Foreign Institutional Investment

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Introduction

In 2004-05 portfolio investments in India accounted for about 62% of total foreign investment in the country and at about 1.29% of GDP well exceeded the current account deficit (0.95% of GDP). Foreign Institutional Investors’ (FIIs’) investments accounted for about 97.5% of this. Ever since the opening of the Indian equity markets to foreigners, FII investments have steadily grown from about Rs. 2,600 crores in 1993 to over Rs.48,000 crores in 2005. At the end of June 2006, the cumulative FII flows to India accounted for a little over 9% of the Bombay Stock Exchange market capitalization.

While it is generally held that portfolio flows benefit the economies of recipient countries, policy-makers worldwide have been more than a little uneasy about such investments. Often referred to as “hot money”, they are known to stampede out at the slightest hint of trouble in the host country leaving an economic wreck in their wake, like Mexico in 1994. They have been blamed for exacerbating small economic problems in a country by making large and concerted withdrawals at the first sign of economic weakness. They have also been held responsible for spreading financial crises – causing ‘contagion’ in international financial markets.

International capital flows and capital controls have emerged as important policy issues in the Indian context as well. The danger of abrupt reversals and their destabilizing consequences on equity and foreign exchange markets are always a concern.

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Nevertheless, in recent years, the government has been making strong efforts to increase FII flows in India. Others (Rakshit (2006)) have argued that, far from being healthy for the economy, FII inflows have actually imposed certain burdens on the Indian economy. Understanding the determinants and effects of FII flows and devising appropriate regulation therefore constitute an important part of economic policy making in India.

**Foreign Institutional Investors – a brief introduction**

Entities covered by the term ‘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 (i.e., fund having more than 20 investors with no single investor holding more than 10 per cent of the shares or units of the fund)” (GOI (2005)). FIIs can invest their own funds as well as invest on behalf of their overseas clients registered as such with SEBI. These client accounts that the FII manages are known as ‘sub-accounts’. A domestic portfolio manager can also register itself as an FII to manage the funds of sub-accounts.

A few large FIIs (less than 3% of all registered ones, according to GOI (2005)), issue derivative instruments called ‘participatory notes’ that are registered and traded overseas, backed by the FIIs’ holdings of Indian securities. This arrangement has raised some concerns in regulatory circles since it makes it difficult to trace the ultimate beneficiary in the funds and may be used to bring in “unclean” funds (funds generated out of illegal activities) into the Indian markets.
As of mid-July 2006, there were 932 FIIs registered with SEBI, of which 115 were registered in the first half of 2006 itself. US-based funds accounted for 39% of all registered FIIs, followed by UK-based ones (16%), Luxembourg (7%) and Singapore (5%). In terms of net cumulative investment, US based funds accounted for 29% at the end of October 2005 (GOI (2005)) followed by UK (17%).

Though initially restricted to investing only in listed company stocks, FIIs are now allowed to invest in equity, bonds and derivative instruments in India subject to limits of foreign ownership for various sectors as well as ceilings on total investment per FII. Regular FIIs follow what has come to be known as the “70:30 rule”, i.e. they must invest no less than 70% of their funds in equity-related instruments and may invest the remainder in debt-related instruments. There are also some FIIs that are registered as “100 per cent debt-fund FIIs” that are permitted to invest exclusively in debt instruments.

Although equity holdings of FIIs have received maximum attention from the press, researchers and policymakers alike, the debt holdings of FIIs are not wholly insignificant. As of July 21, 2006, the regular FIIs held USD 224.25 million (about Rs. 1,009 crores) in government securities/Treasury Bills and USD 82.02 million (about Rs. 369 crores) in corporate debt. At the end of June 2006, the open interest of FIIs in stock and index futures and options exceeded Rs 22,000 crores.

**What we know about FII flows to India**

Over the last few years, research has brought to light a few important features of FII flows to India. The key question has been the relationship between FII flows and returns in the Indian markets shown in Figure 1. Clearly FII equity investments and the stock market performance in India have been very closely interlinked. Also both
variables experience a sharp break around April of 2003 after which they ramp up steeply. The association is unmistakable – the correlation of monthly net FII equity inflows and monthly Sensex returns is 0.61 since April 2003 and 0.33 in the overall sample.

[Figure 1 about here]

FII flows are routinely depicted as a major driver of Indian stock market return in the financial press. However, research seems to suggest they are more of an effect than a cause of stock market performance. Analyzing daily flow data during 1999, Chakrabarti (2001) concludes that in the post-Asian crisis period, stock market performance has been the sole driver of FII flows, though monthly data in the pre-Asian crisis period may suggest some reverse causality. This return-chasing behavior has been confirmed using daily data during 1999-2002 in Mukherjee et al (2002), which also finds that the sales of Indian securities by FIIs are affected by returns but not purchases. On the other hand, Gordon and Gupta (2003) analyze monthly data over the period 1993-2000 to conclude that FII flows are negatively related to lagged stock market returns, suggesting negative feedback trading. There are, however, issues about the appropriateness of using monthly data in this analysis (Rakshit (2006)). In any case, given that there is a structural break in the data around April 2003, careful analysis of more recent data would be instructive in understanding the nature of the relationship and causality, if any, between these two variables.

The largest single-month pull-out of FII funds happened in May 2006 when the FIIs withdrew over $1.7 billion (Rs. 8247 crores) followed by May 2004 ($ 719 million, Rs. 3250 crores). These were also the months with the fourth largest and the largest
single month percent decline in the Sensex respectively (15.8% and 18.8% respectively) in the post reforms era.

As for other features, Chakrabarti (2001) finds no evidence of any informational disadvantage for foreign investors vis-à-vis their domestic counterparts. The Asian crisis marked a regime shift in determining FII flows. In the pre-crisis period, the beta (or co-movement) of the Indian market with the American S&P 500 index seemed to inversely affect FII flows to India, but the effect disappeared in the post-crisis period. India’s country risk rating did not seem to affect FII flows. Mukherjee et al (2002) have questioned the diversification motive behind FII flows to India and report autocorrelation or inertia in FII flows. Gordon and Gupta (2003) report that FII flows are sensitive to the London Inter-bank Offer Rate (LIBOR) as well as India’s macroeconomic fundamentals. Coondoo and Mukherjee (2004) argue that both the stock market as well as FII flows in India have high and related volatility. Finally, in their analysis of the effects of regulatory measures on FII flows, Bose and Coondoo (2004) find that liberalizing policy changes have had expansionary effect on FII flows while restrictive measures aimed at giving regulators greater control over FII flows do not necessarily dampen them.

**Government policy regarding FII flows**

In policy circles in India, FII flows are believed to have a positive impact on the country’s development; so much so that encouraging FII flows – while reducing the financial sector’s vulnerability to speculative capital flows – constitute an objective of the National Common Minimum Programme. Accordingly, an expert group was set up in 2004 (in addition to a committee in 2002 which reported in 2004) to suggest ways to accomplish this goal. The group submitted its report in November 2005 (GOI 2005). Its
rationale for encouraging FII flows is that such flows can increase domestic investment without increasing foreign debt. They can raise stock prices, lower cost of equity and stimulate investment by Indian firms and lead to improvements in securities market design and corporate governance.

In order to further stimulate FII flows, the expert group has suggested setting FII investment caps, if any, over and above the FDI sectoral limits. In cases where the limits have to be combined, they should be set at sufficiently high levels. Another recommendation is to increase the supply of “good quality equities” through disinvestment in the public sector and through encouraging companies with large projects like those in infrastructure and telecom sector to raise money in the domestic markets.

As for the companion objective of reducing the market’s vulnerability to speculative flows, the group recommends participation of domestic institutional investors like pension funds in the equity markets. Entities from “tax haven” countries should be barred from registering as FIIs. The practice of participatory notes (PNs) is acceptable provided SEBI has the powers to track down the final beneficiary for investigation or surveillance by making it obligatory for the FIIs to provide such information. PNs should not be issued to entities not regulated anywhere in the world and FIIs must follow the “know your client” principle. Existing non-eligible PNs should be allowed to expire or wound down within five years, whichever is earlier. Further, to avoid abuse of the sub-account route to circumvent investment limits, the FII limits should be applied to total investments managed by an FII – directly and through its sub-accounts.

Rakshit (2006) has questioned the basic premise of beneficial effects of FII flows in India as well as the expert group’s recommendations. Apart from the risks of financial
instability, which he views as underestimated by the expert group, Rakshit (2006) points out that during the 1992-2002 period there has been little relationship between the capital account balance and aggregate investment in India and except for a couple of years the latter has exceeded the current account balance in all years since liberalization began. This indicates that FII flows are contributing primarily to the amassing of huge foreign exchange reserves at the RBI rather than to real investment in the economy. Further, this accretion of reserves implies significant costs for the economy in terms of a fall in RBI profits through holding of lower yielding reserves, loss of seignorage revenue and the costs of sterilizing the inflows. In the presence of demand deficiency in the economy, the real effects of enhanced FII flows are likely to be far from positive. Thus FII flows should be viewed not in isolation but as part of an integrated policy package for all capital receipts keeping in mind their role in the overall macroeconomic structure.
References
Figure 1:
Cumulative FII Investment and the Sensex

CUMM. INV. (Rs crore)  
Sensex

Source: Equitymaster.com