International Journal of Research in Economics and Social Sciences(IJRESS)
Available online at: http://euroasiapub.org
Vol. 11 Issue 02, February- 2021
ISSN: 2249-7382 | Impact Factor: 8.018|
(An open access scholarly, peer-reviewed, interdisciplinary, monthly, and fully refereed journal.)

FOREIGN BANKING SECTOR IN INDIA

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Abstract

This article analyses the effects of international banking sector on the Indian banking industry using data from 1996 to 2007. In spite of the reduced margins, the study finds that international banks entry increases profitability and asset quality. A variety of indicators of foreign bank presence are consistent with the results. In contrast, the seniority of local banks' credit portfolios appears to be affected by overseas banks. Finally, the findings show that international banks often have better interest rates than local banks.

Keywords: *Investment, International banking Sector, Financial Sectors, Indian Economy.*

Introduction

Over the past decade, the number of international banks operating in emerging nations has grown significantly. It has prompted a number of crucial questions, including: What attracts a country's foreign banks? b) Which banks have international expansion plans? In what ways does a person's manner of entry influence their behavior? and (d) what does the existence of foreign banking industry affect the revenue of the domestic market? To answer the fourth point, the paper explores the effects of foreign banks on local banks profitability, using India as an example. Our research shows that foreign bank participation enhances profit and asset quality, albeit at the cost of a reduction in spreads. This study's findings also show that a grow in the number of outside banks cuts overhead expenses initially, but that when domestic banks benefit from contemporary banking practices, overhead costs must rise as well.

The indian banking system is a good case study for investigative the relationship among foreign bank involvement and local bank presentation. To begin, India's banking system was liberalized in the 1990s in an effort to boost efficiency, production, and profit (Government of India, 1991). To backing increased investment stages and enhance development, a market-driven, efficient, and modest economy necessitated significant changes in the banking division. In addition, the majority of studies on foreign bank operations are either cross-national studies (Terel, 1986; Claesens et al, 2001; MartinezozPeria and Moody, 2004;Hemrmes and Lennsink, 2003; Detragiachhe et al, 2008) or banking marketplaces in industrialized, transition, and MENA countries. For prominent developing economies, there is little, if any, systematic empirical research in this area. To this day, it's unclear how India's government-owned banking system interacts with foreign banks' performance in India's expanding markets like the Philippines. As a result, other developing economies' regulatory strategies may benefit from what we've learned here.

This study aims to investigate the state of foreign banks on the Indian economy and other financial sectors. This study provides a discussion on the recent data and provide an empirical review on the topic. The next part of the study will show previous studies based on this topic and obtains relevant data.

Literature Review

A few practical studies have examined the effect of liberalizing foreign banking sector entrance on the local banking section. ' With data from 80 industrialized and developing countries covering the years 1980-95, Claesens et al. (2001) found that the productivity, non-interest revenue, and overall operational costs of domestically held banks decreased with an upsurge in foreign bank involvement. They are considered to suggest the effectiveness of countrywide banking markets is enhanced by international bank entry.

Hermes and Lensink (2002, 2003) found that the introduction of foreign banks was accompanied by a significant short-term interest margins for banks (Hermes and Lensink 2002, 2003). Interest income and foreign banks' share are frequently found to have no statistically significant association. This shows that the net interest margins is presumably linked to other factors, such as the overall market rivalry, the banks' own share price, money interest rates, and so on.. For banks that are part of a family company, Unite and Sullivan (2003) found aundesirable relationship between foreign bank entrance and local bank interest production rates. When international banks compete with domestic banks, the relationship between these affiliated institutions and their domestic counterparts weakens, resulting in a decrease in their spreads. A study by Denizer (1999) looked at the impact of foreign investment on Turkish banks. Foreign competition has decreased local profitability and overhead costs, according to the findings of the study A decrease in net interest income is typically linked to an increase in competition. As the percentage of foreign banks grows.

The competitiveness of the banking sector can be enhanced by a stronger foreign bank presence.

Having more competition in the financial sector is beneficial for a number of reasons, including enhancing efficiency, promoting innovation, and ensuring general stability. According to the available research, foreign ownership is connected with an increase in productivity. Bank specialization is related with decreased efficiency in emerging countries, according to Demirguc-Kunt et al. (2003).

As more international banks enter the market, their operational expenses fall, indicating greater efficiency. Increasing investments in information technology and human resources are typical responses by local financial institutions to foreign banks entering the market, especially in the near term. This suggests that these institutions want to maintain their clientele base despite the increased competition.

The profitability of a bank can be gauged by looking at its profit margin as a percentage of its total assets. The admission of foreign banks into the banking industry is normally expected to increase competition and hence reduce interest margin, resulting in a decrease in profitability for banks.

NPLs are unclear since foreign banks' presence can have equally positively and negatively influence on the quality of the loans they offer. Higher foreign ownership may lead to "cherry picking" of the best borrowers because foreign groups are more likely to use superior acclaim risk management procedures. If superior credit hazard management from foreign banks encourages local banks to enhance their credit managing abilities, a larger presence of foreign banks may have aundesirable impact on local banks' NPLs. As a result, we have come up with the following hypothesis:

Nonperforming debts at financial institutions are affected by foreign banks' presence in the nation in one of two ways: positively or negatively.

Loan terms and composition could potentially be affected by foreign banks. During a financial crisis, foreign banks may pour in hot money that is easy to withdraw (Rodrik and Velasco, 1999).

The risk of default loans and asymmetric information can be reduced by foreign banks using shorter loan maturities (Ortiz-Molina and Penas, 2008). Our ultimate hypothesis is based on these information:

Lending rates fall when foreign banks enter the market; nevertheless, the influence on loans and composition remains unclear.

The need of a competent banking regulatory framework is also highlighted in a large body of literature. Countries with poor institutional environments, according to Demirguc-Kunt and Detragiache (1998), will experience more instability in their banking system in the immediate aftermath of liberalization. According to La Porta et al. (1997), a country's legal system is largely influenced by its cultural identity as well as its history. Continuing this line of research, Rajan and Zingales (2000) show that political concerns and organizational constraints to financial development are inextricably linked. Because of political-economic concerns, many countries do not create effective legal and financial systems, even though they are widely accepted to be advantageous.

Methodology

We use 5 types of response variable to assess bank performance: NIM, RoA, Cost, NPLs, and CIR to measure the legality, rightness, and effectiveness of the banks in question. Each of these factors has its own weighting. Most of these factors have been used in earlier studies of this genre and are very common in the literature (Claesmens et al., 2001; Hermes and Leensink, 2004).

It is necessary to redefine the variables (y) to be ln[ps,t] as the proportion of loans made by different sectors and maturities, as well as by different types of financial s at time t. The other variables stay the same as before. The following variables are taken into account when allocating credit: credit from the private sector, credit lines and term loan as measures of credit maturity, and protected credit as a measure of loan collateral security. The total credit is used to calculate all of the variables. Lastly, the effect of foreign bank existence on the cost of borrowing of banks. Accumulated interest on loans to total loans is defined as the loan or credit rate in our empirical formulation, following earlier research (MartiinezPeria and Schhmukler, 2001).

The variable pertaining to the foreign bank is of special importance in (2). We look at three different aspects of the existence of a foreign bank. FB Assets, FB Number and FB Branch are all measures of foreign banks' share of overall commercial banks' assets, which are based on their percentage of total commercial bank assets.

Rather than using the overall number of bank branches, we use the total number of FB Branch locations to engage for the fact that foreign banks are often only present in major cities, where they face competition from other major city-based bank groups.

Branches located in rural and semi-urban areas are represented by a higher percentage of our data than those in metropolitan areas, and this is reflected in our capital adequacy ratio (CAR). Any scale efficiency impacts are captured using the natural logarithm of all assets (SIZE). For example, we predict that the size and reputation of a domestic bank may have an impact on how it responds to foreign bank entry. The greater the bank's size, the more important it is to have solid relationships and a solid reputation. Low

CRAR ratios indicate that banks are in relatively riskier circumstances, which is why they are included in the CRAR (Ghossh, 2004). With a significant existence in rural and semi-rural areas, it is.

Bank penetration and market power are two of the banking industry-level variables. Contextually, DemirggucKunnt et al. (2004) and MartíinezPerria and Moody in 2004 found that bank concentration is a critical and effective factor in influencing net interest boundary in their cross-country analysis. In order to measure market strength, the Herfindahl index of credit accumulation, which is the sum of the squares of the share of the market of loans, is used. Bank concentration and market dominance are two of the banking industry-level factors that can be used as proxies for these variables. According to DemirggucKunt et al. (2004) and MartiínezPeria and Moody (2004), bank specialization is a key and crucial element in influencing the net interest margin in a cross-country comparison. The Herfindahl indexes of loan accumulation, well-defined as the ratio of squares of market share, is a measure of market power.

Result and Discussion

The findings of the empirical investigation. Figure 1 shows that foreign bank presence has a beneficial impact on profit while having a negative impact on spread, overhead expenditures and non-performing credits. The fact that profitability is positively correlated with the presence of foreign banks suggests that the degree of competition in the banking industry is reduced. These findings, which are based on the physical existence of foreign banks. Greater foreign bank presence, in particular, reduces costs and non-performing loans.

There is a strong correlation between an increase in international bank outreach and an improvement in profitability and a decrease in non-performing loans. Aside from H2: foreign bank involvement boosts efficiency, data supports H1.

We find that larger banks perform better and efficient when we look at bank-specific controls, but they also have greater operating costs. Larger banks can benefit from economies of scale, but they may also incur higher costs as a result of this increased diversification. Under the influence of foreign entry, domestic banks are forced to maintain higher capitalization in order to retain their spreads. Furthermore, well-capitalized banks have lesser NPLs than their less well-capitalized peers. In both the Indian framework (Dass and Ghosh, 2005) and the international environment, the inverse association among capital and risk (NPLs) has been thoroughly demonstrated (Kwwan and Eisennibis, 1997; Rime, 2001; Stollz, 2009).

SOBs appear to have higher influence, but their productivity and liquidity levels are far lower than those of traditional private banks, according to data from ownership dummies. There is evidence to suggest that more market concentration has some advantages, but it also has some drawbacks. The ability of banks to create "rents" increases as loan concentration increases, but banks also lose efficiency, resulting in increased overheads and cost-income ratios.

Claessens et alfindings .'s do not match ours (2001). Equally indicators of foreign bank entrance are statically important at conservative rates, contrasting the study previously cited in which only one indication of foreign bank engagement was statically important at conventional levels. Foreign banks appear to have a negative impact on most cost and revenue factors, while the impact on interest income is not as clear-cut. This suggests that the associationamong the performance of national banks and the arrival of foreign banks is not linear. Both positively and negatively consequences may be caused by foreign groups entering the United States. Positively, new banking procedures and improved management practices may leak over into national banks, leading them to first increase their expenses in order to enact such practices. Although such techniques are not yet widespread in the domestic banking sector, they will be able to compete more aggressively with their overseas counterparts as time goes on. As a result of foreign bank entry, there could be a flight of high-quality clients to foreign banks, that, over time, will impair the loan range of local banks. This would compel domestic banks to increase their loan loss provisions (i.e., higher costs). As a result of the lower loan portfolio of domestic banks, there are less options for them to spread their risks.

According to lending rates, foreign bank expansion and outreach have a lowering effect on domestic banks' lending rates. There is evidence that international banks pay their borrowers 1.73 to 1.77 percent less annually, depending on the country. Studies have shown that international banks' lending rates are often lower than national counterparts (Dell'Ariccia and Marrquez, 2004; Cllayes and Haiinz, 2006), and these findings support those earlier studies.

It can be said from the above analysis of the literatures on this topic that foreign investment and banking involvement is enhancing the growth of the country and influences the old methods of the local banks and implements new and profitable measures which can be profitable for both the people of this country and the banking industry as well. Thus, this foreign banking industry is also influencing the economical state of the country.

Conclusion

The objectives of this essay is to show how foreign bank entrance affects performance of Indian banks. Our goal was to evaluate the influence of foreign bank entry by combining bank-level qualitative data with banking sector and macroeconomic variables. The influence of foreign banks in India can be quantified in three ways: by asset ownership, branch share (in major cities), and the total amount of outside banks in the country. Foreign bank participation promotes productivity and asset quality, even while it reduces spreads. Foreign banks derives the economic section of the country as this can be stated from the study. The role of foreign bank in the development of the economy is significant in many ways and it can be utilized in more effective way. People in this country are struggling with loans where foreign banks are providing loans with cheaper interest rate.

This means that foreign bank presence appears to be more of a "asset" rather than a "liability," as the study's overall result indicates. Obviously, further research is needed to determine whether the mode of foreign bank presence (greenwood versus acquisition) and type (office versus subsidiary) exerts any significant influence on the presentation of national banks.

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