CHAPTER 7

INDIAN FINANCIAL SYSTEM

CAPITAL MARKET

In this Chapter, I will learn

- COMPOSITION AND FUNCTIONS OF CAPITAL MARKET
- SECURITIES AND EXCHANGE BOARD OF INDIA (SEBI)
- TRADING PROCESS
- STOCK EXCHANGES
- DEVELOPMENT FINANCIAL INSTITUTIONS
- FINANCIAL INTERMEDIARIES
- RELATED TERMS

Capital market is a medium and a platform for long term funds. It helps to generate bulk fund for government and industries. The institutions in the capital market are called Non-Banking Financial Companies. This is evident from RBI's observation which runs as: "Housing Finance Companies, Merchant Banking Companies, Stock Exchanges, Companies engaged in the business of stock-broking/ sub-broking, Venture Capital Fund Companies, Nidhi Companies, Insurance companies and Chit Fund Companies are NBFCs".[1] All the institutions listed in this observation are capital market institutions. But it is not necessary that all NBFCs are capital market institutions.

The RBI defines NBFCs as, "A Non-Banking Financial Company (NBFC) is a company registered under the Companies Act, 1956 and is engaged in the business of loans and advances, acquisition of shares/stock/bonds/debentures/securities issued by Government or local authority or other securities of like marketable nature, leasing, hire-purchase, insurance business, chit business but does not include any institution whose principal business is that of agriculture activity, industrial activity, sale/purchase/construction of immovable property. A non-banking institution which is a company and which has its principal business of receiving deposits under any scheme or arrangement or any other manner, or lending in any manner is also a non-banking financial company (Residuary non-banking company)."[2] NBFCs are classified as deposit taking and non deposit taking NBFCs .The NBFC companies differ from banks in the following aspects:

(i) NBFCs can accept deposits but cannot accept demand deposits;

(ii) NBFCs are not a part of the payment and settlement system and they cannot issue cheques drawn on itself and

(iii) Bank deposits have insurance cover of Deposit Insurance and Credit Guarantee Corporation but it is not available for NBFC deposits.

This chapter covers composition and functions of primary and secondary market.

COMPOSITION AND FUNCTIONS OF CAPITAL MARKET

The capital market can be classified as shown in figure 7.1 in the next page.

Securities Market

Securities market deals with shares (equity shares, preference shares, derivatives) and debt instruments (bonds, debentures etc,.). Both **shares** and **debt** instruments are instruments of fund raising. But, there is a difference between them. In case of shares, the investors have a share in the capital and profit. In case of debt instruments, the investors do not have any share in the

1 http:// www.rbi.org.in / scripts / FAQView aspx?Id=71

2 http:// www.rbi.org.in / scripts / FAQView aspx?Id=71

capital. They just lend to the company. The company is liable to pay interest on capital borrowed through bonds. Regardless of profit or loss, the debt instrument holders are entitled to receive interest income.

Debenture is also like bond but there is a slight difference.Bonds are unsecured one. It means there is no surety for bonds. The lender lends money to companies without any surety. In the case of debentures there is some surety. It may be plant, machinery or building etc.

Shares are of two types. One is Equity share and the other is Preference share. **Equity shares** are shares that has claim over capital, profit and loss. It means, the equity share holders have right to receive profit if the company earns profit and have to forego capital to the extent of loss in case the company incurs loss.

Preference shares are shares that have entitlement to a fixed amount of dividend or dividend at a fixed rate like that of interest on bonds. In the case of winding up (closing up) of company, these shares have the preferential right to get back the capital paid. They have the right to get back capital next to bond holders.

Government and Industrial Securities Market

Based on the fund raiser, we can classify securities market into two types. One is Government securities market and the other is Industrial Securities market.

Government Securities Market

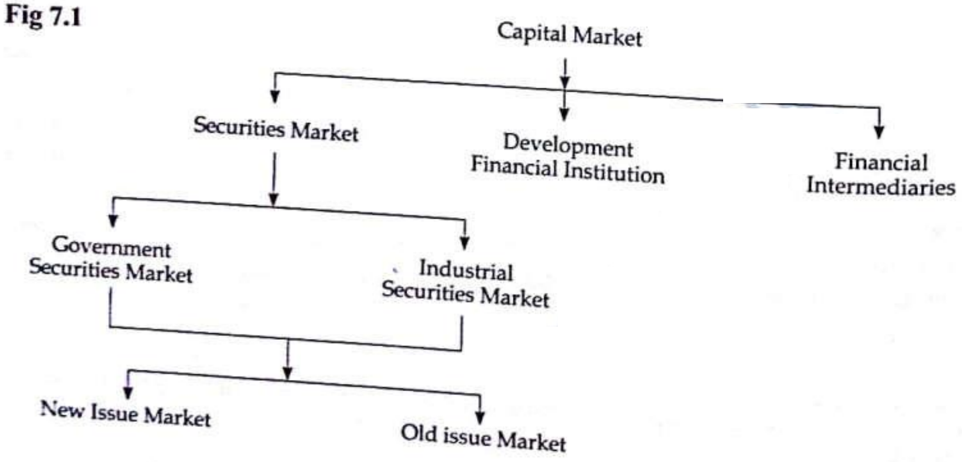
It is a market for Government and semi government securities backed by RBI.

It isalso known as Gilt Edged Market. Gilt edged means "of the best quality". The government securities are more reliable. That is why they are called Gilt edged securities.

Industrial Securities Market

It is a market for securities of industrial

Fig 7.1



and commercial organisations.

Both the Government securities and industrial securities are traded in primary as well as secondary market.

New and old issue market

Further, based on the nature of issue (in lay man's language issue means selling) the securities market can be classified as New issue market and Old issue market. The New issue market is also known as Primary market. The Old issue market also known as Secondary Market.

In new issue market, the securities issued by issuer are purchased by investors that are public. To put in another way, sale and purchase of new (fresh/ first time issued) securities is carried out. In old issue market the sale and purchase of securities that were already issued in the New issue market is carried out. In India, both New issue and Old issue markets are regulated by Securities and Exchange Board of India (SEBI).

SECURITIES AND EXCHANGE BOARD OF INDIA (SEBI)

It was established in 1988 for the development and regulation of securities market through a resolution of government. It was given statutory status in 1992. Its head office is in Mumbai. Its regional offices are in Calcutta, Delhi and Chennai.

New issue Market

The issue of securities in new issue market can be classified as shown in the following figure 7.2.

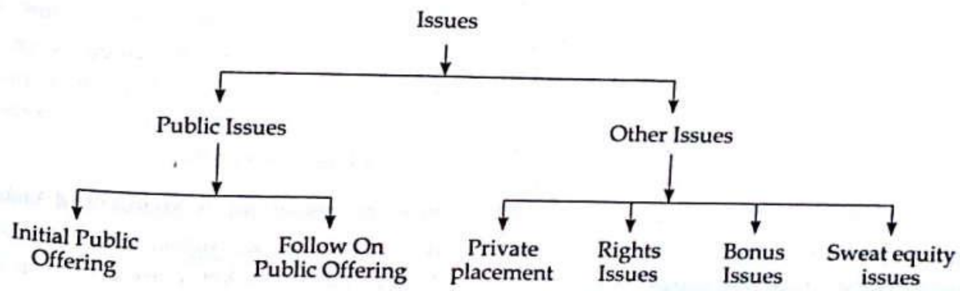
Public and other issues

Public issue means issue of securities to public i.e to all people whoever wants to invest. In other issues the securities are issued to closed group of people.

Public issues

In new issue market, if any company or financial corporation (issuer) issues shares for the first time, it is called as Initial Public Offering (IPO).The issuer may be

Fig 7.2



an existing company or corporation or may be a new start up. And if any company or corporation that has already issued shares, issues shares again, to raise additional fund it is called as Follow on Public Offering (FPO).

Issue Process

There are two ways of issuing securities in the New issue market. One is declared price issue and another is Book building issue. In the case of declared price selling, the issuer offers shares at a pre-fixed price. In **Book building**, the price is not announced. First, the issuer offers the shares and gets application from public and then based on the demand fixes the price. If the demand is high, the price is fixed high and vice versa.

In both IPO and FPO, the issuer usually does not directly issue the security. The issuer appoints any one **Merchant banker** on behalf of it to carry out fund raising activities. The merchant banker issues the application to investors and receives the application and money from investors. It sends the applications and money to issuer for allocation of shares to applied investors.

The issuer can issue to the extent of Authorised capital. **Authorised capital** means the maximum amount authorised by Memorandum of Association (MoA) of a company that can be raised by the company. A company necessarily need not issue shares to the extent of authorised capital. It can issue less than authorised capital. The actual amount issued by the issuer is called **Issued capital**.

After the company issues shares, the public subscribe (apply) to the shares. The subscription sometimes may be more than issued capital. If it is so, it means it is oversubscribed. The subscription sometimes may be less than issued capital. If it is so then it means it is undersubscribed. The actual amount subscribed is called **Subscribed capital**.

In the case of over subscription, the company allots shares to the subscriber based on some criteria. Usually, the small investors get preference. In this case the company can allot shares only to the extent of issued capital. In the case of under subscription, the company allots shares to all those who have applied. The remaining shares are purchased by underwriter. **Underwriter** means a financial intermediary who agrees to purchase the unsubscribed portion of issued capital.

The company usually collects the subscribed capital in installments. The portion of money demanded (called) from subscriber is known as **Called up capital**. The amount actually paid by subscribers when the money is demanded by issuer is known as **Paid up capital**.

Usually, the issuer does not demand the whole amount from subscriber. A small portion of money is left un-demanded (uncalled). The uncalled portion of money is called **Reserve capital**.

Once the issuer allots shares and shares are transferred to subscribers, the role of Secondary market comes in. Further

selling and buying of these shares takes place in Secondary market. Before looking into Secondary Market, let us continue with Primary market.

Other Issues

The issues that are not issued to public and issued to a closed group of people can be classified as other issues.

Private Placement

Private placement means offering shares directly to the financial institutions, mutual funds and high worth investors.

Private placements are made to Qualified Institutional Buyers (QIB). **Qualified institutional buyers** are those who are deemed financially sophisticated and are recognised by security market regulator to need less protection from issuers than most of the public investors. Institutions like Mutual funds, Financial Institutions (FIs), scheduled commercial banks, insurance companies, provident funds, pension funds, State Industrial Development Corporations etc., fall under the definition of being a QIB.

Rights Issue

Rights issue means offer of security to the existing shareholders in the Follow on Public Offering (FPO). It flows to the existing shareholders as a matter of legal right. So it is called Rights issue.

Bonus Issue

Bonus issue means offer of shares against distributable profit to existing shareholders. The shareholders' share in the profit is converted as shares. It is also known as scrip issue or capitalization issue.

Sweat Equity Issue

Sweat equity issue means offer of shares to employees or Directors of the company which issues shares as recognition of their hard labour (sweat) which results in contribution to the company in the form of intellectual property rights, technical know- how etc. It is usually issued at a discounted price. The Companies act 1956 observes as follows: "sweat equity shares means equity shares issued by the company to employees or directors at a discount or for consideration other than cash for providing know-how or making available rights in the nature of intellectual property rights or value additions, by whatever name called."

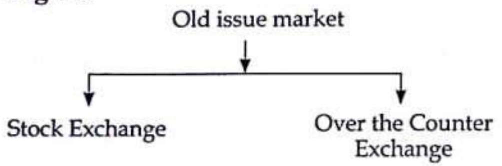
There are two other ways of incentivizing the employees and directors of the company. They are Employees Stock Option Scheme (ESOS) and Employees Stock Purchase Scheme (ESPS). Under the ESOS the whole-time Directors, Officers or employees of the company are given an option to purchase the shares of the company at a future date at a predetermined price.

Under ESPS only the employees are offered shares as part of public issue or in some other way. Usually the share cost is deducted from the salary between the offer date and purchase date.

Old Issue Market

As already said, Old issue/Secondary market is a medium for buying and selling of securities issued in the New issue market. Stock exchange is synonymously used for Old issue market. But it is wider than that. There are two trading media in this as shown in figure 7.3.

Fig 7.3



Stock Exchange

Stock exchange is an institution for orderly buying and selling of listed securities. Listed securities means the securities accepted to be traded in stock exchanges.

Over the Counter Exchange

Over the counter exchange is a platform for trading in securities that are not 'listed' on a recognised Stock exchange.

TRADING PROCESS

The trading of shares in stock exchanges is mediated by stock broking companies. Both buyer and seller have to approach broker. **Brokers** are registered members with stock exchanges to trade on behalf of clients. **Sub-brokers** are trading persons affiliated with Brokers. They act like branches to Brokers. They are subject to SEBI guidelines.

The types of trading are different based on time. In **Cash trading**, the sale and purchase of securities takes place in the prevailing price on the day of trading. In **Forward trading**, both buyer and seller agree to buy and sell respectively at a future date at a pre agreed price, irrespective of the price that prevails on the day of trade. There are two types of forward trade. One is **Futures** and another one is **Options**. Though both are forward trade methods, there is a slight difference. In case of Futures, both buyer and seller have to execute the agreement. In case of Options, the buyer or seller can withdraw from the agreement. To have this option the buyer or seller has to deposit some amount as premium. In the case when he fails to execute the agreement, he has to forego the premium amount. The choice available to seller not to execute the agreement is called **Put option**. If it is available to buyer it is called **Call option**.

The futures and options are **Derivatives**. Derivatives mean any agreement like futures and options which doesn't have independent value. The agreement to trade in the future doesn't have any value. It has value only because of underlying securities which are to be traded.

STOCK EXCHANGES

In India, there are small and big stock exchanges. The most prominent exchanges are National Stock Exchange (NSE) and Bombay Stock Exchanges (BSE).

National Stock Exchange (NSE)

It was established in 1993 on the

recommendation of Pherwani Committee. Industrial Development Bank of India (IDBI) is the main promoter of this exchange. Other leading Financial Institutions are also promoters of it along with IDBI.

Bombay Stock Exchange (BSE)

It was established in 1887.It is Asia's oldest Stock Exchange. It was known as 'The Native Share and Stock Brokers Association'. It was owned by stock brokers. Now it is demutualised. Demutualised means the stock brokers owned organisation made public owned organisation. The shares in the hands of brokers were transferred to public. This process is called **Demutualisation.**

Index

Like wholesale price index which measures the rise/fall in the price of commodities, there are share price indices. The most prominent indices in India are Sensex, Nifty and Nifty Junior.

Sensex stands for **Sensitive index**. This is an index of Bombay stock exchange. This measures the price movement of top 30 company shares. The top 30 companies are called Blue chip companies.

Nifty stands for **National Index for fifty**. This and Nifty Junior are indices of National stock exchange. NIFTY measures price movement of top fifty companies. Nifty Junior is an **index** of next 50 top companies.

The top companies are selected on the basis of total value of all shares that are traded in the stock exchange.

Value of traded shares = Price of one share x Number of shares traded

This value is called **free float market capitalisation**. The value of all {both traded and non-traded (the shares that are kept for a long time)} shares is called **market capitalisation.**

Market capitalisation is the value of shares that were sold to public which are called outstanding shares. In formulaic form:

Market capitalisation = Price x Total outstanding share

For example if the price of a share is ₹ 200 and the total outstanding share of that company is 2000 then market capitalisation is 200 x 2000 = ₹ 400000. The price mentioned here is not actual price but price estimated on the basis of future prospects of the company and economic condition etc.

Depositories

Depositories are institutions that keep securities of investors in electronic format (demat format). Demat stands for **de-materialised**. It means securities that were kept in paper (material) format now made as dematerialised (electronic) one. This electronic format is stored and maintained by these Depositories. The change in ownership, whenever transfer of securities takes place, is done electronically. In India,

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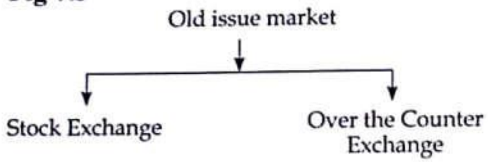

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National Securities Depository Limited (NSDL) is the first Depository in the country. It was established by UTI, NSE and IDBI. Central Depository Services India Ltd (CDSL) was established by BSE, Bank of India, Bank of Baroda, SBI and HDFC Bank.

Clearing Houses

Clearing houses enable easy settlement of securities trade. Like Depositories it also helps in change of ownership and delivery of securities.

Clearing Banks

Clearing banks mediate fund transfer between buyers and sellers. Both securities and fund transfer are made through National Securities Clearing Corporation of India Limited (NSCCL). It mediates between various depositories, clearing houses and clearing banks in settlement of securities and funds respectively. The schematic figure 7.4 explains this.

Securities paid by the delivering member to the clearing house/Depository on morning of T+ 2

Funds are paid-in to the clearing bank by the Receiving Member on morning of T+2.

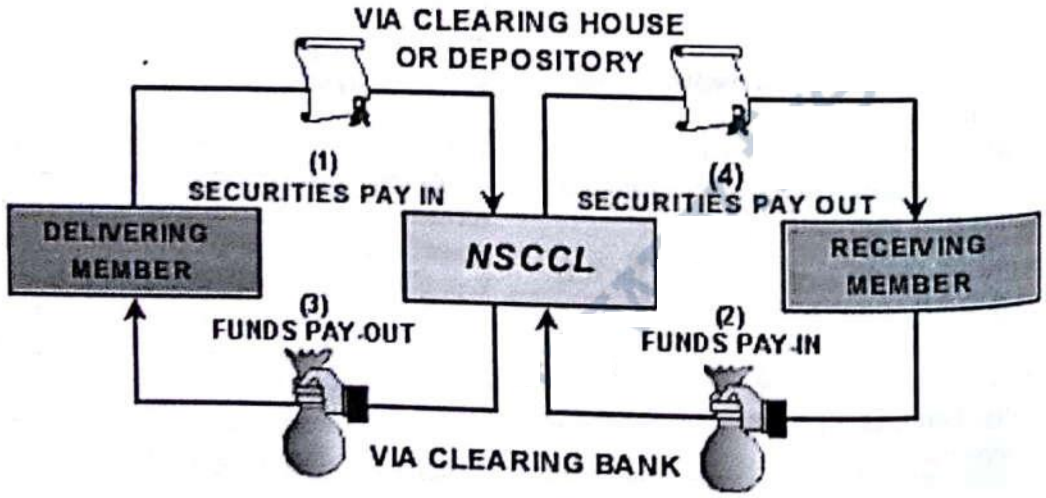
The pay-out for both funds and securities takes place evening of T+2.

Source: http://otcei.net/clearing/

Rolling Settlement

In the above explanation to the diagram, T+2 represents Rolling settlement. Rolling settlement means the trade executed in securities market is settled in few subsequent working days. T stands for trade day, the day on which buyers and sellers agree to buy and sell. The number 2 represents two working days after the trade day in which settlement, that is delivery of securities and funds, takes place which is called settlement day.

Fig 7.4



Online Trading

The trading of shares is now made online. The online trading platform of Bombay is BOLT (BSE Online Trading) and of NSE is NEAT (National Exchange Automated Trading).

DEVELOPMENT FINANCIAL INSTITUTIONS

Development financial institutions provide long term loan (even more than 25 years) and entrepreneurial assistance to industries. The entrepreneurial assistance is in the form of technical advice, helping in feasibility study etc.

In India IDBI, Industrial Financial Corporation of India (IFCI), Exim Bank etc,. are some of the development financial institutions to be named.

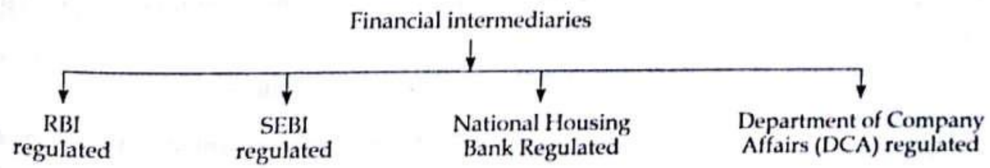
FINANCIAL INTERMEDIARIES

The capital market institutions other than stock exchanges and development financial institutions can be called as Financial Intermediaries. The financial intermediaries can be classified as shown in the following figure 7.5

RBI Regulated NBFCs

RBI regulated NBFCs were initially classified as

Fig 7.5



(i) Equipment leasing company

(ii) Hire-purchase company

(iii) Loan company

(iv) Investment company

i. Equipment leasing company

Equipment leasing companies own machineries and equipment and lease them to clients. In return the equipment leasing companies get rental income.

ii. Hire-Purchase Company

Hire purchase means purchasing equipment, machinery etc., in installment payment system. Hire purchase companies finance this kind of purchase and recover money from clients in installment.

However, with effect from 6th December, 2006 the above NBFCs registered with RBI have been reclassified as:

1. Asset finance company (AFC)
2. Loan company (LC)
3. Investment company (IC)

1. Asset Finance Company

The RBI website defines AFCs as follows: "AFC would be defined as any company which is a financial institution carrying on as its principal business the financing of physical assets supporting productive/ economic activity, such as automobiles, tractors, lathe machines, generator sets, earth moving and material handling equipment, moving on own power and general purpose industrial machines. Principal business for this purpose is defined as aggregate of financing real/ physical assets supporting economic activity and income arising there from is not less than 60% of its total assets and total income respectively."[3]

2. Loan Company

The main business of Loan companies is lending. They provide car loans, mortgage loans, gold loans etc.

3. Investment Company

Investment companies are the companies which invest in shares to acquire stake in other companies to earn profit and not for the purpose of trading. To qualify as investment companies, their main business should be investment and major part of the income should come from investment.

SEBI regulated NBFCs

1. Venture Capital Fund
2. Merchant Banking companies
3. Stock broking companies

1. Venture Capital Companies

Usually the financial institutions are hesitant to finance new products because the profitability of new products is uncertain and involve risks. So, to finance such products, separate type of financial companies who venture to finance them are established. They are called Venture capital companies. The venture capital companies provide capital to companies that produce new products based on innovations and to new industries.

2. Merchant Banks

Merchant bankers manage and underwrite new issues, provide Consultancy and Corporate advisory Services for corporate clients on raising funds and other financial aspects. In India, merchant banking services are carried out by commercial banks. The merchant banks are also called as Investment Company.

Merchant Banker has been defined under the Securities and Exchange Board of

3 http:// www.rbi.org.in / scripts / FAQView aspx?Id=71

India (Merchant Bankers) Rules, 1992 as, "any person who is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to securities as manager, consultant, advisor or rendering corporate advisory service in relation to such issue management".

3. Stock Broking Company

Stock broking companies are those who are registered with and recognised by SEBI to mediate or help investor in buying and selling of securities. The broking companies charge for mediation. It is called brokerage charge.

NHB Regulated NBFC

Housing loan companies are regulated by National Housing Bank. Housing loan companies finance construction and purchase of house.

Department of Company Affairs (DCA) Regulated NBFC

Nidhi companies are regulated by DCA. Nidhi companies accept deposit and lend to its members. Nidhi companies are not regulated exclusively by DCA. Only the administrative matters are controlled by it and deposit and lending norms are regulated by RBI. Nidhi companies, therefore have two regulators:

1. The Department of Company Affairs (DCA)
2. The Reserve Bank of India (RBI)

RELATED TERMS

Face Value and Issue Price

Face value is the actual value of shares. Issue price means price of share including share premium. Premium means extra price a share claims in the market due to high demand for it. For example the face value of share may be ₹ 10 but due to high demand the share can be issued at say ₹ 700. Here the share premium is ₹ 690. The thing to be noted is the companies announce dividend only on face value. In this case, if a company says dividend is 23% it means 23% of ₹ 10.

Short Selling

In short selling, the seller sells the securities without owning the securities. He borrows the securities and sells it.

Bull and Bear Trading

In bull trading, buyers buy more shares in the expectation that the securities price will rise in the future with a plan to sell at that time and earn profit.

In bear trading the sellers sell the securities, with the intention to avoid loss, in the expectation that the security prices will fall.

They are named after the animal sprit of bull and bear. The bull throws up the lives which it attacks and bear grounds the live which it attacks. So rise (up) in price is associated with bull and fall (down) in price is associated with bear.

Securitisation

Securitisation is the method of converting existing assets into securities. Take the case of banks, their unrecovered loans are considered as Non- performing assets (NPA). These assets are sold to Asset Reconstruction Companies (ARCs). The asset reconstruction company divides the total assets into equal parts and sells to investors. The investors are entitled to flow of interest income from these assets and principal amount when repaid.

Buy Back

Buy back means the issuer buying the securities again to accumulate share in his hands.

Market Capitalisation - GDP Ratio

It is called as MC-GDP ratio. It is the ratio between total market capitalisation of all stock exchanges and GDP of the country.

Price Earnings Ratio

Price earnings ratio is the ratio between price of the share and earning (dividend income/ profit)per share.

Price earnings ratio = Price per share (P) / Earnings per share (E)

Net Asset Value (NAV)

Net asset value is the net value of the outstanding shares. Net value means the total asset value minus liabilities of the Mutual Fund. Total asset value means the total number of shares and price per share in the market.

Total asset value = Total number of shares x Price per share in the market.

Net asset value = Total asset value - liabilities

High Net Worth Individual (HNI)

High net worth individuals are those who have net financial asset of at least $1 million and those who have net worth at least $30 million financial asset are called **ultra-high net worth individuals**.

Transferable and Non-Transferable

Securities are of two types. One is transferable and another one is non-transferable. The term non-transferable is often seen in our day to day life. In bus tickets and train tickets we can see these words 'non -transferable. It means that we cannot sell it to others. To put it in another way, we cannot change the ownership of these tickets. Likewise, in case of securities, if it is transferable we can change the ownership and in case of non-transferable securities the ownership cannot be changed.

Cumulative and Non-cumulative Shares

Cumulative shares means the shares are entitled to receive dividends of a particular year in the coming years as arrear if the company didn't give dividend in that particular year. Non- cumulative shares don't have that right.

Convertible- Non Convertible Securities

Convertible means one kind of securities

can be converted into another kind of securities. For example, the bonds can be converted as shares. In the case of Non-convertible securities, this is not possible.

Mutual Funds (MFs)

While merchant banker primarily helps issuer, the Mutual funds help investors. The mutual funds mobilise the savings of the people and invest in securities. The individuals lack expertise in stock market and have very small amount to invest. So the mutual funds collect money from public and create a large pool of money and with their expertise they invest in securities. They invest in product called Units. Units are made up of more number of securities.

The shares of various companies are pooled together. For example 10 shares of ten companies (totally 100 shares) are pooled together. The value of share of each company may be different. Assume that the total value of 100 shares is ₹ 7000. This may be divided into units of ` 10 each. So, totally 700 units are available. It means each unit has a small portion of all the 100 shares. The investor money is invested in these units. Their return depends on growth of all the 100 shares. In this way of investment, the small amount of money gets invested in many shares and not in single share. So the risk is spread out.

Hedge Funds

Hedge funds are similar to Mutual Funds. But in the case of Mutual Funds the fund is collected from public and invested by Mutual fund which is created by somebody else where as incase of Hedge Funds it is not public but a hand full of investors join together and form fund of their own and invest in different securities and use different investment strategies. These investors are financially well and are sophisticated investors. So, they do not need protection of SEBI and they are unregistered and unregulated.

Offer for Sale (OFS)

Offer for sale is also like FPO. While the FPO was to raise additional fund requirements the OFS is to dilute the shareholding of promoters in a listed company. As per the Securities Contract Regulations (Rules) 157 at least 25 % of all type of securities issued by a listed company should be in the hands of Public. To meet this requirement the companies approach public to sell their shares through OFS.

A Note on Commodity Exchange

The commodity exchange is a platform to buy and sell agricultural products, natural resources like iron ore, crude oil and precious metals like gold and silver.

There are many regional exchanges and six national exchanges. They are Multi Commodity Exchange (MCX), National Commodity and Derivatives Exchange (NCDEX), National Multi-Commodity Exchange (NMCE) and Indian Commodity Exchange (ICEX), the ACE Derivatives exchange (ACE) and the Universal commodity exchange (UCX). The apex body for these exchanges is Forward Markets Commission (FMC).

The commodity exchange is more akin to stock exchange. The concepts used in stock exchange and commodity exchanges are same. For example Derivatives trading exist in both the exchanges. In both the exchanges it carries same meaning.