# FOREIGN INSTITUTIONAL INVESTORS (FIIS) AND THEIR IMPACT ON INDIA'S SECURITIES MARKET

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**Abstract:** The global financial crises have sparked numerous inquiries into the interconnectedness of economies on the financial front. The intricate connections among global markets have resulted in significant disruptions to economies' financial mechanisms. Because they do not create debt and are not volatile, foreign institutional investment (FII) and foreign direct investment (FDI) have been more popular than other kinds of external financing in recent years. International trade and the transfer of knowledge, skills, and technology are also made possible by FDI and FII. Since 1991, foreign investment inflows, or FIIs, have increased significantly both globally and particularly in India. Concerns about the type and volume of foreign direct investment (FII) flows into the Indian financial industry are currently very common. The purpose of this research paper is to investigate, over a ten-year period from 2000 to 2010, the relationship between FII and market indices in the Indian stock market. The research will also highlight tactics to promote foreign direct investment (FII) inflows into the nation and their effects on the economy.

**Keywords:** *Portfolio Management, Regulatory Framework, Capital Flows, Emerging Markets, Investment Strategies, Foreign direct investment, Foreign institutional investment, Equity derivatives, Stock market, Stock exchanges, Depositories*.

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## I. INTRODUCTION

Prior to 1997, the rapid growth in emerging Asian markets was credited to attracting foreign investors. However, post-1997, these investors withdrawing funds were accused of exacerbating financial crises. In response to a fiscal and balance of payments crisis in 1990–91, India initiated liberalization in 1992, allowing foreign institutional investors (FIIs) to invest in the country.[1] The objectives aimed to reduce dependence on debt-driven capital inflows, tackle the balance-of-payments dilemma, and foster the growth of capital markets. Subsequently, there has been a marked rise in FII investments, particularly notable post-2003, exceeding US$ 50 billion by March 2007. India now draws approximately a quarter of FII inflows into emerging markets, with the count of registered FIIs reaching 997 by March 2007.[2]

This essay explores the impact of FII flows on Indian capital markets, reviewing existing research and regulatory policy changes post-liberalization. It investigates factors influencing FII investments at both firm and macroeconomic levels. FII inflows are contingent upon the host country's regulatory environment. Despite allowing FII inflows since 1992, India initially approached liberalization cautiously due to past financial crises. However, as foreign investment accelerated, regulatory policies became more lenient, allowing FIIs to invest in various financial instruments, primarily in equity.[3]

## II. NATURE OF FII FLOWS INTO THE INDIAN ECONOMY

Investment trusts, banks, endowments, foundations, mutual funds, pension funds, insurance companies, investment trusts, university funds, and charitable trusts and societies are all included in the category of foreign institutional investments, or FIIs. Furthermore, in accordance with SEBI regulations, asset management firms, institutional portfolio managers, trustees, and holders of power of attorney who make investments on behalf of broad-based funds are considered FIIs. A vast array of securities, including listed and unlisted shares, debt instruments, derivatives, government securities, and treasury bills, are included in these investments.

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[1] P. Srinivasan and K. Sham Bhat, 'An Empirical Analysis of Foreign Institutional Investment and Stock Market Returns in India' (2009) 44 (2) SSRN <https://doi.org/10.1177/0015732515090203> accessed 23 April 2024

[2] Areej Aftab Siddiqui and N.A. Azad, 'Foreign Institutional Investment Flows and Indian Financial Market: Relationship and Way Forward' (2012) 16(3) Sage Journals <https://doi.org/10.1177/0972262912460154> accessed 23 April 2024

[3] Neeta Tripathi, 'Foreign Institutional Investment Flows (FII) in Indian Companies' (2008) 4(1) Asia-Pacific Business Review <https://doi.org/10.1177/097324700800400103> accessed 24 April 2024

The volume of FII inflows into India surged steadily since 2003–04, reaching Rs 5,20,508 crores in 2006–07, though net investments decreased due to increased gross sales. The significant growth in FII inflows from 2003–04 onward was attributed to policy changes aimed at enhancing FII flows.[4] While FDI accounted for 33% of total capital flows in 2005–06, FII comprised 53%, marking a shift from previous years. The number of registered FIIs in India has risen consistently, reaching 997 by the end of 2006–07, with a notable increase in registrations in recent years.

Around 85% of registered FIIs in India originate from ten countries, predominantly the US and the UK. Yet, emerging nations such as Hong Kong, Luxembourg, Mauritius, Ireland, and France are progressively making inroads into the Indian markets. FIIs have been granted permission to engage in trading derivatives and government securities, resulting in cumulative investments in derivatives reaching Rs 2,25,278 crores by March 2007. Participatory notes, issued by FIIs for offshore derivatives, allow hedge funds to indirectly invest in Indian securities. These funds, although unregulated, constitute a significant portion of FII investments and are gaining popularity among investors. Regulatory authorities like SEBI are taking measures to ensure transparency and compliance within this segment of the market.[5]

## III. DETERMINANTS AND IMPLICATIONS OF FIIS

One of the main concerns regarding Foreign Institutional Investments (FIIs) in India is their potential impact on the country's stock markets.[6] There's speculation about the herd behavior and speculative motives of FIIs, especially considering their tendency to pursue quick returns and exit swiftly in response to minor disturbances.[7] Despite being a significant portion of portfolio investment in India, their sudden reversal could disrupt the stability of the balance of

[4] Mukherjee and others, 'Foreign Institutional Investment in the Indian Equity Market: An Analysis of Daily Flows During January 1999-May 2002' (2002) 2(9-10) SSRN <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=430700> accessed 1 May 2024

[5] Rajesh Chakrabarti, 'FII Flows to India: Nature and Causes' (2001) 2 (7) SSRN <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=649852> accessed 1 May 2024

[6] James P. Gordon and Poonam Gupta, 'Portfolio Flows into India: Do Domestic Fundamentals Matter?' (2006) {IMF Working Paper No. 03/20} SSRN <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=879095> accessed on 1 May 2024

[7] Paramita Mukherjee, Suchismita Bose, and Dipankor Coondoo, 'Foreign Institutional Investment in the Indian Equity Market: An Analysis of Daily Flows During January 1999-May 2002' (2003) 2 SSRN <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=430700> accessed 26 April 2024

payments (BOP). Over time, FII investment as a percentage of the previous year's BSE market capitalization has increased, indicating their growing influence.[8]

Various studies have analyzed the relationship between FII investments and stock market volatility in India. It's observed that FIIs wield considerable influence on equity market price trends, with domestic players often following their lead. While FII flows correlate with stock market returns, the causality tends to be from stock prices to FII flows rather than the other way around. Factors such as world interest rates, stock market volatility, exchange rates, and country risk, which typically influence FII flows, don't seem to significantly affect India's case.[9]

Regulatory reforms have been instrumental in attracting FII investments into India's stock markets. Amendments in SEBI and RBI regulations aimed at enhancing transparency and governance have positively impacted FII inflows. Despite concerns about the potential volatility introduced by hedge funds, they also contribute much-needed liquidity to the market. Policy recommendations include measures to curb participatory notes and encourage corporate investment through registered entities to ensure compliance with KYC and FATF norms, thus stabilizing the economy against adverse effects from hedge funds.[10]

## IV. REGULATION OF FII INVESTMENT IN INDIA

In the early 1990s, the High-Level Committee on the Balance of Payments recommended broad external sector reforms, including shifting towards non-debt creating external flows. Consequently, Foreign Institutional Investors (FIIs) were permitted to invest in Indian debt and equity markets starting from September 1992, with actual investment in shares and debentures commencing in January 1993.[11] Portfolio investments in India were restricted to Non-Resident Indians (NRIs) and Overseas Corporate Bodies (OCBs) before to 1992. Foreign firms must register as FIIs with the Securities and Exchange Board of India (SEBI) and receive approval from the Reserve Bank of India (RBI) in order to engage in the Indian equity markets. Once

[8] Suchismita Bose and Dipankor Coondoo, 'The Impact of FII Regulations in India: A Time-Series Intervention Analysis of Equity Flows' (2004) (2) SSRN <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=755324> accessed 21 April 2024

[9] Gurmeet Singh, 'Determinants of Foreign Institutional Investor's Investment in India' 45 (2) SSRN <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2737871> accessed 25 April 2024

[10] Nidhi Dhamija, 'Foreign Institutional Investment in India: An Exploratory Analysis of Patterns across Firms' (2008) 2(3) < https://doi.org/10.1177/097380100800200304> accessed 25 April 2024

[11] Ministry of Finance, Government of India, The High-Level Committee on the Balance of Payments <https://www.rbi.org.in/Scripts/PublicationsView.aspx?id=9479> accessed 02 May 2024

registered with SEBI, an FII can operate freely in India within prescribed limits, with all other transactions requiring RBI permission.

FIIs are classified into two categories: Normal FIIs (70:30 route) and 100 percent debt FIIs, each with specific investment requirements and limits. In order to fully manage FII investment flows, regulations governing FIIs were first published by the government in 1992 and then integrated by SEBI in 1995. These policies have undergone revisions and alterations throughout time to accommodate evolving local and global circumstances. Permissible entities, investment instruments, investment ceilings, tax and registration procedures are all covered by regulatory rules. The RBI monitors investment ceilings daily, with clearances granted on a first-come, first-served basis until the ceiling is reached.[12]

Taxation and registration procedures for FIIs have evolved over the years, with changes aimed at streamlining processes and ensuring transparency. Notable developments include the introduction of a Securities Transaction Tax (STT) in 2005 and the mandatory disclosure of information related to sub-accounts by FIIs. Overall, the regulatory framework governing FIIs in India has undergone significant changes to attract foreign investment while ensuring transparency, stability, and adherence to regulatory norms.

## V. A PROFILE OF FII INVESTMENT IN INDIAN COMPANIES

India has been actively seeking investments through Foreign Institutional Investors (FIIs), particularly in equities, resulting in increased FII holdings in companies. This analysis examines changes in FII holdings and investments from 2001 to 2006. Data from the Prowess dataset reveals several key observations:

1. The number of companies receiving positive FII flows increased from 775 in March 2001 to 1,159 in March 2006;
2. Promoters hold 52% of total equity, while FIIs hold 23% of non-promoter holdings, accounting for 11% of total equity, a slight increase from 10.3% in 2001;
3. The top 150 and 100 FII holding companies in March 2006 accounted for 88% and 80% of total FII shares held respectively;
4. Over 60% of the top 150 FII holding companies are listed on the BSE 100 Sensex.

[12] Securities Exchange Boards of India 1995

Further analysis of company-wise FII holdings and investment value highlights the dominance of certain sectors such as banking, telecom, and petroleum. However, there has been diversification into new sectors like cement and energy in recent years. The increase in FII inflows into mid-cap and small-cap firms reflects growing confidence in the Indian economy and capital market regulations. Despite increases in statutory caps, FII investment has not reached its full potential, suggesting the need for further measures to attract funds and diversify investments. India's cautious approach to foreign investment has yielded less volatile and speculative FII flows.[13]

## VI. IMPACT OF FOREIGN INSTITUTIONAL INVESTMENT ON INDIAN STOCK MARKET: A CAUSE-AND-EFFECT RELATIONSHIP

Over the post-financial reform era, the Indian stock market witnessed a surge in foreign institutional investors (FIIs) activity, shaping its dynamics significantly. The advances to declines ratio (ADR) of the Bombay Stock Exchange (BSE) and FIIs' purchases to sales ratio, empirical methods such as co-integration, Granger causality tests, and variance decomposition analysis are employed to unravel the relationship.[14]

The Granger causality tests reveal a one-way causality from FIIs to BSE-ADR, persisting across different time frames. Additionally, variance decomposition analysis underscores the substantial impact of FIIs on BSE price changes, emphasizing their dominant role in disseminating market information.[15] These findings underscore the significant influence of FIIs on the BSE, with minimal reciprocal influence, indicating a unidirectional causality from FIIs to BSE-ADR.

Over the past two decades, FIIs have emerged as key players in India's stock market, catalyzed by economic reforms opening avenues for foreign investment. While their influx has spurred positive changes like increased capital flows and strengthened domestic savings, concerns linger regarding their impact on market volatility. Global studies echo similar sentiments, expressing both optimism about FIIs' contributions and caution about their potential

[13] Nidhi Dhamija, 'Foreign Institutional Investment in India: An Exploratory Analysis of Patterns across Firms' (2008) 2 (3) Sage Journals <https://doi.org/10.1177/097380100800200304> accessed 30 April 2024

[14] Sunita Mehla and S.K. Goyal, 'Impact of Foreign Institutional Investment on Indian Stock Market: A Cause and Effect Relationship' (2013) 9 (3) Sage Journals <https://doi.org/10.1177/2319510X13519370> accessed 29 April 2024

[15] Ashish Varughese and Tomy Mathew, 'Asymmetric Volatility of the Indian Stock Market and Foreign Portfolio Investments : An Empirical Study' (2017) 11 (6) Indian Journal of Finance <http://dx.doi.org/10.17010/ijf%2F2017%2Fv11i6%2F115595> accessed 29 April 2024

destabilizing effects during crises.[16] To delve deeper, this essay scrutinizes the causal nexus between FII flows and the Indian stock market, employing rigorous econometric techniques.

In recent years, foreign investment has become pivotal for developing nations like India, offering advantages like technological advancement and balanced payments improvements, alongside challenges such as increased competition and the risk of fund repatriation.[17]

## VII. RESULTS AND DISCUSSION

Foreign institutional investors (FIIs) have significantly influenced the Indian stock market over the past two decades, particularly in the 1990s. Their presence has grown steadily, with net investments in India experiencing positive trends, except for a slight decline in 1998–1999, attributed to external factors such as nuclear tests and the East Asian crisis. However, these effects were short-lived for India. Despite the global financial crisis causing a reversal in trends in 2008–2009, subsequent years saw a resurgence in FII investments, driven by factors like strong macroeconomic fundamentals, transparent regulations, and favorable corporate performance.[18]

Co-integration analysis using Johansen and Juselius (1990) approach revealed a long-term relationship between FIIs and BSE-ADR, indicating that deviations from this relationship prompt reactions from both variables. Granger causality tests with error correction terms (ECT) indicated a unidirectional causality from FIIs to BSE-ADR in both short and long terms, suggesting that FIIs lead fluctuations in the BSE stock market, while changes in BSE do not significantly affect FIIs.[19]

In summary, the results indicate that FIIs play a crucial role in driving market dynamics in the Indian stock market, with their investments driven by fundamental factors rather than market technicalities. The findings highlight the importance of understanding FII behavior for effective market analysis and policymaking.

[16] ASHISH GARG and B.S. BODLA, 'Impact of the Foreign Institutional Investments on Stock Market: Evidence from India' (2011) 46 (2) JSTOR <https://www.jstor.org/stable/23266433> accessed on 4 May 2024

[17] E. Han Kim and Vijay Singal, 'Stock Market Openings: Experience of Emerging Economies' (2000) 73 (1) JSTOR <https://www.jstor.org/stable/10.1086/209631> accessed 29 April 2024

[18] Sunita Mehla and S.K. Goyal, 'Impact of Foreign Institutional Investment on Indian Stock Market: A Cause and Effect Relationship' (2013) 9(3) Asia-Pacific Journal of Management Research and Innovation < https://doi.org/10.1177/2319510X13519370> accessed 28 April 2024

[19] International Monetary Fund, 'Testing for Cointegration Using the Johansen Methodology when Variables are Near-Integrated', (June 2007) WP/07/141

## VIII. CONCLUSION

This essay investigates the relationship between foreign institutional investors (FIIs) and the Indian stock market sentiment using analytical techniques like co-integration, Granger causality tests, and variance decomposition analysis. The findings reveal co-integration between FIIs and BSE-ADR, indicating a shared long-term information connection. Granger causality tests show a unidirectional causal link from FIIs to BSE-ADR, both in the short and long terms, suggesting that FIIs drive market fluctuations. Variance decomposition analysis underscores the significant influence of FIIs in disseminating market information, implying their ability to steer Indian stock market movements.

The share of domestic financial institutions in Indian companies has been declining since 2003, while FIIs hold a significant position. However, recent analysis shows some optimism for domestic financial institutions. Increasing investors' awareness and promoting equity culture among small savers is essential. Encouraging institutional investment through mutual funds can enhance equity market participation. Government efforts to improve financial regulation and corporate governance are necessary to attract individual and institutional investments. Despite many companies having FII stakes of 10-20%, their relative share in Indian companies remains small. Therefore, policies should focus on enhancing investment opportunities while regulating financial markets effectively to mitigate stock price fluctuations.

Overall, the analysis revealed evidence supporting the negative feedback trading hypothesis before the global financial crisis period, while during the crisis period, evidence supported the positive feedback trading hypothesis by foreign investors. This suggests that foreign institutional investment acted as a stabilizing force before the crisis, but as a destabilizing force during the crisis. However, such positive feedback trading strategies during the crisis appeared rational given the circumstances of the global financial crisis.