UNIT II

FINANCIAL MARKETS - I

5 CHAPTER

CAPITAL MARKET

முதலிலார்க ஊதிய மில்லை மதலையாஞ்
சார்பிலார்க் கில்லை நிலை.

–குறள் 449

COUPLET

The There can be no gain to those who have no capital; and in like manner there can be no permanence to those who are without the support of adherents.

Learning Objectives

To enable the students to understand the

- Meaning and definition of Capital Market
- Characteristics of Capital Market
- Functions of Capital Market
- Indian Capital Market Evolution and Growth
- New Financial Institutions

Chapter Synopsis

5.01 Meaning and Definition

5.02 Characteristics of Capital Market

5.03 Kinds of Capital Market

5.04 Functions and Importance of Capital Market

5.05 Indian Capital Market – Evolution and Growth

5.06 New Financial Institutions

The term capital market refers to the facilities and institutional arrangements through which long-term funds, both debt and equity are raised and invested. It consists of a series of channels through which savings of the community are made available for industrial and commercial enterprises and for the public in general. It directs these savings into their most productive use leading to the growth and development of the economy. The capital market consists of development banks, commercial banks and stock exchanges. An ideal capital market is one where finance is available at reasonable cost. The process of economic development is facilitated by the existence of a well functioning capital market.

5.01 Meaning and Definition

Capital market is a market where buyers and sellers engage in trade of financial securities like bonds, and stocks. The buying/selling is undertaken by participants such as individuals and institutions.Capital market forms an important core of a country's financial system.

Capital market can be defined as "a market for borrowing and lending of long-term capital funds required by business enterprises". Capital market offers an ideal source of external finance. It refers to all the facilities and the institutional arrangements for borrowing and lending medium-term and long-term funds. Like any market, the capital market is also composed of those who demand funds (borrowers) and those who supply funds (lenders).

Stock Exchange

According to Arun K. Datta, capital market may be defined as "a complex of institutions investment and practices with established links between the demand for and supply of different types of capital gains".

5.02. Characteristics of Capital Market

Following are the nature/characteristic of a capital market:

(i) Securities Market

The dealings in a capital market are done through the securities like shares, debentures, etc. The capital market is thus called securities market.

(ii) Price

The price of the securities is determined based on the demand and supply prevailing in the capital market for securities.

(iii) Participants

There are many players in the capital market. The participants of the capital market include individuals, corporate sectors, Govt., banks and other financial institutions.

(iv) Location

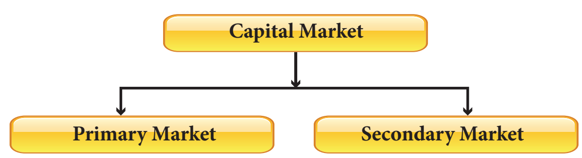
Capital market is not confined to certain specific locations, although it is true that parts of the market are concentrated in certain well-known centers known as Stock Exchanges. It has its impact in the overall economy, wherever suppliers and users of capital get together and do business.

(v) Market for Financial Assets

Capital market provides a transaction platform for long term financial assets.

5.03 Kinds of Capital Market

The capital market is divided into two i.e., primary market and secondary market as shown in the following chart.



I Primary Market

Primary market is a market for new issues or new financial claims. Hence, it is also called New Issue Market. The primary market deals with those securities which are issued to the public for the first time. In the primary market, borrowers exchange new financial securities for long term funds. Thus, primary market facilitates capital formations.

There are three ways by which a company may raise capital in a primary market. They are:

(i) Public Issue:

The most common method of raising capital by new companies is through sale of securities to the public. It is called public issue.

(ii) Rights Issue:

When an existing company wants to raise additional capital, securities are first offered to the existing shareholders on a pre-emptive basis. It is called rights issue.

(iii) Private Placement:

Private placement is a way of selling securities privately to a small group of investors.

II Secondary Market

Secondary Market may be defined as the market for old securities, in the sense that securities which are previously issued in the primary market are traded here. The trading takes place between investors who follow the original issue in the primary market. It covers both stock exchange and over-the counter market.

5.04 Functions of Capital Market

Capital market has a crucial significance to capital formation. For a speedy economic development adequate capital formation is necessary. The significance of capital market in economic development is explained below:-

(i) Savings and Capital Formation

In capital market, various types of securities help to mobilize savings from various sectors of population (Individuals, Corporate, Govt., etc.). The twin features of reasonable return and liquidity in stock exchange are definite incentives to the people to invest in securities. This accelerates the capital formation in the country.

(ii) Permanent Capital

The existence of a capital market/stock exchange enables companies to raise permanent capital. The investors cannot commit their funds for a permanent period but companies require funds permanently. The stock exchange resolves this dash of interests by offering an opportunity to investors to buy or sell their securities, while permanent capital with the company remains unaffected.

(iii) Industrial Growth

The stock exchange is a central market through which resources are transferred to the industrial sector of the economy. The existence of such an institution encourages people to invest in productive channels. Thus it stimulates industrial growth and economic development of the country by mobilizing funds for investment in the corporate securities.

(iv) Ready and Continuous Market

The stock exchange provides a central convenient place where buyers and sellers can easily purchase and sell securities. Easy marketability makes investment in securities more liquid as compared to other assets.

(v) Reliable Guide to Performance

The capital market serves as a reliable guide to the performance and financial position of corporate, and thereby promotes efficiency.

(vi) Proper Channelization of Funds

The prevailing market price of a security and relative yield are the guiding factors for the people to channelize their funds in a particular company. This ensures effective utilisation of funds in the public interest.

(vii) Provision of Variety of Services

The financial institutions functioning in the capital market provide a variety of services such as grant of long term and medium term loans to entrepreneurs, provision of underwriting facilities, assistance in promotion of companies, participation in equity capital, giving expert advice etc.

(viii) Development of Backward Areas

Capital Markets provide funds for projects in backward areas. This facilitates economic development of backward areas.

Long term funds are also provided for development projects in backward and rural areas.

(ix) Foreign Capital

Capital markets makes possible to generate foreign capital. Indian firms are able to generate capital funds from overseas markets by way of bonds and other securities. Government has liberalised Foreign Direct Investment (FDI) in the country. This not only brings in foreign capital but also foreign technology which is important for economic development of the country.

(x) Easy Liquidity

With the help of secondary market investors can sell off their holdings and convert them into liquid cash. Commercial banks also allow investors to withdraw their deposits, as and when they are in need of funds.

5.05 Indian Capital Market – Evolution and Growth

The period between 1947 and 1973 marked the development of infrastructure for capital market. During this period, a network of development financial institutions such as IFCI, ICICI, IDBI and UTI, SFCs and SIDCs were established. These financial institutions strengthened the capital market.

During the period between 1980 and 1992, debenture emerged as a powerful instrument of resource mobilization in the primary market. The public sector bonds were introduced. A number of stock exchanges came into existence. There was a momentous growth in the secondary market.

SEBI emerged as an effective regulatory body for the primary and secondary markets and afford a measure of protection to small investors. New financial services such as credit rating was introduced.

A number of committees were constituted in order to suggest measures to revamp and restructure the working of the secondary market and cause buoyancy in the primary market. Some of these committees were: Committee on Organization and Management of Stock Exchange, Working group on the Development of the Capital Market, A Study Group for Guidelines Relating to Valuation and New Instruments, A High Powered Study Group on Establishment of New Stock Exchange, A Committee on Trading in Public Sector Bonds and Units of Mutual Funds.

5.06 New Financial Institutions

A number of institutions of finance have been established to cater to the credit requirements of various segments of industry and needs. A brief outline of these institutions is presented below;

(i) Venture Fund Institutions

Venture capital financing is a form of equity financing designed especially for funding new and innovative project ideas. Venture capital funds bring into force the hi-technology projects which are converted into commercial production. Many specialized financial institutions have promoted their own venture capital funds. They include Risk Capital Foundation of IFCI, Venture Fund of IDBI, SIDBI, Technology Development and Infrastructure Corporation of India (TDICI), and others.

(ii) Mutual Funds

Financial institutions that provide facilities for channeling savings of small investors into avenues of productive investments are called 'Mutual Funds'. A mutual fund company invests the funds pooled from shareholders and gives them the benefit of diversified investment portfolio and a reasonable return.

Specialized financial institution like LIC, UTI, etc., beside commercial banks such as SBI, and Canara Bank are carrying out the business of mutual funds. The benefits of mutual fund are high return, easy liquidity, safety and tax benefits to the investors.

(iii) Factoring Institutions

"Factoring" is an arrangement whereby a financial institution provides financial accommodation on the basis of assignment/sale of account receivables. The factoring institutions collect the book debts for and on behalf of its clients. Some of the factoring institutions operating in India are SBI Factors and Commercial Services Private Limited, a subsidiary of State Bank of India and Canbank Factors Limited, a subsidiary of Canara Bank.

(iv) Over the Counter Exchange of India (OTCEI)

The OTCEI was set up by a premier financial institution to allow the trading of securities across the electronic counters throughout the country. It addresses some specific problems of both investors and medium-size companies. Some of the greatest strengths of OTCEI are transparency of transactions, quick deals, faster settlements and better liquidity.

(v) National Stock Exchange of India Limited (NSEI)

NSEI was established in 1992 to function as a model stock exchange. The Exchange aims at providing the advantage of nation-wide electronic screen based "scripless" and "floorless" trading system in securities. The institution is expected to allow for an efficient and transparent system of securities trading.

(vi) National Clearance and Depository System (NCDS)

Under the scripless trading system, settlement of transactions relating to securities takes place through a book entry. The entire scripless trading system comprises the following three segments:

a. National Trade Comparison and Reporting System which prescribes the terms and conditions of contract for the securities market

b. National Clearing System which aims at determining the net cash and stock liability of each broker on a settlement date

c. National Depository System which arranges to provide for the transfer of ownership of securities in exchange on payment by book entry on electronic ledgers without any physical movement of transfer deed

(vii) National Securities Depositories Limited (NSDL)

The NSDL was set up in the year 1996 for achieving a time bound dematerialization as well as rematerialization of shares. The establishment of NSDL is expected to alleviate the problems of post trade transactions in the secondary market.

(viii) Stock Holding Corporation of India Limited (SHCIL)

Stock Holding Corporation of India Limited (SHCIL) aims at serving as a central securities depository in respect of transactions on stock exchanges. The Corporation also takes up the administration of clearing functions at a national level.

Foreign Exchange Market

The foreign exchange market abets the foreign exchange trading. It is the largest, most liquid market in the world with an average traded value of more than $5 trillion per day. It includes all of the currencies in the world and any individual, company or country can participate in it.

I. Commodity Market

The commodity market manages the trading in primary products which takes place in about 50 major commodity markets where financial transactions increasingly outstrip physical purchases which are to be delivered. Commodities are commonly classified in two subgroups.

- **Hard Commodities Market**
- **Soft Commodities Market**

Hard commodities are raw materials typically mined, such as gold, oil, rubber, iron, and ore.

Soft commodities are typically grown agricultural primary products such as wheat, cotton, coffee, and sugar.

II. Derivatives Market

Derivatives market facilitates the trading in financial instruments such as futures contracts and options used to help control financial risk. The instruments derive their value mostly from the value of an underlying asset that can come in many forms – stocks, bonds, commodities, currencies or mortgages.

DO YOU KNOW?

Gilt-Edged Market also known as Government Securities market is the market for Government and semi-Government securities. An important feature of the securities traded in this market is that they are stable in value and are much sought after by banks.

- Guaranteed return on investments
- No speculation in securities
- Institutional based investors which are compelled by law to invest a portion of their funds in these securities.
- Predominated by such institutions as LIC, GIC, PFs and the commercial banks
- Heavy volume of transactions necessitating negotiation of each transaction

Exercise

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I. Choose the Correct Answers:

1. Capital market do not provide

a) Short term Funds
b) Debenture Funds
c) Equity Funds
d) Long term Funds

2. When the NSEI was established

a) 1990 b) 1992
c) 1998 d) 1997

3. Primary market is a Market where securities are traded in the

a) First Time b) Second Time
c) Three Time d) Several Times

4. Participants in the Capital Market includes

a) Individuals b) Corporate
c) Financial Institutions d) All of the above

5. The _______ was set up by a premier financial institution to allow the trading of securities across the electronic counters throughout the country.

a) OTCEI b) Factoring
c) Mutual Funds d) Venture Funds Institutions

Answers:

1	a	2	b	3	a	4	d	5	a

II. Very Short Answer Questions:

1. What is Capital Market?
2. Write a note on OTCEI.
3. Who are the participants in a Capital Market?
4. How is price determined in a Capital Market?

III. Short Answer Questions:

1. What are the various kinds of Capital Market? Explain (any 3)
2. Explain any two functions of Capital Market.
3. Explain about Factoring and Venture Capital Institutions.

IV. Long Answer Questions:

1. Discuss the characters of a Capital Market.
2. Briefly explain the functions of Capital Market. (any 5)
3. Explain the various types of New Financial Institutions. (any 5)

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