CHAPTER – I

INTRODUCTION

1.1 Introduction about the Study

When the world is growing as one of the big global markets, people often think of the increasing volume of trade in goods and services. Trade flows are indeed one of the most visible aspects of globalization. Analysts argue that international investment is a much more powerful force in driving the world towards closer economic integration. Investment alters entire methods of production through transfers of know-how, technology and management techniques, and thereby initiates most significant change than the simple trading of goods. The term Foreign Institutional Investor is defined by SEBI as: “FII means an institution established or incorporated outside India which proposes to make investment in India in securities. Provided that a domestic asset management company - or domestic portfolio manager who manages funds - raised or collected or brought from outside India for investment in India on behalf of a sub-account, shall be deemed to be a Foreign Institutional Investor”. Foreign Investment refers to investments made by residents of a country, in financial assets and production process of another country. Foreign investments in the country can take the form of investments in listed companies (i.e., Foreign institutional investments), or unlisted companies other than through stock exchanges (i.e., through the foreign
direct investment or private equity or foreign venture capital investment route), investments through American Depository Receipts or Global Depository Receipts (ADR / GDR), or investments by non-resident Indians (NRIs) and Persons of Indian Origin (PIOs) in various forms. Over the past ten years, foreign investment has grown in India at a significantly more rapid pace than international trade or world economic production. From 1980 to 1998, international capital flows, a key indication of investment across borders, grew by almost 25 percent annually, compared to the 5 percent growth rate of international trade\(^1\). This investment has been a powerful catalyst for economic growth.

As per a Business Today Report (November, 2011), a trend analysis of stock indices since 2006 reveals that the market peaks when FII inflows are high and falls when FII inflows dry out or they start pulling out their investments from Indian markets. FIIs holdings in Indian stocks were close to 19% of overall market value of shares by June 2012. Hence, theoretically, the FIIs hold the power to bring down Indian stock market to shambles in one big exodus, which will have a ripple effect on value of home currency, CAD, external borrowings by companies and costlier imports. Second, the rising level of short-term external debt with respect to foreign exchange (FOREX) reserves from 5.1% in 2002-03 to 31.1% in December 2012 is ringing alarm bells. The problem is further exacerbated by long-term debt, which is also coming up for maturity. Moreover, the slowing

\(^1\) http://unpan1.un.org/intradoc/groups/public/documents/UN/UNPAN006348.pdf
down exports, deceleration of industrial production and growing appetite for imports, including non-essential commodities, is adding fuel to the fire. Flows of investment and the rules that govern or fail to govern it can have profound impacts upon such diverse issues as economic development, environmental protection, labour standards and economic stability. According to MSCI index, India is the ninth best performing market in the global emerging markets. The Boston-based Emerging Market Portfolio Research rates India as the third biggest recipient of FII inflows after Taiwan and Korea. Researcher hence makes an attempt to understand the investment scenario for FII in Indian stock market, the regulatory framework, and the factors that makes things possible or impossible for the FIIs in India.

1.2 Evolution of Indian Stock Market

Stock markets refer to a market place where investors can buy and sell stocks. The price at which each buying and selling transaction takes place is determined by the market forces (i.e. demand and supply) for a particular stock. The working of stock exchanges in India started in 1875. BSE (Bombay Stock Market) is the oldest stock market in India. The history of Indian stock trading starts with 318 persons taking membership in Native Share and Stock Brokers Association, which we now know by the name Bombay Stock Exchange or BSE in short. In 1965, BSE got permanent recognition from the Government of India.
National Stock Exchange (NSE) comes second to BSE in terms of popularity. BSE and NSE represent themselves as synonyms of Indian stock market. The history of Indian stock market is almost the same as the history of BSE.

Until the 1980s, there was a general reluctance towards foreign investment or private commercial flows as India’s development strategy was focused on self-reliance and import substitution and current account deficits were financed largely through debt flows and official development assistance. A major development in our country, post 1991 has been liberalization of the financial sector, especially that of capital markets. After the launch of the reforms, foreign institutional investors (FIIs) from September 14, 1992, with suitable restrictions, were permitted to invest in all securities traded on the primary and secondary markets, including shares, debentures and warrants issued by companies which were listed or were to be listed on the Stock Exchanges in India and in schemes floated by domestic mutual funds. A positive contribution of the FIIs has been their role in improving the stock market infrastructure and the SEBI assured its contribution towards its development.

Portfolio investments in India include investments in American Depository Receipts (ADRs) or Global Depository Receipts (GDRs), Foreign Institutional Investments and investments in offshore funds. Before 1992, only Non-Resident Indians (NRIs) and Overseas Corporate Bodies were allowed to undertake
portfolio investments in India. Thereafter, the Indian stock markets were opened up for direct participation by FIIs. They were allowed to invest in all the securities traded on the primary and the secondary market including the equity and other securities or instruments of companies listed or to be listed on stock exchanges in India. With over 20 million shareholders, India has the third largest investor base in the world after the USA and Japan. Over 9,000 companies are listed on the stock exchanges, which are serviced by approximately 7,500 stockbrokers. The Indian capital market is significant in terms of the degree of development, volume of trading and its tremendous growth potential (Mehra Saniya 2007).\(^2\)

1.3 **Significance of FIIs in Indian Stock Market**

FIIs contribute to the foreign exchange inflow as the funds from multilateral finance institutions and FDI (Foreign direct investment) are insufficient. Following are the some advantages of FIIs.

- It lowers cost of capital providing access to cheap global credit.
- It supplements domestic savings and investments.
- It leads to higher asset prices in the Indian market.
- And has also led to considerable amount of reforms in capital market and financial sector.

---

There are generally two ways to invest for FIIs: Equity Investment or 100% Debt

- 100% investments could be in equity related instruments or up to 30% could be invested in debt instruments i.e. 70 (Equity Instruments): 30 (Debt Instruments)

- 100% investment has to be made in debt securities only

India opened its stock market to foreign investors in September 1992, and in 1993, received portfolio investment from foreigners in the form of foreign institutional investment in equities. This has become one of the main channels of FII in India for foreigners. Initially, there were terms and conditions which restricted many FIIs to invest in India. But in the course of time, in order to attract more investors, SEBI has simplified many terms such as:

- The ceiling for overall investment of FII was increased 24% of the paid up capital of Indian company.

- Allowed foreign individuals and hedge funds to directly register as FII.

- Investment in government securities was increased to US$5 billion.

- Simplified registration norms.
In the year 2008, investments of FIIs were Rs.2, 55,464.40 Crores\(^3\). This is almost 9 percent of the total market capitalization. In simple terms, market pundits often attribute the rally of stock market and fall of stock market to the flow of funds by FIIs. We often hear the terms “FIIs Fuel the Market Run”. The major impacts are:

i. They increased depth and breadth of the market.

ii. They played major role in expanding securities business.

iii. Their policy on focusing on fundamentals of the shares had caused efficient pricing of shares.

These impacts made the Indian stock market more attractive to FIIs and also domestic investors, which involve the other major player MF (Mutual Funds). The impact of FIIs is so high that whenever FIIs tend to withdraw the money from market, the domestic investors become fearful and they also withdraw from market. FIIs purchase and sell in the stock market leads to a high degree of volatility. The development in the stock market encourages the outflow of capital will increase the vulnerability of the situation. The high degree of volatility can be attributed to the following reasons:

- Increased investment by FIIs increases the stock prices and this inturn increases the stock prices and further investments.

\(^3\) [http://foreigninstitutionalinvestors.blogspot.in/2011/06/ffiis-foreign-institutional-investors.html](http://foreigninstitutionalinvestors.blogspot.in/2011/06/ffiis-foreign-institutional-investors.html)
• FII manipulates the situation and waits for the index raise and exit at an appropriate time.

The growing Indian market had attracted foreign investors, or Foreign Institutional Investors (FIIs), to the Indian equity market, and an attempt is made by the researcher to understand the impact of foreign institutional investors in the Indian stock market.

1.4 Statement of the Problem

The Foreign Institutional Investors (FIIs) have emerged as important players in the Indian equity market in recent years. The behaviour of the stock market is affected by the globalization of the world economy. The Foreign Investors are attracted by the Asian markets, especially India, due to many obvious reasons. First, the growth potential in Asian Markets is higher, secondly it is cheaper to invest in countries like India because the costs are low, thirdly there is a higher investor base, and fourthly most Asian economies are developing and thus governments are welcoming foreign investors as they play a major role in boosting the growth of the country. The opening of markets for foreign investors has its own advantages and disadvantages. Advantage of financial liberalization for stock markets is that it has to improve its trading mechanism and match up to world standards. But the major disadvantage was that it brought destabilization in the economy and increased volatility in stock movements. The
last two decades has led to growing participation of Institutional Investors which includes not only the foreign Institutional investments but also investments by domestic institutional investors. The increasing role of Institutional investors led to both qualitative and quantitative developments in Indian Stock Markets.

The performance of the Indian economy does not move in aligned with FII flows since these flows would typically precede a reversal in economic conditions by a few quarters. Again, these investors judge this data in relation to the corresponding numbers from other countries. So factors perceived favourable for investment by Indian investors may not be perceived favourable by a foreign investor. Portfolio investments brought in by FIIs have been the most dynamic source of capital since 1990s. At the same time, there is unrest over the volatility in foreign institutional investment flows and its impact on the stock market and the Indian economy. Apart from the impact they create on the market, their holdings will influence individual firm’s performance. The importance of FIIs in Indian equity market is inevitable. There are literatures that support this evidence, however fail to provide the updated information. To study the impact of FIIs in Indian stock market the investigator has taken up the research problem entitled “STUDY ON THE IMPACT OF FOREIGN INSTITUTIONAL INVESTORS (FIIs) IN INDIAN STOCK MARKET”. It also brings out the relationship between FIIs and Equity Market returns in India and the extent to which the
buying activity of the FIIs of selected securities determine the volatility of the stock market. In this perspective, the following research questions are addressed:

1. What are the trading mechanisms adopted by the FIIs in Indian stock market?
2. What factors influence the flow of FIIs in India?
3. Does there exist a relationship between FIIs investment pattern and Indian stock indices?

1.5 Objectives of the Study

The following objectives are formulated to address the research problem.

1. To understand the regulatory framework for FIIs and the trading mechanisms adopted by FIIs in Indian stock market.
2. To study the trend that exists in FIIs purchases, FIIs sales and Net Investment in FII financial flows.
3. To identify the factors that influence the FIIs capital flows in Indian stock market.
4. To explore the relationship between the FIIs net investment pattern and Indian stock indices.

1.6 Hypotheses of the study

Based on the above stated objectives of the study, the hypotheses are formulated for empirical verification. The basic hypothesis formulated is:
Null Hypothesis (Ho): There exists no significant influence of FIIs on the stock indices.

Alternative Hypothesis (Ha): There exists significant influence of FIIs on the stock indices.

The hypotheses tested for the research include:

1. There exists trend in the FIIs Investment in India.
2. There exists a significant relationship between FII flows and economic indicators.
3. There exists a significant relationship between FII and NIFTY.
4. There exists a significant relationship between FII and BSE Sensex.
5. There exists a significant relationship between FII flows and Stock market Return.
6. There exists a significant relationship between FII flows and Adjusted Sensex close value.
7. There exists a significant relationship between Stock market and FIIs investment behaviour.
8. There is significant association between Net FIIs Investment and Market Capitalization
9. There is significant association between Net FIIs Investment and Market Turnover.
10. Net FII is significantly influenced by movements of Sensex.
1.7 Scope and Need of the Study

Foreign capital flows have come to be acknowledged as one of the important sources of funds for economies that would like to grow at a rate higher than what their domestic savings can support. This resulted in the integration of global financial markets. As a result, capital started flowing freely across national borders seeking out the highest rate of return. India is considered as a good investment option by world investors in spite of political differences and lack of infrastructure facility etc. Indian market presents vast potential, alluring and encouraging foreign investors continuously. Foreign portfolio inflows through FIIs, in India, are important from the policy perspective, especially when the country has emerged as one of the most attractive investment destinations in Asia.

Scope of the study is very broad and covers both the stock indices and its comparison with foreign institutional investments. The study will provide a very clear picture of the impact of foreign institutional investors on Indian stock indices. It will also describe the market trends due to FIIs inflow and outflow. Moreover, it would bring out the need to gain knowledge regarding foreign institutional investments, and help to reorient stock market policies formulated and implemented with regard to FIIs and to undertake further studies on fundamental and structural factors on FIIs.
1.8 Limitations of the Study

As the time available is limited and the subject is very vast the study is mainly focused on identifying whether there exist relationship between FIIs and Indian Equity Stock Market.

i. The study is general.

ii. It is mainly based on the data available in various webs sources.

iii. The inferences made are purely from the past year’s performance.

iv. There is no particular format for the study.

v. Sufficient time is not available to conduct an in-depth study.

1.9 Chapter Scheme

The thesis is organized into six chapters as described below:

Chapter – I – Introduction

This chapter describes the problem statement, objectives, hypotheses, scope, need and limitations of the study.

Chapter – II – Concepts and Regulatory Framework

This chapter discusses various concepts used in the study and the regulatory framework for FIIs investments in India.
Chapter – III – Review of Literature

This chapter brings out the research done by the researchers previously and their contributions. The research gap for the current study is identified from this chapter.

Chapter – IV – Methodology

The design of the study which includes the Source of data, Period of study and the models used to analyze the data were described in this chapter.

Chapter – V – Results and Discussion

The results of the analysis are presented and discussed to draw specific inferences.

Chapter – VI – Summary and Conclusion

A summary of findings is presented; conclusions are drawn after the study on Influence of FIIs in Indian Stock Market.