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# Impact of FII's on Indian Stock Markets

KEYWORDS: FII (Foreign Institutional Investment), BSE Sensex, Regulation Relating to FII Operation, Effect of FII on Indian Economy.

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**ABSTRACT** *The Foreign Institutional Investors (FIIs) have emerged as important players in the Indian equity market in the recent past. This study makes an attempt to develop an understanding of the dynamics of the trading behavior and the factors influencing FIIs and returns in the Indian equity market by analyzing daily and monthly data. The study concludes that FIIs follow positive feedback trading on a daily basis, while they follow negative feedback trading on a monthly basis. But the main determinant remains lagged stock returns. The study concludes that FIIs inflows in India are determined by stock market characteristics, macroeconomic factors and international factors.*

## INTRODUCTION

**Foreign Institutional Investors:**

FOREIGN INSTITUTIONAL INVESTOR: The term Foreign Institutional Investor is defined by SEBI as under:

"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."

FII is defined as an institution organized outside of India for the purpose of making investments into the Indian securities market under the regulations prescribed by SEBI.

'FII' include "Overseas pension funds, mutual funds, investment trust, asset management company, nominee company, bank, institutional portfolio manager, university funds, endowments, foundations, charitable trusts, charitable societies, a trustee or power of attorney holder incorporated or established outside India proposing to make proprietary investments or investments on behalf of a broad-based fund.

**Why FIIS Required?**

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, 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.

**Investments by FIIS:**

There are generally two ways to invest for FIIs.

**1. Equity Investment:**

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% DEBT**

100% investment has to be made in debt securities only

**2 Equity Investment Route:**

In case of Equity route the FIIs can invest in the following instruments:

A. Securities in the primary and secondary market including shares which are unlisted, listed or to be listed on a recognized stock exchange in India.
B. Units of schemes floated by the Unit Trust of India and other domestic mutual funds, Whether listed or not.
C. Warrants

**100% DEBT ROUTE:** In case of Debt Route the FIIs can invest in the following instruments:

A. Debentures (Non Convertible Debentures, Partly Convertible Debentures etc.)
B. Bonds
C. Dated government securities
D. Treasury Bills
E. Other Debt Market Instruments

It should be noted that foreign companies and individuals are not be eligible to invest through the 100% debt route.

**The Eligibility Criteria for Applicant Seeking FII Registration is as Follows:**

- Regulated by appropriate foreign regulatory authority in the same capacity/category where registration is sought from SEBI.
- Permission under the provisions of the Foreign Exchange Management Act, 1999 (FEMA) from the RBI.
- Legally permitted to invest in securities outside country or its incorporation/establishment.
- The applicant must be a 'fit and proper' person.
- Local custodian and designated bank to route its transactions.

**Eligible Securities:**

- Securities in the primary and secondary markets including shares, debentures and warrants of unlisted, to- be-listed companies or companies listed on a recognized stock exchange.
- Units of schemes floated by domestic mutual funds including Unit Trust of India, whether listed on a recognized stock exchange or not, and units of scheme floated by a Collective Investment Scheme.
- Government Securities
- Derivatives traded on a recognized stock exchange – like futures and options. FIIs can now invest in interest rate futures that were launched at the National Stock Exchange (NSE) on 31st August, 2009.
- Commercial paper.
- Security receipts

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**Regulation Relating to FII Operation:**

- Investment by FIIs is regulated under SEBI (FII) Regulations, 1995 and Regulation 5(2) of FEMA Notification No.20 dated May 3, 2000. SEBI acts as the nodal point in the entire process of FII registration.
- FIIs are required to apply to SEBI in a common application form in duplicate. A copy of the application form is sent by SEBI to RBI along with their 'No Objection' so as to enable RBI to grant necessary permission under FEMA.
- RBI approval under FEMA enables a FII to buy/sell securities on stock exchanges and open foreign currency and Indian Rupee accounts with a designated bank branch.
- FIIs are required to allocate their investment between equity and debt instruments in the ratio of 70:30. However, it is also possible for an FII to declare itself a 100% debt FII in which case it can make its entire investment in debt instruments.
- All FIIs and their sub-accounts taken together cannot acquire more than 24% of the paid up capital of an Indian Company. Indian Companies can raise the above mentioned 24% ceiling to the Sartorial Cap / Statutory Ceiling as applicable by passing a resolution by its Board of Directors followed by passing a Special Resolution to that effect by its General Body.
- The definition of "broad based fund" under the regulations was substantially widened allowing several more sub accounts and FIIs to register with SEBI.
- Several new categories of registration viz. sovereign wealth funds, foreign individual, foreign corporate etc. were introduced,
- Registration once granted to foreign investors was made permanent without a need to apply for renewal from time to time thereby substantially reducing the administrative burden,
- Also the application fee for foreign investors applying for registration has recently been reduced by 50% for FIIs and sub accounts Also, institutional investors including FIIs and their sub-accounts have been allowed to undertake short-selling, lending and borrowing of Indian securities from February 1, 2008.

**Entry Options for FII:**
Incorporated Entity By incorporating a company under the Companies Act, 1956 through

- Joint Ventures; or
- Wholly Owned Subsidiaries

Foreign equity in such Indian companies can be up to 100% depending on the requirements of the investor, subject to equity caps in respect of the area of activities under the Foreign Direct Investment (FDI) policy.

**Important Terms to Know About FIIs:**

➲ **Sub-account:**
Sub-account includes those foreign corporations, foreign individuals, and institutions, funds or portfolios established or incorporated outside India on whose behalf investments are proposed to be made in India by a FII.

➲ **Designated Bank:**
Designated Bank means any bank in India which has been authorized by the Reserve Bank of India to act as a banker to FII.

➲ **Domestic Custodian:**
Domestic Custodian means any entity registered with SEBI to carry on the activity of providing custodial services in respect of securities.

➲ **Broad Based Fund:**
Broad Based Fund means a fund established or incorporated outside India, which has at least twenty investors with no single individual investor holding more than 10% shares or units of the fund.

**Acts And Rules:**
FII registration and investment are mainly governed by SEBI (FII) Regulations, 1995.

ELIGIBILITY FOR REGISTRATION AS FII: Following entities / funds are eligible to get registered as FII:

1. Pension Funds
2. Mutual Funds
3. Insurance Companies
4. Investment Trusts
5. Banks
6. University Fund s
7. Endowments
8. Foundations
9. Charitable Trusts / Charitable Societies

Further, following entities proposing to invest on behalf of broad based funds are also eligible to be registered as FIIs:

1. Asset Management Companies
2. Institutional Portfolio Managers
3. Trustees
4. Power of Attorney Holders

**Investment Opportunities for FIIs:**
**The following financial instruments are available for FII investments:**

a) Securities in primary and secondary markets including shares, debentures and warrants of companies, unlisted, listed or to be listed on a recognized stock exchange in India;
b) Units of mutual funds;
c) Dated Government Securities;
d) Derivatives traded on a recognized stock exchange;
e) Commercial papers.
f) Investment limits on equity investments
g) FII, on its own behalf, shall not invest in equity more than 10% of total issued capital of an Indian company.
h) Investment on behalf of each sub-account shall not exceed 10% of total issued capital of an India company.
i) For the sub-account registered under Foreign Companies/Individual category, the investment limit is fixed at 5% of issued capital.

These limits are within overall limit of 24% / 49 % / or the sectoral caps a prescribed by Government of India / Reserve Bank of India.

**Investment Limits On Debt Investments:**

- ✓ For FII investments in Government debt, currently following limits are applicable.
- ✓ For corporate debt the investment limit is fixed at US $ 500 million.

**Brief Profiles of Important Institutions:**

→ **Reserve Bank of India:**
India's Central Bank - the RBI - was established on 1 April 1935 and was nationalized on 1 January 1949. Some of its main objectives are regulating the issue of bank notes, managing India's foreign exchange reserves, operating India's currency and credit system with a view to securing monetary stability and developing India's financial structure in line with national socio-economic objectives and policies.

→ **Securities and Exchange Board of India:**
In 1988 the Securities and Exchange Board of India (SEBI) was established by the Government of India through an executive resolution, and was subsequently upgraded as a fully autonomous body (a statutory Board) in the year 1992 with the passing of the Securities and Exchange Board of India Act (SEBI Act) on 30th January 1992.

**The basic objectives of the Board were identified as:**

- ❖ To protect the interests of investors in securities;

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- ❖ To promote the development of Securities Market;
- ❖ To regulate the securities market and
- ❖ For matters connected therewith or incidental thereto.

Another significant event is the approval of trading in stock indices (like S&P CNX Nifty & Sensex) in 2000. A market Index is a convenient and effective product because of the following reasons:

- ☞ It acts as a barometer for market behavior;
- ☞ It is used to benchmark portfolio performance;
- ☞ It is used in derivative instruments like index futures and index options;
- ☞ It can be used for passive fund management as in case of Index Funds.

**→ Bombay Stocks Exchange:**
Of the 22 stock exchanges in the country, Mumbai's (earlier known as Bombay), Bombay Stock Exchange is the largest, with over 6,000 stocks listed. The BSE accounts for over two thirds of the total trading volume in the country. Established in 1875, the exchange is also the oldest in Asia. Among the twenty-two Stock Exchanges recognized by the Government of India under the Securities Contracts (Regulation) Act, 1956, it was the first one to be recognized and it is the only one that had the privilege of getting permanent recognition Ab-initio.

Approximately 70,000 deals are executed on a daily basis, giving it one of the highest per hour rates of trading in the world. There are around 3,500 companies in the country which are listed and have a serious trading volume. The market capitalization of the BSE is Rs.5 trillion. The BSE `Sensex' is a widely used market index for the BSE.

**→ BSE Sensex:**
The BSE Sensex is a value-weighted index composed of 30 companies with the base April 1979 = 100. It has grown by more than four times from January 1990 till date. The set of companies in the index is essentially fixed. These companies account for around one-fifth of the market capitalization of the BSE.

**→ National Stock Exchange of India:**
The National Stock Exchange of India Limited has genesis in the report of the High Powered Study Group on Establishment of New Stock Exchanges, which recommended promotion of a National Stock Exchange by financial institutions (FIs) to provide access to investors from all across the country on an equal footing. Based on the recommendations, NSE was promoted by leading Financial Institutions at the behest of the Government of India and was incorporated in November 1992 as a tax-paying company unlike other stock exchanges in the country.

On its recognition as a stock exchange under the Securities Contracts (Regulation) Act, 1956 in April 1993, NSE commenced operations in the Wholesale Debt Market (WDM) segment in June 1994. The Capital Market (Equities) segment commenced operations in November 1994 and operations in Derivatives segment commenced in June 2000.

**→ S&P CNX Nifty:**
The average total traded value for the last six months of all Nifty stocks is approximately 58% of the traded value of all stocks on the NSE Nifty stocks represent about 60% of the total market capitalization as on March 31, 2005.

Impact cost of the S&P CNX Nifty for a portfolio size of Rs.5 million is 0.07% S&P CNX Nifty is professionally maintained and is ideal for derivatives trading.

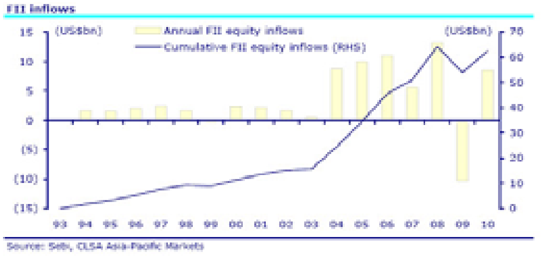
**DATA ANALYSIS & INTERPRETATION**
**General Foreign Institutional Investors (FIIs)**
Including pension funds, mutual funds, investment trusts, university funds, endowments, foundations or charitable trusts or charitable societies, etc. are permitted to invest in all securities i.e. equity shares/debentures/ / Rights renunciations / warrants of Indian companies listed as well as unlisted, dated Government securities, Treasury Bills and units of domestic mutual funds schemes in the primary and secondary markets.

The holding of a single FII or the concerned FII group in any company would also be subject to a ceiling of 10% of total paid up equity capital. Indian companies however, would be permitted to raise the ceiling limit of 24% to 30% provided it has been approved by the Board of Directors of the company and a Special Resolution is passed to that effect by the General Body. The ceiling of 24% or 30% as the case may be, applicable for investment by FLLS will not include investment made by NRIs under the Portfolio Investment Scheme.

India, the second fastest growing economy after China, has recently seen positive foreign institutional investor (FII) inflows driven by the sound fundamentals and growth opportunities. According to analysts, the upward revision of economic growth from 5.8 per cent to 6.1 per cent, better-than-expected performance of companies in the quarter ended-June 30, the proposed new direct taxes code that might lead to savings in the tax payer's money, and the trade policy with an ambitious target of US$ 200 billion exports for 2010-11 have all revived the confidence of FIIs investing in India.

FIIs have made net investments of US$ 10 billion in the first six months (April to September) of 2009-10. A major portion of these investments have come through the primary market, than through buying via secondary markets. FII inflows into Indian equities have been steady ever since the markets were opened up to FIIs in 1993. With the exception of Financial Year 1999 and Financial Year 2009, net flows have been positive.

FIIs own a dominant 16% of Indian equities (worth US$147bn) and account for 10-15% of the equity volumes. Although FIIs pulled out US$ 9.77 billion of the Indian equity markets during Financial Year 2009, they have been quick to return in Financial Year 2010 and within just the first four months they have nearly made up for the exit, reinvesting US$ 8.50 billion or 87% of the amount that they had pulled out in Financial Year 2009.




India is well placed to attract FII flows over the long term. With FIIs holding 16 per cent of equity of India's biggest 500 companies and as growth in the Indian economy accelerates, FII sentiment is expected to remain positive towards India.

**Foreign Institutional Investor shares in top 10 companies:**

| Name of the company | FII Shares in the Company % | Known for |
|---|---|---|
| Sybly Industries Limited | 74.18% | Manufacturing Polyester Yarn & Mercerized cotton Yarn |
| India bulls Real Estate | 67.43% | Real Estate |
| H D F C | 59.85% | Private Sector Banking |

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| | | |
|---|---|---|
| Geodesic | 53.47% | Developing the products in the information, communication & entertainment space. |
| Amtek Auto | 50.84% | Manufacturing Automotive Components. |
| IVRCL Infrastructure | 48.04% | Infrastructure Sectors like water & environment, transportation, buildings and power. |
| Prajay Engineering | 42.55% | Real Estate. |
| Amtek India | 42.55% | --------- |
| Jain Irrigation | 42.02% | Irrigation Instruments Industry. |
| Logix Micro system | 41.96% | Software Products Company. |

**Securities Exchange Board of India (SEBI) Announces The New Regulators for Foreign Institutional Investors (FII's)**

- Market regulator Security Exchange Board of India (SEBI) recently announced new rules for foreign investments through financial instruments such as participatory notes, asking FII's to wind up P-Notes for investing in derivatives within 18 months.
- Security Exchange Board of India (SEBI) also imposing curbs on P-Notes for investing in the spot market
- In derivatives, foreign institutional investors (FII) and their sub-accounts can't issue fresh P-Notes and will have to wind up their current position in 18 months.
- In spot markets, Foreign Institutional Investors will not be issued P-Notes more than 40 per cent of their assets under custody. The reference date for calculating such assets will be September 30.
- That Foreign Institutional Investors (FII) who has issued P-Notes of more than 40 per cent of their assets could issue such instruments only if they cancel, redeem, or close their existing P-Notes. Those FII's who have issued P-Notes less 40 per cent of their assets under custody can issue additional instruments at the rate of 5 per cent of their assets.
- FII's to be registered on a permanent basis instead of earlier practice of renewing registration every year.

**PERFORMANCE OF INDIAN STOCK MARKET**
**Indices: Sensex For the period: from year 1995 to year present:**

| year | Open | High | low | close | Price/earnings | Price/book value | Dividend yield |
|---|---|---|---|---|---|---|---|
| 1995 | 1027.38 | 19554.81.29 | 947.14 | 1908.85 | 22.30 | 3.58 | 1.24 |
| 1996 | 1957.33 | 4546.58 | 1945.48 | 2615.37 | 36.19 | 6.35 | .80 |
| 1997 | 2617.78 | 3459.07 | 1980.6 | 3346.06 | 31.78 | 4.81 | .98 |
| 1998 | 3436.87 | 4643.31 | 3405.88 | 3926.90 | 45.45 | 6.07 | .68 |
| 1999 | 3910.16 | 3943.66 | 2891.45 | 3110.49 | 23.63 | 3.81 | 1.13 |
| 2000 | 3114.08 | 4131.22 | 2713.12 | 3085.20 | 16.07 | 3.02 | 1.50 |
| 2001 | 3096.65 | 4605.41 | 3096.65 | 3658.98 | 14.45 | 2.80 | 1.52 |
| 2002 | 3658.34 | 4322.00 | 2741.22 | 3055.41 | 13.00 | 2.25 | 1.80 |
| 2003 | 3064.95 | 5150.99 | 3042.25 | 5005.82 | 17.35 | 3.07 | 1.38 |
| 2004 | 9209.54 | 6150.69 | 3491.55 | 3972.12 | 24.48 | 3.81 | 1.14 |
| 2005 | 3990.65 | 4462.11 | 2594.87 | 3262.33 | 17.60 | 2.51 | 1.83 |
| 2006 | 3262.01 | 3758.27 | 2828.48 | 3377.28 | 15.22 | 2.30 | 2.14 |
| 2007 | 3383.85 | 5920.76 | 2904.44 | 5838.96 | 15.02 | 2.49 | 2.14 |
| 2008 | 5872.48 | 6617.15 | 4227.50 | 6602.69 | 17.26 | 3.28 | 2.01 |
| 2009 | 6626.8 | 9442.98 | 6069.33 | 9397.93 | 16.21 | 3.94 | 1.58 |
| 2010 | 9422.49 | 14035.30 | 8799.01 | 13786.91 | 20.18 | 4.75 | 1.35 |
| 2011 | 83827.77 | 20498.11 | 12316.10 | 20286.99 | 22.25 | 5.32 | 1.10 |
| 2012 | -- | -- | -- | -- | -- | -- | -- |

**Influence of FII on Indian Market:**
Portfolio investments brought in by FIIs have been the most dynamic source of capital to emerging markets in 1990s. At the same time there is unease 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 firm performance. For instance, when foreign institutional investors reduced their holdings in Dr.Reddy's Lab by 7% to less than 18%, the company dropped from a high of around US$30 to the current level of below US$15. This 50% drop is apparently because of concerns about shrinking profit margins and financial performance.

**Some major impact of FII on stock market:**

- ➲ They increased depth and breadth of the market.
- ➲ They played major role in expanding securities business.
- ➲ Their policy on focusing on fundamentals of share had caused efficient pricing of share.

These impacts made the Indian stock market more attractive to FII & also domestic investors. The impact of FII is so high that whenever FII tend to withdraw the money from market, the domestic investors fearful and they also withdraw from market.

**CONCLUSION:**
In this study I tried to find out the impact of FDIs and FIIs on Indian Stock Market .the important result of this study is that the foreign investment is determined by stock market return. But foreign investment is not a major factor for the stock market boom in India the FII are increasingly dominant in the stock market. The domestic investors and domestic companies remain not so dominant. There is therefore the fear of sudden outflows of the foreign capital and this may be a trigger a third stock market scam as most regulatory changes are being made only as a follow up of an adverse event.

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