Foreign Direct Investment in Banking Sector- A Boon in Disguise

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Abstract

In this paper we use new statistics on Foreign Direct Investments (FDI) in Transitional Economies (TEs) to analyze the issue of foreign ownership in the banking sector, examining the implications for the host banking sector. After considering the potential benefits and risks associated with foreign investment on the banking sector, and on the basis of some empirical results, we reach the conclusion that foreign direct investment is associated with higher profitability; however a substantial foreign ownership is necessary if there is to be a positive effect on cost efficiency. We also analyze the determinants of FDI location choices in TEs providing new empirical evidence, and distinguishing among different levels of foreign partnership.

KEYWORDS: FDI, Banking Scenario, Technology Transfer and Risk Management.

Introduction

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 to 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.

Objectives:

The study covers the following objectives:

- To study the trends and patterns of flow of FDI.
- To assess the determinants of FDI inflows.
- To evaluate the impact of FDI on the Economy.

Limits for FDI

FDI in the banking sector has been liberalized by raising FDI limit in private sector banks to 74 per cent under automatic root including investment by foreign investment in India. The aggregate foreign investment in a private bank from all sources will be 74 per cent of paid-up capital of the bank.

FDI and Portfolio investment in nationalized banks are subject to overall statutory limit of 20 per cent. The same ceiling also applies in respect of such investment in State Bank of India and its associate banks.

The Present Banking Scenario

In recent times economy is been pushing to increase the role of multi-national banks in the banking and insurance sector, despite, the concern expressed by the left communist parties are opposing the finance minister move to raise overseas investment limits in the insurance business. The government wants to fulfill a pledge to allow companies like New York Life Insurance, Met Life Insurance to raise investment in local companies to 49 per cent from 26 per cent.

But it is opposed on the front that it will lead to state run insurers loosing business and workers their job. Left do not want foreign investors to have greater voting rights in private banks and oppose the privatization of state run pension fund.

There are several reasons why such move is fraught with dangers. When domestic or foreign investors acquire a large share holding in any bank and exercise proportionate voting rights, it creates potential problems not only of excursive concentration in the banking sector but also can expose the economy to more intensive financial crises at the slightest hint of panic.

Opposition is not considering the need of present situation. 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. Along with that it entails the following benefits such as –

Technology Transfer

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 days banks have been prominent and prudent in the 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. FDI's tech transfers, information sharing, training programs and other forms of technical assistance may help meet this need.

Better Risk Management

As the banks are expanding their area of operation, there is a need to change their strategies exert competitive pressures and demonstration 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 more safer.

SOURCES OF FDI IN INDIA

India has broadened the sources of FDI in the period of reforms. There were 120countries investing in India in 2008 as compared to 15 countries in 1991. Thus the number of countries investing in India increased after reforms. After liberalization of economy Mauritius, South Korea, Malaysia, Cayman Islands and many more countries predominantly appears on the list of major investors apart from U.S., U.K., Germany, Japan, Italy, and France which are not only the major investor now but during pre-liberalizations era also.

MAJOR SOURCES OF FDI IN INDIA

Mauritius	USA	Singapore	UK	Netherlands	Japan	Germany	Cyprus	France	Switzerland
39.9	8.8	7.2	6.1	4.4	3.4	2.9	2.9	1.5	1.1

Source: *compiled & computed from the various issues of Economic Survey, RBI Bulletin, Ministry o f Commerce*

The analysis presents the major investing countries in India during 1991-2008. Mauritius is the largest investor in India. FDI inflows from Mauritius constitute about 39.9% of the total FDI in India and enjoying the top position on India's FDI map from 1995. This dominance of Mauritius is because of the Double Taxation Treaty i.e. DTAA- Double Taxation Avoidance Agreement between the two countries, which favours routing of investment through this country. This (DTAA) type of taxation treaty has been made out with Singapore also.

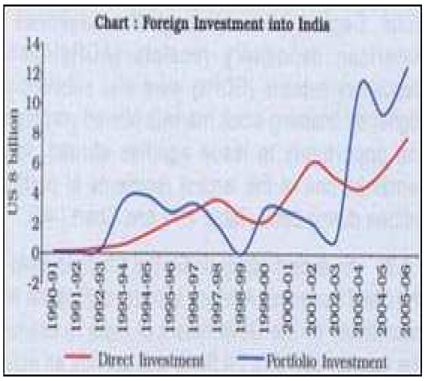
Financial Stability and Better Capitalization

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.

Table 1.76: Foreign Direct Investment to India: Country-wise and Industry-wise*

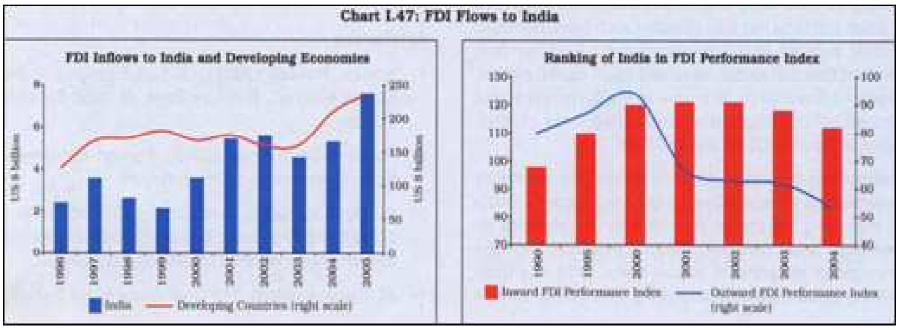
(US $ million)

Source/Industry	2003-04	2004-05	2005-06 P
1	2	3	4
Total FDI Flows	**1,462**	**2,320**	**3,358**
Country-wise Inflows			
Mauritius	381	820	1,363
USA	297	469	346
UK	157	84	261
Germany	69	143	45
Netherlands	197	196	50
Japan	67	122	86
France	34	44	12
Singapore	15	64	166
Switzerland	5	64	68
South Korea	22	14	61
Others	218	300	901



Source : "Economic Review", RBI Annual Report 2005-06.

So due to the aforesaid benefits economy has consistent flow of FDI over the past few years. In addition to that, the govt. has also taken step to enhance the FDI (eg. Telecom, civil aviation) FDI up to 100% through the Reserve Bank's automatic route was permitted for a no. of new sectors in 2005-06 such as Greenfield airport projects, export trading. All these measures have been contributing towards increasing direct investment.



Source : "Economic Review", RBI Annual Report 2005-06.

This overall FDI is evident from the above graph.

'FDI & FII have risen sharply during the 1990s reflecting the policies to attract non-debt creating flows.

Cumulative foreign investment flows have amounted to US & 106 billion since 1990-91 and almost evenly balanced between direct invest flows (US & 49 bn) and portfolio flows (US & 57 bn). Since 1993-94, FDI flows have exceeded portfolio flows in the 5 years while portfolio flows have exceeded FDI in the remaining 8 years. As a proportion to FDI flows to emerging market and developing countries, FDI flows to India have shown a consistent rise from 1.6% in 1998 to 3.7% in 2005'1.

India's FDI growth of above 30% during past 2 years is encouraging. Although the FDI inflows into India are small as compared to other emerging markets, their size is growing on the back of growing interest by many of the world's leading multinationals. India has improved its rank from fifteenth (in 2002) to become the second most likely FDI destination after China in 2005'1.

Importance

It is apparent from the above discussion that FDI is a predominant and vital factor in influencing the contemporary process of global economic development. The study attempts to analyze the important dimensions of FDI in India. The study works out the trends and patterns, main determinants and investment flows to India. The study also examines the role of FDI on economic growth in India for the period 1991-2008. The period under study is important for a variety of reasons. First of all, it was during July1991 India opened its doors to private sector and liberalized its economy. Secondly, the experiences of South-East Asian countries by liberalizing their economies in 1980 sbecame stars of economic growth and development in early 1990s. Thirdly, India's experience with its first generation economic reforms and the country's economic growth performance were considered safe havens for FDI which led to second generation of economic reforms in India in first decade of this century. Fourthly, there is a considerable change in the attitude of both the developing and developed countries towards FDI. They both consider FDI as the most suitable form of external finance. Fifthly, increase in competition for FDI inflows particularly among the developing nations.

The shift of the power center from the western countries to the Asia sub –continent is yet another reason to take up this study. FDI incentives, removal ofrestrictions, bilateral and regional investment agreements among the Asian countries and emergence of Asia as an economic powerhouse (with China and India emerging as the two most promising economies of the world) develops new economics in the world of industralised nations. The study is important from the view point of the macro economic variables included in the study as no other study has included the explanatory variables which are included in this study.

The IMF Study Report

The IMF's study is in supportive to the above-discussed features of FDI. This study talks about the optimism over India emanates from a contribution of following factors.

* India contributed nearly one fifth of Asian domestic demand growth over 2000-05. Looking forward, India slated to be the second largest demand driver in the region, after China.

* India accounts for almost one quarter of the global portfolio flows to emerging market economies, nearly $ 12 bn in 2005.

* India is the world's leading recipient of remittances, accounting for about 20% of the global flows.

Even though above discussed factors are fair enough for the development of economy.

But it is a noted fact that, economy drivers are reluctant towards more liberalization for FDI in the banking sector. As the ceiling rates are not increased, FDI in Financial Sector is not getting a wholesome environment. But the foreign investment is finding its own way to come in the economy. May be the way of FII. It is evident from the diagram.

Now a days, 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.

So, therefore from last 2 years FIIs have exceeded the FDI and in portfolio investment into India since 2003-04 reflects both domestic and global factors. Compared with FII always FDI has a greater and long-term effect on the Indian market due to the whimsical nature of FII. (As it is considered as hot money)

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.

Conclusion:

The economics of developed nations by receiving a descent amount of FDI in the last three decades. Although India is not the most preferred destination of global FDI, but there has been a generous flow of FDI in India since 1991. It has become the 2nd fastest growing economy of the world. India has substantially increased its list of source countries in the post – liberalisation era. India has signed a number of bilateral and multilateral trade agreements with developed and developing nations. India as the founding member of GATT, WTO, a signatory member of SAFTA and a member of MIGA is making its presence felt in the economic landscape of globalised economies. The economic reform process started in 1991 helps in creating a conducive and healthy atmosphere for foreign investors and thus, resulting in substantial amount of FDI inflows in the country. No doubt, FDI plays a crucial role in enhancing the economic growth and development of the country. Moreover, FDI as a strategic component of investment is needed by India for achieving the objectives of its second generation of economic reforms and maintaining this pace of growth and development of the economy.

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