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Foreign Institutional Investment: A Hypothetical Edifice

1.1 Backgrounds

The Economic Development of any country depends upon the existence of well-organized financial markets. It is the financial system, which supplies the necessary financial inputs for the production of goods and services, which in turn promote the well being and standard of living of the people of a country. Capital Market are of crucial significance to capital formation as the main function of these markets is the mobilization of savings and their distribution for the industrial investment, thereby stimulating the capital formation and to that extent, accelerating the process of economic growth.

There are two broad segments of the financial market viz. the money market and the capital market. The money market deals with short-term debt, whereas the capital market deals with long-term debt and stock (Equity and Preference). Each of these markets has a primary segment and a secondary segment. New financial assets are issued in the primary market; whereas outstanding financial assets are traded in the secondary segment. Figure 1.1 depicts the components of the Indian Corporate Security Market. When a company wishes to raise capital by issuing securities or other entity intends to raise funds through units, debt instruments or bonds etc. it goes to the primary market, which is the segment of the capital market where issuers exchange securities for long run funds. The primary market facilitates the formation of capital. There are three ways in which a company may raise capital in the primary market: Public Issue, Right Issue and Private Placement.

The secondary market in India, where outstanding securities are traded consist of the stock exchanges, which are self-regulatory bodies under the overall regulatory
purview of the government and Security Exchange Board of India (SEBI). The government has accorded powers to the SEBI, as an autonomous body, to oversee the functioning of the security market and the operations of the intermediaries like mutual funds, merchant bankers, underwriters, portfolio managers, debentures trustees, bankers to an issue, registrars to an issue, share transfer agents, stock brokers and sub-brokers, Foreign Institutional Investors (FIIs), and rating agencies.

**FIGURE 1.1: INDIA'S CORPORATE SECURITY MARKET**
The evolution of the Indian financial system falls, from the viewpoint of exposition, into three distinct phases. A snap shot of these phases is given as follows:

- Phase I: Pre-1951 Organization
- Phase II: 1951 to Mid-Eighties
- Phase III: Post Nineties

**Phase I: Pre-1951 Organization**

The organization of the Indian financial system before 1951 had a close resemblance with the theoretical model of a financial organization on a traditional economy. The principal features of the pre-independence industrial financing organizations are the closed circle character of industrial entrepreneurship, a semi-organized and narrow industrial securities market, devoid of issuing institutions and the virtual absence of participation by intermediary financial institutions in the long-term financing of industry. As a result industry had very restricted access to outside savings.

**Phase II: 1951 to Mid-Eighties**

The organization of the Indian financial system during the post-1951 period evolved in response to the imperatives of planned economic growth with social justice as enshrined in the Indian Constitution, under Directive Principles of State Policy. The scheme of planned economic development was initiated in 1951. The introduction of planning has had important implications for the financial system. The main elements of the financial organization in planned economic development were as follows:

- Public/Government ownership of financial institutions
- Fortification of the institutional structure
- Protection of investor
- Participation of financial institutions in corporate management

Certain weaknesses still persisted in the organization of the Indian financial system. These pertained to: institutional structure, problem of small and new enterprise and new issue market organization.
Phase III: Post Nineties

The organization of Indian financial system, since mid-eighties in general, and the launching of the new economic policy in particular, has been characterized by profound transformation. The fundamental philosophy of the development process in India has shifted to free market economy and the consequent liberalization/globalization/deregulation of the economy. Major economic policy changes initiated here includes macro-economic stabilization, declining of industry, trade liberalization, currency reforms, reduction in subsidiaries, financial sector reform etc. This liberalization policy starts the rally of reforms in the Indian economy.

A major feature of economic reforms in India since 1991 has been progressive liberalization of external capital flows, especially non-debt creating ones like Foreign Direct Investment (FDI) and Foreign Institutional Investment (FII).

1.2 Foreign Straight Investment

According to International Monetary Fund’s Balance of Payment Manual 5 “Foreign Straight Investment is that category of international investment that reflects the objective of obtaining a lasting interest by a resident entity in one economy in an enterprise resident in another economy. The lasting interest implies the existence of a long-term relationship between the direct investor and the enterprise and a significant degree of influence by the investor in the management of the enterprise.”

However European Union states “Foreign investment is labeled direct investment when the investor buys more than 10 percent of the investment target.”

The OECD also recommends the 10 percent numerical guideline of ownership of ordinary shares or voting stock to determine the existence of a direct investment relationship. If the criteria are met, the concept of FDI includes the following organizational bodies:
♦ Subsidiaries (in which the non-resident investor owns more than 50 per cent);
♦ Associates (in which the non-resident investor owns between 10 and 50 per cent), and;
♦ Branches (unincorporated enterprises, wholly or jointly owned by the non-resident investor).

From the foregoing definitions one can derive that foreign direct investment means funds committed to a foreign enterprise. The investor may gain partial or total control of the enterprise. That can be done through joint ventures, technical collaborations and by taking part in management of a concern.

1.3 Foreign Institutional Investment

As defined by the European Union Foreign Institutional Investment is an investment in a foreign stock market by the specialized financial intermediaries managing savings collectively on behalf of investors, especially small investors, towards specific objectives in term of risk, return and maturity of claims.

SEBI’s Definition of FIIs presently includes foreign pension funds, mutual funds, charitable/endowment/university funds, asset management companies and other money managers operating on their behalf in a foreign stock market.

Foreign institutional investment is liquid nature investment, which is motivated by international portfolio diversification benefits for individuals and institutional investors in industrial country. Currently, the following entities are eligible to invest under FII route:

(i) As FIIs.

Overseas pension funds, 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 holders incorporated or established outside India proposing to make proprietary investment or investment on behalf of a broad-
based funds (i.e. fund having more than 20 investors with no single investors holding more than 10 percent of the shares or units of the fund).

(ii) As Sub-Accounts

The sub account is generally the underlying fund on whose behalf the FII invests. The following entities are eligible to be registered as sub-account, viz. partnership firms, private company, public company, pension fund, investment trust and individuals.

(iii) Domestic Entities

A domestic portfolio manager or a domestic asset management company shall also be eligible to be registered as FII to manage the funds of sub-accounts.

1.4 Dissimilarity between Foreign Direct Investment and Foreign Institutional Investment

On the basis of above definition the FDI ands FII can be segregated on the following grounds:

<table>
<thead>
<tr>
<th>Basis</th>
<th>Foreign Direct Investment</th>
<th>Foreign Institutional Investment</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Explanation</td>
<td>Foreign direct investment means funds committed to a foreign enterprise. The investor may gain partial or total control of the enterprise.</td>
<td>Foreign Institutional Investment means investment in a foreign stock market by the specialized financial intermediaries managing savings collectively on behalf of investors.</td>
</tr>
<tr>
<td>2. Investor</td>
<td>That can be done through joint ventures, technical collaborations and by taking part in management of a concern.</td>
<td>FII presently includes foreign pension funds, mutual funds, charitable/endowment/university funds etc. as well as asset management companies and other</td>
</tr>
</tbody>
</table>
money managers operating on their behalf

3. Control
The basic motive of the FDI is to have control on the enterprise in which they are investing.
FIIs are not interested in managing control.

4. Termination Period
FDI have lasting interest in their company and stay with it through thick or thin.
FIIs are fair weather friends, who come when there is money to be made and leave at the first sign of impending trouble.

5. Interference
FDI have the active power to make the interference in the decisions of the enterprise.
FIIs are the investors who share the project and business risk without interfering in the critical decisions of the company.

6. Volatility
FDI bring stability in the market because they contribute to fundamental strength in the economy.
FIIs might make market more volatile because they are called fair weather friends.

1.5 Foreign Institutional Investment in India

India opened its stock market to foreign investors in September 1992 and has since 1993, received considerable amount of portfolio investment in the form of Foreign Institutional Investor’s (FIIs) investment in equities (Table 1.2). This has become one of the main channels of international portfolio investment in India for foreigners. In order to trade in Indian equity markets, foreign corporations need to register with the SEBI as Foreign Institutional Investors.

| TABLE 1.2: FIIs INVESTMENT IN INDIA |

<table>
<thead>
<tr>
<th>Securities and Exchange Board of India (SEBI) Data</th>
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</table>

<table>
<thead>
<tr>
<th>Year</th>
<th>Purchase</th>
<th>Sale</th>
<th>Rupees Crore</th>
<th>Millions of Dollars</th>
<th>Cumulative in Millions of US $</th>
</tr>
</thead>
<tbody>
<tr>
<td>1992-93</td>
<td>17</td>
<td>4</td>
<td>13</td>
<td>4</td>
<td>4</td>
</tr>
</tbody>
</table>
Table 1.2 indicates that every year since FIIs were allowed to participate in Indian market, net inflows into India remained positive, except 1998-99. This reflects the strong fundamentals of the country, as well as the confidence of the foreign investors in the growth prospects of the Indian market. The year 2003 marked a watershed in FII investment in India as they started in this year in a big way by investing Rs. 985 crore in January itself. Meanwhile, corporate India continued to report good operational results, this along with good macroeconomic fundamentals, growing industrial and service sector led FIIs to perceive great potential for the investment in the Indian economy.

In April 2003, prices of commodities like steel and aluminum went up, propelling FII investment to Rs. 3,060 crore in May 2003. The same time, Morgan Stanley Capital International (MSCI) in its MSCI Emerging Market index gave a weight of 4.3 percent to India among the emerging markets of the world. Calendar year 2004 ended with net FII inflows of US$ 9.2 billion, an all-time high since the liberalization.

The buoyant inflows continued in 2004-05. The weight in MSCI Emerging Market Index was increased to 5.9 percent in April 2004. In 2004-05, after receiving directions briefly during the period May-June, FII inflows become robust again, leading to net inflows of US$ 10.25 billion during the year. The buoyancy continued in 2005-06.
with net inflows aggregating to US$ 10.11 billion at the end of December 2005 and at the end of the December 2007 it was 17.23 billion.

The diversity of FIIs has been increasing with the number of the registered FIIs in India steadily rising over the years as shown in the table 1.3. In 2004-05, 145 new FIIs were registered with the Securities and Exchange Board of India and as on March 31, 2005, there were 685 FIIs registered in India. The names of some prominent FIIs registered during 2004-05 are: California Public Employees Retirement System (CalPERS), United Nations for and on behalf of the United Nation Joint Staff Pension Fund, Public School Retirement System of Missouri, Commonwealth of Massachusetts Pension Reserve Investment Trust, Treasure of the State North Carolina Equity Investment Fund Pooled Trust, the Growth Fund of America and AIM Funds Management Inc. At the end of the year 2007 the Total No of FIIs registered with SEBI was 1219.

### TABLE 1.3: FIIs REGISTERED IN INDIA

<table>
<thead>
<tr>
<th>Financial Year</th>
<th>During the Year</th>
<th>Total Registered at the End of the Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>1992-93</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>1993-94</td>
<td>3</td>
<td>3</td>
</tr>
<tr>
<td>1994-95</td>
<td>153</td>
<td>156</td>
</tr>
<tr>
<td>1995-96</td>
<td>197</td>
<td>353</td>
</tr>
<tr>
<td>1996-97</td>
<td>99</td>
<td>439</td>
</tr>
<tr>
<td>1997-98</td>
<td>59</td>
<td>496</td>
</tr>
<tr>
<td>1998-99</td>
<td>59</td>
<td>450</td>
</tr>
<tr>
<td>1999-00</td>
<td>56</td>
<td>506</td>
</tr>
<tr>
<td>2000-01</td>
<td>84</td>
<td>528</td>
</tr>
<tr>
<td>2001-02</td>
<td>48</td>
<td>490</td>
</tr>
<tr>
<td>2002-03</td>
<td>51</td>
<td>502</td>
</tr>
<tr>
<td>2003-04</td>
<td>86</td>
<td>540</td>
</tr>
<tr>
<td>2004-05</td>
<td>145</td>
<td>685</td>
</tr>
<tr>
<td>2005-06</td>
<td>131</td>
<td>803</td>
</tr>
<tr>
<td>2006-07</td>
<td>190</td>
<td>993</td>
</tr>
<tr>
<td>2007-08</td>
<td>289</td>
<td>1282</td>
</tr>
</tbody>
</table>

Source: Report of the Ministry of Finance, Govt. of India on Encouraging FII Flows Nov. 2005 and data for later period is updated from the RBI website.

*Data is upto 31 January 2008
It is obvious from Figure 1.2 that, in term of the country of origin, the USA topped the list with a share of 42 percent of the number of FIIs registered in India, followed by UK’s 20 percent. Beside UK, and US other investing countries include Luxemburg, Hong Kong, Australia and Singapore. European and Japanese FIIs have also started taking an increasing interest in India and of the FIIs that registered with SEBI in October 2004, a significant number belonged to them. These developments have helped improve the diversity of the set of FIIs operating in India.

**FIGURE 1.2: SOURCE OF FIIS IN INDIA**

1.6 Benefits and Expenses of FIIs Investment

**Benefits**

1. **Reduced Cost of Equity Capital**

   FII inflows augment the sources of funds in the Indian capital markets. In a common sense way, an increase in the supply of funds reduces the required rate of return for equity and enhances stock prices. Simultaneously, it fosters investment by Indian firms in the country.

2. **Imparting Stability to Indian’s Balance of Payment:**

   - 10 -
For promoting growth in India, there is a need to augment domestic investment, over and beyond domestic savings, through capital flow. The excess of domestic investment over domestic savings result in a current account deficit and this deficit is financed by the capital flow in the balance of payment. Prior to 1991, debt flows and official account deficit is widely believed to have played a role in the emergence of balance of payments difficulties, which arose in 1981 and 1991. Foreign institutional investment as opposed to debt-creating flows is important as safer and more sustainable mechanism for funding the current account deficit.

3. Knowledge Flows

The activities of international institutional investors help strengthen financial system. FIIs advocate modern ideas in market design, promote innovation, development of sophisticated products such as financial derivatives, enhance competition in financial intermediation and lead to spillover of human capital by exposing market participants to modern financial techniques and international best practices and systems.

4. Strengthen Corporate Governance

Domestic institutional investors and individual investors, who are used to the ongoing practices of domestic corporates, often accept such practices, even when these do not measure up to the international benchmarks of best practices. FIIs with their vast experience with modern corporate governance practices are less tolerant of malpractice by corporate managers and owners (dominant shareholders). FII participation in domestic capital markets often-lead vigorous advocacy of sound corporate governance practices, improved efficiency and better shareholder value.

5. Improve Market Efficiency

A significant presence of FIIs can improve market efficiency through two channels. First, when adverse macroeconomic news, such as bad monsoon, unsettles many domestic investors, it may be easier for a globally diversified
portfolio manager to be more dispassionate about a country’s prospects, and engage in stabilizing trades. Second, at the level of individual stocks and industries, FIIs may act as a channel through which knowledge and ideas about valuation of a firm or an industry can more rapidly propagate into market. For example, foreign investors rapidly assess the potential of firms like Infosys, which are primarily export-oriented, by applying valuation principles that prevailed outside India for software services companies.

Expenses

1. **Herding and Positive Feedback Trading**

   There are concerns that foreign investors are chronically ill informed about India, and the lack of sound information may generate herding (a large numbers of FIIs buying and selling together) and positive feedback trading (buying after positive returns, selling after negative returns). These kinds of behavior can execrate volatility and push process away from fair values. FIIs behavior in India, however, so far does not exhibit these patterns.

2. **Balance of Payment Vulnerability**

   There are concerns that in an extreme event, there can be a massive flight of foreign capital out of India, triggering difficulties in the balance of payments front. India’s experience with FIIs so far, however, suggests that across episodes like the Pokharn blasts or the 2001 stock market scandal, no capital flight has taken place. A billion or more US dollars of portfolio capital has never left India within the period of one month. When juxtaposed with India’s enormous current and capital account flows, this suggests that there is little evidence of vulnerability so far.
3. **Possibility of Taking Over Companies**

While FIIs are normally seen as pure portfolio investors, without interest in control, portfolio investors can occasionally behave like FDI investors and seek control of companies that they have a substantial share holding in. Such outcomes, however, has not been experienced by India. Furthermore, SEBI’s takeover code is in place and has functioned fairly well ensuring that all investors benefits equally in the event of takeover.

4. **Complexities of Monetary Management**

A policy maker trying to design the ideal financial system has three objectives. The policy maker wants to continue national sovereignty in the pursuit of interest rate, inflation and exchange rate objectives; financial markets that are regulated, supervised and cushioned; and the benefits of global capital markets. Unfortunately, these three goals are incompatible. They form the impossible trinity. India’s openness to portfolio flows and FDI has effectively made the country’s capital account convertible for foreign institutions and investors. The problems of monetary management in general and maintaining a tight exchange rate regime, reasonable interest rates and moderate inflation at the same time in particular have come to the fore in recent times. The problem showed up in terms of very large foreign exchange reserve inflows requiring considerable sterilization operations by the RBI to maintain stable macroeconomic conditions. The government of India had to introduce a Market Stabilization Scheme (MSS) from April 1, 2004.

These are the benefits and harm of the foreign institutional investors. If proper rules are established and implemented by the regulatory body, the harms of the FIIs can be eliminated.

1.7 **Determinants of Foreign Institutional Investment**

Foreign institutional investment can supplement domestic savings and augment domestic investment without increasing the foreign debt of the county. Such investment
constitutes non-debt creating financing instruments for the current account deficits in the external balance of payments. It also provides so many benefits we have discussed above. The behavior of the FIIs depends on so many factors. Let us discuss the factors affecting FIIs flows. These factors can be classified in two categories as is shown in the Figure 1.3.

1.7.1 International or Push Issue:

1. International Market Capitalization

The classical Capital Asset Pricing Model (CAPM) predicts that, to maximize risk-adjusted return investors should hold a diversified market portfolio of risky assets, irrespective of their country of residence. In practice, however, the proportion of foreign assets in investor’s portfolios tends to be very small and there is a home bias. There is evidence of the home bias decreasing over the years, the share of foreign stocks in the equity portfolio of US investors, for example increased from an estimated 2 percent in the late 1980s to about 10 percent at the end of the 1997, but is still far short of the 52 percent of world capitalization accounted for by non US stocks. A part of the home bias is because of barriers to international investment. The international CAPM predict that individuals should hold securities from around the world in proportion to market capitalization. This is predicted on the assumption that there are no barriers to international investment. Or in practice, the international barriers are also decreasing day by day, which led the FIIs.

**FIGURE 1.3: DETERMINANTS OF THE FIIs**

<table>
<thead>
<tr>
<th>International Factors</th>
<th>Domestic Factors</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. International market Capitalization</td>
<td>1. Market Return on Investment in Shares</td>
</tr>
<tr>
<td>2. Exchange Rate Variance</td>
<td>2. Variance of Return in Stock Market</td>
</tr>
<tr>
<td>3. Foreign Interest Rate</td>
<td>3. Beta of the Share Market</td>
</tr>
</tbody>
</table>
2. **Exchange Rate**

FIIs are attracted by the returns calculated in foreign currency, say for example, in US dollars. Thus, what is relevant is the return on their investment in rupee terms and the movement of the exchange rate of the rupees. A high rupee return on equities can be neutralized at least in part, by a depreciation of the rupee. For example, a 15 percent rupee return on equities with a 7 percent depreciation of the rupee results in an effective dollar rate of return of about 8 percent only. Similarly, a relatively unattractive low rupee rate of return on equities can become attractive in dollar terms if the rupee appreciates vis-à-vis the dollar. Given every thing else, FII flows go up when there are expectations of domestic currency appreciation or vice-versa.

3. **Foreign Interest Rate**

FII investment in debt instruments depends on the foreign interest rate. Just an example last year the interest rate of US was comparatively lower than that in Indian. Then almost of the US Institutional investors move to India’s and other emerging markets where the interest rate was comparatively higher. So the interest rate in the international market also affects the FIIs.

4. **Foreign Industrial Production**

Growth rate of foreign markets also affects the FIIs flows in a nation. Suppose that in US, the rate of production in the domestic industry is
comparatively lower in that case the growth prospect will be very low. As a result, the investors of the US will tend to those economies where the growth rate of industrial production is comparatively high and growth prospect is more.

5. International Crisis

International crisis also affects the flow of FIIs in a nation. Take the example of the East Asian Crisis, which erupted in mid-1997. It has been one of the most serious and challenging economic events of the 1990s. The crisis affected primarily five countries- South Korea, Malaysia, Thailand, Indonesia and Philippines. The overall outlooks for the emerging markets took a beating. Its affect was also felt in India. It implies that the international crisis also affect international investing because an international event bears an impact on almost all the countries.

1.7.2 Domestic Issues or Pull Issues

1. Return on Investment in Share Market

The recession in United States, Japan and many other European countries during the early 1990s included the investors in developed countries to channelize their funds to developing countries, since the returns earned in such markets were much higher. There was an increasing flow of funds from developed countries towards emerging markets and therefore these markets became increasingly important in terms of portfolio management for institutional investors. Indian stock market, being among the emerging markets, became favorable destination for international institutional investors to earn diversify and higher return on their investments.

2. The Variance of Return in Share Market

The variance of the stock market return is a measure of risk attached with investing in the capital market. The risk is also a factor, which affects the flow of the FII in a country. The arrival of FIIs depends upon the perception about the
Almost all the FIIs are risk-averse in nature and would like to leave the high-risk profile market or vice-versa.

3. **Beta of Share Market**

With the growing integration of the world capital markets, there has been a tendency to diversify investment. Following the standard International Capital Asset Pricing Model approach, the beta of the Indian market has been used as a measure of the diversification of investing in the Indian market for an internationally diversified portfolio investor. It is a measure of the responsiveness of the domestic stock market to the changes in the international stock market. A positive and significant beta implies similar movements in domestic and foreign share prices and hence, limited diversification opportunity to the investors. In view of this, one can take a hypothesis that with the reduced opportunities to diversify portfolios, FII inflows will be reduced. In other words, a priori there will be an inverse relationship between FII investment and beta.

4. **Information Asymmetry**

Internationally, it has been seen that most of the corporate equity is held by domestic investors. This phenomenon is known as *home bias* among investors. Home bias can be due to several factors such as, differential taxation policies and information asymmetry. Information asymmetry means difference between the time and information available to domestic and international investors. In the case of the symmetry of information between the domestic and foreign investor, the foreign portfolio flow will depend only on the returns in the host market, where as in case of information asymmetry portfolio flow to a country would not be related to the returns.
5. Impact Cost

One of the pre-requisites for an investor to be able to comfortably trade frequently in the market without suffering a great transaction cost. In other words, it requires the market to be liquid. FIIs have financial focus and lay emphasis on liquidity. Liquidity, in this context means the ability of the market to absorb large quantities of trade without a heavy transaction cost. The transaction cost, here, would mean not the fixed costs like brokerage, depository charges etc. but the cost that is attributable to lack of market liquidity. Since these costs are different in different countries and also vary across the stocks listed in the same county’s bourses, it could be the one of the important consideration for the FIIs.

6. Non-promoter Share Holding

The shares that are available for trading in the normal course are those, which are with the investors other than the promoters and other interested and special categories of investors. This is an important variable to be considered in investing in a stock because the available free-float in most American companies is above 90 percent where as Indian promoters have more than 50 percent stakes in majority of large companies. It was found that one of the important determinants of secondary market liquidity is the number of shareholders. As the number of persons currently holding a particular share increases, the number of market participants interested in trading the assets increases in direct proportions. Therefore, the number of transactions per unit of time also increases and the shares will be more available to the FIIs.

7. Credit Rating

Credit rating facility of a nation also affects the FIIs inflow. In these days credit rating is the sign of the credit worthiness of a company. If credit rating facilities is appropriate and credit rating agencies conduct their work rationally in that case that country can attract more FIIs investment because the FIIs relies more on the credit rating and consider the rates for their investment decision.
8. **Domestic Companies Price Earning Ratio**

The price-earning ratio of the domestic companies is also a factor, which stimulates the arrival of the FIIs in any country. If the price-earning ratio is higher, that is a sign of the growth of the company and showing the higher returns, which is one of the motives of the investment of FIIs.

9. **Infrastructure Facility**

It has been found that of financial market infrastructure such as the market size, market liquidity, trading costs, information dissemination and legal mechanisms relating to property rights etc. are attracting foreign portfolio investment.

10. **Macroeconomic Issues**

The various macro economic factors of the countries also affect the volume of FII in a country. These variables are GDP growth rate, Inflationary rate, Production growth rate etc.

11. **Country Risk**

Country risk measures, that incorporate political and other risks in addition to the usual economic and financial variables, may be expected to have an impact on FIIs flow to any country. In order to check the impact of such country risks on FII flows, semi annual country risk index are given by the country-rating agency. If a country is having high rating on the country risk level that country will be more attractive for FII to invest.

1.8 **Means of Investment in Indian Market**

FIIs can invest in the Indian market by purchasing the ADRs, GDRs and FCCBs. The details of the instruments are as follows:
1. **American Depository Receipts (ADRs)**

ADR is a dollar denominated negotiable certificate that represents Non-US Company’s public traded equity. It was devised in the late 1920s to help American invest in overseas securities and to assist non-US companies wishing to have their stock traded in the USA.

2. **Global Depository Receipts (GDRs)**

The properties of the GDRs are also the same as of ADRs but it is relatively a new financing instrument to raise equity capital in multiple markets. GDRs usually represent one security that predominantly trades in at least two countries outside the issuer’s home market. Generally, the issuers are the organization from those countries where foreign investment is highly regulated and restricted. It is becoming popular in developing economies for the main reason that investors have enough liquidity and it is simpler to understand and trade amongst the investors based in different countries.

3. **Foreign Currency Convertible Bonds (FCCBs)**

Convertible bond issue is another innovation in international financial instruments. It allows conversion of bonds into equity that is fully fungible with the original equity market. This method also by passes the local restriction an preemptive rights of equity holders. This instrument is well proven safer, more protective in volatile conditions. Investors get foreign exchange protection. Its secondary market is more stable.

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