

ClientAlert

Bank Advisory/India practice

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The Reserve Bank of India Invites Comments on the Treatment of Foreign Banks in India

On January 21, 2011, the Reserve Bank of India (RBI), India's central bank, released its discussion paper on the form of presence of foreign banks in India titled "Discussion Paper—Presence of Foreign Banks in India" (Discussion Paper). According to the criteria noted in the Discussion Paper, in order to enter the Indian banking market, almost all international banks may be required to set up a wholly owned subsidiary (WOS) in India. Further, RBI has reserved itself substantial discretion on when any existing branch of a foreign bank would have to convert into a WOS, including converting any such branch into a WOS if, in the judgment of the RBI, such branch becomes "systemically important" (as defined by the size of such branch's assets). The RBI has invited public comments on the Discussion Paper by March 7, 2011.

Proposed Framework

- **Entry Norms:** A bank would be required to set up a WOS upon entry into India if it (i) is incorporated in a jurisdiction that has legislation that gives deposits made/credit conferred in that jurisdiction a preferential claim over the assets of the bank, including the branch in India, in a winding up; (ii) does not provide adequate disclosure in its home jurisdiction; (iii) has a complex structure; (iv) is not widely held; or (v) fails to satisfy the RBI with its supervisory arrangements. Any foreign bank that does not fall under any of the categories noted above would be free to choose either a WOS or a branch mode for entry into India. However, any branch set up by a foreign bank would have to mandatorily convert into a WOS if, in the judgment of the RBI, any of the conditions noted above are satisfied or such branch becomes "systemically important" (i.e., assets become 0.25 percent of the total assets of all scheduled commercial banks in India as of March 31 of the preceding year).
- **Existing Bank Branches:** The RBI expects that any existing branch of a foreign bank that meets the criteria noted above or has otherwise become "systemically important" because of the size of its assets would voluntarily convert into a WOS.
- **National Treatment:** A WOS of a foreign bank will not be afforded full national treatment. However, it is expected that such a WOS would receive better treatment than a foreign bank branch but less than that afforded to a domestic bank. Accordingly, (i) the RBI may allow a WOS of a foreign bank to raise INR-denominated non-equity capital in India; (ii) the RBI may extend the branch expansion policy as applicable to domestic banks on January 1, 2010 to any WOS of a foreign bank; and (iii) the RBI will, consistent with India's commitments under the World Trade Organization's General Agreement on Trade in Services, continue to restrict the expansion of foreign banks present in India in branch mode to 12 branches per year.



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- **Capital Requirements:** A WOS of a foreign bank, including a branch of a foreign bank converting into a WOS, would be required to maintain a minimum capital-to-risk (weighted) assets ratio of 10 percent, or such other ratio as the RBI may prescribe from time to time. This treatment is the same as that afforded to a new private-sector bank. Any branch of a foreign bank, whether new or existing, would continue to have a US\$25 million capital requirement.
 - **Corporate Governance:** The RBI may mandate that the members of the board of directors (directors) of a WOS of a foreign bank should satisfy certain criteria including that (i) at least 50 percent of the directors should be Indian nationals residing in India; (ii) at least 50 percent of the directors should be non-executive directors; (iii) at least one-third of the directors should be independent from the management; and (iv) directors should be "fit and proper" according to criteria noted by the RBI separately.¹
 - **Accounting, Prudential Norms and Other Requirements:** Any WOS of a foreign bank would be subject to licensing requirements and conditions that are "broadly consistent" with those for a new private-sector bank. Further, a WOS of a foreign bank would be governed by the provisions of the Companies Act, 1956, Banking Regulations Act, 1949, Reserve Bank of India Act, 1934, and other relevant statutes and regulations promulgated by the RBI.
 - **Priority-Sector Lending:** A new WOS of a foreign bank would be subject to certain priority-sector lending guidelines from the beginning of its operations. However, an existing branch that converts into a WOS would be allowed a transition period of five years from the year in which they incorporate in India to meet the priority-sector lending norms, during which such a WOS would have to follow a prescribed lending roadmap.
 - **Ultimate Parent Support:** The parent of a WOS may not be allowed to provide explicit guarantees to the creditors of such WOS for its liabilities to avoid giving them "unfair competitive advantage over domestic banks." However, the RBI may require the parent bank to issue a letter of comfort to the RBI that it would meet the liabilities of such WOS.
 - **Tax Treatment:** The provisions of the Income Tax Act, 1961 would be applicable to any foreign bank when such a bank transfers its property, goodwill and other assets into a WOS in relation to the conversion from branch mode to the WOS mode.
 - **Declaration of Dividend:** A WOS of a foreign bank would be subject to the same restrictions as any domestic bank for declaring dividends,² including meeting certain minimum prudential standards such as a minimum capital-to-risk (weighted) assets ratio and a cap on the net nonperforming assets, as well as complying with the provisions of the Banking Regulation Act, 1949.
 - **Setting up Nonbanking Financial Companies:** A WOS of a foreign bank would generally not be able to set up a subsidiary or otherwise make a significant investment in an associated entity.
 - **Regulatory Framework for Consolidated Prudential Accounting and Supervision:** A WOS of a foreign bank whose parent or other group companies promote a nonbanking financial company in India may be subject to the same regulatory framework for consolidated prudential reporting and supervision as is currently applicable to branches of foreign banks.³
 - **Mergers, Acquisitions and Dilution of Wholly Owned Subsidiaries to 74 percent:** The RBI has not articulated a new position on the issue at this time. It has reserved its right to promulgate rules once it has reviewed the experience obtained under the existing framework.
 - **Differential Licensing:** The RBI would not grant a differential license to a foreign bank "seeking entry in 'niche markets.'"
- The Discussion Paper raises a number of potential issues for international banks operating in India or looking to enter India and acknowledges that India's commitments on banking services in the World Trade Organization's General Agreement on Trade in Services will have to be kept in mind. Unless the elimination of the branch mode as an option for new entrants in India and other changes can be justified as necessary for prudential reasons, these proposals may be open to challenge as inconsistent with India's commitments to the World Trade Organization. Banks should consider whether they would like to bring to the RBI's attention any specific issues that may affect their operations if the proposals in the Discussion Paper become effective. The deadline for submitting any comments to the RBI on the Discussion Paper is March 7, 2011.

1 The Reserve Bank of India Circular DBOD No.BC.105/08.139.001/2003-04 (June 25, 2004).

2 The Reserve Bank of India Circular DBOD No.BPBC. 88/21.02.067/2005/05 (May 4, 2005).

3 The Reserve Bank of India Circular DBOD No.FSD.BC. 46/24.01.028/2006-07 (December 12, 2006).

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