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Impact of Foreign Banks on the Indian Economy

Gaurav Sharda
PGP Student
Indian Institute of Management Bangalore
Bannerghatta Road, Bangalore – 560076
shardagaurav1@gmail.com

Namratha Swamy
PGP Student
Indian Institute of Management Bangalore
Bannerghatta Road, Bangalore – 560076
namratha.b.swamy@gmail.com

Charan Singh
RBI Chair Professor
Economics & Social Science
Indian Institute of Management Bangalore
Bannerghatta Road, Bangalore – 5600 76
Ph: 080-26993818
charansingh@iimb.ernet.in

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Impact of Foreign Banks on the Indian Economy[1]

Abstract

This paper examines the impact of foreign banks on Indian economy. Further, it discusses the various opinions towards the foreign bank operations in the host country, with India as the example. The paper looks at the regulatory framework in India to understand the attitude of RBI towards foreign banks. It also discusses what several foreign banks feel about the Indian regulatory setup and how these banks have adapted themselves to deal with the changes. To look at the impact of foreign banks the paper analyses various parameters like the rural presence, contribution towards priority sector, technological development and financial ratios like return on asset and equity. Two case studies have been discussed – one, about The Hong Kong and Shanghai Banking Corporation's (HSBC) journey in India and the other, about BCCI in India. The paper ends by discussing various challenges which are faced by foreign banks when they set-up their shop in the country.

Keywords: Foreign Banks, priority sector lending, HSBC, BCCI.

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Introduction

Banking sector in India dates back to 18th century with the establishment of Bank of Hindustan in 1770 followed by the General Bank of India in 1786. There were a number of Public sector banks like Bank of Bengal, Bank of Bombay which came into existence between 1800 and 1850(including State Bank of India. These banks were founded as per the charters from British East India Company. With the trade relations developing between India and various other countries there was a keen interest from banks in other countries to invest in India and grow their customer base here. The banks were following the customers in some cases while in some other banks led new customers to enter new geographies and make investments.

After 1850's the British initiated the process of setting up foreign banks in India and it was followed by banks from countries viz. France, Germany, Japan, Holland and US. Some of the oldest foreign banks that entered India were

a) HSBC (then called the Mercantile Bank of India which started in 1853)
b) Standard Chartered Bank (then called the Chartered Bank of India, Australia and China which started in 1858).

At present the Standard Chartered Bank is the largest foreign bank in terms of numbers, with 99 branches in 42 cities. As per the RBI discussion paper on presence of foreign banks in India (2011), there were 34 foreign banks operating in India as branches. Their balance sheet assets, accounted for around 7.65 percent of the total assets of the scheduled commercial banks as on March 31, 2010. If the credit equivalent of off balance sheet assets were included, the share of foreign banks was 10.52 per cent of the total assets of the scheduled commercial banks as on March 31, 2010, out of this, the share of top five foreign banks alone was 7.12 per cent.

Further sections analyse the regulatory framework that govern the foreign banks and the changes that have gone through in this regard.

This paper examines the impact that foreign banks have had on the Indian economy. The Section I begin with an introduction followed by review of literature about articles on bank regulations, establishment of foreign banks. The Section III brings out the performance of foreign banks with regard to a number of parameters like rural presence, priority sector lending. Section IV introduces the stories of two foreign banks HSBC and BCCI bank through case studies. The Section V highlights the challenges faced by foreign banks and then Section VI is a conclusion based on the analysis.

Section 2: Review of Literature

Academic Literature

Marco, Carment and Francisco [2006] analyse the performance measures of the banks (domestic/foreign) as against the performance of the country and track the changes during the financial crisis and how there was a difference between the domestic and foreign banks in this regard.

Cárdenas, Graf and Dogherty [2008] explain the implication of a foreign banks' entry to the financial system of the host country, the financial viability of a local subsidiary and the possible effects on the market dynamics.

Claessens and Horen [2012] provides a detailed database of bank ownership for several countries over 1995-2009 and reviewed their performance during this period. Schnitzer and Lehner [2006] analyse the impact of foreign bank entry on host countries particularly emphasizing on the transition period in the context of emerging markets by studying impact of foreign banks. Cull and Peria [2010] provide insight on foreign banks participation in emerging economies. According to author, the participation of foreign banks has increased, but process has not been uniform. Eastern Europe & Latin America were quick to adopt this model but Middle-east and Asia were late comers. Elimination of barriers, reduced information cost of operating in foreign markets has been the reasons for foreign banks to participate in a host country.

Hope, Laurenceson and Qin [2008] analyse the impact of foreign bank participation on Chinese banking sector by studying several Chinese commercial banks. They also discuss how the presence of foreign banks did enhance the competitive environment in China's banking sector. The results suggest that Chinese banks which have received foreign investment have not been significantly more efficient than those who have not.

Sathye [2002] studies if the presence of foreign banks in India has resulted in reduced concentration and thus increase in competition. They find that there has not been much impact on concentration of banks in the country.

Ghosh [2012] discusses how foreign banks have an impact on domestic profitability. The paper concludes that foreign banks presence improves profitability and asset quality.

Sanyal and Shankar [2008] talk about the productivity differences that existed pre and post 1991 reforms and results shows that the productivity gap between Indian private banks, public and foreign banks has dramatically increased due to faster productivity growth by Indian private banks.

According to Charvaka [1993], phenomenal profits by foreign banks is not due to highly efficient banking operations, but on account of treasury operations, portfolio management and lending in the money market, non-deposit resources mobilized essentially from other banks, financial institutions and public sector undertakings. Policy has favored foreign banks, in terms of limited social obligation and in contrast, Indian banks have a disadvantageous position in several aspects including social responsibilities, rural banking, priority sector lending, etc. They also face losses from small and big borrowers.

According to research emerging from the RBI, two aspects are highlighted. First, there are opinions in favor of foreign banks by extending support and concerns were expressed over the presence of the same in the country. An observed trend is that with the growth of foreign banks, smaller banks will find it difficult to compete and contribute [Leeladhar 2007]. Many of the foreign banks in India work mainly in high end sectors and have paid less attention to the "Priority sectors". Annex Tables 1-4 show that setting up of ATMs, branches in rural area by foreign banks have been less as compared to Indian Banks. However, others find that foreign banks bring in operational efficiencies in the field of technology, risk management, customer service, investment banking, etc. [Dinesh U, Rebello J 2012].

Regarding the attitude of RBI towards foreign banks there have been a number of views expressed. Despite the promotion of foreign banks in India, there have been concerns in RBI regarding the increasing footprint of foreign banks in the country [Mohan 2009]. Most of the foreign banks in India have confined their work to the areas of Investment Banking and foreign exchange Market [Mohan 2006] and have not paid much attention to the other "*priority sector*" in the country. This results in a small presence in the country which could result in the top management of the bank paying little attention to the operations. Hence any transgression committed by these banks which can have significant impact on the financial market of the host country but have a little effect on the overall global operations of the bank. Sometimes, even strong regulatory action taken by regulators against such global banks has had negligible market impact on them and hence there is loss of regulatory effectiveness as a result of the presence of big financial conglomerates.

Proponents who have been against the increasing footprints of foreign banks have pointed the fact that the direct effect of the global financial crisis on the Indian financial system was almost negligible owing mainly to the limited exposure to riskier assets and derivatives. The impact on domestic economy was also very less due to the relatively low presence of foreign banks[Thorat 2009].Foreign banks do come with certain good aspects like better operational efficiencies, superior customer service and technology, expertise in areas like Investment banking [Chakrabarty 2012].

Reports

In order to allay the concerns as well as take fullest advantage of foreign banks, RBI has set-up a regulatory framework based on recommendation given by several committees mentioned below. 4 main milestones can be identified with regard to regulatory policy changes as applicable to foreign banks. This is explained in detail below:

Narasimham Committee report *of 1991* recommended a structural reorganization of the Banking system in India to improve the efficiency of operations of banks here. There was a clear push for the foreign banks as they indicated an improvement in efficiency. Foreign banks were allowed to open branches in India as fully owned or as subsidiaries. They were also permitted to enter into joint ventures with private banks for merchant banking or investment banking. Also according to the committee report of 1998 the foreign banks seeking to set up business in India need to have a minimum start-up capital of $25 million as against the existing requirement of $10 million. The committee also provided for subsidiaries and Joint Ventures (JVs) to be treated at the same level as private banks [Narasimham Committee 1998]

In 2005 RBI proposed the twin track approach for stabilizing and making the banking sector more efficient. Under this there were 2 models of entry available which were the branch presence model and the other WOS (Wholly owned subsidiary) model. The details regarding each of these forms of presence is explained in Table 5 of Annex. The roadmap was implemented in 2 phases: *The first phase (March 2005 – March 2009)* - there was more focus on consolidation of domestic banking system. During this phase foreign banks were allowed to enter India through establishment of branches or WOS or converting their existing branches into WOS, the clear trend was establishing branches. The second phase began after reviewing the first phase (April 2009 onwards) and after the review there was keen interest on WOS model going ahead. Another roadmap for implementation was released in 2011 which again did not make WOS mandatory because of the WTO commitment. RBI expected that banks would switch to the WOS model once their assets exceeded the threshold of 0.25 percent of all holdings.

The proposed framework specified conditions as to when a foreign bank is allowed to only setup a WOS model and also suggests that it is mandatory to convert into a WOS model from branch form as and when any of these conditions come true. Some of the conditions that were mentioned in the report included adequate level of disclosures, the required level of supervision and others. A comparison of the policies regarding branches in other countries like USA, Canada and Australia is shown in Table 6 of Annex.

The discussion paper released by the RBI in 2011 also covered points such as: The recent global financial crisis highlighted that (i) complex structures (ii) too big to fail (TBTF) and (iii) too connected to fail (TCTF) exacerbated the crisis. And that the post-crisis lessons support domestic incorporation of foreign banks i.e. subsidiarisation. Setting up subsidiaries supports in ring fencing capital within the country. The local incorporation requirement for foreign banks is imposed by several jurisdictions, primarily in order to protect retail depositors and to limit operations of the systemically important banks. Branches are generally not allowed to take retail deposits or enjoy deposit insurance: On this aspect, the paper indicated the position in some countries (Please refer to Annex). The discussion paper weighed the benefits and drawbacks of the branch form of presence in comparison with the subsidiary form of foreign banks and indicated that the positives in the WOS form prevail over the weaknesses.

Following the ***RBI discussion paper*** being made open to comments in 2011, there were many comments/responses from many financial institutions across the world regarding the new framework. Though a few banking experts were of the opinion that the RBI's policy has been very liberal [Parekh and Venkatesh, 2011] in terms of the timelines allowed for changing into WOS or propagating the WOS form of presence there is another faction led by some of the biggest foreign banks of the country which are of an opposing viewpoint. According to Standard Chartered Asia CEO there are not enough incentives for the banks to go for the WOS form of presence. The tax structure, absence of national treatment all act as hindrance to the adherent to policy of RBI. According to audit experts the tax structure [Dinesh U, Rebello J 2012] is not clearly defined on conversion from branch to WOS form i.e. when they are looking for local incorporation. The BBA (British Bankers' association) discussion paper is an elaborate response to the roadmap of RBI and looks at each of the important step taken by RBI [Ashvin 2010].

The next leg of recommendations came through ***the Nair committee*** setup in 2011 to re-examine the classification that existed in priority lending sector and suggest revised guidelines with respect to these issues. The recommendations made were applicable to both domestic and foreign banks. The major changes that were done with regard to Foreign banks regulations was that the priority sector target was increased to 40 percent of ANBC (Adjusted Net Bank credit) or CEOBE (Credit equivalent of off Balance sheet exposure) whichever is greater. There was also a sub-target of 15 percent for exports and 15 percent for MSE sector. The committee also brought up the idea of non-tradable priority sector lending certificates (PSLCs) with foreign banks as well. According to the recommendations all foreign banks which have more than 20 branches will come under this condition and be required to satisfy a minimum priority sector lending of 40 percent as compared to 32 percent for other foreign banks. This served both as an incentive and a disincentive. Looking at it from RBI perspective this is more of involvement of foreign banks in true growth story of India. For banks with a large number of branches like Standard Chartered (99 branches) this regulation will not have much of an impact. But for banks with branches slightly above 20 this might be a big disadvantage. HSBC with 51 branches was one of them who faced this problem. Foreign banks are of the opinion that getting into the higher priority sector lending requirement bracket makes sense if they are given the license and required permissions to expand up to a large number like 100. Else it only ends up putting extra requirement on the banks without giving them the benefits of economies of scale.

RBI's Annual Policy Statement for 2010-11 brought out a realization that as international agreement on cross-border resolution mechanism for internationally active banks was not likely to be reached in the near future, there was considerable merit in subsidiarisation of significant cross-border presence. And that this would not only ease the resolution process, but would also give a greater regulatory control and comfort to the host jurisdictions.

According to the latest norms released by the RBI, those foreign banks which have become "systematically important" (whose assets account for at least 0.25 percent of the total assets of all commercial banks) will have to convert to wholly owned subsidiaries of their parent. Those foreign banks which set up wholly owned subsidiaries (WOS) in India will be given "near national bank" treatment in India. This will allow them to open up new branches which will give them a level playing field vis-à-vis their Indian counterpart. This will also allow them to expand their branch network without seeking prior approval of the RBI (except in sensitive locations from the perspective of national security). As per the release of the framework for setting up of WOS by foreign banks in India, by the RBI, the policy is guided by two cardinal principles of (i) reciprocity and (ii) single mode of presence (the proposed framework in the discussion paper of 2011 had indicated that these principles should guide the framework of the future policy regarding presence of foreign banks in India). The policy incentivizes the existing foreign bank branches which operate within the framework of India's commitment to the WTO to convert into WOS due to the attractiveness of near national treatment. Such a conversion is also desirable from the financial stability point of view [RBI, 2013].

According to the scheme for setting up of WOS by foreign banks in India, WOSs may also be permitted, to enter into mergers and acquisition transactions with any private sector bank in India subject to the overall foreign investment limit of 74 per cent. This would be considered after a review regarding the extent of penetration of foreign investment in Indian banks and functioning of the foreign banks (branch mode and WOS). The WOSs of the foreign banks may, at their option dilute their stake to 74 per cent or less in accordance with the extant FDI policy on foreign investment in banking sector and list on stock exchanges in India. Key features of the framework (Press release, RBI 2013):

- Banks which would be mandated entry into India only in the WOS mode: Banks with complex structures, banks which are not widely held, banks which do not provide adequate disclosure in their home jurisdiction, banks from jurisdictions having legislation giving a preferential claim to depositors of home country in winding up proceedings, etc.
- In the case of foreign banks for which the above conditions are not applicable, can opt for a branch or WOS form of presence
- A foreign bank opting for branch form of presence shall convert into a WOS as and when the above conditions become applicable to it or it becomes systemically important on account of its balance sheet size in India
- Foreign banks which commenced banking business in India before August 2010 shall have the option to continue their banking business through the branch mode. However, such banks will be incentivized to convert into WOS due to the attractiveness factor of near national treatment given to WOS
- When the capital and reserves of the WOSs and foreign bank branches in India exceed 20 per cent of the capital and reserves of the banking system, in order to avoid domination by foreign banks, restrictions would be placed on further entry of new WOSs of foreign banks/ capital infusion
- For new entrants, the initial minimum paid-up voting equity capital for a WOS shall be Rs. 5 billion. The existing branches of foreign banks desiring to convert into WOS shall have a minimum net worth of Rs. 5 billion
- A letter of comfort would need to be issued by the parent of the WOS to the RBI for meeting the liabilities of the WOS
- Corporate Governance: (i) Not less than two-third of the directors should be non-executive directors; (ii) A minimum of one-third of the directors should be independent of the management of the subsidiary in India, its parent or associates; (iii) Not less than fifty per cent of the directors should be Indian nationals/NRIs/PIOs subject to the condition that not less than 1/3rd of the directors are Indian nationals resident in India
- Branch expansion guidelines as applicable to domestic scheduled commercial banks would generally be applicable to the WOSs of foreign banks except that they will require prior approval of RBI for opening branches at certain locations that are sensitive from the perspective of national security
- Priority Sector lending requirement would be 40 per cent for WOS like domestic scheduled commercial banks with adequate transition period for existing foreign bank branches converting into WOS.
- On arm's length basis, WOS would be permitted to use parental guarantee/ credit rating only for the purpose of providing custodial services and for their international operations. However, WOS should not provide counter guarantee to its parent for such support.
- WOSs may, at their option, dilute their stake to 74 per cent or less in accordance with the existing FDI policy. In the event of dilution, they will have to list themselves.

Foreign banks have been hesitant of conversion to WOS. Hence in order to promote foreign banks to convert their branches to wholly-owned subsidiary, according to a recent directive, I RBI has decided to exempt stamp duty and capital gains on conversion [Dinesh U 2013]. This exemption is valid from 1st April 2013.

Section 3: Performance of foreign banks

In order to compare the performance of foreign banks with respect to Indian counterpart several performance indicators have been considered. To prove the point that Foreign banks are focusing only on urban areas proxy indicators like number of ATM branches opened in urban and rural are discussed. To understand the impact of foreign banks towards agriculture, their net advances towards agriculture is compared with Indian banks. In order to understand how foreign banks are managing their assets a comparison of return of assets is performed. A discussion on non-performing assets of various banks in India is done by analyzing Capital to Risk-Weighted Assets ratio.

Focus on urban areas

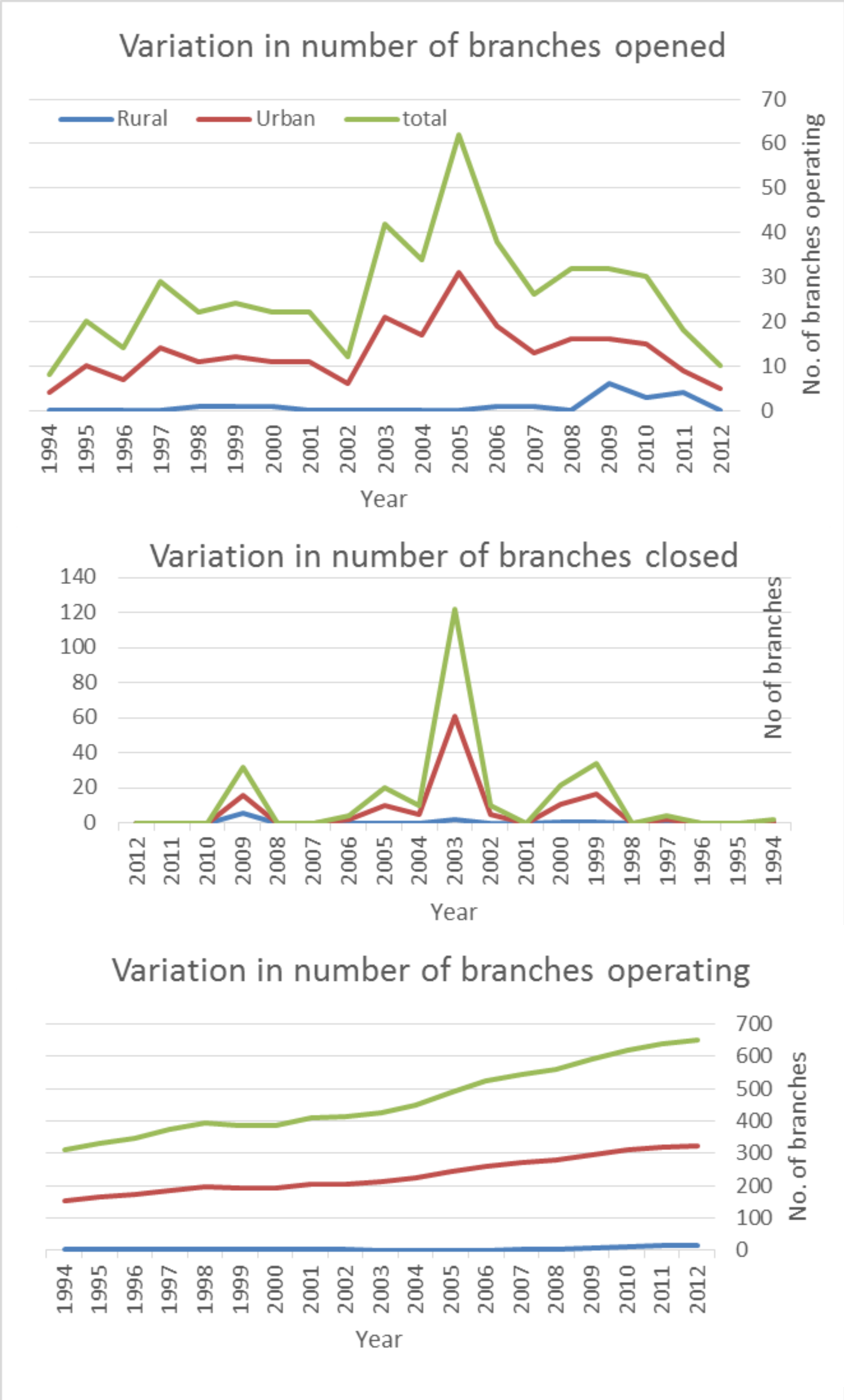
One of the clear trends that emerge from the growth of foreign banks is the kind of population that they cater to. The table in the appendix indicates the percentage of branches in rural areas for foreign banks (around 2 to 3 percent of total branches) and this number is negligible compared to the same percentage for other scheduled commercial banks (here rural and semi-urban branches account for 58 percent of the total branches). The key inferences that can be drawn from this are:

1) Foreign banks clearly are focusing on expansion activities in urban areas. This makes sense because the initial amount of deposit required is also high and would not be feasible for people in rural areas.
2) Over the last 20 years the number of rural branches in foreign banks have only increased to about 15 branches (in 1995 there were 3 branches) in comparison to the private sector banks which have more than doubled their rural branches in the same time period.

The charts shown below represent the variation in number of branches of Foreign banks opened, closed and in operation during a particular year in different geographies i.e. the rural and urban areas.

However, licenses issued by the RBI are few in number; hence it is difficult to open branches in rural areas. This situation could be corrected if banks opt for wholly owned subsidiary structure, in which case banks will be forced to open at least 25% branches in rural area. However they will also be entitled to open as many branches as they like in bigger cities. Therefore the loss, if any arising from operating rural branches can be absorbed by bigger branches in cities.

Graph 1



Source: a) Report on Trends and Progress of Banking in India, RBI
b) Statistical Tables Relating to Banks in India,

Priority Sector Lending

Priority Sector lending refers to those sectors which may not be as attractive to lenders as other sectors can be, but is important to the economy for various reasons, including providing source of livelihood to many. Major areas which are covered under priority sector lending are Agriculture, Small and micro enterprises, education, housing, export credit, etc.

According to government regulation the following are the requirement to be satisfied by each bank:

Table 1: Priority Sector Lending (% of adjusted net bank credit)

Category	Domestic Bank / Foreign Banks (With More than 20 Branches)	Foreign Banks With Less than 20 Branches
Total Priority Sector Lending	40	32
Contribution to Agriculture	18	No Specific Requirement
Contribution to Weaker Section	10	No Specific Requirement

Source: a) Report on Trends and Progress of Banking in India, RBI publication
b) Statistical Tables Relating to Banks in India, RBI publication

Looking at the above table, foreign banks with less than 20 branches have no mandatory requirement to contribute towards agriculture. Considering the large number of NPA, it is neither an attractive proposition for them. Taking advantage of this, most of the foreign banks cover their priority sector requirement by contributing towards the export sector. A look at the trend in contributing towards agriculture/export is shown below:

Table 2: Priority Sector Advances to Agriculture (% of adjusted Net banking Credit)

Bank Type	**1999-00**	**2005-06**	**2011-12**
Public Sector bank	15.8	15.2	15.8
Private Sector banks	9.1	13.5	14.3
Foreign Banks	1.8	5.6	0.1

Source: Same as Table 1.

And Contribution towards Other sectors (including exports) is shown below:

Table 3: Advance to "Other" Sector (% of adjusted Net Banking Credit)

Bank Type	**1999-00**	**2005-06**	**2011-12**
Public Sector bank	11.0	8.1	9.5
Private Sector banks	13.9	4.2	5.4
Foreign Banks	22.5	19.4	29.8

Source: Same as Table 1.

The Return on Asset is an Indicator of how efficiently the bank is managing its resources. Foreign banks are better in managing their resources as compared to public sector banks and private banks. With the entry of foreign banks it has been observed that the ROA of domestic banks have also increased significantly this may be due to the “spillover effect” which foreign banks’ operations in India have over the other banks. Their operations might have encouraged domestic banks to adopt better practices of operations in order to compete with foreign banks. A trend of ROA for the Last decade can be seen below:

Return on Asset is the indicator of the efficiency in which the bank employs its resources, while return on equity is the indicator of the efficiency in which the bank uses its capital. As it can be seen from Tables 4 and 5, foreign banks are the most productive in using their resources while Public sector banks have used their funds more judiciously.

Table 4: Return on Assets

Bank Type	**1999-00**	**2005-06**	**2011-12**
Public Sector bank	0.6	0.8	0.9
Old Private Sector Bank	1.2	0.5	1.2
New Private Sector Bank	1.1	0.9	1.6
Foreign Banks	0.3	1.6	1.8

Source: Same as Table 1.

Table 5: Return on Asset and Return on Equity for the year 2012-2013

Bank Type	Return on Asset	Return on Equity
Public Sector bank	0.8	13.2
Old Private Sector Bank	1.3	16.2
New Private Sector Bank	1.7	16.5
Foreign Banks	1.9	11.5

Source: Same as Table 1.

As seen from the Table - 6, NPA’s for foreign banks were relatively low in the past decade. This probably shows their superior risk management capabilities or more generally, exclusivity, of giving loans to a select group.

Table 6: Net NPAs (% of Net Advances) for various categories of banks

	1999-00	**2005-06**	**2011-12**	**2012-13**
Public Sector Banks	7.4	1.3	1.7	2.0
Old Private Sector Banks	7.3	1.6	0.6	0.8
New Private Sector Banks	2.9	0.8	0.5	0.4
Foreign Banks	2.4	0.8	0.6	1.0

Source: Same as Table 1.

Table – 7 points to the fact that the cost of Deposits, borrowing and cost of funds are the least for foreign banks but their return on investment is the highest. This indicated the superiority in operational efficiencies which foreign banks have achieved. Capital to Risk-weighted asset ratio is the amount of money (as a percentage of shareholder's capital) which the bank is supposed to have. Internationally, this has been agreed to be at 8 percent. Of all types of banks, Foreign Banks in India have the highest capital to risk-weighted asset ratio (Table 8).According to Tale 9, long term deposits with foreign banks are very few, least among the rest of the banks. Most Loans and Advances given by foreign banks are still very mature (mostly less than 1 year). Borrowings, with less than 1 year are highest for foreign banks as compared to other banks and with itself.

Table 7: Cost of Funds and Returns on Funds for the year 2012-2013

	Cost of Deposits	Cost of Borrowings	Cost of Funds	Return on Advances	Return on Investments	Return on Funds	Spread
Public Sector	6.6	2.5	6.3	10.1	7.60	9.4	3.1
Old Private Sector	7.5	4.3	7.1	12.2	7.5	10.6	3.4
New private Sec	6.5	3.2	5.8	11.3	7.2	9.9	4.1
Foreign	4.7	2.8	4.1	9.6	8.1	8.9	4.8

Source: Same as Table 1.

Table 8: Capital to Risk-Weighted Assets Ratio under Basel I and II for the year 2013

	Basel 1	Basel 2
Public Sector Banks	11.31	12.38
Old Private Sector banks	12.33	13.73
New private sector banks	15.71	17.52
Foreign Banks	18.76	17.87

Source: Same as Table 1.

Table 9: Maturity Profile of Select Liabilities/Assets

Deposits	**Public Sector Bank**	**Old Private Sector Bank**	**New Private Sector Bank**	**Foreign Banks**
Less than 1 year	49.6	48.1	48.9	61.8
Between 1 and 3 years	25.3	39.2	26.6	29.8
Between 3 and 5 years	8.5	6.9	5.2	8.3
Over 5 years	16.6	5.8	19.3	0.1
Borrowing				
Less than 1 year	45.4	63.7	49.2	84.5
Between 1 and 3 years	12.2	13.4	11.7	9.2
Between 3 and 5 years	15.2	7.8	12.9	2.7
Over 5 years	27.2	15.1	26.2	3.5
Loan and Advances				
Less than 1 year	34.3	44	32.4	67.4

Between 1 and 3 years	37.4	36.1	37.4	15.5
Between 3 and 5 years	11	9.1	12	4.5
Over 5 years	17.3	10.8	18.2	12.5
Investments				
Less than 1 year	20.1	30.3	45.7	76.6
Between 1 and 3 years	12.6	12.2	18.6	12.9
Between 3 and 5 years	14.2	13	8.2	5.2
Over 5 years	53.1	44.4	27	5.3

Source: Same as Table 1.

Section 4: Case study of two foreign banks

Key findings about 2 foreign banks have been discussed in this section. The growth story of HSBC spanning over 150 years and the challenges and the situations of BCCI bank in India are presented below.

A. The Hong Kong and Shanghai Banking Corporation

HSBC began its operations in India as Mercantile Bank in October 1853. The Mercantile bank of India, London and China was founded in Mumbai with branches in 3 countries: India, China and London. The bank was mainly established for facilitating trade between the 3 countries then. This bank had offices in 9 cities by 1855 and the next 100 years were profitable for the bank. The Mercantile bank was acquired by the Hong Kong and Shanghai Banking Corporation Ltd in 1959 laying the foundation for today's HSBC group. The bank has grown tremendously over the last 150 years following a strategy of 'Managing for Value', and the managing for value has undergone several changes throughout its existence in India. HSBC gave India its first ATM in 1987 and has been a major contributor in terms of the technology evolution of banks in India.

The HSBC group in India provides 24 hour banking services through the 140 ATMs throughout the country and is known for its high end technology based banking services like phone banking, internet banking, trade banking and treasury dealing services. HSBC in India offers a very wide range of services which include:

1) Retail Banking and Wealth Management: The Bank has around 1.4 million customers worldwide and offers a wide range of services to these resident and non-resident Indian segments in India, USA, UK, Canada, Australia, Middle East and South East Asia.
2) Commercial Banking
3) Private Bank
4) Global Markets
5) Asset Management
6) Audit Services
7) Investment Banking and Institutional Equities Broking

This wide array of services is what differentiates HSBC from the rest of the banks. The technology inclination of HSBC coupled with the unique offerings has helped it achieve the differential advantage compared to the other banks.

Sector focus: HSBC in India is focused equally on all sectors except a few industries like defense, aviation which HSBC cannot serve. Though there are not many rural area branches of HSBC the social concern is addressed by HSBC through the various projects launched like Mann Deshi, Micro financing, education of children etc.

Corporate Sustainability: Here there are 3 main areas in which HSBC works

a) Financial Inclusion- Providing education to children in rural areas and also underprivileged kids, teaching live skills that will be essential for building a career and make them independent throughout. The focus is also on women empowerment and financial support to women to help them start businesses on their own or provide them education to make them capable to compete and survive in the industry. HSBC scholarship program, Future first investment in children program and Micro finance fund are all initial steps of HSBC towards this direction.
b) Environment sustainability initiatives - Focused on climate change, ecosystem conservation, direct impact reduction, business development and risk management. They have supported projects in climate change which work on impact of climate change on business and work with supported organizations in collaboration to tackle the challenge on a global level. Ecosystem conservation and direct impact reduction measurement of any environmental sustainability measures are some of the other areas of focus for HSBC.
c) Volunteering programs: HSBC is keen on allowing its employees to be a part of the change that they drive by encouraging them to be a part of the various social and environmental initiatives that they come up with.

The key factors that make HSBC unique amongst the other foreign banks are:

1) Heritage and Long association**:** HSBC has been in India for 150 years and has been an integral part of the India growth story over the years. The long association has made it a trusted name across the country which is a key factor in establishing a connect with customers.
2) India is a part of the progress story: The growth rates in India have been high compared to the other developed countries which have almost stagnated. There is mutual benefit obtained both for HSBC and for India.
3) Environment sustainability**:** The work HSBC has carried out in this sector is encouraging and has made the other banks progress in this direction as well.

Attitude towards RBI's regulatory policies: HSBC India Ms. Naina Lal Kidwai in her interview [Press trust of India, 2013] tells that the attitude of RBI has been a positive one and the regulations that have been brought out will be adhered to by HSBC. Even to the recent news that RBI might want foreign banks to only run as subsidiaries, Ms. Naina remarked that HSBC would be willing to go the way described.

The number of branches of HSBC has increased from 28 in 2001 to 48 by the end of 2012 which is one of the highest in India as compared to other foreign banks. The Return on asset has increased from a mere 0.96% in the year 2000 to more than double to 1.98% in 2012 which is above the average value of all the foreign banks combined. The net non-performing assets (as a percentage of Net Advances) have come down from 1.04% in the year 2000 to a mere 0.62% in the year 2012. This is again lower than the average of 1% of all foreign banks combined. The return on equity has increased from 11.83% in 2011 to 13.88% in the year 2012, while the average for all foreign banks is a mere 6.33%.

The entire analysis above indicates that if a foreign Bank stays engaged with a developing country like India, the rules allow it to maintain a healthy profit without compromising on its social obligations.

B. BCCI Bank (Bank of Commerce and Credit International)

BCCI bank started in 1972 as a Pakistani bank in Luxembourg. By 1988 there was a number of money laundering charges against BCCI across nations [The Guardian, 2005]. There were a number of investigations against the bank to verify the authenticity of the charges levied. Owing to all the regulatory pressures BCCI pled guilty and ceased operations worldwide from 5th July 1991. At that point, it had only one office in India, in Mumbai. The closure of the bank impacted its clients adversely including those in India. Most of the depositors with BCCI were NRIs who were lured by the high rate of interest being offered by BCCI. It was felt by RBI that in order to protect the interests of its clients having business with the Bombay branch of BCCI, who were either resident Indians, Indian firms with running businesses or NRIs, the assets and liabilities of its Mumbai Branch could be taken over by an Indian bank which could either absorb the Bank or open a new bank as its subsidiary. The faith in the Indian banking system of NRIs was at stake when the closure of BCCI in India was about to take place and hence it became essential to not liquidate the bank but try and keep it afloat. Hence the SBI was asked by RBI to acquire the operations of the Mumbai Branch of BCCI from the liquidators. On account of its assets having a significantly high percentage of toxic assets, as well as several other reasons, SBI was granted a license to start the operations of the erstwhile BCCI in its new avatar of SBICI as a wholly owned subsidiary of SBI. A key reason that could be identified for risky loans forming a bigger chunk of portfolio is the absence of asset classification guidelines. These guidelines came into effect only after 1992-93 which was a year after BCCI shut down its operations. SBICI commenced operations on 17th January 1993. As SBICI had not been set up under an Act of Parliament in the manner that SBI and the nationalized banks had earlier been but was set up under the Companies Act, 1956, RBI categorized it as a Private Sector Bank and not a Public Sector Bank despite being a fully owned subsidiary of SBI.

SBICI functioned as a single branch bank till 1999 when it opened its second branch in the city of Mumbai itself. SBICI in its initial few years tried to stabilize the bank and reduce the toxic assets so as to have sufficient capital to lend. The takeover conditions put in my liquidators when BCCI operations were taken over included some minimum wage stipulations and this resulted in very low capital available for expansion of the bank. In 2002 bank was faced with a major issue of its net worth being less than paid-up capital. This is when RBI began insisting that SBI merge SBICI with itself and there would be no further expansion in its branch network. SBICI remained a bank with a single city, two branch footprint confined to a metropolis till its acquisition by SBI in July 2011. The low capital present with the bank also led to limit on the corporate lending that the bank could do. The retail lending got limited by the number of branches and the cities in which they were present. The lower paid up capital meant lending to small corporates which was again of lower quality and hence higher risk associated. However, the period between 2004 till its acquisition, the Bank cleaned up its Balance Sheet, became a profitable entity, and for the last six years of its existence, had a Nil Net NPA position. Internally a number of systems and mechanisms were cleared up to ensure better operating efficiency and utilization of assets improving. Considering that it were the NPAs which had choked its operations, the turnaround resulting in consistent profits, decent financial ratios and NIL Net NPAs was regarded as commendable.

However, there were no tangible takeaways from the foreign bank, BCCI, either on the technological side or in terms of any specialized skills, practices or management inputs. Though a foreign bank, BCCI was already being spoken of in a negative light well before it went bust. SBI felt it necessary to rely on its own executives to provide managerial support and to deliver. The executives brought with them the typically conservative and financially prudent business practices of SBI to SBICI. Moreover, the local top management of erstwhile BCCI and many others at various levels left during the process of takeover or immediately thereafter.

Merger of SBICI with SBI

When State Bank of India Commercial and International Bank Ltd (SBICI) was set up in 1994 after taking over the Indian operations of the erstwhile Bank of Credit & Commerce International Ltd (BCCI), its net worth stood at Rs.128.74 crores on the capital base of Rs.100 crores[PTI,2011]. It had total business (deposits and advances) of less than Rs.700 crores, with a ROA of 0.49 per cent.

According to RBI guidelines, for ownership in private sector bank, the minimum cap needed for capital was increased to Rs.300 crores. Considering the existing business model of SBICI (and the returns generated by it) did not justify the capital infusion required. Hence the government approved merger of SBICI with its parent bank SBI [Press trust of India, 2011].

Section 5: Challenges faced by Foreign Banks

This section looks at foreign banks and some of the major problems they face in India.

Foreign banks play an important role in financing foreign trade. The 2011 discussion paper mentions that most of the foreign banks have opened branches to cater to trade-finance. With their know-how in handling foreign trade, the foreign banks have contributed significantly in rapid rise of cross border trade.

RBI's report on currency and finance (2006-08) brought out the aspect of being liberal: While India had committed 12 branches of foreign banks in a year, during the period 2003 to October 2007; India gave approval for 75 new foreign bank branches. The report stated that the regulatory regime followed by RBI in respect of foreign banks was non-discriminatory and very liberal by global standards. To support this, the following was pointed out:

- India issues a single class of banking license to foreign banks and does not require them to graduate from a lower to a higher category of banking license over a number of years
- The single class of license places them virtually on the same footing as an Indian bank and does not place any restrictions on the scope of their operations
- No restrictions exist on establishment of non-banking financial subsidiary in India for the specified 18 activities under automatic route by the foreign banks and their group companies
- Deposit insurance cover is uniformly available to all foreign banks at a non-discriminatory rate of premium
- Prudential norms applicable to the foreign banks for capital adequacy, income recognition and asset classification, etc., are, by and large, the same as for the Indian banks

With the backdrop of the significance of foreign banks in financing foreign trade and the RBI's stance towards foreign banks, following are some of the major challenges faced by the foreign banks as discussed in the PWC Report, 2013:

- Regulatory concerns
- Overall political environment and particularly, uncertainties owing to the forthcoming national election in 2014.
- Some issues and general discussions which appear to have surfaced following the RBI framework for setting up of WOSs by Foreign Banks in India:
  - Requirement of specifications and further clarity: Such as, the amount of stamp duty; Accounting norms; Specifications regarding the letter of comfort; specific meaning of terms such as "complex structures", "adequate disclosure requirements"
  - Perhaps only the foreign banks with a high level of trade between India and their home country, would be interested in subsidiarisation
  - Requirement of branch expansion in rural centers: Hitches regarding hiring, local problems such as electricity
  - Issues pertaining to stamp duty, taxation rules (uncertainty that has crept in due to the recent issues with regard to retrospective taxes etc.)

Our interview with an industry expert who has worked in the evolution of a foreign bank in India from the ground level revealed some insights that are listed below:

1) Shortage of quality people: Human resource is a major problem that new organizations face and getting the right set of people is essential for the success of any organization.
2) Underestimating the value of capital needed: Though the minimum cap required by RBI is very low (25Mn Dollars) the need to expand is a core problem that they face. Being profitable requires operation on a large scale to get benefits from scale economies and also be able to generate the right amounts of investments as and when needed. The issue with lower capital is the inability to serve large clients which would mean serving lower quality clients that makes the entire operations more risky and hence be more difficult to sustain on a larger scale.
3) Limited branch networks: RBI regulations allow the number of branches increase only at a certain prescribed limit. The cap on this number prevents banks from being able to grow in all regions and obtain pan-India presence. Most of the foreign banks are dependent on the Headquarters for the funds and this may have an unnecessary delay in the growth stage.
4) Technology: The mismatch between the technology present at the Headquarter level and also India is a major cause of concern. The technology that needs to be implemented in the foreign country and the interface with the headquarters' system needs to be clearly identified.

Though there are a few issues that the new banks face there are also a number of positives that India has offered which has made India an emerging market for most foreign banks:

a) Fast paced economy: India being a developing economy offers a number of business opportunities to banks which are present here and also for the ones who would like to enter the Indian market. The other markets in the world have already saturated.
b) Indian banks: In India the banks need to go to other banks or markets in order to raise the required money. Raising capital is a difficult problem and most foreign banks go back to headquarters for getting money required.
c) Priority sector: Foreign banks have a smaller priority lending requirement of 32 percent as against 40 percent for government sector banks. Also the sectors which are a part of the lending sectors allowed are also different for foreign banks. Foreign banks can fulfil this through exports, imports and do not have to lend to agricultural sector like the other banks.
d) IT systems are useful to speed up processes: The It development in India at a faster pace than the other countries gives India an advantage and makes it more sought

Section 6: Conclusion

The report talks about the various opinions towards the foreign banks operations in the country. It begins by looking at the regulatory framework that existed in order to understand the central bank's attitude towards foreign banks entry into India. While the regulations have been successful in setting up a guideline that needs to be followed by banks there is still not a push for one particular form of presence. The 2005 RBI policy on the roadmap for presence of foreign banks laid out the 2 forms of presence with an aim to push for Wholly-owned subsidiary (WOS) model. But from the view of foreign banks there is no incentive for moving to the WOS model. The contention regarding the form of presence has remained over the years. Looking at the impact of foreign banks over the years, the following characteristics have been observed:

1) Rural presence: Foreign banks have a very small presence in rural and semi-rural areas. Only 1 or 2 percent of the total branches of foreign banks are in rural / semi-rural areas. This is in contrast with the scheduled commercial banks which have grown enormously in the rural sector (currently rural branches account for 58 percent of their total number of branches).
2) Technological development: Foreign banks have helped in bettering the technology used in the banking sector. The first ATM in India was brought up by HSBC and from then on foreign banks have contributed to the latest banking practices helping them become more efficient
3) Priority sector lending: The priority sector requirement itself is different for foreign banks and also the percentage rates are lower for them. For banks with less than 20 branches the requirement is at 32 percent as against 40 percent for the other nationalized banks. Also the requirement is mostly satisfied by banks by lending in the export-import sector and not lending in sectors like agriculture which are the actual constituents of the priority sector.
4) Return on Assets: This has clearly shown a positive trend bringing into forefront the improvements brought across by the operational improvements through better practices of foreign banks.

Our case study on HSBC has also revealed insights similar to that explained above. There are positives and negatives from presence of foreign banks in India. They have aided in technological improvements but not really entered the growth sectors like the agriculture sector in India. The common perception of foreign banks in India is that they are focused on profitability and not on the development issues of the country.

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Annexure

Table 1: Comparison of various foreign banks regard to number of branches and ATMs

Bank	No of Branches								
	2001			2006			2012		
	Rural	Urban	total	Rural	Urban	total	Rural	Urban	total
AB Bank	0	9	9	0	0	0	**0**	1	1
Abu Dhabi Commercial Bank	0	2	2	0	2	2	**0**	2	2
American Express Banking Corp.	0	4	4	0	8	8	**0**	1	1
Antwerp Diamond Bank	0	0	0	0	1	1	**0**	1	1
Bank Internasional Indonesia	0	1	1	0	1	1	**0**	1	1
Bank of America	0	4	4	0	4	4	**0**	5	5
Bank of Bahrain & Kuwait	0	2	2	0	2	2	**0**	2	2
Bank of Ceylon	0	1	1	0	1	1	**0**	1	1
Bank of Nova Scotia	0	5	5	0	5	5	**0**	5	5
Bank of Tokyo-Mitsubishi UFJ	0	1	1	0	3	3	**0**	3	3
Barclays Bank	0	2	2	0	1	1	**1**	8	9
BNP Paribas	0	1	1	0	9	9	**0**	9	9
Chinatrust Commercial Bank	0	1	1	0	1	1	**0**	1	1
Citibank	0	15	15	1	38	39	**2**	41	43
Commonwealth Bank of Australia	0	1	1	0	1	1	**0**	1	1
Credit Agricole Bank	0	2	2	0	1	1	**0**	6	6
Credit Suisse AG	0	0	0	0		0	**0**	1	1
DBS Bank	0	0	0	0	2	2	**0**	6	6
Deutsche Bank	0	6	6	0	8	8	**0**	14	14
FirstRand Bank	0	1	1	0		0	**0**	1	1
Hongkong & Shanghai Banking Cor	0	28	28	7	43	50	**0**	48	48
JP Morgan Chase Bank	0	15	15	0	1	1	**0**	1	1
JSC VTB Bank	0	1	1	0		0	**0**	1	1
Krung Thai Bank	0	1	1	0		0	**0**	1	1
Mashreq Bank	0	2	2	0	2	2	**0**	2	2
Mizuho Corporate Bank	0	0	0	0	1	1	**0**	2	2
Oman International Bank	0	2	2	0	2	2	**0**	2	2
Royal Bank of Scotland	0	0	0	0		0	**2**	29	31
Sberbank	0	28	28	0	3	3	**0**	1	1
Shinhan Bank	0	2	2	0	0	0	**1**	2	3
Societe Generale	0	1	1	0	2	2	**0**	2	2
Sonali Bank	0	1	1	0	1	1	**0**	2	2
Standard Chartered Bank	2	61	63	0	85	85	**0**	94	94
State Bank of Mauritius	0	2	2	0	3	3	**0**	3	3
UBS AG	0	0	0	0	0	0	**0**	1	1
United Overseas Bank	0	0	0	0	0	0	**0**	1	1
	2	202	204	8	231	239	6	302	308

Source: a) Statistical Tables relating to Banking in India, RBI

b) Report and trends and progress in Banking in India, RBI

Table 2: Table showing comparison of Foreign banks with respect to ATMs and employees

Bank	No. of ATMS		No. of employees	
	2006	2012	2006	2012
AB Bank	0	0	0	31
Abu Dhabi Commercial Bank	3	0	38	48
American Express Banking Corp.	10	0	1773	622
Antwerp Diamond Bank	0	0	19	24
Bank International Indonesia	0	0	15	1
Bank of America	0	0	282	279
Bank of Bahrain & Kuwait	6	0	68	98
Bank of Ceylon	0	0	33	27
Bank of Nova Scotia	0	0	0	193
Bank of Tokyo-Mitsubishi UFJ	0	0	0	273
Barclays Bank	0	36	46	978
BNP Paribas	0	0	303	342
China trust Commercial Bank	0	0	21	36
Citibank	388	703	3250	5176
Commonwealth Bank of Australia	6	0	0	27
Credit Agricole Bank	0	0	0	106
Credit Suisse AG	0	0	131	32
DBS Bank	0	39	678	786
Deutsche Bank	22	64	0	1453
FirstRand Bank	0	0	4985	74
Hong Kong & Shanghai Banking Corp. Ltd.	165	143	82	5191
JP Morgan Chase Bank	0	0	0	256
JSC VTB Bank	0	0	0	18
Krung Thai Bank	0	0	11	10
Mashreq Bank	0	0	10	14
Mizuho Corporate Bank	0	0	50	176
Oman International Bank	0	0	40	72
Royal Bank of Scotland	0	122	0	1951
Sberbank	0	0	0	16
Shinhan Bank	0	0	0	76
Societe Generale	0	0	113	94
Sonali Bank	0	0	45	38
Standard Chartered Bank	182	307	5390	7527
State Bank of Mauritius	0	0	29	47
UBS AG	0	0	0	57
United Overseas Bank	0	0	0	9
	782	*1414*	*17412*	*26158*

Source: Same as Annex Table 1.

Table 3: Total percentage of branches in rural areas for commercial banks, Public sector banks

Name of the Bank	Branches									ATMs					
	2000			2006			2012			2006			2012		
	Rural	Urban	Total	Rural	Urban	Total	Rural	Urban	Total	On-site	Off-si	Total	On-site	Off-site	Total
Scheduled Commercial Banks	44282	15889	60171				46244	34996	81240				47545	48141	95686
Nationalised Banks	20686	11735	32421	29365	18478	47843	27760	20876	48636	6587	6021	12608	18277	12773	31050
Private Sector Banks	2816	2167	4983	2802	3714	6516	6268	7184	13452	3309	4350	7659	13249	22830	36079

Source: Same as Annex Table 1.

Table 4: Number of branches of foreign banks in various years and in various geographies

Year	Branches opened			Branches closed			No of branches present		
	Rural	Urban	total	Rural	Urban	Total	Rural	Urban	Total
2012	0	5	5	0	0	0	15	309	324
2011	4	5	9	0	0	0	15	304	319
2010	3	12	15	0	0	0	11	299	310
2009	6	10	16	6	10	16	8	287	295
2008	0	16	16	0	0	0	2	278	280
2007	1	12	13	0	0	0	2	270	272
2006	1	18	19	0	2	2	1	260	261
2005	0	31	31	0	10	10	0	245	245
2004	0	17	17	0	5	5	0	224	224
2003	0	21	21	2	59	61	0	212	212
2002	0	6	6	0	5	5	2	204	206
2001	0	11	11	0	0	0	2	203	205
2000	1	10	11	1	10	11	2	191	193
1999	1	11	12	1	16	17	3	189	192
1998	1	10	11	0	0	0	3	193	196
1997	0	14	15	0	2	2	3	183	186
1996	0	7	7	0	0	0	3	170	173
1995	0	10	10	0	0	0	3	162	165
1994	0	4	4	0	1	1	3	152	155

Source: Same as Annex Table 1.

Table 5: Comparison of the various forms of presence – Branch Form and Subsidiary form

Branch Form	
Pros	**Cons**
(i) Greater operational flexibility.	(i) In the event of failure of the bank, it is difficult to determine assets available for local creditors.
(ii) Increased lending capacity (loan size limits based on the parent bank's capital).	(ii) Management of a branch does not have a fiduciary responsibility to the branch's local clients.
(iii) Reduced Corporate Governance requirements.	(iii) Assets attributable to a branch can be transferred by it to the foreign head office. In times of distress, this would be a negative from the branch country perspective.
(iv) Strong support from parent in situations of local adversity	(iv) Insolvency procedures may differ in different countries with some following separate entity doctrine while others follow one-entity doctrine.
Subsidiary form	
Pros	**Cons**
(i) Clear delineation between the assets and liabilities of the domestic bank and those of its foreign parent.	(i) Parent support may not be there in all weathers
(ii) Ring-fenced capital within the host country.	(ii) Where the liquidity is managed centrally by the parent and the local subsidiary is funded on a short-term basis, the failure of the parent may result in the failure of the subsidiary too.
(iii) Own set of directors who are required to act in the best interest of the bank.	(iii) Possible downside risk to financial stability if the subsidiaries dominate the domestic financial system.
(iv) The host country authorities are able to exercise greater control in times of distress.	

Table 6: Some features about branches:

USA	Canada	Australia
In order to accept or maintain domestic retail deposits of less than $ 100,000 a foreign bank must establish an insured banking subsidiary. This requirement does not apply to a foreign bank branch that was engaged in insured deposit-taking activities on December 19, 1991.	To undertake the business of banking in Canada, a foreign bank must: (i) Incorporate a bank subsidiary under the Bank Act; or (ii) Establish a bank branch under the Bank Act. Full service bank branches and lending branches cannot be member institutions of the Canada Deposit Insurance Corporation. In order to establish a bank branch, a foreign bank must be authorised under the Bank Act and must be incorporated by or under the laws of another jurisdiction outside Canada (i.e., an authorised foreign bank). No one person (Canadian or foreign) may own more than 10 per cent of any class of shares of a Schedule I bank	Foreign banks satisfying prudential requirements and that are able to demonstrate their potential contribution to competition in Australia may conduct banking in Australia. Foreign banks may under take banking operations in Australia through locally incorporated subsidiaries and/or an authorised branch. However, a branch may not accept “retail” deposits. A foreign bank wishing to deposits must seek authorisation as a locally incorporated subsidiary for that purpose. Foreign bank branches many accept deposits (and other funds) in any amount from incorporated entities, non-residents and their own employees. Deposits (and other funds) may only be accepted from other sources where the initial deposit (or other funds) are greater than $A250, 000.Deposit-taking outside of this is considered to be “retail” banking business.

Source: RBI