# Wto and indian banking assignment

Economics

WTO and Indian Banking-Challenges of 2009 Impact of WTO commitments on Indian banking Industry Prof. S. Visalakshi Faculty – Banking and Finance, Bangalore Management Academy (BMA). Naman Kumar Gupta, MPFB II, Bangalore Management Academy (BMA) Kartheek Yerolla, MPFB II, Bangalore Management Academy (BMA) Mahesh Bondili, MPFB II, Bangalore Management Academy (BMA) Introduction India had a deep rooted and well structured banking system since independence. After nationalization of the banks, the focus of the Indian banking System has been two fold – commercial and social.

While meeting their commercial considerations like profitability, viability of operations and financial stability the banks have also been focusing on social considerations like poverty alleviation, employment generation, balanced regional growth and such others. However, on account of economic liberalization in 1991 and the need to adhere to various prudential norms laid down by the Basel committee, the focus of Indian banks has been predominantly on the commercial aspects of banking. In 1997, India has made certain commitments to the WTO in providing market access to the foreign banks that intend to operate in India.

These commitments would assume operational character in 2009. As the banking industry has been at the forefront of Indian economic resurgence, the WTO commitments have become a matter of concern to many sections and sectors of our economy. The purpose of this paper is to provide a proper perspective on the impact of WTO commitments. Firstly, this paper would deal with exact nature of commitments made by India to WTO regarding the

banking industry. Secondly, this paper seeks to evaluate the impact of foreign banks on the Indian economy.

Thirdly, this paper seeks to highlight the major issues and challenges that Indian banking system would encounter if they have to effectively compete with foreign banks. Fourthly, this paper attempts to lay down a time bound road map for the Indian banking industry as they march to 2009. In conclusion this paper would answer the following question – Can Indian banks sustain competition from foreign banking institutions? A. Commitments made to WTO The Financial services sector is governed by the General Agreement on Trade and Services (GATS) under the World Trade Organization.

As per the 5th protocol of the GATS agreement, India has made a commitment to the WTO to permit establishment of branch operations of foreign banks subject to an annual limit of 12 branches per year. However, India reserves the right to deny entry to the foreign bank if its market share exceeds 15%. The ceiling of 12 branches does not include off-site ATM counters. Further, the foreign banks are required to constitute a local advisory board which comprises of only Indian nationals. In addition, public sector banks can park their surplus funds only with other scheduled commercial banks in India and not in foreign banks.

As per the existing policy of RBI that allows FDI in the banking sector, foreign banks can get into mergers and acquisitions of Indian private sector banks with an equity ceiling of 49 %. This equity participation would be increased to 74% by 2009. Existing Scenario 1. As against the commitment to open 12

branches on an annual basis, the RBI had already issued licenses to foreign banks to open 75 branches in the period 2003-07 other than offsite ATMs. (Refer exhibit 5 of Appendix 1). During the same period, USA has declined to give authorization to any Indian bank to open their offices in that country. . RBI's licensing of foreign banks has been non discriminatory in nature. There have been no restrictions placed on the scope of the activities of foreign banks. On the other hand, USA places restrictions on the scope of banking activities that can be carried on by Indian banks in USA. For example, USA disallows financial brokerage and certain specialized foreign exchange business. 3. While Indian banks are required to lend at least 40% of their advances to the priority sector, foreign banks are required to lend only 32% to the priority sector (Refer exhibit 2 of Appendix 1).

Foreign banks also enjoy deposit insurance at the same premium and terms extended to the Indian banks. 4. The market share of foreign banks in Indian foreign exchange business is as high as 52%. 5. The net profit of foreign banks per branch in the year 2007 was Rs. 11. 99 crores as against Rs. 33 lakhs for domestic public sector banks. (Refer exhibit 4 of Appendix 1). 6. The market share of foreign banks in off balance sheet business in 2007 was as high as 72. 66%. (Refer exhibit 3 of Appendix 1)

As may be inferred from the above mentioned facts and figures, it is not an uphill task for RBI or the Government of India to uphold their commitments to WTO. In fact, one can logically say that the commitments have already been met if not far exceeded. B. Impact of foreign banks on Indian economy The Indian economy has recorded impressive growth figures in the last few years. With a GDP growth rate of 9%, the Indian industry and the services

sector are increasingly tapping global markets and streamlining their activities to gain a competitive edge on a global scale. There is a growing demand for bank credit by the domestic industry.

For the growth of the industry and services sector, it is imperative to have access to the world banking and financial centers. Indian companies are going in for mergers and acquisitions which have to be financed by banks. State Bank of India had part financed the acquisition of Corus by the Tatas because it is subject to the RBI ceiling of 15% exposure of a Bank to a single customer. Perhaps, a foreign bank with a higher capital base could have totally financed the deal instead of part financing it. Risk Management has become an area of utmost operational importance to banks worldwide.

The world over, industry and services sector are hedging their risks through a wide array of financial risk mitigation instruments like derivatives (futures, options and swaps). The foreign banks like Citibank, ABN Amro Bank, Bank of America, and HSBC have a well entrenched position in international financial markets. Comparatively, Indian banks are on weaker ground as far as penetration in international financial markets is concerned. It must be stated that most of the growth of Indian banks overseas has followed the Indian diaspora. Indian companies can avail the benefit of such risk mitigating instruments under the aegis of foreign banks.

New banking services like forfaiting and securitization offer unfettered growth opportunities to the Indian economy. The domestic credit off-take has also been growing significantly. There is a mismatch between the demand and supply of bank credit because of the limited capital structure of the

Indian banks. This scenario would increase the interest rates thereby having a dampening effect on entrepreneurship and investment. Infusion of fresh capital in the banking industry through the entry of foreign banks would overcome this mismatch between supply and demand of bank credit.

It is of interest to note that the recent branch licenses secured by foreign banks in India have been in towns like Kolhapur, Nanded, Kurnool, Kanchipuram, Nelamangala and such other small centres. This does not mean that foreign banks are looking for non-urban penetration in India, but they do foresee an explosive economic potential for trade finance in these centres. A foreign bank having this kind of strategic interest in potential economic development and augmenting it with banking opportunities augurs well for the Indian economy. In fact, RBI itself acknowledges the positive impact of Citibank on retail finance and HSBC on trade finance.

In fact, it is a matter of surprise why the banking systems as well as the government policies have not tried to exploit innate economic growth possibilities in centres like Moradabad, Bidri, Benaras, Lepakshi and also the above mentioned centres. Hence, it can be concluded that the presence of foreign banks will open up latent economic growth opportunities. (Refer exhibit 6 of Appendix 1) C. Key Emerging Issues and challenges There are a plethora of issues and challenges that encounter the Indian Banking system as they approach the year 2009.

However, the major issues that this paper would analyse are: a. Human capital b. Financial capital c. Risk management a. Human capital – the biggest challenge before the Indian Banking System today is recruitment and

retention of human talent. It must be understood that the banking industry in India is straight jacketed by various labour laws and regulations of the Government of India. The bank managements do not have the liberty of recruiting people whom they consider as the appropriate talent pool for the future. Recruitment has to be done as per established norms and procedures.

Pay scales are in accordance with tripartite agreements forged between Bank management, bank employees unions and the government. Any wage hike has to be across the board for all employees and for a fixed duration. Banks do not have the liberty to pay differential wages for differential performance. They are not empowered to provide incentives to people who excel in their work assignments. Out of turn promotions, adhoc bonuses and esops are alien to the banking system. This poses problems both for recruitment and retention of employees as compared to the deregulated environment obtaining in the foreign banks.

A few studies have indicated that the average age of a PSU bank is around 50 years whereas the same in ICICI is 28 years. Massive retirement of PSU bank employees is to occur in the next few years. This poses a huge challenge to the human resources available to PSU banks. It is needless to highlight the importance of human resources in a service industry like banking. b. Financial capital – the recommendations of BASEL committee stipulate a capital adequacy of 12% for the banking industry. Only an elite pool of PSU banks meets this criterion of capital adequacy.

In India, it is a known fact that banks have a social obligation to perform. The social obligation is essentially in the area of meeting priority sector advances which have the twin disadvantages of low rate of return and a high default risk. Recent trends have established the escalating rates of NPA (non-performing assets) accumulation in the banking industry. On the other hand, foreign banks operate purely on commercial lines and have minimal social obligations. In the countries of their origin, they hardly maintain cash reserves of 1 or 2 % and have no stipulations to meet any kind of statutory liquidity ratio.

Consequently, their equity multiplier and credit multiplier are much higher than their counterparts in India. Given their huge capital base, they are at the forefront of financing global mergers and acquisitions. The Government of India and RBI did initiate measures to bolster the capital structure of Indian banks like promoting M & A activity, encouraging FDI in Indian banking, allowing Indian banks to raise public issues and such other measures. However, these measures have been reactive in nature to an existing malady rather that proactive in nature to face up to foreign competition and establishment of a healthy banking system. . Risk management: The BASEL committee has identified many types of risks faced by the banking industry. It is not as though these risks never existed earlier but presently we have reached a stage where methodologies are evolving for identification, measurement and monitoring of various risks. Some of the risks identified by the BASEL committee are credit risk, market risk, exchange rate risk, interest rate risk, operations risk among many others. Specific provisions have to be made to mitigate the possible impacts of these

risks. d. Addressing these risks pose a three-fold problem to the Indian banks.

Firstly, a higher amount of capital outlay is required to make specific and general provisions to meet these varied risks. Higher the capital requirements lower will be the equity multiplier (as per DuPont Model) and hence, lower will be the return on equity. Bigger banks (mostly foreign banks) are at an advantage to meet these capital norms as compared to the smaller ones (mostly Indian Banks). Secondly, usage of technology poses a challenge to the Indian banking system. Risk identification, risk measurement and risk monitoring requires a high degree of information integration through technology.

This in turn entails high levels of financial commitment by the banking industry. Thirdly, human resources that are highly skilled and sensitive to various kinds of risks are another problem facing the Indian banking system. D. Road map to the future An examination of the growth of the banking industry in India shows that competition has always had a salutary effect. Initially, the public sector banks were threatened by private sector or new generation banks. The public sector banks came out unscathed and much stronger from this bout with the private sector banks.

Technology adoption, customer satisfaction, profitability and productivity have become the buzzwords for public sector banks. Hence, it is not unrealistic to expect that the Indian banks would reform and innovate under the onslaught of competition by foreign banks. Since 1991, Indian banks have scaled many heights which looked improbable at one point of time.

They have achieved commendable results in the area of NPA management, infusion of banking technology, recapitalization of their balance sheets and ALM management. With this backdrop, one has to be extremely optimistic about the capability of Indian banks to meet orthcoming challenges. However, one cannot ignore the stranglehold that the government and their policies have on the banking system. Hence, any progress made by the Indian banking system has to be in tandem with a change in the mindset of both the Central government and the Central bank. This paper sets out to lay a road map for further banking reforms in the following suggested measures. a. The Government of India must adopt a strategy similar to the MOU (memorandum of understanding) policy that has been adopted towards the public sector undertakings.

The MOU policy envisages greater autonomy to the PSU sector and totally delineates the role of the government and the PSUs. A similar system of administration must be adopted by the government towards the public sector banks. A few of the public sector banks with good track record of performance and profitability can be identified as “ Navrathna” banks. These banks should only be given overall policy guidelines to meet their social banking obligations. The actual conduct of banking business must be left to the concerned bank management.

This will infuse greater autonomy and greater responsibility in the public sector banks who can explore the possibility of commercial gain even under social banking. b. Banks must be given a free hand to select manpower of their requirement and choice. It is well known that the world of finance and banking has witnessed a virtual explosion of high breed products. To grapple

with this complex market reality, the banking industry will require employees with a distinct set of skills. Training of existing employees can only supplement recruitment of talented manpower but cannot supplant it.

The remuneration structure to the employees must be discriminative and based on performance. The existing time scale system of wages is non-discriminative and does not segregate performers from non-performers. The remunerative structure must be sensitive to the structures prevalent in the private sector corporate world. c. It must be acknowledged that banks have made significant strides in bank computerization. Functional areas like book-keeping, payment/settlement systems, messaging services, and such others have been effectively addressed through computerization.

However, there is a need to scale up information flows between the branches and various control points in the bank. This is vital for addressing the problem of risk management. Risk management is critically dependent on seamless interchange of data where the control points in the bank have a see-through access to the information available at the branches. BASEL committee has come up with softwares like COREP and FINREP to augment risk management systems. d. The government must set up an institution for priority sector refinance.

This institution would be akin to NABARD and EXIM bank. It would essentially be responsible for coming out with banking derivative products which would translate social banking products into commercially viable products. This institution will provide interest rate differential finance to the banks without actually refinancing their principal amount. It is possible to develop

derivative products related to the social sector. In fact, development of derivative products in the social sector is another fertile area of academic research.

In conclusion, it must be stated that the Indian banking industry can effectively take on competition from foreign banks provided they are operating on a level playing ground. It is up to the Central bank and the Government of India to provide this level playing ground. If the basic rules of the game remain unaltered, the Indian banks would be cribbed and curtailed. The Indian banks have amply demonstrated their potential for significant improvements if they are unchained and unburdened by the Government and RBI. Appendix 1 Exhibit 1 [pic]

Source: RBI REPORT ON TREND AND PROGRESS OF BANKING IN INDIA 2006-07 page number 92 Exhibit 2 [pic] [pic] Source: RBI REPORT ON TREND AND PROGRESS OF BANKING IN INDIA 2006-07 page number 96 Exhibit 3 [pic] Source: RBI REPORT ON TREND AND PROGRESS OF BANKING IN INDIA 2006-07 page number 106 Exhibit 4 [pic] Source: RBI REPORT ON TREND AND PROGRESS OF BANKING IN INDIA 2006-07 page number 113 Exhibit 5 [pic] Source: RBI REPORT ON TREND AND PROGRESS OF BANKING IN INDIA 2006-07 page number 129 Exhibit 6 [pic] Source: RBI REPORT ON TREND AND PROGRESS OF BANKING IN INDIA 2006-07 page number 133

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