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An Analytical Research on Foreign Institutional Investment in India

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Abstract

Foreign institutional investors have gained a significant role in Indian stock markets. The increase in the volume of foreign institutional investment (FII) inflows in recent years has led to concerns regarding the volatility of these flows, threat of capital flight, its impact on the stock markets and influence of changes in regulatory regimes. The dawn of 21st century has shown the real dynamism of stock market and the various benchmarking of sensitivity index (Sensex) in terms of its highest peaks and sudden falls it can be said that while return declined reasonably after the entry of FIIs, the volatility has been reduced significantly after their entry. Besides, FIIs investment flows, there may be other reasons as well that may have some degree of influence on market volatility and return. While the FIIs investment flows and contemporaneous SENSEX, NIFTY, market capitalization and market turnover have been strongly correlated in India, the correlation between FIIs investments and market volatility and market return has been comparatively low. It means volatility in Indian market is not the function of FIIs investment flows. There may be some other reasons which induced the volatility in Indian market over the time.

***Key words**: Sensitivity index, Stock market, Sensex, NIFTY, market capitalization and market turnover.*

Introduction:

Foreign Institutional Investment

As defined by the **European Union** Foreign Institutional Investment is an investment in a foreign stock market by the specialized financial intermediaries managing savings collectively on behalf of investors, especially small investors, towards specific objectives in term of risk, return and maturity of claims.

SEBI's Definition of FIIs presently includes foreign pension funds, mutual funds, charitable/endowment/university funds, asset management companies and other money managers operating on their behalf in a foreign stock market.

Foreign institutional investment is liquid nature investment, which is motivated by international portfolio diversification benefits for individuals and institutional investors in industrial country. Currently, the following entities are eligible to invest under FII route:

(i) As FIIs.

Overseas pension funds, mutual funds, investment trusts, asset management companies, nominee companies, banks, institutional portfolio managers, university funds, endowments foundations, charitable trusts, charitable societies, a trustee or power of attorney holders incorporated or established outside India proposing to make proprietary investment or investment on behalf of a broad-based funds (i.e. fund having more than 20 investors with no single investors holding more than 10 percent of the shares or units of the fund).

(ii) As Sub-Accounts

The sub account is generally the underlying fund on whose behalf the FII invests. The following entities are eligible to be registered as sub-account, viz. partnership firms, private company, public company, pension fund, investment trust and individuals

(iii) Domestic Entities

A domestic portfolio manager or a domestic asset management company shall also be eligible to be registered as FII to manage the funds of sub-account

Review of literature:

Bahmani-Oskooee and Sohrabian (1992), were among the first to use co integration and Granger causality to explain the direction of movement between exchange rates and stock prices and found FIIs using positive feedback trading strategies; Causality may run from stock prices to foreign investment.

Kim and Singal (1993), study the behavior of stock prices following the opening of a stock market to foreigners or large foreign inflows.

Warther, V. (1995), separate the flows into expected and unexpected flows, using time-series models to estimate expected flows and then investigate their correlation with market returns and find high positive correlation between returns and unexpected inflows.

Rao, Murthy and Rangnathan (1999), conducted a study of developed market by taking the data for a period of 8 years (1990 to 1998). They suggest that FIIs investments would help the stock markets directly through widening investor base and indirectly compelling local authorities to improve the trading system

Banaji, J. (2000), emphasized on the fact that the capital market reforms like improved market transparency, automation, dematerialization and regulations on reporting and disclosure standards were initiated because of the presence of the FIIs.

PandaMazumdar (2004), found that FII flows have enhanced liquidity in the Indian stock market but not much evidence is there to support the hypothesis that FII flows have generated volatility in the returns

Chkradhara (2005), examined the impact of FIIs and mutual fund investments on Indian stock market by using Vector Auto regression (VAR) analysis and Granger Causality Test on data of NSE and BSE for the period from Oct. 2003 to Mar. 2004 and found that the returns on Indian stock market indices were more affected by the mutual fund investment than FIIs investment. FIIs are found to follow positive feedback strategy and to have return chasing tendency.

Upadhyay, Saroj (2006), found in her study that FII flows supplement and augment domestic savings and domestic investment without increasing the foreign debt of our country.

Karmakar, Madhusudan (2006), measured the volatility of daily market return in the Indian stock market over the period from 1961 to 2005 by using the GARCH Model and observed that the market was tranquil and volatile

Objectives of the Study:

1) To bring out the impact of FIIs investment on the return of Indian stock market;
2) To assess the impact of FIIs on the volatility of the stock market in India;
3) To examine whether arrivel of FIIs have affected trading volume and market capitalization of Indian stock market;
4) To identify the determinants of FIIs investment and assess their impact on FII flows;

Research methodology:

Research methodology comprises the following:

a) **Database:**

The data is likely to be collected using secondary sources. The data relating to foreign institutional investment will be collected from the NSE and BSE website as well as from the published sources such as various journals, Govt. reports, newspaper set c.

b) **Research Tools:**

Research tools deals with the econometric techniques to measure the volatility, liquidity & marketability. To measure the volatility, the GARCH class of models would be used. GARCH model has been developed by Bollerslev (1986) from the

Autoregressive Condtional Hetroscedasticity (ARCH) model previously introduced by Engle (1982). GARCH framework is very widely used in financial literature due to in ability to capture volatility clustering especially when the data is large and hetroscedastic in nature. Other statistical tools would be used as per the requirement of the study.

Foreign Institutional Investment in India

India opened its stock market to foreign investors in September 1992 and has since 1993, received considerable amount of portfolio investment in the form of Foreign Institutional Investor's (FIIs) investment in equities (Table 1.2). This has become one of the main channels of international portfolio investment in India for foreigners. In order to trade in Indian equity markets, foreign corporations need to register with the SEBI as Foreign Institutional Investors.

TABLE 1.2: FIIs INVESTMENT IN INDIA

Securities and Exchange Board of India (SEBI) Data					
Gross in Rupees Crore			**Net**		
Year	**Purchase**	**Sale**	**Rupees Crore**	**Millions Dollars**	**Cumulative Millions of US $**
1994-95	615	710	411	416	544
1995-96	5,592	466	5,126	1,634	1,638
1996-97	7,631	8,835	4,796	1,528	3,166
1997-98	9,694	2,752	6,942	2,036	5,202
1998-99	15,554	6,979	8,575	2,432	7,634
1999-00	18,695	12,737	5,958	1,650	9,284
2000-01	16,115	17,699	-1,584	-386	8,898
2001-02	56,855	46,734	10,121	2,339	11,237
2002-03	74,051	64,116	9,935	2,159	13,396
2003-04	49,920	41,165	8,755	1,846	15,242
2004-05	47,061	44,371	2,690	562	15,804
2005-06	1,44,858	99,094	45,765	9,950	25,755
2006-07	2,17,911	1,71,696	46,215	10,248	36,008
2007-08	3,46,978	3,05,512	41,466	9,332	45,340
2008-09	4,77,515	4,50,629	26,886	6,626	51,966
2009-10*	7,91,175	7,34,748	56,427	15,234	67200

Source: Report of the Ministry of Finance, Govt. of India on Encouraging FII Flows Nov. 2005 and data for later period is updated from the RBI website. *Data is upto 31 January 2010

Table 1.2 indicates that every year since FIIs were allowed to participate in Indian market, net inflows into India remained positive, except 1998-99. This reflects the strong fundamentals of the country, as well as the confidence of the foreign investors in the growth prospects of the Indian market. The year 2003 marked a watershed in FII investment in India as they started in this year in a big way by investing Rs. 985 crore in January itself. Meanwhile, corporate India continued to report good operational results, this along with good macroeconomic fundamentals, growing industrial and service sector led FIIs to perceive great potential for the investment in the Indian economy.

In April 2003, prices of commodities like steel and aluminum went up, propelling FII investment to Rs. 3,060 crore in May 2003. The same time, Morgan Stanley Capital International (MSCI) in its MSCI Emerging Market index gave a weight of 4.3 percent to India among the emerging markets of the world. Calendar year 2004 ended with net FII inflows of US$ 9.2 billion, an all-time high since the liberalization.

The buoyant inflows continued in 2004-05. The weight in MSCI Emerging Market Index was increased to 5.9 percent in April 2004. In 2004-05, after receiving directions briefly during the period May-June, FII inflows become robust again, leading to net inflows of US$ 10.25 billion during the year. The buoyancy continued in 2005-06 with net inflows aggregating to US$ 10.11 billion at the end of December 2005 and at the end of the December 2007 it was 17.23 billion.

The diversity of FIIs has been increasing with the number of the registered FIIs in India steadily rising over the years as shown in the table 1.3. In 2004-05, 145 new FIIs were registered with the Securities and Exchange Board of India and as on March 31, 2005, there were 685 FIIs registered in India. The names of some prominent FIIs registered during 2004-05 are: California Public Employees Retirement System (CalPERS), United Nations for and on behalf of the United Nation Joint Staff Pension Fund, Public School Retirement System of Missouri, Commonwealth of Massachusetts Pension Reserve Investment Trust, Treasure of the State North Carolina Equity Investment Fund Pooled Trust, the Growth Fund of America and AIM Funds Management Inc. At the end of the year 2007 the Total No of FIIs registered with SEBI was 1219

TABLE 1.3: FIIs REGISTERED IN INDIA

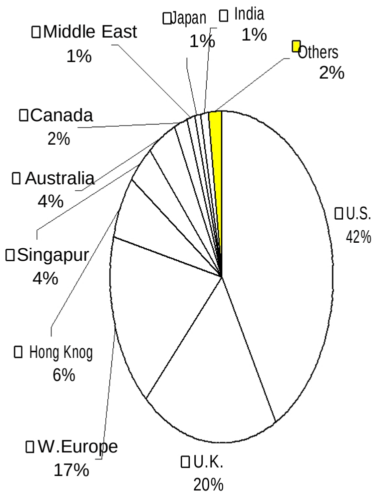
Financial Year	**During Year**	**Total Registered at the End of Year**
1994-95	1	1
1995-96	3	3
1996-97	153	156
1997-98	197	353
1998-99	99	439
1999-00	59	496
2000-01	59	450
2001-02	56	506
2002-03	84	528
2003-04	48	490
2004-05	76	603
2005-06	86	540
2006-07	145	685
2007-08	131	803
2008-09	190	993
2009-10	289	1282

Source: Report of the Ministry of Finance, Govt. of India on Encouraging FII Flows Nov. 2005 and data for later period is updated from the RBI website.

*Data is up-to 31 January 2010

It is obvious from Figure 1.2 that, in term of the country of origin, the USA topped the list with a share of 42 percent of the number of FIIs registered in India, followed by UK’s 20 percent. Beside UK, and US other investing countries include Luxemburg, Hong Kong, Australia and Singapore. European and Japanese FIIs have also started taking an increasing interest in India and of the FIIs that registered with SEBI in October 2004, a significant number belonged to them. These developments have helped improve the diversity of the set of FIIs operating in India.

FIGURE 1.2:SOURCE OF FIIs IN INDIA



Benefits and Costs of FIIs Investment

Benefits

1. **Reduced Cost of Equity Capital**

FII inflows augment the sources of funds in the Indian capital markets. In a common sense way, an increase in the supply of funds reduces the required rate of return for equity and enhances stock prices. Simultaneously, it fosters investment by Indian firms in the country.

2. **Imparting Stability to Indian's Balance of Payment:**

For promoting growth in India, there is a need to augment domestic investment, over and beyond domestic savings, through capital flow. The excess of domestic investment over domestic savings result in a current account deficit and this deficit is financed by the capital flow in the balance of payment

3. **Knowledge Flows**

The activities of international institutional investors help strengthen financial system. FIIs advocate modern ideas in market design, promote innovation, development of sophisticated products such as financial derivatives, enhance competition in financial intermediation and lead to spillover of human capital by exposing market participants to modern financial techniques and international best practices and systems.

4. **Strengthen Corporate Governance**

FII participation in domestic capital markets often-lead vigorous advocacy of sound corporate governance practices, improved efficiency and better shareholder value.

5. **Improve Market Efficiency**

A significant presence of FIIs can improve market efficiency through two channels. First, when adverse macroeconomic news, such as bad monsoon, unsettles many domestic investors, it may be easier for a globally diversified portfolio manager to be more dispassionate about a country's prospects, and engage in stabilizing trades. Second, at the level of individual stocks and industries, FIIs may act as a channel through which knowledge and ideas about valuation of a firm or an industry can more rapidly propagate into market**.**

Costs

1. **Herding and Positive Feedback Trading**

There are concerns that foreign investors are chronically ill informed about India, and the lack of sound information may generate herding (a large numbers of FIIs buying and selling together) and positive feedback trading (buying after positive returns, selling after negative returns). These kinds of behavior can execrate volatility and push process away from fair values. FIIs behavior in India, however, so far does not exhibit these patterns.

2. **Balance of Payment Vulnerability**

There are concerns that in an extreme event, there can be a massive flight of foreign capital out of India, triggering difficulties in the balance of payments front. India's experience with FIIs so far, however, suggests that across episodes like the Pokharn blasts or the 2001 stock market scandal, no capital flight has taken place. A billion or more US dollars of portfolio capital has never left India within the period of one month. When juxtaposed with India's enormous current and capital account flows, this suggests that there is little evidence of vulnerability so far.

3. **Possibility of Taking Over Companies**

While FIIs are normally seen as pure portfolio investors, without interest in control, portfolio investors can occasionally behave like FDI investors and seek control of companies that they have a substantial share holding in. Such outcomes, however, has not been experienced by India. Furthermore, SEBI's takeover code is in place and has functioned fairly well ensuring that all investors benefits equally in the event of takeover.

4. **Complexities of Monetary Management**

A policy maker trying to design the ideal financial system has three objectives. The policy maker wants to continue national sovereignty in the pursuit of interest rate, inflation and exchange rate objectives; financial markets that are regulated, supervised and cushioned; and the benefits of global capital markets. Unfortunately, these three goals are incompatible. They form the impossible trinity. India's openness to portfolio flows and FDI has effectively made the country's capital account convertible for foreign institutions and investors. The problems of monetary management in general and maintaining a tight exchange rate regime, reasonable interest rates and moderate inflation at the same time in particular have come to the fore in recent times. The problem showed up in terms of very large foreign exchange reserve inflows requiring considerable sterilization operations by the RBI to maintain stable macroeconomic conditions. The government of India had to introduce a Market Stabilization Scheme (MSS) from April 1, 2004.

These are the benefits and harm of the foreign institutional investors. If proper rules are established and implemented by the regulatory body, the harms of the FIIs can be eliminated.

Conclusion:

This paper concludes that the increase in the volume of foreign institutional investment (FII) inflows in recent years has led to concerns regarding the volatility of these flows, threat of capital flight, its impact on the stock markets and influence of changes in regulatory regimes. The determinants and destinations of these flows and how are they influencing economic development in the country have also been debated. This paper examines the role of various factors relating to individual firm-level characteristics and macroeconomic-level conditions influencing FII investment. The regulatory environment of the host country has an important impact on FII inflows. As the pace of foreign investment began to accelerate, regulatory policies have changed to keep up with changed domestic scenarios.

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