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Overview of Foreign Institutional Investors in Indian Securities Market

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Abstract: *The foreign institutional investors (FII) have become a significant driving force of the Indian capital market and their growing presence marks the development of the capital market of India. To facilitate foreign capital flows developing countries seek to strengthen their capital markets. As a result of which Indian capital markets have achieved new heights and have become more volatile opening the dimensions of new research in the arena of Foreign Institutional Investments and Indian capital market. This paper makes an attempt to study the effects of trading behavior of foreign institutional investors on the Indian capital market. The researcher found out that there are significant changes in the Indian capital market returns and volatility is significantly reduced after opening up of the market to foreign investors.*

Keywords: *Foreign institutional investors, Liberalization, Net investments, Returns, Volatility, Foreign Capital*

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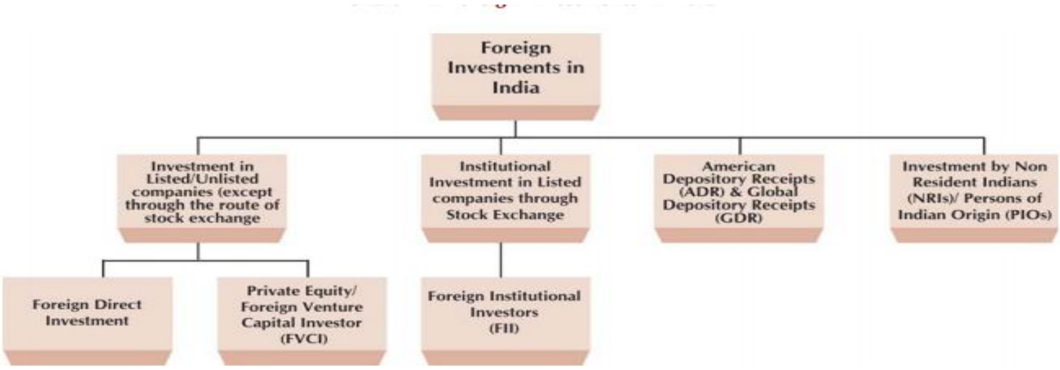
I. Introduction

Foreign investment provides a channel through which these countries can have access to foreign capital. It can come in two forms: foreign direct investment (FDI) and foreign portfolio investment (FPI). Foreign direct investment involves direct production activities of medium to long-term nature. But the foreign portfolio investment is a short-term investment mostly in the financial markets and it consists of Foreign Institutional Investment (FII). Foreign investments in the country can take the form of investments in listed companies (i.e., FII investments), investments in listed/unlisted companies other than through stock exchanges (i.e., through the foreign direct investment or private equity/foreign venture capital investment route), investments through American Depository Receipts/Global Depository Receipts (ADR/GDR), or investments by non-resident Indians (NRIs) and Persons of Indian Origin (PIOs) in various forms.



In the Budget 2011-I2, the Government of India, for the first time, permitted Qualified Foreign investors (QFIs), who meet the KYC norms, to directly invest in Indian equity mutual fund (MF) schemes and in MF debt schemes that invest in infrastructure. It was for the first time that this new class of investors was allowed to directly participate in the Indian capital market. In January 2012, the Government expanded this scheme to allow QFIs to directly invest in Indian equity markets. In the budget 2012-13, Government announced its intention to permit QFIs to invest in corporate bonds in India. The Securities and Exchange Board of India has introduced a new class of foreign investors in India known as the Foreign Portfolio Investors (“FPIs”) effective from June 2014. This class has been formed by merging the following existing classes of investors - Foreign Institutional Investors (“FIIs”), Qualified Foreign Investors (“QFIs”) and sub-accounts of the FIIs.

According to a poll conducted by Bank of America Merrill Lynch (BofA-ML) recently, in which 50 investors participated, India was the most favorite equity market for the global investors for the year 2015 at 43 per cent, followed by China at 26 per cent. The global investment bank is of the view that India remains to be in a structural bull market.

Objectives Of The Study

Following are the objectives of the study:

1. To study the structure and functioning of FIIs in the Indian capital market
2. To study the role of Foreign Institutional Investors in the growth and development of Indian capital market.
3. To study the procedure, rules and regulations to invest in Indian Capital Market.
4. To determine the relationship between FIIs and Indian Securities Market.
5. To find out pattern of Investment by FII.

II. Research Methodology

The research is Descriptive Research. The research technique used is both "Qualitative and Quantitative".

Limitations

The study is limited to the foreign investment in Indian Securities Market.

Need Of The Study

Since the beginning of the liberalization FII inflows to India have grown in importance. Foreign capital has become one of the most important sources of funds for economies that would like to grow at a higher rate that what their domestic savings can support. This has resulted into global integration. As a result capital started moving freely across borders. India is considered as a good investment option by world investors in spite of political differences and lack of infrastructure facility. Indian stock market shows a development phase over the last 15 years due to growing participation of FIIs. FIIs are significant investor segment of the Indian capital market accounting for an average of 20% turnover in both the equity and debt market. This paper attempts to study the impact of FIIs on Indian Capital Market.

Foreign Institutional Investors (FIIs)

Countries with the highest volume of foreign institutional investments are those that have developing economies. These types of economies provide investors with higher growth potential than in mature economies. This is why these investors are most commonly found in India, all of which must register with the Securities and Exchange Board of India to participate in the market.

If, for example, a mutual fund in the United States sees an investment opportunity in an Indian-based company, it can purchase the equity on the Indian public exchange and take a long position in a high-growth stock. This also benefits domestic private investors who may not be able to register with the Securities and Exchange Board of India. Instead, they can invest in the mutual fund and take part in the high growth potential.

Foreign Institutional Investors can make Investment in the followings:

- Securities in primary and secondary markets including shares, debentures and warrants of companies, unlisted, listed or to be listed on a recognized stock exchange in India, and
- Units of schemes floated by domestic mutual funds including Unit Trust of India, whether listed on a recognized stock exchange or not
- Units of scheme floated by a collective investment scheme
- Derivatives traded on a recognized stock exchange
- Commercial papers * Dated Government Securities
- Security receipts
- Indian Depository Receipt

Restrictions on FIIs

A Foreign Institutional Investor cannot invest in (1) Asset Reconstruction Company, (2) Nidhi Company & (3) Trading in Transferrable Development Rights.

III. Review Of Litrature

1. Stanley Morgan (2002) has examined that FIIs have played a very important role in building up India's forex reserves, which have enabled a host of economic reforms. Secondly, FIIs are now important investors in the country's economic growth despite sluggish domestic sentiment. The Morgan Stanley report notes that FII strongly influence short-term market movements during bear markets. However, the correlation between returns and flows reduces during bull markets as other market participants raise their involvement reducing the influence of FIIs. Research by Morgan Stanley shows that the correlation between foreign inflows and market returns is high during bear and weakens with strengthening equity prices due to increased participation by other players.

2. Agarwal, Chakrabarti et al (2003) have found in their research that the equity return has a significant and positive impact on the FII. But given the huge volume of investments, foreign investors could play a role of market makers and book their profits, i.e., they can buy financial assets when the prices are declining thereby jacking up the asset prices and sell when the asset prices are increasing. Hence, there is a possibility of bi-directional relationship between FII and the equity returns.

3. P. Krishna Prasanna (2008) has examined the contribution of foreign institutional investment particularly among companies included in sensitivity index (Sensex) of Bombay Stock Exchange. Also examined is the relationship between foreign institutional investment and firm specific characteristics in terms of ownership structure, financial performance and stock performance. It is observed that foreign investors invested more in companies with a higher volume of shares owned by the general public. The promoters' holdings and the foreign investments are inversely related. Foreign investors choose the companies where family shareholding of promoters is not substantial. Among the financial performance variables the share returns and earnings per share are significant factors influencing their investment decision.

4. Gurucharan Singh (2004) highlighted that the securities market in India has come a long way in terms of infrastructure, adoption of best international practices and introduction of competition. Today, there is a need to review stock exchanges and improve the liquidity position of various scrips listed on them. A study conducted by the World Bank (1997) reports that stock market liquidity improved in those emerging economies that received higher foreign investments.

5. Anand Bansal and J.S. Pasricha (2009) studied the impact of market opening to FIIs on Indian stock market behaviour. They empirically analyze the change of market return and volatility after the entry of FIIs to Indian capital market and found that while there is no significant change in the Indian stock market average returns; volatility is significantly reduced after India unlocked its stock market to foreign investors. In the next section we are discussing the data sources and methodology of the study.

Determinants Of Fii Flow In India

1. **Risk:** Whenever risk in home market increases, the foreign investors would start to pull out of their home country thereby creating a deficiency of funds in domestic market, hence so as to attract investment domestic interest rate would increase thereby to ensure that the above equality is restored
2. **Inflation:** At the time of high inflation, the real return on fixed income securities like bonds and fixed deposits declines. Thus a bond which gives say around 7.5% interest rate actually gives a real return of just 1% if the inflation is 6.5%. If the inflation increases further, the real return would decline more.
3. **Interest Rates:** For the business, cost of borrowing rises this has a negative result on their profit margins. As a result, they might even delay any investment activity which may be funded by borrowing to some later period when the interest rates are lower so as to reduce their investment costs. As it can be seen from the above table, over the past year RBI has increased the repo rate reverse repo rate, CRR and SLR. This has led to an increase in the Prime Lending Rate (PLR) and hence the general interest rate in the economy.
4. **Good news /bad news:** If say there is some bad news in the nation, which affects the asset price, which in turn decreases the return and hence FII would withdraw from the market. However on the other hand, if there is good news, asset prices would increase; thereby increasing return and hence FII would be attracted. But the sensitivity with which investors withdraw is greater than with which they invest i.e. they would be more cautious while investing than at the time of withdrawing. This is primarily due to their basic nature of being risk averse, thus they would react more vigorously to bad news than good news.
5. **Equity Returns:** The results show that, the equity return in India (RBSE) is the main driving force for foreign institutional investment, which is significant at all levels. That is increase in the returns in US stock market adversely affects the portfolio investment flowing to India. Predictable risk in foreign market (SDSRF) adversely affects FII flow to India and is highly significant in the model.
6. **GDP of India:** Both have more or less direct relationship. The reason is change in capital account. When interest rates were high, India was attracting lot of investments so the credit balance was high for that period.

Effects Of Fii On Indian Economy

The various effects of foreign institutional investors can be illustrated as follows:

1. **Enhanced Flows of Equity Capital**: FII's are well known for a greater appetite for equity than debt in their asset structure. For example, pension funds in the United Kingdom and United States had sixty-eight per

cent and sixty-four per cent, respectively, of their portfolios in equity in 1998. Not only it can help in supplementing the domestic savings for the purpose of development project like building economic and social infrastructure but can also help in growth of rate of investment, it boosts the production, employment and income of the host country

2. **Managing Uncertainty and Controlling Risks:** FII's promote financial innovation and development of hedging instruments. These because of their interest in hedging risks, are known to have contributed to the development of zero-coupon bonds and index futures. FII's not only enhances competition in financial markets, but also improve the alignment of assets prices to fundamentals. FII's in particular are known to have good information and low transaction costs. By aligning assets prices closer to fundamentals, they stabilize markets. In addition, a variety of FII's with variety of risk-return preferences also help in dampening volatility.

3. Improving Capital Markets: FII' as professional bodies of asset managers and financial analysts enhance competition and efficiency of financial markets. By increasing the availability of riskier long term capital for projects, and increasing firms' incentives to supply more information about them, the FIIs can help in the process of economic development.

Participatory Notes

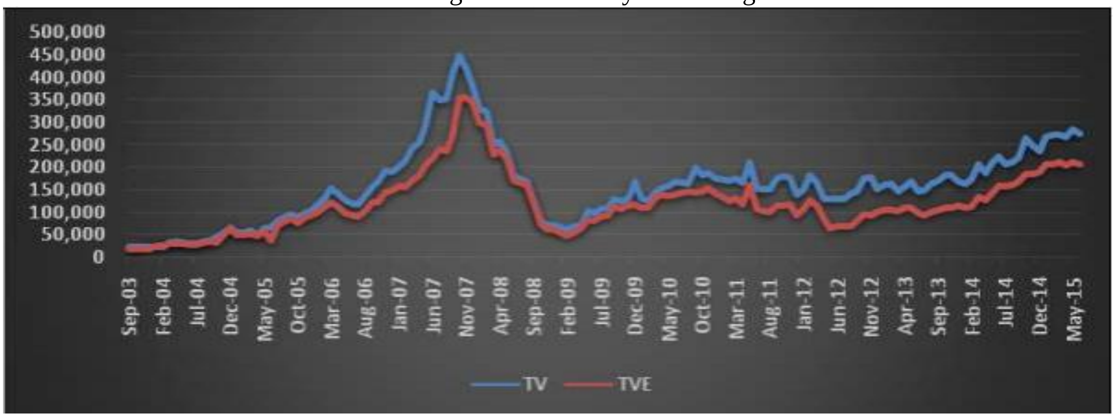
Participatory notes, also referred to as "P-notes," are financial instruments used by investors or hedge funds that are not registered with the Securities and Exchange Board of India (SEBI) to invest in Indian securities. Any dividends or capital gains collected from the underlying securities go back to the investors. Indian regulators are against participatory notes because they fear that hedge funds acting through participatory notes will cause economic volatility in India's exchanges. To invest in Indian stock markets without the hassle of involvement with the regulatory approval process, FIIs trade P-notes.

Pros of Participatory Notes

Participatory Notes are popular because investors anonymously take positions in Indian markets, and hedge funds anonymously carry out their operations. Some entities route their investments through P-notes to take advantage of certain countries' tax laws.

Cons of Participatory Notes

Indian regulators face difficulty determining a P-note's original and end owner. Therefore, much unaccounted money enters the country through P-notes. In addition, SEBI has no jurisdiction over trading P-notes. Although FIIs must register with SEBI, the P-notes trading among FIIs are not registered. For this reason, India's government is concerned that P-notes are being used for money laundering.



Interpretation

The total value of PNs on equity, debt and debentures (TV) has been compared with the total value of the PNs on equity and debt excluding debentures (TVE). The growth in TV and TVE as on June 2015, is more than 11 times its total value in September, 2003. The total value of PNs investments in equity, debt and derivatives surpassed 2,75,000 crores in June, 2015 from the total value of around 23,000 crores in September, 2003. We can also observe that, the total value of PNs investments in derivatives has been steadily widening from its 2008 levels. The total value of PNs on derivatives can be observed to be around 5,198 crores in September, 2003 and is now at its all-time high of 66,000 crores.

Government Initiatives

The Ministry of Finance plans to set up an expert panel to work out the modalities of implementing changes in the new tax regime post the withdrawal of capital gains benefits under the India-Mauritius tax treaty, which is expected to help prevent any potential confusion and assuage foreign investors facing changes in the tax regime. The Securities and Exchange Board of India (SEBI) has allowed Foreign Portfolio Investors (FPI) to

invest in units of Real Estate Investment Trusts (REITs), infrastructure investment trusts (InvITs), category III Alternative Investment Funds (AIFs), and also permitted them to acquire corporate bonds under default.
The RBI has also allowed a number of foreign investors to invest, on repatriation basis, in non-convertible/redeemable preference shares or debentures issued by Indian companies listed on established stock exchanges in India. The investment should be within the overall limit of US$ 51 billion allocated for corporate debt. Long-term investors registered with SEBI will also be deemed as eligible investors. The Government of India is also planning to relax some of the safe harbour rules set for offshore fund managers, in order to allow private equity investors to shift their base to India without attracting a tax on capital.The People's Bank of China (PBoC) has invested US$ 500 million in Indian bonds for the first time since the Indian government eased restrictions on foreign investors.

IV. Data Analysis

Net Investment by FIIs Over the Last 5 Years

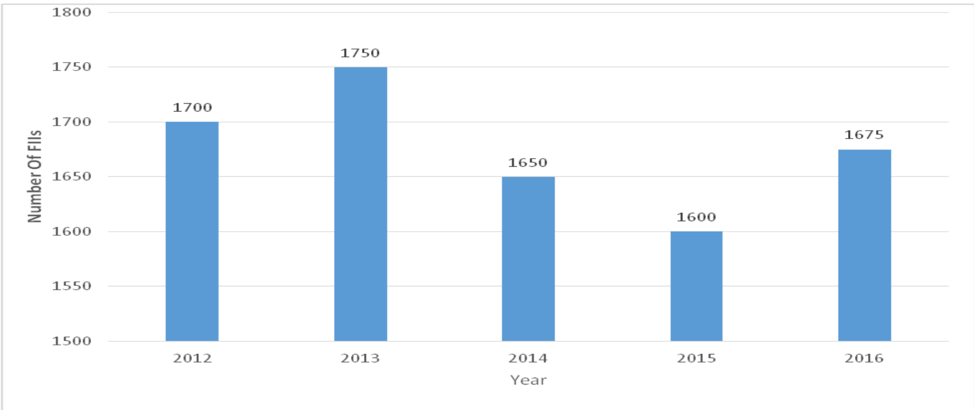
Year	Net Investment(million)	Net Investment (in million $)
2012	9,37,250	18,923
2013	1,683,670	31,047
2014	2,562,130	42,702
2015	10,180	170
2016	18,10,60	3,018

Table 1: Investment by FII over last 5 years

Net Investment in the year 2015 was the lowest in the last five years?
There are 4 main reasons the net investment in the year 2015 was the lowest:
1) Weakening Rupee, (2) Slowing GDP, (3) Shrinking Corporate Profitability, (4) Rising bad loans of the banks

Number of FIIs Registered With SEBI

The number of SEBI-registered FIIs declined in 2013-14 to 1,710 from 1,757 in the previous year. Number of FIIs registered with SEBI has been increasing at a lower rate in the past few years; there was a net addition of 43 SEBI-registered FIIs in 2011–12, compared to more than 300 in 2007-08 and 2008-09. During 2013-14, 106 fresh FII registrations were granted and 529 registrations were renewed. FIIs from 51 different countries, led by USA, have been registered with SEBI in 2013-14.



V. Conclusion

The study is concluded by understanding the huge impact of foreign investment on Indian Securities Market. Foreign Institutional Investors are crowd - puller to magnetize the foreign investment in India and have brought $ 124 billion in the last ten years, over half of which came in since 2010. FII has huge impact on Indian economy. It plays a huge role in deciding the GDP of India. 10 years ago, if a foreign investor had to invest in Indian Securities Market, It had to follow certain protocols that used to be very time consuming but because of various reform initiatives undertaken by the Government, lack of investment options in other countries and overall a positive investor sentiment are certain factors that have made India attract the highest amount of foreign inflows as against its Asian peers.

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