

Destination India

*Banking Opportunities: Entry Strategy
and the Road Ahead*

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Foreword

The Indian economy has quite clearly emerged as an attractive market, driven by growing demand, increased savings and high investment rate. The steadily increasing middle class segment in India, coupled with its demographic advantages continues to fuel its growth. Nearly 35% of the population classifies as being young, with a median age of 25.5 years, which signifies that India is set to gain the benefits of its demographic dividend. India has a strong middle class of 250-300 million expected to double in the next two decades. India is also set to become the fifth largest consumer economy with aggregate consumption expected to grow to 1.53 trillion USD in 2025.

India is ready to experience an average real Gross Domestic Product (GDP) growth of 5.8% between 2007-50 and it is likely to grow to almost 90% of the size of the US economy by 2050, while in the short-term, the GDP growth is projected to be 8.2% in FY11 and 9% in FY12.

The rapid growth of the Indian economy is adequately supported by foreign direct investments (FDI), with investments exhibiting a growth from \$5.5 billion in 2006 to \$22.9 billion in January 2010. Over the last five years, India has ranked amongst the top three FDI destinations, taking its place after China and the United States.

This publication aims to establish the fact that India is an attractive destination for conducting business, with a focussed approach on the banking sector. It illustrates the regulations governing the banking sector, the Indian tax regime, with a separate section on NBFCs and their licensing requirements.

The publication has been compiled by a team of PricewaterhouseCoopers inbound investment advisory specialists in India, drawing on their extensive knowledge and experience of the typical issues faced by first time investors in India.

We invite you to contact us for further details. Our specialists will be pleased to provide advice and assistance tailored to your specific requirements.

September 2010

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Chapter 01

Destination India

Introduction

India has a huge and untapped potential for banks to explore and provide enhanced geographic coverage to the unbanked areas. Counted as one of the prime emerging markets, there is a robust demand of banking services in India. The rural population of India remains significantly under-penetrated, and it is essential to leverage technology to reach this unbanked population. Mobile technology, in today's times has been recognised as a cost-effective and popular channel to extend the financial services net to the unbanked population.

In emerging markets, banking reaches about 37% of the population, compared to a 50% penetration rate for mobile phones. For every 10,000 people, these countries have one bank branch and one ATM—but 5,100 mobile phones.

Banks are progressively integrating technology in their systems and this has been reflected in the rising number of banks moving into the 'more than 90% but less than 100% category'.

Why India?

India is governed by strong growth fundamentals, which is eminently reflected in the macroeconomic situation of the country. In addition, policy measures undertaken by the government have helped India withstand the crisis and turn towards a quick recovery. India could become the world's third largest economy by purchasing power parity (PPP), overtaking Japan in 2012. India could also rise from relatively low levels today to emerge as third largest domestic banking market in the world by 2040.

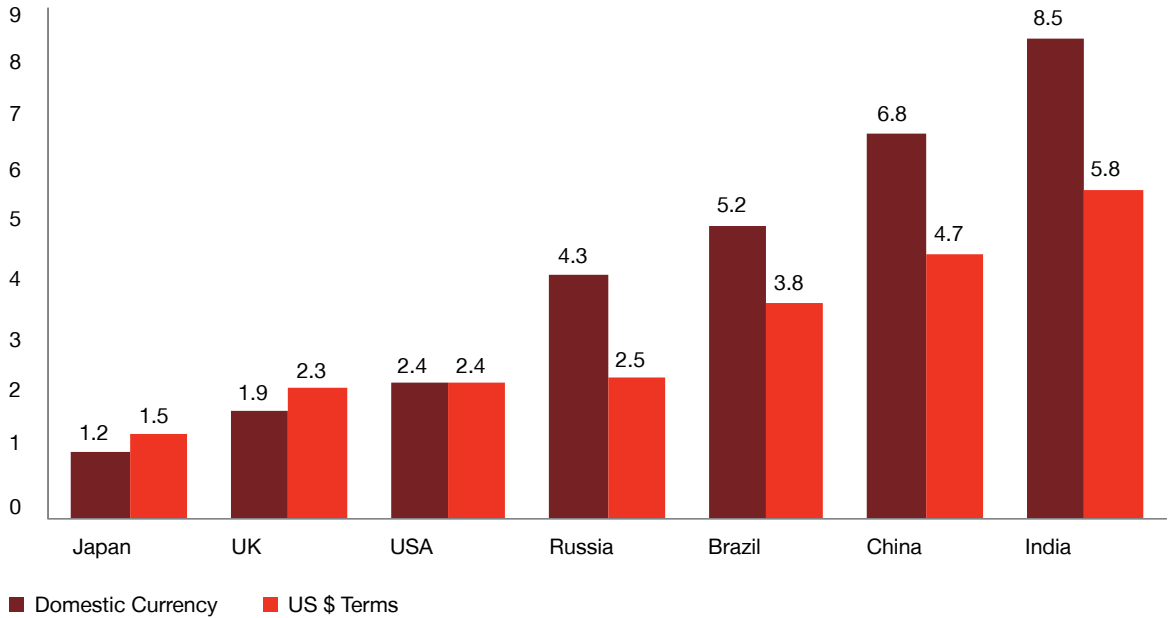
Economic Growth

India has witnessed GDP growth in the range of 8-9% from FY03-07, which slowed down in FY08-09. However, the forecast by IMF for 2009-10 is 6.75% and 8% in 2011, supported by increased private consumption and investment. India is set to experience real average GDP growth of 5.8% between 2007-50 and PPP growth of 8.5%; likely to grow to almost 90% of the size of the US economy by 2050.

Bank Credit

Total Credit stood at around 60% of GDP in 2009-10 YTD. Credit has seen an expansion of around 25% from FY03-07; however, growth slowed down to 17.5% in FY09 and currently is at 14.4%. RBI has pared the 2010 growth target of 18% to 16%.

Projected GDP growth 2007 - 2050



Source: PwC Research

Demographic Advantage

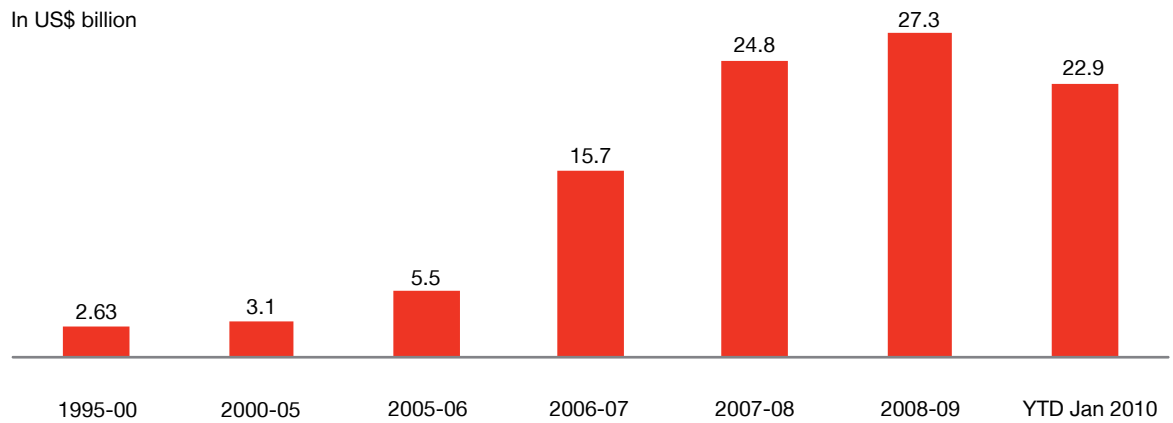
India's middle class segment is steadily rising and with 250-300 million people in this segment, it is expected to double in the next two decades. Compared to other economies, India has a relatively young population with around 35% of the population falling in this category. The median age of the Indian population is 25.5 years which indicates that India is in a good position to benefit from its demographic dividend.

Foreign Trade

The Indian economy is opening up at a steady pace. The quantitative restrictions on imports ended in 2001, opening up the economy to foreign businesses, especially in consumer goods. Gradually, barriers to trade and investment are coming down. The peak customs duty rate was reduced to 10% in 2008 (for non-agricultural and other specified goods). In August 2009, India signed Free Trade Agreements with the Association of Southeast Asian Nations (ASEAN) nations and Korea, which is expected to boost trade.

Foreign Direct Investment Regime

In US\$ billion



Source: Ministry of Commerce, India

Currently, India has one of the most liberal investment regimes among the emerging economies. Opportunities exist for investment in India in sectors as diverse as tourism and infrastructure, defence production and engineering. The Indian government has released its draft Direct Tax Code, indicating a paradigm shift in the direct tax regime for the Indian economy. It seeks to address some of the key facets of a progressive tax regime—simplicity, uniformity, clarity, stability, ease of compliance, and, most importantly, compatibility with the needs of a rapidly developing economy.

Chapter 02

India Overview

Key Statistics

Size	3.3 million sq. kms. World's seventh largest nation
Population	Over 1.1 billion people, World's second most populous nation
Political set up	Parliamentary democracy since independence from British Rule in 1947
Written Constitution	Preamble
Written Constitution	Preamble
State Religion	Secular State - there is no state religion
Directive principles of State Policy	Promotion of peoples' welfare in a social order
Union of India	28 Federal States and seven Union Territories
Parliament	Two Houses - Lok Sabha (Lower House) and Rajya Sabha (Upper House).
Head of State	President
Head of Government	Prime Minister
Independent Judiciary	Supreme Court - highest judicial authority in India High Court - Head of judicial hierarchy in the State
Language	Official Language is Hindi, but English is the preferred language for conducting business and is widely read and spoken

Source: PwC Research

Laws Governing India

India has an exhaustive legal framework governing all aspects of business. Some of the important ones include

Arbitration & Reconciliation Act, 1996	Law relating to alternate redressal of disputes amongst parties
Central Excise Act, 1944	Governs duty levied on manufacture or production of goods in India
Companies Act, 1956	Governs all corporate bodies
Competition Act, 2002	Law to ensure free and fair competition in the market
Consumer Protection Act, 1986	Law relating to protection of consumers from unscrupulous traders/manufacturers Law
Customs Act, 1962	Deals with import and export regulations
Customs Tariff Act, 1975	Puts in place a uniform commodity classification code based on the globally adopted Harmonised System of Nomenclature (HSN) for use in all international trade-related transactions
Environment Protection Act, 1986	Provides framework for seeking environmental clearances
Factories Act, 1948	Law regulating labour in factories

Foreign Exchange Management Act,	Regulates foreign exchange transactions including foreign investment
Indian Contract Act, 1872	Law relating to contracts in India
Income Tax Act, 1961	Governs direct taxes on income of all persons, both corporate and non corporate as well as residents and non-residents
Industrial Disputes Act & Workmen Compensation Act, 1951	Labour laws dealing with disputes
Industrial (Development & Regulation) Act, 1951	An Act to provides for the development and regulation of certain industries
Information Technology Act, 1999	Law governing E-commerce transactions.
Money Laundering Act	Prevents money laundering and provides for confiscation of property derived from, or involved in, money laundering
Patents Act, Copyright Act, Trade Marks Act, Design Act, 2000	Protects intellectual property rights.
Central Sales Tax Act, 1956	Governs the levy of tax on all inter-state sales in India.
Securities and Exchange Board of India,1992	Law relating to protection of interests of investors in securities and regulation of the securities market.
Securities and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002	Securities and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002
Special Economic Zones Act, 2005	Governs the establishment, development and management of the Special Economic Zones (SEZ) for the promotion of exports and for matters connected therewith or incidental thereto. It also provides for fiscal and economic incentives for developer of units in SEZs.
Right to Information Act, 2005	Sets out the right of every citizen to access information under the control of public authorities and to promote transparency and accountability in the working of every public authority. Provides for constitution of a Central Information Commission and State Information Commission
Limited Liability Partnership Bill, 2008	Provides for establishment of a new form of entity which combines organisational flexibility of partnership with the advantage of limited liability of its partners. It provides operational flexibility for such enterprises by sparing them from detailed legal and procedural requirements intended for large and widely held Companies
Direct Taxes Code Bill 2010	The objective of the code is to moderate tax rate and simplify tax laws, all direct taxes including wealth tax and income tax would be brought under one code. The new code is aimed at eliminating the scope of litigation as far as possible

Source: PwC Research

Key Challenges for the Indian Economy

Inflation: India is currently experiencing high inflation with food price rises hovering around 17% and Wholesale Price Index around 9.9% in Feb' 2010. Inflationary concerns will force the Reserve Bank of India (RBI) to tighten monetary supply. This in turn will raise interest rates and impact banks adversely.

Inclusive growth: There are concerns that the benefits of economic growth are not reaching the poor due to inadequate delivery mechanisms. Financial inclusion is one of the key challenges for the economy and banks need to ensure that low, affordable and cost-effective banking reaches the poor.

Infrastructure development: India currently lacks the infrastructure required to attract foreign capital vis-à-vis countries like China. While infrastructural development requires huge capital, private sector participation and favourable regulatory regime can help raise investment demand. Banks need to act as conduit to attract more investment in infrastructure.

Withdrawal of stimulus: The economic recovery in India in 2009 was aided by the economic stimulus provided by government through interest rate subvention, reduction in excise duty etc. The fiscal deficit moved up to 6.7% of the GDP which is unsustainable in the medium-term. Withdrawal of stimulus will impact the economy through rise in prices and reduction in demand. The banking sector will also face the impact in their core business of lending.

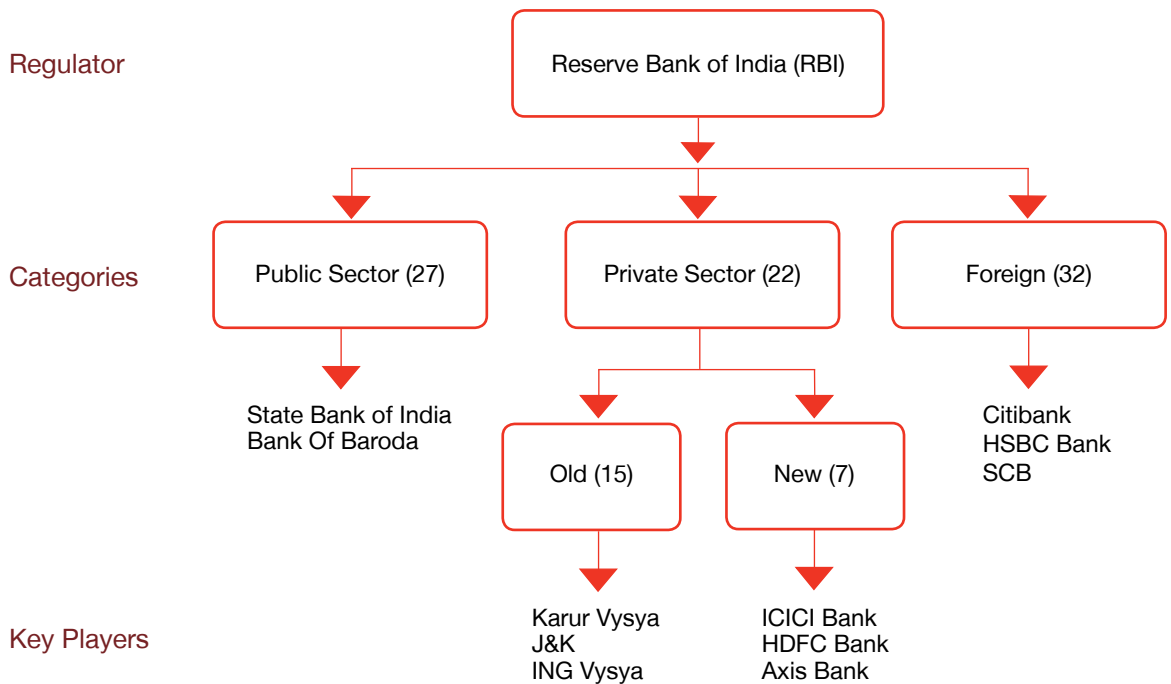
Chapter 03

Indian Banking Industry

Overview

The Indian Banking Sector consists of 81 Scheduled Commercial Banks as of June '2009 apart from Regional Rural Banks, Co-operative Banks and Local Area Banks. The Scheduled Commercial Banks consists of 27 Public Sector Banks, 22 Private Sector Banks and 32 Foreign Banks.

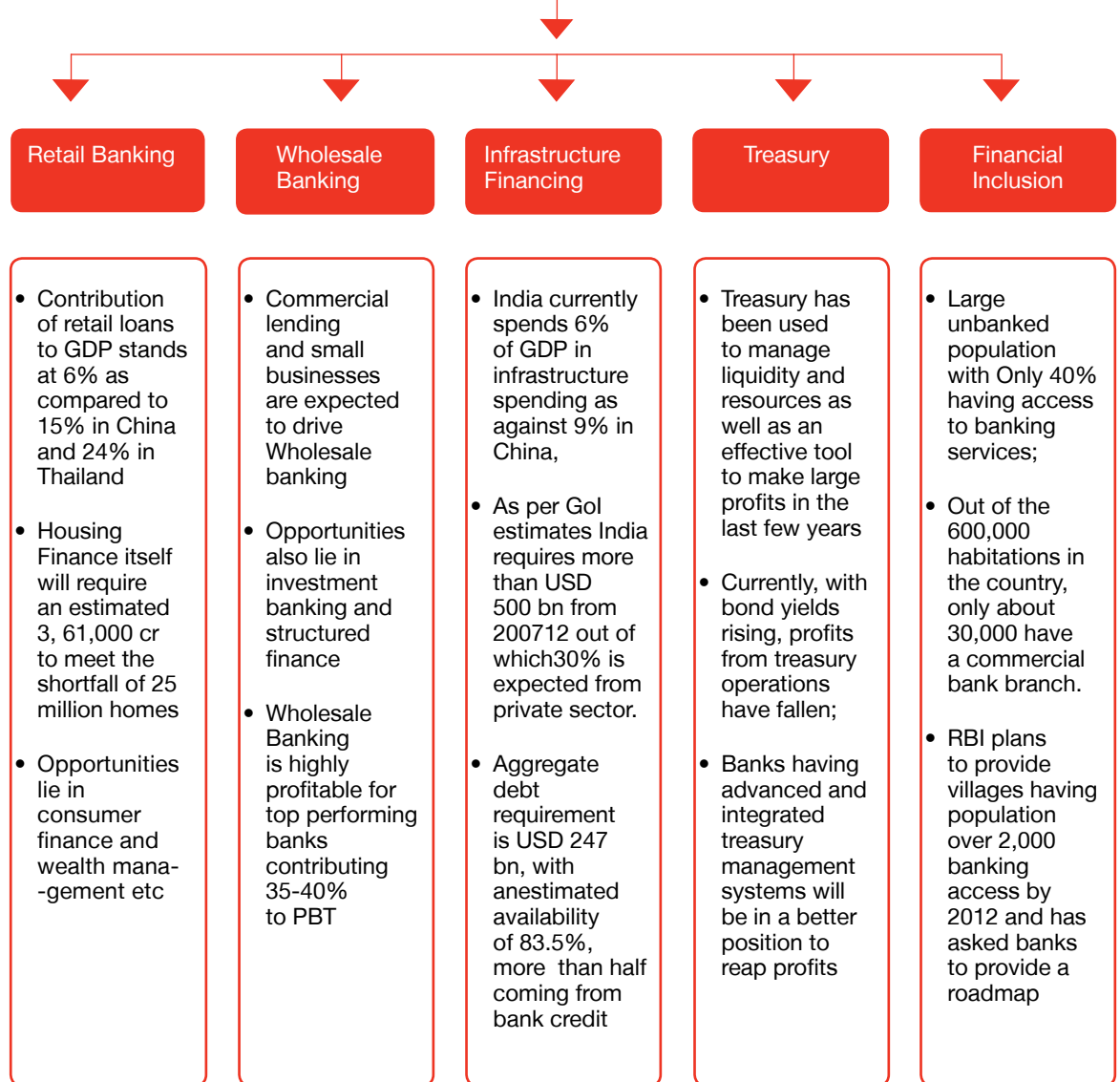
The Indian Banking Sector is dominated by Public Sector Banks (PSBs) with a combined market share of around 75% for both credit and deposit till Sept 2009. PSBs have increased their market share by 250 bps between Sept' 08 and '09 while private sector players saw a de-growth of 230 bps.



The total number of branches for Commercial Banking (including RRBs & LABs) as of June'09 is 80,369 with 63% in rural and semi-urban areas, 37% in metro and urban areas.

The pillars for the banking industry are illustrated below, which explicitly show that the contribution of retail banking is minimal and that currently, all efforts are being concentrated towards financial inclusion.

Growth Drivers of the Banking Sector

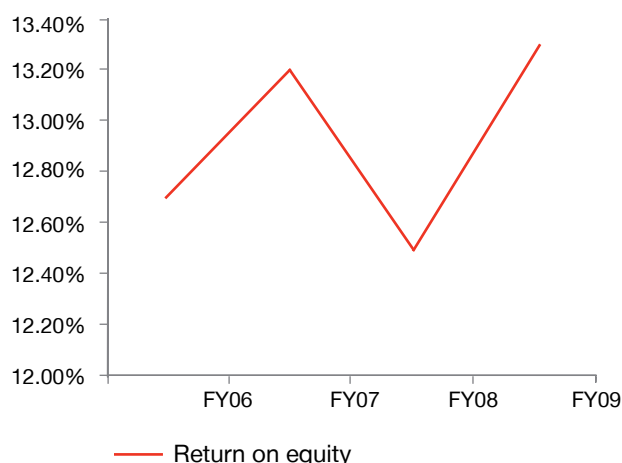


Source: PwC Research

Attractiveness of the Banking Sector

Banking is one of the strongest performing sectors in India with advances and deposit growing more than 20% in the last five years. The Return on Equity for the banking sector has been around 13% in the last four years with top performing banks having 18-20% as Return on Equity (RoE).

Given below is an analysis of the performance of scheduled commercial banks, over the last two years, which establishes the growth of each category in banking. A few of the key metrics have been assessed over the period 2007-09.



Source: PwC Research

Snapshot of Performance of Scheduled Commercial Banks

Items	Public Sector Banks		Private Banks		Foreign Banks		All Banks	
	2007-08	2008-09	2007-08	2008-09	2007-08	2008-09	2007-08	2008-09
No. of banks	28	27	23	21	28	30	79	78
Market Share in Credit	72.8%	75.5%	20.9%	19.0%	6.3%	5.5%	100%	100%
Growth in Deposits-YoY	23.1%	26.9%	23.0%	7.7%	27.0%	11.9%	23.3%	22.1%
Growth in Advances-YoY	24.8%	25.7%	25.4%	9.7%	28.2%	2.1%	25.1%	20.8%
CASA (%)	35.0%	32.0%	32.4%	32.4%	49.6%	46.5%	35.1%	32.9%
Business Employee (Rs. lakh)	549.22%	650.28%	618.28%	778.06%	1064.14%	1252.28%	633.22%	750.55%
Profit/Employee (Rs lakh)	3.62%	4.43%	3.77%	4.83%	19.97%	24.78%	4.67%	5.60%
Cost to Income Ratio	48.1%	45.1%	36.6%	47.3%	42.5%	38.0%	43.7%	44.5%
Cost of Funds (CoF)	5.90%	6.07%	5.82%	6.18%	4.37%	4.51%	5.80%	6.05%
NIM as % of Total Assets	2.4%	1.9%	2.7%	3.6%	4.3%	4.3%	2.6%	2.6%
Return on Average Assets	0.97%	1.02%	1.13%	1.09%	2.09%	1.85%	1.12%	1.13%
Op. Profit to Total Income	20.3%	21.2%	21.9%	23.6%	56.3%	57.4%	22.5%	24.0%
CRAR	13.21%	13.96%	12.13%	13.24%	13.08%	14.30%	13.01%	13.98%
Net NPA ratio	1.43%	1.45%	0.77%	0.68%	0.77%	1.80%	1.00%	1.05%

Source: PwC Research

Another avenue which manifests huge opportunity for growth is wealth management. The increase in the disposable income, thereby resulting in higher amounts of investible surplus at the hands of the investor has paved the way for growth in wealth management.

Wealth Management/Private Banking

Emerging economies like India present huge opportunities for banks buoyed by the rising affluence in the country. Wealth Management Services (WMS) market in India is currently at a nascent state, though it has taken rapid strides in last few years. As of 2008, High Net Worth Individuals (HNWI) wealth was down 29% to US\$310 billion.

India still lacks the much needed sophistication as compared to the developed countries, but with improving customer awareness, India is moving towards a stage where investors will have access to a range of diversified products, across asset classes, with product innovation leading to hybrid structures and offshore locations.

Wealth creation has increased rapidly in the last few years and is not restricted to the traditional business families providing strong impetus to WMS. The Indian investor is slowly changing to become more sophisticated and demanding a variety of products in the marketplace. However, in the Mass Affluent customer segment, there is low penetration of WMS products and services till now, despite being the segment with the highest potential due to the sheer volume of potential business. A large base of 'young achievers', with a high potential to upgrade to HNI (High Net Worth) & UHNI (Ultra High Net Worth) segments, exists here

PwC Global Wealth management survey 2009 presents some interesting results for India

- CEOs' expect Assets Under Management (AUM) growth in the next two years to be driven existing clients and new clients gained organically
- Organisations have focused on relationship management to fight the global crisis
- Quality of service and strategic growth has been the topmost agenda amongst the service providers
- Focus is on increasing "share of wallet" for revenue growth by focusing on key clients and offering new products
- Organisations will be focusing on improving operational efficiency to control the cost base in next two years in the wake of economic recession
- Technology will be a key driver for wealth management in banks

Growth Enablers for the Indian Banking Sector

Apart from the favourable macro-economic factors, the growth enablers include:

Alternate Channels: Technological advances in the functioning of banks, low transaction costs of alternate channels like ATM, internet and mobile channels and the ability to provide banking at customer's doorsteps has encouraged banks to use these channels in an effective way. Favourable regulatory regime on alternate channels will help banks to reach out to the masses at lower cost and greater efficiency.

Technology as a differentiator: In the last few years, technology has served not only as a tool for improving products and processes but also to reach out to the masses in a cost-effective way. Core banking has changed the face of banking in India through reduction of cost at an operational level and increase efficiency. In the coming years, technology will

remain a key driver for multiple channel integration, product and process innovation, financial inclusion and risk management.

Consolidation: Consolidation in Indian banking is necessary to create higher value in a short period of time leading to key expertise and synergy gains. As competition heats up, banks will have an incentive to acquire the assets of the non-performing banks, since they can generate greater value from the assets of those banks by combining them with the winning strategies.

The Focus on Financial Inclusion

RBI has emphasized the need to focus on spreading the reach of banking services to the un-banked population of India. Statistics state that only 37% of bank branches of Scheduled Commercial Banks are in rural areas with only around 40% of the population holding bank accounts. It is therefore essential that people get connected with the banking system, availing a range of transactions, payment services, access to affordable credit, insurance and savings products.

Limited Rural Banking Penetration

- Only 5% of the 600,000 village habitations in the country have a commercial bank branch
- Only 40% of the population have bank accounts
- Debit card holders constitute only 13% of the population and only 2% have a credit card
- 51.4% of nearly 89.3 million farm households do not have access to any credit either from institutional or non-institutional sources.
- Only 13% of farm households are availing loans from the banks in the income bracket of < Rs. 50,000.

The Committee on Financial Inclusion chaired by Dr. C. Rangarajan has suggested a National Mission on Financial inclusion and observed that financial inclusion must be taken up in a mission mode.

Measures undertaken for Inclusive Growth:

Various steps have been taken by the Reserve Bank and the Government to bring the under banked population under the umbrella of banking services.

- Nationalization of banks was a major step in that direction.
- Other steps include identifying priority sectors and setting up targets for these sectors, setting up of RRBs, LABs, credit delivery focus in rural areas through the Service Area Credit Plans, and enabling policy for microfinance by banks.

- Further, simplification of the KYC norms, introduction of no-frills accounts, Kisan Credit Cards, General Purpose Credit Cards, small overdrafts in no-frills accounts and permitting banks to use the business correspondent and the business facilitator models were specifically aimed to promote financial inclusion. (RBI Report on Trend and Progress of Banking in India: 2008-09).
- A further impetus has been given to financial inclusion with a growing emphasis on mobile technology based banking.

The Finance Minister in his budget speech 2010-11, stated the Government and RBI will collaborate to provide banking facilities to habitations which have a population in excess of 2000 (as per 2001 census) by March 2012. The Business Correspondent model will be used extensively to fulfill this objective, aided by investments in technology.

The RBI 100 % Financial Inclusion Drive

- In order to have focused attention for the financial inclusion efforts, the State Level Bankers Committee (SLBC) has been advised to identify one or more districts, one district in each state, for 100 % financial inclusion. Responsibility is given to the banks in the area for ensuring that all those who desire to have a bank account are provided with one, by allocating the villages among the different banks.
- The 100 % financial inclusion drive is progressing all over the country. So far, 431 districts have been identified by SLBCs for 100% financial inclusion. As on March 31, 2009, 204 districts in 18 States and 5 Union Territories have reported having achieved the target.

The challenges that are likely to be encountered include:

- **Coverage** – The large size and population makes it difficult for any program to include everyone. Moreover, it is difficult to account for migrant labor, where money primarily flows through unorganized channels
- **Infrastructure** – Insufficient and underdeveloped infrastructure emerges as a potent barrier in the functioning of a banking outlet
- **Financial Products** – Products need to be simple and flexible in order to cater to the requirements of the mass population
- **Technology** – The use of adequate and appropriate technology has the ability to steer the direction of inclusive growth, helping to reduce the cost of transactions.

The focus on financial inclusion has prompted RBI to consider giving additional banking licenses to private sector players, for increased coverage of banking services

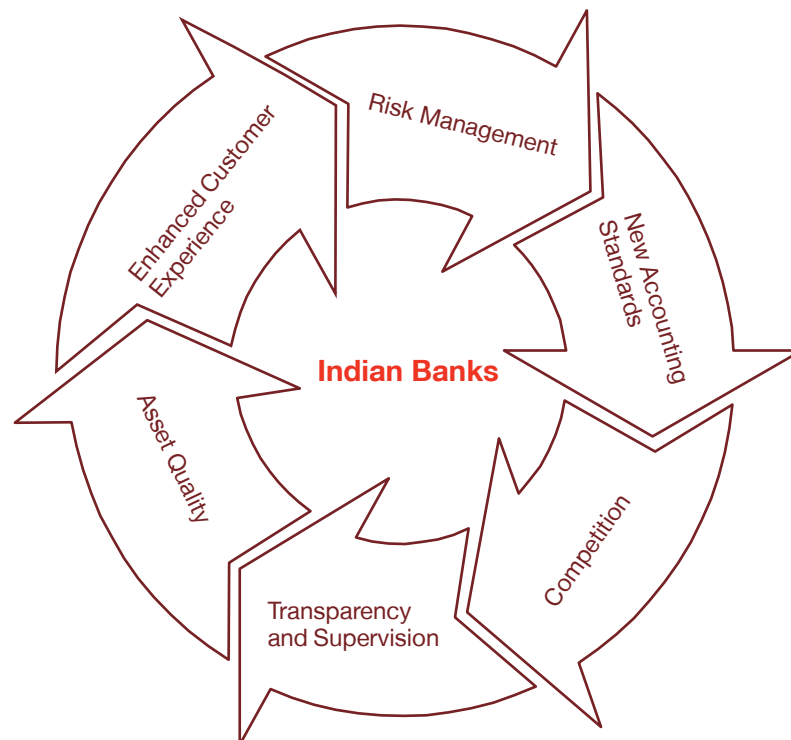
Recent Developments

Banking licenses: The 2010 Union Budget has stated that the RBI is considering giving some additional banking licenses to private sector players to extend geographic coverage and providing improved access to banking services. In line with this, the RBI on August 11, 2010 released the much awaited discussion paper on 'Entry of New Banks in the Private Sector'. The discussion paper seeks views / comments of banks, non-banking financial institutions, industrial houses, other institutions and the public at large by September 30, 2010.

Credit Derivatives: RBI is currently having second thoughts over relaxing norms for derivatives in the wake of the global crisis. RBI has indicated that it will be cautious when it comes to filling gaps in the Indian markets.

Business challenges for the Indian Banking Sector

Enhanced Customer Experience: Banks are facing challenges as customers have become demanding and the loyalties are diffused with low switching costs. High service user charges is also concern.



Asset Quality: Asset quality in the banking sector is set to be a key issue as Crisil projects net NPA as a percentage of net Advances to touch 2.3% in FY11, as a fallout of the downturn and consequent restructuring of advances.

Transparency and Supervision: The disclosure requirements have become stringent over the years and covers Capital adequacy, Asset quality, Asset liability management, Profitability, Country risk exposure, Risk exposures in derivatives, Segment reporting and Related Party disclosures.

New Accounting Standards: The impending implementation of IFRS in 2011 will have a significant impact for the banking sector particularly in the area of treatment of taxes. The core group of the ministry of corporate affairs extended the deadline for banks and NBFCs to April 2013 at a recent meeting held on March 29, 2010. The top five accounting challenges to be faced by banks are loan impairment, use of fair value, derivatives and hedge accounting, de-recognition of financial assets and consolidation of entities.

Risk Management: Banks in India are also moving from the individual silo system to an enterprise wide risk management system. Banks would be required to allocate significant resources towards this objective over the next few years.

Foreign Banks in India

There are 32 foreign banks in India as of June 2009 and some banks are awaiting approval from the Reserve Bank of India for opening branch in India.

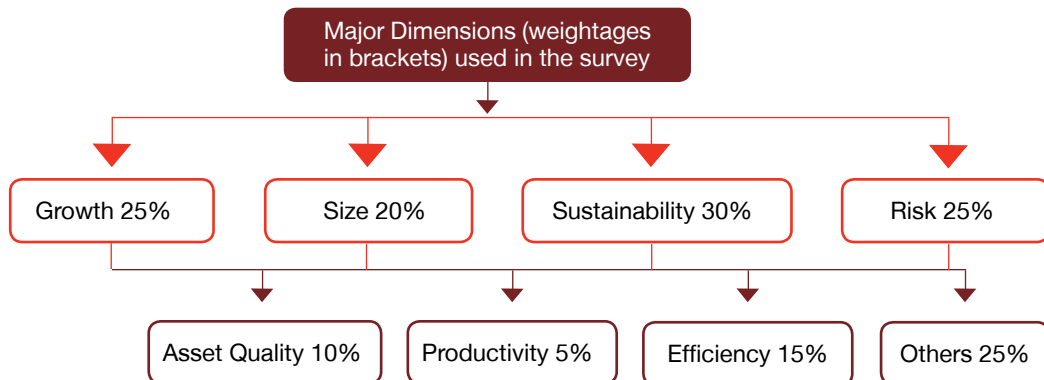
Key players and major service offerings by foreign banks

Area	Key Players
Foreign Exchange Trading	Citibank, Standard Chartered, HSBC
NRI Banking	Standard Chartered, Barclays, Citibank, HSBC
Treasury	Citibank, Standard Chartered, HSBC
Corporate Lending	Standard Chartered, HSBC, Citibank
Project Financing	Standard Chartered, HSBC, Citibank
Investment Banking	Citibank, HSBC, Deutsche Bank
Wealth Management	Deutsche Bank, HSBC, Standard Chartered, Citibank, Barclays
Corporate Finance	Citibank, HSBC, Standard Chartered
Mergers and Acquisitions	Citibank, HSBC
Trade Finance	Deutsche, Standard Chartered, Citibank, HSBC
Cash Management	Deutsche Bank, Citibank, HSBC, Standard Chartered
Retail Banking	Citibank, Standard Chartered, HSBC
Credit Cards	Citibank, Standard Chartered, HSBC, Barclays

Key Insights from Business World (BW) -PwC Banking Survey

A wide survey was conducted by BW and PwC to arrive at the best performing banks in each of the categories of large size, mid-size and small size.

- Public sector banks dominated the banking industry in terms of growth with an average y-o-y growth (FY08 to FY 09) in assets at 25.5%, for deposits at 27.8%, advances at 26.6% and operating profit at 35%.
- The annual growth rate for the old private sector banks for FY09 stood at 19% in assets, 20% in deposits and 14.6% in advances. However, operating profit grew by 34%.
- New private sector banks like Axis and HDFC performed well but ICICI faltered, lowering the average. The annual growth rate for this group for FY09 stood at 6.7% in assets, 10% in deposits and 14% in advances. However, operating profit grew by 27.5%.
- Foreign banks did not grow their credit portfolio. The annual growth rate for this group for FY09 stood at 22% in assets, 11% in deposits and 2% in advances. However, operating profit grew by 42%.



Source: BW-PwC Survey 2009

- The public sector banks accounted for 76% of the total deposits, 75% of total advances and 61% of the operating profits, amongst scheduled commercial banks. The share of the new private sector banks in these three areas was in the range of 15-17%.
- The ratio of net NPAs to total assets was 0.74% in public sector and 1.05% old private sector banks, 1.55% in new private sector banks and 1.3% in foreign banks.

Snapshot of Top Performing Banks

Large Banks

Rank	Name of Bank	Growth in Advances (FY07-09)	Cost to Income FY09	CASA % FY09	RoA FY09	RoNW FY09	NIM% of Total Assets FY09	Net NPA% FY09	CRAR FY09
1	State Bank of India (SBI)	26.81%	46.62%	40.19%	1.08%	17.05%	2.5%	1.76%	14.25%
2	HDFC Bank	45.13%	51.65%	43.83%	1.42%	17.17%	4.7%	0.63%	15.69%
3	Axis Bank Ltd.	48.72%	43.42%	42.01%	1.41%	19.13%	2.9%	0.40%	13.69%
4	Bank of India	29.58%	36.18%	26.62%	1.49%	29.18%	2.7%	0.44%	13.01%
5	Punjab National Bank	26.55%	42.27%	38.15%	1.39%	25.84%	3.2%	0.17%	14.03%

Source: PwC Research

Medium Banks

Rank	Name of Bank	Growth in Advances (FY07-09)	Cost to Income FY09	CASA % FY09	RoA FY09	RoNW FY09	NIM% of Total Assets FY09	Net NPA% FY09	CRAR FY09
1	Corporation Bank	27.27%	35.79%	31.5%	1.16%	19.57%	2.2%	0.29%	13.61%
2	Indian Bank	33.08%	38.83%	31.6%	1.61%	23.01%	3.4%	0.18%	13.98%
3	HSBC	9.19%	34.43%	41.1%	1.51%	13.99%	4.3%	1.42%	15.31%
4	Federal Bank	22.59%	31.21%	24.2%	1.40%	12.15%	3.7%	0.30%	20.22%
5	Allahabad Bank	19.34%	42.40%	34.5%	0.85%	16.49%	2.4%	0.72%	13.11%

Source: PwC Research

The Banking Banana Skins Survey

PwC along with the Centre for the study of Financial Innovation (CSFI) has been conducting this survey since 1994, to identify key concerns faced by the industry. There were 443 responses from individuals in 49 countries, the breakdown being - bankers 62%, observers 32% and regulators 6%.

Global Banking Key Concerns

- Political Interference
- Credit Risk
- Too much regulation
- Macro-economic trends
- Liquidity
- Capital Availability
- Derivatives
- Risk Management quality
- Credit Spreads
- Equities

India Banking Key Concerns

- Credit Risk
- Derivatives
- Currencies
- Fraud
- Money Laundering
- Political Interference
- Dependence on technology
- Liquidity
- Credit Spreads
- Macro-economic trends

The concerns that seem to be predominant in the Indian landscape are credit risk, derivatives, currencies and fraud.

Credit risk has become a cause of concern as the number of defaults on mortgage loan, credit card, line of credit and other loans have increased. The risk of the derivative market lies in its complexities, and a poor understanding of the exposures that ensue. Volatility in currency markets affected by the movement of interest rates is likely to add to the risk burden.

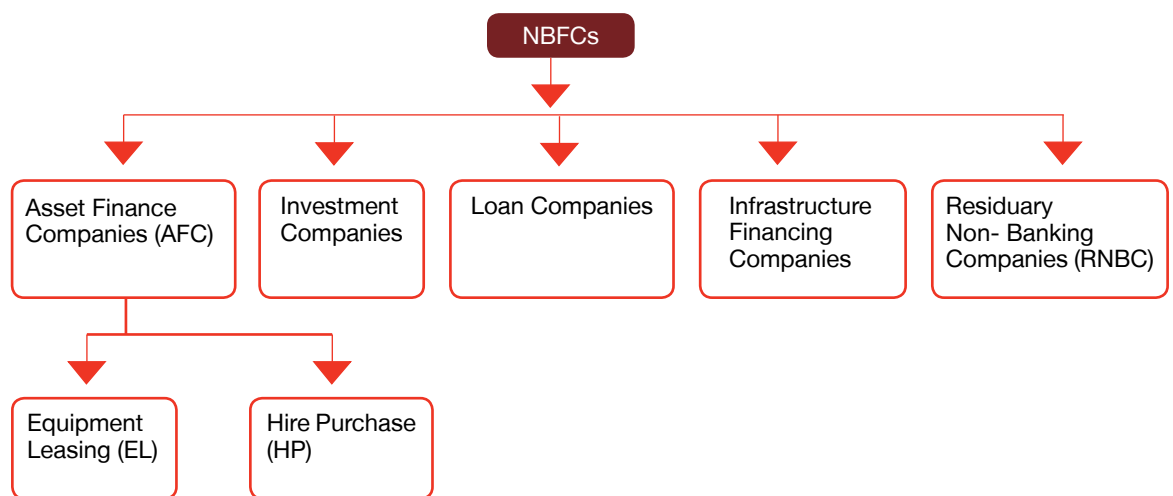
A banker said: "In India, there is a general perception that the country is either fairly immune to the economic activity elsewhere, or is already benefiting from an economic recovery, both of which might be over-optimistic." The risk of "too little regulation" ranked much higher than elsewhere in the world.

Chapter 04

NBFCs in India

Overview

Regulations in India classify Non-Banking Financial Companies (NBFCs) into four main categories, however recently Infrastructure Financing Companies have been added in Union Budget 2010-11 as the fifth one. Residuary Non-Banking Companies (RNBCs) are another category of NBFCs whose principal business is acceptance of deposits and investing in approved securities.



Source: Circular No. RBI/2009-10/316 dated February 12, 2010

The current Reserve Bank of India Act provides a comprehensive legislative framework for regulation of NBFCs. It provides for compulsory registration and minimum Net Owned Funds for all NBFCs. NBFCs can also be classified into two broad categories, viz., (i) NBFCs accepting public deposit and (ii) NBFCs not accepting public deposit. Till the end of June 2009, there were 12,740 NBFCs in India, of which 336 NBFCs are permitted to accept public deposits. Although significantly smaller than Scheduled Commercial Banks (SCBs), NBFCs are regarded as one of the major institutional purveyors of credit in India for the following reasons:

- NBFCs play an important role by complementing banks in providing a wide range of financial services which includes providing credit to the unorganised sector and to small borrowers at the local level.
- They have displayed flexibility in meeting the credit needs of specific sectors like EL, HP where gaps between the demand and supply of funds have been high and where SCBs were earlier not easily accessible to borrowers.

- As compared to many SCBs, they have an ability to take quicker decisions, assume and customise their services and charges more according to the needs of the clients.
- NBFCs had been focusing on higher yielding customer segments like personal loans of small ticket size, home equity etc to boost their margins. However, the financial crisis has led to higher NPAs.
- Larger NBFCs expected to register high growth in business – smaller NBFCs are being weeded out due to increasing competition. They account for 90% of the total assets.
- In response to the increased competition from SCBs, NBFCs are entering into JV with foreign/domestic players or are taken over by big financial players.

Banks v/s NBFCs: A quick comparison

It is important to note in this context, where NBFCs are placed vis-à-vis banks. The pros and cons of both banks and NBFCs have been discussed under certain pre-defined criteria.

Activities	Banks	NBFCs
Acceptance of Demand and Term Deposits	Demand Deposits- Permitted Term Deposits- Permitted, subject to term restrictions	Demand Deposits-Not permitted Term Deposits- Permitted subject to limitations, but the term of deposit is at least one year
Functional limitations	Banking Regulation Act expressly bars any business other than that permitted by the Act [Sec 6 (1)]	a. For domestic NBFCs, no bar on non-financial the business, except that on crossing of a certain barrier (50% of income or assets), the NBFC will lose its character as an NBFC b. For NBFCs having international funding under automatic route, any activity included within the 19 permitted activities is possible. Any other activity is possible only with the express FIPB.
Payment and Settlement Systems	Banks are a part of Payment and Settlement system	NBFCs cannot take part in Payment and Settlement systems i.e. it cannot issue cheque drawn on itself
Leasing and hire purchase	Banks are allowed to a limit of 10% of their assets	No limit
Operating lease	Treated as a non-financial business, not permitted	Permitted, though treated as non-financial business
Securitisation	Permitted subject to capital norms and other limitations	Permitted subject to capital norms and other limitations

Licensing restrictions		
Need for a license	Licensing norms are tightly controlled and generally, it is perceived to be quite difficult to get a license for a bank	It is comparatively much easier to get registration as an NBFC. Besides, there are NBFCs currently registered, many of which may be available for sale
Ownership structure/ change in ownership		
Indian ownership	Not more than 10% of capital in a bank may be acquired without the approval of the RBI	While prior intimation of a takeover is required, there is no need for express permission for a change in voting control. No limit as to the percentage holding.
Foreign ownership	Upto 74% capital in banking companies may be acquired for foreign owners.	100% capital may be held by foreign owners subject of minimum capitalisation requirements under FDI
Capital adequacy requirements and provisioning		
Minimum Capital	Investment of INR 3 bn (USD 70mn) in case of wholly owned subsidiary. In case of branch, USD 25mn is required upfront.	Minimum net owned funds required for registration of NBFCs is INR 20 mn (USD 0.45mn). Under FDI policy minimum capitalisation varies from USD 0.5mn to USD 50 mn.
Basel norms	Capital requirement generally 9% of risk weighted assets	Capital requirement generally 10% of risk-weighted assets. Currently it is hiked to 12%
Provisioning	90 days past due leads to NPA characterisation	12 months' overdue is permitted in case of lease and hire purchase. Six months in case of loans and other exposures
Credit control and sectoral asset restrictions		
SLR/ CRR norms	A part of assets of banks is blocked due to SLR and CRR	Only 15% of the deposit liabilities of NBFCs are to be held in certain permitted securities.
Sectoral exposures	In certain segments banks need to allocate minimum percentage of assets	Little limitations have been placed on assets of NBFCs. Investment in real estate and unquoted equity shares are controlled. Capital market exposure is to be reported.

Chapter 05

Regulatory Authorities

There are various regulatory bodies which act as a first point of contact between foreign investors and the Indian Government. This chapter gives a brief outline of the functions entrusted to key regulators that are relevant to foreign investments in India with respect to the banking sector.

Foreign Investment Promotion Board (FIPB)

The FIPB is the nodal agency for all matters concerning foreign direct investment, as well as its promotion, in the country. The main functions of FIPB include:

- Ensuring faster clearance of proposals for foreign investment;
- Periodically reviewing the implementation of the proposals cleared by the Board;
- Reviewing the general and sectoral policy guidelines and, in consultation with Administrative Ministries, incorporating a set of transparent rules for each of these sectors;
- Undertaking investment promotion activities including establishing contact with and inviting selected international companies to invest in appropriate projects in India.

The FIPB (functioning under the Ministry of Finance), in its approach to granting approvals, maintains flexibility in purposeful negotiations with investors and considers project proposals in their totality, with a view to maximising foreign direct investment in the country. The Board meets once every week, ensuring the speedy disposal of applications.

Reserve Bank of India (RBI)

The RBI, India's Central Bank, was established on 1 April 1935. The Banking Regulations Act, passed in 1949, brought the RBI under government control. Its basic purpose is to secure monetary stability and develop India's financial structure in line with national socio-economic objectives and policies. The following functions have been outlined for RBI to reach its objective:

- Formulating, implementing and monitoring the monetary policy to ensure an adequate flow of credit to the productive sectors.
- Prescribing the broad parameters of banking operations within the country's banking and financial system functions.
- Administering external trade and payment, thus promoting the orderly development and maintenance of the foreign exchange market in India.

The RBI also acts as a banker to central/state governments, commercial banks, state cooperative banks and some financial institutions. It further plays an important role in maintaining the exchange value of the Rupee and acts as an agent of the Government for India's membership of International Monetary Fund.

Registrar of Companies (ROC)

The ROC plays a crucial role in the governance of the Companies Act, the nodal law regulating companies doing business in India. The ROC is primarily responsible for:

- Ensuring adherence to the filing and registration requirements under the Companies Act;
- Collecting information on companies registered within its jurisdiction and making it publicly available;
- Bringing non-compliant companies and officers to Court, where necessary.

In essence, the ROC has two distinct, but complementary roles: (i) facilitating business and commerce by providing a vehicle for the incorporation of companies and the registration of documents and charges and (ii) assisting in the regulation of business and commerce by striking off and prosecuting companies which fail to comply with their statutory obligations under the Companies Act.

Securities and Exchange Board of India (SEBI)

SEBI was established with the prime objective of protecting the interests of investors in securities, and promoting the development of, and regulating the securities market and for matters connected therewith or incidental thereto. Its primary functions include:

- Promoting fair dealing in the issue of securities;
- Ensuring that the capital markets function efficiently, transparently and economically in the better interests of both the issuers and the investors;
- Safeguarding the interests of investors from unethical practices;
- Coordinating and monitoring the work of stock exchanges across the nation and intermediating with stock brokers.
- Focusing on the principle of investor protection, SEBI acts as a vigilant watchdog in both the primary and secondary securities markets.

Central Board of Excise and Customs (CBEC)

The CBEC is part of the Department of Revenue under the Ministry of Finance, Government of India. It is responsible for:

- Formulation of policy concerning levy and collection of Customs and Central Excise duties and service tax; and
- Administration of related matters

The CBEC is also the administrative authority for its subordinate organisations like Custom Houses, Central Excise and Service Tax Commission rates and the Central Revenues Control Laboratory.

Central Board of Direct Taxes (CBDT)

The CBDT is a statutory authority functioning under the Central Board of Revenue Act, 1963. It governs matters relating to:

- Levy and collection of direct taxes;
- Formulation of policy concerning administrative reforms and changes for the effective functioning of the Income-tax Department.

Authority for Advance Ruling (AAR)

The AAR has been constituted under the Income-tax Act, 1961 in order to help taxpayers plan their income-tax matters well in advance and to avoid long drawn out and expensive litigation. A non-resident applicant can seek an advance ruling on any question of law or fact in relation to a transaction which has been undertaken or is proposed to be undertaken by the non-resident applicant. A separate Authority for Advance Rulings (AAR) has also been constituted under the indirect tax regime.

Competition Commission of India (CCI)

The CCI, constituted under the Competition Act, 2002, seeks to prohibit and enquire into cases relating to an “Anti-Competitive Agreement”, “Abuse of Dominant position by an Enterprise”, as well as to regulate certain “Combinations” which include acquisition of shares, acquisition of control and mergers/amalgamation between and amongst enterprises.

Chapter 06

Regulations governing banking sector

The two key regulations governing the Indian banking sector are Reserve Bank of India Act, 1934 and the Banking Regulations Act, 1949. The Reserve Bank of India Act, 1934, apart from providing for the constitution, management and functions of the RBI, also empowers it to exercise control and regulations, over the banks, the NBFCs and other financial institutions.

Further, Indian banking sector is also governed by the following:

- Foreign Exchange Management Act 1999 and regulations framed under it by RBI;
- RBI Master Circulars issued each year; etc.

RBI, in addition to its role of being the Central Bank of India, acts as a principal regulatory authority in the Indian money market. There are around 26 departments which function in RBI. However, only 15 of such departments generally interface with the banks in India.

The business presence in Financial Services sector can be set up broadly in the form of banks or non-banking financial service companies (NBFCs).

Banking presence

It is essential that every banking company, Indian or foreign, acquires a license from RBI, before it commences its business in India. The policy framework for issuing licences to private sector and foreign banks are discussed below.

Private sector banks

Guidelines for licensing of new banks in private sector were first issued by RBI on January 22, 1993. While many companies had sent applications to RBI for setting up a bank, only 10 were issued licenses.

These guidelines were revised vide a press release dated January 3, 2001. In terms of the same, only applications filed up to March 31, 2001 were considered for the purpose.

Besides prescribing guidelines for set up of new banks, guidelines for conversion of NBFC in to bank were also prescribed. However, NBFCs promoted by large industrial houses desiring conversion into a bank were not permitted.

The key requirements for setting up a bank as laid out in these guidelines were as under:

- Initial minimum capital of the bank should be INR 2 bn (approx.US\$ 46 mn). The said capital had to be increased to INR 3 bn (approx.US\$ 70 mn) within three years of commencement of business;
- Overall capital structure of the proposed bank including the authorised capital had to be approved by the RBI;
- Large industrial houses cannot not be a promoter of the proposed bank. However, individual companies, directly or indirectly connected with large industrial houses could participate up to a maximum of 10% but were not allowed to have controlling interest in the bank. Limit of 10% limit was for all the group companies and the decision of RBI in this matter was to be final.

Additionally, the following key criteria were to be considered by RBI for issuance of a banking license:

- Fit and proper management
- Track record
- Financial soundness/ net-worth
- Diversified ownership pattern
- Business plan
- Priority sector lending (such as financing to rural, agro based industries, etc.);
- Credit rating;
- Best domestic and international standards of customer service and efficiency; etc.

However, considering that only two banks viz. Kotak Mahindra Bank and Yes Bank filed their applications before March 31, 2001, these were the only banks which were issued licenses in 2003 and 2004 respectively under the above guidelines.

Subsequently, in February 2005, the Government of India and RBI released the 'Roadmap for presence of Foreign Banks in India and Guidelines on Ownership and Governance in Private Banks'. Vide these guidelines, the minimum net-worth of banks was prescribed at INR 3 bn (approx.US\$ 70 mn) and an added emphasis was laid on the 'Fit and Proper' management. It was provided that that no single individual/ entity could have ownership and control in a bank in excess of 10%. Investment by industrial houses was restricted at 10% subject to RBI approval.

The Finance Minister announced during the Union Budget 2010 speech, that RBI is considering giving some additional licenses to private sector players. NBFCs could also be considered, if they meet the RBI's criteria. The RBI on August 11, 2010 released the much awaited discussion paper on 'Entry of New Banks in the Private Sector'. The discussion paper seeks views / comments of banks, non-banking financial institutions, industrial houses, other institutions and the public by September 30, 2010. The key objective of

allowing new entrants is to promote financial inclusion. The discussion paper outlines past approaches, experience with new private sector banks in the last decade, international experience, and also considers various costs and benefits of increasing the number of new banks as well as the pros and cons of various policy parameters in licensing new banks. The RBI will frame detailed guidelines for licensing of new banks based on the feedback, comments, suggestions received on the possible approaches discussed in this discussion paper and detailed discussions with the stakeholders.

The discussion paper¹ highlights the following key issues for consideration and probable options / solutions in the context of these issues:

- Minimum capital requirements for new banks and promoters contribution;
- Minimum and maximum caps on promoter shareholding and other shareholders;
- Foreign shareholding in the new banks;
- Whether industrial and business houses could be allowed to promote banks;
- Should Non-banking financial companies be allowed conversion into banks or to promote a bank; and
- Business model for the new banks.

Any investment in private banks where shareholding reaches and exceeds five per cent either individually or as a group is required to obtain RBI acknowledgement for transfer of shares.

Foreign banks / FDI in banking

(a) Branch of foreign bank in India

Foreign Investments in India is subject to restrictions and conditions imposed by FDI policy.

Foreign banks may operate in India through only one of the three channels, namely (i) branch/es (ii) a Wholly owned Subsidiary (WOS) or (iii) a subsidiary with an aggregate foreign investment up to a maximum of 74% in a private bank. This has been discussed in detail in the roadmap issued by the RBI in 2005.

RBI follows a very stringent policy on giving branch licence to a foreign bank. As regards investments in Indian banking company, as per the FDI policy, foreign investment upto 74% of the paid up capital of the Bank from all sources (FDI/FII/ADR/GDR) is permitted in private sector banks. FDI up to 49% is permitted under the automatic route and beyond that up to 74% after obtaining Government approval. At all times atleast 26% of the paid up capital of a private sector bank will have to be held by residents, except in regard to a wholly-owned subsidiary of the foreign bank.

Under the Insurance Act, the maximum foreign investment in an insurance company is restricted up to 26%. Therefore, application for foreign investment in banks, which have joint venture / subsidiary in insurance sector, should be made to RBI. Such applications will be considered by RBI in consultation with Insurance Regulatory and Development Authority (IRDA).

¹ - Refer to page 37

The roadmap for presence of Foreign Banks in India issued in early 2005 was divided into following two phases:

- Phase I – March 2005 - March 2009; and
- Phase II – April 2009 onwards

Phase I

During the first phase (which continues even today), foreign banks are permitted to establish presence by way of:

- Setting up a WOS or conversion of the existing branches into a WOS; or
- Branch; or
- Investment in a weak private sector bank up to 74%.

Foreign banks are allowed to set up presence in India only in one the above forms. The criteria and aspects considered by RBI while granting permission to foreign banks for setting-up banking presence in India in either of the aforesaid forms are as under:

Wholly Owned Subsidiary(WOS)

WOS is to be treated on par with the existing branches of foreign banks for branch expansion in India. Further, the RBI has reserved the rights to prescribe market access and national treatment limitation consistent with its WTO commitment and also other appropriate limitations to the operations of WOS consistent with international practices and the country's requirements.

Eligibility of the parent bank

- The setting up of a wholly-owned banking subsidiary in India should have the approval of the home country regulator

Capital requirements

- The minimum capital requirement is of INR 3 bn (approx. US\$ 70 mn),
- Capital adequacy ratio of 10% is to be maintained as against 9% for foreign bank branch
- The parent foreign bank will need to hold 100% equity in the Indian subsidiary for a minimum prescribed period of operation (no period prescribed till date)

Corporate Governance

- The composition of the Board of directors need to meet the following requirements:
- Minimum 50% of the directors to be Indian nationals resident in India.
- Minimum 50% of the Directors to be non-executive directors.
- A minimum of one-third of the directors to be totally independent of the management of the subsidiary in India, its parent or associates.

- The directors to conform to the 'Fit and Proper' criteria as laid down by RBI
- RBI's approval will need to be sought for the directors as per the procedure adopted in the case of the erstwhile Local Advisory Boards of foreign bank branches.

Branch

The minimum capital requirement for banking branch licence is US\$ 25mn, which is to be brought in upfront.

While according the banking branch licence, the key factors considered by RBI are:

- Business plan of the foreign bank,
- Reciprocity to Indian banks in home country of the applicant foreign bank,
- Economic and political relations between India and home country of the applicant foreign bank,
- Existing and past presence of the applicant foreign bank / its group entities in India,
- International and home country ranking, rating, etc.

Further, vide the Roadmap, it is proposed to permit branch expansion beyond the existing World trade organisations ('WTO') commitment of 12 branches in a year although the number of branches permitted each year has been higher than the WTO commitments.

Investment in weak private sector banks

Foreign banks are permitted to apply to RBI for making investment in private sector banks that are identified by RBI for restructuring. Till date, there have been no instances of foreign bank being permitted to acquire Indian banks identified by RBI for restructuring.

Phase II

Under Phase II, RBI was proposing to permit the following:

- According full national treatment to WOS
- Dilution of stake in WOS, so that at least 26% of the paid up capital of the subsidiary is held by resident Indians.
- Foreign bank to enter into merger and acquisition transactions with any private sector bank in India subject to the overall investment limit of 74%.

The second phase was proposed to commence in April 2009 after the review of experience gained during the first phase and due consultation with all the stakeholders in the banking sector. However, considering the global financial market turmoil and uncertainties surrounding the financial strength of banks around the world, RBI kept the review of Phase I on hold and proposed to continue with the policy and procedures prescribed under the said phase even post April 2009. Further, the review of Phase I is proposed to be undertaken (after due consultation with the stakeholders) once there is greater clarity regarding stability, recovery of the global financial system, and a shared understanding on the regulatory and supervisory architecture around the world.

(b) Liaison Office

A foreign bank can also set up presence in India in the form of a liaison office (LO) in India. Generally, foreign banks initially set up a liaison office to establish its presence in India. 'Liaison Office' means a place of business to act as a channel of communication between the principal place of business or head office by whatever name called and entities in India. The Liaison does not undertake any commercial/trading industrial activity, directly or indirectly, and maintains itself out of inward remittances received from abroad through normal banking channel¹.

A prior approval of the RBI is required to establish an LO in India. The RBI scrutinises all applications for setting-up an LO on a case-by-case basis. The RBI has discretionary powers to accept or reject any application for setting-up an LO.

Further, there are restrictions on the activities that can be carried out by an LO in India. The role of the LO is limited to collecting information about possible market opportunities and providing information about the HO and its products to prospective Indian customers. An LO cannot undertake any commercial activity directly or indirectly and cannot, therefore, earn any income in India.

Other key regulatory requirements after set up

(a) Various registrations/ memberships

Once the RBI grants banking licence, the bank is required to obtain several additional licences, membership and registrations. Further, it also needs to maintain various accounts with the RBI and other regulators. Application for these additional licences, membership and accounts need to be made in a particular sequence as they are dependent on each other. Some of these include registration with Foreign Exchange Dealers' Association of India, Clearing Corporation of India Limited, membership with Society for Worldwide Inter-bank Financial Telecommunication, Subsidiary General Ledger account, etc.

(b) Ongoing compliance requirements

RBI has issued various directives to banks operating in India in order to regulate them. Some of the key regulatory compliances prescribed for a bank are maintenance of Statutory Liquidity Ratio, Cash Reserve Ratio, Capital adequacy based on risk weighted assets, Priority sector lending norms, etc some of which are briefly discussed below:

- **Statutory Liquid Ratio (SLR)**
The Banking Regulation Act empowers RBI to fix this ratio as a percentage of the banks total demand and time liabilities in India. The SLR is to be maintain in cash or gold or in unencumbered approved securities or in one or more aforesaid in India as on the last Friday of the second preceding fortnight. Presently SLR is 25%.
- **Cash Reserve Ratio (CRR)**
Cash Reserve Ratio (CRR) refers to this liquid cash that banks have to maintain with the RBI as a certain percentage of their demand and time liabilities. Currently CRR is 6%.

¹ Regulation 2(e) of Foreign Exchange management (Establishment in India of branch or office or other place of business) Regulations, 2000

- **Capital Adequacy Norms**

Capital Adequacy Norms take into account the elements of risk in various types of assets in the balance sheet as well as off-balance sheet business and also strengthen the capital base of banks. Banks are required to maintain a minimum Capital Adequacy Ratio (CAR) of 9% on an ongoing basis.

- **Priority Sector Lending**

Banks in India are required to lend a certain percentage of their credit to priority sectors such as agriculture, small and medium scale enterprises, export credits, etc. The priority sector norms target fixed in case of foreign banks (branch of foreign bank) is 32% of the net bank credit. This is lower than the targets fixed for domestic banks which are 40% of net bank credit.

A bank in India needs to file approximately 120 reports annually with the RBI, depending on the business model. These reports are to be filed on a daily, fortnightly, quarterly, half yearly and yearly basis, either on-line and / or in hard copy form as prescribed. Various reports are also to be filed with other regulators such as ROC, service tax authorities, FEDAI, etc.

(c) **Voting rights**

No person is authorised to exercise voting rights in excess of 10% of the total voting rights of all the shareholders of the Indian banking company.

(d) **Acknowledgement of RBI for transfer of shares more than 5%**

RBI had issued guidelines for acknowledgment of transfer/ allotment of shares in private sector banks on February 3, 2004. Per the said guidelines, acknowledgement from RBI for acquisition/transfer of shares is required for all cases of acquisition of shares which will take the aggregate holding (direct and indirect, beneficial or otherwise) of an individual or group to equivalent of 5 % or more of the paid-up capital of the bank. Any transfer of shares of a banking company from residents to non-residents will require approval of FIPB under FEMA. Pricing guidelines are applicable on transfer of shares from resident to non resident

Para-banking activities

In terms of the RBI regulations, banks in India can undertake certain eligible financial services or para-banking activities either departmentally or by setting up subsidiaries. Such para-banking activities include undertaking insurance business, underwriting of corporate shares and debentures, mutual fund business, etc.

Outsourcing of Financial Services by banks

Banks operating in India are allowed to outsource various financial services in accordance with the guidelines issued by the RBI. These guidelines detail the necessary safeguards to address the risks related to outsourcing of financial services activities.

NBFC presence

Foreign investors including foreign banks can also take the NBFC route to enter the financial sector.

Under FDI Policy

FDI upto 100% is permitted under the automatic route in the following 18 NBFC activities subject to compliance with the minimum capital requirements as prescribed:

1. Merchant banking
2. Underwriting
3. Portfolio Management Services
4. Investment Advisory Services
5. Financial Consultancy
6. Stock Broking
7. Asset Management
8. Venture Capital
9. Custodial Services
10. Factoring
11. Credit Rating Agencies
12. Financial Leasing & Hire Purchase Finance
13. Housing Finance
14. Forex Broking
15. Credit card business
16. Money changing business
17. Micro Credit
18. Rural Credit

The minimum capital requirements as prescribed are as under:

For fund based activities		
Level of equity participation	Minimum capital required	Remarks
Up to 51%	Up to 51%	To be brought upfront
Above 51% and up to 75%	US\$ 50 mn	To be brought upfront
Above 75% and up to 100%	US\$ 50 mn	US\$ 7.5 mn to be brought upfront, balance to be brought within 24 months
For non fund based activities		
For all levels of equity participation	US\$ 0.50 mn	To be brought upfront

Some of the aforesaid activities such as merchant banking, underwriting, portfolio management services, stock broking, asset management, venture capital, custodial services, factoring, etc. are regulated by the SEBI. Accordingly, entities proposing to undertake the said activities would require separate registration with SEBI.

Under RBI Regulations

Some of the NBFCs are regulated by RBI. Under the RBI regulations, NBFCs are classified into four categories, i.e.

- asset finance companies,
- investment companies,
- loan companies and
- infrastructure financing companies.

The above types of companies may be further classified into:

- NBFCs accepting public deposits (NBFC-D), and
- NBFCs not accepting/ holding public deposits (NBFCs ND)

A separate category of NBFCs called the Residuary Non-Banking Companies (RNBCs) also exist. RNBCs are a category of NBFCs whose principal business is acceptance of deposits and investing in approved securities.

Every NBFC regulated by RBI is mandatorily required to get itself registered with RBI to commence or carry on any business of non-banking financial institution. However, to obviate dual regulation, certain categories of NBFCs which are regulated by other regulators are exempted from the requirement of registration with RBI viz. Venture capital fund/ Merchant banking companies/ Stock broking companies registered with the SEBI, Insurance company holding a valid certificate of registration issued by IRDA, etc. In addition to the registration requirements, NBFCs have to fulfill the specific requirements of RBI as set out in the directions, prudential norms, various notifications and amendments. The RBI also prescribes a set of compliance norms for all NBFCs.

Discussion paper on entry of new entities in the private banking sector

1. Background

“It is not by augmenting the capital of the country, but by rendering that capital active and productive, that the most judicious operations of banking can increase the industry of the country” said Adam Smith, the father of modern economics.

More than two centuries after the above wise words were mentioned, the task of marrying social and economic objectives of banking still poses a daunting challenge to the regulators globally including those in India. In the recent two decades, the Indian financial system has registered significant growth in resource mobilization, geographical and functional reach, profitability and competitiveness. However, vast segments of the population in India, especially the underprivileged sections of the society continue to be unbanked. With the key objective of broadening and deepening the reach of banking

services in India, the Reserve Bank of India ('RBI') intends to issue banking licences to a limited number of new entrants and it has issued today i.e. on August 11, 2010, a discussion paper on 'Entry of new banks in the private sector' for views / comments of banks, non-banking financial institutions, industrial houses, other institutions and the public at large, by 30 September 2010.

The release of the discussion paper was keenly awaited by the industry after a reference to this proposal was made by the Union Finance Minister in February this year in his budget speech for the year 2010-11 and by the RBI in the Annual Policy Statement for the year 2010-11.

The discussion paper outlines past approaches, experience with new private sector banks in last decade, international experience, and considers various costs and benefits of increasing the number of new banks as well as the pros and cons of various policy parameters in licensing new banks.

2. Gist of the discussion paper

The discussion paper indicates that financial inclusion (which is a key focus of the public policy) is an important objective for which new entrants would be given a banking licence.

The RBI's experience from the time when financial sector reforms were initiated (year 1993 for banks) till date, suggests, inter-alia, that only those banks that had adequate experience in broad financial sector, financial resources, trustworthy people, strong and competent managerial support could withstand the rigorous demands of promoting and managing a bank.

The RBI has also considered, in this discussion paper, inputs from the various expert committees whose recommendations include enhancement of foreign and domestic investments levels in Indian banks and allowing non-banking finance companies ('NBFCs') to convert into banks. It has also taken into account lessons from the recent global financial crisis and the need to improve the quality and level of capital, risk management and governance standards.

In the above backdrop, the RBI has listed the following five issues which merit consideration:

- Minimum capital requirements and promoters contribution
- Minimum and maximum caps on promoter and other shareholders
- Foreign shareholding
- Eligible Promoters: Industrial / business houses and NBFCs
- Business model

The discussion paper reviews the Indian and international experience on the above issues. Further, it also proposes possible solutions / options and discusses pros and cons of each solution / option. We have highlighted below the key pros and cons of each possible solution mentioned in the discussion paper.

3. Minimum capital requirements for new banks

Option	Description	Key Pros	Key Cons
a	A low minimum capital requirement but more than INR 300 crore / INR 3 billion (which is the current requirement)	Optimum utilization of capital.	Entry of non-serious entities; concentration and governance risks.
b	A high (say INR 1000 crores / INR 10 billion) minimum capital requirement	Entry of serious entities; Investment in technology for financial inclusion.	Likely to be focused on more profitable large ticket size commercial banking.
c	Initial minimum capital (say INR 500 crores / INR 5 billion) with a condition to raise the amount (say INR 1000 crores / INR 10 billion) within a specified period (say 5 years)	Easier to dilute promoter stake as the bank grows.	Some new entrants may not be able to expand capital and level of operations within the specified period.

4. Minimum and maximum caps on promoter shareholding and other shareholders

Option	Description	Key Pros	Key Cons
a	Retaining the current system requiring promoters to bring in a minimum of 40 percent of capital with lock-in clause for 5 years and the threshold for other significant shareholders to be restricted to maximum of 10 percent with the requirement to seek acknowledgement from the RBI on reaching 5 percent threshold and above. Promoters to dilute to the extent required in a time bound manner say, 5 years after the lock in period	Ensures that promoters have stake in development of the bank in the initial stages and the bank would be run professionally in the long run.	The dilution requirement to a very low level could act as a deterrent; In the absence of a serious promoter, there would be difficulty in fixing accountability and responsibility.
b	Retain the general threshold for the shareholders at 5 percent of the capital but raise the threshold for promoters and other significant shareholders to say 20 percent in the long run. Higher shareholding could be considered exceptionally subject to increasingly stringent criteria	Invites serious promoters as well as serve the purpose of diversified shareholding; Easier for fixing responsibility and accountability for the regulator.	Any change would also have to be implemented for other existing banks.
c	Allow promoters to hold their initial shareholding of 40 percent	Ensure continuing stake of promoters with benefits of providing direction, commitment and resources.	Concentrated shareholding in banks, which could be detrimental to depositors' interests.

d	No restriction on ownership up to 5 / 10 percent with permission to hold up to 40 percent of capital with shareholders' equity up to say INR 1000 crore / INR 10 billion, 30 percent of capital in banks with shareholders' equity more than say INR 1000 crore / INR 10 billion and up to say INR 2000 crore / INR 20 billion, and permitted maximum holding (10 percent or 20 percent) in banks with shareholders' equity of more than say INR 2000 crore / INR 20 billion (Based on Canadian Model)	Promoter's support in the formative phase and independence to the bank in the long run.	Concentrated shareholding for smaller banks; Induce slower expansion, so that promoters have control for a longer period.
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5. Foreign shareholding in the new banks

Option	Description	Key Pros	Key Cons
a	Cap on aggregate non-resident investment including Foreign Direct Investment, Non-resident Indian and Foreign Institutional investment at a suitable level below 50 percent and locked at that level for the initial 10 years	Enable foreign capital to be used in the promotion of domestic banks; Increase in foreign technical collaboration; No requirement of monitoring downstream investment by banks for indirect foreign Investment.	Constraint to foreign capital willing to invest in India; Contrasts the present FDI policy which allows 74 percent foreign equity in private sector banking.

6 Eligible Promoters

(a) Industrial and business houses

Option	Description	Key Pros	Key Cons
a	Permit industrial and business houses to promote banks	Capital and professional competence.	Conflict of interest; Difficulty in supervision and regulation.
b	Permit industrial and business houses that have predominant presence and experience in the financial sector, subject to other due diligence process	Core professional expertise; Prudent track record.	Possible concentration of economic power.
c	As an intermediate step, permit industrial and business houses to take over Regional Rural Banks, before considering allowing them to set up banks	Opportunity for new players to prove themselves; Immediate impetus to financial inclusion.	Points mentioned above and need to expedite legislative changes.

(b) Conversion of NBFCs into banks / allowing NBFCs to promote a bank

Option	Description	Key Pros	Key Cons
a	Permit conversion of NBFCs into banks	Scale up the NBFC model to achieve financial inclusion.	Different business and regulatory framework for NBFCs.
b	Permit standalone (i.e. those not promoted by Industrial / Business Houses) NBFCs (including those regulated by SEBI, IRDA & NHB) to promote banks	Expertise from NBFCs would flow to into the bank.	Regulatory arbitrage.

The RBI proposes to prohibit NBFCs or its subsidiaries / associates engaged directly or indirectly in real estate activities for being considered eligible to promote banks.

7. Business Model

Option	Description	Key Pros	Key Cons
a	Permit business models as per 2001 guidelines (permit branches in metros but with requirement of minimum priority sector lending and number of rural branches, use of technology, etc)	Provides level playing field, uniform norms and supervision for all banks.	May not achieve accelerated financial inclusion.
b	Primary orientation towards financial inclusion (significant outreach in Tier 3 to 6 centres especially unbanked regions)	Thrust on financial inclusion and use of technology.	May not provide adequate returns to enable banks to compete with other banks.

8. Way forward

The RBI will frame detailed guidelines for licensing of new banks based on the feedback, comments, suggestions received on the possible approaches discussed in this discussion paper and detailed discussions with the stakeholders. Once the guidelines are formed and applications for establishing new banks are received, the RBI will forward all such applications to an external group, who would then make recommendations to the RBI with regard to granting licences to a limited number of applicants.

Chapter 07

Indian Tax Regime

Rate of Corporate Tax

The corporate rate of tax for domestic companies in India is 30% (plus applicable surcharge and cess). Additionally, domestic companies are also required to pay dividend distribution tax of 15% (plus applicable surcharge and cess) on the amount of dividend distributed/ paid. Indian branch of foreign banks are currently subject to tax @ 40% (plus applicable surcharge and cess) in India. There is no further profit repatriation tax payable by branches on repatriation of profits to head office. The aforesaid rates are further increased marginally by a surcharge and cess.

The Income tax Act, 1961 (the Act) levies Minimum Alternate Tax (MAT) on companies (including foreign companies) in case the tax payable on total income computed under the provisions of the Act is less than 18% of its book profits. MAT is levied @18% (plus applicable surcharge and cess) of the book profits. Book profit means the net profit as shown in the profit and loss account for the relevant previous year after certain adjustments as provided for in the Act.

Key tax issues for Foreign Banks

A foreign bank may take benefits under the tax treaties signed by India with the Governments of the respective country of which such foreign bank is a tax resident. By virtue of the definition of a Permanent Establishment (PE) in the tax treaties, a branch of a foreign bank in India is held to be a PE of the foreign bank. Further, in view of the business article in the tax treaties, profits attributable to the operations of the Indian PE may be taxed in India. On this principle, the income of the Indian branch of a foreign bank is charged to tax in India. However, there is no clarity around treatment of the branch (PE) as a separate independent unit from its head office in relation to transactions between head office and the branch.

A liaison office in India of a foreign bank generally does not result in PE if the activities of the LO are restricted to preparatory and auxiliary in nature. However, if the activities performed by the LO if are said to significantly exceed the threshold of preparatory and auxiliary activities, such LO may constitute a PE in India and benefit of the tax treaty will not be available.

Based on the non-discrimination clause in the tax treaties that India has entered into with other countries, some of the foreign banks claim that the rate applicable to Indian companies should apply to them on the basis that the difference in tax rate results in discrimination. The litigation on this issue is currently pending before the courts for past several years.

Currently the law provides for deduction to the Indian branches of foreign banks in respect of head office expenses to the extent of 5% of taxable income. The deduction is restricted to the expenses in the nature of head office expenses. Expenses which are incurred by head office specifically for Indian branch e.g. an employee receives salary from head office could be claimed as deductible.

Non Performing Assets (NPAs)

Under the existing law, deduction is allowed for provision for NPAs in case of Indian banks @ 7.5% of the taxable income and in case of foreign banks @ 5% of the taxable income. Thus the deduction is allowed only if the taxable income is positive. No such deduction is allowed to NBFCs even though NBFCs have to adhere to the RBI guidelines for making provisions in the accounts.

Banks / Housing Finance Companies (HFCs) / FIs are taxed on interest on NPAs on receipt basis and not on accrual basis on the lines of RBI directives on NPA. However NBFCs are taxed on such interest on accrual basis though there are certain favourable court rulings.

Other issues

There is considerable litigation over the issue of transactions between Indian branch and the head office of foreign banks. There is a lot of uncertainty over taxability of interest received by the branch from head office, deductibility of interest paid by the Indian branch to its head office and the related issue of whether tax is required to be withheld.

Another issue that has been the subject of recent litigation is the allowance of depreciation on assets given on a finance lease. The CBDT had issued clarification to the effect that irrespective of the accounting treatment given to lease transactions in the books of the lessor and the lessee, depreciation on leased assets would be available to the owner thereof, which, in law, ought to be the lessor. The allowability of depreciation to the lessor in finance leases is however increasingly being questioned and there are a plethora of cases where the lessor is not held to be the owner by the tax department.

Another issue affecting banks in particular is the treatment of notional loss on revaluation of forward or foreign exchange contracts. While the loss is required to be booked in accordance with the accounting standards, the tax authorities at lower level have not been accepting the deduction claim of the banks.

Direct Taxes Code

A new Direct Taxes Code Bill, 2010 ('DTC') is proposed which will replace the existing Income Tax Act 1961 w.e.f. April 1, 2012.

The DTC proposes marginal reduction in the corporate tax rate to 30% from the current effective rate of 33.22% (including surcharge and cess). Rate of MAT is proposed at 20% as compared to current rate of 19.93% (including surcharge and cess). Effective rate of DDT is proposed to be reduced to 15% from 16.61% (including surcharge and cess). Branch Profits Tax introduced for foreign companies, chargeable at the rate of 15% in respect of the income attributable, directly or indirectly, to the permanent establishment or an immovable property situated in India, as reduced by the amount of income-tax payable on such attributable income.

Some of the provisions of the DTC relevant to Banks and NBFCs are given below:

Nil withholding tax certificates: The DTC allows a deductee (resident or non-resident) to ask for a certificate for lower or nil rate of withholding tax. The notes to clauses indicate that only a resident deductee can make an application for such lower or nil rate of withholding tax. It is hoped that this dichotomy would be removed.

Finance Lease: The DTC provides that in case of finance lease the lessee would be the deemed owner of business capital asset and would be allowed to claim depreciation on the same.

Sale and buy back transactions: Where the original holder sells the security to another person before the due date of the interest / dividend and subsequently buys back the security after the due date, the amount of interest accrued to another person would be considered as income in the hands of the original holder as if the transaction had not taken place. Similarly, in case of buy and sale-back of securities, the interest / dividend shall not be regarded as income of the buyer. The loss, if any, arising on subsequent sale shall be ignored to the

extent of such interest / dividend income. The DTC does not provide for any time frame and could apply to any sale and buy-back (and vice-versa) transactions in security

Deduction of interest expense: Interest expense on any capital borrowed or payable to any financial institution will be allowed as a deduction in the financial year in which the amount is paid or in which the liability has accrued, whichever is later.

Interest income deemed to accrue in India: The interest income is deemed to accrue in India if the interest is payable by any non-resident, in respect of any debt incurred and used in a business carried on by the non-resident in India or earning any income from any source in India. However, such interest income will not be deemed to accrue in India in cases where it has not been claimed by the non-resident as a deduction from his income which is chargeable to tax in India. For eg, if an overseas bank has taken a loan outside India and then onwards lent this amount to an Indian corporate (for permissible purposes), the interest paid by the overseas bank to the ultimate overseas lender should not be taxable in India, unless the overseas bank claims such interest as a deduction from its income in India.

Provisions for bad and doubtful debts and bad debts written off: It is proposed to allow deduction in respect of amounts credited to provision for bad and doubtful debts account subject to the cap of 1% of aggregate average advances computed in the manner prescribed and subject to some conditions. This would apply to banks and NBFCs.

Interest on bad and doubtful debts: The DTC proposes that the interest on sticky loans should be taxable in the financial year in which the interest is credited to the profit and loss account or is actually received by the banks/NBFCs, whichever is earlier.

Transfer Pricing Norms

The Act has a separate code on Transfer Pricing (TP) which prescribes that income arising from “international transactions” between “associated enterprises” should be computed at the “arm’s length” price. The regulations are broadly based on the OECD Guidelines and describe the various transfer pricing methods, impose extensive annual transfer pricing documentation requirements and contain harsh penal provisions for non-compliance.

TP is a challenging exercise for Banks and the Financial services industry, especially in functions such as Treasury and Investment Banking. Moreover, this industry has been receiving considerable attention from tax authorities in the course of conducting TP audits. Few key transactions and related challenges faced from a TP perspective are enumerated below:

- Investment banking, being highly integrated in nature (i.e. characterised by complex global arrangements and multiple-party involvement), may often necessitate the use of a profit or a revenue split. The key challenges here are to be able to substantiate the basis for allocating global profit/loss, to customise global policies from an India TP standpoint, if necessary, and to consider the possibility of a transition from the use of cost plus method during start-up years to a profit or revenue split later on, as the operations evolve.
- Treasury, for its fund management operations, transacts by choosing appropriate real-time currency and interest rates. Treasury trades typically include foreign exchange contracts, derivatives like options, swaps and variants thereof and fund placements / borrow-

ings. The pricing dynamics of such transactions are closely linked to market-determined variables, thus making the application of conventional TP methods a challenging exercise. Moreover, in a TP analysis of such transactions, it would be important to recognise, that these are subject to the bank's internal control mechanisms, which include comprehensive procedures to deal with deviations through reliance on market data and trends; and also ensure regulatory compliance.

- Equity broking transactions are typically characterised by high volumes with their pricing closely linked to market determined variable. From a TP perspective, a tax payer may face problems like considering the impact of functional differences while evaluating reliability of the Comparable Uncontrolled Price ('CUP') method for benchmarking broking services provided to affiliates, non-acceptability of economic adjustments for factors such as volumes, etc. by tax authorities.
- Services provided to overseas group entities such as technology related services, relationship management support, customer referral, investment advisory / research operations etc have typically attracted high mark-ups during the course of TP audits. The challenge here is to be able to demonstrate the captive and limited risk nature of such operations and to be able to carry out comparability adjustments to factor-in the aforesaid, while benchmarking against financial results of entrepreneurial companies whose data is publicly available.
- Management / Head office charges: The Head Office generally makes an allocation of administrative and other common support related expenses incurred at a group level to the Indian operations. Due care would need to be taken to document the benefits accruing to the Indian operations from such support along with establishing that the allocation is appropriately made, keeping in perspective the OECD guidance available in this regard.

The issues analysed here, though common across the industry, often have case to case nuances. For all entities planning to set up banking operations in India there is a need for developing systems / processes to maintain contemporaneous transaction and comparable data, careful evaluation of global TP policies and their applicability in the Indian context, keeping in perspective relevant industry and market dynamics and tax authorities approach to intra-group arrangements in this industry.

Indirect taxes in India

Service tax

Service tax is levied on specified taxable services identified under Chapter V of the Finance Act, 1994 (the Act). At present, over 100 services are specified under the Act. The existing rate of service tax is 10%. In addition, EC of 2% and SHEC of 1% are also leviable on taxable services. Thus effective rate of service tax is 10.30%.

Service Tax is generally payable at the time of receipt of consideration for taxable services including advance receipts. However, in the case of Associated Enterprises (as defined under Section 92A the Income Tax Act, 1961, the liability to pay service tax is triggered either on the debiting/ crediting in the books of accounts or on receipt of the consideration whichever is earlier.

Taxable services directly relevant for the Banking Sector include inter alia 'banking and other financial services' and 'credit card, debit card, charge card or other payment card service'.

The current threshold limit for service tax exemption for small service providers is INR 1 mn (approx.US\$ 22,000). The threshold limit for obtaining service tax registration is INR 0.9 mn (approx.US\$ 19,800). All persons liable to pay service tax on eligible taxable services received or provided by them are required to obtain service tax registration for the service premises from the jurisdictional service tax Commissionerate. In this connection, the Service Tax Rules, 2004 provide that service recipients liable to pay service tax who receive services in more than one premises or office, and who have a centralised billing or accounting system, can opt for centralised registration by making an application to the Commissioner of Central Excise within whose jurisdiction the premises or office from where the centralised billing or accounting is performed is located.

Taxable services provided by service providers located outside India to a recipient in India are subject to service tax in terms of the Services (Provided from Outside India and Received in India) Rules, 2006. In terms of these rules, where the taxable services are provided from outside India and received in India, the service recipient is required to register and pay the tax in accordance with the relevant provisions of law.

Service tax was earlier charged on the gross value of the services, which have been rendered. The Central Government has now introduced the Service Tax (Determination of Value) Rules, 2006 ("the Valuation Rules").

- Interest has been specifically excluded from the value of taxable services and is therefore not liable to service tax in terms of Rule 6(2)(iv) of the Valuation Rules.

In light of the integration of goods and services, a service provider can avail CENVAT credit of excise duties paid on capital goods and inputs used for providing output services, apart from availing CENVAT credit of the service taxes paid on input services.

The Central Government has, vide Export of Service Rules, 2005 (Export Rules), provided that no service tax is chargeable on export services. The benefit of exemption from service tax would be available on exported services, subject to the fulfillment of the conditions prescribed under the Export Rules.

- As an alternative, the service provider can also discharge the service tax on exports and claim a rebate of the service tax paid. In addition to the rebate of tax paid on the exported services, rebate/refund provisions have also been established with regard to the service tax paid on input services and excise duty paid on input goods used in providing the exported services.

E-payment of service tax has been made mandatory for certain categories of large assess-ees with effect from 1 October 2006.

In order to enable foreign investors to ascertain their indirect tax liabilities arising from proposed business ventures in India, the Central Government has constituted the Authority for Advance Rulings (AAR) as a high level quasi-judicial body. The functions of the AAR cover giving advance rulings on a specific set of facts relating to specified matters under customs, central excise and service tax.

- Advance rulings may be sought by any non-resident investor entering a joint venture in India in collaboration with another non-resident or a resident of India, or a resident setting up a joint venture in India in collaboration with another non-resident or a resident of India, or a resident setting up a joint venture in India in collaboration with a non-resident. Through the Finance Act, 2005 this facility has also been made available to an existing Joint Venture in India. The Central Government is also empowered to declare any other class or category of persons eligible for availing the benefit of an advance ruling.

Sales Tax / VAT

Sale of movable goods in India is chargeable to tax at the Central or State level. The Indian regulatory framework has granted power to State legislatures to levy tax on goods sold within that State. Such sales are, therefore, chargeable to Value Added Tax (VAT) at the rates notified under the VAT laws of the relevant State.

All goods sold in the course of interstate trade are subject to Central Sales Tax (CST).

CST is sought to be phased out with the introduction of the Goods and Services Tax (GST). To this end, the rate of CST was reduced from 4% to 3% with effect from 1 April 2007. A further reduction of 1% was effected on 1 June 2008. It is proposed to eliminate CST by reducing the rate from 2% to Nil with the introduction of the GST. In the interim, CST continues to co-exist with the State VAT.

Under the VAT regime, the VAT paid on goods purchased from within the State is eligible for input tax credit. The input tax credit can be utilised against the VAT/ CST payable on the sale of goods. It is thus ensured that the cascading effect of taxes is avoided and that only the value addition is taxed.

Currently, there is no VAT on imports into India. Exports are zero rated. This means that while exports are not charged to VAT, VAT charged on inputs purchased and used in the manufacture of export goods or goods purchased for exports is available to the purchaser as a refund.

State VAT is charged on uniform tax rates of 1%, 4% and 20%. Goods other than those notified to be covered under the above rates are charged at a Revenue Neutral Rate (RNR) of 12.5%. Most goods will thus be charged to VAT at RNR. Some of the States have varied these tax slabs.

Custom Duty

Customs duty is levied by the Central Government on the import of goods into, and export from, India. The rate of customs duty applicable to a product proposed to be imported/ exported depends upon its classification under the Customs Tariff. With regard to exports from India, duty is levied only on a very limited list of goods.

The Customs Tariff is aligned with the internationally recognised HSN provided by the World Customs Organisation.

The peak rate of Basic Customs Duty (BCD) is currently pegged at 10% for all goods other than agricultural and other specified products. In addition, preferential/concessional rates of duty are available under the various bilateral and multilateral trade agreements entered into by India with other countries.

Customs duty is levied on the transaction value of the imported or exported goods. While the general principles adopted for valuation of the goods in India are in conformity with the WTO agreement on customs valuation, the Central Government has established independent Customs Valuation Rules applicable to the export and import of goods.

The types of customs duties applicable are as follows:

- BCD is the basic component of customs duty levied on the landed value of the goods
- Countervailing Duty (CVD) is equivalent to, and is charged in lieu of, the excise duty applicable on like goods manufactured in India.
- Education Cess (EC) at 2% and Secondary and Higher Education Cess (SHEC) at 1% is also levied both on BCD and CVD
- Special Additional Duty of Customs (ADC) at 4% is charged in addition to the above duties on all imports subject to a few exceptions.

CENVAT (Excise Duty)

Central Value Added Tax (CENVAT) is an excise duty levied by the Central Government on the manufacture or production of movable and marketable goods in India. Excise duty is paid by a manufacturer. The existing rate of excise duty is 10%. In addition, EC of 2% and SHEC of 1% are also leviable. Thus effective rate is 10.30%.

Foreign Trade Policy

The Ministry of Commerce, Government of India has announced various export promotion schemes under the Foreign Trade Policy 2009-2014 ('Policy') to boost exports from India and incentivise the Indian exporters. The Policy provides for two kinds of Schemes. These Schemes provide for import of inputs, capital goods, equipments, etc either duty free or at concessional rate of duty subject to certain conditions. These Schemes also provide for duty free import of capital goods or inputs against export of goods or services subject to certain conditions. Various export promotion schemes designed over a period of last forty five years have provided Indian Exporters with a valuable policy tool kit to neutralise the impact of a host of indirect taxes/cess/duties incurred by them while manufacturing goods or rendering services.

Proposed Goods and Services Tax (GST)

In Budget 2010, the Finance Minister stated that the Government earnest endeavor is to introduce GST by April 1, 2011. In November 2009, the Empowered Committee of State Finance Ministers released the First Discussion Paper on GST and a Task Force has made its recommendations to the XIIIth Finance Commissions on the structure of GST in India.

Under the proposed dual GST model, a Central GST as well as a State GST will be levied on the taxable value of a transaction of supply of goods and services and both the Centre and the State will legislate, levy and administer the Central GST and the State GST respectively. An Integrated GST (IGST) is proposed to be levied on all inter-state supplies of goods and services. Introduction of GST will eliminate the cascading effect that exists today.

Chapter 08

How can PwC help

PwC can assist new entrants in obtaining a banking license, from the advisory and tax perspective, facilitating the entire process of branch enablement.



Step 1: Establishing Rationale for Market Entry

- PwC can help in analysing the attractiveness of the Indian banking sector and also evaluate the synergies which will accrue for the new entrant
- Assess the banking landscape and undertake an analysis of emerging competition from NBFCs, Industrial houses, etc.
- A comparative analysis of how well-positioned the new entrant is to obtain a banking license, with respect to the existing competition
- Regulatory Analysis which includes –
 - (a) Analyzing the licensing requirements in terms of the earlier and expected regulations of the RBI, which include parameters of ownership and governance guidelines
 - (b) Review of international licensing practices for commercial banks, in a representative set of countries, eg major countries and banking centres
 - (c) Review of the current organizational structure of the new entrant from a regulatory perspective, identifying alternative group re-structuring options which could be explored for the purpose of setting up banking presence

Step 2: Establishment of Presence

- Evaluating an appropriate structure with tax and regulatory efficiency
- Facilitating interactions/ discussions with the regulator
- Assistance in the preparation and filing of application
- Follow-up with RBI for obtaining an in-principal approval
- Assistance in obtaining license and help in submission/ compilation of all requisite details as required by RBI

Step 3: Assistance in Branch Enablement

- Develop and Designing of policy framework, structuring of process manuals and SOPs
- Assessment of Operational risk policies, market risk policies and credit risk policies for improved efficiency
- Enabling technology infrastructure in terms of IT architecture, CBS selection, IT security and business continuity plan, IT Service Delivery and Support, Vendor Selection
- Develop an Organisation design & HR Management
- Formulate a Corporate governance objective, scope, structure and policies

- Ensure Quality standards for customer service and internal processes, Internal audit guidelines, reporting format and templates
- Assist in obtaining various licenses/registrations/memberships with RBI/other authorities/Associations
- Assistance in understanding the reporting of regulatory reports including providing a spreadsheet with details of reports, formats, timelines etc
- Provision of an Implementation roadmap, Program Manage Technology Implementation, Training, Pilot run, Soft launch, Review and feedback, Go-live
- Advice on Direct tax, Indirect tax and Transfer pricing issues
- Advice on optimum use of corporate tax incentives
- Suggesting tax planning strategies for profit and dividend repatriation
- Advice on tax optimisation for specific financial transactions and financial products
- Assistance in Permanent Establishment review
- Assistance in tax compliance, representation before tax authorities and assistance in litigation
- Advice on withholding tax obligations on corporate payments

We can thereby conclude by saying that PwC can help new entrants enter the banking space, right from “concept to launch”.

Conclusion

The growth story of the Indian banking industry showcases vast opportunity, and it is imperative to appreciate the attractiveness of this sector. Further, the granting of additional banking licenses to private sector players and NBFCs manifests huge opportunity for the sector as a whole. Opening up of the banking sector will definitely ensue increased competition and will help in reaching out to the un-banked population of India.

Strong performance of the banking sector over the past few years and future growth potential succeeds in attracting new entrants to the industry, although challenges remain in the form of maintaining asset quality, risk management, compliance with new accounting standards, use of technology and better customer experience.

It has also been an established fact that regulations act as an anchor for the industry, and the umbrella of regulation is necessary to show the way forward for the banking industry.

Annexure

List of Abbreviations

NPA	Non-Performing assets
NBFC	Non-Banking Financial companies
SLR	Statutory liquidity ratio
CRR	Cash reserve ratio
RBI	Reserve bank of India
ROC	Registrar of Companies
SEBI	Securities and Exchange board of India
CBEC	Central Board of Excise and Customs
AAR	Authority for Advance Rulings
FDI	Foreign Direct Investment
FII	Foreign Institutional Investor
ADR	American Depository Receipts
GDR	Global Depository Receipt
RNBC	Residuary Non-Banking Company
CBDT	Central Board of Direct Taxes
CENVAT	Central Value Added tax
VAT	Value added Tax
GST	General Sales Tax
BCD	Basic Customs Duty

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PwC has offices in Ahmedabad, Bangalore, Bhubaneswar, Chennai, Delhi NCR, Hyderabad, Kolkata, Mumbai and Pune.

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