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LIBERALIZATION OF FOREIGN INSTITUTIONAL INVESTMENTS (FIIS) IN INDIA: MAGNITUDE, IMPACT ASSESSMENT, POLICY INITIATIVES AND ISSUES

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ABSTRACT

In this age of transnational capitalism, a significant amount of capital is flowing from developed world to emerging economies. Portfolio investments brought in by FIIs have been the most dynamic source of capital to emerging markets since 1990s. Since the beginning of liberalization in 1990s, FII flows to India have steadily grown in importance. From a near absence of FII inflows till 1992, today such inflows represent a dominant proportion of total flows. Positive fundamentals, gradual removal of structural barriers combined with fast growing markets have made India an attractive destination for foreign institutional investors. Today, FIIs are the key drivers of the Indian equity market and rising stakes in Indian companies. But, at the same time there is unease over the volatility in foreign institutional investment flows and its impact on the different segments of the economy. The increase in the volume of foreign institutional investment (FII) inflows in recent time has led to concerns regarding the volatility of these flows, threat of capital flight, its impact on the stock markets and influence of changes in regulatory regimes. The determinants and destinations of these flows and how are they influencing economic development in the country have also been debated. The present paper revealed that any problem related to FIIs is basically the problem of management. India should develop new tools to manage FIIs effectively and efficiently.

Key Words: FIIs, Stock Markets, Performance, Firms, Economy

JEL Codes: G15, N 25, F41, G28

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I. INTRODUCTION

India, among the world investors, is believed to be a good investment destination in spite of political uncertainty, bureaucratic hassles, shortages of power supply and infrastructural deficiencies. Despite the Asian financial turmoil, India has improved its position among the most attractive foreign investment destinations in the world. India presents a vast potential[3] for overseas investment and is actively encouraging the entrance of foreign players into the market. No company, of any size, aspiring to be a global player can no longer ignore this country, which is expected to become one of the top emerging economies (Bardhan, 2000;). India, which is the second fastest growing economy after China, has lately been a major recipient of foreign institutional investor (FII) funds driven by the strong fundamentals and growth opportunities (Banaji, 1998). FIIs have recognized the fact and unlike other countries where FDI has gained predominance[4], India has seen significant growth in FII investment (Chakrabarti, 2001; Khanna, 2002). Since the beginning of liberalization in 1990s, FII flows to India have steadily grown in importance. But, India's attractiveness as a destination for foreign investment is a relatively recent phenomenon, barely a few years old. After their flight last year, foreign institutional investors flocked back to bet on the India growth story by pouring in a record over Rs. 80,500 crore in domestic equities in 2009. According to analysts, the late revival of monsoon, upward revision of economic growth from 5.8 per cent to 6.1 per cent, better-than-expected performance of companies in the quarter ending June 30, 2009, the new direct taxes code, leading to savings in the tax payer's money, the trade policy with an ambitious target of US$ 200 billion exports for 2010-11 have all revived the confidence of FIIs investors in India. Both consumption and investment led industries linked to domestic demand, such as auto, banking, capital goods, infrastructure, retail, etc are likely to continue attracting FII funds (Rao, 2008). FIIs have made net investments of US$ 10 billion in the first six months (April to September) of 2009-10, major portion of these investments have come through the primary market, more than through secondary markets. The combination of gradual removal of structural barriers and an improving economic environment is likely to lead to a significant amount of value being unlocked. Added to this, since the beginning of year 2000, policy of government of India has been quite encouraging and in the recent year, the government has been making strong efforts to increase FII flows in India.

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[3] Based on the IMF's 2008 estimates of worldwide GDP, India is today the world's 12th largest economy.

[4] What explains the greater attraction of the Indian market for portfolio investors as compared to foreign direct investment (FDI)? In his column 'Bullish FII versus cautious FDI' Senthil Chengalvarayan has compared the Indian scenario, characterized by strong portfolio inflows and much weaker foreign direct investment (FDI), with China, where the situation is the reverse. He attributes the difference to the opening of the capital market. Open up the real sector and investments will flow, he argues. While his broad thrust is correct, there is another factor that's just as critical, if not more. Ease of entry and exit.

II. FIIS INVESTMENT POLICY OF INDIA

India embarked on a gradual shift towards capital account convertibility with the launch of the reforms in the early 1990s (Bose and Dipankar, 2004). Ever since September 14, 1992, when FIIs were first allowed to invest in all the securities traded on the primary and secondary markets, including shares, debentures and warrants issued by companies which were listed or were to be listed on the Stock Exchanges in India and in the schemes floated by domestic mutual funds. The holding of a single FII and of all FIIs, NRIs and OCBs[5] in any company were subject to the limit of 5 per cent and 24 per cent of the company's total issued capital, respectively (Lahiri *et al*, 2004) Initially, Pension Funds, Mutual Funds, Investment Trusts, Assets Management Companies nominee companies and incorporated institutional portfolio managers were permitted to invest directly in the Indian stock market. In 1995, Security Exchange Board of India (SEBI[6]) empowered by the Securities and Exchange Board of India Act, 1992 institutionalized the FII regulations, known as the Securities and Exchange Board of India (Foreign Institutional Investors) Regulations, November 14, 1995[7]. These regulations allowed an institution established or incorporated outside India as a Pension Funds, Mutual Funds, Investment Trusts, insurance company or re-insurance company; any Asset Management Company or 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; any Trustee or Power of Attorney holder, incorporated or established outside India, and proposing to make investments in India on behalf of broad

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[5] Overseas Corporate Bodies (OCB's) are bodies predominantly owned individuals of Indian Origin or nationality resident outside India and include overseas companies, partnership firms, societies and other corporate bodies which are owned, directly or indirectly, to the extent of at least 60% by individuals of Indian nationality or origin resident outside India as also overseas trusts in which at least 60% of the beneficial interest is irrevocably held by such persons. Such ownership interest should be actually held by them and not in the capacity as nominees.

[6] SEBI is the regulator for the Securities Market in India. It was formed officially by the Government of India in 1992 with SEBI Act 1992 being passed by the Indian Parliament.

[7] As per regulation 6 of SEBI (FII) Regulations, 1995, FIIs are required to fulfill the following conditions to qualify for grant of registration.

- Applicant should have track record, professional competence, financial soundness, experience, general reputation of fairness and integrity;
- The applicant should be regulated be an appropriate foreign regulatory authority in the same capacity/category where registration in sought from SEBI. Registration with authorities, which are responsible for incorporation, is not adequate to qualify as FII;
- Permission under the provisions of the Foreign Exchange Regulation Act 1973 (46 of 1973) by RBI for making investment in India as a FII;
- The applicant is required to have the permission under the provisions of the Foreign Exchange Management Act, 1999 from the RBI;
- Applicant must be legally permitted to invest in securities outside the country or its incorporation;
- The applicant must be a "fit and proper person";
- The applicant has to appoint a local custodian and enter into an agreement with the custodian. Besides it also has to appoint a designated bank to route its transactions'
- Payment of registration fee of US$5,000.

based funds to apply for FII status to carry out trading in equities and debentures listed on the Indian stock exchanges. Beginning 1996-97, the group was expanded to include registered University Funds, Endowment, Foundations, Charitable Trusts and Charitable. Furthermore, funds invested by FIIs had to have at least 50 participants with no one holding more than 5 per cent to ensure a broad base and preventing such investment acting as a camouflage for individual investment in the nature of FDI and requiring Government approval.

In February 2000, the FII regulations were amended to permit foreign firms and high net-worth individuals to invest in sub-accounts of SEBI-registered FIIs. FIIs were also permitted to seek SEBI registration in respect of sub-accounts for their clients under the regulations. FII ceiling under special procedure was enhanced to 49 per cent in March 2001. The objective was to increase FIIs participation. In September 2001, FII ceiling under the special procedure was raised to sectoral cap. In December 2003 FII dual approval process of SEBI and RBI was changed to single approval process of SEBI. The objective of this was to streamline the registration process and reduce the time taken for registration. In November 2004, cumulative sub-ceiling of US$ 0.5 billion outstanding has been fixed for FII investments in corporate debt. The objective was to limit short-term debt flows. The outstanding corporate debt limit was also increased to US$ 1.5 billion in April 2006. The limit on investment in Government securities was enhanced to US$ 2 billion in the Budget of 2006-07, FII limit capped at 23 percent in infrastructure companies in the securities market viz. stock exchanges, depositories and clearing corporations. FIIs registered with SEBI were allowed to invest in government securities up to US $ 3.2 billion.

Securities and Exchange Board of India (SEBI) amended SEBI (Foreign Institutional Investors) Regulations, 1995 (popularly known as FII Regulations) by Notification dated 22 May 2008[8]. The FII Regulations of 1995 have been one of the most debated pieces of SEBI regulations, as uncertainty has shrouded many of its provisions whether these were related to eligibility norms for registration, Know Your Client (KYC[9]) requirements or issuance of ODIs. In an attempt to clear this ambiguity, SEBI made a substantive amendment in the form of SEBI

[8] Notification No. F. No. LAD-NRO/GN/2008/10/126204 dated 22nd May 2008 on Securities and Exchange Board of India (Foreign Institutional Investors) (Amendment) Regulations, 2008 and Press release Ref. PR No. 11/2008 dated 29th May 2008 issued by SEBI.

[9] Know Your Client (KYC), are the ethical and practice guidelines for investment advisors to make detailed assessments about their clients' risk tolerance. Know your client rules are also called suitability rules because they are concerned with the suitability of securities investment for each specific customer. Similar to KYC for brokers, know your client for investment advisors goes beyond appropriateness and know your client requires investment advisors to assess investment clients' knowledge as well as financial position, tax status, and suitability criteria. Know clients who want to be eligible as sophisticated investors for private investments, and know your client rules protect investment advisors in this way complete your client forms. NASDAQ's know your client suitability rule is rule 2310. The NYSE's know your client is rule 405. Brokerages and other regulators have additional know your client policies and rules. The SEC has enforcement power over brokerages that require them to maintain know your client policies. Know your client rules require collection of suitability information both at account opening and with periodic updates.

(FIIs-Amendment) Regulations 2008. While on the one hand this amendment sees the earlier policy measures on ODIs (Participatory Notes) and the eligibility criterion modifications of October 2007 being incorporated in the regulations, it also sees fresh and significant modifications to the eligibility definitions for FII and sub accounts, measures that are intended to overall smoothen the registration process (Mehta, 2008) In another significant inclusion, NRIs are now eligible to be registered as FIIs (but not as sub accounts). 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. In October 2008, SEBI lifted the curbs, with the pace of slowing economic growth, companies facing a credit crunch and foreign investors fleeing the stock market. Interestingly, in the period from October to December 2008, when the Sensex dropped to the year's lowest, at least 100 new FIIs registered with SEBI. In June 2008, while reviewing the External Commercial Borrowing policy, the Government increased the cumulative debt investment limits from US $3.2 billion to US $5 billion and US $1.5 billion to US $3 billion for FII investments in Government Securities and Corporate Debt, respectively. In order to give a boost to the corporate bond market, the FII investment limit in rupee-denominated corporate bonds has been increased from $6 billion to $15 billion in January 2009. FIIs can now invest in interest rate futures that were launched at the National Stock Exchange (NSE) on 31st August 2000. As a result of encouraging policy measures by government of India, Foreign institutional investors have registered a remarkable growth in India.

III. GROWTH OF FOREIGN INSTITUTIONAL INVESTORS IN INDIA

Consequent to the liberalization of registration norms, the number of foreign institutional investors (FIIs) registered with the Securities and Exchange Board of India (SEBI) has increased to 1,514 (Figure 1) which includes Pension Funds, Mutual Funds, Investment Trust, Insurance and Reinsurance Companies, Endowment Funds, University Funds, Foundation or Charitable Trusts or Charitable Societies who propose to invest on their own behalf, Assets Management Companies[10] (AMCs), Nominee Companies, Institutional Portfolio Managers, Trustees, Power of Attorney Holders and Banks. In 2001, there were 482 foreign investors registered with SEBI (Securities and Exchange Board of India). The number increased to 489 in 2002 and to 517 and 637 in 2003 and 2004 respectively. With the increase in the number of FIIs, the number of sub-accounts registered with FIIs has also hit an all-time high. The number of FII sub-accounts[11] has reached 5,325 as on December 2009.

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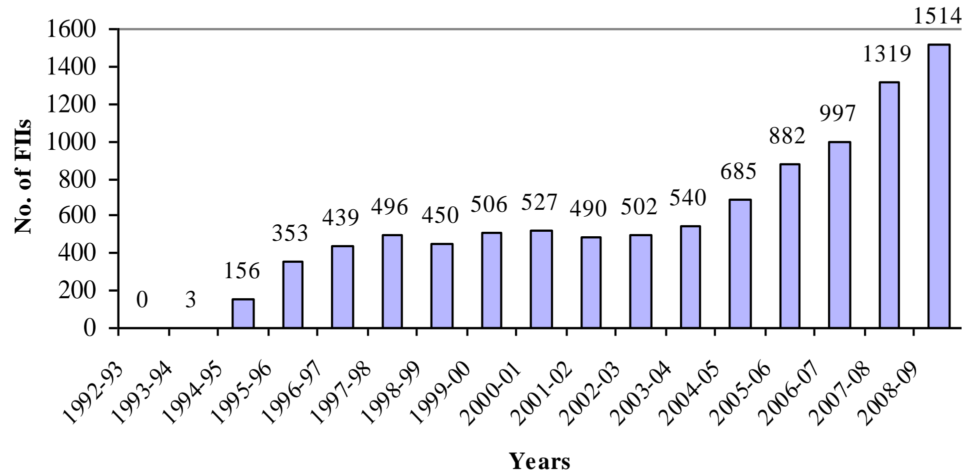
[10] An Asset Management Company (AMC) is an investment management firm that invests the pooled funds of retail investors in securities in line with the stated investment objectives. For a fee, the investment company provides more diversification, liquidity, and professional management consulting service than is normally available to individual investors.

[11] The sub account is generally the underlying fund on whose behalf the FII invests. The eligibility conditions for sub-accounts include: (I) the applicant may be an institution or fund or portfolio established or incorporated outside India and proposes to make investment in India; (II) the applicant may be a broad

Figure 1: Number of Registered FIIs in India



Source: SEBI

454 new (Table 1) FIIs registered with SEBI in 2008. FIIs registered with the SEBI, last year-equivalent to almost one-fourth the total operating in the country at the end of 2008. Last year, about one-third of the new FII registrations were from the US, and the UK came a distant second as the home of new FIIs that entered India last year. FIIs from other geographies that have registered include the UAE, Japan and Taiwan.

Table 1: New FIIs Registered from Different Countries in 2008-09

Country	No. of FII Registered
US	155
UK	67
Mauritius	33
Hong Kong	22
Singapore	21
Australia	21
Luxembourg	17
Ireland	16
Cayman Island	14
Canada	13
Others	75

Source: SEBI

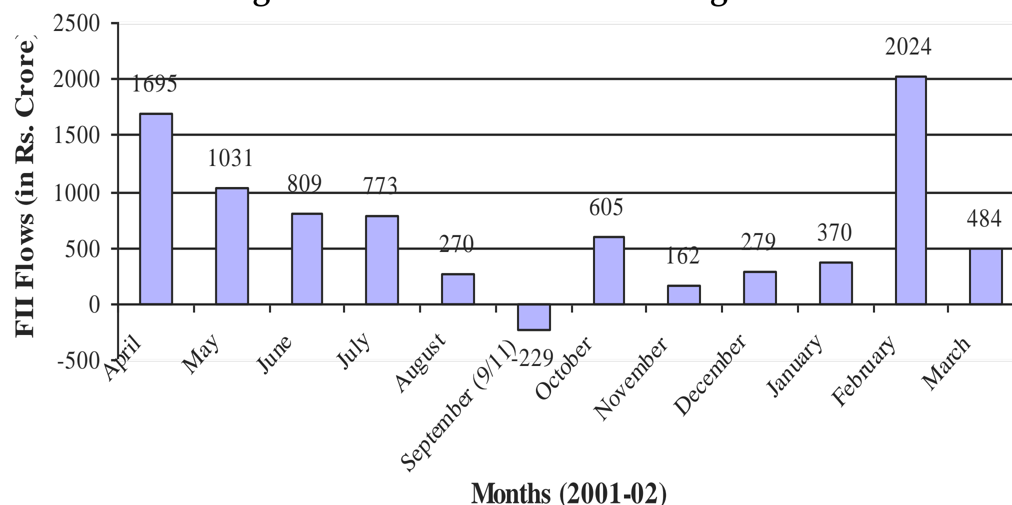
based fund or proprietary fund or a foreign institutional investor or a foreign corporate or foreign individual; (III) the Foreign Institutional Investor through whom the application for registration is made to the Board holds a certificate of registration as Foreign Institutional Investor. A non-resident Indian or an overseas corporate body registered with Reserve Bank of India should not be eligible to invest as sub-account or as foreign institutional investor.

Last year's global financial crisis has affected the number of investors registering with the Indian capital market regulator. Despite the gain of almost 80 per cent in the equity market in 2009, the number of new FII coming to Indian has touched a six year low. The number of new FIIs registered with the Securities and Exchange Board of India has declined 70 per cent in the 2008-09. Only 111 new FIIs got registered with SEBI till November, 2009 against as many as 375 in calendar year 2008 and 226 in 2007.

Growth and Magnitude of FIIs in India

FII flows to India formally began in September 1992 under the foreign portfolio investment (FPI) scheme, when the Government of India issued the Guidelines for Foreign Institutional Investment. However, the investments were first made in January 1993. Since then, FII investments have grown substantially (Sumanjeet, 2009). During the year 1994, net investments by FIIs were US $ 2164 million, which came down to US $ 1191.4 million in 1995. During 1996, net FII investments were at US $ 3058 million. Net monthly FII investment remained positive until November 1997, when they turned negative for the first time, the trend which continued till January 1998. Despite this, the overall investments during 1997-98 remained positive although they declined in 32 percent. Net investments by FIIs on a yearly basis turned negative at US $ 338 million for the first time during 1998.

Figure 2: FII Flows in India during 2001-02



Source: Compiled by Researcher from various sources

Since then, there have been steady improvements in the inflows in 1999 except for a marginal fall in 2000 and 2001. Decline in FIIs inflows in 2001 is largely attributed to 9/11 attacks on USA. However, the effect has tended to be short lived. Evidently, FII flows turned negative in September 2001 following the terrorist attacks, but recovered after a month (Figure 2). Thereafter, FIIs have shifted their position significantly, except for the a few instances of net outflows,

often coinciding with the external shock or a domestic political event. The cumulative net FII investments at the March end 2002 stood at US $ 15242.3 million (Table 2).

Table 2: Trends in FIIs Investment in India (1992-933-2008-09)

Year	Gross Purchase (Rs Crore)	Gross Sales (Rs. Crore)	Net Investment (Rs. Crore)	Net Investment (US$ Million)	Cumulative Investment (US$ Million)
1992-93	2661.9	66.8	2595.1	827.2	827.2
1993-94	9267.2	2476.1	6791.2	2164.8	2991.9
1994-95	6665.9	2812.2	3853.8	1191.4	4183.4
1995-96	15739.2	4935.6	10803.6	3058.2	7241.6
1996-97	18926.5	12719.2	6207.3	1746.7	8988.2
1997-98	13899.8	15379.7	-1479.9	-338	8650
1998-99	37221.5	30514.7	6696.8	1559.9	10209.9
1999-00	77666.6	71155.4	6511.2	1492.2	11702.1
2000-01	56799.2	43506.5	13292.7	2843.3	14545.3
2001-02	15286.4	11921.3	3365.1	697	15242.3
2002-03	470601	443710	26889	562	15804
2003-04	1448575	990940	457645	9949	25754
2004-05	2169530	1710730	458800	10173	35927
2005-06	3449780	3055120	394660	9334	477063
2006-07	5205090	4896680	308410	6709	51967
2007-08	9480196	8818422	661774	16040	68006
2008-09	1844490	2013450	168960	4189	63819

Source: Compiled by Researchers from Various Sources

FII investment registered at US $9949 million during 2003-04 against US $562 million in the corresponding period. The Inflows of FII during 2004-05 was US$ 10713. The net investment by FIIs in 2005-06 declined mainly due to large net outflows from the debt segment. FIIs declined by 46 percent in 2006-07. The months of August 2007, November 2007, January 2008 and March, 2008 saw net outflows of FII investment, with the largest pull out of US $ 2727 million in January, 2008. During 2008-09, till June 2008, FIIs have been net sellers to the tune of US $ 4,189 million. This can be attributed to the generally weak sentiments of investors following the global credit crisis, which has engulfed the developed countries and is seen to be affecting the developing countries as well. After their flight in 2008 (US $ 13 billion), FII flocked back to bet on the India growth story by pouring in a record over Rs 80,500 crore (Rs 805 billion) in domestic equities in 2009. FII inflow in 2009 has broken the previous high of Rs 71,486 crore parked by foreign fund houses in domestic equities in 2007. However, what makes 2009 different from the previous bull market year of 2007 is that a good portion of the FII investments this year came in through subscription to qualified institutional

placements[12] (QIPs), rather than the secondary market. According to the BSE category-wise turnover data (which captures secondary market investments on both the exchanges) net investments by FIIs in the stock markets have been only Rs 22,849 crore. QIP offers raised around Rs 42,000 crore (Venkatasubramanian, 2009), most of which has been subscribed by FIIs. This suggests that FIIs invested far more through the QIP route than through the secondary market route. FII flows remained dull until March 2009, when a combination of factors such as global liquidity crunch and, in the Indian context, the Satyam fraud and the possibility of a hung Parliament after the general elections weighed on inflows. But inflows started to swell from April 2009. The Congress-led UPA government won a decisive mandate without requiring the support of the Left. This gave confidence to FIIs that India will keep going on the road to reform and they invested massive sums in May 2009 (net investments: Rs 20,117 crore). Also aiding this inflow was the fact that central banks around the world had eased interest rates and infused capital into banks, which flooded the markets with abundant liquidity. Another important fact that needs to be highlighted is the rise of domestic institutional investors, whose investment in secondary markets was quite sizeable. With the Cayman Islands[13] Monetary Authority (CIMA) now being admitted as an 'ordinary member' of IOSCO[14], the investment gateway for

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[12] Qualified institutional placement (QIP) is a capital raising tool, whereby a listed company can issue equity shares, fully and partly convertible debentures, or any securities other than warrants, which are convertible into equity shares, to a qualified institutional buyer (QIB). Apart from preferential allotment, this is the only other speedy method of private placement for companies to raise money. It scores over other methods, as it does not involve many of the common procedural requirements, such as the submission of pre-issue filings to the market regulator. To enable listed companies raise money from domestic markets in a short span of time, market regulator Sebi introduced the concept of QIP in 2006. This was also done to prevent listed companies in India from developing an excessive dependence on foreign capital. Prior to introduction of QIPs, the complications associated with raising capital in the domestic markets had led many companies to look at tapping overseas markets via foreign currency convertible bonds (FCCB) and global depository receipts (GDR). This has also helped issuing companies price their issues closer to the prevailing market price. The specified securities can be issued only to QIBs, who shall not be promoters or related to promoters of the issuer. The issue is managed by a SEBI-registered merchant banker.

[13] The Cayman Islands is a major international financial center with over 9,000 registered funds. With a well-developed financial services sector, hedge funds with global investment strategies have set up their shop in the Cayman Islands.

[14] IOSCO" stands for the International Organization of Securities Commissions. It is a body comprising of securities regulators from across the world and includes the Securities and Exchange Board of India ("SEBI"), which is registered with it as an ordinary member. IOSCO has been primarily set up to achieve the following objectives, which it seeks to attain through its network of members:

- co-operation to promote high standards of regulation in order to maintain just, efficient and sound markets;
- exchange of information on their respective experiences in order to promote the development of domestic markets;
- unite their efforts to establish standards and an effective surveillance of international securities transactions;
- provide mutual assistance to promote the integrity of the markets by a rigorous application of the standards and by effective enforcement against offenses

investing in the Indian capital markets has opened up for Cayman Islands-based CIMA registered funds and fund managers.

IV. IMPACT OF FIIS

International capital investment can play a useful role in development by adding to the savings of low and middle- income developing countries (Michael and Menkhoff, 2003; Mody *et al*, 2001) in order to increase their pace of investment. However, foreign investment can also prove unproductive to developing economies by exposing them to disruptions and distortions from abroad, and by subjecting them to surges of capital inflows or massive outflows of capital flight (Dodd, 2004). Thus, foreign capital has several implications for any economic system. But, implications of foreign capital largely depend on many factors like absorption capacity of host country, size of investment and above all nature of investment. After significant outflows of FIIs in 2009, FIIs have made net investments of US$ 10 billion in the first six months (April to September) of 2009-10. For the long-term investment there is little reason for worry, but short-term traders are adversely getting affected by the role of FIIs are playing at present. Rakshi (2006) have argued that, far from being healthy for the economy, FIIs inflows have actually imposed certain burdens on the Indian economy. Sudden fall and sudden increase in FIIs in India has raised several issues before the policy makers regarding the real implications of FIIs. Impact of FIIs can largely be observed at: (1) stock market (2) exchange rate and (3) forex reserves.

Institutional investors have enormous financial clout in the world's financial markets, especially in BRIC (Brazil Russia, India, and China) nations. India, which opened its gates to foreign institutional investors in September 1992, in the wave of economic reforms, has seen the impact of institutional investment. It has also witnessed their strategies, trading techniques both in financial markets and business sectors. Their investment strategies have seen a profound impact on financial infrastructure and functioning of Indian Capital Markets. In India, major portion of these investments have come through the primary market, more than through buying via secondary markets. FIIs continued to invest large funds in the Indian securities market since 1992 (Table 3). For the two consecutive years in 2004-05 and 2005-06, net investment in equity showed year on year increase of 10 percent.

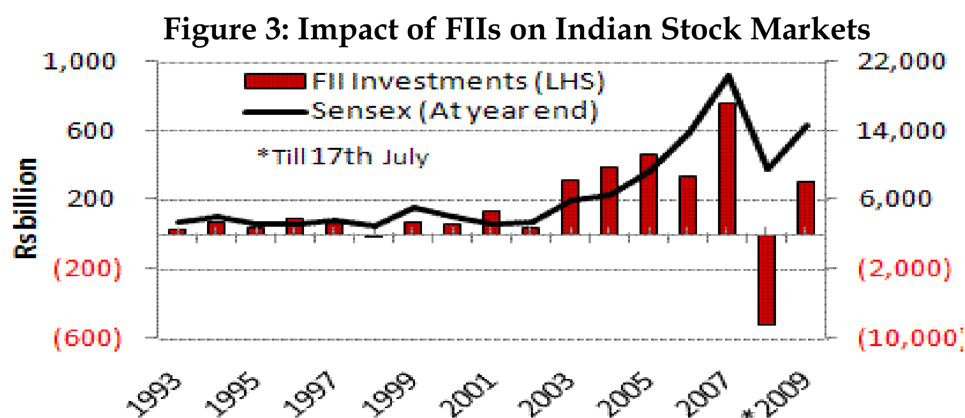
Table 3: Net Investment by FIIs in Equity and Debt (Rs Million)

Year	Net Investment in Equity	Net Investment in Debt
2001-02	80,670	6,850
2002-03	25,280	600
2003-04	399,590	58,050
2004-05	441,230	17,590
2005-06	488,010	*-73,340*
2006-07	252,370	56,070
2007-08	534,038	127,753
2008-09	*-140,325*	*-28,663*
2009	61954.40	3282.12

Source: NSE

Net investment in equity by FIIs was seen in 2007-08 of Rs. 534,038 million (US $ 13, 361 million) an increase of 112 percent over the 2006-07 net investment figure of Rs. 252,370 million (US$ 5,790). During the first quarter of the fiscal 2008-09, FIIs have been net sellers in the equity markets. They sold equity worth Rs 140,325 million (US$ 3,267 million). This has changed the face of Indian stock market. It had brought both quantitative and qualitative change. It had also increased the market depth and breadth. The emphasis on fundamentals had caused efficient pricing of shares. Since there is no condition on FIIs that they should disclose in which company they are investing, those figures are not available. Since FII are the most successful investors in India and their investments and disinvestments (Inflows and outflows) also determine the direction of Indian stock market (Figure 3 and 4) Many qualitative tests like regression tests had proved that there is direct relation between market movements and fund flows of FIIs.

Figure 3: Impact of FIIs on Indian Stock Markets

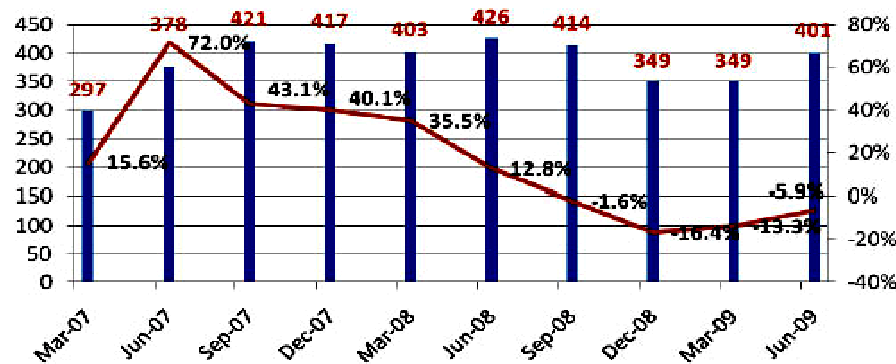


Source: RBI

Figure 3 clearly shows that there is relationship between FIIs inflows and stock market performance. In keeping with the FII flows (Srinivasan and Bhat, 2009), the Sensex rose from 3,000 points in May 2003 to its peak on May 10, 2006 up 420

per cent. Even as the SEBI and the Finance Ministry celebrated the surge, there were warnings from abroad. Interestingly, the dependence of the Indian equity markets on the foreign investors is further proved by the fact that in the period between May 10, 2006 and June 14, 2006, when the Sensex moved from a high of 12,612.38 to a low of 8,928.44, FIIs were net sellers at nearly Rs 9,500 crore. In other words, FIIs sold equities worth Rs 365 crore on an average on each of the 26 trading sessions. Significantly, in 2008 FIIs had pulled out a net Rs 52,900 crore (Rs 529 billion) from the domestic bourses-a trend triggered with the collapse of global financial services icon Lehman Brothers in the middle of September 2008. As a result, the index has dropped 33 per cent in 2008 (Figure 4), its worst six months since the benchmark's introduced in 1979.

Figure 4: Nifty Index Chart



Source: NSE

During 2009, when the stock market barometer added over 70 per cent to its valuation, foreign institutional investors (FIIs) made a net investment of whopping over Rs 80,500 crore (about 16.8 billion dollars) in the Indian share market. The Bombay Stock Exchange's benchmark Sensex, comprising 30 blue-chip stocks, has gained more than 70 per cent so far in 2009, one of the best performers among leading global bourses. Keeping in pace with FIIs, the Sensex surged to 17,644.76 on March 26, 2010 from 16,254.20 on February 2010.

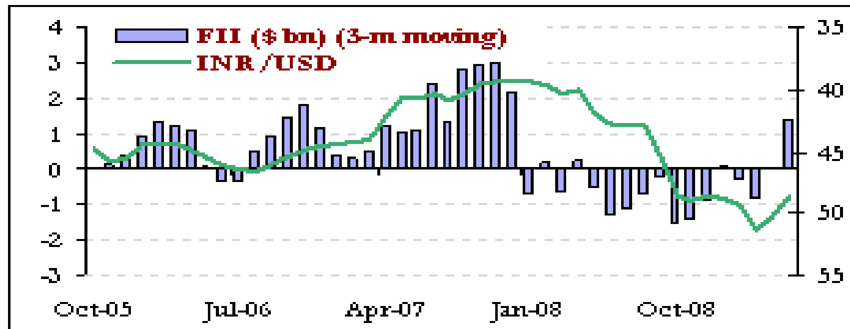
Recently, a new index, Instanex FII index[15], has come into existence. This is similar to the Sensex and Nifty. It gives a feel of the FII pulse, and their moves in the stock markets. The Instanex FII index tracks the 15 stocks in which FII funds have been invested. These 15 stocks under the Instanex index account for 55 per cent of the market capitalization of the FII holdings. Long-term investors can track the FII investment data released by SEBI. The net FII investment data helps in understanding the mood of the FIIs. Since they are key drivers of stock markets, tracking their investment data helps in understanding the decisive

[15] A new index, namely the Instanex FII Index came into existence to compete Nifty and Sensex. It will track the 15 stocks in which FII funds have been invested. These stocks account for 55 per cent of the market cap of the FII holdings in India.

direction of the stock markets. However, there are also evidences that relationship between FII and Stock market is weak (Gordon and Gupta, 2003; Wang and Shen, 1999). But, in general, FIIs buying pushes the stocks up and their selling shows the stock market the downward path. Digging into a subjective interpretation of the correlation between Sensex rally from 2006 to 2008 and FII investment for the same period, one can see that when the Sensex crossed the 15, 000 mark for the first time, net FII investment was Rs. 31.79 billion. When the Sensex crossed 17,000 mark, the net FII investment strangely had fallen down to Rs. 10.04 billion. At 19,000 mark, FII investment was lower at Rs. 7.81 billion. But suddenly, when the Sensex breached the 20,000, net FII investment was at Rs. 18.48 billion. That puts paid to the theory that FII have mostly been reason for the rise in the Sensex (Moin, 2010). FII contribution to the rise of the Sensex is more psychological than real.

FIIs also have an impact on the foreign exchange rate (Klein and Rosengrem, 1992). FII inflows make the currency of the country invested to appreciate (e.g. FII investing in India may lead to Rupee appreciating with several other currencies) and their selling and disinvestment may lead to depreciation (Mishra, 2008; Sumanjeet, 2007). Figure 5 clearly indicates that there is relationship between FIIs inflows and value of Indian rupee.

Figure 5: Impact of FIIs on Exchange Rate



Source RBI

Forecasters were very bullish on India's growth story in the beginning of 2008 and were anticipating heavy FII inflows. But FIIs actually pulled out $9.3 billion from Indian markets in 2008. Due to these heavy capital outflows the INR tumbled to around 50-levels against the US$ in December 2008. In 2008 dollar was weakening against the Euro and the pound. But that was not the case with the rupee, because capital flows were not good. The Reserve Bank of India sold a record $20.63 billion foreign currency during October to check steep depreciation of the rupee. In another evidence, the rise of the rupee was the key economic development of 2007. FII investment saw the rupee close 2007 at 39.41 against the US dollar. Overseas investors bought a record $17.2 billion of Indian shares in 2007, helping the rupee gain 12.3 per cent, the biggest annual gain since 1974. It touched 39.19 against the dollar on November 7, last year, the highest in nearly a decade. Recently on 17th May 2010, FII pulled out Rs. 1,224 crore from the stock

markets though losses capped by Larsen & Turbo's forecast beating quarterly earnings and recovery in European shares. The FII outflow is considered temporary as foreign investors are likely to step up investments in strong emerging markets like India. The FII pullout was one of the reasons for the fall in the rupee as well. The rupee fell to its lowest level in nearly two and half months on 17th May 2010 as sovereign debt worries in the euro zone sent the single currency to four year lows. The Indian currency closed at 45.63 per dollar after hitting 45.77, its weakest since March 5, 2010.

India's foreign exchange reserves have grown significantly since 1991. The robust accretion to the forex reserves is mainly on account of foreign institutional investors (RBI, 2007) chasing higher returns in the Indian stock markets. Foreign exchange reserves rose $2.3 billion during the week ended July 17, 2009, on the back of inflows as a result of share purchases by foreign institutional investors and external commercial borrowings by corporates. The FIIs have sold stocks worth Rs 10,000 crore in June 2006 and added to the depletion of forex reserves (US$ 370 million). Table 4 details the major sources of accretion to foreign exchange reserves during the period from March 1991 to March 2009.

Table 4: Sources of Accretion of FOREX Reserves since 1991 (US$ Billion)

Items		1991-92 to 2008-09
A	Reserves Outstanding as on end March 1991	5.8
B.I	Current Account Balance	-81.6
B.II	Capital Account (Net *a* to *e*)	331.7
a	Foreign Investment	155.2
	FDI	75.8
	FII	51.6
b	NRI Deposits	*34.1*
c	External Assistance	18.6
d	ECBs	*68.2*
e	Other Items in Capital Account*	55.6
B.III	Valuation Change	*-4.0*
	Total (A+BI+BII+BIII)	252.0

Source: Reserve Bank of India

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 FII's. 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 of demand-pull inflation). Thus there should be a limit to the FII inflow in the country. FII bring lot of funds to the country' markets leading to free availability of funds for the local

companies in need of funds to carry on expansion in their production capacities or starting new ventures.

V. ISSUES OF CONCERNS

From the above discussion it is clear that FIIs has strong implications on Indian economy. In fact FIIs are more than just money. It represents investor's sentiments. Various studies revealed (Batra, 2003; Krishnamurti *et al* 2003) that importance of such capital is foremost for the developing countries like India. FIIs investments are non-debt creating flows, also a reason why Indian policymakers sought to liberalize such flows in the wake of BOP crisis in 1990-91[16]. FIIs inflows bring global liquidity into the equity markets and raise the price-earning ratio and thereby reduce the cost of capital domestically. FIIs inflows help supplement domestic savings and smoothen inter-temporal consumption. But, recent upsurge of FIIs has raised several issues before the policy makers. Some of the most important are:

First, with the increasing number of FIIs dominating the capital markets and a sizeable portion of foreign investment coming in through FIIs, their taxation in India has assumed considerable significance. There has always been ambiguity in respect of characterization of income earned by FIIs on transfer of securities as capital gains or business income. Historically, most FIIs have been offering gains from transfer of securities to tax as capital gains-a position that has also been accepted by the revenue authorities. However, several rulings by the Indian Authority for Advance Ruling[17] (AAR) examined the characterization of income arising on transfer of securities in the case of FIIs. In a recent ruling, AAR held in the case of a UK based FII that income from purchase and sales of derivatives contracts constitutes business income and is not taxable in India in the absence of a permanent establishment (PE) in India. Further, on the basis that FIIs did not

[16] Crisis was caused by current account deficits and currency overvaluation. The economic crisis was primarily due to the large and growing fiscal imbalances over the 1980s. During mid eighties, India started having balance of payments problems. Precipitated by the Gulf War, India's oil import bill swelled, exports slumped, credit dried up and investors took their money out. Large fiscal deficits, overtime, had a spill over effect on the trade deficit culminating in an external payments crisis. By the end of 1990, India was in serious economic trouble. The gross fiscal deficit of the government (center and states) rose from 9.0 percent of GDP in 1980-81 to 10.4 percent in 1985-86 and to 12.7 percent in 1990-91. For the center alone, the gross fiscal deficit rose from 6.1 percent of GDP in 1980-81 to 8.3 percent in 1985-86 and to 8.4 percent in 1990-91. Since these deficits had to be met by borrowings, the internal debt of the government accumulated rapidly, rising from 35 percent of GDP at the end of 1980-81 to 53 percent of GDP at the end of 1990-91. The foreign exchange reserves had dried up to the point that India could barely finance three weeks worth of imports.

[17] To facilitate foreign investment into the country a number of steps have been taken by Government of India in recent period. Setting up an Authority for Advance Rulings, Central Excise, Customs & Service Tax to give binding rulings, in advance, on Central Excise, Customs and Service Tax matters pertaining to an investment venture in India is one such measure. The legal provisions of Advance Rulings were introduced through the Finance Acts of 1998, 1999 and 2003. The scheme of Advance Rulings has assumed special significance in the context of greater emphasis on FDI. Advance Rulings afford far greater certainty to foreign investors in respect of their prospective indirect tax liabilities.

have a (PE[18]) in India, the income of FIIs was held to be not taxable in India under the provisions of the applicable tax treaty. Another issue faced by FIIs is the manner of set-off of capital losses incurred prior to April 1, 2002. Up to (and including) financial year ended March 31, 2002, the Act permitted a tax payer to set-off losses from one source against income from another source under the same head of income (the Act was amended effective April 1, 2002 restricting the manner of set-off of long-term capital losses).

Second, issue is related with P-Notes (PNs). Investing through P-Notes is very simple and hence, very popular. 'Hedge funds', which invest through participatory notes, borrow money cheaply from Western markets and invest these funds into stocks in emerging markets. This gives them double benefits: a chance to make a killing in a stock market where stocks are on the rise; and a chance to make the most of the rising value of the local currency. P-Notes are issued to the real investors on the basis of stocks purchased by the FII. The registered FII looks after all the transactions, which appear as proprietary trades in its books. It is not obligatory for the FIIs to disclose their client details to the SEBI, unless asked for specifically. However, Indian regulators are not very happy about participatory notes since they have no way in knowing who owns the underlying securities. Regulators fear that the hedge funds, acting through participatory notes, will cause economic volatility in India's exchanges. Hedge funds were largely blamed for the sudden sharp falls in indices. Unlike FIIs, hedge funds are not directly registered with SEBI, but they can operate through sub-accounts with FIIs. These funds are also said to operate through the issuance of participatory notes (Bahadur, 2007). According to the SEBI, the current position of these instruments is as follows: Currently, 34 FIIs /Sub-accounts issue ODIs[19]. This number was 14 in March 2004. The notional value of PNs outstanding, which was at Rs 31, 875 crore (20 per cent of Assets under Custody (AUC) of all FIIs/Sub-Accounts) in March 2004, increased to Rs 3, 53,484 crore (51.6 per cent of AUC) by August 2007. The value of outstanding ODIs, with underlying as derivatives, currently stands at Rs 1, 17,071 crores, which is approximately 30 per cent of total PNs outstanding. The notional value of outstanding PNs, excluding derivatives, as underlying a percentage of AUC is 34.5 per cent at the end of August 2007. This implies that more than 50 per cent of the funds are flowing through this anonymous route, which needs to be re-thought with regard to this entire issue.

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[18] The concept of permanent establishment is one of the most important issues in international double tax treaty law. Virtually all modern tax treaties use PE as the main instrument to establish taxing jurisdiction over a foreigner's unincorporated business activities.

[19] In the context of the Indian market, offshore derivatives instruments (ODIs) are investment vehicles used by overseas investors for an exposure in Indian equities or equity derivatives. These investors are not registered with SEBI, either because they do not want to, or due to regulatory restrictions. These investors approach a foreign institutional investor (FII), who is already registered with SEBI. The FII makes purchases on behalf of those investors and the FII's affiliate issues those ODIs. The underlying asset for the ODI could be either stocks or equity derivatives like Nifty futures.

Third, should FIIs be taxed on Indian like Brazil[20]? India's discomfort is widely shared. Less than a year ago, policy makers in emerging economies fretted about capital flight. There reserves were falling as foreigners tried to raise cash by ditching whatever assets they could sell. Several governments queued up for emergency loans from the IMF or a currency swap with the Federal Reserve. Now they are worried about capital flowing in the opposite direction. Many emerging economies are reluctant to impose such controls. They fear such an infringement on economic freedom will cast doubt on their commitment to market friendly policies. Brazil seems almost apologetic about its taxes, which it insists are meant only to prevent excesses. India, by contrast, is less bashful about these things. It is proud of its 'carefully calibrated' easing of capital restrictions over the past 18 years. It has no need to impose a tax on foreign investment because such purchases are still banned beyond a fixed amount. At opposite front, experts argued that investments in Indian equities are likely to exceed record levels of close to US$ 18 billion in the current fiscal. If this goes unchecked, neither the rupee appreciation be stopped nor inflation put to check and India's exports competitiveness would gradually fizzle out. Imposing the tax would help the RBI to manage rupee at reasonable levels to safeguard and support Indian exporters, hit hard by input cost and appreciating rupee.

Fourth, today India is in a situation where, purely due to a surfeit of capital flows, equity primary market issuances are aggressively priced and are getting subscribed largely by institutional investors with limited participation by retail. Not surprisingly, most of them are quoted at a discount post listing. Land and real estate (which saw large infusion of foreign capital flows between 2007 and 2008) prices ran up too much too fast and almost formed a virtual bubble. India is witnessing the adverse effects of overpricing even now. At a point in time in 2007 when huge capital flows were clearly driving stock prices, secondary markets in equities saw valuations for certain sectors being discounted 3 or 4 years forward as opposed to 1 year that markets traditionally follow. Were those valuations justified?

Fifth, issue of concern is hedge funds. The problem with hedge funds is that they operate in unregulated realms; their dealings are secret and operational methods opaque. Many of them could be OCBs which have been banned after the Joint Parliamentary Committee (JPC) report on stock scam. Much of it is "*round tripping*.".

[20] Brazil 's recent experience to impose a 2 per cent tax on free capital inflows has wide ranging implications for global finance ad for the countries such as India. The move is aimed at arresting the sharp appreciation of its currency, which since the beginning of the year has gained 36 per cent against the dollar, undermining Brazil's export competitiveness. This is not the first time that a major developing country has imposed restrictions on foreign inflows. In 1998, during the Asian currency crisis, Malaysia defied financial orthodoxy and imposed controls in a successful attempt to curb currency speculation, which devasted any of its neighbors.

Last but not the least, FIIs are not allowed to trade in currency futures. Currency futures trading currently are being offered by MCX-SX[21], NSE and BSE. The market regulator, SEBI, has said it is looking at easing restrictions in currency futures trade and the possibility of including more market participants in currency futures trade. Lessons from domestic stock markets indicate that FII participation has the potential to make currency futures segment more speculative and volatile. Rupee being the currency of a major economy such as India, contrarian views on its current strength and position could lead to wide swings in currency rates affecting trade balance.

VI. CONCLUDING REMARKS

FII inflows and control have emerged as important policy issue in India. Among the Indian policymakers, FIIs flows are believed to have a positive impact on the country's development. FII flows supplement and augment domestic savings and domestic investment without increasing the foreign debt of country. Added to this, FII inflows to the equity market increase stock prices, lower cost of equity capital and encourage the investment by Indian firms and lead to improvements in securities market design and corporate governance. But, recent upsurge in FIIs inflows have generated many issues of concerns. Some issues are real, whereas others are just exaggerated. A biggest issue of concern is capital flight and its impact on stock market (Sumanjeet, 2010). The FII manipulate the situation of boom in such a manner that they wait till the index rises up to a certain height and exit at an appropriate time. This tendency increases the volatility further. But, volatility is too good for the market as it helps in keeping the economy cycle moving and it will again help the values of the stocks at a fair price for investments to again keep flowing and so will the FIIs too. It was the same in the case of impact of FIIs on currency appreciation. The FII lead to appreciation of the currency, they lead to the exports industry becoming uncompetitive due to the appreciation of the rupee. But, recent evidence suggests that export is largely influenced by many other factors like cost and quality of product, not only by value of currency. The real problem with FII is that it can not be utilized for long term like FDI and also gives false representation of economy. Various studies blamed FIIs for exacerbating some economic problems in a country by making large and concerted withdrawals at the first sign of economic weakness. Large share of FIIs in Forex reserves also 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

[21] MCX Stock Exchange (MCX-SX) - India's New Stock Exchange was launched in October 2008, under the regulatory framework of Securities & Exchange Board of India (SEBI). The exchange received approval from SEBI and Reserve Bank of India (RBI) and launched a platform for trading currency futures. Currently MCX-SX offers Currency Futures contracts. Clearing and Settlement is conducted through the MCX Stock Exchange Clearing Corporation Ltd (MCX-SX CCL).

cost of sterilizing inflows. But in nutshell, any problem related with FIIs is basically problem of management. India should develop new tools to manage FIIs effectively and efficiently. India must learn to live with foreign capital eventually, as its regulators freely admit. Some capital control may help. But its current rules seems less like stepping-stones to a more open future than relies of its shuttered past.

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