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Foreign banks in India: A literature review

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Abstract
This study is further an addition to the debate relating to further deregulation of foreign banks in Indian context. It contributes to the debate by analyzing the evolution of foreign banks, beginning with the colonial era, up to the current period. It presents the analysis till 2015 and concludes that foreign banks enjoy high profits in spite of entry of new foreign banks. Post reforms Era saw a significant increase in the number of banks after deregulation of entry was found to be accompanied by considerable fluctuations. It is not clear how supposed benefits of entry of foreign banks will gear up the economy in the absence of stability of new entrants.

Keywords: foreign banks, economic history, post-reforms era

Introduction

Foreign banks have been demanding for a number of years that they be allowed to acquire local banks. Many visiting ministers and politicians lobbied with the government and the RBI without much success. The current paper seeks to contribute to the debate by providing it the required historical context, made possible by a very long period of operation of foreign banks in India. After all, the stakes in the debate is very high and this debate needed to be firmly rooted in history of foreign banking in India, theory of international banking and the objective scenario relating to operation of foreign banks in India. After all, there exists a voluminous literature arguing against deregulating foreign banks in emerging countries. In India as well there are studies (Charvaka, 1993; Vishwanathan, 1993; Deb, 2010; Murthy and Deb, 2011; Deb and Murthy, 2012a; Murthy and Deb, 2012b) [3, 5, 1, 2, 4, 6], which argue in favour of preserving the status quo for foreign banks in the country. In the context of the debate, the objective of the present paper presents the analysis of the evolution of foreign banks in India since their inception with special reference to the present era of globalization of the banking industry. While the period covered by the chapter is long enough, it may be analytically useful to classify the period in three phases: the period till independence, the post WTO phase and the intervening period. This distinction may be rationalized on the basis of the policy regime followed during the said phases. A lasseiz faire policy followed during the period till independence gave to a stable phase of restricted policy regime for foreign banks, which in turn was replaced by a liberalized set of policies in the post reforms phase.

Review of literature

Foreign banks operating in India have received scant research attention in the literature on banking. History of foreign banks has been reviewed by Panandikar and Mithani (1966) [5] followed by Karunagaran (2006) [7]. Karunagaran (2006) [7] provides an analysis of foreign banks in India in the colonial period based on descriptive analysis of data devoid of any theoretical framework and econometric analysis. However, Panandikar and Mithani (1966) [5] is an excellent source for analyzing role of foreign banks in colonial India and our next section will be mainly based on the study. Apparently, the earliest attempt to analyse the potential role of foreign banks in independent India was made by Viswanathan way back in 1993, the year in which Narasimham Committee Report (1991) was implemented. Viswanathan (1993) contributed to the literature through a critical assessment of foreign banks through a reference to experience of other countries with regard to foreign banks. She argued that the role of foreign banks in issuing and underwriting securities must be regulated to the extent necessary to ensure that the interest cost of obtaining financing directly on the capital market does not lead to an external debt burden in India similar to that which plagues Latin America. Viswanathan (1993) further argues that new innovations in securitised lending involve off-balance sheet transactions, which are not subject to the controls imposed on banks' balance sheet business. Viswanathan (1993) should be credited with the fact that it underlines for the first time the significance of a discussion on off balance sheet activities in an evaluation of role of foreign banks in India. She sounded a note of caution to the policy makers' way back in 1993. Next in line is a study authored by Charavaka (1993), which draws our attention to the mind-boggling levels of income and profit allowed to be earned by branches of foreign banks in India, largely from non-operating sources. Such, a phenomenal profit of foreign banks operating in India is termed by the author as Drain of Wealth. The study used bank wise data relating to 1991-2 and 1992-93, which have been presented in two monographs by the Indian Banks' Association on the performance highlights of public sector banks and foreign banks in India. The author prepared a table based on the above data set, which shows that the profit levels of foreign banks have been vastly disproportionate to the their deposits. This leads Charvaka to look for reasons behind such phenomenal profits of foreign banks. Charvaka concluded that the profits earned by the foreign banks, the bulk of them at any rate, are predatory in character not based on genuine banking operations.

Foreign Banks in India: Laissez Faire Policy Till Independence

The issue related to the development of foreign banks in colonial India in a completely laissez faire situation and the impact of foreign banks on development of banking in its initial period deserves severe attention. During the colonial period, the term which was generally used for foreign banks in India and China were exchange banks in Western countries and the primary function of these banks was concerned with providing a financing facility for trade in India and china, and other the countries which are characterized by without a gold standard, having extensively fluctuating exchange rates. Supernatural profits in banking lured the nationals from a number of countries having trade relations with India to establish banks in India. They may be bifurcated into two groups: those with a substantial proportion of business in India and agencies of large banks with a major business abroad. The section will analyze the development of foreign banks in the colonial period and also analyze the factors that affected the course of their development. There was further expansion of activities of foreign banks during the Second World War when restrictions were imposed on foreign trade. During this whole period, foreign bank offered a serious competition was faced by Indian banks in financing internal trade which was at least 15 times as large as the foreign trade. The profits were reflected in a number of purchases of domestic banks, absorption of banking business and acquisition of controlling interest in financial companies and an increase in the number of Indian branches from 69 in 1960 to 90 in 1964. Interestingly, while on the one side profits led to the substantial expansion in the operation of the foreign banks but it did not lead to any entry, as may be expected in a market. This was an exception to what was happening in the other part of the banking industry, where domestic private players were operating. Although foreign banks play a very important function to the economy through financing of foreign trade, which was not in the capacity of domestic banks for a number of reasons during the colonial period, they have also able to create entry barriers by building a strong goodwill for themselves . The bank of America could establish a branch in the country in 1961 because it is one of the largest and most powerful banks in the world. During the British Regime, Foreign banks operated in Indian under a situation of complete freedom. They were not subject to any legal restrictions in India including the statutory obligations to which the Indian joint–stock banks have been subject to. The controlling part of these banks was done from abroad, their directors and shareholders were foreigners and there was no statutory compulsion on them to get their accounts audited by recognizing auditors. The main reason of crisis of banking in India at the beginning of the First World War was the inadequacy of cash reserves of these banks. Learning their lesson they started keeping a larger proportion of reserve for a few years but again the proportion decreased in order to make large profits. The foreign banks in India used to create a negative image of Indian commercial houses before the foreign traders and simultaneously provided enhanced images of foreign houses operating in India even with low standing. The reason for this difference was that being a foreigner, the managers of the foreign banks was not able to keep themselves in close touch with their Indian clients. As they had lack of social contact with Indian client, they had to rely upon the reports of the subordinate members for information regarding their financial standing. Therefore overseas exporter started following discriminating practice by overseas towards an Indian importer. The development path of Indian joint stock banks was adversely affected by the foreign bank as they had a monopoly over financing of the foreign trade of India. They reaped the fullest advantage of a situation of laissez faire and conducted their operations with zero transparency. Last but not least, they produced an adverse impact on the development of indigenous banking skills necessary for development of the banking market in the country.

Foreign banks: The pre-reforms era

A general distrust of foreign capital by policy makers in newly independent countries was the norm in the early era of policy making. India was no exception. The distrust extended to market mechanism as an instrument of economic development in the early attempts towards the development of the third world. The policy makers sought to use a public sector dominated inward looking development model to deliver the goods. Banking was no exception. There occurred two episodes of nationalization in 1969 and 1980, which severely curtailed private stakes in banking in the country. The policy regime which did not favour domestic private capital in banking in the country remained hostile to the participation of foreign capital in banking.

Foreign banks: The post reforms era

Until the mid-1990s, the banking systems in most of Asia remained heavily regulated, and barriers to foreign competition were prohibitively high. However, in the aftermath of the East Asian crisis of 1997-98, financial sector restructuring, including the revamp of the financial regulations, has been an important element in the structural adjustment programmes in Indonesia, Korea, Thailand and the Philippines. Broadly, governments in the crisis-hit regional economies have restructured their financial systems by shutting down commercial banks and finance companies, merging some existing institutions and nationalizing others, injecting public funds to recapitalized viable banks, putting in place systematic asset resolution strategies, as well as easing regulatory impediments to foreign bank entry. After a period of relatively robust performance in the late 80's, the Indian economy entered into a period of severe liquidity crisis during 1990-91. The macroeconomic crisis was precipitated mainly by the growth of public spending through 1980s that increased the budget deficit as a proportion to GDP, while external factors played a contributory role. The macro imbalance, fueled by a budget deficit and financed by external borrowing and decumulation of reserves was accompanied by accelerating inflation to double digit levels. The macroeconomic crisis became the occasion for undertaking substantial microeconomic reforms, known as structural reforms. They were broadly in the area of industrial licensing and regulation, foreign trade and financial sector. The structural reforms were undertaken in July 1991 at the behest of the IMF, which sanctioned $2.2 billion as stand-by credit to India. As a precursor to financial sector reforms, Narasimham Committee was set which submitted its report in 1991. It suggested that the policy towards foreign banks be made more liberal through creation o level playing field for foreign banks. While structural reforms and Narasimham Committee (1991) set the tone of a liberal policy towards domestic and foreign capital in the economy. A proximate cause of liberal treatment of foreign banks has been the World Trade Organization Agreement on Trade in Financial Services which requires gradual easing of restrictions on foreign banks. The nature of entry policies relating to foreign banks changed favourably after India ratified the agreement establishing the WTO in December 1994. It was felt that India possessed a fair advantage in the availability of skilled manpower in several hi-tech areas such as computer software, engineering consultancy, etc. and it was in India's interest that free movement of these personnel was allowed into the developed markets abroad. Although policy towards foreign banks took a favourable turn in 1994 we extended the time period for analysis a little backwards to 1992. The Narasimham Committee was constituted in 1991, whose recommendations about the liberalizing banking industry were implemented in 1993. Such an exercise will be of some use to future researchers to put our results relating to foreign banks in a comparative prospective. The years 1992 and 1993 immediately proceed 1994, which saw no change in the number of foreign banks. This serves as a background against which changes in number of foreign banks over time will be analyzed.

Table 1: Number of Foreign Banks During 1992-2015

Year	Number of Foreign Banks
1992	25
1993	25
1994	23
1995	27
1996	31
1997	40
1998	42
1999	44
2000	42
2001	42
2002	40
2003	36
2004	33
2005	31
2006	29
2007	29
2008	28
2009	31
2010	32
2011	34
2012	41
2013	43
2014	44
2015	46

RBI, Statistical handbook of RBI

A cursory look at the above table reveals that, the number of foreign banks rises during the first half of the period and then falls during the latter half but again rises at the end of later half gradually. In the year 19192 there were 22 foreign banks which became 31 in 1996 and increased to 40 in 1997. The Foreign banks increased to 44 in 1999 and decreased to 28 in 2008. The data of 2015 reveals that the number of foreign banks increased steadily and touched the figure of 46. It appears from the above data that a number of new foreign banks entered after being promoted by the new liberal policy, but started withdrew after the new scenario was exactly not in accordance with their expectations. They again started to enter at the end of the later half century, as the whole world suffered from the global financial crisis and India is in a much better position than other part of the world in terms of financial soundness.

Conclusion

The objective of this study was to analyze the evolution of foreign banks in India in various phases. The chapter rationalizes discussion of the process of evolution in three phases. The first phase runs up to independence, the second is linked to pre-liberalization period and the third may be related to the post-reforms period. During the first phase, it is observed that foreign banks carried on a virtual monopoly in a very profitable business with no transparency and negligible risk, defended their monopoly against domestic as well as foreign competition through various means, created an adverse effect on the development of the banking market through the imbalanced development of local banking talent, while undermining the authority of the central bank. However, it needs to mention here that they played a very significant role in financing foreign trade at a time when Indian joint stock banks were not efficient enough to provide such a service. In the second phase, the policy regime in the country remained hostile to the participation of foreign capital in banking. The third phase with its liberal policy regime introduced dynamism in the industry. Post reforms Era saw a remarkable rise in the number of banks by more than 70% of what was in the beginning of the time period of the study. However, such a rise was found to be accompanied by considerable fluctuations.

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