supervision and off-site surveillance mechanisms.

01 Early identification of risks and vulnerabilities

RBI has been deploying advances in data analytics to quarterly off-site returns to provide sharper and more comprehensive inputs to the on-site teams.

02 Root cause analysis of vulnerabilities

The RBI's supervision concentrates more on root causes of the vulnerabilities identified. Structured frameworks are being put in place to assist with the same.

03 Framework for early, effective and consistent supervisory action

In line with BCBS recommendations, the main aim is to initiate early and effective corrective actions that are consistent across the entities.

04 Harmonised and consolidated supervision

The supervisory functions have the objective of harmonising the supervisory approach based on the activities/size of the entities.

05 Specialised structure for KYC/AML risk

A risk-based supervision framework focusing on KYC/AML risk has been created in line with the principles of BCBS and Financial Action Task Force (FATF) requirements for prudential supervision.

06 Leveraging technologies

Innovative technologies for regulation (RegTech) and supervision (SupTech) is being embraced. An Integrated Compliance Management and Tracking System and a Centralised Information Management System are two major initiatives being implemented.

07 Strengthening cyber security resilience

Key cyber risk indicators were introduced for all SCBs since June 2019. A certification/ awareness programme on cyber security was also conducted and made mandatory for members of the Board, senior management and CXOs.

08 Regular deep-dive into areas of concern through thematic studies

A number of thematic studies on various areas were conducted to provide inputs to top management for proactive policy interventions.

Operations of foreign banks in other jurisdictions

Structure and operations of foreign banks in other jurisdictions

Due to globalisation over past few decades, banks have established branches or subsidiaries to expand operations in foreign jurisdictions to provide financial services to a global customer base. Expanding operations across the globe entails administrative burden to ensure compliance with the domestic and foreign regulatory requirements while ensuring to achieve economies of scale. Below is a snapshot of the structure and operational guidelines for foreign banks in large jurisdictions:

United States of America

The Federal Reserve Bank

Key operating guidelines

- Prior to the International Banking Act of 1978 (IBA), rules governing foreign banking institutions were significantly different from those governing US banks. **The IBA harmonised the different rules to a great extent, particularly those relating to chartering, branching, and reserve requirements.** Additional regulations were introduced which included provisions granting foreign bank branches direct access to Federal Reserve services such as check clearing, provision of coin and currency, Fedwire, and the discount window. All such Federal Reserve services are offered to foreign bank branches under the same rules and at the same prices as other domestic banking institutions. (Federal Reserve Bank, 2007)
- Qualified foreign banking organisations wherein more than half its banking activities are outside the United States are exempt from some **Federal Reserve regulations. Federal Reserve examines foreign bank branches and agencies annually.** Examiners assess branches and agencies based on their Risk management, Operational controls, Compliance, and Asset quality (ROCA). In addition, the Federal Reserve **assesses parent banks' financial conditions** to ensure that the banks can support their US branches effectively. (Federal Reserve Bank, 2007)
- An approval from the Federal Reserve bank is mandatory to establish any foreign bank in the US. In addition, foreign banks must **obtain regulatory approval from the state banking supervisor when establishing new branches**. Although branches have no capital of their own, those that are licensed must deposit cash or eligible securities at approved depository banks to satisfy the 'capital equivalency requirement' specified by the IBA. (Federal Reserve Bank, 2007)
- Licensed foreign bank branches are allowed to provide a **full range of banking services**. They can provide short term and long term loans, make investments, and can accept certain types of deposits. Branches tend to be significantly less expensive to operate than subsidiary banks, and so they are the most common type of foreign banking institution operating in the US.
- However, foreign bank branches do face certain limitations. Although branches may receive deposits of any size from foreigners, they **may accept deposits only in excess of USD 100,000 (wholesale deposits) from US citizens and residents**. Furthermore, deposits in any foreign bank branch established after 19 December 1991, are **not covered by US deposit insurance**; deposit insurance is now offered only to US banking institutions.(Federal Reserve Bank, 2007)
- A foreign bank with more than USD 100 billion of consolidated assets and USD 50 billion of combined US assets, must maintain a **US risk committee** and larger foreign banks are also required to appoint a US CRO who is employed and located in the US and reports directly to the US risk committee. (Federal Reserve Bank, 2007)
- All foreign banks with **USD 50 billion or more in US non-branch assets need to establish an Intermediate Holding Company (IHC).** The IHC must hold the bank's US Bank Holding Company, bank subsidiaries and substantially all other US non-bank subsidiaries. (Federal Reserve Bank, 2007)
- Foreign Banks which are systemically important are also required to **file a resolution plan every two years** as part of the Dodd Frank Act with the Federal Reserve and other regulatory authorities. (Office of the Comptroller of the Currency, 2017)
- Bank holding companies of foreign banks are generally subject to **minimum capital requirements** although they may opt for the US standardised approach to calculate risk-based capital and leverage ratios regardless of the size. Foreign banks that seek financial holding company status must showcase that they meet the comparable standards under their home country's capital requirements. IHCs are also subject to adherence to **LCR requirements basis own risk profile.** (Office of the Comptroller of the Currency, 2017)

Australia

Australian Prudential Regulation Authority

Key operating guidelines

- The main acts of the Australian regulator governing deposit-taking institutions including foreign banks are:
  - Banking Act 1959 (Banking Act).
  - Reserve Bank Act 1959 (RBA Act).
  - Financial Sector (Shareholdings) Act 1998 (FSSA).
  - Corporations Act 2001 (Corporations Act).
  - Financial Sector (Collection of Data) Act 2001 (FSCODA).
  - Financial Sector (Transfer and Restructure) Act 1999 (FSTRA).

(Ian Paterson, King & Wood Mallesons, September 2021)

- An **authorisation from Australian Prudential Regulation Authority (APRA)** is mandatory to establish a foreign bank in Australia. Foreign banks with established branches in Australia which are allowed to accept deposits, are not **permitted to accept initial deposits or other funds from individuals and non-corporate institutions of less than AUD 250,000.** Such branches can accept deposits and other funds of any amount from incorporated entities, non-residents and their employees. (Ian Paterson, King & Wood Mallesons, September 2021)
- APRA does not require a foreign bank to obtain a license to conduct business with Australian counterparties from its overseas offices, under the conditions that the bank has not established a permanent office or appointed staff in Australia. Additionally, any business contracts and arrangements are to be clearly transacted and booked overseas and are subject to overseas legal and regulatory jurisdiction.
- APRA also provides restricted banking license under the **restricted banking licensing framework.** The framework issues restricted banking license before the institution is equipped to be fully licensed, along with phase wise regulatory obligations to support the restricted range of permitted activities. The restricted license is of importance for start-ups and smaller businesses with limited banking experience and lower risk banking activities. The guidelines of APRA state that the assets of the applicant shall not exceed AUD 100 million and such restricted organisations will be provided a time period of two years to ensure adherence and showcase compliance with the prudential framework.
- APRA takes into account **several requirements** while considering an application from an entity to be licensed as an ADI, including:
  - Capital adequacy
  - Ownership standards
  - Governance standards
  - Risk management and internal control systems
  - Compliance processes and systems adequate to ensure compliance with prudential regulations.
  - Information and accounting system requirements
  - External and internal audit arrangements

(Ian Paterson, King & Wood Mallesons, September 2021)

- **A foreign bank must also adhere to the below, in addition to any of the other requirements**:
  - Authorised to conduct banking business in its domestic jurisdiction.
  - Have necessary approvals from its domestic country supervisor to establish a bank in Australia.
  - Satisfy APRA that it has adequate prudential supervision in its home country.
  - Satisfy APRA that it has adequate reporting arrangements to the parent foreign bank or head office.
  - Meet ownership standards relating to the foreign bank itself and its substantial shareholders.

(Ian Paterson, King & Wood Mallesons, September 2021).

- The requirements for a foreign bank wishing to establish **a representative office in Australia are less stringent**. The representative office must be confined to the conduct of **liaison and research activities and it cannot undertake banking business.** (Ian Paterson, King & Wood Mallesons, September 2021)
- The APRA generally takes the position that foreign banks operating an active business in Australia should be subject to Australian prudential regulation and supervision. Australia does not have a passporting regime. An entity wishing to carry on banking business through a branch in Australia will therefore require authorisation to operate as a foreign Authorised Deposit-taking Institution (ADI) and be willing to submit to APRA supervision in respect of its Australian business. (Ian Paterson, King & Wood Mallesons, September 2021)

European Central Bank

European Central Bank

Key operating guidelines

- The scope of the European Central Bank's (ECB) inputs in the bank licensing process has three main criteria:
  - ensuring that a bank is sufficiently engaging in the essential activities that it must undertake in order to be eligible as a credit institution as defined by the Capital Requirements Regulation (CRR);
  - granting a credit institution authorisation at an entity's inception as well as amending the content of an existing license, e.g., in terms of the scope of the permissible banking activities;
  - authorising all regulated activities that are subject to a credit institution authorisation pursuant to the applicable law. (European Central Bank, 2019)
- The ECB representative supervisor needs to independently assess each situation and transaction that may have an impact on an entity's eligibility for a banking authorisation to ascertain whether authorisation or supervisory approval, is required. (European Central Bank, 2019)
- At an overall level, a wide range of measures with implications for banking operations were introduced post the financial crisis. The measures included changes in the authorisation process, scope of permitted activities, financial requirements, governance and risk management requirements, operational requirements, and ownership and control requirements. (European Central Bank, 2019)
- Since the Global Financial Crisis (GFC), there have been stringent regulations introduced for branches of foreign banks. In harmonisation with the local banks, foreign branches are also subject to financial and governance requirements. However, capital requirements continue to be at equivalence with the regulations in the host and home countries. In Europe, harmonisation of the regulatory treatment of foreign branches arises from the passport concept, giving European Economic Area (EEA) banks the right to provide financial services throughout the European Union (EU) based on a harmonised set of prudential requirements, whereas the equivalence concept continues to apply to foreign country bank branches.
  (European Central Bank, 2019)

Licensing requirements include the following:

- Common procedures: the **licensing of banks, withdrawal of banking licenses and authorisation of acquisitions** of qualifying holdings in banks. These decisions are taken by the ECB for **all banks and investment firms** authorised as banks under European banking supervision (both significant and less significant institutions).
  - The supervisory approval or exemption from approval of (mixed) financial holding companies owning banks under direct ECB supervision.
  - 'Fit and proper' assessments, that look into whether members of the management body of a bank (or an investment firm authorised as a bank) or a (mixed) financial holding company are suitable for their roles. Outside the context of licensing or qualifying holdings, the ECB only takes fit and proper decisions for significant banks.

(European Central Bank, 2019)

United Kingdom

Prudential Regulatory Authority

Key operating guidelines

- Prior to the Brexit, as per the regulatory landscape of UK, banks that were headquartered and authorised to operate in European Economic Area (EEA) states were also permitted to operate in the UK based on their home state banking license. Under the Capital Requirements Directive passporting regime, EEA bank was allowed to offer banking services in the UK without seeking a separate UK banking license. **EEA banks may operate by establishing a UK branch or by providing services to UK clients on a cross-border basis (passporting).** Passporting was subject to a notification procedure between the EEA bank, the EEA home state regulator and the Prudential Regulation Authority (PRA) as host state regulator. This required the home state regulator to verify that the firm meets the specified conditions. However, subject to Brexit and the new negotiations, the passporting regime has been discontinued and EEA banks are now treated in a similar manner as other foreign banks and the supervisory approach has been adjusted for these EEA banks. (Bob Penn, Allen & Overy, 2018)
- **Foreign banks** are in principle permitted to operate in the UK by way of a **UK-authorised branch**. A foreign bank seeking to establish a UK branch must complete a detailed branch authorisation application to the PRA and obtain its consent before establishing a branch in the UK. (Bob Penn, Allen & Overy, 2018)
- The **PRA and the Financial Conduct Authority** must make their decision within **six months of receipt of the completed** application to issue the banking license. However, due to operational challenges, the licensing process may also take up to a year to complete. The regulators may also grant licenses with restriction on certain specified operations that it may consider appropriate. (Bob Penn, Allen & Overy, 2018)
- Foreign banks proposing to offer services from a location in the UK must generally be authorised under Financial Services and Markets Act (2000), although exemptions may be applied at the discretion of the regulator in limited circumstances. The legal position for foreign banks operating in the UK on a purely cross-border basis (without a UK place of business) is more complicated and varies across activities. For certain types of wholesale financial services, foreign banks can deal on a cross border basis without triggering licensing requirements where they limit marketing. (Bob Penn, Allen & Overy, 2018)
- Branches of foreign banks are subject to **high-level liquidity requirements only**. Many of the regulatory capital requirements for UK-authorised banks on a solo and consolidated basis are determined according to Capital Requirements Directive IV - comprising the CRR and the CRD, which is implemented in the UK mainly through the PRA and FCA rules. (Bob Penn, Allen & Overy, 2018)
- Banks are required to assess themselves, the adequacy of their capital (a process known as the **Internal Capital Adequacy Assessment Process**, or ICAAP), which is then subject to review by the PRA (the **Supervisory Review and Evaluation Process** (SREP)). This usually results in the PRA providing individual capital guidance to the firm and setting a capital planning buffer. In addition, the PRA requires banks to carry out stress testing and scenario analysis, including 'reverse stress testing' identifying circumstances in which a bank would no longer be viable, to assess the UK banking system's capital adequacy. (Bob Penn, Allen & Overy, 2018)

Creating an enabling environment for foreign banks

Challenges faced by foreign banks

Overview

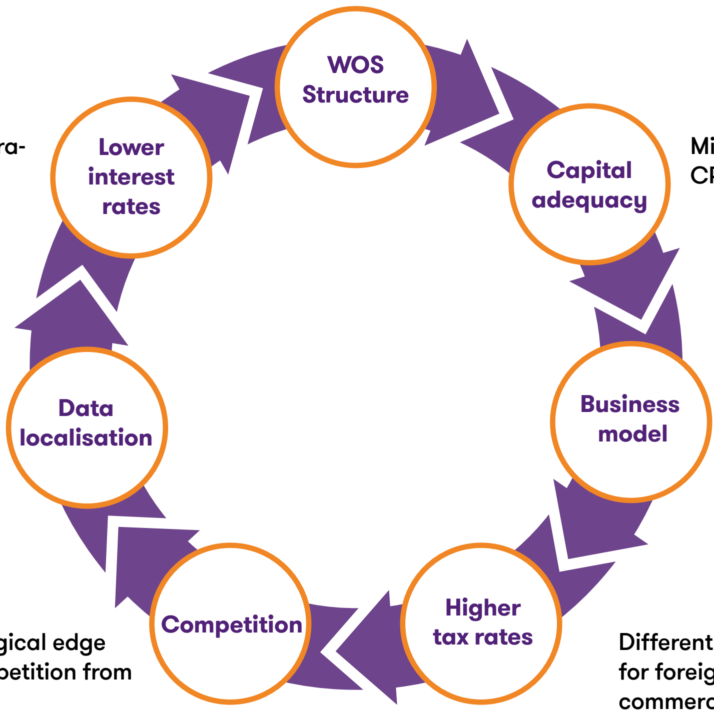
- Citi Global has decided to exit from the consumer banking business in India. First Rand Bank has decided to move to a representative office structure from its existing branch structure. While these are two banks of different sizes and scales, it does make one think of the reasons that led to their exit.
- While both the banks have made official statements on the reasons for their exit, they do reflect some of the challenges inherent within the Indian financial system, that the organisations no longer have a risk appetite for. While it would not be right to assume that all these challenges led to the decisions of the two proposed banks in question to re-evaluate their position in India, these might have had some role to play. Over the years, India has also witnessed foreign banks shutting down India operations or curtailing business operations.
- Considering the above, it is important to look at some of the key challenges currently faced by foreign banks in India.

Macro-economic issues, strategic issues, regulatory complexities and operational challenges faced by foreign banks

Setting up wholly owned banking subsidiary (WOS) and longer gestation periods

Surplus liquidity and ultra-low interest rates

Minimum capital requirements and CRAR norms



Increased costs from adhering to data localisation norms

Business model suited towards niche markets and difficulties in supporting financial inclusion

Decline in technological edge and increased competition from domestic players

Differential taxation – higher taxation rates for foreign banks vis-à-vis other scheduled commercial banks

Given the above challenges, it is important for the government and the RBI to create an enabling environment and provide a level playing field to enable foreign banks to thrive in India. Some of the considerations that RBI can look at to enhance the regulatory framework to create an enabling environment are detailed out in the subsequent sections.

Easing priority sector lending (PSL) norms

Understanding the background

PSL targets have been prevalent for almost four decades in India to promote weaker segments such as agriculture, micro enterprises, etc. Commercial banks have been lending to priority sectors since the late 1960s even though the description of priority sectors was formalised by RBI in 1972. The stipulated lending target to the priority sector was 33.33% in March 1979 which was later revised to 40% in March 1985.

The RBI, by way of the Master Circular on Lending to Priority Sector, in July 2007 revised the targets and sub-targets for PSL, and also specified the targets for foreign banks. The total PSL targets for foreign banks was stipulated at 32% of adjusted net bank credit (ANBC) or credit equivalent amount of Off-Balance Sheet Exposure, whichever was higher, as against 40% applicable to domestic commercial banks. Additionally, there were sub-targets specified for foreign banks for small enterprise advances, micro enterprises within small enterprises and export credit. Export credit, at that point, was not a part of the priority sector for domestic commercial banks.

The foreign banks having shortfall in lending to stipulated priority sector target/sub-targets were required to contribute to Small Enterprises Development Fund (SEDF) set up by Small Industries Development Bank of India (SIDBI), based on conditions stipulated.

Revised PSL guidelines issued in July 2012

Foreign banks with 20 and above branches	Foreign banks with less than 20 branches

The PSL targets with foreign banks having 20 and above branches were the same as those applicable to domestic commercial banks. The total PSL target was 40% of ANBC or credit equivalent amount of Off-Balance Sheet Exposure (CEOBE), whichever is higher. The target for foreign banks with less than 20 branches continued to be 32%. Additionally, foreign banks with 20 and above branches were required to adhere to sub-targets for lending to agriculture, micro and small enterprises and advances to weaker sections, while sub-targets were not applicable to foreign banks with less than 20 branches.

Further, while the earlier guidelines provided a specific sub-target for foreign banks for lending towards export credit, RBI, in the 2012 guidelines, stipulated that export credit is not a separate category. Export credit to eligible activities under agriculture and MSE will be reckoned for priority sector lending under respective categories.

Current priority sector lending norms

The total PSL targets for foreign banks with 20 and above branches continued to remain the same. The total PSL targets for foreign banks with less than 20 branches was 40% of ANBC or CEOBE, whichever is higher out of which 32% was allowed for lending towards exports.

The sub-targets for export credit stand revised as under

Domestic banks / WoS of foreign banks/ SFBs/ UCBs	Foreign banks with 20 branches and above	Foreign banks with less than 20 branches
Incremental export credit over corresponding date of the preceding year, up to 2% of ANBC or CEOBE whichever is higher, subject to a sanctioned limit of up to INR 40 crore per borrower.	Incremental export credit over corresponding date of the preceding year, up to 2% of ANBC or CEOBE whichever is higher.	Export credit up to 32% of ANBC or CEOBE whichever is higher.

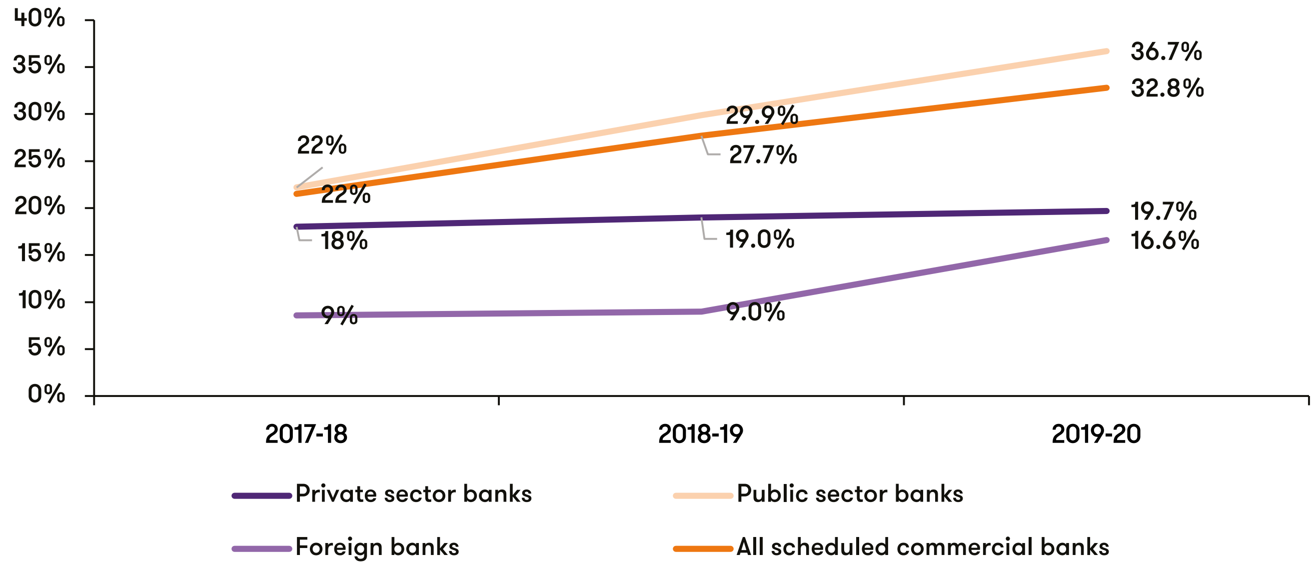
Understanding the associated challenges

PSL has traditionally been one of the most preferred tools available at RBI's disposal to ensure a steady flow of credit to priority sectors. Banks have been known to turn risk averse during times of NPA surges and economic crisis, curtailing their lending portfolio. At such times, PSL targets ensure that lending to priority sectors is not curtailed.

However, while this may seem to benefit the economy and RBI at large, it creates a competitive disadvantage for foreign banks who have historically known to concentrate on niche focus areas, of which retail lending is not a part. Foreign banks, though seem to have met their total PSL targets, have a reluctance to lend towards sectors specified under the PSL norms citing lack of understanding of these sectors, increasing credit risk and mounting stressed assets owing to loans made to these sectors.

In order to mitigate the risk arising out of lack of understanding of priority sectors, RBI introduced the concept of Priority Sector Lending Certificates (PSLCs) in April 2016. PSLCs are instruments that allow banks to meet their PSL targets without actually lending to priority sectors. Banks sitting on surplus loans made under PSL can sell certificates to banks that have not met their targets, without an exchange of risk or loan assets. The certificates are traded through the CBS portal (e-Kuber) of RBI. The costs attached to the PSLCs is the fee paid on these certificates which is determined by the demand and supply. These certificates would expire on 31 March of the financial year. Thus, achievement of PSL targets is the only incentive available against purchase of PSLCs.

GNPAs pertaining to priority sector loans



Foreign banks have witnessed a rise in the GNPA ratio pertaining to priority sector loans. The sectors comprising the priority sector such as agriculture, small and micro enterprises are unorganised sectors and agriculture especially is subject to the vagaries of the monsoon in India, which are potential reasons for growing NPAs.

Nearly

40%

of Adjusted Net Bank Credit (ANBC) needs to be lent by foreign banks to priority sector in India. These priority sectors include agriculture, micro, small and medium enterprises (MSME), export credit, education, housing, social infrastructure, renewable energy and personal loans to weaker sections, loans to distressed persons, loans to state sponsored organisations for SC/ST.

Most of the above sectors fall within the definition of unorganised sectors in India.

Agricultural sector which has a sub-target of 18% is subject to the vagaries of the monsoon. The borrowers comprising the other sectors are economically weaker sections. Due to the reasons, there are mounting NPAs from loans made to these sectors.

While these sectors contribute to India's economic growth, it is to be noted that in the current pandemic scenario, these sectors were most impacted and the already increasing NPAs are expected to mount further. Foreign banks would need to make heightened provisions and write-offs of loans made to these sectors.

Hence, in the current scenario, PSL targets are not only increasing the risk exposure of foreign banks substantially, but also increasing the pressure on the balance loan book to deliver profits to ensure that foreign banks are able to sustain the current economic scenario.

Further, foreign banks are specialised to operate niche segments such as wealth management and private banking, investment banking and trade finance. Foreign banks do not seem to have the required maturity as well as the infrastructure necessary to make informed decisions to lend to sectors such as agriculture, MSME, social infrastructure and other weaker sections. Foreign banks desirous of serving the unbanked rural population neither understand the target segments nor have the necessary risk management and legal infrastructure to manage the associated stressed assets and NPAs pertaining to these advances. In this situation, it is not expected that many foreign banks will enter Indian markets. In contrast, the country could witness some more foreign banks curtailing operations in India.

RBI may need to relook at the PSL targets for foreign banks. **The RBI can start by allowing flexibility in the sub-targets for PSL by which means foreign banks may then choose to fulfill PSL targets by lending towards export credits.** Gradually, considering the business model for foreign banks and the niche markets that they cater to, the **RBI can look at reducing the overall PSL targets for foreign banks.**

The government can also additionally look at introducing structural reforms in the priority sectors to ensure that they are no longer unorganised and are more viable for lending.

Priority sector lending certificates as an alternative to actual PSL investments

In order to mitigate the risk arising out of lack of understanding of priority sectors, RBI introduced the concept of Priority Sector Lending Certificates (PSLCs) in April 2016.

The regulatory can consider the following when it comes to easing associated challenges around PSLCs :

- The market experiences significant volatility towards the end of the quarters when banks are in a rush to fulfil PSL targets. In order to avoid such a scenario and make markets lesser volatile, the RBI could potentially consider including NBFCs, micro-finance institutions (MFIs) and small finance banks in the PSLC space to deepen the market further.
- A framework to regulate the market can be put in place by RBI.

Providing fungibility in meeting PSL targets

The RBI can consider providing some leeway and flexibility to foreign banks in meeting priority sector targets by pro. The scale at which a large number of foreign banks operate is far lesser than some of the leading private and public sector banks in India. A review of the list of offices of commercial banks as at the end of the quarter ended March 2021 published by RBI as part of the Database on Indian Economy reveals that the total number of offices/branches of public sector banks amounts to 92,566 as compared to 921 branches of foreign banks. Despite the above, foreign banks are equated at par with other commercial banks in India in terms of fulfilling priority sector requirements.

In order to provide an enabling environment to foreign banks and ensure a level playing field, it is important to consider the structure and set-up with which foreign banks operate. Foreign banks have developed expertise in specialised niche businesses one of which is export trade. Thus, in a scenario where PSL targets are fungible across categories, foreign banks can contribute efficiently towards export credit.

Including ESG, sustainability and others within the ambit of PSL

Globally, there is an increasing focus on environment, social and governance (ESG) aspects, including sustainability and sustainable finance. Considering the focus on environment and sustainability, RBI can consider the following with respect to priority sector lending where expertise of foreign banks can be leveraged to a large extent:

- Inclusion of green financing and financing towards renewable energy and ancillary industries (example: Lithium batteries) could be considered for addition to the list of priority sector lending.
- There is also a considerable focus on electric vehicles (EVs) from an India standpoint in order to curtail fuel imports as well as focusing on pollution control. There have been various subsidies offered to encourage production and sale of EVs as well as setting up electric charging stations. Considering the economic importance of the initiative, the same could be potentially included within the ambit of priority sector lending.
- Given the recent pandemic that witnessed the near collapse of the health infrastructure across the nation, there is an increasing focus on the inclusion of accessible and innovative health care in the priority sector for the long term, given that the weak health care system in India needs more attention to manage and mitigate a pandemic of this scale and nature.

Foreign banks in advanced jurisdictions have already achieved a considerable degree of progress towards sustainable financing, healthcare and other emerging sectors and foreign banks with presence in India will be able to leverage the global expertise and become pioneers in creating such a market in India.

02

Easing requirements around setting up the wholly owned subsidiary structure to incentivise foreign banks

Background and the Indian context

The lessons learned during the global financial crisis prompted RBI to introduce a subsidiary structure for foreign banks operating in India. Although the direct impact of the crisis was limited in the Indian markets due to the low presence of foreign banks then and the prudential policies put in place by RBI, the economy did witness a change in the external environment. Foreign banks operating in India reduced their long term lending and shifted to short-term exposures. While Indian banks have traditionally relied on domestic deposits as their source of funds, foreign banks have relied on funds from their head office, which was curtailed to an extent following the crisis.

For foreign banks, the contraction in deposits/borrowings received from overseas banks/FIs was INR 254 billion between September 2008 and June 2009. Foreign banks' liabilities, including funding from head offices, had declined by 27.5% by the end of March 2009 before declining even steeply to 42.0% by the end of June 2009. As a consequence, advances by foreign banks contracted by INR 261 billion between September 2008 and June 2009 (14%).

In contrast to the above, loans by public sector banks (accounting for 75% of commercial bank advances) increased by INR 2,347 billion, contributing to a growth of INR 2,085 billion (11% annualised) in commercial bank advances during the same period.

Given the constraints in obtaining funding from their head offices, foreign banks' ability to raise capital and borrowings was curtailed and India witnessed a global flight to liquidity and risk aversion. In contrast to domestic banks, some foreign banks also resorted to measures such as reduction in headcount and rationalisation and/or reduction of their expenses base.

Given these events, RBI felt it important to implement a framework for a more stringent regulation and supervision of foreign banks operating in India to protect the interest of domestic depositors. The wholly owned subsidiary structure provided greater regulatory autonomy to RBI besides providing a clear delineation of assets and liabilities and ring-fencing of capital. BIS Papers - Impact of the international banking crisis on the Indian financial system

Practices in advanced jurisdictions

United States of America

All foreign banks in the United States with USD 50 billion or more in US non-branch assets need to establish an Intermediate Holding Company (IHC). The IHC must hold the bank's US Bank Holding Company, bank subsidiaries and substantially all other US non-bank subsidiaries.

Further, rules have been enacted in the US wherein home countries depositors or creditors are senior claimants over depositors from branches located overseas during bankruptcy proceedings. This is also the case in Australia. During liquidation of a foreign bank's branch, US authorities can collect all the assets of the foreign bank in their jurisdiction, even when those assets do not belong to the branch; hence, more assets will be available to reimburse the claimants of an ailing foreign bank's branch.

Canada

In Canada, foreign banks must incorporate a bank subsidiary under the Bank Act or establish a bank branch under the Bank Act.

However, such full-service branches and lending branches cannot be member institutions of the Canada Deposit Insurance Corporation.

Australia

Foreign banks may undertake banking business in Australia through locally incorporated subsidiary and/or an authorised branch. However, a branch may not accept 'retail' deposits. Hence, a foreign bank wishing to accept deposits must seek authorisation as a locally incorporated subsidiary for that purpose.

Assessing the challenges under the WOS structure

RBI formalised the wholly owned subsidiary structure scheme in November 2013. However since then, there have been only two banks that have opted for the WOS route. WOS structure eliminates certain advantages applicable under the branch presence model.

Some of the advantages include:

Lower capital requirements	**Operational flex-ibility under the branch model**	**Increased lending capacity as lending limits are determined based on the parent bank's capital**	**Reduced corporate governance requirements such as setting up of local board and senior management**	**Lesser legal complexities as the branch is an extension of the parent bank**

There is also a hesitance in investing in a WOS structure given the financial inclusion plans of RBI. Foreign banks' objectives often do not work in tandem with RBI's financial inclusion agenda, given their expertise if focused on specialised functions such as private banking and wealth management, investment banking, etc.

Increase in rural branches over the years

Rural branches	Mar-21	Mar-20	Mar-19	Mar-18	Mar-17	Mar-16	Mar-15	Mar-14	Mar-13	Mar-12	Mar-11
Public sector banks	-0.17%	0.24%	-1.24%	0.32%	2.40%	3.99%	7.98%	13.92%	8.15%	8.13%	5.21%
Private sector banks	2.58%	5.73%	10.83%	6.23%	9.43%	36.99%	14.80%	63.24%	53.56%	19.19%	10.45%
Foreign banks	747%*	25%	50%	0%	60%	0%	25%	0%	33%	0%	

*** Merger of Laxmi Vilas Bank with DBS Bank**
Source – RBI Offsite Returns and Database on Indian Economy

Conceding to RBI's financial inclusion agenda may require foreign banks to invest in developing the expertise to understand India's rural unbanked population as well as superior risk management systems to manage the NPAs that the rural sector is generally prone to. Setting up a WOS structure comes with its own costs and lack of expertise in understanding the retail banking structure in India will impact profitability.

Promoting an environment of financial stability

The IL&FS crisis created a chain of events that resulted into a full-blown liquidity crisis, which impacted the loan servicing ability of some NBFCs and Corporates. This resulted in exposure write offs for foreign banks despite strong credit quality ratings for the corporations at the time of granting loans. During challenging times, this does not bode well with global Banks, who find it more sensible to cut exposure on markets where they see a lot of potential financial instability.

The regulator needs to take steps to instill confidence amongst potential foreign banks willing to set up operations in India by curbing the domino effect of one such crisis by tightening the norms around end use monitoring of funds.

Easing licensing requirements and reducing longer gestation periods

To avoid the administrative hassles and potential foreign banks needing to connect with 'license consultants', the RBI could define the licensing requirements in adequate detail for foreign banks intending to set up operations in India. It could be a time bound watertight process with minimum ambiguity to lure foreign banks to set up operations in India.

The ease of doing business needs to be looked at. The on-tap licensing norms can be amended to include timelines and requirements for foreign banks as well. Fixed timelines with caveats only for exigencies need to be defined for approval of licenses for banking operations in India.

Differentiated licensing structure for foreign banks

Foreign banks usually have a business model that caters to niche segments. Foreign banks usually focus on segments such as wealth management and private banking, investment banking, trade finance and corporate lending. When foreign banks look at setting up business in India, they would need to realign their business models to cater to RBI's financial inclusion agenda.

Given RBI's strong focus on financial inclusion and banking for the masses, allowing foreign banks to provide niche banking services will be a path away from carrying banking to the masses. This may not result in providing a level playing field for foreign banks as they are quite often not able to focus well on their core competencies to increase profitability.

The Indian banks traditionally have a business model best suited to cater to the retail banking segment. Hence, stipulating similar capital requirements for foreign banks at par with Indian banks without considering the business model often results in a competitive disadvantage for foreign banks.

The RBI may look at adopting a differentiated licensing structure in India. The structure shall ensure that foreign banks can continue to focus on niche areas and harness their core competencies in a better manner. The capital requirements applicable to foreign banks under the WOS structure may be reduced under the differentiated licensing structure.

Rationalising timelines and basis for decision making with respect to foreign bank licensing

The Prudential Regulatory Authority and the Financial Conduct Authority who must make their decision within six months of receipt of the completed application but can deem an application incomplete and require further information, which defers the start of the six-month period. In practice, the licensing process may take up to a year to complete. In India, no such timelines for decision making have been defined.

Generally, RBI has been cautious about giving financial licenses. Banking licenses in the private sector were last given in 2003, later in 2014, and recently in 2019. Licenses for foreign banks are considerably harder to come by because of the intricacies in question. Aside from administrative issues, licenses to foreign banks are given based on relations between India and the nation of origin of the foreign bank, and equal arrangements between the banking controllers of the two nations. This resulted in a wide delay between applying for and in the end getting the license. Meanwhile, the expense of setting up and operating a bank in India is likely to go up generously and may require a revision of the marketable strategy.

Easing the minimum capital requirement and CRAR norms

RBI in its 'Roadmap for presence of foreign banks in India' released in February 2005, had first stipulated a minimum capital requirement of INR 300 crore for the wholly owned subsidiaries of foreign banks. This was in line with the entry level capital requirements prescribed for new banks in the private sector.

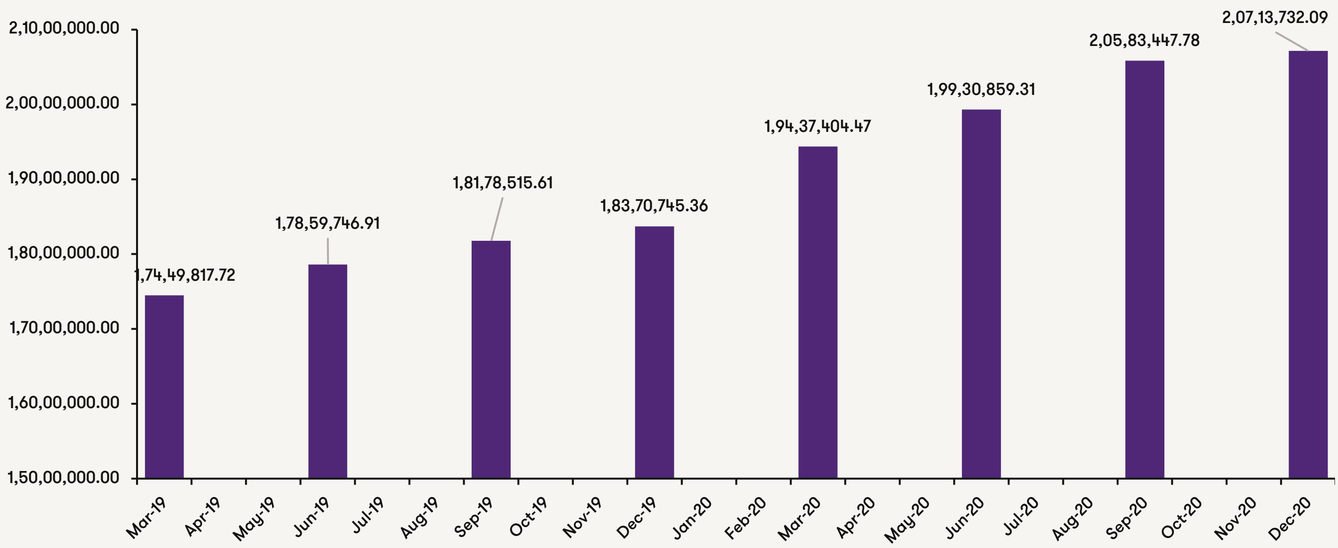
Harmonisation with capital requirements for private sector banks

When RBI had released the guidelines for licensing of new banks in the private sector in 1993, the minimum capital prescribed was INR 100 crore which was increased to INR 200 crore in the 2001 guidelines. The 2001 guidelines further stipulated that the minimum capital requirement of INR 200 crore was to be gradually increased to INR 300 crore over three years from the commencement of business. The guidelines were further amended in February 2013 and the minimum capital requirement was raised to INR 500 crore.

In order to establish harmonisation of capital requirements across private sector banks and foreign banks operating in India through the WOS structure, RBI stipulated a minimum capital requirement of INR 500 crore when the Framework for setting up of Wholly Owned Subsidiaries by Foreign Banks in India was released in November 2013.

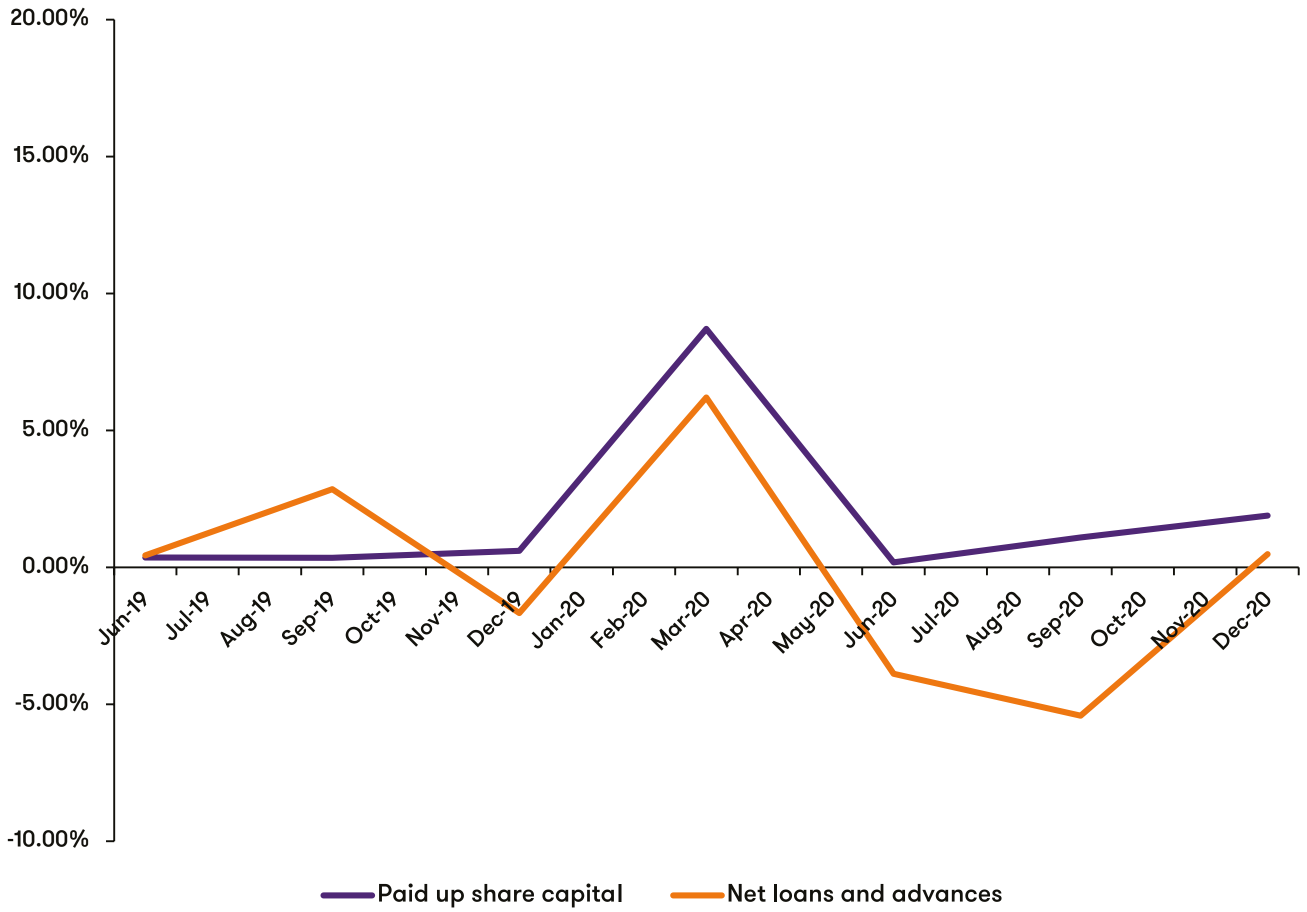
The total paid-up share capital of the 45 foreign banks in operation as on December 2020 amounted to INR 88,545 crore. This includes capital of foreign banks who have been incorporated in India under the WOS structure

Increase in the paid up capital and reserves of foreign banks (INR)



Considering the huge capital requirements applicable to the WOS structure of foreign banks, it often comes across as a detriment for foreign banks to convert to the WOS structure from the branch mode of presence. However, it is to be noted that out of the 45 foreign banks in operation as at the end of December 2020, a total of 27 banks operating through the branch mode of presence had paid up share capital in excess of INR 500 crore.

Increase in paid up share capital vis-à-vis net loans and advances



While foreign banks have increased their capital base over the years, the increase in the size of their loan portfolio has not been proportionate to the increase in their capital base. This is mainly due to the niche markets that foreign banks cater to. Over the years, foreign banks such as Barclays Bank, HSBC Bank, Citibank, UBS AG, Morgan Stanley have curtailed banking operations in India to reposition capital resources to more profitable businesses and geographies.

Hence it is important to incentivise the subsidiary form of presence of foreign banks through lower capital requirements. The RBI can consider a framework for step-wise capital infusion in line with the business needs and expansion plans of the WOS considering the economic environment in order to allow foreign banks to sustain and grow in India.

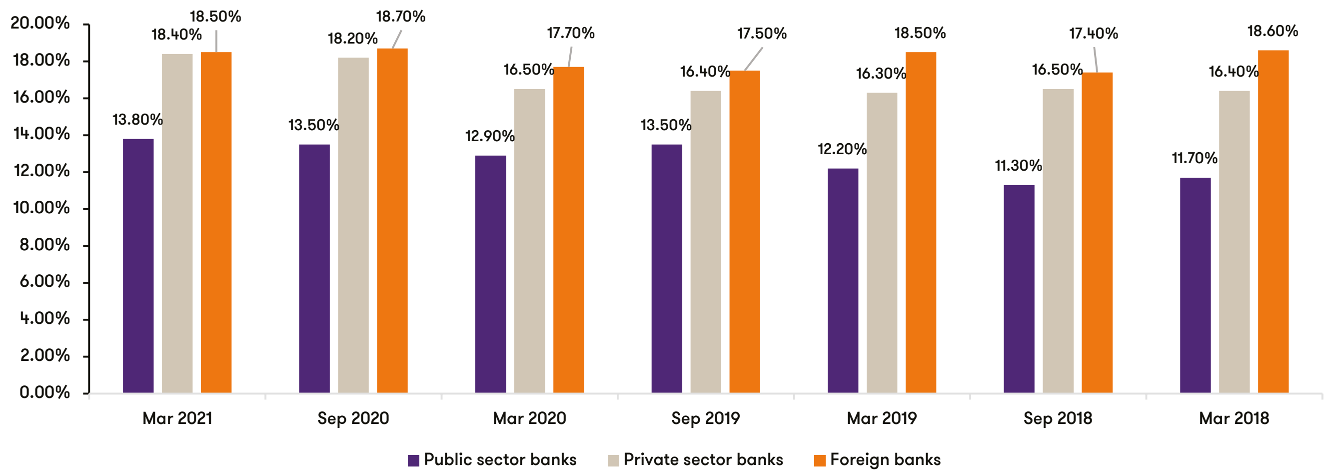
The BASEL III Capital Regulations stipulate the below capital adequacy requirements for banks operating in India

Regulatory capital	As a % of RWA
Minimum Common Equity Tier 1 Ratio	5.50%
Capital Conservation Buffer (comprised of Common Equity)	2.50%
Minimum Common Equity Tier 1 Ratio plus Capital Conservation Buffer	8.00%
Additional Tier 1 Capital	1.50%
Minimum Tier 1 Capital Ratio	7.00%
Tier 2 Capital	2.00%
Minimum Total Capital Ratio	9.00%
Minimum Total Capital Ratio plus Capital Conservation Buffer	11.50%

Currently, the Capital to Risk Weighted Asset Ratio (CRAR) for commercial banks in India is at 9% as per the RBI norms. Further, as banking companies in India keep their CRAR level well above the required level, a large amount of foreign bank capital is already trapped in keeping a high CRAR level.

The CRAR to be maintained by foreign banks setting up wholly owned subsidiaries in India is 10% for the first three years, which is 1% more than the requirement for other banks operating in India.

Capital to risk-weighted assets



Foreign banks are known to have the highest capital to risk weighted assets ratio vis-à-vis private and public sector banks in India. The CRAR is well above the applicable regulatory requirements.

Further, the Basel III Capital Regulations by RBI stipulate that foreign banks can include remittable surplus held in Indian books and capital reserves representing surplus from the sale of assets in India provided both of these are held in a separate account and are not eligible for repatriation. Foreign banks also additionally need to provide an undertaking to RBI to this effect for inclusion of these aspects under CET 1. While these requirements have been stipulated by RBI with a view to protect interests of domestic depositors and ensure adequacy of capital in the event of default of the foreign bank, they may need to be relooked at to ensure a level playing field and incentivise foreign banks.

Foreign banks usually have a business model that caters to niche segments. Foreign banks usually focus on segments such as wealth management and private banking, investment banking, trade finance and corporate lending. When foreign banks look at setting up business in India, they would need to realign their business models to cater to RBI's financial inclusion agenda.

Given RBI's strong focus on financial inclusion and banking for the masses, allowing foreign banks to provide niche banking services shall be a path away from carrying banking to the masses. This may not result in providing a level playing field for foreign banks as they are quite often not able to focus well on their core competencies to increase profitability. The Indian banks traditionally have a business model best suited to cater to the retail banking segment. Hence, stipulating similar capital requirements for foreign banks at par with Indian banks without considering the business model often results in a competitive disadvantage for foreign banks.

The RBI may look at adopting a differentiated licensing structure in India. The structure shall ensure that foreign banks can continue to focus on niche areas and harness their core competencies in a better manner. The capital requirements applicable to foreign banks under the WOS structure may be reduced under the differentiated licensing structure.

Rationalising the large exposures framework (LEF)

The Indian branches of foreign banks provide liquidity in non-INR products like G10 IRS, G10 Cross currency/basis swaps, FCYINR (Non USDINR) FX Swaps/Forwards, FCYFCY FX Swaps/Forwards, FCY Options. For this purpose, such Indian branches execute back-to-back derivative transactions with their head office and/or offshore branches (inter-branch derivative transactions) to hedge such exposure.

Applicability of LEF, with effect from 1 April 2021, has limited the ability of foreign banks' Indian branches to execute back-to-back inter-branch derivative transactions, and consequently, will result in lower liquidity and wider prices in non-INR and INR products, resulting in higher hedging costs. The issue has intensified due to the lack of availability of Credit Risk Mitigation (CRM) tools and increased hurdle rate required to accommodate derivative exposures over other products within the LEF limits. We anticipate that the bid - offer can widen by two to three times of the current spreads for many of these products. Banks generally require clients to pre-fund their FCY obligations in advance, to reduce intra-day credit risk or settlement risk on clients. Such FCY amounts lying in the nostro accounts of the Indian branches (of foreign banks), consume available LEF limit on overseas parent and or branches. Doing away with such pre-funding requirements by clients, increases the credit risk run by the banking system, instead of reducing the same.

The RBI shall look at exempting derivatives exposures from large exposure framework as has been done by some other regulators or alternatively consider the following:

01 To postpone the implementation till enabling regulations like exchange of variation margin, Standardised Approach – Counterparty Credit Risk (SA-CCR) regulations, etc., are in place

02 Separate LEF limit for Inter-branch derivative transactions and have a different limit

03 Grandfather existing derivative transactions from the application of LEF, otherwise it will have retrospective regulatory effects

04 Allow the principle of local regulatory capital to apply to Credit Risk mitigation tools required to solve for exposures

05 Permit maintenance of CRR in foreign currency that will help alleviate the current problem that banks have in managing nostros that have LEF implications

06 Notify the Standardised Approach – Counterparty Credit Risk (SA-CCR) regulations to mitigate the impact of Potential Future Exposure (PFE)

Easing tax burden on foreign banks

The RBI allows foreign banks to operate through branches as well as by setting up wholly owned subsidiaries. This comes with a heavy taxation cost.

The taxation structure during the last financial year 2020-21 can be explained as follows:

Income range	Corporate tax rate			
	For domestic companies (%)		For foreign companies (%)	
	Basic rate*	Effective rate	Basic rate	Effective rate
Less than INR 10 million	22	25.17	40	41.60
More than INR 10 million but less than INR 100 million	22	25.17	40	42.43
More than INR 100 million	22	25.17	40	43.68

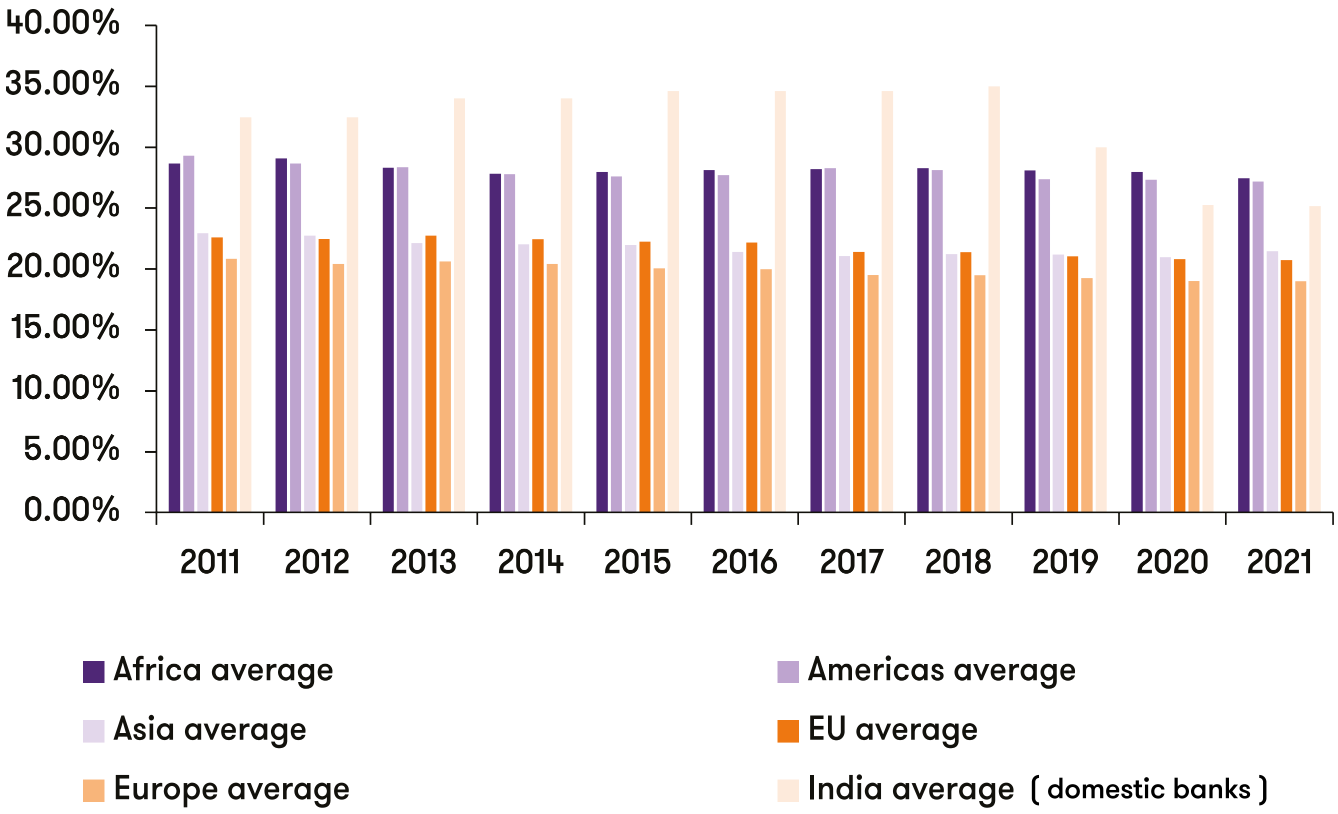
* Tax rate applicable to Indian company opting for special tax regime under the Income-tax Act

Foreign banks now pay tax at a rate ranging between 41% and 44%, depending on their net income earned during the year as against 25.17% paid by Indian banks.

The above disparity poses a major challenge to foreign banks, whose earnings after tax for the same amount of revenue is much lower than that of their Indian peers due to the differential corporate tax rates, albeit without considering the taxability of dividend income in the hands of recipient shareholder of an Indian bank.

A quick look at the taxation rates prevailing across the globe highlights the high amount of taxes that foreign banks have been subject to in India:

Corporate taxation rates



Now that the effective tax rate of Indian banks is 25.17%, having approximately 44% tax rate for the Indian branch of a foreign bank may be looked at as unfair and will push them out of an extremely competitive financial services market in India, with lower post-tax earnings to re-invest in business.

The government can look at rationalising the tax structure for foreign companies, on account of which Indian branch of a foreign bank can expect lesser tax burden on the Indian operations.

Rationalising the tax structure is an important measure to ensure fair and equitable treatment and creating a level playing field for foreign banks, where all other requirements such as prudential norms, capital adequacy norms and other regulatory/supervisory norms are in line with banks incorporated in India.

05

Easing norms for data localisation

Understanding the framework for storage of payment system data

The RBI by way of its first bi-monthly Monetary Policy Statement for 2018-19 dated 5 April 2018 and subsequent notification on Storage of Payment System Data dated 6 April 2018 put in place a regulatory framework to ensure that RBI, as part of its supervisory objectives, has unfettered access to data stored with payment system providers and other related entities in the value chain.

The guideline was also made applicable to banks in addition to payment system operators given the role banks play as participants in payments systems operated by RBI namely, RTGS and NEFT as well as systems operated by CCIL and NPCI and other cards schemes. The framework stipulated that all system providers ensure that the entire data relating to payment systems operated by them are stored in a system only in India, including data comprising of full end-to-end transaction details/information collected/carried/processed as part of the message/payment instruction. Only the foreign leg of the transaction, if any could be stored in a foreign country if need be.

The guideline also required system providers to also submit a System Audit Report (SAR) on completion of the requirement by a CERT-In empaneled auditor which should inter-alia, include aspects around data storage, maintenance of database, data backup restoration, data security, etc.

Outlining the challenges faced by the foreign banks

- The challenge has been that the SAR has not been submitted by certain system providers, including foreign banks, given the fact that the report requires a certification that the data that has been sent or stored overseas has been deleted. The RBI has been stringent in ensuring compliance with these guidelines and the recent regulatory actions barring American Express Bank and Diners Club from onboarding new customers citing violation of data storage norms are steps in this direction.
- Additionally, banks and other payment system providers have identified additional costs that they will need to incur to set up the local infrastructure for storage of payments data in India which results in potential reduction in associated revenue costs benefits. Foreign banks have perpetually resorted to sharing of technology architecture as a cost-efficient manner of operation. Foreign banks operating in India usually have data centres or servers stored in jurisdictions such as Singapore or Hong Kong to derive benefits from cost reductions and centralised data management.
- Regulators globally have increasingly started resorting to digital surveillance as an effective mode of supervision, especially in times of a global pandemic situation. It is important for the RBI to consider the fact that foreign banks will need to comply with local regulatory requirements of the country of incorporation and such regulators, like the RBI, may also require banks to provide them with access to data stored in India.

Considering the challenges and representations made by banks in this regard, RBI issued clarifications stating the following:

- Local data may be shared with overseas regulators, if so required, depending upon the nature/origin of transaction with due approval of RBI.
- In the case of banks, especially foreign banks, earlier specifically permitted to store the banking data abroad, they may continue to do so; however, in respect of domestic payment transactions, the data shall be stored only in India.

Evaluating practices followed in other advanced economies

In order to assess the practices followed by economies across the globe and corresponding regulations introduced by their regulatory and/or statutory authorities, it is important to understand the form in which data localisation norms have been prescribed:

1 Mandating the storage of data strictly within local borders

Governments have imposed restrictions mandating the storage, transmission and processing of data within servers or data centres exclusive to national borders only. Such restrictions may be imposed to all categories of data generated within the national territory or specific categories of data which may include data in relation to financial services.

- The law in Russia requires storage, transmission and processing of personal data of Russian citizens.
- The People's Bank of China issued Personal Financial Information Protection Technical Specification (the PFI Specification) in February 2020 by means of which personal financial information collected or generated in mainland China is stored, processed and analysed within the territory. However cross border transfers are permitted provided explicit consent is obtained from data subjects, a security assessment is conducted, and the relevant financial institution supervises the offshore recipient to ensure responsible processing, storage and deletion of PFI.
- Turkey, under the data protection laws, requires banks and payment system operators to have their information systems within the national territory.
- RBI's framework on storage of payment system data is on similar lines as the above. A similar stringent data localisation norm is underway in Indonesia wherein strategic electronic data is being proposed to be processed, transmitted and stored in onshore data centres only with prohibitions on cross border transfers.

2 Mandating the storage of a local copy of the data

Under this category of data localisation norms, institutions are mandated to retain a local copy of data in servers and data centres within the national territory, without prohibiting the transmission and processing of data outside of national borders. However, any change in the data shall necessarily be replicated in the copy of the data stored locally.

The Personal Data Protection Bill proposed for implementation in India provides for storing, on a server or data centre located in India, at least one serving copy of personal data, while stipulating more stringent norms for critical personal data. Further, the bill also stipulates certain conditions under which cross border transfer of data may be permitted, including but not limited to, conditions such as obtaining explicit consent and permitting transfers for standard contractual clauses.

3 Applying conditional restrictions to the flow of data

Under this category of cross border transfers, the same are permitted only upon meeting certain conditions, including requirements around seeking approvals, stricter legal framework and ensuring data security.

Certain advanced economies such as the EU, through its General Data Protection Regulation (GDPR), as well as economies such as Brazil and Argentina have similar laws when it comes to cross border data transfers.

It is important to consider that local borders around storage of data may defeat the purpose of cross border transactions. Further, if a similar view is adopted by regulators around the globe, the regulator in India may have potential supervisory challenges with respect to Indian banks with overseas operations. Hence, the regulation needs to be approached with an element of balance and reciprocity.

The regulation by RBI also invited caution from the United States India Business Council cautioning that policies restricting the flow of data can act as barriers to expansion of services in India, impacting consumers as well as the growth of payments market in India.

A collaborative environment in this regard is essential to ensure advancement of the payments ecosystem in India through global technologies and providing an enabling environment to achieve this.

1 Adopting a collaborative approach and discussions at the G20 forums

Challenges with respect to data security and privacy, which are the basis for implementing stricter data localisation norms, are prevalent across jurisdictions. However, in a global economic setup, a free flow of data across borders is necessary to promote global trade and commerce. The banking industry is an important participant in global trade and is impacted by strict data localisation norms, varying across jurisdictions.

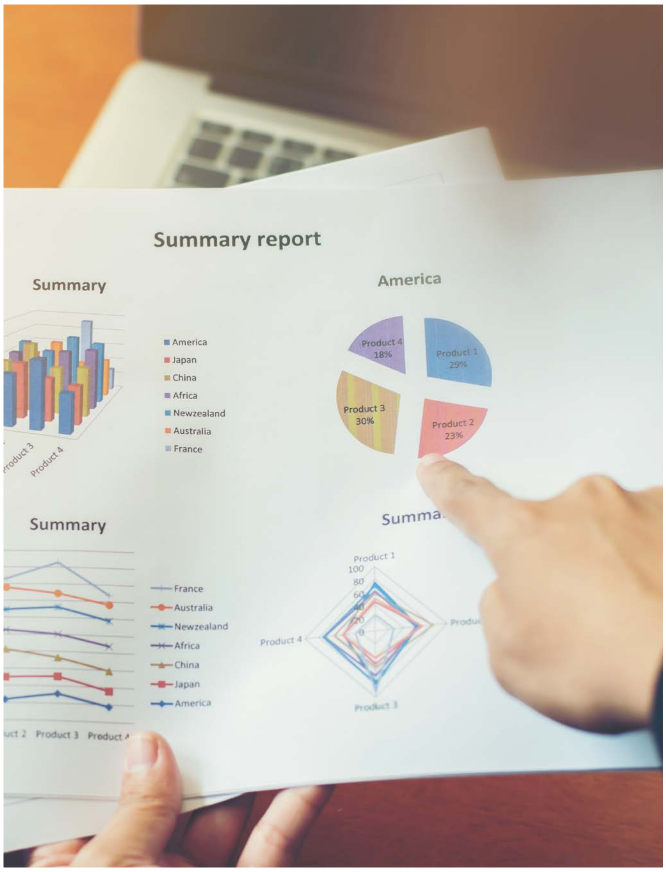
Given the above, discussions are necessary at global forums such as the G20 summit to ensure member nations put in place a framework to ensure free flow of data with an element of data security and privacy, as well as providing supervisory access to regulators when required.

2 Adopting global cross border arrangements

In order to ensure a collaborative approach towards cross border data transfers, it is essential to standardise data localisation norms across jurisdictions. However, given the economic set-up and privacy concerns that each jurisdiction may have, it will be difficult to operationalise a global law that can be made universally applicable. Hence, it is important to put in place global governance arrangements on cross border data transfers that provide for interoperability arrangements. Such arrangements can be taken up for discussion by the government at the appropriate forums.

3 Global forum for financial services regulators

The financial services sector is impacted by data localisation norms to a great extent. It is important for global regulators to come together to discuss specific challenges, regulatory and supervisory objectives, framework prevalent within the local borders and design a mechanism to implement cross border governance arrangements in a manner that is effective and helps in fulfilling supervisory objectives. The government will need to promote such proposals at relevant global forums.



06

Providing KYC portability for opening non-resident accounts

Understanding the framework

In order to assess the practices followed by economies across the globe and corresponding regulations introduced by their regulatory and/or statutory authorities, it is important to understand the form in which data localisation norms have been prescribed:

Given the pandemic and restrictions on movement of individuals, the RBI in May 2021 introduced an amendment to the Master Direction - Know Your Customer (KYC) Direction, 2016. The amendment introduced a framework for Video-based Customer Identification Process (V-CIP).

The V-CIP is an alternative method of customer identification with facial recognition and customer due diligence by an authorised official of the regulated entity by undertaking seamless, secure, live, informed-consent based audio-visual interaction with the customer to obtain identification information required for CDD purpose, and to ascertain the veracity of the information furnished by the customer through independent verification and maintaining audit trail of the process.

The V-CIP framework by RBI stipulates that the video recordings should contain the live GPS co-ordinates (geo-tagging) of the customer undertaking the V-CIP and date-time stamp. The V-CIP infrastructure/application should be capable of preventing connection from IP addresses outside India or from spoofed IP addresses.

A similar framework has also been stipulated by the Securities and Exchange Board of India (SEBI). Both SEBI and RBI have mandated the capture of the customer's live location through geo-tagging, which shall necessarily be a location within India. Hence, e-KYC along with video-based customer identity verification is not permissible for non-resident Indians.

A large proportion of account-based relationships of foreign banks comprise of NRI clientele. The current KYC norms by RBI act as a deterrent to the free flow of NRI investments in India.

The RBI shall evaluate a framework for providing KYC portability for NRIs, who constitute a large proportion of foreign bank clientele and contribute to maintaining the balance of payments position. A framework for extending the V-CIP requirements to NRIs along with stipulating a KYC registration agency (KRA) and geo-tagging outside the country shall be evaluated.

Rationalisation of current account guidelines

The RBI, in August 2020, issued guidelines on opening of current accounts by banks. The broad contours of the guidelines can be summed up as under

01

No bank shall open current accounts for customers who have availed credit facilities in the form of cash credit (CC)/ overdraft (OD) from the banking system and all transactions shall be routed through the CC/OD account.

02

Where a bank's exposure to a borrower is less than 10% of the exposure of the banking system to that borrower, while credits are freely permitted, debits to the CC/ OD account can only be for credit to the CC/OD account of that borrower with a bank that has 10% or more of the exposure of the banking system to that borrower.

03

The credit balances in such accounts shall not be used as margin for availing any non-fund based credit facilities.

04

In case there is more than one bank having 10% or more of the exposure of the banking system to that borrower, the bank to which the funds are to be remitted may be decided mutually between the borrower and the banks.

05

Further, the guidelines also provide a framework for allowing banks to open current accounts in case of customers who have not availed CC/OD facility from any bank.

25 January 2000

RBI advises banks to insist on a declaration from the account-holder to the effect that he is not enjoying any credit facility with any other bank or giving particulars of credit facilities enjoyed by the intending customer with any other bank(s).

15 May 2004

RBI cautions banks against the risk of diversion and siphoning of funds and advises banks to not open current accounts for entities which enjoy credit facilities (fund based or non-fund based) from the banking system without specifically obtaining a No-Objection Certificate from the lending bank(s).

02 July 2015

RBI advised banks to leverage information available on CRILC and not limit their due diligence to seeking NOC from the bank with whom the customer is supposed to be enjoying the credit facilities as per his declaration.

Foreign banks have been providing cash management facilities to MNCs and large corporates since decades. This means providing facilities such as opening of current accounts of corporates without providing loans which effectively means with virtually very little or without an element of credit risk exposure. Corporates have preferred obtaining loans from public sector banks and domestic private sector banks and availing current account facilities from foreign banks given the service quality and incentives offered by foreign banks.

The RBI has been wary of risks in relation to diversion of funds, evergreening of loans and money laundering through the current account route. Corporates have been using current accounts as a means to divert funds. The lending accounts are subject to end use monitoring by banks but when the transactions move to current accounts of banks other than lending banks, the lending banks lose visibility on the funds. Hence, aspects such as funds diversion or even wilful default cannot be ascertained by lending banks.

However, the revision in the current account guidelines do not seem to precisely address the issue around diversion of funds. It may be noted that the root cause of diversion of funds and money laundering is weak controls around the end use of funds. The revision in the guidelines reduces the risk to an extent but do not entirely seem to mitigate the same. Further, the guidelines also seem to be stifling competition since the focus of the guidelines is now on restricting the opening of current accounts to banks who have larger relationships.

The RBI can evaluate the below when it comes to strengthening the framework to prevent funds diversion and money laundering and relook at the current account guidelines to provide a level playing field:

1. Enhance the framework for sharing of data between banks and establish strong compliances with respect to the same.
2. Enhance the governance framework for end use monitoring for lending and current accounts.
3. Evaluate a reduction in the exposure limit from 10% to a lower number.
4. Usage of SupTech and other technology tools as enablers to monitor end-use and funds diversion in place of stipulating stringent regulatory norms.

08

Other considerations to create an enabling environment for foreign banks

Potential to consider amendments to the Banking Regulation Act, 1949

The Banking Regulation Act, 1949 requires amendments as many parts of the law have become archaic. Banking has considerably evolved in recent times and the gamut of businesses undertaken by banks in India has changed. Given the evolution of the banking industry since the introduction of the Act, there have been new businesses introduced such as insurance, mutual funds, pension fund management, and such other businesses.

The ambit of services that a bank is allowed to carry out may be broadened to include a host of services that foreign banks provide in other advanced jurisdictions.

09

Potential to include foreign banks within the ambit of empanelled agency banks to undertake government business

The RBI appoints banks to function as agency banks for government business for state and central governments. The agency business includes collection of taxes and other revenue receipts under CBDT, CCBI and GST, pension disbursement, collection of stamp duty charges, amongst other services.

Initially, only public sector banks were accredited as agency banks to perform such services for the state and central government. Subsequently, three of the leading private sector banks were permitted to function as agency banks. In January 2012, the RBI vide its circular 'Government Agency Business Arrangement – Appointment of Private Sector Banks as agency banks of RBI' dated 31 January 2012 decided to consider all private sector banks as eligible to handle any central/state government business at par with public sector banks.

There was a subsequent embargo imposed in September 2012 disallowing private sector banks to function as agency banks, which was also recently lifted in February 2021.

The RBI can consider including foreign banks too as agency banks to provide similar services, given the level of customer service quality and convenience that foreign banks bring to the table.

Need for a differential risk-based premium structure for deposit insurance premium

The deposit insurance provided by the Deposit Insurance and Credit Guarantee Corporation (DICGC) covers all insured commercial banks, including local area banks, payment banks, small finance banks, regional rural banks, and cooperative banks.

The breakup of the number of registered insured banks is as follows:

Category of registered insured banks	No. of banks
Scheduled commercial banks	78
Regional rural banks	43
Local area banks	2
Payment banks	6
Small finance banks	10
Cooperative banks	1919
Total number of registered insured banks	**2058**

In order to maintain the adequate level of deposit insurance, the DICGC currently collects premium from member banks at a flat rate 12 paise per INR 100 of deposits. This does not consider the risk profile of the banks which implies that foreign banks with a more advanced risk framework and structure pay premium at a rate similar to other banks such as cooperative banks, Regional Rural Banks, Local Area Banks, etc. The flat rate structure hence seems unfair to banks with sophisticated risk management structures.

The RBI, in its annual report for 2020-21 dated August 2021, mentioned about forming an Internal Committee on Risk-based Pricing (RBP), which undertook a risk assessment of banks based on a CAMELS model and recommended the introduction of RBP. This is a step in the right direction as this will incentivise banks to take calculated risks and also do away with the unfairness associated with a flat rate pricing structure. The recommendations of the Committee are under consideration for implementation.

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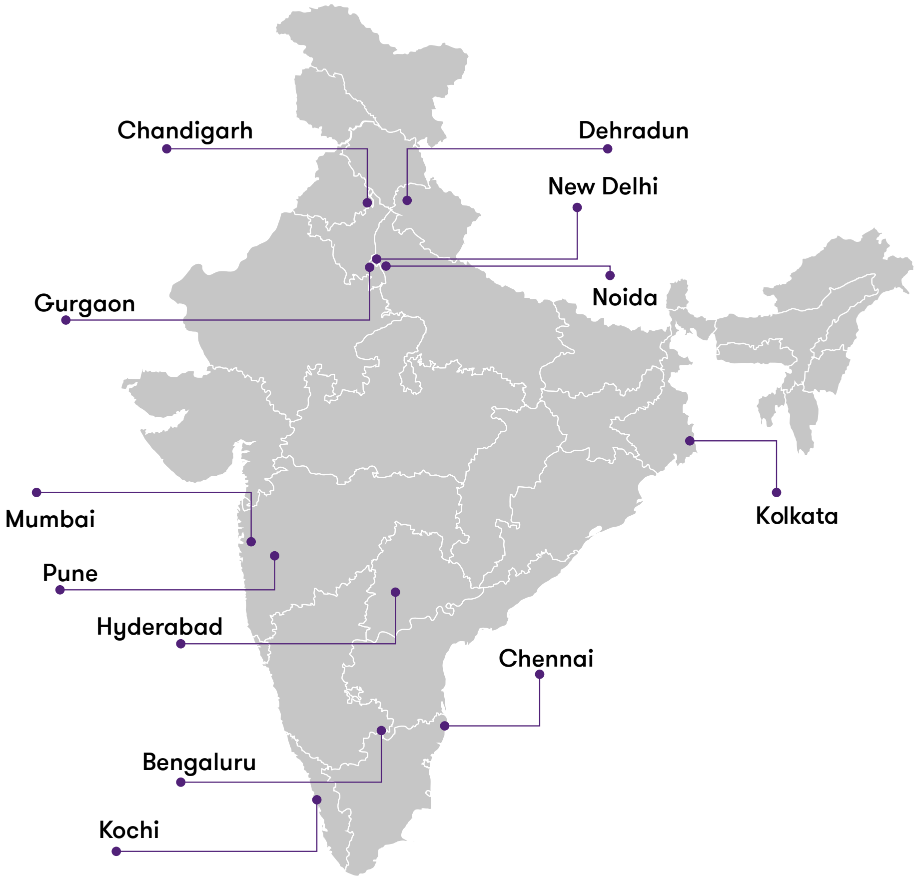

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