A Review of Foreign Institutional Investment (FII) in India

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Abstract

The role of investment in promoting economic growth has held considerable importance in the Indian economy since its independence. But the most recent topic of debate among economists and development planners is the role of foreign institutional investment (FII) in the economic development of India. FII flows to India have steadily grown in importance in the Indian economy since the beginning of economic reforms in 1991. As a part of this reform, India opened its market to foreign institutional investors in September 1992 with appropriate restrictions that permitted them to invest in the Indian financial markets. Since then, the Government of India has relaxed certain barriers to facilitate foreign capital flows and improve the financial structure. Constructive fundamentals and the ongoing removal of structural barriers linked to fast-growing markets have made India a pleasant destination for foreign institutional investors. Since 1993, India has received a huge amount of portfolio investment from foreigners in the form of FIIs investing in equities. This has marked a turning point in the Indian stock market. As a result, India gained favour among investors, offering relatively higher growth than other developed economies. In the recent past, it has also emerged as an important player in the Indian equity market and is gradually becoming one of the major factors that contribute to the growth of the financial markets. FIIs chose India as an investment destination because of the high expected return and low risk in the market, the advantages of exchange rate fluctuations and the growth potential of their domestic market.

Keywords: Investment, India, Foreign Institutional Investment (FII), Market, Development, Destination, Growth.

Introduction

India has emerged as one of the most attractive investment destinations in the world due to its rapid economic growth and liberalized foreign investment policies since economic liberalization in 1991. India has been able to attract large foreign investments from the developed economies both in the form of foreign direct investment (FDI) and foreign institutional investment (FII). Foreign investment flows to India have steadily grown in size and importance over the years. FDI complements the direct financing institutions in providing investments for corporate projects and provides technical and managerial know-how that is of a long and medium-term nature. FIIs

supplement domestic investments in the country's capital markets rather than taking a direct route. As far as the FIIs are concerned, they are of a short-term nature and short-term investments are not an option. Foreign institutional investors (FIIs) invest in financial markets such as money markets, stock markets and foreign exchange markets. Thus, understanding the determinants of FIIs is important for any developing economy as FIIs greatly affect domestic financial markets in the short run and have a real impact in the long run. India as a capital-scarce country has taken several measures to attract foreign investment since reforms began in 1991.

The Government of India embarked on liberalization and economic reforms from 1990–1991 with a view to bringing about fast and substantial economic growth and moving towards globalization. As part of the reform process, the government under its New Industrial Policy has overhauled its foreign investment policies, recognizing the growing importance of foreign direct investment as an instrument of technology transfer, the growth of foreign exchange reserves and the globalization of the Indian economy along with the pile-up of foreign exchange reserves in the country. Simultaneously, the government allowed portfolio investments from abroad by foreign institutional investors in the Indian capital market for the first time. The FIIs act as a follow-up to the recommendations of the Narasimham Committee Report on Financial Systems. While recommending entry, the committee did not elaborate on the objectives of the suggested policy. The committee suggested that capital markets be gradually opened up to foreign portfolio investments. In a historic move, the FIIs were permitted to make an investment in the securities transacted in the Indian capital markets.

India embarked on a programme of economic reforms in the early 1990s to overcome its balance of payment crisis and take steps towards capital account convertibility and the globalization of the economy. An important milestone in the history of economic reforms in India happened on September 14, 1992 when Foreign Institutional Investors (FII) were permitted to invest in all the securities traded in the primary and secondary markets including shares, debentures and warrants issued by companies that were listed or were to be listed on Indian stock exchanges.

Under Section 30 of the SEBI Act 1992, sufficient powers have been conferred upon SEBI to regulate the workings of FIIs in India. As per these guidelines of the given act, the provisions have clearly stated who is eligible for registration as an FII, the registration process, eligibility conditions of FIIs, applicable fees, investment areas, investment restrictions etc. Along with 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) have also been mentioned in the same Act.

The SEBI (foreign institutional investors) Regulations for 1995 were notified in November 1995 which were mainly based on the previous guidelines. One of the major objectives of these guidelines was to maintain a proper balance and link between the guidelines issued by the Government of India and the regulator (SEBI) in such a manner that FIIs were not only guided by SEBI but also followed the same. Through this mechanism, the government has been able to prescribe limits for FII in various Indian industries. FIIs in India are governed by the Securities and Exchange Board of India (foreign institutional investors) Regulations 1995 which have been amended by SEBI from time to time.

The regulations require foreign institutional investors to register with SEBI and obtain approval from the Reserve Bank of India under the Foreign Exchange Regulations Act (FERA) of 1973 to enable them to purchase and sell securities, access foreign money and rupee bank accounts and remit and repatriate funds. Once a SEBI registration has been obtained, an FII does not require any further permission to buy or sell securities or to transfer funds in and out of the country subject to the payment of applicable taxes. As per the SEBI guidelines and RBI rules, initial permission was granted for the FIIs to trade in the Indian stock market and thereafter they were mandated to get it renewed. As per the FEMA Act 1999 which applied in 2000, the purpose of these guidelines was to control FII's transactions while also thereby protecting the Indian economy from overheating or underheating.

SEBI lays down parameters relating to eligibility, investment and taxation. Chief among these are investment limits. In general, FIIs invest either directly or through sub-accounts (through participatory notes), or through domestic entities.

Concept of FII

Foreign institutions investing in Indian financial markets are generally referred to as "Foreign Institutional Investors" (FIIs) in India. International institutional investors (FII) have to register with the Securities and Exchange Board of India (SEBI) to take part in the market. One of the most important market regulations referred to by FIIs involves placing limits on FII ownership in Indian companies.

FIIs can be said to include investors or investment funds that are from or registered in a country outside of the one in which they are currently investing. Institutional investors bring in hedge funds, pension funds, mutual funds and insurance companies. In other words, a Foreign Institutional Investor refers to an entity begun or incorporated outside India that offers to make an investment in India. Positive tidings about the Indian economy that come together with a fast-growing market have made India's economy a pleasant destination for foreign institutional investors (FIIs). FII investment

is generally referred to as Hot Money as it leaves the country at the same speed at which it came in. According to Michael Frenkel and Lukas Menkhoff, "FIIs are beneficial for an economy under specific institutional conditions. It is defining characteristic of an emerging market that these conditions are often not met".

The definition given by European Union is "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."

The term Foreign Institutional Investor (FII) is defined by SEBI as "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 institutional investment (FII) is generally a short-term investment in the financial markets. FII given its short-term character can have bidirectional effects on the returns of other domestic financial markets for example money markets, stock markets and foreign exchange markets. Therefore, recognizing the deciding element of FII is important for any developing countrybecause FII exerts animportant impact on domestic financial markets in the short run and areal impact in the long run.

Market and Regulatory Framework for Foreign Institutional Investors in India

Foreign Institutional Investors (FIIS) means an organization set up or registered out of India for making investments in Indian securities. A working group was established in April 2003 to recommend measures to rationalize dealings with foreign institutional investors. They suggested the reformation of the SEBI registration process and recommended that the existing twofold sanction requirement of SEBI and RBI be transformed into a solitary sanction process for SEBI. This proposal was approved and put into effect in December 2003. Currently institutions that are qualified to invest under the FII regime are:

•**As FII**: Mutual funds, investment trusts, overseas pension funds, nominee companies, banks, institutional portfolio managers, university funds, endowments, foundations, charitable trusts, asset management companies, charitable societies, a trustee or power of attorney holder registered outside India which propose to make portfolio investments with the restriction that no single investor can hold more than 10 percent of the shares or units of the fund.

•**As sub-accounts**: The sub-account is essentially the original or underlying fund on behalf of which

the FII invests. Partnership firms, pension funds, private companies, public companies, investment trusts and individuals are qualified to be registered as sub-accounts.

FIIs operating in India belong to the below-mentioned classes.

• **Regular FIIs** - institutions that have invested at least 70% of their investment in equities and the remainder in non-equities.

• **100% debt-fund FIIs**- institutions that are allowed to make investments solely in debtsecurities.

Entities that Register as FIIs in India

Entities who propose to invest their proprietary funds or on behalf of "broad-based" funds (funds having more than twenty investors with no single investor holding more than 10% of the shares or units of the fund) or foreign corporations and individuals that belong to any of the following categories can be registered as Foreign Institutional Investors (FIIs).

- Pension Funds
- Mutual Funds
- Investment Trust
- Insurance or reinsurance companies
- Endowment Funds
- University Funds
- Foundations or Charitable Trusts or Charitable Societies that propose to invest on their own behalf
- Asset Management Companies
- Nominee Companies
- Institutional Portfolio Managers
- Trustees
- Power of Attorney Holders
- Banks
- Foreign Government Agency
- Foreign Central Bank
- International or Multilateral Organization
- Or an Agency thereof

Prohibition on Investments

Foreign institutional investors (FIIs) are not allowed to invest in equity issued by an Asset Reconstruction Company. They are also not permitted to invest in any company that is engaged in or

proposes to engage in the following activities:

- Business of chit fund
- Nidhi Company
- Agricultural or plantation activities
- Real estate business or construction of farmhouses (business of real estate does not enterthe development of townships, the construction of residential/commercial premises, roads or bridges).
- Trading in Transferable Development Rights (TDRs)

Benefits of Foreign Institutional Investment

FIIs can increase domestic savings as well as domestic investment without increasing the country's foreign debt. The inflow of foreign capital into the equity market results in a higher stock price, lowers the cost of equity capital and promotes investment by Indian firms. Foreign investors often help spur domestic reforms aimed at improving the design of the security market and strengthening corporate governance. FII inflow imparts stability to India's balance of payments, increases knowledge flow and improves market efficiency.

1. Enhanced Flows of Equity Capital

FIIs are well recognized for having a greater appetite for equity than debt in their asset structure. For example, pension funds in the United Kingdom and the United States had 68% and 64% respectively of their portfolios in equity in the year 1998. As a result, opening up the economy to FIIs is the accepted preference for non-debt-creating foreign inflows over foreign debt. Because of this preference for equities over bonds, FIIs can help in compressing the yield differential between equity and bonds and improving corporate capital structures. Further, given the prevalent savings-investment gap of around 1.6 percent, FII inflows can also provide to close the investment gap. To facilitate a sustained high GDP growth rate of around 8 percent targeted under the 10th five-year plan certain conditions must be met. Equity returns have a significant and positive impact on FII investment. But given the huge volume of investments, foreign investment could play the role of market makers booking their profits and enhancing equity capital in the host country.

2. Improving Capital Markets

FIIs as professional bodies of asset managers and financial analysts enhance the competitiveness and efficiency of financial markets. Equity market development aids economic development. By increasing the availability of uncertain, long-standing capital for projects and improving firms' incentives to supply more information about themselves, the FIIs can help in the process of economic development. The growing importance of institutional investors has contributed to the stock market's quantitative and qualitative growth, i.e. growth of the securities business, depth and

breadth of the market and overall their leading investment philosophy which is indicative of the basics that go with well-organized pricing of the stocks. FII flows should not be seen in isolation but as part of a combined policy package for all capital receipts, recognizing their function in the overall macroeconomic structure.

3. Strengthening Corporate Governance

It is an internationally accepted principle that good corporate governance improves market efficiency and raises shareholder value. FIIs normally prefer to invest in securities issued by companies that practice sound corporate governance. Domestic companies should adapt to the portfolio selection criteria of the FIIs because investment by FIIs will raise their share prices and thereby reduce their cost of capital. Having reputed FIIs on the shareholder list has become a status symbol for Indian companies. Companies are increasingly motivated to improve their corporate governance practices.

FIIs form expert bodies of asset managers and financial experts, who by contributing to a better understanding of firms' operations, improve corporate governance. Among the four models of corporate control, takeover or market control via equity, leveraged control via debt, direct control via equity and direct control via debt or related banking, the third model known as the corporate governance movement has institutional investors at its core. In this third model, board representation is supplemented by direct contacts with institutional investors. Institutions are known for challenging excessive executive compensation and removing underperforming managers. In a nutshell, it has been shown that FIIs have not only increased payout ratios but have also increased the productivity of the company.

4. Managing Uncertainty and Controlling Risks

Financial innovation and the development of hedging instruments are encouraged by institutional investors. Institutions due to their interest in hedging risks are known to have contributed to the development of zero-coupon bonds and index futures. FIIs, as professional bodies of asset managers and financial analysts not only increase competition in financial markets but also improve the alignment of asset prices to fundamentals. Institutions in general and FIIs in particular are recognized to have good information and low transaction costs. By backing asset prices closer to fundamentals, they are creating stable markets. Fundamentals are believed to be inactive in these movements. Thus, if prices are aligned with fundamentals, they should be as stable as the fundamentals themselves. Different FIIs with a variety of risk-return preferences also help diminish instability.

5. Reduced Cost of Equity Capital

FII inflows supplement the sources of funds in the Indian capital markets. In a common-sense way, the impact of FIIs on the cost of equity capital could be visualized by asking what stock prices would

be if no FIIs were operating in India. An FII investment reduces the required rate of return for equity, enhances stock prices and fosters investments by Indian firms in the country. From the perspective of international investors, rapidly growing emerging markets offer potentially higher rates of return and help in diversifying portfolio risk. It is claimed that FPI flows increase stock prices in the recipients' markets which in turn increases the price-earnings (P/E) ratio of the concerned companies. An increase in the P/E ratio tends to reduce the cost of capital and boost the stock market. The cost of equity capital is also reduced due to the sharing of risk by foreign investors. A few investment projects with a negative net present value (NPV) before the entry of foreign investors can turn into projects with a positive NPV later on. The result is a boost to the primary markets that have been affected.

6.Imparting Stability to India's Balance of Payments

To boost growth in a developing country such as India, there is a need to encourage domestic investment, over and beyond domestic savings, through capital flows. Excess domestic investment in domestic savings results in a current account deficit and this deficit is financed by capital flows that are in the balance of payments. Earlier in 1991, debt flows and official development assistance helped drive these capital flows. This mechanism of funding and the current account deficit is generally believed to have played a role in the rise of the balance of payments difficulties in 1981 and 1991. Portfolio inflows, especially from FIIs in the equity markets with FDI as opposed to debt-creating flows are significant as a safer and more sustainable mechanism for funding the current account deficit. The portfolio capital helps a number of developing countries alleviate their balance of payments deficits by maintaining liquidity in the financial markets. It is also noted that both returns in the source country's stock market and the inflation rate are not having any impact on the FII. The global stock market capitalization of India has a positive impact on the FPI.

7. Improving Knowledge Flow

The actions of international institutional investors help strengthen Indian finance. FIIs often follow excellent trading mechanisms and systems. They support innovative new market ideas like modern trading systems, new financial instruments like derivatives and new systems for holding securities such as depositories. They also increase competition from financial intermediaries, which in turn helps the market at large. Several of the reform measures that were initiated in the Indian capital markets after 1992 were declared by FII. An FII would not have been possible in the absence of depositors. Similarly, many of the best practices experienced in the Indian capital market, such as the establishment of institutions like the Securities and Exchange Board of India (SEBI) were implemented because of this knowledge flow.

8. Improving Market Efficiency

There is substantial evidence that FIIs in India can enhance market efficiency through two channels. First, when unfavorable macroeconomic news such as a bad monsoon, disturbs domestic investors, it may be easier for a globally diversified portfolio manager to be more dispassionate about India's prospects, and participate in stabilizing trades. Second, at the level of individual stocks and industries, FIIs may act as a route through which knowledge and ideas about the valuation of a firm or an industry can more quickly propagate into India. As such foreign investors were able to rapidly assess the potential of firms like Infosys which are primarily expert-oriented, apply valuation principles and are prevalent outside India for software services companies. In the Indian context, the FIIs are said to have been instrumental in promoting market efficiency and clarity. The argument in favour of this conclusion is that the arrival of FIIs has benefited all investors by offering them a broader range of instruments with variable degrees of risk, return and liquidity. Thus, the policy measures have been targeted toward promoting more FII investment.

Cost of Foreign Institutional Investment

There are concerns that foreign investors are ill-informed about India and this shortage of perfect information may create herding and a positive response to trading. Such behaviour can exacerbate volatility and push prices away from their fair value which may turn into a market crisis. Other concerns include the balance of payments, increased knowledge flow and improvements to market efficiency.

1. Volatility and Capital Outflows

There is also an increased prospect of rapid outflows of capital if the inflows are of a short-term nature as in the case of portfolio inflows from FIIs. The recent experience of the reversal of private capital flows observed in the global crisis of 2008, the Asian crisis in 1997 and in Mexico at the end of 1994 due to rapid changes in FII's investment attitude provides a vivid illustration of such risks. FIIs typically take into account certain specific risks in emerging markets such as (i) political instability and economic mismanagement, (ii) liquidity risk and (iii) currency movement. Currency movement can have a dramatic impact on equity returns from the FIIs with a depreciation hurting the value of the FIIs. The removal of FIIs from ASEAN countries managed a large inflow of funds to India and equity markets in India are resistant at present. Thus, short-term flows including portfolio flows of FIIs to developing countries in particular are inherently unstable and increase volatility in emerging equity markets. They are speculative and respond adversely to any real economic or financial instability. Investment in developing markets by FIIs can at times be focused more on a perceived insufficiency of opportunities in industrial nations than on sound fundamentals in developing nations including India.

FII inflows are generally described as "hot money" due to herding behavior and the potential for large capital outflows. Herding behavior with all FIIs attempting to buy or sell at the same time, especially during market stress can be rational. With performance-related fees for fund managers and performance judged based on how other funds are doing, there is a great incentive to suffer the consequences of being wrong when everyone else is wrong rather than taking the risk of being wrong when others are right. The incentive structure highlights the danger of a contrarian bet going wrong and makes it much more difficult to perform worse than most others in the market. This leads to a greater reliance on the same information as the others and reduces the planning horizon to a relatively short one. Another source of concern is hedge funds, which, unlike pension funds, life insurance companies and mutual funds, engage in short-term trading, take short positions and borrow more aggressively and numbered around 6,000 with $500 billion of assets under control in 1998.

2. Price Rigging

A beating from FIIs has been claimed in the case of the majority of companies in India tapping the GDR market. There are some important examples of price rigging in the Indian stock market like SBI and VSNL which are most illuminating in showing how the FIIs manipulate the domestic market of a company before its GDR issues. The process of FIIs functioning in collusion functions in the following methods. First, they sell en masse and then when the price has been pulled down a sufficient amount, they carry on some shares economically in the GDR market. Though FIIs have the liberty of entry and exit, they lonely have access to both the domestic and GDR markets even though the GDR market is not open to domestic investors. Hence, FIIs gain a lot at the expense of domestic investors due to their manipulation and the consequent integration of the Indian equity market with global markets that follow liberalization.

3. Possibility of Taking Over Companies or Backdoor Control

In addition to price rigging, FIIs are trying to control indigenous companies through the GDR route where they are also dynamic. GDRs obtain voting rights once an ordinary share has been converted into equity within a specific time limit. Thus, the GDR route known as a foreign direct investment (FDI) plus portfolio investment (PI) is a roundabout route adopted by FIIs to gain control of indigenous companies in the country. While FIIs are normally seen as genuine portfolio investors, they rarely behave like FDI investors and seek control of companies in which they have considerable shareholdings. As a result, it is inconsistent with India's search for improved FDI. Moreover, SEBI's takeover code has been in place and has been fairly well suited, confirming that all investors benefited equally as a result of the takeover.

4. Herding and Market Destabilization

There are concerns that foreign investors are chronically ill-informed about India and this lack of sound information may generate herding (a large number of FIIs buying and selling together) and favourable response trading (Buying after positive returns, selling after negative returns). This kind of behavior can exacerbate volatility and push prices away from their fair value. One of the common features of 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 country with the highest potential for good returns. If the calculations done by them turn out to be correct, they will continue to invest in the same country, hoping to earn more in the future. But the moment they find out about any negatives about the same country, they immediately withdraw their money and put it in a different country with better prospects, leaving the other country unprepared for such a situation.

5. Balance of Payment Vulnerabilities

There are concerns that in the event of a massive outflow of foreign capital out of India, this could generate problems on the balance of payments front. India's experience with FIIs to this point, on the other hand shows that across episodes like the Pokhran blasts or the 2001 stock market scandal, no capital flight has taken place. A billion or more US dollars of portfolio capital has left India in just one month. When compared with India's enormous current and capital account flows, this suggests that there is little sign of susceptibility so far.

6. Money Laundering

The movement of hot money into FII due to the incorporation of emerging markets in India and other countries with global markets has helped hawala traders and criminal elements as an easy means to launder international money from the illegal activity which in consequence has also affected the equity markets. Often, FIIs are used as instruments for money laundering.

It has also been argued that the FIT engages in price rigging through collusive transactions. Another negative effect of opening up the capital market to FIIs has been the possibility of FIIs trying to gain control of indigenous companies. Finally, it is claimed that FIIs might indulge in money laundering transactions. There is a general belief among economists, bankers and traders that there is no substantial benefit of FIIs for the Indian economy at large but this is not proven.

7. Management Control

The first and most common apprehension about FII's inflows has been their management. FIIs perform as representatives on behalf of their principles as financial investors maximizing returns. There are domestic laws that effectively ban institutional investors from taking management control. For example, U.S. laws prevent mutual funds from owning more than 5% of a company’s stock.

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

However, under EU law, foreign investment is labeled as FDI when the investor purchases more than 10% of the investment target and FPI when the acquired stake is less than 10%. Institutional investors, on the other hand are specialized financial intermediaries that manage savings collectively on behalf of investors, especially small investors with specific objectives in terms of risk, returns, and maturity of claims.

Conclusions

Foreign Institutional Investment (FII) inflows and controls have emerged as important policy issues in India since their inception in 1992. Among Indian policymakers, the growth of FIIs is believed to have a positive impact on the country's development. FII flows supplement and augments domestic savings and domestic investment without increasing the country's foreign debt. FII inflows to the equity market increase stock prices, lower the cost of equity capital and encourage investment by Indian firms and lead to improvements in securities market design and corporate governance. But the recent upsurge in FII inflows has generated great concern. The FII controlled the appreciation of the currency, monitoring the export industry and became uncompetitive because of the appreciation of the rupee. But recent evidence suggests that exports are largely influenced by several other factors including the cost and quality of the product rather than simply the value of the currency.

Costs and benefits are both associated with foreign institutional investment. However, it is not yet clear which aspect outweighs the other. There are differences of opinion among economists, researchers and policymakers regarding the extent to which we should open our capital markets to foreign investments. In light of huge and growing FII investment inflows to India, appropriate policy formulation is needed that will help in reducing the impact of possible threats and taking full advantage of the benefits to enhance the economic and financial development of the Indian economy.

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