Challenges for Foreign Banks Entering India Open New Opportunities for Consulting Firms

Consulting firms can play a crucial role in helping foreign banks navigate the regulatory, technological and social hurdles associated with doing business in India.

Executive Summary
India's banking industry has long enjoyed a sizable foreign presence, and the country remains a favored destination for conducting business. Since the economic liberalization policies initiated in 1991, foreign entities have invested in almost every sector of the Indian economy. They have navigated the country's tough business and regulatory environments, modified their business models to suit India's conditions, and become an integral part of the Indian business and social landscape.

Foreign banks have operated in India since the 1860s, when Comptoir d'Escompte de Paris (which later combined with three other banks to form BNP Paribas) set up a branch in Calcutta. Of the current crop of foreign banks operating in India, HSBC is the oldest one - having established a branch as early as 1853. Standard Chartered Bank has operated in India since 1858, while Citibank began operations in the country in 1902. The fact that these banks have functioned and flourished in India for so long is testimony to the fact that they have successfully met the challenges posed by the Indian banking environment.

However, today's environment is very different; foreign banks looking to enter the Indian market have to face a number of tough and unique challenges. This paper will examine these roadblocks, and discuss how foreign banks can overcome them. We will also analyze why, despite the numerous barriers, foreign banks are keen to set up shop in India, and analyze the Reserve Bank of India's (RBI) regulations and guidelines concerning foreign banks. Lastly, we will highlight the opportunities that the entry of foreign banks in India present for consulting firms.

India – An Enticing Market for Foreign Banks
There are a total of 43 foreign banks operating in India through 331 branches. Another 46 banks have a presence in the form of a representative office. Out of the 43 banks, Standard Chartered Bank,
HSBC, Citibank and The Royal Bank of Scotland lead in terms of number of branches, with 101, 50, 42 and 31 branches respectively as of 31 March, 2013.¹

The vast Indian market, the significant unbanked and underbanked populace, and the corresponding business opportunities are some of the more obvious reasons why foreign banks are looking to expand in India. There is also a demand for specialized banking services, which 85 banks, other than the four mentioned above, have set up and maintained as a limited presence in India — either in the form of a branch or a rep office. These banks see opportunities in areas such as investment banking; private banking and wealth management; trade finance; cash management; and specialized lending services, for example, which do not require a large branch/ATM network and customer base.

There are several reasons foreign banks look to do business in India:

**The growing HNI population** — A majority of the fastest-growing high-net-worth individual (HNI) markets are located in the Asia-Pacific region (See Figure 1). The annual growth in wealth in the APAC region was at 12.2% in 2012 — the strongest gain among all geographies. Within the APAC region, India recorded a 22.2% increase in its HNI populations.²

For most foreign banks, the private banking and wealth management business forms a substantial portion of their revenue. The erosion of wealth and negative growth in their traditional markets of North America and Europe have necessitated that they look at other markets. India, with its growing number ofHNIs, is an obvious choice (See Figure 2, next page).

**Demand for investment banking services** — Investment banking is another significant source of fee income for foreign banks (see Figure 3, next page). In the past few years, India has witnessed steady growth in inbound/outbound, as well as domestic, M&A activities.

As Indian entities have grown in size and scope, they have felt the need to tap into newer and cheaper sources of funds from overseas markets. Consequently, they have turned to foreign banks with experience and expertise in such activities. This trend is likely to continue as Indian corporations look to cost-effectively raise funds to reduce leverage and restructure their balance sheets.³ Foreign banks such as Citibank, which helped Indian clients raise US$18 billion from equity and debt markets and advised on M&A deals worth US$10.4 billion during 2012-13,⁴ are well entrenched. However, there seems to be ample opportunity for other players to take advantage of the expected growth in this area.⁵

**Growth in international trade** — Since the opening up of the Indian economy in the early 1990s, India’s share in global exports and imports has shown considerable improvement. From a share of 0.5% and 0.7% in global exports and imports in 1990, it has more than tripled — to 1.6% and 2.6% in 2012.⁶ FDI inflows and outflows, though at lower levels in 2012-13 compared to 2011-12, stand at US$36.9 billion and US$26.9 billion.⁷ The increase in
Trading activity has ensured the establishment of trading relations with more countries. This in turn has led banks in those countries to set up branches and representative offices in India (and vice versa), and explore the possibility of expanding into traditional banking services.

The list of foreign bank branches in India, as well as the roster of foreign banks having representative offices in the country, will show that expansion in trade seems to be the primary reason these banks established a presence in India. Statistically, the number of foreign banks in India has gone up from 28 in 2007-2008 to 43 in 2012-13, while the number of branches has expanded from 277 to 331 in the same period. Although this increase may not seem overly impressive, one should consider that the number of foreign banks applying for licenses could have been substantially higher had the RBI not been so stringent about giving out bank and branch licenses.

**Obstacles Facing Foreign Banks**

Foreign Banks looking to start operations in India are likely to face challenges that are both unique and specific to any foreign entity that wants to do business in India. The difference is that the risks associated with setting up and operating a bank will be far greater than in any other type of business.

**Regulatory Issues**

For any bank looking to start operations in India - foreign or domestic - compliance with stringent RBI regulations is a major challenge. For example:

- **No differential licensing** – The RBI does not encourage banks whose business model does
not take into account the RBI’s objective of financial inclusion. Thus, foreign banks that are looking to offer very specialized banking services in India must apply for a universal banking license that mandates the roll-out of full-fledged banking services in the country. Consequently, giving precedence to financial inclusion may not be viable for all foreign banks entering the banking sector.

However, this issue might be resolved soon. The RBI’s discussion paper, “Banking Structure in India – The Way Forward” (August, 2013), supports differential licensing for banks in India, and mentions that this is a “desirable step” in a changing economic environment.

Financial inclusion — Complying with the RBI’s guidelines on financial inclusion requires offering banking products and services to unbanked and underbanked areas and customers. This involves costs that foreign banks with few branches and fewer sources of raising low-cost funds may find difficult to implement.

As of 31 March 2013, out of the 331 branches of foreign banks in India, only 17 were located in the rural and semi-urban areas. Out of the total 1,261 ATMs set up by foreign banks, only 51 were in rural and semi-urban areas.

More stringent monitoring and follow-up by regulators may slightly rectify this skewed ratio. However, a better solution would be to evolve a business model that enables foreign banks to benefit from opening rural/semi-urban branches.

Priority sector lending (PSL) — Foreign banks with less than 20 branches are supposed to lend to the priority sector to the extent of 32% of Adjusted Net Bank Credit (ANBC). For banks that have 20 or more branches, this figure stands at 40%. Lending to the priority sector includes lending to agriculture, micro and small enterprises, and providing export credit and advances to weaker sections of the society. Meeting PSL targets is especially difficult for foreign banks, given the high NPAs and defaults associated with this sector.

To ease the impact of PSL targets, the Nair committee (formed in 2011 to re-examine the existing classification and suggest revised guidelines with regard to priority sector lending and related issues) recommended that foreign banks with more than 20 branches achieve PSL targets over a period of five years, starting April 1, 2013. Banks must share a relevant action plan with the RBI.

Setting up a wholly owned banking subsidiary (WOS) — Currently, foreign banks in India operate as branches of the parent bank located overseas. However, RBI has recently released guidelines for setting up wholly owned subsidiaries (WOS) by foreign banks in India. A WOS would have to be in the form of a locally incorporated entity. These new guidelines will result in banks losing the advantages of a branch structure (greater operational flexibility, support from the parent, reduced corporate governance requirements, etc.). Such new entities are also likely to attract significant tax liabilities that arise with operating a WOS.

Longer gestation period — Traditionally, the RBI has been tight-fisted about issuing banking licenses. Banking licenses in the private sector were last issued in 2003; new licenses will likely be issued in 2014. Licenses for foreign banks are even harder to come by due to the complexities involved. Apart from regulatory issues, licenses to foreign banks are issued on the basis of relations between India and the home country of the foreign bank, and reciprocal arrangements between the banking regulators of both countries. This results in a wide time gap from applying for and eventually getting the license. In the interim, the cost of setting up and operating a bank in India is likely to go up substantially, and may require a rework of the business plan. The proposed banking sector reforms may provide a solution in the form of banking licenses “on tap.”

Marketplace Challenges

Foreign banks have to factor in the challenges they are likely to encounter from the Indian banking environment, as well as the unique market in which they are expected to operate:

Diverse banking environment — As of March 31, 2009, India housed 27 public sector banks; seven new private sector banks; 15 old private sector banks; 31 foreign banks; 86 Regional Rural Banks (RRBs); four Local Area Banks (LABs); 1,721 urban cooperative banks; 31 state cooperative banks, and 371 district central cooperative banks. As of March 31, 2013, the
number of foreign banks operating in India had risen to 43. Any foreign bank planning to enter India faces intense competition from existing players with a large network of branches/ATMs and a largely loyal customer base.

Currently, foreign banks are prohibited from starting operations in India’s Tier 3 - Tier 6 towns and cities. The proposed guidelines may remove this restriction. This could be an opportunity for foreign banks, as existing players may not have a significant presence in such areas. However, apart from the difficulty in achieving financial viability in those locations, new players will also face competition from non-banking finance corporations (NBFCs), credit cooperative societies and individual money lenders operating beyond the scope of regulations - hindering any formal set-up.

**Unique product mix** – Products offered by banks in India are generally skewed towards the retail banking business; for most banks, the retail customer is their primary source of cheap funds and fee income. What the retail customer cannot make in value is made up in volume. As a result, product innovation also focuses on these customers. For foreign banks that derive value largely from specialized banking services, such as private banking, investment banking, trade finance and the like, it is a challenge to offer innovative retail banking products, since domestic competitors already offer them. Also, products offered by foreign banks in their home countries may not be permitted by the regulator in India.

**Social Issues**

Acknowledging and overcoming social challenges is vital for a bank operating in a foreign country. Among these:

**Social integration** – Even today, a lot of banking in India is carried out on the basis of relationships and trust. For example, customers expect the bank to contact them when the balance in their account is insufficient to cover a check they issued, even though banks are not obligated to do so. Such practices may not fit the model for foreign banks. The bank would also need to understand the complex guidelines that are issued by the RBI from time and time, and how they apply to their institution. The RBI, especially in the case of regulatory reporting, is known to leave it to banks’ discretion to accurately report numbers. Master Circulars - a one-point reference of instructions issued by the Reserve Bank of India on a particular subject between July-June can often be vague. In such cases, foreign banks need to understand and follow industry best practices.

**Conflicting objectives** – The reason behind RBI’s stated objective of giving out new banking licenses - whether to domestic or foreign entities - is to promote financial inclusion. The CRISIL Inclusix score, which measures financial inclusion on three parameters - branch penetration, deposit penetration and credit penetration - stands at 40.1 for banks in India, which is quite low. India’s six largest cities have 11% of the total bank branches, while regions such as the Northeast are severely under-banked (four districts in the Northeast have just one bank branch among them). Foreign banks will find it difficult to balance this objective with the expectations of their stakeholders and their own reasons for starting Indian operations.

**Branding and publicity** – As mentioned earlier, a lot of banking in India is based on relationships and trust. In this regard, public sector banks, on account of their government antecedents, tend to score heavily over private sector and foreign banks. Foreign banks especially are associated with high costs and fees and aggressive marketing tactics, and are more prone to upheavals in the global financial markets. Foreign banks looking to enter India will need to counter this perception with smart and effective branding. They can highlight their strengths, such as technology advancements in banking, a better understanding of financial markets and/or a proven track record in various geographies.

**Infrastructure Issues**

Foreign banks entering India are likely to face infrastructure challenges in terms of systems and branch infrastructure.

**System challenges** – Banks in India already use some of the best core banking solutions available on the market. Since retail and commercial banking are the most developed lines of business (LOBs) in India, innovation and product implementation concentrate on these areas. Foreign Banks with robust private
banking, wealth management, Anti Money Laundering (AML), trade finance, and investment banking systems and processes may not find much use for them until the market attains a certain level of maturity. The current volume of transactions in these areas may not justify implementation of the systems.

**Branch infrastructure** – The number of branch walk-ins in Indian banks is much higher compared to other countries, where the focus is on keeping customers engaged through channels such as the Internet, phone and mobile banking. Foreign banks will need to develop an infrastructure (both physical and human) equipped to handle more footfalls. Additionally, setting up a new infrastructure and processes takes much longer in the Indian banking scenario. A good example is CTS (Cheque Truncation System), which has yet to be implemented across the country – even 10 years after the pilot program was launched.

**RBI Guidelines for Foreign Banks:**

**The Framework for Setting Up A WOS**

In a press release dated November 6, 2013, RBI announced the framework for the setting up of wholly owned subsidiaries (WOS) by foreign banks in India. As a locally incorporated entity, the WOS will be treated at par with other Indian banks in terms of branch expansion, and will also be permitted to participate in the development of the Indian financial sector. Existing foreign banks will be incentivized to convert into a WOS. An analysis of this proposal reveals more pros than cons as far as the banking sector is concerned (see Figure 4, below).

Below are some other significant changes proposed in the discussion paper:

- Banks that do not provide adequate disclosure in their home country, banks with complex structures, banks that are not widely held represent types of banks that will be permitted entry only by setting up a WOS.
- Wholly owned subsidiaries of foreign banks will not be given “full national treatment” even though they are locally incorporated. This is to prevent foreign banks from dominating domestic banks.

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**RBI Policy for Foreign Banks Setting Up a WOS.**

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<th>Pros</th>
<th>Cons</th>
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<tr>
<td>&quot;Ring Fence Banks&quot; from Global Risks</td>
<td>Huge Tax Liability for Subsidiaries</td>
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<tr>
<td>Easier for the RBI to Regulate</td>
<td>Less Operational Flexibility</td>
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<tr>
<td>At Par With Domestic Banks in Terms of Branch Expansion</td>
<td>Greater Corporate Governance Requirements</td>
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<td>Raising of Non-Equity Capital in India</td>
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Figure 4
Some other significant changes announced are as follows:

- Foreign banks that become “systemically important” because of their balance sheet size in India have to convert themselves into wholly owned subsidiaries. Systemically important banks are those whose assets account for at least 0.25% of the total assets of all commercial banks.

- Banks with complex structures, banks that do not provide adequate disclosure in their home jurisdiction, banks that are not widely held, banks from jurisdictions that have legislation giving a preferential claim to depositors of the home country in winding up proceedings, etc., will be allowed entry into India only in the WOS mode.

- Foreign banks that commenced banking business in India before August 2010 shall have the option to continue their banking business through the branch mode. However, they will be incentivized to convert into a WOS because of the attractiveness of being treated almost on par with national banks.

- The initial minimum paid-up voting equity capital for a WOS shall be 5 billion rupees for new entrants. Existing branches of foreign banks desiring to convert into WOS will need to have a minimum net worth of _5 billion rupees.

RBI — Proposed Banking Sector Reorientation

The Reserve Bank of India is also contemplating major banking sector reforms.(6) (See Figure 5, below). These reforms are not specific to foreign banks, but could be a solution to some of the challenges they face. The RBI recently released a discussion paper, “Banking Structure in India - The Way Forward,” which deals with the reorientation of India’s banking sector. The intention is to have a dynamic and flexible structure that remains resilient, even during periods of financial instability.

Opportunities for Consulting Firms

The Indian banking sector currently offers significant scope and opportunities for consulting firms and system integrators (SIs). The licensing of new banks in the private sector and the RBI’s automated data flow (ADF) program are some of the business opportunities that IT and business consulting firms are already targeting. This space is likely to get a further boost when the RBI goes

Proposed Banking Sector Reforms

![Diagram showing proposed banking sector reforms](image-url)
ahead with its proposed banking sector reforms, and if it announces new guidelines for foreign banks operating in India. Here is a look at some of the business opportunities for consulting firms in the Indian banking space. The opportunities primarily apply to foreign banks. However, the same may also be applied to other new banks looking to enter the Indian market.

Defining Operational Processes, Listing Key Requirements
It is essential that foreign banks planning to enter the Indian market have a thorough understanding of the Indian banking sector. Apart from the rules, regulations and guidelines defined by the regulator, new entrants have to gain knowledge about the products and services they need to offer, the business and IT processes that must be in place, and the staffing required to set up and operate a branch. Gaining this level of knowledge within the short span of time when the banking license is valid is a tough task.

Consulting firms with experience and expertise in the banking domain and similar projects can help develop a strategy and a set of requirements for new banks looking to start operations in India. These requirements can include functions such as cash management; teller management; account and deposit management; lending; payments; clearing; and trade finance, for example. Within these systems, services encompass inward/outward clearing; withdrawals; account opening/closure; export collection; and inward/outward remittances, among others. Qualified consulting firms can also offer research and findings based on peer banks’ best practices – and actual regulatory reporting requirements.

Business Process Consulting
Foreign banks that seek to enter Indian markets carry the legacy of business processes followed in their home markets or in other geographies in which they operate. However, those processes may not be suitable for the Indian market. New entrants can make use of business process consulting to design or restructure their processes to help cut costs, improve productivity, lower turnaround time and enhance customer service, for example. Banks can use these services to document processes for training and reference, and to identify gaps.

Business process consultants can also help banks design or modify business processes related to banking functions, including retail banking, corporate banking and private banking. Existing process repositories can be used to showcase domain expertise, which can be used as the building blocks for a bank’s specific processes.

Internal Process Consulting
In addition to business processes, a qualified consulting firm can offer banks entering India’s banking market internal process consulting, which focuses on processes carried out by the bank’s “in-house” departments, such as finance, human resources and legal. These consulting services are geared to foreign banks, and address local requirements as well as industry best practices.

Selecting a Core Banking Product
With multiple core banking solutions (CBSs) on the market, and considering banks’ unique requirements, selecting the right one becomes critical. A foreign bank entering the Indian market may look to implement its existing CBS. However, determining whether this solution is appropriate locally, and whether it provides support for local regulatory reporting can only be determined after a detailed gap analysis – a task ideally suited to consulting firms with experience in core banking product selection and implementation.

Selecting a core banking product should consider the following:
- The bank’s target operating model.
- The bank’s size and scope of operations.
- Expected transaction volumes.
- The viability of using an “off-the-shelf” product.
- Customizations required and costs involved.
- Implementation, maintenance and upgrade costs.

Opportunities in Core Banking Implementation
Considering the constraints – time, tasks and the interdependencies among multiple stakeholders involved in any CBS implementation, there is a significant role to be played by consulting firms acting as Systems Integrators (SIs). Systems integration consulting enables a new foreign bank to maintain a single point
of contact and communication for multiple
vendors and different groups within the bank.
An experienced SI also brings the domain and
process expertise required to understand the
functions of various dependent and independ-
et banking systems and processes.

The Role of Automated Data Flow (ADF)
Banks in India are required to submit a set of
reports to the RBI at various periods through-
out the year. These are used by the regulator
to analyze a bank’s financial health and its
compliance with other regulatory directives.
The RBI also uses statistical reports for macro-
economic analysis - making the quality of data
extremely important. Some of these reports
have been prepared manually by banks, which
increases the odds of producing and reporting
inaccurate data. With this in mind, the Reserve
Bank of India launched its automated data flow
(ADF) program, whereby “clean” data from a
bank’s source system is captured, compiled and
submitted to the RBI in the prescribed format.

Since this is a comparatively new area of focus
for banks, ADF consulting and implementation
is a prime opportunity for consulting firms
with expertise in the regulatory reporting
domain. Consulting firms acting as SIs can be
the link between the bank and the ADF product
vendor. Services such as ADF consultancy
(short-listing of reports to be submitted by the
bank; analyses of data to be reported in short-
listed reports; applicability of reports based
on the bank’s target operating model; a gap
analysis of data required to be reported; data
available in the source system, and ADF imple-
mentation) can all be provided by these firms.

Banking License Consulting
Banking Licensing Consulting is a niche
area of consulting with significant potential.
It involves consulting services for obtaining a
banking license in the country. Services in this
area can include end-to-end services - starting
with a feasibility analysis for the foreign bank
planning to enter the Indian market; applying
for the license within the specified time frame;
interacting with the various government
and RBI departments involved in the entire
process; updating the foreign bank regard-
ing changes in policy, as well as defining the
implications for the bank and its license appli-
cation. Banking Licensing Consulting can
extend to post-licensing; consulting firms can
assist banks in obtaining memberships of
clearing and settlement houses, depositories,
credit-rating agencies, insurance and credit
guarantee corporations, as well as various
banking associations such as IBA and IIBF.

Conclusion
In spite of stringent RBI regulations and other
restrictions, India will continue to attract foreign
banks looking to set up branches/representative
offices in order to facilitate trade and commerce
in their home markets. There will also be bank-
ing institutions keen to enter India as full-fledged
banks that offer the entire gamut of banking
services, and emulate the success achieved by a
Citibank or an HSBC or SCB.

The various challenges these foreign banks are
likely to face in the Indian markets provide a
significant opportunity for IT and business con-
sulting firms to position themselves, provided
they suitably gauge the bank’s requirements and
offer pertinent solutions at competitive prices.
Firms that have experience and expertise in
providing comprehensive end-to-end solutions
for foreign banks - from conducting a commer-
cial feasibility analysis and outlining target oper-
ating models, to defining business and internal
processes and selecting a CBS, to setting up a
branch and providing solutions for MIS and regu-
latory reporting - will have an edge over “prod-
uct-specific” firms. There are likely to be ample
business opportunities for such “all-inclusive”
firms acting as system integrators, since the
services they offer are based on an objective and
unbiased approach.
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