

## **IMPACT OF FOREIGN PRESENCE ON DOMESTIC FINANCIAL MARKETS —CASES OF INDIA AND CHINA**

By Dr. Sayuri Shirai\*

India's Banking Sector Reform (distributed, based on ADBI paper #32)

Prior to the 1991 reforms, India's banking sector had long been characterized as highly regulated and financially repressed. The prevalence of a reserve requirement (CRR), liquidity requirement (SLR), interest rate controls, and allocation of financial resources to so-called "priority sectors" (i.e., agriculture and small scale industries) increased the degree of financial repression and adversely affected the country's financial resource mobilization and allocation. Moreover, in order to assist India's planned development strategy, all large private sector banks were nationalized. Although non-nationalized private sector banks and foreign banks were allowed to coexist with public sector banks at that time, their activities were highly restricted through entry regulations and strict branch licensing policies. Thus, their activities remained negligible. As a result of these measures, many banks remained unprofitable, inefficient, and unsound.

Given this background, the Government launched comprehensive banking sector reforms in 1991. The reforms included (1) a reduction of the CRR and SLR, (2) interest rate and entry deregulation, (3) reform of priority sector lending, (4) entry and branch deregulation, (5) a shift in banking sector supervision from intrusive micro-level intervention over credit decisions toward prudential regulations, and (6) restructuring of public sector banks. India joined in the WTO since 1995.

In particular, the Government allowed new domestic banks to enter provided that a new bank maintains minimum paid-up capital of Rp1 billion; lists its shares on stock exchanges; and uses modern infrastructural facilities to provide good customer service. As of end-2001, there are eight new private sector banks, increasing the number of private sector banks from 24 in 1993 to 31 in 2000. As for foreign banks, a new foreign bank is required to bring in minimum assigned capital of \$25 million, of which \$10 million should be brought in at the opening of each of the first two branches and the balance of \$5 million at the opening of a third branch. Upon entry, the RBI (central bank) examines dealings of the foreign bank with Indian parties, international and home country ranking where available, international presence, and supervisory standards prevalent in the home country. A total of 26 new foreign banks have opened branches in India since the reforms, in addition to the 18 that existed before.

The reforms brought out some favorable impact on India's banking sector. The performance of public sector banks (sum of 19 nationalized and eight SBI banks) improved in the second half of the 1990s. Profitability (measured by return on assets [ROA]) of 19 nationalized banks turned positive in 1997-2000 and that of eight SBI banks was superior in 1996-2000 compared to earlier. Further, these public sector banks have steadily improved their cost efficiency (measured by operating costs divided by operating income) over the reform period. Even though foreign banks and private sector domestic banks generally performed better than public sector banks in terms of profitability, earnings efficiency (measured by the ratio of income to assets), and cost efficiency in the initial stage, such differences have diminished as public sector banks have improved profitability and cost efficiency. This suggests that the banking sector reforms since 1991 have

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\* Associate Professor of Economics, Keio University and Visiting Scholar, ADB Institute. The views expressed herein are the views of the author and do not necessarily reflect the views or policies of the ADB or its Board of Directors or the governments they represent. ADB makes no representation concerning and does not guarantee the source originality, accuracy, completeness, or reliability of any statement, information, data, finding, interpretation, advice, opinion, or views presented.

exerted increased pressure and, thus, had a positive non-negligible impact on the performance of public sector banks.

Foreign banks also maintain greater own equity (equity plus reserves) over liabilities, increasing from 7% in 1993 to 20% in 2000. Their risk-weighted capital adequacy ratio also exceeded above 30% during 1997-2000. This ratio is significantly high not only compared to the global standard but also with other domestic banks. Foreign banks generally have allocated greater provisions for NPAs. Given that more stringent accounting and auditing standards of their mother countries are applied to foreign banks, they are more resilient to adverse shocks. The introduction of foreign banks certainly contributed to improving the balance sheets of other banks, although the scale of the improvement has been small.

However, it should be stressed that this does not imply that the reforms have had wholly satisfactory results; indeed, this has been far from the case, for the following reasons. First, public sector banks have remained dominant, accounting for about 80% of deposits and assets in the commercial banking sector. Foreign banks account for only at 7-8%. The share of private sector domestic banks has increased somewhat from 5% in 1995 to 12% in 2000.

Second, although some nationalized banks have promoted partial privatization, this has not improved their corporate governance through greater shareholder supervision. This is partly because rules have restricted individual (including foreign institutional investors) voting rights to a maximum of 10%, and partly because the share held by the Government or the RBI has remained large. While privatization of viable public sector banks should be promoted further, mere privatization without institutional changes, where external shareholders and independent boards of directors cannot practice corporate governance properly, will not have a favorable impact on the performance of partially privatized public sector banks. The Government should transform public sector banks into purely commercial-oriented banks with greater autonomy for their operations and human resources policies. This is particularly so if it wishes that these banks could become more profitable and efficient, thereby being able to compete with private sector and foreign banks on a level playing field and lowering their dependence on government financial support. Moreover, the board of directors system should be reformed by increasing the number of competent external directors, guaranteeing independence of the board from government and political interference, improving accounting and disclosure standards, and strengthening minority shareholders' rights. Improving corporate governance in the banking sector would also help to increase the price of IPOs and, hence, promote privatization.

Third, given that public sector banks enjoy scale advantages because of their nationwide branch networks (especially compared with private sector banks, which tend to compete in the retail market), the current approach of improving their performance without rationalizing or downsizing them may not have further and substantial benefits for India's banking sector. As for foreign banks, they generally engage in the wholesale market without hardly increasing employees and branches, and thus do not participate actively in intermediation. In this sense, the impact of foreign banks on India's banking sector is limited, since they do not compete in the same retail market with domestic banks.

Fourth, priority sector lending (40% of advances in the case of domestic banks and 33% in the case of foreign banks) should be gradually phased out even though the negative impact of such lending has declined in recent years. Thanks to reforms that liberalized lending rates on advances of more than Rs200,000 and broadened the coverage of priority sector lending, advances to priority sectors have exerted a positive effect on earnings efficiency and cost efficiency on the whole banking sector. However, priority sector lending has lowered profitability of public sector

banks and contributed to an accumulation of NPAs. A positive impact on profitability of the overall banking sector was also not evident. It also discouraged banks, particularly foreign banks, from conducting lending activities. Priority sector lending, if performed by commercial banks, should be exercised on market terms and at the initiative of banks. It is important to ensure a separation of commercial lending and policy lending, which would be a prerequisite for enhancing banks' accountability and management skills. Otherwise, such lending should be conducted under a government budget and increasingly undertaken by specialized financial institutions. It would also be difficult for the Government to cease financial support to problematic banks as long as it imposes policy loans on these banks.

Therefore, it is concluded that the impact of foreign banks on India's banking sector is limited at this stage although it contributed to improving domestic banks' management and balance sheets. While foreign banks are to be allowed to engage in the local-currency activities under the WTO framework, the Government should give in the next reform agenda the highest priority to more drastic measures for reforming public sector banks and liberalizing the whole commercial banking sector, through careful consideration of the various aspects indicated above. The existence of remaining barriers, such as administered interest rates on saving deposits and other saving schemes, may partly explain why financial deepening has taken place at a relatively mild pace in India, compared with the earlier period. Household sector savings have remained at 20% of GDP, while physical savings account for only 9% of GDP. Given India's large population and relatively high-income growth, there is room for the country's banking sector to grow further through increased deposit mobilization.

China's Banking Sector Reform (not distributed, JBIC Discussion Paper No.2;  
[http://www.jbic.go.jp/japanese/research/report/discussion/pdf/dp02\\_e.pdf](http://www.jbic.go.jp/japanese/research/report/discussion/pdf/dp02_e.pdf))

The Government has embarked on a series of financial reform programs since 1979. The programs in the 1980s focused on the establishment of a two-tier banking system that comprising primarily of a central bank and four specialized banks that are owned fully by the central government. Once the two-tier banking system was formed, the Government launched the second wave of financial reforms since 1994, consisting of two major parts: further institutional building and the management of nonperforming loans (NPLs). Institutional building focused on the commercialization of specialized banks and a separation between policy and commercial lending activities. Other reform measures included an attempt to reduce local government intervention, the removal of credit allocation, a narrowing of the scope of business, interest rate and entry deregulation (albeit to a limited extent), and a gradual tightening of accounting and prudential regulations. The management of NPLs included the recapitalization of wholly state-owned commercial banks (WSCBs) and the disposal of NPLs held by WSCBs, and the merger and closure of problematic banks.

China's banking sector reforms have been less comprehensive and took place at a slower pace than India's reforms. Thus, these reforms have hardly brought any changes on the banking sector. First, the banking sector has remained dominated by the four WSCBs in the reform period since 1994. Competition has emerged but only at the lower end. Moreover, tight entry regulations prevailed until China's accession to the WTO at ent-2001. Engagement in local currency-denominated transactions by foreign banks was largely limited to only Shanghai and Shenzhen and was allowed only against foreign capital enterprises. Second, the impact of the financial reforms has not had a noticeable impact so far on WSCBs' performance. Their profitability and cost-efficiency (measured by the ratio of operating cost to operating income) have remained poor and more or less constant throughout the reform period, and earnings-efficiency (measured by total income as a percentage of assets) has steadily deteriorated.

Third, and more worrying, is that other banks' performance (i.e., profitability and cost efficiency) has deteriorated in recent years regardless of whether these banks are city or nationwide, and whether listed or nonlisted. The deterioration reflects an increase in operating costs driven by rises in personnel expenditure in addition to a decline in operating income caused by a falloff in net interest income. Fourth, the decline in other banks' profitability is closely associated with the slowdown of real gross domestic product (GDP) growth and a shift in depositors' preference from these banks to WSCBs in 1997-1999. Fifth, the poor performance of the banking sector is attributable partially to their holding of excess reserves and substantial investments in government bonds. This may reflect a cautious lending attitude driven by tighter prudential regulations as well as the high cost involved in extending credit to small and medium enterprises (SMEs) and new borrowers (i.e., information gathering and monitoring costs). In addition, PBC's (central bank's) payment of interest on excess reserves increases banks' incentives to hold such excess reserves. Sixth, the narrow scope for diversification granted to banks tends to raise operating costs, mostly likely due to their limited ability to exploit economies of scale.

These outcomes suggest that the impact of foreign banks is not yet evident. There is an urgent need for the government to undertake more comprehensive and drastic steps to restructure the WSCBs. Since most of their funds are extended to SOEs (of which about 40% are loss making while the rest are making a profit), this suggests that WSCBs have continued to function as a major financier of SOEs. Thus, so-called "direct (policy) lending" still occurs even though these banks became commercialized in 1995. Therefore, there can be no drastic improvement in WSCBs' NPLs unless the problems of loss-making SOEs are tackled.

#### China's Equity Market Development (distributed, based on ADB Institute Paper No.41)

The Government attempts to improve balance sheets of WSCBs in anticipation of increased competition driven by its entry to WTO. As a result, banks have become more cautious about extending credit and had instead increased holdings of safe, more liquid government bonds. Thus, the Government intends to develop the equity market not only to improve the performance of relatively promising SOEs through public listings, but also to raise funds to finance companies and the budget. In 1997, moreover, the Government endorsed a plan to transform more than 10,000 SOEs into publicly listed companies. Thus, development of a sound equity market has become one of the most important policy issues facing the PRC.

However, the fact that the same company can issue A- and B-shares aimed at different types of investors has segregated equity markets between investors. Domestic investors have been allowed to trade only A-shares, while foreign investors are restricted to B-shares, even though the two shares are identical with respect to shareholder rights (i.e., voting and profit sharing rights). Thus, these two domestic markets are highly segmented owing to the de facto non-transferability of shares between them. Reflecting the rapid increase in the number of investors and the consequent high demand, A-shares have been traded at a substantial premium over identical B- (also H-) shares. Such high price differentials have fueled speculation by investors. Since A-shares have been heavily oversubscribed, they account for most of the differential. However, the Government opened the B-share market to individual domestic investors legally holding foreign currency accounts in early 2001, helping to narrow the price differentials from a factor of more than five to two.

Moreover, most of listed firms issue only A-shares, dwarfing the amount of B- and H-shares. This is partly because until recently, quotas were determined by the State in accordance with the national investment and credit plan. Moreover, there is a less stringent accounting system applied

to firms issuing A-shares compared with those issuing B- and H-shares. Also, firms issuing only A-shares face lower initial public offering (IPO) requirements. For example, a firm wishing to be listed in the A-share market must achieve at least two or three consecutive years of operating profits, while one issuing B- or H-shares must also be able to generate sufficient foreign exchange incomes to pay dividends in foreign currencies.

In addition, most of listed firms have remained largely State-owned. The proportion of shares under State ownership (sum of State-owned and legal person shares) is in the 40-80% range for about 90% of listed firms. This indicates that the majority of listed firms remain SOEs. The predominance of State ownership indicates that there remain fundamental problems of corporate governance in listed SOEs because public shareholders are not in a position to exercise voting power with any prospect of control. Moreover, such large-scale State ownership leaves ambiguities concerning property rights associated with State ownership. The state manages SOEs without in practice bearing any residual risks or profiting from the control and use of their assets, while SOEs continues to obtain a large amount of bank loans and subsidies. Thus, there are few incentives for the State to perform better. The people bear the residual risks, but these are ultimately felt through the budget. This, then, is the classic problem of who monitors the monitor?

Also, many listed firms operate in protected sectors (such as petrochemicals, energy and raw materials), which are largely monopolistic. Since each IPO remains small and competition among SOEs for listing is intense, State and regional authorities are subject to lobbying and political pressure. This suggests that firms selected for public listings are not necessarily better performers than those rejected. It is sometimes pointed out that the State Council and CSRC select SOEs in the protected sectors, because these firms are State monopolies and operate under the direct supervision and control of the State Council. These protected firms often obtain direct subsidies from the central Government's budget, and some chief executive officers (CEOs) of these firms have even previously held Cabinet-level positions.

More surprisingly, the study finds that firms issuing B- and H-shares turn in inferior performances to firms issuing only A-shares. The results could be a reflection of the fact most listed firms were given approval to issue only A-shares, so that there is a greater proportion of relatively profitable firms among them. Alternatively, firms that issue only A-shares may find it easier to manipulate their books, since they face lower accounting and auditing standards than those applied to issuances for foreign investors. Managers might exaggerate profitability in order to achieve higher issuing prices. Further, results suggest that the monitoring role of foreign investors has not been effective so far. This reflects not only that the State remains the largest shareholder, but also that minority shareholders' rights including foreign investors are not yet well-established. Another finding of the study is that firms' performance declined not only in the year they launched their A-share IPOs but also subsequently. More surprisingly, the same results are obtained in the case of B-share IPOs, even though they would be expected to perform better, given that they are intended for foreign investors who have a diverse set of portfolio choices.

These results suggest that China's equity market remains underdeveloped. Also, banks are neither allowed to invest in stocks, nor extend credit to stock-related activities (although some banks violated in recent years). The Government should also float more shares to foreign institutional investors invested.