BRIEFING PAPER

India-EU FTA: Rethinking Banking Services Liberalization

Since 2007, India and EU have been negotiating a free trade agreement (FTA) — covering trade in goods and services, investments, intellectual property rights and government procurement — that is fraught with problems. Till now, ten negotiating rounds have been held. The agreement is expected to be finalized by mid-2011.

One of the major underlying themes in the ongoing negotiations is the liberalization of trade and investment in banking services. With the help of FTA with India, EU is seeking greater market access and export gains for its banks through cross-border supply and direct investments. Some of the key demands emanating from Europe include removal of all barriers to market access (commercial presence, cross-border supply and consumption) and grant of national treatment commitments. The EU banks and powerful lobby groups such as European Services Forum (ESF) have put forward a slew of demands including removal of all restrictions pertaining to branch licenses, foreign ownership (of both public and private banks), numerical quotas, equity ceilings, differential taxation, and voting rights. The ESF is seeking removal of priority sector lending on locally incorporated EU-owned banks besides removal of current restrictions under which branch licenses may be denied if foreign banks' aggregate share of the banking market exceeds 15 percent.

Another key demand of ESF relates to the removal of restrictions on foreign banks to participate in exchange traded commodity products. Currently, Indian commodity exchanges do not allow direct participation by foreign banks. The ESF has also demanded free access to deposits made by the state-owned companies.

By asset size, six out of top 10 foreign banks in India are EU-based. The 9 EU-based banks together controlled 65 per cent of total assets of foreign banks in India in 2008. Hence, the policy implications of opening up of Indian banking sector under the India-EU FTA would be markedly different from other FTAs signed by India.

The Burgeoning Financial Services Trade

Though there are 27 member-states of the EU, the banking services agenda is aggressively pushed by the UK and Germany under the proposed India-EU FTA. The UK is one the leading centers for global banking with the largest share of cross-border banking lending (18 percent) in the world. The financial services alone account for 8.3 percent of its GDP.[1] London accounts for an estimated 41 per cent of EU's financial services.[2] London also accounts for over 30 percent of world foreign exchange trade and 40 percent of the over-the-counter derivatives market.[3]

The UK remains the leading exporter of financial services in the world. Despite the global financial crisis which erupted in 2007, the UK's financial sector net exports were £41.8 billion in 2009.[4] Banks were the largest single contributor, with net exports of £25.3 billion. The bulk of UK banks' net exports were generated through spread earnings (£10.6 billion) with the largest contribution by derivatives, FISIM[5] (£9.9 billion) and net fee income (£4.0 billion).

In terms of UK's balance of trade in goods and services in 2009, trade surpluses generated by financial services (£40.2 billion) managed to partially offset large deficits in goods (£82 billion). The UK's financial services trade surplus with India was £206 million in 2007, with banks contributing £197 million. Over the years, Germany and Ireland have also registered significant trade surpluses in financial services.

Tapping Diaspora Remittances

A number of Indian banks (especially big private banks) are also striving for increased presence in Europe. It is interesting to note that Indian banks are not aiming at capturing the highly competitive domestic banking markets in Europe. Rather their aim is to tap the non-resident Indians (NRIs) based in EU member-states. Since India is the largest remittance recipient country in the world ($55 billion in 2010), Indian banks are keen to serve this lucrative business segment by increasing their presence in the European banking markets.

Of late, some domestic banks are also facilitating acquisition of European companies by big Indian corporations. For instance, ICICI Bank co-financed United Spirits' takeover of Scotch whisky distillers, Whyte & Mackay, in 2007 and Tata Motors' $2.3 billion takeover of Jaguar and Land Rover in 2008.

The Lure of Niche Banking Markets

The commercial motives of EU-based banks behind entering Indian banking markets are obvious due to immense profit opportunities. For London-headquartered Standard Chartered, India became the largest contributor to the bank's global operating profits in 2010. The bank's profits in India reached $1.06 billion in 2009. For UK-based HSBC Holdings, Europe's largest bank by market capitalization, India was the seventh largest contributor to its global profits in 2008.

By and large, European banks are interested in serving three niche market segments in India: up-market consumer retail finance, wealth management services and investment banking. Several European banks (such as Societe Generale and BNP Paribas) are keen to expand their presence in niche markets such as private banking. The big ticket mergers and acquisitions (particularly in cross-border segment) taking place in corporate India require investment banking, underwriting and other advisory services where big European banks have a competitive edge over domestic banks. Deutsche Bank has been a leader in mergers and acquisitions, with the bank involved in Tata Steel's acquisition of Corus.

The Urban-centric European Banks

To date, most of bank branches of EU-based banks are located in metropolitan areas and major Indian cities where bulk of premium banking business is concentrated. As on March 2010, there were 9 EU-based banks operating in India with a network of 213 branches. Out of which, 163 branches (76.5%) were located in metropolitan areas, 45 (21%) in urban areas and merely 5 (2.3%) in semi-urban areas (Table 1). It is distressing to note that EU-based banks have not yet opened a single branch in the rural areas. This is despite the fact that several EU banks have been operating in India

for more than 150 years. Established in 1858, Standard Chartered Bank is the oldest foreign bank in India. BNP Paribas and HSBC began their operations in India in 1860s.

Not surprisingly, European and other foreign banks are not serving the poor and low-income people residing in metropolitan and urban areas. There is no regulatory ban on foreign banks to serve the urban poor and low-income people.

The Extent of Financial Exclusion

In India, financial exclusion has strong linkages with poverty and is predominantly concentrated among the poor and marginalized sections of society. Various studies have measured the extent of financial exclusion in India. The National Sample Survey Organisation of the Ministry of Statistics and Programme Implementation carried out All India Debt and Investment Survey (AIDIS) 2002-03 to assess the indebtedness of Indian farmers.[6] The Survey revealed that 45.9 million farmer households in the country (nearly 51%), out of a total of 89.3 million, do not have access to credit, either from institutional or non-institutional sources.[7] Further, merely 27 percent of total farm households are indebted to institutional sources. In other words, 73 percent of farmer households have no access to formal sources of credit.

One of the negative consequences of banking sector reforms is the decline in bank branches in rural areas even though the total number of bank branches in India has increased. The total number of bank branches of all scheduled commercial banks (including regional rural banks) increased from 72,752 at end-June 2007 to 76,518 at end-June 2008 but the share of rural branches declined to 40.7 percent at end-June 2008 from 42.1 percent at end-June 2007.[8] In 1991, the share of rural branches was the highest (58.5 percent). In other words, the recent spurt in bank branches has worsened the rural-urban ratio. In August 2005, the RBI issued a list of 391 underbanked districts in India with population per branch more than the national average of 16,000. The underbanked population is higher in the North Eastern and Eastern regions.

Table 1: Branches of EU-based Banks

Bank	Rural	Semi-Urban	Urban	Metros
Antwerp Diamond	0	0	0	1
BNP Paribas	0	0	0	9
Barclays Bank	0	1	3	3
Calyon Bank	0	0	0	6
Deutsche Bank	0	0	6	7
HSBC	0	2	10	38
RBS	0	2	10	19
Societe Generale	0	0	0	2
Standard Chartered	0	0	16	78
Total	**0**	**5**	**45**	**163**

Source: Compiled by author from RBI statistics.

Since the 1990s, the banking sector has witnessed a secular decline in agricultural credit. This is in sharp contrast to the 1970s and 80s when a significant shift in bank lending in favor of agricultural sector took place. The state-owned banks contributed 77.3 per cent of total credit to agriculture at end-March 2007 while the remaining was contributed by private sector and RRBs.

Besides, there is a significant decline in banking lending to small- and medium-sized enterprises (SMEs) since the 1990s. The SMEs account for almost 40 per cent of India's total production, 42 percent of exports and are the second largest employer after agriculture. The SMEs produce over 8,000 value-added products and are involved in several services sector.

The Exclusive Banking Model

Since European banks have no branches in the rural areas, they are not obliged to serve the vast sections of rural households who are excluded from the formal banking system. Their contribution in the opening of "no frills" bank account under the financial inclusion program has been abysmal.

Typically, foreign (and big private banks) are averse to provide banking services to the poor people because they find such clients less lucrative.

In particular, foreign banks tend to follow "exclusive banking" by offering services to a small number of clients. Several EU-based banks and their lobby groups have expressed their discomfort in fulfilling the mandatory priority sector lending requirements. Rather they prefer a niche banking model with no riders in terms of social and developmental banking.

It is well established that not only foreign banks in India charge higher fees from customers for providing banking services but maintaining a bank account requires substantial financial resources. Given the fact that the average up-market retail banking customer can be ten times more profitable than the average mass-market retail customer, it is highly unlikely that the commercial interests of European banks would match with the developmental needs of unbanked population.

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

Some Pertinent Questions

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

Will European banks augment the reach of the banking system to millions of Indians citizens who do not have access to basic banking services? Will EU-based banks undertake social and developmental banking? Can European banks meet the targets of financial inclusion for rural households, as suggested by the Committee on Financial Inclusion? Where would European banks open their branches in metros? Dharavi or Nariman Point? What extraordinary services European banks would provide to serve unbanked population? What specialization and experience do European banks have when it comes to providing basic banking services to landless rural workers and urban poor dwellers?

The Fallout of the Global Financial Crisis

Several European banks had acquired US-based mortgage and “toxic” financial assets whose value plummeted sharply during 2007-08. This contributed to a sudden loss of confidence within the European banking system as banks became reluctant to lend to one another, thereby causing a dramatic loss of liquidity.

Are Foreign Banks More Efficient Than Domestic Banks?

There is a widespread perception that foreign banks perform better than domestic banks on efficiency and productivity levels in India. However, a recent analysis by Reserve Bank of India (RBI) found that on several efficiency indicators, state-owned banks outperform both foreign and private banks. This is despite the fact that state-owned banks undertake substantial social banking and run a huge branch network in the rural and semi-urban areas where the transaction size is small.

The Reserve Bank of India has measured efficiency of different bank-groups in India using both accounting and economic measures.[9] Based on its rigorous analysis, the RBI observed that “ownership has no definite relationship with efficiency.”[10]

The intermediation cost is the standard benchmark of bank efficiency. The higher the intermediation cost, the lower is the efficiency of a bank. In contrast to domestic banks, intermediation costs of foreign banks were much higher in India during 2006-07. Two other accounting indicators, return on assets (RoA) and return on equity (RoE), measure the overall profitability of banks. Foreign banks have higher RoA as compared to domestic banks, largely on account of profits generated by off-balance sheet businesses in India. However, RoE of state-owned banks was higher than both foreign and private banks in 2006-07.

The RBI has also used a non-parametric methodology called Data Envelopment Analysis (DEA) to measure bank efficiency. Based on this methodology, the RBI found that during 2006-07, the government-owned State Bank group was the most cost efficient with efficiency level of 0.85, followed by new private sector banks (0.83), nationalized banks (0.80), foreign banks (0.66) and old private sector banks (0.59). The RBI analysis further found that out of 10 most efficient banks, top 5 were state-owned banks, followed by 3 private sector banks while the remaining two were foreign banks.[11]

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

The highly leveraged EU-based banks (particularly in the UK, France, Germany and Ireland) sought billions of euros of state help to rebuild their balance sheets battered by the financial meltdown.

The European governments provided more than €3 trillion through guarantees and recapitalization schemes to save the ailing banks. Since the financial crisis badly infected the real economy, the EU economies are not out of the woods yet as there are renewed worries about rising unemployment.

Post-crisis, serious questions have been raised about the strength and credibility of European banks. The global financial crisis has put a big question mark about their efficiency, "best practices" and state-of-the-art risk management models. The crisis has also exposed the poor corporate governance and transparency norms of several European banks.

Given the higher degree of interconnectedness among EU banks, problems in one country quickly put the entire financial system at risk. Without doubt, the EU is facing unprecedented challenges in maintaining financial stability and strengthening banking regulations.

In contrast, India banking system has largely remained insulated from global turmoil thanks to limited presence of foreign banks, negligible exposure of domestic banks to US sub-prime markets and related financial instruments, and enlarged state ownership of banking system. Often criticized as "inward-looking" and "conservative," India's regulatory framework also acted as a key determinant in protecting the domestic banking system from the global financial turmoil.

Rethinking the Benefits and Costs of Banking Sector Liberalization

The proponents of banking services liberalization tend to overlook the potential costs associated with the entry of foreign banks in host countries. If the entry of foreign banks is allowed through acquisition of domestic banks, it may lead to concentration of banking markets and loss of competition.

The foreign banks can be a source of cross-border contagion from adverse shocks originated elsewhere. A large presence of foreign banks

Market Access Asymmetry

India is opening up its banking markets, far exceeding the international commitments. Under the WTO agreement, India has given commitments to offer 12 new branch licenses every year to foreign banks. But the actual number of branches permitted each year to foreign banks has been higher than the WTO commitments. During July 2006-June 2007, India allowed seven established foreign banks (including ABN AMRO Bank, Barclays Bank and Deutsche Bank) to open 20 new branches.

During 2003-07, India allowed US-based banks to open 19 branches (excluding the off-site ATMs). But, in the same period, the US did not allow a single Indian bank to open a branch or subsidiary or representative office in its territory despite requests by several Indian banks.

In the case of India-Singapore Comprehensive Economic Cooperation Agreement (CECA), which came into effect in 2005, the principle of reciprocity has not been followed. The CECA provided special privileges to three Singapore banks (DBS Bank, United Overseas Bank and Overseas-Chinese Banking Corporation) as they were given a separate quota of 15 branches (for all three banks) over four years, over and above the quota for all foreign banks.

In return, three Indian banks were to be given the Qualifying Full Banking (QFB) status in Singapore. The QFB status allows banks to undertake all activities (including retail and wholesale banking) in Singapore. Besides, banks with QFB status can also transact business in Singapore dollars.

India has given far greater market access to Singapore banks than its commitments under CECA. As of November 2010, Development Bank of Singapore had 12 branches in India along with other Singapore banks. But Singapore has not fulfilled its commitments under the CECA for providing QFB status to three Indian banks. Only State Bank of India was given QFB status in 2008. After much pressure from New Delhi, ICICI Bank was offered QFB status in 2010 while Bank of India has been denied the QFB status.

originated in crisis-ridden countries could lead to rapid transmission of financial shocks in the host countries.

The parent bank may also reduce exposure in a host country or move out completely due to losses suffered in home or other countries. Post-crisis, foreign banks have drastically reduced lending in India. During 2009-10, the loan portfolio of foreign banks contracted by 9.7 percent. The UK's Royal Bank of Scotland has decided to exit from or shrink its operations in 36 countries (including India and China) due to problems at its parent bank.

In addition, it is highly debatable whether foreign banks presence has a stabilizing role in the case of a systemic crisis. In Argentina, for instance, several foreign banks chose to leave the country when a financial crisis erupted in 2001.

Furthermore, the entry of foreign banks poses new challenges to regulation and supervision. The regulatory and supervisory authorities are restricted to their national borders while foreign banks can easily cross national borders and operate internationally. The overall responsibility for the parent bank remains with the regulatory authorities in the home country. But there is little coordination and sharing of information among the regulatory authorities of home and host countries.

The global financial crisis has proved beyond doubt that increased financial integration can transmit financial shocks across countries. Financial innovation in certain unregulated products and markets can also augment financial shocks. The crisis has highlighted the risks associated with the presence of large financial conglomerates in the domestic banking system. Post-crisis, several proposals for enhanced regulation and supervision of financial conglomerates (which operate in different segments such as banking, insurance, securities and private equity) are under consideration at various levels.

Keeping these new developments in view, the policy makers should rethink about the benefits of opening up of banking services under the framework of India-EU FTA.

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Notes

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2. UK Trade & Investment, "Key Statistics," 2008 (available at www.ukti.gov.uk).

3. Ibid.

4. Duncan McKenzie, "UK Financial Sector Net Exports 2010," TheCityUK, August 2010 (available at www.thecityuk.com/media/177588/uk%20financial%20sector%20net%20exports%202010.pdf).

5. FISIM stands for Financial Intermediation Services Indirectly Measured. It represents the implicit charge for the service provided by banks paid for by the interest differential between borrowing and lending rather than through fees and commissions.

6. NSSO, All India Debt and Investment Survey (2003), 59th Round Report, Government of India.

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