Introduction to Indian Capital Market

Introduction

Capital market is a platform wherein buyers and sellers of securities meet. It is a market through which companies and government raise their fund requirements. Funds are raised through stocks and debt instruments. Thus we can say that capital market comprise of stock market and bond market. Equity has been and always will be a lucrative investment for investors, since it provides opportunity to make money not in the long term but also in medium to short term. For a developing economy like India, capital market play an important role as these bridges the gap between savings and investment also the fund requirement in met which is crucial for companies. Thus there are two components of India capital market – Equity market and Debt market.

Evolution

The equity market in India is one of the oldest in the Asia region. The stock market in India had been active for about 150 years that played a significant role in developing risk markets. This also helped in promoting enterprise and supporting the growth of industry.

The stock market in India began in the 1860s during the American Civil War that led to a sudden surge in the demand for cotton from India resulting in setting up of a number of joint stock companies that issued securities to raise finance. This trend was akin to the rapid growth of securities markets in Europe and the North America in the background of expansion of railroads and exploration of natural resources and land development.

There were about 1,000 brokers with the stock markets functioning from three places in Mumbai; between 9 am to 7 pm. Share prices rose sharply even at that time. Bombay, at that time, was a major financial centre having housed 31 banks, 20 insurance companies and 62 joint stock companies. The first stock exchange was established in Mumbai. Before the first exchange set up the market was completely under the control of local enterprises. Later other stock exchanges came up in cities like Ahmadabad, Hyderabad, Madras etc. there are a number of factors that led to faster growth of the Indian stock market. Some of them are mentioned:

Foreign Exchange Regulation Act (FERA) was set up which bought in foreign investment by various multinational firms. This in turn increased the scope of capital market.

- Many economic and financial reforms helped greatly in the growth of the capital market.
- The trading processes and the infrastructure required were improved with the current demand and the technological improvement.
- The importance of an efficient micro market infrastructure was realized.

Stock markets have been showing phenomenal growth since 1990s. This has been possible because of growing participation of both Indian and foreign investments, also the wide range of reforms and regulations that has been bought time to time based on the market and economic conditions. Foreign Institutional investment which is one important component has shown a continuous growth since inception. Stock market slowly became technology oriented i.e. they became computerized and manual transaction decreased. This helped in saving time, cost and reduced the risk of error. Electronic trading, digital certification, straight through processing, electronic contract notes, online broking have made the market more dynamic.

The products offered at the stock market also increased from mere equity to derivative, future, option and many more. The proper risk management system came into place reducing the risk of payment defaults. The demutualization and corporatization of all stock exchanges is nearing completion and the boards of the stock exchanges now have majority of independent directors. The knowledge of people regarding stock market also is one important factor leading to the growth of the Indian stock market. The number of high net worth individual has been increasing who invest in the stock market either directly or through mutual funds.

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Impact Of Capital Market On Indian Economy

Long term finance for corporate and government: The capital market is the market for securities, where companies and governments can raise long term funds. Selling stock and selling bonds are two ways to generate capital and long term funds. It provides a new avenue to corporate and government to raise funds for long term.

Helps to bridge investment – savings gap: Capital market expand the investment options available in the country, which attracts portfolio investments from abroad. Domestic savings are also facilitated by the availability of additional investment options. This enables to bridge the gap between investment and savings and paves the way for economic development.

Cost – effective mode of raising finance : Capital market in any country provides the corporate and government to raise long term finance at a low cost as compared to other modes of raising finance Therefore capital market is important, more so for India as it embarks on the path of becoming a developed country.

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Provides an avenue for investors to park their surplus funds: Capital market provides the investors both domestic as well as foreign, various instruments to invest their surplus funds. Not only it provides an avenue to park surplus funds but it also helps the investors to reap decent rewards on their investment. This realization has resulted in increased investments in capital market both from domestic as well as foreign investors in Indian capital market.

Conducive to implementation of Monetary Policy: since RBI controls the movement and availability of money in the economy. When RBI follows the expansionary policy it purchases government securities from the bond market and sells the same in the in the secondary market. This process has some effect on the interest rates. Thus capital market helps RBI in applying the monetary policy.

Indicates the state of the economy: Capital market is said to be the face of the economy. This is so because when capital market is stable, investments flow into capital market from within as well as outside the country, which indicates that the future prospects of the economy are good.

Structure

The capital market consists of the primary markets and the secondary markets and there is a close link between them. The primary market creates long-term instruments through which corporate entries borrow from the capital market. But secondary market is the one which provides liquidity and marketability to these instruments. These markets interact with one another. If the secondary market is active it enables the corporate entities to enter the new issue market or the primary market and raise funds. Simultaneously the depth of the secondary market depends upon the activities of the primary market because it is only when more corporate entities enter into the market and raise funds through the market that more instruments are available in the secondary market for the purpose of improved activities in this market.

Market Components

Equity

1. Stock or any other security representing an ownership interest.

2. On the balance sheet, the amount of the funds contributed by the owners (the stockholders) plus the retained earnings (or losses), also referred to as "shareholder's equity".

3. In the context of margin trading, the value of securities in a margin account minus what has been borrowed from the brokerage.

In the simplest term Equity is an ownership in any asset after all the debts associated with it are paid off. Stocks are termed as equity as they give ownership of the company to the person who possesses it. Since they are the owner any profit earned by the company are first paid to the debenture and bond holders. After all the obligations are met, if still anything left is distributed among the equity holders as per the number of stocks held by them. Equity delivers good results if held for a longer period of time. On the other hand short term investment in equity is very risky and volatile. Most of the time fund and portfolio managers suggest long term investment if the investment equity oriented.

Derivatives

Different types of derivatives

- **Forwards** **-** A forward contract is an agreement between two parties wherein settlement takes place at a specified future date but at a price agreed today eg.:- On 1st October a farmer entering into a forward contract to sell 1000 KGs of wheat on 31st December at 50 Rs/Kg.

- **Futures** – It is agreement between two parties to buy/sell an asset on a specified future date at a certain price.

Difference between Futures and Forwards

Futures	Forwards
Traded in organized exchange	Traded privately between two parties
Standardized contract	Non-standardized contract
Cleared by clearing house	No clearing house
No credit risk	Some default risk
Traders deposit margin irrespective of trading position	No such provision
Settled daily	Settled once
Usually settled in cash prior to maturity	Delivery usually occurs
Contract can be easily closed	Contract closure is difficult
Monitored and regulated	Regulation is not tight
MTM (Mark to market settlement) is done daily	No such adjustments

Options - It is a financial derivative entered between two parties' buyer (option holder) and seller (option writer). In this contract the buyer of the option has the right but not the obligation to buy/sell the security at the agreed upon price.

Types of options:-

- **Call option –** In simple terms whenever an investor longs an option contract it is known as call option.
- **Put option –** whenever an investor shorts a particular option it is known as put option.

If an investor is positive about the prices that they will go up then he goes for call option and if he feels that prices are expected to come down then he will go for put option.

Working of futures

- **Open interest** – It reflects the total number of outstanding position on a particular day.

There is general misconception that open interest and total volume traded are one and the same, which is not true. The following example clearly depicts how the open interest is calculated.

Day	Trade/Transaction	Open interest position

Nov1	A buys one option and B sells one option	1
Nov2	C buys 5 options and D sells 5 option	6 (1+5)
Nov3	A sells his option to D	6 (there is no addition of any new position the same contract has changed hands)
Nov4	E buys 5 options from c	6 (the same contract has changed hands)

Market Participants

NSCCL

The NSCCL is the first clearing Corporation in India. It had been set up by NSE as a wholly owned subsidiary of it. The corporation was incorporated in August 1995 and started its clearing operations in April 1996. It was formed to have a formal clearing and settlement of the securities market. It helped in ensuring confidence among the traders and investors. Apart from ensuring confidence it maintained and promoted consistent settlement cycles. It also had a tight risk management system which provided risk guarantee.

Banker To An Issue

Bankers serve as a prominent role in the working of primary market. When the securities are first issued their job is to collect application along with the money for both shares and debentures. They do so as the companies are not allowed to collect the application money.

They also refund the application amount to the people whom shares cannot be issued. Any issuing company must appoint a bank to collect application money on their behalf. This rules lies in companies act, 1956. No person is allowed to act as banker unless he registers himself. He cannot carry any activity as a banker unless he holds a certificate granted by the Board under the regulations

“Banker to an issue” means a scheduled bank carrying on all or any of the following issue related activities namely:-

- Acceptance of application and application monies.
- Acceptance of allotment or call monies.
- Refund of application monies.
- Payment of dividend or interest warrants.

Conditions for grant or renewal of certificate

The Board may grant or renew a certificate to a banker to an issue subject to the following conditions,

- He shall enter into a legally binding agreement with the body corporate for or on whose behalf he is acting as banker to an issue stating therein the duties and responsibilities between himself and the body corporate for the issue for which he is acting as a banker to an issue
- He shall pay the amount of fees for registration in the manner provided in the regulations
- He shall take adequate steps for redressal of grievances of the investors within one month of the date of the receipt of the complaints and he shall keep the Board informed about the number, nature and other particulars of the complaints received and the manner in which such complaints have been redressed
- The certificate granted shall be valid for a period of three years from the date of the grant of the same.

Regulators

Need for Regulators in Securities Market: Regulators help the market participants to behave in a desired way. It is the duty of these regulators to continuously keep a check on the working of various market participants. They make sure that the rules and guidelines that have been made are being followed by all the market participants. They are also entitled to take appropriate action for those not following the rules.

Regulators of the Securities Market:

The various regulators of the stock market are:

- Department of Company Affairs (DEA)
- Reserve Bank of India (RBI)
- Securities and Exchange Board of India (SEBI)

Department of Economic Affairs (DEA): Department of economic Affairs works under the Right to Information (RTI) Act. Its major work is to prepare the union budget annually. It also formulates and monitors the internal and external aspects of the economic life of the country. It is also responsible for the manufacturing of bank notes and coins.

It works for raising the internal resources with the help of taxation and market lending. The working of DEA is highly linked with the capital market, as they help in raising the external resources which is an important component of capital market.

Main Functions -

- It formulates as well as monitors the economic life of the country at macro level that is connected with the Capital Market inclusive of Stock Exchange
- It manages both the internal and external aspects of the economic policies and programmes of the country
- It also lifts up external resources of the country's economy with the help of multilateral and bilateral official development assistance along with commercial borrowings from overseas countries, foreign

direct investments, preserving foreign exchange resources, and balance of payment

- The department contributes in raising the internal resources of the country's economy with the help of market borrowings, taxation, gathering of small savings, and ordinance of money supply system
- It plays a cardinal role in manufacturing bank notes and coins available in varied denominations.
- It also makes available the postal stationery, postal stamps, and many more.

It is highly responsible for the disbursement of loans as well debt servicing of the loans

Legal Framework

IPO

IPO is the medium through which a company raises equity capital from the public and by this process it also gets listed on the stock exchange

Clearing and Settlement

The clearing and settlement mechanism in Indian securities market has witnessed significant changes and several innovations during the last decade. These include use of state-of-art technology, emergence of clearing corporations to assume counterparty risk, shorter settlement cycle, dematerialization and electronic transfer of securities, fine tuned risk management system etc.

The stock exchanges in India were following a system of account period settlement for cash market transactions. T+2 rolling settlement have now been introduced for all securities. The members receive the funds/securities in accordance with the pay-in/pay-out schedules notified by the respective exchanges. Given the growing volume of trades and market volatility, the time gap between trading and settlement gives rise to settlement risk. In recognition of this, the exchanges and their clearing corporations employ risk management practices to ensure timely settlement of trades.

The regulators have also prescribed elaborate margining and capital adequacy standards to secure market integrity and protect the interests of investors. The trades are settled irrespective of default by a member and the exchange follows up with the defaulting member subsequently for recovery of his dues to the exchange. Due to setting up of the Clearing Corporation, the market has full confidence that settlements will take place on time and will be completed irrespective of possible default by isolated trading members.

Reforms in Indian Securities Market

Reform in any area is necessary to bring necessary changes and to be on par with the current situation. Various countries are adopting different capital market reforms to strengthen their economy. All the countries have had various capital market reforms in the past and are having currently too.

These reforms have helped them by bringing new ideas and techniques. Since the capital market is globalised the economic or financial change in one economy effects the other, so the reforms have to be made keeping in mind not only the nation's situation but all other aspects that will be affected by the same.

SEBI has announced a number of far-reaching reforms to promote the capital market and protect investor interests. Reforms in the secondary market have focused on three main areas:

- Structure and functioning of stock exchanges
- Automation of trading and post trade systems
- The beginning of surveillance and monitoring systems.

Computerized online trading of securities, and setting up of clearing houses or resolution guarantee funds were made compulsory for stock exchanges. Stock exchanges were allowed to expand their trading to locations outside their jurisdiction through computer terminals.

Thus, major stock exchanges in India have in progress of locating computer terminals in far-flung areas, while minor regional exchanges are planning to consolidate by using centralized trading under a federated structure. Online trading systems have been started in almost all stock exchanges. Trading is much more transparent and faster than in the past.

Until the early 1990s, the trading and settlement infrastructure of the Indian capital market was deprived, trading on all stock exchanges was through open outcry, settlement systems were paper-based, and market intermediaries were largely unregulated.

The regulatory structure was fragmented and there was neither complete registration nor an apex body of regulation of the securities market. Stock exchanges were run as "brokers clubs" as their management was mainly composed of brokers. There was no prevention on insider trading, or fraudulent and unfair trade practices.

Since 1992, there has been intensified market reform, resulting in a big development in securities trading, particularly in the secondary market for equity. The majority stock exchanges have introduced online trading and set up clearing houses/corporations. A depository has become operational for script less trading and the regulatory arrangement has been overhauled with most of the powers for amendable the capital market vested with SEBI.

The Indian capital market has practiced a process of structural transformation with operations conducted to standards equal to those in the developed markets. It was opened up for investment by foreign institutional investors (FIIs) in 1992 and Indian companies were permitted to increase resources abroad through Global Depository Receipts (GDRs) and Foreign Currency Convertible Bonds (FCCBs).

The primary and secondary segments of the capital market extended rapidly, with greater institutionalization and wider participation of individual investors accompanying this growth.

But, various problems, including lack of confidence in stock investments, institutional overlaps, and other governance issues, continue as obstacles to the improvement of Indian capital market efficiency.

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The major reforms in the Indian capital market since the 1990s are presented below:

- As a first step to reform the capital market, the Securities and Exchange Board of India (SEBI), which was earlier set up in April 1988 as a no statutory body under an administrative arrangement, was given statutory powers in January 1992 through an enactment of the SEBI Act, 1992 for regulating the securities markets. Investor protection and orderly development are two main objectives in the SEBI act 1992 of the capital market.

- The most significant development in the primary capital market has been the introduction of free pricing. The issuers of securities are now allowed to raise the capital from the market without requiring any consent from any authority either for making the issue or for pricing it. However, the issue of capital has been brought under SEBI's purview in that issuers are required to meet the SEBI guidelines for Disclosure and Investor Protection, which, in general, cover the eligibility norms for making issues of capital (both public and rights) at par and at a premium by various types of companies, reservation in issues, etc.

- The abolition of capital issues control and the freeing of the pricing of issues led to unprecedented upsurge of activity in the primary capital market as the corporate mobilized huge resources. It, inter alia, exposed certain inadequacies of the regulations. Therefore, without seeking to control the freedom of the issuers to enter the market and freely price their issues, the SEBI further strengthened the norms for public issues in April 1996. Alongside, SEBI raised the standards of disclosure in public issues to enhance their transparency for improving the levels of investor protection. Issuers of capital are now required to disclose information on various aspects, such as, track record of profitability, risk factors, etc. Issuers now also have the option of raising resources through fixed price floatation or the book building process.

- Trading infrastructure in the stock exchanges has been modernized by replacing the open outcry system with on-line screen based electronic trading, unlike several of the developed countries where the two systems still continue to exist on the same exchange. In all, 23 stock exchanges in India have approximately 8,000 trading terminals spread all over the country. This improved the liquidity of the Indian capital market and a better price discovery.

- The trading and settlement cycles were initially shortened from 14 days to 7 days. Subsequently, to further enhance the efficiency of the secondary market, rolling settlement was introduced on a T+5 basis. With effect from April 1, 2002, the settlement cycle was further shortened to T+3 for all listed securities. The settlement cycle is now T+2.

- All stock exchanges in the country have established clearing houses. Consequently, all transactions are settled through the clearing house only and not directly between members, as was practiced earlier.

- Several measures have been undertaken/ strengthened to ensure the safety and integrity of the market. These are: margining system, intra-day trading limit, exposure limit and setting up of trade/settlement guarantee fund.

- Securities, which were earlier held in physical form, have been dematerialized and their transfer is done through electronic book entry, which has eliminated some of the disadvantages of securities held in physical form. There are two depositories operating in the country.

- In India, all listed companies are now required to furnish to the stock exchanges and also publish unaudited financial results on a quarterly basis. To enhance the level of continuous disclosure by the listed companies, the SEBI decided to amend the Listing Agreement to incorporate the Segment Reporting, Accounting for Taxes on Income, Consolidated Financial Results, Consolidated Financial Statements, Related Party Disclosures and Compliance with Accounting Standards.

- The Indian capital market is also increasingly integrating with the international capital markets. One of the significant steps towards integrating Indian capital market with the international capital markets was the permission given to Foreign Institutional Investors (FIIs) such as, mutual funds, pension funds and country funds to operate in the Indian markets. Indian firms have also been allowed to operate in the Indian markets. Indian firms have also been allowed to raise capital from 14 international capital markets through issues of Global Depository Receipts (GDRs), American Depository Receipts (ADRs), Euro Convertible Bonds (ECBs), etc.

- Boards of various stock exchanges, which in the past included mainly brokers, have been broad-based in order to make them more widely representative so that they represent different interests and not just the interests of their members. Reconstituted Governing Boards have now broker and non-broker representation in the ratio of 50-50 apart from the Executive Director who has a seat on the Board and is required to be a non-broker professional. To remove the influence of brokers in the functioning of stock exchanges, the SEBI decided that no broker member of the stock exchange shall be an office bearer of an exchange or hold the position of President, Vice President, Treasurer, etc. Efforts are afoot to demutualise and corporatize the stock exchanges.

- Apart from stock exchanges, various intermediaries, such as mutual funds, stock brokers and sub-brokers merchant bankers, portfolio managers, registrars to an issue and share transfer agents, underwriters, debenture trustees, bankers to an issue, custodian of securities, venture capital funds and issuers have been brought under the SEBI's regulatory purview.

- There are now regulations in place governing substantial acquisition of shares and takeovers of companies. The Regulations are aimed at making the takeover process more transparent and to protect the interests of minority shareholders.

- Trading in derivative products, such as stock index future, stock index options and futures and options in individual stocks have also been introduced.

Portfolio Management

A portfolio refers to a collection of different financial assets held either by an individual or by any other institution. Generally investment is made in different asset classes in order to diversify and also reduce the probability of incurring a loss or negative returns on total funds – it works on the principle that even if returns from one or two asset classes is negative and from other is positive the investor still stands to gain on the overall funds invested and the risk of losing money is less as compared to the investment made in one asset class.

Different asset classes

- Equities
- Bonds
- Mutual funds
- Commodities
- Insurance
- Real estate
- Antiques
- Derivatives