USINDIA BusinessCouncil

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March 7, 2011

The Chief General Manager
Reserve Bank of India
Department of Banking Operations and Development
Central Office, 13th floor, Central Office Building
Fort, Mumbai 400001

Dear Sir,

On behalf of the U.S.-India Business Council (USIBC) and our member companies, joined by the Securities Industry and Financial Markets Association (SIFMA), I present the following comments on the RBI's Discussion Paper on the Presence of Foreign Banks in India ("the Discussion Paper"). We appreciate the opportunity to comment on the Paper and share the global banking industry's perspective on the proposed policies.

Now more than ever, the world looks to India as an economic leader. Given this role, it has become increasingly important for India to implement clear financial policies that promote deep investment, stability, and market integrity. Subsidiarization and other policies proposed in the Discussion Paper have immense implications for global and Indian financial institutions, global banking oversight, financial markets, and ultimately Indian consumers.

Given the importance of this discussion, we believe additional industry and government-to-government consultation is required beyond the comment period deadline. Significant clarification is required on many issues, including on mandatory subsidarization for new foreign bank entrants, the conditions and incentives for voluntary conversion of existing branches, priority sector lending requirements, and a lack of national treatment even with full compliance to the proposed rules.

It is our hope that the following comments will serve to inform and support continued deliberation of these critical policy issues.

We look forward to being full partners in this vital endeavor.

Sincerely,

Ron Somers, President
U.S.-India Business Council

1. BACKGROUND

1.1 In 2005, the Reserve Bank of India ("**RBI**") released the "Road map for presence of foreign banks in India" ("**Road map**") with the aim of gradual increase in the presence of foreign banks in a synchronized manner. Under the first phase of the road map (March 2005 to March 2009), foreign banks were permitted to establish presence by way of setting up a wholly owned banking subsidiary ("**WOS**") or conversion of existing branches into a WOS. The second phase was to commence after review of the experience gained in the first phase. However, at the time of such review, it was considered advisable to continue with the policy as set out in the first phase.

1.2 The RBI has now issued a Discussion Paper on the presence of foreign banks in India (published on its website on January 21, 2011) (the "**Discussion Paper**") and has invited comments of banks, non-banking financial institutions, all stakeholders and the public at large on the Paper. We understand that based on feedback received, RBI will frame detailed guidelines on the presence of foreign banks in India.

1.3 USIBC is the premier bilateral business organization representing nearly 400 of America's largest companies invested in India and global Indian companies, with the aim of deepening trade and strengthening commercial ties. USIBC jointly presents this representation with the Securities Industry and Financial Markets Association, the leading financial industry association and the U.S. regional partner of the Global Financial Markets Association (GFMA). USIBC is also joined in this representation by Knowledge Partner Amarchand & Mangaldas & Suresh A. Shroff & Co., India's premier and largest law firm and a USIBC member.

1.4 We appreciate that RBI has invited comments on the Discussion Paper and take this opportunity to make recommendations on some of the key policies that RBI has set out for regulating the presence of foreign banks in India.

1.5 The comments in this submission represent the general collective views of USIBC and SIFMA member companies, rather than the response of any individual member. Nothing in this industry submission is intended to negate or substitute for more detailed, case-specific consultations by individual members.

2. SUBMISSION

2.1 WOS VS. BRANCH MODEL

2.1.1 Issue of Concern: The RBI is considering a policy whereby foreign banks looking to set up operations in India and that meet certain criteria must incorporate a Wholly-owned Subsidiary (WOS) (and will no longer have the option to operate as a branch, as is presently the case), as described in Paragraph 6.1.1 of the Discussion Paper. Foreign banks that do not meet the specified criteria would be allowed initially to establish a branch on entry, but would be required to convert into a WOS if any of the specified conditions materialize or if they become classified as "systemically important" by the RBI by virtue of their balance sheet size.

2.1.2 Comments:

(a) *Analyzing the advantages of presence through a WOS*

In Paragraph 3.1.6 of the Discussion Paper, the RBI has identified certain advantages of local incorporation. However, many of the concerns with the branch model of operation that RBI has identified are adequately addressed under the existing legal regime and there are no significant advantages of operating as a WOS that would necessitate a policy of mandatory subsidiarization or conversion. In a macroeconomic context, WOS are not proven to be more stable than branches, and we would request further industry consultation before this conclusion is reached.

- Greater Ring-Fencing in a WOS structure

  The RBI Paper notes that presence though WOS ensures that there is a clear delineation between the assets and liabilities of the domestic bank and those of its foreign parent and clearly provides for ring-fenced capital within the host country, which is important in a situation of insolvency of the foreign bank.

  However, the Banking Regulation Act, 1969[1] ("**BR Act**") and the Companies Act, 1956[2] ("**Companies Act**") already recognize the separate legal identity status of a branch and provide a limited ring fenced structure for assets of a branch. We believe the ring fencing requirements under the BR Act will, in the event of bankruptcy of the foreign bank, protect Indian depositors and creditors.

[1] Section 11 (2) requires a branch of a foreign bank to deposit and keep deposited with the RBI, certain specified reserve in the form of cash and/or unencumbered approved securities. Section 11(4) of the BR Act provides that any amount deposited and kept deposited with the RBI by the banking company shall, in the event of the company ceasing for any reason to carry on banking business in India, be an asset of the company on which the claims of all the creditors of the company in India shall be a first charge. Further, Section 25(1) of the BR Act and prudential norms applicable to the banks require maintenance of certain reserves and assets by a bank.

[2] Section 584 of the Companies Act provides that where a body corporate incorporated outside India which has been carrying on business in India, ceases to carry on business in India, it may be wound up as an unregistered company, notwithstanding that the body corporate has been dissolved or otherwise ceased to exist as such under or by virtue of the laws of the country under which it was incorporated.

In fact, the WOS structure could have significant negative consequences to Indian entities of global banks in the event of a bank failure. In a bank failure, it may be easier as a legal matter to allow a stand-alone WOS to go insolvent because such insolvency would have less risk to the global franchise than a branch, which is legally part of the parent and whose creditors and depositors have recourse to the assets of the entire bank.

For bank branches that pose supervisory discomfort due to circumstances such as higher non-performing assets (NPAs), weak financials, and accumulated losses, higher CRAR may be prescribed.

➢ Clearly-defined Laws

The Discussion Paper points out that in the WOS model, it is easier to define laws of which jurisdiction applies, since laws characterize a subsidiary as a locally-incorporated entity with its own capital.

However, there is no legal uncertainty in the branch mode of presence of foreign banks as Indian legislation (such as the BR Act, Companies Act, the Reserve Bank of India Act 1934 and related regulations) equally apply to branches of foreign banks. A branch of a foreign bank in India is subject to RBI regulatory supervision and direction.

➢ Corporate Governance

The Discussion Paper has expressed concern that a branch does not have a locally situated board of directors or governance structure. For existing branches of foreign banks that are systemically important or which subsequently become systemically important, in lieu of the expectation articulated by RBI of conversion to WOS, RBI may consider prescribing additional norms for corporate governance to derive supervisory and regulatory comfort.

We believe that it is necessary to allow foreign banks to own 100 percent of the subsidiary that is being established. Foreign banks should not be forced to dilute their ownership in the subsidiary. Any ownership level below 100 percent complicates management and decision-making, thereby increasing risk. Additionally, minority shareholders often bring little positive value to the entity and may create considerable complications and conflicts that could damage diluted WOS and increase the risk of financial instability.

(b) *Higher costs and operational inefficiencies linked to operating as a WOS*

➢ The WOS requirement would present cost, operational, and business issues and would limit "scale of economy" benefits for customers. The cost implications for a foreign bank of operating as a WOS (as opposed to a branch) are significant. The Discussion Paper suggests that minimum capital requirement for WOS on entry should be the same as those prescribed for new private sector banks.

- Apart from capital requirements, concerns exist about where the mandatory subsidiarisation could lead under local regulatory philosophies. If a requirement of operational autonomy develops, the impact on operational ability is significant. Aside from the concern that setting up a WOS isolates capital, liabilities, etc. in the host country, global banks provide critical operational infrastructures that are used locally as well. If the RBI requires shared services to stop and mandates that a WOS must operate autonomously from the parent's systems, in a bank crisis, the cost would be enormous. Clients rely on the strength of the global infrastructures that global banks offer and isolating the WOS from the parent could have a serious negative impact.

- As a separate legal entity having its own capital base, WOS will have limited parent support (as compared to a branch). As subsidiaries operate at arms length with the parent, they will not be able to benefit from the global infrastructural services of the parent to the same extent as a branch. This will lead to higher costs that may be transferred to the customers, making banking services more expensive.

- Most international financial institutions have business models for operating in different countries, based on their past experience and their business exigencies. Mandating operation though WOS would force these institutions to rethink their business models, and could discourage such banks from setting up operations in India.

(c) *Policy impact of India setting such a precedent*

We are not aware of any other jurisdiction that has forced subsidiarisation for branches of foreign banks operating in their country. In most jurisdictions, Indian banks have the operational flexibility of setting up as a branch or as a WOS. For interest of reciprocal, fair, and harmonized global overisght, the same flexibility should also be available to foreign banks operating in India or are looking to enter into India.

(d) *Increased clarity required for when entry via the WOS model is mandatory*

The Discussion Paper proposes that certain categories of banks will be mandated entry in India only by way of setting up a WOS (Paragraph 6.1.1 of the Discussion Paper). In addition, banks other than those identified may be required to incorporate locally if "for any other reason that the RBI considers that subsidiary form of presence of the bank would be desirable on financial stability considerations."

In the model presented in the Discussion Paper, it is not clear whether and when WOS is required. Given that setting up a WOS has profound operational, cost, and governance implications for a foreign bank, RBI should clearly identify upfront the situations under which a foreign bank will be required to set up a WOS. We are concerned that any ambiguity in such policy would prevent foreign banks from developing a predictable strategy for establishment in India.

Below is a summary of our key submissions on this issue:

- **The WOS model should not be mandated at this time. Significant industry and government-to-government consultation is required.**

- **Foreign banks should have the operational flexibility to determine their entry strategy into India (i.e. whether to set up a branch or a WOS).**

- **If however, the RBI feels that in certain cases, the WOS model is required, such criteria should be clearly and narrowly defined upfront.**

2.2 FULL NATIONAL TREATMENT

2.2.1 Issue of Concern: The Discussion Paper (Paragraph 7.1) emphasizes that *"it would not be possible nor desirable to provide full national treatment to WOS of foreign banks. However, they would be placed in a much better position than the foreign bank branches operating in India but less than that of domestic banks."*

The Discussion Paper (Paragraph 12.2) contemplates extension of the branch expansion policy as applicable to domestic banks as on January 1, 2010, to WOS of foreign banks. However, we note that RBI has proposed a lower sub-target for lending to the agriculture sector (Paragraph 14.5 of the Discussion Paper) by WOS since "*the branch spread of these banks will be limited due to their not being given full national treatment.*" Therefore, it appears that RBI is not contemplating an equal branch licensing policy for WOS of foreign banks.

Also, we note the RBI has suggested (Paragraph 13.1 of the Discussion Paper) that when the capital and reserves of foreign banks in India including WOS and branches exceed 25% of the capital of the banking system, it will place restrictions on branch expansion in Tier 1 and Tier 2 centres of WOS.

2.2.2 Comments:

(a) *International Standards*

Full national treatment is the international standard. We are concerned that WOS would not be eligible for full national treatment, given (a) India's commitments in global forums such as the WTO that any new regime must be consistent, transparent and should abide by national treatment principles, and (b) Indian banks are accorded such treatment in the U.S. and other jurisdictions.

(b) *Application of branch licensing policy*

We believe the branch expansion policy that applies to domestic banks should equally apply to WOS of foreign banks. This is especially relevant to incentivize subsidiarization by foreign banks. Further, given that the regulatory compliance framework for a WOS will be the same as that for domestic banks (e.g. capital requirement, priority sector lending requirements, and prudential norms), to ensure a level playing field between a WOS and domestic banks and to encourage foreign banks to set up WOS, the number of branches for WOS should not be restricted.

Also, we note that the Discussion Paper does not clarify whether access to Tier 1 and Tier 2 cities will be "de facto" fair as compared to Indian domestic banks. This proves to be a significant competitive disadvantage for foreign banks as Indian domestic banks already have a significant presence in those cities.

(c) *Access to Credit Support of Parent Bank*

While a WOS is subject to capital requirements that are similar to those imposed on a domestic bank, RBI has proposed that a WOS will not be entitled to credit support from its parent (Paragraph 15.1 of the Discussion Paper). However, note that domestic banks have access to credit support by their Indian promoters/shareholders. Restricting a WOSs from accessing parent support, will place them at a disadvantage vis-à-vis domestic banks. Further, as recognised by the RBI itself, such credit support will strengthen the subsidiary structure (thereby incentivising the WOS model) and will also allow access to a strengthened pool of assets in the event of domestic claims.

We would like emphasize that foreign banks have global relations with clients and such relationship extends to multiple jurisdictions where global clients operate. Clients such as corporates, foreign institutional investors and other global financial institutions derive comfort from the rating of the parent bank and balance sheet, in making decisions to deal with banks in multiple jurisdictions including availing of cash management and custody facilities.

Excluding use of credit rating and head office support to WOS would result in adverse market implications and inefficiency in the settlement process, as institutional investors may be constrained to deal with multiple counterparties for cash management, custody arrangements, and investment decisions. This will in turn impact transaction costs and may influence global investment decisions, which we believe could eventually hamper India's overall economic growth.

(d) *Priority sector lending norms:*

The priority sector lending norms for a WOS should be directly correlated to RBI's policy on both national treatment and branch licensing policy applicable to WOS.

In the absence of required clarity on these issues, it is not practically feasible for WOS to meet the priority sector lending norms at par with domestic banks (as their reach and growth capacity is not at par with domestic banks). Further, we recommend:

- Given that the core strength of foreign banks is trade-based financial activities, infrastructure lending and ability to raise resources for capital intensive projects, the scope of priority sector lending should be widened beyond its current form to include in addition to export finance, infrastructure and indirect agricultural lending, without any sub limits.

- WOS should also have flexibility to deposit as part of priority sector lending, money in the Rural Infrastructure Development Fund of NABARD on rolling basis, i.e. current deposits should be factored while computing the deficit in priority sector lending. In addition, we believe other infrastructure funds should be considered part of the priority sector classification.

Below is a summary of our recommendations on this issue:

- **Full national treatment is the international standard. We strongly urge the RBI to accept, as a policy objective, the fair and equal treatment of all foreign-owned subsidiaries. We believe that a compliant WOS should be treated at par with domestic banks.**

- **RBI should identify upfront the specific areas in which the treatment of WOS will be different from treatment of domestic banks.**

- **There is a lack of clarity on application of branch licensing policy to a WOS. There should be flexibility to open branches across all centers at par with the domestic private sector banks or, at minimum, there should be flexibility to establish at least 25 branches in Tier 1 & Tier 2 cities to begin with, which will give an option to have branches across geographical regions and which would make subsequent expansion into the Tier 3 to Tier 6 cities more commercially viable.**

- **Priority sector lending norms should be linked to branch expansion policy for WOS:**

    - **Given that the core strength of foreign banks is trade-based financial activities, infrastructure lending, and ability to raise resources for capital intensive projects, the scope of priority sector lending should be widened beyond its current form to include in addition to export finance, infrastructure and indirect agricultural lending, without any sub limits.**

    - **WOS should also have flexibility to deposit as part of priority sector lending, money in the Rural Infrastructure Development Fund of NABARD and other infrastructure funds.**

2.3 OWNERSHIP STRUCTURE AND DILUTION REQUIREMENTS

2.3.1 Issue of Concern: The Discussion Paper states that a WOS would be governed by the provisions of Companies Act, BR Act, RBI Act, 1934, other relevant statutes, and the directives, prudential regulations and other guidelines issued by RBI and other regulators from time to time (Paragraph 10.2).

Given this position, clarity is required on whether the following existing guidelines will apply to a WOS:

(a) *Guidelines on entry of new banks in the private sector, issued by the RBI on January 3, 2001:* As per these guidelines, the promoters' contribution in a private bank shall be a minimum of 40 % of the paid-up capital of the bank, with a lock-in period of 5 years. In case the promoter contribution is in excess of 40%, dilution is required within a prescribed period.

(b) *The Guidelines on Ownership and Governance in Private Sector Banks issued by the RBI on February 28, 2005:* As per these guidelines no single entity or group of related entities can have shareholding or control in any bank in excess of 10% of the paid up capital of the bank. Any higher level of acquisition will be with the prior approval of RBI.

2.3.2 Comments:

(a) We believe that it is necessary to allow foreign banks to own 100 percent of the WOS that is being established. Foreign banks should not be forced to dilute their ownership in the WOS. Any ownership level below 100 percent complicates management and decision-making, thereby increasing risk. Additionally, minority shareholders often bring little positive value to the entity and may create considerable complications and conflicts that could damage diluted WOS and increase the risk of financial instability.

(b) Therefore, a WOS should be specifically exempted from the application of the ownership and governance-related guidelines (discussed above) issued by the RBI to private banks. Also, the current regulation that no shareholder can exercise voting rights in excess of 10% irrespective of the extent of shareholding should be amended.

Below is a summary of our key recommendations on this issue:

- **The guidelines on ownership and control (that apply to private sector banks) should not apply to a WOS.**
- **RBI should take up with the authorities concerned for appropriate amendment to the relevant legislation, so that the voting rights restriction does not in any way result in loss of management control by the parent of WOS, should shareholding fall below 100%.**

2.4 CONVERSION OF AN EXISTNG BRANCH INTO A WOS

2.4.1 Issue of Concern: Paragraph 6.2 of the Discussion Paper outlines a policy on conversion of foreign banks that currently operate as a branch in India. The paper states "*the expectation of RBI would be that existing branches of foreign banks that meet the parameters set out in paragraph 6.1.1 above, or which are or become systemically important on account of their balance sheet size exceeding a threshold limit, would voluntarily convert themselves into WOS in view of the incentives proposed to be made available to WOS.*" (emphasis supplied)

2.4.2 Comments:

(a) *Voluntary v. Mandatory Conversion:*

RBI has proposed that it is their expectation that branches of foreign banks that meet specified criteria will voluntarily convert themselves into WOS. However, it is unclear if an existing branch (that meets the specified criteria) will be mandated to convert into a WOS or if such conversion will be at the option of the relevant foreign bank. Also, it is unclear what will be the consequences, if any, for branches that do not convert into WOS voluntarily. Greater clarity and industry consultation is required.

(b) *Significant Cost Implications:*

The costs of converting from a branch to a WOS may be significant, and may even make conversion commercially unviable. In this respect, we would like to highlight the following implicaions for RBI's consideration:

- Capital Gains Tax*:*

  Transfer of assets from branches into WOS will attract short term or long term capital gains tax, depending on the mode of transfer (slump sale/ amalgamation or itemised sale). Though the Discussion Paper states that Section 47 (iv) of the Income Tax Act, 1961[3] ("**Income Tax Act**") may be applicable to foreign banks converting their branches into subsidiaries, the RBI has suggested that the *"foreign banks may approach the Ministry of Finance for suitable clarification"* (Paragraph 16 of the Discussion Paper). The benefit of exemption that is available under Section 47(iv) of the Income Tax Act is curtailed by stringent conditions imposed under Section 47A (1) of the Income Tax Act[4]. As per Section

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[3] Transactions not regarded as transfer
Section 47: Nothing contained in section 45 shall apply to the following transfers:-
(iv) any transfer of a capital asset by a company to its subsidiary company, if-
(a) the parent company or its nominee hold the whole of the share capital of the subsidiary company, and
(b) the subsidiary company is an Indian company

[4] Withdrawal of exemption in certain cases.
47A. (1) Where at any time before the expiry of a period of eight years from the date of the transfer of a capital asset referred to in clause (iv) or, as the case may be, clause (v) of section 47,-
(i) such capital asset is converted by the transferee company into, or is treated by it as, stock-in-trade of its business; or
(ii) the parent company or its nominee or, as the case may be, the holding company ceases or cease to hold the whole of the share capital of the subsidiary company,

47A(1) of the Income Tax Act, the transfer of assets by the branch to the WOS will attract capital gains in the event the foreign bank (i.e. the holding company of WOS) ceases to hold the whole of the share capital of the WOS for eight years.

Consequently, though foreign banks setting up a WOS in India can use such one-time exemption to avoid paying capital gains tax, it prevents the parent from diluting the stake in the WOS for eight years. Doing so voids the exemption. This means the parent bank can neither dilute its holding in the local subsidiary for eight years nor tap the Indian capital markets to mobilize funds during the eight-year "lock-in" period.

- Sales Tax:

  Conversion of a branch into WOS may, depending upon the nature and situs of the sale, attract sales tax if assets of the branch are transferred to WOS by way of itemised sale. The rate of tax for intra-state sales ranges from 4% - 12.5%/15.5% of the value of transfer. Inter state sales are charged to tax at 2% of the value of transfer, subject to production of statutory declaration forms. Where statutory declaration forms are not available, the rate of tax prevailing in the State where the sale originates would apply.

- Stamp Duty:

  Stamp duty will be payable on an instrument effecting transfer of assets from branches to WOS, depending on the mode of transfer and the State in which the asset is located.

- Cost of repatriation of profits:

  A branch in India is liable to pay tax at 42.23% (inclusive of applicable surcharge and education cess). Thereafter, any repatriation of profit by a branch to its head office is exempt from tax. However, once a branch is converted into a WOS, such WOS would be required to pay corporate tax at 33.22% (inclusive of applicable surcharge and education cess) on net profits. Further, at the time of payment of repatriation of profits (dividends), the WOS will be required to pay dividend distribution tax at 16.61% (inclusive of applicable surcharge and education cess). Consequently, the cost of repatriation of profits by a WOS will be 49.83% (33.22% + 16.61%).

- Precedent for Exemption:

  We would like to highlight that a precedent for such exemptions exist. To incentivise corporatisation and demutualisation of a recognised stock exchange in India, specific exemption from capital gains and stamp duty was made

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the amount of profits or gains arising from the transfer of such capital asset not charged under section 45 by virtue of the provisions contained in clause (iv) or, as the case may be, clause (v) of section 47 shall, notwithstanding anything contained in the said clauses, be deemed to be income chargeable under the head "Capital gains" of the previous year in which such transfer took place.

available under section 47 of the Income Tax and section 8B of the Indian Stamp Act, 1899 for transfer of membership right to the stock exchange company. Similarly, upon passing of Limited Liability Partnership Act, 2008, to enable conversion of proprietary concern or a company into a limited liability partnership, specific exemption from capital gains was made available under section 47 of the Income Tax for transfer of assets from such proprietary concern or company to the limited liability partnership.

Below is a summary of our key comments on this issue:

- **Greater clarity is required on the proposed policy regulating voluntary conversion of an existing branch (of a foreign bank) to a WOS.**

- **Conversion to a WOS should be made tax-neutral and such tax exemption should be unconditionally available to a bank on subsidiarization.**

- **RBI should make a recommendation to the Ministry of Finance to make a specific exemption from capital gains in case of transfer of assets from a branch to a WOS.**

- **Each state should be encouraged to make a specific exemption from sales tax in case of transfer of assets from a branch to a WOS.**

- **RBI should make a recommendation to the relevant authorities to make a specific exemption from stamp duty in case of transfer of assets from a branch to a WOS.**

2.5 NON-BANK FINANCIAL COMPANY (NBFC) OVERSIGHT

2.5.1 Issue of Concern: For existing or new non-banking financial companies (NBFC) operations, the paper does not set out a clear path.

2.5.2 Comments: The paper emphasizes the both existing and new foreign banks to locally incorporate their operations in India. It is unclear if this means that foreign banks would either have to eventually exit their NBFC business or seek special approval of the regulator to retain such business. Furthermore, grandfathering is not mentioned in the paper. It is for this reason that we would request additional industry consultation on this issue before the final guidelines are determined.

Below is a summary of our key comments on this issue:

- **We request additional clarity and industry consultation on the impact to NBFC operations of mandatory and voluntary conversion to WOS.**

For inquiries or additional information, please contact:

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