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ROLE OF FOREIGN INSTITUTIONAL INVESTORS IN INDIA: AN INVESTIGATION

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ABSTRACT

Initiation of reform process in early 1990's transformed India's policy stance on development strategy completely. Initial approach of financing current account deficit mainly through debt flows and official development assistance has changed to harnessing non-debt creating capital flows. Under this strategy from September 14, 1992; Foreign Institutional Investors (FIIs) were permitted to invest in financial instruments in India. Since then Indian financial markets have changed substantially in its size, depth and character. In this period, Indian and world markets have seen good times and periods of crises both on external fronts and in financial markets. This paper tries to evaluate role of FIIs in Indian markets due to increasing share of FIIs in financial markets in India.

KEYWORDS

Indian financial market, foreign institutional investors (FII), investment.

1. INTRODUCTION

In globalised economy global integration take place through money flow. Money flow can be of two type i.e. foreign direct investment (FDI) and Foreign Institutional Investment (FII) which is essential for globalisation.** FDI is in the form of direct investment in the business, useful for the production of goods or providing services. "Foreign Institutional Investor" means an institution established or incorporated outside India which proposes to make investment in India in securities (SEBI Regulation, 1995). FII invest in financial markets like money market, stock market and foreign exchange market. Thus, it is very important for the country to maintain continuous inflow from FII in financial market. **Foreign direct investment (FDI) and Foreign Institutional Investment (FII) are the channels through which developing country get access capital in terms of foreign currency. It also helps them to increase in their foreign exchange reserve.**
Rational capital allocation looks for the opportunity. At the same time developing countries are facing capital scarcity as major road block in their development. India being developing economy depends upon capital flow from overseas for its development and moved towards liberalize economic policy. Since 1991 India has taken several steps to attract capital inflow, as result substantial investment from foreign institutional investors have been made.
In year 2011-12 Indian stock markets gave the second highest returns globally, driven largely by higher inflows from foreign institutional investors (FII) **(Economic Survey, 2012-13)**. This faith of FII in Indian financial market could be considered as upbeat indication for the potentials of Indian economy as well as the probable boost to industrial as well service sector in India. Table 1 shows the corroboration increase in inflow of FII. It shows yearly net flow (INR in Crores) of FII in Indian capital market from 1992-93 to 2013-14.

TABLE 1: FII FLOW FROM 1992 – APRIL 2014

Financial Year	Equity	Debt	Total	Financial Year	Equity	Debt	Total
1992-93	13	0	13	2004-05	44,123	1,759	45,881
1993-94	5,127	0	5,127	2005-06	48,801	-7,334	41,467
1994-95	4,796	0	4,796	2006-07	25,236	5,605	30,840
1995-96	6,942	0	6,942	2007-08	53,404	12,775	66,179
1996-97	8,546	29	8,575	2008-09	-47,706	1,895	-45,811
1997-98	5,267	691	5,958	2009-10	110,221	32,438	142,658
1998-99	-717	-867	-1,584	2010-11	110,121	36,317	146,438
1999-00	9,670	453	10,122	2012-13	140,033	28,334	168,367
2000-01	10,207	-273	9,933	2013-14	79,709	-28,060	51,649
2001-02	8,072	690	8,763	2014-15 **	9,602	-9,185	418
2002-03	2,527	162	2,689	** upto April 30, 2014			
2003-04	39,960	5,805	45,765				

Source: http://www.sebi.gov.in/sebiweb/investment/statistics.jsp?s=fii

2. LITERATURE REVIEW

2.1 LITERATURE REVIEW ON POSITIVE ROLE OF FII

FII work on strengths of developing countries and then they invest in respective countries. This also helps developing countries to know about their strengths and opportunities available. Hence they can work upon their strengths to make them strengthen and encash opportunities. O'neil (January, 2014) has studied few of the important aspect related to MINTs while stating their advantages. Mexico was fortunate to be next to the United States while Indonesia was in a prime position as it is in Southeast Asia; the centre of global growth in recent years, and ties to China (Klimes & O'Neil, 2014). Three of the Mints including Mexico, Indonesia and Nigeria are also commodity producers. O'neil also noted reforms in energy market in Mexico and Nigeria. This analysis show various important components for the growth potential are Geographic Location, Tie-up with fast growing countries, Manufacturing basic commodities and reforms in infrastructures.
Flow of foreign investment plays important role in boost of economic growth as well as financial markets of developed as well developing countries. As a result inflow of Foreign Direct investments has become a striking measure of economic development in both developed and developing countries (Sultana & Pardhasaradhi, 2012). They stated that FDI and FII have become instruments of international economic integration and stimulation. At onset of FDI, Fast growing economies like Singapore, China, and Korea etc have registered incredible growth. They finally concluded that the impact of flow of FDI & FII on Indian stock market is significant.
When there would be good amount of fund flow in market it also provides good amount of liquidity in financial system. Sing (2011) stated that FII investment in India helped in achieving a higher degree of liquidity at domestic stock market; it had increased price earnings ratios and finally reduced the cost of capital for investment. Along with this they also help in improving the functioning of the domestic stock market.

When any country has more suitable regulatory environment it provides opportunity to institutional investors for investment than other country. Different financial institutions viz. mutual funds, banks, insurance companies, pension funds and foreign institutions have different investment objectives. Depending on their investment objectives and the regulatory environment, their influence firm performance is dissimilar. For example, while there are regulatory restrictions for banks to invest in a firm's equity in the US; they are the largest shareholders in Germany and Japan; and also have a significant participation on management's actions (Johnson et al., 2010).
Foreign investment also motivates domestic companies to perform better. FII invest more systematically than retail investors and analysis various aspects of various organisations. Kim and Yi (2006) studied a large sample of firms in the Korean market and found evidence that foreign investors look at firm-specific data in making investment decisions. Bushee and Noe (2000); Chung et al. (2002); McCahery et al. (2010) and Chung and Zhang (2011) reported that institutional investors choose such companies with better corporate governance practices. But in contrast, Chang (2010) argued that in emerging markets the foreign investors may lack expertise in local environment which might lead to informational disadvantage.
To invite foreign investment Government have to provide them rigor platform in terms of regulations and policies. Thus overall government regulations also improve through FII. With the growth in institutional investment in equity markets around the world, financial institutions have become the largest investor group in many countries; and are observed mostly in countries with stronger regulatory and governance structure (Li et al., 2006).
FII provides stability to financial market. They also provide systematic analysis and sophisticated tools for investment. Mukherjee and Ghosh (2004) found that among the institutional investors, FIIs show consistency in stock picking as compared to DFIs who are sporadic and volatile.

2.2 LITERATURE REVIEW ON NEGATIVE ROLE OF FII

Once when emerging countries get fund from FII that does really make them independent for their growth. It has been found that these countries become habituated to get fund from FII for their growth. The 'Fragile Five' Turkey, Brazil, India, South Africa and Indonesia as economies that have become too dependent on skittish foreign investment to finance their growth ambitions (James Lord, Morgan Stanley reported in New York Times January, 2014).
FII always look for better opportunity and their flow moves from country to country, as they also want to maximize their return on investment. O'Neill has identified Mexico, Indonesia, Nigeria, and Turkey (Mint) as the new frontier of the global economy. Mint has potential to replace the emergent Bric economies of Brazil, Russia, India and China (Klimes & O'Neil, 2014)***. O'Neill (2001) suggested Brazil, Russia, India and China (BRIC) as emerging market on the basis of opportunities for new investments. As per*** IMD WORLD COMPETITIVENESS YEARBOOK 2013***, also India's ranking in competitive position has come down from 27 to 40 among 60 countries.***
It has been observed that many times FII withdraw their funds in crucial time when developing countries really need their support. Even sometimes external forces also affect FII flow, which is not under control of developing countries. ***Vishnoi (February 3, 2014) has mentioned in his article that*** although India is seen in a better position than other countries such as Turkey due to its improved current account deficit and foreign exchange reserves, the country is being hit nonetheless. Indian markets will thus continue to be beholden to global risk factors, including concerns about the Federal Reserve's withdrawal in monetary stimulus and an economic slowdown in China. FII inflows to India are essentially determined by exchange rate, domestic inflation, domestic equity market returns, returns and risk associated with US equity market (Srinivasan & Kalaivani, 2013).
When FII dominate financial market they influence trend of market significantly. If at that time their investment behaviour would not be rational then overall market may get dragged in wrong direction. Chen, Vang & Lin (2008) identify qualified foreign institutional investors (QFIIs) in Taiwan herd when picking stocks. The evidence shows that QFIIs herd in Taiwan's securities market: They follow each other into and out of the same securities. They herd on securities classified in specific industries and also prefer stocks with high past returns as well as large firm size, supporting the argument that QFIIs are momentum traders. Characteristic herding and investigative herding explain QFIIs' trading behavior in Taiwan.

3. FII IN INDIA

Until the 1980s, India's policy towards development was paying attention on self-reliance and import-substitution. Current account deficits were financed largely through debt flows and official development assistance. There was reluctance towards foreign investment or private commercial flows. From 1990s there is substantial change through reform, with a focus on exploiting the growing global foreign direct investment (FDI) and portfolio flows. The broad approach to reform in the external sector after the Gulf crisis was delineated in the Report of the High Level Committee on Balance of Payments (Chairman: C. Rangarajan). It recommended, inter alia, a compositional shift in capital flows away from debt to non-debt creating flows; strict regulation of external commercial borrowings, especially short-term debt; discouraging volatile elements of flows from non-resident Indians (NRIs); gradual liberalization of outflows; and dis-intermediation of Government in the flow of external assistance (Indian Securities Market A Review, 2010).
After the reforms in the early 1990s, there was a gradual shift found towards capital account convertibility. FIIs and Overseas Corporate Bodies (OCBs) were permitted to invest in financial instruments on **September 14, 1992**. As per the guidelines from September 14, 1992 FIIs have to obtain an initial registration with SEBI and also RBI's general permission under FERA for five years and were to be renewed after that period. This permission allows FII to buy, sell and realize capital gain on investment in Indian stock exchanges. For this they are required to appoint domestic custodian and a designated bank, as it is required for cash transaction and securities related transactions. The Government guidelines of 1992 also provided for eligibility conditions for registration, such as track record, professional competence, financial soundness and other relevant criteria, including registration with a regulatory organisation in the home country (Indian Securities Market A Review, 2010).
Foreign Institutional Investors define under a particular regulation. As per Securities and Exchange Board of India (Foreign Institutional Investors) Regulations, 1995 "Foreign Institutional Investor" means an institution established or incorporated outside India which proposes to make investment in India in securities". Investment by SEBI registered FIIs is regulated under SEBI (FII) Regulations, 1995 and Regulation 5(2) of FEMA Notification No.20 dated May 3, 2000, as amended from time to time. FIIs include Asset Management Companies, Pension Funds, Mutual Funds, and Investment Trusts as Nominee Companies, Incorporated / Institutional Portfolio Managers or their Power of Attorney holders, University Funds, Endowment Foundations, Charitable Trusts and Charitable Societies.
Further time to time developments related to FIIs are as follow:
Union Budget, 2001–02 proposed Foreign Institutional Investors (FIIs) can invest in a company under the portfolio investment route up to 24% of the paid up capital of the company. This can be increased to 49% with the approval of the general body of the shareholders by a special resolution as per RBI guidelines and FEMA. These regulations were amended in September 2001 to provide that the limit of 24% can be increased up to the sectoral cap/statutory ceiling, as applicable, provided this has the approval of the Indian company's board of directors and also its general body.
In Year 2002 FIIs permitted to invest in government securities. In **February 2000** Foreign firms and high networth individuals permitted to invest as sub-accounts of FIIs. Domestic portfolio manager allowed to be registered as FIIs to manage the funds of sub-accounts. The objective was to allow operational flexibility, and also to give access to domestic asset management capability.
AMENDMENT TO SEBI (FII) (SECOND AMENDMENT) REGULATIONS 2003 (http://www.sebi.gov.in/acts/act07a.html)
The SEBI (Foreign Institutional Investors) Regulations has been amended by the SEBI to include the new clauses as stated herewith. The FIIs should fully disclose information concerning the terms of and parties to off-shore derivative instruments such as Participatory Notes (P-Notes), Equity Linked Notes (ELN) or any other such instruments listed or proposed to be listed. The code of conduct has also been specified which states that (a) a FII and its key personnel should observe high standards of integrity, fairness and professionalism in all their dealings with intermediaries, regulatory and other government authorities in the Indian securities market. They should, at all times, render high standards of service, exercise due diligence and independent professional judgment (b) a FII should ensure and maintain confidentiality in respect of trades done on its own behalf and/or on behalf of its sub-accounts/clients. There should be clear segregation of its own money/securities and sub-accounts' money/securities; arms length relationship should be maintained between its business of fund management/investment and its other business (c) a FII should maintain an appropriate level of knowledge and competency and abide by the provisions of the Act, regulations made there under and the circulars and guidelines applicable and relevant to them. Every FII should also comply with award of the Ombudsman and decision of the Board under SEBI (Ombudsman) Regulations, 2003 (d) a FII should not make any untrue statement or

suppress any material fact in any documents, reports or information furnished to the Board (e) they should ensure that good corporate policies and corporate governance are observed and do not engage in fraudulent and manipulative transactions in the securities listed in any stock exchange in India (f) a FII and/or any of its affiliates should not indulge in any insider trading, should not be a party to or instrumental for creation of false market in securities listed or proposed to be listed in any stock exchange in India. They should not be involved in price rigging or manipulation of prices of securities listed or proposed to be listed in any stock exchange in India.

In **December 2003** the FII dual approval process of the SEBI and the RBI changed to a single approval process of the SEBI. The objective was to streamline the registration process and reduce the time taken for registration.

The **Union Budget for 2004 -05** proposed the procedure for registration and operation of FIIs is to be made simpler and quicker. The investment ceiling for FIIs in debt funds have been raised to US$ 1.75 billion from US$ 1 billion. In **February 2004**, SEBI amended the SEBI (FII) Regulations, 1995 to include a new regulation which states that "a FII or sub-account may issue, deal in or hold, offshore derivative instruments such as Participatory Notes (P-Notes), Equity Linked Notes (ELN) or any other similar instruments against underlying securities, listed or proposed to be listed on any stock exchange in India, only in favor of those entities which are regulated by any relevant authority in the countries of their incorporation or establishment, subject to compliance of "Know your client" requirement, provided that if any such instrument has already been issued, prior to February 2004, to a person other than a regulated entity, contract for such transaction should expire on maturity of the instrument or within a period of five years from February 3, 2004 whichever is earlier".

In **November 2004** outstanding corporate debt limit of US $ 0.5 billion prescribed. The objective was to limit short-term debt flows.

The **Union Budget for 2006-2007** proposed limit on FII investment in Government securities to be increased from $ 1.75 billion to $ 2 billion, and limit on FII investment in corporate debt from $ 0.5 billion to $ 1.5 billion. As mentioned in Circular NO. IMD/FII/20/2006 the Government of India has raised the cumulative debt investment limits from US$1.75 billion to US$2 billion and US$1.5 billion for FII/Sub Account investments in Government securities and Corporate Debt, respectively. These limits are separate and not fungible. The following shall be applicable:

TABLE 2: REVISED LIMIT OF FII AFTER BUDGET 2006-07 (Figures in USD Billion)

Revised limit	100% debt	70:30	Total permissible
Govt. securities/ t-bills	1.75	0.25	2.00
Corporate debt	1.35	0.15	1.50
Total			**3.50**

In **November, 2006** FII investment upto 23percent permitted in market infrastructure institutions in the securities markets, such as stock exchanges, depositories, and clearing corporations. This was a decision taken by the government following the mandating of demutualization and corporatization of stock exchanges.

The Committee on Fuller Capital Account Convertibility submitted its report in July 2006 with some recommendations pertaining to FII segment and NRIs:

i) The limit of FII Investment in Government Securities could be gradually raised to 10 percent of gross issuance by the Centre and States by 2009-10. The allocation by SEBI of the limits between 100 percent debt funds and other FIIs should be discontinued.
ii) FII investment limits in government bonds to be increased in 3 phases up to 6, 8 and 10 percent of total gross issuance by Centre and States in a year.
iii) FII investment limit in corporate bonds to be increased to 15 and 25 % of fresh issuance in phase II and phase III.
iv) FIIs to be prohibited from investing through promissory Notes (PN); existing PN-holders to be phased out.
v) Foreign institutions to be allowed to raise rupee bonds, subject to a ceiling.
vi) Repo facility in Government facility should be widened by allowing all market players without any restrictions.
vii) Non-resident investors, especially longer term investors, could be permitted entry without any restrictions.

Gross Purchases and Gross Sales by FIIs increased in the 2006-07 as compared to 2005-06. The cumulative net FII investment touched Rs. 2,181,376 million (US $ 51,967 million) by end March 2007. The strong risk adjusted returns of the Indian market have led FIIs to make more allocations to India. A FII net investment was highest during the month of November 2006, amounting to Rs. 101,860 million. (US $ 2,213 million). The month of May 2006 witnessed the largest single-month pull-out of FII funds, when FII withdrew over Rs.66, 470 million (US $ 1,473 million). During the same month, Nifty 50 saw a decline of 13.68 %. The correlation coefficient between net investment by FIIs and NSE Nifty 50 during 2006-07 was 0.29 percent.

Though the volume of trades done by FIIs is not very high as compared to other market participants, to a considerable extent, they are the driving force in determination of market sentiments. The FIIs registered net investments of Rs. 308,410 million (US $ 6,708 million) in year 2006-07 as against Rs.394, 660 million (US $ 9,334 million) during the previous year 2005-06.

In **January 2007**, these limits were further enhanced. The existing limit of US $ 2 billion available for investment by FIIs in Government Securities/ T-Bills was raised to US $ 2.60 billion. The incremental limit of US $ 0.6 billion was added to the existing headroom of US $ 55 million available for investment by 100% debt FIIs in Government Securities/ T-Bills. The enhanced limit was allocated among the 100% debt and general 70:30 FIIs/ Sub-Accounts in the following manner.

TABLE 3: REVISED LIMIT OF FII AFTER BUDGET 2007-08 (Figures in USD Billion)

Types of FII	100 % debt	70:30	Total permissible limit
Govt. securities/T-bills	2.0	0.6	2.60
Corporate Debt	1.0	0.5	1.50
Total			**4.10**

In **January and October 2007** FIIs allowed investing US $ 3.2 billion in government securities (limits were raised from US $ 2 billion in two phases of US $ 0.6 billion each in January and October).

In **June, 2008** While reviewing the External Commercial Borrowing policy, the government increased the cumulative debt investment limits from US $ 3.2 billion to US $ 5 billion and from US $ 1.5 billion to US $ 3 billion for FII investments in government securities and corporate debt, respectively.

In **October 2008** While reviewing the External Commercial Borrowing policy, the government increased the cumulative debt investment limits from US $ 3 billion to US $ 6 billion for FII investments in corporate debt. Removal of regulation for FIIs pertaining to the restriction of a 70:30 ratio of investment in equity and debt, respectively. Removal of restrictions on Overseas Derivatives Instruments (ODIs).

In **March 2009** Disapproval of FIIs lending shares abroad. E-bids platform for FIIs.

In **August 2009** FIIs allowed participating in interest rate futures.

In **April 2010** FIIs allowed to offer domestic government securities and foreign sovereign securities with AAA rating as collateral (in addition to cash) to recognized stock exchanges in India for their transactions in the cash segment of the market.

In **November 2010** Investment cap for FIIs increased by US $ 5 billion each in government securities and corporate bonds to US $ 10 billion and US $ 20 billion, respectively.

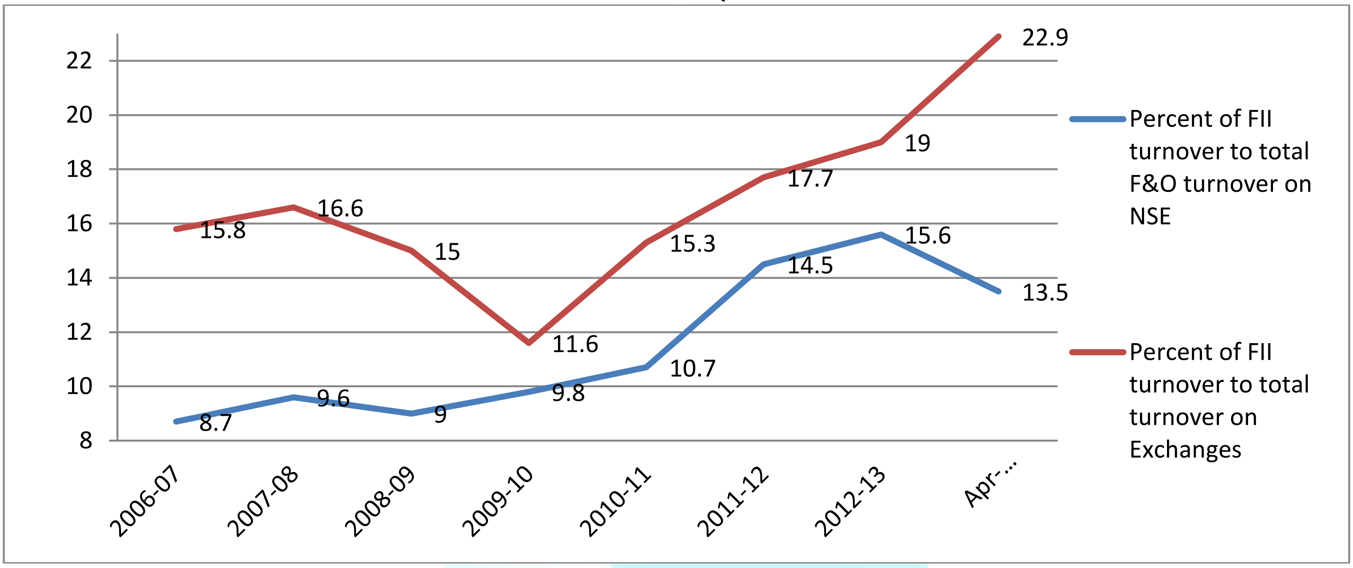
In **March 2011** the limit of US $ 5 billion in corporate bonds issued by companies in the infrastructure sector with a residual maturity of over five years increased by an additional limit of US $ 20 billion, taking the total limit to US $ 25 billion

TABLE 4: GROSS TURNOVER OF FIIS IN EQUITY MARKET SEGMENT OF NSE AND BSE AND F&O SEGMENT OF NSE

Year	Percent of FII turnover to total F & O turnover on NSE	Percent of FII turnover to total turnover on Exchanges
2006-07	8.7	15.8
2007-08	9.6	16.6
2008-09	9	15
2009-10	9.8	11.6
2010-11	10.7	15.3
2011-12	14.5	17.7
2012-13	15.6	19
Apr-Sep'13	13.5	22.9

Source: Indian Stock Market A Review, 2013

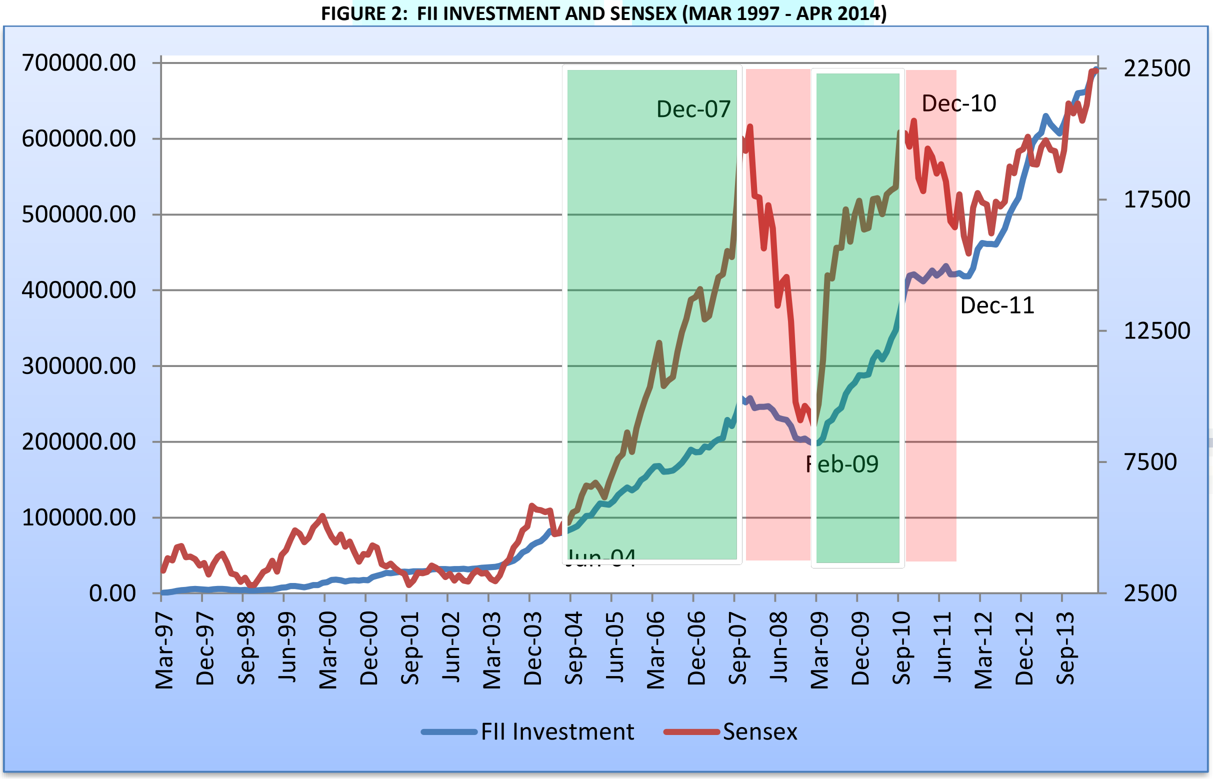
FIGURE 1: PERCENTAGE OF FII IN EQUITY AND F&O SEGMENT



3.3. RELATIONSHIP BETWEEN FII INVESTMENT AND INDIAN STOCK MARKET

To study the effect of FIIs' investment in Indian stock market monthly values of FII and Sensex value is consider. To make data normal and to minimize problems related to stationary and other requirement of regression analysis % change in FII and % change in Sensex values are calculated.

FIGURE 2: FII INVESTMENT AND SENSEX (MAR 1997 - APR 2014)



From the above figure we can see the movement of monthly values of Sensex and monthly values of FII investment. In above figure we can observe major bullish (green shaded) and bearish (red shaded) trend. We can see that movement of both Sensex and FII investments have parallel movement of up and down. Statistically we can check this relation with correlation coefficient. At the same time, it is also important to observe relation during bullish and bearish trend. Following table will help us in understanding this relationship during bullish and bearish trend.

TABLE 5: CORRELATION BETWEEN SENSEX AND FII INVESTMENT

Trend	Period	Correlation Co-efficient
Bullish	Jun 2004 – Dec 2007	0.986967
Bearish	Dec 2007 – Feb 2009	0.983528
Bullish	Feb 2009 – Dec 2010	0.888427
Bearish	Dec 2010 – Dec 2011	0.206862

From the above table we can see that correlation between FII investment and Sensex varies from period to period. From the above table we can see that FII Investment and Sensex are having strong positive correlation during bullish trend than correlation during bearish trend. Thus we can say that FII may have more positive role during long term bullish trend rather than negative role during long term bearish trend.

3.4. RISK DUE TO FII IN INDIAN MARKET

If Indian financial market has not still bitter experience of FIIs, it doesn't mean that in future also we don't have any threat from them. Any financial institutions have their preliminary objective to increase their return and they are least interested in being the part of story of growth of any nation. Too much rely on FII may bring certain problems for emerging countries like India. They are a new form of land lords and money lenders in villages. Slowly they may make developing countries habituated for high growth in economy and make them dependent for chipper capital – funds from developed countries. These emerging economies can grow at faster rate with help of capital inflow of FIIs, but when due to any reason when they quit from these market their market may drop drastically and blessing becomes veto. Legal frame work and systems are there to protect financial market from few of adverse effect, but many times they found lacking in that. Investment of FII is depending upon the various major factors like political situation, economic growth, exchange rates, performance of companies, inflation rate etc. They used to switch their funds from one country to another country they don't try to improve various economic parameters. Hence emerging countries can rely on FIIs investment for short term but in long run they cannot control internal as well external factors so they may not able to sustain to look lucrative investment for FIIs in long-run.

4. CONCLUSION

Whether an individual, a company or a country, everyone needs capital to invest and grow. But it is hard fact that there are limited means to satisfy unlimited wants. Foreign Institutional Investors (FIIs) helps in fulfilling this need upto certain extent. They judiciously invest in countries having high growth potential. So emerging economies like India may get good amount of financial flow, which is essential for their growth. Investment of FII also brings rationality within the financial markets; it helps retail investors to become more logical in their investments too. Using their vast knowledge in financial market FIIs identify up-and-coming companies and provide a good prospect to develop and grow. Thus, FII facilitate Indian financial market in becoming more transparent and efficient.

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