“Bank Internationalisation: Effects and Impacts on the Indian Economy”

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Abstract

The literal meaning of internationalization is to make available the product in such a way that it meets the needs of several users at the same time. The global corporate trend toward internationalization has helped push the world economy into a state of globalization, where economies throughout the world are highly interconnected due to cross-border commerce.

The bank globalization is irresistible nowadays. There are two themes that focus on bank internationalization theory, i.e. the general theory of motivation of bank internationalization and the evolution theory of bank internationalization stage.

Bank internationalization means the entry of foreign banks into host banking market and it is being followed rapidly across developing and developed economies of the world. The main reason could be attributed to globalization primarily but the liberalization of financial systems and formation of international organizations like World Trade Organization (WTO) and International Monetary Fund (IMF) also have contributed towards the establishment of foreign banks and the development of sophisticated technology and communication system has made it all the more easy to monitor foreign banks by home country regulator.

Another fact representing increased bank internationalization is – asset share of foreign banks in the host banking market, especially in the developing economies. The development of foreign banks brings competition in the market that in turn leads to an efficient banking sector. Moreover, foreign banks charge low interest margin in the host economies that makes them earn more profits and perform better than their domestic banking systems.

1 Colombia's financial sector, Journal of development economics, 63(1), pp.157-196
India has liberalized its banking sector to achieve high competition, profitability, and efficiency of domestic banks and in India, the impact of entry of foreign banks demonstrates the reduction in the efficiency gap among the public and the private banks. Although the first foreign bank was established in India in the year 1853, however, the presence of foreign banks is recognized after the financial liberalization in 1991. The Narasimham Committee suggested GOI to liberalize for more foreign banks along with full scale financial sector reforms to enhance competition and institute level playing field for them in India. Hence, the Indian banking sector became exposed to greater foreign banks’ entry in diverse geographical locations and various regions of Indian Territory began to receive their maiden foreign bank. International markets are believed to be riskier owing to a lot of factors, one of them being the local market forces like culture, regulatory complexity, economic and political instability, disadvantage of being foreign etc.

**Introduction to Internationalization**

With strategic management approaches and case studies, we develop a new argument of explanation of the internationalization of retail banks. We argue that the internationalization of Service companies may be motivated by the objective of strengthening their position in the household market. This differs from previous studies that focused on the host country market and neglected the potential impact of internationalization on the internal market.

**Money** - It is that entity that is used for the transfer of goods and services. Money has multiple roles to play in an economy; primarily it is used as a medium of exchange, in an economy both the parties’ wants money, which is to say it enhances the chances of accepting what the other person has to offer in the economy. Money as a medium of exchange is speedier and holds value over time, hence also advantageous in commerce and more convenient in commerce.

**Banks** - Banks are those institutions that buy and sell money - " the money from the depositors which is usually that share which is not to be spent by them is bought by the banks with an incentive of interest to the depositors and its safe-keeping and the same money is then sold to the borrowers which is called the loan and in lieu of the same, banks get additional interest."\(^2\) The globalization and internationalization process has influenced the financial

\(^2\) Macroeconomics: Money and Banking, [https://www.investopedia.com/university/macroeconomics/macroeconomics](https://www.investopedia.com/university/macroeconomics/macroeconomics)
system greatly. There are similarities between the expansion agendas of various facets of the economy, but there are a few differences as well. For instance, the commercial banking has a very strong national base if considered from the viewpoint of the customer and the bank itself. The development of these commercial banks differs in various countries. It can be assumed reasonably that bank internationalization is one such strategy that aims to achieve various goals of a particular economy, which can be large size of the market, the diversification of risk and the proximity to other financial markets.  

The banking sector is one of the sectors most affected by globalization and has become much internationalized. The impetus for globalization enforced the countries to apply different strategies at different times to support their companies in this globalized scenario. The banks have different strategies, namely sprinkler strategy, waterfall strategy and the combination of sprinklers and a cascade strategy as a means of internationalization. Multinomial Logistic regression model is used to understand the determinants that influence internationalization of Commercial banks with proprietary, internationalization and Location advantages. The results show that Indian commercial banks favor the branch market other forms for their internationalization and factors such as host country, cross-border trade, banking Internationalization and the freedom of eating are crucial determinants of internationalization Indian banks. Despite the fact that the globalization spread out the significant obstacles for going into the worldwide markets, still there is a wide hole in the procedures received by various parts and diverse organizations in internationalization of their exercises, going from their size, understanding to the simplicity in doing business by various host nations. Thus, there is a need to discover the diverse methodologies embraced by Indian business banks and the elements influencing their techniques.

**Waterfall strategy**: The present strategy requires a larger span of time wherein the banks gradually enter the market of the selected countries by means of different modes. The banks after slowly entering into the economy of one nation establish its market and then enter into another nation’s market. This particular strategy is slower.

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5 Id.
and is generally opted and preferred by the smaller banks due to the fact that they have limited resources.

_Sprinkler strategy_\(^6\): The sprinkler system alludes to the synchronous entry by the banks in various nation markets. The banks which are using this system appreciates the upside of first mover and gets advantages and eminence as well as constructs boundaries to the contenders who may expect to enter the nation showcase later.

A combination of the above two may also be adopted by the banks while internationalization. Initially the banks may adopt the waterfall strategy and slowly enter the market and observe the conditions and then subsequently adopting the latter strategy expands the same and simultaneously enters the other economies as well. Later it may come back to the waterfall strategy in order to monitor the current conditions and circumstances of any particular economy and accordingly deal with the same.

**Factors Leading to Internationalization**

The initiation of the concept of internationalization of banks took place owing to certain factors and reasons. One of the reasons widely accepted for the same is the establishment and coming up of international organisations like the International Monetary Fund (IMF) and the World Trade Organisation (WTO) which led to the liberalization of the financial institutions. Further, development of communication and other technology also aided in the same because it now became easier for the regulating banks in the home nation to monitor the banks in the foreign economies. The increase in the bank internationalization can be seen by the increase in the Cross Country Banking Claims and the reaching of the transactional statistics to half of the World GDP in 2007.\(^7\) Other factors also reflect towards the increase in the internationalization of banks such as the share of assets of foreign banks in the banking market of the host specifically in the economies that are developing.

In developing nations such as the Czech Republic, the bank assets shares held by foreign banks was 10% in 1990 and came up to 84% in 2011; in Hungary, the statistics showed increase from 10% in 1990 to 85% in 2011; in Argentina, it was 10% in 1990 which later

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\(^6\) _supra_ note 3

\(^7\) Global Financial Stability Report, International Monetary Fund, 2014
increased to 48% in 2004; in Mexico, it went from only 2% in 1990 to 82% in 2004; and in Croatia it was a mere 4% in 1997 and a drastic increase to 92% in 2011. Foreign banks have taken over 20% of all assets in the countries of the Organization for Economic Co-operation and Development (OECD) and on average 50% in those nations which are developing and emerging. It can therefore be inferred that the injection of foreign banking companies into the countries that are hosts has been at a swift pace and that has become a subject of concern for the economists on such an entry of banks and subsequently the impact of the same on the host nations.

The foreign banks, with their development, not only brings in more capital but also becomes a cause of increase in competition and this in turn aids to the efficiency of this particular sector of banking. Nonetheless, in certain developing nations, the domestic banks have experienced an enhanced profit following the ingress of foreign banks. Owing to this result there is an argument amongst the few that due to the entry of such foreign banks there is actually a decrease in the competitiveness in the host nations. Furthermore, the rate of interest charged by such foreign banks, is lower in the host nations as compared to the domestic ones and this in turn leads them to earn more profits and subsequently perform better than the former. Therefore it can be concluded that there are varied stands on the affects and impacts of the entrance of foreign banks in the domestic economies of host nations and the performance of the native banks.

The Indian Scenario

The liberalization of the Indian banks and the banking reforms in India was brought keeping in mind the broad target of gaining higher profits and increasing competition, which would subsequently lead to the increased efficiency of national banks. Owing to the Government of India’s policies that were restrictive in nature, the impact that was created by the foreign

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8 International Monetary Fund, 2013
10 Id.
banks on the operation of the domestic banks was higher.\textsuperscript{13} The national banks become alert by the mere entry of the foreign banks in India before even counting the share of assets of these foreign banks.\textsuperscript{14} On the grounds of physical presence, around 50\% of the banks in India were Foreign Banks by the year 2014.\textsuperscript{15} As far as India is concerned the, the effect caused by the entrance of foreign banks reflected the decrease in the gap of efficiency amongst the private and public banks.\textsuperscript{16} It is suggested by a study that the achievement of competition in the banking sector of India was due to the fact of the restrictive policies of the GOI relating to the entrance of the Foreign Banks in the country.\textsuperscript{17}

Factually the first establishment of a foreign bank in India was in the year 1853, called the “Chartered Bank of India, China and Australia”, but the recognition of the presence of the foreign banks was after the 1991 liberalization of Banks in India following the recommendations of the Narsimham Committee Report. It suggested a liberal response to the foreign banks in India in order to initiate a level playing field and augment competition. This exposed the Indian banking sector to the entry of more foreign banks and hence the same started in the various territories within the nation. India became a founding member of the International Monetary Fund in the year 1995 and this instance became the rising point for the entrance of foreign banks in India. Due to the WTO agreement, Indian Government finally took a more liberal approach towards both the existing banks and the entry of the foreign banks. An example can be taken of the permission granted for the branches with ATMs which started from 5 initially to 12 in the year 1998. Although the Reserve Bank of India did not increase the branches from 12 for a long time till 2006 but later it increased the cap and that too excluding the ATMs.\textsuperscript{18}

Foreign banks can be present in India through different modes, which are “Branch mode”, a “wholly owned subsidiary mode” (WOS) or a “representative office mode” of presence and

\textsuperscript{13} Kalluru, S.R. and Bhat, S.K., Does Foreign Bank Entry Affect Operations of Domestic Banks? A Study on Indian Public Sector Banks, IUP JOURNAL OF MANAGERIAL ECONOMICS, 2009

\textsuperscript{14} Claessens, S. and Horen, N., Foreign banks: Trends and impact, JOURNAL OF MONEY, CREDIT AND BANKING, 2014

\textsuperscript{15} Number of foreign banks in India (in percentage from 1999 to 2014), Statistical Tables relating to banks in India, Reserve Bank of India

\textsuperscript{16} Bhaumik, S.K. and Dimova, R., How important is ownership in a market with level playing field? The Indian banking sector revisited, JOURNAL OF COMPARATIVE ECONOMICS, 2004

\textsuperscript{17} Sathye, M., Efficiency of banks in a developing economy: The case of India, EUROPEAN JOURNAL OF OPERATIONAL RESEARCH, 2003

\textsuperscript{18} Gormley, T.A., The impact of foreign bank entry in emerging markets: Evidence from India, JOURNAL OF FINANCIAL INTERMEDIATION, 2010
only one such mode were allowed for foreign banks in India. Also, the permission of foreign capital in the national or rather domestic banks of India has been capped to 74 per cent in the banks in private sector and to 20 percent for the banks in the public sector. In 2014, there were 44 foreign banks with 332 branches from different 25 countries of origin, representing 50 percent of the bank’s share and less than 1 percent of the retail share. Despite the small number of branches, foreign banks in India were able to average 7% of total bank assets, suggesting that the presence of foreign banks is important.

The purpose of this research is “current and topical” for several reasons. First, it was a silver jubilee for the gradual liberalization of the Indian economy and financial markets. Second, the banking sector in India has a huge chunk of foreign capital because Indian-based commercial banks have huge foreign capital in their balance sheets (74% and 20% of foreign capital are allowed in Indian public and private banks, as discussed above). Third, nearly half of the commercial banks that are operational in India are foreign-controlled (44 foreign companies + 46 state-owned enterprises). Fourth, if we consider the national banks of a single country "India" in our panel data set, there is no probability of heteroscedasticity, as happens in countries in transnational datasets. Fifth, there is a lack of empirical literature examining the subject in the Indian context. Therefore, this study considers this an important subject to study.

A majority of studies that are done over the impact of entry of foreign banks over the domestic banks’ performance are based on the nation that are developed or is rather based on inter-national study. A study which was done on the foreign banks in a cross-national basis and covered 7900 banks in 80 nations from the period of 1988 to 1995, suggested that the foreign banks through their presence reduce the profit and margins of the domestic banks in the host nation. On the other hand, a contrary view suggests that the effect or the impact

19 MASSAND, supra note 8
20 Foreign Investment in Private Banks in India, Statistical Tables relating to banks in India published by RBI, March 2014
21 Foreign Investment in Public Sector Banks, Statistical Tables relating to banks in India published by RBI, March 2014
22 supra note 14
23 Asset share by foreign banks in India (in percentage from 1999 to 2014), Statistical Tables relating to banks in India, Reserve Bank of India
24 CLAESSENS, supra note 13
25 supra note 8
created by the foreign banks on the domestic banks of the host nation is dependent on the status quo of the financial development of that particular nation. In the nations that are less financially developed, the margins and costs of the domestic banks are pulled up by the foreign banks whereas in the nations having higher level of financial development, the same is pushed down by the foreign banks.

Another study done by “Claessens and Horen” that used the balance sheet data of many nations that were developing including India too in the years of 1999 to 2006. It was found that the profitability of foreign banks was determined by many factors, which include the height of development, its size and more importantly the monopoly enjoyed by the bank. Another important factor that needs to be considered is the cultural as well as regulatory differences between the host and the home nation. The claim of the study was that a foreign bank entering from a high income nation to a host nation that is comparatively weaker in regulatory norms tends to perform better than the counterpart domestic banks.

**Conclusion**

The advent of Liberalization has invited many foreign banks and foreign capital into the Indian economy. At the time of the liberalization of the Indian economy, the objective of the entry of foreign banks remains to be examined. This study seeks to measure how the influx of foreign banks and the influx of bank loans affect the performance of domestic banks. The study examines four ratios of the proportion of foreign banks - shares of foreign banks, their shares in offices, their assets and foreign direct investment in the Indian banking sector. It shows that the scope of foreign banks has a positive impact on business performance with domestic banks. Entry allows for greater competition and increases the efficiency of domestic banks by increasing profitability and reducing overhead costs. The presence of foreign banks improves the quality of domestic bank assets, presumably due to the transfer of credit risk management techniques from foreign banks. For example, the spill over effects of foreign banks in the Indian banking sector are clearly visible through the use of high tech and improvised bank investments. The study therefore suggests that policymakers create more room for bank FDI and reduce the entry limit for overseas offices in India.

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