



EU-INDIA JOINT INITIATIVE FOR ENHANCING TRADE AND INVESTMENT

JOINT RECOMMENDATIONS FOR FINANCIAL SERVICES

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Therefore the views expressed herein do not engage the European Commission, Asia-Invest or the Indian business federations CII and FICCI.



EU-India Joint Initiative for Enhancing Trade And Investment

FINANCIAL SERVICES

This list of Joint Recommendations on the financial service industry, will be discussed and presented to the political leadership at the third EU-India Summit in Copenhagen (October 8 and 9, 2002).

The initial findings have been derived from extensive desk and field research (in Europe and in India), including face-to-face interviews with most European banks active in India as well as other large international institutions not present in India, and with the largest domestic Indian institutions. The team of consultant also benefited from the views of most regulators, in Europe as well as in India, as well as from exchanges of views with the Indian business federations (FICCI and CII).

A prioritisation process took place during a Business Forum held in India (Mumbai, September 7) and in Europe (Brussels, September 26), where the interested parties agreed on the recommendations to put forward as the most important ones (15 High Priority Recommendations, numbered from HP1 to HP15). The other recommendations which were not considered high priority ones but remain critical issues, are presented below under the heading 'other recommendations' (16 Recommendations numbered from 1 to 16).

The following Recommendations are articulated around the three major aspects of financial services currently under consideration, i.e. banking, life insurance and investment vehicles or asset management.

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High Priority Recommendations

ISSUES AND RATIONALE	RECOMMENDATIONS
BANKING	
<p>Clarify entry / capital conditions in India as well as in EU to enhance mutual presence of banking institutions</p> <ul style="list-style-type: none"> ➤ Rationale: Enhanced entry will provide borrowers and other users of banking services the best offer and improve overall banking efficiency and level of services. ➤ Consequence: Respective status and entry conditions of branches, subsidiaries and participation in local banks need to be clarified. 	<p>⇒ in India</p> <p>HP1. Concept of branch should be fully taken into account for capital and other prudential regulations, especially for banks that are under a consolidated supervision authority in their home country. Possible comfort could be given by head offices undertaking to infuse capital in case of prudential ratios falling below the required level set by RBI.</p> <p>HP2. During possible discussion on the prior item, European banks should be allowed to delay the adjustment to the single borrower limit beyond April 2003 in order to protect customer relationship and easy access of companies in India to needed funds, and to issue local currency subordinated debt as tier 2 capital.</p> <p>HP3. The share of voting rights should be aligned on the share of capital held by any investor as provided by the Company Act.</p> <p>HP4. The minimum capital requirements for 100% foreign-owned NBFCs should be lowered from the very high USD 50 mn to a level more appropriate (in terms of risks and need for long term own funds) for such activities (suggestion: USD 10 mn).</p>

⇒ **in the EU**

HP5. Conditions applying for entry of Indian banks should be fully transparent and based on ‘objective’ criteria for prudential control, including India’s compliance with BIS 26 ‘best practice’ list of supervisory criteria, country risk and currency convertibility. Possible comfort (in the cases of branches) could be given by head offices undertaking to infuse capital in case of prudential ratios falling below the required level set by EU member states’ prudential authorities, and by a RBI commitment to provide necessary foreign currency in such events.

Improve overall efficiency in the banking industry while moving towards internationally recommended 3rd generation supervision and regulatory surveillance

- Rationale: : Overall efficiency in the banking intermediation activities brings substantial macroeconomic benefits in the form of lower cost of capital, expanded access by medium or small size corporate borrowers to financial resources, more fluid transactions and higher systemic resistance. This improved efficiency is supported by a fair level playing field and needs to be accompanied by enhanced risk supervision through which 'risk processes' are assessed while leaving greater autonomy to institutions.
- Consequence: Improvement of level playing field through homogenisation of rules for all participants, enhanced but simplified regulation, and increased autonomy by individual institution able to demonstrate the performance of their risk management systems should be targeted.

⇒ **in India**

- HP6. The concept of 'compulsory' priority lending should be phased out for the entire banking sector. The ultimate objective would be to clearly separate 'economic development functions' from 'commercial operations by banks'. The former should be taken over by dedicated public institutions. During possible policy discussion / adjustment on this item, conditions (e.g. interest rates) should be aligned on market conditions, and foreign banks should be allowed to 'outsource' the bulk of this obligation considering their lack of sufficient network to analyse the risks and find the commercial interest in this priority lending.
- HP7. Income taxation and other regulation should be homogenised between foreign and domestic institutions, provided the previous Recommendation (HP6) is dealt with.
- HP8. Creation and development of a forward interest rate market should be decided in order to improve the liquidity management in banks and reduce maturity-mismatch risks, and quantitative regulation on call money market resources should not apply to banks that can demonstrate a strong asset-liability management and control process.

⇒ **in the EU**

- HP9. Indian banks should be allowed to market products designed, managed and lodged in India, in the EU markets, provided all regulatory requirements in terms of the nature of the products, disclosure, etc. be met.
- HP10. Movements of qualified staff from India to EU should be facilitated, so that Indian banks can benefit from one of their competitive advantages in their European activities.

LIFE INSURANCE

Clarify entry / capital conditions in India

- Rationale: Enhance the development of life insurance while avoiding problems related to heavy capital requirements in the initial phase of such development and strengthening the technical expertise needed.
- Consequence: Need to allow larger inflows of foreign capital into the Indian life insurance companies.

⇒ **in India**

- HP11. The 26% limit on share participation by foreign insurance companies should be increased, especially since the heaviest capital increases occur in the initial stages of life insurance development.
- HP12. A broad review of the tax regime (Income Tax Act 1961) should be promoted to meet the new challenges raised by liberalisation in the insurance industry (e.g. single fund for policyholder and shareholder; deficit allowed to be carried forward for setting off against future surpluses).

Improve overall efficiency in the life insurance industry

- Rationale: Overall efficiency in life insurance activities brings substantial macroeconomic benefits in the form of better financial intermediation and long-term savings, lower cost of capital, expanded cover of households 'financial risks', and higher systemic resistance.
- Consequence: Need to look at all regulations that are affecting this efficiency, clarify their purposes and find positive ways to remove unnecessary burdens.

⇒ **in India**

- HP13. Regulation on Pension should be enacted as soon as possible while integrating regulatory issues and competition rules between various types of financial institutions.

INVESTMENT VEHICLES (asset management, private equity and venture capital)

Improve level playing field between institutions

- Rationale: A ‘fair level’ playing field should improve savers’ choice while limiting future systemic risks.
- Consequence: All asset management companies should be subjected to the same set of rules

⇒ in India

HP14. Venture capital should be made at least at par with Foreign Institutional Investors (FIISs): once registered, they should have the same facility as FIIs: free investments without need of approval from FIPB/RBI.

Improve overall efficiency in the financial investment industry

- Rationale: Overall efficiency in asset management brings substantial macroeconomic benefits in the form of better financial intermediation, lower cost of capital, and higher systemic resistance.
- Consequence: Need to look at all regulations that are affecting this efficiency, clarify their purposes and find positive ways to remove unnecessary burdens.

⇒ in India

HP15. The tax system applied to the sector and its products has to be made more stable to foster greater predictability in the sector.

Other Recommendations

ISSUES AND RATIONALE	RECOMMENDATIONS
BANKING	
<p>Clarify entry / capital conditions in India as well as in EU to enhance mutual presence of banking institutions</p>	<p>⇒ in India</p> <ol style="list-style-type: none"> 1. Capital and subordinated loans provided by European head offices to their Indian branches should be protected against currency depreciation, either by allowing to keep them in foreign currency, or by allowing banks to hedge their funds. <p>⇒ in the EU</p> <ol style="list-style-type: none"> 2. Better harmonisation of criteria for accepting a branch of foreign bank should be promoted in the EU Member States, in order to facilitate a multi-country presence by Indian institutions.

Improve overall efficiency in the banking industry⇒ **in India**

3. Foreign banks should be allowed to raise subordinated debt as tier 2 capital on the domestic Indian market.
4. Previously useful guidelines, which are not adapted to the current situation, should be updated or abolished, provided that the regulators are satisfied with the internal operation/control processes in banks (e.g. definition of secured lending).
5. Provisioning of doubtful loans should be tax deductible before the write-off/loss is declared in order to encourage higher provisioning and stronger resistance of banks in case of unexpected economic conditions. Symmetrically, cancellation of prior provisions would be re-integrated in the taxable profits.
6. Overall supervisory functions for multi-activity financial institutions (including financial holdings) should be clarified and strengthened in order to avoid regulatory overlap and duplication, regulatory arbitrage, and regulatory 'black holes'. The current board of Supervisors could be given more powers and/or an administrative structure to deal with these issues. Occasional and specific difficulties in some financial areas should not lead to indiscriminate strengthening of regulations.
7. Administrative / reporting obligations by banks should be simplified and made possible through electronic communications. Clarity of regulatory processes should be enhanced and 'single windows' for regulatory contact should be established.

<p>Improve overall efficiency in the banking industry (cont.)</p>	<ol style="list-style-type: none"> 8. Legal environment should be revised in order to allow creditors to have a better access to doubtful borrowers’ resources. The recent regulatory change allowing creditors to seize assets is considered a very positive step, but it is felt very important not to limit creditors’ right to the assets, but to allow a more direct control on the borrowers’ cash flows (e.g. escrow accounts to centralize all revenues). 9. Improved financial information and development of ratings for a much larger segment of corporate borrowers should be encouraged in order to prepare for Basel- II regulations on capital adequacy. 10. New banking products or services should be automatically approved, provided that the banking institution satisfies a number of overall regulatory criteria (e.g. Islamic banking). 11. The specific nature of banks’ activities (notably the possibility to outsource a large number of functions at a cost advantage) should be taken in consideration for labour reforms, in order to give more flexibility to banks in terms of operations and cost structure.
<p>LIFE INSURANCE</p>	
<p>Improve overall efficiency in the life insurance industry</p>	<p>⇒ in India</p> <ol style="list-style-type: none"> 12. Regulation on the training of sales force should be based on a level examination and not on a pre-defined number of training hours. 13. Life insurance companies should be allowed to transfer a part of their asset management functions to specialized Asset Management Companies in order to benefit from out-sourced / specialized expertise. 14. Corporate brokerage of insurance products as announced in the recent regulation should be extended in full to bank branches (including possibility of selling products from various providers).

INVESTMENT VEHICLES (asset management, private equity and venture capital)

<p>Improve level playing field between institutions</p>	<p>⇒ in India</p> <p>15. All government undertakings should be allowed full choice of AMC when investing their financial resources.</p>
<p>Improve overall efficiency in the financial investment industry</p>	<p>⇒ in India</p> <p>16. Greater flexibility and freedom for institutional investors including banks, mutual funds and insurance companies to invest in VCFs should be granted provided that this remains within some size limits.</p>