Analysis of FDI in India: A Case Study of Banking Sector

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ABSTRACT

FDI is a tool for economic growth through its strengthening of domestic capital, productivity and employment. Today Indian Banks are as technology savvy as their counter parts in developed countries. 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. FDI is a tool for economic growth through its strengthening of domestic capital, productivity and employment. FDI also plays a vital role in the up gradation 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 inter-connections. This paper discusses the FDI Equity inflows in Service Sector in India and also highlights the top countries which are investing in the Service Sector in the form of FDI. In this paper an attempt is made to present the FDI inflows in sub sectors of Service Sector. Further, this paper also analyzes the FDI inflows in Banking Sector.

Keywords: *FDI, Service Sector, Banking Sector, Equity Inflows, Indian Economy*

I. Introduction

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, 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 into 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 up gradation 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 resources.

II. Foreign Direct Investment and Benefits

International Monetary Fund (IMF) and Organization for Economic Cooperation and Development(OECD) define FDI similarly as a category of cross border investment made by a resident in one economy (the direct investor) with the objective of establishing a 'lasting interest' in an enterprise (the direct investment enterprise) that is resident in an economy other than that of the direct investor. The motivation of the direct investor is a strategic long term relationship with the direct investment enterprise to ensure the significant degree of influence by the direct investor in the management of the direct investment enterprise.

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 will 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 in the banks. Now a day's banks have been prominent and prudent in t he rapid expansion of consumer lending in 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. 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.

III. FDI in Indian banks

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 a handful of private banks formed around the 1940s. Further, foreign banks and financial institutions were allowed only 20 percent ownership 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.

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 practices. The objective was to make the Indian banking sector more competitive. C.P.Chandrasekhar and Jayati Ghosh (2002) have pointed out that an important objective of promoting 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 to benefit from the profit earned in the Indian market". Laghane B.K (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 that FDI must be considered in poverty reduction, unemployment reduction and primary education and priority sectors of banking. Finally, he concluded that the LPG sponsored

IV. Objectives of the Study

- To study and analyze the Foreign Direct Investment inflows in Service Sector.
- To present the Foreign Direct Investment inflows in Banking Sector.

V. Analysis and Discussion

The fact of the matter is that governance rules in the banking system have indeed been changed to accommodate the private investor (domestic and foreign) after liberalisation. Besides permitting the entry and consolidation of new private banks, the government (through the Ministry of Commerce) had as far back as March 5, 2004, announced a set of decisions with reference to foreign investment in the banking sector, which relaxed the cap on foreign equity in Indian banks to 20 per cent in the case of public sector banks and 74 per cent in the case of private banks. This was in addition to the permission granted to foreign banks to operate in the country through wholly owned subsidiaries subject to increasingly relaxed rules.

Consequent to the Ministry of Commerce announcement, the Reserve Bank of India issued a more detailed and comprehensive set of policy guidelines on ownership of private banks. Recognising that the 5th March 2004 notification by the Union Government had hiked foreign investment limits in private banking to 74 per cent, the guidelines first clarified that this ceiling was applicable to the sum total of foreign investment in private banks from all sources (FDI, Foreign Institutional Investors, Non-Resident Indians).

More importantly, in the interests of diversified ownership the guidelines had declared that no single foreign entity or group could hold more than 10 per cent of equity. There was also a 10 per cent limit set for individual FIIs and an aggregate of 24 per cent for all FIIs, with a provision that this can be raised to 49 per cent with the approval of the Board or General Body. Finally, the 2004 guidelines set a limit of 5 per cent for individual NRI portfolio investors with an aggregate cap for NRIs of 10 per cent, which can be raised to 24 per cent with Board approval. Finally, in keeping with this more cautious policy, the RBI decided to retain the stipulation under the Banking Regulation Act, Section 12 (2), that in the case of private banks the maximum voting rights per shareholder will be 10 per cent of the total voting rights (1 per cent for public banks). The 10 per cent ceiling on equity ownership by a single foreign entity was partly geared to aligning ownership guidelines with the rule on voting rights.

The response to this from liberalisation advocates was that the whole exercise was pointless inasmuch as the ceiling on single investor ownership and voting rights would deter foreign investors. The evidence shows that this expectation has turned out to be completely false. As Chart 1 shows, the share of foreign investors in private bank equity exceeds 50 per cent in five banks and stands at between a third and a half in another eight. Moreover, Chart 2 shows that in a number of instances the share of foreign equity has increased between 2005 (when the guidelines had come into force) and 2012. Problems arose only in the case of those entities in which single foreign entities held more than 10 per cent equity. This was, for example, true of the Development Credit Bank (which had the Aga Khan Fund for Economic Development as lead shareholder with around 25 per cent of equity) and the Catholic Syrian Bank (in which Surachan Chawla of the Siam Vidhya group from Thailand had acquired 36 per cent shares in the 1990s and has since been able to reduce the total to only 21 per cent). The problem faced by these entities is that of finding buyers willing to acquire small blocks of equity to ensure adequate dilution of lead stakeholder ownership in a bank being run by a dominant foreign shareholder. As a result they have been under pressure for not complying with the RBI's demand to dilute equity and faced with threats of penal action.

The implication of this is clear. The problem with well-performing private banks is not that it is difficult to attract foreign equity investment. The problem is that current rules do not allow entry of those whose intent is to exercise control over a local bank with an adequate share holding and equivalent voting rights. Hence, if the need is to allow foreign equity infusion to meet prudential requirements such as the Basel norms that is still possible. What is not allowed is the entry of single foreign investors seeking to establish or acquire domestic private banks with a controlling stake and voting rights.

The case for such regulation of foreign presence had been clearly specified in the past. The RBI has for long strongly advocated diversified ownership of banks. The RBI's Report on Trend and Progress of Banking in India, 2003-04 states: "Concentrated shareholding in banks controlling substantial amount of public funds poses the risk of concentration of ownership given the moral hazard problem and linkages of owners with businesses. Corporate governance in banks has therefore, become a major issue. Diversified ownership becomes a necessary postulate so as to provide balancing stakes."

A more elaborate exposition of the RBI's views on the matter came from Rakesh Mohan, a former Deputy Governor of the RBI. In a speech made at a Conference on Ownership and Governance in Private Sector Banking organised by the CII at Mumbai on 9th September 2004 he remarked:

The banking system is something that is central to a nation's economy; and that applies whether the banks are locally-or foreign-owned. The owners or shareholders of the banks have only a minor stake and considering the leveraging capacity of banks (more than ten to one) it puts them in control of very large volume of public funds of which their own stake is miniscule. In a sense, therefore, they act as trustees and as such must be fit and proper for the deployment of funds entrusted to them. The sustained stable and continuing operations depend on the public confidence in individual banks and the banking system. The speed with which a bank under a run can collapse is incomparable with any other organisation. For a developing economy like ours there is also much less tolerance for downside risk among depositors many of whom place their life savings in the banks…Hence diversification of ownership is desirable as also ensuring fit and proper status of such owners and directors.

It is evident that 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.

- India is considered to be the Third most preferred investment destination in the world after China and United States.
- Service Sector is one of the most dominating sectors of Indian economy in attracting highest FDI Equity inflows which account for 19 per cent of total FDI Equity inflows.
- Among the sub sectors of Service Sector, Financial Services stood at top place in attracting more FDI Equity inflows (7.28%), followed by Non-Financial/ Business Services (5.62%), Banking Services (1.74%) and Insurance Services (1.68%).
- Top countries that are investing in the form of FDI in Service Sector are- Mauritius (39.12%), Singapore (14.78%) and United Kingdom (8.24%).
- FDI in Banking Sector can solve various problems such as Inefficient Management, Non-Performing Assets, Financial Instability and Poor Capitalization.
- FDI Equity inflows in Banking Sector have been increasing year by year in an increasing trend.

VI. Conclusion

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 mot 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 other calendar years.

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