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ROLE OF FIIs IN INDIAN CAPITAL MARKET

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Abstract

Until the 1980s, there was a general disinclination towards foreign investment or private commercial flows as India's development strategy was focused on self-reliance and import substitution and current account deficits were financed largely through debt flows and official development assistance. After the launch of the reforms, Foreign Institutional Investors (FIIs) have been allowed to invest in all securities traded on the primary and secondary markets, including shares, debentures and warrants issued by companies which were listed or were to be listed on the Stock Exchanges in India and in schemes floated by domestic mutual funds. From September 14, 1992, with suitable restrictions, FIIs were permitted to invest in financial instruments. Since then foreign portfolio inflows through FIIs, in India, have been important from the policy perspective, especially when the country has emerged as one of the most attractive investment destinations in Asia. Although the FIIs have been blamed for large and concerted withdrawals of capital from the country at the time of recent financial crisis, they have emerged as important players in the Indian capital market. As on June 4, 2009, the net equity investment by FIIs in India is Rs. 2,52,233.10 crore with the registration of 1662 foreign institutional investors. Thus, in this paper an effort has been made to examine the performance of the Indian capital market by empirically studying the impact of net equity investment by FIIs on stock returns. The study using monthly data on Sensex based stock return and net FII flows over a period of 17 years spanning from Jan 1993 to May 2009, provides the evidence of positive correlation between FII net flows into India and stock market return. And, the analysis finds that the movements in the Indian capital market are fairly explained by the FII net inflows.

Keywords: FIIs, Indian Capital Market, Global Financial Crisis, BSE Sensex
JEL Classifications: C10, C22, E44, F36, G10

I. INTRODUCTION

Foreign Institutional Investors (FIIs) have been playing a significant role in the Indian capital market and hence, in the process of capital formation and economic development of the country since the implementation of New Economic Reforms in 1991. India, being a capital scarce country, has taken many measures to make the investment environment encouraging for Foreign Institutional Investment since the beginning of reforms. As of 2007, India succeeded in attracting a total foreign institutional investment of around Rs.8,05,167.00 crore by allowing the registration of 987 FIIs. Currently India is passing through financial downsizing; still the gross FII purchases is Rs. 30, 66, 359.90 crore and the gross sales Rs. 28, 14, 27.60crore as on June 4, 2009 leading to the net investment of Rs. 2, 52, 233.10 crore with the registration of 1662 FIIs. These figures highlight the importance of FIIs in the investment scenario in India.

The term 'Foreign Institutional Investors' is most commonly used in India to refer the companies that are established or incorporated outside India and are investing in the financial markets of India by registering themselves with the Securities & Exchange Board of India (SEBI). The term FIIs include overseas pension funds,

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mutual funds, investment trusts, asset management companies, nominee companies, banks, institutional portfolio managers, university funds, endowments, foundations, charitable trusts, charitable societies, a trustee or power of attorney holder incorporated or established outside India proposing to make proprietary investments on behalf of a broad-based fund (i.e., fund having more than 20 investors with no single investor holding more than 10% of the shares or units of the fund) (Government of India, 2005). FIIs can invest their own funds as well as invest on behalf of their overseas clients registered as such with SEBI. Foreign Institutional Investment is basically short-term in nature and mostly made in the financial markets. India opened its stock market to foreign investors in September 1992, and in January 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. Now, FIIs are allowed to invest in equity, bonds and derivative instruments, but subject to limits of foreign ownership for various sectors as well as ceilings on total investment per FII. Regular FIIs follow the ‘70:30’ rule, i.e., they must invest no less than 70% of their funds in equity-related instruments and may invest the remainder in debt-related instruments.

In policy circles, FII flows are considered to increase the domestic investment without increase in foreign debt. FII flows can raise stock prices, lower cost of equity and stimulate investment by Indian firms and lead to improvements in securities market design and corporate governance. Thus, FIIs increase the depth and breadth of the market; expand securities business, and their policy of focusing on fundamentals of the shares cause efficient pricing of shares. However, market pundits often attribute fall of the stock market to the flow of funds by FIIs. FIIs are known to rush out at the slightest hint of trouble in the host country leaving an economic crisis, like Mexico in 1994 and India in 2008. Thus, FIIs exacerbate small economic problems in a country by making large and concerted withdrawals. And, they can be held responsible for spreading financial crisis – causing ‘contagion’ in international markets.

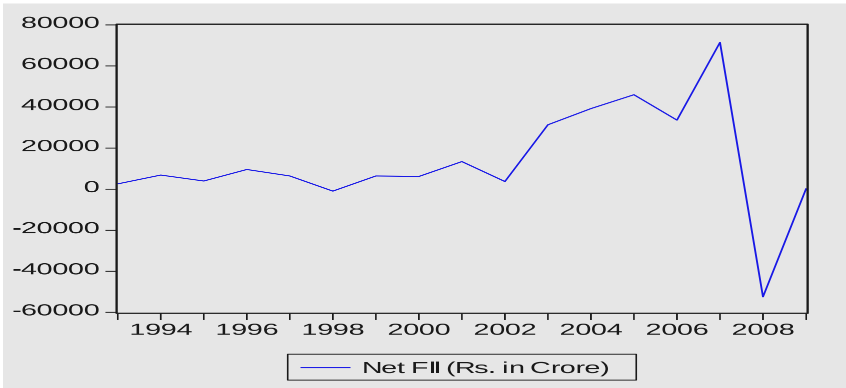
In recent past, the positive impacts of FIIs have made the Indian capital market more attractive to FIIs and Indian capital market has witnessed a Bull Run till mid-2008, which was driven by increased buying by the FIIs. The Table-1 and Fig.1gives Net Investment by FIIs from 1993 to May 2009.

TABLE-1: NET INVESTMENT OF FIIS

Year	Net Investment (Rs. in crore)
1993	2608.13
1994	6892.66
1995	4005.03
1996	9569.37
1997	6439.53
1998	-930.96
1999	6422.77
2000	6202.51
2001	13422.99
2002	3734.92
2003	31325.35
2004	39200.27
2005	45969.37
2006	33617.25
2007	71486.30
2008	-52375.96
2009 (End May)	20473.60

Since the economic reforms in 1991, Indian economy has been increasingly integrated into the global economy and hence, Foreign Institutional Investment (FII) is largely open to the India’s equity, debt and derivatives markets. It is clear from the Fig.1 that there is an increase in net investments by FIIs till 2002 in which year such flow experienced a break. After 2002, FII flow shows a steep ramp. Again there was a small decrease in net investments in the year 2006. But there was a steep increase in the year 2007. The net FII increased to Rs. 71,486.30 crore. This was the best period in the Indian capital market during which stock prices were increased and the market witnessed a Bull Run. And, FII investment treated as 'Hot Money' that 'Fuel the Market Run'. Till end of 2007 FIIs have been the Net Buyers. But they became Net Sellers in 2008.

FIG.1 YEARLY TREND OF NET FII IN INDIA



In January 2008, the US financial crisis came into light with sub-prime effect, which led the major financial companies to post heavy losses. In September 2008, this crisis worsened with some of the companies had to file for bankruptcy and some had to take financial aids from government to continue their business operations. This crisis has significant impact on FII investment in India, as investors all over the world lack confidence on the market. The crisis in confidence resulted in the selling of equities of Rs. 44,660 crore in 2008 by FIIs which comes to around 15% of net investment of Rs. 2, 84,942 crore as on 1st January 2008 of last eight years. This has significant impact on India's stock market. When FIIs started withdrawing money from the financial market, the domestic investors became fearful and they also withdrew money from the market. Thus, the Sensex which touched above 21,000 mark in January 2008, has plunged as below as 8160 mark in March 2009. In fact, major falls in stock market has been accompanied by the withdrawal of money by FIIs. This indicates a relationship between FIIs' equity investments and the stock market performance in India. Thus, the objective of this paper is to examine empirically the relationship between net investment by FIIs and movement of stock market.

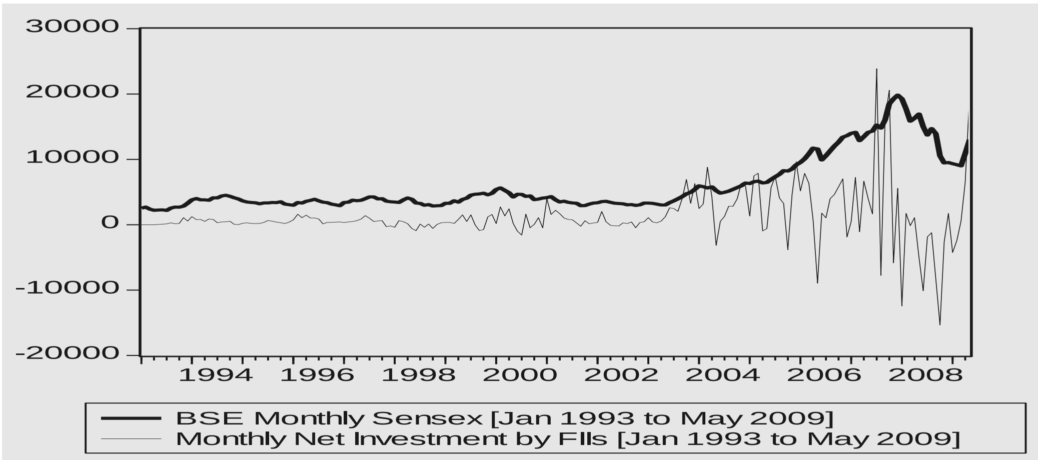
II. DATA AND METHODOLOGY

This paper provides an empirical analysis of the relationship between the investment by FIIs in India and the performance of the India capital market. We have selected the Stock Exchange, Mumbai (BSE) as the representative of Indian capital market because of its undoubted popularity among researchers and market analysts. Established in 1875, BSE is not only the oldest stock exchange in India, but is also the oldest in Asia. It accounts for over one-third of the total trading volume in the country. BSE Sensex is a basket of 30 constituent stocks representing a sample of large, liquid and representative companies. The base year of SENSEX is 1978-79 and the base value is 100. The index is widely reported in both domestic and international markets through print as well as electronic media. The stocks in this index are the ones in which the FIIs are most likely to invest in. Thus, the study uses monthly data on Sensex, Sensex based stock return, and Net Investments by FIIs in the Indian Capital Market to examine the impact of net FII flows on the performance of the Indian capital market. The relevant data are collected from the SEBI and RBI database for the period January 1993 to May 2009. The most popular statistical technique, Regression Analysis is used to examine the empirical dependence of Indian capital market on investments by FIIs through the most important capital market indicator, that is, Stock return.

III. EMPIRICAL ANALYSIS

The movement of BSE Sensex with FIIs net investment flows in Indian capital market starting January 1993 is shown in the Fig.2. Both the variables moved in the same direction from Jan 1993 to Dec 2007. But from Jan 2008 to Dec 2008 the direction of movement is almost opposite. The correlation between these variables is -0.15 in the year 2008. The impact of FIIs is so high that whenever FIIs tend to withdraw the money from the market, Indian stock market witnessed major falls. This is evidenced from the intra-day market study. For instance, on January 18, 2008, the Sensex lost 687 points and the net investment by FIIs was –Rs. 271.20 crore which is a major contributor to the Sensex fall on that day. Again from Jan 2009 to May 2009 the movement is in the same direction and correlation is 0.96. It infers that the performance of Indian stock market is dependent on FII flows.

FIG.2 MOVEMENT OF BSE SENSEX WITH FII FLOWS



The correlation between monthly Net FII equity inflows and monthly Sensex is 0.14 since Jan 1993 to May 2009. And, the correlation between the monthly Net equity investment by FIIs and monthly Sensex returns is 0.44.These positive correlations establish the fact that the FII flows are an important driver of Indian Capital Market performance and hence, have a positive impact on country's development. But to what extent the movements in Indian capital market are explained by movements in FII flows, can be examined by running the regression analysis.

In running the regression analysis, Sensex based monthly return is taken as the dependent variable and the net equity investment flow by FIIs is considered as the independent variable. Regression looking at relationship between BSE returns and FII flows is:

$$SR_t = \alpha + \beta NFII_t + \varepsilon_t$$

Where SR_t is the Sensex based monthly return at time t ; $NFII_t$ is the net equity investment flow by FIIs at time t ; α and β are constants; ε_t is the white noise. The monthly return on Sensex (SR_t) has been calculated as:

$$SR_t = \ln\left(\frac{S_t}{S_{t-1}}\right)$$

Here, S_t is the Sensex at time *t*, and S_{t-1} is the Sensex at time *t-1*.

TABLE-2: RESLUTS OF REGRESSION MODEL

Period	**R-Square**	**Adjusted R-Square**	**S.E. of Regression**
Jan 1993 to May 2009	0.1974	0.1933	0.0633
Jan 1993 to Dec 2000	0.0484	0.0383	0.0696
Jan 2001 to Dec 2006	0.1974	0.1859	0.0519
Jan 2007 to May 2009	0.4919	0.4731	0.0703

As seen from Table-2, the regression model has been estimated for the sample period as well as for sub-periods. For the entire sample period the value of R-square is 0.1974. It indicates that only 19.74% of movements in Sensex based stock return are explained by the movements in FII flows. For the period from Jan 1993 to Dec 2000, the R-square is 0.0484 which means only 4.84% of movements in stock return are due to FII flows. Thus, the effect of FII flows on Indian capital market for this period was very negligible. Similarly, for the period from Jan 2001 to Dec 2006, the R-Square is 0.1974 which infers that only 19.74% of movements in stock return are explained by FII flows. The last phase, i.e. from Jan 2007 to May 2009, is fairly important in the emergence process of capital market. The R-square is 0.4919. This signals that about 49.19% of movements in stock return are due to FII flows. The most interesting part of the story is that during this period the Indian market remained volatile due to the impact of global financial crisis and acute credit crunch on the part of FIIs. The investors in the global market as well as domestic market lacked confidence and thus, FIIs withdrew their money from the Indian stock market. This caused a notable stock market crash which is further worsened by the large scale sell of stocks by domestic investors in the country. In last 8 years, first time FIIs have been the Net Sellers in 2008. The trend continued till first quarter of 2009. But in the last two months the situation has been reversed. In May 2009, the net FII flow to the Indian capital market was Rs. 20,117.20 crore as against Rs. 6,508.00 crore in the last month. Thus, FII flow can be considered one of the factors driving the performance of Indian capital market.

IV. CONCLUSION:

This paper studies the impact of trading of Foreign Institutional Investors on the performance of Indian capital market. By examining the empirical relation between stock market return and FII flows, it is found that the FII net inflows are not only correlated with the stock market return but fairly explains the movements in the Indian capital market. Although FIIs were the net sellers in the last year, they have resumed their investment activities in a big way in last two months and the stock market barometer touched 15,000 after 9 months of downsizing. This reflects the strong economic fundamentals of the country, as well as the confidence of the Foreign Institutional Investors in the growth with stability of the Indian capital market. Besides, improved regulatory standards, high quality of disclosure and corporate governance requirement, accounting standards, shortening of settlement cycles, efficiency of clearing and settlement systems and risk management mechanisms led FIIs to perceive great potential for investment in the Indian economy.

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