Using Foreign Institutional Investment as a Tool towards Corporate Social Responsibility

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Abstract

In recent years, a growing interest in corporate social responsibility (CSR) has emerged, both in the academic literature as well as the business world. CSR is rooted in the recognition that businesses are an integral part of society and that as such they have the potential to make a positive contribution to social goals and aspirations. CSR encompasses a wide spectrum of issues ranging from business ethics, corporate governance and Socially Responsible Investing to environmental sustainability and community investment. CSR envisages the ideal whereby enterprises integrate social and environmental concerns in their business operations and their interaction with their stakeholders usually on a voluntary basis. At present, the world over, there is an increasing awareness about Corporate Social Responsibility. Corporate Social Responsibility (CSR) developed very slowly in India though it was started a long time ago. CSR has been assuming greater importance in the corporate world. There is a visible trend in the financial sector of promoting environment friendly and socially responsible lending and investment practices. This paper aims to examine by using of foreign institutional investment as a tool towards corporate social responsibility

Keywords: Corporate social responsibility, foreign institutional investment, Capital inflows, Knowledge flows.

Introduction

Foreign institutional investors have been active in India for over 10 years. India has gradually liberalized to foreign institutional investors. Indian Stock Markets have been highly dependent on foreign institutional investor's money and the market performance is usually directly proportional to the foreign institutional investors investment inflows and outflows.

Huge funds inflows by the foreign institutional investors (FIIs) and enough liquidity in the system is driving the stock market up now a days. But huge amounts of foreign institutional investors fund inflow into the country creates a lot of demand for rupee, results into the inflation in the country.

It also causes appreciation of the domestic currency which further creates problems for exporters, and makes Indian export industry uncompetitive. RBI is still in dilemma about the measures to control the high foreign investment. India is the only nation among emerging nations that is inducing foreign investors to invest in the market.

The foreign institutional investors provide the avenues for the nations to have access to foreign capital which increases the level of economic activities and development. Moreover, they move to developing countries because of increased globalization and low barriers.

Also, foreign investors are driven by the need for low cost of production, cheaper labour, and competition and profit maximization. The foreign institutional investors use better technological equipment that produce cleaner energy and pollute less.

Importance of Corporate Social Responsibility

Corporate social responsibility (CSR) plays a major role in developing the economy of a country. It can be defined as the way in which a institution (company) manages various business entities to produce an impact on the society. Institutions (companies) with high CSR standards are able to demonstrate their responsibilities to the stock holders, employees, customers, and the general public.[1]

Many national and multinational firms are booming in various developing countries. But at the same time, these countries suffer social challenges such as poverty, corruption, population growth, etc. Therefore, it is important for all companies to strive together and adapt corporate social responsibility standards to make the society better than before.

It lies in two things: 1) organizations understanding their role in developing a society and 2) awareness among business houses, corporate bodies, and the people. Versatile, profitable, and dynamic businesses are the driving forces that build the economy of the country. We must remember that the growth of a country purely depends on the growth of the society and the people in the society.

Benefits of Foreign Institutional Investment

1. Reduced cost of equity capital

Foreign institutional investor's inflows augment the sources of funds in the Indian capital markets. Foreign institutional investor's investment reduces the required rate of return for equity, enhances stock prices, and fosters investment by Indian firms in the country.

2. Knowledge flows

The activities of international institutional investors help strengthen Indian finance. Foreign institutional investors advocate modern ideas in market design, promote innovation, development of sophisticated products such as financial derivatives, enhance competition in financial intermediation, and lead to spillovers of human capital by exposing Indian participants to modern financial techniques, and international best practices and systems.

3. Strengthening corporate governance

Domestic institutional and individual investors, used as they are to the ongoing practices of Indian corporate, often accept such practices, even when these do not measure up to the international benchmarks of best practices.

Foreign institutional investors, with their vast experience with modern corporate governance practices, are less tolerant of malpractice by corporate managers and owners (dominant shareholder).

Foreign institutional investment participation in domestic capital markets often lead to vigorous advocacy of sound corporate governance practices, improved efficiency and better shareholder value.

4. Improvements to market efficiency

A significant presence of foreign institutional investors in India can improve market efficiency through two channels.

First, when adverse macroeconomic news, such as a bad monsoon, unsettles many domestic investors, it may be easier for a globally diversified portfolio manager to be more dispassionate about India's prospects, and engage in stabling trades.

Second, at the level of individual stocks and industries, foreign institutional investors may act as a channel through which knowledge and ideas about valuation of a firm or an industry can more rapidly propagate into India. For example, foreign investors were rapidly able to assess the potential of firms like Infosys, which are primarily export-oriented, applying valuation principles that prevailed outside India for software services companies.

Pros and Cons of FII Flows into a Country

FII flows into a country are associated with several pros and cons.

Pros of FII

1. Enhanced flows of equity capital

FIIs have a greater appetite for equity than debt in their asset structure. The opening up the economy to FIIs has been in line with the accepted preference for non-debt creating foreign inflows over foreign debt. Enhanced flow of equity capital helps improve capital structures and contributes towards building the investment gap.

2. Managing uncertainty and controlling risks.

Foreign institutional investment inflows help in financial innovation and development of hedging instruments. Also, it not only enhances competition in financial markets, but also improves the alignment of asset prices to fundamentals.

3. Improving capital markets.

Foreign institutional investors as professional bodies of asset managers and financial analysts enhance competition and efficiency of financial markets.

4. Equity market development aids economic development.

By increasing the availability of riskier long term capital for projects, and increasing firms incentives to provide more information about their operations, foreign institutional investors can help in the process of economic development.

5. Improved corporate governance.

Foreign institutional investors constitute professional bodies of asset managers and financial analysts, who, by contributing to better understanding of firms operations, improve corporate governance. Bad corporate governance makes equity finance a costly option. Also, institutionalization increases dividend payouts, and enhances productivity growth.

Cons of FII

1. Problems of Inflation

Huge amounts 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.

2. Problems for small investor

The foreign institutional investors profit from investing in emerging financial stock markets. If the cap on foreign institutional investment is high then they can bring in huge amounts of funds in the country's stock markets and thus have great influence on the way the stock markets behaves, going up or down.

The foreign institutional investment buying pushes the stocks up and their selling shows the stock market the downward path. This creates problems for the small retail investor, whose fortunes get driven by the actions of the large foreign institutional investors.

3. Adverse impact on Exports

Foreign institutional investment flows leading to appreciation of the currency may lead to thee exports industry becoming uncompetitive due to the appreciation of the rupee

4. Hot Money

"Hot money" refers to funds that are controlled by investors who actively seek short-term returns. These investors scan the market or short-term, high interest rate investment opportunities. Hot money" can have economic and financial repercussions on countries and banks. When money is injected into a country, the exchange rate for the country gaining the money strengthens, while the exchange rate for the country losing the money weakens. If money is withdrawn on short notice, the banking institution will experience a shortage of funds.

Major Road Blocks in Foreign Investment

The major obstacle is fortunately a non economic one. Rampant corruption is also said to prevail is, of course, is most common in developing economies, which are on path of reforms.

1. Lack of political stability

It's not the case that every government may allow the FII to enter into their country. Different government follows different policy framework for FII. One government may follow liberal approach while other may follow the conservative approach. India has emerged as the second most option for FII destination in Asia after china. Incidentally successive government wasted considerable time identifying the desirable sectors where the FII could be encouraged and those where it must be discouraged.

2. Lack of economic stability

FII are the foreign investments and they are always done if the economy of the country supports them. The economy always follows business cycle. Economic prosperity is followed by recession. This is inevitable. During the time when the economy is facing a recession or depression, FII is hard to come because the foreign players do not feel safe to invest. Apart from this there are also many factors that affect the economy adversely and thereby discourage FII.

3. Poor infrastructure

Infrastructure plays a very important role in affecting the decision of the Foreign Institutional Investors whether to invest in a particular country or not. If the infrastructure of the country is poor the Foreign Institutional Investors may not invest in that country as it would affect their returns and at the same time they would invest where the infrastructure is good and returns are good. So initiative should be taken by the government to im5prove the infrastructure.

4. Corruption cum lack of transparency

Corruption deters several efficient players from investing as they think that the clearance of their proposal is not performance or reputation but under the table dealings. This clearly shows lack of transparency and bureaucracy. The fundamental problem is the government instability to formulate a clear and consistent regulatory framework for FII.[2]

Foreign Institutional Investors and Corporate Social Responsibility

1. What - information do the foreign institutional investors want from corporate CSR reporting?

2. How - is this information used by asset managers and foreign institutional investors?

3. Where – do investors get their information, if not provided directly by the subject company?

The foreign institutional investors are more involved in environmental management than indigenous investors. The positive relationship between foreign institutional investors and CSR suggests they are inclined to long term values, strategic goodwill and financial performance. There is a small effect of foreign institutional investors on CSR due to lack of experience and knowledge about the environment.

Shareholders as a whole and in particular foreign institutional investors and block holders have the ability to influence companies' decision-making processes. We have witnessed in recent years an increase in shareholder participation in corporate affairs, termed as "Shareholders' Activism".

Foreign institutional investors have emerged as more powerful influential players in corporate affairs because of their increasing shareholding in large companies revealing a high owner stake in the equity markets. Institutional investors hold a significant portion of equity markets throughout the world and that they have a positive impact on their portfolio companies.

The Role of Foreign Institutional Investors in the Market for CSR

Institutional investors, primarily pension funds, drive global financial markets. The result is investors vulnerable to the risks companies face in global consumer and capital markets. Though some market risks are inevitable, others, such as reputation risk, can be mitigated through increased corporate social and environmental standards and the increased transparency that such higher standards demand.

The transparency necessitated by reputation management has a dual role in monitoring corporate behaviour and providing all stakeholders (internal and external) with the information to evaluate corporate behaviour. Driving this process is the belief that higher standards of corporate responsibility pay off for investors over the long term both through potential equity premia and through risk reduction.[3]

The role of institutional investors in corporate affairs and strategic decisions of their portfolio companies has attracted more attention, in recent years, not only from the government but also from the regulatory bodies.[4]

Foreign institutional investors have been successful in improving the financial performance of companies but they also play a critical role in the encouragement and promotion of Corporate Social Responsibility (CSR).

Being legal entities, corporations are expected to behave in a socially responsible way which not only benefits the society but also leads the company towards stability and success in the long run by securing customer loyalty.

Foreign institutional investors are "the majority owners of most quoted businesses" and therefore, they are expected to align the interests of shareholders with those of other stakeholders i.e. employees, customers, suppliers, environment and the whole society because "they have the power to request, and if necessary instruct, corporate executives to include social and environmental guidelines in their business objectives"

Foreign institutional investors can catalyze greater engagement in CSR on the part of corporations through two different routes, either i) through more intimate involvement in their decision making processes or ii) through investing only in those companies that take social responsibility into account in their operations.

The second way, although it seems to be passive, has become a crystallized philosophy of some big investment companies in recent years and has been termed as Socially Responsible Investment (SRI) or also social screening, as in the application of social criteria to investment decisions.

Some previous literature has also referred to this growing trend as Ethical Investment and defined it as "the exercise of ethical and social criteria in the selection and management of investment portfolio, generally consisting of company shares (stocks)"

If institutional investors consider ethical investment criteria in their investment decisions, they are capable of punishing (by selling or not purchasing the shares and thus reducing the market value) companies that do not meet these criteria. The development of socially responsible indexes has directed increased attention to the importance of social responsibility in investment decisions.

The foreign institutional investors have emerged as an integral force in the equity market and they are pushing companies to take long-term decisions that account for the welfare of communities- corporate social responsibility in the broader sense where they operate. One potential motivation is that institutional investors are interested in the long-term cash flows of their investments which are increasingly linked to good CSR performance.

Although some Institutional investors e.g. mutual funds look for short-term returns, most of them seek stable returns on their investments in the long run in order to deliver their promises. Therefore, they are interested in long-term profitability of the companies in their portfolios and hence have the incentive to get engaged in corporate strategic management rather than switching.

Conclusion

Given the increasingly documented positive correlations between long run health of institutions (companies) and their social behaviour, the foreign institutional investors have an incentive, because they look for long term cash flows to take the social responsibility of companies into account. Because of their expertise and strategic economic role, the foreign institutional investors are also encouraged by regulators to take active part in the governance and social behaviour of their investees.

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