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Equity Investments by Foreign Institutional Investors (FIIs) in the Indian Capital Market

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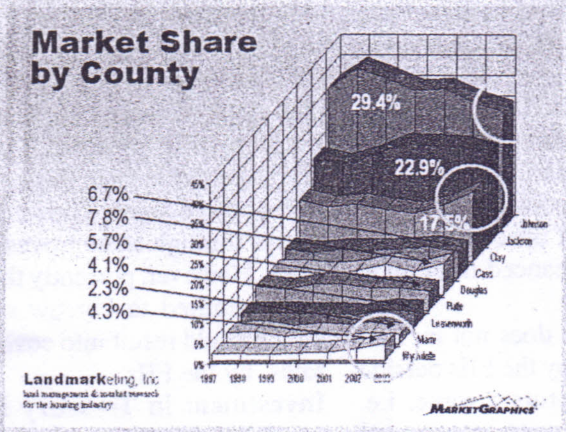

The Capital Market is used as a main vehicle to mobilize funds for economic growth of a country. It performs crucial functions like the conversion of savings of households and institutions into different investments, creation of financial assets and development and use of asset related products. The Indian capital market witnessed unprecedented euphoria in the early nineties and it won critical appreciation from various quarters. The Indian companies mainly raise funds through capital market. In the globalization era, every country encourages investment. In order to encourage investment necessary changes in the existing regulation/ new laws are made and India is no exception to this. Investment by individuals and institutions are encouraged in India. Today, FIIs are permitted to invest in all securities including equity shares and other securities listed or to be listed on the stock exchanges. Over the years, different types of FIIs have been allowed to operate in Indian Stock Markets. FIIs may invest in India through two routes: Equity Investment route and Debt route. Against this background, this paper discusses the current trend of equity investment by FIIs in the Indian Capital Market.

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The Indian companies mainly raise funds through capital market.Two types of capital are essentially raised viz equity and debt. The debt capital includes its various kinds of debts and bonds. It is true that there is considerable difference in the quality of capital raised through equity rather than that of debt. The equity forms part of 'Networth', the key determinant of capital stock while the debt forms part of outside liability of the firm.

2. Significance of Equity Capital

The following are select significance of equity capital. The debt capital reduces the borrowing power of the firm. Equity enhances the borrowing power from banks and financial institutions. This is highly desirable for the overall growth of an economy.

- If a firm is able to mobilize sizable amount of equity capital through primary market, it can approach banks to fund long-term investment.
- Banks generally would be willing to finance all such firms which are able to arrange required capital through public issue of equity. In other words, banks will be reluctant to finance firms which fail to raise capital through public issue.
- The capital raised through equity is of superior capital rather than that of debt capital.

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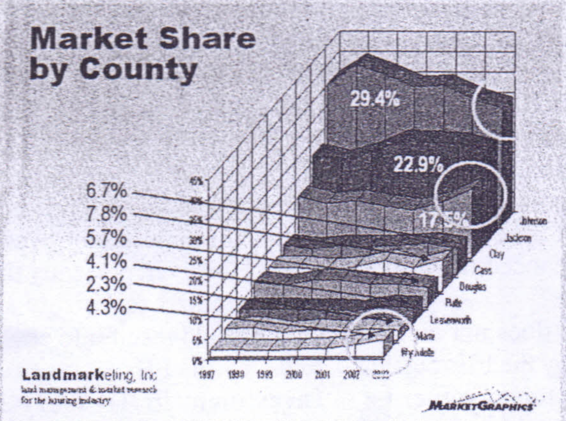

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3. Entry of FIIs

The union Government allowed the entry of FIIs in order to encourage the capital market and attract foreign funds to India. Today, FIIs are permitted to invest in all securities including equity shares and other securities listed or to be listed on the stock exchanges. Over the years, different types of FIIs have been allowed to operate in Indian Stock Markets. They now include institutions such as pension funds, mutual funds, investment trusts, asset management companies, nominee companies, incorporated institutional portfolio managers, university funds, endowments, foundations and charitable trust, societies with a track record. The proprietary funds have also been permitted to make investments through the FIIs route subject to certain conditions.

4. Regulatory Framework

The quick perusal of available literature shows that FIIs are the primary source of portfolio investment in India. In September 1992, the Government of India announced the opening of the country's stock markets to direct participation by FIIs through guidelines for Foreign Institutional Investment. In November 1995, the SEBI (Foreign Institutional Investors) Regulations 1995 had been notified, which were largely based on the earlier guidelines. The regulations require FIIs to register with SEBI and to obtain approval from the RBI under the Foreign Exchange Regulation Act, 1973 to enable them to buy and sell securities to open foreign currency and rupee bank accounts and to remit and repatriate funds.

Equity Investment

FIIs may invest in India through two routes: Equity Investment route and 100% Debt route. Under the equity investment route 100% investments should be in the equity-related instruments or up to 30% could be invested in debt instruments, i.e.70% in Equity Instruments and 30% Debt Instruments. Under the 100% debt route, 100% investment has to be made in debt securities only. In the case of equity route, the FIIs can invest in the securities in the primary and secondary market, units floated by the UTI and other domestic mutual funds and warrants. In the case of debt route, the FIIs can invest in debentures, bonds, dated government securities, treasury bills and other debt market instruments. A FII (investing on its own behalf) or a sub-account can hold upto 10% of Paid-up Equity Capital of any company.

Total Investment

The total investment by FIIs and Sub- accounts in any Indian Company cannot exceed 40% of its total Paid-up Capital. However, this is Subject to-

(a) Approval by the board of directors of the company to the enhanced limit up to 40%.

(b) A special resolution passed by the general body of the company approving the enhanced limit up to 40%.

The 40% limit does not include investments made by the FIIs outside the portfolio investment route, i.e. through the direct investment approval process. Investments made offshore through purchases of Global Depository Receipts and convertibles are also excluded. The overall investment limit is monitored by RBI. When the overall investment by FIIs reaches 38% in a company, RBI gives a caution notice. Subsequently, all purchases have to be done by prior approval of RBI. However, for Public Sector Banks (except HDFC Bank), the investment limit is 20% and the trigger point is 18%.

Investment in Debt Securities

FIIs can make 100% investments in debt securities subject to specific approval from SEBI as a separate category of FIIs or sub-account. Investment by FIIs in debt through the 100% debt route is subject to an overall capital under the category of external commercial borrowings. SEBI allocates individual ceilings to FIIs or sub-accounts within this overall limit on the basis of their track record or experience in debt markets. FIIs investing through 100% debt route may either invest proprietary funds or on behalf of broad based funds. There is no limit on investment in the debt securities of any particular issuer. FIIs are permitted to invest in derivative contracts, which are traded on a recognized stock exchange.

Tax Rate

FIIs have to pay tax at the rate of 10% on long-term capital gains, at the rate of 30% on short-term capital gains and at the rate of 20% on interest income. The amount invested by FIIs is fully convertible with the permission from the RBI under the Foreign Exchange Regulation Act -1973. This permission is procured by SEBI. The stock-lending scheme was introduced by SEBI in 1996. The FIIs the active participants in the Indian securities, have been allowed to lend stocks through an approved intermediary. However, presently the FIIs are not permitted to borrow securities, which could result into covered short sales, by the FIIs.

Investment in Treasury Bills

While announcing the policy measures relating to the Government securities market in the credit policy announcement on April 29, 1998, the RBI allowed FIIs to invest in treasury bills within the overall approved debt ceiling. A previous amendment in 1997 had permitted FIIs to invest in proprietary funds and also to invest in dated Govt securities.

The finance minister in his budget speech for 1998-99 announced that FIIs investing through the 100 percent debt route would be permitted to invest in unlisted securities. Amendments to this effect have been approved and notified by the SEBI. The SEBI (Foreign Institutional Investors) regulations 1995 require FIIs to

TABLE-I

EQUITY INVESTMENTS BY FIIs IN THE INDIAN CAPITAL MARKET

(Rupee in crore)

Year/Month	Apr.	May	Jun.	Jul.	Aug.	Sept.	Oct.	Nov.	Dec.	Jan.	Feb.	Mar.	Total Investment	
													Annual	Cummulative
1992-93										0.56	0.29	3.42	4.27	
1993-94	4.71	41.39	95.95	148.54	298.67	166.76	195.27	1087.27	565.3	1233.6	787.13	820.01	5444.6	5444.87
1994-95	525.39	882	816.37	328.23	424.65	442.64	544.3	61.88	26.16	232.32	293.1	199.26	4776.6	10225.47
1995-96	186.58	203.03	360.58	647.88	548.19	409.87	320.87	191.05	412.3	737.98	1613.39	1089.18	6720.9	16946.37
1996-97	1472.59	1036.27	1041.79	874.45	148.38	364.66	365.81	402.64	422.23	339.74	424.08	493.56	7386.2	24332.57
1997-98	624.74	889.14	1403.88	1002.8	493.66	598.59	641.59	-289.87	-182.38	-374.97	629.05	472.22	5908.45	30241.02
1998-99	169.17	-557.45	-896.3	104.68	-390.83	111.09	-552.46	47.37	307.46	370.38	354.11	203.67	-729.11	29511.91
1999-00	814.61	1523.52	504.27	1508.49	-11.7	-877.84	-734.9	1196.83	1571.33	184.31	2726.58	1359.63	9765.13	39277.04
2000-01	2438.06	172.17	-985.51	-1569.19	1626.01	-454.2	76.32	1090.11	-461.78	3971.58	1574.14	2204.8	9682.52	48959.56
2001-02	1694.98	1030.83	808.64	773.45	270	-228.91	604.98							

Source: Handbook of Statistics on Indian Economy, RBI, 2001.

CHART-I

FIIs Annual Net Investment and Cummulative Net Investment

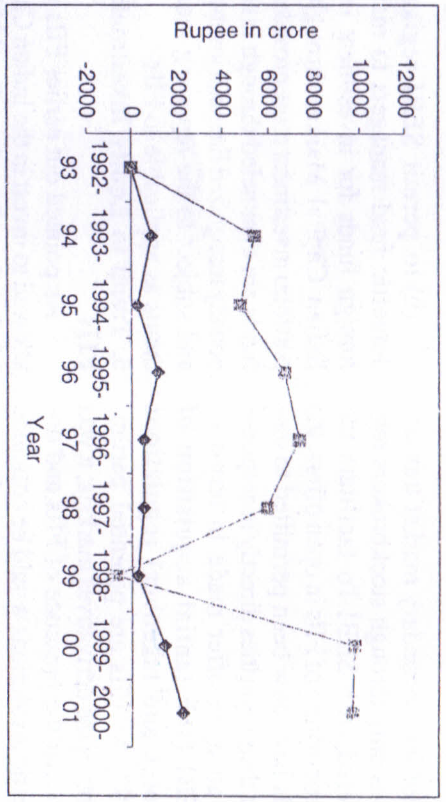

TABLE-II

GROWTH TREND OF EQUITY INVESTMENTS BY FIIs

Year/Month	Annual Investment	Growth Trend
1992-93	4.27	2783.23
1993-94	5444.6	3447.41
1994-95	4776.6	4111.59
1995-96	6720.9	4775.77
1996-97	7386.2	5439.95
1997-98	5908.45	6104.13
1998-99	-729.11	6768.31
1999-00	9765.13	7432.49
2000-01	9682.52	8096.67

Source: Computed from Table-I

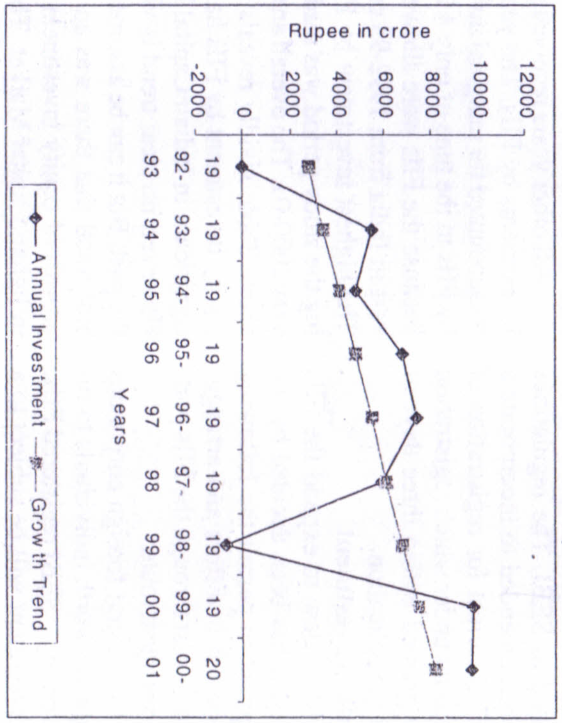

CHART-II

Growth Trend of Equity Investments FIIs

enter into secondary market transactions only through stockbrokers registered with SEBI. To facilitate the participation of FIIs in open offers, the FIIs have now been permitted to tender their securities directly in response to an open offer made in terms of SEBI (substantial acquisition of shares and takeover) regulations 1997. As FIIs are potential participants in the derivatives markets; it was felt that the presence of FIIs and domestic institutions would be critical to the success of the market. It was; therefore, decided to permit FIIs to buy and sell derivative contracts traded on a stock exchange.

According to section 12 and 13 of the SEBI (Foreign Institutional Investors) regulations, 1995, FIIs may invest on behalf of sub-account, which are registered, with SEBI. While considering an application for registration of sub-accounts, the regulations required submission of detailed information for registration. Under this procedure, considerable time was sometimes taken in determining whether the applicant was "broad based" as required by the regulations. To simplify the registration process for sub-accounts, it has been decided that the determination of fulfillment of broad based criteria be done by the FIIs itself and a declaration to this effect be submitted to SEBI. The regulations have been amended to incorporate a simplified format for registration of sub-account under which registration is now granted within three days of receipt of application.

Portfolio Investment

With a view to expand the FIIs category, it has been decided by the government to permit the following categories of investors and arrangements to invest through the FIIs portfolio investment route:

(a) to permit foreign corporates and high net worth individuals to invest through SEBI registered FIIs. Such investment will be subject to a sub limit of 5% within the aggregate limit for FIIs portfolio investments of 40% in a single company; and

(b) to permit SEBI registered domestic fund managers to manage foreign funds for investment in the Indian Capital Market through the portfolio investment route provided the funds are channeled through internationally recognized financial institutions and subject to the reporting requirements as applicable to FIIs.

5. Trend in Equity Investment by FIIs

As pointed out earlier FIIs were allowed to invest in the Indian Capital Market Securities from Sep 1992 but investments by them were first made in Jan 1993. Table –I shows equity investments by FIIs in the Indian Capital Market from 1992-93 to 2001-02. The equity investments by FIIs have been increased with fluctuations from 4.27 crore in 1992-93 to 9682.52 crore in 2000-01. It is surprise to record here that the year 1998-99 received negative growth of Rs.729.11% for the first time. The reason for the negative investment was by a factor, which led to continuous out flow of funds during the middle and end of the year 1988. Further the credit worthiness of almost all the south-east Asian countries was severely affected by the crises, which started in July 1997. As a result, the FIIs were facing heavy redemption pressures from the emerging market funds.

All other years received positive investments by FIIs. The year 1992-93 accounted for marginal investment by FIIs to the tune of only 4.27 crore because the FIIs were allowed to invest in India from 1992-93 onwards. The highest investment by FIIs during the study period was made in the year 2000-01. The overall analysis of above Table vividly reveals that the equity investment by FIIs have been significant in Indian Capital Market. However, no clear trend is visible in the past. But it can be assumed a general trend that there was an upward growth of equity investment by FIIs in Indian Capital Market. The chart-I explains FIIs annual & cumulative investment in Indian Capital Market.

The trend of equity investment by FIIs is given in Table-II. The upward trend of equity investment by FIIs calculated by using linear trend (y=a bt) method. The Table shows that the rate of upward growth of equity investment was recorded at Rs.664.18 crore every year. This upward trend of equity investment may continue in future too. Then the growth rate equity investment would be about Rs.14738.47 crore by the year 2010-11. This will have positive implication for the economy of our country. The foreign exchange reserve may also improve as a result of equity investment by FIIs. The chart -II shows the upward trend of equity investment by FIIs in Indian Capital Market during the period from 1992-93 to 2001-02.

6. Conclusion

The entry of FIIs in the Indian Capital Market demands the active and growing role of capital market and evolution of the institutions and financial structure to support it. FIIs are mainly concerned about macro-economic policy of India. They expect privatization programme to create an appropriate climate for portfolio investment. However there is no certainty about how long FIIs will hold on to their investment. i.e. when they will sell for profit and repatriate the earning in foreign currency. It is, a known fact from past experience that worldwide FIIs are branded as notoriously fickle investors. The recent east-Asian crisis also reinforced these doubts.

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