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INFLUENCE OF FIIS (FOREIGN INSTITUTIONAL INVESTORS) IN INDIAN STOCK MARKET: AN OVERVIEW

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Abstract:

Foreign institutional investors have gained a significant role in Indian stock markets. The Foreign Institutional Investors (FIIs) have emerged as important players in the Indian equity market in the recent past. This study makes an attempt to develop an understanding of the dynamics of the trading behavior and the factors influencing FIIs and returns in the Indian equity market by analyzing the secondary data. The dawn of 21st century has shown the real dynamism of stock market and the various benchmarking of Sensex/Nifty in terms of its highest peaks and sudden falls. The present study is an attempt to determine the impact of Foreign Institutional Investments (FIIs) on Indian stock market as India has emerged as one of the most attractive investment destinations in Asia In this context present paper examines the contribution of foreign institutional investment in Indian Stock Market FII, because of its short-term nature, can have bidirectional causation with the returns of other domestic financial markets such as money markets, stock markets, and foreign exchange markets. Hence, understanding the determinants of FII is very important for any emerging economy as FII exerts a larger impact on the domestic financial markets in the short run and a real impact in the long run. Also attempts to understand the recent trends of FII during the period of 2001 to 2012 and examine the volatility of BSE/NSE due to FII. The data for the study uses the information obtained from the secondary resources like website of BSE, NSE and SEBI. This paper attempts to study the impact of foreign institutional investment on stock market and Indian economy. Being India part of BRICS and part of emerging economy FIIs play an important role in growth and sustainable development of

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Indian economy. This paper attempts to present the correlation between FII and BSE /NSE as well as Market capitalization through use of Karl Pearson Correlation test.

Key Words: FII (Foreign Institutional Investment), influence of FIIs, bidirectional causation, BRICS (Brazil, Russia, India, China and South Africa)

1 Introduction:

With rapid changes in the economy because of liberal economic policies and fast pace changes due to globalization, Indian market has become a focus point for foreign investors. Organizations tend to target for large volume of trade in this era of globalization. Trade flows are indeed one of the most visible aspects of globalization. International investment is a powerful source in propelling the world toward closure economic integration.FII refers to the investment made by resident of one country in the financial capital and asset of another country It facilitates and persuades large productivity and help in shaping up balance of payments.

FII flows in India have continuously grown in importance and derivatives, easing the norms for FII registration, reducing procedural delays, lowering fees, mandating stricter disclosure norms, improved regulatory standards etc. with a view to improving the scope, coverage and quality of FII flows into India. As a result, India, also supported by her strong economic fundamentals, has become one of the attractive destinations for FII flows in the emerging market space today. The expansionary effect of various reform measures on FII flows over the years can be gauged from the fact that net (i.e., gross purchases minus gross sales) .This increasing dominance of foreign investors in Indian market has necessitated research on the implications of FII flows for the Indian stock market time and again.

Although FII flows help supplement the domestic savings and augment domestic investments without increasing the foreign debt of the recipient countries, correct current account deficits in the external balance of payments' position, reduce the required rate of return for equity, and enhance stock prices of the host countries, yet there are worries about the vulnerability of recipient countries' capital markets to such flows. FII flows, often referred to as 'hot money' (i.e., short-term and overly speculative), are extremely volatile in character compared to other forms of capital flows. Foreign portfolio investors are regarded as 'fair-weather friends' who come in when there is money to be made and leave at the first sign of impending trouble in the host country thereby destabilizing the domestic economy of the recipient country. Often, they have been blamed for exacerbating small economic problems in the host nation by making large and concerted withdrawals at the slightest hint of economic weakness. Further, it is feared that too much of FII inflows may build up sizeable surpluses on a country's balance of payments, create excess liquidity and hence exert upward pressure on the exchange rate of the domestic currency or on domestic prices.

Foreign institutional investor means an entity established or incorporated outside India which proposes to make investment in India. Positive tidings about the Indian economy combined with a fast-growing market have made India an attractive destination for foreign institutional investors. FII is defined as an institution organized outside of India for the purpose of making investments into the Indian securities market under the regulations prescribed by SEBI

1.1 Entry Options For FII

A foreign company planning to set up business operations in India has the following options:

Incorporated Entity

By incorporating a company under the Companies Act,1956 through

• Joint Ventures; or

• Wholly Owned Subsidiaries

Foreign equity in such Indian companies can be up to 100% depending on the requirements of the investor, subject to equity caps in respect of the area of activities under the Foreign Direct Investment (FDI) policy

1.2 FOREIGN INSTITUTIONAL INVESTORS REGISTRATION

Following entities / funds are eligible to get registered as FII:

• Pension Funds

•Mutual Funds

• Investment Trust

• Insurance or reinsurance companies

• Investment Trusts

• Banks

• Endowments

• University Funds

• Foundations

• Charitable Trusts or Charitable Societies

Further, following entities proposing to invest on behalf of broad based funds, are also eligible to be registered as FIIs:

• Asset Management Companies

• Institutional Portfolio Managers

• Trustees

• Power of Attorney Holders.

The eligibility criteria for applicant seeking FII registration

As per Regulation 6 of SEBI (FII) Regulations,1995, Foreign Institutional Investors are required to fulfill the following conditions to qualify for grant of registration:

• Applicant should have track record, professional competence, financial soundness, experience, general reputation of fairness and integrity.

• The applicant should be regulated by an appropriate foreign regulatory authority in the same capacity/category where registration is sought from SEBI. Registration with authorities, which are responsible for incorporation, is not adequate to qualify as Foreign Institutional Investor.

• The applicant is required to have the permission under the provisions of the Foreign Exchange Management Act, 1999 from the Reserve Bank of India.

• Applicant must be legally permitted to invest in securities outside the country or its in-corporation / establishment.

• The applicant must be a "fit and proper" person.

• The applicant has to appoint a local custodian and enter into an agreement with the custodian. Besides it also has to appoint a designated bank to route its transactions.

• Payment of registration fee of US $ 5,000.00

"Form A" as prescribed in SEBI (FII) Regulations, 1995 is to be filled before applying for FII registration.

1.3 Investment Opportunities for FIIs:

The following financial instruments are available for FII investments:

a) Securities in 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 mutual funds;

c) Dated Government Securities;

d) Derivatives traded on a recognized stock exchange;

e) Commercial papers.

f) Investment limits on equity investments

g) FII, on its own behalf, shall not invest in equity more than 10% of total issued capital of an Indian company.

h) Investment on behalf of each sub-account shall not exceed 10% of total issued capital of an India company.

i) For the sub-account registered under Foreign Companies/Individual category, the investment limit is fixed at 5% of issued capital. These limits are within overall limit of 24% / 49 % / or the sectoral caps a prescribed by Government of India / Reserve Bank of India.

2.0 Review of Literature:

Gordon and Gupta (2002) on the portfolio flows in India and the influence of domestic fundamental factors, it was found that there exists a strong impact of the domestic fundamentals on the investment flows into India. They used the data from September 1992 till October 2001 and applied regression model and unit root test. It was concluded that the portfolio flows to India are small, compared to other emerging markets and also less volatile. The combination of domestic, regional and global variables are important in the determination of the portfolio flows into India

Stanley Morgan (2002) has examined 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. The Morgan Stanley report notes that FII 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

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 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.

3.0 RESEARCH METHODLOGY

The present study is of analytical nature and makes use of secondary data. The relevant secondary data are collected from various publications of Government of India; Reserve Bank of India, websites, annual reports, SEBI, Economic Times, World Bank reports, DIPP, research reports etc. Sensex and Nifty was a natural choice for inclusion in the study, as it is the most popular market indices and widely used by market participants for benchmarking. The present study considers 12 years data starting from 2001 to 2012. To have an empirical idea about the status of FII in India trend analysis has been conducted. The study conducted is empirical in nature and hence descriptive research has been conducted. The main source of obtaining necessary data for the study was Secondary Data An attempt has also been made to present composition of capital inflows in recent years. The present study has been undertaken with a conduct empirical analysis of status of FIIs. Also, examines the trends and patterns in the foreign Institutional investors (FII) across different sectors in India.

3.1Objectives of study:

a) To study the pattern and recent trends of FII flow in India.

b) To study the effects of FIIs in Indian Economy.

c) To study and analyze the relationship of Foreign Institutional Investors (FII) with:

i) FII and Indian Stock Market (Sensex/Nifty)

ii) FII and Market Capitalization (BSE/NSE)

Hypothesis:

- **Null Hypothesis :(Ho)There is no relationship between FII and Indian Stock Market (Sensex/Nifty)**
- **Alternative Hypothesis :(Ha) There is relationship between FII and Indian Stock Market (Sensex/Nifty)**
- **Null Hypothesis :(Ho)There is no relationship between FII and Market Capitalization of (BSE/NSE)**
- **Alternative Hypothesis :(Ha) There is relationship between FII and Market Capitalization of (BSE/NSE)**

3.2 Analytical Tools & Technique

In order to analyze the collected data the statistical tool(SPSS) such as correlation model is used. Correlation coefficient is a statistical measure that determines the degree to which two variable's movements are associated. Correlation coefficient value ranges from -1 to 1. Negative value of correlation indicates: if one variable increases in its values, the other variable decreases in its value and positive value indicates: if one variable increases in its values the other variable also increases in its value. In the current study to study the linear relationship between variables such as FDI and Indian GDP as well as Sensex correlation is applied. The multiple correlation analysis is a statistical technique used to evaluate the effects of two or more independent variables on a single dependent variable. In the current paper attempt is made to study the impact of FII & Indian Stock Market (Sensex/Nifty) as well with market capitalization (BSE/NSE). So FII is considered as the independent variable and the dependent variables for model i.e. Sensex/Nifty and Market Capitalization.

4 EFFECTS OF FII ON INDIAN ECONOMY

To study the positive and the negative side of this rise of investments by FIIs one by one.

MERITS OF FIIs:

It has been emphasized upon the fact that the stock market reforms like improved market transparency, automation, dematerialization and regulations on reporting and disclosure standards were initiated because of the presence of the FIIs. But FII flows can be considered both as the cause and the effect of the stock market reforms. The market reforms were initiated because of the presence of them and this in turn has led to increased flows.

1) Enhanced Flows Of Equity Capital :FIIs are well known for a greater appetite for equity than debt in their asset structure. For example, pension funds in the United Kingdom and United States had 68 per cent and 64 per cent, respectively, of their portfolios in equity in 1998. Not only it can help in supplementing the domestic savings for the purpose of development projects like building economic and social infrastructure but can also help in growth of rate of investment, it boosts the production, employment and income of the host country.

2). Managing Uncertainty And Controlling risks :FIIs promote financial innovation and development of hedging instruments. These because of their interest in hedging risks, are known to have contributed to the development of zero-coupon bonds and index futures. FIIs not only enhance competition in financial markets, but also improve the alignment of asset prices to fundamentals. FIIs in particular are known to have good information and low transaction costs. By aligning asset prices closer to fundamentals, they stabilize markets. In addition, a variety of FIIs with a variety of risk-return preferences also help in dampening volatility.

3). Improving Capital Markets :FIIs as professional bodies of asset managers and financial analysts enhance competition and efficiency of financial markets. By increasing the availability of riskier long term capital for projects, and increasing firms‘incentives to supply more information about them, the FIIs can help in the process of economic development.

4). Improved Corporate Governance : Good corporate governance is essential to overcome the principal-agent problem between share-holders and management. Information asymmetries and incomplete contracts between share-holders and management are at the root of the agency costs. Bad corporate governance makes equity finance a costly option.. FIIs constitute professional bodies of asset managers and financial analysts, who, by contributing to better understanding of firms‘operations, improve corporate governance.

DEMERITS OF FIIs: Market trends of past few recent years it is quite evident that Indian equity markets have become slaves of FIIs inflow and are dancing to their tune. And this dependence has to a great extent caused a lot of trouble for the Indian economy. Some of the factors are:

1). Potential Capital Outflows :Hot money refers to funds that are controlled by investors who actively seek short-term returns. These investors scan the market for short-term, high interest rate investment opportunities. ―Hot money can have economic and financial repercussions on countries and banks. When money is injected into a country, the exchange rate for the country gaining the money strengthens, while the exchange rate for the country losing the money weakens. If money is withdrawn on short notice, the banking institution will experience a shortage of funds.

2). Inflation :Huge amounts of FII fund inflow into the country creates a lot of demand for rupee, and the RBI pumps the amount of Rupee in the market as a result of demand created. This situation leads to excess liquidity thereby leading to inflation where too much money chases too few goods.

3). Problem To Small Investors :The FIIs profit from investing in emerging financial stock markets. If the cap on FII is high then they can bring in huge amounts of funds in the country‘s stock markets and thus have great influence on the way the stock markets behaves, going up or down. The FII buying pushes the stocks up and their selling shows the stock market the downward path. This creates problems for the small retail investor, whose fortunes get driven by the actions of the large FIIs.

4). Adverse Impact On Exports :FII flows leading to appreciation of the currency may lead to the exports industry becoming uncompetitive due to the appreciation of the rupee.

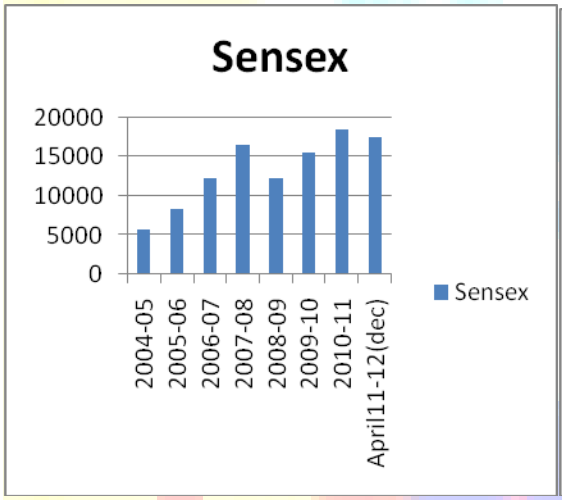
4.2 Annual Averages of Share Price Indices and Market Capitalization

Mkt. Capitalization (In Crs.)

Year	Sensex	Nifty	BSE	NSE
2004-05	5741	1805	1698428	1585585
2005-06	8280	2513	3022191	2813201
2006-07	12277	3572	3545041	3367350
2007-08	16569	4897	5138014	4858122
2008-09	12366	3731	3086075	2896194
2009-10	15585	4658	6165619	6009173
2010-11	18605	5584	6839084	6702616
April11-12(dec)	17506	5257	5348645	5232273

Table no-1

Source-SEBI



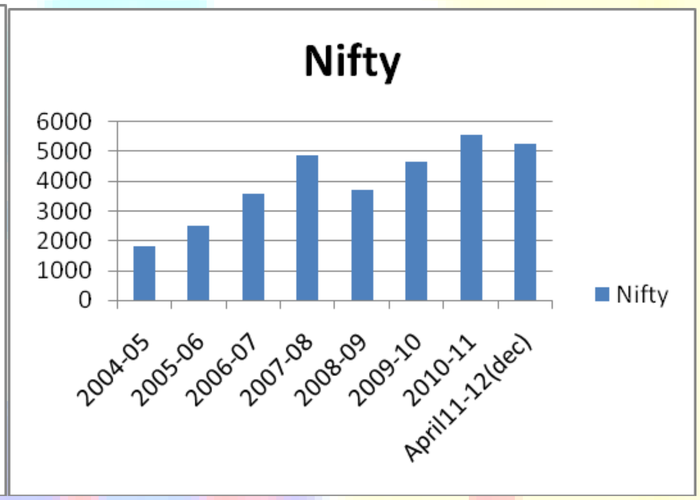


Fig:1 &2 Market Capitalisation of BSE and NSE.

Above table clearly interprets that increasing trend of market capitaliastion of both BSE/NSE as well as the volatility of market indicies of both BSE/NSE.The volatility may be of internal as well as external factors affecting the Stock market.

4.3 Trends of FIIs in Indian stock market

The growth of institutional investors in the market is having its own advantages as well as its own share of problems on the brighter side almost always purchase stocks on the basis of fundamentals. And this means that it is essential to have information to evaluate, so research becomes important and this leads to increasing demands on companies to become more transparent and more disclosures. This will lead to reduction in information asymmetries that plagued the Indian markets for quite a while. Also, the increasing presence of this class of investors leads to reform of securities trading and transaction systems, nurturing of securities brokers, and liquid markets. If we see the numbers of FII flows, It is increasing every year expect some of rare years where global factors like slowdown have effected Indian market too.

YEAR	NET INVESTMENT BY FIIs IN (Cr)	YEAR	NET INVESTMENT BY FIIs IN (Cr)
92-93	4.27	02-03	2666.5
93-94	5444.65	03-04	44000
94-95	4776.6	04-05	41416.5
95-96	6720	05-06	36539.6
96-97	7386	06-07	71486.5
97-98	5980	07-08	-52987
98-99	729.9	08-09	83425
99-2000	9767.5	09-2010	133266
2000-01	9685	10-11	-2715
01-02	8272.2		

Table no. 2- Net Investment By FIIs In Crore

Source-SEBI

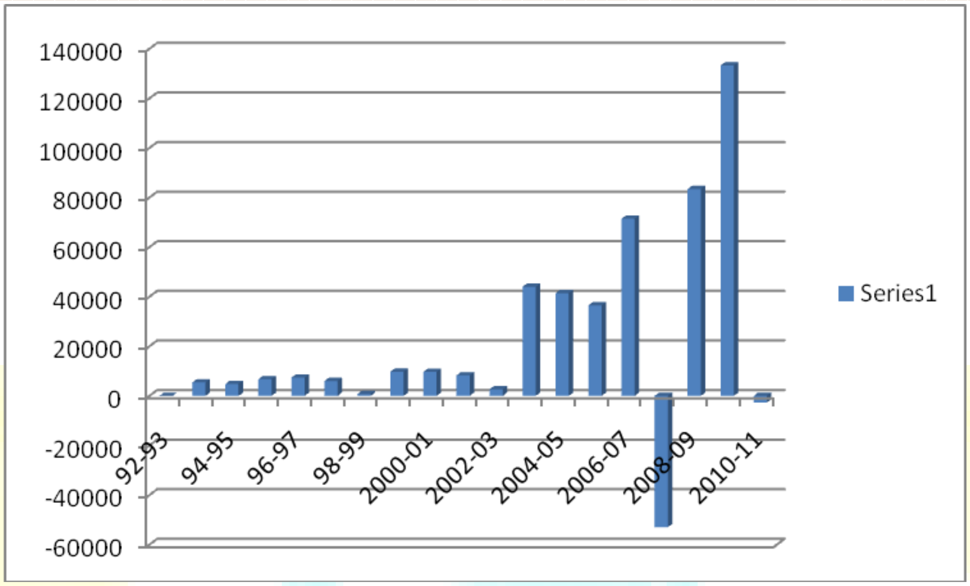


Fig no-3

Source: Economic Times ((Table no. 5)

Year	Gross Purchase (Cr)	Gross Sale (Cr)	Net Investment (Cr)	Cummulative Investment ($Mn)
2012	869,179.90	699,838.90	169,341.50	31,971.50
2011	611,055.60	613,770.80	-2,714.20	-357.83
2010	766,283.20	633,017.10	133,266.80	29,361.83
2009	624,239.70	540,814.70	83,424.20	17,458.14
2008	721,607.00	774,594.30	-52,987.40	-11,974.30
2007	814,877.90	743,392.00	71,486.30	17,655.80
2006	475,624.90	439,084.10	36,540.20	8,107.00
2005	286,021.40	238,840.90	47,181.90	10,706.30
2004	185,672.00	146,706.80	38,965.80	8,669.80
2003	94,412.00	63,953.50	30,459.00	6,627.60
2002	46,479.10	42,849.80	3,629.60	749.5
2001	51,761.20	38,651.00	13,128.20	2,806.40

2000	74,791.50	68,421.60	6,370.08	1,532.60

Year	FII US$ millions	Sensex
2000-01	1847	4272
2001-02	1505	3332
2002-03	377	3206
2003-04	10918	4492
2004-05	8686	5741
2005-06	9929	8280
2006-07	3225	12277
2007-08	20328	16569
2008-09	-15017	12366
2009-10	29048	15585
2010-11	29422	18605
2011-12	16813	17506

Table no-4

4.4 Relationship between FII and SENSEX:

Correlations

		FII	SENSEX
FII	Pearson Correlation	1	.583(*)
	Sig. (2-tailed)		.047
	N	12	12
SENSEX	Pearson Correlation	.583(*)	1
	Sig. (2-tailed)	.047	
	N	12	12

* **Tableno-6**

Correlation is significant at the 0.05 level (2-tailed).

Year	FII US$ millions	NSE
2000-01	1847	1335
2001-02	1505	1077
2002-03	377	1037
2003-04	10918	1428
2004-05	8686	1805
2005-06	9929	2513
2006-07	3225	3572
2007-08	20328	4897
2008-09	-15017	3731
2009-10	29048	4658
2010-11	29422	5584
2011-12	16813	5257

Source-SEBI

Tableno-5

Correlation between FII & Sensex:

FIIs have been investing on financial instruments in India and providing incentives for financial innovations in the country. Recently, they have become the movers and shakers of the market. Given this growing importance of FIIs for the Indian economy, it is essential that the dynamics of such cross-border portfolio investment in the context of economic growth of the country. The value of Karl Pearson co relation(r) is found to be +.583. It means that there is medium degree positive correlation between the FII and SENSEX.

Above Table no. 6 clearly analyses that Null Hypothesis :(Ho) that There is no relationship between FII and Sensex is rejected and Alternative Hypothesis (Hi) is accepted i.e. the positive correlation between these two variables is +.583. So there is positive correlation between the FII and SENSEX.

4.5 Relationship between FII and NIFTY:

		FII	NSE
FII	Pearson Correlation	1	.587(*)
	Sig. (2-tailed)		.045
	N	12	12
NSE	Pearson Correlation	.587(*)	1
	Sig. (2-tailed)	.045	
	N	12	12

Tableno-8

Correlation is significant at the 0.05 level(2-tailed).

Tableno-7

Source:SEBI

Given this growing importance of FIIs for the Indian economy, it is essential that the dynamics of such cross-border portfolio investment in the context of economic growth of the country. The value of Karl Pearson co relation(r) is found to be +.587. It means that there is medium degree positive correlation between the FII and NSE.

Above Table no. 8 clearly analyses that Null Hypothesis :(Ho) that there is no relationship between FII and Nifty is rejected and Alternative Hypothesis (Hi) is accepted as correlation between these two variables is +.587. So there is positive correlation between the FII and NIFTY.

4.6 Relationship between FII and BSE Market capitalization:

Year	FII US$ millions	BSE capitalization
2000-01	1847	571553
2001-02	1505	612224
2002-03	377	572198
2003-04	10918	1201207
2004-05	8686	1698428
2005-06	9929	3022191
2006-07	3225	3545041
2007-08	20328	5138014
2008-09	-15017	3086075
2009-10	29048	6165619
2010-11	29422	6839084
2011-12	16813	5348645

Table no-9
Source:SEBI

		FII	BSE Mkt. cap.
FII	Pearson Correlation	1	.720(**)
	Sig. (2-tailed)		.008
	N	12	12
BSE MKT. CAP.	Pearson Correlation	.720(**)	1
	Sig. (2-tailed)	.008	
	N	12	12

Table no-10

Correlation is significant at the 0.05 level(2-tailed).

Given this growing importance of FIIs for the Indian economy, it is essential that the dynamics of such cross-border portfolio investment in the context of economic growth of the country. The value of Karl Pearson co relation(r) is found to be +.720. It means that there is high degree positive correlation between the FII and BSE Market Capitalization.

Above Table no.10 clearly analyses that Null Hypothesis :(Ho) that There is no relationship between FII and BSE Market Capitalization is rejected and Alternative Hypothesis (Hi) is accepted i.e. there is correlation between these two variables is +.720. So there is positive correlation between the FII and BSE Market Capitalization.

4.7 Relationship between FII and NSE Market capitalization:

Year	FII US$ millions	NSE capitalization
2000-01	1847	657847
2001-02	1505	636861
2002-03	377	537133
2003-04	10918	1120976
2004-05	8686	1585585
2005-06	9929	2813201
2006-07	3225	3367350
2007-08	20328	4858122
2008-09	-15017	2896194
2009-10	29048	6009173
2010-11	29422	6702616
2011-12	16813	5232273

Table no-11

Source:SEBI

		FII	NSE MKT. CAP.
FII	Pearson Correlation	1	.728(**)
	Sig. (2-tailed)		.007
	N	12	12
NSE MKT. CAP.	Pearson Correlation	.728(**)	1
	Sig. (2-tailed)	.007	
	N	12	12

Tableno-12

Correlation is significant at the 0.01 level (2-tailed).

Given this growing importance of FIIs for the Indian economy, it is essential that the dynamics of such cross-border portfolio investment in the context of economic growth of the country. The value of Karl Pearson co relation(r) is found to be +.728. It means that there is high degree positive correlation between the FII and NSE Market Capitalization.

Above Table no. 12 clearly analyses that Null Hypothesis :(Ho) that There is no relationship between FII and NSE Market Capitalization is rejected and Alternative Hypothesis (Hi) is accepted i.e. there is correlation between these two variables is +.728. So there is positive correlation between the FII and NSE Market Capitalization.

5.0 Conclusion:

The empirical investigation of the direction of causation between FII flows to India and Indian stock market returns over the time period April 1997- March 2005 has thus revealed that FII flows are caused by rather than causing the national stock market returns. The slight evidence of a reversion of causality running from flows to returns as well has policy implications because of the potential of FII flows to aggravate the crisis already set in the stock market. But, given the ability of FII flows to augment the sources of funds in the Indian capital markets, strengthen the market liquidity and efficiency, advocate modern ideas in market design and sound corporate governance practices, and expose the Indian investors to modern financial techniques and international best practices and systems, it can be effectively argued that the role of foreign investors in developing and strengthening the functioning of Indian capital markets cannot be underplayed. However, the Indian policy makers must adopt a cautious approach while further liberalizing the FII policy by instituting built-in-cushion within the system against the possible destabilizing effects of sudden reversal of FII flows.

On the basis of above discussion and data analysis, It is clear that the FIIs are influencing the Sensex movement to a greater extent. Further it is evident that the Sensex has increased when there are positive inflows of FIIs and there were decrease in Sensex when there were negative FII Inflows. According to findings and results, it is concluded that FII did have high significant impact on the Indian capital market. Therefore, the alternate hypothesis is accepted. FII'S have positive impact on BSE Sensex and Nifty.

However there are other major factors that influence the bourses in the stock market, but FII is definitely one of the factors. This signifies that market rise with increase in FII's and collapse when FII's are withdrawn from the market. The Pearson correlation values indicate positive correlation between the FII and the movement of Sensex (Karl pearson' correlation value is 0.583) and FII and Nifty (Karl pearson' correlation value is 0.587). Above paper also analyses that positive correlation between the FII and the movement of BSE Market Capitalization (Karl pearson correlation value is 0.720) and there is also positive correlation between the FII and the movement of NSE Market Capitalization(Karl pearson correlation value is 0.728)

So it can be concluded that being India part of BRICS and part of emerging economy FIIs play an important role in the overall growth and sustainable development of Indian economy.

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