FDI in Banking

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As the next session of Parliament approaches, the Prime Minister and the Congress Party seem adamant about further advancing their programme of financial liberalisation. Controversial among their favoured "reforms" is a change in the rules governing foreign investment in India's banking sector. Opposition to this move was one of the issues motivating a two-day strike by around a million bank employees in August this year.

But those advocating liberalisation of governance regulations in the form of equity caps for foreign shareholders and caps on voting rights for both domestic and foreign investors are unwilling to listen. They often even suggest that this is an area in which reform has been almost absent or creeping, and is restricting the ability of private banks to mobilise foreign capital to enhance their capital base. But are they right?

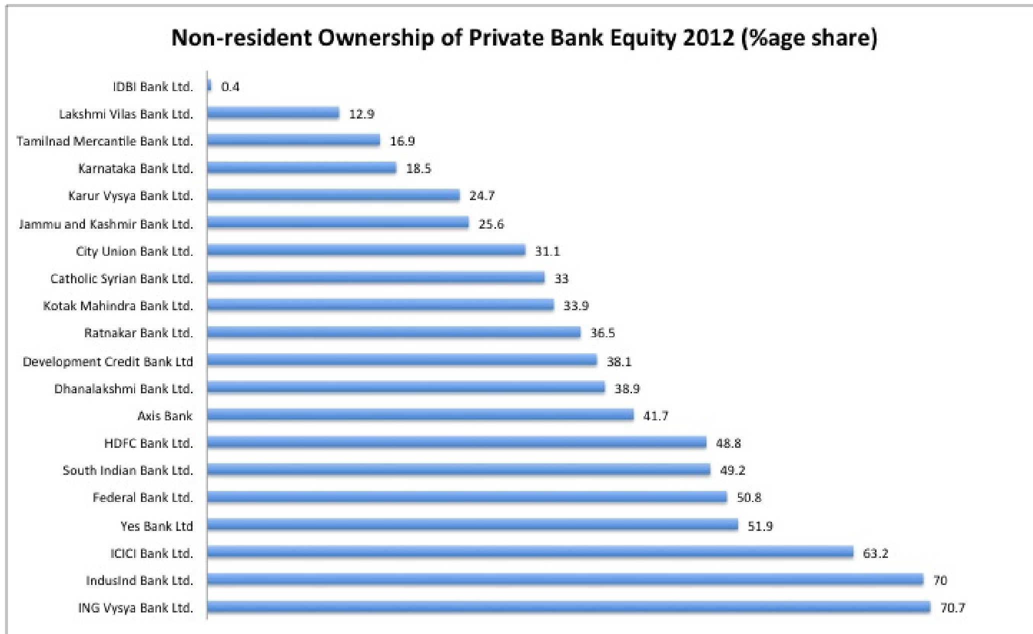
The fact of the matter is that governance rules in the banking system have indeed been changed to accommodate the private investor (domestic and foreign) after liberalisation. Besides permitting the entry and consolidation of new private banks, the government (through the Ministry of Commerce) had as far back as March 5, 2004, announced a set of decisions with reference to foreign investment in the banking sector, which relaxed the cap on foreign equity in Indian banks to 20 per cent in the case of public sector banks and 74 per cent in the case of private banks. This was in addition to the permission granted to foreign banks to operate in the country through wholly owned subsidiaries subject to increasingly relaxed rules.

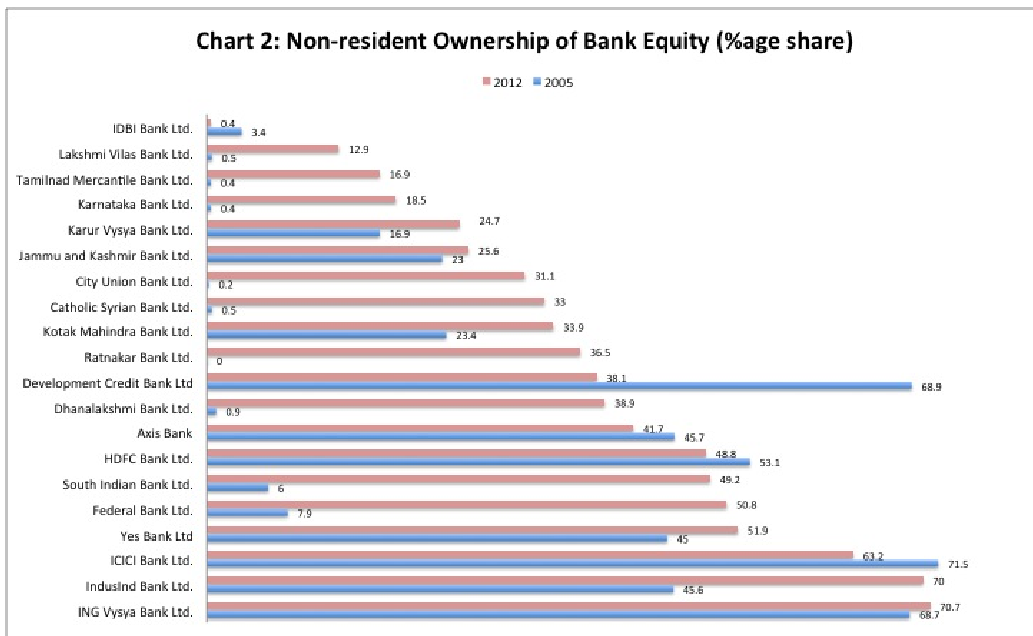
Consequent to the Ministry of Commerce announcement, the Reserve Bank of India issued a more detailed and comprehensive set of policy guidelines on ownership of private banks. Recognising that the 5th March notification by the Union Government had hiked foreign investment limits in private banking to 74 per cent, the guidelines first clarified that this ceiling was applicable to the sum total of foreign investment in private banks from all sources (FDI, Foreign Institutional Investors, Non-Resident Indians).

More importantly, in the interests of diversified ownership the guidelines had declared that no single foreign entity or group could hold more than 10 per cent of equity. There was also a 10 per cent limit set for individual FIIs and an aggregate of 24 per cent for all FIIs, with a provision that this can be raised to 49 per cent with the approval of the Board or General Body. Finally, the 2004 guidelines set a limit of 5 per cent for individual NRI portfolio investors with an aggregate cap for NRIs of 10 per cent, which can be raised to 24 per cent with Board approval.

Finally, in keeping with this more cautious policy, the RBI decided to retain the stipulation under the Banking Regulation Act, Section 12 (2), that in the case of private banks the maximum voting rights per shareholder will be 10 per cent of the total voting rights (1 per cent for public banks). The 10 per cent ceiling on equity ownership by a single foreign entity was partly geared to aligning ownership guidelines with the rule on voting rights.

The response to this from liberalisation advocates was that the whole exercise was pointless inasmuch as the ceiling on single investor ownership and voting rights would deter foreign investors. The evidence shows that this expectation has turned out to be completely false. As Chart 1 shows, the share of foreign investors in private bank equity exceeds 50 per cent in five banks and stands at between a third and a half in another eight. Moreover, Chart 2 shows that in a number of instances the share of foreign equity has increased between 2005 (when the guidelines had come into force) and 2012.





Problems arose only in the case of those entities in which single foreign entities held more than 10 per cent equity. This was, for example, true of the Development Credit Bank (which had the Aga Khan Fund for Economic Development as lead shareholder

with around 25 per cent of equity) and the Catholic Syrian Bank (in which Surachan Chawla of the Siam Vidhya group from Thailand had acquired 36 per cent shares in the 1990s and has since been able to reduce the total to only 21 per cent). The problem faced by these entities is that of finding buyers willing to acquire small blocks of equity to ensure adequate dilution of lead stakeholder ownership in a bank being run by a dominant foreign shareholder. As a result they have been under pressure for not complying with the RBI's demand to dilute equity and faced with threats of penal action.

The implication of this is clear. The problem with well-performing private banks is not that it is difficult to attract foreign equity investment. The problem is that current rules do not allow entry of those whose intent is to exercise control over a local bank with an adequate share holding and equivalent voting rights. Hence, if the need is to allow foreign equity infusion to meet prudential requirements such as the Basel norms, that is still possible. What is not allowed is the entry of single foreign investor seeking to establish or acquire domestic private banks with a controlling stake and voting rights.

The case for such regulation of foreign presence had been clearly specified in the past. The RBI has for long strongly advocated diversified ownership of banks. The RBI's Report on Trend and Progress of Banking in India, 2003-04 states: "Concentrated shareholding in banks controlling substantial amount of public funds poses the risk of concentration of ownership given the moral hazard problem and linkages of owners with businesses. Corporate governance in banks has therefore, become a major issue. Diversified ownership becomes a necessary postulate so as to provide balancing stakes."

A more elaborate exposition of the RBI's views on the matter came from Rakesh Mohan, a former Deputy Governor of the RBI. In a speech made at a Conference on Ownership and Governance in Private Sector Banking organised by the CII at Mumbai on 9th September 2004 he remarked:

> The banking system is something that is central to a nation's economy; and that applies whether the banks are locally-or foreign-owned. The owners or shareholders of the banks have only a minor stake and considering the leveraging capacity of banks (more than ten to one) it puts them in control of very large volume of public funds of which their own stake is miniscule. In a sense, therefore, they act as trustees and as such must be fit and proper for the deployment of funds entrusted to them. The sustained stable and continuing operations depend on the public confidence in individual banks and the banking system. The speed with which a bank under a run can collapse is incomparable with any other organisation. For a developing economy like ours there is also much less tolerance for downside risk among depositors many of whom place their life savings in the banks… Hence diversification of ownership is desirable as also ensuring fit and proper status of such owners and directors.

It is evident that the RBI, which is the regulator of the banking sector, had a strong case for issuing elaborate guidelines on bank ownership to ensure diversification. Those reasons retain their relevance even today. So there is no case for altering them,

especially if the evidence suggests that accessing foreign equity, if needed, to enhance the capital of banks is possible within the current regulatory framework.

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