

## **FOREIGN DIRECT INVESTMENT & INDIAN BANKING SECTOR**

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### **INTRODUCTION**

Indian banking had come a long way since India adopted reforms path. 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, to let banks attract and retain customers. This apart retail lending has emerged as another major opportunity for banks. As result of this innovation banking products are a reality now. Even saving accounts, personal loan accounts and home loan account have become subject of innovation. Due to globalization, liberalization and privatization mode, 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 strength going into the future. Banks IPO will be lifting the market to increased their capital and gearing up for the Basel II norms. Their will be increased pressure on small private banks which are not doing well merge with public sector banks and one can expect the pace of consolidation to increase. It means it is certain that a greater presence of international players in the Indian financial system and some of the Indian banks will become global players in the coming years.

In future Indian Banking is poised to face significant challenge, with continues deregulation of the sector and with the increased integration with world economy, FDI are going to have strong influence on Indian bank's overall performance. Hence it is essential to understand present position of FDI and its impact on banking sector so as to face any challenge in future and

to make India super power as per the expectation of Hon.Dr.A.P.J. Abdul Kalam. Against this background an attempt is made in the paper to know the present status of FDI and its impact on banking sector. The present paper is based on the secondary data available from different publications of the Reserve bank of India and other journals and periodicals. The limitation of this paper is that other than FDI, no other factor, impact is assessed. It is assumed here that i) FDI is increasing evenly ii) FDI in India is increasing consistently. Iii) USA is contributing highest in India's FDI on banking sector is positive.

To know the systematic approach of the FDI and its impact on banking sector and suggestive measures for improving the situation prevailing in banking sector. It is must to highlight on the banking sector. The present paper is divided into following four sections.

Section –I : Introduction and Research Methodology

Section-II : FDI in India

Section-III Impact of FDI on banking sector.

Section-IV :Summary, conclusion and suggestions.

## Section-II

The objective of section II is to assess the trend of FDI in India during 1991-2006 period which is called LPG Sponsored FDI model in India.. The section begin with understanding, FDI in the global world It means an attempt is made to highlight on the position of FDI flows in the world in general and India in particular.

### **FDI in the Global World**

Foreign direct investment flows (inflows and outflows) have occupied a prominent place in the global economy. It is an important avenue through which investment takes place in any country. The importance of FDI extends beyond the financial capital that flows into the country. In addition, FDI can be a tool for bringing knowledge and integration into global production Chinas, which are the foundation of a successful exports strategy (1). It is also said that the FDI flows are vital for accelerating desired degree of growth and

development. If this is so then it is essential first, to know FDI's position of the world.

The past few decades have witnessed a dramatic increases in the world FDI flow. The world inflows and outflows of FDI in absolute terms has increased by showing upward trend. The world FDI annual growth rate of both in flows and outflows increased during 1996-2000 as compared to 1991-1995 from 20.0% to 40.1. The world FDI inflows and outflows in 2001 amounted to \$ 735 billion and \$ 621 billion respectively, It has increased from \$ 203 billion and \$ 233 billion respectively in 1990. This is presented in Table No : 1

**Table-1**  
**FDI IN THE GLOBALISED WORLD ( 1990-2000)**

| FDI                 | Value at current prices (Billions & Dollars) |            | Growth rate in % |           |
|---------------------|----------------------------------------------|------------|------------------|-----------|
|                     | 1990                                         | 2001       | 1991-1995        | 1996-2000 |
| <b>FDI inflows</b>  | <b>203</b>                                   | <b>735</b> | 20.0             | 40.1      |
| <b>FDI Outflows</b> | <b>233</b>                                   | <b>621</b> | 15.8             | 36.7      |
| <b>Source</b>       | World Investment Report (2002) P.No. 4       |            |                  |           |

It is clear from the above table that FDI inflows and outflows in absolute terms showed an increasing trend in 2001 as compared to 1990 in the globalised world. However, it is strange to notice that the sharp decline of global flows in FDI has been marked in spite of the fact that there were about 208 national regulatory changes between 1991-2001 in world economy by about 71 countries. Another most important feature of FDI is the globalised world is that the developed nations have attracted more FDI inflows as compared to that of developing countries. Table 2 shows distribution of FDI inflow during 1991-2001.

**Table-2**  
**DISTRIBUTION OF WORLD FDI INFLOWS (1991-2001)**

| Year      | Developing Countries | Developed Countries |
|-----------|----------------------|---------------------|
| 1991-92   | 31.2                 | 66.5                |
| 1999-2000 | 17.9                 | 80.0                |
| 2001      | 27.9                 | 68.4                |

**Source : UNCTAD, FDI/NTC database ( 2001)**

It is evident from table 2 that more than 68% share of FDI in the world goes to developed nations in 2001. The share of Developing nations was just 27% in 2001. However it is improved as compared to 1999-2000. In 1999-2000 the share of FDI in developed and developing countries was in the ratio 80:18. The story of FDI is not Stopped here but further it state that FDI centered around the US, the European Union and Japan. The top-10 FDI receivers are the USA, Mauritius, UK, South Korea, Japan, Germany, Australia, Malaysia, Israel and Netherlands.

**TABLE NO : 3**

| <b>RFOREIGN DIRECT INVESTMENT APPROVAL AND INFLOWS</b> |                 |                |                                           |                                          |                                    |                     |
|--------------------------------------------------------|-----------------|----------------|-------------------------------------------|------------------------------------------|------------------------------------|---------------------|
| <b>Year</b>                                            | <b>Approval</b> | <b>Inflows</b> | <b>Realization rate of FDI approval %</b> | <b>% increase over the previous year</b> | <b>Index of change 1992-93-100</b> | <b>FDI % of GDP</b> |
| 1992-93                                                | 5546            | 1094           | 19.73                                     | -                                        | 100                                | 0.13                |
| 1993-94                                                | 7469            | 2018           | 27.01                                     | 84.46                                    | 184                                | 0.21                |
| 1994-95                                                | 9971            | 4312           | 43.25                                     | 133.68                                   | 394                                | 0.41                |
| 1995-96                                                | 36608           | 6916           | 18.89                                     | 60.39                                    | 632                                | 0.60                |
| 1996-97                                                | 40206           | 9654           | 24.01                                     | 39.54                                    | 882                                | 0.73                |
| 1997-98                                                | 40033           | 13548          | 33.84                                     | 40.34                                    | 1288                               | 0.87                |
| 1998-99                                                | 30324           | 12343          | 40.70                                     | -8.89                                    | 1128                               | 0.59                |
| 1999-00                                                | 17976           | 10311          | 57.36                                     | -16.46                                   | 943                                | 0.48                |
| 2000-01                                                | 25207           | 12645          | 50.16                                     | 22.64                                    | 1156                               | 0.88                |
| 2001-02                                                | 14465           | 19361          | 133.84                                    | 53.11                                    | 1770                               | 1.28                |
| 2002-03                                                | 7904            | 14932          | 188.92                                    | -22.88                                   | 1365                               | 0.99                |
| 2003-04                                                | 6724            | 12117          | 180.20                                    | -18.85                                   | 1108                               | 0.78                |
| 2004-05                                                | 6784            | 11726          | 172.85                                    | -03.23                                   | 1072                               | 0.80                |
| <b>Total</b>                                           | <b>250062</b>   | <b>131385</b>  | <b>52.54</b>                              | <b>-</b>                                 | <b>-</b>                           | <b>-</b>            |
| <b>average</b>                                         | <b>17862</b>    | <b>9385</b>    | <b>77.73</b>                              |                                          |                                    |                     |

- Source
1. Economic survey 2001,2005, various issues for approval and inflows
  2. economic and political weekly 2005 for FDI / GDP.

Table No 3 shows that there was more than ten fold increase in the foreign direct investment during 1992-2005. The inflows of FDI increased from Rs. 1094 crore in 1992-93 to Rs. 11726 crore in 2004-05. The highest

FDI was reported in 2001-02 amounted Rs. 19361 crores. The FDI trend shows that FDI has increased between 1991-92 to 1997-98 from Rs.1094 crore to Rs. 13548 crore. After 1997-98 it declined upto 1999-2000. Further table shows that the aggregate FDI inflows into India were somewhat lowest during 2003-04 as compared to that 2002-03. After rising sharply from 1999-2000 have been showing a decline trend since 2001-02 till 2004-05. Thus there is no consistency in rising the FDI. But it is clear that FDI has moved upwards. It has increased by 1991-92 to 2004-05 more than 10 times. Looking to approval of FDI, one can sound that it is very healthy position and India is receiving very large amount of FDI. But this not so. Realization rate of inflows as compared to FDI's approval is just above 52%. That too there is no uniformity in realization. There is a wide gap between approval and actual inflows/ Again year to year variations are wide.

It is evident from the Table No third that total FDI inflow in India from august 1991 to Dec. 2004 was Rs. 1,33,892.85 crores. Out of these top ten (T10) countries contribution in India's FDI was Rs. 94466.85 crores where as next T-10 countries contribution towards India was just Rs. 8428 crore. Total being Rs. 102894.85 crores for t-20 countries averaging of first T-10 Rs. 9446.69 crore and next T-10 Rs. 842.80 crore and T-20's average is Rs. 5144.74 crore. In terms of share in total FDI table no third shows that share of FDI inflow of T-10 was to the extent of 70.56, next T-10's share was 6.30% and total being 76.86% for top 20. This clearly indicate that only top 10 are contributing in India's FDI considerable. Then it would be interesting to know that what are that countries who are contributes india's FDI considerably.

The above table also shows that the share of T-10 countries FDI inflow during August 1991 to Dec. 2004, Mauritius Rs. 38024.76 crores (28.90%) stand first followed by USA Rs. 18048.05 (13.48%) second and further table shows that third most important contributor is Netherland whose FDI inflow was Rs.7940.06 crores with 5.93% followed by Japan. The FDI inflow from Japan was Rs. 7900.06 crore with 5.90%. The first four countries FDI inflow to India is more than 50%. At fifth place is the UK who contribute to the extent of 7013.66 crore (5.24%). France, South Korea, Singapure and Switzerland are the next countries in the top-ten. The US which allocates \$ 450 billion per

year to military spending for bombing Somalia, Afghanistan and Iraq and allocates merely \$12 billion per year to development assistance for poor countries is the biggest beneficiary in respect of FDI and stand first in rank for FDI. But the rank of US for India's FDI inflow is second. Under the situation it is interesting to understand and know from India's point of view that, who are the first five top states in the India who are attracted major share of FDI inflows (see table 4) they are Maharashtra who stand first with 14.8% shares, Delhi second) with 12.2 % Tamilnadu (9.05 %), Karnataka (7.63 % ) & Gujrat (4.97 %).

### **Section – III**

#### **IMPACT OF FDI ON BANKING SECTOR:**

As Indian banking had come a long way since nationalization and after adopting reforms model, FDI inflow is now both a challenge and an opportunity for Indian bankers to gain strength in the domestic market and increase presence in the global market. FDI in banking brings in competition players with deep pockets and superior managerial practices. Mobile phones will now turn into virtual wallets and there is chance that the entire concept of payment may change in near future. The RBI's road map for foreign ownership limits the role of FDI in banking until 2009 and after 2009 foreign bank will be permitted of acquire up to 74% equity in private Indian banks. Therefore status of impact of FDI on Indian banking is urgently needed to study due to in the Indian context, the necessity for FDI must be judged in relation to the trends in efficiency and stability. Hence an attempt is made in this section to understand what is an impact of FDI on Indian banking in terms of

1. Whether borrower accounts in banking industry increasing or decreasing?
2. Whether number of banking branches increasing or decreasing?
3. Whether time deposit increasing or decreasing? And
4. Whether profitability of domestic and foreign banks increasing or decreasing?

In other words impact of FDI is assessed in terms of borrower accounts, number of branches, time deposit and profitability.

#### **IMPACT ON BORROWAL ACCOUNTS:**

After LPG Sponsored FDI model adoption, 1991-1996 year have witnessed a dramatic increasing in borrower Account at initial years and then it has witnessed decreasing trend. The position of borrower accounts on banking, industry and on the government is presented in Table-No :4

**Table-4**

##### **NO. OF BORROWAL ACCOUNTS IN BANKING INDUSTRY**

| <b>Year</b> | <b>No. of Accounts in "000"</b> | <b>% change to Previous year</b> |
|-------------|---------------------------------|----------------------------------|
| 1990        | 52113                           | 3.34                             |
| 1991        | 53851                           | 15.03                            |
| 1992        | 61946                           | 6.32                             |
| 1993        | 65862                           | -5.69                            |
| 1994        | 65116                           | -3.97                            |
| 1995        | 59651                           | -2.61                            |
| 1996        | 58097                           | -2.45                            |

(Source : Economic Survey of India 2005)

It is clear from above table that borrower account were increased from 52113 in 1990 to 65862 in 1993 after this they are declined to 58097 in 1996. percentage previous year evident that borrower accounts trend is going towards negative direction. It has changed from 15.03% in 1991 to –2.45 in 1996. Thus the impact of LPG sponsored FDI model's impact on number of borrower account is negative.

#### **IMPACT ON BRANCHES AND TIME DEPOSITS:**

Table no five shows that during 1985-86 to 1990-91 period average branches were increased by 6933, whereas during 1992-93 to 1997-98 period branches were increased an average 3049. the pre FDI model period growth rate in branches was 13% which was come down to 40% in post FDI model period. This is presented in Table no five.

**Table-5****SCHEDULED COMMERCIAL BANKING BRANCHES AND TIME DEPOSIT GROWTH**

| Sr.No.                                                                                                                                               | SCB Branches and time deposit    | Pre-FDI model period | Post-FDI model period | Result |
|------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------|----------------------|-----------------------|--------|
| 1.                                                                                                                                                   | Average increase in branches     | 6933                 | 3049                  | - ve   |
| 2.                                                                                                                                                   | % growth rate in branches        | 13%                  | 4%                    | - ve   |
| 3.                                                                                                                                                   | Average increase in time deposit | 112341               | 344896                | + ve   |
| 4.                                                                                                                                                   | % growth in time deposit         | 127%                 | 123%                  | - ve   |
| <b>NOTE :</b><br>1) Pre FDI model Period : 1985-86 to 1990-91<br>2) Post FDI model Period : 1992-93 to 1997-98<br>3) SCB : Scheduled commercial Bank |                                  |                      |                       |        |

Regarding time deposit table-5 further shows that time deposit rose to 344896 Crores during post FDI model period as compared to pre FDI model period from 112341 Crores. This is positive impact. The growth rate for pre FDI model period was 127% which declined to 123% for the post FDI model period. However banks are facing stiff competition from private and foreign bank due to FDI inflow. As a result of this the growth rate in time deposit lower down from 127% to 123%. In this way post FDI model period witnessing down words growth in branches and as well as in time deposit collection.

**IMPACT ON PROFITABILITY OF DOMESTIC AND FOREIGN BANKS :**

Another important impact of FDI model policy is that at the end of June 1991 there were 24 foreign banks with 42 branches in the Indian financial market. This number had gone up to 140 foreign bank 182 branches as on June 1998 with total assets of Rs.10, 000 crores and with 3.1% profitability rate. Indian Banking branches are decreasing whereas foreign bank branches are increasing trends during FDI model phase. FDI is motivating factor to increase profitability. As FDI increases profitability increases Indian concern then it is positive impact whereas FDI increases foreign banks profitability increases at higher rate than Indian banking profitability rate then it is negative impact on Indian banking system, it is assumed here. The result of profitability of foreign and domestic bank is given in Table No: 6



**Table-No : 6**

**PROFITABILITY RATIOS OF FOREIGN BANKS AND DOMESTIC BANKS : (1985 –1997)**

| Year      | Foreign Bank Profitability | Domestic Banks Profitability | % as compared to Foreign bank profitability |
|-----------|----------------------------|------------------------------|---------------------------------------------|
| 1985-86   | 0.7                        | 0.1                          | Higher                                      |
| 1986-87   | 2.7                        | 0.2                          | Higher                                      |
| 1995-96   | 3.1                        | 1.3                          | Higher                                      |
| 1996-97   | 3.1                        | 1.2                          | Higher                                      |
| 1985-1997 | 2.7                        | 0.5                          | Higher                                      |

It is revealed from table no.- 6, that the profitability of Indian Banking as well as Foreign banking in increasing trends. The pre FDI mode period profitability of Indian banking was 0.2 which increased to the extent of 1.3 in post FDI model period. It means the impact of FDI model is positive on both Indian banking and foreign banking profitability. However the rate of profitability of foreign bank is higher than Indian bank in pre and post FDI model period. It is still higher in post FDI model period. Therefore, it can be said that impact of FDI model on Indian banking profitability is not much or higher than foreign bank. In fact it is lower and hence to that extent. It can be treated as impact is negative.

**Conclusion and Suggestions.**

It can be concluded that

1. FDI in the world is increased as compared to 1991 in 2001.
2. FDI trends of the world is upward direction
3. FDI share of development countries is higher than developing countries to extent of 68 % in 2001, it was 80 % in 1999-2000.
4. FDI inflow of the USA is the highest in the world
5. The top five FDI attractors are USA, Mauritius, UK, South Korea and Japan.
6. The inflows of FDI increased from Rs.1094 crore in 1992-93 to Rs.11726 crore in 2004-05 in India
7. There is no consistency in rising the FDI in India

8. India's FDI is moving upward direction
9. Top-10 contribution of Indian's FDI are Mauritius, USA, Netherlands, Japan, UK, Germany, France, South Korea, Singapore and Switzerland.
10. Contribution of Mauritius is highest in India's FDI, USA in second highest.
11. The first Top FDI attractors states are Maharashtra, Delhi, Tamil Nadu, Karnataka and Gujrat. Maharashtra being highest to the extend of Rs.37020 crores.
12. FDI in service sector is only 8.20%
13. The borrowal account in the banking industries is following down since 1990. Annual growth rate of borrowal account is negative since 1993 and onwards.
14. The LPG sponsored FDI Model's impact on number of borrowal accounts is negative.
15. The LPG sponsored FDI Model's impact on branches and time deposit growth is negative.
16. The LPG sponsored FDI Model's impact on foreign banks and Indian bank's profitability is positive
17. The Impact of FDI on India Banking sector is negative except profitability.

## **SUGGESTIONS :**

1. What is needed is to development a coherent and forward looking FDI policy based on the concepts or shared responsibility between the India government and NRI's
2. Give freedom 80% only and no automatic FDI inflow
3. A selective FDI must be prepared.
4. FDI must be considered in poverty reduction, unemployment reduction and primary education and priority sectors of banking.
5. FDI inflows in emerging markets typically ride on the back of privatization. The rise in FDI in Latin America and to some extend,

in East Asia in recent years is the result of privatization of domestic banks, following banking crises and bank failures but our study shows that India have crises nor is the biggest chunk of the sector, state-owned banks available for foreign acquisition yet. Therefore remain in this status is advisable.

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