Impact of Foreign Institutional Investment in Indian Stock Market

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Abstract: Foreign Institutional investors have gained a significant role in Indian stock markets. The increase in the volume of foreign institutional investment (FIIs) inflows in recent years has led to concerns regarding the volatility of these flows, threat of capital flight, its impact on the stock markets and influence of changes in regulatory regimes. The dawn of 21st century has shown the real dynamism of stock market and the various benchmarking of sensitivity index (Sensex) in terms of its highest peaks and sudden falls it can be said that while return declined reasonably after the entry of FIIs, the volatility has been reduced significantly after their entry. Besides, FIIs investment flows, there may be other reasons as well that may have some degree of influence on market volatility and return. While the FIIs investment flows and contemporaneous SENSEX, NIFTY, market capitalization and market turnover have been strongly correlated in India, the correlation between FIIs Investments and market volatility and market return has been comparatively low. It means volatility in Indian market is not the function of FIIs investment flows. There may be some other reasons which induced the volatility in Indian market over the time.

Key words: Sensitivity index, Stock market, Sensex, Nifty, Market capitalization and Market turnover.

1. INTRODUCTION

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

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

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

- As FII.
  
  Overseas pension funds, mutual funds, investment trusts, asset management companies, nominee companies, banks, institutional portfolio managers, university funds, endowments foundations, charitable trusts, charitable societies, a trustee or power of attorney holders incorporated or established outside India proposing to make proprietary investment or investment on behalf of a broad-based fund (i.e. fund having more than 20 investors with no single investors holding more than 10 percent of the shares or units of the fund).

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

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

II. REVIEW OF LITERATURE

Banaji, J. (2000), emphasized on the fact that the capital market reforms like improved market transparency, automation, dematerialization and regulations on reporting and disclosure standards were initiated because of the presence of the FIIs.

Panda Mazumdar (2004), found that FII flows have enhanced liquidity in the Indian stock market but not much evidence is there to support the hypothesis that FII flows have generated volatility in the returns.

Chkradhar (2005), examined the impact of FIIs and mutual fund investments on Indian stock market by using Vector Auto regression (VAR) analysis and Granger Causality Test on data of NSE and BSE for the period from Oct. 2003 to Mar. 2004 and found that the returns on Indian stock market indices were more affected by the mutual fund investment than FIIs investment. FIIs are found to follow positive feedback strategy and to have return chasing tendency.

Krishna (2009), reveals in his study that the liquidity as well as volatility was highly influenced by the FIIs investment. Sultana and Pardhasaradhi (2012) examined the impact of flow of FDI and FIIs on Indian stock market by analyzing the impact on Sensex and Nifty. They used secondary data for the period of 11 years from 2001 to 2011 and used multiple regression and correlation analysis. The study found that there is high degree of statistically significant positive correlation between foreign capital flows and Indian stock market.

Anubha (2013), in his research studied the influence of FIIs investment on Indian stock market by utilizing daily FIIs investment data and daily reruns of Sensex and Nifty for the period from 2001 to 2010. The study used correlation and regression techniques and observed that FIIs investment have significant positive impact on stock market and on major stock indices. The findings also show that the degree of impact of FIIs varies among various sectors of the economy.

III. OBJECTIVES OF THE STUDY

To bring out the impact of FIIs investment on the return of Indian stock market;
To assess the impact of FIIs on the volatility of the stock market in India;
To examine whether arrival of FIIs have affected trading volume and market capitalization of Indian stock market;
To identify the determinants of FIIs investment and assess their impact on FII flows;

IV. RESEARCH PROBLEM

Undoubtedly, the portfolio investment has become a dominant path of foreign investment in Indian economy. The sources of these FIIs flows are varied. The FIIs registered with SEBI come from as many as 28 countries (including money management companies operating in India on behalf of foreign investors). US based institutions accounted for slightly over 42 percent; those from the UK constitute 20 percent with other Western European Countries hosting another 17 percent of FIIs.

Foreign institutional investors have always remained the hot issue of the debate and discussion world over. India is not exception to this controversy and the issue has become more important among the economist, regulators, researchers and academicians due to the beginning of sub-prime crisis in US. The questions which are generally raised about the FIIs investments include: I) How do the foreign portfolio investments effect the stock market and economy of the host country? II) What determines the quantum of capital flows from FIIs?

V. RESEARCH METHODOLOGY
It comprises the following:

- **Sample Size:**
  In this study, twenty-five Sensex scripts have been taken as a sample for the period of 2005 to 2014 (information was not available for five firms for the specified time period). The information about ownership structure, financial performance and the stock returns of the sample companies is collected from CMIE Prowess package.

- **Database:**
  The data is likely to be collected using secondary sources. The data relating to foreign institutional investment will be collected from the NSE and BSE website as well as from the published sources such as various journals, Govt. reports, newspaper set c.

- **Research Tools:**
  Research tools deals with the econometric techniques to measure the volatility, liquidity & marketability. To measure the volatility, the GARCH class of models would be used. GARCH model has been developed by Bollerslev (1986) from the Autoregressive Conditional Heteroscedasticity (ARCH) model previously introduced by Engle (1982). GARCH framework is very widely used in financial literature due to in ability to capture volatility clustering especially when the data is large and heteroscedastic in nature. Other statistical tools would be used as per the requirement of the study.

Channels of international portfolio investment in India for foreigners. In order to trade in Indian equity markets, foreign corporations need to register with the SEBI as Foreign Institutional Investors.

### VI. ANALYSIS AND INTERPRETATION

*Foreign Institutional Investment in India:*

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

#### Sources of Foreign Institutional Investment in India

<table>
<thead>
<tr>
<th>NAME OF COUNTRY</th>
<th>%AGE</th>
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<tbody>
<tr>
<td>US</td>
<td>42</td>
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<tr>
<td>UK</td>
<td>20</td>
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<tr>
<td>WEST EUROPE</td>
<td>17</td>
</tr>
<tr>
<td>HONGKONG</td>
<td>6</td>
</tr>
<tr>
<td>SINGAPORE</td>
<td>4</td>
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<tr>
<td>AUSTRALIA</td>
<td>4</td>
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<tr>
<td>CANADA</td>
<td>2</td>
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<tr>
<td>MIDDLE EAST</td>
<td>1</td>
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<tr>
<td>JAPAN</td>
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<td>INDIA</td>
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<tr>
<td>OTHERS</td>
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*Table 1.2*
It is obvious from table 1.2 that, in terms of the country of origin, the USA topped the list with a share of 42 percent of the number of FIIs registered in India, followed by UK’s 20 percent. Besides UK, and US other investing countries include Luxemburg, Hong Kong, Australia and Singapore. European and Japanese FIIs have also started taking an increasing interest in India and of the FIIs that registered with SEBI in October 2004; a significant number belonged to them. These developments have helped improve the diversity of the set of FIIs operating in India.

**VII. BENEFITS AND COSTS OF FIIS INVESTMENT**

- **Benefits**
  - **Reduced Cost of Equity Capital**
    FII inflows augment the sources of funds in the Indian capital markets. In a common sense way, an increase in the supply of funds reduces the required rate of return for equity and enhances stock prices. Simultaneously, it fosters investment by Indian firms in the country.
  - **Imparting Stability to Indian’s Balance of Payment:**
    For promoting growth in India, there is a need to augment domestic investment, over and beyond domestic savings, through capital flow. The excess of domestic investment over domestic savings result in a current account deficit and this deficit is financed by the capital flow in the balance of payment.
  - **Knowledge Flows**
    The activities of international institutional investors help strengthen financial system. FIIs advocate modern ideas in market design, promote innovation, development of sophisticated products such as financial derivatives, enhance competition, in financial intermediation and lead to spillover of human capital by exposure market participants to modern financial techniques and international best practices and systems.
  - **Strengthen Corporate Governance**
    FII participation in domestic capital markets often lead vigorous advocacy of sound corporate governance practices, improved efficiency and better shareholder value.
  - **Improve Market Efficiency**
    A significant presence of FIIs can improve market efficiency through two channels. First, when adverse macroeconomic news, such as bad monsoon, unsettles many domestic investors, it may be easier for a globally diversified portfolio manager to be more dispassionate about a country’s prospects, and engage in stabilizing trades. Second, at the level of individual stocks and industries, FIIs may act as a channel through which knowledge and ideas about valuation of a firm or an industry can more rapidly propagate into market.

- **Costs**
  - **Herding and Positive Feedback Trading**
    There are concerns that foreign investors are chronically ill informed about India, and the lack of sound information may generate herding (a large numbers of FIIs buying and selling together) and positive feedback trading (buying after positive returns, selling after negative returns). These kinds of behavior can exacerbate volatility and push process away from fair values. FIIs behavior in India, however, so far does not exhibit these patterns.
  - **Balance of Payment Vulnerability**
    There are concerns that in an extreme event, there can be a massive flight of foreign capital out of India, triggering difficulties in the balance of payments front. India’s experience with FIIs so far, however, suggests that across episodes like the Pokharn blasts or the 2001 stock market scandal, no capital flight has taken place. A billion or more US dollars of portfolio capital has never left India within the period of one month. When juxtaposed with India’s enormous current and capital account flows, this suggests that there is little evidence of vulnerability so far.
  - **Possibility of Taking Over Companies**
While FIIs are normally seen as pure portfolio investors, without interest in control, portfolio investors can occasionally behave like FDI investors and seek control of companies that they have a substantial share holding in. Such outcomes, however, has not been experienced by India. Furthermore, SEBI’s takeover code is in place and has functioned fairly well ensuring that all investors benefit equally in the event of takeover.

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

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

**VIII. FINDING AND LIMITATIONS**

- **Findings:**
  - The study brought out that after the introduction of foreign institutional investment in the Indian stock market the daily return of the market (BSE) has decreased. But, this decline is not found statistically significant at 5 percent level, rather it is significant at 10 percent level.
  - Regarding the impact of FIIs on volatility of Indian stock market, the study revealed a significant decrease in the volatility after introduction of the foreign institutional investment in India.
  - The study has shown that the net investment made by the foreign institutional investors (FII) in Indian stock market proved as a casual force of Market Capitalization. It refers that arrival of the foreign institutional investors increase market capitalization.

- **Limitations of the Study**
  During the completion of this study, we have faced some limitations. First, it has been assumed that prices discount a symmetric response to the news. Secondly, some of the part of the study is not based on high frequency data due to its unavailability.

**IX. CONCLUSION**
This paper concludes that the increase in the volume of foreign institutional investment (FII) inflows in recent years has led to concerns regarding the volatility of these flows, threat of capital flight, its impact on the stock markets and influence of changes in regulatory regimes. The determinants and destinations of these flows and how are they influencing economic development in the country have also been debated. This paper examines the role of various
factors relating to individual firm-level characteristics and macroeconomic-level conditions influencing FII investment. The regulatory environment of the host country has an important impact on FII inflows. As the pace of foreign investment began to accelerate, regulatory policies have changed to keep up with changed domestic scenarios.

REFERENCES