International Journal of Economics, Commerce and Management
United Kingdom Vol. II, Issue 6, 2014
http://ijecm.co.uk/ ISSN 2348 0386

FII'S PERFORMANCE IN INDIAN CAPITAL MARKET (APRIL 2009 - MARCH 2011) AN EMPIRICAL STUDY

Alam, Mohamed Noor

Faculty of Management Sciences, Bakhtar University, Kabul, Afghanistan

mohammed8668@gmail.com

Alam, Mohamed Shabbir

College of Administrative & Financial Sciences, Saudi Electronics University,

Madinah, Kingdome of Saudi Arabia

shabbir.alam28@gmail.com

Abstract

The remarkable economic growth during the past two decades in most of the emerging countries had been stimulated by foreign capital inflows from developed countries. The post 1990s period witnessed sharp augment inflows of foreign private capital and official development finance lost its predominance in net capital inflows. Most of the developing countries opened their capital markets to foreign investors either because of inflationary pressures, widening current account deficits, exchange depreciation, increase in foreign debt or as a result of economic policy. There was a surge in capital inflows into India too since 1992 as in India, the purchase of domestic securities by FIIs was first allowed in September1992 as part of the liberalization process that followed the balance of payment crisis in 1990-91. Now days, a significant portion of Indian corporate sector's securities are held by Foreign Institutional Investors, such as pension funds, mutual funds and insurance companies. These investors are often viewed as sophisticated investors as these institutional investors are better informed and better equipped to process information than individual. As the share of foreign investors in emerging markets has risen, they have influenced the assets prices considerably. Consequently, policymakers have become increasingly concerned about the factors determining international investment, the performance of foreign capital investments, and the impact of foreign investment on local turnover and on the volatility of stock.

Keywords: FII, FDI, SENSEX, NIFTY, BSE, GDRs, ADRs, NRIs, TDRs

INTRODUCTION

The liberalization policies initiated in India in the early 1990s brought about radical changes in the conduct of stock market. Rising globalization, deregulation, and foreign portfolio investments made the Indian stock exchanges competitive and efficient in their functioning. With the rise of equity culture across the globe, even India which has a long history of stock exchanges, has witnessed a perceptible shift in the proportion of investor's participation in equity markets. The role of investors is the key to success of market guided economic system and since it is they who pump their savings into the markets, their investments need to be channelized to the most rewarding sectors of the economy. One of the most dominant investors groups that has emerged to play a critical role in the overall performance of the capital market are Foreign Institutional Investors (FIIs). Foreign Investment refers to investments made by residents of a country in financial assets and production process of another country. After the opening up of the borders for capital movement these investments have grown in leaps and bounds. But it has varied effects across the countries. It can affect the factor productivity of the recipient country and can also affect the balance of payments. In developing countries there is a great need of foreign capital, not only to increase their productivity of labor but also helps to build the foreign exchange reserves to meet the trade deficits. Foreign investment provides a channel through which these countries can have access to foreign capital. It can come in two forms: foreign direct investment (FDI) and foreign portfolio investment (FPI). Foreign direct investment involves direct production activities of medium to long-term nature. But the foreign portfolio investment is a short-term investment mostly in the financial markets and it consists of Foreign Institutional Investment (FII).

Introduction to Foreign Institutional Investors (FII's)

Since 1990-91, the Government of India embarked on liberalization and economic reforms with a view of bringing about rapid and substantial economic growth and move towards globalization of the economy. As a part of the reforms process, the Government under its New Industrial Policy revamped its foreign investment policy recognizing the growing importance of foreign direct investment as an instrument of technology transfer, augmentation of foreign exchange reserves and globalization of the Indian economy. Simultaneously, the Government, for the first time, permitted portfolio investments from abroad by foreign institutional investors in the Indian capital market. The entry of FIIs seems to be a follow up of the recommendation of the Narsimhan Committee Report on Financial System. While recommending their entry, the Committee, however did not elaborate on the objectives of the suggested policy. The committee only suggested that the capital market should be gradually opened up to foreign portfolio investments.

From September 14, 1992 with suitable restrictions, Foreign Institutional Investors were permitted to invest in all the 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. While presenting the Budget for 1992-93, the then Finance Minister Dr. Manmohan Singh had announced a proposal to allow reputed foreign investors, such as Pension Funds etc., to invest in Indian capital market.

Channels of Foreign Institutional Investments in India

Portfolio investments in India include investments in American Depository Receipts (ADRs)/ Global Depository Receipts (GDRs), Foreign Institutional Investments and investments in offshore funds. Before 1992, only Non-Resident Indians (NRIs) and Overseas Corporate Bodies were allowed to undertake portfolio investments in India. Thereafter, the Indian stock markets were opened up for direct participation by FIIs. They were allowed to invest in all the securities traded on the primary and the secondary market including the equity and other securities/instruments of companies listed/to be listed on stock exchanges in India.

Entities which can register as FII's in India

Entities who propose to invest their proprietary funds or on behalf of "broad based" funds (fund having more than twenty investors with no single investor holding more than 10 per cent of the shares or units of the fund) or of foreign corporate and individuals and belong to any of categories given below can be registered for Foreign Institutional Investors (FII's).

- Pension Funds
- Mutual Funds
- Investment Trust
- Insurance or reinsurance companies
- Endowment Funds
- University Funds
- Foundations or Charitable Trusts or Charitable Societies who propose to invest on their own behalf
- Asset Management Companies
- Nominee Companies
- Institutional Portfolio Managers
- Trustees
- Power of Attorney Holders
- Banks
- Foreign Government Agency
- Foreign Central Bank
- International or Multilateral Organization

Investment Conditions and Restrictions for FIIs:

A Foreign Institutional Investor may invest only in the following:-

(a) Securities in the primary and secondary markets including shares, debentures and warrants of companies, unlisted, listed or to be listed on a recognized stock exchange in India.
(b) units of schemes floated by domestic mutual funds including Unit Trust of India, whether listed or not listed on a recognized stock exchange.
(c) Dated Government securities.
(d) Derivatives traded on a recognized stock exchange.
(e) Commercial paper.
(f) Security receipts.

The total investments in equity and equity related instruments (including fully convertible debentures, convertible portion of partially convertible debentures and tradable warrants) made by a Foreign Institutional Investor in India, whether on his own account or on account of his sub-accounts, should not be less than seventy per cent of the aggregate of all the investments of the Foreign Institutional Investor in India, made on his own account and on account of his sub-accounts. However, this is not applicable to any investment of the foreign institutional investor either on its own account or on behalf of its sub-accounts in debt securities which are unlisted or listed or to be listed on any stock exchange if the prior approval of the SEBI has been obtained for such investments. Further, SEBI while granting approval for the investments may impose conditions as are necessary with respect to the maximum amount which can be invested in the debt securities by the foreign institutional investor on its own account or through its sub-accounts. A foreign corporate or individual is not eligible to invest through the hundred percent debt route.

Even investments made by FIIs in security receipts issued by securitization companies or asset reconstruction companies under the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 are not eligible for the investment limits mentioned above. No foreign institutional should invest in security receipts on behalf of its sub-account.

Prohibitions on Investments

Foreign Institutional Investors are not permitted to invest in equity issued by an Asset Reconstruction Company. They are also not allowed to invest in any company which is engaged or proposes to engage in the following activities:

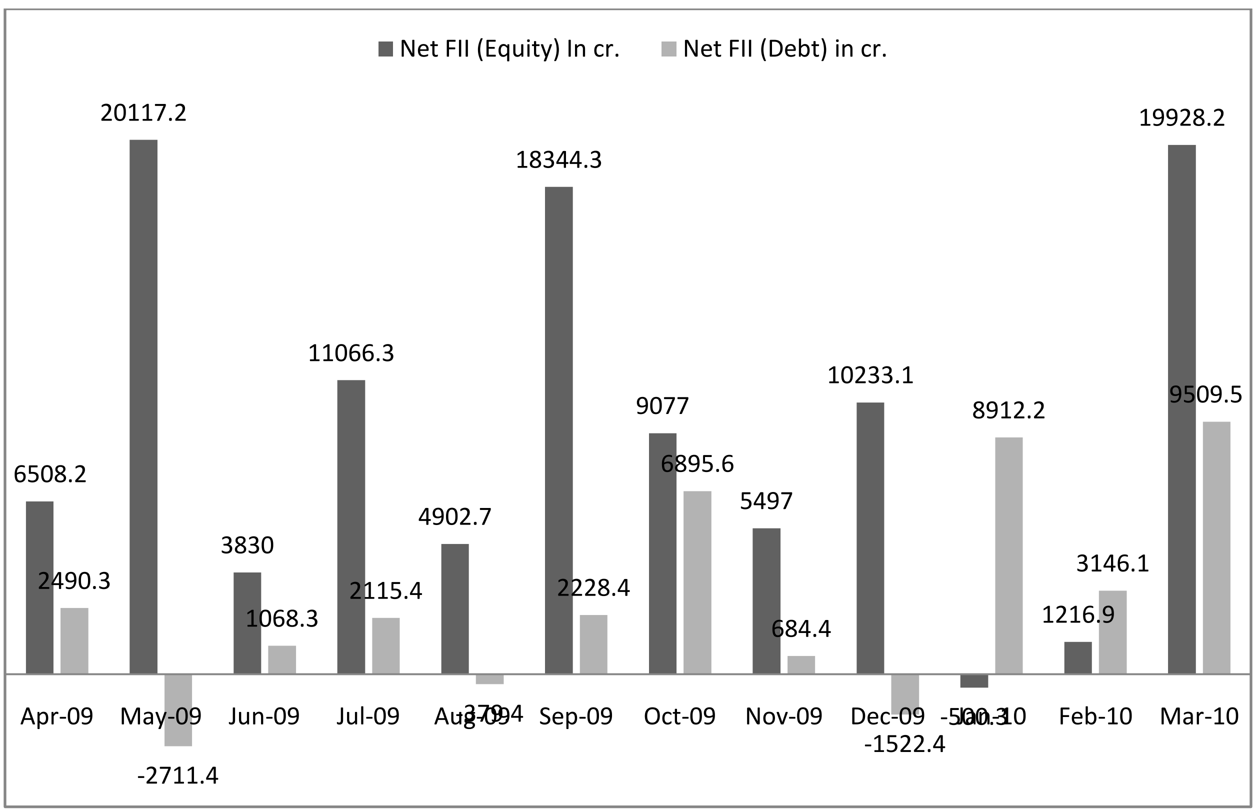
- Business of chit fund
- Nidhi Company

- Agricultural or plantation activities
- Real estate business or construction of farm houses (real estate business does not include development of townships, construction of residential/commercial premises, roads or bridges).
- Trading in Transferable Development Rights (TDRs).

FIIs OPERATIONS IN INDIAN CAPITAL MARKET (April 2009- March 2011)

The net investment in equity made by the FIIs amounted to Rs. 90292.4 crores (1 US Dollar = Rs. 58.5294) which was far better than the previous year which was also affected by global crisis and FIIs were net sellers throughout the year amounted to Rs.(47706.2) crores. But FIIs pumped the investment in equities a record high since 1992-93. The FIIs investment touched the 20000 crores mark in May 2009 and revived the Indian Capital market, the sensex rose from 12365.55 from previous year to 15585.1 at the end of March 2010.The FIIs were positive investors throughout the year except one instance of net outflow recorded in January 2009 amounting to Rs. (500.3) crores. Therefore, it was evident from the performance of FIIs in this financial year that it helped contributing in promotion of Indian Capital market. Thus, FII flow can be considered one of the factors driving the performance of Indian capital market.

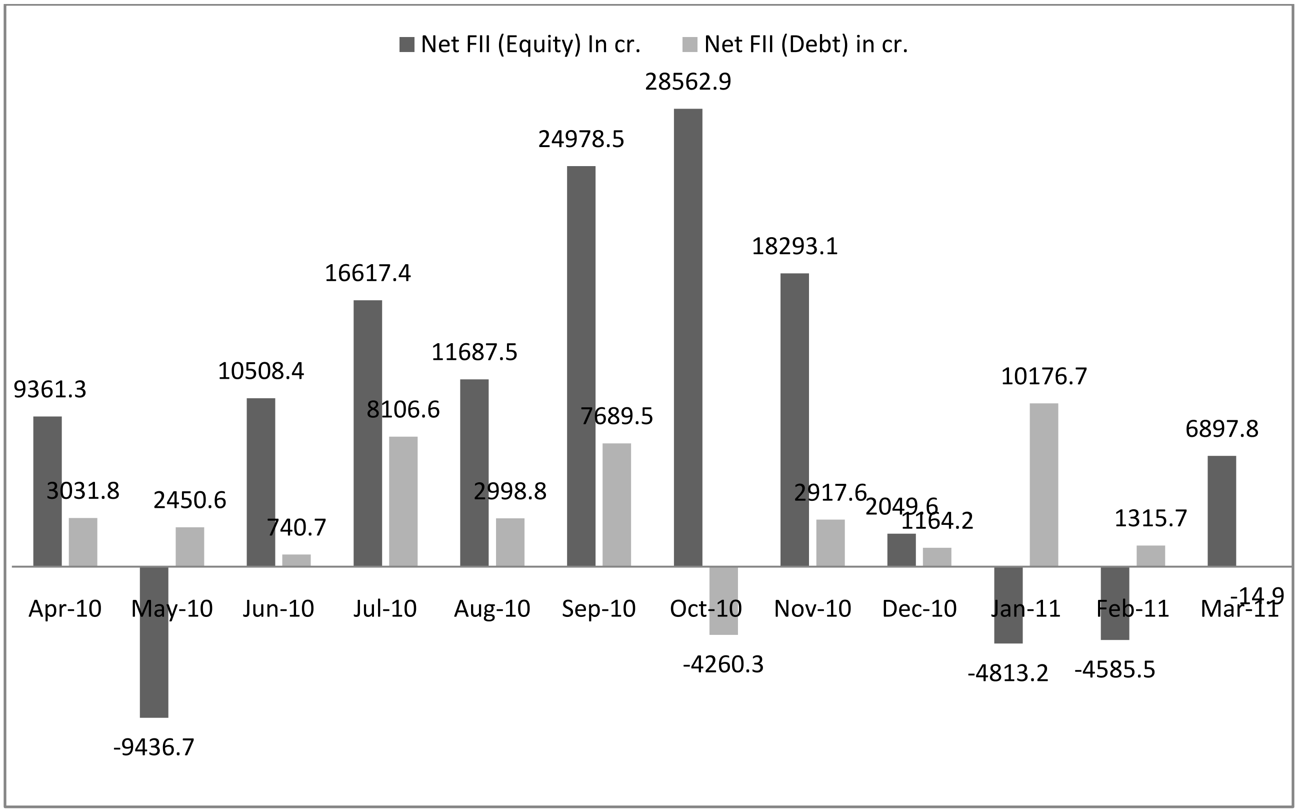
Figure 1:Net FII (equity) and FII (debt) investment inflows from April, 2009 to March, 2010



It is also 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 financial year 2007-08 due to global crisis, but they resumed their investment activities in a big manner and the stock market barometer touched 15,000 after 9 months of downsizing. This reflected the strong economic fundamentals of the country, as well as the confidence of the Foreign Institutional Investors in the growth and 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. After the global crisis in 2008, the FIIs once again showed confidence in Indian Capital market and surge their money in Indian Capital market like a thunder and invested at a tune of Rs. 122729.4 crores (including debt) and revived the Indian Capital market, in this period BSE sensex rose to 15581.21 which is more than 3000 points from the previous year which was affected by the global crisis. According to the BSE category-wise turnover data (which captures secondary market investments on both the exchanges) net investments by FIIs in the stock markets have been only Rs 22,849 crore. QIP offers raised around Rs 42,000 crore most of which has been subscribed by FIIs. This suggests that FIIs invested far more through the QIP route than through the secondary market route. The net additions in the registration of FIIs recorded in this period were 78 and at the end of year, March 2010, total registered FIIs were 1713. On the whole it was the good year relating to FIIs investment in the Indian Capital market and contributing in revival of Indian Capital market.The long moribund Indian debt market sprung to life in April 2009-March 2010. Total investment by foreign institutional investors (FIIs) reached Rs 32,437 crores in this financial year, this was more than 24,000 crores from the previous financial year and it was a good sign for Indian Capital market. Once again FIIs showed interest in debt securities and surged a record investment in debt securities. There were few instances when FIIs become net sellers in three months i.e., May, August and December to the tune of Rs. (2711.4) crores, (379.4) crores and (1522.4) crores respectively. Except from these months FIIs was net buyers throughout the year.

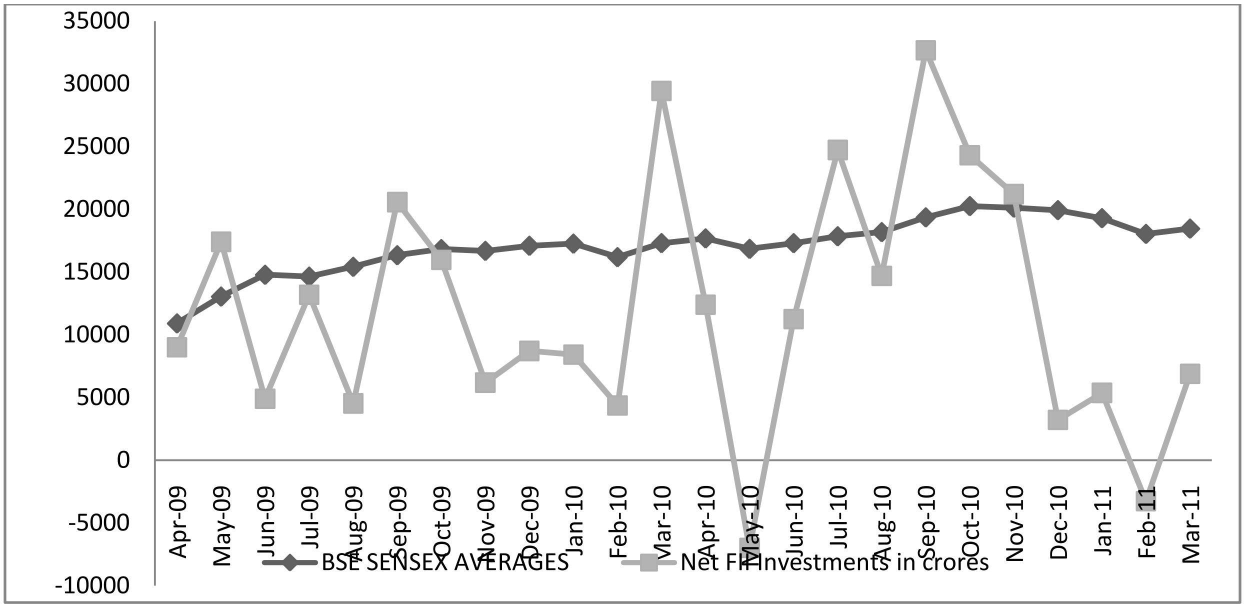
Debt market dealers said investors have been attracted by the stability of returns commanded by some corporate groups. Even if spreads have been comparable to paper from other emerging markets, this has been a differential factor. There are some very good names in the corporate sector, so investors are content to part funds with them even if the yields are only marginally higher. The Higher interest rate was also a good reason for overseas investors to invest in the debt market. On the whole it was a better year for the Indian Capital market due to record breaking investment made by the FIIs in equity and debt for the financial year 2009-10 after a discouraging previous year due to global crisis.

Figure 2:Net FII (equity) and FII (debt) investment inflows from April, 2010 to March, 2011



The net investment made by the FIIs in April 2010-March 2011 amounted to Rs. 146438 crores India, among the world investors, is believed to be a good investment destination in spite of political uncertainty, bureaucratic hassles, shortages of power supply and infrastructural deficiencies. Despite the Asian financial turmoil, India improved its position among the most attractive foreign investment destinations in the world. India presented a vast potential for overseas investment and actively encouraged the entrance of foreign players into the market. No company, of any size, aspiring to be a global player could no longer ignore this country, which is expected to become one of the top emerging economies. The FIIs investment in Indian Capital market stood to Rs. 146438 crores (in equity and debt both) were the largest in any year since the entry of FIIs in Indian soil. After the discouraging 2008-09, FIIs surge the heavy investment in Indian capital market which resulted to stability in BSE SENSEX, and the average sensex for this year recorded at 18607 and even touched the 20000 mark in two consecutive months of Oct and Nov 2010.

Figure 3: Line chart of FIIs Investment and BSE Senex for the period Apr 2009-Mar 2011



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 past investments data 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. And again Indian capital market witnessed a heavy investment by FIIs in 2010-11. 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'.

After their flight in 2008, foreign institutional investors flocked back to bet on the India's growth story by pouring in a record over Rs. 110121.1 crores in domestic equities and Rs. 36317 crores in debt securities in the financial year 2010-11 and Indian stock market witnessed a remarkable growth.Market experts said it was strong FII inflows that provided the much-needed warmth to Indian capital markets at times when the global economy continued to reel under the pressure of financial sector crisis. According to analysts, FIIs have been pumping funds into emerging markets like India because of their strong growth potential. Besides, rising concerns over the European countries' debt issue, political unrest in the West Asia and North Africa, and nuclear disaster in Japan are also driving foreign funds into the Indian market. Market analysts further said that FII inflows into the country will continue to rise this year as well because Indian market continues to be attractive. "FIIs are bullish on the Indian market as the stock market is on self-correction mode and quite attractive at this time. Besides, the situation in the rest of the world is not good, so, they don't have much opportunity. Apart from the country's robust economic growth, weakness in overseas markets due to European crisis, the Federal Reserve's second quantitative easing plan and Indian government's disinvestment (measures) added to the huge inflows. 2010 has broken all the records of investment by FIIs.

By applying 2-tailed Karl Pearson correlation on net FII investment and BSE Sensex, the following table has emerged

Table 1: Correlations Statistics

	N	Minimum	Maximum	Mean	Std. Deviation
BSE SENSEX AVERAGES	24	1.091120000000E4	2.024975000000E4	1.70733962500000E4	2.212181972805823E3
Net FII Investments in crores	24	-6986.1	32668.0	1.205E4	9845.2902
Valid N (listwise)	24				

		BSE SENSEX AVERAGES	Net FII Investments in crores
BSE SENSEX AVERAGES	Pearson Correlation	1	.195
	Sig. (2-tailed)		.362
	N	24	24
Net FII Investments in crores	Pearson Correlation	.195	1
	Sig. (2-tailed)	.362	
	N	24	24

From the above results, it is found that the correlation between Net FIIs investment and SENSEX is .195. This shows that is a relationship between Net FIIs investment and SENSEX. It shows that there is a impact of FIIs investment in the fluctuation of SENSEX. This positive correlation establishes the fact that the FII flows are an important driver of Indian Capital Market performance and hence, have a positive impact on country's economic development.

CONCLUSION & SUGGESTIONS

After observing the movement of FIIs movement and the impact of the trading of Foreign Institutional Investors on the performance of Indian capital market and 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 year 2008, but they have resumed their investment activities in a big way in next year 2009 and the stock market barometer touched 15,000 after 9 months of downsizing and again touched 20000 marks in Oct and Nov 2010. 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. Thus, FII flow can be considered one of the factors driving the performance of Indian capital market. The dominance of FIIs has serious inferences, even if large sections of the people are outside the dominion of the financial markets. The volatility triggered by the FIIs in 2008 and the markets limping back to normalcy following the response of the Indian establishment to the crisis makes an interesting reading not only to academicians but also to the policy makers. Huge withdrawals by the FII from the Indian capital markets were mainly due to the crash of financial markets in European markets that has been attributed to events like anticipation of a hike in the interest rate in US, fall in the prices in the stock market across the globe and technical correction in respect of overvalued stocks in the Indian capital market. Notwithstanding the crash in the Indian market, FIIs continue to be interested in investing in India-mostly due to the reforms that had been undertaken to ease the policies relating to foreign investments. The steady increase in the size of FII inflow in the recent years has attracted unwarranted attention as to whether the capital account of India is gradually coming to be dominated by 'Hot Money' – a phrase that is commonly used to describe the FII flows, though the usage might not be completely correct. FII flows are referred to as above, owing to their tendency to reverse their decision in response to adverse market sentiments and precipitating large capital outflows. Though the possibilities of 'herd' behavior by FIIs and mass withdrawal (as per the theoretical framework) cannot be ruled out, strong fundamentals and a well regulated market, comprising mainly of pension funds, life insurance companies and mutual funds, mostly involved in long-term investments, can minimize such possibilities.

The Indian capital market is currently buoyant, and also bestowed with a strong regulatory framework, which is extremely conducive for FII participation on a long-term basis. As the Indian economy gears up to counter the competition in the international investment market, by introducing reforms in its FII policy, overseas institutional investors seem to have identified the potential of India in providing attractive returns from investment and playing a significant role in promotion of Indian capital market. But apart from this the investment in the economy should be enhanced in the face of rising demand for investible resources. This can be done by encouraging more FII inflows into the country particularly given the advantage that FII is a form of non-debt creating inflows and thus does not increase the country's debt liabilities.

The fact is that developing country like India has its own challenges arising out of the very state of their social, political and economic development. To attract portfolio investments and retain their confidence, the host country has to follow stable macro-economic policies.

The ability of Government to prevent and reduce financial crises also has a great impact on the growth of capital flows. Steps to address these crises should include strengthening banking supervision, requiring and ensuring more transparency in international financial transactions, ensuring adequate supervision and regulations of financial markets which can be used in attracting more FIIs in the Indian Capital market and helps in building the growth story of Indian economy as well as Indian Capital market.

REFERENCES

Ahmed, K.M, Ashraf S., and A. Ahmed (2005), "An Empirical Investigation of FII"s role in the Indian equity Market" ICFAI Journal of Applied Finance 11 (8): 21-33.

Aitken, Brian (1996),"How Institutional Investors Destabilised Emerging Markets", working paper no 96/34, IMF, Washington.

Banaji J., (1998) Foreign Portfolio Investment in Indian Equity Markets: Has the Economy Benefited? QEH Working Paper No. 54.

Bandyopadhyaysankhanath (2005), "Foreign Institutional Investment: issue and challenges" Foreign Institutional Investments-Perspective and Experiences, ICFAI university press, p. 3-18.

Bardhan, Pranab K. (2000), "Understanding Underdevelopment: Challenges for Institutional Economics from the Point of View of Poor Countries", Journal of Institutional and Theoretical Economics, Vol. 156 No. 1, pp 216-235.

Chakrabarti, R. (2001), "FII Flows to India: Nature and Causes" Money & Finance, Vol. 2, No. 7, October–December. Pp. 34-44.

Kumar, S. (2001), "Does the Indian Stock Market Play to the tune of FII Investments? An Empirical Investigation" ICFAI Journal of Applied Finance 7 (3): 36-44.

Kumar, Saji (2006), "FIIs vs. Sensex- An Emerging Paradigm" Treasury Management, The ICFAI University Press.

Mazumdar, T. (2004), "FII Inflows to India; Their effect on stock market liquidity" ICFAI Journal of Applied Finance 10 (7): 5-20.

Mishra P.K., Das K.B. and Pradhan B.B. (2009): "Role of FIIs in Indian Capital Market" The Research Network, Vol.4, No.2, June.

Moin, Amir (2010), "The Nuisance Formula and the FII Hype", Business and Economy, Vol. 5, No. 13, pp 30-31.

Pal, Parthapratim (2005), "Recent volatility in stock markets in India and Foreign Institutional Investors" Special Articles Issue, Vol. 40, No. 8, (Feb 19-Feb 25,), Economic and Political Weekly.

Prasanna, P. K. (2008), "Foreign Institutional Investors: Investment Preferences in India", JOAAG, Vol. 3. No. 2.

Rakshit, Mihir (2006), "On Liberalizing Foreign Institutional Investment", Economic and Political Weekly, March 18.