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ORIGINAL ARTICLE

FOREIGN DIRECT INVESTMENT (FDI) & INDIAN BANKING SECTOR

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Abstract:

The effect of foreign direct investment on the domestic economy has been widely debated in literature, but a consensus opinion has not emerged. Critics have attributed the Asian banking crisis to the growth of foreign direct investment following the liberalization of foreign investment restrictions. Generally, the argument runs that foreign investors create a destabilizing influence on stock prices. Stiglitz (1998) posits that unregulated capital flows render developing economies more vulnerable to fluctuations in supply of international capital. According to Dornbusch and Park (1995), foreign investors tend to follow positive feedback strategies which cause markets to overreact to fundamental changes in value. Radelet and Sachs (1998) attribute the Asian financial crisis to financial panic. Hamann (1999) concludes that currency crises lead to financial crises: collapse in exchange rates lead to the collapse of banks that underestimate exchange rate risk and accumulate vast currency reserves. Several other researchers including Delhaise (1998) blame the Asian crisis on overgenerous and indiscreet lending by banks, especially western banks, and then switching to overly strict lending policies when market turned sour. Kim and Singal (2000) characterize "movement of hot money" as a major concern with policy makers in developing nations. Hot money investment is highly sensitive to interest rate and future growth expectations, such that adverse changes in these factors result in large changes in international flow of capital which exacerbates the shock, destabilizing the economy. The authors further point out that when markets are integrated, excess volatility in the foreign market

INTRODUCTION:

induces a similar effect in the domestic market which increases risk premium, and cost of capital, and reduces investment. In addition, opening the market increases the demand for and the value of domestic currency. Appreciation in exchange rate can adversely impact the country's competitive position for goods and services in the world market. Finally, inflow of excess capital can bring in inflationary pressures. The potential benefits of opening domestic markets to foreign investors cannot be overlooked, however. A major benefit is the opportunity to attract foreign capital. Infusion of foreign capital enhances economic growth [Boyd and Smith(1996), Levine and Zervos (1996)].

More significantly, as Rajan and Zingales (1998), and Stulz (1999) demonstrate, integration with world market through relaxation of foreign investment restrictions reduces cost of capital. Stulz (1999) attributes the decrease in cost of capital to the improvement in managerial monitoring and governance following foreign ownership of domestic stock. The stringent disclosure requirements foreigners impose improves transparency, enhances monitoring, and disciplines management through increased accountability. Kim and Singal (2000), Bekaert and Harvey (2000), Henry (2000) and Chari and Henry (2002) provide empirical evidence that stock market liberalizations induce growth in private investment and reduce systematic risk of securities that

allow foreign equity participation.

As Chari and Henry (2002) note, most of the empirical tests of the potential effects of liberalization of stock markets have used aggregate data. With aggregate data, however, only one aggregate stock price revaluation per country can be observed when stock market liberalization occurs, but it is difficult to incorporate firm level information. The authors assert that the gain in stock values that occurs at liberalization is the most direct signal that the policy change has reduced the cost of capital. Stulz (1999) observes that studies employing long time-series data to investigate the impact of liberalization suffer from the requirement that the cost of capital be held constant over the time period. However, if sudden relaxation of investment barriers induces unexpected decrease in cost of capital, stock prices will post unanticipated valuation gains and standard event study tests are more appropriate. Recently, event study tests of valuation effect of liberalization have been conducted by Kim and Singal (2000), Bekaert and Harvey (2000), Henry (2000), and Chari and Henry (2002).

The first three studies use aggregate data and find evidence consistent with decreases in cost of capital following liberalization of investment restrictions. The first to use firm level analysis,2 Chari and Henry (2002) identify stock market liberalization dates for several countries and discriminate between firms that become eligible for foreign ownership when the market is liberalized and those that do not. They demonstrate that the valuation gain of stocks following liberalization is a function of the decrease in systematic risk and the cost of capital. Chari and Henry (2002) use monthly data for their analyses. No study to date has reported results on impact of liberalization on stock prices with daily data. Using a unique data set of daily returns of Indian banks, we provide evidence of significantly positive valuation effect associated with liberalization of foreign direct investment rules. On February 16, 2002, the Reserve Bank of India (RBI) announced that foreign entities will be allowed to make direct investment of 49 percent in private Indian banks.

RBI decision allowed foreign direct investors and foreign institutional investors a combined ownership of 98 percent of an Indian bank, giving them virtually complete control over operating decisions. An equally-weighted portfolio of private Indian banks registered excess returns of nearly 25 percent over the three days surrounding the announcement. Interestingly, a portfolio of government controlled banks for which the FDI limit was only 20 percent also posted significant gains at the announcement. We interpret the evidence as unambiguous support for Stulz's (1999) hypothesis that liberalization induces a reduction in domestic firms' cost of capital eliciting a positive rice reaction. Further, we provide evidence that the valuation gain is significantly related to the factors that make an individual bank a potential takeover target. This finding is consistent with the assertion that the reduction of the cost of capital is attributable to the monitoring benefits associated with control of domestic bank's shares by foreign entities. The rest of the paper proceeds as follows. In the next section, we focus on the liberalization of the capital market in India with particular emphasis on the developments in the banking sector culminating with the RBI announcement on February 16, 2002. A chronology of the major events over the one-year period from May 2001 to March 2002 is provided. In section 3, we discuss the hypothesis on the impact of liberalization on domestic firms' cost of capital and valuation. In section 4, the results of the standard event study analysis surrounding the important dates over the one-year period are reported.

A test of the hypothesis that valuation effect of an individual bank is related to its acquisition probability is conducted in section 5. Specifically, the association between the abnormal return and selected firm-specific attributes is explored. Section 6 concludes the paper.

FOREIGN DIRECT INVESTMENT (FDI) IN INDIAN BANKS

The traditional argument against foreign equity participation in domestic companies is that these businesses often involve national and strategic interests and therefore, operational and strategic control must be retained to prevent a take-over or a buyout [Lam (1997)]. Until 1993, most Indian banks were 100 percent owned by the central government and private investment was allowed only in a handful of private banks formed around the 1940s. Further, foreign banks and financial institutions were allowed only 20 percent ownership stakes in Indian banks. In 1993-94, nine new banks were formed in the private sector and one co-operative bank was converted to a private bank. Banks were permitted to issue Certificates of Deposits (CDs) and offer foreign currency deposits to Non-resident Indians (NRIs) with exchange rate risk borne by the banks.

A major push towards liberalization occurred in 1995-96 when India committed to the World Trade Organization (WTO) recommendations and relaxed the requirement to continue shielding the priority sector from foreign equity participation. For the next five years, changes in the banking sector mainly aimed at allowing banks more flexibility in the design and marketing of products. On May 9, 2001, the Indian central ministry decided to increase Foreign Direct Investment (FDI) limits in private banks from

the existing 20 per cent to 49 per cent along with increase in Non-resident Indian (NRI) investment from 40 per cent to 49 per cent. The reaction of the capital market was lukewarm at best. Analysts attributed the market's unenthusiastic response to two factors. First, the market was disappointed that, even under the revised rules, no foreign entity will be able to assume majority control of an Indian bank. It was recognized that significant differences existed between foreign and Indian banks with respect to labor and management policies, work ethics, and culture. These weaknesses can be corrected only if

foreign banks are allowed majority control with “boardroom implications on the entire bank”, said one prominent foreign bank executive. Second, confusion ensued over the interpretation of the 49 percent rule -- investors were unsure if the 49 percent included investments by Foreign Institutional Investors (FII), and non-resident Indians (NRI). To clarify the confusion, the Ministry of Commerce and Industry issued a press note on May 21 specifying that FDI up to 49% from all sources is permitted in the banking sector on the automatic route3 subject to conformity

with guidelines issued by RBI from time to time.” On June 19, 2001, French financial giant BNP Paribus announced that it was exploring the possibility of acquiring an Indian Bank, but only after the government further liberalizes foreign investment norms.

The disappointment intensified when Reserve Bank decided on September 20, 2001 to put a limit on foreign institutional investment into a company at par with sectoral cap for foreign direct investment. The market reaction was uniformly negative as 3 Under the Foreign Exchange Regulations Act (FERA) of 1973. most foreign investment was done in India with the prior approval of the Government of India. The New Industrial Policy of 1991 introduced an innovation by way of an analysts expected the decision to adversely affect companies in sectors where the cap was at 49 percent or lower, ruling out any potential takeover attempts. Specifically, for banking where the cap was 49 per cent, foreign institutions would have to shed their investments to bring down the total foreign investment to the sectoral cap. On November 28, 2001, it was reported that CitiBank had evinced interest in Centurion bank which was looking for a buyer for the 26.2 per cent stake pledged with the bank by its promoter. CitiBank had earlier indicated that they would consider acquisitions in the Indian banking sector if regulations permitted. Talks did not proceed further, however, as they appeared to be interested in majority control which was not permitted under the current law. On February 1, 2002, Bank Brussels Lambert (BBL) informed the regulators of their intention to assume management control of Vyasa Bank in the private sector. BBL already held a 20 per cent stake in Vyasa Bank and wanted to buy out another 28.1 per cent owned by a promoter. If allowed, the total foreign holding in Vyasa Bank including the BBL stake and other institutional holding would exceed the RBI stipulated limit of 49 per cent. Bank stocks surged in anticipation that if the BBL proposal went through, it would open the door for other foreign banks contemplating acquisitions. On February 12, Mr. Kenneth Dunn, the US Deputy Treasury Secretary, who was visiting India at that time, urged the Governor of RBI, Mr. Bimal Jalan, to immediately take measures to promote foreign investment in India.

On February 16, 2002, the Reserve bank, in a consolidated notification, laid to rest all doubts raised with regard to FDI in the banking sector by releasing the following decision: “Foreign banks having branch presence in India are eligible for FDI in private sector banks, subject to the overall cap of 49 per cent (by way of FDI) subject to the approval of RBI. For the purpose of determining the ceiling in private sector banks under the automatic route following categories of shares will be included – initial public offerings, private placements, fresh issuances of American depository receipts (ADRs)/global depository receipts (GDRs), and acquisition of shares from existing shareholders. However, FDI in the state-run banks, including the State bank of India will be permitted only upto 20 per cent”.

Automatic route does not allow transfer of existing shares in a banking company from residents to non-residents, however. Further, issue of fresh shares is not allowed to those foreign investors who have a financial or technical collaboration in the same or allied field. That would require approval from the Foreign Investment Promotion Board (FIPB) for FDI. While the decision appeared to facilitate formation of foreign majority stakes, RBI stipulated that no person holding shares, in respect of any share held by him, shall exercise voting rights in excess of 10 percent of the voting rights of all the shareholders. For public sector banks, the voting right was capped at 1 percent of all shareholders. The limited voting rights does put serious restrictions on foreign banks' ability to push their agenda without broad shareholder support, but as one foreign senior banker said, “this is not so much an issue. Once you have management control and are making board decisions, the voting rights on equity shares hardly matter,” (Times news Network, February 18, 2002).

The Reserve bank announcement is silent on the issue of foreign institutional investors. But, market analysts interpreted the RBI circular as clearly excluding foreign institutional investment from the FDI limit. If so, it would mean that foreign holding in Indian private banks could go as high as 98 percent, 49 percent in FDIs plus the FII holding which was earlier raised from 40 percent to 49 percent in the 2001 budget. While the banking stocks posted hefty gains in response to the news, the market still had to wait for

the confirmation from the commerce ministry or the finance ministry that FDI and FII limits were now independent and separate. The Finance minister's 2002- 03 budget unveiled on February 28 clarified that “FII portfolio investments will not be subject to the sectoral limits for foreign direct investment except in specific sectors”, but kept the issue in abeyance by adding that “guidelines will be issued separately”. This prompted a series of press reports critical of the central government's

ambiguous stand on the issue. Finally, on March 19, the Minister of State of Finance told the Rajya Sabha that the portfolio investment by foreign institutional investors in the private sector banks would be outside the foreign direct investment limit of 49 per cent.

We present a chronology of the developments in the Indian banking sector over the period May 2001 to April 2002 in Table 1. Two aspects of the Indian experience are particularly noteworthy. First, and this is possibly a characteristic that prevails in most developing countries, capital market liberalization policies are viewed with a lot of skepticism and there is general apathy towards them. Second, foreign banks are reluctant to undertake equity participation without sufficient control to be able to effect changes in management style and work culture. This implies that foreign banks consider monitoring of management a necessary condition for success in developing countries.

THEORETICAL PERSPECTIVE

We follow Stulz (1999) to develop the hypotheses on the potential impact of foreign direct investment on the domestic stocks. In this model, liberalization has two significant effects on the domestic country's capital market. First, discount rates fall when the domestic market allows international investment in its securities. Second, shareholders have more confidence in management because globalization allows ownership by foreign entities, which improves governance and monitoring of management. Stulz argues that foreign direct investment reduces a country's cost of capital by decreasing systematic risk, such that stock prices react positively to unanticipated announcements of liberalizations. To elaborate, in a market which is completely segmented from the rest of the world, domestic investors bear all the risk. As the capital market of the country opens up to foreign investors, they bear some of the risks associated with the country's economic activities. If the entire world constitutes one capital market, we would have a global equity market where the beta of a risky security would be computed relative to the global market portfolio.

Conceivably, in a global economy with a large number of countries, the volatility of the world portfolio could be reduced to zero such that risk premium of each country would fall to zero. Stulz demonstrates that as long as the correlation between the small country's market portfolio and the world portfolio is not too high, or the volatility of the small country's market portfolio is not too low, the small country's risk premium, and hence its cost of capital will fall when it removes the barriers to international investment. Under this scenario, an individual firm with an increase in it cost of capital would be an exception rather than the rule. Lower cost of capital induces greater firm valuation only if managers' can convince shareholders of higher expected cash flows in order to raise the necessary investment capital. Asymmetric information between managers and shareholders, however, renders managers' claims suspect. Also, managers' propensity and opportunity to overinvest in unprofitable projects, and

increase firm size only to entrench and benefit themselves, make shareholders skeptical of their motives. Liberalization can improve information dissemination and managerial focus. The factors that benefit from liberalization to facilitate better governance of management include an independent board of directors, relationship with skilled investment bankers, the formation of large ownership stakes, and a pool of investors, who compete to gain control of poorly managed firms.

In addition, globalization affords better protection of minority shareholders' interest, and instills financial discipline by requiring compliance with strict disclosure laws. Greater disclosure encourages trading in the firm's securities, improves liquidity, and reduces bid-ask spread, and cost of capital. Lower bid-ask spread also helps monitoring since shareholders are better able to liquidate their holdings if managers deviate from value maximizing policies [Bhide (1993)]. Stulz concludes that “globalization enables firms to finance valuable projects, reduces

the benefit of control to managers, and decreases deadweight costs associated with agency problems and asymmetric information.” This implies two testable hypotheses: Hypothesis 1: Liberalization of the capital market leads to decreases in the cost of capital, resulting in immediate valuation gains for domestic stocks that benefit from it. Hypothesis 2: The differential valuation gain for individual domestic stocks following liberalization is attributable to and associated with the improvements in managerial monitoring, greater disclosure of information, and the creation of an environment conducive to control contests. If integration with the world market enhances domestic security values, an event study focused on the time of liberalization can capture the impact of globalization on cost of capital. Using this

framework, Chari and Henry (2002) demonstrate that change in valuation of individual firms induced by liberalization is positively associated with the change in systematic risk. They model the change in systematic risk after liberalization, but focus mainly on liquidity issues.

Lam focuses on the average daily premium of foreign-owned shares over locally-owned shares. Our paper provides the first direct evidence on potential valuation gains at the individual firm level at the announcement of a sweeping change in foreign direct investment limits. Anecdotal evidence suggests that investors focused on the attractiveness of individual banks as potential acquisition targets for foreign banks under the new FDI regulations in India. As such, our analysis provides a direct test of the second hypotheses motivated by Stulz's model.

CONCLUSION

On February 16, 2002, the central government in India relaxed foreign ownership limits in the banking sector. Although the change made foreign control possible only in the private sector banks, a portfolio of Indian banks posted hefty gains at the announcement. Our objective in this paper is twofold. First, in contrast to the extant evidence which focuses on the aggregate stock price effect of FDI limits, we provide the first evidence of valuation changes at the 17 individual firm level. Second, we test the hypothesis that the valuation gain of an individual firm

reflects a takeover premium, and is a function of the probability of takeover of the firm. The results demonstrate that valuation gains by private sector banks are significantly higher than government owned banks. Further, valuation gain is a function of an individual bank's market value, investment opportunity and efficiency, labor productivity, earnings quality, and asset quality. Inefficient, and poorly managed banks with lower relative market valuation, and excess non-performing assets are likely to benefit most from a potential takeover, and post the largest gains. We conclude that our evidence is consistent with the notion that investors welcome the removal of protective barriers and the ultimate takeover of inefficient firms following the liberalization. As such, our study has important policy implications for third world countries where foreign ownership of domestic companies is still restricted to a level where takeover and control is too costly, and often, impossible.

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