



SECTION - 4

INTERNATIONAL FINANCIAL SERVICES AND INSURANCE: IMPORTANT ISSUES AND FEATURES

This Section includes

- Introduction
- Implications of a large, rapidly growing home market for International Financial Services (IFS) in India:
- What drives the demand for IFS?
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4.1 INTRODUCTION

- 4.1.1 The term financial services refers to services provided by the finance industry. The finance industry encompasses a broad range of organizations that deal with the management of money. Among these organizations are commercial banks, investment banks, asset management companies, credit card companies, insurance companies, consumer finance companies, stock brokerages, and investment funds.
- 4.1.2 A detailed discussion on the subject is presented in Module 2.

4.2 IMPLICATIONS OF A LARGE, RAPIDLY GROWING HOME MARKET FOR INTERNATIONAL FINANCIAL SERVICES (IFS) IN INDIA

- 4.2.1 A little appreciated aspect of India's impressive growth from 1992 onwards is that it has resulted in even faster integration of India with the global economy and financial system. There has been a rapid escalation of two-way flows of trade and investment. Since 1992, India has globalised more rapidly than it has grown, with a distinct acceleration in globalisation after 2002. Capital flows have been shaped by:
- (a) global investors in India (portfolio and direct); and
 - (b) Indian firms investing abroad (direct).
- 4.2.2 Indian investors – corporate, institutional and individual – have as yet been prevented from making portfolio investments abroad on any significant scale by the system of



capital controls. By the same token, Indian firms have borrowed substantially abroad. But foreign firms and individuals have yet to borrow from India. Capital controls still preclude that possibility.

- 4.2.3 Despite the controls that remain, these substantially increased two-way flows reflect an increase in demand-supply for IFS related to trade/investment transactions in India. Put another way, there has been an increase in IFS consumption by Indian customers and by global customers in India. Demand for IFS from both has been growing exponentially. Cumulative two-way flows in 1992–2005 were a multiple of such flows in 1947–92. The degree of ‘globalisation-integration’ that has occurred in the last 15 years, since reforms began in earnest, is much larger than in the 55 years between independence and India embarking on ‘serious’ reforms. We have made up for six lost decades of economic interaction with the world in a decade and a half. Still, what has happened over the last 15 years is a small harbinger of what is to follow over the next twenty: particularly if the current growth rate of 8% per annum is accelerated to 9–10% as is evocatively being suggested, and if India continues to open up the economy on both trade and capital flows.
- 4.2.4 The typical discussion about an Indian International Financial Services Centre (IFC) exporting IFS (especially made by those arguing for locating such an IFC in a SEZ) has been analogous to that for software exports: *i.e.*, a sterile relationship between Indian producers and foreign customers of ‘support services’. However, in the case of IFS, India is itself a large, fast growing customer of IFS. Conservative estimates of IFS consumption in India just a few years out, amount to \$48 billion a year. That is more than the output of many Indian industries today.

4.3 WHAT DRIVES THE DEMAND FOR IFS?

- 4.3.1 An understanding of what drives rapidly the growing demand for IFS in India needs to take into account two features:
1. IFS demand is driven by increases in **gross** two-way financial flows that have occurred in transactions with the rest of the world. It is not driven by *net* flows. Demand for IFS by Indian customers – as well as foreign firms trading with and investing in India – is driven by imports **and** exports. India-related purchases of IFS are related to inbound **and** outbound FDI/FPI.
 2. The annual growth of gross flows has accelerated dramatically in recent years. India’s external linkages have been transformed since 1991–92. But that transformation has been more radical since 2002. The Indian economy is now exhibiting signs of a ‘take-off’ both in growth and even more rapidly in its globalisation (or integration with the world economy).

Hong Kong and China



Hong Kong evolved as an enclave IFC to provide IFS for traders dealing with a closed China. In the 1970s and 1980s, Hong Kong had superior institutions, and provided IFS to North Asia (China, Taiwan and Korea) as well as part of ASEAN (the Philippines and Vietnam which are closer to Hong Kong than to Singapore). But, as a colonial artifice, Hong Kong's role as an IFC was compromised, if not damaged, as China opened up and connected itself to the world through Shanghai and Beijing.

Since the 1980s, China has not required its economic partners to deal with it exclusively through Hong Kong. With the gradual rise of Shanghai as an IFC, Hong Kong's role as an IFC serving China is diminishing, although it is unlikely to be completely eclipsed. At the same time ASEAN regional finance has gravitated decisively toward Singapore.

4.4 THE IMPACT OF GLOBALIZATION ON IFS DEMAND AND ON IFCs

- 4.4.1 When the economy of a country or region (*e.g.*, the EU or ASEAN) engages with the world through its current and capital accounts, a plethora of IFS are purchased as part-and-parcel of these cross-border transactions. The hinterland effect of a rapidly growing national or regional economy has been a crucial driver of growth in IFCs.
- 4.4.2 The 21st century has yet to unfold. But the emergence of China and India as global economic powers is likely (as in the US, EU and ASEAN) to provide the same *raison d'être* for these two economies evolving their own IFCs to interface with those that serve other regions. History suggests that no country or regional economy can become globally significant without having an IFC of its own. But the emergence of IFCs has not always been a tale of growth potential and start-up followed by prolonged competitive success in exporting IFS to global markets.
- 4.4.3 The trajectories of IFCs can wax and wane depending on how world events unfold. Growth in Indian IFS demand is driven by the progressive, inexorable integration of the Indian economy with the world economy. As such integration deepens it triggers a variety of needs for IFS. For example:
1. Current account flows involve payments services, credit and currency risk management.
 2. Inbound and outbound FDI (as well as FPI like private equity and venture capital) involves a range of financial services including investment banking, due diligence by lawyers and accountants, risk management, etc.
 3. Issuance of securities outside the country involves fees being paid by Indian firms to investment bankers in IFCs around the world.
 4. The *stock* of cross-border exposure (resulting from accumulation of annual *flows*) requires risk management services to cover country risk, currency risk, etc. This applies in both directions: foreign investors require IFS to protect the market value of their exposure in India while Indian investors require the same services to protect the market value of their exposure outside the country.



5. The shift to import-price-parity (owing to trade reforms) implies that Indian firms that do not import or export are nevertheless exposed to global commodity price and currency fluctuations. These firms require risk management services.
 6. Many foreign firms are involved in complex infrastructure projects in India. Indian firms are involved in infrastructure projects abroad. These situations involve complex IFS. The same applies to structuring and financing privatizations (especially those involving equity sales to foreign investors) and public-private partnerships which are becoming a growing feature in infrastructure development around the world.
 7. The growth of the transport industry (shipping, roads, rail, aviation, etc) involves financing arrangements for fixed assets at terminals (ports, etc.) as well as for mobile capital assets with a long life: *i.e.*, ships, planes, bus and auto fleets, taxis, etc. That is done by specialised firms engaged in 'fleet financing'. India is now one of the world's biggest customers of aircraft buying roughly 40% of the world's new output of planes in 2006. This requires buying 40% of the world's aircraft financing services.
 8. Indian individuals and firms control a growing amount of globally dispersed assets. They require a range of IFS for wealth management and asset management.
- 4.4.4 Outbound FDI by Indian firms in joint ventures and subsidiaries abroad has increased since 2004–05 as they have globalised. Foreign investments by Indian firms began with the establishment of organic presence, and acquisitions of companies, in the US and EU in the IT-related services sectors. Now they encompass pharmaceuticals, petroleum, automobile components, tea and steel. And, geographically, Indian firms are spreading well beyond the US and EU by establishing a direct presence or acquiring companies in China, ASEAN, Central Asia, Africa and the Middle East. Such outward investments are funded through: draw-down of foreign currency balances held in India, capitalization of future export revenue streams, balances held in EEFC accounts, and share swaps.
- 4.4.5 Outward investments are also financed through funds raised abroad: *e.g.*, ECBs, FCCBs and ADRs / GDRs. Leveraged buy-outs related to these investments and executed through SPVs abroad are not captured in the overseas investment transactions data. The Tata Steel-Corus transaction, for example, involved substantial IFS revenues going to financial firms in Singapore and London.
- 4.4.6 When two firms across the globe agree to undertake current or capital account buy-sell transactions, the associated IFS are usually bought by the firm with better access to high quality, low cost IFS. Consider the example of an Indian firm exporting complex engineering goods to a firm in Germany. It can contract and invoice in: INR, USD or EUR. Because India has limited IFS capabilities, and a stunted currency trading market, the transaction is likely to be contracted in INR or USD. But the German importer generates revenues in EUR. It has to buy INR or USD to pay the Indian firm. It may have to use a currency derivative (future, forward or option) to cover the risk of a movement in the exchange rate of the INR or USD vs. the EUR between placing the order and receiving the goods. This would typically be done in London.



- 4.4.7 However, if India had a proper currency spot and derivatives market, the Indian exporter would be able to invoice in EUR. Local IFS demand would be generated by this local firm converting locked-in future EUR revenues into current INR revenues at a known exchange rate. Indian exporters are not as flexible as they wish to be in their choice of the INR or of global currencies for invoicing (*i.e.*, USD, JPY, EUR or GBP) – or even the choice of currencies such as the SGD or CNY for trade with ASEAN and China. If they were, that could influence the effective price received by them. When goods are sold by an Indian exporter, and a German importer pays IFS charges in London for converting EUR into INR and managing the exchange risk, the net price received by the Indian exporter is lower. When the Indian exporter sells in EUR, and local IFS are purchased for conversion of EUR receipts into INR, the price received would be higher.
- 4.4.8 These differences are invisible in standard BoP data, which do not separate out and recognise charges for IFS being purchased or sold as part and parcel of contractual structures on the current or the capital account. For this reason, the standard BoP data grossly understate the size and importance of the global IFS market. Focusing on the transactional aspects of trade flows would tend to understate IFS demand since this tends to ignore the risk management business which rides on trade flows.

4.5 PROJECTIONS FOR REVENUE POTENTIAL OF MUMBAI AS AN IFC

- 4.5.1 The median (base case) projections involve IFS demand in India rising from \$ 13 billion in 2006 to \$ 48 billion in 2015. A low-case assumption would see IFS consumption rising from US\$ 6.6 to nearly US\$ 24 billion over the same period. A more optimistic (but not implausible) ‘high-case’ assumption would see it grow from US\$ 19.7 to nearly US\$ 72 billion.

4.6 INSURANCE

- 4.6.1 Finance and insurance have much in common. Each provides its customers with tools for managing risks. The valuation techniques in both finance and insurance are formally same: The fair value of a security and an insurance policy is the discounted expected value of the future cash flows they provide to their owners. The definition of risk is the same: The variation of future results (cash flows) from expected values. Finally, the management of insurable and financial risks rely on the same two fundamental concepts: risk pooling and risk transfer.
- 4.6.2 Since the early 1990’s, we have seen substantial convergence between finance and insurance. A shortage of property and liability insurance in the 1980s forced many corporate insurance customers to consider alternatives to traditional insurance, such as self-insurance, captive insurers, and contingent borrowing arrangements to finance losses. Investment bankers and insurance brokers provided many of these alternatives. The demand for catastrophe insurance in the 1990s led to the development of options and futures for this type of insurance. Investment banks, sometimes with insurance company or insurance broker partners, formed subsidiaries to offer catastrophe and other high-demand coverage through new financing arrangements.



- 4.6.3 Life insurers have developed products with embedded options on stock portfolios. Insurers have begun to use structured securities, such as bonds with indexed coupons, in their investment portfolios.
- 4.6.4 Thus, in the 1990s, financial markets offered products for managing risks traditionally handled by insurers. The high demand for catastrophe insurance on property started the movement. We now see convergence in the investment markets as well as in various new alliances, partnerships and joint ventures.

4.7 INTEGRATION AND GLOBALIZATION OF FINANCIAL SERVICES

- 4.7.1 Changing customer needs, more knowledgeable and demanding customers, new technology, liberalization, deregulation, and a combination of other forces are blurring the lines between financial products, institutions, sectors, and countries. Regulators are responding to market pressures by allowing more inter-sectoral competition. Banks, securities firms, insurance companies, and other financial intermediaries increasingly compete with each other by offering similar products and services and by entry into fields previously reserved for one sector only.
- 4.7.2 **Financial services integration** occurs when financial products and services traditionally associated with one class of financial intermediaries are distributed by another class of financial intermediaries.
- 4.7.3 **Financial services convergence** is the tendency of financial products and services traditionally one sector to take on characteristics traditionally observed with financial products and services of another financial services sector.
- 4.7.4 Convergence occurs through customer demand across traditional sector lines. Examples include the introduction by insurance companies of variable (unit linked) life and annuity products that contain both insurance and securities features. Another burgeoning area is the banking industry's creation of securitized mortgage and corporate debt portfolios, which involves packaging a group of mortgages or other loans into marketable securities that are sold to investors.
- 4.7.5 As banks, securities firms, and insurers construct products and offer services that resemble the features of their competitors, product convergence will be an important driving force toward financial services integration.
- 4.7.6 This integration gave birth to **financial services conglomerates**. A Financial services conglomerate is a firm or group of firms under common control which offers financial services that extend beyond the traditional boundaries of any one sector. The two most commonly discussed arrangements are bancassurance and universal banks.
- 4.7.7 **Bancassurance** describes arrangements between banks and insurers for the sale of insurance through banks, wherein insurers are primarily responsible for production and banks are primarily responsible for distribution.
- 4.7.8 **Universal banks** are financial intermediaries that typically offer commercial and investment banking services, and also insurance.