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A Study on Changing Role of Foreign Institutional Investors (FIIs) in Indian Capital Market

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Abstract

The commencement of financial sector reform initiated in early 1990's changed India's policy on development strategy absolutely. The preliminary approach of financing current account deficit mainly by way of debt flows and official development assistance has altered to harnessing non-debt creating capital flows. Under this approach since September 14, 1992; Foreign Institutional Investors (FIIs) were allowed to invest in financial instruments in India and consequently Indian financial markets have changed greatly in its volume, size, depth and nature. FIIs are important to emerging economies because they bring funds and capital to businesses in developing countries. Foreign institutional investors play a very important role in any economy, since these are the big companies such as investment banks, mutual funds etc, who invest considerable amount of money in the Indian markets. These investors typically include hedge funds, mutual funds, insurance companies and investment banks among others. FIIs generally hold equity positions in foreign financial markets. Due to this, the companies invested in by FIIs generally have improved capital structures due to healthy inflow of funds. Thus, FIIs facilitate financial innovation and growth in capital markets. The entry of an FII can cause a drastic swing in domestic financial markets. It increases demand for local currency and directs inflation. Therefore, there are restrictions put by the managing authority of a country on how much stake FIIs can hold in the domestic company. This ensures that the FII's influence on the company is limited, so as to avoid exploitation. However, not every FII will make an FDI in the country it is investing in. FIIs directly impact the stock market of the country, its exchange rate and inflation. FIIs can invest in listed, unlisted, and to-be-listed companies on the stock markets, in both the primary and secondary markets. This paper tries to analyse the changing role of FIIs in Indian capital markets because of their increasing share in the market.

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INTRODUCTION:

Foreign institutional investors (FII) are investor who are registered in a country other than India and is investing in India. Mainly, foreign institutional investors include investing in stocks, hedge funds, insurance companies, pension funds and mutual funds investment. The term is very common in India and thus, refers to outside companies investing in the financial markets of India. FIIs also include banks, large corporate buyers or representatives of large institutions. Every FII activities take a position in a foreign financial market on behalf of the home country in which they are registered. Foreign institutional investors play a very important role in any economy, since these are the big companies such as investment banks, mutual funds etc, who invest considerable amount of money in the Indian markets. With the buying of securities by these big players, markets trend to move upward and vice-versa. They exercise strong influence on the total inflows of foreign currency coming into the economy.

Indian policy towards growth was paying attention on self-sufficiency and import-substitution until 1980s. Government's Current account deficits were financed mostly through debt flows, foreign credit and official development assistance and there was unwillingness for seeking foreign investment or private commercial flows. With effect from 1990s there has been significant change through financial sector reform, with a focus on inviting foreign direct investment (FDI) and portfolio investment flows. The extensive move toward 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 suggested, inter alia, a compositional shift in capital flows away from debt to non-debt creating flows; severe regulation of external commercial borrowings, particularly short-term debt; discouraging volatile elements of flows from non-resident Indians (NRIs); steady liberalization of outflows; and dis-intermediation of Government in the flow of external assistance (Indian Securities Market A Review, 2010). Following the reforms in the early 1990s, there was a continuing shift initiated towards capital account convertibility. FIIs and Overseas Corporate Bodies (OCBs) were permitted to invest in financial instruments w.e.f September 14, 1992. According to the guidelines, from September 14, 1992, FIIs have to obtain a preliminary 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 markets. The Government of India's guidelines (of 1992) furthermore provided for eligibility conditions for registration, such as track record, professional competence, financial soundness and other relevant criteria, including registration with a regulatory organization in the home country (Indian Securities Market A Review, 2010).

Objective of the Study: The study aims at understanding the role of FIIs in in Indian Capital Market with the following other objectives

- To know about changing role of FIIs in Indian capital market
- To understand about regulations of FIIS in India
- To study the FII flows in Indian stock market

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Important of the Study: This study will to help understand role and importance of FIIs in Indian stock market as they are important to emerging economies because they bring foreign funds and capital to businesses in emerging countries like India. It will also help to understand how FIIs involve in hedge funds, mutual funds, insurance companies and investment banks among others and hold equity positions in foreign financial markets.

Methodology of the study: The method used in this paper is descriptive and the data has been collected through secondary sources by taking help of various research papers, books, articles and websites of NSE, BSE, NSDL, CDSL, SEBI and Government of India.

FOREIGN INSTITUTIONAL INVESTORs (FIIs) IN INDIA:

Countries with developing economies have the highest volume of FII activities because these economies are dynamically growing; they provide bigger opportunities for investors by contribution higher growth potential as compared to mature economies. FII activities are most commonly found in India as our economy is growing. The objective of the foreign institutional investor is to anticipate the movement of the markets in the target country and make investment decisions based on the analysis to maximize return on investment from such movements. Investors in Indian frequently imagine and attempt to predict the actions of Foreign Institutional Investors in India or the Role of FII in the stock markets. FIIs are after all hold a substantially large share of Indian capital markets. According to India Brand Equity Foundation (IBEF), a Trust under Ministry of Commerce and Industry, Government of India, FPIs/FIIs had invested Rs. 4,433 crore (US$ 597.94 million) in 2021-22 up to June 22, 2021.

According to different research carried out over the year since the Indian capital markets were opened for foreign investments, it is found there have been strong correlations between the FIIs activity and market movements. This not only includes the secondary equity markets (listed stocks), but also the primary markets (private placements, IPOs, qualified institutional buyers, anchor investors), the debt and bond markets. Therefore, one needs to understand the extent of the involvement of FIIs, which is already very intense, in order to understand the factors that drive the role of FII Indian stock markets. In India, FIIs also tend to invest via Portfolio Investment Schemes (PIS). Foreign Institutional Investors choose to invest in developing countries because they provide greater growth potential, due to the emerging economies. Sometimes, FIIs invest in the securities for a short period of time. This is helpful for liquidity in the market, but they also cause instability in flow of money. It is mandatory for all the investors to register themselves with (SEBI to participate in FII activities as all investments by FIIs are regulated by the SEBI and the RBI defines and maintains the cap or ceiling on such investments. FIIs who are allowed to invest in India are- Foreign Mutual Funds, Asset Management Companies, Investment Banks, Pension Funds, Endowments, Hedge Funds, Insurance Companies, Sovereign Wealth Funds, Treasury Funds, Trusts – Private and Public, University Funds etc.

Eligible FIIs invest in Indian market through registered stock exchanges and our regulator has levied strict regulations that limit the maximum investment by FIIs in any Indian company. Currently, the maximum permissible limit by any FII in an Indian company stands at 24% of the paid-up capital and can be increased up to a sectoral cap or statutory ceiling provided such increase is backed by passing a resolution of the Board and the general body of the company. RBI has also set a cut-off which is fixed at 2% lower than the prescribed maximum investment ceiling i.e., at 22% of the paid-up capital in any company. As soon as the FII investment reaches the cut-off point, RBI is immediately notified and any further investment in such investee company is only sanctioned after receiving prior approval from RBI.

LITERATURE REVIEW:

Sandhya Ananthanarayanan (2004) held that as part of its initiative to liberalize its financial markets, India opened her doors to foreign institutional investors in September, 1992. This event represents a landmark event since it resulted in effectively globalizing its financial services industry. We study the impact of trading of Foreign Institutional Investors on the major stock indices of India.

David A. Carpenter et al (2005) has examined that the Indian government has established a regulatory framework for three separate investment avenues: foreign direct investment; investment by foreign institutional investors; and investment by foreign venture capital investors.

Samy Dr. P. Chella et al (2006) held that Investors can pick up stocks at these levels for a growth story for long term i.e. for equities a 5 years holding period is reasonable to give a very above average return. Caution may be exercised to buy only good, well established market movers and never, to buy on margins or play intraday or dabble in derivatives market, which is high risk.

Sikdar Soumyen (2006) held that the surge in inflows has not been matched by a corresponding growth in the absorptive capacity of the Indian economy. The major reason is the persistent slowdown of industrial activity since 1997. At the same time, the Reserve Bank of India (RBI) has been reluctant to let the rupee find its market-clearing level under the circumstances. This has resulted in steady accretion to our foreign exchange reserves (FER) over the last few years. Problems of Foreign Capital are widening of current account deficit, monetization, appreciation of real exchange, etc.

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

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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.

It has been found in many occasions that FII exit their investment in critical time when developing countries actually need their assistance and from time to time external forces also influence the inflow by FII, which is not under control of developing countries. Vishnoi (February 3, 2014) has stated in his paper that even though India is seen in a improved position than other countries such as Turkey due to its improved current account deficit and foreign exchange reserves, the country is being hit even so in many times. Indian stock markets will thus continue to be grateful to global risk factors, including concerns about the US Federal Reserve's withdrawal in monetary stimulus and an economic slowdown in China. FII inflows to India are basically determined by exchange rate, domestic inflation, domestic equity market returns, returns and risk associated with US equity market (Srinivasan & Kalaivani, 2013).

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.

CHANGING ROLE OF FII IN INDIAN CAPITAL MARKET:

For a long, the foreign institutional investors have influenced the Indian markets as they were one of the biggest blocks with an almost ravenous appetite and an unending reservoir of low-priced capital. Their funds ran into hundreds of billions of dollars and even a fraction of that huge sum was able to affect the market sentiments in our country. Consequently since the FIIs were first allowed in the early 1990s, in the Indian markets, till very recently, if they poured money into Indian markets substantially, and when they pulled the investment allowing the Indian markets to fall down.

FII activity in Futures and Options (F&O): The foreign institutional investors (FIIs) also play in the futures & options (F&O) segment, which is very crucial for Indian markets, including in terms of setting the short-term trend. FII statistics has been proved crucial in predicting the undercurrent of the market; hence, many traders and investors track it keenly. F&O trades are concentrated on returns month on month. Apart from looking at leverage levels, traders also see when FIIs are long with huge positions, as any small negative news leads to unwinding and vice versa. There has been a rise in FII activity in the F&O segment and one of the key reasons are the higher returns.

FIIs, mostly based out at Europe and the US, see lucrative opportunities in India. These returns are considerably higher when compared to their home market fixed income returns. The rise in FII activity in F&O segment is also partly due to the depth in the cash segment, which is not big enough to absorb high

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volumes. Thus, FIIs activity, with strong back up of significant holding in most index heavyweights from banking, software and automobiles sectors, have raised their game in the F&O segment rather than buying heavyweights in the cash market. Had it not been for the higher activity in the F&O segment, Indian markets would have been more volatile. Although, today FDI investments are clubbed with the FII and FPI, it is to be remembered that FII is now an umbrella term that includes active business owners (FDI), passive investors (FPIs), and speculators (FIIs). The following are some important aspects of FII investment to be taken into consideration.

a) Foreign Institutional Investors route their money into emerging economies because of greater growth potential and possibility of getting higher return.
b) In India, there has seen significant investment by FPIs and FIIs with close to Rs. 4,433 crore (or USD 600 million) in 2021-22 up to June 22, 2021 (Source: IBEF)
c) Some FIIs are also interested in short-term investments in securities because this can, on one hand, boost the liquidity in the market, but on the other hand can cause instability in the money supply.
d) FIIs act as both a vehicle and a trigger for the receiving markets. They can encourage better performance and corporate governance by voting by their feet. Sometimes, due to completely unrelated reasons, FIIs can alienate a company or a market leaving the retail investors to fend for themselves.
e) Foreign institutional investors directly affect the stock and bond markets of the country, the exchange rate, inflation, and overall market sentiment.
f) The actions of FIIs are driven by many factors such as external and internal that may be too complex to predict even approximately such are:
    - The US, European and global interest rates
    - The prices of International crude and commodity
    - The international geopolitical stability or lack thereof
    - Performance of the international markets
    - Geo political tension such as Russia- Ukraine war
    - Performance of Indian markets - standalone basis and vis-à-vis other emerging economies
    - Inflation, interest rate, and growth scenario in India
    - Taxation policies and other regulations in India
    - Future prospects of the overall sector, industry, and the security

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The following table shows the quantum of FII flows in Indian stock market.

Table showing FPI/FII Investment in Indian Capital market detail in last 10 years

Financial Year	INR in Crores				
	Equity	Debt	Debt-VRR	Hybrid	Total
2012-2013	140032.60	28334.40	0.00	0.00	168367.00
2013-2014	79708.68	-28059.89	0.00	0.00	51648.79
2014-2015	111332.59	166127.09	0.00	0.00	277459.68
2015-2016	-14171.57	-4003.76	0.00	0.00	-18175.33
2016-2017	55702.67	-7291.64	0.00	0.00	48411.03
2017-2018	25634.19	119035.74	0.00	10.29	144680.22
2018-2019	-87.73	-42355.97	0.00	3514.24	-38929.46
2019-2020	6152.26	-48710.23	7331.17	7697.63	-27529.17
2020-2021	274031.96	-50443.62	33264.56	10247.09	267099.99
2021-2022	-140009.60	1628.53	12642.83	3498.41	-122239.83
2022-23 ** Upto June, 30	-107340	-11358	7954	116	-110628
Total	**790967**	**279422**	**61192**	**25085**	**1156667**

Source: Central Depository Services (India) limited

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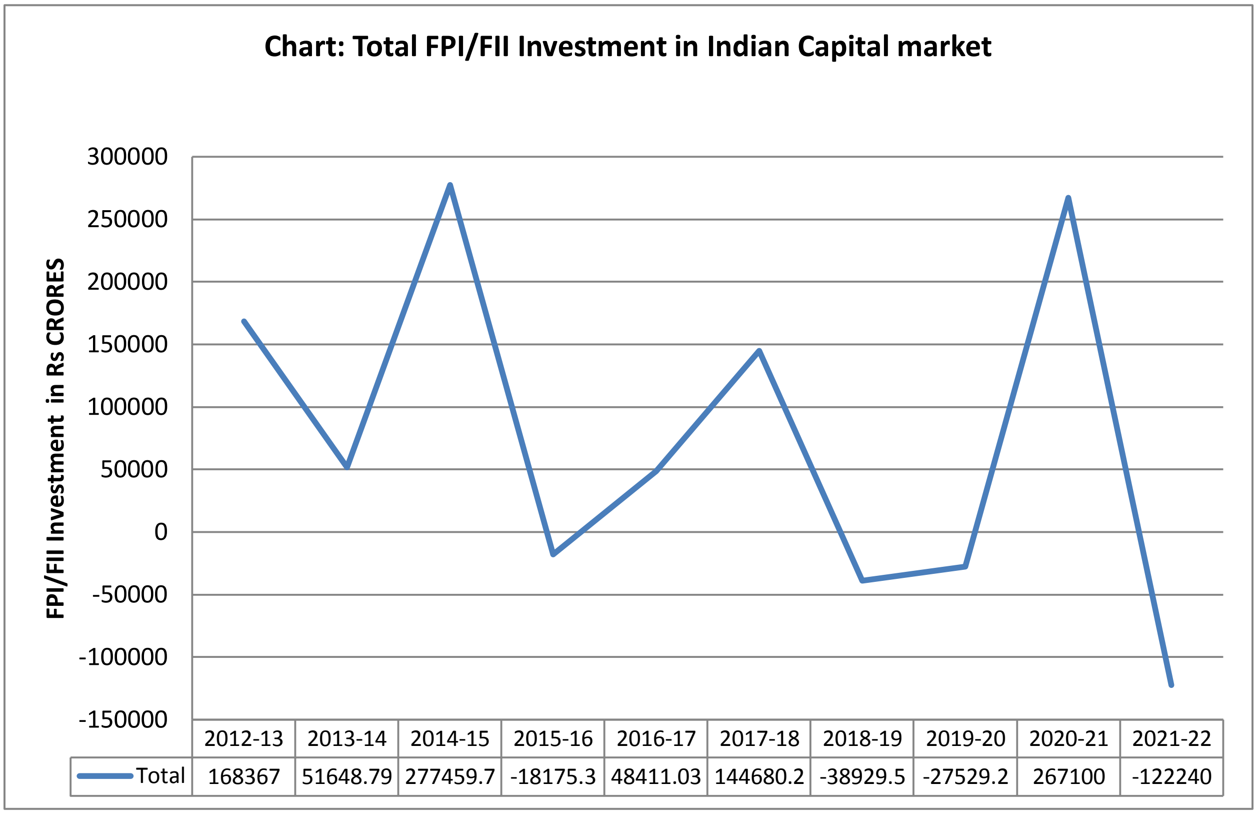

Source: Central Depository Services (India) limited

The Indian Government, investors and financial institutions people kept close track of the actions by the FIIs and external factors that could affect their decisions. Even a slight change in the interest rates in the US, the UK, or Europe could result in billions of dollars going in or out of Indian markets in a matter of days. This used to affect the exchange rate, making currency management that much more difficult. Even today, after the enhance participation by retail investors and DIIs becoming almost as prominent as FIIs, they still hold sufficient heft to control the market movement. But over the years, their actions and movements have become more predictable.

REGULATIONS OF FIIS IN INDIA:

FIIs have been an important source of capital in emerging markets, but due to their volatile nature, India has placed limits of varying degrees – both in percent terms and absolute terms – on the total value of assets an FII can purchase. These limits are not broad-based or blanket, but case to case -in some cases up to 100% foreign holding is allowed and is some others none. The purpose of such limits is to curb the influence of FIIs to an extent on individual companies and on the overall financial markets. This way the potential damage that FII fleeing en masse might inflict can be curtailed and spread over a longer duration to help the retail investors.

FIIs can invest via the Portfolio Investment Scheme (PIS) by registering with the Securities and Exchange Board of India. According to SEBI, over 10,000 foreign bodies are registered with it under FPIs and Deemed FPIs (the erstwhile FIIs/QFIs). The rules governing FIIs are strictly followed. In general, FII investment in a company is limited to a maximum of 24% of its paid-up capital. In the direction of allowing investment beyond this limit, it may be allowed if it is approved by passing a special resolution by the company's Board. In strategic sectors, like public sector banks, the ceiling on FIIs' investments is only 20% of their paid-up capital.

The Reserve Bank of India monitors the compliance of these limits daily. It does so by implementing cutoff points at 2% below the maximum investment limit thereby giving it sufficient time and headroom to caution the Indian company receiving the investment. Then only the final 2% is allowed to be purchased.

ARGUMENTS IN FAVOUR OF FII'S:

- FII's will enhance the flow of capital into the country
- These investors generally prefer equity over debt. So this will also help maintain and even improve the capital structures of the companies they are investing in.
- They have a positive effect on the competition in the financial markets
- FII help with the financial innovation of capital markets in our country
- These institutions are professionally managed by expert asset managers and analysts who may generally improve the capital markets of the country.

ARGUMENTS AGAINST FII'S:

- These FII's drive the fortune of big companies in which they invest bur but their buying, selling or trading of securities have a huge impact on the stock market. The smaller companies are taken along for the ride.
- Due to the activities of FII's, the demand for the Indian currency (rupee) increases and this can cause severe inflation in the economy.
- Sometimes many FII's are interested in making only short-term returns and thus when they pull their investments, banks and financial institutions can face a shortage of funds.

CONCLUSION:

FIIs have been playing an important role in the Indian capital market in the process of capital formation and economic development of the country after the implementation of Financial Reforms Policies in 1991. India, being a capital sparse country, has taken many actions to make the investment environment encouraging for Foreign Institutional Investment since the beginning of reforms. FIIs help in fulfilling this need up to definite extent as they judiciously invest in countries having high growth potential. Therefore, emerging economies like India may get good amount of foreign investment flow, which is essential for their growth. Investment of FII also brings rationality within the financial markets; they help retail investors to become more rational in their investments too. Using their vast knowledge in financial market, FIIs identify upcoming companies and make available a good prospect to develop and grow of Indian capital market.

Thus, FII facilitate Indian financial market in becoming more transparent and efficient. FIIs are essential to promising economies because they bring capital to businesses by way of capital market to needy countries. They play a very significant role in any economy, since these are the giant companies such as mutual funds, investment banks, etc, who invest substantial amount of capital in the Indian markets. FIIs make easy financial innovation and growth in capital markets. The entrance of FIIs in the Indian capital market can cause a strong move in domestic financial markets by increasing demand for local currency and regulation of inflation. For that reason, there are restrictions put by the managing authority of a country on how much stake FIIs can hold in the domestic company. This ensures that the FII's influence on the company is limited, so as to avoid exploitation. However, not every FII will make an FDI in the country it is investing in. FIIs directly impact the stock market of the country, its exchange rate and inflation. FIIs can invest in listed, unlisted, and to-be-listed companies on the stock markets, in both the primary and secondary markets. FDIs are more intentional, while FIIs are more concerned with transfer of funds and looking for capital gains in a prospective company.

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