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Foreign Direct Investment in Indian Banking Sector: Trends, Opportunities and Impact

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Abstract

In the rapidly changing economic environment, Foreign Direct Investment (FDI) is used as the stimulus for growth in the most of developing countries including India. Globalization has engulfed all the sectors into its fold, out of which the banking sector is a crucial one. FDI in Indian banking sector has a lot of opportunities as well as challenges. This Paper explores the opportunities for FDI in Indian banking sector and highlights its various forms of presence in India. It further investigates the trends in FDI into Indian banking sector and attempts to reckon the impact of presence of foreign banks on Indian domestic banks. The study also throws light on RBI's amendments and recent foreign policy with respect to FDI in India.

Key Words*: Foreign Direct Investment (FDI), RBI, Indian Banking Sector, Foreign Banks*

1. Introduction

Foreign Direct Investment (FDI) is considered to be life blood of economic development especially for developing and underdeveloped countries (Shylajan, 2011). Though FDI has its own shortcomings, many developing countries have opened up their economies. For last two decades, the attentions of developed countries have been drawn by developing countries due to their high growth potential, untapped market and investor friendly environment. In 2012, developing countries took over the developed countries, first time ever, in attracting FDI accounting for 52 per cent of global FDI flows. One of the reasons may be the rate of return. The return on FDI was 7 per cent globally and higher in both developing (8 per cent) and transition economies (13 percent) than in developed ones (5 per cent). India has been ranked at 15th Place in receiving FDI in 2012. It gained the 3rd place in attracting FDI in the world (IMF, 2013).

Foreign Direct Investment is used as the stimulus for growth in the most of developing countries including India. Globalization has engulfed all the sectors into its fold, out of

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which the banking sector is the crucial one. FDI in Indian banking sector has lot of opportunities as well as challenges. According to the Department of Industrial Policy and Promotion (DIPP), India has attracted US$ 293,641million as a cumulative foreign inflow from 2000-2013, out of which the service sector bagged the highest portion of 19%. With the rise in International service transactions and economic integration, the banking services befitted as crucial activities for any business. This has further led to high opportunities for FDI in the Indian banking sector.

2. Objectives

The present study tries to reduce the gap by studying on foreign banks in India and by digging various opportunities for FDI in Indian banking sector. By having handful of studies on foreign banks in India, the present study has the following objectives in mind.

- To explores the opportunity for foreign direct investment in Indian banking sector.
- To investigate the trends in the matter of foreign investment into Indian banking sector.
- To determine the impact of foreign banks presence on Indian domestic banks.
- To discuss the role of new phase of FDI policy by Reserve Bank of India (RBI) in Indian banking.

3. Methodology and Data Sources

The information for the study has been collected mainly from secondary sources. The present study is descriptive and analytical in nature. The data is obtained from various publications like Narasimhan committee report, RBI Bulletin, statistical tables relating to banks in India, Basic Statistical Returns of Scheduled Commercial Banks in India and Handbook of Statistics on Indian Economy published by the RBI from year to year. The data collected relate to FDI in banking sector in India are analyzed through simple tabular and graphical statistical methods. By surveying the available theoretical and empirical evidences in the Indian context from various research studies, the study examines the role of new phase of FDI policy by RBI in Indian banking.

4. Literature Survey

There is abundance of literature available on FDI in Indian economy but it is shocking that very few have focused on FDI in Indian banking sector. Though studies on Indian banking system repetitively highlighted about the lack of competition as high net interest margin prevails in the Indian banking sector; however, the focus of studies on scope for foreign banks' entry is minimal. The discussion on FDI in Indian banking sector, opportunities for foreign banks and their impact on Indian banks through literature support is provided.

FDI in banking sector has different forms, nature and scope depending on the development level of economy and its Central Bank's policies (Hurduc & Nitu, 2011).

While the impact of foreign banks on domestic banks also depends on the financial development of host country, banking rules can discriminate between countries of origin, based on bilateral treaties, reciprocity reasons or industry structure (Hermes and Lensink, 2004). Alternatively, a country may restrict the expansion of its banks abroad (Hurduc & Nitu, 2011). The existing literature shows that local market opportunities are major factors in attracting foreign banks into new markets (Dunning, 1977). According to Kim and Pant (2010), Indian market is attractive to foreign investors for a variety of reasons including customer base, a relatively developed financial sector and high economic growth. Claessens et. al. (2001) has an interesting finding that foreign bank entry alerts domestic banks and not the market share of foreign banks.

There are two forms of entry on a foreign market: Greenfield investment, which involves setting up an institution from scratch. The newly established institution may require a capital infusion from the beginning, but in the cases of a representative office or a branch, the transfer is very limited or replaced only by the transfer of human capital; secondly acquisition of a control position from a local institution. Acquisition size can range from a 100% purchase of the social capital of a given institution to a minority stake (Hurduc & Nitu, 2011). Rezvanian and Mehdian (2008) strongly urged to promote merger and acquisition among Indian banks.

From the institutional point of view, the foreign investment is associated with establishing or acquiring one of the following organizational structures: a local representative office, a branch office or a subsidiary. Representative offices of foreign banks do not perform self-independent activities; they rather attract and set up businesses abroad for the mother company. A branch is not an independent legal entity, but an integral part of the mother company. It can offer a complete range of banking services. Subsidiaries of foreign banks are legally independent from their mother company and use their own capital for performing their activities. Hence, foreign banks need to invest more capital abroad if they want to facilitate the same level of lending activity through a subsidiary rather than through a branch. Under the Basel agreements, the supervisory authorities from the host country are responsible for prudential supervision of subsidiaries and the authorities from the country of origin are responsible for the branches of the mother company. If a foreign affiliate bank does not have control over its subsidiary, it has a clear exploring role and does not express a long-term commitment. Acquisitions may be advantageous for multinational banks where little is known about host markets (Hurduc & Nitu, 2011).

From the investor's point of view, the determining factors for their investment in the host countries are important. But, for host countries, the impact of foreign investment in the banking sector on them is crucial, especially if the host countries are developing countries (Kim & Pant, 2010). However, Lensink and Hermes (2004), report that foreign entry is associated with shrinking margins in developing countries but not necessarily in developed countries. Gosh (2012) analysis favors foreign bank presence for improving

profitability and asset classes of Indian domestic banks. The study concludes by accepting foreign banks more as assets than as a liability for India. Kalluru & Bhat (2009) found a negative correlation of foreign bank presence with the net interest margins and non-interest income of public sector banks. The study concludes that foreign bank entry in the Indian banking system adversely affects the operations of public sector banks. Nam (2013) concluded that foreign banks were believed to be good friends in tranquil times, but they could become foes in times of crisis especially at the time of their parent banks suffering with illiquidity.

Mohan (2013) highlighted various pros and cons of foreign banks entry in India by analyzing the World Bank's Global Development Financial Report 2008. He has welcomed the innovative products, risk management techniques, cross-border services and quality of service delivery of foreign banks. However, he criticized the role of foreign banks in improved access to financial services, improved efficiency of banks and easing of domestic credit constraints on manufacturing firms. Among the Indian studies, Rezvanian and Mehdian (2008) indicated that foreign ownership was significantly more efficient than public and private ownership. Panandikar (2013) observed that foreign banks have the highest average market based efficiency. The study by Bhattacharya and Pal (2013) also revealed that first phase of reforms in 1991-92 had a positive impact on banks efficiency, whereas the second phase of reforms in 1998 had a negative impact on efficiency of banks.

Ghosh (2012) showed that foreign banks presence dampened spreads in Indian domestic banks, as foreign banks lend money through hard information and they give away loans at very lower rate than the domestic banks. The study also claimed that foreign banks also influence the maturity of credit portfolio of domestic banks. The empirical study by Kalluru & Bhat (2009) showed that foreign banks entry was associated with increasing profitability, growing overhead expenses and rising non-performing loans in Indian public sector banks. The study concluded that foreign bank entry in the Indian banking system adversely affects the operations of public sector banks.

5. Conceptual Clarification: Opportunities for FDI into Indian Banking Sector

Government of India (GOI) launched economic reforms to resolve the deficit problem in 1991 and suggested to deregulate financial sector specified by Narasimham Committee. Though foreign bank entry in India had been made in 1853 by Hong Kong and Shanghai (HSBC) bank, the real foreign investment was gained after liberalization in 1991-92. Indian banking sector was liberalized by Government of India with the objective to enhance efficiency, productivity and profitability through competition. RBI does not maintain any data to measure FDI in Indian banking sector. Thus, foreign banks are mainly considered as FDI into Indian banking system (Kim & Pant, 2009). As a founder member of World Trade Organization (WTO), India is abided by WTO's guideline to allow opening up of 12 branches of foreign banks in a single year.

In 2005, RBI announced its "Roadmap for the presence of foreign banks" in India. In the first phase, foreign banks were allowed to establish their own subsidiary or transform the existing branches into a Wholly Owned Subsidiary (WOS). In this phase RBI also allowed to open up more than 12 branches in a single year by considering the principle of reciprocity. After reviewing the first phase by April 2009, RBI was supposed to initiate second Phase which was delayed due to global financial crisis in 2008. The committee on financial sector chaired by Dr. Raghuram Rajan also supported further opening up of foreign bank's entry into India to improve the banking sector. Besides, India has being engaged with bilateral trade agreements with Singapore and Korea. The Agreement with Singaporean banks, Comprehensive Economic Cooperation Agreement (CECA) granted them permission to open 15 branches in India within four years from the 2006. While the agreement with Korean banks, Comprehensive Economic Partnership Agreement (CEPA) permitted them to open 10 branches within four years from 2010.

Direct investment into Indian banking Sector follows four distinct channels. In order to invest in Indian banking sector, Foreign Direct Investors would open their branches or wholly owned subsidiary (WOS), but not both. According to consolidated FDI Policy by DIPP-2014, Foreign Direct Investors can invest into Indian private banks up to 74%. This 74 percentage limit will include investment under the Portfolio Investment Scheme (PIS) by FIIs, NRIs and shares acquired prior to September 16, 2003 by erstwhile OCBs, and continue to include IPOs, Private placements, GDR/ADRs and acquisition of shares from existing shareholders. Out of 74 percent limit, 49 percent would be invested through automatic route. But in order to invest beyond 49 percent and up to 74 percent, Government route is a must.

5.1 Trends of FDI in Indian Banking Sector

Trends of FDI in Indian banking sector would be represented as the number of foreign banks entered into Indian markets, the increasing number of branches and asset share in the total banking system. The rising trend is high stock of foreign investors in private and public sector banks in India. Most of FDI into Indian banking Sector exist in the form of branches or acquiring a stake in Indian banks. Though RBI has allowed foreign banks to establish WOS, not a single WOS has been established so far.

Table 1: Number of foreign banks present throughout 1980 -2013

Year	1980	1985	1990	1995	2000	2005	2010	2013
No. of Foreign banks	13	20	22	27	42	31	32	43

Source: Database on Indian Economy by RBI

Figure-1: Presence of foreign banks in India

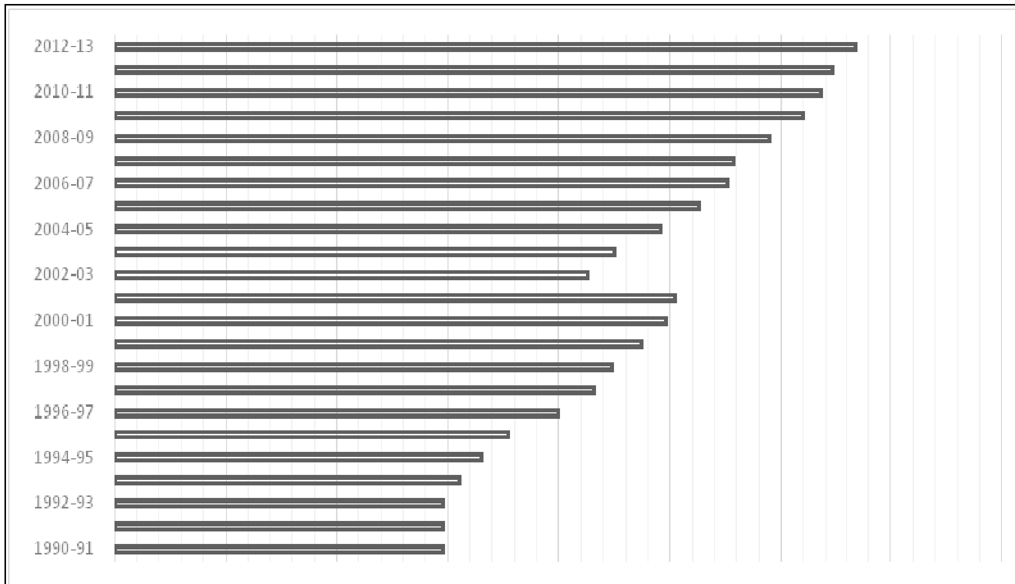
(Data is in numbers) Source: Database on Indian Economy by RBI

The table-1 shows that the number of foreign banks tripled from 1980 to 2013 from 12 to 43, which may represent the determination of foreign banks to enter into India. In 1991, when Indian economy was liberalized, the rules for foreign bank entry were also liberalized further which generated the opportunity for foreign banks to enter. Most of the times, developing countries open their market through economic reforms due to financial crisis or current account deficit, which creates scope for foreign investment (Mohan, 2013). Banking crisis creates opportunities for a foreign bank to acquire domestic banks as its asset value declines for example, Thailand in 1997 crisis (Clark, 2008). It is learnt from the chart that foreign banks entered in India in a large number in 1997 during Asian financial crisis. After reaching to the peak in 1999, the number declined sharply and it surged again from 2009at the time of Global financial crisis. Thus, the good number of foreign banks entry during Asian financial crisis and Global financial crisis in India is to be observed.

Foreign banks have shown interest to establish as branches rather than in any other forms. It is also noted that before 2006, ATMs of foreign banks were also considered branches. Hence, foreign banks had a little opportunity to open up more branches. But, As soon as India has allowed 12 branches per year to foreign banks and ATMs were excluded to be considered as branches, foreign banks branches were rapidly enhanced throughout the country. There were 145 offices in 1990 and the number of foreign banks' offices increased by 100 ending up with 272 offices in 2007 (Kim & Pant, 2010). As per Figure-2, foreign banks branches raised 29 percent in 2013 considering 2006 as the base year and it is raised by 130 percent by considering 1990 as a base year. It has also interesting to note that till 2006; ATMs of foreign banks were considered branches by GOI.

5.2 Branch Expansion by Foreign Banks

Figure 2: Number of Foreign banks' branches in India



Source: Database on Indian Economy by RBI

Table 2: Number of foreign banks' branches in India from 1991-2013

Year	1991-92	1995-96	2000-01	2006-07	2011-12	2012-13
No. of foreign branches	148	177	248	276	323	334

Source: Database on Indian Economy by RBI

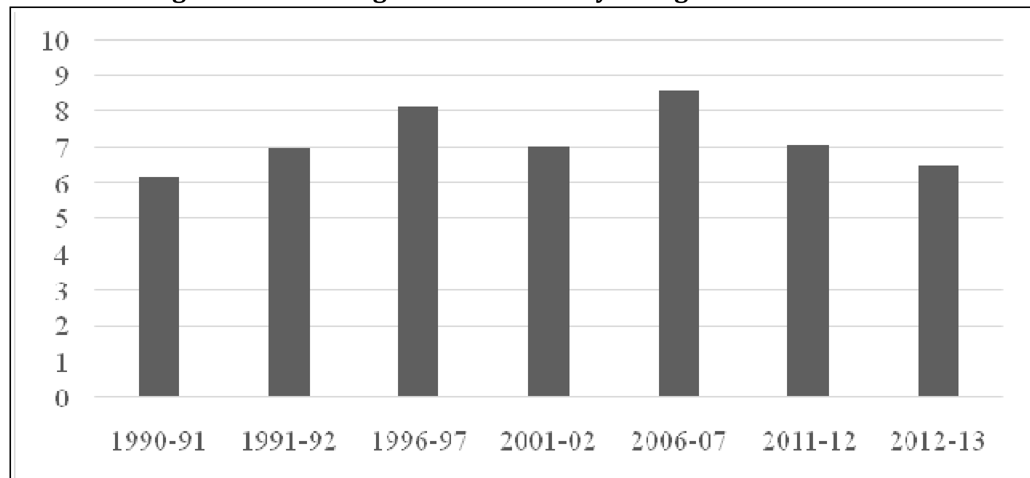
5.3 Foreign banks' asset

As far as the asset share is concerned, foreign banks could not achieve any big share due to the dominance of Indian public sector banks. In the year 2006-07 foreign banks gained the highest asset share of 8.58% and in the year 1990-91 the lowest asset share was 6.2% after liberalization. The average asset share of foreign banks from 1990 to 2013 is 7.4%. It is observed from Figure 3 that the asset share in the beginning of the years of liberalization i.e. 1991 & 1992 and at recent years i.e. 2012 & 2013 are almost equal. Mild fluctuation in the asset share by foreign banks is observed between 1991 and 2013. The empirical study by Classens et. al. (2001) has concluded that it is not the asset share that matters but the foreign bank entry which alerts the domestic banks.

5.4 Foreign Investment in Private Banks and Public Sector Banks in India

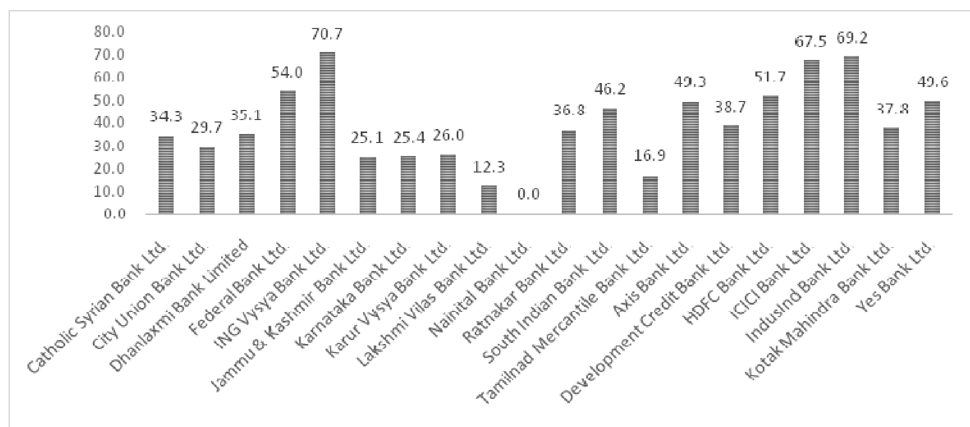
Foreign investment is allowed 74 percent in Indian private banks. Till March 2013, most of the private banks in India were flooded with foreign capital.

Figure 3: Percentage of asset share by foreign banks' in India



Source: Database on Indian Economy by RBI

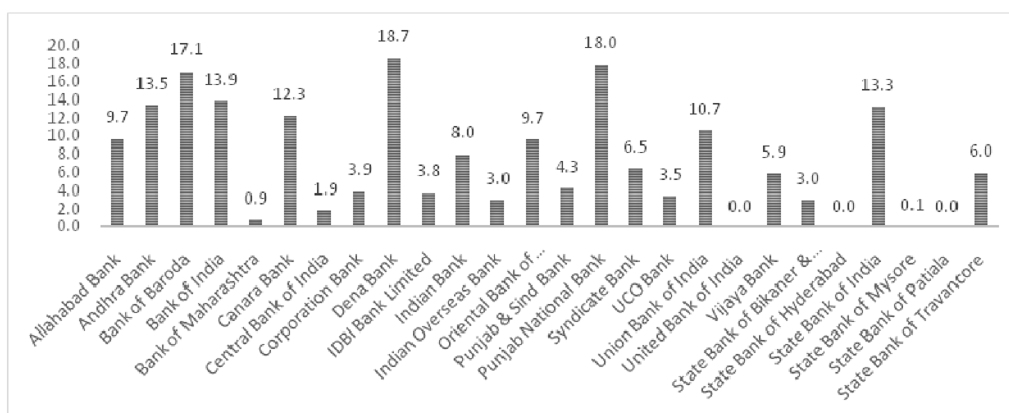
Figure 4: Foreign investment in private banks in India



(In percentage, as on March2013) Source: Database on Indian Economy by RBI

It is visible from the figure 4 that ING-Vysya, ICICI and Indus Ind banks availed higher foreign capital than the rest of private banks in India. According to the recent news, FIPB has declined the HDFC bank's request to raise foreign capital as it would have crossed the limit of 74 percent cumulative foreign capital. In PSBs the limit is 20% for foreign investment. It is obvious from figure-5 that Bank of Baroda, Punjab National Bank and Dena Bank have acquired higher foreign capital till March 2013.There are banks like Union Bank of India, State Bank of Patiala, State Bank of Mysore and State Bank of Hyderabad having no foreign investment.

Figure 5: Foreign investment in PSBs



*(In percentage, as on March 2013**)** Source: Database on Indian Economy by RBI*

5.5 Impact of foreign banks on Domestic Indian Banks

There are a few studies available on measuring impact of foreign bank entry on Indian domestic banks. Foreign banks improve profitability and asset quality, although they dampen spreads (Ghosh 2012). Foreign banks bring modern technology and new financial services to home country as a spillover effect (Kalluru & Bhat, 2010). In India, foreign banks introduced the sophisticated technology and products. The first ATM was introduced by HSBC in 1987, while Citibank and Standard Chartered Bank introduced credit card and credit card with photo respectively for the first time in India (Kim &Pant, 2010). As these sophisticated products help banks to reduce their labor and administrative cost, the contribution of foreign banks in the direction of improving efficiency of domestic banks do exist.

Few studies also claimed that foreign banks adopt "follow your customer" theory. They find their own country mates and grant high credits to them and encourage them in their businesses. But, on the other hand they neglect the need for local entrepreneurs. Foreign banks "Cherry Pick" customers in the home country and grant loan to only few potential corporate. The critics also confine that domestic banks may follow high credit allocation and finds themselves in trouble by raising their Non-Performing Assets (NPA) (Kalluru& Bhat,2009; Kim & Pant, 2010; Nam,2013).

5.6 FDI Policy in Indian Banking Sector

As a sequel to the roadmap of 2005 and pursuant to the announcements made in the Annual Policy Statement for 2010-11, the Reserve Bank issued a discussion paper in January 2011 on "The mode of presence of foreign banks in India". The framework for setting up of WOS by foreign banks in India has been finalized taking into account the feedback received on the discussion paper and factoring in the lessons from the crisis which favors a subsidiary mode of presence from financial stability perspective (RBI,

2013). However, RBI has left it on foreign banks to choose any one option to present either in the form of branch or WOS. Reserve Bank, in terms of the powers conferred on it under Section 35A with Section 44A of the Banking Regulation Act, 1949, in the public interest and in the interest of banking policy issued a 'Scheme for Setting up of Wholly Owned Subsidiaries (WOS) by foreign banks in India'.

Foreign banks which commenced banking business in India from August 2010 onwards were required to furnish an undertaking that they would convert their branches into wholly owned subsidiaries if so required by RBI. RBI has incentivized foreign banks by providing national treatment to WOS of foreign banks. WOS can be opened up in any city from tier-1 to tier-6, removing the previous restriction of only in tier-1 and tier-2 cities. Thus, WOSs of the foreign banks, even though locally incorporated, being foreign owned and controlled companies, will be treated as "foreign banks" which also can be listed on Indian stock market for disinvestment up to 26 percent. The main purpose of incentivized foreign banks with national treatment to WOS is financial stability. In order to reduce down size risk, prior approval is needed when the capital and reserves of the foreign banks (i.e. WOSs and foreign bank branches) in India exceed 20% of the capital and reserves of the banking system. Moreover as per the WTO commitments licenses for new foreign banks may be denied when the maximum share of assets in India both on and off balance sheet of foreign banks' branches to total assets both on and off balance sheet of the banking system exceeds by 15 %.

6. Conclusion

FDI is considered the lifeblood of economic development for developing countries like India. As the economic liberalization leads to entry for foreign international banks which enhance efficiency, productivity and profitability in banking sector; the scope for further liberalization of banking sector in India was expected. In this line, RBI has initiated second phase of Liberalization for Indian banking sector with its new FDI policy in 2014. It is quite clear from the present reforms in the FDI policy on Indian banking sector that foreign banks have wide scope in India. Foreign banks have entered into India taking the advantage of the opportunity given by GOI. The important observation of the study was that good number of foreign banks entered during Asian financial crisis and Global financial crisis in India. Although foreign banks entry in India has increased, the RBIs' favored WOS a mode of presence has not seen yet. Further it is understood that Indian banking system seeks more competition, which can be achieved through foreign banks entry.

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