ECONSPEAK: A Journal of Advances in Management IT & Social Sciences,
Vol. 10, Issue 3, March 2020 Impact Factor 5.132 ISSN: (2231-4571)
www.skirec.org Email Id: skirec.org@gmail.com

THE ECONOMIC IMPACTS OF FOREIGN BANK: EVIDENCE FROM INDIA

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Abstract

From 1990 to 2006, this research article analyses the financial effect of the India' liberalization of foreign bank. The findings display that foreign bank within the market has aimportant impact on local commercial banks' revenue and overhead expenses due to the dominance of competition it creates.

These findings, which show that foreign banking institutions employ competitive burden on domestic ones even when they are not actually present on the market, suggest that foreign banks can aid as an operative competitive strength, plummeting the additional revenues produced by domestic ones and forcing domestic ones to apprise their business approach and methods in order to improve their cost efficacy.

A procedure perspective justifies the liberalization of foreign bank entry in India based on results on the competition implications of foreign banks in the national banking sector. Results show that converting national banks to be more competitive and effective works extremely well in the India as a consequence of liberalization of the banking sector. Bank-specific variables have a substantial impact on domestic bank performance besides the strategy of opening the market to international banks. It is therefore necessary to maintain increasing domestic prudential regulation and supervision in order to achieve long-term improvements in domestic commercial banks' efficiency.

Keywords: *Foreign Bank, Liberalization of the Banking, Domestic Bank, Market*

Introduction

FDI or foreign direct investment inflows grows from US$56 billion in 1980 to US$1412 billion in 2000, as per the UNCTAD, before settling at US$1989 billion in 2007 and falling to US$1699 billion in 2008 as a consequence of financial market chaos and the global economic crisis. (Foreign direct investment)or FDI streams to emerging nations have increased at an even quicker rate than FDI flows to industrialized countries, from US$8 billion in 1980 to US$622 billion in 2008. A total of 92 percent of fluctuations in national laws between 1992 and 2005 are advantageous to FDI, according to UNCTAD (2006), showing that rules stimulate FDI through simpler procedures, better incentives and decreased taxes. FDI in the service sector, and in particular financial FDI, was the primary driver of this exceptional increase in FDI. Global Development Finance report by the World Bank states that the recent boom in foreign direct investment in the banking sector of developing nations is mostly due to the relaxing of cross-

border loan or credit regulations and the development of foreign bank divisions and affiliates. Financial FDI is increasingly being sought by developing countries due to the potential advantages of loosening and expanding restrictions on foreign financial institutions' ability to operate.

Increased foreign involvement in Philippine financial systems has been particularly evident since the government opened the country's borders to foreign banks in 1994. It was as a result that from 1995 to 2000, the ratio of total banking assets detained by foreign banks climbed from 9.8% to 14.9%, and finally settled at 10.3 percent in 2009. While the quantity of foreign banks in the India has risen, past studies have found that they have had only a small impact on the country's competitiveness, contrary to what is commonly assumed in the academic literature on the topic. Increased participation by foreign banks, according to preliminary results, may not yet have significant effects on the financial system.

In any event, an investigation into whether foreign bank participation affects domestic banks' performance is necessary.

The major goal of this research is to investigate the financial effects of the presence of foreign banks withinIndia utilizing inclusive data from the year 1990 through the year 2006. If foreign banks are present in a country, this research article examines whether they boost profitability and lower overhead expenses through spillovers or reduce both productivity and overhead expenses through competition.

It's important to know where national banks stand in terms of their presentation when international banks enter the market. Foreign and local banks' performance must be compared in order to understand how the existence of foreign banks affects the localfinance sector. Foreign bank entrance liberalization's impact on domestic banks' profitability and overhead expenses has been studied from a policy perspective, and certain conclusions have been drawn. For this reason, if the entry of foreign banks has efficiency spillover and/or competitive impacts, host nations like the India should emphasis on efforts to entice more international banks to enter the national banking sector. A policy to attract international banks, such as loosening limitations on foreign investment and offering (potentially excessive) incentives, will therefore be justified by the findings of this research article. This includes the probable costs linked with luring foreign investors.

Competition in the overseas bank entrance

As anoutcome of foreign investment, host countries benefit from a combination of productivity spillovers and the removal of distortions imposed by multinational corporations (Caves, 1974). Due to spillovers, the productivity of both domestic and international companies can be increased through foreign firms' higher productivity and domestic companies' increased productivity (Girma et al., 2001). Human capital is enhanced when administrative and technical know-how is transferred to the host nation. This should result in increased productivity among employees and other benefits for workers, customers, and governments alike, including higher real earnings and reduced prices. The introduction of modern techniques and talents by international banks is projected to boost the management efficiency and organizational structure

of domestic banks (Claesens et al., 2001). Further things being equal, local banks will be more profitable and have reduced overhead expenses as a result of increased productivity and efficiency.

Although this may be true, foreign firms have a substantial impact on local market competition in two methods: through the characteristics of FDI-generated enterprises that can be linked to the presence of knowledge-based, organization-specific properties; and through the actions of these firms on the market. Because of this, local businesses are forced to take steps to safeguard market share and earnings. (Blomsström et al., 2000) As a result of variations in the competitive construction of the finance industry, Goldberg (2004) claims that foreign bank entrance provides competence improvements. Nationwide bank administrators may also be pushed to give up their "peaceful life" and attention more on cost effectiveness by implementing more effective practices as a result of the increased foreign presence (Berger and Hannan,1998). As a result, international banks can enhance efficiency by reducing domestic banks' earnings and overhead expenses by increasing competition. In general, increased competition is related with lower productivity, lower non-interest revenue, and higher overall costs for national banks (Beerger and Hanan, 1989; Claesens et al., 2001).

This study shows the overview of the economic state of India and defines the foreign investment and banks in terms of its influences on the Indian economy. The study looks over the revenues and growths in recent years and compares them to see how foreign banks are influencing the state of economic aspects. This section of this study provides the details of the study and an introduction to the reader about the objectives of this study and expected outcomes. The study also shows that there is a substantial role of foreign banks in the Indian economy. This study provides a discussion on the previous literatures on this topic in the next section.

Literature Review

In both developed and emerging nations, the influence of foreign bank has been broadly studied in the literature. However, the outcomes of studies looking at the influence of foreign bank on the local financial market and its consequences for enhanced rivalry and efficiency are at best mixed, whether they are conducted across countries or in a single one. A few research studies have found that implying ansurge in the effectiveness of host nation banks in financial prudence that have liberalized their banking marketplaces (McFaden, 1994; Barajaas et al., 2000; Clarkee et al., 1999; Claesaens et al., 2001; Denizer, 2000; Hermes and Lensink, 2002; Claesens and Laeven, 2003; Levy-Yeyati and Miicco, 2003;). Foreign bank entry may have had a restriction on the impact, according to other research findings (Gren et al., 2003; Detrragiache and colleagues, 2006; Schullz, 2006). The studies also emphasizes that foreign banks have influences local banks through their new approaches and techniques that is profitable for the banking industry of India.

The contradictory findings for developed and developing countries are another surprising discovery in the available research. Some researchers have found that foreign banks in developing countries have performed better than domestic counterparts in terms of cost and

profit efficiency (Claesens et al., 2001;Thi and Vencapa, 2007;Naborg et al., 2004;), the case in established countries (Berrger et al., 2000; DeYooung and Nole, 1996; Hassan and Hunnter, 1996). It's probable that research in industrialized countries covers a time period when banking regulations and restrictions were more liberalized, which may explain the discrepancy. Comparatively, the banking system in emerging nations has remained liberalized or has experienced a financial disaster at the time of these research.

Limitedofficial economic studies have scrutinized the impacts of overseas bank entrance on Asian banking as there have been for U.S. and European banks. It has been discovered that foreign bank branches in the wholesale market, where they have an advantage, and domestic bank branches in the retail market, where they have an advantage, in Thailand's Okuda and Rungsommboon (2004) comparison of the relative cost structures. Wiliams and Intarrachote (2003) found that the effectiveness of Thai banks degrades at angrowing rate over time, and international banks are much more effective than local banks from the profit function standpoint. This could be attributed to international banks' stronger culture, while national banks operate on a "learning-by-doing" basis in the United States.

Indonesia's banking sector has become more competitive as a result of the presence of foreign banks, according to Cho (1990). It has been shown that foreign banks helped to facilitate access to international money for domestic initiatives in countries like Pakistan, Turkey, and Korea studied by Bhattacharaya (1993). In the meantime, Bhaumik and Piesse (2004) show that the increasing existence of foreign banks in the credit market correlates with a gradual development in the technical efficiency of credit disbursal by national banks. Though foreign banks in India have performed less resourcefully and productively than state-owned or private local banks, Sensarma (2006) points out that this could be ascribed to their costly practices in India. Foreign banks have depicted their role in several countries which can be stated from the literature and the role of foreign bank in growing economy of a country can be crucial with proper flow of cash and investments.

Studies on the effect of allowing foreign banks to operate in the Indianeconomic system, in particular, have shown fascinating results and implications for policy. Unnite and Sulivan (2003) found that international competition forces domestic banks to become more effective, focus operations due to higher risk, finance practices because of increasing risk. Although Manlagit and Lamberte (2004) stated that the deregulation of foreign banks in 1994 led to modest gains for bank profitability and cost efficiency, this development was reversed by the Asian economic crisis.

The introduction of foreign banks has had a major impact on bank performance as measured by the spread between commercial bank deposit and loan rates. The banking sector of the country is noted for having a wide spread, which reflects the sector's structural weakness(World Bank, 1986). After the Asian crisis, the reduction in bank profitability has been more pronounced, and the rate of return has decreased as a result. Preceding to the financial crisis, private national banks had better average returns than international banks. Foreign banks, apart from that, have seen their profits soar since the financial crisis ended.

Methodology

Using the Generalized Least Square (GLS) methodology, this research article examines whether spillovers that can take to ansurge in productivity and a decrease in overhead expenses of national banks or competition effects, which can both decreasepredominate. A regression model with a variety of bank-specific variables is used in this research article, which is in line with previous empirical research on foreign bank presence. Data from financial statements for domestic banks from 1990 to 2006 are used in the estimationHowever, the estimate ignores the years 1997–1999, when the economy was struggling. Banking costs are likely to rise as a result of stricter restrictions implemented by the monetary authorities as banks comply with the Asian financial crisis. In addition, the financial crisis is projected to have an impact on the profitability of a bank. Contrary to popular belief, the India was not as badly hit by the crisis as Thailand or Indonesia.

Data and variables

The (Safeties and Exchange Commission)or SEC provides the annual financial statements of each domestic commercial bank (SEC). From the BSP and the Indian Insurance Corporation, further banking information is available for the India. 31 domestic commercial banks are included in the unstable panel data made up of 390 observations, 15 of which are worldwidemarketable banks and 18 of which are ordinary commercial banks. Approximately 80 percent and 63 percent, on regular, of the commercial finance system and local banking system assets are accounted.

The success and costs of the banks are the dependent variables, which serve as measures of their performance. According to a definition of profitability, before-tax profits divided by total assets is employed as a metric. A bank's expense management efficiency can also be gauged using another dependent variable: the overhead cost. Non-interest expenses, such as labor costs, real estate and equipment costs, fees and service costs, and other costs, make up the bulk of an organization's overhead costs. Rather of utilizing a total cost function, Berger and DeYoung (1997) argue that overhead costs account for ineffectiveness in banks and are heavily impacted by the bank's local market strength.

Two procedures of foreign bank presence are utilized in this research article in accordance with banking literature on the introduction of foreign banks: Foreign bank assets are a percentage of overall commercial banking assets, as well as the rate of the quantity of foreign banks to the total quantity of banks in the commercial financestructure. As the proportional importance of international banks shifts, so do the success and overhead expenditures of local banks, and these factors reflect that.

To establish the measure of competition, the quantity of foreign banks is an appropriate indicator of foreign bank existence, as claimed by Claesens et al. (2001). When foreign banks come in the local market, local banks modify the rating of their loaning and other doings to prevent them from gaining a large market share. However, according to the authors, the section of assets held by foreign banks is more appropriate if and only if foreign banks begin to influence domestic

banks' pricing and profitability after gaining market share. It must be large enough to have a major impact on the spreads of the banks in this situation.

Taking into account banks' varying risk appetites, the book cost of equity divided by total properties yields a variable equity measure of asset quality (Hughes and Mester, 1993; Mester, 1996). Since a bank's risk managing and risk gesturing are closely linked, it is argued that well-capitalized banks have reduced production costs because their cautious risk taking behavior reflects high-quality managing (Rao, 2005). Banks with adequate capital are able to obtain financing at lower costs, resulting in higher profit margins. Berger is the author of this article (1995a). As a result, it is speculated that equity and bank profitability are linked.

It is estimated by dividing the bank's total assets by the overall commercial finance system's total assets. As the size of a bank might affect its performance, this variable is used to control for this. It is possible that large financial institutions can save money on information gathering and processing because of economies of measure (Boydd and Runklle, 1993), or that they can make more money by diversifying their lending and product offerings and entering markets that smaller financial institutions are unable to enter because of economies of scope (Smirlock, 1985).

Results

Local banks no longer make as much money as they used to before foreign banks entered the market, as seen by the above finding. Results in the India are constant with the results of Hapiitan (2001) that domestic banks lose a significant amount of revenue when the competition increases. The decrease in anticompetitive excesses at national banks is a direct result of variations in the competitive construction of the finance sector brought on by foreign entrance, as stated by Goldberg (2004). Since this could have forced domestic and regional financial institutions to focus more on cost efficiency by slashing operating expenses, the decline in overhead costs could be seen. Overhead expenses of domestic banks have decreased, which indicates an improved effectiveness of local banks as a consequence of their foreign presence. It is claimed by Claesens et al. (2001) that foreign bank entrance has a detrimental effect on the overall costs of national banks, and that domestic banks are attempting to attain cost efficiency by incorporating foreign banking techniques and practices.

It is possible to make a number of inferences based on this fact. To begin, these findings suggest that the level of rivalry in the Philippine banking business is largely determined by the number and asset share of international banks. Another important takeaway from this research article is that the arrival of new foreign banks is predicted to boost domestic banks' operational efficiency by increasing managerial effectiveness and the structure of the organization as a whole. When it comes to the presence of foreign banks ang domestic banks are being forced to give up their insulated "peaceful life" and put more effort into cutting costs.

Overall, the data show that commercial banks are affected. Expansion of the national banking system by foreign banks may act as a powerful competitive factor, diminishing domestic banks' excess profits and forcing them to modernize their production methods and processes in order to decrease their expenses.

Overhead costs have a considerable undesirable impact on bank revenues while bank marketplace share has a significant positive impact. As a result, this shows that major commercial banks routinely outperform their smaller counterparts in profitability and cost efficiency.

Another measure of market structure and scale impacts is the variable bank asset concentration, which reveals aundesirableconnection between bank profitability and overhead expenses. According to this correlation, marketplace selection and consolidation lead to the emergence of more efficient banks, resulting in decreased earnings and reduced operating expenses.

It appears that bank profitability and overhead costs are not explained by the other control variables, which have the predictable sign but aren't statistically important.

Conclusions

Foreign bank entrance liberalization and Philippine commercial bank profitability and overhead expenses were evaluated in this research during a twenty-year period, from 1990 to 2006. A rise in foreign bank participation in the local market may have both spillover and competition impacts, but the empirical evidence shows that rivalry has a greater impact on productivity and overhead expenses for local commercial banks. As a result of these findings, it appears that foreign banks employ competitive burden on local banks, lowering their profitability and overhead costs as well as forcing national banks to apprise their manufacture technologies and methods in order to progress their cost effectiveness. This suggests that overseas banks may be an operative competitive force.

As a result, local banks may have been compelled to focus more on cost efficiency, as evidenced by the fall in domestic banks' overhead costs. Taking a larger view, this research not only shows the India' experience in welcoming foreign banks, but also serves as a model for other Asian countries. For example, other nations in the area, mainly those with banking sectors that are still insulated from outside competition, could benefit from the experience gained here.

These banking variables have predictable effects on profit margins and overhead costs. There is a strong correlation between bank market share and profitability and aundesirable correlation between bank overhead costs, for example. As a result, this shows that major commercial banks routinely outperform their smaller counterparts in profitability and cost efficiency.

A policy approach justifies the liberalization of foreign bank in the India based on the results on competition consequences. According to the research article's major results, banking liberalization in the India has had aimperative impact on the country's domestic banks. Even if international banks are allowed to operate freely, bank-specific circumstances can significantly affect the performance of domestic institutions. It is therefore imperative that both domestic and international banks be allowed to enter the commercial banking system in order to achieve long-term enhancements in the effectiveness of the localfinance system.

According to a prior research article on FDI (particularly manufacturing FDI), the difficulty in determining the extent of competitive effects decreases the query to one about the

connectionamongeffectiveness and foreign bank existence. An investigation into the effect of a foreign bank's existence in the host country would be worthwhile.

As a problem as well as an inspiration, we may say that the role of international banks in India's economy is a challenge for the country's domestic commercial banks. It's impossible to generalize that foreign banks haven't done their part in advancing the country. According to the author, the government's lenient stance toward international banks is founded on sound justifications for doing so. Following are some ideas for reducing or eliminating the negative effects of dealing with foreign banks.

The maximum quantity of deposits that can be taken by a single foreign bank should be set either in terms of time or in terms of the total number of branches in that country.

Small industrial units that produce export goods should be able to access foreign trade financing from these banks as well.

They should not be motivated by profit maximization; rather, they have adapted themselves to the changing economic requirements of the time in order to remain relevant.

A minimum percentage of these banks' deposits should also be allocated to support the credit needs of priority sectors and/or agencies engaged in funding priority sectors.

In order to deal with operational risks associated with technology banks, these banks and public sector banks should collaborate to share services in the zones of imbursement and settlement, back-office processing, etc.

These banks should lower their startup costs in order to improve their profitability.

There should be no remittances of profit from these foreign banks back to their home nations; instead, these gains should be used to strengthen the foreign bank's capital basis.

The Reserve Bank of India may include the aforementioned criteria in its "Conditions for scheduling" for these banks.

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