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IMPACT OF FOREIGN INSTITUTIONAL INVESTORS ON INDIAN CAPITAL MARKET

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ABSTRACT

An important feature of the development of capital market in India in the last 20 years has been the growing participation of Institutional Investors. Institutional investors comprise both foreign institutional investors and the domestic institutional investors. In India, these institutional investors manage large amount of funds which constitutes a significant share of the entire market capitalization. Impact of these investors especially FIIs in Indian capital market has been a matter of debate. FII investments seem to have influenced the Indian capital market to a considerable extent. This paper makes an attempt to understand whether there exists a relationship between FII and capital market returns in India. Here, will see the impact of FIIs movement on index prices through the analysis of historical investment of FIIs and historical prices of BSE SENSEX and NSE NIFTY.

KEYWORDS

FIIs, Indian Capital Market, BSE SENSEX, and NSE NIFTY.

INTRODUCTION

The economic landscape of India underwent a paradigm change when the economy was liberalized in 1991. It also laid the foundation for a strong regulatory network. India witnessed stellar economic performance through the period 2005-09. This was manifested through an average 8.5 – 9 percent GDP growth rates, rising domestic savings and investment levels and the amount of foreign capital flowing into the country.

Foreign investments can any of the three forms:

- Portfolio investments in Indian companies Foreign Institutional Investor (“FII”) route– essentially entailing transactions executed on stock exchanges in India;
- Direct investment into Indian companies Foreign Direct Investment – (“FDI”) route;
- Private Equity investments – Foreign Venture Capital Investor (“FVCI”) route

Foreign Institutional Investors have been a major source of funds into the Indian Capital Markets in the past few years. Foreign Institutional Investors are defined under SEBI Regulations as “an institution that is a legal entity established or incorporated outside India proposing to make investments in India only in securities.” Foreign institutional investors also include domestic asset management companies or domestic portfolio managers who manage funds raised or collected or bought from outside India for the purpose of making investment in India on behalf of foreign corporate or foreign individuals. These investments are governed by the Securities and Exchange Board of India (Foreign Institutional Investors) Regulations, 1995. Potential investors also have to get approval from the Reserve Bank of India to operate foreign currency accounts to bring in and take out funds and rupee bank accounts to pay for transactions. The Reserve Bank of India also regulates the activities of FIIs, through exchange control regulations.

BOMBAY STOCK EXCHANGE

Of the 22 stock exchanges in the country, Mumbai's (earlier known as Bombay), Bombay Stock Exchange is the largest, with over 6,000 stocks listed. The BSE accounts for over two thirds of the total trading volume in the country. Established in 1875, the exchange is also the oldest in Asia. Among the twenty-two Stock Exchanges recognised by the Government of India under the Securities Contracts (Regulation) Act, 1956, it was the first one to be recognised and it is the only one that had the privilege of getting permanent recognition ab-initio.

BSE SENSEX

BSE Sensex or **Bombay Stock Exchange Sensitive Index** is a value-weighted index composed of 30 stocks that started January 1, 1986. The Sensex is regarded as the pulse of the domestic stock markets in India. It consists of the 30 largest and most actively traded stocks, representative of various sectors, on the Bombay Stock Exchange. These companies account for around fifty per cent of the market capitalization of the BSE. The base value of the sensex is 100 on April 1, 1979, and the base year of BSE-SENSEX is 1978-79.

NATIONAL STOCK EXCHANGE OF INDIA

NSE was promoted by leading Financial Institutions at the behest of the Government of India and was incorporated in November 1992 as a tax-paying company unlike other stock exchanges in the country. On its recognition as a stock exchange under the Securities Contracts (Regulation) Act, 1956 in April 1993, NSE commenced operations in the Wholesale Debt Market (WDM) segment in June 1994. The Capital Market (Equities) segment commenced operations in November 1994 and operations in Derivatives segment commenced in June 2000.

S&P CNX NIFTY

The Standard & Poor's CRISIL NSE Index 50 or S&P CNX Nifty nicknamed Nifty 50 or simply Nifty (NSE: ^NSEI), is the leading index for large companies on the National Stock Exchange of India. The Nifty is a well diversified 50 stock index accounting for 23 sectors of the economy. The S&P CNX Nifty stocks represent about 60% of the total market capitalization of the National Stock Exchange (NSE). It is used for a variety of purposes such as benchmarking fund portfolios, index based derivatives and index funds. Nifty is owned and managed by India Index Services and Products Ltd. (IISL),

OBJECTIVES

- To determine the factors that influences the dependency of Indian stock market on foreign institutional investors.
- To analyze graphically, Net purchases and sales by FIIs in the sampling period.
- To analyze the stock market returns of indices and determine FII's Percentage Change in Investment.
- To analyze the Trends in FII Investment in India in the sampling period.
- Examine whether FIIs have any influence on Equity Stock Market.

SCOPE OF THE STUDY

The scope of the study extends up to the analysis of analysis of stock market returns of dependent factors like FII investments of a country. The analysis lies as a means for comparison between the net purchase, sales, and investments in Indian stock market taken in the sample data only.

METHODOLOGY

- **SOURCE OF DATA**

Various sources of secondary data are:

- Books, Journals, and Internet(BSE, NSE, SEBI)

- **SAMPLING SIZE**

- Monthly closing data of Sensex and Nifty(2001-2010)
- Yearly FII Inflows (2001-2010)
- Yearly returns of sensex and nifty(2001-2010)

- **RESEARCH TOOLS**

- Correlation, Co-efficient of Determination, and SPSS Software

ANALYSIS**TRENDS IN EQUITY**

The year 2010 has seen a net inflow of ₹ 140,497 crore in equities so far. The cumulative investments in equity stand at ₹ 982,251 crore the graph below shows the trend in FII sales and purchases over the 2001-2010 period.

TABLE 1: TABLE SHOWING EQUITY FII FLOWS IN ₹ CRORE

Year	Purchases	Sales	Net
2001	51,866.60	38,572.80	13,294.70
2002	46,320.31	42,673.54	3,627.23
2003	94,816.50	64,024.10	29,953.2
2004	183,883.70	145,185.50	38,688.40
2005	278,186.10	232,378.50	45825.6
2006	435,804.30	404,523.22	31,281.08
2007	805,167.57	734,227.52	709,40.05
2008	720,757.80	773,809.50	-53,051.70
2009	626,004.50	540,636.90	85,367.6
2010	768,402.60	634,110.70	140,497.20

Source: Moneycontrol.com

There has been a steep rise in FIIs in Equity beginning 2003. Except for 2008 to mid 2009 due to recession period, since 1993, only once have foreign investors turned net sellers. This has primarily been on account of rise in global liquidity conditions primarily driven by low interest rates in US that was affected to counter recessionary condition post the dot-com bubble, a rising aversion towards US, for its huge current account deficit and growth of the 'emerging' economies like China, India etc. FIIs have been progressively raising their investments in Indian market since 2003, the year that saw the beginning of the bull-run in the Sensex. This continued until 2008, when the recession hit. Liquidity dried up. So did the risk-aversion of investors towards emerging markets. The equity began to rise in middle of 2009 and gradually attracted foreign investors last financial year.

TRENDS IN DEBT**TABLE 2: TABLE SHOWING DEBT FII FLOWS IN ₹ CRORE**

Year	Purchases	Sales	Net Purchase
2001	5116.9	4998.5	119
2002	2777.79	2713.04	64.86
2003	10688.9	5757.26	4939.74
2004	13682.6	10569.4	3113.2
2005	6733.5	11838.9	-5105.4
2006	9549.23	6255.65	3629.18
2007	31,210.58	22,061.45	9,149.13
2008	48,586.10	36,245.70	12,340.40
2009	110,438.70	106,980.30	3,458.40
2010	213,849.20	161,749.00	54,442.80

Source: Moneycontrol.com

The period 2001-2010 witnessed relatively high debt flows as compared to the preceding periods into currency bond markets owing to low inflation and high global liquidity. FII investments into Debt have been ₹ 790 crore for in the month of October 2010 and ₹ 899.80 crore in the first ten days of November, 2010. Cumulative debt FII flows till 31st November stand at the level of ₹ 7109.30 crore.

GROWTH OF FII INVESTMENTS AND REGISTERED FII IN INDIA**TABLE 3: TABLE SHOWING GROWTH OF REGISTERED FII IN INDIA**

Year	Registered FII
2001	556
2002	482
2003	489
2004	517
2005	639
2006	822
2007	993
2008	1219
2009	1594
2010	1741

Source: SEBI

In 1993, when investments in FIIs were introduced, Pictet Umbrella Trust Emerging Markets' Fund, an institutional investor from Switzerland, was the only FII to enter the Indian market. While no new registrations were reported till 2001 thereafter from 2003, an average of 51 new FIIs began operations in the country each FIIs began operations in the country each year. The graph clearly indicates the steep increase in number of FIIs since the year 2003. Currently, there are 1,741 registered FIIs and 6,164 registered sub registered FIIs and 6,164 registered sub-accounts.

IMPACT OF FII ON STOCK MARKET

CORRELATION OF FII WITH SENSEX CORRELATIONS

	FII	SENSEX
FII Pearson Correlation	1	.423**
Sig. (2-tailed)		.001
N	120	120
SENSEX Pearson Correlation	.423**	1
Sig. (2-tailed)	.000	
N	120	120

** . Correlation is significant at the 0.01 level (2-tailed). 2001-2010

The correlation between FII and SENSEX is significant. This means that the FII inflows influence to a considerable extent on the Sensex volatility. The number of observations considered for this correlation analysis is 120. The observations being the Monthly closing price of Sensex, Monthly FII Net cash inflow. The effect of FII on Sensex is positive, it means if FII increases, the value of sensex also increases. The behaviour of the foreign portfolio investors matched the behaviour of Sensex during this period. Net FII investment in the Indian capital markets started fluctuating sharply during the year 2007 and it turned negative. Net FII investment in the Indian stock market was positive from 2008 to 2010. During this period, the Sensex and net FII investment showed very high degree of correlation. On the whole, there exists a relationship between FIIs.

CORRELATION OF FII WITH NIFTY CORRELATIONS

	FII	NIFTY
FII Pearson Correlation	1	.429**
Sig. (2-tailed)		.001
N	120	120
NIFTY Pearson Correlation	.429**	1
Sig. (2-tailed)	.000	
N	120	120

** . Correlation is significant at the 0.01 level (2-tailed).

The correlation between FII and NIFTY is significant. This means that the FII inflows influence to a considerable extent on the Nifty volatility. The number of observations considered for this correlation analysis is 120. The observations being the Monthly closing price of Nifty, Monthly FII Net cash inflow. FII flows and contemporaneous stock returns are strongly correlated in India. The correlation coefficients between different measures of FII flows and market returns on the National Stock Exchange during different sample periods are shown in Table above. While the correlations are quite significant throughout the sample period, they exhibit a significant rise since the beginning of the 2001-10. The calculations show that there exists a relationship between FIIs and Nifty.

CORRELATION OF NET INVESTMENT IN EQUITY WITH NET INVESTMENT IN DEBT CORRELATIONS

	EQUITY	DEBT
EQUITY Pearson Correlation	1	.251**
Sig. (2-tailed)		.006
N	120	120
DEBT Pearson Correlation	.251**	1
Sig. (2-tailed)	.006	
N	120	120

** . Correlation is significant at the 0.01 level (2-tailed).

The correlation between Net Investment in Equity and Net Investment in Debt is significant. The number of observations considered for this correlation analysis is 120. The observations being the Monthly Net Inflow in Equity, Monthly Net Inflow in Debt. The flow of Equity is considerably more than Debt, during 2009-2010.

CALCULATION OF CO-EFFICIENT OF DETERMINATION

The *coefficient of determination*, r^2 , is useful because it gives the proportion of the variance (fluctuation) of one variable that is predictable from the other variable.

It is a measure that allows us to determine how certain one can be in making predictions from a certain model/graph.

Co-efficient of Determination = r^2

FII with Sensex	0.178
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Only 17.8% of the total variation of FII is explained by the Sensex and the remaining 82.2% is accounted for by something other than Sensex. Similarly, in the case of FII and Sensex we have $r^2 = .178$, indicating that variation in FII explains about 17.8% of the variation in Sensex. 82.2% of the variation in Sensex is unexplained by FII, explainable by other factors, omitted variables, random variation, etc. We shouldn't put too much emphasis on r^2 , t-stat is more important. However, r^2 , or some other measure of goodness of fit is expected in reported empirical results.

FII with Nifty	0.184
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Only 18.4% of the total variation of FII is explained by the Nifty and the remaining 81.6% is accounted for by something other than Nifty. Coefficient of Determination (r^2) ranges from 0 - 1, is always part of the standard regression output, the important measure of goodness of fit. r^2 = correlation coefficient (r) squared, since the range of r is from -1 to +1, squaring r forces r^2 to fall between 0 and 1. r^2 in the above table gives the percentage (%) of the total variation in Nifty that is explained by the regression equation, or explained by FIIs. During the period the total variation in Nifty explained by FII amounted to 18.4% and the remaining 81.6% is explained by other factors which influence Nifty.

CALCULATION OF CO-EFFICIENT OF NON-DETERMINATION

The coefficient of non determination; represents that part of the dependent variable's total variation not accounted for by linear association with the independent variable.

Co-efficient of Non-Determination = $1 - r^2$

FII with Sensex	0.822
FII with Nifty	0.816

CONCLUSION

Results of the study shows that not only the FIIs are the major players in the domestic stock market in India, but their influence on the domestic market is also growing, FII trading is having a higher percentage in the total BSE turnover, from which it can be said that FIIs presence can significantly impact the BSE trading. This paper analyses the impact primarily of FII Inflows on the volatility of the Index (Sensex and Nifty). On the basis of the results from the analysis given above it can be said that the impact of FII cash inflows on the index volatility is significant enough to influence. The correlation between the FII inflow and Sensex, Nifty is positive. Therefore it can be concluded from the analysis that then FII operate only in the index and Blue Chip stocks and Mutual Fund operate in the Non index and non blue chip stocks.

The return on the Indian stock market is considerably high and it is attracting more and more FII. FII's are interested in Indian stock exchanges especially Sensex and Nifty as it constitutes the best most liquid companies in India. So the FII are playing a dominant role in the volatility of the Sensex and Nifty. The investment of FII is more in Sensex and Nifty as compared to other stock exchanges of India. The Purchase and Sale of securities by FII has a bearing on the Sensex and Nifty prices. This is very much evident from the crash of index prices when the FII are very active in selling of securities when they see some economic instability. The domestic institutional investors have to play an active role in the stock market so as to bring the stability in the stock market. The stability of the stock market is important indicator of the economic development.

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