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Banking Watch

India

Hong Kong,
October 23, 2013
Economic Analysis

Asia

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A review of foreign bank performance and retail prospects in India

- **As part of the larger reform effort to promote economic openness and encourage foreign investment, the Indian authorities are taking steps to liberalize the nation's banking sector.** The reform agenda has gained renewed importance in light of the current growth slowdown. According to published plans, one of the aims is to provide greater flexibility to foreign banks that choose to operate under the existing wholly owned subsidiary structure. In turn, it is hoped that foreign bank expansion will foster financial inclusion and improve competition and efficiency.

- **The appointment of a reform-minded central bank governor last September has lifted hopes that the Reserve Bank of India (RBI) will accelerate the opening of India's financial sector.** The new governor, Raghuram Rajan, has taken office by announcing measures to further liberalize and deepen domestic financial markets and ease external financing constraints. These include steps to boost electronic banking, issue more bank licenses and with greater regularity, ease regulatory restrictions on investment, and address asset quality issues.

- **The authorities hope that foreign banks will make greater use of the wholly owned subsidiary (WoS) structure, as opposed to branches.** To date, all 43 of the foreign banks in India operate under a branch-of-the-parent structure. The authorities prefer that banks adopt a WoS structure in order to enhance regulatory capacity and improve financial stability.

- **A review of the 12 major foreign banks, accounting for 90% of the total assets of foreign banks in India, reveals that their operations are skewed towards wholesale rather than retail banking**. This is not surprising, given the limited scale of foreign banks as a share of total assets, at just 7%. However, our study suggests there may be benefits for foreign banks in enhancing their retail banking presence. Retail banking remains largely untapped in India, and returns from consumer banking have proved to be more stable during periods of financial uncertainty, helping to cushion volatile wholesale returns. Higher retail focus alongside better credit selection has also helped improve profitability ratios and keep asset quality concerns in check for domestic private banks.

- **Ongoing financial reforms should present wider opportunities for foreign banks in India.** In particular, RBI's focus on technology, a liberal branch expansion policy, a relaxation of investment norms and a favorable regulatory framework bodes well for greater foreign bank participation in India's consumer banking space. However, these steps alone will not be enough. To enable foreign banks to gain sufficient scale to enter the retail space more deeply, it would be useful to liberalize policies relating to mergers and acquisitions which are highly constrained at present under existing rules.

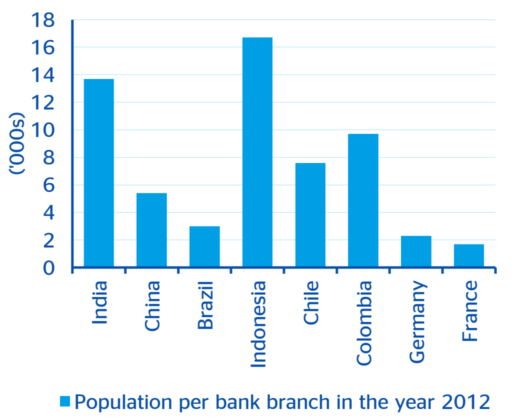
India's new banking liberalization plan is an important element of the broader reform agenda to revive slowing growth

The Indian banking sector stands on the cusp of change. The Reserve Bank of India, under the leadership of its new Governor, Raghuram Rajan, is laying the groundwork for accelerated growth through a series of sector specific liberalization measures (see Appendix 1 for details). A key feature of RBI's reform agenda is to provide greater flexibility to foreign banks that choose to operate under the existing wholly owned subsidiary (WoS) structure. In turn, it is hoped that foreign bank expansion will improve competition and efficiency and foster financial inclusion given India's low banking penetration rates (Charts 1 & 2).

The RBI's plans follow three important banking bills enacted by the government in mid-January 2013 (see Appendix 2 for details) which together aim to improve governance standards and regulatory compliance and foster capital raising by banks. Recent financial sector initiatives are an important element of India's broader economic reform agenda to restore growth prospects.

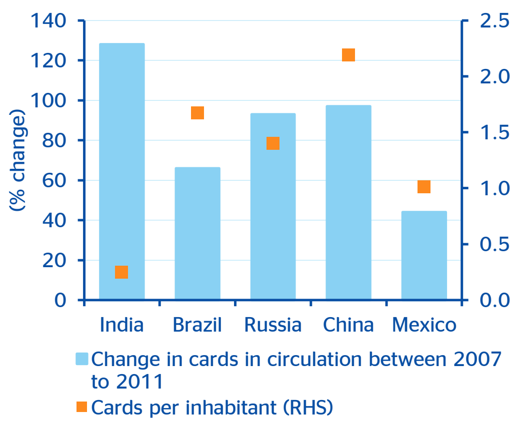
In light of the fast changing banking landscape, this Banking Watch analyses the performance of foreign banks' in India over the past decade and, looking ahead, explores growth opportunities for existing as well as potential foreign players.

Chart 1
Bank branch penetration in India is very low



Source: World Bank and BBVA Research

Chart 2
Credit card ownership per-capita is low in India



* Cards with cash function
Source: BIS and BBVA Research

Lessons from foreign banks' performance in India

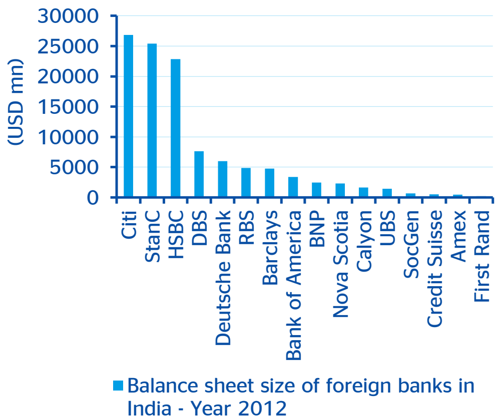
Currently, 43 foreign banks are present in India, all of whom operate under the branch-of-the-parent structure. Together, the foreign banks constitute just 7% of total assets of the banking sector and 0.4% of total branches. Furthermore, of the 333 foreign bank branches in India today, all but two are located in urban or metropolitan areas.

We analyse the performance of the 12 major foreign banks, accounting for 90% of total assets of all foreign banks in India (Chart 3; see Appendix 3 for the methodology). Key takeaways are:

1. **Wholesale banking is the favored activity of most foreign banks in India:** Foreign bank operations are skewed towards wholesale banking, accounting for more than 70% of their revenues. This is not surprising given the limited scale of foreign banks as a share of total banking assets. That said, the bias towards wholesale banking is driven by its higher operational efficiency, lower intermediation costs, as well as fewer regulatory restrictions on capital allocation, particularly with regards to priority sector lending.

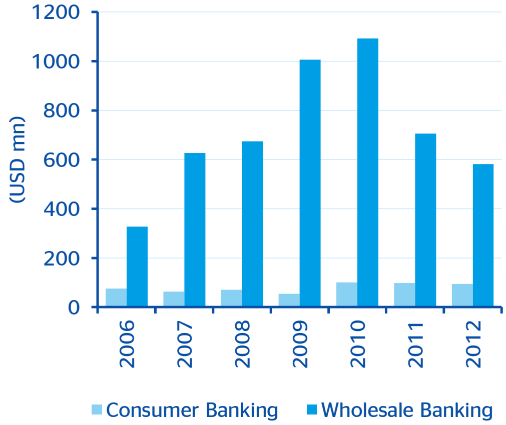
2. **Returns from consumer banking business are low but generally more stable:** While wholesale banking has been the main driver of profits for foreign banks in India (more than 80% share), returns from consumer banking have proved to be more stable, in turn cushioning volatile wholesale returns during periods of financial volatility.
3. **Declining fee and trading incomes associated with wholesale banking have weighed on operating profits:** Since 2007-08, declining non-interest income - trading profits, commissions, brokerage, profit on sale of investments and exchange transactions – have weighed on operating profits of foreign banks even as net interest margins have been relatively stable (Charts 5 & 6).

Chart 3
Balance sheet size of foreign banks in India



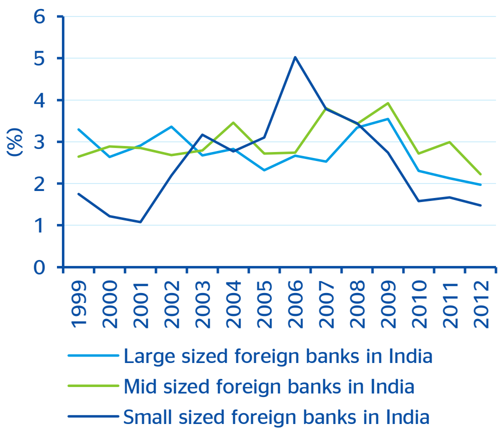
Source: RBI and BBVA Research

Chart 4
Consumer banking is a stable source of profits (Standard Chartered Bank in India)



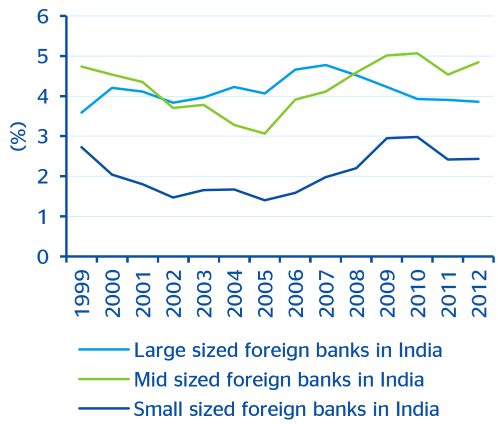
Source: Company data and BBVA Research

Chart 5
Non-interest income has slowed...



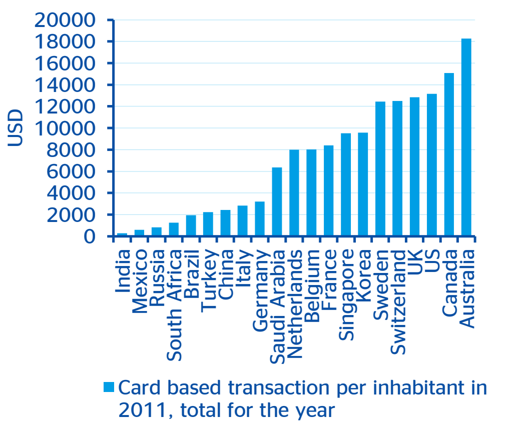
* Fiscal year ending March
Source: RBI and BBVA Research

Chart 6
... while net interest margins remain stable



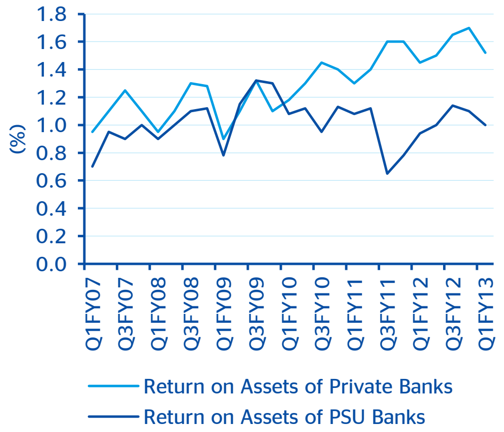
* Fiscal year ending March
Source: RBI and BBVA Research

Chart 7
Card-based transactions are low in India



Source: BIS and BBVA Research

Chart 8
Higher retail focus benefit private banks



Source: Company data and BBVA Research

The RBI's reforms bode well for the long-term growth of foreign banks in India

The RBI has promised near national treatment for foreign banks that choose to operate in India under the existing WoS structure. The authorities prefer that banks adopt a WoS structure in order to enhance regulatory capacity and improve financial stability. In this context, RBI's decision not to accord full national treatment for foreign banks, apparently amid concerns over risks to financial stability, is a minor setback, although we believe that an effective implementation of RBI's proposed reforms should open wider growth opportunities for foreign banks going forward. Foreign banks, backed by a menu of sophisticated financial products, technological innovation, and high funding capacity can be expected to accelerate India's financial inclusion by tapping the unbanked across India's hinterland.

Meanwhile, to attract foreign banks specialising in niche segments such as investment banking, portfolio management and global markets, RBI has, over the long term, proposed to issue 'differentiated licenses' for domestic and foreign banks instead of granting universal banking licenses. Currently, RBI issues a single class of banking licenses for conducting all activities ranging from retail, wholesale, forex, derivative products, and credit cards.

Experience of Indian private banks underscores the benefits of a higher retail mix focused on secured lending

Given India's underpenetrated market -- credit card usage in India is among the lowest in the world (Chart 7) -- and the lack of progress on infrastructure development, domestic private banks in India have faced high operating costs, especially during their initial years of branch expansion. Furthermore, retail slippages in the early years were high, which in turn inflated credit costs.

That said, over the medium to long term, a higher retail mix with greater focus on secured retail loans augurs well for domestic private banks in India. In contrast to public sector banks, which face more serious asset quality concerns due to larger wholesale lending exposure to stressed sectors such as power and airlines, private banks have posted higher return on assets since the 2009 credit crisis (Chart 8). A step up in retail banking by Indian banks alongside better credit selection and underwriting have kept asset quality concerns in check for domestic private banks in India.

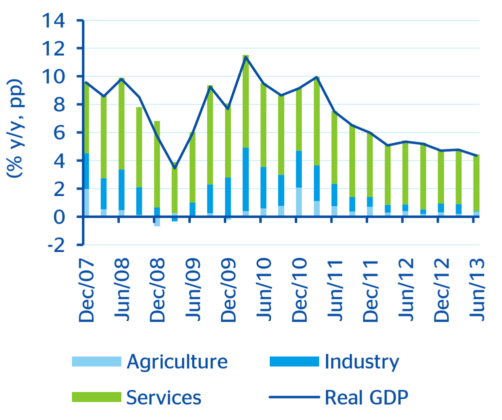
Against a challenging macro backdrop, the government needs to do its part in leveraging RBI's banking reforms agenda

Potential foreign banks or those with expansion plans will encounter headwinds from a challenging domestic macro environment at present (Chart 9). Elevated inflation, tight funding conditions and slowing domestic demand have weighed on margins of domestic banks amid slowing credit and deposits growth (Chart 10). Although we remain sanguine about India's long term growth potential, we expect the current macro difficulties to persist in the near to medium term and the economic recovery to be long drawn.

While a timely and effective execution of these financial liberalization measures is essential, they also need to be complemented by parallel investment reforms by the government. These include further relaxation of foreign direct investment limits across related sectors such as pension and insurance and expediting infrastructure development, particularly in the roads and telecom sector. The present 26% foreign direct investment cap in India's insurance and pension sector is among the lowest in the world – 50% in China, 100% in Japan, South Korea, Vietnam, Hong Kong and Taiwan. More importantly, clarity in policy formulation and the absence of bureaucratic hurdles are critical factors for foreign investments to actually materialise. Addressing these issues would help stimulate the expansion of the financial services industry in India, which remains significantly under-penetrated.

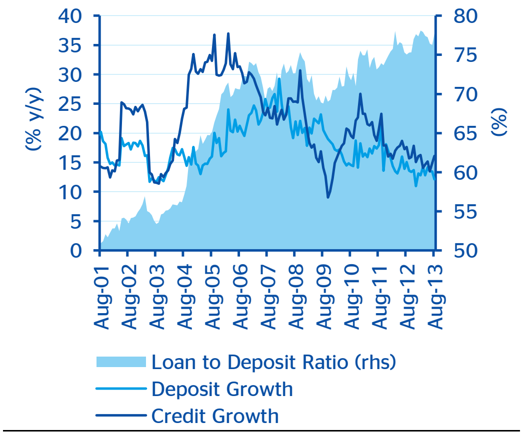
Looking ahead, RBI's focus on technology, a liberal branch expansion policy, a relaxation of investment norms and a favourable regulatory environment bode well for greater foreign bank participation in consumer banking. However, these steps alone will not be enough. To enable foreign banks to gain sufficient scale to enter the retail space more deeply, it would be useful to liberalize restrictions on mergers and acquisitions, which are highly constrained under present rules which set a limit of 10 percent equity participation in local banks.

Chart 9
India's growth has slowed to multi-year lows...



Source: RBI and BBVA Research

Chart 10
... in turn weighing on deposit and credit growth



Source: RBI and BBVA Research

Appendix

1. List of bank-related reforms and financial liberalization measures initiated/proposed by the RBI

Table 1
List of banking and financial sector reforms planned by the Reserve Bank of India

	Financial Reforms	Rationale	Status	Evaluation
1	**Shift to a wholly owned subsidiary structure**	A near national treatment for foreign banks operating under the Wholly Owned Subsidiary structure	Final guidelines expected before mid 2014	Would help boost foreign bank expansion in India and foster financial inclusion while enhancing regulatory comfort through ring-fenced domestic capital and greater control
2	**New domestic private bank licenses**	Allows eligible business groups and private and public financial institutes to apply for a bank license	Likely to be issued in 1H14	Enhance competition, fosters efficiency in Indian banking sector, aids financial inclusion. Presents regulatory challenge in selecting the right candidates and dealing with conflict of interest in case of eligible business groups
3	**Lift restrictions on branch expansion**	To ease regulatory hurdles in deepening banking penetration	Pending	This alone would do little to incentivise branch expansion unless accompanied by rapid infrastructure development
4	**Issue differentiated licenses for small and wholesale banks**	To help set up boutique banks which specialise in niche segments	Pending	Would help attract more foreign banks in India
5	**Free new bank entry**	An 'on-tap' bank licensing process to make the bank licensing process more frequent	Pending	Provides potential bank entrants with the flexibility to apply for a license when they see themselves fit. Helps boost India's long term banking sector growth
6	**Ease regulatory norms on banks' investments in government securities**	To ease investment restrictions for banks	Pending	Greater autonomy in investments bodes well for greater foreign bank participation in India
7	**Enable the use of electronic and mobile based payments across households using a unique identification card**	To deepen banking penetration	Pending	Addressing infrastructure related issues are crucial to gain the full benefits of electronic payments using the unique id card
8	**Lift restrictions on investments in financial instruments and ease norms on position taking**	Step towards deepening financial markets	Pending	Positive for attracting foreign capital inflows although optimal regulations are vital amid risks excessive speculation in financial market
9	**Facilitate setting up of 'white' point of sale devices and mini ATMs by non-banks**	To deepen banking penetration	Pending	A key positive in expanding card based usage and transactions in India
10	**Issue inflation indexed saving certificate to retail investors by November 2013**	To boost financial savings in India	Initiated	Although still at a nascent stage, the move would help divert household wealth from physical savings such as gold and real estate to financial savings, augurs well for India's savings-investment balance
11	**Accelerate the working of debt recovery tribunals**	To address asset quality issues of banks	Pending	With rising gross NPA issue a key concern for the Indian banking sector, the tribunal would play a key role in easing balance sheet strain for banks

Source: RBI and BBVA Research

2. Banking and financial reforms by the Government

Table 2
Banking and financial Reforms by the Government

	Financial Reforms	Rationale	Status
1	Banking Laws bill	Enhances the Reserve Bank of India's (RBI) regulatory powers, eases capital raising norms for banks, strengthens voting rights for investors, and paved way for the RBI to release its eagerly awaited new guidelines on issuing banking licenses and for the final guidelines on foreign bank licenses in India under the wholly owned subsidiary structure	Done
2	Anti-money laundering Bill	Raises corporate governance standards	Done
3	Issuance of new private bank licenses	Would enhance competition and foster efficiency in Indian banking sector, aid financial inclusion	Pending, likely in 1H14
4	Tax breaks on interest on small housing loans	To deepen banking penetration	Done
5	Interest subvention scheme to private banks	To deepen banking penetration	Done

Source: Government of India and BBVA Research

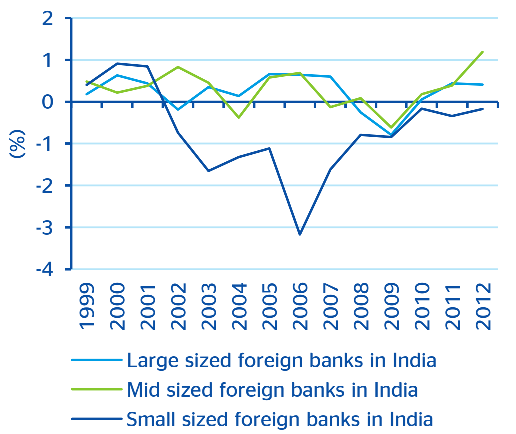
3. Examining past performance of foreign banks in India:

For a better understanding of the financial performance of foreign banks operating in India, we group 12 leading banks into three segments according to their balance sheet size. These include Standard Chartered Bank, HSBC, Citi, Deutsche bank, Bank of America, Barclays, Societe Generale, BNP Paribus, RBS, Calyon, Nova Scotia and DBS, which together constitute 90% of total assets of foreign banks in India. We classify these banks into three categories according to their balance sheet size:

- Large sized foreign banks in India : Asset size > USD 10 bn each (Standard Chartered, HSBC, Citi)
- Mid-sized foreign banks in India: Asset size between USD 3 bn to USD 10 bn (Deutsche bank, Bank of America, BNP, RBS, DBS)
- Small sized foreign banks in India: Asset size less than USD 3 bn (Barclays, Societe Generale, Calyon, Nova Scotia).

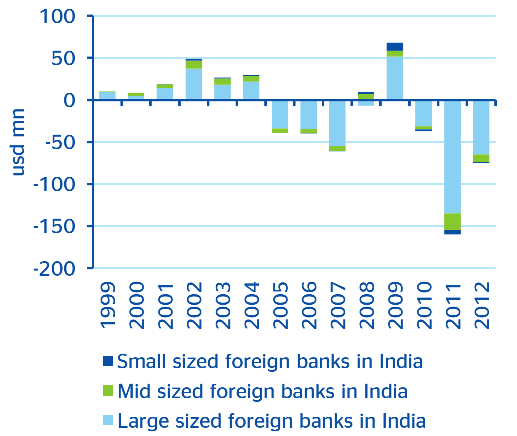
Each variable under study is thus a weighted average of the parameter for each individual bank in the group, weighted as per their balance sheet size. Below are additional graphs from our study:

Chart 11
Foreign bank burden has increased...



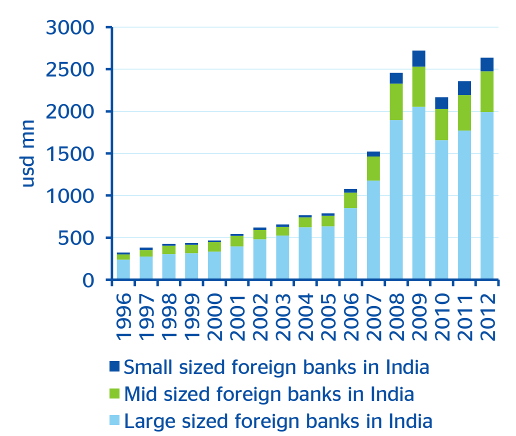
* Burden = non-interest expenses minus non-interest income
** Fiscal year ending March
Source: RBI and BBVA Research

Chart 12
... weighed in part by loss on investments



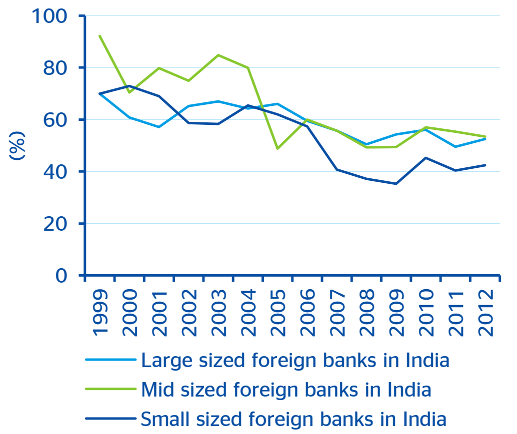
* Fiscal year ending March
Source: RBI and BBVA Research

Chart 13
... that despite, total income has trended up



* Fiscal year ending March
Source: RBI and BBVA Research

Chart 14
... As foreign banks focus on secured advances



* Fiscal year ending March
Source: RBI and BBVA Research

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