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Foreign direct investment in Indian banking sector: An appraisal

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Abstract
Foreign Direct Investment plays a vital role in the economy because it does not only provide huge opportunities to host countries to enhance their economic development but also opens new vistas to home countries to optimize their earnings by employing their ultimate resources. On the other hand, the banking sector in India has seen remarkable improvement in financial health and in providing jobs. Even in the wake of severe economic downturn, the banking sector continues to be a very dominant sector of the financial system. The aggregate foreign investment is a private bank from all sources is allowed to reach as much as 74% under Indian regulations. FDI in banking sector can address several issues pertaining to the sector like encouraging development of innovative financial products, improving the efficiency of the banking sector, better capitalization of banks and better ability to adapt to changing financial market conditions. Due to globalization, at present, local banks are competing in the global market, where an innovative financial product of multinational banks is the key factor in the development of local bank.

Keywords: economic development, foreign direct investment, indian banking sector, reserve bank of india, world trade organisation

Introduction

Government around the world, in both advanced and developing countries, have been attracting MNCs to come to the respective countries with their FDI. India pursued a development policy based on centralized planning, regulation and control of private enterprise, state ownership, trade protection and limits on the penetration of foreign capital and technology. This regime determined India's economic development until the mid – 1980s when there began some movement towards economic liberalization and market orientation. Foreign Direct Investment as seen as an important source of non – debt inflows and is increasing being sought as a vehicle for technology flows and as a means of attaining competitive efficiency by creating a meaningful network of global interconnections. India has sought to increase inflows of FDI with a much liberal policy since 1991. Basically, opening of the economy after 1991 does not live much choice but to attract the foreign investment, as an engine of dynamic growth especially in view of fast paced movement of the world forward Liberalization, Privatization and Globalization. In 1991, India was forced by the International Monetary Fund to embark on market liberalization and economic reforms to attract foreign direct investment. A decade after liberalization, India finds itself at a cross roads – investors are generally upbeat about the country. India has done less than other emerging markets to reduce fundamental obstacles to investment. Among the developing countries in Asia, India is a major economy that has adopted market oriented economic policies designed to attract FDI inflows. India is now getting increasingly integrated with the global economy as they open up their markets to international trade and investment inflows and has enjoyed high positive average GDP growth rate over the last two decades. The global financial crisis has recently raised the concern among policy makers and economists on the issue of the dramatic reduction of private capital inflows to developing countries and its impact on economic growth. FDI inflows to developing countries in 2008 grew at slower rate (7.2%) than in the previous year (20%), and in 2009 were expected to fall for the first time in a decade by 30%. One of the dimensions of India's increasing integration with the world economy has been the increase in both gross Foreign Direct Investment (FDI) inflows to and outflows from the country over the last decade. The rise of India as both a source and host of FDI has begun to generate a sizeable literature on the determinants and characteristics of such flows at an aggregate level. During the later half of the 1990s, foreign direct investment (FDI) into the banking industry in the Emerging Market Economies (EME) grew at unprecedented scale. FDI definitions involves normally a stake of 10% or more in a host country enterprise, together with managerial control. This empirical definition of FDI has been adopted by many countries to distinguish it from portfolio flows. Portfolio investment includes equity securities, debt securities in the form of bonds and notes, money market instruments, and financial derivatives that include a variety of new financial instruments. However, if any of those instruments compiles with the criteria of FDI capital transactions that they are considered part of FDI. All other financial transactions not covered in direct investment and portfolio investment are classified in the balance of payments as reserve assets or other investment. India is consistently making efforts to encourage more flows through FDI route than the portfolio route and

moreover, enhancing the quality of portfolio so as to safeguard its financial markets from the abnormal momentum.
India has adopted liberalization since 1991 by slowly shedding its FDI restrictions and allowing FDI through automatic route barring a few strategic industries of security concern. FDI in India is freely allowed in all sectors, including the services sector. FDI for virtually all items/activities could be brought in through the automatic route under the power vested with the RBI and, for the remaining items/activities, through Government approvals.

Review of Literature

The traditional argument against foreign equity participation in domestic companies is that these businesses often involve national and strategic interests and therefore, operational and strategic control must be retained to prevent a take – over or a buyout (Lam, 1997). Until 1993, most Indian banks were 100 percent owned by the central government and private investment was allowed only in handful of private banks formed around the 1940s, further, foreign banks and financial institutions were allowed only 20 percent stakes in Indian banks. In 1993-94, nine new banks were formed in the private sector and one co – operative bank was converted to a private bank. Banks were permitted to issue Certificates of Deposits (CDs) and offer foreign currency deposits to Non – resident Indians (NRIs) with exchange rate risk borne by the banks.
A major push towards liberalization occurred in 1995-96 when India committed to the World Trade Organization (WTO) recommendations and relaxed the requirement to continue shielding the priority sector from foreign equity participation. For the next five years, changes in the banking sector mainly aimed at allowing banks more flexibility in the design and marketing of products. Chandrasekhar and Ghosh (2012) have pointed out that an important objective of FDI has been to promote efficiency in production and increase exports. However, any increase in the equity stake of the foreign investors in existing joint ventures or purchase of a share of equity by them in domestic firms would not automatically change the orientation of the firm. That is, "the aim of such FDI investors would be benefit from the profit earned in the Indian market."
Banking system is an important part of financial system of any country and in India; banking system act as a key driver for Indian financial system. If banks are expanding their area of operation, the changing strategies are required to face the competitive pressures and demonstration effect on local institutions. Through FDI, the host countries will know efficient management technique and able to solve various problems of the overall banking sector like innovative financial products, technical developments in the foreign, markets, problem of inefficient management, non – performing assets, financial instability, poor capitalization and changing financial market conditions etc. So, Government should make liberal FDI policy for banking services for taking advantage of such important tool (Goyal and Arif, 2010) [5].
Laghane (2011) empirically examined the impact of FDI model on borrower account, bank branches, time deposits and profitability of domestic and foreign banks. In the study, he suggested the FDI must be considered in poverty reduction, unemployment reduction and primary education and priority sectors of banking. Finally, be concluded that the LPG sponsored FDI model's impact on foreign banks in Indian bank's profitability is positive. The impact of FDI on Indian banking sector is negative except profitability.
Badade & Katkar (2011) have studied that India has sought to increase inflows of FDI with much liberal policy since 1991 after decade cautious attitude. The 1990s have witnessed a sustained rise in annual inflows to India. They rightly pointed out that the present scenario looks more closely at the paradigm of exponential growth and laments that India's role as an engine for global growth has been limited by the still relatively closed nature of its economy. FDI plays a vital role in the economy by providing opportunities to host countries to enhance their economic development. India is considered to be the third not preferred investment destination in the world. It is observed that service sector is one of the dominating sectors in attracting more FDI inflows. The top countries investing in the form of FDI in service sector are Mauritius, Singapore and United Kingdom. FDI in Banking Sector solves various problems like inefficient management, non – Performing Assets, Financial Instability and Poor Capitalization. Further, FDI in Banking sector provide benefits of Technology Transfer, Better Risk Management, Financial Stability, Innovative Products and Employment. Interestingly, FDI inflows in banking sector have been increasing year by year. It is found that, during period from January to June, 2013 banking sector received FDI inflows Rs. 1702.03 crores which account for 17.06 per cent of total FDI in Service Sector. It is very high FDI inflows in Banking Sector when compared to the same period of another calendar year (Malla Reddy, 2014) [8].

FDI in Indian Banking Sector

Today Indian Banks are technology savvy as their counter parts in developed countries. The competitive and reform forces have led to the emergence of internet, e – banking, ATM, credit card and mobile banking too, in order to attract and retain the customers by bank. As a result of Liberalization, Privatization and Globalization mode, Indian banks going global and many global banks setting up business in India, the Indian banking system is set to involve into a totally new level it will help the banking system grow in strength going to the future.
The banking sector plays an important role in the economic development of a country. It supplies the lifeblood – money that supports and fosters growth in all the industries. True, monetary resources per se, cannot ensure business success, which requires competencies on several other fronts, including technology, availability of skilled manpower, well – managed structure and a well – executed competitive strategy.
FDI is a tool for economic growth through its strengthening of domestic capital, productivity and employment. FDI also plays a vital role in the upgradation of technology, skills and managerial capabilities in various sectors of the economy. Foreign Direct Investment as seen as an important source of non – debt inflows and is increasing being sought as a vehicle for technology flows and as a means of attaining competitive efficiency by creating a meaningful network of global

interconnections. FDI plays a vital role in the economy because it does not only provide opportunities to host countries to enhance their economic development but also opens new vistas to home countries to optimize their earnings by employing their ideal resource.
There are three components of FDI, namely, equity capital, reinvested earnings and intra company loans:

- Equity capital is the foreign direct investor's purchase of shares of an enterprise in a country other than his own country.
- Reinvested earnings comprise the direct investor's share (in proportion to direct equity participation) if earnings not distributed as dividends by affiliated or earnings not remitted to the direct investor. Such retained profits by affiliates are reinvested.
- Intra company loans or intra – company debt transactions refer to short or long term borrowing and lending of funds between direct investors (parent enterprises) and affiliate enterprises.

FDI in banking sector can solve various problems of the overall banking sector. Such as:

1. Innovative Financial Products
2. Technical Developments in the Foreign Markets
3. Problem of Inefficient Management
4. Non – performing Assets
5. Financial Instability
6. Poor Capitalization

If we take into consideration the root cause of these problems, the reason is low – capital base and all the problems are the outcome of the transactions carried over in a bank without a substantial capital base. In a nutshell, we can say that, as the FDI is a non – debt inflow, which all directly solve the problem of capital base. As due to the globalization local banks are competing in the global market, where Innovative financial products of multinational banks is the key limiting factor in the development of local bank. They are trying to keep pace with the technological development of banks. Now a day's banks have been prominent and prudent in the rapid expansion of consumer lending to domestic as well as in foreign markets. It needs appropriate tools to assess (how such credit is managed) credit management of the banks and authorities in charge of financial stability. It may need additional information and techniques to monitor for financial vulnerabilities. FDI's tech transfers, information sharing, training programs and other forms of technical assistance may help meet this need.

The Road Ahead

As the Banks are expanding their area of operation, there is a need to change their strategies exerts competitive pressures and demonetization effect on local institutions, often including them to reassess business practices, including local lending practices as the whole banking sector is crying for a strategic policy for risk management. Through FDI, the host countries will know efficient management technique. The best example is Basel II. Most of the banks are opting Basel II for making their financial system safer. Host countries may benefit immediately. From foreign entry, if the foreign bank re capitalize a struggling local institution. In the process also provides needed balance of payment finance. In general; more efficient allocation of credit in the financial sector, better capitalization and wider diversification of foreign banks along with the access of local operations to parent funding, may reduce the sensitivity of the host country banking system and lead towards financial stability.
In the private banking sector of India, FDI is allowed up to a maximum limit of 74% of the paid – up capital of the bank. On the other hand, Foreign Direct Investment and Portfolio Investment in the public or nationalized banks in India are subjected to a limit of 20% in totality. This ceiling is also applicable to the investments in the State Bank of India and its associate Banks. FDI limits in the banking sector of India were increased with the aim to bring in more FDI inflows in the country along with the incorporation of advanced technology and management prices. The objective was to make the Indian banking sector more competitive.
The Reserve Bank of India (RBI), has allowed foreign players to set up bank branches in rural India and take over weak banks with an investment of up to 74%, and further relaxations by 2010, with the second phase of opening expected to commence in April 2009.The banking industry in India has witnessed many changes since the early 1990s. Initially the Government contributed substantially to the equity of a large number of public sector banks in order to improve their capital adequacy levels. Then the Government sought to change the structure of the Indian banking industry by granting licenses to a new generation of private sector banks. This step has been quite successful, as these banks have introduced the latest technology to differentiated themselves, opened ATMs and branches at a rapid pace and successfully weanded away customers from other banks. The Government has now taken the next step by allowing foreign banks to take over private sector banks.

Conclusion

Indian banking had come a long way since adopted reforms path. Today Indian Banks are as technology savvy as their counter parts in developed countries. The competitive and reform force have led to the emergence of internet, e – banking, ATM, credit card and mobile banking too, to let banks attract and retain customers. This apart retail lending has emerged as another major opportunity for banks. Due to globalization, liberalization and privatization mode, Indian banks going global and many global banks setting up shops in India, the Indian banking system is set to involve into a totally new level it will help the banking system grow in strength going into the future.

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