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Inflow of FDI in Banking Sector

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Abstract

Foreign direct investment is the investment made by a foreign individual or company in productive capacity of another country. It is the movement of capital across national frontiers in a manner that grants the investor to control over the acquired asset.

Inflow of Foreign investment is the main economic activity for the development of country. There are two basic types of foreign investment.

1.) *Foreign direct investment*
2.) *Foreign portfolio investment*

This abstract is based on the foreign direct investment in banking industry in India. Banking sector is the main sector of a country. Because over all development of the country is fully dependent on the growth of banking sector. Banking sector creates the infrastructure development as well as economical development.

The performance of foreign banks in India and compare the foreign bank to the Indian domestic banks whether public banks or private banks. There are various angles in which analyze the performance of foreign banks like according to the investment, growth, market share, profitability etc. On the basis of all these angles researcher is analyzing the performance of foreign banks in India. The banking industry in India seems to be unaffected from the global financial crises which started from U.S in the last quarter of 2008. Despite the fallout and nationalization of banks across developed economies, banks in India seems to be on the strong fundamental base and seems to be well insulated from the financial turbulence emerging from the western economies. The Indian banking industry is well placed as compare to their banking industries western counterparts which are depending upon government bailout and stimulus packages.

The strong economic growth in the past, low defaulter ratio, absence of complex financial products, regular intervention by central bank, proactive adjustment of monetary policy and so called close banking culture have favored the banking industry in India in recent global financial turmoilance.

The RBI, which is the regulator of the banking sector, had a strong case for issuing elaborate guidelines on bank ownership to ensure diversification. Those reasons retain their relevance even today. So there is no case for altering them, especially if the evidence suggests that accessing foreign equity, if needed, to enhance the capital of banks is possible within the current regulatory framework.

Keywords: *Foreign direct investment, Indian banking industry, Foreign portfolio investment*

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1. INTRODUCTION

Inflow of Foreign investment is the main economic activity for the development of country. Foreign direct investment is the investment made by a foreign individual or company in productive capacity of another country. It is the movement of capital across national frontiers in a manner that grants the investor control over the acquired asset The paper is analyzing the foreign direct investment in banking industry of India. Banking sector is the main sector of a country. Because over all development of the country is fully dependent on the growth of banking sector. Banking sector creates the infrastructure development as well as economical development.

In the present work the main objective of this paper is to analyze the banking sector with the growth perspective of foreign banks investment as FDI. In research, the performance of foreign banks in India and compare the foreign bank to the Indian domestic banks whether public banks or private banks. There are various angles to analyze the performance of foreign banks like according to the investment, growth, market share, profitability etc. On the basis of all these angles we are analyzing the performance of foreign banks in India.

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 resources.

India has sought to increase inflows of FDI with a much liberal policy since 1991 after decade's cautious attitude. The 1990's have witnessed a sustained rise in annual inflows in India. 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.

Foreign bank or its wholly owned subsidiary regulated by a financial sector regulator in the host country can now invest up to 100% in an Indian private sector bank. This option of 100% FDI will be only available to a regulated wholly owned subsidiary of a foreign bank and not any investment companies. Other foreign investors can invest up to 74% in an Indian private sector bank, through direct or portfolio investment. The Government has also permitted foreign banks to set up their wholly owned subsidiaries in India. The government, however, has not taken any decision on raising voting rights beyond the present 10% cap to the extent of shareholding. The new FDI norms will not apply to PSU banks, where the FDI ceiling is still capped at 20%. Foreign investment in private banks with a joint venture or subsidiary in the insurance sector will be monitored by RBI and the IRDA to ensure that the 26 percent equity cap applicable for the insurance sector is not be reached.

All entities making FDI in private sector banks will be mandatory required to have credit rating. The increase in foreign investment limit in the banking sector to 74% includes portfolio investment, foreign institutional investors and non-resident Indians (NRIs), IPOs, private placement, ADRs or GDRs and acquisition of shares from the existing shareholders. This will be the cap for any increase through an investment subsidiary route as in the case of HSBC-UTI deal.

The decision on foreign investment in the banking sector, the most radical since the one in 1991 to allow new private sector banks, is likely to open the doors to a host for mergers and acquisitions. The move is expected to also augment the capital needs of the private bank. The structure of the Indian economy has undergone considerable changes in the last decade. These include increasing importance of external trade and of external capital flows. The service sector has become a major part of the economy with GDP share of over 50 per cent and the country becoming an important hub for exporting IT services. The share of merchandise trade to GDP increased to over 35 per cent in 2007-08 from 23.7 per cent in 2003-04. If the trade in services is included, the trade ratio is 47 per cent of GDP.

The rapid growth of the economy from 2003- 04 to 2007-08 also made India an attractive destination for foreign capital inflows and net capital Inflows that were 1.9 per cent of GDP in 2000-01 increased to 9.2 per cent in 2007-08. Foreign portfolio investment added buoyancy to the Indian capital markets and Indian corporate began aggressive acquisition spree overseas, which was reflected in the high volume of outbound direct investment flows.

Now a day, foreign commercial and investment banks have quietly begun picking up public sector bank's bond issues. Bankers said that the funds were coming into these bonds; some of the foreign banks were also using the banks' bonds as an arbitrage opportunity in view of the increasing liquidity.

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.

The Banking Sector Today

Depth
- Countrywide coverage
- Large number of players
- Increasingly sophisticated financial markets

Diversification
- Emergence of integrated players
- Diversifying capital deployment
- Leveraging synergies

Technology
- Increasing use of technology in operations
- Poised to expand and deepen technology usage

Regulation
- Robust regulatory system aligned to international standards
- Efficient monetary management

GUIDELINES FOR FDI IN BANKING

According to the guidelines for FDI in the banking sector, Indian operations by foreign banks can be executed by any one of the following three channels -

1. Branches in India
2. Wholly owned subsidiaries.
3. Other subsidiaries.

Banks are "special" as they not only accept and deploy large amount of uncollateralized public funds in fiduciary capacity, but they also leverage such funds through credit creation. The banks are also important for smooth functioning of the payment system. In view of the above, legal prescriptions for ownership and governance of banks laid down in Banking Regulation Act, 1949 have been supplemented by regulatory prescriptions issued by RBI from time to time.

FORM OF INVESTMENT MADE BY FOREIGN COMPANY

A foreign company planning to set up business operations in India has the following options:

- Joint Ventures
- As an office of a foreign entity through
- Liaison Office / Representative Office
- Project Office
- Branch Office
- Wholly owned subsidiaries

TYPES OF FDI

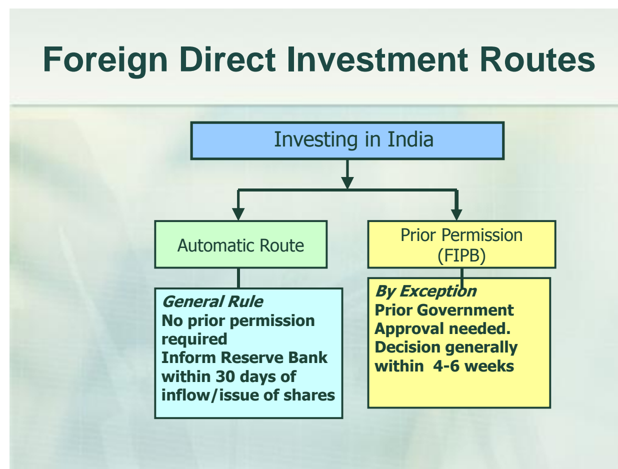
There are two basic types of foreign investment.

- Foreign direct investment
- Foreign portfolio investment

WAYS TO INVESTMENT MADE BY FDI

Foreign direct investment is done in two ways:

- **GREENFIELD INVESTMENT:** It is the direct investment in new facilities or the expansion of existing facilities. It is the principal mode of investing in developing countries.
- **MERGERS AND ACQUISITION:** It occurs when a transfer of existing assets from local firms takes place.



LIMITS OF FDI IN BANKING SECTOR

1. LIMITS OF FDI IN PRIVATE SECTOR BANKS

(a) FDI up to 49 per cent from all sources will be permitted in private sector banks on the automatic route.

(b) For the purpose of determining the ceiling of 49 per cent FDI under the "automatic route" in respect of private sector banks, the following category of shares will be included IPOs; private placements; ADRs/GDRs; and acquisition of shares from existing shareholders.

(c) However, as per government guidelines, issue of fresh shares under the automatic route is not available to those foreign investors who have a financial or technical collaboration in the same or allied field. This category of investors requires the Foreign Investment Promotion Board approval.

2. LIMITS OF FDI IN PUBLIC SECTOR

Limit for FDI in public sector banks In the case of nationalised banks as well as SBI and its associate banks, the overall statutory limit of 20 per cent as FDI and portfolio investment will continue.

Voting rights of foreign investors

In the case of private sector banks, no person holding shares, in respect of any share held by him, shall exercise voting rights in excess of 10 per cent of the total voting rights of all shareholders.

Budget announcements

Further, the Finance Minister has made the following announcements in the budget 2002.

* It has been decided to give an option to foreign banks to either operate as branches of their parent banks or to set up subsidiaries. A foreign bank will have to choose one of the two options. It has also been decided to relax the maximum ceiling of voting rights of 10 per cent for such subsidiaries.

* New FII portfolio investments will not be subject to the sectoral limits of FDI except in specific sectors. Guidelines in this regard will be issued separately.

Earlier, it had been interpreted that FII investments in private sector banks could be made up to 49 per cent of equity, at the same level as FDI limit. However, after the Finance Minister's announcement one has to wait and see as to the level that FII investment will be allowed in this sector.

Interesting possibilities

With FDI investments of up to 49 per cent of equity and supported by substantial FII investments, foreign banks can control nearly the entire equity of taken over private sector banks. If this is the intention of the Government/RBI, then what happens to branch restrictions applicable to foreign banks? We may then witness a dual policy of foreign banks with branches not being allowed to open new branches, while foreign banks controlling private sector banks being allowed to operate all over the country.

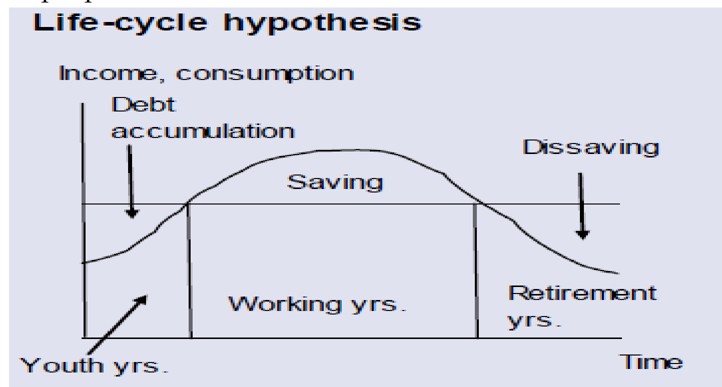
In case foreign banks convert their branch operations in India into a subsidiary, then in the normal course the new legal entity should be treated as a domestic company and not a foreign

company. In addition to the issue of differential taxation, would such a conversion enable more freedom in geographical expansion.

WHY FOREIGN BANKS ARE INVESTING IN INDIA

1. GROWING HOUSEHOLD SAVINGS

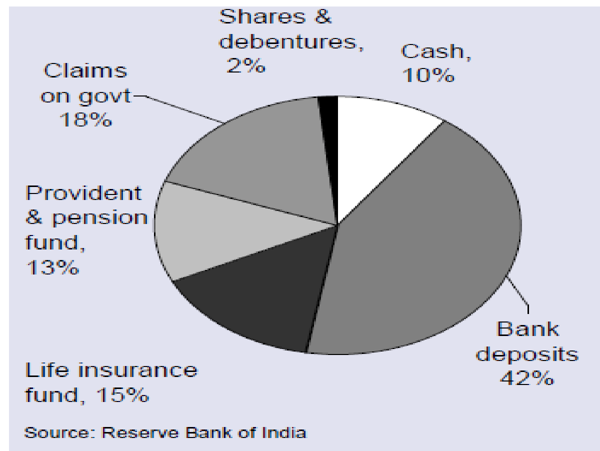
The young structure of the Indian population means that a huge cohort will enter the working years phase in the next decade or so. The size of this group has been estimated at 40% of India's population, or 266m people.



According to the life-cycle hypothesis15, this should bring about a very sizeable increase in household savings (see chart). Taking the past five years as reference, household savings could pick up to at least 30% of GDP by 2020 from the current level of 22.6%.

2. INVESTMENT MADE BY INDIAN HOUSEHOLD

Thus far, investments made by households have characteristically been conservative and poorly diversified. Of the household domestic savings in 2009, roughly 54% of the total went into physical assets, while the balance was invested in financial instruments. The lion's share of the latter was accounted for by bank deposits, followed at a distance by government bonds. Investment in equities, either through direct ownership or via mutual fund purchases, was muted (see chart).

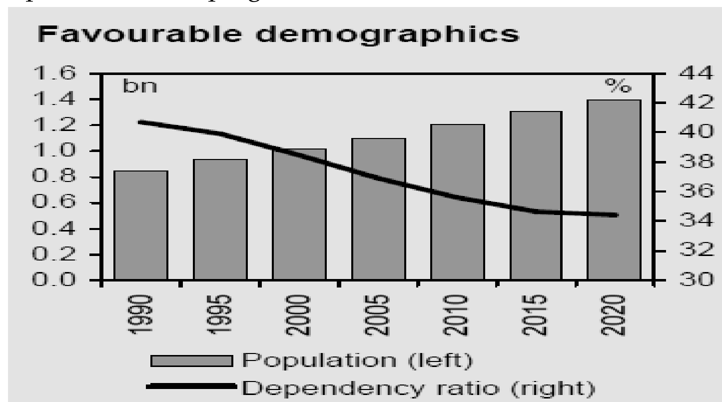


However, recent trends indicate growing ownership – albeit at a gradual pace – of mutual funds by households, suggesting their willingness to venture into other asset classes that offer higher expected returns in the future. Given India's relatively young population, a lower risk aversion leading to increasing demand for non-traditional investment products is to be expected. Adding to that a rising income level for this population group, and a defined-contribution pension reform in the making, the scope for expansion in investment services appears large going forward.

FACTORS WHICH MAKE INDIA A HOT DESTINATION FOR FDI

1. POPULATION AND DEMOGRAPHIC TRENDS

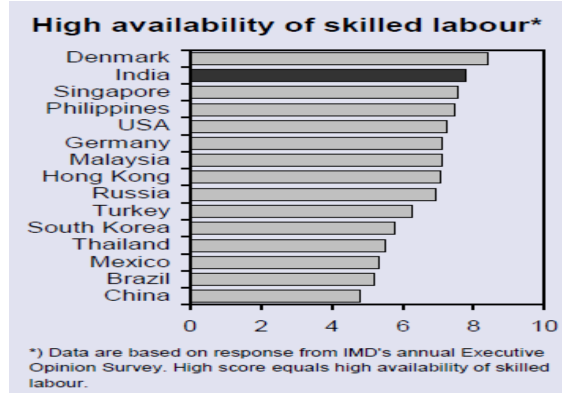
India has a population of just below 1.2 billion today, the 2nd largest in the world after China, increasing at roughly 1.5% per year. Our model shows that while the growth rate is expected to moderate to around 1.3% by 2020, India will still have the 2nd fastest population growth in our sample of 34 developed and developing economies.



Importantly, India has a young population. As of 2009, roughly 33% of its population was below the age of 15 while only around 5% was above the retirement age of 65. This implies that over the next 10 to 15 years a big portion of the country's population will be within the working age

2. HUMAN CAPITAL

However, economic growth does not depend on population growth alone. The quality of labour input plays a critical role in unleashing the productive capacities and technical progress that ultimately lead to higher growth. In this light, India still has a long way to go.

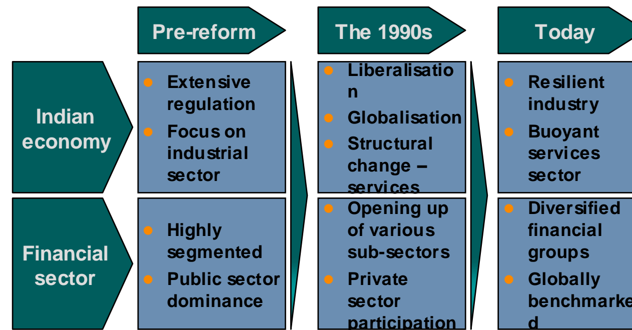


3. EXPECTED GROWTH CHANGES IN CONSUMPTION AND SAVINGS PATTERNS

India's projected growth trajectory, together with demographic developments, will have a critical influence on consumption and savings patterns in the next few years.

This substantial rise in per capita income, coupled with the sheer size of the Indian population, will give a tremendous impulse to the rise of a mass-consumption market. Moreover, due to structural changes in income distribution that has occurred over the past decade, a sizeable fraction of the poorest segments of the population has migrated to a higher income class, implying a larger potential consumption capacity. Not surprisingly, this effect has been more pronounced in urban than in rural areas

IMPACT of FOREIGN BANKS



NEW FDI NORMS FOR BANKING SECTOR

The new foreign direct investment (FDI) guidelines may be revised with respect to the banking sector to avoid adverse fallout for Indian banks with majority foreign equity.

Under the new regime any downstream investment by a firm with more than 50 per cent foreign equity will be considered as FDI. Thus, banks like ICICI Bank, which have more than 50 per cent foreign equity, will be treated as foreign-owned but Indian-controlled entities and any downstream investment by them will be subject to FDI restrictions. The Reserve Bank of India had recently pointed out to the finance ministry that the press notes, released by the Department of Industrial Policy and Promotion (DIPP) in February 2009, could impact seven Indian private sector banks.

According to the provisions of these press notes, ICICI Bank, ING Vysya, YES Bank, HDFC Bank, Development Credit Bank, IndusInd Bank and Federal Bank are foreign-owned Indian-controlled banks, the central bank observed. As a result, their downstream investments will have to conform to restrictions applicable to the FDI route.

DIPP feels that since banking is a regulated sector, it may need some additional provisions on FDI. "The issue will be examined, followed by inter-ministerial consultations between DIPP, Department of Financial Services, Department of Economic Affairs and even the RBI. If there is a consensus in these discussions that specific relaxations need to be provided to the banking sector, they would be carried out," said a government official. The new regulations will be applicable only after they are notified under the Foreign Exchange Management Act (FEMA). However, this process will take time due to inter-ministerial consultations .ICICI Bank has written to DIPP, stating its current shareholding pattern, and asking for a clarification on its status. "DIPP has not received any other communication from other banks," the official added.

The industry department maintains that the new foreign investment guidelines are one of the most comprehensive and ensure foreigners do not get control of Indian firms in sensitive sectors, which have FDI limits. "Concepts like ownership and control, which were incorporated in the FDI policy for the first time, ensure this. These definitions were finalised after consulting legislation like the Companies Act, lawyers and industry experts," the official said.

RBI, in its observations on the FDI policy, had also stated that the new FDI norms could lead to "de-facto" capital account convertibility, which is restricted at the moment. Moreover, the DEA also expressed similar views on the new press notes and maintained that they would lead to breach of sectoral caps.

DIPP maintains that the new FDI guidelines were finalised after inter-ministerial consultations and approved by the Union Cabinet, after the nod of a Group of Ministers headed by Finance Minister Pranab Mukherjee.

BENEFITS FROM FDI TO INDIAN BANKING SECTOR

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

i) Innovative Financial Products
ii) Technical Developments in the Foreign Markets
iii) Problem of Inefficient Management

iv) Non-performing Assets
v) Financial Instability
vi) Poor Capitalization
vii) Changing Financial Market Conditions

If we consider the root cause of these problems, the reason is low-capital base and all the problems is 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 will directly solve the problem of capital base.

3. CONCLUSION

Foreign direct investment is the investment made by a foreign individual or company in productive capacity of another country. It is the movement of capital across national frontiers in a manner that grants the investor control over the acquired asset. Foreign Investment is made in two ways that is foreign direct investment and foreign portfolio investment. Foreign investment is done as joint venture, project offices, branch offices and wholesale subsidiaries. In the present research work the main objective is to analyze the banking sector with the growth perspective of foreign banks investment as FDI. Large population, availability of human capital and growth in consumption and saving pattern made India a hot distinction for FDI. Public banks gain profitability due to foreign banks is 24.20 %and commercial banks is 17.50%. India has acquired innovative technology due to foreign banks and large amount of people employed by these banks. The effect of entry of private and foreign banks on the efficiency of the public or domestic banks has been demonstrated empirically. Especially the presence of the foreign banks has been shown to be very effective in efficiency improvements in the emerging market economies. Before the 1991 era, public sector banks had completely monopoly due to government regulation and they were not measured for such parameters and thus never cared much. The big improvement came due to the entry of foreign banks and various private sector banks which matched the global players and this focus by other players forced public sector banks to look into their backyard to improve their profitability. Although there have been much improvements in term of efficiencies in the public and domestic private banks, foreign banks still have the highest efficiency levels. This may be attributed to the priority sector lending and various other restrictions on the public sector banks and also less number of branches for foreign banks lead to smaller size and thus better control. The profitability of the foreign banks has been much higher consistently.

The foreign banks had definitely put a positive impact on the domestic banks but the desire to acquire market and high competition resulted in product offerings which were very complex in nature and also the exposure to different sectors was highly skewed. This meant that such banks would come under pressure at the first signs of trouble in the economy or a particular sector to which they were over-exposed. This was proved true in the recent global meltdown when the banks across the world were facing difficulties due to their unrestrained behavior whereas the Indian public sector banks had not too much of difficulty.

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