

A Study on the Role of Foreign Institutional Investors FII's in the Indian Capital Market

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Abstract

FII's are institutions established or incorporated outside India, which proposes to make investment in Indian securities. The FII's have been playing key role in the Indian capital market, since their entry in the early 1990's. Their importance has been growing overtime and their net investment is on the rise in the recent past. This portfolio flows by FII's bring with them great advantage as they are engines of growth while lowering the cost of capital in the emerging market. This paper indicates whether Foreign Institutional investors have emerged as the most dominant investor group in the domestic market or not.

Capital Market

The capital market is the market for securities, where companies and the government can raise long-term funds. The capital market includes the stock market and the bond market. Financial regulators such as U.S Securities and Exchange Commission, Oversee the capital markets in their designated countries to ensure that investors are protected against fraud. The Capital Markets consist of the primary market (where new issues are distributed to

investors) and the secondary market, where existing securities are traded.

Foreign Institutional Investors

Foreign Institutional Investors (FII' s) during last one decade have become an integral part of Indian equity Markets. They have been an incredible source of money ever since. The influence of FII's is such that the market players anticipate their arrival with breathless anxiety. This Reputation of FII's is a well earned status. The authority of these institutions is

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evident from the very fact that by the mere news of their arrival it is sufficient for the market to supplement itself with a double-digit growth. The era of FH's investments in India originated in 1993. FH's of different countries, mainly the US, started operating in India. The number of FII's in India has grown over the years from 250 to nearly 750. The big names include Morgan Stanley, Templeton, Capital International, CDC, Warburg and JFAM. FII's own almost a third of the free-floating market available for investment in the country.

Definition

A FII may be institution established or incorporated outside India which proposes to invest in securities in India. A FII may be a company or other institution established abroad A FII might be any of the following:

- A Company or an institution incorporated outside India as pension Fund. Mutual Fund or Investment trust.
- An Asset management company, Nominee Company, Bank or Institutional portfolio manager incorporated outside India and proposing to invest in India for broad-based funds.

- Foreign Trustee or power of Attorney holder proposing to invest in India for broad based funds.
- Foreign university funds, Endowments, Foundation or Charitable trusts or Charitable societies in existence for at least 5 years and that they are registered with a statutory in the country of their incorporation and it is legally permissible for them to invest in securities outside the country of their incorporation

A portfolio manager or mutual fund doing business in India, approved by SEBI, who act as investment agent for a foreign party and who makes investment in securities on behalf of the foreign party out of funds brought from abroad shall also be deemed to be the FII.

India - An Attractive Destination

India presents a vast potential for overseas investment and is actively encouraging the entrance of foreign players into market. There are many reasons for India being viewed with a sense of expectation by FIIs. Typically, all the logics percolate to a stronger fundamental of the national economy and the success of the reforms process being undertaken over the last

one decade. Global fund managers have put their bets on India because of the following combination of reasons.

Fastest Growing Economy: India has the largest global economy based on the purchasing power parity and since last few years, it has been one of the fastest growing economies of the world.

Strong Forex Reserves: The Forex situation had never been stronger. For a global investor the dollar reserve situation is a key criteria to evaluate a Market and the healthy reserves comes as a big plus for India. The strength of the local currency is of great significance for FIIs as it can eat into their returns significantly. Chances are that with dollar revenues from technology sector increasing in the next couples of years, this situation will only consolidate.

Economic reforms: Even though the place of reforms has been slow, there is a consensus among major political parties that reform must go on the decision on divestments of HP, BP, and Nalco has come as a relief to the market.

Corporate restructuring: In spite of tough times during past two years, corporates have been able to restructuring themselves effectively. Many of Indian

manufacturers like TISCO and Na1co are among the lowest cost producers of steel and aluminum in the world. With chances of improved business environment along with the removal of the infrastructure bottlenecks in the country will lead to better performance in most sectors. The restructuring of major old economy companies is leading for a higher GDP growth in Indian economy.

Information technology - The growth engine: Despite Indian software sector going through a rough patch on account of the recession in the US, the business has bounced back as business activity has picked up. It makes considerable sense for the US corporate to outsource services from India for the cost advantage it offers. With BPO services heavily betting on the usage on English as a tool for verbatim and India enjoying a distinct advantage compared to other nations as its English-speaking labor force is available at a fraction of cost available in most western countries. IT, being the major growth driver, will not only spur exports and improve the balance of trade position but also increases forex reserves, thus benefiting the overall economy.

Issues and Challenges Facing FIIs in India

Concentration and liquidity: The biggest concern plaguing Indian Markets is that of concentration and liquidity. There are only a handful of stocks that have a kind of liquidity for foreign investors to take significant positions. Indian markets are concentrated in very few stocks in terms of volume turnover.

Market Capitalization to GDP Ratio: The second major concern is market - cap to GDP ratio in India, which is quite low. This means that only a small fraction of Indian business is captured in stock markets and some of the major businesses are not even available in investing. This is because of increased government ownership in various segments. For example, Indian Railways, India Posts, State Road Transport Corporation, with their size and business credentials can ignite a lot of investor interest. There are major players, which are closely held, and unless all these come into stock market fold, opportunities will be limited.

Corporate Governance and Disclosure Norms: There are concerns on the corporate governance standards as well. Despite accounting scandals in the US,

Global investors have more faith in US regulatory system and corporate governance standards. Unlike domestic fund Managers who feel reasonably confident because of their regular interaction with the managements, foreign investors do feel quite insecure. For a fund manager managing funds from his head quarters in the US, the quantum of investment in Indian companies may not really justify the cost of monitoring them on a regular basis. Stock trading at PE multiple of 2 or 3 in spite of their steady financial performance, raises suspicion about the quality of management and in this respect global investors look at emerging markets like Korea and Taiwan, much more favorably.

Macro-economic Parameters: Selection of the right country is the main objective for FIIs investments rather than stitching together sector themes. FIIs are paying more attention than ever to country - specific factors like reform momentum, local political situation and macro - economic ratios. Macro- economic stability and fiscal stability are basic hygiene factors to attract foreign investors. The cost of rescuing government-owned financial institutions such as UTI and IFCI will affect the fiscal situation. The global rating agency

Standard & Poor downgraded India's local currency rating to junk grade from investment grade is definitely worrying global investors, through local fund managers are more bothered about ground realities such as corporate profitability and growth prospects.

Methodology

Data: Secondary data are used for the study. The literature pertaining to FIIs are collected from book, journals and newspapers. Access to the annual reports of RBI and the economic survey. For the purpose of the study, extensive use of the

database like website of NSE, BSE and RBI are used.

Data analysis: The data collected were put to statistical analysis whether Foreign Institutional investors have emerged as the most dominant investor group in the domestic market or not. For the purpose of study statistical tools like correlation analysis, regression analysis and trend analysis are used.

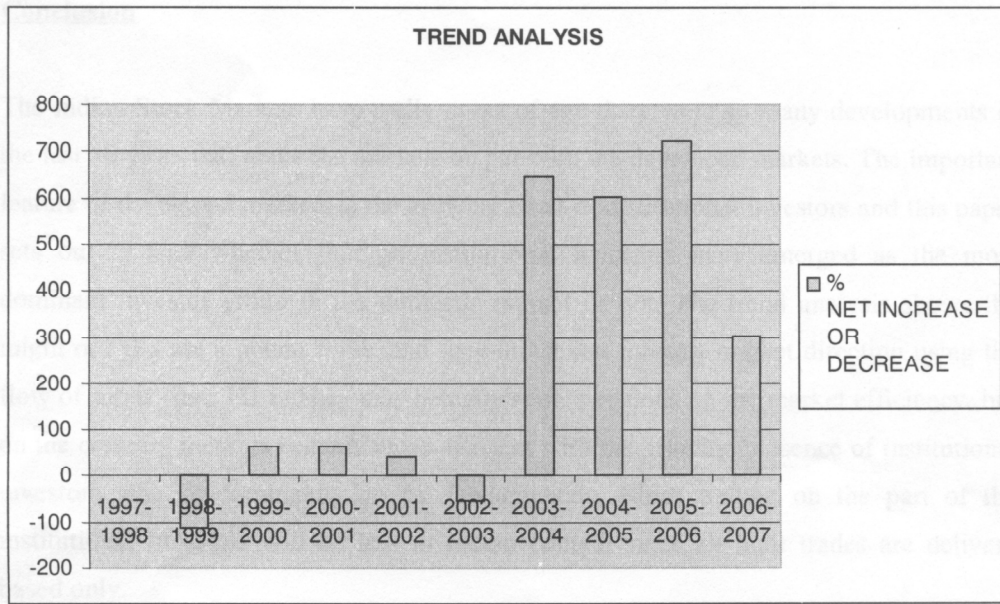
Period of the study: For this purpose data's are collected for the years from 1997 to March 2007.

Analysis and Interpretation

Table 1 (Rs. Crores)

Year	FII Net Investment	%	% Net Increase or Decrease
1997 - 1998	5908	100	-
1998 - 1999	-729	-12	-122
1999 - 2000	9765	165	65
2000 - 2001	9683	164	64
2001 - 2002	8273	140	40
2002 - 2003	2669	45	-55
2003 - 2004	44000	745	645
2004 - 2005	41417	701	601
2005 - 2006	48650	823	723
2006 - 2007	23754	402	302

Note : 1997 - 98 is Base year =100 Source : RBI Report



Interpretation

As revealed in the figure 1, it is observed that FII flow is remained flat between the years 2000-2002. However during the period between 2002 to 2006 we could see more FII inflows. Based on the findings we can conclude that FII inflows will be in an increase trend in the coming years.

Conclusion

The Indian Stock Markets have really come of age there were so many developments in the last 10 years that make the markets on par with the developed markets. The important feature of developed markets is the growing clout

of institutional investors and this paper sets out to find whether Foreign Institutional Investors have emerged as the most dominant investor group in the domestic market or not. The trend analysis shows the might of FII's are a potent force, and they infact can forecast market direction using the flow of funds from FII's. They may actually raise questions on the market efficiency, but on the contrary markets become more efficient with the growing presence of institutional investors who predominantly go by fundamentals. Noise trading on the part of the institutional investors will be less in Indian context since all their trades are delivery based only.

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