

# **Global Financial System in the Post-crisis Era**

## **Challenges and Opportunities**

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- Their use of risk-based credit evaluation tends to reduce concentration in lending and in times of financial distress, fosters prompter recognition of losses and more timely resolution of problems.
- The integration of EME financial firms into the global market has resulted a wider diversity of financial institutions operating in EMEs and given greater emphasis on risk-adjusted profitability.
- Expansion into local retail banking and securities markets, where elements such as client relationships and reputation are important components of the franchise value of operations. Such factors have tended to raise the costs of exiting a country and hence increased the permanence of FSDI.
- FSDI was fostered by financial liberalization and market-based reforms in many EMEs.
- The liberalization of the capital account and financial deregulation paved the way for foreign acquisitions and the integration of EME financial firms into an expanding global market for corporate control and a broader trend towards consolidation and globalization in the financial industry.
- In some cases competition in traditional markets increased pressure on major international banks to find new areas for growth.
- Financial institutions in advanced economies increasingly searching for profit opportunities at the customer and product level with attractive strategic opportunities to expand.
- The growing involvement of foreign firms in the financial systems of EMEs has given rise to a situation where majorities of EME banking assets have become foreign owned.
- Developing pertinent technical skills is considered be an important area of cooperation between authorities in advanced and EME countries.
- In some markets, foreign-owned banks have been prominent in the rapid expansion of consumer lending and foreign currency lending to both households and businesses.
- Appropriate supervision is needed to assess such credit managed by banks, and authorities in charge of financial stability.
- Public policy should be focused on maximizing benefits by continuing to encourage diversity and competition in financial systems not only between foreign and domestic banks but also between banks and other financial institutions.
- One essential component among host country policy is commitment for growth and stability. Another is the protection of property rights and equal treatment of banks irrespective of ownership.
- Implementation of the internationally recognized set of financial standards and codes can help to reduce country risk. Strengthening of legal frameworks act as a parameter for reducing country risk. Smooth functioning of the market for corporate control would be assisted by greater international compatibility of accounting standards, takeover rules, and insolvency codes.

### BASEL NORMS

While Basel I framework was confined to the prescription of only minimum capital requirements for banks, the Basel II framework expands this approach not only to capture certain additional risks in the minimum capital ratio but also includes two additional areas, viz. Supervisory Review Process and Market Discipline through increased disclosure requirements for banks. Thus, Basel II framework rests on the following three mutually-reinforcing pillars:

**Pillar 1** Minimum Capital Requirements — prescribes a risk-sensitive calculation of capital requirements that, for the first time, explicitly includes operational risk along with market and credit risk.

**Pillar 2:** Supervisory Review Process (SRP) — envisages the establishment of suitable risk management systems in banks and their review by the supervisory authority.

**Pillar 3:** Market Discipline — seeks to achieve increased transparency through expanded disclosure requirements for banks.

Basel II is the international capital adequacy framework for banks that prescribes capital requirements for credit risk, market risk and operational risk. Basel II is the second of the Basel Accords recommended on banking laws and regulations issued by Basel Committee on Banking Supervision. The purpose behind applying Basel II norms to Indian banks is to help them comply with international standards. These international standards can help protect the international financial system from problems that may arise from the collapse of a major bank.

## CONCLUSION

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. FDI in banking sector can solve various problems of the overall banking sector, such as Innovative Financial Products, Technical Developments in the Foreign Markets, Problem of Inefficient Management, Non-performing Assets, Financial Instability, Poor Capitalization and Changing Financial Market Conditions

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1. Includes 'equity capital components' only.
2. The Region-wise FDI inflows are classified as per RBI's – Regional Office received FDI inflows, furnished by RBI, Mumbai.
3. Represents, FDI inflows through acquisition of existing shares by transfer from residents to non residents. For this, RBI Regional wise information is not provided by Reserve Bank of India.

### STATUTORY LIMITS

The statutory limits permitted by the Reserve Bank of India (RBI), country's central banking authority, should be adhered mentioned as below with respect to FDI.

- Foreign direct investment (FDI) up to 49 percent is permitted in Indian private sector banks under "automatic route" which includes Initial Public Issue (IPO), Private Placements, ADR/GDRs; and Acquisition of shares from existing shareholders.
- Automatic route is not applicable to transfer of existing shares in a banking company from residents to non-residents. This category of investors require approval of FIPB, followed by "in principle" approval by Exchange Control Department (ECD), Reserve Bank of India (RBI).
- The "fair price" for transfer of existing shares is determined by RBI, broadly on the basis of Securities Exchange Board of India (SEBI) guidelines for listed shares and erstwhile CCI guidelines for unlisted shares. After receipt of "in principle" approval, the resident seller can receive funds and apply to ECD, RBI, for obtaining final permission for transfer of shares.
- Foreign banks having branch-presence in India are eligible for FDI in private sector banks subject to the overall cap of 49% with RBI approval.
- Issue of fresh shares under automatic route is not available to those foreign investors who have a financial or technical collaboration in the same or allied field. Those who fall under this category would require Foreign Investment Promotion Board (FIPB) approval for FDI in the Indian banking sector.
- Under the Insurance Act, the maximum foreign investment in an insurance company has been fixed at 26 percent. Application for foreign investment in banks which have joint venture/ subsidiary in insurance sector should be made to RBI. Such applications would be considered by RBI in consultation with Insurance regulatory and Development Authority (IRDA).
- FDI and Portfolio Investment in nationalised banks are subject to overall statutory limits of 20 percent.
- The 20 percent ceiling would apply in respect of such investments in State Bank of India and its associate banks.

### VOTING RIGHTS OF FOREIGN INVESTORS

**Private Sector Banks** Not more than 10 percent of the total voting rights of all the shareholder.

**Nationalised Banks** Not more than 1 percent of the total voting rights of all the shareholders of the nationalised bank.

**State Bank of India** Not more than 10 percent of the issued capital. This does not apply to Reserve Bank of India (RBI) as a shareholder. However, government in consultation with RBI, ceiling for foreign investors can be raised.

**SBI Associates** : Not more than 1 percent. This ceiling will not be applied to State Bank of India. If any person holds more than 200 shares, he/she will not be registered as a shareholder

### RBI APPROVAL

RBI approval is essential on the following matters:

1. Transfer of shares of 5 percent and more of the paid-up capital of a private sector bank requires prior acknowledgement of RBI.
2. For FDI of 5 percent and more of the paid-up capital, the private sector bank has to apply in the prescribed form to RBI.
3. Under the provision of Foreign Exchange Management Act (FEMA), 1999, any fresh issue of shares of a bank, either through the automatic route or with the specific approval of FIPB, does not require further approval of Exchange Control department (ECD) RBI from the exchange control angle.
4. The Indian banking company is only required to undertake two-stage reporting to the ECD of RBI as follows: (1) the Indian company has to submit a report within 30 days of the date of receipt of amount of consideration indicating the name and address of foreign investors, date of receipt of funds and their rupee equivalent, name of bank through whom funds were received and details of govt. approval, if any. (2) Indian banking company is required to file within 30 days from the date of issue of shares, a report in form FC-GPR together with a certificate from the company secretary of the concerned company certifying that various regulations have been complied with. The report will also be accompanied by a certificate from a Chartered Accountant indicating the manner the manner of arriving at the price of the shares issued.

### DIVESTMENT BY FOREIGN INVESTORS

- Sale of shares by non-residents on a stock exchange and remittance of the proceeds thereof through an authorised dealer does not require RBI approval.
- Sale of shares by private arrangement requires RBI's prior approval.

### IMPACT OF FOREIGN DIRECT INVESTMENT IN BANKING SECTOR IN INDIA

Opening up of doors by many countries of the world has resulted foreign participation in the financial sectors of emerging market economies (EMEs) during the 1990s. It has continued to expand so far in this decade, on balance. It is seen that banks accounted for the majority of financial sector foreign direct investment (FSFDI) and the impact felt since opening up of banking sector are discussed below:

- Host countries benefit from the technology transfers and innovations in products and processes commonly associated with foreign bank entry.
- Foreign banks exert competitive pressures and demonstration effects on local institutions. This results better risk management, more competitive pricing and in general a more efficient allocation of credit in the financial sector as a whole.
- Foreign banks presence help to achieve greater financial stability in host countries.
- Host countries benefit immediately from foreign entry.
- The 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 to local business cycles and changing financial market conditions.

The banking industry is slated for growth in future with a more qualitative rather than quantitative approach. The total assets of all scheduled commercial banks by end-March 2010 is projected to touch Rs 40,90,000 crore. This is going to comprise around 65% of GDP at current market prices as compared to 67% in 2002-03. The bank's assets are estimated to grow at an annual composite rate of growth of 13.4% during the rest of the decade as against 16.7% between 1994-95 and 2002-03. Barring the asset side, on the liability perspective, there will be huge additions to the capital base and reserves. People will rely more on borrowed funds, pace of deposit growth slowing down side by side. However, advances and investments would not see a healthy growth rate. The Indian banks are hopeful of becoming a global brand as they are the major source of financial sector revenue and profit growth. The financial services penetration in India continues to be healthy, thus the banking industry is also not far behind. As a result of this, the profit for the Indian banking industry will surely surge ahead. The profit pool of the Indian banking industry is probable to augment from US\$ 4.8 billion in 2005 to US\$ 20 billion in 2010 and further to US\$ 40 billion by 2015. This growth and expansion pace would be driven by the chunk of middle class population. The increase in the number of private banks, the domestic credit market of India is estimated to grow from US\$ 0.4 trillion in 2004 to US\$ 23 trillion by 2050. Third largest banking hub of the globe by 2040 is that vision too far away.

India would see a large number of global banks controlling huge stakes of the banking entities in the country. The overseas banking units would bring along with it capital, technology, and management skills. This would lead to higher competition in the banking frontier and ensure greater efficiency. The FDI norms in the banking sector would give more leverage to the Indian banks. Thus, a consolidation phase in the banking industry in India is started with mergers and acquisitions gathering more pace. One might also see mergers between public sector banks or public sector banks and private banks. Credit cards, insurance are the next best strategic places where alliances once formed.

#### FOREIGN DIRECT INVESTMENT IN BANKING SECTOR

Indian federal government has opened up the banking sector for foreign investors raising the ceiling of foreign direct investment in the Indian private sector banks to 49 percent. However, the ceiling of FDI in the country's public sector banks remains unchanged at 20 percent. Foreign banks having branches in India are also entitled to acquire stakes upto 49% through "automatic routes". It is to be noted that under "automatic route" fresh shares would not be issued to foreign investors who already have financial or technical collaboration in banking or allied sector. They would require FIPB approval. However, some statutory approvals of the Reserve Bank of India (RBI), country's central banking authority, would be required.

**Table 1** Sector-Wise FDI Inflows from April 2000–November 2009 (Amount in million)

S. No	Sector	Amount of FDI inflow (in Rs.)	Amount of FDI inflow (in US \$)	%age to total FDI inflow
1	Services Sector (Financial and Non-financial)	1,010,188.83	22,686.68	21.86
2	Computer software & hardware	422,590.84	9,528.60	9.14
3	Telecommunications	391,786.76	8,600.00	8.48
4	Housing and Real estate	343,480.27	7,701.09	7.43

5	Construction activities	305,567.00	6,945.31	6.61
6	Power	200,056.45	4,427.96	4.33
7	Automobile industry	195,660.39	4,322.31	4.23
8	Metallurgical industries	129,901.38	3,032.19	2.81
9	Petroleum & natural gas	112,612.24	2,612.12	2.44
10	Chemicals	105,668.42	2,342.9	2.01
Grand Total	All 63 sectors	4,864,793.51	109,219.77	

Source: Factsheet on Foreign Direct Investment, Govt. of India release, November 2009

Note (i) Sector-wise FDI inflows data re-classified, as per segregation of data from April 2000 onwards.

(ii) \* Percentage of inflows worked out in terms of rupees and the above amount of inflows received through FIPB/SIA route, RBI's automatic route & acquisition of existing shares only.

Among all the sectors, service sectors (both financial and non-financial) got priority in foreign direct investment in India. (Table 1). Region-wise inflow of FDI within the country is shown in Table 2.

**Table 2** Statement on RBI's Regional Offices (With State Covered) Received FDI Equity Inflows(1) (From April 2000–November 2009)

S.No.	RBI's Regional offices(2)	Amount Of FDI inflow ( in Rs.)	Amount Of FDI inflow ( in US \$)	%age to total FDI inflow
1	Mumbai	165,652.24	37204.69	35.84
2	NewDelhi	89,500.93	19806.44	19.36
3	Bangalore	28,921.75	6550.90	6.26
4	Ahemadabad	27,927.48	6328.95	6.04
5	Chennai	23,569.31	5245.70	5.10
6	Hyderabad	19,797.86	4479.23	4.28
7	Kolkatta	5,486.15	1293.46	1.19
8	Jaipur	2,188.50	462.57	0.47
9	Chandigarh	1,927.33	421.26	0.42
10	Panaji	1,844.88	399.48	0.40
11	Kochi	1,265.52	282.40	0.27
12	Bhopai	839.58	186.19	0.18
13	Bhuvaneshwar	793.13	170.68	0.17
14	Guwahati	240.98	55.74	0.05
15	Kanpur	217.01	46.73	0.05
16	Patna	1.78	0.39	0.00
17	Region not indicated (3)	92,004.87	20845.99	19.19
18	Sub-Total	462,197.30	103786.80	100.00
19	Stock swapped	14,804.77	3354.85	
20	Advance Inflows	8,962.22	1962.82	
21	RBI-NRI scheme	533.06	121.33	
	Grand Total	486,476.35	109219.80	

interested in various investment avenues. In last four years from 2004 to 2008, they identified the fascinating avenues of investment in a diversified manner. The covariance of investment (Rs. 61.73) is high; this implies that the continuous change of plan of FDIS in their investment process.

### CONCLUSION

The cost efficiency studies revealed the meticulous and careful approach of FDIS on investments criteria. In an useful study Sekar (2007) argued the cost efficiency of FDIS is totally influenced by their investment process and expected profitability. The continuous planning and strategies aided them to control their cost efficiency system.

Similarly, it can be concluded that the total assets of FDI increased considerably due to profit in the initial moves. But in the continuous effort, the FDI diversified its profits on various financial elements. Total asset acquired is not enormous in a span of considerable time. The sales volume really helped FDI to acquire total assets. But at the same time, increased number of FIIs did not aid FDI to increase its assets. It is further found that the profitability obtained is not used by the FDI to accumulate more assets.

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# Impact of Foreign Direct Investment in Banking Sector

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## INTRODUCTION

India, the largest democracy in the world, with its consistent growth/performance and abundant skilled manpower provides enormous opportunities for investment, both domestic and foreign. India is the fourth largest economy in terms of *Purchase Power Parity* and the tenth most industrialized country in the world. Major initiatives such as industrial decontrol, simplification of investment procedures, enactment of competition law, liberalisation of trade policy, full commitment to safeguarding intellectual property rights, financial sector reforms, liberalisation of exchange regulations etc., have been taken, which provide a liberal, attractive, and investor friendly investment climate. 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.

## CONCEPT OF FOREIGN DIRECT INVESTMENT (FDI)

FDI eludes definition owing to the presence of many authorities: Organisation for Economic Co-operation and Development (OCED), International Monetary Fund (IMF), International Bank for Reconstruction and Development (IBRD) and United Nations Conference on Trade and Development (UNCTAD). All these bodies attempt to illustrate the nature of FDI with certain measuring methodologies. Generally speaking FDI refers to capital inflows from abroad that invest in the production capacity of the economy and are "usually preferred over other forms of external finance because they are non-debt creating, non-volatile and their returns depend on the performance of the projects financed by the investors. FDI also facilitates international trade and transfer of knowledge, skills and technology." [1] It is furthermore described as a source of economic development, modernization, and employment generation, whereby the overall benefits (dependant on the policies of the host government) ...triggers technology spillovers, assists human capital formation, contributes to international trade integration and particularly exports, helps create a more competitive business environment, enhances enterprise development, increases total factor productivity and, more generally, improves the efficiency of resource use. [2]

## BANKING INDUSTRY IN INDIA

The banking scenario in India has already gained all the momentum, with the domestic and international banks gathering pace. The focus of all banks in India has shifted their approach to 'cost', determined by revenue minus profit. This means that all the resources should be used efficiently to better the productivity and ensure a win-win situation. To survive in the long run, it is essential to focus on cost saving. Previously, banks focused on the 'revenue' model which is equal to cost plus profit. Post the banking reforms, banks shifted their approach to the 'profit' model, which meant that banks aimed at higher profit maximization



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