Vulnerability of capital markets to FPI inflows

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Until June 2019, 9425 FPIs accounted for about $492 Billion of Assets in India, accounting for almost 40% of the total Institutional Assets, comprised mainly of listed stocks. It does not include the ever increasing FPI's interest in derivatives segment and the investments in the unlisted segment. FPIs presence in India has grown over the decades from the partly $200 million in the early 1990s.

FPI flows are through investments through the Capital market routes. As Capital markets move upwards/ downwards/sideways, investment decisions get influenced and vice versa. As like any other investors (domestic or otherwise) FPI flows behave similarly. Inflows have also been accompanied by outflows during periods of uncertainty caused by local/Global scenario and risk appetite. The evolution of FII policy in India has displayed a steady and cautious approach to the liberalization of a system of quantitative restrictions (QRs). At times, RBI has treaded with caution when portfolio debt flows have been volatile; given that exchange rates being sensitive to these flows, the need to attract more stable sources of financing gains more importance. Thus it's a tight balance between attracting the much desired FDIs and enabling Inflows from FPIs, to reduce vulnerabilities. Increased/ spurts in FPI inflows also has an impact on the rupee-dollar rate, leading to intervention by the Reserve Bank to mop the liquidity through a variety of measure. These being done to contain sustainability and economic value while absorbing the foreign currency inflows.

Over the last two decades Policy makers and Regulators in India, have increasingly recognized the importance of FPI segment and noted their concerns, that make the India Capital market vulnerable. Policy makers provided political stability, enabled greater ease of doing business, provided tax related clarifications, induced Harmonization of FPI class, provided thrust to greater Corporate Governance, KYC etc addressed some of the concerns. These initiatives have made the Capital markets more secure, predictable and to an extent, reduced their vulnerability while creating greater confidence amongst FPI Investors. More liquidity, lesser operational complexities, Increased diversity of FPIs(Cat III since 2014), increased participation of NRI(Budget 2019), the stupendous growth of Mutual Funds segment and AIFs, recommendations wrt NRI-FPI-FDI limits in the SEBI constituted H.R Khan Report are some of the initiatives that have made the Capital markets diverse, deep and attractive.

Vulnerability of FPI inflows could be characterized by the types of investors, the longevity of their investment patterns as well as the jurisdictions. Over the last decade, steps taken by SEBI and other regulators have led to the slow but sure demise of the P-note structures and facilitated direct entry of FPIs. A direct entry is more stable than a derivative instrument traded overseas. The belief that banning of P- note structure will impact FPI inflows, have been unfounded as over the years the nos of FPIs have actually increased. In fact, the largest percentagewise increase has been in the newly created Category III- registering approx 13% of the FPIs in India. Likewise, Category II FPIs have also been increasing over the years. The increased regulatory tightening of norms wrt funds coming via the low- tax jurisdictions have pared the unpredictability as well as the type of FPIs coming into India. There has been a percentage fall in the inflows from such jurisdictions, substituted by the more Stabler jurisdictions. The 2019 budget announcement of merging NRI limits into FPI limits is bound to increase the inflows from the NRIs and thereby add to stability and longevity in the investment pattern. This to an extent offsets the vulnerability to FPI inflows which are guided by a number of factors including risk-appetite.

FPI inflows have time and again come handy when domestic flows, especially from the Mutual Funds segment have been muted. For instance, the assets of FPIs during the Feb-May 2019 increased by 2.5 times vs those from the Mutual Fund assets. The reduced unpredictability of the FPI inflows have also contributed to stabler Capital Markets. If any, the FPI inflows impacts have moved from long- duration impacts to the shorter duration impacts which primarily are an outcome of Intensification of trade war, geo-political tensions, certain KYC measures etc. Given the global scenario, India's demographic advantage and projected growth numbers continue to attract investors from developed countries, ensuring inflows over the long-term. In effect, it can be said that Indian Capital markets are no longer as vulnerable as it was a decade ago, largely due to initiatives of the successive Governments, SEBI and RBI. Market efficiencies too have contributed towards such a shift, enabling entry of more qualitative Investors and intermediaries.

While FPI have been increasing their footprints through investments in equity, debt and derivatives segments, they have on occasions served as balancing factors when domestic funds inflows into capital market have been muted. The quality of inflows has improved significantly with the advent of the longer staying Funds and the regulatory changes induced by SEBI. The renewed political stability from the elections of 2019, the growth projections of the Economic Survey of 2019 and the Budgetary announcements of July 2019 are expected to increase the attractiveness of Indian Capital Markets.

However, FPI inflows have been constrained by factors, that also contribute to vulnerability of the India Capital markets. Some of them being:

I. Need for stability of policies
II. Investors do not like one change at a time, they prefer all together at beginning and certain point of time
III. FPIs are concerned about an almost continuous clarifications on the taxation front. Given that Investors need to make several investments before the actual investments are made, the dynamic changes impacts
IV. The cost of doing business with almost over 50 lines of costs, also is a key driver
V. Indian policy makers need to showcase globally the developments, to attract diverse set of investors
VI. Slow pace of regulatory evolution in the pension fund Industry
VII. The near demise of the Depositary Receipts business adds to uncertainty. What was once a throbbing segment, is now almost at standstill, awaiting key clarifications
VIII. The FPI registration process is more comprehensive than that for FDIs, as well as vs some of the other fast developing emerging markets. This perception impacts growth
IX. Governance related concerns wrt SMEs also impacts the investments in this segment, by FPIs, though FDI investments are growing
X. Creation of liquidity (now being addressed through the announcements in the Budget of 2019)

The H. R Khan Report has provided for 49 recommendations, which will significantly address the operational issues for FPIs, NRIs and thereby enabling greater Ease of doing business. As next steps focus should be also in introducing new products, improving governance and a hard look at bringing down the costs of doing business. A stabler Capital markets will serve the interest of the Investors (Local and FPI) as well as that of India through a wealth creation mode.

To conclude, the dependence on FPI flows has rendered Indian Capital markets more vulnerable to short-term fluctuations. The reality is that the flows are from more legitimate sources now.