<u>A STUDY OF MAJOR AREA AFFECTED BY FOREIGN INSTITUTIONAL INVESTORS.</u>

Track: Stock Market

ANJALI.S
M COM
SSMRV COLLEGE.
8050935502
krupanjali23@gmail.com

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Abstract

Since recent past, it has been observed that Indian stock market is experiencing violent fluctuations in current scenario of Indian stock market can investor is required to be alert enough about happenings in the market. For that purpose it is very important for each and every investor to be aware about major factors affecting stock market. In this paper it has been tried to find out major factors responsible for up and down movements in Indian stock market. From the study it has been found out that factors like flow of foreign institutional investors, Inflation, Exchange rate are major factors responsible /affecting a movement in Indian stock market.

Key words: Inflation, FII, Exchange rate, Stock market.

INTRODUCTION

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."

. An institution established or incorporated outside India which proposes to make investment in securities in India .They are registered as FIIs in accordance with Section 2(f)of the SEBI(FII)Regulations 1995.

Mutual funds, insurance companies, pension funds, university funds, investment trusts endowment funds and charitable trusts incorporated in outside India but investing in equity and debt securities in the country are known as FIIs. They collect money from individuals and corporate (primarily from countries belonging to the European and American continents),and invest it in financial instruments worldwide, with India being one of the targeted markets.FII who want to invest in the Indian markets have to registered with the SEBI(security and Exchange Bureau of India) and also from the RBI to maintain a foreign currency account to bring in and take out the funds and also a rupee bank account to make the transactions.

In India, a particular FII is allowed to invest up to 10% of the paid up capital of a company, which implies that any investment above 10% will be constructed as FDI.

WHY FIIs REQUIRED?

FIIs contribute to the foreign exchange inflow as the funds from multilateral finance institutions.

Following are the some advantages of FIIs.

- FII inflows help in financial innovation and development of hedging instruments.
- Improving capital markets.
- FIIs can help in the process of economic development.
- Enhanced flows of equity capital.
- Reduced cost of equity capital.
- Knowledge flow.

INVESTMENT BY FIIS

Generally two ways to invest for FIIs equity and debt.

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

Equity Investment route.

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

Debts investment route

- Debenture
- Bonds
- Government securities
- Treasury bills
- Other Debt market instrument.

Prohibitions on Investments:

Foreign Institutional Investors are not permitted to invest in equity issued by an Asset Reconstruction Company. They are also not allowed to invest in any company which is engaged or proposes to engage in the following activities:

•Business of chit fund

•Nidhi Company

•Agricultural or plantation activities

•Real estate business or construction of farm houses (real estate business does not include development of townships, construction of residential/ commercial premises, roads or bridges).

•Trading in Transferable Development Rights (TDRs).

STOCK MARKET

Industrial Securities Market

It is market for securities issued by different companies. Such securities are equity shares, preference shares and debentures. In this market investor invest their money by purchasing these securities and companies raise their fund from different issues. This market can be subdivided into Primary market and secondary market.

1. Primary Market

Primary market is the market where industrial securities are first time issued. This market is also known as new issue market. It deals with those securities which were previously not available to the public. Thus it deals with issue of fresh capital by companies either for cash or for consideration other than cash. This capital may in any of the form i.e. equity shares, preference shares, debentures etc.

2. Secondary Market

The stock market is a market for old securities i.e. those which have been already issued and listed on a stock exchange. These securities are purchased and sold continuously among investors without the involvement of companies. Stock exchange provides not only free transferability of shares but also makes continuous evaluation of securities traded in the market.

HISTORY OF FIIS

Since 1990-91, the government of India embarked on liberalization and economic reforms with a view of bringing about rapid and substantial economic growth and move towards globalization of the economy. As a part of the reforms process, the Government under its New Industrial Policy revamped its Foreign Investment policy recognizing the growing importance of foreign direct investment as an instrument of technology transfer, augmentation of foreign exchange reserves and globalization of the Indian economy. Simultaneously, the Government, for the first time, permitted portfolio investments from abroad by foreign institutional investors in the Indian capital market. The entry of FIIs seems to be a follow up of the recommendation of the

Narsimhan committee Report on Financial system. The committee only suggested that the capital market should be gradually opened up to foreign portfolio investments.

From September 14, 1992 with suitable restrictions, Foreign Institutional investors were permitted to invest in all the securities traded on the primary and secondary markets, including shares, debentures and warrants issued by companies which were listed of were to be listed on the stock exchanges in India.

PROCEDURE FOR REGISTRATION:

The Procedure for registration of FII has been given by SEBI regulations. It states- “no person shall buy, sell or otherwise deal in securities as a Foreign Institutional Investor unless he holds a certificate granted by the Board under these regulations”. An application for grant of registration has to be made in Form A, the format of which is provided in the SEBI (FII) Regulations, 1995.

FEE FOR REGISTRATION:

- US$ 5000 for an FII account
- US$ 1000 for each sub account
- SEBI targets a timeline of 10 to 12 days for proceeding of FII applications
  Valid for 5 years

A FII is required to obtain a certificate by SEBI for dealing in securities. SEBI grants the certificate SEBI by taking into account the following criteria:

I)the applicant's track record, professional competence, financial soundness, experience, general reputation of fairness and integrity.

ii)whether the applicant is regulated by an appropriate foreign regulatory authority.

iii) Whether the applicant has been granted permission under the provisions of the Foreign Exchange Regulation Act, 1973 (46 of 1973) by the Reserve Bank of India for making investments in India as a Foreign Institutional Investor.

iv) Whether the applicant is

a) an institution established or incorporated outside India as a pension fund, mutual fund, investment trust, insurance company or reinsurance company.

(b) an International or Multilateral Organization or an agency thereof or a Foreign Governmental Agency or a Foreign Central Bank.

(c) an asset management company, investment manager or advisor, nominee
company, bank or institutional portfolio manager, established or incorporated outside India and proposing to make investments in India on behalf of broad based funds and its proprietary funds in if any or

(d) University fund, endowments, foundations or charitable trusts or charitable societies.

v) Whether the grant of certificate to the applicant is in the interest of the development of the securities market.

vi) Whether the applicant is a fit and proper person.
The SEBIs initial registration is valid for a period of three years from the date of its grant of renewal.

<u>THE ELIGIBILITY CRITERIA FOR APPLICANT SEEKING FII REGISTRATION IS AS FOLLOWS:</u>

- Good track record, professional competence and financial soundness.
- 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

A FII can make investments only in the following types of 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

REVIEW OF LITRATURE

1. **Stanley Morgan (2002)** has examined that FIIs have played a very important role in building up India's for ex reserves, which have enabled a host of economic reforms. Secondly, FIIs are now important investors in the country's economic growth despite sluggish domestic sentiment. The Morgan Stanley report notes that FII strongly influence short-term market movements during bear markets. However, the correlation between

returns and flows reduces during bull markets as other market participants raise their involvement reducing the influence of FIIs. Research by Morgan Stanley shows that the correlation between foreign inflows and market returns is high during bear and weakens with strengthening equity prices due to increased participation by other players.

2. **Agarwal, Chakrabarti etal (2003)** have found in their research that the equity return has a significant and positive impact on the FII. But given the huge volume of investments, foreign investors could play a role of market makers and book their profits, i.e., they can buy financial assets when the prices are declining thereby jacking-up the asset prices and sell when the asset prices are increasing. Hence, there is a possibility of bi-directional relationship between FII and the equity returns.

3. **Kumar (2001)** investigated the effects of FII inflows on the Indian stock mark represented by the Sensex using monthly data from January 1993 to December 1997. Kumar (2001)inferred that FII investments are more driven by Fundamentals and they do not respond to short-term changes or technical position of the market. In testing whether Net FII Investment (NFI) has any impact on Sensex , a regression of NFI was estimated on lagged values of the first difference of NFI, first difference of Sensex andone lagged value of the error correction term (the residual obtained by estimating the regression between NFI and Sensex). The study concluded that Sensex causes NFI. Similarly, regression with Sensex as dependent variable showed that one month lag of NFI is significant, meaning that there is causality from FII to Sensex. This finding is in contradiction with the findings of Rai and Bhanumurthy (2003) who did not find any causation from FII to return in BSE using similar data between 1994 a 2002. However, Rai and Bhanumurthy have also found significant impact of return in BSE on NFI

4. **Desai Jayesh N. (2009):** depicted in his paper that world output rose at 5% in 2007, Slow down at 3.9% and 3% in 2008 and 2009 respectively. According to IMF world economic outlook; India grew at9.3% in 2007 and 7.9% and 6.9% in year 2008 and 2009

respectively. He has also focus on measurement of effect on developing countries, which can be identify by decrease in Export.

5. **Bhalla V. K. (2011)** has described in his book that the extent of stock price volatility is also influenced by the extent of integration between the domestic and international capital markets as well as the regulatory frame work governing the stock market. In India, two most important factors which had significant bearing on the behavior of stock prices during the 'nineties were net investment by FII and trend in the international stock exchange, especially NASDAQ.

OBJECTIVES OF THE STUDY

Primary Objectives of the study are as follow:

- To identify major factors affecting Indian stock market.
- To get the knowledge of stock market.
- To find out the relationship between the FIIs investment and stock market.

DISCUSSION

FIIs (Foreign institutional investors) inflows and outflows are affecting in stock market, exchange rate, inflation and export industries.

- <u>Stock markets:</u>

The inflow of FIIs is high then they can bring in lot of funds in the countries stock markets and thus have great influence on the way the stock markets behaves, going up and down. The FII buying pushes the stock markets up and their selling shows the stock market the downward path. So this is how influencing FII can be, as is seen in the present downward trend of the stock markets in India courtesy heavy FII selling.

- Exchange rate:

The difference between two currencies is called exchange rate. (Foreign institutional investors need to maintain an account with the RBI for all the transactions.)

To understand the implications of FII on the exchange rate we have to understand how the value of one currency goes up (appreciate) or goes down against the other currency. The simple way of understanding is through ***Demand and supply.*** If say US imports from India it is creating a demand for Rupee thus the Indian rupee appreciates the dollar. If India imports then the dollar appreciates the Indian rupee.
Now considering FIIs for every dollar that they bring into the country, there is a demand for rupee created and the RBI has to print and release the money in the country. Since the FIIs are creating a demand for rupee, it appreciates the dollar.

For example:

If prior to the demand the exchange rate was 1USD=Rs 61, it could become 1 USD=60 after they invests. Similarly when FII withdraw the capital from the markets, they need to earn back the green buck(USD) so that leads to a demand for dollars the rupee depreciates .1USD goes back to Rs.61. Thus FII inflows make the currency of the country invested in appreciate (e.g. FII investing in India may lead to Rupee appreciating several other currencies) and their selling and disinvestment may lead to depreciation.

Thus FIIs to gain investing in India the rupee should appreciate the dollar. Recently the rupee has depreciated with respect to the dollar due to FII selling, and due to the selling it has been depreciating even further.

- Inflation:

The huge amount of FII fund inflow into the country creates a lot of demand for rupee, and the RBI pumps the amount of Rupee in the market as a result of demand created by the FIIs. This situation could lead to excess liquidity (amount of excess cash floating in the market) thereby leading to Inflation, where too much money chases too few goods (perfect example is demand pull-inflation). Thus there should be a limit to the FII inflow in the country.

- Exports industries:

FII inflow lead to appreciation of the currency, they lead to the exports industry becoming uncompetitive due to the appreciation of the rupee.

For example:

If 1USD=Rs.50 and a soap costs 1USD. Now when the rupee appreciates 1 USD=Rs.25 I will have to sell the same soap to the US for 2 US dollars in order to sustain the same income that I have been making i.e.Rs.50. Thus excess FII fund inflow in the country can also make a negative impact on the economy of the country.

BENEFITS OF FIIs

1. IMPROVING CAPITAL MARKETS:

FIIs as professional bodies of asset managers and financial analysts enhance competition and efficiency of financial markets. By increasing the availability of riskier long term capital for projects, and increasing firms' incentives to supply more information about them, the FIIs can help in the process of economic development.

2. IMPROVED CORPORATE GOVERNANCE:

Good corporate governance is essential to overcome the principal-agent problem between shareholders and management. Information asymmetries and incomplete contracts between shareholders and management are at the root of the agency costs. Bad corporate governance makes equity finance a costly option. With boards often captured by managers or passive, ensuring the rights of shareholders is a problem that needs to be addressed efficiently in any economy. Incentives for shareholders to monitor firms and enforce their legal rights are limited and individuals with small shareholdings often do not address the issue since others can free-ride on their endeavor. FIIs constitute professional bodies of asset managers and financial analysts, who, by contributing to better understanding of firms' operations, improve corporate governance. Among the four models of corporate control - takeover or market control via equity, leveraged control or market control via debt, direct control via equity, and direct control via debt or relationship banking-the third model, which is known as corporate governance movement, has institutional investors at its core. In this third model, board representation is supplemented by direct contacts by institutional investors.

3. REDUCED COST OF EQUITY CAPITAL

FII inflows augment the sources of funds in the Indian capital market. In a common sense way an increase the supply of fund reduce the required rate of return for equity and enhance stock prices. Simultaneously, it fosters investment by Indian firms in the country.

4. 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, enhances competition in financial intermediation and lead to spill over of human capital by exposing market participants to modern financial techniques and international best practices and system.

CAUSES OF FIIs

1. POTENTIAL CAPITAL OUT FLOWS:

"Hot money" refers to funds that are controlled by investors who actively seek short-term returns. These investors scan the market for short-term, high interest rate investment opportunities. "Hot money" can have economic and financial repercussions on countries and banks. When money is injected into a country, the exchange rate for the country gaining the money strengthens, while the exchange rate for the country losing the money weakens. If money is withdrawn on Short notice, the banking institution will experience a shortage of funds.

2. INFLATION:

Huge amounts of FII fund inflow into the country creates a lot of demand for rupee, and the RBI pumps the amount of Rupee in the market as a result of demand created. This situation leads to excess liquidity thereby leading to inflation where too much money chases too few goods.

3. PROBLEM TO SMALL INVESTORS:

The FIIs profit from investing in emerging financial stock markets. If the cap on FII is high then they can bring in huge amounts of funds in the country's stock markets and thus have great influence on the way the stock markets behaves, going up or down. The FII buying pushes the stocks up and their selling shows the stock market the downward path. This creates problems for the small retail investor, whose fortunes get driven by the actions of the large FIIs.

4. ADVERSE IMPACT ON EXPORTS:

FII flows leading to appreciation of the currency may lead to the exports industry becoming uncompetitive due to the appreciation of the rupee**.**

Suggestion:

Excess of inflows creates a demand for rupee so the currency will appreciate the dollar and vise versa, Both excess of inflow and outflows create a problems to stock market , export industries and to the economy So, there should be a limit to inflow and outflow of foreign institutional investment in India.

CONCLUSION:

The behavior of stock market depends upon the inflow and outflow of foreign institutional investor's funds .Excess of inflows causes for inflation and excess of outflows causes for rupee depreciations So , there should be a limit to the inflows of FIIs into the country.

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