India Flash

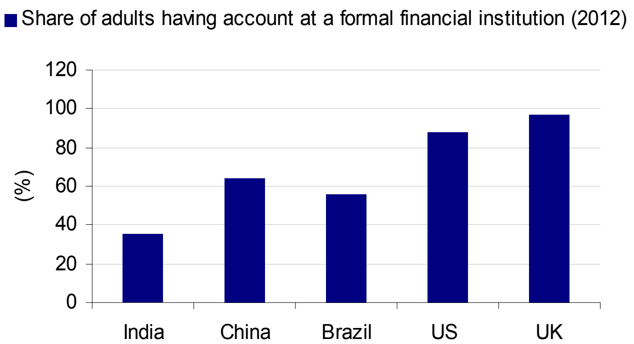
Advances in India's banking reforms

In mid-January three long-awaited banking bills were enacted following Parliamentary approval. If implemented successfully, the bills should widen the scope for foreign bank entry in India, and facilitate financial inclusion (Chart 1), capital raising by banks and improvements in regulatory compliance. Specifically, the three bills encompass: (i) the Prevention of Money Laundering (Amendment) Bill (ii) the Enforcement of Security Interest and Recovery of Debts Laws, and 3) the Banking Laws (Amendment) Bill. The first two bring India's anti-money laundering legislation on par with international standards and strengthen the regulatory and institutional frameworks for the recovery of debts owed to financial institutions (creditors' rights). The third, and arguably most significant, enhances the Reserve Bank of India's (RBI) regulatory powers, eases capital raising norms for banks, strengthens voting rights for investors, and paves way for the RBI to release its eagerly awaited new guidelines on issuing banking licenses, with potential positive implications for foreign investors.

- **New banking bill to end the long drawn wait of potential foreign entrants.** The Banking Laws (Amendment) Bill was seen as a pre-requisite by the RBI for releasing its new guidelines for banking licenses, which have been delayed for nearly two years, in turn keeping potential foreign entrants on hold. RBI's draft guidelines, issued in August 2011, sought to facilitate foreign bank entry through the wholly owned subsidiary (WOS) route, allowing them to raise capital locally. But the draft lacked clarity on minimum capital standards, scope for expansion, taxation, and future requirements on dilution of ownership. The new banking bill helps address some of these impediments to foreign bank expansion, including:
  - Exemption of stamp duty charges on conversion of existing foreign bank branches into WOS.
  - Increasing individual shareholder voting rights to a maximum of 26% (from 10% previously) in the case of private banks, which may facilitate foreign participation in domestic banks.
  - Entry of new domestic banking players, which may present opportunities for foreign banks to engage in mergers and acquisitions with Indian banks.

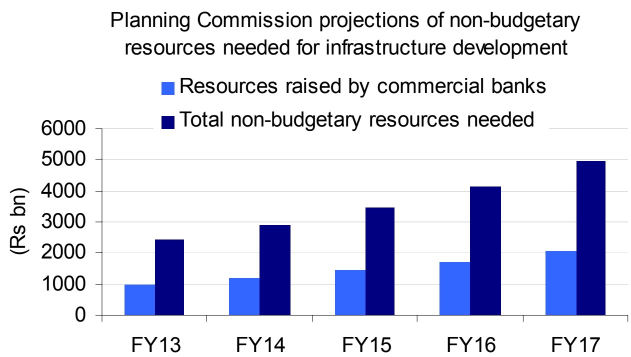
We view the banking reforms as an important element of the government's broader efforts to facilitate robust medium-term growth (Chart 2). That said, much still needs to be done to address asset quality issues of Indian banks and to maintain the momentum of reform. Moreover, it remains to be seen how the RBI will allocate banking licenses and how the framework will be implemented in practice. In the meantime, we will be watching for the RBI's final guidelines on new bank licenses and the upcoming Budget session of parliament, which begins on February 21st, for further progress on reforms, including the approval of the government's proposal for higher foreign direct investment in insurance and pension sector.

Chart 1
India's has much to achieve in financial inclusion



Source: "Measuring Financial Inclusion: The global findex database", April 2012, Asli Demirguc-Kunt & Leora Klapper (World Bank)

Chart 2
Banking sector to play a key role in stimulating growth



* FY13 stands for fiscal year 2013 (ending March 2013)

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