IMPACT OF FOREIGN INSTITUTIONAL INVESTORS ON INDIAN EQUITY MARKET

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ABSTRACT

Equity market in India has evolved over time with the market practices and conditions generally reflecting the policies put in place. This paper focuses on the impact of Foreign Institutional Investors' trading behavior on Indian Equity market by using the data obtained from the SEBI statistical reports i.e., FIIs investments during the period 2002-2012 and also analyzes the impact on India's leading exchanges' indices such as Sensex and CNX Nifty. The findings reveal that there is positive moderate relation among Net FIIs Investments and Sensex, Nifty returns. FIIs have great impact on Indian Equity market.

Key words*: FII (Foreign Institutional Investor), Sensex, Nifty, SEBI*

Introduction

Indian capital market has been one of the emerging markets in the global markets in recent years. This growth has been supported by market reforms and huge inflows of foreign investments and these in turn help capital market to flourish. The Indian security market in the last decade witnessed a significant transformation as well as voluminous growth on several counts such as number of brokers, institutional investors, number of listed companies, market capitalization, trading volume and turnover on stock exchange. India, after United States hosts the largest number of listed companies. Global investors now ardently seek India as their preferred location for investment. Once viewed with skepticism, stock market now appeals to middle class Indian also. Many Indians working in foreign countries now divert their savings to stocks. This recent phenomenon is the result of opening up of online trading and diminishing interest rates from banks. The stock brokers based in India are opening offices in different countries mainly to cater the needs of Non-Resident Indians.

Foreign Institutional Investors (FII)

When investors who have same interest to invest in foreign company, they create the company and start to invest in foreign companies. In India, SEBI defines all these investors as FIIs. Developing countries like India are generally capital scarce. This is because of low levels of income in comparison to other developed countries, which in turn means savings and investments are also lower. So how do developing nations get out of such a situation ? They

borrow money. Countries can thus invest this borrowed money in various social and physical infrastructures, earn a return on them which helps them pay off their debt and simultaneously boost the country to a higher growth trajectory.

However, there is another way in which a country can attract foreign money. This is by way of Foreign Direct Investment (FDI). However there is a slight difference between them. FDI is defined as "long term investment/ acquisition and is associated with investment in capital assets that a parent company makes in a foreign country which eventually leads to creating employment in India. It manifests in various forms i.e. leading to change in management, transfer of technology, increase in production etc. Examples of FDI would include POSCO setting up a steel plant in Orissa (in-bound FDI), Tata buying Arcelor (out-bound FDI) and so on. It is perceived to be beneficial because it increases production, brings in more and better products and services besides increasing the employment opportunities and revenue for the Government by way of taxes. Considering the investment is long term in nature, they cannot be immediately converted into cash and are often only liquidated in a worst-case scenario; whereas FII is a short term investment by foreign institutions, in the financial markets of other countries. These institutions are generally mutual funds, investment companies, pension funds and insurance houses. The SEBI is the nodal agency for dealing with FIIs and they have to obtain initial registration with SEBI. 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, they will be required to hold a registration from an appropriate foreign regulatory authority in the country of domicile/ incorporation of the FII. The rules and regulations to enter the Indian market are not much. The fluctuations in the stock market are generally due to the FII investments as the investor can leave the market at any point of time. FII widens and deepens the stock exchanges and provides a better price discovery process for the scripts. It is a fair-weather friend and can desert the nation with what is happening in India right now, thereby pulling down not only our share prices but also wrecking havoc with the Indian rupee because when FIIs sell in a big way and when they leave India they take back the dollars they had brought in.

Role of stock exchanges & SEBI

Bombay Stock Exchange (BSE) which is one of the oldest in the world and accounts for the largest number of listed companies and has also started a screen-based trading system with the introduction of the Bombay On-Line Trading system. There are 23 recognized stock exchanges in India, including the Over the Counter Exchange of India (OTCEI) for small and new companies and the National Stock Exchange (NSE) which was set up as a model exchange to provide nation-wide services to investors. NSE, which in the recent past has accounted for the largest trading volumes, has a fully automated screen based system that operates in the wholesale debt market segment as well as the capital market segment.

In countries like India, statutory agencies like SEBI have prescribed norms to register FIIs and also to regulate such investments flowing in through FIIs. Yet, we intuitively know that the FIIs are important for the market because they start a market rally attracting subsequently flows come from all classes of investors. At this stage, the market behaves like a self-organised system.

No single class of investors drives the market - asset prices go up, driven by the collective momentum of all investors including FIIs. Finally, the market enters the state of self-organised criticality. This is when any negative information could have non-linear effect on the market. The FIIs play a major role during this phase too. So, why is a rise or decline in the market always attributed to the FIIs ? How relevant are FIIs to drive the market rally?

A simple model using FII investments, change in their investments and market returns shows that FIIs do not drive returns. The relationship is also not significant if returns are used with a time lag. This brings us to the point about the mutual influence of FIIs and the market. The FIIs do matter because their entry starts off a market rally. Further, their exit or rumours of their exit at best temporarily halts the rally. At worst, their exit could halt the rally completely. But the FII factor is not very important when the market functions as a self-organised system. This phase has a longer duration than the entry and exit phase of the rally.

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. Thus the FIIs are playing an important role in bringing in funds needed by the equity market. Additionally, they are contributing to the foreign exchange inflow as the funds from multilateral finance institutions and FDI are insufficient. However, the fact remains that FII investments are volatile and market driven, but this risk has to be taken if the country has to ensure steady inflow of foreign funds.

Review of the Literature

During 1990, Political uncertainty and protected economy has precipitated the Balance of Payment crises. The crippling economy and yoke external debts along with exports added to the woes of the Indian economy. As the country was critically poised to default on its external payments, resulting in mortgage of its gold reserves, Indian economists opted for more liberal and global approach to the age old protectionism by opening its door to FDI inflows. Liberalization and globalization initiatives and polices have also instilled the confidence of foreign investors.

The extant of literature on impact of FDI and FII is presented below:

Nitin Kansal examined the "Impact of FDI & FII on India". The objective of his research is to find the trends & patterns in the FDI from different countries flown into India during 1991-2007 period means i.e during post liberalization period & Influence of FII on movement of Indian stock exchange during the post liberalization period that is 1991to 2007. The key findings of this research are that Net FDI in India during 2005-2006 was valued at $4.7 billion. During 2006-2007, it got tripled, to $15.7 billion. Almost one-half of all FDI is invested in the Mumbai &New Delhi regions. Researcher concludes that the process of economic reforms initiated from July 1991 have opened up many sectors to the financial institutors. It concludes that FII did have high significant impact on the Indian capital market.

A study conducted by the World Bank in 1997, reports that stock market liquidity improved in those emerging economies that received higher foreign investments.

Kumar [1] investigated the effects of FII inflows on the Indian stock market represented by the Sensex using monthly data from January 1993 to December 1997 and inferred that FII investments are more driven by Fundamentals and do not respond to short-term changes or technical position of the market. In testing whether Net FII Investment (NFI) has any impact on Sensex, a regression of NFI was estimated on lagged values of the first difference of NFI, first difference of Sensex and one lagged value of the error correction term (the residual obtained by estimating the regression between NFI and Sensex). Similarly, regression with Sensex as dependent variable showed that one month lag of NFI is significant, meaning that there is causality from FII to Sensex. This finding is in contradiction with the findings of Rai and Bhanumurthy[2] who did not find any causation from FII to return in BSE using similar data between 1994 and 2002. However, Rai and Bhanumurthy have also found significant impact of return in BSE on NFI.

Chopra[3] examines the effect of policy reforms on the FDI in India. The analysis has been carried out with the help of annual data from 1980-2000. The research includes policy related variables such as the degree of openness of the economy, debt-service ratio, foreign exchange rate and GDP as the explanatory variables of FDI inflows in India. Empirical result shows that GDP is an important factor which motivates FDI in the country.

Stanley Morgan[4] has examines that FIIs have played a very important role in building up India's FOREX reserves, which have enabled a host of economic reforms. Secondly, FIIs are now important investors in the country's economic growth despite sluggish domestic sentiment. According to Morgan Stanley report FIIs strongly influence short-term market movements during bear markets. However, the correlation between returns and flows reduces during bull markets as other market participants raise their involvement reducing the influence of FIIs. Research by Morgan Stanley shows that the correlation between foreign inflows and market

returns is high during bear and weakens with strengthening equity prices due to increased participation by other players.

Agarwal[5], Chakrabarti[6] have found in their research that the equity return has a significant and positive impact on the FII. But given the huge volume of investments, foreign investors could play the role of market makers and book their profits, i.e., they can buy financial assets when the prices are declining thereby jacking-up the asset prices and sell when the asset prices are increasing. Hence, there is a possibility of bi-directional relationship between FII and the equity returns.

John Andreas[7] in his paper titled "The Effects of FDI Inflows on Host Country Economic Growth" discusses the potential of FDI inflows to affect host country economic growth. The author argues that FDI should have a positive effect on economic growth as a result of technology spillovers and physical capital inflows. A cross section and panel data analysis on a dataset covering 90 countries during the period 1980 to 2002, finds that FDI inflows enhance economic growth in developing economies only but not in developed economies. He has assumed that the direction of causality goes from inflow of FDI to host country economic growth. However, economic growth could itself cause an increase in FDI inflows. Economic growth increases the market size of the host country market and strengthens the incentives for market seeking FDI. This could result in a situation where FDI and economic growth are mutually supporting. However, for the ease of most of the developing economies growth is unlikely to result in market – seeking FDI due to the low income levels. Therefore, causality is primarily expected torun from FDI inflows to economic growth for these economies.

Prasanna[8] has examined the contribution of foreign institutional investment particularly among companies including Sensex of Bombay Stock Exchange. It examined 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 such companies where family shareholding of promoters is not very substantial. The financial performance variables which influenced the financial decisions of FII include share returns and earnings per share.

Bansal and Pasricha[9] studied the after impact of opening market to FIIs on Indian stock market behavior. They empirically analyze the change of market return and volatility after the entry of FIIs to Indian capital market and found that there is no significant change in the Indian stock market average returns. The volatility got significantly reduced after India unlocked its stock market to foreign investors.

Jayachandran and Seilan[10] investigate the relationship between trade, Foreign Direct Investment (FDI) and economic growth of India over the period 1970-2007. The results of Granger causality test show that there is a causal relationship between the examined variables. The direction of causality relationship is from FDIs to growth rate and there is no causality relationship from growth rates to FDIs.

Most of empirical studies carried out in the past used multi regression model to study the impact of flow of FDI & FII.

Need for the Study

Since the beginning of liberalization FII flows to India have steadily grown in importance. Foreign capital flows have come to be acknowledged as one of the important sources of funds for economies that would like to grow at a rate higher than what their domestic Savings can support. This resulted in the integration of global financial markets. As a result, capital started flowing freely across national borders seeking out the highest rate of return. India is considered as a good investment option by world investors in spite of political differences and lack of infrastructure facility etc. Indian market presents vast potential and alluring and encouraging foreign investors continuously. In this regard everyone's query is whether the FII positions have caused Indian markets as we see most often vice –versa. Foreign portfolio inflows through FIIs, in India, are important from the policy perspective, especially when the country has emerged as one of the most attractive investment destinations in Asia. This study reveals the influence of FIIs the Indian Equity Market. The present study also focuses on their investment pattern in the Indian stock market. It examines the factors that affect the investment decisions of FIIs.

Objectives of the study

Following are the three objectives of the study

- To study the equity market in India.
- To study the trading mechanism of FIIs in India.
- To study the investment behavior pattern of FIIs in Indian equity market.

Research Methodology

The research study is descriptive in nature. The study was conducted with the secondary data of various sources. The various information and statistics derived from the different sources i.e., web sites, journals, books, reports and magazines etc. Mostly Securities Exchange Board of India (SEBI) and Reserve Bank of India (RBI) reports were used for this study with these, additionally different websites such as NSE, Moneycontrol.com etc. Various books on capital markets, foreign institutional investments, journals, magazines referred to this study. The study

period covered under this is for the years 2002-2012. The analysis made by using the correlation analysis and also made analysis according to result with empirical basis.

Data Analysis

This study has analyzed the data of FIIs Investments during the period 2002 - 2012 and Stock indices such as Sensex and CNX Nifty.

Table 1: Foreign Institutional Investment Flows to India during the study period [2002-2012]

Year	Gross Purchases (Rs. Cr)	Gross Sales (Rs. Cr)	Net Investments (Rs. Cr)
2002-03	47,062	44,372	2,689
2003-04	1,44,855	99,091	45,764
2004-05	2,16,951	1,71,071	45,880
2005-06	3,46,976	3,05,509	41,467
2006-07	5,20,506	4,89,665	30,841
2007-08	9,48,018	8,81,839	66,179
2008-09	6,14,576	6,60,386	45,811
2009-10	8,46,433	7,03,776	1,42,658
2010-11	9,92,596	8,46,158	1,46,438
2011-12	9,21,285	8,27,562	93,725

Source: SEBI

From the above table, we can observe that Foreign Institutional Investments in India increasing rapidly. These flowed continuously in our country as they get better return than developed markets and since India encouraged foreign flows either directly or thru' Portfolio Investments. These flows increased from year to year except in the year 2008 majorly, because of World Economic Crisis. These flows helped Indian market reforms in trading and settlement system.

Table 2: Foreign Institutional Investments and Sensex, Nifty indices during the period [2002-2012]

Year	Net Investments (Rs. Cr)	Sensex	CNX Nifty
2002-03	2,689	5,839	1880
2003-04	45,764	6,603	2081
2004-05	45,880	9,398	2837
2005-06	41,467	13,787	3966
2006-07	30,841	20,287	6139
2007-08	66,179	9,647	2959
2008-09	45,811	17,465	5201
2009-10	1,42,658	20,509	6135
2010-11	1,46,438	15,455	4624
2011-12	93,725	19,427	5905

Source: http://www.moneycontrol.com/stocks/hist_index_result.php?indian_indices=9

Correlation Analysis:

	Net Investments
Sensex	r= 0.515098
CNX Nifty	r=0.513449

The above table shows that there is positive correlation between FIIs flows and both BSE Sensex and CNX Nifty. From the above results we can infer that, the Net Foreign Institutional Investments have great impact on the stock indices of BSEs Sensex and NSEs CNX Nifty positively. These flows not only affect the indices but also impacted on stock market reforms in India enormously.

Conclusion

FII is a vital component which helps in the development of financial markets and the overall Financial development thereby allowing the capital flows available in a country to pursue its trajectory of economic growth. This study also found that Net FII flows have positive impact on both indices of BSE Sensex as well as NSEs CNX Nifty.

In this study, it is found that Foreign Institutional Investment flows in emerging markets like India have great impact and importance in the development of stock market. This also indicates that India is a good destination for global investors to gain better returns than other countries.

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