CHAPTER – 1
INTRODUCTION

1.1 INTRODUCTION

Since 1991, Indian economy has emerged as a prominent market for the global investors. The FII, in particular, has constituted a major portion of the total foreign capital flows in India over the last few decades (Pati, 1999). These capital flows have had both positive as well as negative repercussions for the Indian economy. On the positive side, these capital flows have speeded up the process of economic development by augmenting the domestic investment, contributed towards increased market capitalization, enhanced the level of competition in the Indian capital market and widened the scope for financial intermediation of the Indian economy. But at the same time, these capital flows have also posed several threats to the economic and financial system of the Indian economy in terms of inflationary trends, appreciation in ER, overheating of the Indian economy and unmanageable volatility in the Indian capital market due to the uncertain nature of these FII flows characterised by the possibility of their sudden withdrawal.

Foreign institutional investors’ money is often referred to as ‘Hot Money’ because the FII flows are considered more volatile than other market forces working in the capital market. However, there is one more school of thought who considers FIIs as fair weather friends because they continue to invest in a country till the time they enjoy good returns; and pull their money back from the market, the moment they smell small sign of trouble (Report of Working Group on Foreign Investment, 2010). The same experience was felt in India during 2007. FIIs showed great interest in the Indian economy during the year 2007-08 putting in an investment worth Rs. 66179 crore the highest ever investment since their beginning in India in 1992. These unprecedented flows of FII led BSE Sensex and NSE Nifty to go beyond the level of 20000 and 6000 points respectively during that year itself. But, due to the global financial crisis (sub-prime crisis which originated in USA), their investment took a total turnabout change and they pulled back more than Rs. 50000 crore from the Indian stock market during 2008 leading to the biggest ever market crash.
(Sumanjeet, 2010). Thus, FII flows have been impacting various economic factors of the Indian economy directly and indirectly. Some of the major factors which have been affected by FII flows include Risk-Return patterns, Volatility in the Stock Market, Inflationary Trends, Economic Growth, FERs, ER and so on.

Thus, there are many perspectives attached with FII flows in the Indian economy. From the problem of scarcity in the early 1990s to the problem of plenty now, the large FII flows in our economy have assumed great importance in recent times. However, at the same time, managing such enormous flows has become a challenge in itself. Such foreign capital flows have thrown up new policy challenges before the country as they have influenced all the major macro level economic factors like Inflation, FERs, ER, Market Capitalization, Market turnover etc.

Moreover, as India has already been undergoing the process of liberalization of the capital account, it is going to have an important effect on the flows of foreign investments and particularly on flows of FII, because this would have an untold impact on the stability of Indian stock market in the short period and the Indian financial market in the long period. This issue has become extremely important for the contemporary policy makers since managing such large FII flows in India in recent times has come to haunt both the RBI and the capital market regulator (SEBI). Given the above scenario, it is important to study further the FII magnitude, their investment trends, their determinants and their impact upon various macro level factors of the Indian economy as it would help various stakeholders (Government, RBI, Capital Market Regulator-SEBI, domestic and individual investors, middlemen etc.) to fine tune their policies and decision making process with regard to FII. More precisely speaking, the aim of this study is to throw more light on the analysis of FII flows in India. It is hoped that the insight offered by this study would help the policy makers to construct suitable foreign investment policies in such a way that, on the one hand, the Indian economy would enjoy substantially large flows of FII, but at the same time, there would not be any unnecessary enhanced degree of volatility in the Indian capital market. This would help in cementing, consolidating and stabilising the economic scenario of the Indian economy in general and
confidence of the investors in particular. This would further help India in showcasing its self as a desired and potential destination for foreign investment by FIIs.

1.2 EVOLUTION OF INDIAN FINANCIAL SYSTEM

There have been continuous developments in the Indian financial system since independence and the present system is the outcome of these developments. Broadly speaking, the evolution of the Indian Financial System can be classified into three phases from the point of view of its exposure. The brief details of these phases have been outlined as below:

i) Phase I : Pre 1980
ii) Phase II: 1980 -1990
iii) Phase III: Post Nineties

i) Phase I : Pre 1980

From 1947 till 1980, Indian economy was not an open economy. There were many noticeable characteristics which featured the Indian economy. Some of the prominent features were as follows:

- Interest rates were controlled and not market driven.
- Lot of controls existed upon the industry through licensing policy.
- Public sector dominated the industry scenario.
- There was very limited competition.

The consequent impact of these controls was that the Indian resources, be it the human resources or the natural resources remained not only underutilized; there was also emergence of a non-economic and an ineffective Indian economic system. This led to low productivity and more dependence on foreign aid in spite of high saving rates in the country. Because of the closed economic system, economic growth rate of India hovered around 4 % for more than 35 years (Mohan, 2008). And on the contrary, many other comparatively less developed countries achieved a growth rate of over 5 % per annum. Moreover, countries like Japan and other East Asian countries were also able to catch up
with the industrialized countries of the west by adopting market-oriented patterns of industrialization.

ii) Phase II: 1980 -1990

Prior to the onset of financial sectors reforms in 1991, the capital market structure in India remained subject to several controls and opaque procedures were adopted from 1980 to 1990. During these years, the main objective of control over capital issues was to channelize the limited capital resources available for investment in the country into the desired areas. Apart from this main objective, capital issues control was also put to several others uses, some of these were as follows (Phull, 2013):

- Regulation of bonus issues.
- Regulation of terms and conditions of foreign capital participation in the Indian companies and regulations of the terms and conditions of dilution or repatriation of foreign equity.
- Regulation of capital re-organization plans of companies including mergers and amalgamations.
- Regulation of capital structure of companies as well as the terms and conditions of additional issues.
- Regulation of the volume and timing of the private issue of capital.

Moreover, during this period, the trading and settlement system was outdated and was not much in tune with the international practices. At that time, the capital fund raising from the market was under the regulation of the Capital Issues Control Act, 1947 which in turn was under the administration of the Controller of Capital issues, the Ministry of Finance, Government of India.

iii) Phase III: Post Nineties

In the initial phase of 1990s, the whole world faced the trauma of Gulf war; and as a result, the oil prices all over the world observed unprecedented increase. This increase in oil prices was further accentuated by steep decrease in the foreign capital in the form of reduced capital remittances which the people settled in gulf countries used to
remit to their country including India. And a result, foreign exchange crisis was seeded in the worsening condition of India’s balance of payment account (Cerra and Saxena, 2002). The story did not stop here, the birth of one more fear that the Indian government might default in its external financial commitments led to the outflows of foreign capital from the Indian economy. Thus, the real reason behind this crisis was burgeoning fiscal deficit and non existence of an effective financial strategy which allowed many lacunas to exist and ultimately got aggravated. Under such conditions, the first task before the Government of India was to control fiscal deficit there by ‘the balance of payment’ scenario; and second task was to keep the momentum high for the economic reforms initiated post 1980s.

Under such pressing economic conditions, Government of India initiated many reforms in the post 1990s era for the above stated objectives. Under this process of reforms initiation, domestic investment was liberalized, infrastructure sector was opened for private players, a large number of barriers like import tariffs and controls were reduced to bring in more competition, interest rates were de regularized, foreign capital was encouraged as the polices motivated the entry of FIIs along with provoking them to enhance their investment in the Indian capital market, public sector units were disinvested and a large number of tax reforms were also introduced in the Indian economy.

Thus, along with all these reforms, the major thrust was undertaken to encourage FDI and FII in India. Subsequently, in almost all the sectors of the Indian economy, foreign direct investment with 100 % participation was allowed. More importantly in 1992, FIIs were also allowed to make investment in the India stock market. Though in the initial stage, the limit was fixed up to 24 % only. This limit was kept applicable on the paid up share capital of the concerned public limited company. However, it was made mandatory for the company to have approval from the shareholders for allowing FIIs to make investment in the concerned company. These limits were further increased many folds subject to certain conditions. Moreover, the protection of property rights, physical as well as intellectual; and other basic rights continued to be a recognized aspect of the operating environment for foreign investment in India. Later on, India became the
member of the Multilateral Investment Guarantee Agency (MIGA) which protected investors by way of insurance for their non-business risks including expropriation. Further, India entered into investment agreement on bilateral basis with many countries as a result of which the foreign investments from these respective countries remained protected.

Gradually, many positive steps were announced and taken by the Government of India which helped in making Indian capital market more efficient and lucrative. These developments enabled the companies to raise finance from the domestic as well as from the foreign market. One of the major steps amongst these was that the office of the Controller of Capital Issues (CCI) was abolished and in lieu of that, autonomous body called ‘Securities and Exchange Board of India’ was established. Through these steps, government helped the Indian companies to raise their required funds through various foreign markets like Euro issues. The establishment of SEBI also helped in creating a more congenial environment for FIIs as various effective measures were announced by it from time to time. Moreover, to make trading more transparent and efficient and for minimizing transaction costs, open outcry trading system was also replaced with screen based online trading system. This practice integrated Indian stock market further with the global stock markets as the flow of information became more speedy and transparent.

Thus, one of the best responses of India’s liberalization policy has been from FIIs in terms of their huge portfolio investment, particularly, in the equity capital of the Indian companies. And moreover, GDRs and ADRs issues have also been permitted to be issued by the Indian companies with high credit rating. In short, it is safely concluded that the private capital flows have become a very important part of the Indian capital market and these flows have dominated FPI scenario in the Indian economy (Kohli, 2003).

1.3 EVOLUTION OF POLICY FRAME WORK FOR FII IN INDIA

Till 1980s, the overall objective of the Indian economic policies has focussed on being more self reliant and self sufficient for the substitution of imports. Till that time, Indian government has been trying to meet its needs for capital account deficit particularly through official development assistance (ODC) and debt flows. Foreign
capital flows and other private flows have not been much resorted to. However post 1990s era, when Indian government introduced many large scale economic reforms, its primary aim got focussed on the foreign capital flows including both FDI and FII. The overall perspective about the financial reforms pertaining to external sector was also discussed in the ‘High Level Committee Report’ framed to give valuable suggestions on the balance of payment situation under the Chairmanship of C. Rangarajan. This committee gave many land marking recommendations. Some of the major recommendations of this committee were as follows:

- It suggested that there should be a gradual shift from debt-oriented flows to non-debt oriented flows.
- It suggested that there should be strict regulations for the External Commercial Borrowings (ECBs).
- It also suggested that the volatile portion within the NRIs investment in the Indian economy should be discouraged.
- It suggested that gradually capital flows in the Indian economy be further liberalised for getting more FERs.
- It also advocated that the government’s role as a middleman should be reduced as much as possible.

Consequently, after the government introduced many reforms in post 1990s era, the capital account component of balance of payment was made more convertible which was earlier totally non-convertible. After September, 1992, FIIs as well as Overseas Corporate Bodies were allowed to make investment into the primary market of the Indian economy. However, a separate press note (dated 14 September, 1992) on FII was issued in the form of GOI’s guidelines which not only made it compulsory for FIIs to get registered with SEBI but it also clarified each and every aspect relating to FII in the Indian economy (Indian Securities Market Review, 2011).

As per the SEBI guidelines and RBI rules, the initial permission was granted for 5 years for FIIs to trade in the Indian stock market and thereafter, they were required mandatorily to get it renewed. As per the rules and regulations contained under FERA
Act, 1973, FIIs could involve themselves in selling, buying and making capital gains on the securities held by them. However, they could trade in the securities of only those companies which were registered on the recognised stock exchanges. They were also allowed to operate through their domestic agents i.e. authorised bank and one authorised custodian which would maintain all the records relating to their trading activities in the Indian stock market.

The guidelines issued by SEBI in 1992 also mentioned as to who is eligible to be registered as FIIs, their financial condition, past history (track record) etc. These guidelines were exclusively explained in SEBI Regulations Act 1995. One of the major objective of these guidelines was to maintain a proper balance and link between the guidelines issued by Government of India and the regulator (SEBI) in such a manner that FIIs were not only guided by SEBI, they also follow the same. By this mechanism, the government has been able to prescribe the limits for FII in various Indian industries. As per the FEMA Act, 1999 which started applying from 2000 onwards, the purpose of these guidelines was to control FIIs’ transactions also, thereby protecting the Indian economy from over or under heating.

From 1992 till date, almost all the securities have been opened where FIIs could make investment or where they could trade. This includes the securities of the Indian primary market as well as secondary market like equity shares, preference shares, warrants, debentures and different types of mutual fund schemes started by various Indian companies and mutual fund houses which have got themselves registered on the recognised stock exchanges. A brief review of the major policy changes and initiatives for FII has been provided in the following table:

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<th>Year</th>
<th>Policy Changes</th>
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<td>September 1992</td>
<td>For the first time in the history of the Indian stock market, the FIIs were allowed to make investment in almost all types of securities of the Indian primary as well as secondary market. However, there were some conditions to be observed e.g. a single foreign institutional investor could invest up to 5% and all FIIs taken together could invest up to 24% of the company’s total capital issued.</td>
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<td>Year</td>
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<td>November 1996</td>
<td>Operational flexibility was offered to FIIs by allowing fully debt oriented FII.</td>
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<tr>
<td>April 1997</td>
<td>30 % was the new limit up to which FIIs could invest. However such limit was subject to some special provisions and resolutions. And the aim was to encourage more FII in India.</td>
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| April 1998      | Dated government securities were opened for FII. This investment was allowed through the normal route as well as through fully debt oriented fund route.  
But there was an overall approved limit up to US $ 1 billion. In 2004, this limit was enhanced to US$ 1.75 billion. |
| June 1998       | Total investment limit in portfolio securities was increased from 5 % to 10 % for FIIs, Persons of Indian Origin/Non Resident Indians/Overseas Commercial Borrowers. |
| June 1998       | Forward contracts were permitted in equity market. FIIs were allowed to invest in equity based derivatives so that hedging instruments could also be made available. |
| February 2000   | Foreign organisations and individuals with high net worth were allowed to make investment as sub-accounts.  
Domestic overseas bodies with interest in portfolio investment were permitted to get registered in the name of FIIs so that they could manage the sub-accounts’ funds.  
The aim of this reform was to bring in more operational flexibility, and also to ensure that FIIs could have access to the domestic asset management capability. |
| March 2001      | Under the provision of special procedure, FII limit was increased to 49 %.                                                                  |
| September 2001  | Under the provision of special procedure, FII limit was raised to sectoral cap.                                                              |
| December 2003   | A single approval system was introduced for FIIs’ registration instead of dual system of approval from SEBI and RBI which was existing earlier.  
The objective of this initiative was to make the system simpler and less time consuming. |
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<td>November 2004</td>
<td>The limit for outstanding corporate debt had been prescribed up to US $ 0.5 billion. The main objective of this move was to reduce the flows of short-term debt.</td>
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<td>April 2006</td>
<td>US $ 1.5 billion was the new corporate debt limit. Moreover, for FII to be made in government securities, the limit was increased to US $ 2 billion. There was a special mention of the same in the Union Budget of 2006-07.</td>
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<td>November 2006</td>
<td>FIIIs could make investment up to 23 % of their capital in the securities of a special class of institutions e.g. Clearing House corporations, Depository Houses and Stock Exchanges. This was done in the light of compulsory regulations for demutualisation and stock exchanges’ corporatisation.</td>
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<td>January and October 2007</td>
<td>Further, the limit for FII in government securities was increased to US $ 3.2 billion.</td>
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<td>June 2008</td>
<td>In the light of analysis of the ECBs’ scenario, the following decisions were taken: 1. The cumulative debt investment limit was increased from US $ 3.2 billion to US $ 5 billion. 2. The cumulative corporate investment limit was increased from US $ 1.5 billion to US $ 3 billion.</td>
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<td>October 2008</td>
<td>The cumulative debt investment limit in corporate was increased from to US $ 3 billion to US $ 6 billion.</td>
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<td>October 2008</td>
<td>The FII limit restriction in the ratio of 70:30 in equity and debt respectively was removed.</td>
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<tr>
<td>October 2008</td>
<td>The restrictions applying on Overseas Derivative securities were removed.</td>
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<td>March 2009</td>
<td>FIIIs’ lending of shares in the foreign market was disapproved. And a new platform of E-bids was introduced for FIIIs.</td>
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<td>August 2009</td>
<td>Interest rate futures were opened for FIIIs also.</td>
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<td>April 2010</td>
<td>Domestic government securities and foreign sovereign securities (having AAA rating) were permitted to be used as collateral securities (in addition to cash) to be deposited with the Indian stock exchange for transacting the business in the cash domain.</td>
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<td>Year</td>
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<tr>
<td>November 2010</td>
<td>FII limits both in corporate bonds as well as in government bonds were increased by US $ 5 billion. In case of corporate bond, it was increased to US $ 10 billion; and in case of government bond, it was increased to US $ 20 billion.</td>
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<tr>
<td>March 2011</td>
<td>FII limit in the corporate bonds of those companies which deal in infrastructure was increased substantially from US $ 5 billion to US $ 25 billion.</td>
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<tr>
<td>August 2011</td>
<td>Guidelines had been issued for Qualified Foreign Investors also. These guidelines were applicable for those QFIs who followed KYC norms. Direct route was opened for Qualified Foreign Investors’ investment in equity and debt scripts of various mutual funds.</td>
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<td>September 2012</td>
<td>The allocation procedure for FII’s debt limits was changed to the open bidding process wherein bifurcation in terms of lock-in-period and manner of allocation for long term infrastructure limits was increased up to US $ 22 billion.</td>
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<td>January 2012</td>
<td>The re-investment mechanism had been discontinued for all new allocations applying to debt limits for FIIs/sub-accounts; And the limits would come to the pool once the investment was sold/redeemed. These limits would again be allocated in the subsequent bidding processes.</td>
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<tr>
<td>January 2012</td>
<td>Qualified Foreign Investors (QFI) meeting ‘Know Your Customers’ norms were also permitted to make investment into the securities of those companies which had been registered with the recognised stock exchange(s) in India. But the applicable condition was that all these shares had to be held by them in DEMAT account. And such account must also be opened with a recognised depository participant which in turn should be registered with SEBI.</td>
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<tr>
<td>March 2012</td>
<td>A dossier on the use of very advanced automated software was recommended by SEBI in order to avoid various types of risks caused by brokers.</td>
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<tr>
<td>September 2012</td>
<td>SEBI simplified the ‘Know Your Client’ (KYC) requirements for foreign investors thereby making it simpler for FIIs to make investment through the portfolio route.</td>
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<tr>
<td>Year</td>
<td>Policy Changes</td>
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<tr>
<td>January 2013</td>
<td>For that FIIs/sub-accounts which could not be able in holding debt investment limit during 2012 were allowed to exercise re-investment provision and facility up to maximum of 50 % of the debt holding during the year 2013.</td>
</tr>
<tr>
<td>April 2013</td>
<td>Again all FIIs and sub-accounts were allowed to make re-investment facility provision to the maximum limit of 50 % of the holding of debt by them by the end of the year</td>
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</table>

Source: Indian Stock Market Review-2011, NSE.

### 1.4 SOURCES OF FOREIGN CAPITAL FLOWS IN INDIA

There has been a large range of sources in the global capital market from where funds have been flowing to various developing countries including India. Some of the major sources amongst the same include FDI, FVCI or Private Equity, investment by NRIs, ECBs, ODA, FCCBs, FDI and FPI. A brief summary of foreign capital flows has been shown in the Figure 1.1.

After various capital market reforms initiated under the slogan of LPG (Liberalisation, Privatisation and Globalisation) in the post 1990s period, one of the main policy change was the fact that the Indian corporates were permitted to raise funds from the global financial market. Earlier, debt was the main source which was permitted to be raised from the global market. In the early part of 1990s, the corpus of Indian FERs came down drastically and the country’s rating was downgraded by various international credit rating agencies. This led to a big crisis in maintaining the required amount of FERs (Cerra and Saxena, 2002). Under such circumstances, it became very difficult for the Indian government to meet the import bill requirements of the Indian companies. Thus, one of the most amicable solutions under such tight financial conditions was the decision to allow Indian corporates to raise funds from the equity and bond market of the foreign countries.

Subsequently, the Indian companies have tapped foreign market and raised the money from international markets through various instruments like American Depository Receipts, Global Depositary Receipts, Foreign Currency Convertible Bonds (FCCBs) and
other methods of External Commercial Borrowings (ECBs). Along with this, FIIs from many foreign countries have also showed great interest in the Indian capital market and have invested heavily in the securities of the Indian companies.

**Figure 1.1 : Foreign Investments in India**

![Diagram of Foreign Investments in India]

Source: Indian Stock Market Review-2011 published by NSE.

Though there are many channels of foreign capital flows in developing countries like India, some of the important ones are discussed as follow:

1.4.1 ODA (Official Development Assistance)
1.4.2 ECBs (External Commercial Borrowings)
1.4.3 FCCB (Foreign Currency Convertible Bond)
1.4.4 Foreign Venture Capital Investor (FVCI)
1.4.5 FDI (Foreign Direct Investment)
1.4.6 FPI (Foreign Portfolio Investment)

1.4.1 Official Development Assistance (ODA)

These are the official flows for financing various types of projects. The reason for the existence of ODA is to promote the welfare and all round development of the developing countries. Such financing is done with some concessional rate of interest usually fixed at 10%. These flows also carry an element of grant up to 25% of the total
flows. It has been the convention that ODA flows are financed by the various donor agencies of government at different levels to either multilateral agencies/institutions or the under developed or the developing countries too. There may be some bilateral ODAs also. ----- *(Organisation for Economic Cooperation and Development)*

The government and the government agencies of the developed countries have been providing economic assistance to the less developed and the developing countries of the world. Through UN General Assembly resolutions in 1970, the developed countries of the world have pledged to commit at least 0.7 % of Gross National Product as ODA for the underdeveloped and the developing countries *(Kevin, 2010)*. The target has been reaffirmed in the subsequent conferences on ODA. The UN Millennium Project which has specific development goals known as ‘Millennium Development Goal’ to be achieved by 2015 has again urged all developed countries to contribute at least 0.7 % of their GNP towards achieving MDG by 2015 *(Kevin, 2010)*.

Though the developed countries have generally failed to achieve this target, they have been an important source of official development assistance. Unfortunately, over the years, ODA has lost its dominance in capital flows because of certain underlying reasons, like failure on the part of developed countries to achieve the targets, misappropriation of aid receipts, prevalence of corruption at all levels in the recipient countries and availability of other sources of foreign capital across the world.

1.4.2 External Commercial Borrowings (ECBs)

External Commercial Borrowings typically mean the loans from commercial banks in the form of commercial loans. These loans may take any of the forms like bank loan or buyers’ credit or also other securities which may include fixed interest rate bonds and floating interest rate notes. Such loans are usually made available in the country by non-resident lenders. These loans are usually issued for a duration of 3 years. The spectrum and scope for ECBs also get extended to include FCCBs (foreign currency convertible bonds). There are two routes through which ECBs can be raised: Automatic Route Method and Approval Route Method *(Khan, 2011)*.
i) **Automatic Route Method**: The ECBs under automatic route don’t require the approval from RBI or Government. Usually, the money raised and to be used in the real sector like infrastructure and the industrial sector fall under the category of automatic route method. In addition to banks, NBFCs and the housing finance companies, only those corporates are allowed to borrow money through this route which are registered under the Companies Act 1956. Additionally various international banks and agencies like Asian Development Bank, International Finance Corporation, Import Export Houses are also legally recognised body to operate through this route. External Commercial Borrowings up to US $ 500 million having maturity period between 3 to 5 years per borrowing company per financial year has been permitted under this route (Sumanjeet, 2009).

ii) **Approval Route Method**: The eligible borrowers under this route are as follows:

(a) Financial institutions which deal specifically in infrastructure and export financing e.g. Power Finance Corporation (PFC).

(b) Financial institutions which are active participants in the steel and textile restructuring processes approved by Government of India.

(c) NBFCs which apply for ECBs with minimum 5 years having enjoyed the status of Multilateral Financial Institutions.

(d) FCCBs and Corporates in service sectors like Hotels, Hospitals and NGOs engaged in micro finance.

During 1970s, Official Development Assistance from bilateral sources of multilateral agencies like World Bank, IFC, and ADB was the main source of capital for the developing countries. Initially, ODA sources were very limited to meet the ever rising demand of the developing countries, so they started searching for alternative sources of capital. Subsequently, ECBs emerged as an alternative source of international capital. It has been experienced over the last couple of years that Indian companies have been raising ECBs for financing their various types of projects including infrastructure projects. In August 1996, it was the Reliance Petroleum which became the first Indian
corporate to raise funds through the channel of ECB. The aggregate value of the issue was US $125 million (Pathak, 2008), and it was considered to be one of the most important event because Reliance was the only Indian company at that time which raised such a huge amount from the international market through this route. As ECBs supplement to the domestically available sources of funds, it helps the companies in enhancing their existing production capacity as well as making fresh investment. Over the years, Indian corporates have followed and preferred this means of funds because the cost of ECBs has been found to be comparatively low in global markets. As the norms of raising funds through the channel of ECBs are quite sound, hence in case of any default, the repercussions are also stern and wider as it increases the risk premium for the borrowers. FCCB being very important component of ECB has been discussed separately in the subsequent pages.

1.4.3 Foreign Currency Convertible Bond (FCCB)

FCCB simply connotes a bond which is expressed in foreign currency denomination. In this case, the principle as well as interest amount due on FCCB is also expressed and paid in foreign currency. Indian companies also issue such bonds. These are subscribed and applied to by a person who is a resident outside India. Such bonds offer a fixed coupon rate and they can be converted into equity shares at a pre decided price. There are two options for the conversion of FCCBs i.e. full conversion or conversion in parts. These bonds are listed in the foreign stock exchanges and are traded therein. Till the time, the conversion option of FCCBs is not used, the issuing company has to make payment of interest in US dollar. Suppose the conversion option of FCCBs is not used till the time of maturity, then even redemption of FCCBs has to be made in US $. One important thing to note is that the interest rate due on FCCBs is quite low but the exchange risk is quite high as the interest due is payable in foreign currency. Therefore, the companies having low debt-equity ratio and good potential for earning more foreign exchange reserves prefer such option. It has been observed that the rate of coupon interest on FCCBs is lower than the domestic rate and it becomes quite cheaper for the corporates to raise the funds from such a source. The issuance period of FCCBs is 5 years. However, no time period restriction has been existing with regard to conversion of FCCBs into shares.
The scheme of FCCBs has three types of controlling mechanism:

i) Automatic Clearance: Bonds up to the value of US $ 50 million are cleared automatically.

ii) RBI: Bonds having value between US $ 50 million to US $ 100 million are cleared by RBI.

iii) Ministry of Finance: Bonds with value above US $ 100 million are cleared by Ministry of Finance.

Between 2001 and 2002, there were two public issues of FCCBs, one by BSES and another by Gujrat Ambuja Cement. Subsequently in 2004, US $ 1.6 billion FCCBs were issued by Indian companies. This had been possible for the two reasons namely: low interest rate and surge of Indian equity market (Pathak, 2008). With the stock market becoming buoyant, FCCBs have also emerged as more preferred route to raise foreign currency than pure ECBs.

1.4.4 Foreign Venture Capital Investor (FVCI)

It is an investor which is established and incorporated outside India. Such investor proposes to make investments in venture capital fund(s) or venture capital undertakings operating in India and are compulsorily registered as per the SEBI (FVCI) Regulations Act, 1996 and Foreign Venture Capital Investor - SEBI Regulations Act, 2000.

Venture capital means an investment opportunity or venture which has very high degree of return as well as high degree of risk. The financing from venture capital is done generally in the form of equity stake rather than as a loan by an outside party which may be a bank or a financial institution. In 2000, as per the recommendations of the committee under the chairmanship of Sh. K.B. Chandrasekhar, SEBI was made the nodal regulator for this. Subsequently, SEBI (FVCI) regulations Act, 2000 was enacted which freed the industry from bureaucratic hurdles and provided a platform for the entry of foreign funds in India. Total VCs and FVCIs registered with SEBI stood at 205 and 164 respectively in the year 2011-12. There was total US $ 10.78 billion investment by VCs and FVCIs in the venture capital undertaking as on 31 March 2011. Now, almost all the sectors have been opened for financing by FVCIs except very few areas like financing of gold trading,
non-banking services and activities not allowed as per the Industrial Policy of Government from time to time (Parekh, 2012).

1.4.5 Foreign Direct Investment (FDI)

Under this form of foreign capital flow, either there is direct participation by the foreign players in the ownership of the Indian company or setting up of its branches, subsidiaries or expanding its foreign branch business or acquiring an Indian company or merging with the same with long term interests to be pursued. The United Nations Conference on Trade and Development (UNCTAD) has defined FDI as “When a foreign player makes permanent investment in the enterprise outside the boundaries of its own country with the long lasting interests to be pursued, it reflects a true example of FDI”. Broadly speaking FDI takes place through two routes namely: Government Approval Route and Automatic Route.

- **Government Approval Route:**

  Under the philosophy of government approval route, a specialised board called ‘Foreign Investment Promotion Board’ (FIPB) operating under the control of Government of India has been established. The main objective of the board is to consider the FDI proposals which do not fall within the purview of automatic route as per certain guidelines issued from time to time. For the following sectors, FDI is neither allowed through government route nor through automatic route (FDI policy 2013).

  i) Business of Chit Fund
  ii) Lottery Business
  iii) Nidhi Company
  iv) Atomic Energy
  v) Gambling
  vi) Agricultural and Plantation activities. However, in case of agriculture, there are certain areas which are not covered under the government approval route like Animal Husbandry, Horticulture, Development of seeds, Pisciculture, Floriculture, and vegetable cultivations, mushrooms cultivations and agro and
allied sectors. In case of plantation activities, tea plantations are also excluded from the scope of this approval.

vii) Real Estate and Housing Business. There are certain areas like townships development, commercial premises and residential buildings, bridges and roads which are excluded from the scope of this route but to the extent as specified in the FIPB guidelines.

viii) Trading involving Transferable Development Rights.

ix) Cigars, Cigarillos, Cheroots and Cigarettes, Tobacco or substitutes for tobacco products.

All these sectors fall in the negative list. Basically, FDI investment promotes a long-term relationship between the foreign entity and the domestic company through active participation in managing the affairs of the company on a mutual consent basis. Foreign individual, corporate, company, or organisation may bring in FDI in various forms. For example, it may be joint a venture or merger or acquisition or starting of new subsidiary with 100% stake in it or even expanding the business of existing branches or establishment of new branches also (Kevin, 2010).

• **Automatic Route:**

It is the FDI route under which no prior permission of Government is needed to make investment. As per the *FDI Policy 2013*, some of these sectors are as follows, subject to the conditions provided in the same policy:

i) Agriculture and Animal Husbandry

ii) Mining and Exploration of Metal and Non-Metal

iii) Coal and Lignite

iv) Petroleum and Natural Gas

v) Broadcasting Carriage Services

vi) Cable Networks

vii) Airports

viii) Air Transport Services

ix) Construction and Development : Township, Housing, Built in infrastructure
x) Industrial Parks
xi) Trading (Cash and Wholesale)
xii) Banking –Private Sector
xiii) Insurance
xiv) NBFCs

However, a special approval of Government is required in the following sectors:

i) Sectors that involve Industrial Licensing.
ii) If the proposed foreign direct investor is already having existing tie up in the same field.
iii) If an NRI makes a proposal to acquire stake in the Indian company.

1.4.6 Foreign Portfolio Investment (FPI)

Foreign Portfolio investment consists of the following forms of investment:

i) Global Depository Receipts
ii) American Depository Receipts
iii) Country Funds
iv) Offshore Funds
v) FIIs

The investment horizon of FDI is usually broader than FPI. This is so because FDI flows are encouraged by long term interest in controlling the destination of the firm whereas FPI flows are predominantly tempted by financial returns which may take the form of dividend or capital gain to be earned on investment in the host country. Within FPI, GDRs, ADRs and FII are the major sources of finance (Kohli, 2003). The discussion on the active components of FPI is undertaken in the following pages:

i) Global Depository Receipts (GDRs)

GDRs are the negotiable financial securities traded on a local stock exchange but they represent securities (usually equity shares) issued by a foreign public listed company (Kevin, 2010). GDRs allow investors in one country to hold the securities of companies
of other countries. In the functioning of GDRs, the two key functionaries are the depository and the custodian. Depository is a bank or financial institution in the foreign country such as Europe where GDRs are proposed to be issued, appointed or designated as depository by the issuing company. The shares or other securities set apart for the foreign market are issued to the depository. Custodian is a bank appointed by the depository to keep custody of the securities issued to the depository.

The shares issued to the depository are bundled or grouped into convenient lots by the depository. A depository receipt is issued by the depository to represent ownership in such group of shares of the issuing company. These GDRs are issued to the investors in that country; these are negotiable and are traded in the stock exchanges of the country. These are freely transferable outside the domestic country (e.g. India) and dividend due on them is paid in rupee form as GDRs can be converted into shares at any time. Before the conversion of GDRs into shares, there are no voting rights available to GDRs holders. But the moment GDRs are converted into shares, the holders of GDRs get the voting rights.

Many of the Indian companies have had their GDRs issue on London Stock Exchange and Luxemburg stock exchange. GDRs of big Indian corporates are mainly issued to the institutional investors and majority of them are based in USA, UK, Singapore, and France. It is worth to note that GDRs also provide some special benefits to the issuing companies (Kevin, 2010). Some of these benefits are:

- There is no dilution of control as the GDRs before conversion have no voting rights.
- There is no foreign exchange risk as dividends and other benefits are paid in the domestic currency.
- Foreign Exchange resources become available to the issuing companies.

ii) American Depository Receipt (ADRs)

ADRs represent ownership in the stock of a non-US based company. Each and every ADR may represent a fraction of a security. This means, it may represent a single share or multiple shares also (Kevin, 2010). ADRs are issued by a US depository bank in
exchange for the shares of a foreign company deposited with the depository based in the domestic country. The largest depository bank in USA is the Bank of New York. There are various types of ADR issues which a foreign company may choose and finalise for listing and trading its shares in USA based stock exchange(s).

In case of ADRs, there are both sponsored and unsponsored programmes followed. The sponsored programmes are of different level such as Level 1, Level 2 and Level 3. In a sponsored Programme Level 1, the foreign company is required to have a single designated depository to act as its transfer agent. The ADRs which are issued as per Level 1 can be traded only on the OTC exchange market. The company which adopts Level 1 programmes for its ADRs issue has minimal reporting requirements.

**Figure 1.2: Process of Issuing ADRs and GDRs**

Board Approval → Tendering of Shares by the shareholder → Conversion to ADRs or GDRs → Sales of ADRs or GDRs to the overseas Investors → Repatriation of proceeds to India within one month of the closure of the issue → Distribution of proceeds to shareholders

The company or companies issuing ADRs under level 1 programmes are not required to issue periodic reports like quarterly or annual reports. They are also not required to follow the standards explained as US Generally Accepted Accounting Principles (GAAP) for their reporting purpose and they may use their own currency in their reports.

ADRs issued under Level 2 programmes are eligible for their listing on the national stock exchange(s) of USA such as NYSE, NASDAQ and AMEX. Such issue comes under the American SEC (Securities and Exchange Commission) regulations. The foreign companies are required to comply with the SEC reporting regulations. They have to file annual reports prepared according to the GAAP standards. They are also required to fulfil the listing requirements of the stock exchanges where these ADRs are listed.

A foreign company which adopts Level 3 programmes can not only list the ADRs for trading in the US national stock exchanges but can also use them to raise fresh capital from the USA capital market. Other reporting requirements applicable under SEC are the same as are applicable for companies following Level 2 programmes. In an unsponsored ADR programme, there is no formal agreement between the foreign company and any custodian bank in the USA. ADRs are issued by any depository as per the demand for such ADRs. These ADRs can be traded only on the OTC market. As these are mostly private in nature, no regulatory reporting requirements are imposed on the foreign company. The process of issuing GDRs and ADRs has been outlined in figure 1.2.

1.5 REGULATORY FRAMEWORK FOR FIIs IN INDIA

A foreign institutional investor is an institution which has been incorporated and established outside India and whose objective is to earn return by investing into different types of securities of various companies operating in the Indian capital market.

“FII is a proposed investment into the stocks of Indian companies on behalf of the small and big foreign investors with a common goal of getting returns, bearing various types of risks and enjoying the capital gains also.” ---- (European Union)
“Foreign institutional investors, in simple words, mean specialised financial institutions which include mutual funds, assets management companies, foreign pension funds, charitable/university/endowment funds and other portfolio managers on whose behalf they make investment in the foreign capital market.”

---- (Securities and Exchange Board of India)

The FIIs are basically the members of the investment advisory community that act on the behalf of the owners of foreign funds for a given fee. In other words, they are the portfolio managers which trade on behalf of the owners of the funds. They may take form of any of the mentioned structure like insurance companies, portfolio managers, mutual funds, high net worth individuals, pension funds or corporations (ISMR, 2011). Under section 30 of SEBI Act, 1992, sufficient powers have been conferred upon SEBI for the regulation of the working of FIIs in India. As per these guidelines of the given act, the provisions have clearly stated as to who get eligible for registration as FIIs, its registration process, eligibility conditions of FIIs, fees applicable, investment areas, investment restrictions etc.

Along with this, general responsibilities and obligations, the process and procedure for action against FIIs (in case they do not follow the rules and regulations e.g. default in case of fee payment) has also been mentioned in the same Act.

1.5.1 Entities to be Qualified as Foreign Institutional Investor

The following entities are eligible for registration as foreign institutional investor in the Indian capital market:

i) As Foreign Institutional Investor

- Bank
- Insurance Company/ Reinsurance Company
- Mutual Fund
- Investment Trusts
- Pension Fund
- University Fund
• Charitable Trusts/Charitable Societies
• Foreign Central Bank or Multilateral Organization
• Foundations (with big social cause)
• Endowments (with big broader social cause)

Further, the following entities which propose to make investment (with broad based fund acting as their principal) are also qualified for their registration as foreign institutions investor:

• Assets Management Company (AMC)
• Institutional Portfolio Bodies
• Investment Advisor and Manager
• Trustees

‘Broad Based Fund’, in simple words, means a fund which has been incorporated and/or established outside India. The main features of such fund are that there must be at least 20 investors but not even single investor should hold more than 10% units of the fund with two exemptions:

• If such a fund has a foreign institutional investor or investors, then it will not be mandatory to have 20 investors with itself.
• If such a fund has a foreign institutional investor which is the owner of more than 10% of units of the funds, it is automatically implied that the foreign institutional investor is itself a broad based fund.

ii) As Sub-Accounts:

Sub-accounts simply means the institutional funds, foreign corporate managers, or portfolios which have been established or incorporated outside India and these are the principal on whose behalf FIIs make investment in the Indian financial market.

Following foreign bodies are eligible to invest through sub-account route:

• Pension Funds
• Investment Trusts
• Institutions or portfolios or funds incorporated and established outside India.

• Foreign Companies: Foreign individual with a net worth of at least US $ 50 million with a valid passport for 5 years, with a good standing from a bank of a foreign country, holds a certificate of good credibility from a bank, and is also the client of the foreign institutional investor for a minimum period of three years.

• Foreign companies which have got their securities registered in the global market, having asset base of not less than US $2 billion and also having been able to maintain an average net profit of at least US $ 50 million during the last three financial years preceding immediately from the date of application.

• Partnership Firms

iii) Domestic Entity:

A domestic asset management company or domestic portfolio manager is also eligible for its registration as foreign institutional investor for managing the funds of sub accounts. Foreign institutional investor can get registered with SEBI either as a regular foreign institutional investor or 100% debt fund foreign institutional investor. These are:

• Regular FIIs: These funds are required to make 70% of their investment in the equity or equity related instruments and the rest i.e. 30 % in debt or debt related instruments.

• FIIs with 100% Debt-fund: These funds are permitted to make investment in debt securities or debt related instruments only.

1.5.2 Registration of FIIs

1.5.2.1 FIIs’ Registration

FIIs have to get registered with SEBI compulsorily before they start buying, selling or otherwise start trading in the Indian securities market. After FIIs get registered with SEBI, they get registration certificate. The registration process of FIIs has been shown in Figure 1.3. The whole process of registration is discussed in the follows paragraphs:
i) Application for Registration

As shared earlier, registration certificate from SEBI is compulsory before starting trading operation in Indian stock market. FIIs are required to submit application for registration with SEBI as per the "Form A" which has been prescribed in SEBI Regulations Act, 1995. The following documents are the other important documents which should also be attached while submitting form A:

a) Memorandum of Association (MOA), Article of Association (AOA) and Article of Incorporation (AOI).

b) Financial statements and annual reports for the last one year which has been audited and authenticated by a competent authority.

Figure 1.3: Registration Process for FIIs

Source: www.sebi.gov.in
ii) Furnishing of Information, Explanation and Personal Representation

The FIIIs are also required to furnish information or clarifications, as the SEBI may consider necessary from time to time. If in any case, SEBI insists for personal appearance of FIIIs before board for some clarification, FIIIs themselves or their authorized representative will have to appear before the SEBI board. Board after scrutiny of the application and after its satisfaction with the documents and clarification given with application, will issue a registration certificate to foreign institutional investor. The validity of the registration certificate is for 3 years. After the lapse of 3 years, certificate registration has to be renewed. Three months before the expiry of certificate registration, FIIIs will apply for renewal of registration on a special application form along with the requisite documents. This registration will remain in force till FIIIs continue to satisfy all conditions imposed on them at the time of registration. If applicant happens to be a bank or its subsidiary, then SEBI board will seek the comments and feedback from RBI also.

iii) Conditions for Registration

The FII applicant has to comply with the following conditions for its registration as foreign institutional investor in India as per the provisions of SEBI Regulations Act, 1995:

- FII applicant needs to have professional competency, good track record, and general reputation of fairness, financial soundness, experience and integrity.
- In the home country, the FII applicant should also be regulated by an appropriate regulatory authority.
- The domestic regulator should permit the FII applicant to make investment outside the country where it has been incorporated.
- The FII applicant must get the approval as per the provisions of the FEMA Act, also.
- The FII applicant needs to have a valid contract with the local custodian which would carry on custodial services with respect to all trading securities on its behalf.
• The applicant needs to be a fit and proper person with regard to SEBI Regulations 2004.
• The FII applicant needs to appoint a designated bank to facilitate its transactions in the Indian security market. Designated bank is a branch of any commercial bank operating in India that has been authorized by RBI.
• A bank account denominated in foreign currency; and a special non-resident rupee account will be required to be opened with a specified bank branch by the FII applicant.

iv) Payment of Fees

The institutions wishing to get registered as FIIs need to deposit US $ 5000 with SEBI. And in case of the Institution wishing to invest as sub-account the fee payable is US $ 1000. The registration is valid for 5 years. The institutions registered as FIIs or FIIs as sub-accounts need to redeposit US $5000 and US $1000 three months before the expiry of the registration with SEBI every time when renewal is due. The renewal application should be submitted with SEBI at least 3 months before the lapse of registration; and FIIs are required to deposit the renewal fees within 15 days from the date of intimation by SEBI. Thus, the institutions seeking the status of FIIs in India are required to pay registration fees at the beginning and at the time of each renewal. The registration fees is payable by the applicant through demand draft which should be drawn in favour of “Securities and Exchange Board of India” or through any other accepted mode(s) as specified by SEBI. However, the board has the power to get exempted from fees, an applicant like World Bank or any other institution incorporated outside India which has been provided with certain privileges by the central government.

v) Grant of Certificate

When the registration fee as applicable is deposited by FIIs with SEBI as per the mentioned regulations, the board, if satisfied with regard to all particulars furnished by FIIs, will grant registration certificate. Generally, seven days are taken by SEBI in granting registration to foreign institutional investor. But, in case, incomplete information
is provided by foreign institutional investor applicant, the seven days period is calculated from the day when the complete information as demanded by SEBI reaches its office.

vi) Certificate Validity

The FII registration and the subsequent renewal of the same would be valid for five years from its registration date or the date of renewal, as the case may be. In case, the registration certificate or renewal expires in the face of non-submission of fees or any other reasons as per the SEBI regulations, the concerned foreign institutional investor will automatically be stopped from carrying on any trading activities and will be conditioned to SEBI’s guidelines about the trading activities, or the concerned records that happen to be under the control of the concerned foreign institutional investor.

vii) Application for the Renewal of Certificate

It is also important to note that the FIIs’ registration is valid for a period of five years. If foreign institutional investor wishes that the same be renewed, again it has to make a renewal request with SEBI for registration at least three months before the expiry of the initial registration. The renewal application will go through the same procedure as the original certificate of registration undergoes. If the board is satisfied with respects to all the requirements, it will issue a renewal registration certificate subject to the payment of applicable fees.

viii) Circumstances for Renewal Certificate to FIIs

The renewal certificate is granted to FIIs with the following conditions to be observed:

• It would follow all the provisions of the applicable regulations.
• In case, the foreign institutional investor has submitted any information and particulars earlier and they have been found misleading, it will immediately inform the board.
• If the information provided by the foreign institutional investor has some change(s) which may have an impact on the grant of renewal certificate, the foreign institutional investor will inform to the board about this change.
• Foreign Institutional Investor, before starting trading in India, will appoint a
domestic custodian and will also have a contract with it to possess the securities to
be traded into its custody.
• Foreign institutional Investor, before starting trading in India, will also have a
contract with a designated bank which will undertake to operate an account
denominated in foreign currency or it may also be a special non-resident rupee
account.
• Foreign institutional investor, before it starts trading on the behalf of sub-account,
needs to get the registration certificate to act on behalf of sub-account from SEBI
without any delay.

ix) **Circumstances when Certificate is not Granted**

If SEBI is not satisfied with the information stated by FII applicant, SEBI may
reject the application. However, it needs to give a reasonable opportunity to the FII
applicant for being heard. The final rejection decision is intimated to the concerned
foreign institutional investor in writing, along with the objections due to which
permission has not been granted.

**1.5.2.2 Registration of FIIs as Sub-Account**

A sub-account simply means a fund or a portfolio which has been incorporated
outside the country of its investment like India. The sub-account cannot make investment
in India directly. FIIs make investment on the behalf of the sub-accounts. The main path
of investment by FIIs on behalf of these sub accounts is mainly through P Notes
(Participatory Notes). This sub account fund to get eligible to be used as an investment
channel needs to be a ‘broad based fund’. The broad based fund simply means the fund
which has more than 20 shareholders and not even a single customer should possess more
than 10 % of the share of the total fund. However, a foreign individual or a foreign
corporate is also eligible to get registered as a sub account, though; it is not required to be
broad based. But neither NRIs nor OCBs can get themselves registered as sub-account as
per the SEBI regulations.
i) Application for FII Registration as Sub-Accounts

Foreign institutional investor needs to apply for the registration of each and every sub-account separately on whose behalf it would invest. Form AA needs to be deposited by foreign institutional investor for each of its sub-account. However, there is no other document to be submitted along with this form in this case. Both the parties namely foreign institutional investor as well as sub-account should sign the application form. The fee for sub-account registration is US $ 1000 which needs to be deposited at the time of submission of application form. Though, there is no specific period described for sub-account registration’s validity but validity goes hand in hand with the concerned foreign institutional investor’s registration. The sub-account transfer is allowed by SEBI from one foreign institutional investor to another foreign institutional investor. For this purpose, the transferred foreign institutional investor has to give a No Objection Certificate (NOC) and the transferee foreign institutional investor has to submit an undertaking that it has the authority to invest on behalf of the sub-account. Generally, three days are taken by SEBI in affecting this change. However, in case of incomplete information submitted by FII applicant, three days would be counted from the day of submission of complete information by the concerned foreign institutional investor.

ii) Conditions for FII Registration as Sub-Account

For the purpose of registration of foreign institutional investor as sub-account, the board shall consider all relevant matters which are important for such certification. More specifically, the following are the conditions which must be ensured by the board before issuing a certificate to foreign institutional investor as sub-account:

- The foreign institutional investor applicant needs to be a fund or an institution or portfolio which has been incorporated and established outside India and which proposes to invest in India.
- The foreign institutional investor applicant is a proprietary fund or a broad based fund be it a corporate and individual who are fit and proper person as per SEBI regulation 2004. The condition applicable to this is that no NRI or OCB can get themselves registered as sub-account or foreign institutional investor.
• The foreign institutional investor which proposes to get registered as sub-account needs to hold registration certificate as foreign institutional investor.
• The foreign institutional investor which proposes to get registered as sub-account needs to have authority to invest on behalf of sub-account.
• The foreign institutional investor applicant through whom the application for registration of sub-account is moved needs to deposit one undertaking that the sub account fulfils all the criteria as per the provisions of SEBI Act 1995.
• The sub-account has paid the registration fees in accordance with second schedule.

After the SEBI board has received undertaking and the registration fees, it would grant registration certificate to the concerned sub-account. Once a sub-account has been granted registration as per the provisions of SEBI Act 1995, it would be deemed to have got registered as foreign institutional investor with SEBI. However it would be applicable only for the pre decided purpose(s) and benefits being available to FIIs as per the section 115 AD of Income Tax, Act 1961.

1.5.3 Investment Opportunities and Limits

SEBI has issued specific guidelines with regard to the investment by foreign institutional investor and sub-account into the Indian capital market. These guidelines are contained under the chapter third of SEBI (foreign institutional investor) Regulations, 1995. As per the SEBI guidelines, FIIs and sub-accounts can make investment in the following types of securities of the Indian capital market:

i) Various types of scripts and securities existing in Indian capital market (both primary and secondary) like shares, warrants and debentures of companies which are either listed or are to be listed with the recognized Indian stock exchanges.
ii) Commercial papers.
iii) Units of mutual funds floated under various types of schemes.
iv) Securities receipts.
v) Debt instruments and Government Securities.
vi) Derivatives tradable on Indian stock exchanges.
1.5.3.1 Investment Limits for FIIs

The applicable limits are specified for the investment by FIIs into equity, debt related instruments, government securities and derivatives. There are two types of ceilings on FII: statutory and administrative. Currently the ceiling for overall investment is 24% of the company’s paid up capital. The ceiling of 24% can be raised subject to certain conditions. Public sector banks and insurance sector are capped under the Act at 20% and 26% respectively.

(a) Limits on Equity Investments

In SEBI (FII) Regulations Act, 1995 and thereafter, there has been no specification with regard to ‘lock in period’ for the investment in equity shares by FIIs, but, following are some limits regarding the investment by FIIs in equity shares as specified by the regulations:

i) Each and every foreign institutional investor, if investing singly, or if investing on behalf of sub-account, can invest only up to 10% of the Company’s paid up capital.

ii) While a sub-account, if covered under the category of being the foreign corporate or individual category, can invest only up to 5% of the company’s paid up capital.

iii) The maximum permissible investment limit into the shares of an Indian company by all the FIIs taken together is 24% of the company’s paid up capital.

iv) The maximum limit of 24% investment by all the FIIs taken jointly can be raised up to 30%, or 40% or 49% or up to FDI limits specified for that sector, however, the company needs to have approval for the same from its shareholders as well as from RBI.

v) In case of public sector banks, the ownership limits is 20%.

vi) Equity shares obtained only from primary and secondary market will be included in calculating the limits applicable on foreign institutional investor.
<table>
<thead>
<tr>
<th>Type</th>
<th>Limits</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ban on FDI and FII</td>
<td>Lottery Business, Betting, Gambling, Chit Fund and Nidhi Company</td>
</tr>
<tr>
<td>Print Media</td>
<td>Up to 26% Investment by FIIs/PIOs/NRIs</td>
</tr>
<tr>
<td>Airport Transport</td>
<td>49% by FDI and FII together</td>
</tr>
<tr>
<td>Asset Construction Companies</td>
<td>74% of paid-up capital when FDI and FII taken together</td>
</tr>
<tr>
<td>Banking –Private sector</td>
<td>74% overall (49% by Automatic route and up to 25% by Government route)</td>
</tr>
<tr>
<td>In Commodity Exchange</td>
<td>49% investment when FDI and FII taken together and Up to 23% by FIIs as per Portfolio Investment policy and up to 26% under the FDI policy.</td>
</tr>
<tr>
<td>Credit Information Companies (CICs)</td>
<td>49% investment when FDI &amp; Foreign Institutional Investor taken together</td>
</tr>
<tr>
<td>Companies dealing in infrastructure of Securities Markets, e.g. Clearing Corporations, Stock Exchanges and Depositories as per the SEBI Regulations.</td>
<td>49% investment when FDI &amp; Foreign Institutional Investor taken together; and in case of FII, up to 23% of company’s paid up capital and in case of FDI, up to 26% of the company’s paid up capital.</td>
</tr>
<tr>
<td>Power Exchanges incorporated as per the Central Electricity Regulatory Commission, 2010</td>
<td>49% - FDI and FII taken together</td>
</tr>
</tbody>
</table>

Source: Consolidated FDI Policy (2013), Department of Industrial Policy and Promotion, Ministry of Commerce and Industry, Government of India

However, the acquisition of company shares through direct investment approval rout and investment through ADRs, GDRs and FCCBs will not be included in this.
vii) Monitoring of Investment Position by RBI

RBI has been empowered to keep a check on FIIs in terms of them complying with their investment limits in the Indian stock market even on daily basis. In practice, RBI fixes 2% limit less than the actual limit applicable for that company. For instance, if the actual limit for a particular company is 30%, then RBI will fix 28% as the cut-off limit. And in case the FIIs’ buying limit reaches the cut off limit i.e. 28%, it instructs all the designated bank branches to stop buying additional shares of the company. RBI at the same time also informs the public through its notifications.

(b) Limits on Debt Investments and Government Securities.

The policy of Government of India governs the FII in the debt or debt related securities. As per the policy, normally FIIs (registered as regular foreign institutional investors) have to compulsorily divide their investment between equity and debt instruments in the proportion of 70:30. But, it is quite possible that a foreign institutional investor is declared 100% debt-oriented foreign institutional investor. In that situation, it will put all its funds into the debt or debt oriented instruments only. For the sake of FII in debts, they are further classified into two categories:

1. Government Debt
2. Corporate Debt

Table 1.3: FII Limits in Government Debt and Corporate Debt

<table>
<thead>
<tr>
<th>Type of Investment</th>
<th>100% Debt Route FIIs</th>
<th>70:30 Route FIIs and Regular FIIs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Government Debt or Treasury Bills</td>
<td>2.0</td>
<td>0.6</td>
</tr>
<tr>
<td>Corporate Debt</td>
<td>1.0</td>
<td>0.5</td>
</tr>
</tbody>
</table>

Source: sebi.gov.in
(c) **Derivative Position Limits**

To cover the risk in cash markets, SEBI and RBI have allowed FIIs to do trading in derivative markets also. However, foreign institutional investor or sub-accounts can trade in derivative as per the rules specified by SEBI and RBI only.

i) **Investment Limits in Stock based Derivative Contracts by FIIs and Sub Accounts**

The position limits of the foreign institutional investor and sub-account in case of a derivative contract applying to a particular stock (stock future or stock option) are as follows:

- For those stocks on which market-wise position limit (MWPL) of Rs. 500 crore or more applies, the combined limit for future and option contract would be 20% of MWPL or Rs. 300 crore, whichever happens to be lower. Moreover, within this limit, future position can go to a maximum of 10% of MWPL or Rs. 150 crore, whichever happens to be lower.

- For those stocks on which market-wise position limit (MWPL) of less than Rs. 500 crore applies, the combined limit for future and option contract would be 20% of MWPL. Moreover within this limit, stock future position can go to a maximum of 20% of MWPL or Rs. 50 crore whichever happens to be lower.

In addition to that, the gross position applying on all derivative contracts of a foreign institutional investor’s sub account (applying on a specified stock) must not exceed the following’s higher up:

- Up to 1% of the market capitalization of free float (when counted as number of shares)

  **Or**

- 5% of the derivative contracts’ open interest applying on a particular specified stock (when counted as number of contracts).
The above mentioned limits would be applicable on all the derivative contracts entered into about a specified stock tradable at the Indian stock exchange.

ii) **FII Position Limits in Index Derivative Contracts**

Every foreign institutional investor will have the following position:

- Position limit of a foreign institutional investor in case of all index option contracts (applying on a specified index) will be Rs. 500 crore or 15% of the market’s total open interest in index options, whichever happens to be higher (per stock exchange). Moreover, this will be applicable for all open positions taken in option contracts on a specified index.

- Position limit of a foreign institutional investor in case of all future contracts (applying on a specified index) will be Rs. 500 crore or 15% of the market’s total open interest in index future, whichever happens to be higher (per stock exchange). Moreover, this will be applicable for all open positions taken in future contracts on a specified index.

Additionally, FIIIs can also make themselves exposed in equity index derivatives with following conditions to be met:

- All short positions taken in index derivatives (be short calls or short futures) must not exceed the holding of stocks by FIIs in terms of its notional value.

- All long positions taken in index derivatives (be it long calls or long futures) must not exceed the holding of cash, government securities, T-Bills and similar instruments by FIIs in terms of its notional value.

- There needs to be full disclosure about the person or persons who together own 15% or more of all derivative contracts’ open interest on a specified index.

iii) **Position Limits for Interest Rate Derivative Contracts by FIIls**

- **At Foreign Institutional Investor Level:** The limit for the gross open position’s notional value of a foreign institutional investor in the interest rate derivative contracts (tradable on stock exchange) will be as follows:
  - US $ 100 million
Moreover, the FIIs can also get exposure in the interest rate derivative contracts (tradable on stock exchange) equivalent to their cash market exposure’s book value to be traded in Government securities.

- **At Sub-account level:** For a Sub-account, the position limits in interest rate derivative contracts (being traded in near month exchange) will be higher of the following:
  - 15% of open interest being into the interest rate derivative contracts (being traded in stock exchange)
  - Rs. 100 crore.

### 1.5.3.2 Other Important Clauses Related to FIIs and Sub-Accounts

There are some other important clauses related to FIIs and sub-accounts which are discussed below:

i) It is compulsory for FIIs for taking and giving the deliveries of securities of business transactions, that is, they are not permitted to get involved in short selling of securities. This condition is not applicable in derivative trades carried on by them on a recognized stock exchange.

ii) Carry forward of transactions is not allowed on the stock exchange.

iii) All kinds of business transactions in securities will be undertaken only through the SEBI certified share brokers. However, FIIs may sell the securities without the interference of certified broker in the case of buyback offer by the company as per the guidelines of the SEBI (Buy-back of Securities) Regulations Act, 1998. Similarly, this condition is not applicable where FIIs are selling the securities on the basis of ‘a letter of offer’ from an acquirer as per the guidelines of the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations Act, 1997. Moreover, in case of government securities, commercial papers and treasury bills,
FIIIs will purchase and sell the securities according to the procedure specified by RBI for such type of securities.

iv) Normally, all the securities (tradable on the Indian stock exchanges) are registered in the name of foreign institutional investor or in the name of sub-account in case of foreign institutional investor investing on behalf of sub-account. However, in that case foreign institutional investor has to disclose the name of sub-account on whose behalf foreign institutional investor proposes to make investment in the Indian capital market.

v) All the transactions will be settled through the dematerialisation account by the last working day of the financial year, in case, foreign institutional investor or sub-account are having investment worth Rs 10 crore or more.

vi) Any change in the name of foreign institutional investor or sub-account should be immediately informed to SEBI along with the reasons for such a change in the name. An undertaking should also be submitted declaring that only name has been changed and no other change has taken place with regard to control or beneficiary or ownership. Moreover, the application should be accompanied with the certificate of approval from home regulator mentioning its new name. Original registration certificate should also be submitted for necessary amendments.

vii) The foreign institutional investor/sub-account can issue, hold or deal in off-shore derivative instruments like Equity Linked Notes, P-Notes against the specified securities which are either listed or will be listed on the Indian stock exchanges (in favour of those companies/corporations which are under the regulation of the specific regulating body of the country, with specific condition of “Know Your Client” requirement).

viii) Foreign institutional investor can change its domestic custodian. However, the request for the same by foreign institutional investor must be supported by a ‘No Objection Certificate’ from the domestic custodian to be submitted with SEBI for the above stated objective.
1.5.4 Obligations and Responsibilities of FIIs

1.5.4.1 Opening Foreign Currency Account or Non-Resident Rupee Account

For sale and purchase of the securities (officially accepted and allowed in the Indian capital market and money market), there must be a ‘Foreign Currency Account or Non-Resident Rupee Account’ to be opened by each and every foreign institutional investor proposing to make investment in India. It also needs to have one branch of an authorized exchange dealer. All trading of securities must be done through this account only. All cash inflows and cash outflows of shares and debentures traded need to be deposited in this account. All the purchases of permitted securities need to be made through this account. Foreign institutional investor is permitted to send sale proceeds abroad only after the payment of applicable taxes at that time. It is also important to note that the transfer of funds from ‘Foreign Currency Account’ to ‘Non-Resident Rupee Account’ and vice-versa is permitted. However, the applicable condition for the same is that the funds should belong to the same foreign institutional investor.

Earlier in the beginning, FIIs were allowed to hedge their foreign exchange exposure position only for their investments in debt instruments. But from 1998 onwards, forward cover of FIIs’ investment equity has also been allowed with some conditions to be fulfilled by FIIs. So now FIIs can obtain a forward exchange cover from authorized dealers as per the specific guidelines framed in this respect.

1.5.4.2 Appointment of Domestic Custodian

Each and every foreign institutional investor has to get the services of domestic custodian. This domestic custodian would keep the custody of all types of securities traded by foreign institutional investor in the Indian capital markets. The prime responsibility of custodian is to monitor the investments of foreign institutional investor in Indian financial markets and report the transactions to SEBI on daily basis. From time to time, the domestic custodian is required to provide the desired information to SEBI within the stipulated time period. Foreign institutional investor has to ensure that the local custodian has been accomplishing its duties accordingly. With the prior approval of SEBI, foreign institutional investor may also appoint more than one local custodian. As
domestic custodian plays a significant role in the functioning of foreign institutional investor, SEBI would ensure that the domestic custodian looks after the interests of foreign institutional investor(s). For this purpose, domestic custodian will be required to undertake the following actions on its part:

- Keeping a vigilant eye on the foreign institutional investor investment in India.
- Feedback on the daily trading by foreign institutional investor(s) to SEBI
- Up keep of official records of all trading activities by foreign institutional investor(s) for at least last five years.
- Providing all the necessary and desired information about foreign institutional investor trading activities which may be called for by the board from foreign institutional investor from time to time.

1.5.4.3 Appointing a Designated Bank

One branch of a bank is appointed by the foreign institutional investor out of the list approved by RBI as FII designated bank. In that bank branch, foreign currency denominated special Non-Resident account is opened by foreign institutional investor for facilitating its trading activities in the Indian capital market.

1.5.4.4 Investment Advice at the Public forum

Foreign institutional investor or its employee is not allowed to get involved in providing specialised counselling and advice about the securities being traded in the Indian stock market at the public forum. However, in case, any of its member or employee is involved into such activities, and then he/she has to disclose the interest therein.

1.5.4.5 Maintaining Books of Accounts and Records

Every foreign institutional investor is required to maintain the following books of accounts and records:

- Correct record about the trading activities of its investment.
- Bank statement for all types of its accounts;
• Records of all cash inflows to India for investing purpose, the capital gains realised and the outflows of money out of the country.
• All information about the trading activities from its domestic custodian.
• Contract notes about the trading activities like purchase and sale of securities.

The foreign institutional investor will provide all the information to SEBI board about the place where these records have been prepared and maintained.

1.5.4.6 Preservation of Books of Accounts and Records

All FIIs are required to maintain their books of account and other records at least for a minimum period of 5 years subject to any other laws (if any and being in force).

1.5.4.7 Appointing a Compliance Officer

Every foreign institutional investor is required to appoint one compliance officer who would ensure that all the rules, regulation or instructions by SEBI, RBI and central government are being followed. This compliance officer may report to SEBI board independently also whenever he feels that there are some instances of non-compliance.

1.5.4.8 Information to the Board

Each and every foreign institutional investor is required to provide and submit all the desired information/documents/records to SEBI board and RBI as and when needed. Moreover, foreign institutional investor is also required to disclose the information about its sub-account(s), equity linked notes and P-Notes as and when required.

1.5.5 Cancellation of Registration

As per the rules, cancellation of registration of foreign institutional investor and sub-account is allowed by SEBI. For this purpose, a written request containing registration number is required to be submitted to SEBI. Before cancellation of the registration, concerned foreign institutional investor has to ensure that it itself and sub-account does not have any cash and holding of securities.
In case, the application for the renewal of registration is not deposited well on time by foreign institutional investor, then its exiting registration formalities come to an end or get cancelled. Moreover, foreign institutional investor or sub-account is not permitted to make investment or trade in Indian capital market through any unmentioned and non approved channel. In addition to this, in case, the foreign institutional investor or sub-account do not want to renew their application but it has some residual assets left out, it can apply for the disinvestment process to be followed as per the guidelines specified by SEBI in this regard.

1.6 ADVANTAGES AND DISADVANTAGES OF FII

FIIs have many natural advantages in the processing of information. It is expected that as there has been rapid progress in disclosure norms, legal framework is providing more supporting environment, accounting standards being equalised with the global standards, shareholders rights being protected more and corporate governance practices being stressed upon, FII is going to accelerate in India. Since India has opened its stock market, it has enjoyed very good flows of foreign investment in general and FII in particular.

1.6.1 Advantages

Some of the major advantages of having FII are discussed as below:

i) Flows of Equity Capital

It is a well-known fact that the FIIs have a great preference for equity investment than the debt investment. This has probably been one of the underlying reasons that the opening of the Indian capital market (equity market in particular) has come up to their expectations. And the subsequent results have been that they have brought in huge flows of capital in the Indian stock market. Moreover, the tendency of FIIs investing into equity market has also reduced the return-differential and has helped in improving the capital structure of the companies. More importantly, the FII flows have also gone a long way in bridging the gap between saving and investment which the Indian economy could not do due to the limited capacity of the Indian public to save and invest. And this phenomenon has, in turn, led to the capital formation process (Pathak, 2008). The role of foreign capital has been demonstrated by the Figure 1.4.
Figure 1.4 : Role of Foreign Funds in Domestic Secondary and Primary Market


ii) Management of Uncertainty and Controlling of Risk

FIIs do not bring capital flows only; they also bring in financial innovation along with various types of hedging instruments. As FIIs always try to hedge their risks and enhance their returns, these tendencies on their part lead to the growth of zero coupon bonds and index futures market. Moreover, FIIs being financial experts, market analysts and professional bodies enhance the degree of competition in the capital market. It also leads to a situation when the prevailing market prices of securities are aligned to the economic fundamentals (Kevin2010).

iii) Improved Capital Markets

FIIs also play an effective and important role in improving the Indian capital market. Firstly, they have consolidated the Indian financial market by increasing the degree of competition. This way, the realistic market forces have tended to prevail in the market; and market prices have become more representative of the demand and supply forces; and thereby have consolidated financial market further. Secondly, by supplying
long term capital in the Indian economy for financing various types of projects, FIIs have helped in strengthening the industrialisation process further. In nutshell, it has also played an important in the development of the Indian economy as a whole (Guruswamy, 2009).

iv) Market Stability

FIIs are known to be good carrier of full information about the market they are investing in. Hence, their investment decisions are considered to be well guided. This way, their trading activities help in aligning the Indian stock market prices to its basic economic fundamentals. Secondly, as FIIs are always risk hedger, they tend to enter into various types of hedging contracts like future contract. Thirdly, their reasonably good presence in the Indian capital market also shows that they value the strength of the Indian economy. All these developments help in reducing volatility and enhancing the market stability (Kevin, 2010).

v) Improvement in Corporate Governance Practices

In Indian economy, lack of good corporate governance practices has been a key feature of the financial markets. However, over the years, in order to make their presence felt across the globe and raise funds from the foreign markets, many corporate houses have been approaching foreign markets on the one hand. And on the other hand, to make the Indian economy integrated with the world economy, foreign investment has been permitted and a congenial environment has been created for the same. Both these macro level developments have led to the philosophy of more accentuated ‘corporate governance practices by the Indian companies. FIIs’ presence has been ensuring that there is proper spread of information. All these developments have helped in bringing in better corporate governance practices along with the growth of the Indian capital market (Pathak, 2008).

vi) Overcoming Limitations of Small Shareholding

It is worth to note that the problem arising due to the small shareholding pattern has also been addressed by the presence of FIIs in the Indian stock market. It has been
observed over a long time that small shareholders do not have adequate say in the decision making process during the AGM and they are also taken for granted for many strategic issues like announcement of dividend. But, with the presence and participation of foreign institutional investor, not only decisions are taken with more consensuses; nobody can have free ride upon the rights of the small shareholders. However, at the same time, it needs to be taken care that there is also some hidden danger in this positive development, because as the FIIs’ shareholding goes beyond 5% in the capital structure, it may also lead to exploitation of the small shareholders. This undesirable phenomena needs to be well taken care by SEBI (Guruswamy, 2009).

vii) Professional Management

As the FIIs are professionally sound financial analysts, they participate in the affairs of the company very constructively. For example, they ensure adoption of better corporate governance practices by companies, managing the company’s affairs on sound principles, compliance to various acts, adoption of rules and regulations and so on. This way, they help in managing the company with more professional approach. FIIs also ensure more role for the performance oriented persons and removal of underperforming employees. In nutshell, it has been the experience that FIIs have not only increased payout ratios but have also increased the productivity of the company (Guruswamy, 2009).

1.6.2 Disadvantages

In spite of many advantages, there are also many disadvantages of FII flows. Some of the major disadvantages of FII flows are discussed below:

i) Management Control

It has been found that the ultimate aim of the FIIs has been to get maximum returns on their investment in the Indian stock market along with controlling the affairs of their investing company. FIIs through their huge investment get to have the lasting interest in the affairs of the company. This shows that there happens a presence of long term relationship between the company and themselves. This relationship, on the one
hand gives opportunity to FIIs to start controlling the affairs of the company and on the other hand, it also provides leveraged favour to FIIs. Moreover, one another effect of such development is that when FIIs misuse this power, it leads to uncalled and undesirable enhanced control by FIIs upon the small shareholders and sometimes unnecessary decisive say in the crucial decisions of the company. The ultimate repercussion of these developments leads to hampering in the healthy existence and growth of the company (Guruswamy, 2009).

ii) Market Destabilization

As noted, one of the typical features of the FII flows is that they are “Hot Money” due to their herding behaviour and instantaneous withdrawal practices. Under their natural choice, FIIs park their money in any of the country with high potential for good returns. If the calculations done by them happen to be correct, they continue to invest in the same country thinking that there would be more opportunities to earn. But the moment, they feel or they get to know about any negatives of the same country, they immediately withdraw their money and put the same in a different country with better future prospects leaving the earlier country totally unprepared for such a situation (Shajan, 2006).

iii) Danger of Hedge Funds

One of another major source of concern is the hedging activities undertaken by FIIs. By hedge funds, FIIs take short position through aggressive borrowings. Thus, these funds also tend to increase the volatility of the stock market (Shajan, 2006).

1.7 RESEARCH METHODOLOGY

1.7.1 Need for Study

Since the opening of Indian economy in the post period of 1990s, there have been large flows of FII in India. Their number and investment have grown many times in the span of last 20 years. These FII flows have been affecting Indian economy in different respects like enhancement of capital formation process, more FERs, contribution towards market turnover and capitalization, volatility in the stock market and so on. Due to these
reasons, research in the field of FII flows in the Indian Economy has received reasonably good amount of attention for academicians, policy makers and the market regulator (SEBI). But, it has been observed that though there has been a good research work undertaken on this area; the same has not been very comprehensive. Moreover, most of the researches have included stock return as the deciding variable for studying the determinants of FII flows in India. Since the investment in stock market is based on market sentiments, thus FII flows are affected by almost everything which has a direct and indirect impact on the psychology of the investors. This means there have been many factors which have been affecting FII flows in India. However, the critical task has been to zero in on the critical market determinants which affect the flows of FII in India. In addition, majority of the research works have offered mixed results. There have been some studies whose findings have not been inconsonance with each other though pertaining to the same data base. For example, Gordon & Gupta (2003) whose findings supported the view that there was causation from FII to return in BSE were found to be contradictory to the findings of Rai and Bhanumurthy (2003) who concluded that there was no causation from FII to return in BSE.

Moreover, it has been observed that there is a void in the field of research on FII flows in India as far as empirical investigations are concerned. After going through the review of literature, it is found that study and analysis on FII flows, their magnitude, their trends, their determinants and the impact of FII flows on the volatility of the Indian stock market need more intensive investigation. Partly, this could fill part of the existing knowledge gap. Hence the study undertaken is important for the following reasons:

i) The main reason for investment in the stock market by an investor is to earn good return. Good returns depend upon the price movement. Price movement is affected by volatility which is caused by many factors including FII flows. Therefore, FIIs being major players in the Indian stock market are of utmost importance to be studied.

ii) In 2008, when there was a big global economic subprime crisis, the most haunting question which chased everybody mind was the role of FIIs in affecting price movement and thereby volatility of the stock market.
iii) As FII flows are not normally long term capital investment and they act like hot money, it is very important for the government to study FII strategy; and to ensure objective and safe investment environment in the country.

iv) For the protection of investors, it is important for the market regulator (SEBI) to regulate the FII flows and frame out its strategy accordingly.

v) As majority of FIIs bring in huge money which may supplement the capital formation and fill up the saving gaps. But at the time an immediate withdrawal by FIIs may also lead to big crash and in turn collapse the stock market. So it is very important on the part of market regulator to observe the trends of FII flows and take action if the need be.

1.7.2 Research Design

The present research study is both descriptive as well as empirical research aimed at describing and exploring the relationship between the FII flows and various economic fundamental factors like BSE Sensex, ER, FERs and Inflation.

1.7.3 Objectives of the Study

The present research work has been undertaken with the below mentioned objectives to be achieved:

i) To study the magnitude and trends of FII flows in India since 2000 and their forecasting.

ii) To find out the factors affecting FII flows in India.

iii) To examine the relationship between FII and other economic factors like Stock Market, FERs, ER and Inflation.

iv) To study the impact of FII flows on the volatility of the stock market in India.

1.7.4 Hypothesis

In the light of the above mentioned objectives of the study, the following hypotheses have been framed and tested:
i) Stock Market Return, ER, FERs and Inflation rate do not affect the flows of FII in India.

ii) FII flows do not have an impact on the stock market volatility in India.

1.7.5 Sources of Secondary Data Collection

The secondary data required for this research work have been collected from various sources as mentioned below:

i) Annual Reports of Securities and Exchange Board of India (SEBI)

ii) Handbook of Statistics on the Indian Securities Market, Securities and Exchange Board of India (SEBI)

iii) Bulletins, Securities and Exchange Board of India (SEBI)

iv) Annual Reports, Reserve Bank of India (RBI)

v) Handbook of Statistics on the Indian Economy, Reserve Bank of India (RBI)

vi) Bulletins, Reserve Bank of India (RBI)


viii) Annual reports of BSE, NSE.

ix) Annual Reports, Ministry of Finance, Government of India (GOI)

x) Publications and Reports of Central Statistical Organisation (CSO)

xi) Data from Newswire and Capital line.

1.7.6 Period of the Study

The study has been conducted for the period starting from 2000-01 to 2011-12.

1.7.7 Selection of Variables

The present study includes various economic variables namely FII, BSE Sensex, ER, FERs and Inflation. The logic of including these variables into this study is based upon the trading behaviour of FIIs. Objectively speaking, the trading behaviour of the FIIs is classifiable into two types:
i) **Positive Feedback Trades or Momentum Trading**

As per this approach, FIIs prefer to observe the returns being generated by the movements of stock market index and identify who are the winners and the losers coming out of this development. Accordingly, they take a decision in buying the recent winners and selling the recent losers. Thus, they prefer to have a continuous eye on the performance of major stock indices like BSE. Hence, BSE Sensex is a very important variable which has been included in this study to analyse the behaviour of FIIs with respect to its movements.

ii) **Herding Strategy**

As per this approach, FIIs prefer to observe the behaviour of other FIIs and behave in the same manner as the other FIIs do. It has been empirically observed that many FIIs while investing in India observe the performance of various economic indicators. Therefore, many economic indicators like ER, FERs and Inflation are some of the important variables which reflect the overall health of the economy. Even during post 1990s era, it was the FERs which became the pivotal of economic problems of India. Thus, all these variables amongst many others play a crucial role in the decision making process of FIIs. Hence, they have been included in the study.

All other variables have been assumed to be constant in the present study.

**1.7.8 Techniques of Data Presentation, Analysis and Interpretation**

For the present study, various statistical tools have been employed. The secondary data collected from various sources have been properly classified, edited, tabulated and analysed. For the purpose of graphical presentation and statistical analysis, various statistical tools like Histogram, Frequency Curve, Simple Percentage Analysis, t Test and Correlation Analysis with the help of Microsoft excel have been used. And for the advanced statistical testing and analysis, various econometric tools like Granger Causality, VAR, Variance Decomposition, Impulse Response Function, ARCH, GARCH and ARIMA have been used with the help of Eviews. A comprehensive description of the statistical tools used in this study is as follows:
i) **Histogram**

This is one of the popular graphical methods of presenting a frequency distribution. While constructing the histogram, the variables are always taken on the x-axis and the frequencies are taken on the Y-axis. This method has been used in the present research work to present various types of frequency distributions like FIIs registered with SEBI in India.

ii) **Frequency Curve**

A smoothed frequency curve can also be drawn through various points of the polygon. The same has been used in this research work for presenting various types of time series data like county wise classification of FIIs, composition of foreign portfolio investment in India, trends of FII in India, shareholding patterns of FII in companies listed on NSE, FII in equity and debt market, MCR, TOR and VTR for BSE and NSE, total FII as percentage of total market turnover, FII as percentage of total market capitalization.

iii) **Simple Percentage Analysis**

Mathematically, percentage is a mode of expressing a figure as fraction of 100. Simple percentage analysis is one of the most important and widely used statistical tools in the analysis and interpretation of the time series data. In the present research work, this method has been used for analysing various types of data through a single figure and comparison of various percentages also. The following formula has been used for calculating percentage.

\[
\text{Percentage} = \frac{\text{Single Unit in a Whole of } N \text{ Units}}{N} \times 100
\]

iv) **t-Test**

T test is based on the t distribution and is considered an appropriate test for judging the significance of a sample mean or for judging the significance of difference between the means of two samples in case of sample(s) when population variance is unknown. In
the present research study, t test has been applied to know the significance of FII in the total FPI, significance of FII in the Indian equity and debt market, significance of FIIs’ assets as compared to the total assets under various custodians, significance of FII in total market turnover, significance of FII in total market capitalization and significance of FII in Indian GDP.

v) Correlation Analysis

The correlation is one of another widely used, most common and handy statistical tools to indicate the strength and direction of a linear relationship between two random variables. A correlation is single number having value between +1 and -1 which explains the degree of relationship between the two variables. In the present study, the correlation has been calculated with the help of e-view software by using the differenced time series data to avoid the problem of non-stationarity. For instance, the following data have been used for relationship analysis:

DFII = Differenced FII

DSensex = Differenced Sensex

DER = Differenced Exchange Rate

DFERs = Differenced Foreign Exchange Reserves

DWPI = Differenced Whole Sale Price Index (used for Inflation)

vi) Granger Causality Test

It is important to note that correlation analysis is not sufficient to have an in-depth study of relationship between the variables. There exists a more relevant concept called the concept of causality. This test is conducted to know whether the behaviour of one variable is caused by another given variable or vice versa named as unidirectional causality or behaviour of both the variables is caused by each other, this phenomena called the concept of ‘bi-directional causality’ or there may exist a situation when both the variables do not cause each other, this situation is called a no causality situation between them. Framed as one of the major objectives of this study, in order to know the
causality between the given variables under consideration, granger causality test has been applied for this purpose. Under the application of this econometric model, various steps discussed below have been followed:

- **Hypotheses to be Tested using Granger Causality:**

  The following hypotheses have been framed to be tested by applying granger causality econometric model:

  **Null Hypothesis \((H_0)\):** FII does not granger cause Sensex, FERs, ER and Inflation.

  **Alternative Hypothesis \((H_a)\):** FII does granger cause Sensex, FERs, ER and Inflation.

  Before this test is applied, the following conditions need to be fulfilled:

  i) All the series to be used for the analysis need to be checked for their stationarity and in case of non-stationary series, the same need to be been converted into stationary by differencing.

  ii) The lag length selection has been made as per the relevant criteria.

- **Testing of Stationarity or unit root test – Augmented Dicker Fuller (ADF) Test**

  As there are five time series in the present study, namely, FII, BSE Sensex, FERs, ER and Inflation, all these have been tested for their stationarity by using the following form of ADF regression equation:

  \[
  Y_t = \beta_1 + \beta_2t + \delta Y_{t-1} + \alpha_i \sum_{i=1}^{m} \Delta Y_{t-1} + \epsilon_t \]

  Where \(\epsilon_t\) is a white noise error term and \(Y_{t-1}\) additional lagged terms are with an idea to ensure that the error terms are not correlated. \(\beta_1, \beta_2, \delta, \alpha\) are the coefficients where \(\delta\) is the first difference operator which is equal to \((p-1)\), estimated to test the null hypothesis that \(\delta = 0\). If \(\delta\) is equal to 0, it means that there is a unit root which implies non-stationarity in the time series under consideration.
• **Hypothesis for Checking the Stationarity of time series**

**Null Hypothesis (H₀):** FII /FERs/ER/Inflation/Sensex is a non stationary time series or it has unit root.

**Alternative Hypothesis (Hₐ):** FII/FERs/ER/Inflation/Sensex is a stationary time series or it has no unit root.

• **Conversion of Non-stationary time series into stationary series**

The time series of the given variables (FII, BSE Sensex, FERs, ER and Inflation) if found non-stationary have been converted into stationary time series by differencing them.

• **Testing for Selection of Proper Lag Length through AIC**

The second requirement for the granger causality test is to find out the appropriate lag length for each pair of variables. For this purpose, Akaike information criterion (AIC) has been used for choosing optimal lag order selection.

In general case, the AIC is

\[ AIC = 2k-2l \]

where k is the number of parameters in the statistical model, L is the maximized value of the likelihood function for the estimated model.

• **Co-integration Analysis for choosing the Vector Auto Regression (VAR) Model**

In the present research study, Co integration (long term association) amongst the variables under study has been checked by using the Johansenn Co integration model. Restricted VAR model has been used in the granger causality model as the four variables namely FII, FERs, ER and Inflation have been found to have long term association.

• **Relationship Study with Granger Causality Test**

Granger causality test has been applied to analyse whether there is any casual relationship between the variables under study. As it is a known fact that the granger
casualty is a bi-variate analysis, hence, we have developed two equations for each and every variable one by one:

**FII and Sensex pair of regression equations are:**

\[
\text{FII}_t = \sum_{i=1}^{n} \alpha_i \text{Sensex}_{t-1} + \sum_{i=1}^{n} \beta_i \text{FII}_{t-1} + \mu_{1t}
\]

\[
\text{Sensex}_t = \sum_{i=1}^{n} \lambda_i \text{FII}_{t-1} + \sum_{i=1}^{n} \delta_i \text{Sensex}_{t-1} + \nu_{2t}
\]

**FII and Foreign Exchange Reserves (FERs) pair of regression equations are:**

\[
\text{FII}_t = \sum_{i=1}^{n} \alpha_i \text{FER}_{t-1} + \sum_{i=1}^{n} \beta_i \text{FII}_{t-1} + \mu_{1t}
\]

\[
\text{FER}_t = \sum_{i=1}^{n} \lambda_i \text{FII}_{t-1} + \sum_{i=1}^{n} \delta_i \text{FER}_{t-1} + \nu_{2t}
\]

**FII and Exchange Rate (ER) pair of regression equations are:**

\[
\text{FII}_t = \sum_{i=1}^{n} \alpha_i \text{ER}_{t-1} + \sum_{i=1}^{n} \beta_i \text{FII}_{t-1} + \mu_{1t}
\]

\[
\text{ER}_t = \sum_{i=1}^{n} \lambda_i \text{FII}_{t-1} + \sum_{i=1}^{n} \delta_i \text{ER}_{t-1} + \nu_{2t}
\]

**FII and Inflation pair of regression equations are:**

\[
\text{FII}_t = \sum_{i=1}^{n} \alpha_i \text{Inflation}_{t-1} + \sum_{i=1}^{n} \beta_i \text{FII}_{t-1} + \mu_{1t}
\]

\[
\text{Inflation}_t = \sum_{i=1}^{n} \lambda_i \text{FII}_{t-1} + \sum_{i=1}^{n} \delta_i \text{Inflation}_{t-1} + \nu_{2t}
\]

In the above equations FII, Sensex, FERs, ER and Inflation are the variables to be tested. \( \alpha_i, \beta_i, \lambda_i, \delta_i \) are the coefficients which explain the relation of dependent variable with the lag terms of independent variable and the lag terms of dependent variable itself.

\( t \) is the period and \( I \) is the number of lags.

\( \nu_{1t} \) and \( \nu_{2t} \) are the disturbances or white noise errors or residuals which are assumed to be mutually uncorrelated.

vii) **Vector Auto regression (VAR)**

This model is basically used to find the relationship between various economic variables by taking into account the feedback by other variables. Estimation based on
VAR includes endogenous (or also named dependent) as well as exogenous (or also named independent) variables in the equation making. It is an important tool for multivariate analysis. In this model, the value of a given variable (endogenous) is considered as the linear function of its own lagged value or its past value and also the function depending upon all other variables (exogenous) variables considered in this model. All the variables are considered as endogenous (dependent) variables one by one and its own past or lagged values and other variables are considered as exogenous (independent) variables. Two very useful methods of examining the properties of VAR are Variance Decomposition and Impulse Response.

viii) Variance Decomposition

In the present study, variance decomposition method has been applied to examine the dynamics of VAR system. Under this econometric model, an effort has been made to know as to how much movement in the value of a given variable (dependent one) is due to its own shock or its lagged value (s); and how much movement is attributable to other variables (independent one). It is stated that whenever there is a shock in the value of the ith variable (dependent), it would not only affect that variable directly, it would also get travelled to other variables through the dynamic system of VAR.

In addition to this, it is also worth to notice that the order of selecting the variables is an important issue in variance decomposition. In the present study, Cholesky Decomposition model has been employed for deciding the order of the variables.

The equations for variance decomposition are as follows:

\[ \Delta X_t = \alpha_1 + k \sum_{i=1}^k (\alpha_{11}(t) \Delta X_{t-i}) + k \sum_{f=1}^F \alpha_{12}(F) \Delta Y_{t-f} + \epsilon_{Xt} \]

\[ \Delta Y_t = \alpha_2 + k \sum_{i=1}^k (\alpha_{21}(t) \Delta X_{t-i}) + k \sum_{f=1}^F \alpha_{22}(F) \Delta Y_{t-f} + \epsilon_{Yt} \]

where \( \epsilon \)'s are stochastic error term; called impulse response or innovation or shock in the language of VAR.

ix) Impulse Response Function (IRF)

In order to have an in-depth understanding of the behaviour of one variable due to the changes in the value of other variables or due to the changes in its own value, IRF has
been used in the present study. In simple words, Impulse Response is a graphical statistical tool through which the change (s) brought in one variable due to the shock or the impulse in the same variable; or due to shock or the impulse in the other variables over a short period of time normally one year is shown. Though, there are various techniques which can be used to know what type of change is desired to be made in the system, however, normally, a positive change of one standard deviation is made in the system. When this positive change of one standard deviation is introduced in the system, it gets propagated or spread into the entire system and also changes the value of the dependent (endogenous) variables for each and every period of time. When both the econometric methods namely variance decomposition and impulse response function are used together, they are collectively called ‘Innovation Accounting’ as termed by Enders in 1995. In the present study, Choleski Impulse Response model has been used for the generation of impulse response.

x) Autoregressive Conditional Heteroscedasticity (ARCH) and Generalised Autoregressive Conditional Heteroscedasticity (GARCH)

FIIs are motivated not only by the domestic and global factors but also by the short run expectations normally called market sentiments. These market sentiments give birth to the element of speculation and high mobility. Volatility is, thus, the uncalled and naturally present phenomena in the stock market which enhances the degree of risk for the investment made by the investors. As stock market volatility as a measure of risk plays an important role in the financial decision making for many stakeholders, the data from 2000 to 2012 of net FII along with BSE Sensex have been used to study the phenomena of volatility in the Indian stock market.

Before ARCH and GARCH models are applied, the cluster Volatility present in the residual of variance has been checked along with model selection.

- Checking of Cluster Volatility in Residuals or Errors terms

This has been investigated by analysing the existence of cluster volatility in the residuals or errors terms generated with the help of Eviews application on Sensex monthly time series data from 2000 to 2012.
• **Model Selection**

Lag length has been selected by using Normal Gaussian Distribution Model on the basis of various information criteria like Akaike Information Criteria AIC, Schwarz Information Criteria or Bayesian Information Criterion (SIC) and Hannan-Quinn Information Criterion (HQ).

To specify the ARCH and GARCH model, two equations have been specified. One is mean equation and the second is variance equation.

**Mean Equation is as follows:**

\[
\text{Sensex} = C_1 + C_2 \times \text{FII} + e \quad \ldots \ldots \quad (1.1)
\]

Here Sensex = sensitivity index of BSE, C1, C2 = constant, FII = FII, e = Residual.

**Second equation (developed from mean equation) is the Variance Equation which is as follows:**

Residual derived from mean equation (1.1) is used in making variance equation.

\[
H_t = C_3 + C_4 \times e^2_{t-1} + C_5 H_{t-1} + C_6 \times \text{FII} \quad \ldots \ldots \quad (1.2)
\]

\(H_t\) = Variance of the residual (error term) derived from equation (1.1). It is also known as current period’s variance or volatility of stock market (BSE Sensex).

C3=Constant

C4, C5……C6 = Constant/Coefficient

\(e^2_{t-1}\) or \(\text{RESID} (-1)^2\) = Previous period’s squared residual derived from equation (1.1). It is also known as previous period’s stock market (Sensex) information about volatility. It is **ARCH term**.

\(H_{t-1}\) = Previous days’ residual variance or volatility of stock market (Sensex). It is **GARCH term**.

FII = FII (variance repressor or exogenous or independent variable)
xi) Time Series Modelling using ARIMA Model (Autoregressive Integrated Moving Average) for forecasting

In the present research work, the forecasting of FII for the future period has been done with the help of ARIMA modelling. Under this technique, firstly the stationarity of the time series of foreign institutional investor has been checked with the help of ADF. Steps involved in ARIMA estimation include checking of stationarity of time series, equations building, identifying the model, checking model adequacy and forecasting.

- Checking Stationarity of the time Series

It is one of the important conditions that ARIMA models can be applied only on a stationary time series. If a series is not stationary, then stationarity need to be induced into it by differencing it and that differenced time series $\Delta Y_t$ is represented by:

$$\Delta Y_t = Y_t - Y_{t-1} \text{ ............................................................}$$

In the present series, the same procedure has been adopted to make the non-stationary time series into stationary time series.

- Equation Building: In an autoregressive model, the value of FII depends linearly on its own past values:

$$FII_t = b_0 + b_1 FII_{t-1} + b_2 FII_{t-2} \ldots + b_p FII_{t-p} + u_p \text{ .............................................................}$$

where $b_0, b_1, b_2 \ldots b_p$ are the coefficients which can be estimated by ordinary least squares regression and $u_p$ is white noise error term.

In moving average model (MA), the current value of FII depends linearly on past ‘shocks’.

$$FII_t = c_0 + c_1 FII_{t-1} + c_2 FII_{t-2} \ldots + c_q FII_{t-q} + u_q \text{ .............................................................}$$

where $c_0, c_1, c_2 \ldots c_q$ are the parameters and $u_q$ is the shock or disturbance which affect for q period.
• **ARIMA Model Section**

The selection of p, d and q value is very important in case of ARIMA model as the value when used as an input in the given ARIMA model can directly affect forecasting results. The ARIMA model has been selected on the basis of AIC, SC and DW test.

• **Checking Model Adequacy through Residuals of AC and PAC**

Before the forecasting is done with the help of ARIMA model, it is important to see whether residuals of the AC (auto correlation) and PAC (Partial Auto correlation) show random movement. If residuals of AC and PAC show random movement, then the given ARIMA models best fit for the further processing.

1.7.9 **Limitations of the Study**

The present study has the below mentioned limitations:

i) The present study is based upon the secondary data collected from the official sites of SEBI, RBI, BSE, and NSE along with other database like newswire and capital line. The results and conclusions are also based on this data. Hence, any inconsistency in the results and conclusions drawn on the basis of this data cannot be ruled out.

ii) As the data has been tabulated as per the need of this study, hence some chances of human errors cannot be ruled.

iii) The results and outcome of this research will not be capable of being generalized for all the time as the data analysis has been made for a specific time period.

iv) Though due care has been taken to overcome the limitations of statistical tools used in this research, the inherent limitations of the tools cannot be ruled out and it also applies to this research.

v) The findings and conclusions are the results of human interpretations and hence the chances of less objectivity cannot be ruled out also.
1.8. CHAPTER SCHEME

The present study has been divided into five chapters which are discussed as below:

First chapter titled ‘Introduction’ studies the inception of the concept of FII in India, its evolution, conceptual and regulatory framework.

Second chapter titled ‘Review of Literature’ undertakes an extensive and exhaustive review of the empirical research studies on the present research area.

Third chapter titled ‘Trends, Magnitude and Composition of FII in India’ studies FII magnitude, their trends and the composition. It also discusses the FII flows in equity and debt instruments along with their contribution in the market turnover, market capitalization and Indian GDP.

Fourth chapter titled ‘Determinants of FII and Their Relationship Study’ discusses the selection of various variables as determinants of FII on the basis of different empirical researches and the study on their dynamic relationship.

Fifth chapter titled “Summary of Findings, Conclusions and Suggestions” summarises all the findings and gives final conclusion. It also gives suggestions to the policy makers, academicians and market regulator for attracting more FII flows by ensuring a more congenial investment environment. It also provides glimpse on the scope for future research.