B.Com. Program in Accounting
Semester-IV
CC-8: Capital Market

Unit 1: Introduction to Capital Market

Compiled By
Sukumar Paitandi
Dept. of Commerce
Raniganj Girls'' College

Concept:

Capital Market, is used to mean the market for long term investments, that have explicit or implicit claims to capital. Long term investments refers to those investments whose lock-in period is greater than one year.
In the capital market, both equity and debt instruments, such as equity shares, preference shares, debentures, zero-coupon bonds, secured premium notes and the like are bought and sold, as well as it covers all forms of lending and borrowing.

Role and Functions of Capital Market:

1. Mobilization of savings to finance long term investments.
2. Facilitates trading of securities.
3. Minimization of transaction and information cost.
4. Encourage wide range of ownership of productive assets.
5. Quick valuation of financial instruments like shares and debentures.
6. Facilitates transaction settlement, as per the definite time schedules.
7. Offering insurance against market or price risk, through derivative trading.
8. Improvement in the effectiveness of capital allocation, with the help of competitive price mechanism.

Capital market is a measure of inherent strength of the economy. It is one of the best source of finance, for the companies, and offers a spectrum of investment avenues to the investors, which in turn encourages capital creation in the economy.

Distinction between Money Market and Capital Market:

BASIS FOR COMPARISON	MONEY MARKET	CAPITAL MARKET
Meaning	A segment of the financial market where lending and borrowing of short term securities are done.	A section of financial market where long term securities are issued and traded.
Nature of Market	Informal	Formal
Financial instruments	Treasury Bills, Commercial Papers, Certificate of Deposit, Trade Credit etc.	Shares, Debentures, Bonds, Retained Earnings, Asset Securitization, Euro Issues etc.
Institutions	Central bank, Commercial bank, non-financial institutions, bill brokers, acceptance houses, and so on.	Commercial banks, Stock exchange, non-banking institutions like insurance companies etc.
Risk Factor	Low	Comparatively High
Liquidity	High	Low
Purpose	To fulfill short term credit needs of the business.	To fulfill long term credit needs of the business.
Time Horizon	Within a year	More than a year
Merit	Increases liquidity of funds in the economy.	Mobilization of Savings in the economy.
Return on Investment	Less	Comparatively High

Industrial Securities Market:

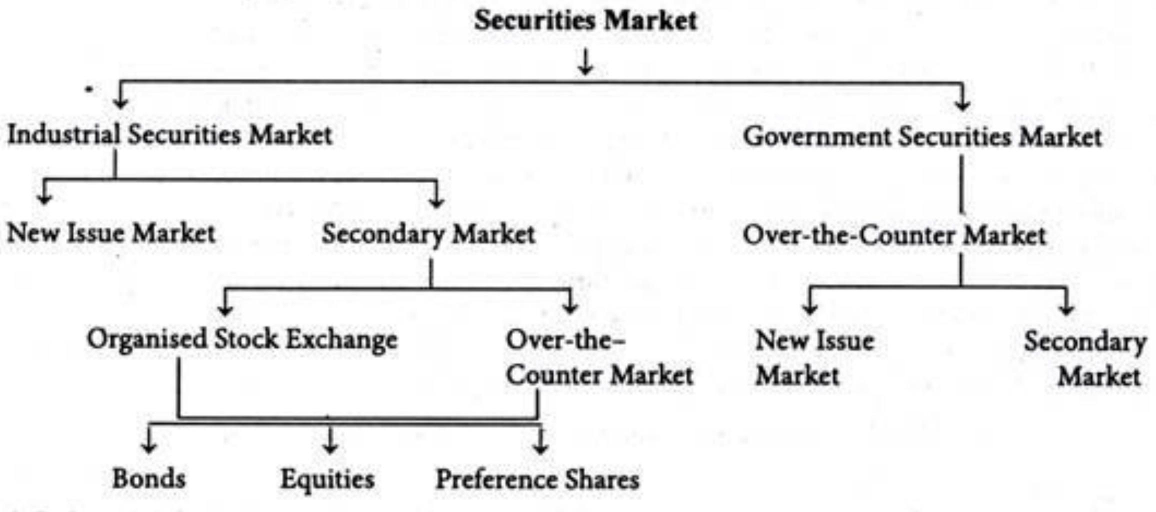
The Industrial securities market refers to the market for shares and bonds of the existing companies, as well as those of new companies.

Initially, a securities market is created to help finance growing, or sometimes new, corporations. A securities market finances directly when its principals or members invest or lend their own funds.

Structure of Industrial Securities Market

The Industrial securities market is further divided into New Issue Market (NIM) and Old Issue Market. The New Issue Market is also called Primary Market. Likewise, the Old Issue Market is also called Secondary Market or Stock Exchange.

Table 40.1. The Structure of Securities Market



Financial Instruments in Industrial Securities Market

Financial instruments mean documents that evidence the claims and income or asset as "any contract that gives rise to both a financial asset on one enterprise and a financial liability or equity instrument of another enterprise".

1. Securities:

'Securities' is a general term for a stock exchange investment.

Securities Contract (Regulation) Act, 1956 defines securities as to include:

1. Shares, Scripts, Stocks, Bonds, Debentures.
2. Government Securities.
3. Such other instruments as may be declared by the Central government to be securities.
4. Rights or interests in securities and,
5. Derivatives
6. Securitized instruments

Securities are generally classified into ownership securities and creditorship securities. Equity shares and preference shares are ownership securities. They are also known as capital stock. Creditorship securities are bonds, debentures etc. They are referred to as debt capital.

2. Equity Shares:

Equity Shares are the ordinary shares of a limited company. It is an instrument, a contract, which guarantees a residual interest in the assets of an enterprise after deducting all its liabilities- including dividends on preference shares. Equity shares constitute the ownership capital of a company. Equity holders are the legal owners of a company.

3. Preference Shares:

The Companies Act (Sec, 85), 1956 describes preference shares as those which Carry a preferential right to payment of dividend during the life time of the company and Carry a preferential right for repayment of capital in the event of winding up of the company.

Preference shares have the features of equity capital and features of fixed income like debentures. They are paid a fixed dividend before any dividend is declared to the equity holders.

4. Debentures:

Debenture is an instrument under seal evidencing debt. The essence of debenture is admission of indebtedness. It is a debt instrument issued by a company with a promise to pay interest and repay the principal on maturity. Debenture holders are creditors of the company. Sec 2 (12) of the Companies Act, 1956 states that debenture includes debenture stock, bonds and other securities of a company. It is customary to appoint a trustee, usually an investment bank- to protect the interests of the debenture holders. This is necessary as debenture deed would specify the rights of the debenture holders and the obligations of the company.

5. Bonds:

Bonds are debt instruments that are issued by companies/governments to raise funds for financing their capital requirements. By purchasing a bond, an investor lends money for a fixed period of time at a predetermined interest (coupon) rate. Bonds have a fixed face value, which is the amount to be returned to the investor upon maturity of the bond.

During this period, the investors receive a regular payment of interest, semi-annually or annually, which is calculated as a certain percentage of the face value and known as a 'coupon payment.' Bonds can be issued at par, at discount or at premium. A bond, whether issued by a government or a corporation, has a specific maturity date, which can range from a few days to 20-30 years or even more.

Both debentures and bonds mean the same. In Indian parlance, debentures are issued by corporates and bonds by government or semi-government bodies. But now, corporates are also issuing bonds which carry comparatively lower interest rates and preference in repayment at the time of winding up, comparing to debentures.

<u>Distinction between Primary Market and Secondary Market:</u>

BASIS FOR COMPARISON	PRIMARY MARKET	SECONDARY MARKET
Meaning	The market place for new shares is called primary market.	The place where formerly issued securities are traded is known as Secondary Market.
Another name	New Issue Market (NIM)	After Market
Type of Purchasing	Direct	Indirect
Financing	It supplies funds to budding enterprises	It does not provide funding to

	and also to existing companies for expansion and diversification.	companies.
How many times a security can be sold?	Only once	Multiple times
Buying and Selling between	Company and Investors	Investors
Who will gain the amount on the sale of shares?	Company	Investors
Intermediary	Underwriters	Brokers
Price	Fixed price	Fluctuates, depends on the demand and supply force
Organizational difference	Not rooted to any specific spot or geographical location.	It has physical existence.

Government Securities:

Securities issued by the central government or state governments are referred to as government securities (G-Secs).

A Government security may be issued in one of the following forms, namely:

1. A Government promissory note payable to or to the order of a certain person, or
2. A bearer bond payable to bearer, or
3. A stock, or
4. A bond held in a ‘bond ledger account,

They have the safety and security of investments made in them with regularity of return. These are guaranteed by the government. The papers issued by the Bank of England used to have gift-edged borders. The term is believed to have originated from there. Thus, gilt edged securities or gilt securities have the strong consistent record of earnings and can be relied on the cover dividends and interest.

The central government raises funds through the issue of dated securities (securities with maturity period ranging from two years to 30 years, long-term) and treasury bills (securities with maturity periods of 91 or 364 days, short-term).

State governments go about raising money through State Development Loans (SDLs). Local bodies of various states like municipalities also tap the bond market from time to time.

They are issued in denominations of Rs. 100 or Rs. 1000. The interest is payable half yearly. They are issued through the public debt office of RBI (PDO). The Public Debt Office (PDO) of RBI manages the government issues. G-secs may be issued in Physical form or in dematerialised form. They are issued by RBI in consultation with Government, through auctions conducted electronically.

Types of Government Securities:

Following are the types of Government Securities:

1. Promissory Notes:

Promissory Notes are instruments containing the promises of the Government to pay interest at a specified rate. Interests are usually paid half yearly. Interest is payable to the holder only on presentation of the promissory notes. They are transferable by endorsement and delivery.

2. Stock Certificates (Inscribed Stock):

Stock certificate, also known as Inscribed Stock, is a debt held in the form of stock. The owner is given a certificate inserting his name after registering in the books of PDO of RBI. The execution of transfer deed is necessary for its transfer. Since liquidity is affected, these are not much favoured by investors. One will have to wait till maturity to get it encashed.

3. Bearer Bonds:

A bearer bond is an instrument issued by government, certifying that the bearer is entitled to a specified amount on the specified date. Bearer bonds are transferable by mere delivery. Interest Coupons are attached to these bonds. When the periodical interest falls due, the holder clips off the relevant coupon and presents it to the concerned authority for payment of interest.

4. Dated Securities:

They are long term Government securities or bonds with fixed maturity and fixed coupon rates paid on the face value. These are called dated securities because these are identified by their date of maturity and the coupon. Dated securities are sold through auctions. They are issued and redeemed at par.

5. Zero Coupon Bonds:

These bonds are issued at discount to face value and to be redeemed at par. As the name suggests there is no coupon/interest payments.

6. Partly Paid Stock:

This is a stock where payment of principal amount is made in installments over a given time frame. It meets the needs of investors with regular flow of funds and the needs of Government when it does not need funds immediately.

7. Floating Rate Bonds:

These are bonds with variable interest rate, which will be reset at regular intervals (six months). There may be a cap and a floor rate attached, thereby fixing a maximum and minimum interest rate payable on it. Floating rate bonds of four year maturity were first issued on September 29, 1995.

8. Bonds with Call/Put Option:

These are Govt. bonds with the features of options where the Govt. (issuer) has the option to call (buy) back or the investor can have the option to sell the bond (Put option) to the issuer.

9. Capital Indexed Bonds:

These are bonds where interest rate is a fixed percentage over the wholesale price index. The principal redemption is linked to an index of inflation (here wholesale price index). These provide investors with an effective hedge against inflation. These bonds were floated on December, 1997 on an on tap basis. They were of five year maturity with a coupon rate of 6 per cent over the wholesale price index.

10. Fixed Rate Bond:

Normally government securities are issued as fixed rate bonds. In this type of bonds the coupon rate is fixed at the time of issue and remains fixed till redemption.

Gold bonds, National Defence bonds, Special Purpose Securities, Rural Development bonds, Relief bonds, Treasury bill etc. are other types of Government securities.

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