

Banking and Insurance Services Liberalization in the Context of an Indo-EU Trade and Investment Agreement

Abhijit Sen Gupta

Consultant, World Bank, New Delhi, India



INDIAN COUNCIL FOR RESEARCH ON INTERNATIONAL ECONOMIC RELATIONS

Acknowledgments

This project was initiated when the author was working as a Fellow at the Indian Council for Research on International Economic Relations (ICRIER), New Delhi, India. The author would like to thank Jayant Dasgupta, Mathew Joseph, Suparna Karmakar, Rajiv Kumar, Sanjay Kumar, Arpita Mukherjee, Rupa Rege Nitsure, Sonia Pant, TCA Srinivasa Raghavan and Amit Yadav for their very helpful comments. Thanks are also due to Indian Council for Market Research for helping with the surveys.

The author benefitted immensely from discussions with officials from Indian public and private sector banks, foreign banks and insurance companies. Officials from the RBI, IRDA, IBA, Ministry of Finance, Government of India and Department of Commerce, Government of India also provided crucial insights. The author would also like to thank the seminar participants at a discussion seminar held at ICRIER on 28th January for the valuable comments and suggestions.

A number of officials from the various embassies and high commissions of the EU member states also provided useful inputs. Inputs from the EU Commission, Brussels, Department of Business Enterprise and Regulations, UK, HM Treasury, UK and Financial Services Authority, UK are also appreciated.

Logistic and research support extended by the Indian Embassy in Brussels and Indian High Commission in London is gratefully acknowledged

The author would like to thank Saswata Chaudhury for excellent research assistance. The author would also like to thank Renu Gupta for helping with the copyediting of the report.

Email: abhijit@icrier.res.in, Phone: 91-11-24645218-20

List of Abbreviations

ATM	Automated Teller Machine
BaFin	Bundesanstalt für Finanzdienstleistungsaufsicht
CEBS	Committee of European Banking Supervisors
CECEI	Comité des Établissements de Crédit et des Entreprises d'investissement
CEIOPS	Committee of European Insurance and Occupational Pensions
CRAR	Capital to Risk Weighted Asset Ratio
CRD	Capital Requirements Directive
CRR	Cash Reserve Ratio
CSO	Central Statistical Organization
DDT	Dividend Distribution Tax
DNB	De Nederlandsche Bank
DTL	Demand and Time Liabilities
EC	European Commission
ECB	European Central Bank
EEA	European Economic Area
EU	European Union
FBT	Fringe Benefit Tax
FDI	Foreign Direct Investment
FII	Foreign Institutional Investment
FINREP	Financial Reporting
FRBM	Fiscal Responsibility and Budget Management
FSA	Financial Services Authority
FSAP	Financial Services Action Plan
GATS	General Agreement on Trade in Services
GDP	Gross Domestic Product
GIC	General Insurance Corporation
HUF	Hindu Undivided Family
IRDA	Insurance Regulatory and Development Authority
ITES	Information Technology Enabled Services
LIC	Life Insurance Corporation
M&A	Mergers and Acquisitions
MAT	Minimum Alternate Tax
NABARD	National Bank for Agricultural and Rural Development
NDTL	Net Demand and Time Liabilities
NPA	Non-Performing Assets
NPL	Non- Performing Loans
NRI	Non- Resident Indian
OECD	Organization for Economic Cooperation and Development
PPP	Purchasing Power Parity
RBI	Reserve Bank of India
RBS	Risk-Based Supervision
RO	Revised Offers
SARFAESI	Securitization and Reconstruction of Financial Assets and Enforcement

	of Security Interest
SBI	State Bank of India
SEPA	Single European Payment Area
SLR	Statutory Liquidity Ratio
SME	Small and Medium Enterprises
SSI	Small Scale Industries
STT	Securities Transaction Tax
UCITS	Undertakings for Collective Investment in Transferable Securities
VHI	Voluntary Health Insurance
WOS	Wholly- Owned Subsidiaries
WTO	World Trade Organization

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1 Introduction

The term “financial services” is broadly used to define a set of services that are provided to ensure efficient mobilization and allocation of funds to facilitate the overall growth of an economy. By directing investment funds to their most productive use, an efficient financial services sector can significantly promote growth and income. As a result, the effective provision of these services is a basic prerequisite for a dynamic modern economy.

In the General Agreement on Trade in Services (GATS), financial services are divided into two main categories: (i) insurance and insurance-related services, and (ii) banking and other financial services. These two categories are further divided into a list of activities that better illustrate the notion of financial services. These include banking, insurance, insurance intermediation, pension and retirement services, payment systems, and asset management among others.

In recent years this sector has witnessed increased globalisation as more and more financial services are being traded among countries. Global exports of financial services increased nearly six-fold from \$27 billion in 1990 to over \$158 billion in 2005. With the advent of information technology, there is great potential for increasing trade in financial services manifold. In this report we investigate the opportunities and constraints to enhance trade in banking and insurance services between India and the 27-member European Union (EU).

The report focuses on the banking and insurance sector within the entire gamut of financial services. Capital markets and non-banking financial intermediaries are kept outside the scope of the paper. The exact coverage of the sector (according to MTN.GNS/W/120 – service sector classification list of the WTO) is outlined in Table A1 in the Appendix.

2 Indian Financial Services Sector

Over the years, the Indian financial system has grown a great deal in terms of size and complexity. In recent years, the growth has been accelerated by an ever-burgeoning middle class, demanding a host of financial services. Currently, the Indian financial sector encompasses a large number of institutions including some 70,000 branches of commercial banks, the majority of which are in the public domain. These include nearly 15,000 branches each of regional rural banks and cooperative banks, and close to 100,000 branches of various primary agriculture and credit cooperative societies, government-owned term-lending institutions and insurance companies.

The success of the Indian financial sector can be judged from the fact that despite being characterized by low per capita GDP, India has achieved an impressive savings rate as well as financial depth, which are higher than several other major developing economies with a higher per capita GDP like Argentina, Brazil, Russia and the Philippines.

Moreover, the size of the financial sector is also significantly higher than many of the other emerging markets.

Table 1. Cross-Country Comparison of Financial Sector (2006)

	Per Capita GDP (USD)	Savings Rate (%)	Financial Depth ^a
Argentina	5458.01	23.98	0.28
Brazil	5716.67	22.22	0.55
China	2001.46	50.65	1.54
India	796.83	32.00	0.67
Indonesia	1640.32	23.89	0.39
Korea, Rep.	18391.68	32.18	0.68
Malaysia	5718.43	35.79	1.23
Philippines	1344.58	30.53	0.52
Russian Federation	6856.08	31.87	0.33
Thailand	3136.46	29.41	1.01

^a Financial Depth is measured as the ratio of liquid liabilities of the financial system to GDP. Liquid liabilities consist of currency held outside the banking system plus the demand and interest-bearing liabilities of banks and non-bank financial intermediaries.

Source: World Development Indicators 2007, and CSO Statistics.

The Indian financial sector has proved to be an integral sector of the economy. In recent years it has witnessed a modest increase in its share in both value added and employment. While in value added the share has increased from 5.55% in 2000-01 to over 6.68% in 2006-07, in terms of employment in the organized sector the share has gone up to 7.30% in 2004-05 from 5.94% in 2000-01. The strength of the financial sector can also be gauged from the fact that despite more than 15 years of liberalization and opening up to external forces, the Indian financial system has not been affected by any serious crisis including the Asian Crisis of 1997.

Table 2. Contribution of the Financial Sector in India

	Value Added		Employment	
	Rs. Crores	% of Total	Lakhs	% of Total
99-00	105662	5.91	16.54	5.94
00-01	103571	5.55	16.51	5.94
01-02	113036	5.73	16.21	5.96
02-03	125845	6.15	18.03	6.68
03-04	128659	5.79	18.66	7.06
04-05	139940	5.86	19.31	7.30
05-06	159881	6.12		
06-07	191387	6.68		

Source: CSO Statistics

2.1 Indian Banking System¹

The Indian financial sector underwent significant changes over the past 15 years due to a large set of reforms that were undertaken during this period. The financial sector reforms formed the mainstay of the overall structural reforms that were undertaken in the early 1990s. The primary objective of these reforms was to enhance efficiency and productivity of the financial sector. Prior to these reforms, the Indian financial sector was primarily characterized as highly regulated and financially repressed. The banking sector was characterized by strong entry barriers, administered interest rates, high reserve requirements, low profitability and high levels of non-performing loans. Banks were widely perceived as an effective instrument to be utilized to assist India's planned development strategy by mobilizing financial resources and directing them towards strategically important sectors.

As a result of this mindset, a substantial number of large private sector banks were nationalized in 1969 and 1980. Once nationalized, these banks were directed to open a major share of new branches in unbanked areas through strict branch licensing policies, extend a large share of their credit to the priority sector, charge a regulated interest rate on these loans, etc. The objective was to mobilize deposits on an extensive scale across the country as well as expand banking facilities to achieve regional balance. Apart from this, the RBI prescribed that 40% of the net bank credit should go to the priority sector, consisting mainly of agriculture, specified small-scale industries and weaker sections of society at concessional interest rates. Thus, the perceived need of the borrower was given preference over commercial considerations and scarce resources were directed to them, ignoring the commercial viability and profitability of the venture.

Table 3. Reserve Requirements for Banks, 1950-1991

Year	Cash Reserve Ratio*		Statutory Liquidity Ratio**	
	Range of Rates	No. of Times Changed	Range of Rates	No. of Times Changed
1950-60	5.0 and 2.0 ⁺	1	20.0	0
1960-70	3.0	3	25.0-26.0	2
1970-80	4.5-6.0	11	27.0-34.0	7
1980-90	6.50 – 15.0 [@]	23	34.5-38.0	8
1990-91	15.00 [@]	0	38.50	1
1991-92	15.00 [@]	1	38.50 ^a	1

Note: The data for CRR are as a percentage of NDTL while the data for SLR are as a percentage of DTL.

⁺ Separate rates for demand and time liabilities, respectively.

[@] Excludes 10% additional reserve requirements of CRR on incremental NDTL.

^a In addition, 30% SLR on the increase in NDTL over April 3, 1992 level.

Source: Handbook of Statistics on Indian Economy, Reserve Bank of India.

¹ For an excellent review on the background of the Indian banking sector, please see Chanda (2005) and Joseph and Nitsure (2005).

While credit was available to the priority sector at concessional rates, minimum lending rates were prescribed for the commercial sector. Both lending and deposit rates were determined by the RBI, while coupon rates on government securities, interest rates on public sector bonds, provident funds and postal savings were administered by the Central Government. The rate at which the RBI lends to commercial banks was rarely used as a tool of monetary policy and remained unchanged from July 1981 to July 1991.

The banks also acted as a captive source of funds for the government as they were directed to hold a sizeable portion of their funds in the form of government bonds. Extremely high levels of preemptions of primary and secondary reserve requirements in the form of Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR) were introduced.² The CRR, which stood at 4.0% of net demand and time liabilities (NDTL) in 1974, was steadily increased to 15% in May 1991. Meanwhile the SLR was raised from 33% of NDTL in 1974 to 38.5% in September 1990. In the 1980s and up to 1991-92 there was a 10% additional reserve requirement of CRR on incremental NDTL. As can be seen from Table 3, in 1991 effective preemptions on incremental deposits through these two instruments were a staggering 63.5%.

2.2 Reform of the Indian Banking Sector

The blueprint for the first generation reform of the Indian financial sector was guided by the recommendations of the Narasimham Committee in 1991. Beginning in 1993, regulatory constraints on bank funds were removed through a series of measures, which gave banks greater flexibility in managing their fund portfolio. Reserve requirements were cut from more than 60% to less than 30%; the CRR was lowered to 4.75% with the stated medium-term objective of bringing it down to the statutory minimum of 3% and to amend the law to allow the RBI to reduce it below this minimum, if warranted; and the SLR ratio was brought down from an average effective rate of 37.5% in 1992 to the statutory minimum of 25% by 1997.³ As a result, bank lending witnessed a significant rise. The reform period also witnessed a concerted move towards interest rate deregulation with the structure of interest rates being progressively rationalized over the years. Currently, the rate on savings deposits is the only administered domestic deposit rate and stands at 3.5% a year. Lending rates have been gradually deregulated and each bank is required to announce a prime lending rate and its maximum spread. Banks are allowed to lend at rates below the prime lending rate with a few exceptions.⁴ While lending rates for exports and certain advances in foreign currencies are still stipulated, the interest rate on smaller advances (less than Rs. 200,000) can not exceed the prime lending rate.

² CRR is the share of total deposits that the banks have to necessarily park with the RBI; the RBI pays the bank interest on this amount. Currently the CRR stands at 9%. SLR is the share of total deposits that banks have to maintain in the form of cash, gold or approved securities. Currently the SLR stands at the statutory minimum of 25%.

³ As per recent amendments to the RBI Act, SLR can now be brought below 25% and CRR below 3%.

⁴ While agricultural loans are administered at 7%, loans to the small sector are administered at 4%.

Decades of financial repression had eroded the net worth of many scheduled commercial banks. During the reforms, the need to strengthen the banks was recognized and the government financed the nationalized banks with a view to augment their capital base. Between 1992-93 and 2001-02 the government contributed Rs. 177 billion, around 1.9% of 1995-96 GDP, to augment the capital base of the nationalized banks. Banks were also allowed to raise fresh equity to meet their capital requirements. Public sector banks were encouraged to raise Tier-II capital, without government guarantees, subject to certain limits linked to their capital fund. Banks have been allowed to raise fresh equity to meet the shortfall in capital requirements. As a result of these efforts the majority of the commercial banks in India were compliant with Basel I norms and seem to be in a good position to meet the stipulated deadlines for embracing Basel II norms. Apart from meeting capital adequacy norms, the banks were also encouraged to raise the standards of transparency to meet international standards. While prior to the Asian financial crisis the banks were reporting some major performance indicators like ratio of non-performing assets to net advances, gross and net value of investments, etc., since the crisis, the disclosures have indicated other indicators such as ratio of interest and non-interest income to working capital, maturity profile of loans and advances, investments, and movements in non-performing assets as well as lending to sensitive sectors.

As a result of these reform measures, there was a substantial improvement in the performance indicators of these banks. Table 4 lists some of the major performance indicators of the scheduled commercial banks between 1996-97 and 2006-07. In terms of business per employee and profit per employee, the nationalized banks and the State Bank of India (SBI) with its associates recorded the highest growth followed by Indian private sector banks and foreign banks. The high growth rate in the public sector banks is partly explained by the base effect as these banks scored relatively low on these indicators in 1996-97. However, by 2005-06 the public sector banks had almost caught up with the Indian private sector banks.

Table 4. Major Performance Indicators of Commercial Banks

	Foreign Banks		Pvt. Sector Banks		Nationalized Banks		SBI & Associates	
	96-97	06-07	96-97	06-07	96-97	06-07	96-97	06-07
Business per Employee (Rs lakhs)	474.02	996.08	210.43	697.75	72.91	490.21	66.25	435.52
Capital Risk-weighted Assets Ratio (%)	62.58	12.00	12.47	12.10	8.67	12.50	10.44	12.30
Net NPA as percent to Net Advances	3.69	0.80	5.24	1.00	10.41	1.00	8.71	1.10
Profit per Employee (Rs lakhs)	9.68	16.46	2.47	4.69	0.47	2.87	0.44	2.56
Return on Assets (%)	1.10	2.27	1.49	1.03	0.58	0.94	0.76	0.86

Source: Reserve Bank of India, A Profile of Banks, 2007.

In India, the predominance of core deposits contributes to systemic stability, which can be seen from the fact that at end-March 2007, deposits constituted 77.9% of total liabilities. This is significantly higher than several OECD countries, where banks rely considerably more on market borrowing. Such a high ratio indicates the general confidence in the banking sector. Moreover, in India, banks' exposure to sensitive sectors like capital markets, real estates and commodities is relatively low. While the commodities sector and real estate account for around 1% each, the capital market accounts for less than 0.5% of total loans. Moreover, public sector banks and Indian private sector banks still continue to limit themselves in their off-balance sheet exposure. More than 60% of these exposures are concentrated in foreign banks, particularly in foreign exchange contracts.

Despite these strengths, there are still several inherent weaknesses in the Indian banking sector. Some of these weaknesses are listed below.⁵

1. **Overwhelming Reliance on Government Securities.** The heavy investment in government securities is largely explained by the existing preemptive requirements in the form of CRR and SLR requirements. However, the fact that scheduled commercial banks were holding as much as 28% of NDTL as opposed to the statutory requirement of 25% indicates that there is a dearth of quality credit demand. Moreover, since these government securities carry zero risk they bolster the capital adequacy ratios of the banks.
2. **Non-Performing Loans.** Though the volume of non-performing loans (NPL) has decreased in recent years, it still continues to be an issue of major concern. At the end of March 2006, the volume of NPLs of the total banking sector was Rs. 1186 billion or nearly 3% of the GDP. Of these NPLs, commercial banks accounted for 42.6%, regional rural banks for 5.7%, and cooperative banks for 51.7%. The ratio of NPLs to total loans was 5.1% for the entire banking sector. Of this, the ratio was highest for the cooperative banks at 21.9%, followed by regional rural banks at 13.9% and commercial banks at 2.5%.

There are significant differences across bank groups in terms of their NPL holdings. For commercial banks, the ratio of gross NPLs to total loans fell from 25% in 1994 to 2.5% by end-March 2007. This decline in NPL ratios reflects stronger efforts by banks to follow up on NPLs. The enactment of the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002 also allowed previously noncompliant debtors to come to the table for negotiations.

3. **Low Loss Provisioning Ratio.** Loan loss provision or provisioning refers to an expense set aside as an allowance for bad loans (customer defaults, or terms of a

⁵ For an in-depth analysis of the weaknesses in the Indian banking system, the reader is directed towards Basu (2005).

loan have to be re-negotiated, etc) and reflects the ability of a bank to withstand losses in asset values. Globally, banks exhibit wide variations in the provisioning to NPL ratio from less than 10% to more than 200%. India's loss provisioning ratio is lower than a number of developing countries like Argentina, Brazil, Mexico, and Singapore. Among major developing economies, Malaysia and Philippines have lower ratios than India.

As a result of these weaknesses in the banking sector, careful thought needs to be given to further liberalization of the sector at a bilateral or a multilateral level. Several precedents in history (like the United States in the early 1980s) point to the occurrence of a systematic banking crisis after the financial sector has been deregulated.

As shown by the Asian crisis, financial sector liberalization has to be accompanied by improvements in supervisory rules and regulations. One of the key reasons behind the financial crisis of 1997 was the inability of the prudential rules on foreign currency exposures to limit excessive foreign open positions as banks became more exposed to foreign capital. Moreover, the East Asian banks were also impacted by maturity mismatch with the balance sheets reflecting short-term assets and long-term liabilities.

There are some important areas where reforms have to be carried out to strengthen the Indian financial sector before allowing further deregulation of the sector. These include strengthening the supervisory, regulatory and legal frameworks. These are discussed in greater detail in Section 8.

2.3 The Indian Insurance Industry

The Indian insurance industry for a long time was dominated by public sector players, viz., Life Insurance Corporation (LIC) and General Insurance Corporation (GIC). LIC was formed in 1956 by nationalizing 256 domestic and foreign players operating in India. Over the next 40 years, LIC, which operates in the life segment, significantly increased in presence across the country by building an extensive network of branches and offices offering employment to a large number of agents. The non-life insurance sector was overwhelmingly dominated by GIC along with its subsidiaries, which were formed with the nationalization and amalgamation of over 100 domestic and foreign insurance companies under the General Insurance Business Nationalization Act of 1972.⁶

One of the major reasons behind the nationalization of the insurance companies in the 20th century was to channel greater resources towards development programs. It also sought to increase insurance market penetration and reduce the incidence of failures of insurance companies, which were thought to be a result of mismanagement. However, in the post-nationalization period, GIC and LIC funds were largely used to finance the

⁶ The four subsidiary companies were National Insurance Company Limited, New India Assurance Company Limited, Oriental Insurance Company Limited, and United India Insurance Company Limited.

government deficit and this severely constrained their operations. Moreover, these corporations were also asked to channel funds towards meeting social objectives.

With the initiation of the reforms in the financial sector in the early 1990s, the need to restructure the insurance sector was also realized. Consequently, the Malhotra Committee was formed to evaluate the Indian insurance industry and recommend its future direction. The committee submitted its report in 1994 and some of the key recommendations of the committee included:

- Reduction of government stake-holding in the insurance companies to 50%.
- Allowing private companies with a minimum paid-up capital of Rs.1 billion to enter the sector. However, no company should be allowed to operate in both Life and General Insurance through a single entity.
- Foreign companies to be allowed to enter the industry in collaboration with domestic companies.
- Postal Life Insurance should be allowed to operate in the rural market.
- Reduction in the mandatory investment of LIC Life Fund in government securities from 75% to 50%.
- GIC and its subsidiaries should not hold more than 5% in any company.
- Improvement in customer service quality. LIC should pay interest on delays in payments beyond 30 days.
- Modernization of insurance companies through computerization and implementation of updated technology. Insurance companies should provide new financial instruments like unit-linked pension plans.

While the Malhotra Committee emphasized the introduction of competition from domestic private and foreign players to improve customer services and increase the coverage of insurance policies, it was also aware of the need for exercising caution as any failure on the part of new players could ruin public confidence in the industry. Hence, it was decided to allow competition in a limited way by stipulating a minimum capital requirement of Rs.100 crore. To ensure greater autonomy to insurance companies in order to improve their performance and enable them to act as independent companies with economic motives, it proposed setting up an independent regulatory body – the Insurance Regulatory and Development Authority (IRDA).

In 1999 the Insurance Regulatory and Development Authority Bill was passed, ushering in a wide range of changes in the insurance sector. The bill provided for:

- The establishment of IRDA as a corporate body to regulate insurance.
- The establishment of an insurance advisory committee with not more than 25 members.
- The entry of private companies.
- The minimum capital requirement for life and general insurance to be retained at Rs 100 crore and for re-insurance firms at Rs 200 crore.
- Solvency margins of Rs. 50 crore (US\$11.51 million) for life and general insurance and Rs. 100 crore (US\$23.02 million) for re-insurance companies.

- 26% cap on foreign equity, including foreign institutional investors. Indian promoters are also required to bring down their equity holding to 26% after a period of 10 years from the commencement of business.
- Obligations of insurer in respect of rural and unorganized sector and backward classes, and penalty for failure to comply with the provisions.
- Specifying percentage of life insurance business and general insurance business to be undertaken by the insurer in the rural or social sector.

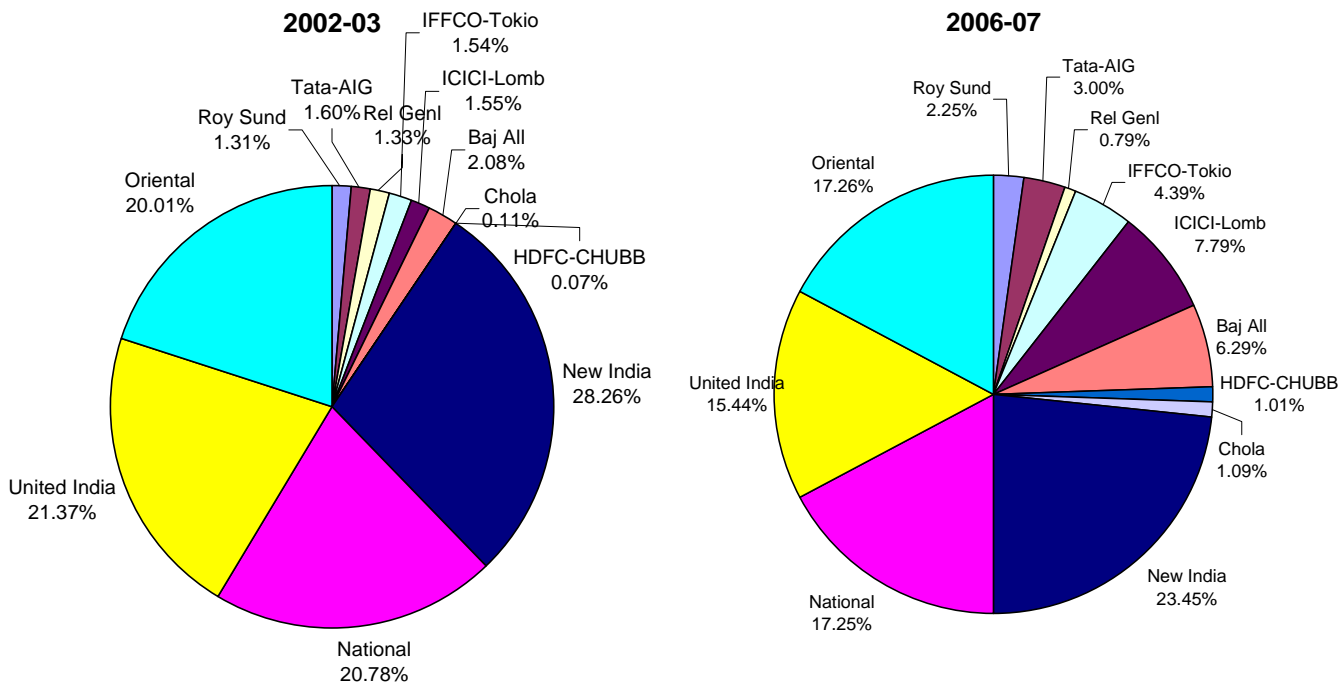
The liberalization of the insurance sector in 2000 opened the sector to greater private participation from domestic as well as foreign players. In 2000, 10 private players – six in life insurance and four in general insurance – entered the market. The numbers have swelled to 29 private players with 16 in life insurance and 13 in general insurance. Apart from this, public sector participation is made up of Life Insurance Corporation in the life segment and National Insurance Company Limited, New India Assurance Company Limited, Oriental Insurance Company Limited, and United India Insurance Company Limited in the non-life segment.

Liberalization has also been associated with rapid expansion of the insurance sector. In the life segment, gross insurance premiums have increased from less than Rs. 35,000 crore in 2000-01 to well over 106,000 crore in 2005-06. First-year premiums in the life segment increased from Rs. 12,000 crore in 2002-03 to nearly Rs. 40,000 crore in 2006-07. The non-life segment is much smaller but has still witnessed impressive growth in the past five years. Gross premium in this sector increased from Rs. 14,000 crore in 2002-03 to over Rs. 25,000 crore in 2006-07, growing by almost 20% every year.

A decomposition of this growth story shows that the private sector has grown at a much faster rate than the public sector and the increase in the share of the former has come at the expense of the latter. In 2002-03, LIC was responsible for nearly 93% of first-year premiums. However, it witnessed a strong decline in its monopoly over the next four years and by 2006-07, LIC accounted for only 76% of Rs. 40,000 crore earned as first-year premiums. The loss in the share of the public sector undertaking was the result of several private sector companies like Bajaj Allianz, SBI Life and ICICI Prudential increasing their share several fold, as well as the entry of a number of new players like Shriram Life, Sahara Life and Reliance Life in the life segment.

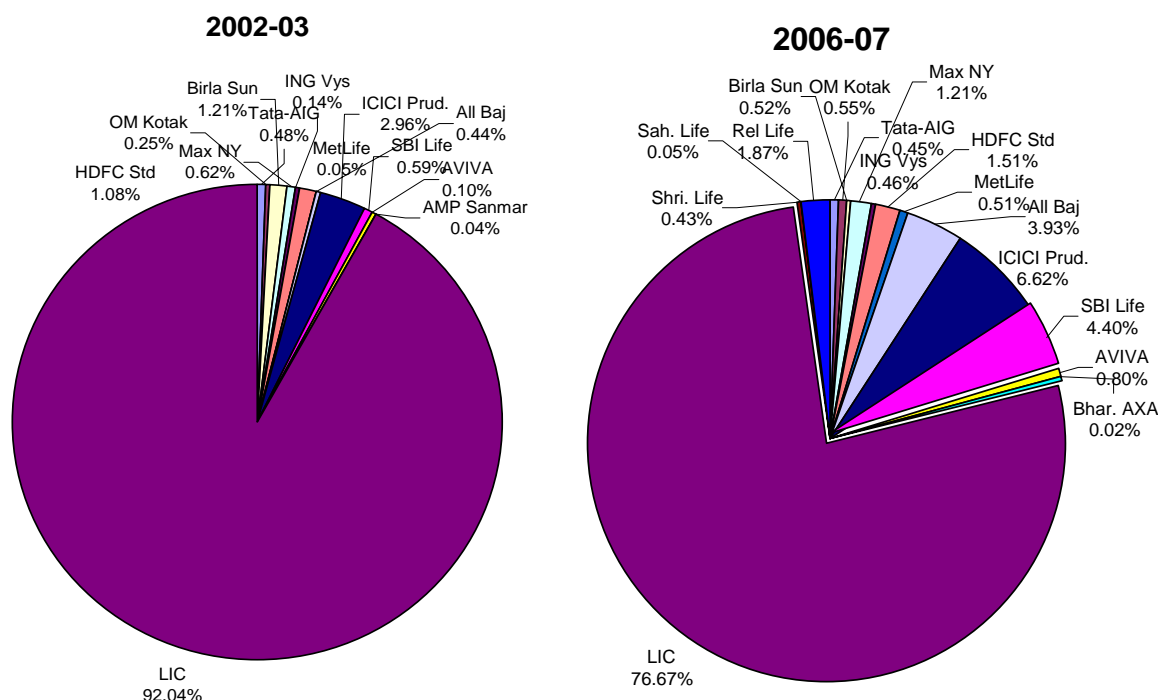
A similar trend was observed in the non-life insurance segment. According to Figure 1, in 2002-03, the four public sector companies cornered more than 90% of the total market. However, by 2006-07, their share fell to below 75%. Again this was accomplished by the rapid growth of several private sector companies. The fastest-growing private sector companies in this segment included Bajaj Allianz, ICICI Lombard and IFFCO-TOKIO. Among the public sector companies, while New India Assurance continued to remain the market leader, its share declined from 28.26% in 2002-03 to 23.45% in 2006-07.

Figure 1. Composition of the Non-Life Insurance Segment in India



Source: IRDA journal, various issues

Figure 2 Composition of the Life Insurance Segment in India



Source: IRDA journal, various issues

3 Financial Services in the European Union

The size of the financial sector in the European Union is one of the biggest in the world at par with that in the United States. However, the financial sector as a proportion of GDP accounts for a greater share in the United States compared to the European Union, although in the latter the sector witnessed more rapid growth. Financial services account for 2.8% of EU employment and 4.5% of US employment. Interestingly there has been a steady decline in the share of the workforce engaged in these services in recent years.

Table 5. Contribution of Financial Sector in EU and USA

Year	European Union				USA			
	Value Added		Employment		Value Added		Employment	
	Billion €	% Share	000s	% Share	Billion \$	% Share	000s	% Share
2000	423.8	4.8	5596	2.83	740.5	7.5	5710	4.4
2001	434.4	4.8	5638	2.82	782.6	7.7	5670	4.37
2002	474.9	5.1	5624	2.80	822.7	7.9	5707	4.45
2003	534.7	5.6	5600	2.80	864.6	7.9	5809	4.55
2004	588.6	6.0	5622	2.79	907.9	7.8	5841	4.52
2005	608.4	6.1	5658	2.79	982.5	7.9	5940	4.51

Note: Value added refers to gross output at current basic prices (in millions of PPP-converted Euros)

Source: EU KLEMS Database

Given the wide range of economic and social disparity among the European Union member states, there is also a wide difference in the structures of the financial systems in these states. At the broadest level, financial superstructure can be differentiated as being of two basic types: bank-based and market-based. In a country where bank-based financial structure gains dominance, the banks play a major intermediary role. These include primarily collecting deposits and providing credit to the corporate sector. In collecting deposits, banks rely on household savings. In these countries the general public exhibits a low willingness to take risks and they mostly prefer bank deposits to various securities. On the asset side, corporate loans form the biggest part as the funds acquired from the banks are almost exclusive and in most cases the primary source of attracting external funds. This type of system is more prevalent in the European Union with major countries like France and Germany having a bank-based financial structure.

The United Kingdom and to an extent the Netherlands are primarily characterized by the market-based system. These economies have a highly-developed securities market and businesses give preference to corporate bonds or equity issues in the face of funds acquired from banks. Moreover, in these economies households are more willing to undertake risks and hold their savings in the form of risky market assets whose returns may not be certain. A small part of household savings appears on the market directly, whereas the larger part appears through institutional investors. Accordingly, the dominance of these institutions compared to banks is detectable on the market.

Moreover, with the historical expansion of the EU in 2004 with the entry of 10 new members, the diversity in the structure of the financial sector among EU member countries has only increased. However, the European Union has focused on the objective of an integrated financial sector for over 10 years now. An integrated financial sector or a Single Market would imply that financial institutions authorized to provide financial services in one Member State would be able to provide the same services throughout the EU. It would also imply a competing level playing field for financial institutions of other EU member states within a consistent regulatory environment. Such a Single Market in financial services is likely to prove to be a catalyst for economic growth across all sectors of the economy, boost productivity and provide lower cost and better quality financial products for consumers and enterprises, in particular Small and Medium Enterprises (SMEs).

3.1 Banking Sector in the European Union

The banking sector has continued to grow at a positive rate in the European Union with total assets of the credit institutions being valued at €36,820 billion in 2006, up by 11.9% compared with the previous year, and €24,685 billion in 2001. However, these assets were not distributed uniformly and the bulk of it was concentrated in a few countries. Member states, which cornered a significant proportion of these assets, include the UK (26.21%), Germany (19.34%), France (15.56%), Spain (6.83%) and Italy (7.59%). There were nearly 8,500 credit institutions operating across the European Union in 2006, of

which nearly one-fourth were located in Germany followed by France (9.82%), Austria (9.58%), Italy (9.56%) and Poland (8.57%).

On the other hand, the number of people employed in the various credit institutions has declined marginally in recent years from 3,146,000 in 2002 to 3,050,000 in 2006 with most of the employment being concentrated in Germany (22.70%), the UK (14.85%), France (14.28%) and Italy (11.14%).

One of the key trends in the banking sector in recent years has been a large spate of consolidations through mergers and acquisitions (M&As). The number of credit institutions declined from 9,363 in 2001 to 8,441 in 2006. During the same period in the Euro area (countries using Euro as their currency), the number of credit institutions witnessed a decline from 7,213 to 6,130, with the Netherlands, Germany and France being the main drivers of this trend.

This trend of increased concentration in the banking sector has been on an upswing since 2001 and a break in this trend was observed only in 2006 when concentration remained at the same level as the previous year. More specifically, the EU 25 weighted average share of the five largest institutions in terms of total assets (the CR5) stood at 42% with the Euro area appearing slightly more concentrated at 43%. Concentration levels remained comparatively high in the majority of the smaller Member States. Countries that reported a lower concentration than the EU 25 weighted average were Germany, Italy, Luxembourg, the United Kingdom and Spain. In contrast, concentration in the newer member states of the European Union declined between 2001 and 2006. In 2006 the share of the five largest institutions stood at 59%, compared with 60% for the previous year. Nonetheless, the banking sector in the majority of these countries is more concentrated than in other EU Member States.

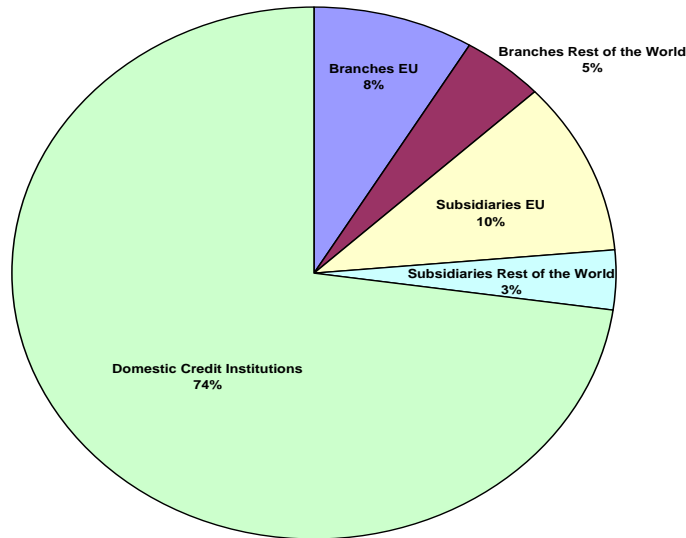
The M&A activity in the EU has been characterized by two distinct trends. Over the years while the number of M&A transactions has declined, the value of these transactions has been increasing. This was also observed in 2006, with the value of M&A transactions increasing as a result of large domestic deals such as Banca Intesa and San Paolo IMI, and Natexis and Ixis. The trend towards a declining number and increasing value of M&A transactions is likely to continue in 2007, signaling an increase in the average transaction value. Currently, two such transactions with a potential significant impact for the EU banking sector are in the pipeline, namely the merger of Unicredit and Capitalia, and the acquisition of ABN Amro.

The European Union banking sector is mainly dominated by domestic institutions with a market share of approximately 73% in 2006, down marginally from 73.4% in 2005.⁷ While other Member States' institutions accounted for 19%, extra-EU institutions have a share of only 8.2% of EU 25 total assets. However, the picture varies greatly across the Member countries. In the 10 Member states that joined the EU in 2005, institutions with the parent company in the EU controlled nearly 61% of the market share while extra-EU

⁷ Here domestic institution refers to host country institutions while foreign institutions refer to those from other EU member states as well as outside the European Union

institutions' share was around 6.8%. In contrast, foreign entities (including companies with their headquarters in the EU) held only 17.9% of total assets in the Euro area countries. However, even among these countries there were considerable differences, with France and Luxembourg representing the two extremes, having foreign entities that accounted for 11% and 95% of total assets, respectively.

Figure 3. Share of Foreign Banks and Subsidiaries in the EU by Total Assets in EU, 2006



Source: ECB (2007).

Across EU 25, foreign establishment of banks were in the form of subsidiaries and branches. Figure 3 indicates the decomposition of foreign branches and subsidiaries of credit institutions in the EU in 2006. At the overall EU level, foreign branches held 13.2% of total assets, while foreign subsidiaries controlled 14% of the assets. However, the picture looks very different if we focus on the 19 countries that joined the EU in 2005. Here subsidiaries have an overwhelming presence with foreign subsidiaries controlling 61.2% of total assets, of which 56.4% was owned by an institution that had an EU parent. In contrast only 6.5% of the total assets were controlled by foreign branches.

The presence of foreign bank branches and subsidiaries varies widely across the different member states. In 2006, there were 641 branches of intra-EU credit institutions and 202 branches from the rest of the world. While branches from other EU member states were spread evenly across a number of countries like the UK, Germany, France, Italy etc. branches of extra-EU countries were largely concentrated in the UK, which accounted for more than 44% of such branches. On the other hand there were 499 foreign subsidiaries from other EU member countries and 255 from the rest of the world. Germany (20.04%), Luxembourg (15.03%) and Spain (8.22%) accounted for the bulk of intra-EU subsidiaries. The United Kingdom was again the most favored destination for extra-EU

foreign subsidiaries with more than 27% of subsidiaries from the rest of the world being set up there. This was followed by France (20.78%), Germany (7.45%) and the Netherlands (6.27%).

The United Kingdom also showed an overwhelming dominance in terms of the assets of these extra-EU foreign branches and subsidiaries. While the UK accounted for 66.28% of the total assets of extra-EU subsidiaries, its share in the assets of extra-EU branches was close to 94%. However, an overall analysis of the presence of foreign credit institutions in EU shows that by and large the EU is more closed than India. While in India foreign bank branches account for nearly 0.50% of the total branches, in the EU the ratio is less than 0.10%. As shown in Table A2, there are significant divergences across the EU member states. Among the major players, the United Kingdom is the most liberal country with foreign credit institutions having a share in excess of 0.70%. On the other hand in Germany, Italy and Spain, they account for less than 0.05% of the share.

Apart from branches and subsidiaries, trade in financial services is also increasingly taking place through cross-border provision of financial services. According to the ECB (2007), cross-border holdings of non-bank securities and inter-bank loans were significant in 2006, and continued to increase despite showing signs of stagnation. In contrast, cross-border holdings of non-bank shares and especially cross-border loans have remained low. On the liabilities side, cross-border inter-bank deposits constitute an important means of funding for credit institutions and overall have been increasing over time, while cross-border non-bank deposits have stagnated at a low level.

Finally, any negotiations in the banking services must be undertaken keeping in mind the size and the structure of the banking services market in India and the European Union. Looking at some of the major banking indicators it is evident that the EU market as a whole is more saturated than the Indian financial markets. On average, EU 25 has 0.460 branches per thousand people; this is nearly 10 times more than India where there are 0.051 branches per thousand people. However, there is wide variation across some of the major members of the European Union. In terms of branch density among the major members, Spain ranks the highest with nearly one branch per thousand people, closely followed by France, Italy, Austria and Germany. On the other hand, the United Kingdom and the Netherlands are the only major players that have a relatively low branch density. The strength and the size of the financial sector in the various EU members can be gauged from the asset to GDP ratio. It is evident that India has an extremely low asset to GDP ratio compared to almost all the EU member countries (only Romania has a lower asset to GDP ratio).

Table 6. Banking Sector Indicators in India and the EU

	Average Annual GDP Growth Rate (2002-07)	Branch per 1000 population	Asset-GDP Ratio	Number of Loans per 1000 People	Average Loan Size/GDP Per Capita	Number of Deposits per 1000 People	Average Deposit Size/GDP per Capita
Austria	2.17	0.517	309.45	647.64	1.84	3120	0.26

Belgium	2.03	0.439	377.00	59.47	21.09	3080	0.38
Bulgaria	5.73	0.726	88.85	73.85	4.24	1351	0.26
Cyprus	3.25	1.249	539.92				
Czech Republic	4.77	0.184	109.94	.	.	1923	0.42
Denmark	1.92	0.398	392.03	450.99	2.09	2706	0.22
Estonia	8.82	0.187	129.27				
Finland	3.22	0.308	160.82				
France	1.7	0.634	327.00	.	.	1801	0.40
Germany	1.15	0.490	314.05				
Greece	4.23	0.335	177.67	776.48	0.83	2418	0.29
Hungary	3.93	0.322	105.65				
Ireland	5.2	0.227	745.01				
Italy	0.87	0.553	201.03	328.15	2.35	976	0.47
Latvia	9.23	0.268	148.90				
Lithuania	7.93	0.263	73.05	58.86	3.65	1166	0.21
Luxembourg	4.05	0.597	2936.64				
Malta	2.03	0.276	599.61	407.21	6.24	2496	1.22
Netherlands	1.62	0.213	363.34				
Poland	4.48	0.136	71.81	773.87	0.33	.	.
Portugal	0.87	0.532	271.42				
Romania	6.15	0.207	55.62	.	.	1208	0.25
Slovakia	6.13	0.219	109.23				
Slovenia	4.35	0.348	117.27				
Spain	3.38	0.993	277.04	556.48	1.91	2076	0.44
Sweden	3.08	0.223	274.64				
United Kingdom	2.65	0.216	697.59				
EU25	2.3	0.460	364.54				
India	7.82	0.051	70.38	75	5.53	310	2.04

Source: EU Banking Structure (2007), Reserve Bank of India (2007) and Leeladhar (2005).

In terms of number of deposits per thousand people, India is behind most of the major EU countries. Thus with high branch density, high asset to GDP ratio, and large numbers of loan and deposit accounts, there seems to be relatively limited opportunity for Indian banks to expand operations in the EU.

The unsaturated banking market in India can be seen from the number of deposit and loan accounts in India. At 0.31 deposit accounts per capita, India is far behind than most of the major EU countries. While in Austria and Belgium an individual has more than 3 accounts on average, in Spain, Denmark and Greece there are more than 2 deposit accounts for every individual. On the other hand, the relatively high average deposit to per capita GDP ratio is an indication of the Indian proclivity towards savings. The gross domestic saving rate in India steadied around 34% in 2006. On average, between 2003-04 and 2006-07 India enjoyed a private savings rate of 30.4%. Out of this, household savings constituted 23.8%, while the rest was made up of private corporate savings. Within household savings more than half is made up of physical assets, part of which is primarily held because of lack of access to adequate banking intermediaries.

Given the high saving propensity of the Indian public, limited access to banking intermediaries and a swelling middle class on the back of strong growth during the last five years, there is a tremendous unfulfilled demand for banking services.

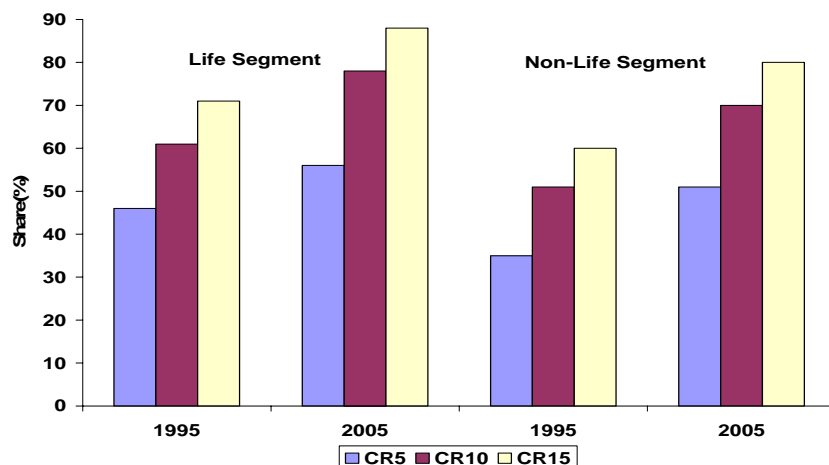
3.2 *Insurance Sector in the European Union*

Insurance activity in Europe is carried out by nearly 5,300 companies. In recent years there has been a steady decline in the number of companies operating in the insurance sector owing to intense merger and acquisition activities. With the creation of the European single market at the end of the 20th century, insurance companies entered a phase of intense merger and acquisition activities at national and European levels in order to reach a critical size that would allow them to act at the European level. The breakdown of M&A activity across countries is very similar indicating that the M&A phenomenon is taking place all over Europe.

The rising concentration in the insurance sector is driven by the change in capital analysis and by the intense use of business models that allow better allocation of capital. The Solvency II exercise, which gave value to diversification, allowed larger groups to reduce their capital. Moreover, the restoration of insurers' solvency margins since the financial crisis of 2001-2003 has raised their level of capital above the minimum required and enabled them to pursue the merger/acquisition process which was at stake in 1999 and 2000.

However, the structure of the market is quite heterogeneous. On one hand a small number of groups hold a large part of the market share, while on the other hand a larger number of small and medium firms account for a very low market share of the insurance business. The number of small companies is mainly noticeable in non-life activities where we observe more monoliners and companies that specialize in specific business lines. According to Committee of European Insurance and Occupational Pensions (CEIOPS) data, about 4500 companies have a premium income below €10 million, most of them being active in life and 30% being mutual companies.

Figure 4. Concentration Ratios in EU Insurance Sector



Source: ECB (2007).

The concentration ratio measure, which looks at the share of the largest groups in the insurance sector, indicates a substantial increase in concentration between 1995 and 2005 driven by the M&A process. In the life segment, the average CR5 (share of the five largest companies) of the European countries increased from 46% in 1995 to 56% in 2005. During the same period CR15 increased from 72% to 88%. The non-life segment is slightly less concentrated than the life segment and CR5 in 2005 was 53% compared to 35% in 1995. A major difference between the life and the non-life segment is the broader scope of products offered by the non-life insurers, which allows for more monoliners and specialized insurers.

However, at the national level there are some differences. The eastern European countries witnessed a decline in CR5 for both life and non-life due to liberalization of these markets, which opened these markets to national and European competitors. The major markets like Germany, Spain, UK and France are also relatively less concentrated, with CR5 of 40%-55%. It is the relatively smaller economies like the Scandinavian and Baltic countries that have a very high concentration ratio with CR5 in excess of 85%.

Overall, the European insurance market witnessed healthy growth over the last 12 years with total premium income more than doubling from €425 billion in 1994 to €1065 billion in 2006. While the life business has grown to €659.3 billion, non-life business reached €405.9 billion in 2006. European insurance increased its level of investment in the economy to close at €7 trillion in 2006. However, in recent years the sector has been characterized by some degree of stagnation especially in the more saturated Western markets.

Most of the growth in insurance premiums in the life segment has been observed in the Eastern European countries (26%), while the western countries recorded a modest growth of 4.3%. A country-wise breakup of the growth rate shows that life premium in Latvia,

Lithuania, Poland and Hungary grew at an average annual rate of 26%, while France, Greece, Luxembourg and Denmark grew at an impressive rate of more than 10%. Some of the countries which witnessed negative growth rate in recent years include Portugal, Austria, Estonia and Belgium.

In the non-life segment, premiums grew by 53% in 2006 compared to only 1.3% in 2005. However, the growth rate has been artificially boosted this year by the privatization of the health aspects of social security in the Netherlands. When this is excluded, the growth rate plummets to 1%. The slowdown in recent years reflects strong competition among the insurers. Such competition has reduced the price of several classes of insurance like motor, which recorded a decrease in its price at the European level. Again the development in the non-life segment is not uniform across the member states. Eastern European countries like Latvia, Estonia, Romania, and Slovenia witnessed significantly higher growth rates than the more saturated Western markets.

Moreover, there were significant differences in the performance of the various constituents of the non-life segment. The largest class of non-life business, motor insurance, recorded a negative growth of 1% with €129 billion worth of premium income in 2006. This decline was widespread across a number of Western countries like the United Kingdom (-1.6%), Germany (-5.4%), the Netherlands (-2%) and France (-1.7%). The negative growth rate witnessed in a large number of countries is primarily due to the high level of competition amongst insurers. This competition has given place to a wide range of premium reductions or advantages offered to the insured in order to attract more insured without greatly increasing the moral hazard and the risk of anti-selection.

In contrast, the health and accident segment witnessed a growth rate of over 20% in 2006. Again this was largely due to the privatization of the health sector in the Netherlands. When this “Dutch effect” is removed, the growth rate was a moderate 2.8% in 2006, down from 4.5% in 2005. This slowdown in the health insurance market has been observed for the third consecutive year in Europe and parallels the decline in growth of total health expenditure and in benefits paid out by insurers.

Property insurance premium also grew by only 1.4% to reach a total of €82 billion. The slow growth was attributed to a strong increase in price of new construction and a general increase in the price of housing.

Thus overall, the insurance sector in Europe has been growing at a relatively slow rate during the past three years. Most of this sluggish growth is due to the performance of the more developed Western countries, where intense competition and a saturated market have slowed the pace of insurance sector growth.

3.2 Integration of Financial Services in European Union

Europe has made significant progress in integrating its financial markets. The objective of the Treaty of Rome (1957) was to create a common market where goods, services,

people, and capital could move freely. Consequently, efforts were made towards the creation of a single financial market, characterized by a free flow of capital and the free provision of financial services across borders. The success or failure of such efforts is of tremendous interest to external countries like India that are looking at avenues to increase export of financial services in the EU. A harmonized financial sector in the EU implies that an Indian company setting up operation in one of the EU countries would find it easier to access the market of other EU countries through cross-border supply of services.

Concerted efforts towards greater integration of the financial sector over the last quarter of a century have yielded several positive results, like open capital accounts and a “single passport”, implying that any bank licensed in an EU country is free to open branches in any other EU country.⁸ Nonetheless, Europe is still a long way from achieving a single financial market. Cross-border provision of financial services is still difficult. The most fundamental reason is that financial products are essentially legally binding contracts that reflect the legal system under which they are executed, and these systems differ deeply across countries. While some relevant legislation is specific, the functioning of financial systems typically is affected by broad areas of law that depend, in turn, on the legal fundamentals of a country, including its constitution. Not only do laws and constitutions differ across countries, but basic legal principles and judicial approaches reflect different traditions.

The Cockfield White Paper (1985) identified the opening up of the financial services market, like banking, mortgage lending and insurance, as an essential element of the Single Market Programme. However, not much progress in this area was made till the late 1980s. In the late 1980s Directives on credit institutions, funds, solvency ratios and the provision of financial services – including the Second Banking Directive of 1989—were introduced. Harmonization of insurance services was put on the backburner at that time.

In the past 10 years, the Commission has shown greater activism in the area of financial services integration. Two major developments in this area were the launching of the Financial Services Action Plan (FSAP) in 1999 that was endorsed at the Lisbon summit (March 2000), and the development of the Lamfalussy Process. Finally, in 2005 the European Commission came out with a White Paper on Financial Services Policy that is aimed at building and completing FSAP’s achievements.

3.2.1 Financial Services Action Plan

The Cardiff European Council in June 1998 invited the European Commission to table a framework for action to develop the Single Market in financial services. In May 1999, the Commission published a Communication that contained a Financial Services Action Plan, which was endorsed by the Lisbon European Council in March 2000. The FSAP relates to a Single Market across the EU as a whole and consists of a set of measures intended to fill gaps and remove remaining barriers so as to provide a legal and

⁸ It is subject only to the regulation and supervision of the country that had issued the license.

regulatory environment that supports the integration of EU financial markets. The original date by which these measures were to be put in place was 2005.

Although the broad objective of the FSAP was to complete the creation of the Single Market in financial services, some of the specific objectives of the Plan were:

- Creating a single wholesale market to provide investors and intermediaries with access to various markets from a single point of entry as well as to enable corporate issuers to raise finance on competitive terms on an EU-wide basis. A single market would also allow investment service providers to offer their services across borders without encountering unnecessary regulatory and legal barriers. It would also facilitate the establishment of a sound and well-integrated prudential framework for investment by fund managers.
- Ensuring an open and secure retail market that will give consumers the information and safeguards they need to participate in the single financial market. A harmonized retail market would also remove unjustified barriers to the cross-border provision of retail financial services and create the legal conditions for electronic commerce on a pan-European scale. This would enable consumers to make small-value cross-border payments without excessive charges.
- Finally, the FSAP also focused on creating state-of-the-art prudential rules and supervision.

Within FSAP, a large number of financial services were covered. Wholesale services like securities issuance and trading, securities settlement, accounts, and corporate restructuring were included along with retail services related to insurance, savings through pension funds and mutual funds, retail payments, electronic money, and money laundering. Apart from these services, other services were related to financial supervision, corporate insolvency, and cross-border savings.

The FSAP measures sometimes took the form of EC Regulations, which apply directly in all Member States. However, most of the measures took the form of EC Directives, which need to be transposed into the law of each Member State. Typically, Regulations and Directives are proposed by the Commission and adopted by ‘co-decision’, under which the Council of Ministers of the Member States and the European Parliament both need to consider, amend and agree on the final content of each legislative proposal. Both Regulations and Directives are published in the Official Journal, and come into force on a specified date. Member States are given a period (usually of 18 months) to implement Directives, by transposing the provisions into their national law. There are 42 original measures in the FSAP. While some are non-legislative, a few are regulations and there are almost 30 directives.⁹

⁹ The important directives affecting the Banking and Insurance Sector can be found in Table A2 in the Appendix. A detailed list of the directives along with their dates of implementation and transposition into law can be found at

http://ec.europa.eu/internal_market/finances/docs/actionplan/index/070124_annex_a_en.pdf

The various harmonization measures undertaken in the original 1999 Action Plan were given specific priority levels from 1 to 3. This move was necessitated due to the quantity of measures included in the FSAP that ran concurrently. Among the Priority 1 legislative proposals all but one had been adopted by the Commission by the time of the Mid-Term Review of the FSAP in April 2002. The exception was the Take-Over Bids Directive which had been completed by the deadline for completion of the FSAP in 2004.

Of the Priority 2 measures, only one measure had not been completed by the 2004 cut-off date, namely the Capital Requirements Directive. However, the work going on in parallel in the Basel committee meant that it would be premature to proceed with capital requirement legislation any earlier, as it may not have fit into the global framework. Those measures with Priority 3 status included the two remaining actions out of the 42 that had not been completed by the 2004 deadline, namely, proposed directives on cross-border mergers and cross-border transfer of seats. However, progress has been made in these areas. They were the focus of additional attention in the Commission Communication on Company Law and Corporate Governance published in May 2003 and this, combined with the negotiations on employee participation that led to the adoption after many years of the European Company Statute, meant that there was renewed impetus to adopt these proposals.

While substantial progress has been made in the integration of wholesale financial services, there are strong barriers to greater integration of the retail financial services. At the broadest level wholesale financial services refers to financial services that are primarily undertaken between financial institutions, while retail financial services refers to financial services that are transacted between an individual and an institution.

The success of the integration in wholesale financial services can be gauged from the fact that Government bonds are increasingly traded on a pan-European basis, supported by the emergence of electronic platforms (in particular, BrokerTec and EuroMTS). In addition, most government bond transactions can be cleared through a central counterparty, and settled in Euroclear or Clearstream. Moreover, along the yield curve for government bonds by EU issuers, there are only relatively small differentials, which reflect the market's perception of differences in liquidity and credit risk.

Where bonds are available only in their domestic depository, differences in systems and delivery deadlines mean that they cannot be used as cross-border collateral as quickly or easily. As a result, the repo market is not yet fully integrated across borders. Equity trading still takes place predominantly on national exchanges, partly because national listing rules for equities are complex and in some countries specifically require stocks to be traded on national exchanges. However, the role of national exchanges has been changing, with an increase in international listing and trading; mergers and alliances between exchanges and the emergence of electronic platforms with cross-border access as well as growth in remote membership. Finally, there is some evidence of an increase in investment across borders, using pan-European rather than national benchmarks, though a "home bias" remains.

However, in the case of retail financial services there are still several impediments to greater market integration. The retail financial services sector is still segmented largely along national lines. Some products that are authorized in one country (interest-bearing current accounts) cannot yet be provided in all the others. Moreover, the cost of local registration and compliance with regulatory or marketing requirements (as in the case of mutual funds) can be prohibitive.

Another major impediment is the difference between tax laws and regulations across the various member states. The existing tax laws in several member states continue to differentiate between local and foreign (other EU member states) products (as in the case of pension contributions across borders). Differences in cultural preferences also act as a strong impediment as many consumers prefer familiar domestic products that provide information in their own languages, as well as easy and direct access to the product provider. Several of the EU member states still follow an implicit policy of delaying foreign products until local firms can compete.

The retail financial sector of the various EU member states continues to be regulated by different sets of regulations. Although most Member States have adopted a mixed approach to regulation, a broad distinction can be drawn between those which have traditionally focused on the regulation of products and those which have tended to focus on the regulation of sales/providers. Finally the arrangements enabling consumers to obtain redress across borders are still at a very early stage of development.

3.2.2 The Lamfalussy Process

The Lamfalussy Process was devised to address challenges related to speed, quality and adaptability of regulatory and legislative decision-making and to harmonize implementation and supervisory practices of the Member States. Initially, the Lamfalussy Process was designed specifically for securities regulation. It was being increasingly felt that the increased role of various EU institutions as regulators of rapidly changing financial markets was conflicting with its slow decision-making process. The primary objective was to speed up the legislative process and deliver a uniform and better technical regulation and supervisory process. However, in November 2003 the Lamfalussy Process was extended to cover the banking and insurance sectors as well.

The Lamfalussy Process has become a major vehicle for the design and implementation of the FSAP. In the banking sector, major emphasis is given to the implementation of the directives and harmonization of the sector, whereas in insurance the Solvency II directive has been given prominence. The process is typically organized in four layers or levels

- Level 1. The core principles of legislation take the form of directives and regulations adopted by the European Council and European Parliament on the basis of proposals prepared by the European Commission.
- Level 2. Technical implementation of framework directives and regulations are done by the European Commission on the basis of recommendations made by

high-level regulatory committee in consultation with Level 3 committee and users and experts from industry.

- Level 3. Implementation of the EU legislation at the national level is undertaken by an expert committee comprised of national regulators and central banks. This committee issues guidelines and reviews national regulatory practice to support the implementation of the legislation.
- Level 4. Compliance with and enforcement of legislation by member countries is mainly the responsibility of the European Commission.

By end of 2006, most of the FSAP legislative work was completed and the focus shifted to implementation and harmonization. Thus in the coming months the work of Level 2 and Level 3 committees will assume great importance. The major project currently under preparation at Level 1 of the Lamfalussy structure is Solvency II in the insurance sector.¹⁰ The work on the Directive codifying existing insurance Directives has been progressing on schedule and the Commission tabled its proposal in July 2007.

At Level 2, the Commission completed work on the implementing measure for the Transparency Directive when it adopted Directive 2007/14/EC in March 2007. In February 2007, the Commission amended its regulation implementing the Prospectus Directive to include specific provisions in respect of issuers with a complex financial history. With regard to the issue of equivalency of third-country accounting standards applying both to the Prospectus and Transparency Directives, the Commission informally published the draft implementing Regulation to be adopted before the end of 2007 which establishes a definition of equivalence and a mechanism for the determination of the equivalence of third-country accounting standards.

The Level 3 Committees have made significant progress in some areas. In the banking sector, the Committee of European Banking Supervisors (CEBS) advanced in work on mediation and published in September 2007 a protocol on mediation mechanisms that aimed to facilitate and speed up the supervisory procedures set out in the Capital Requirements Directive (CRD). It also amended the Guidelines on Financial Reporting (FINREP). In the insurance sector, the Committee of European Insurance and Occupational Pensions (CEIOPS) continued to provide technical advice to the Commission in the framework of the Solvency II project and also contributed to assessing its economic impact by organizing rounds of Quantitative Impact Studies.

¹⁰ The solvency margin is the amount of regulatory capital an insurance undertaking is obliged to hold against unforeseen events. Solvency margin requirements have been in place since the 1970s and have been amended by the Solvency I Directives in 2002. Whereas the Solvency I Directives aimed at revising and updating the current EU solvency regime, the Solvency II project has a much wider scope. Solvency II undertakes a review of the current insurance Directives. It includes a review of the overall financial position of an insurance undertaking and is aimed at ensuring adequate policyholder protection in all EU Member States. It takes into account current developments in insurance, risk management, finance techniques, international financial reporting, prudential standards, etc. For more details, see http://ec.europa.eu/internal_market/insurance/solvency2/index_en.htm

Although the Lamfalussy process has helped to deliver the Financial Services Action Plan (FSAP) on time, and has contributed to improving the quality of legislation through improved consultation processes, it has not delivered on the expected improvement of the transposition of the directives into national laws. One reason for this is the excessively detailed principle-based financial services legislation, especially at Level 1. This has prevented Member States from converting these directives into laws. The Inter-institutional Monitoring Group in its recent review of the process recommended as a general principle that all rulemaking bodies within the Lamfalussy framework (adopting both binding and non-binding rules) commit to "regulatory self-restraint", which is consistent with the principles of better regulation.¹¹

Another obstacle towards faster transposition of these directives is the overtly tight timeframe for the implementation of Level 1 and Level 2 measures. The Inter-institutional Monitoring Group has recommended that the timeframe for the Level 1 and Level 2 measures as well as their effects on institutions, market participants and other users should be properly assessed by EU institutions before defining the deadlines for transposition and implementation.

3.2.3 *The White Paper*

The primary purpose of the European Commission's White Paper on Financial Services Policy is to build on and complete the FSAPs arrangements. The White Paper outlines the Commission's policy priorities for the period 2005-10. It primarily focuses on finalizing, consolidating and implementing past initiatives, promoting better regulation and increased transparency, and launching a few new initiatives. Some of the major initiatives are described below.

Retail Banking. To ensure greater harmonization of retail banking, three major retail initiatives are currently under way. The first relates to integration of the mortgage credit market, and research is ongoing on initiatives that are necessary and economically justified for greater integration. On consumer credit, a modified proposal for a Directive published on 10 October 2005 aimed at creating a genuine internal market for consumer credit and improving consumer protection. The most important proposal is related to a Payments Services Directive which is aimed at enhancing competition and clarifying rules for the rights and obligations of users and providers. This initiative will facilitate the creation of a Single European Payment Area (SEPA) by 2010.

Solvency II. The objective of the Solvency II project is to overhaul EC regulation and supervision in the insurance area. Risk-oriented calculations of the solvency requirements for insurance undertakings will be introduced. Calculation of insurance liabilities (technical provisions) will be more harmonized, while fostering the convergence of supervisory practices. This project, which is widely

¹¹ Criticism of the Lamfalussy Process can be found in the Final Report of the Inter-institutional Monitoring Group at http://ec.europa.eu/internal_market/finances/docs/committees/071015_final_report_en.pdf

supported, is closely linked with international developments in accounting, supervision and actuarial science and will take account of important developments in the banking area under Basel II.

Clearing & Settlement. Currently, cross-border clearing and settlement infrastructures are far more expensive than at the domestic level and their level of safety and efficiency is lower. The primary reasons for the high cost of cross-border transactions are technical, legal and fiscal obstacles. Moreover, there is no regulatory framework at the EU level. The European Commission suggested in its Communication of 2004 that a framework Directive may be needed for an efficient, safe and cheap cross-border clearing and settlement industry. To test this possibility, the Commission is conducting a thorough consultation and impact assessment. Once this process is finished, while taking into account any new market developments the Commission will decide during 2006 on the course to take and whether to come forward with a formal proposal.

Mergers and Acquisitions. The White Paper also announced the Commission's intention to revise the Banking and Insurance Directive in order to increase clarity, transparency and disclosure related to supervisory approval of mergers and acquisitions. The Commission proposed a directive in September 2006 that will introduce specific criteria against which supervisors should judge merger and acquisition proposals and would reduce the timeframe from three months to 40 days.

Despite these efforts there are several challenges to greater harmonization of financial services in the European Union. Integrating the fragmented retail market is likely to remain a long-term challenge and varied consumer protection laws, languages, and legal systems will impose significant obstacles in the path of greater harmonization. Given the strong information asymmetry in the retail credit market and the limited impact of deregulation and technological progress on cross-border retail business to date, a local presence may well remain necessary for banks to conduct business.

4 Financial Services Trade & Investment in India and the European Union

4.1 India's Trade & Investment in Financial Services

Within India, trade in insurance¹² and other financial services¹³ has witnessed a significant increase over the past few years. In the case of insurance services, total trade

¹² *Insurance services* covers the provision of various types of insurance to nonresidents by resident insurance enterprises, and vice versa. Such services cover freight insurance (i.e., insurance on goods that are in the process of being exported or imported); other types of direct insurance (i.e., life—including pension and annuity services, other casualty or accident, health, general liability, fire, marine, aviation, etc. insurance); and re-insurance. The specific classification of various types of insurance is determined by individual countries according to particular requirements. Also recorded as *insurance services* are agent commissions related to insurance transactions.

¹³ *Other Financial Services* covers financial intermediary and auxiliary services (except those of insurance enterprises and pension funds) conducted between residents and nonresidents. Included are intermediary service fees, such as those associated with letters of credit, bankers' acceptances, lines of credit, financial leasing, and foreign exchange transactions. (For the latter, the spread between the midpoint rate and the

increased from \$353 million in 1999-00 to well over \$1841 million in 2006-07. Other financial services witnessed an even more rapid increase. Within a short span of three years, i.e., between 2004-05 and 2006-07, it exhibited an increase from \$1344 million to well over \$5 billion. Table 7 below highlights the increase in trade of other financial and insurance services.

Table 7. Import and Export of Financial Services

	Insurance		Financial Services	
	Import	Export	Import	Export
1999-00	122	231		
2000-01	223	270		
2001-02	280	288		
2002-03	350	369		
2003-04	363	419		
2004-05	722	870	832	512
2005-06	1028	1050	1308	1704
2006-07	641	1200	1832	3213

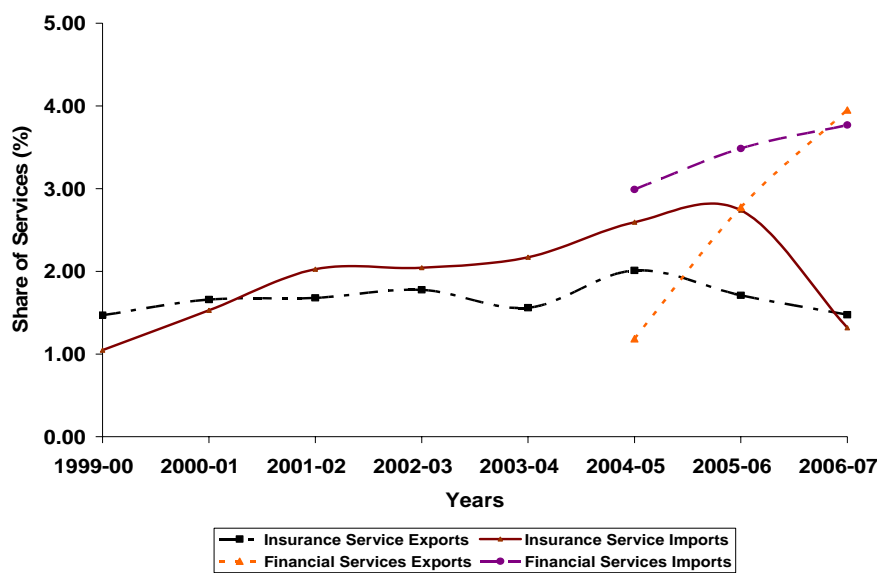
Note: Numbers are in USD million.

Source: Reserve Bank of India, Handbook of Statistics.

Moreover, there has been a significant increase in the share of these services within the overall service trade. Within exports of commercial services, the share of insurance services increased from 1.05% in 1999-00 to well over 2.74% in 2005-06. During the same period the share of insurance services in total service imports also increased from 1.47% to 1.71%. However, last year both exports and imports of insurance services witnessed a decline in their shares.

buying or selling rate is the service charge.) Also included are commissions and other fees related to transactions in securities—brokerage, placements of issues, underwritings, redemptions, and arrangements of swaps, options, and other hedging instruments; commissions of commodity futures traders; and services related to asset management, financial market operational and regulatory services, security custody services, etc. Service charges on purchases of International Monetary Fund resources are included among an economy's financial service payments, as are charges (similar to commitment fees) associated with undrawn balances under stand-by or extended arrangements with the IMF.

Figure 5. India's Trade in Insurance and Financial Services



Source: Reserve Bank of India, Handbook of Statistics.

Other financial services have also experienced a rapid growth in trade, which increased nearly four times from \$1344 million in 2004-05 to over \$5 billion in 2006-07. The share of other financial services in total service exports grew from 1.18% in 2004-05 to nearly 4% in 2006-07, while in imports it increased from 3% to 3.75% during this period. India's trade in other financial services is well above that of other developing economies like China (\$304.71 million), Argentina (\$213 million) and Malaysia (\$179 million). On the other hand, Brazil (\$1244 million) and Korea (\$ 1788 million) trade much more in financial services.¹⁴

This spurt in other financial services trade in India has been made possible by rapid technological innovations, the increasing interest of Indian companies in the global market, and India being perceived as an attractive destination for other financial services. Moreover, a significant portion of the incoming FDI has been directed towards banking and insurance services. In 2007, they accounted for more than 12% of FDI inflow. FDI going to these sectors increased from \$82.88 million and \$69.71 million in 2005 to over \$552 million and \$276 million in 2007.

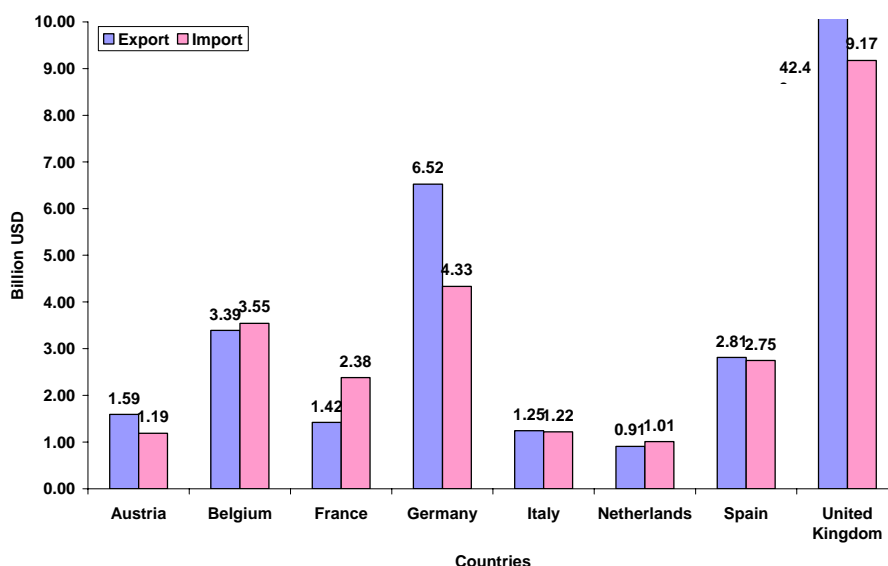
4.2 EU Trade & Investment in Financial Services

Within the EU, the major traders of other financial services include the United Kingdom, Germany, Belgium, Spain and the Netherlands. The United Kingdom is by far the largest exporter of other financial services, exporting \$42.5 billion in 2005. It is also the largest importer of other financial service but has a huge financial services trade surplus of over \$31 billion. This is largely due to the presence of London as a financial sector hub. With

¹⁴ These numbers are for 2005.

a view to attract more financial companies to London, the UK government has offered several concessions like fiscal incentives and regulatory waivers.

Figure 6. Financial Sector Trade in Major EU Countries, 2005



In other financial and insurance services, exports from the EU are three times that of the United States. However, the bulk of EU exports is to EU countries themselves. In fact only one-third of financial services and less than half of insurance services are exported to extra-EU members. Among the non-EU members, Switzerland, Canada, Australia and the United States were the principal destinations, while some Asian countries like Japan, South Korea, Singapore and Hong Kong also cornered a significant part of EU exports.

According to the World Investment Report (2007), the financial sector continued to be an important destination for inward FDI. The stock of global investment in the financial sector grew strongly from \$359 billion in 1990 to \$1.877 trillion in 2005 at an average annual growth rate of 28.2% and accounted for 20.39% of the global FDI stock. However, there was a marginal decline in the contribution of the financial sector to total FDI inflow with its share falling from 20.34% in 1990 to 19% in 2005. This decline was primarily driven by developing countries where the share of the financial sector declined from 26% to 15%. On the other hand in developed countries, the financial sector witnessed a marginal increase in its share from 18.9% in 1990 to 20.4% in 2005.

Table 8. Global Inward FDI Stock

	1990			2005			
	Developed	Developing	World	Developed	Developing	Europe & CIS	World

Primary Sector	139013	27847	166860	551202	201559	37717	790478
Manufacturing	584069	144996	729065	2196968	716624	61927	2975519
Sector							
Services	713721	155123	868844	4683574	1339703	87484	6110761
Sector							
Financial	271612	87431	359043	1515866	341036	20654	1877556
Services							
Total	1436803	327966	1764769	7431744	2257886	187128	9876758

Note: Numbers are in million USD.

Source: World Investment Report 2007

Services continued to be the main target and acquiring sector for cross-border M&As in the developed countries. A major chunk of this was concentrated in financial services due to ongoing financial deregulation and restructuring. Out of the total value of \$727.955 billion worth of M&A sales and \$752.482 billion worth of M&A purchases in 2006, more than \$92.055 billion (12.8%) and \$333.967 billion (44.38%) was concentrated in the financial sector. Moreover, while financial sector M&A sales grew by 45.40% in 2005-06, M&A purchases grew by nearly 32%.

4.3 India-EU Bilateral Trade in Financial Services

The European Union and the US are the biggest traders of insurance services in the world. In the case of the United States, about 41% of the insurance service exports and 36% of financial services exports from the United States find their way to the EU. Other major destinations of US exports include Canada, Japan and Australia. Thus, the bulk of US trade in financial services is with developed countries. In the case of foreign banks, more than 90% of foreign banks have their headquarters in the EU, Switzerland, Canada, Australia and Japan. Banks from developing countries like China, Korea, Brazil and India account for less than 2% of the assets held by foreign banks in the US. However, banks from other developing nations like Israel, Taiwan, Brazil and China have cornered a greater share in the US market. Specifically, Indian banks own less than 0.17% of the assets in the US.¹⁵ In contrast, US banks in India corner nearly 30% of the share among foreign banks.

In fact in 2005, US exported only \$116 million of financial services to India and imported \$56 million. In the case of insurance services, the scene is even more dismal with \$9 million of exports and \$7 million of imports. Thus, while combined exports of financial and insurance services to India as a share of worldwide US export of these services stands at 0.305%, in the case of imports the share is 0.154%.

Table 9. Major Destinations of US and EU Exports of Financial and Insurance Services, 2005

Exports from European Union			Exports from United States								
Insurance Services			Financial Services			Insurance Services			Financial Services		
Destination	Value	Share	Destination	Value	Share	Destination	Value	Share	Destination	Value	Share

¹⁵ Federal Reserve Bank <http://www.federalreserve.gov/releases/iba/default.htm>

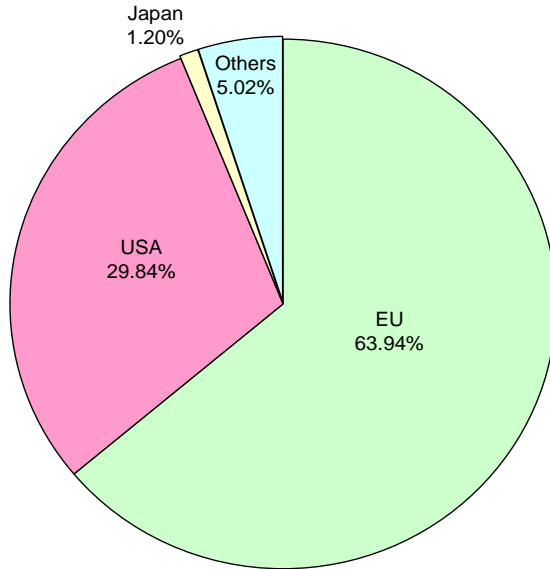
World	24349	100.0	World	96001	100.0	World	6831	100.0	World	34081	100.0
EU 25	16367	67.2	EU (25)	51931	54.1	EU (25)	2794	40.9	EU (25)	12291	36.1
Switzerland	1001	4.1	USA	14437	15.0	Canada	981	14.4	Bermuda	1880	5.5
Canada	846	3.5	Switzerland	6756	7.0	Japan	710	10.4	Canada	1590	4.7
Australia	548	2.3	Japan	3869	4.0	Bermuda	665	9.7	Japan	1253	3.7
USA	500	2.1	Russia	910	0.9	Australia	200	2.9	Australia	734	2.2
Above 5	19262	79.1	Above 5	77904	81.1	Above 5	5351	78.3	Above 5	17748	52.1
South Africa	353	1.4	Norway	897	0.9	Mexico	158	2.3	Switzerland	671	2.0
Japan	329	1.4	Hong Kong	811	0.8	Switzerland	87	1.3	Mexico	547	1.6
			Chinese								
Mexico	156	0.6	Taipei	607	0.6	South Korea	74	1.1	Hong Kong	455	1.3
Turkey	139	0.6	Australia	591	0.6	Brazil	58	0.8	Brazil	431	1.3
						Chinese					
Norway	123	0.5	Singapore	586	0.6	Taipei	56	0.8	China	349	1.0
Russia	114	0.5	Canada	582	0.6	Hong Kong	54	0.8	Singapore	347	1.0
South Korea	109	0.4	South Korea	417	0.4	Chile	47	0.7	South Korea	344	1.0
						Chinese					
New Zealand	104	0.4	China	344	0.4	Singapore	42	0.6	Taipei	302	0.9
Singapore	89	0.4	Turkey	329	0.3	Israel	38	0.6	Norway	243	0.7
Hong Kong	89	0.4	South Africa	293	0.3	Norway	38	0.6	Argentina	212	0.6
Above 15	20868	85.7	Above 15	83362	86.8	Above 15	6001	87.8	Above 15	21649	63.5

Source: International Trade Statistics (2007), World Trade Organization.

In financial services, nearly 67% of insurance services and 54% of other financial services are traded within the EU. The bulk of extra-EU export of financial services went to the USA, Switzerland, Canada and Japan. Among developing countries, South Korea, Singapore, Hong Kong, Turkey etc. were the main recipients of financial services from the EU. Given that India does not find a mention in the top 15 destinations of insurance service or financial service exports from the EU implies that India imported less than 0.4% of insurance services and less than 0.3% of financial services.

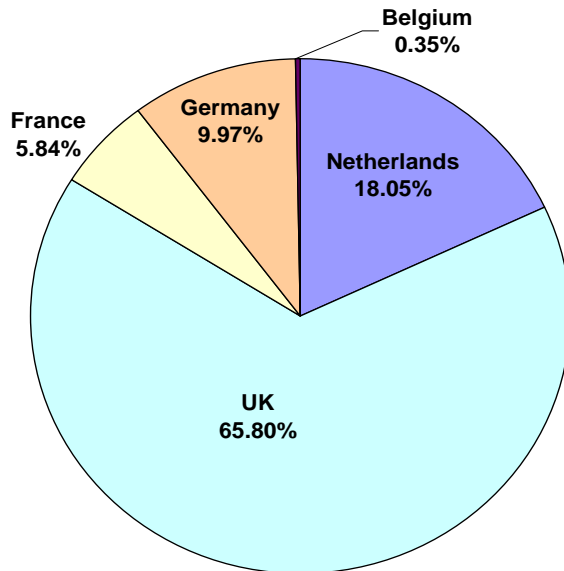
Within the EU, the United Kingdom is the most favored destination with older players like the State Bank of India, Bank of Baroda, Canara Bank and Bank of India operating for a number of years. Recent years have also witnessed the entry of Indian private banks like ICICI, which has set up a wholly-owned subsidiary in the UK; this subsidiary has further opened a branch in Belgium. Other Indian banks which have a presence in Belgium include Bank of Baroda and Bank of India. The State Bank of India and Bank of India have set up branches in France as well. In contrast, in India the EU banks have the largest share among the foreign banks, accounting for almost two-thirds of the total assets held by foreign banks. US banks are a distant second with less than half the assets of the EU banks.

Figure 7. Foreign Banks in Indian Banking Sector (Based on Assets)



Source: Reserve Bank of India, A Profile of Banks

Figure 8. Major EU Countries in Indian Banking Sector (Based on Assets)



Source: Reserve Bank of India, A Profile of Banks

A country-wise breakup of the EU banks shows that more than 65% of the assets are held by banks from the United Kingdom. The overwhelming share of the United Kingdom is

largely explained by the presence of two big banks, viz., Standard Chartered Bank and Hong Kong and Shanghai Bank Corporation (HSBC). Other major countries which have a presence in India include the Netherlands, France and Germany.

Even in the Indian insurance sector, EU firms corner a dominant position. Though more than 67% of the insurance market is captured by the public sector LIC, joint ventures with EU companies have cornered nearly 80% of the remaining market. Between April and October 2007, joint ventures with partners from the EU accounted for Rs. 9500 crore of insurance premium. Of this more than 50% was from joint ventures with UK companies, including HDFC Standard Life, ICICI Prudential, and Dabur CGU Life Insurance. Other important EU countries with which Indian companies have set up business include Germany (Bajaj Allianz), the Netherlands (ING Vysya) and France (SBI Life Insurance). Other major players in the Indian life insurance market include the USA and Australia.

Table 10. Share of First-Year Premiums (Life) in India, 2007

	Market Premium (in Rs. crore)	Share (%)
LIC	25901.19	67.07
Private	12713.5	32.92
Joint Venture	11813.07	30.59
EU	9509.31	24.62
UK	5057.1	13.10
France	1497.61	3.88
Germany	2649.83	6.86
Netherlands	304.77	0.79
USA	2170.85	5.62
Others	132.91	0.34
Domestic	900.43	2.33
India	38614.69	100

Source: IRDA Journal, December 2007.

Similarly, in the non-life insurance sector in India, EU companies have cornered more than 11% of the share. The dominant EU player in non-life insurance is Germany (HDFC Chubb General Insurance) followed by the UK (Royal Sundaram Alliance Insurance). Other major foreign countries in the Indian non-life insurance market include the USA, Japan and Canada.

Table 11. Share of Gross Premium (Non-Life) in India, 2007

	Market Premium (in Rs. crore)	Share (%)
Public	9854.96	60.54
Private	6424.80	39.46

Joint Venture	5296.12	32.53
EU	1833.93	11.27
Germany	1454.62	8.94
UK	379.31	2.33
USA	472.40	2.90
Japan	925.66	5.69
Canada	2064.13	12.68
Domestic	1128.68	6.93
India	16279.76	100.00

Source: IRDA Journal, December 2007.

5. Barriers to Trade in Financial Services

5.1 Barriers faced by Foreign Financial Service Providers in India

A survey of the leading foreign banks in India combined with meetings with officials from various embassies and the European Commission point to several barriers faced by foreign service suppliers in entering and expanding their operations in India. Within the banking sector the principal barrier pointed out related to the restriction on branch expansions by foreign firms. As per the Uruguay Round Commitments, India is committed to allowing the opening up of only 12 new branches of foreign banks annually. While in recent years the number of branches opened by foreign banks has exceeded 12, and India has offered to commit to opening up 20 new branches annually in its Revised Offer, the foreign players consider this limit to be relatively low because it prevents them from effectively servicing the market. Most foreign banks, however, pointed out that the guidelines to establish a new branch were not cumbersome and relatively easy to follow.

The foreign banks as well as officials from various EU country embassies pointed out that the existing limit on foreign participation also poses a barrier to their expansion plans. Currently, aggregate foreign investment in private banks from all sources is allowed up to a maximum of 74% of the paid-up capital of the bank¹⁶. Moreover, while individual FII and NRI holding is restricted to 10% and 5%, the aggregate limit for all FIIs and NRIs cannot exceed 24% and 10%.¹⁷

The regulation denying additional licenses to foreign banks once their share exceeds 15% of total banking assets is also viewed as being arbitrary and restrictive. The foreign banks are of the view that such a restriction preserves the hegemony of the Indian public sector and private banks.

¹⁶ Except in regard to the wholly-owned subsidiary of a foreign bank.

¹⁷ While the FII holding can be raised to 49% by the bank concerned passing a resolution by its Board of Directors followed by passing a special resolution to that effect by its General Body, NRI holding can be allowed up to 24% provided the banking company passes a special resolution to that effect in the General Body.

Some of the foreign banks also expressed their reservations on the amount they have to lend to the priority sector pointing out that this restricts their ability to efficiently allocate credit on the basis of merit. However, here it is important to recognize that foreign firms often benefit from fewer social and developmental obligations. Currently, the foreign banks are required to devote 32% of their net bank credit to the priority sector of which 10% and 12% must be in the form of SSI advances and export credits, while the rest is divided between agricultural advances and advances to weaker sections. In contrast, Indian banks have to allocate 40% of their credit to the priority sector with a minimum of 18% to agriculture and 10% to weaker sections. Moreover, export credit does not form a part of priority sector lending for Indian banks.

Another issue of contention is the limit on voting rights, which is currently capped at 10% for private banks. The foreign banks are proposing an amendment to abolish this requirement but this can be done only through an amendment to the Banking Regulation Act of 1949.

The foreign players also pointed out discriminatory treatment regarding tax rates. While Indian corporations are taxed at 30%, the foreign corporations are taxed at a relatively higher rate. While dividends and interest income of foreign banks are taxed at 20%, royalties and technical services are taxed at 30% and other income at 55%.¹⁸

¹⁸ For the fiscal year ending March 31, 2008 the basic corporate tax rate for domestic companies is 30%, and the surcharge is 10% if income is in excess of INR 1 crore. The effective tax rate for domestic companies having income of more than INR 1 crore is 33.99% (30%, plus surcharge of 10% of the tax, plus education cess of 3% on tax and surcharge). The effective tax rate for domestic companies having income less than INR 1 crore is 30.90% (30% plus education cess of 3% on tax). A Minimum Alternate Tax (MAT) is levied at 10% of the adjusted profits of companies where the tax payable is less than 10% of their book profits. In the case of companies having income of more than INR 1 crore, the effective rate would be 11.33/10.558% (10% plus a surcharge of 10/2.5% of the tax, plus an education cess of 3% on the tax plus surcharge).

The effective tax rate for foreign companies having income of more than INR 1 crore is 42.23% (40%, plus surcharge of 2.5% of the tax, plus education cess of 3% on tax and surcharge). The effective tax rate for foreign companies having income less than INR 1 crore is 41.2% (40% plus education cess of 3% on tax). Income of domestic shipping companies can be computed under the tonnage tax scheme. Non-residents and foreign companies engaged in shipping, aviation, oil/gas and turnkey power projects are taxed on a deemed profit basis of 7.5%, 5% and 10% respectively, plus surcharge and education cess. Dividend Distribution Tax (DDT) is levied at 16.995% (15%, plus surcharge of 10% of the tax, plus education cess of 3% of tax and surcharge) on dividends distributed by a domestic company. DDT is levied at 28.33% (25%, plus surcharge of 10% of the tax, plus education cess of 3% on tax and surcharge) on the income distributed by money market mutual fund or liquid fund to unit holders. DDT is levied at 14.163% (12.5%, plus surcharge of 10% of the tax, plus education cess of 3% on tax and surcharge) on the income distributed by a non-equity oriented mutual fund other than money market mutual fund or liquid fund to individuals or HUF unit holders. DDT is levied at 22.66% (20%, plus surcharge of 10% of the tax, plus education cess of 3% on tax and surcharge) on the income distributed by a non-equity oriented mutual fund other than money market mutual fund or liquid fund to unit holders other than individual and HUF. Securities Transaction Tax (STT) is levied at varying rates on the value of specified taxable securities transactions through a recognized stock exchange, or on the sale of units of equity-oriented mutual funds to the mutual fund. Fringe Benefit Tax (FBT) is levied on certain fringe benefits provided to employees at

However, comparing India with some of the EU countries and the USA, it is evident that India imposes lower tax rates than several of the EU countries.

Table 12. Corporate Tax Rates, 2007

Country	Corporate Tax Rate (%)
USA	40.00
Germany	38.36
Italy	37.25
India	33.99
Belgium	33.99
France	33.33
Spain	32.50
UK	30.00
Netherlands	25.50
Austria	25.00

Source: KPMG Corporate and Indirect Tax Rate Survey, 2007.

Moreover, several EU member countries have given preferential tax treatment to their own corporations. According to KPMG (2007):

- Austrian corporations may benefit from liberal international participation exemption and group taxation (including cross-border loss utilization and goodwill depreciation for the acquisition of qualifying Austrian subsidiaries).
- Belgian companies and foreign companies that have an establishment in Belgium benefit from a risk capital deduction (also called notional interest deduction), i.e., a deduction equal to a percentage based on the return of a 10-year government bond of the companies' adjusted equity capital (including retained earnings).

However, in India wholly-owned subsidiary of a foreign bank is given the same treatment as domestic banks. Other areas where Indian public sector banks are favorably treated include government guarantees, subsidies and bailouts. These are not available to Indian private banks or foreign banks.

Currently, when a foreign bank expresses the desire to acquire more than 5% of an Indian private sector bank, the RBI looks at the standing and reputation of the foreign bank as well as the level and nature of its presence in India. Generally, after the RBI finds that such investment by the foreign bank is in the long-term interest of all the stakeholders in the investee bank, it permits acquisition of such percentage as it may deem fit. The

33.99% for domestic companies having income in excess of INR 1 crore and 31.673% for foreign companies having income in excess of INR 1 crore and 30.90% for companies having income less than INR 1 crore (30% plus education cess of 3% on tax).

foreign banks pointed out that these guidelines are arbitrary and need to be made more transparent. Moreover, prior RBI approval is also required for a non-bank, either foreign or domestic, to purchase more than 10% of such banks.

Foreign banks are also critical of the stipulation in RBI (2005), whereby foreign banks are allowed to establish wholly-owned subsidiaries but must divest their ownership stakes down to 26% by 2009. Such stipulations make this option largely unattractive. As a result, currently there are no wholly-owned subsidiaries of a foreign bank in India.

In the insurance sector the single most important barrier faced by foreign companies is the allowance of minority shareholding with only 26% FDI. The foreign insurance companies pointed out that this severely restricts their operation and expansion plans. Apart from this, EU companies also pointed out that they face barriers in providing marine, aviation, and transport insurance, insurance intermediation services, and re-insurance through cross-border supply.

5.2 Barriers faced by Foreign Financial Service Providers in the EU

Currently, India is not a major exporter of financial services to the European Union and Indian financial companies have cornered a very small portion of the market. However, with increasing innovation in telecommunication and information technology there are significant opportunities for Indian companies to increase the export of financial services. However, there are several constraints in realizing this potential. While most of the important constraints impeding the export of financial services from India are primarily domestic, stemming from the inefficiencies and deficiencies that characterize the financial sector in the home market, there are also a number of external factors that hamper India's financial service exports.

While most financial service providers pointed out that there are no FDI restrictions in the EU that constrain their expansion or operation plans, they are subject to other barriers. In the EU, the treatment accorded to European corporations or wholly-owned subsidiaries of a third country is very different from that given to branches. The majority of Indian banks operating in the EU are in the form of branches and not subsidiaries. Hence, they are treated as foreign companies and face several barriers in their daily operations. Branch regulations in the EU are not harmonized at the EU level and it is up to the individual Member States to formulate the guidelines. Moreover, the Secretariat Report points out that “[a]ccording to EC legislation, Member States shall not treat branches of third country credit institutions more favourably than those having their head office in the European Community”, thereby giving leeway to Member States to pursue discretionary policies in favour of domestic companies. This condition stems from Article 38 of the Capital Requirements Directive (2006/48/EC).

Capital Requirements Directive: Article 38

1. Member States shall not apply to branches of credit institutions having their head office outside the Community, when commencing or carrying on their

business, provisions which result in more favorable treatment than that accorded to branches of credit institutions having their head office in the Community.

2. The competent authorities shall notify the Commission and the European Banking Committee of all authorizations for branches granted to credit institutions having their head office outside the Community.
3. Without prejudice to paragraph 1, the Community may, through agreements concluded with one or more third countries, agree to apply provisions which accord to branches of a credit institution having its head office outside the Community identical treatment throughout the territory of the Community.

A similar condition is laid down in the re-insurance segment. The EC Reinsurance Directive, which came into force on 10 December 2007, abolishes collateral requirements for all re-insurance undertakings authorised under the directive. However, the current Reinsurance Directive 2005/68/EC does not apply to re-insurance undertakings whose head office lies outside the Community. The treatment of these third-country re-insurance undertakings remains a matter for Member States. Nevertheless, *Article 49 of the Directive does require that a Member State ensures that third country reinsurance undertakings commencing or carrying out reinsurance activities in its territory, do not receive a more favourable treatment than that afforded to a reinsurance undertaking with its head office in that Member State.* Consequently, Member States again have the freedom to favour domestic companies.

Reinsurance Directive: Article 49

A Member State shall not apply to reinsurance undertakings having their head offices outside the Community and commencing or carrying out reinsurance activities in its territory provisions which result in a treatment more favorable than that accorded to reinsurance undertakings having their head office in that Member State

One of the key barriers faced by Indian banks operating in the EU is in expanding their operations in Member States when they already have operations in another Member State. Unlike subsidiaries, branches need separate approval to set up operations in individual Member States. Typically in several EU countries like Austria, European Economic Area (EEA) Member States' banks may operate branches on the basis of their home country licenses, whereas banks from outside the EEA must obtain the Member State license to operate there. In Bulgaria, local companies in which foreign partners have controlling interests are required to obtain licenses to engage in both banking and insurance. Under current regulations, Indian and other non-Italian banks must obtain Bank of Italy approval to operate in Italy.

Article 51 of **Directive 2002/83/EC** and Article 23 of **Directive 73/239/EEC** state that each branch needs an authorisation granted by the EC Member State in question.

However, there is no obligation for an EC Member State to grant authorisation.

Furthermore, given that the laws governing minimum capital requirement, corporate tax rates, reciprocity requirements, etc. vary widely from country to country within the EU, it becomes very cumbersome for Indian banks to expand operations in the EU. The various EU countries also have the freedom to have different guidelines regarding solvency margins. The minimum guidelines for life insurance across the European Union are guided by Directive 2002/83/EC. The minimum required solvency margin for life insurance is 4% of the mathematical provisions and 0.3% of capital at risk. In the case of permanent health insurance not subject to cancellation, the required solvency margin is equal to 4% of the mathematical provisions plus the required solvency margin for insurance undertakings as laid down in Article 16a of Directive 73/239/EEC. For tontines, the required solvency margin is equal to 1% of their assets.¹⁹

However, these criteria are the minimum guidelines and individual countries are free to impose stricter guidelines. In addition, insurance companies that are subject to the equity method because they have management control over other companies despite having less than 15% of total shares of those companies should deduct the amount of the book value that is in excess of the fair market value from the solvency margin. Those insurance companies with more than 15% in total shares (i.e., affiliates as stated under the Insurance Business Act) are excluded because the chances of accounting manipulation using the equity method are slim as the Insurance Business Act recognizes the actual management control of the stakeholder over the affiliate, and regulates the business scope of such an affiliate.

Moreover, European banks are also able to operate with cheaper funds. The local European banks have direct access to the payment system, whereas all other banks have to go through the local banks. The local banks therefore enjoy access to flat funds which reduces the overall cost of funds. Indian banks operating in the EU also face a shortage of skilled manpower especially in areas of treasury and capital market operations.

Table A5 in the Appendix focuses on six countries of interest, viz., the United Kingdom, France, Germany, Italy, Spain and the Netherlands and lists the main regulations and requirements that foreign banks have to conform to while setting up a presence in these countries.

An analysis of the regulations pertaining to setting up a branch, subsidiary or representative offices in the above countries shows that the requirements for extra-EU banks are very different from banks that are incorporated in another EU Member State. Moreover, the financial authority is vested with a wide range of discretionary powers that it can use to restrict the entry of foreign service providers. For example, even after meeting the guidelines to set up a bank branch in the United Kingdom, the FSA can deny the license if it feels that the bank does not meet the 'fit and proper standards'. These

¹⁹ For more details please refer to Directive 2002/83/EC at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2002:345:0001:0051:EN:PDF>

standards need to be clarified and universally applied since the main idea behind the imposition of these standards is to minimize the risk of contagion. Similarly, in France, the CECEI can restrict the license given to a foreign bank if it is of the view that the business plan and scope of operation are inappropriate. CECEI also has the ability to impose additional conditions on these foreign banks after granting them licenses; these range from raising the capitalization level to providing a letter of comfort. *BaFin* in Germany and *DNB* in the Netherlands also retain the ability to reject the application of a foreign bank if they find that overall supervision is inefficient.

Typically foreign bank branches of extra-EU member states are subject to several additional regulations compared to their EU counterparts. Primarily, in the case of the EU banks, the focus is on home-state regulations with the central authority of the host country exercising limited controls. On the other hand, in the case of extra-EU banks the host country regulator imposes a number of additional conditions.

A foreign bank wishing to establish operations in the UK must obtain authorization from the FSA in addition to its home state authorization. Non-EU banks seeking to carry on deposit-taking activities through its UK branches require authorization from the FSA. In the case of subsidiaries, a single banking license may extend to subsidiaries of credit institutions. This can happen if the subsidiary is subject to consolidated supervision with the parent and certain rigorous conditions are satisfied. These conditions include ownership of the subsidiary by the parent or 90% or more of the voting rights attaching to the shares in the capital of the subsidiary.

In France extra-EU bank branches are subject to a host of technical requirements. These include the branch to be directed by a central administration established in the country of incorporation as well as two executives to be designated to serve as legal representatives of the bank. Spain imposes a number of restrictions on the working of an extra-EU bank in the initial years of operations. These include limitations on carrying out certain activities, distribution of dividends, granting of credits, transfer of shares, as well as use of initial capital. Italian authorities also impose additional regulatory requirements on foreign branches of developing countries. These include filing of detailed plans, minimum endowment fund, and stringent requirements if the bank wants to carry out cross-border activities.

While subsidiaries of extra-EU banks are largely subject to the same procedures and rules that govern the domestic banks, there are some exceptions. Germany retains the option of subjecting subsidiaries of banks incorporated outside the EU to some special rules. Spain also distinguishes between EU and non-EU controlled entities. While in the case of an EU-controlled subsidiary, the Bank of Spain and Ministry of Economy consult with the home country regulator, for an extra-EU controlled subsidiary the parent company may have to guarantee the obligation of the Spanish subsidiary.

In Italy, the guidelines for setting up a subsidiary of an extra-EU bank is much more demanding than if the controlling entity is incorporated in the EU. Additional

requirements involving adequate supervision, exchange of information, and financial soundness certification are imposed on subsidiaries of extra-EU banks.

Currently, several EU banking, insurance and investment services directives include “reciprocal” national treatment clauses under which a financial services firm from a third country may be denied the right to establish a new business in the EU if the EU determines that the investor’s home country denies national treatment to EU service providers. For example, all EU member countries are subject to Article 23 of the Banking Consolidation Directive under which if it appears that an EU bank or a credit institution cites a problem of market access or of national treatment in a third country, the European Commission can ask the various EU Member States to limit or suspend decisions regarding pending applications from the third country.²⁰ Such provisions have the potential of being used to deny effective entry and operation of Indian firms.

Also Indian banks face problems related to processing of visas and work permits. Some of the banks pointed out that the uncertainty regarding visas and work permits provides a disincentive for them to expand operations as there might not be enough Indian personnel for these operations. Moreover, with diverse visa and work permit rules, it becomes difficult for an Indian worker to work across different EU countries.

Ireland, in the health insurance market, has advocated ‘risk equalization’ whereby private insurers are required by law to compensate the quasi-governmental body Voluntary Health Insurance (VHI) Board for the additional risk that the latter accepts in offering community (or equal) rating for policy-holders of different ages and medical profiles. The compensation is to be paid once a certain threshold of number of insured is reached. However, the formula for determining the threshold has not been clarified and is ambiguous, acting as a strong deterrent for foreign insurance companies to enter the Irish insurance market.

Other barriers faced by Indian financial firms in the EU relate to operations being subject to the host country’s financial institutions receiving reciprocal treatment in India, data protection requirements, directives to protect individual privacy with regard to the storage, processing, and transmission of personal data, local staffing requirements and restrictions in the form of economic needs tests that affect the movement of natural persons in the financial sector.

Indian financial firms also pointed out that they are hampered by financial laws in the EU like Anti-Money Laundering and Know Your Customer, which are used to discriminate against foreign banks even when they fulfill other guidelines. They have demanded that these norms be made transparent and be applied universally to banks of all countries.

Indian banks are also constrained by the unfavorable exchange rate between some of the European currencies and the Indian Rupee. As a result, requirements like minimum capitalization and solvency requirement become a financial burden for Indian companies.

²⁰ Article 23 of the Banking Consolidation Directive 2000/12/EC

6. Liberalization of Financial Services in India and the EU under Multilateral/Bilateral Agreements

6.1 Liberalization of Indian Financial Services

At the completion of the Financial Services Agreement in 1997, India undertook commitments under various sub-sectors within financial services.²¹ In the banking sector, India committed to allow the establishment of branch operations of a foreign bank subject to a license limit of 12 per year. However, India retained the option of restricting entry of foreign banks if their market share exceeded 15%. Apart from this, foreign banks were allowed to install ATMs at branches and other places. It also allowed licensed foreign bank branches to invest in other financial services up to a certain limit. The foreign banks were required to constitute a Local Advisory Board, whose Chairman and Members had to be Indian nationals. Finally, public sector banks could invest their surplus funds in term deposits only with scheduled commercial banks in India.

Within the insurance sector, India allowed foreign insurers to insure goods in transit to and from India. Foreign re-insurers were also allowed to take re-insurance but only that part of the risk that was left as residual after statutory placements domestically with Indian insurance companies. This part of the re-insurance could be placed with foreign insurers through overseas brokers. These brokers were also allowed to have resident representatives and representative offices to procure re-insurance business from Indian companies. However, these representatives and offices were not allowed to undertake any other activity in India and their expenses were to be entirely met by remittances from abroad.

Though these commitments signaled some improvement from the original commitments given in 1993, they were well short of the existing regime. Consequently, in the current round of negotiations India's trading partners made several requests for liberalization. India received plurilateral requests for liberalizing trade in financial services from a number of developed and developing countries.²² Some of the major demands made in the banking sector include undertaking full market access and national treatment commitments in Modes 1 & 2 for all services, and removal of restrictions on preferred form of presence, numerical quotas, monopolies, exclusive service suppliers, use of foreign capital, equity ceilings, and limits on investment by public sector entities in foreign banks. Foreign service providers have also expressed a desire for removal of the priority sector lending requirement as well as restrictions on land acquisition by foreigners and 'discriminatory' regulations affecting income tax, solvency ratios, and borrowing limits.

In the insurance sector, other members have requested India to undertake full market access and national treatment commitments in Mode 1 and 2 for marine, aviation and transport insurance, re-insurance, insurance intermediation, and insurance auxiliary services. They have also expressed a desire for the removal of restrictions on the choice

²¹ WTO (1998) India's Schedule of Specific Commitment Supplement 4, GATS/SC/42/Suppl.4.

²² India has received a Financial Services Collective Request on behalf of Australia, Canada, the European Community, Ecuador, Hong Kong, Japan, Republic of Korea, Norway, Macau, and the United States.

of the form of commercial presence and partner for foreign service providers as well as limitations on equity participation. In addition, they have asked for greater transparency in the development and application of domestic regulations.

In the current round of talks India has offered to further open up this sector provided other WTO members make substantive and satisfactory offers in sectors and modes of supply where India has indicated its interests.²³ Within the financial services, India has requested developed countries like Australia, Canada, the European Community and the United States to liberalize restrictions on market access and national treatment for data processing of financial services under Mode 2. India has also made several country/member specific requests. For example, India has requested Australia to allow bank branches to accept retail deposits and remove the requirement of approval of Australian authorities for setting up bank branches of parent banks where a single shareholder holds a 15% or larger share. In the case of the European Community, India has requested that a bank subsidiary incorporated in any one of the Member States should be accepted as incorporated within the EC and be authorized to render financial services throughout the entire EC. In the United States, the form of commercial presence, i.e., bank branch or bank subsidiary, depends on individual states' regulations and India has requested the removal of such restrictions as they restrict provision of financial services.

India's conditional revised offer for banking services is largely guided by RBI's Roadmap for Presence for Foreign Banks in India.²⁴ The Roadmap has divided further liberalization into two phases. During the first phase, between March 2005 and March 2009, foreign banks will be permitted to establish a presence by way of setting up a wholly-owned banking subsidiary (WOS) or conversion of the existing branches into a WOS. Consistent with the Roadmap, India has offered to allow foreign banks to enter through branch operations or the wholly-owned subsidiary of a foreign bank. Given that the number of branches permitted each year has been higher than the WTO commitments, India has agreed to offer up to 20 licenses per year, both for new entrants and existing banks. The minimum start-up capital requirement for the WOS would be Rs. 3 billion (\$73 million) and they have to maintain a capital adequacy of 10%. India has also offered to allow WOS of foreign banks to hold surplus funds of public sector entities as term deposits, subject to RBI guidelines. .

India has also agreed to allow foreign banks to invest in private sector banks through the FDI route subject to a foreign equity ceiling of 49%. However, the combined foreign equity (through FDI, FII and NRI routes) is capped more liberally at 74%.

The resource allocation requirements will be applicable to foreign banks on a non-discriminatory basis. While public and Indian private sector banks have to ensure that 40% of their net bank credit goes to the priority sector, the limit is only 32% for foreign banks. Finally, India has offered to replace the Local Advisory Board requirement with guidelines on the composition of the board of directors.

²³ WTO (2005) India's Revised Offer TN/S/O/IND/Rev.1

²⁴ RBI (2005) Road map for presence of foreign banks in India

In the case of insurance, for both life and non-life insurance as well as re-insurance and retrocession, India has offered to allow foreign equity up to 26%. This is in accordance with the existing system in India, although an amendment to increase the restriction to 49% is under consideration. In the case of auxiliary services like consultancy, actuarial and risk assessment, foreign equity up to 51% has been allowed. Moreover, India has offered to impose no national treatment limitations on foreign players in life and non-life insurance.

6.2 Liberalization of Financial Services in European Union

With a view to further liberalize the services sector, the European Union (EU 25) tabled its revised offers (RO) under the Doha Development Round in early 2005. The revised offer, like the initial one, is conditional on other WTO members making substantive offers in sectors where the EC has made requests.

A detailed look at the horizontal commitments under the revised offer reveals that the EU has left a lot of ambiguity in several statements and as a result given itself a wide range of discretionary powers to regulate the extent and type of foreign entry in various services sectors.

Typically foreign banks can enter a country either as a branch or as a subsidiary. All the Member States of the EU have imposed national treatment limitations that give them the option of opposing the entry of foreign banks. For example, the treatment given to branches, agencies and representative offices of a third-member country can be different from the treatment given to the subsidiary of the third-member country. Moreover, in the case of subsidiaries of third-country companies, the EU retains the right to treat them less favorably unless they can show that they possess an *effective and continuous link* with the economy of one of the Member States. Such statements are extremely ambiguous and give a lot of discretionary power to the EU to prevent foreign service suppliers from effectively operating in the EU market.

Almost all Member States of the EU have also pointed out that the subsidies from the European Union or Member States will be limited to juridical persons established within the territory of a Member State.

Spain, which can prove to be a potential market for Indian financial service providers, requires that investment in Spain by foreign government and foreign public entities directly or through companies or other entities controlled directly or indirectly by foreign governments needs prior authorization by the Spanish government. This would act as barriers to investment decisions of nationalized banks and public sector insurance companies. In France, foreign purchases exceeding 33.33% of the shares of capital or voting rights in existing French enterprises, or 20% in publicly quoted French companies are subject to several regulations. Moreover, foreign participation in newly privatized companies is limited to a variable amount that is determined by the government of France. This again gives a lot of discretionary power regarding the limit on foreign investment. Moreover, France retains the right to approve the applications for foreign participation in newly-privatized companies on a case-by-case basis. Italy also retains the

option of giving exclusive rights to newly-privatized companies as well as to restrict voting rights in some of them. Acquisition of large equity stakes of companies in several sectors like telecommunications, transport and energy services are subject to the approval of the Ministry of Treasury.

In the revised offer, the EU has pointed out that foreign bank subsidiaries are subjected to prudential regulations that are harmonized at the EU level and these regulations enable the subsidiaries to benefit from enhanced facilities to set up new establishments and provide cross-border subsidiaries throughout the EU. However, branches can be established directly in one of the EU countries without being subject to these harmonized prudential regulations but then they are unable to get the benefits available to subsidiaries. Moreover, even though the branches are not subject to the harmonized prudential regulations, they are subject to a host of other regulations that include separate capitalization, solvency requirement, reporting and publication of accounts requirement, etc. in the banking sector, and specific guarantee and deposit requirements, separate capitalization and localization of the assets representing the technical reserves and at least one-third of the solvency margin in the concerned EU country.

Finally in Mode 4 for financial services, the EU has undertaken commitments only under the categories of intra-corporate transferees and business visitors. For the former, the EU requires the service provider to work with a juridical person, excluding non-profit making organizations, for at least the year immediately preceding the date of admission. Moreover, the transfer has to be to a commercial presence (branch, subsidiary) of the parent company. The latter needs to be constituted in a member state of the EU as well as must be providing similar services.

Looking across the various modes of supply in the insurance services, it can again be seen that many of the EU countries where India has a trade interest have listed several barriers in their commitments. In insurance services out of the 27 EU member states, only nine member states, viz., Belgium, the Czech Republic, Greece, Hungary, Ireland, Luxembourg, the Netherlands, the Slovak Republic and the United Kingdom have not maintained any restrictions in Mode 1. Apart from these countries, Spain, Finland and Sweden have not maintained any restrictions in Mode 2.

On the other hand, Latvia, Lithuania, Malta, Poland and Slovenia have completely left cross-border supply of life insurance unbound. While Latvia has also completely restricted cross-border supply of the entire gamut of non-life insurance services, Lithuania, Malta and Slovenia have allowed only maritime and aviation insurance. Slovenia has also imposed restrictions on retrocession and re-insurance services. In Cyprus, no insurer can offer life insurance or non-life insurance (except marine, aviation and transit insurance) services unless licensed as an insurer by the Superintendent of Insurance in accordance with the Insurance Laws. Even for re-insurance and retrocession services to insurance companies incorporated and licensed in Cyprus, an approval from the Superintendent of Insurance is required. Both Poland and Slovenia have also left Mode 2 for life and non-life insurance unbound.

Across both these modes, air and other transport insurance in Austria, Denmark, Germany, France, Italy and Portugal can largely be carried out by a subsidiary established in the Community or by a branch established in these Member States. In addition, Austria prohibits promotional activity and intermediation on behalf of a subsidiary not established in the EC or a branch not established in Austria. Denmark restricts insurance companies that are not licensed by Danish law from assisting to effect direct insurance for Danish residents, property or ships. Moreover, Italy and Spain have left actuarial profession unbound.

Again, in Mode 3 several restrictions have been imposed by a number of member states. Barring nine countries, viz. Belgium, Denmark, Germany, France, Hungary, Ireland, Luxembourg, the Netherlands and the United Kingdom, all other member states have imposed some barriers to overseas commercial presence. Austria and the Slovak Republic have restrictions on forms of incorporation that restrict foreign branch offices if the insurer in the home country is neither a joint stock company nor a mutual insurance association. Moreover, in the Slovak Republic only joint stock companies or subsidiaries are allowed to undertake any insurance activity.

In Mode 3, Spain and Portugal allow a branch or agency of foreign companies to provide certain insurance services only if the foreign insurer has been providing the same insurance services in its own country for at least five years. This acts as a strong barrier to new Indian companies wishing to expand their operations in these countries as well as existing Indian companies wishing to provide new services. Moreover, Italy allows only natural persons and professional associations, without any incorporation, to provide actuarial services. The authorization of the establishment of branches is subject to the evaluation of the supervisory authorities, thereby giving a lot of discretionary power to the regulatory authorities.

Countries have also imposed restrictions on the composition of the supervisory board of the insurance companies. For example, Finland requires that at least one auditor, half of the promoters, and the board of directors should reside in the European Community. Moreover, the general agent of the foreign insurance company needs to have his place of residence in Finland, unless the company has its headquarters in the EU. In Slovakia, the purchase of shares expressing interest in equity capital of existing commercial banks is subject to prior approval by the National Bank of Slovakia.

While foreign insurance companies can operate in the field of life and non-life insurance as well as retrocession in Cyprus through a subsidiary or branch, they have to conform to certain conditions. In the case of subsidiaries, they have to adhere to the legal forms allowed by Cyprus Companies Laws, while in the case of branches the foreign insurer must be authorized to operate in his country prior to establishing a branch. Cyprus also prohibits a company from operating as a re-insurer unless authorized by the Superintendent of Insurance. Poland also has imposed restrictions on forms of incorporation and allows only joint stock companies except for insurance intermediation. Moreover, local incorporation is required for insurance intermediaries.

In Mode 4, where India has a special interest, virtually all EC Member States have left business visitors and intra-corporate transferees unbound except as indicated in the horizontal commitments. Apart from the horizontal restriction, countries have imposed specific restrictions. For example, in Greece the majority of the members of the board of directors of a company established in Greece shall be nationals of one of the EU Member States. Moreover, none of the EC Member States have made any commitments in the areas of independent professionals and contractual service suppliers.

In banking-related services, while the major EU countries, barring Belgium, Ireland, the Slovak Republic and Italy have not imposed any significant sectoral restrictions on cross-border supply, smaller EU countries have scheduled a number of restrictions. Belgium requires establishment in the country for the provision of investment advisory services. Italy has not made any commitments for cross-border supply of financial salesman's services.²⁵ Ireland restricts the provision of investment services or investment advice only to those financial entities that are incorporated in Ireland or are in a partnership or a sole trader with the head office in Ireland or are authorized in another Member State in accordance with the EC Investment Directives. Slovakia also imposes a number of restrictions on cross-border provision of banking services. Only authorized domestic banks and branches of foreign banks can trade in foreign exchange assets, effect non-cash cross-border payments, and grant and obtain guarantees and liabilities according to limits determined by its central bank.

Among the smaller emerging markets a number of countries have not committed under certain financial services. For example, Malta and Poland have not scheduled any commitments in financial leasing, guarantees and commitments, and auxiliary financial services. In addition, Malta has not scheduled commitments in payments and money transmission services. Across a number of banking services, including acceptance of deposits, lending, financial leasing, payment and money transmission services, Cyprus has either made an unbound commitment or allows only legal entities licensed by the central bank to offer these services.

Latvia has left cross-border supply of all financial services except transfer of financial information, financial data processing, and advisory and auxiliary services unbound. Similarly, Poland has left all banking and related services unbound except for financial information and financial data processing services.

While Cyprus and Poland have refrained from making any commitments in Mode 2 across virtually all banking and related services, Slovakia has imposed restrictions in Mode 2 that are identical to its restrictions in Mode 1 mentioned above.

On the other hand almost all the EU Member States have imposed strong restrictions on the establishment of foreign commercial presence. Across all the Member States, establishment of a specialized management company is required to perform the activities

²⁵ A financial salesman is a person who, as an employee, agent or holder of a mandate, practises the profession of financial intermediation. This activity must only be performed on behalf of a single investment company.

of management of unit trusts and investment companies. Moreover, only firms that have their registered office in the EC can act as depositories of the assets of investment funds. Several Member States have imposed further restrictions. Finland has imposed a number of residency requirements that necessitate at least one half of the founders and members of the board of directors have their permanent residence in the EC. Similarly, one ordinary and one deputy member of the supervisory board, the managing director, and the person entitled to sign in the name of the credit institution have to be permanent residents of the EC. Greece requires a certain amount of foreign exchange to be imported, converted into Euros and kept in Greece as long as a foreign bank continues to operate in Greece. For the first four branches, this amount is equal to half of the minimum amount of share capital required for a credit institution to be incorporated in Greece, which doubles to the entire amount of minimum share capital for subsequent branches.

Italy stipulates that for door-to-door selling intermediaries must utilize authorized financial salesmen who are residents within the territory of one of the Member States. Moreover, both legal and natural persons who intend to offer the public financial instruments in a place other than their registered offices or establishments (door-to-door selling, including any technique of distance selling) are required to make use of intermediaries duly authorized to provide investment services in Italy. Italy also prohibits banks, insurance companies, and investment firms from carrying out the activity of pension fund management unless they are managing UCITS harmonized under EC legislation and have their head office in the EC.²⁶ Even in Portugal, only specialized companies incorporated in Portugal for the purpose of pension fund and insurance companies established in Portugal and authorized to take up life insurance business can undertake pension fund activities.

Malta has undertaken commitments to allow commercial presence only in services related to acceptance of deposits and lending, where foreign-owned credit and other financial institutions may operate as a branch or local subsidiary. Similarly Slovenia has only allowed commercial presence for transfer of financial information, financial data processing, and advisory and auxiliary services. In Poland, for most of the banking services, establishment of a bank only in the form of joint stock company is allowed. Moreover, there are certain nationality requirements for the bank executives.

Finally, in Mode 4, all the countries have left movement of intra-corporate transferees and business visitors unbound and have undertaken liberalization only to the extent covered by the horizontal commitments. A number of countries including Greece and France have imposed residency and nationality requirements. Again movement of contractual service suppliers and independent professionals has been completely restricted across the entire financial services sector.

²⁶ Undertakings for Collective Investment in Transferable Securities (UCITS) are a set of European Union directives that aim to allow collective investment schemes to operate freely throughout the EU on the basis of a single authorization from one Member State. In practice many EU member nations have imposed additional regulatory requirements that have impeded free operation with the effect of protecting local asset managers.

Thus one can see from evaluating the revised offer submitted by the EU at the WTO that there is a great deal of variation in the commitments undertaken by the Member States. Among the original 15 Member States, Italy, Spain and Austria have imposed the majority of restrictions in Mode 1 and Mode 3. The newer member states, i.e., those that joined the EU in May 2004, are much more restrictive and have imposed significant barriers across all modes. Moreover, a number of these newer members have not scheduled any commitments across some sub-sectors. Looking at the various modes of supply, it seems that the maximum restrictions have been imposed in Mode 1 with a number of countries leaving it unbound. In Mode 3 countries have imposed a number of residency and nationality requirements as well as requirements related to the forms of establishment. Finally all the EU members have retained stringent restrictions on movement of financial service professionals across all sub-sectors.

7 India's Negotiating Strategy

Financial services is an area of tremendous interest to the EU Member States. As evident from the plurilateral requests, questions related to India's trade policy review, and meetings with officials from the European Commission and foreign stakeholders, the EU will vigorously pressurize India to undertake greater liberalization in the banking and insurance sector.

7.1 Likely Demand by European Union

Based on the literature review and meetings with foreign stakeholders and officials from the European Commission, in our view there are several areas where the EU will seek greater liberalization from India. In our discussions with European Commission officials it was also pointed out that the EU's demand for further liberalization in this sector is largely going to be based on the "Revised Request to India" that the EU submitted in 2005. This request was in response to the initial offer submitted by India at the WTO.

However, since then India has tabled its revised offer at the WTO, which has addressed some of the concerns. In the **insurance sector** the EU is likely to seek greater market access through Mode 1 and Mode 3. In particular, the demands are likely to include the following:

- In the case of life insurance, the EU is likely to demand full commitment in Mode 3.
- Take full commitments in Mode 1, Mode 2 and Mode 3 for services auxiliary to insurance.
- Expand Mode 1 commitment given to freight insurance to marine, aviation and transport insurance.
- Schedule commitments in Mode 2 for freight, marine, aviation and transport insurance.

- Remove all restrictions for entry by Mode 3 for all non-life insurance services.
- Undertake full commitments in Mode 1, Mode 2 and Mode 3 in re-insurance.
- Within insurance intermediation, schedule full commitments in re-insurance intermediation, marine, transport and aviation insurance in Mode 1 and Mode 2. Also across the entire sub-sector, schedule full commitments in Mode 3.
- Ease FDI limits in the formation of joint ventures in the insurance sector. This is going to be one of the key issues for the European Union during negotiations and it will vigorously pursue the relaxation of the limit to 49%.

In **banking services**, the EU is especially keen on further liberalization of Mode 3. In its request to India it has asked India to schedule full commitment in Mode 3 across a number of sub-sectors such as provision and transfer of financial information and financial consultancy services. In addition, the EU is likely to demand the following liberalization measures in the trade and investment agreement.

- Allow wholly-owned subsidiaries (WOS) of foreign banks including through the acquisition of Indian banks, in addition to branches of the foreign banks.
*(As per RBI (2005), foreign banks wishing to establish a presence in India for the first time could either choose to operate through branch presence or set up a 100% WOS, following the **one-mode presence** criterion. Moreover, foreign banks already operating in India are allowed to convert their existing branches to WOS while following the **one-mode presence** criterion.)*
- Remove the limit on branch licenses issued to foreign banks every year.
In the initial offer India raised the number of licenses issued to foreign banks from 12 to 15. In the revised offer, the license was further increased to 20.)

Regarding the removal of limit on branch licenses issued to foreign banks it must be pointed out that foreign banks in India enjoy a much greater presence than they do in the EU. As Table A6 shows, extra-EU banks account for less than 0.1% of the branches across EU Member States compared to 0.15% in India. The total share of foreign banks in India (including EU Banks) is much higher at 0.5%. Moreover, nearly half of the extra-EU bank branches are established in the United Kingdom, France and Germany. In fact in countries like Germany, France, Spain, Bulgaria, Malta, Finland, Romania and Portugal, the share of extra-EU bank branches is less than 0.05%. Finally, EU Member States like the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia do not have a single extra-EU branch.

- Remove the restriction limiting the share of foreign banks in total assets (both on and off balance sheet) of the banking system at 15%.
- Eliminate the discriminatory treatment by which public sector enterprises can invest surplus funds in term deposits only with commercial banks incorporated in India.

*As per the revised offer, public sector enterprises can **also** invest surplus funds in term deposits with WOS of foreign banks. However, such investments are subject to guidelines by the Reserve Bank of India.)*

- Lower the limits on priority sector lending for foreign banks.
(As per existing laws domestic banks are required to lend 40% of their net credit to the priority sector, which includes agriculture, small-scale industries, exports and other ‘weaker’ sectors, whereas foreign banks are required to lend only 32% of net credit to priority sectors of which 12% can go to exports.)
- Eliminate FDI limits in the formation of joint ventures in the banking sector.
- Amend the Banking Regulation Act 1949, proposing the abolition of the 10% cap on voting rights.
- Relax the regulation requiring RBI’s prior approval for acquisition of 5% or more shares or voting rights in a banking company by any person.
- Reduce the limit on the capital that the parent bank is required to provide to its off-shore banking unit; currently it stands at \$10 million.
- Remove the stipulation requiring wholly-owned subsidiaries of foreign banks having to divest their ownership down to 26% by 2009.
- Allow foreign bank branches to use parent bank’s capital to meet prudential requirements.
- In the case of branch capital, take into account the guarantee extended by the branch’s head office or by another foreign bank for additional lending volume.

7.2 Likely Demands by India

Based on the discussion in Section 6.1, there are several areas where India could improve its export of financial services if some of the existing impediments in the EU to greater trade are removed. Moreover, given that financial services is a sector where the EU has a much greater interest in expanding into the Indian market than the other way round, India should use the negotiations in financial services to get leverage in other sectors, which are in India’s interest like health services, movement of natural persons, and information technology enabled services (ITES). Thus, cross-sectoral negotiations should form an integral part of discussions related to financial services liberalization. Apart from seeking greater market access and national treatment in other sectors, India should make certain demands that would promote the export of financial services.

First, there should be a strong demand for harmonization of rules like minimum capital requirement, solvency, and tax rates across the EU Member States. This should be

undertaken at a rapid pace, especially in retail financial services, which are of paramount interest to Indian firms. There should be strong pressure from India to harmonize rules related to setting up and expansion of branches. Member countries need to coordinate and set up a uniform set of rules applicable to all foreign banks. In this context, India can invoke the Capital Requirements Directive, wherein Article 38 points out that the EU can, through agreements with third countries, agree to apply provisions which accord to branches of a credit institution having its head office outside the Community identical treatment throughout the territory of the Community.

At the negotiations India should also explore the possibility of Indian financial organizations setting up branches with derogation status of working, i.e., working with less capital. This would allow Indian financial firms to expand operations to several newer Member States where they have no presence hitherto.

India should also demand greater transparency in EU laws regarding Know Your Customer, Anti-Money Laundering, etc. These laws should be applied uniformly to financial institutions of all countries and not be used as tools of discrimination against emerging markets.

Needless to say, an important issue that needs to be raised at these negotiations relate to the guidelines regarding issuance of visas and work permits. Apart from relaxing the guidelines for work permit and visa issuance, there is also an urgent need to harmonize these guidelines, which are currently quite diverse, among the EU Member States, India needs to put pressure on the EU to liberalize movement of natural persons especially contractual service suppliers and independent professionals, which has been left unbound by the EU in the revised offer.

Finally, India should demand the same concessions given to some other countries with which the EU has concluded trade agreements. Several specific demands can be made based on the Association Agreement signed between EU and Chile in 2002. In the revised offer for cross-border supply of insurance services, Spain has refrained from making any commitment for the actuarial profession, but has not undertaken any restriction in the association agreement. Moreover, under the revised offer, Spain restricts the establishment of commercial presence of certain insurance service providers unless the foreign insurer has been operating in the same classes of insurance in its home country for at least five years. In the Association Agreement no such restriction has been imposed on Chilean insurers.

In terms of further liberalization of financial services in India, the revised offer on financial services signals a substantial improvement on what was committed over the Uruguay Round. Across most sectors India has offered to bind the existing trade and investment regime. However, India has been hesitant in making pre-commitments in areas where further reforms are in India's own interest. In the insurance sector, increasing the FDI investment limit to 49% over the next three years will allow greater infusion of capital, introduction of new instruments, market expansion and deeper penetration of insurance services. India can also undertake pre-commitments for merger and

acquisitions between foreign banks and Indian private sector banks, especially as RBI's Roadmap envisions foreign banks entering into mergers and acquisitions with Indian private sector banks after 2009, subject to the 74% investment limit.

Another area where pre-commitment would send a positive signal to India's trading partners would be regarding the provision of national treatment to foreign banks involving solvency ratios, income tax, borrowing limits, etc. These would again be consistent with what has been outlined in the Roadmap.

Such pre-commitments would signal the direction of future reforms and give domestic service providers and regulators time to prepare themselves for competition and put in place the required regulatory regime.

Finally, given the move towards greater capital account convertibility and the advent of e-commerce in financial services, it would be advisable for India to undertake some commitments in Mode 1 and 2 across most financial services. This would also strengthen India's case since it demands that developed countries provide full market access and national treatment commitment in Mode 1, and data processing of financial services under Mode 2.

However, concomitant with further liberalization, there is a need to undertake several reforms in the financial sector to make the Indian financial sector strong enough to face the onslaught of foreign competition in the financial sector. Such measures would also ensure that Indian financial firms are able to exploit their export potential.

8 Domestic Reforms

The domestic reforms that need to be carried out to enhance the efficiency of the financial system in India can be broadly categorized into two groups: reforms involving issues that lie outside the financial sector and reforms within the financial sector. One of the key areas where reforms are a priority is in the reduction of the government's structural fiscal deficit. Typically a high fiscal deficit generates a steady increase in public sector debt, crowding out credit to the private sector, and slows private sector growth. The crowding out occurs through an increase in the real interest rate, which makes it expensive to undertake investment. Though the fiscal deficit has decreased in line with the Fiscal Responsibility and Budget Management Act 2003 (FRBM), off-balance sheet items like oil bonds and fertilizer subsidies have risen considerably this year. The fiscal deficit along with off-balance sheet items must be brought under control.

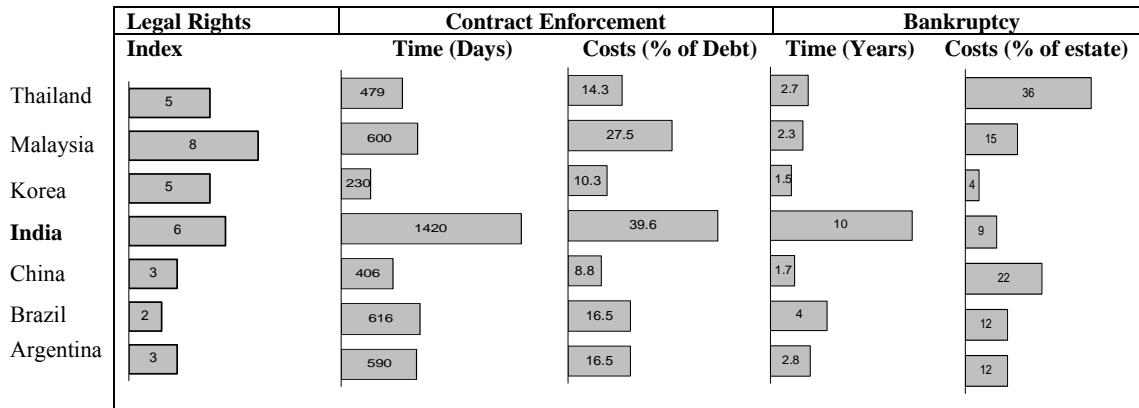
Another area of reform outside the financial sector deals with improving the judicial framework for executing collateral and improving incentives for debt servicing. While the judicial framework for executing collateral has improved, further action is needed on several fronts. Hanson (2005) suggests that the debt tribunals could be improved through expansion and computerization, which can be funded from the court fees. Procedures in

the debt tribunal system must not be long drawn and should be concluded within a short period.

Prompt debt servicing can also be ensured by establishing a credit registry. This would also help in better selection of borrowers and better credit access for small borrowers. With a credit registry borrowers have an incentive to pay promptly to maintain their credit standing. Banks would have a way to identify serial defaulters and avoid willful defaulters and this would improve banks' lending at entry. The registry should cover all loans and not just negative reports, and include non-bank loans and even small credits.

The strength of the financial sector as well as the willingness of the participants to enter the market depends on the institutions prevailing in the economy. Unfortunately, India ranks relatively low on a number of institutional parameters. According to the World Bank (2008), in India it takes 62 days to register a property compared to 29 days in China, 11 days in South Korea and 6 days in the United States. Moreover, entrepreneurs have to go through significantly more procedures to enforce contracts in India, which leads to substantial delays.

Figure 9. Comparison of Institutional Frameworks in Select Developing Countries



Source: World Bank (2008).

Apart from having to go through more procedures in India, entrepreneurs also find that the average time on each procedure in India is far higher than other countries. For example, in India it takes an average of 30.87 days to complete one procedure to enforce a contract compared to 11.6 days in China and 6.57 days in South Korea. This is primarily due to the stifling culture of red tape and needs to be curbed. Apart from stringent entry barriers, entrepreneurs also have to deal with very complex and dysfunctional exit barriers. It normally takes 10 years for a firm to close its business in India, compared to less than 2 years in China and South Korea. A careful review of the existing procedures is needed and redundant procedures weeded out.

Besides these broad reforms outside the financial sector, specific reforms within the sector are key to the emergence of Indian financial firms as global players. Below we highlight some of these reforms.²⁷

- **Managed Consolidation:** One way to create players that are able to compete at the global level could be through the path of managed consolidation. Under this, consolidation between banks that have similar profiles and interests would create banks that can operate on a global scale and have the appetite for global risks. In this context the merger of the associated banks with SBI is a step in the right direction.
- **ATM Integration:** With Automated Teller Machines (ATM) gaining prominence as a major delivery channel for banking transactions in India, a move needs to be taken to encourage inter-bank ATM networks, which would facilitate the use of ATM cards of one bank at the ATM(s) of other banks. While there are several multilateral and bilateral agreements between banks that facilitate such transactions, most banks charge fees while processing another bank’s ATM card. Moreover, RBI (2008) points out that since a customer is not aware beforehand of the charges that will be levied for a particular ATM transaction, they are reluctant to use the ATMs of other banks.

Table 13. Approach to Enhance Access to ATMs

Service	Proposed charges
For use of own ATMs for any purpose	Free
For use of other bank ATMs for balance inquiries	Free
For use of other bank ATMs for cash withdrawals	<ul style="list-style-type: none"> • No bank shall increase the charges prevailing as on December 23, 2007 • Banks which are charging more than Rs. 20 per transaction shall reduce the charges to Rs. 20 per transaction by March 31, 2008 • Free with effect from April 1, 2009.

In several EU countries like the UK, Germany and France, bank customers have access to all ATMs in the country, free of charge except when cash is withdrawn from white-label ATMs or from ATMs managed by non-bank entities.²⁸ Ideally customers should be able to access any ATM installed in the country free of charge through an equitable cooperative initiative by banks. In this context, the RBI (2008) has enacted the following charges for access to ATM.

²⁷ Interested readers are also directed towards Planning Commission (2008a, 2008b) and Government of India (2007) to get an idea of further reforms in the financial sector.

²⁸ White-label ATMs are owned and operated by non-bank entities but also branded separately by them. This means that these ATMs are not branded under a bank name.

The deadlines suggested above need to be strictly adhered to and by April 1, 2009, all ATM transactions involving cash withdrawal and balance enquiry should be free across various banks.

- **Relaxation of Directed Credit.** A move should be initiated to relax priority sector requirements, asset allocation, and guaranteed deposit schemes. Priority sector lending at less than market rate should be available only to the poorest section of society and not be cornered by influential interests in the designated sectors. Asset allocation restrictions on banks and other intermediaries must also be phased out. This will ensure that more capital is available for investment and banks can direct most of their lending on the basis of economic rationale. Investment in government securities must not be burdened on the banking sector and government securities should be made to compete with other savings instruments on a level playing field. Such a move is likely to squeeze the market for government securities, making reduction of the fiscal deficit a first-order priority.
- **Reduction of Government Control.** Increased market-based lending can be encouraged by promoting greater competition in the banking sector. This can be done by reducing the government stake in public sector banks. This needs to be accompanied by clear lines of accountability through management, a greater focus on performance, an independent board, and standards for how board committees should be configured.
- **Separate Regulatory Agency.** Currently, the Reserve Bank of India acts as a bank regulator as well as the central bank that formulates the monetary policy. However, conflicts of interest can easily arise between these objectives since a bank regulator's concern with the health of the banking sector can be in conflict with the requirements of price stability and monetary policy decisions. Like several other developed and developing countries, there should be an independent regulatory authority that looks at the health of the banking system. In a related move it is also necessary to give adequate autonomy to both the central bank as well as the regulator of the banking sector. As several cases have shown, the existing financial sector regulators in India are not sufficiently empowered and their decisions have often been influenced by political interference and not been backed by economic rationale. The regulatory bodies also need to be more transparent and held accountable to the public for their decisions rather than reporting only to government officials and ministries. Improved functioning of the regulatory agencies will also require them to improve the quality of their manpower.
- **Technology Upgrade.** There is an urgent need to develop the electronic payments system as this would yield immense benefits to consumers, businesses and banks in terms of cutting costs and saving time. Currently, electronic clearing and settlement has hardly penetrated the retail payments segment. Thus regulators need to create incentives for banks in urban, semi-urban and rural areas to bear

the initial cost of setting up these systems. Moreover, merchants and consumers also need to be provided the incentive to switch to electronic retail payments.

- **Review of Existing Branch Licensing.** As per the recommendations of the Narasimham Committee, the requirement of branch licensing should be urgently reviewed. To achieve the objective of financial inclusion, there is a need to formulate a new approach that focuses on alternative methods of access to financial services. One way forward can be to establish a linkage between accounts opened in metro cities with rural areas. The banks can be allowed to open a certain number of new accounts in a metro location provided it has opened a given number of accounts in low income/rural areas.
- **Stabilization of Risk-Based Supervision.** The Basel II norms have shifted focus to the need for a more comprehensive risk management framework to deal with various risks, including credit and market risk and their inter-linkages. In India, banks are moving from the individual silo system to an enterprise-wide risk management system. The first step would be to ensure risk integration across the entity and then one can move on to entailing risk aggregation across the group both in the specific risk areas as also across the risks. Consequently, banks will have to allocate significant resources towards this endeavour. In India, the risk-based approach to supervision is also serving as a catalyst to banks' migration to the integrated risk management systems. However, taking into account the diversity in the Indian banking system, stabilizing the risk-based supervision (RBS) as an effective supervisory mechanism is another challenge.

Though the insurance sector grew quite rapidly after being opened to private and foreign players in 2000, it currently caters to only a fraction of the Indian population. Given the rising income of the Indian populace, there is strong potential for growth in the sector. However, the sector suffers from certain disadvantages that need to be overcome. In our opinion, the key reforms in the insurance sector include the following:

- **Provide diverse products and rates.** The various insurance instruments offered by service providers should be tailored to meet the customers' needs. To fulfil this objective there is a need to de-tariff these products subject to appropriate regulatory oversight. The non-life sector is likely to benefit from such a process as are areas like motor vehicle insurance.
- **Increase FDI Cap.** Given that 80% of the Indian population is without any form of insurance coverage there is an urgent need to increase penetration. One way to achieve this is by attracting more firms and capital into the sector. In this context increasing the cap on foreign ownership on insurance companies from 26% to 49% is a viable option. This would enable joint ventures to gain access to the capital they need to maintain and expand their operations, and acquire enhanced management and consumer marketing skills.

- **Liberalize portfolios in the life insurance segment.** In the life insurance segment only 15-25% of the available corpus may be invested in ‘other than approved’ investments. Given that a number of long-term, high-yielding investments fall into the ‘other than approved’ category, the investment regulations should be reviewed. The regulations must conform to current realities and be framed in a manner that maximizes the ability of the insurance companies to optimally manage their portfolios and be free to invest in emerging instruments and derivative products.²⁹
- **Allow foreign players in Re-insurance.** A number of mature general insurance companies have capital that is in excess of current solvency requirements. As a result they are in a position to take additional risks originated by other players and earn greater premium income. FDI restrictions in this sector should be removed and foreign re-insurance companies should be allowed to set up their representative offices and operate in India through a network of branches and divisions.
- **Establish greater supervisory norms.** Increased liberalization of the sector must be matched with adequate supervision to ensure that something like the sub-prime crisis currently ravaging the US does not happen. As a result, disclosure norms, liquidity conditions and other performance indicators must be adequately supervised.

Finally, poor corporate governance, in the form of poor management of conflict of interest, inadequate understanding of key banking risks, and poor oversight of the mechanisms for risk management and internal audit result in risk management failures and financial instability. Consequently, the choices that banks make when they decide on their risk management and corporate governance systems have important ramifications for financial stability. Indian banks need to cultivate a good governance culture, building appropriate checks and balances into their operations. Leeladhar (2007) points out four important forms of oversight that should be included in the organizational structure of any bank in order to ensure appropriate checks and balances:

- (i) oversight by the board of directors or supervisory board;
- (ii) oversight by individuals not involved in the day-to-day running of the various business areas;
- (iii) direct line supervision of different business areas; and
- (iv) independent risk management, compliance and audit functions.

In addition, it is important to ensure that key personnel are ‘fit and proper’ for their jobs. Furthermore, the general principles of sound corporate governance should also be applied to all banks, irrespective of their unique ownership structures.

²⁹ Planning Commission (2008a)

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Appendix

Table A 1. Coverage of Financial Services in the Report

A.	<u>All insurance and insurance-related services</u>	812**
a.	Life, accident and health insurance services	8121
b.	Non-life insurance services	8129
c.	Re-insurance and retrocession	81299*
d.	Services auxiliary to insurance (including broking and agency services)	8140
B	<u>Banking and other financial services</u>	
a.	Acceptance of deposits and other repayable funds from the public	
b.	Lending of all types, incl., inter alia, consumer credit, mortgage credit, factoring and financing of commercial transactions	8113
c.	Financial leasing	8112
d.	All payment and money transmission services	81339**
e.	Guarantees and commitments	81199**
f.	Trading for own account or for account of customers, whether on an exchange, in an over-the-counter market or otherwise, the following:	
	• money market instruments (cheques, bills, certificate of deposits, etc.)	81339**
	• foreign exchange	81333
	• derivative products incl., but not limited to futures and options	81339**
	• exchange rate and interest rate instruments, incl. products such as swaps, forward rate agreements, etc.	81339**
	• other negotiable instruments and financial assets, incl. bullion	81339**
k	Advisory and other auxiliary financial services on all the activities listed in Article 1B of MTN.TNC/W/50, incl. credit reference and analysis, investment and portfolio research and advice, advice on acquisitions and on corporate restructuring and strategy	8131
l	Provision and transfer of financial information, and financial data processing and related software by providers of other financial services	8133

Table A 2. List of Key Directives Affecting the Banking and Insurance Sector

Directive	Details	Status
Collateral Directive (2002/47/EC)	This Directive reduces the formal collateral requirements and harmonises and clarifies the collateral process at the minimum level. It also limits credit risk in financial transactions through the provision of securities and cash as collateral.	Adopted (Deadline: 27/12/2003)
Anti-Money Laundering (2001/97/EC)	This directive sets a high standard in protecting the financial sector and other vulnerable activities from the harmful effects of crime. The Directive imposes obligations regarding in particular the reporting of suspicious transactions. The obligations of the Directive concerning customer identification, record-keeping and the reporting of suspicious transactions needs to be extended to a limited number of activities and professions which have been shown to be vulnerable to money laundering.	Adopted (Deadline: 15/06/2003)
Capital Requirements Directive (2006/48/EC and 2006/49/EC)	This directive sets out new rules on capital requirements – the amount of their own financial resources that banks and investment firms must have to cover their risks and protect depositors. It aims at modernizing the existing framework of capital adequacy to make it more comprehensive and risk-sensitive and to foster enhanced risk management amongst financial institutions. It also maximizes the effectiveness of the framework in ensuring continuing financial stability, maintaining confidence in financial institutions and protecting consumers, and is in line with the planned global introduction of the Basel II rules.	Signed in 2006
Single Euro Payment Area (SEPA)	This is a major initiative of the European banking industry and is aimed at making all electronic payments across the euro area – for example, by credit card, debit card, bank transfer or direct debit – as easy as domestic payments within one country are now. It will help improve all payments, whether they are domestic payments or cross-border payments between two euro area countries. All consumers will benefit from new rules ensuring transparent pricing and prompt transfer. Banks will be able to make the first SEPA products available starting 1 January 2008, and are aiming to make SEPA a reality for everyone by the end of 2010.	In Process
Exchange of Information with Third Countries (2000/64/EC)	This Directive allows the exchange of information between competent authorities and with certain other authorities or bodies within a Member State or between Member States. It also allows the conclusion by Member States of cooperation agreements providing for the exchange of information with the competent authorities of third countries. Ideally this authorization to conclude agreements on the exchange of information with third countries should be extended so as to include the exchange of information with certain other authorities or bodies in those countries provided that the information disclosed is subject to appropriate guarantees of professional secrecy.	Adopted (Deadline: 17/11/2002)

Directive	Details	Status
Financial Conglomerate (2002/87/EC)	All financial conglomerates subject to supplementary supervision should have a coordinator appointed from among the competent authorities involved. The tasks of the coordinator should not affect the tasks and responsibilities of the competent authorities as provided for by the sectoral rules.	Adopted (Deadline: 11/08/2004)
Reorganisation and winding up of credit institutions (2001/24/EC)	Under this Directive, persons participating in the operation of the internal structures of credit institutions as well as managers and shareholders of such institutions, considered in those capacities, are not to be regarded as third parties for the purposes of this Directive. Moreover, voluntary winding up is possible when a credit institution is solvent.	Adopted (Deadline: 05/05/2004)
Insurance Solvency (2002/13/EC)	This Directive lays down minimum standards for the solvency margin requirements and guidelines for home Member States to be able to lay down stricter rules for insurance undertakings authorized by their own competent authorities. The requirement that insurance undertakings establish, over and above the technical provisions to meet their underwriting liabilities, a solvency margin to act as a buffer against adverse business fluctuations is an important element in the system of prudential supervision for the protection of insured persons and policyholders.	Adopted (Deadline: 20/09/2003)
Reorganisation and winding-up of insurance undertakings (2001/17/EC)	This Directive concerns winding-up proceedings whether or not they are founded on insolvency and whether they are voluntary or compulsory. In the case where there are branches in more than one Member State of an insurance undertaking whose head office is located outside the Community, each branch should be treated independently with regard to the application of this Directive. This Directive is also likely to ensure an appropriate balance between the protection of insurance creditors and other privileged creditors protected by the Member State's legislation and not harmonize the different systems of privileged creditors existing in the Member States.	Adopted (Deadline: 20/04/2003)
Taxation of savings income in the form of interest payments (2003/48/EC)	This Directive is aimed at guarantying the free movement of capital. Under this directive savings income in the form of interest payments from debt claims constitutes taxable income for residents of all Member States. Member States have the right to apply the relevant provisions of their tax law which distinguish between taxpayers who are not in the same situation with regard to their place of residence or with regard to the place where their capital is invested, and to take all requisite measures to prevent infringements of national law and regulations, in particular in the field of taxation.	Adopted (Deadline: 01/01/2004)
Insurance mediation (2002/92/EC)	Insurance and re-insurance intermediaries should be registered with the competent authority of the Member State where they have their residence or their head office, provided that they meet strict professional requirements in relation to their competence, good repute, professional indemnity cover and financial capacity.	Adopted (Deadline: 15/01/2005)

Table A 3. Major Financial Indicators across EU countries, 2006

	Credit Institutions	Branches	Employees	Assets (Million €)	CR5 ^a (%)	Branches from EU	Branches from ROW	Assets of Branches from EU (Million €)	Assets of Branches from ROW (Million €)	Subsidiaries from EU	Subsidiaries from ROW	Assets of Subsidiaries from EU (Million €)	Assets of Subsidiaries from ROW (Million €)
Belgium	105	4,574	67,957	1,121,905	84.4	46	8	32,080	30,103	20	5	212,622	4,159
Czech Rep	57	1,877	37,825	114,756	64.1	13	0	10,541	0	18	3	94,201	6,429
Denmark	191	2,144	46,394	822,399	64.7	17	3	40,554	148	6	3	110,920	14,027
Germany	2,050	40,282	692,500	7,122,777	22	68	18	105,634	23,228	22	19	556,579	106,216
Estonia	14	245	5,681	15,379	97.1	7	0	1,522	0	4	0	13,620	0
Ireland	78	935	39,154	1,186,228	45	31	1	123,447	N.A.	21	10	264,732	123,771
Greece	62	3,699	62,171	315,081	66.3	20	4	31,287	471	10	0	85,950	0
Spain	352	43,691	261,890	2,515,527	40.4	62	7	183,879	5,068	41	7	91,240	5,684
France	829	40,013	435,413	5,728,127	52.3	59	25	118,960	12,523	100	53	439,472	57,018
Italy	807	32,337	339,878	2,793,244	26.3	65	9	165,955	6,838	13	3	210,812	3,975
Cyprus	336	941	10,845	74,397	63.9	4	17	733	3,277	8	1	18,535	N.A.
Latvia	27	610	11,656	22,694	69.2	3	0	1,398	0	6	4	12,248	1,056
Lithuania	77	892	8,624	17,347	82.5	2	0	N.A.	0	5	0	13,304	0
Luxembourg	154	234	24,752	839,564	29.1	34	8	111,420	19,721	75	34	615,839	47,501
Hungary	212	3,243	39,302	93,754	53.5	4	0	1,210	0	20	3	48,783	2,800
Malta	18	110	3,515	30,556	71.4	0	2	0	N.A.	9	1	11,400	N.A.
Netherlands	345	3,456	116,500	1,873,129	85.1	16	5	44,040	946	12	16	205,408	26,256
Austria	809	4,258	76,323	789,770	43.8	25	1	8,285	N.A.	15	8	141,832	4,098
Poland	723	5,158	155,881	189,511	46.5	12	0	5,463	0	31	9	103,726	14,714
Portugal	178	5,618	58,213	397,123	67.9	23	1	24,170	N.A.	9	3	61,082	3,139
Slovenia	27	696	11,838	34,879	62	2	0	N.A.	0	8	0	10,075	0
Slovak Rep	24	1,175	19,633	41,716	66.9	7	0	6,284	0	14	1	32,212	N.A.
Finland	361	1,598	23,947	255,055	82.3	22	1	13,611	N.A.	5	1	130,436	N.A.
Sweden	204	2,004	47,069	773,708	57.8	16	3	65,115	1,552	8	2	2,500	N.A.
UK	401	12,880	453,045	9,651,517	35.9	83	89	2,027,000	1,620,000	19	69	367,000	842,000
MU 12	6,130	180,695	2,198,698	24,937,530	42.8	471	88	962,768	99,236	343	159	3,016,004	382,046
EU25	8,441	212,670	3,050,006	36,820,142	42.1	641	202	3,123,941	1,733,943	499	255	3,854,528	1,270,291

^a CR5 – Share of the five largest players in total assets of the sector
Source: ECB (2007)

Table A 4. Shares of Various EU Countries in Major Financial Indicators, 2006

	Credit Institutions	Branches	Employees	Assets	CR5 ^a	Branches from EU	Branches from ROW	Assets of Branches from EU	Assets of Branches from ROW	Subsidiaries from EU	Subsidiaries from ROW	Assets of Subsidiaries from EU	Assets of Subsidiaries from ROW
Belgium	1.24	2.15	2.23	3.05	84.4	7.18	3.96	1.03	1.74	4.01	1.96	5.52	0.33
Czech Rep	0.68	0.88	1.24	0.31	64.1	2.03	0.00	0.34	0.00	3.61	1.18	2.44	0.51
Denmark	2.26	1.01	1.52	2.23	64.7	2.65	1.49	1.30	0.01	1.20	1.18	2.88	1.10
Germany	24.29	18.94	22.70	19.34	22	10.61	8.91	3.38	1.34	4.41	7.45	14.44	8.36
Estonia	0.17	0.12	0.19	0.04	97.1	1.09	0.00	0.05	0.00	0.80	0.00	0.35	0.00
Ireland	0.92	0.44	1.28	3.22	45	4.84	0.50	3.95	N.A.	4.21	3.92	6.87	9.74
Greece	0.73	1.74	2.04	0.86	66.3	3.12	1.98	1.00	0.03	2.00	0.00	2.23	0.00
Spain	4.17	20.54	8.59	6.83	40.4	9.67	3.47	5.89	0.29	8.22	2.75	2.37	0.45
France	9.82	18.81	14.28	15.56	52.3	9.20	12.38	3.81	0.72	20.04	20.78	11.40	4.49
Italy	9.56	15.21	11.14	7.59	26.3	10.14	4.46	5.31	0.39	2.61	1.18	5.47	0.31
Cyprus	3.98	0.44	0.36	0.20	63.9	0.62	8.42	0.02	0.19	1.60	0.39	0.48	N.A.
Latvia	0.32	0.29	0.38	0.06	69.2	0.47	0.00	0.04	0.00	1.20	1.57	0.32	0.08
Lithuania	0.91	0.42	0.28	0.05	82.5	0.31	0.00	N.A.	0.00	1.00	0.00	0.35	0.00
Luxembourg	1.82	0.11	0.81	2.28	29.1	5.30	3.96	3.57	1.14	15.03	13.33	15.98	3.74
Hungary	2.51	1.52	1.29	0.25	53.5	0.62	0.00	0.04	0.00	4.01	1.18	1.27	0.22
Malta	0.21	0.05	0.12	0.08	71.4	0.00	0.99	0.00	N.A.	1.80	0.39	0.30	N.A.
Netherlands	4.09	1.63	3.82	5.09	85.1	2.50	2.48	1.41	0.05	2.40	6.27	5.33	2.07
Austria	9.58	2.00	2.50	2.14	43.8	3.90	0.50	0.27	N.A.	3.01	3.14	3.68	0.32
Poland	8.57	2.43	5.11	0.51	46.5	1.87	0.00	0.17	0.00	6.21	3.53	2.69	1.16
Portugal	2.11	2.64	1.91	1.08	67.9	3.59	0.50	0.77	N.A.	1.80	1.18	1.58	0.25
Slovenia	0.32	0.33	0.39	0.09	62	0.31	0.00	N.A.	0.00	1.60	0.00	0.26	0.00
Slovak Rep	0.28	0.55	0.64	0.11	66.9	1.09	0.00	0.20	0.00	2.81	0.39	0.84	N.A.
Finland	4.28	0.75	0.79	0.69	82.3	3.43	0.50	0.44	N.A.	1.00	0.39	3.38	N.A.
Sweden	2.42	0.94	1.54	2.10	57.8	2.50	1.49	2.08	0.09	1.60	0.78	0.06	N.A.
UK	4.75	6.06	14.85	26.21	35.9	12.95	44.06	64.89	93.43	3.81	27.06	9.52	66.28
Euro 12	72.62	84.96	72.09	67.73	42.8	73.48	43.56	30.82	5.72	68.74	62.35	78.25	30.08
EU 25	100.00	100.00	100.00	100.00	42.1	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00

^a CR5 – Share of the 5 largest players in total assets of the sector

Note: All variables except CR5 are in percent

Source: ECB (2007)

Table A 5. Key Guidelines Affecting Foreign Banks in Entering and Operating in Select EU Countries

United Kingdom	France	Germany	Spain	Italy	Netherlands
Laws Related to Licensing of New Banks					
<p>1. If the applicant is interested in carrying out activities involving accepting deposits or issuing electronic money, the applicant must be either a corporate or a partnership.</p> <p>2. A corporate body must have its head and registered office in the United Kingdom, and other entities with a head office in United Kingdom must carry on business there.</p> <p>3. The Financial Services Authority's (FSA) powers to effectively supervise the applicant must not be eroded by the applicant having any close links with other persons (parent or subsidiary undertakings). The FSA also has to be satisfied that neither overseas laws nor any deficiency in their enforcement will prevent the effective supervision by the FSA of the applicant.</p> <p>4. The FSA imposes financial resources requirement identifying</p>	<p>1. A commitment of € 5 million minimum capital for a general commercial bank (other classes of credit institutions are subject to different capital requirements).</p> <p>2. A business plan outlining the institution's proposed scope of operation.</p> <p>3. The legal status of the proposed entity and representations that all requirements have been met.</p> <p>4. The financial resources, experience and fitness of the capital providers, i.e., the primary share holders.</p> <p>5. The banking experience of the individuals who will serve as directors of the institution.</p>	<p>1. Suitable evidence of funds adequate to carry out the proposed activities.</p> <p>2. The submission of information required for the determination of the reliability of the applicant and the proposed executive officers and of the professional qualifications of the owners and the proposed executive officers.</p> <p>3. A viable business plan showing the nature of the proposed business, the organizational structure of the bank to be established and the proposed internal control procedures.</p> <p>4. The submission of information on the amount(s) of substantial participation(s) in the bank to be established and the persons or entities who are the owners of such participations, & information required to judge the reliability of such owners and its executive officers or partners; audited financial statements for three years of such owners, if required</p>	<p>The incorporation of a bank is subject to the discretionary authorization of the Spanish ministry of Economy and a favourable report from the Bank of Spain. Authorization may be denied if: (1) the shareholders that will hold a significant interest in the projected entity-equal to or over 5% or that may lead them to exercise a significant influence in such entity-are not reliable or trustworthy, or (2) the bank fails to meet any of the basic requirements for incorporation mentioned below. The Directive on Consolidated Supervision also allows the Ministry of Economy to limit, suspend or deny authorization to incorporate a bank in Spain when the controlling entity of the projected bank is a non-EU entity located in a country which imposes restrictions on EU credit institutions that restrict them from an effective access to the local market.</p> <p>The basic requirements for incorporating a bank in Spain include the</p>	<p>Applications for establishing a bank in Italy has to be submitted to Banca d'Italia, which looks at a number of criteria.</p> <ul style="list-style-type: none"> • The company is a joint stock company or a limited liability company. • Both the registered office and the headquarters are located in Italy. • The paid-up capital is not less than that established by Banca d'Italia which is €6.3 million for joint stock companies and €2 million for limited liability companies. • Submission of a detailed business plan to Banca d'Italia together with its deed of incorporation and bylaws. • Certain integrity requirements established by the Treasury and the other requirements set by Article 19 of the Banking Act have to be met by holders of a controlling interest or significant participation. • Individuals performing administrative, managerial and control functions have to meet certain experience, integrity and independence requirements established by 	<p>1. Number, names and past history of the key members of the institution including those who influence day to day decisions, members of the supervisory board etc. have to be submitted to De Nederlandsche Bank (DNB).</p> <p>2. Annual accounts or an opening balance sheet, have to be provided with the auditor's report, signed by the external auditor of the applicant.</p> <p>3. A program of operations which the institution intends to carry on have to be passed on.</p> <p>4. The proposed administrative organization — including the financial accounting system and internal control-- have to be declared.</p> <p>5. The envisaged measures aimed at promoting and maintaining trustworthy conduct of its business have to be outlined.</p> <p>6. Formal and actual</p>

United Kingdom	France	Germany	Spain	Italy	Netherlands
<p>the initial and ongoing capital requirements of UK banks. All banks are required to hold initial capital in excess of €5 million. The financial resources requirement, however, varies above this amount for banks. Each bank receives individual guidance from the FSA on the ‘individual capital ratio’ applicable to them.</p>		<p>to be prepared</p> <p>5. The submission of facts which indicate a close relationship of the bank to be established to other individuals or enterprises.</p>	<p>following:</p> <p>1. New banks must have a fully paid minimum capital of € 8030364. Shares representing this capital must be issued in registered form.</p> <p>2. The bank must be incorporated as a corporation with liability limited to the amount of shareholder capital.</p> <p>3. The corporate purpose of the new bank must be limited to credit institutions activities. However, as previously mentioned, banks may engage in both commercial and investment banking.</p> <p>4. No special rights or preferences may be granted to the founders of a new bank.</p> <p>5. All new banks must be governed by a board of directors of at least five members, all of whom must be reliable and trustworthy. Furthermore, at least the majority of them must possess practical and theoretical banking knowledge.</p> <p>6. The bank must have an adequate administrative and accounting organization.</p> <p>7. The bank’s domicile and management office must be located in Spain.</p> <p>Applications for banking licenses are submitted to</p>	<p>the Treasury.</p> <ul style="list-style-type: none"> • There are no connections between the applicant or members of its group and third parties, which could impede Banca d’Italia’s supervisory authority. <p>Upon receipt of these documents Banca d’Italia must approve or reject the application within 90 days. The 90 days period is suspended if the documents are not complete.</p>	<p>control structure of the group which the institution is a part of have to be mentioned.</p> <p>7. For subsidiaries of foreign banks, a declaration from the supervisory authority of the country where the foreign bank is located is required stating that the authority approves the establishment of the subsidiary.</p>

United Kingdom	France	Germany	Spain	Italy	Netherlands
			General directorate of Treasury and Monetary Policy and must include a number of things like bank's proposed business plan, copy of the proposed bylaws, certificate issued by the Commercial Registry showing that the bank's name is not used by another corporation, list of the initial shareholders, with their percentage of shares, list of initial board of directors and proof that 20% of the initial capital of the proposed bank has been deposited with the Bank of Spain.		
Minimum Capital Requirement					
€5 million	€5 million	€5 million	Reserve of €8,030,364	€6.3 million for joint stock companies and €2 million for limited liability companies.	€ 5 million
Discretionary Powers of the Regulatory Authority					
The FSA also exercises additional control through a set of de facto powers looking at the suitability of the applicant and the existing service providers. The application of the 'fit and proper' standards allows the FSA to take into account the risk of contagion and thereby invests it with considerable discretionary powers in granting applications for authorizations.	The CECEI has wide discretion in passing on licensing decisions. In general, licensing decisions are ad hoc and involve a balancing of various factors, including whether the experience and capitalization levels of the proposed institution are appropriate given the applicant's business plan and the institution's scope of operation. Significantly, the granting of a license may	The BaFin can refuse to grant a license if the application does not contain the above stated documentation. In addition to the grounds listed above, an application for a license may be rejected by the BaFin if facts justify the conclusion that an effective supervision of the bank to be established is impeded. This is, in particular, the case if the bank to be	Once a license has been granted, a new bank is subject to special requirements during its early years of business. During the first three years in business, new bank cannot distribute dividends without the permission of the Bank of Spain. During the first five years, the bank cannot grant credits, loans or bonds in favour of shareholders, members of its board of directors, general		The DNB can reject the application, if it thinks that the day-to-day policy decisions will be decided by less than three persons, the paid up capital is €5 million and members of the supervisory board are found to be inefficient or their trustworthiness is not without doubt.

United Kingdom	France	Germany	Spain	Italy	Netherlands
<p>Specifically, a foreign bank wishing to establish operations in the UK must obtain authorization from the FSA in addition to its home state authorization. Non-EU banks seeking to carry on deposit-taking activities through its UK branches require an authorization from the FSA. In the case of subsidiaries, the single banking license may extend to subsidiaries of credit institutions. This can happen if the subsidiary is subject to consolidated supervision with the parent and certain rigorous conditions are satisfied. These conditions include ownership of the subsidiary by the parent or 90% or more of the voting rights attaching to the shares in the capital of the subsidiary.</p>	<p>be subject to conditions either precedent or subsequent. For instance, the institution may be required to increase its initial capital within a specified period of time or have other establishment conditions imposed, such as the providing of a comfort letter from the proposed institution's principal shareholders. Failure to meet any of the specified conditions may lead to a revocation of the license.</p>	<p>established is part of a group of enterprises or has a close relationship with such a group and the group lacks structural or economic transparency, if the law of another country applicable to enterprises impedes the effective supervision of the bank to be established, or if the bank to be established is a subsidiary of a bank domiciled abroad that is not effectively supervised in its home country or the supervisory authority of the home country is not willing to cooperate with the BaFin in a satisfactory manner. Furthermore, the application may be rejected if the required relevant information and documents are not presented.</p> <p>Before issuing a license to such deposit-taking credit institution or securities trading enterprises, the BaFin must consult with the competent authorities of such other member state of the EU or the EFTA in which the parent or controlling person is located. KWG requires the BaFin to suspend the decision on an application for a banking license for, or to issue a limited license to, a</p>	<p>managers or their families. Moreover, transfer or pledges of its shares cannot be carried out without the prior approval of the Bank of Spain. Additionally, at no time during this five-year period, a company or group can hold more than 20% of the bank's shares. To ensure compliance with these restrictions, and to guide the implementation of the bank's business plans, the Bank of Spain tends to closely monitor new banks during their initial 5 years of business.</p>		

United Kingdom	France	Germany	Spain	Italy	Netherlands
		<p>subsidiary of an enterprise domiciled in a country outside the EU, if the EU commission or the council of the EU has adopted a decision to that effect because the country of domicile of such enterprise discriminates against banks or investment firms from member states of the EU.</p>			
Additional Guidelines for Setting up a Branch of a Foreign Bank					
<p>The EU firms looking to establish a branch in UK have to satisfy the ‘establishment conditions’, while those looking to provide cross-border services have to satisfy the ‘service conditions’. The establishment condition requires the firm’s home-state regulator to give a ‘consent notice’, containing certain prescribed information to the FSA. The FSA would then notify the incoming EU firm of any UK rules applicable to it, on receipt of which the EU firm may commence operations in UK. If no such notice is received within two months after the date on which the FSA received the consent notice, the EU firms may begin to carry on regulated activities through its UK branch.</p>	<p>The opening of a branch by a foreign non-EU bank requires a license, even if that bank already operates another registered bank in France. The rules and procedures pertaining to the application for a branch license and the subsequent regulation and supervision of a licensed branch are basically analogous to the rules that apply to an incorporated bank entity.</p> <p>The capital requirements applicable to non-EU foreign branches are the same as those that apply to domestic entities. Foreign bank branches are subject to some additional technical requirements, such as the requirement that the branch be directed by a central administration established in the</p>	<p>The branch needs an initial capital of at least € 5 million if it intends to accept deposits or other repayable funds from the public and to extend credit.</p> <p>The initial capital has to be at the free disposal of the branch in an account with a deposit-taking credit institution in a member state of the EU or the EEA.</p> <p>The license to establish a branch of a non-EU and a non-EEA bank may be refused if reciprocity is not guaranteed on the basis of international agreements.</p> <p>The license of a branch must be revoked if and in so far as the enterprise’s license to conduct banking business or financial service business has been</p>	<ol style="list-style-type: none"> 1. The name of the branch must be the same as that of the parent bank. 2. The branch must have a reserve of € 18,030,364 available at all times to set off potential losses. 3. The branch must have at least two managers, who must be reliable and trustworthy. 4. The corporate purpose of the branch must confirm to Spanish banking law and the law of the parent company’s country of incorporation. For example, if the parent company of the foreign branch is incorporated in a country that prohibits banks from engaging in securities activities, the branch will also be barred from engaging in securities activities, even though 	<p>The establishment of a branch of a non-EU bank is subject to the prior authorization of the Treasury and has to meet the following conditions.</p> <p>(a) An endowment fund of at least €6.3 million.</p> <p>(b) The filing of detailed business plan.</p> <p>(c) Management, which meets certain integrity, experience and independence requirements.</p> <p>The decision to authorize will take into account whether the applicant’s home jurisdiction provides reciprocity. The need to establish the existence of an adequate capital fund is waived if the bank is domiciled in a G10 country.</p>	<p>The opening of a branch in the Netherlands by a non-EU bank requires a license, even if the bank already operates another registered branch in the Netherlands. The legal rules that deal with the application for a branch license and the subsequent regulation and supervision of a licensed branch are similar to the rules for a bank incorporated in the Netherlands. However, the EU credit institutions can engage in banking activities in the Netherlands – either as a branch or through cross-border activity – without requiring the approval or license by the DNB. Once established, the Dutch branch of an EU-based bank is subject to home state control, with two major exceptions. Firstly, the DNB will supervise the</p>

United Kingdom	France	Germany	Spain	Italy	Netherlands
<p>The service conditions applicable to EU credit institutions do not require any action from the FSA. Rather, an EU firm wishing to provide services in the UK must give notice to its home regulator of its intention to do so. The relevant home regulator will then inform the FSA of the EU bank's intentions, and the FSA must then notify the EEA bank of any applicable provisions. However, there are no requirements that the EU firm must wait either for the arrival of the FSA notice or for the expiry of a period of two months prior to commencing operations. Thus in the case of the EU firms, the focus is on the home-state regulations, leaving the FSA with little ongoing control over the incoming EU firms. Prudential supervision of the incoming EU firms is generally the responsibility of the home state authority with the FSA responsible for liquidity supervision and the prevention of fraud.</p>	<p>country of incorporation and that two executives be designated to serve as a legal representative of the branch.</p>	<p>revoked by the competent authority of the foreign bank's home country.</p>	<p>banks and branches under Spanish law are entitled to engage in securities activities.</p> <p>5. The corporate domicile as well as the management office of the branch must be located in Spain.</p> <p>6. The proposed branch must be approved by the supervisory authorities of the country of incorporation, or, if such approval is not required, the filing must state that the approval is not needed. In addition, a description of the bank's activities must be submitted to the Bank of Spain, with a description of the management of the relevant bank and a chart explaining the bank's organization. In addition to these specific rules, non-EU branches must comply with the requirements applicable to domestic banks and branches.</p>	<p>Even if the non-EU bank has already an Italian branch, the opening up of additional branches must nevertheless be authorized by Banca d'Italia. Non-EU banks wishing to conduct cross-border activities need authorization from Banca d'Italia and the authorization is contingent on the following findings.</p> <ol style="list-style-type: none"> 1. Supervision by the home country of the bank and banking group is adequate and encompasses activities by the bank offshore 2. There exists an arrangement between Italy and the home country for the exchange of information or such exchanges are allowed. 3. Proper authorization has been given by the regulatory authority in the home country to conduct specific activities in Italy. 4. Home country supervisory authorities have certified the financial soundness and the adequacy of the organizational structure, administration and internal accounting systems of the parent bank. 5. The non-EU bank already carries out in its home countries the activities which it proposes to perform in Italy. 6. The activities will be 	<p>liquidity of the branch and the market conduct will be supervised by Authority for the Financial Markets (AFM). Cross-border activities are not subject to Dutch prudential regulations but will have to comply with Dutch market conduct rules.</p>

United Kingdom	France	Germany	Spain	Italy	Netherlands
				<p>carried out in the same manner as they are carried out by Italian banks and the home country of the non-EU bank permits Italian banks to carry out the same activities on a reciprocal basis.</p> <p>Again the rules are much more lax for the banks that are domiciled in the EU. These banks can engage in banking activities and set up branches in other Member States if they are duly authorized by the home country regulator and do not require host country authorization. Moreover, the branches of EU banks can carry out in Italy, activities that they carry at home and are authorized by home country supervisor.</p>	
Additional Guidelines for Setting up a Wholly-Owned Subsidiary of the Foreign Bank					
<p>Reciprocity plays an important role in determining the setting up of a subsidiary of a third country bank. If it appears that there is a problem of market access or of national treatment of a UK authorized bank, or any other EEA credit institution, in relation to a third country the European Commission can request the</p>	<p>While foreign banks incorporated outside the EU are subject to basically the same procedures and rules as govern the establishment of a domestic bank, there is some differentiation in cases of banks that are incorporated in countries that have been found by the EU commission not to provide access to EU financial institutions.</p>	<p>While the rules on establishment of subsidiaries by foreign banks are similar to the rules applicable to licensing of foreign banks, some special rules apply for banks that are</p> <ul style="list-style-type: none"> • Subsidiary of a bank licensed as a bank in a member state of EU. • Sister company of the foreign bank and the parent company is 	<p>Foreign banks may establish bank subsidiaries in Spain. While the rules for incorporating a subsidiary of a foreign bank are substantially the same as the rules for incorporating a domestic bank, Article 7 of Royal decree 1245/1995 establishes specific authorization rules for new banks that will be controlled by foreign entities. It distinguishes</p>	<p>The guideline for setting up an Italian subsidiary, where the applicant is a non-EU bank is much more demanding and involves several additional requirements.</p> <ul style="list-style-type: none"> • Whether the home country of the controlling non-EU bank provides for adequate supervision of banking groups both on an individual and a consolidated basis. 	<p>Subsidiaries of foreign banks are treated as domestic banks and therefore subject to all Dutch banking regulations and supervision by DNB. Such a subsidiary can open branches throughout the Netherlands under the same license.</p>

United Kingdom	France	Germany	Spain	Italy	Netherlands
<p>European Council to enter into negotiations. However, if there is a problem of national treatment, the Commission can itself initiate negotiations and all EU member states can be asked to limit or suspend decisions regarding pending applications from the third country.³⁰</p>		<p>licensed as a bank in a member state of EU.</p> <ul style="list-style-type: none"> It is controlled by a natural person or an enterprise that also controls banks having its domicile in the member state of EU. <p>The Banking Directive establishes a requirement of reciprocity for the establishment of banking subsidiary. In conformity with the Banking Directive, KWG requires the BaFin to suspend the decision on application for a banking license for, or to issue a limited license to, a subsidiary of an enterprise domiciled outside the EU, if the EU Commission or Council has adopted a decision to that effect because the country of domicile of such enterprise discriminates against banks from member states of EU.</p>	<p>between EU and non-EU controlling entities. When the controlling shareholder of a new bank is a credit institution incorporated in an EU member state, the Bank of Spain, prior to issuing the report to be submitted to the Ministry of Economy, must consult with the home-country regulatory authorities of the controlling credit institution.</p> <p>Should the control of a new bank be exercised by a non-EU entity regardless of its status of credit institution, the Ministry of Economy may require the parent entity to guarantee the obligation of the Spanish subsidiary.</p> <p>However, the Ministry typically only asks for the guaranty in situations where the subsidiary bears the same name as the parent bank. In addition and pursuant to the Directive on Consolidated Supervision, should Spanish authorities be notified of a decision approved by the Council of the EU stating that, in the home country of the controlling entity, EU</p>	<ul style="list-style-type: none"> Whether there exists arrangement between Italy and the relevant home country for the exchange of information or, where no such agreement exists, that there are no prohibitions against the exchange of information. Whether the supervisory authorities in the home country have authorized the parent company to set up an Italian bank and to carry out the specific activities it will carry out in Italy. Whether the supervisory authorities in the home country have certified the financial soundness and adequacy of the organizational structure, the administration and the internal auditing of the parent bank and its banking groups. <p>Under some circumstances, the permissible activities of the foreign subsidiary may be limited by Banca d'Italia for capital adequacy reasons. In contrast to non-EU banks, EU banks are subject to basically the same set of rules and conditions that are applicable to Italian banks.</p>	

³⁰ Article 23 of the Banking Consolidation Directive 2000/12/EC.

United Kingdom	France	Germany	Spain	Italy	Netherlands
			credit institutions are not subject to the same competition conditions as local entities and that EU credit institutions do not have effective access to the local market, the Ministry of Economy may limit, suspend, or deny the authorization to incorporate the subsidiary in Spain.	If a non-EU entity proposes to acquire a significant participation or control of a bank or of the parent company of a banking group, Banca d'Italia will forward the application to the Treasury if the country of origin of the potential acquirer does not provide for reciprocity of treatment. In such circumstances, the Prime Minister may deny the authorization. Even when reciprocity requirements are met, prior authorization is required if any of the thresholds are met: 10%, 15%, 20%, 33% and 50% of shares with voting rights. In contrast, if the entity seeking to acquire the control of an Italian bank is EU-based, Banca d'Italia consults with the relevant authorities of that EU country. Banca d'Italia gives the authorization if the necessary conditions for the sound and prudent management of the bank are met.	
Additional Guidelines for Setting up a Representative Office of the Foreign Bank					
There is no longer any specific procedure for the recognition of a UK representative office of a non-EU bank. The	A foreign credit institution may establish a representative office without a license provided the office does not engage	Representative offices must be reported to BaFin and the Bundesbank. The representative office must restrict its activities to the	Prior authorization from the Bank of Spain is required to open a representative office. In order to obtain the	Non-EU banks can set up representative offices in Italy upon prior notification to the branch of Banca d'Italia in the region. The	A foreign bank can establish representative office in the Netherlands without being subject to a license requirement or to

United Kingdom	France	Germany	Spain	Italy	Netherlands
<p>establishment of such an office will not therefore require authorization or approval, provided that the activities of the office are restricted to no banking activities.</p>	<p>in any banking activities. However, prior to the opening of a representative office, the affiliated home office of the entity must provide detailed information to the CECEI. This would include name, legal form, capital stock distribution, main functions, etc. of both the main institution and the proposed representative office.</p>	<p>collection of information on banking and economic development in Germany and the arrangement and intermediation of business.</p>	<p>necessary permission, the following information must be submitted to the Bank of Spain:</p> <ol style="list-style-type: none"> 1. activities to be carried out by the representative office, and 2. name and personal data of the future manager of the office. <p>Representative offices may only engage in gathering information for the parent bank and are prohibited from carrying out transactions in any other business.</p>	<p>Banca d'Italia must be notified of the activities that the representative office will engage in, its address, the date of opening and the list of individuals in charge. A copy of the by-laws and a certificate from the relevant home country authority stating that the bank has complied with the requirements imposed to set up a representative office.</p>	<p>supervision by DNB, provided it does not engage in any banking activities.</p>
<p>Other Guidelines Impacting the Entry and Operation of Foreign Banks</p>					
<p>A foreign bank has to satisfy the FSA that it meets the relevant liquidity retirement. This can happen if the home state regulator certifies to this effect. Once a branch is authorized, ongoing supervision is conducted in accordance with standards generally applicable to domestic banks. In practice, the FSA expects to collaborate with relevant authorities in the home state of the parent institution and, where appropriate, apply the principles governing the supervision of overseas institutions set out in the Basel Concordat, Basel minimum standards and the Basel Core Principles.</p>	<p>Subsidiaries and branches of foreign banks are subject to the same general liquidity requirement as applicable to domestic institution. These provisions also apply to branches of EU banks. However, the branches of extra-EU banks may be exempted from liquidity requirements upon finding by the Banking Commission that the following conditions are met.</p> <ul style="list-style-type: none"> • Home country regulations of the foreign banks are at least as stringent as French regulations. • Home country of the foreign bank provides confirmation that the home 	<p>Special capital provisions apply to German branches of foreign banks. A branch's own funds consist of the sum of the amounts shown in the monthly return as working capital supplied to the branch by its head office plus the operating profit retained by the branch to strengthen its capital and reserve, less the amount of a credit balance on any inter-branch settlement account. Capital raised by the issue of participation rights or in the form of long or short-term subordinated debt and Tier III net profits only counts towards the own funds (liable capital</p>	<p>The provisions of Law 13/1992 on capital requirements do not apply to branches of EU banks if such branches are under the supervision of their domestic authorities. Subject to the Bank of Spain's approval and the satisfaction of certain requirements set forth in Circular 5/1993, branches of non-EU banks located in Spain may also be exempted from the provision of Law 13/1992, as long as comparable capital requirements have been established by their home countries.</p> <p>Branches and subsidiaries of foreign banks are subject to the minimum</p>	<p>Italian banks and wholly-owned subsidiaries of the foreign banks and branches of EU banks are subject to the 'home country control' under which inspections, and in general, supervision of subsidiaries located outside the country are conducted by the home country. This 'home country control' does not apply to branches of non-EU banks. On the basis of reciprocity, Banca d'Italia may conclude agreements with supervisory authorities of non-EU countries concerning the inspections of the branches located in the respective territories.</p>	<p>Branches of banks based in other EU member states are not subject to Dutch solvency regulations under capital adequacy norms and are guided by home regulations. In contrast, non-EU bank branches continue to be subject to Dutch solvency regulations.</p> <p>The laws governing large exposures are also vastly different for EU and non-EU banks. A large exposure is defined as an exposure to counterparty or group of counterparties that exceeds 10% of the regulatory capital. A hard limit, i.e., never to be exceeded, of 25%</p>

United Kingdom	France	Germany	Spain	Italy	Netherlands
<p>Banks from countries outside the EU have to satisfy a number of reporting requirements including an analysis of profits, large exposures, bad debts and off-balance sheet items on a half yearly basis. Moreover, these banks are also required to provide adequate information on mismatch liquidity on a quarterly basis. However, incoming EU banks are largely exempt from these reporting requirements in most circumstances</p>	<p>country regulations cover external branch operations.</p> <ul style="list-style-type: none"> • Home office of the foreign bank provides confirmation that its branches have sufficient funds to meet their commitments. <p>The branches of the intra-EU banks are only required to submit to the Banking Commission reports of their liquidity status. Other aspects of their activities are primarily subject to home state supervision rules.</p> <p>The prudential reporting requirements for the non-EU banks are subject to the same reporting requirements as French incorporated banks. However, annual accounts may be drawn up in a manner customary in the country where the institution is headquartered, and in that country's currency, but the branch must supply a certified French translation.</p>	<p>or Tier III capital, as the case may be) of a branch, if the contractual limitations as to maturity, subordination etc., are binding on the banking enterprise to which the branch belongs as a whole.</p> <p>When computing liable capital of a branch of a foreign bank, the portion constituting supplementary capital may not exceed the amount of core capital and the sum of long-term subordinated debt may not exceed 50% of core capital.</p> <p>The sum of Tier III capital of a branch of a foreign bank and the available supplementary capital must not exceed 250 % of the available core capital.</p> <p>Branches of banks licensed in another member state of the EU or the EEA do not need own funds as the capital adequacy of the whole bank is monitored by the home state authority.</p>	<p>reserve requirements noted above. However, the effect of minimum reserve requirements on foreign banks depends on the particular activities which those banks perform. Foreign banks focusing on merchant banking rely primarily on inter-bank deposits and are therefore less affected by the reserve requirements than those focusing on retail banking, which depend on consumer deposits.</p>	<p>Italian branches of EU banks are not required to prepare accounts separate from those published by the head office in the bank's home country. The EU banks have to file both the financial statements of the bank and the consolidated financial statement with Banca d'Italia. Such accounts are to be drafted and audited according to the requirements applicable in the bank's home country. These accounts must be filed together with other documents required by law along with a certified Italian translation and submitted to Banca d'Italia. In contrast, non-EU banks have to prepare accounts that are separate from the accounts published by the head office in the bank's home country.</p>	<p>regulatory capital applies to large exposures in the banking books. In addition, a hard limit of 800% of regulatory capital applies to the aggregate of all large exposures in the banking book. These rules do not apply to branches of banks established in other EU countries, which are subject to home state control.</p> <p>Branches of non-EU banks are subject to the following regime</p> <p>(a) Exposures to the head office are exempted.</p> <p>(b) Exposures to subsidiaries and other branches of the head office need not be reported if these are subject to supervision equivalent to that in EU/G10 countries. If this condition is not met, such exposures are treated as exposures to third party.</p> <p>(c) Exposure to third party exceeding 25% of the branch's own capital must be reported and DNB reserves the right to disclose this information to the supervisor of the head office. The cumulative limit of 800% is not applicable.</p> <p>The rule on large exposures does not apply to exposures of a</p>

United Kingdom	France	Germany	Spain	Italy	Netherlands
					<p>subsidiary to its parent bank in an EU/G10 country nor to exposures to other subsidiaries or financial institutions, which are covered by the consolidated banking supervision of the group concerned. Banks of certain non-EU/G10 countries are also not subject to these regulations if it is established that these banks are subject to regulations that are equivalent to the ones in EU/G10 countries.</p> <p>In the Netherlands, the banks are required to submit to the DNB, monthly detailed accounts and reports including balance sheets, tables with data relevant to solvency (capital adequacy) and data on its liquidity. However, Dutch branches of banks established in other EU countries are only required to submit prudential statements regarding their liquidity to DNB. Other aspects of their activities are subject to home state control. Similarly, other EU banks are also not subject to the internal control requirements of the DNB. These requirements include</p>

United Kingdom	France	Germany	Spain	Italy	Netherlands
					<p>continuous and systematic analysis of all banking risks, systematic monitoring of compliance with internal organizational and administrative procedures, and segregation measures to avoid conflict of interest among others. Other EU banks continue to be subject to home state control regarding these requirements.</p>

Source: Gruson and Reisner (2005)

Note: While some of the important regulations for negotiations are highlighted, they are meant to be indicative only. The reader is requested to peruse the entire table.

Table A 6. Presence of Foreign Credit Institutions in EU and India

	Number of Branches				Proportion in Total Branches		
	Local	EU	Third Country	Total	EU	Third Country	Foreign Country
Austria	4258	25	1	4284	0.584	0.023	0.607
Belgium	4574	46	8	4628	0.994	0.173	1.167
Bulgaria	5569	2	2	5573	0.036	0.036	0.072
Cyprus	941	4	17	962	0.416	1.767	2.183
Czech Republic	1877	13	0	1890	0.688	0.000	0.688
Denmark	2144	17	3	2164	0.786	0.139	0.924
Estonia	245	7	0	252	2.778	0.000	2.778
Finland	1598	22	1	1621	1.357	0.062	1.419
France	40013	59	25	40097	0.147	0.062	0.209
Germany	40282	68	18	40368	0.168	0.045	0.213
Greece	3699	20	4	3723	0.537	0.107	0.645
Hungary	3243	4	0	3247	0.123	0.000	0.123
Ireland	935	31	1	967	3.206	0.103	3.309
Italy	32337	65	9	32411	0.201	0.028	0.228
Latvia	610	3	0	613	0.489	0.000	0.489
Lithuania	892	2	0	894	0.224	0.000	0.224
Luxembourg	234	34	8	276	12.319	2.899	15.217
Malta	110	0	2	112	0.000	1.786	1.786
Netherlands	3456	16	5	3477	0.460	0.144	0.604
Poland	5158	12	0	5170	0.232	0.000	0.232
Portugal	5618	23	1	5642	0.408	0.018	0.425
Romania	4470	6	1	4477	0.134	0.022	0.156
Slovakia	1175	7	0	1182	0.592	0.000	0.592
Slovenia	696	2	0	698	0.287	0.000	0.287
Spain	43691	62	7	43760	0.142	0.016	0.158
Sweden	2004	16	3	2023	0.791	0.148	0.939
United Kingdom	12880	83	89	13052	0.636	0.682	1.318
EU 27	222709	649	205	223563	0.290	0.092	0.382
India	57042	189	84	57315	0.330	0.147	0.476

Source: EU Banking Structure, ECB and Reserve Bank of India