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# IMPLICATIONS OF FINANCIAL SECTOR REFORMS FOR FDI IN INDIA

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***Abstract***

*The financial sector reforms and globalization of Indian economy in 1991 invited many Foreign Institutional Investors to India. The global economy focused its concentration on India's economy and found viable earning domains in India. This induced the rapid increase in Foreign Direct Investments (FDI) in India and mutual economic developments of foreign countries and India. Several research papers clearly noted the implications of financial sector reforms in the Indian Capital Market, the growth of IT, steel and pharmaceutical industries. The changes in Primary, and Secondary Market, their respective instruments and the changes in their return on investments are predominant in determining the potentiality of FDI in India. The main aim of this research article is to explore the factors influencing Foreign Institutional Investors (FII) to invest in various portfolios in Indian Capital Market. In particular, the total investment, total assets and total sales in Indian Capital Market are analyzed systematically. The study is based on Secondary Data. Trend Analysis, and Numerical Cluster Approaches were systematically employed to analyze the flow of FDIs in the span of 10 years since1998.*

***Key words:*** *Liberalization and Globalization, Foreign Investors, Capital Markets*

## Introduction

The Capital Market is an important constituent of the Indian Financial System. It is a market for long term funds and includes both Equity and Debt. It mainly deals with financial assets, excluding coin and currency. The financial assets comprise of shares, debentures, bonds, mutual funds, fixed deposits, pension funds, provident fund, insurance policies, and derivatives. The Indian Stock Exchanges, as they are well-regulated, function smoothly and it is an indication of a healthy Capital Market in the country. Stock Exchange provides good leverage to the Capital Market and it helps investors to maximize their returns. India has multi-stock exchange system. Regional and National Stock Exchanges (NSE) are functioning across the country. The political changes in the country and the economic policies of the Government affect the trends of Capital Market.

## Financial Sector Reforms

The need for financial reforms has arisen because the financial institutions and markets were in a bad shape. The Banking Sector suffered from lack of competition, low capital base, low productivity and high intermediation costs. The role of technology was minimal and the quality of service was abysmal. Proper Risk Management System was not followed and prudential norms were weak. Developmental financial institutions operated in a over-protected environment with most of the funding coming from assured sources. Financial markets were characterized by control over pricing of financial assets, barriers to entry, and high transaction costs. The banks were running either at a loss or on very low profits, and consequently, they were unable to provide adequately for loan defaults, and build their capital. There had been organizational inadequacies, weakening of management and control functions, the growth of restrictive practices, the erosion of work culture, and flaws in credit management. Financial Sector Reforms have been operating in conjunction with a larger set of goals relating to economic stability and growth. The reforms, which have been introduced at a gradual pace, combine with effective and appropriate regulation and intervention policy. Efforts have also been made to fulfill the "commandments" of Financial Sector Reforms, namely, carrying out a macro-economic stabilization programme, introducing supportive fiscal and external sector policies, and implementing wide-ranging reforms in other sectors simultaneously.

**Objectives of Financial Reforms Introduced in 1991**

1. To develop a market oriented, competitive, world-integrated, diversified, autonomous, transparent financial system.
2. To increase the allocative efficiency of available savings and to promote accelerated growth of the real sector.
3. To increase the rate of return on real investment.
4. To promote competition by creating level-playing fields and facilitating free entry and exit for institutions and market players.
5. To reduce the levels of resource pre-emption and to improve the effectiveness of directed credit programs.
6. To build a financial infrastructure relating to supervision, audit, technology, and legal matters.
7. To modernize the instruments of monetary control so as to make them more suitable for the conduct of monetary policy in a market economy i.e., to increase the reliance on indirect or market – incentive based instruments rather than direct or physical instruments of monetary control.
8. To increase effectiveness, accountability, profitability, viability, vibrancy, balanced growth, operational economy and flexibility, with professionalizing and depoliticisation in the financial sector.

**Major Reforms After 1991**

The reforms have had a broad sweep comprising of operational matters related to banking, primary and secondary stock markets, Government securities market, external sector policies and the system as a whole. The reforms have been classified into three areas: Firstly, issues relating to creating a Resilient Banking System; secondly, Development of Institutions such as private sector banks and mutual funds; and thirdly, Monetary Policy Instruments such as interest rates, reserve ratios, and refinancing facilities. While presenting a list of reforms, it needs to be pointed out that sometimes a distinction between normal policy changes which are specific in time and economic conditions and reforms which are not properly maintained. The former are included in the latter, which makes the list of reforms unduly and unmanageably long. It is primarily in this sense that the major reforms are listed in terms of certain categories – Systematic and Policy Reforms, Banking Reforms, Primary and Secondary Stock Market Reforms, Government Securities Market Reforms and External Financial Market Reforms.

**FDI's Dependence on Securities Market**

The 1990s witnessed the emergence of the Securities Market as a major source of finance for trade and industry in India. A growing number of companies have been accessing the Securities Market rather than depending on loans from financial institutions (FIs) and banks. The corporate sector is increasingly depending on external sources (domestic market borrowings and loans) for meeting its funding requirements.

Due to the increase in fiscal deficits of Governments (State and Central), their dependence on market borrowings to finance fiscal deficits has also increased over the years. During the year 1990-91, the State Governments and the Central Government financed nearly 14% and 18%, respectively, of their fiscal deficit by market borrowing. In percentage terms, dependence of the State Governments on market borrowing did not increase much during the decade as it ranged between 13.8% and 23,.0%. In 2004-05, the State and the Central Government market borrowings financed 27.3% and 65.8% of the fiscal deficit respectively (ISMR, 2005).

**Foreign Institutional Investors- Population and Perception**

SEBI, in association with the National Council of Applied Economic Research (NCAER), conducted a Survey of Indian Investors in 1998-99 and then followed it up in 2000-01. The Survey of 2000-01 was based on a sample of 288,081who were geographically dispersed in both rural and urban areas. The findings of this Survey were released in September 2003. The Survey estimated that a total of 13.1 million or 7.4 per cent of all Indian Households, totaling 21 million individuals, directly invested in equity shares or debentures or both during 2000-01. The other findings are as listed below:

1. The number of debentures owning households and individual debenture holders far exceeded household and individual equity investors. Of the total 13.1 million investor households, 9.6 million households owned bonds or debentures, whereas only 6.5 million investor households owned equity shares.
2. The percentage of households investing in equity or debentures was more in urban areas than in rural areas. This divergence was more in the case of equities compared to debentures. Of the 51 million urban households, 7.8 million households representing more than 12 million urban individual investors, owned equity shares or debentures or both. Of the 125 million rural households, only 5.3 million households, representing more than 8 million individual investors.
3. The survey results also clearly reveal that a number of non-investor households have increased from about 156 million in 1998-99 to nearly 164 million in 2001-02, constituting nearly 92.6 per cent of all households.
4. It is also observed that the investor population and town size were directly proportional. The largest city with more than 59 lakhs population accounted for about 17 per cent of investor households and the next higher segment, i.e. more than 31 per cent investor households were in towns with a population between 10 and 50 lakhs (Pratip Kar and et. al. 2000).

**International Scenario**

Following the implementation of reforms in the Securities Market during the last decade, Indian Stock Markets have stood out in the world ranking as well as in the developed and emerging markets. As may be seen from the **Table - 1**, India has a turnover ratio of 113.7%, which is quite comparable to the other developed markets like the US and UK which have turnover ratios of 126.5% and 140.5% respectively. As per the Standard and Poor's Fact Book, India ranked 18th in terms of market capitalization (17th in 2003), 18th in terms of total value traded in Stock Exchanges (16th in 2003) and 15th in terms of turnover ratio (6th in 2003) as on December 2004. India ranked second in terms of the listed securities on the Exchange next to the USA. These data, though quite impressive, do not reflect the full Indian market, as Standard & Poor's (S&P) or even other international publications did not cover the whole market. For example, India has approximately 9000 listed companies at the end of March 2005, while S&P considered only 4,730 companies. If whole markets were taken into consideration, India's position vis-a-vis other countries would be much better.

A comparative study of concentration of market indices and indices stocks in different world markets is presented in the **Table - 2.** It is seen that the index stocks' share of total market capitalization in India is 73.7% whereas US index accounts for 92.6%. The ten largest index stocks share of total market capitalization, with 33.4% is India and 14.7% in the case of US.

The stock markets worldwide have grown in size as well as depth over the last decade. As can be observed from the **Table - 2**, the turnover on all markets taken together, though have grown from US $ 37.75 trillion in 2002 to $39.31 trillion in 2004, it witnessed a decline and stood at US $ 29.6 trillion in 2003. It is significant to note that US alone accounted for about 49.24% of worldwide turnover in 2004. Despite having a large number of companies listed on its Stock Exchanges, India accounted for a meagre 0.96% in the total world turnover in 2004. The market capitalization of all listed companies taken together on all markets stood at US$ 38.90 trillion in 2004 ($32.01 trillion in 2003). The share of US in worldwide market capitalization decreased from 44.54% as at the end of 2003 to 41.96% at the end of 2004, while Indian listed companies accounted for 1.00% of the total market capitalization in 2004.

**Globalization**

Indian Securities Market is getting increasingly integrated with the rest of the world. Indian Companies have been permitted to raise resources from abroad through the issue of ADRs (American Depository Receipts), GDRs (Global Depository Receipts), FCCBs (Foreign Currency Convertible Bonds) and ECBs (External Commercial Borrowings). Further, foreign companies are allowed to tap the domestic stock market. Indian Companies are permitted to list their securities on foreign stock exchanges through the ADR/GDR issued against block shareholdings. FIIs (Foreign Institutional Investors) have been permitted to invest in all types of securities, including Government Securities. The investments by FIIs enjoy full capital account convertibility. They can invest in a company under portfolio investment route up to 24% of the paid-up capital of the company, which can be increased up to the sector cap/statutory ceiling, as applicable. The Indian Stock Exchanges have been permitted to set up trading terminals abroad. The trading platform of Indian Exchanges could be accessed through the Internet from anywhere in the world. The two-way convertibility for ADR/GDR has been permitted by RBI, which means that the investors in any company that has issued ADR/GDR could freely convert ADR/GDR into underlying domestic shares. They could also reconvert the domestic shares into ADRs/GDRs, depending on the direction of price change in the stock. This is expected to bring an improvement in the liquidity in ADR/GDR market along with elimination of arbitrage opportunity. This will better align ADR/GDR prices and domestic share prices of companies that have floated ADRs/GDRs.

**Objectives of the Study**

Based on the above observations, facts, and information, this Study was undertaken with the following specific research objectives:

- Ø To study the various reforms in Capital Market and their influence on Foreign Direct Investment (FDI).
- Ø To analyze the enhanced awareness of the foreign investors with regard to the latest developments in the Capital Market after 1991 and to assess and predict the extent of Return on Investment (ROI).

## Methodology

The data collected from all the sources were scrutinized, edited and tabulated. The data were analyzed using SPSS (Statistical Package for Social Sciences) Packages. Financial Analytical Techniques like Ratio Analysis, Fund Flow Statement, Common Size Statements, Comparative Statements and Trend Percentages were used to analyze the financial data. Numerical Cluster Analysis was employed to classify the different financial ratio units based on the different financial elements. The Ratio Analysis was performed by the mathematical formula a/b. Karl Pearson's Co-Efficient of Correlation and Trend Analysis were used to study the oscillations in the data for the ten years. The measures of Central Tendency, Covariance, Percentage Analysis and Diagrammatic Representations were also used to establish the contributions of the data to the Study.

## Analysis and Interpretations

### Net Worth and Equity Share Capital

The details of Net Worth and Equity Share Capital are shown in the Table for analysis. Net Worth to Share Capital = (Net Worth / Share Capital) times. Net Worth consists of share capital plus reserves and surplus of a concern. The purpose of computing this ratio is to test the effective utilization of share capital in a business. If it is effectively utilized then the volume and percentage of reserves and surplus must be in the positive trend and vice versa. In this ratio, the reserves and surplus are an indicator to spell out the performance of share capital.

**Table -3** shows the details of net worth of FDI for a period of 10 years from 1999 to 2008. It is found that the net worth in 1999 was Rs. 2717.94 crores and it consistently increased. It once dropped from Rs. 6486.27 crores to Rs. 5897.68 crores but regained its growth path to Rs. 8440.858 crores in the year 2008.

The Index Number Analysis, considering the base year as 1999 and the value as 100, showed that it had consistently increased but for one year when it dropped down. It reached double the value in 2003 and ended with more than thrice the value in 2008. The mean net worth of the firm was Rs. 5635.90 crores and the standard deviation was Rs 1837.02 crores. The coefficient of variation was 32.59 per cent. The annual compounded growth of the net worth was Rs. 11.999 crores and it is significant from the point of the view of the growth. If the same trend continues, then the net worth of the firm would be Rs. 11271.55 crores by the year 2010 and it is approximately 12 times of the base figure.

Analysis of the details of equity share capital of FDI for a period of 10 years from 1999 to 2008, was done. Equity share capital in 1999 was Rs. 206.95 crores and it consistently increased to Rs. 338.93 crores in the year 2008. The Index Number Analysis, considering the base year as 1999 and value as 100, showed that the value reached as high as 163.77 and likely to reach a value of 971.25 by 2020. The trend value as an increase of share capital was to the extent of Rs. 1767.04 crores which was five times the base value by 2010. The annual compounded growth of the share capital was Rs. 5.057 crores and it is significant from the growth point of view.

### Net Worth to Investments

The Ratio of Net Worth to Investments was calculated and shown in **Table - 4**. Net Worth to Investments = (Net Worth / Investments) times. The objective of deploying this ratio is to bring out the relationship between the net worth and investments. There is a perfect correlation between these two. Whenever there is positive sign and output in the investments, accordingly the net worth will be strengthened. So it is a suitable tool to judge the financial performance of a concern.

**Table - 4** shows the details of Net Worth and Investments of FDI for a period of 10 years from 1999 to 2008. The performance of net worth is depicted in the **Table - 1**. The performance of investment is discussed. Analysis of investments shows that it has been increasing and decreasing year after year and ended up at Rs. 1756.84 crores (in 2008) from Rs. 282.47 crores in 1999. The annual compounded growth rate figure expected is Rs. 14557.71 crores to capitalize the market demand.

The Numerical Ratio Comparison identified that the ratio values were high in the first four years from 1999 to 2003 and low in the last four years from 2004 to 2008. The covariance of investment (Rs. 61.73) is significantly high. This shows that in the initial four years, FDIs were moderately interested in various investment avenues. They identified the fascinating avenues of investment in a diversified manner from 2004-2008. The covariance of investment (Rs. 61.73) is high and this implies that the change of plan of FDI in their investment process was almost continuously done.

## Conclusions

The Cost Efficiency Studies revealed the meticulous and careful approach of FDI on investment criteria. Sekar (2007) argued that the cost efficiency of FDIs was totally influenced by their investment process and expected profitability. The continuous planning and strategies aided them to control their Cost Efficiency System.

Similarly, it can be concluded that the total assets of FDI increased considerably due to profit in the initial moves. But in the continuous effort, the FDI diversified its profits in various financial elements. Total assets acquired were not enormous in a span of 10 years. The sales volume really helped FDI to acquire total assets. But at the same time, increased number of FIIs did not aid FDI to increase its assets. It is further found that the profitability obtained was not used by the FDI to accumulate more assets.

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**Table – 1**

**International Comparison: End of December 2009**

| Particulars | USA | UK | Japan | Germany | Singapore | Hong kong | China | India |
|---|---|---|---|---|---|---|---|---|
| No. of listed Companies | 5,231 | 2,486 | 3,220 | 660 | 489 | 1,086 | 1,384 | 4,730 |
| Market Capitalisation ($ Bn.) | 16,324 | 2,816 | 3,678 | 1,195 | 172 | 861 | 640 | 388 |
| Market Capitalisation Ratio (%) | 148.2 | 167.6 | 84.3 | 57.3 | 190.1 | 488.8 | 45.2 | 68.0 |
| Turnover ($ Bn.) | 19,355 | 3,707 | 3,430 | 1,406 | 81 | 439 | 748 | 379 |
| Turnover Ratio (%) | 126.5 | 140.5 | 103.5 | 123.7 | 51.2 | 55.7 | 113.3 | 113.7 |

***Source:*** S&P Global Stock Markets Facebook, 2009

**Table – 2**
**Market Concentration in the World Index as on End 2009 (In Percent)**

| Market | Index Stocks Share of Total Market Capitalization | 10 largest Index Stocks' Share of Total Market Capitalization |
|---|---|---|
| Japan | 97.1 | 18.2 |
| Singapore | 94.6 | 34.2 |
| France | 75.1 | 35.6 |
| Germany | 87.1 | 45.1 |
| Italy | 98.8 | 57.2 |
| United Kingdom | 95.9 | 40.9 |
| United States | 92.6 | 73.7 |
| India | 14.7 | 33.4 |

***Source:*** S&P Global Stock Markets Facebook, 2005

**Table - 3**
**Showing the Net Worth and Share Capital - FDI in India**

| Year | Net worth (in crores) | Index | Equity share capital (in crores) | Index | Ratio | Ratio Clusters |
|---|---|---|---|---|---|---|
| 1999 | 2717.94 | 100.00 | 206.95 | 100.00 | 13.13 | L |
| 2000 | 3292.67 | 121.15 | 208.55 | 100.77 | 15.79 | L |
| 2001 | 4292.98 | 157.95 | 221.44 | 107.00 | 19.39 | M |
| 2002 | 5037.21 | 185.33 | 225.59 | 109.01 | 22.33 | H |
| 2003 | 5771.69 | 212.36 | 338.75 | 163.69 | 17.04 | L |
| 2004 | 6486.27 | 238.65 | 338.77 | 163.70 | 19.15 | M |
| 2005 | 5897.68 | 216.99 | 338.81 | 163.72 | 17.41 | M |
| 2006 | 6678.85 | 245.73 | 338.83 | 163.73 | 19.71 | M |
| 2007 | 7742.81 | 284.88 | 338.90 | 163.76 | 22.85 | H |
| 2008 | 8440.85 | 310.56 | 338.93 | 163.77 | 24.90 | H |
| Sum | 56358.95 | 2073.59 | 2895.52 | 1399.14 | 191.69 | |
| Mean | 5635.90 | 207.36 | 289.55 | 139.91 | 19.17 | |
| SD | 1837.02 | 67.59 | 63.85 | 30.85 | 3.53 | |
| CV | 32.59 | 32.59 | 22.05 | 22.05 | 18.42 | |
| Trend | 11271.55 | 73.95 | 1767.05 | 971.25 | 109.28 | |
| ACGR | 11.999 | 11.999 | 5.057 | 5.057 | 6.608 | |
| Co-relation | 0.87 | | | | | |

**Table - 4**
**Showing the Net Worth to Investments – FDIs of India**

| Year | Net Worth (in crores) | Index | Investments (in crores) | Index | Ratio | Ratio Clusters |
|---|---|---|---|---|---|---|
| 1999 | 2717.94 | 100.00 | 282.47 | 100.00 | 9.62 | M |
| 2000 | 3292.67 | 121.15 | 283.83 | 100.48 | 11.60 | H |
| 2001 | 4292.98 | 157.95 | 1640.99 | 580.94 | 2.62 | L |
| 2002 | 5037.21 | 185.33 | 940.88 | 333.09 | 5.35 | M |
| 2003 | 5771.69 | 212.36 | 586.96 | 207.80 | 9.83 | M |
| 2004 | 6486.27 | 238.65 | 627.29 | 222.07 | 10.34 | H |
| 2005 | 5897.68 | 216.99 | 2133.43 | 755.28 | 2.76 | L |
| 2006 | 6678.85 | 245.73 | 2015.22 | 713.43 | 3.31 | L |
| 2007 | 7742.81 | 284.88 | 2048.42 | 725.18 | 3.77 | L |
| 2008 | 8440.85 | 310.56 | 1756.84 | 621.96 | 4.80 | M |
| Sum | 56358.95 | 2073.59 | 12316.33 | 4360.23 | | |
| Mean | 5635.90 | 207.36 | 1231.63 | 436.02 | | |
| SD | 1837.02 | 67.59 | 760.29 | 269.16 | | |
| CV | 32.59 | 32.59 | 61.73 | 61.73 | | |
| Trend | 11271.55 | 73.95 | 14557.71 | 711.58 | | |
| ACGR | 11.999 | 11.999 | 20.054 | 20.054 | | |
| Correlation | 1 | | | | | |

Source: Annual Reports of FDI