Challenges on Attracting Foreign Portfolio Investors in the Age of Global Business

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ABSTRACT

Capital is a vital ingredient for economic growth, but since most nations cannot meet their total capital requirements from internal resources alone, they turn to foreign investors. Foreign direct investment (FDI) and foreign portfolio investment (FPI) are two of the most common routes for investors to invest in an overseas economy. FPI means investing in financial assets, such as stocks and bonds of entities located in another country. FPI is important sources of funding for most economies. Foreign capital can be used to develop infrastructure, set up manufacturing facilities and service hubs, and invest in other productive assets such as machinery and equipment, which contributes to economic growth and stimulates employment, however to attract these investors are really challenging for an economy. Along with this, these economies has to come up with keeping their economies more attractive than other economies across the globe because investment through FPI is highly liquid and investors will liquidate and invest in other economy which they find more attractive in any given point of time. In India’s context we see somewhere India kept itself making an attractive market place for FPI’s however there were much volatility sees in past years. Also there are different hindrances which come across while making the economy more attractive, whether it is taxation policies or GDP.

Keywords: Foreign Direct Investment, Foreign Portfolio Investment, Taxation Policies, Economy, Assets.
INTRODUCTION

International trade is as old as human history as the barter of goods or services among different people. The function of international trade within that highly nationalistic body of thought known as mercantilism. The trade policy dictated by mercantilist philosophy was accordingly encourage exports and discourage imports and takes the proceeds of the resulting export surplus in gold. This law lingered until 1849. Finance is the lifeblood of any kind of trade. Finance refers to source of money for a business. Firms need finance to start up a business, run the business, expand the business etc. New businesses find difficulties to raise finance because of few customers and abundant competitor. Company raises finance through owner’s fund and borrowed fund. For businesses lender put off by the risk that start up may fail. Businesses can raise finance through internal sources and external sources of finance.

**Internal sources of finance:** The funds which are found inside the business and that are no longer really needed to free up cash. For example profit can be kept back to finance expansion, owner’s capital, by selling assets (item of its own).

**External sources of finance:** These funds are raised outside the business. These include overdraft facilities, trade credit, factoring etc.

The type of finance chosen depends on the type of business. Start up and small firms are considered very high risk and find it difficult to raise external finance. External sources of finance include:

- Equity capital
- Preferred stock
- Term loans
- Venture capital
- Leasing
- Hire purchases
- Trade credit
- Bank overdraft
- Factoring etc.

International investment or capital flows fall into four principal categories:

**Commercial loans:** The formal bank loans issued to foreign business or government.
Official flows: Forms of development assistance that developed nations give to developing ones.

Foreign Direct Investment (FDI): It is International investment in which the investor obtains a lasting interest in an enterprise in another country. FDI is calculated to include all kinds of capital contribution such as purchase of stock as well as the reinvestment of earning by a wholly owned company incorporated abroad. According to united nation conference on trade and development (UNCTAD), The Global expansion of FDI is currently being driven by over 65000 transactional corporation with more than 850000 foreign affiliates.

Foreign portfolio investment (FPI): These include Instruments (Stocks) or depts. (Bonds) of a foreign enterprise which does not necessary represent a long term interest. FPI comes from diverts sources such as a small company’s pensions or through mutual fund held by individuals. Finance is the life blood for every business but to raise finance the difficult task. While big and established from find it relatively easy to raises finance, small firms find it more difficult to raise funds for their activities.

FPI invest in Indian market keeping a track on its technicalities, also GDP gives positive indication and interest rates are also fair as compared to other economies. For a FPI as their capital is short supply and is highly mobile, they have standard criteria when evaluating the desirability of an overseas destination, which include:

- Economic factors: the strength of the economy, GDP growth trends, infrastructure, inflation, currency risk, foreign exchange controls
- Political factors: political stability, government’s business philosophy, track record
- Incentives for foreign investors: taxation levels, tax incentives, property rights
- Other factors: education and skills of the labor force, business opportunities, local competition

In the context of Indian economy if you see the trend of FPI in the below table, the data shows much volatility, which clearly resembles that there is a state of uncertainty and depending on the performance or future prospect of the market the investors invest and can liquidate their positions. These investments are often referred as hot money also because of its tendency to flee at the first signs of trouble in an economy. These massive portfolio flows can exacerbate economic problems during periods of uncertainty. FPI investors can exit a
nation literally with a few mouse clicks, as financial assets are highly liquid and widely traded.

BELOW TABLE ILLUSTRATE THE TREND OF FPI IN INDIAN ECONOMY.

FPI/FII Investment Details (Financial Year)

| Financial Year | INR crores |  |
|----------------|------------|
|                | Equity | Debt | Hybrid | Total |
| 1992-93        | 13     | 0    | 0      | 13    |
| 1993-94        | 5127   | 0    | 0      | 5127  |
| 1994-95        | 4796   | 0    | 0      | 4796  |
| 1995-96        | 6942   | 0    | 0      | 6942  |
| 1996-97        | 8546   | 29   | 0      | 8575  |
| 1997-98        | 5267   | 691  | 0      | 5958  |
| 1998-99        | -717   | -867 | 0      | -1584 |
| 1999-00        | 9670   | 453  | 0      | 10122 |
| 2000-01        | 10207  | -273 | 0      | 9933  |
| 2001-02        | 8072   | 690  | 0      | 8763  |
| 2002-03        | 2527   | 162  | 0      | 2689  |
| 2003-04        | 39960  | 5805 | 0      | 45765 |
| 2004-05        | 44123  | 1759 | 0      | 45881 |
| 2005-06        | 48801  | -7334| 0      | 41467 |
| 2006-07        | 25236  | 5605 | 0      | 30840 |
So now it is understood that to keep an economy stable India has to maintain stock market attractive at all times. Also the GDP need to be consistent and interest rate needs to be more attractive than other economies which are also in competition to seek more and more Foreign Portfolio Investments. The major country which attracts FPI gives various reasons for investments unlike developing countries like India. USA, Singapore, Luxembourg, Ireland, UK also attract FPI for Hedge funds. Many of the states Cayman, Bermuda, Delaware, where these funds are established are tax heaven for FPI. Below table is reflecting top 10 economies of the world and total FPI investment.

<table>
<thead>
<tr>
<th>Year</th>
<th>FPI 1</th>
<th>FPI 2</th>
<th>FPI 3</th>
<th>Total</th>
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</thead>
<tbody>
<tr>
<td>2007-08</td>
<td>53404</td>
<td>12775</td>
<td>0</td>
<td>66179</td>
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<td>2008-09</td>
<td>-47706</td>
<td>1895</td>
<td>0</td>
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<tr>
<td>2009-10</td>
<td>110221</td>
<td>32438</td>
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<td>142658</td>
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<tr>
<td>2010-11</td>
<td>110121</td>
<td>36317</td>
<td>0</td>
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<tr>
<td>2011-12</td>
<td>43738</td>
<td>49988</td>
<td>0</td>
<td>93726</td>
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<tr>
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<td>28334</td>
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<td>168367</td>
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<tr>
<td>2014-15</td>
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<td>166127</td>
<td>0</td>
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<td>119036</td>
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<td>2018-19</td>
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<td>3515</td>
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<td>2019-20 **</td>
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<td>26897</td>
<td>5141</td>
<td>28158</td>
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<tr>
<td><strong>Total</strong></td>
<td>882621</td>
<td>398814</td>
<td>8667</td>
<td>1290099</td>
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</table>

**upto 21-Sep-2019**
FPI/FII AUC COUNTRY-WISE (TOP 10 COUNTRIES) DATA

Year : 2019; Month August

<table>
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<tr>
<th>Sr. No.</th>
<th>Country</th>
<th>AUC (INR Cr.)</th>
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<td>Equity</td>
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<tr>
<td>1</td>
<td>UNITED STATES OF AMERICA</td>
<td>988,720</td>
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<tr>
<td>2</td>
<td>MAURITIUS</td>
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<td>3</td>
<td>LUXEMBOURG</td>
<td>241,906</td>
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<td>4</td>
<td>SINGAPORE</td>
<td>192,572</td>
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<tr>
<td>5</td>
<td>UNITED KINGDOM</td>
<td>148,173</td>
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<tr>
<td>6</td>
<td>IRELAND</td>
<td>106,961</td>
</tr>
<tr>
<td>7</td>
<td>CANADA</td>
<td>91,600</td>
</tr>
<tr>
<td>8</td>
<td>JAPAN</td>
<td>87,741</td>
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<td>9</td>
<td>NORWAY</td>
<td>62,767</td>
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<tr>
<td>10</td>
<td>NETHERLANDS</td>
<td>52,822</td>
</tr>
<tr>
<td>11</td>
<td>Other</td>
<td>413,360</td>
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<tr>
<td></td>
<td>Total</td>
<td>2,751,674</td>
</tr>
</tbody>
</table>

Data as provided by DDPs

FPIs includes FIIs, Sub Accounts & QFIs

When an Foreign Portfolio Investor looks at the Indian economy, the data looks very promising. Indian GDP increased by 6.75% during the fiscal year 2017/2018, while it further increased by 7.3% during the following fiscal year of 2018/2019. There are various challenges which a country come across while keeping the inflow of FPI money into an economy and sustain itself in Global market. Some of the important factors are listed below.
REGULATORY REQUIREMENTS:

Various regulatory requirements like KYC, Anti money laundering, Registration with exchange, Due Diligence requirements plays a vital role in attracting FPI’s. It is obvious that all investors who want to invest in foreign markets has to go through the initial regulatory requirements of the country. In some of the economy these rules are thinly regulated which attracts FPI’s. In Indian context if we see there are various steps taken in respect to regulatory requirements in order to make the market more attractive. In India there were many regulatory changes made by SEBI in 2018 and afterwards due to which there was an impact in net flow to capital invested by FPI’s. Few of them are listed below.

- Discontinuance of requirements for seeking prior approval from SEBI in case of change in local custodian (LC) / Designated Depository Participant (DDP).
- Rationalization of procedure for submission of protected cell companies /multi class share vehicles Declarations and Undertakings (D&U) and Investor grouping requirement at the time of continuance of registration of FPIs
- Placing reliance on due diligence carried out by erstwhile DDP at the time of change of LC/ DDP of FPIs.
- Exemption to FPIs having Multiple Investment Managers (MIM) structure from seeking prior approval from SEBI in case of Free of Cost (FOC) transfer of assets
- Simplification of process for addition of share class
- Permitting FPIs operating under the Multiple Investment Managers (MIM) structure to appoint multiple custodians
- Permitting appropriately regulated Private Bank/ Merchant Bank to invest on their behalf and also on behalf of their clients
- For Interest rate futures, No FPI to acquire net long position in excess of INR 18 billion at any point of time.

TAXATION POLICIES:

A part of the profit goes to tax which apparently decreases the net profit. Most of the countries that are looking forward for FPI’s are considering this as an important factor for inviting these investments. On a global level countries who give tax benefit or charging less tax are able to attract more investments. Most of the hedge funds in United States are established in places like Cayman, Delware or Bermuda, which gives investors a huge tax
These places are also known as tax heaven. These funds attract investment from their offshore feeder funds, where the feeder funds collect money from foreign investors. There are also funds which are established in Luxemburg and few parts of Ireland which gives some tax relief to investors. Indian market also see this area as a big challenge as a part of the global market. To keep its stake increasing, SEBI, RBI and Finance Ministry all keep working together and keep reviewing it timely manner so as to make any necessary amendments. However as compared to US, Mauritius & Luxembourg, India does not look much attractive however as an developing economy it has other indices along with taxation policy which make it attractive. The current Indian finance minister has taken few steps and trying to cope up with the global situation, it is seen that couple of days back on sep 20, 2019, Finance Minister NirmalaSitharaman slashed corporate tax which is an invitation letter to global investors. This is just an example of a step taken to keep Indian market more attractive. Also this indicates the seriousness to attract FPI’s by the economy. Also there were many changes in recent taxation policies which are listed below.

- The Finance Bill, 2018 proposed to withdraw exemption under Section 10 (38) of the Income-tax Act, 1961 and introduce a new Section 112A to provide that Long Term Capital Gain(s) (LTCG) arising from transfer of long-term capital asset exceeding INR1 lakh be taxed at a concessional rate of 10 percent.
- Double Tax Avoidance Agreement (DTAA) between India and Hong Kong made effective from 1 April 2019
- Central Board of Direct Taxes (CBDT) issued press release on amendment to IndiaChina tax treaty
- Tax deducted at source (TDS) rate under India-Japan DTAA not to be topped with surcharge, education cess.

**MEASURES TO ATTRACTING FPI**

**Flexibility in investing**

Most of the countries across the Globe who seek FPI’s try to provide flexibility in investing as well as they try to offer more option to invest so that the interest in the economy shall be intact. India is a good market place for FPI’s however due to regulatory implications there are options like Hedge funds or Private equity funds which are not available for FPI’s. However
Finance ministry along with RBI and SEBI is trying to give more areas of investment and making these more flexible to attract the investors. Below are few of the recent steps taken.

- RBI launch $30-35 billion NRI bonds in Q3
- Offshore funds will be able to sell their India investment products to NRIs without any major restrictions
- FPIs are set to get deeper access into the Indian markets as the government has also proposed to increase FPI limits in listed companies. Currently, there is a cap of 24 per cent on FPI investments in a company. This cap can be increased up to the sectorial limit by the company through a board resolution
- It has also been proposed to permit investments made by FIIs/FPIs in debt securities issued by Infrastructure Debt Fund – Non-Bank Finance Companies (IDF-NBFCs) to be transferred/sold to any domestic investor within the specified lock-in period.
- FPIs can now vote through a single online platform: Global custodians are offering a single online voting platform for their foreign institutional clients as a measure to improve transparency in the voting system. FPIs can now get on to their custodian website, see all the forthcoming board meetings in a single window and access what their proxy advisors’ recommendations are on the subject.

THE GEOPOLITICAL VIEW

This is one of the major factors which a Investor looks into before investing into a market. It’s clearly understood that an FPI do not go and invest in an economy which looks attractive however they need to take care of Geopolitical factors as these are major factor which moves stock exchange. FPI’s also play a safe game as far as this aspect is concerned, this is the reasons why you see the top countries which are an investment hub for FPI’s looks stable in terms of Geopolitical aspect. If we talk about Indian context there are basically two geopolitical conflicts which FPI’s seeking to invest in India knows, which can be a concern for them: (1) Tensions with Pakistan, and (2) the disputed border with China.

(1) India is a member of ASEAN, the Association of Southeastern Asian Markets, and of G-20, which makes it a well-respected and well-integrated political and economic force in Asia, yet it has a very difficult relationship with its neighbor Pakistan ever since it became an independent nation. So far, there have been three wars between these two nations, and it is needless to say that another war - especially an escalating war - could usher in a sudden
economical downturn. An investor willing to invest in this emerging market must accept the fact that another war with Pakistan is still a possibility in the mid-term. The downing of two Indian jets by Pakistan showed the world how quickly tensions can arise between these two nuclear powers. This bilateral conflict is something an investor should definitely keep in mind.

(2) Another conflict exists between China and India over their shared (and disputed) border. Both countries fought a brief war over it in 1962. Both countries still have military forces stationed along the border as this dispute is still not settled. There are two reasons why an investor seeking more exposure to the Indian market should mind this. First, China is increasingly flexing her muscles in Asia, which creates tensions in this region in general. Secondly, China's push for a China-centered trading network called the "Belt and Road Initiative" might create further tensions with India in the disputed territories during the mid-term.

**CHALLENGES IN ATTRACTING FOREIGN INVESTORS**

1. **Cost of trading in India is moderate but can be decreased further**

In India, the cost of trading includes several levies like brokerage, service tax, stamp duty, STT, SEBI turnover fees, exchange transaction fees and custody fees. These costs, coupled with high tax administrative and compliance costs and hedging costs, result in the overall cost moving upwards. Several other factors lead to an overall increase in the cost of trading for investors. For example, currently, interoperability between clearing corporations is not permitted. Interoperability would allow trading members to choose a clearing corporation of their choice. Interoperability may also reduce margining requirements (and thereby cost) for opposite positions taken across exchanges. FPIs do not earn interest on their bank accounts nor do they earn any money on their margins. Setting off margin money against full consideration is not permitted. Additional costs are also incurred in cases where FPIs have to bid to get debt allocation limits.

2. **Trade and settlement process and regulator’s responses to queries**

China and Singapore have a T+1 trade settlement cycle, however Indian market follow T+2 settlement cycle, so in order to make a significant space in Asian market and compete with these economies Indian market has a scope of improvement and this will help to attract more FPI’s as this will increase the liquidity for the investors.
3. Stability in terms of geopolitical aspect
   This is one of the major factors which an Investor looks into before investing into a market. It’s clearly understood that an FPI do not go and invest in an economy which looks attractive however they need to take care of Geopolitical factors as these are major factor which moves stock exchange. FPI’s also play a safe game as far as this aspect is concerned, this is the reasons why you see the top countries which are an investment hub for FPI’s looks stable in terms of Geopolitical aspect. If we talk about Indian context there are basically two geopolitical conflicts which FPI’s seeking to invest in India knows, which can be a concern for them: (1) Tensions with Pakistan and POK, and (2) the disputed border with China. Any news of tension across border or any internal news may have impact on the markets and this can be a risk for FPI’s

4. Tax rates on capital gains
   In India Long-term capital gains on listed equity shares are taxed at nil and short-term capital gains on listed equity shares are taxed at 15%. According to survey by PWC some of the investors think that this is moderate but there are many investors who think this is little bit on the higher side. So there Indian market has a scope of improvement in order to attract those investors who are investing for a short term and part of their profit is accounted for tax.

MEASURES FOR ATTRACTING FOREIGN PORTFOLIO INVESTMENT

1. Some measures to reduce the cost of trading can be:
   a. Abolish STT or reduce STT on delivery
   b. Allow deduction of STT paid while calculating capital gains
   c. Bring the capital gains tax on derivative transactions to 15%, i.e. on a par with equities

2. Reduce the settlement cycle
   SEBI introduced the T+5 rolling settlement in the equity market in July 2001 and subsequently shortened the settlement cycle to T+3 in April 2002. After their experience with the T+3 rolling settlement and taking other steps such as introduction of STP, SEBI further reduced the settlement cycle to T+2, hoping to further reduce the risk in the market and protect the interests of investors. The T+2 rolling settlement were introduced from 1 April 2003. Further, in 2013, SEBI had toyed with the idea of moving towards a T+1 trade settlement cycle. It had
issued discussion paper titled ‘Risk Management – Safer Markets for Investors’, inviting suggestions from various stakeholders. So the idea of moving to T+1 settlement was on hold afterward however if we see some of the economies like China and Singapore who have T+1 settlement cycle, so in order to compete and make a remarkable position in Asian market Indian market has a scope of improving the settlement cycle. Some of the benefits of lowering the trade settlement cycle are:

- Reduction in the risk of non-payment or non-delivery of shares by the broker
- Reduction in the risk of default in the stock market
- Increase in liquidity for the investors

3. Measures to counter Geopolitical issues

After the BJP government came and manage the issues like Kashmir issue, PAK border tension or China Border tensions, most of the issues are under control but has not yet sorted out. Although we have noticed BJP government/(Narendramodi) is trying hard to keep things stabilize by keeping all international alliances informed on these issues so that there can be some external pressure on PAK and China. However as of now these issues are not fully resolved but in one way it is much controlled as compared to last 10 years. If India will be able to clear these issues then we can expect more FPI’s to be interested in long term investments in the market.

4. Measures to control tax rate:

SEBI also want Indian market to attract FPI’s. This is the area where the finance ministry and SEBI both has to go hand in hand. There has been some steps taken however, further rationalization can be done by the government with respect to the taxation of derivatives like;
- FPIs should be given the option of categorizing their income from derivative transactions as business income, if this is more beneficial to them.
- The short-term capital gain tax on derivatives should be made on a par with that on equities.

CONCLUSION

On a global level there are many countries which are investment hub for FPI’s, out of those India also looks attractive among FPI’s. Being one of the largest economies of the world which has increasing demand of products and have various exchanges and
investment product to offer FPI, however the economy has experienced lot of uptrend and
downtrend of these investments as the money invested are liquid in nature. There are
different economies as well which a big marketplace is also for the same investors who are
investing in Indian economy so it’s a big challenge to keep the money of these investors
intact invested in the market. There are various challenges which is India is facing to keep the
investors attention on its market, which is very crucial in this age of globalized market.
There are various areas like regulatory framework, taxation policy, exchange fees,
geopolitical aspects etc. where they keep reviewing in order to keep the investors intact and
give them a sense of justification so they also understand and follow different requirements
and at the same time they have less difficulty in following and covering the requirements.
Along with that rupee to dollar ratio and performance of the market is also a key player in
attracting these investors.

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