ROLE OF FOREIGN DIRECT INVESTMENT IN INDIAN BANKING SECTOR

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ABSTRACT

FDI is of growing importance to global economic growth. FDI from investors in developed areas like EU and US provide funding and expertise to help smaller companies in these emerging markets to expand and increase international sales. Due to FDI, the competitive and reform force have led to the emergence of internet, e-banking, ATMs, credit cards and mobile banking too, to let banks attract and retain customers. This apart retail lending has emerged as another major opportunity for banks.

This paper briefly discusses the role of FDI in Indian Banking sector and also recognizes that FDI in Banking can address several issues pertaining to the sector such as encouraging development of innovative financial products, improving the efficiency of banking sector and better ability to adapt to changing financial market conditions.

Keywords: *Foreign Direct Investment, Banking system, De-facto, Globalization, Indian Economy*

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INTRODUCTION

The Indian banking system is significantly different from those prevalent in other countries due to its unique geographic, social and economic characteristics. India has a large population, different cultures in different parts of the country and also disparities in income. Also in India the population spread among rural and urban areas is also skewed in the favour of urban areas. All these features reflect in the size and structure of the Indian banking system. Further in order to fulfill the needs to the government policy it has been subjected to various nationalization schemes at different times. **RBI credit policies** form the guidelines for banks in India. Since they had to satisfy the domestic obligations, the banks have so far been confined within the Indian borders. Banking in India originated in the last decades of the 18th century. The first banks were The General Bank of India, which started in 1786, and Bank of Hindustan, which started in 1770; both are now defunct. The oldest bank in existence in India is the State Bank of India, which originated in the Bank of Calcutta in June 1806, which almost immediately became the Bank of Bengal. This was one of the three presidency banks, the other two being the Bank of Bombay and the Bank of Madras, all three of which were established under charters from the British East India Company. For many years the Presidency banks acted as quasi-central banks, as did their successors. The three banks merged in 1921 to form the Imperial Bank of India, which, upon India's independence, became the State Bank of India in 1955.

In the early 1990s, the then Narasimha Rao government embarked on a policy of liberalization, licensing a small number of private banks. These came to be known as New Generation tech-savvy banks, and included Global Trust Bank (the first of such new generation banks to be set up), which later amalgamated with Oriental Bank of Commerce, UTI Bank (since renamed Axis Bank), ICICI Bank and HDFC Bank. This move, along with the rapid growth in the economy of India, revitalized the banking sector in India, which has seen rapid growth with strong contribution from all the three sectors of banks, namely, government banks, private banks and foreign banks.

Now Foreign Direct Investment permitted in Indian Private Banks for 74 percent under the automatic route whereas in Nationalized banks permitted only 20 percent.

RELATED LITERATURE

One strand of related literature studies the relation between the turn of the year effect and impact of FDI in Indian Banking sector.

Laghane.K.B (2007), LPG sponsored FDI model's impact on the foreign banks and Indian bank's profitability is positive. He also stated that FDI must be considered in poverty reduction, unemployment reduction and primary education and priority sector of banking. Due to LPG, Indian banks going global and many global banks setting up shops in India, the Indian banking system is set to involve into a totally new level it will help the banking system grow in strengths going into future.

Singh Arjun and Singh Narender (2011), states that FDI is a tool for economic growth through it's strengthens 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. They also analysis the significance of the FDI inflows in Indian service sectors since 1991 and relating the growth of the service sector FDI in generation of employment in terms of skilled and unskilled.

OBJECTIVE OF STUDY

- To study the role of the FDI in the Indian Banking Sector.

RESEARCH METHODOLOGY

Research and experimental development is formal work undertaken systematically to increase the stock of knowledge. The present study is of descriptive nature. Therefore the use is made of secondary data collected primarily from journals, articles, online database of Indian Economy, RBI bulletin, websites or newspaper etc.

DISCUSSION ON TOPIC

The UPA Government had chosen to carry forward the policy of banking deregulation, following the footsteps of the NDA Government. On 28th February, 2005, the same day that the Union Budget 2005-6 was presented before the Parliament, the Reserve Bank at the instance of the Finance Minister, released a roadmap for the presence of foreign banks in India. The RBI notification formally adopted the guidelines issued by the Ministry of Commerce and Industry under the previous government on March 5, 2004 which had raised the FDI limit in Private Sector Banks to 74 per cent under the automatic route, and went on to spell out the steps that would operationalise these guidelines. The RBI roadmap demarcates two phases for foreign bank presence. During the first phase, between March 2005 and March 2009, permission for acquisition of share holding in Indian private sector banks by eligible foreign banks will be limited to banks identified by RBI for restructuring. RBI may, if it is satisfied that such investment by the foreign bank concerned will be in the long term interest of all the stakeholders in the investee bank, permit such acquisition subject to the overall investment limit of 74 percent of the paid up capital of the private bank. Appropriate amending legislation will also be proposed to the Banking Regulation Act, 1949, in order to provide that the economic ownership of investors is reflected in the voting rights. Further, the notification announces that foreign banks will be permitted to establish presence by way of setting up a WOS or conversion of the existing branches into wholly owned banking subsidiary. A clause on one-mode-presence, i.e. one form of banking presence, as branches or as wholly owned banking subsidiary or as a subsidiary with a foreign investment in a private bank, has been added as the only safeguard against concentration. The global banking industry weathered turbulent times in 2007 and 2008. The impact of the economic slowdown on the banking and insurance service sector in India has so far been moderate. The Indian Financial System has very little exposure to foreign assets and there derivatives products. Indian economy is been pushing to increase the role of multinational 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 fulfil a pledge to allow companies like New York life insurance, Met Life Insurance to raise investment in local companies to 49 percent from 26 percent. But it is opposed on the front that it will lead to state run insurers losing 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 elusive concentration in the banking sector but also can expose the economy to more intensive financial crisis at the slightness hint of panic. Opposition is not considering the need of present situation. There are various problems faced by the Indian Banking Sector such as:

- Inefficiency in Management
- Instability in Financial matters
- Innovativeness in financial products or scheme
- Non-performing areas or properties
- Poor marketing strategies
- Changing financial market conditions

Foreign Direct Investment is a non-debt inflow, which will directly solve the problem of capital base of the Indian Banks.

1. **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.
2. **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 Basel II for making their financial system safer.
3. **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.

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 (e.g. Telecom, civil aviation) FDI up to 100 percent 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.

CONCLUSION

Last but not a least, growth and diversification in banking sector has transcended limits all over the world. The banking industry has not been fully globalized is that it is more convenient to have local banks provide loan to small business and individuals. On the other hand, for large corporations, it is not as important in what nation the banks is in, since the corporation's financial information is available around the globe. FDI in banking sector also assures the better capitalization and offers financial stability in the banking sector in India.

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List of Abbreviations

- **FDI –** Foreign Direct Investment
- **HDFC – H**ousing Development Finance Corporation
- **ICICI –** Industrial Credit and Investment Corporation of India
- **RBI-** Reserve Bank of India
- **UTI –** Unit Trust of India
- **WOS –** Wholly Owned Banking Subsidiaries