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Foreign Direct Investment in Indian Banking Sector: A Study

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Abstract: 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 from January, 2000 to June, 2013.

Keywords: Foreign Direct Investment, Service Sector, Banking Sector, FDI 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.

According to the 2012 World Investment Report released by the United Nation's Conference on Trade and Development (UNCTAD), of 179 major global companies surveyed, India is considered to be the third most-preferred investment destination after China and the United States.

II. Foreign Direct Investment

A. Definition

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.

B. Components of FDI

There are three components of FDI, namely, equity capital, reinvested earnings and intra company loans

1. Equity capital is the foreign direct investor's purchase of shares of an enterprise in a country other than his own country.

2. 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.

3. 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 will directly solve the problem of capital base.

C. Benefits of FDI

***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 day's 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 exerts 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 Base II for making their financial system safer.

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.

D. 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.

E. Ceiling on FDI in Indian banks

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.

Review of Literature

1. ***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”.

2. 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 FDI model’s impact on foreign banks and Indian bank’s profitability is positive. The impact of FDI on Indian banking sector is negative except profitability.

3. Kunal Badade & Medha katkar (2011) have studied that India has sought to increase inflows of FDI with a much liberal policy since 1991 after decade cautious attitude. The 1990's 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.

Objectives of the study

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

Research methodology

This is a Descriptive as well as Analytical type of research in nature. This study is purely based on secondary data. The secondary data was collected from various sources such as Journals, Articles, RBI publications, Ministry of Finance publications, Department of Industrial Policy& Promotion publications, SIA news letter, Online database of FDI and Newspapers etc. Data was analyzed by using statistical tools such as Averages, Percentages, Tables, Charts and Diagrams wherever necessary.

III. FOREIGN DIRECT INVESTMENT INFLOWS IN SERVICE SECTORS

A. Cumulative FDI Equity Inflows received in Indian Economy

Cumulative FDI Equity inflows received (remittance-wise) during January, 2000 to June, 2013 have been shown in the Table-1 and Chart-1.

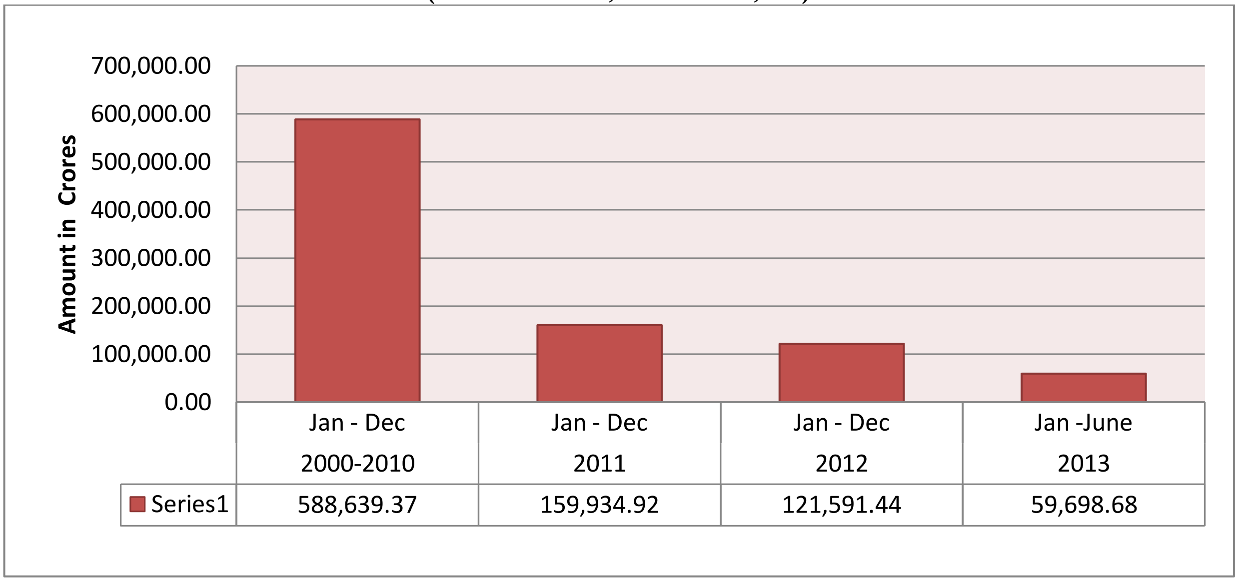
Table-I
STATEMENT ON CUMULATIVE YEAR-WISE FDI EQUITY INFLOWS
(FROM JANUARY, 2000 TO JUNE, 2013)

	2000-2010 Jan - Dec	*2011 Jan - Dec*	*2012 Jan - Dec*	*2013 Jan -June*	*Cumulative Total (from January, 2000 to June, 2013)*	
	FDI in Rs	*FDI in Rs*	*FDI in Rs*	*FDI in Rs*	*(In Rs Crores)*	*(In US$ million)*
Total	**588,639.37**	**159,934.92**	**121,591.44**	**59,698.68**	**929,864.4.1**	**199,479.65**

Source: DIPP-SIA News Letter

It is evident from the Table-1and Chart-1, Cumulative FDI Equity Inflows (remittance wise) received during January, 2000 to June, 2013 are Rs.929,864.41 Crores (US $ 199,479.65 million). While an amount of Rs.588,639.37 crores FDI Equity Inflows received during January, 2000 to December, 2010, Rs. 159,934.92 crores of FDI Equity Inflows received in the calendar year 2011. During calendar year 2012, an amount of Rs. 121,591.44 crores and during January to June, 2013, Rs. 59,698.68 crores of FDI Equity Inflows received. During the period from January, 2000 to December, 2011, cumulative FDI inflows are received from FIPB/SIA, acquisition of existing shares and RBI's automatic routes only.

Chart-1
CUMULATIVE FDI EQUITY INFLOWS RECEIVED
(FROM JANUARY,2000 TO JUNE,2013)



B. Cumulative FDI Inflows In Services Sector

CUMULATIVE FDI EQUITY INFLOWS *(remittance-wise)* received during **January, 2000 – June, 2013,** were **Rs.** 929,864.41 **crore (US$199,479.65 million).** Out of this, the amount of **FDI inflows** in the **Services Sector** during January, 2000 to June, 2013 is **Rs. 177488.44 crore (US$ 38207.53 million)** which is **19.17% of the total FDI inflows**.

FDI Equity Inflows in Sub Sectors of Service Sector have been shown in the Table-2 and Chart-2 as below.

Table-2 and Chart-2 shows that the Service Sector consists of various sub sectors viz. Financial, Banking Services, Insurance, Non Financial/Business Services, Outsourcing, Research & Development, Courier, Technical Testing and Analysis and Other Services etc. Commodity Exchange, new sub sector, was included in Service Sector from 2012 of total sub sectors of Service Sector, Financial sector received majority of the FDI Equity inflows of Rs.65, 535.75 crores (US $ 14,507.78 million) which account for 7.28 per cent of the total FDI Equity inflows in terms of US $, followed by Non-Financial/ Business Services which received FDI Equity inflows of Rs.54,272.49 crores (US $ 11,206.67 million) account for 5.62 per cent. 1.75 per cent of the total FDI inflows were received by Banking Services which amounted to Rs.15, 572.31 (US $ 3,469.63 million) and 1.68 per cent of FDI inflows were attracted by Insurance sector which amounted to Rs.15852.56 crores (US $ 3,339.27 million). Remaining other sub sectors received below one per cent of the total FDI inflows such as Outsourcing Rs.5, 898.75 crores (US $ 1,279.28 million), Courier Rs. 1,996.93 crores (US $ 438.87 million) and Research & Development Rs. 677.51 crores (US $ 138.97 million) which account for 0.64 per cent, 0.22 per cent and 0.18 per cent respectively.

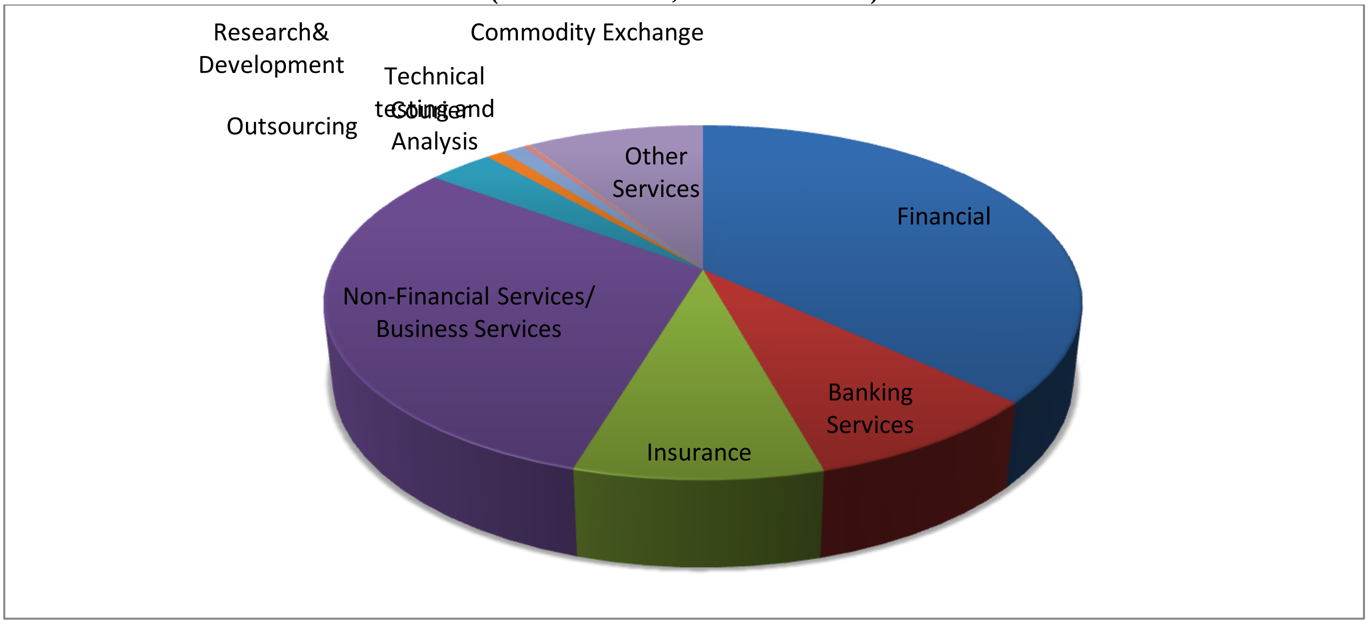
Table-II
SUB SECTORS FDI EQUITY INFLOWS IN SERVICE SECTOR
(FROM JANUARY, 2000 TO JUNE 2013)

Sl.No.	Sub Sector	Amount of FDI inflows		% with total FDI inflows(in terms of US $)
		Rupees in Crores	US $ in million	
1	Financial	65,535.78	14,507.66	7.28
2	Banking Services	15,572.31	3,469.63	1.74
3	Insurance	15,852.56	3,339.27	1.68
4	Non-Financial Services/ Business Services	54,272.49	11,206.67	5.62
5	Outsourcing	5,898.75	1,279.28	0.64
6	Research& Development	1,624.51	363.63	0.18
7	Courier	1,996.93	438.87	0.22

8	**Technical testing and Analysis**	**677.51**	**138.97**	**0.07**
9	**Commodity Exchange**	**47.52**	**9.22**	**0.00**
10	**Other Services**	**1,6010.08**	**3,454.33**	**1.73**
	Sector Total	**177,488.44**	**38,207.53**	**19.17**

Source: DIPP-SIA News Letter

Chart-II
SUB SECTORS FDI EQUITY INFLOWS IN SERVICE SECTOR
(FROM JANUARY, 2000 TO JUNE 2013)



From the above discussion, it can be said that Financial, Non-Financial/ Business Services, Banking Services and Insurance sub sectors are receiving more FDI Equity inflows in the Service Sector which is one of the dominating sectors that is attracting more FDI inflows.

C. Share Of Top 5 Countries Attracting FDI Inflows For Service Sector

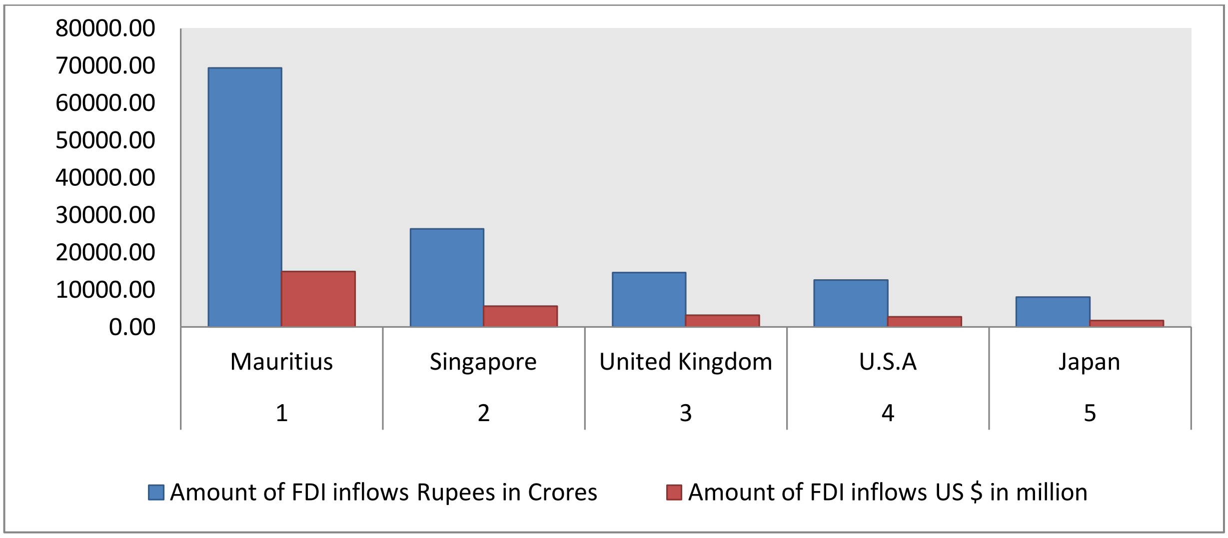
Data regarding share of top five countries attracting FDI inflows for Service Sector from January, 2000 to June, 2013 has been placed in Table-3.

Table-III
SHARE OF TOP FIVE COUNTRIES ATTRACTING FDI INFLOWS FOR SERVICE SECTOR
(FROM JANUARY, 2000 TO JUNE, 2013)

Ranks	Country	Amount of FDI inflows		%age with FDI in Service Sector
		Rupees in Crores	US $ in million	
1	Mauritius	69433.48	14946.79	39.12
2	Singapore	26232.79	5647.07	14.78
3	United Kingdom	14625.05	3148.30	8.24
4	U.S.A	12601.68	2712.73	7.1
5	Japan	8022.48	1726.98	4.52
Total		130915.47	28181.87	73.76

Source: DIPP-SIA News Letter

Chart -III
SHARE OF TOP 5 COUNTRIES ATTRACTING FDI INFLOWS FOR SERVICE SECTOR



It is clear from the Table -3 and Chart-3 that Maritius occupied First place with an investment of Rs.69433 crores (US $ 14,946.79 million) which account for 39.12 per cent of total FDI Equity inflows in Service Sector, followed by Singapore with an investment of Rs.26, 232.79 (US $ 5,647.07 million) stood at Second place, which account for 14.78 per cent of FDI inflows in Service Sector. United Kingdom, USA and Japan occupied Third, Fourth and Fifth places with 8.24 per cent, 7.1 per cent and 4.52 per cent of total FDI inflows in Service Sector. It is said that the Maritius is the country investing more in Service Sector.

IV. FDI EQUITY INFLOWS IN BANKING SECTOR

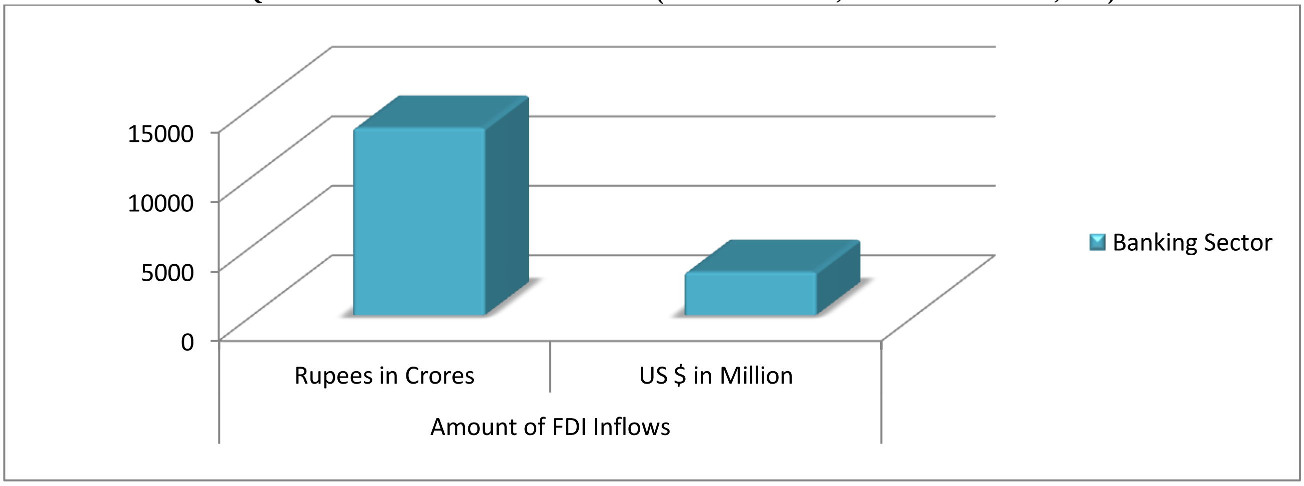
Cumulative FDI Equity Inflows in Banking Sector from January, 2000 to December, 2010 received Rs 13,471.60 crores (US $ 3,099.06 million) which account for 1.89 per cent in total FDI inflows and 11.64 per cent in total Service Sector FDI inflows in terms of US $. Data regarding cumulative FDI Equity inflows in Banking Sector has been shown in the table-4 and chart-4 below.

Table-IV
FDI EQUITY INFLOWS IN BANKING SECTOR
(from January, 2000 to December, 2010)

Sl.No.	Sector	Amount of FDI Inflows		%age with	
		Rupees in Crores	US $ in Million	Total FDI (In terms of US $)	Total FDI in Service Sector(In terms of US $)
1	Banking Sector	13471.6	3099.06	1.89	11.64

Source: DIPP-SIA News Letter

Chart -IV
FDI EQUITY INFLOWS IN BANKING SECTOR (FROM JANUARY, 2000 TO DECEMBER, 2010)



A. *Year Wise FDI Equity Inflows In Banking Sector*

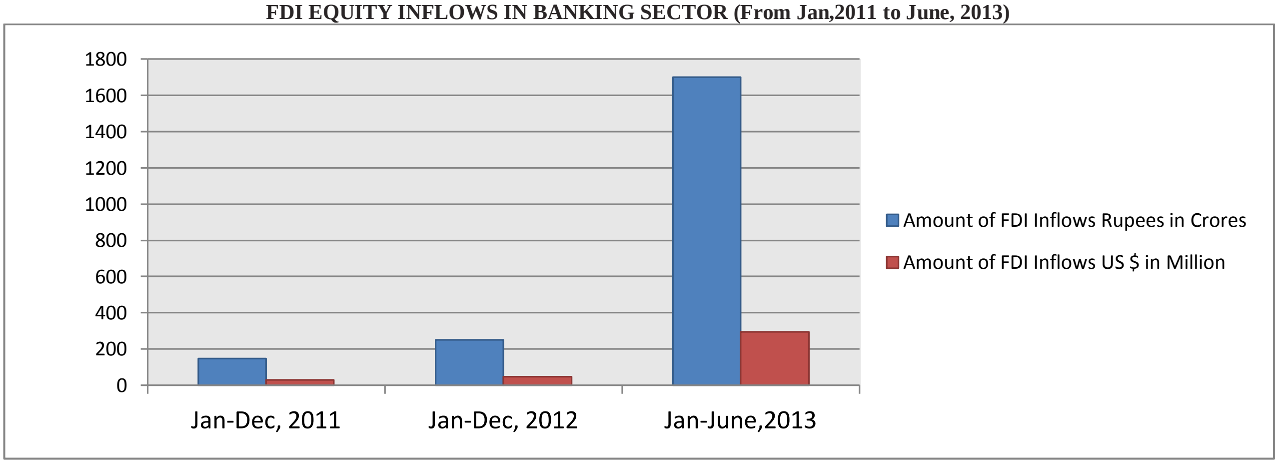
Year wise FDI Equity inflows in Banking Sector from January, 2011 to June, 2013 have been shown in the table-5 and chart-5 as below.

Table-V
FDI EQUITY INFLOWS IN BANKING SECTOR
(From January, 2011 to June, 2013)

Sl.No.	Year	Amount of FDI Inflows		%age with	
		Rupees in Crores	US $ in Million	Total FDI (In terms of US $)	Total FDI in Service Sector(In terms of US $)
1	January-December, 2011	147.15	28.88	0.1	0.56
2	January-December, 2012	251.53	46.25	0.2	0.99
3	January-June, 2013	1702.03	295.44	2.72	17.06

Source: DIPP-SIA News Letter

Chart- V
FDI EQUITY INFLOWS IN BANKING SECTOR (From Jan,2011 to June, 2013)



It is evident from the Table-5 and Chart-5 that the Banking Sector received FDI Equity inflows during period from January to December, 2011 was an amount of Rs. 147.15 crores (US $ 28.88 million) which account for 0.10 per cent of total FDI inflows and 0.56 per cent in total Service Sector FDI inflows in terms of US $. Banking Sector received Rs. 251.53 crores (US $

46.25 million) in the form of FDI that account for 0.20 per cent of total FDI and 0.99 per cent of Service Sector FDI inflows. When compared to Jan-Dec, 2011, FDI inflows in Banking Sector increased by 41.49 per cent for the same period in 2012. Rs. 1702.13 crores (US $ 2.72 million) of FDI inflows received during period from January to June, 2013 which account for 2.72 per cent of total FDI inflows and 17.06 per cent of total Service Sector FDI inflows in Banking Sector. It is very clear from the above discussion that the FDI Equity Inflows in Banking Sector have been increasing year by year.

V. FINDING

- 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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