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FOREIGN INSTITUTIONAL INVESTMENTS AND INDIAN CAPITAL MARKET: AN EMPERICAL ANALYSIS

MRS. AMANDEEP KAUR SHAHI
PH.D. SCHOLAR
RAYAT INSTITUTE OF MANAGEMENT
S. B. S. NAGAR, PUNJAB

MS. KRITI AVASTHI,
LECTURER
RAYAT INSTITUTE OF MANAGEMENT
S. B. S. NAGAR, PUNJAB

ABSTRACT

Capital Market plays a vital role in channelizing the savings of individuals for investment in the economic development of the country. The investors are not constrained by their individual abilities, but by the abilities of the companies, which in turn enhance the savings and investments in the Country. This paper examines the impact of Foreign Institutional investors on Indian capital market. This also aims to find out the relationship between the Sensex and Nifty variations with the variation of the investments made by the foreign institutional investors. For the research purpose we selected BSE i.e. Sensex and NSE i.e. S&P CNX Nifty. The sample data of foreign institutional investors consists of their yearly investment trends from January 1999 to June 2009. The sample data of Nifty and Sensex consists of the yearly closing index from December 1998 to June 2009. Regression and Correlation statistical tools are used for the analysis. The study concluded that the movement of Foreign Institutional Investments flows almost a significant influence on the movement of stock market indices when there is an upward trend in FIIs due to greater buying, Sensex and Nifty also rises on the other hand.

KEY WORDS
Capital Market, Foreign institutional Investors, Investment Trends, Nifty and Sensex.

INTRODUCTION
Capital market plays a vital role in channelizing the savings of individuals for investment in the economic development of the country. The investors are not constrained by their individual abilities, but by the abilities of the companies, which in turn enhance the savings and investments in the Country. Liquidity of Capital Market is an important factor affecting growth. Since projects require long term finance, but on the other hand, the investors may not like to relinquish control over their savings for a long time. A liquid stock market ensures a quick exit without incurring heavy losses or costs. Thus development of efficient market system is necessary for creating conductive climate for investment and economic growth. The capital markets consist of the primary market, where new issues are distributed to investors, and the secondary market, where existing securities are traded. The Indian Equity Markets and the Indian Debt markets together form the Indian Capital market.

The Indian Equity Market depends mainly on monsoons, global funds flowing into equities and the performance of various companies. The Indian Equity Market is almost wholly dominated by two major stock exchanges -National Stock Exchange of India Ltd. (NSE) and The Bombay Stock Exchange (BSE). The major players in the Indian Equity Market are Mutual Funds, Financial Institutions and FIIs representing mainly Venture Capital Funds and Private Equity Funds. India opened its stock market to foreign investors in September 1992 and has, since 1993, received portfolio investment from foreigners in the form of foreign institutional investment in equities. This has become one of the main channels of FII in India for foreigners. In order to trade in Indian equity market foreign corporations need to register with SEBI as Foreign Institutional Investor (FII). India allows only authorized foreign investors who are referred to as FII's and which are registered with a statutory authority in their own country of incorporation or settlement. It is possible for foreigners to trade in Indian securities without registering as an FII but such cases require approval from the RBI or the Foreign Investment Promotion Board. FII generally concentrate in secondary market. Initially, there were many terms and conditions which restricted many FIIs to invest in India. But in the course of time, in order to attract more investors, SEBI has simplified many terms such as: -

The ceiling for overall investments of FIIs was increased to 24% of the paid up capital of Indian company.
Allowed foreign individuals and hedge funds to directly register as FIIs.
Investment in government securities was increased to US $ 5 Billion.
Simplified registration norms.

REVIEW OF LITERATURE
Mukherjee, Bose and Coondoo (2002) found that FII's activities exert a strong demonstration effect and thus drive the domestic stock market in India, evidence from causality tests suggests that FII flows to and from the Indian market tend to be caused by return in the domestic equity market and not the other way round.

Gordon & Gupta, (2003) found that foreign investor could play a role of market makers and book their profits that is they can buy financial assets when the prices are declining thereby jacking-up the asset prices and sell when the asset prices are increasing. They found that there is a possibility of bi-directional relationship between FII and the equity returns.

Kumar (2006) examined that an important feature of the development of stock market in India in the last 15 years has been the growing participation of Institutional Investors, both foreign institutional investors and the Indian mutual funds combined together, the total assets under their management amounts to almost 18% of the entire market capitalization.

Shromon (2007) mentioned spectacular rise of the Sensex over the past few months and it also shows how volatile FII flows are. It is almost impossible to predict whether FIIs will be net sellers or net buyers tomorrow. What is more important is that there is no rigid relationship between the Sensex and FII flows.

Aravind, Raghavendra & Philip (2008) found that FII's has a major impact in Indian stock market. Particularly, the fall on October 17, 2007, in which just a speculation about governments plan to control P-Notes had caused the biggest fall in Indian stock market, even market had to be closed for one hour without trade.. They also found that the major (almost 50%) of FIIs' investments are from P-Notes. This has a negative impact on stock market.

Gupta and Kawatra (2008) explained the reason behind the major downfall in Indian stock market on January 21, 2008 and March 3, 2008. The major reason behind the fall of 1408 points in sensex on January 21, 2008 was the panic selling of shares by the FIIs

Parakh (2008) analyzed the role of FIIs in Indian Stock Market. The flow of FIIs is increasing every year. The study found that FII's cash inflows increase the market indices and cash outflows decreases the Indian stock market indices. This is the way FII is supplementing volatility in Indian market.

Prasanna (2008) found the reaction of the stock market when SEBI imposed a ban on Participatory Notes (PN) and mandated registration of FIIs. Since the Fed rate cut on September 18, 2007, FIIs have consistently invested in Indian stock markets. To check the increase surge of this capital flow, the Indian capital market regulator authority, SEBI showed its strong intent to introduce capital controls and check capital inflows in the long run.

Chand (2009) launched The INSTANEX FII INDEX in India to tracks the price performance of the portfolio of listed Indian equity shares owned by FIIs. The Index comprises of the top 15 companies by value of FII holdings. Reviews are conducted quarterly and companies are deleted from the Index if they are not among the top 20 FII holdings. The study found that, in March, FIIs have increased their investing activity and out of the 15 components, 13 showed the heightened interest of the FIIs determine the direction of the market. They are also the most successful portfolio investors in India with 102 per cent appreciation since September 30, 2003.

THE OBJECTIVES OF THE STUDY

First is to Study the impact of Foreign Institutional Investors on the Indian capital market and second is to find the relationship between the FIIs investment and stock indices.

Null Hypothesis (Ho): The BSE index Sensex and S&P CNX Nifty index does not rises with the increase in FIIs investment.

Hypothesis (H): The BSE index Sensex and S&P CNX Nifty index rises with the increase in FIIs investment.

METHODOLOGY

Sources of Data: Secondary data is collected from BSE i.e. Sensex and NSE i.e. S&P CNX Nifty.

Period of Study: The sample data of Foreign Institutional Investments consists of the Yearly investment from December 1999 to June 2009. The sample data of Nifty and Sensex consists of the yearly closing index December 1998 to June 2009.

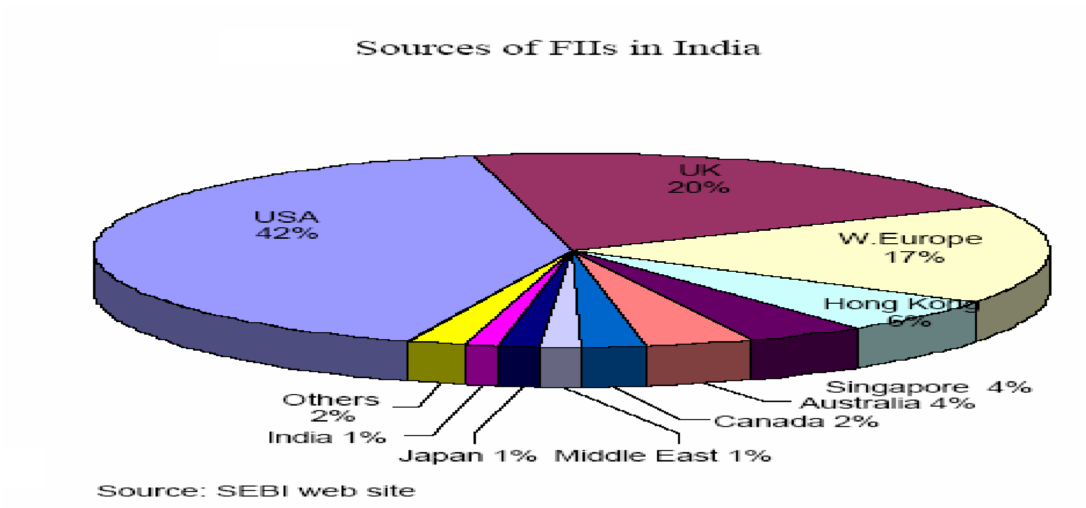
Statistical Tool: A simple linear relationship has been shown between two variables using correlation and regression as the data analysis tools. FIIs have been taken as the independent variables while the stock index has been taken as dependent variables.

SOURCES OF FOREIGN INSTITUTIONAL INVESTORS IN INDIA

FIIs is used to denote an investor - mostly of the form of an institution or entity, which invests money in the financial markets of a country different from the one where in the institution or entity was originally incorporated. FII investment is frequently referred to as hot money for the reason that it can leave the country at the same speed at which it comes in. In countries like India, statutory agencies like SEBI have prescribed norms to register FIIs and also to regulate such investments flowing in through FIIs are as Pension Funds, Mutual Funds, Investment Trust, Insurance or reinsurance companies , Endowment Funds , University Funds, Foundations or Charitable Trusts or Charitable Societies, Asset Management Companies, Nominee Companies , Institutional Portfolio Managers, Trustees, Power of Attorney Holders and Banks.

The sources of these FII flows are varied. The FIIs registered with SEBI come from as many as 28 countries (including money management companies operating in India on behalf of foreign investors). US-based institutions accounted for slightly over 42%; those from the UK constitute about 20% with other Western European countries hosting another 17% of the FIIs. It is, however, instructive to bear in mind that these national affiliations do not necessarily mean that the actual investor funds come from these particular countries. Given the significant financial flows among the industrial countries, national affiliations are very rough indicators of the 'home' of the FII investments. In particular institutions operating from Luxembourg, Cayman Islands or Channel Islands, or even those based at Singapore or Hong Kong are likely to be investing funds largely on behalf of residents in other countries. Nevertheless, the regional breakdown of the FIIs does provide an idea of the relative importance of different regions of the world in the FII.

Figure 1. Sources of FII's in India



MAJOR FOREIGN INSTITUTIONAL INVESTORS

FIIs are playing an important role in the Indian capital market by making investment. Major players are Deutsche group, Citigroup, HSBC global investments, Merill lynch capital markets etc.

Figure 2. Major Foreign Institutional Investors

GLOBAL PLAY IN INDIAN MARKETS

Holdings of world's top investment banks and brokerages in Indian firms*.

	No. of companies	Value (in Rs crore as on 19 Mar)
Deutsche group	84	33,579.37
Citigroup	184	23,890.38
HSBC Global Investments	126	18,074.74
Morgan Stanley and Co. International	154	16,638.36
Merrill Lynch Capital Markets	142	15,130.72
CLSA Asia-Pacific	42	9,146.96
Goldman Sachs Investments Mauritius	104	7,307.17
JPMorgan Chase	20	6,835.11
UBS Securities Asia Ltd**	88	5,847.64
Bear Stearns Asset Management Ltd	86	2,490.76
ABN Amro NV	45	1,580.72
Lehman Brothers Asia Ltd	14	439.35

*As on 31 Dec. Only 1% or above stakes are taken into account

**With its subsidairy Swiss Finance Corp. (Mauritius) Ltd

Source: Capitaline

Source-Capital line

- **DEUTSCHE GROUP** is a part of Deutsche Asset Management, was founded in 1956 in Frankfurt/Main. With fund assets under management of euro 267 bn, the company is **one of the Top 10 companies worldwide.** In Europe, DWS is one of the leading mutual fund companies and currently manages euro 173 bn. In excess of more than euro 147 bn assets under management, DWS represents 22, 3% of the fund market **in Germany,** making it the **unchallenged number one.** The International nature of its business differentiates DWS significantly from its domestic and international competitors. DWS Investments' activities span all the key European markets. In the USA, DWS is represented by DWS Scudder and manages assets of euro 86 bn. In spring 2006, it launched its first funds as well as the DWS brand in Singapore and India, continuing its **successful expansion in the Asia-Pacific region.** Thereafter, more funds were registered in other countries in Asia-Pacific.
- **CITIGROUP** formed in 1998 created a new model of financial services organization to serve its clients' financial needs. As the company continues to grow and evolve, it's increasingly evident that such a large, complex grouping of businesses can indeed succeed. With 275,000 employees working in more than 100 countries and territories, Citigroup's globality and diversity contribute to its continued success.
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- **MORGAN STANLEY & CO INTERNATIONAL LTD** is a global financial services firm and a market leader in securities, investment management and credit services. It has more than 600 offices in 27 countries and manages $421 billion in assets for institutional and individual clients around the world. Stanley Investment Management (MSIM), the asset management company of Morgan Stanley was established in 1975. Morgan Stanley entered Indian market in 1989 with the launch of India Magnum Fund. In 1994, Morgan Stanley launched Morgan Stanley Growth Fund (MSGF). It is one of the largest private sector schemes investing in equities.
- **DSP MERRILL LYNCH** Mutual Funds are managed by DSP Merrill Lynch Fund Managers. DSP Merrill Lynch Ltd. (DSPML) is a premier financial services provider and Merrill Lynch (ML) holds 90% stake in DSPML. DSPML was originally called DSP Financial Consultants Ltd. The firm traces its origins to D. S. Purbhoodas & Co., a securities and brokerage firm with over 140 years of experience in the Indian market. Merrill Lynch is one of the world's leading wealth management, capital markets and advisory companies with offices in 37 countries and territories and total client assets of approximately $1.5 trillion.

SEBI GUIDELINES FOR FIIS

The SEBI is the nodal agency for dealing with FIIs, and they have to obtain initial registration with SEBI. The registration fee is $10,000. For granting registration to an FII, the SEBI takes into account the track record of the FII, its professional competence, financial soundness, experience and such other criteria as may be considered relevant by SEBI. Besides, FIIs seeking initial registration with SEBI will be required to hold a registration from an appropriate foreign regulatory authority in the country of domicile/incorporation of the FII. The broad based criteria for FII registration has recently been relaxed. An FII is now considered as broad based if it has at least 20 investors with no investor holding more than 10 per cent of shares/units of the company/fund. The SEBI's initial registration is valid for five years. The Reserve Bank of India's general permission to FIIs will also hold good for five years. Both will be renewable. There are approximately 506 FIIs registered with SEBI, but not all of them are active.

- FIIs can invest in all securities traded on the primary and secondary markets. Such investments include equity/debentures/warrants/other securities/instruments of companies unlisted, listed or to be listed on a stock exchange in India including the Over-the-Counter Exchange of India, derivatives traded on a recognized stock exchange and schemes floated by domestic mutual funds. A major feature of the guidelines is that there are no restrictions on the volume of investment - minimum or maximum - for the purpose of entry of FIIs. There is also no lock-in period prescribed for the purpose of such investments.
- Further, FIIs can repatriate capital gains, dividends, incomes received by way of interest and any compensation received towards sale/renouncement of rights offering of shares subject to payment of withholding tax at source. The net proceeds can be remitted at market rates of exchange.
- All secondary market operations would be only through the recognized intermediaries on the Indian stock exchanges, including OTCEI. Forward exchange cover can be provided to FIIs by authorized dealers both in respect of equity and debt instruments, subject to prescribed guidelines. Further, FIIs can lend securities through an approved intermediary in accordance with stock lending schemes of SEBI.

NET INVESTMENT OF FIIS FROM 1992-2009

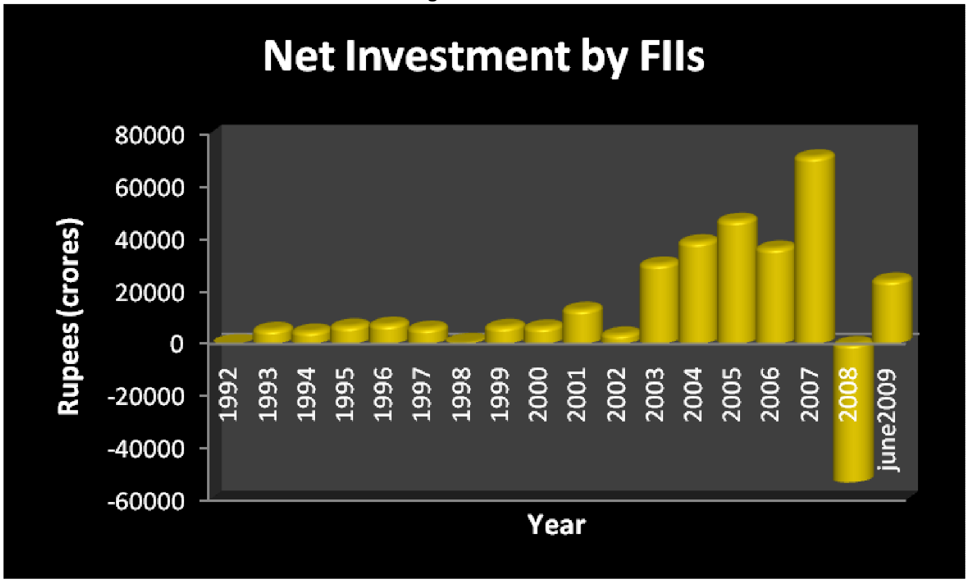
The following figure depicts the net investment by FIIS from their entrance into the Indian capital market from 1992 till June 2009.

Table- 1 Net Investments of FII from 1992-2009

Year	Net Investments (Rs Cr.)
1992	4.27
1993	5444.60
1994	4776.60
1995	6720.90
1996	7386.20
1997	5908.45
1998	729.11
1999	6578.40
2000	6369.9
2001	13128.2
2002	3629.6
2003	30458.7
2004	38965.1
2005	47181.2
2006	36539.7
2007	71486.5
2008	-52987.1
2009 (June)	24303.5

Source-sebi.gov.in

Figure 3. Net Investments of FII from 1992-2009



FIIS made their entry in Indian capital market in the year 1992 with Rs. 4.27 crores of investment. In the year 1993 they have improved their stake by making investment of 5444.60 crores. With the passage of time foreign investment has increased so much that Indian market started depending on it. As the investment by FIIs is increased it started putting positive impact on to the market and when FIIS started withdrawing their money from market, market fells down. Is clearly seen from table 1 that in the year 2007 investment by FIIs was Rs 71486.5 crores and this was the period when market touched 21K and when they had started withdrawing investment in the year 2008 then it put negative impact on to the market. As we can see in the investment trends table 1 except for 2008, the net investment by the FIIs in the Indian market has always been positive since liberalization which to a large extent tells about the consistency of their presence in Indian market. This is also evident from the fact that the number of FII registering in India is increasing in spite of the fact that SEBI has declined to issue any further Promissory Notes and also asked them to get registered. This shows that India still remains the hot spot for the foreign investors in the coming years.

STATISTICAL ANALYSIS

For the purpose of statistical analysis we have considered 9 yrs data of FII Net Investments, NSE S&P CNX Nifty and BSE Sensex Indices. Statistical Analysis is carried out to find the degree of association between the Net investments by the Foreign Institutional Investors with the capital market i.e. (Sensex & Nifty indices). Since 9 years data is a very comprehensive data and the internal and the extraneous factors have been changing over the time which does have impact on the Indian capital market. We have applied correlation and regression analysis to find out the degree of association among the FII Net Investments and the Sensex. Similarly the degree of association is been calculated for Nifty index with FII's.

In order to trade in Indian equity market foreign corporations need to register with SEBI as Foreign Institutional Investor (FII). India had 506 FIIs registered with SEBI by end of 2000 and as on 30th June 2009 is 1668 (sebi.gov.in). In order to study the impact of FII in Indian Capital Market, Now we can do the analysis to study the impact of FIIs on Capital Market.

Table 2 Analysis of Net Investment by FIIs, Sensex and Nifty from December 1999 to December 2007

Year	Net Investment by FIIs (in cr.)	Sensex	Nifty
1999	6578.40	5005.82	1480.45
2000	6369.9	3972.12	1263.55
2001	13128.2	3262.33	1059.05
2002	3629.6	3377.28	1093.5
2003	30458.7	5838.96	1879.75
2004	38965.1	6602.69	2080.5
2005	47181.2	9397.93	2836.55
2006	36539.7	13786.91	3966.4
2007	71486.5	20286.99	6138.6

Source: www.bse.com, www.nse.com

Table 2 shows net investment made by FIIs, Sensex and Nifty from 31st December 1999 to 31st December 2007. As the table depicts that in year 1999 investment by FIIs was around 6578 crores and sensex was at 5005 points. In year 2003 FIIs investment was around Rs. 30458 crores and it has increased to Rs 47181 crores in year 2005 it means in these two years there is an increase in FIIs investment by Rs 16723 crores and market also behaves respectively. In this period Sensex was also increased by 3559 points and Nifty increased by 957 points. In year 2007, FIIs investment has increased to around Rs 71486 crores and it also depicts an increase in Sensex and Nifty figure. At this point of time Sensex and Nifty indices were near to its life time high around 20286 and 6138 Points respectively.

EMPIRICAL ANALYSIS

	Correlation with FII	R square	Standard Error	Significance
BSE Sensex	.881	.777	2891.45908	.002
NSE Nifty	.894	.799	806.26558	.001

The analysis shows the results from year 1999 to year 2007 and correlation value is .881 between FIIs and Sensex, as .894 between FIIs and Nifty. It depicts that Foreign Institutional investors has an influence on Sensex, Nifty and market's direction. As we can see the degree of association is around 77% among FII and Sensex, 79% between FIIs and Nifty. It means that Sensex and Nifty is highly dependent on FIIs investment. The result analysis that, as the FIIs invests in the market, it behaves accordingly.

Year	Net Investment by FIIs in cr.	Sensex	Nifty
2008	-52987.1	9647.31	2959.15
June 2009	24303.5	14493.84	4291.10

As we see the results of analysis from 1999-2007 that with the increase in the investment by FIIs market goes upward likewise in the year 2008 when FIIs started withdrawing their money steadily around 52000 crores from the market then market showed downward trend to 9647 points from 21000 points from BSE Sensex and around 3000 points from Nifty . Again when FIIs started investing money in year 2009, capital market goes upward. As FIIs increased their investment up to Rs. 24303 crores till June, Sensex goes to 14493 points and Nifty goes to 4291 points. It is examined from the study that there is an impact of investment made by the Foreign Institutional investors on stock market Indices i.e. SENSEX and NIFTY. According to this study we found that SENSEX and NIFTY are highly dependent on the investment made by FIIs.

FINDINGS

- In India there is a continuous increase in number of Registered FIIs and with that there is an increase in the Foreign Institutional Investments flows till December 2007.
- Foreign Institutional Investments and movement of Sensex and Nifty are closely correlated in India. The movement of Foreign Institutional Investments flows almost a significant influence on the movement of stock market indices when there is an upward trend in FIIs due to greater buying, Sensex and Nifty also rises on the other hand.
- The high degree of volatility in Capital market can be attributed to the Foreign Institutional Investments.

RECOMMENDATIONS

After analyzing the nature and behavior of the foreign institutional investment in the past and its influence on the Indian capital market it would be safe enough to say that foreign funds are one of the most volatile instruments floating in the market and needs to be handled cautiously. Government should certainly encourage foreign institutional investment but should keep a check on the volatility factor. Long term funds should be given priority and encouraged some of the actions that could be taken to ensure stability are strengthening domestic institutional investors, broad basing of eligible entities, Knowledge activities and research programs.

CONCLUSION

According to the findings and results, we concluded that FIIs have significant impact on the Indian capital market. Therefore the hypothesis is accepted. Foreign Investments are influencing the Indian market but the extent of this influence cannot be determined or rather the extent of India's dependence on the FIIs is a subjective issue as on no clear grounds can we see a permanent relationship between the stock market returns and the foreign inflows. But to generalize they have shown a positive relation most of the time apart from a few occasions where the behavior of their relation was difficult to explain.

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Thanking you profoundly

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Editor