Topic-III Money and Capital Markets (2nd Class)

Bonds and Debentures(Both Debt Instruments)

- Bonds are secured loans as both principal & interest payments are guaranteed on maturity.
- Debentures are less secured loans as during crisis the company may not pay back principal.
- Interest rates on Debentures is higher than on bonds & is paid periodically
- **Convertible Bonds/Debentures** are the ones which can be converted into shares later but these provide less interest than **Non-Convertible Bonds/Debentures** which can not be converted into shares.

Inflation Indexed Bonds (IIBs)

- Bonds whose maturity value varies with movement in inflation rate so that positive real return can be ensured.
- In 2013, government had issued IIB whose returns were linked to WPI.
- In 2014, new IIBs (Inflation Indexed National Savings Securities-Cumulative) have been launched with fixed annual interest rate of 1. 5% over & above CPI for every 6 months
- Principal and interest will be paid on maturity after 10 years.

Primary Equity Market: Instruments

1. **Initial Public Offering (IPO):** Under this process, a company issues new shares to the public for the first time at Stock Exchange

- Money paid by the investors for shares under IPO (& other Primary Instruments) goes directly to company unlike for secondary shares where money passes between investors.

- But it is risky for fund-raiser as they don’t know if IPO will be successful.
- Therefore, **Underwriting is important for all primary market instruments.**
- Underwriters (Commercial or Investment Bankers) reduce risk by helping IPO issuer in determining type and price of share, best time to bring it in market etc.

2.Further/Follow-on Public Offer (FPO) and Rights Issue (RI)

- After getting listed on SE (IPO Issue), fresh equity can later be raised via FPO or RI.
- Under **RI**, new shares are offered to **existing shareholders only** in proportion to their shareholding while FPO is open to all investors
- RI is better than FPO for the shareholders as under RI there is no dilution in their proportional shareholding.

3. Offer For Sale (OFS):

- This is a new instrument similar to IPOs & FPOs, but the process of OFS is simpler.
- No need for physical application in OFS and the process completes in one single day unlike IPO and FPO which is open for 3 to 4 days
- OFS is **cost and time effective** and is also **more transparent** than IPO &FPO

4. Private Placement (PP)

- It is Direct Sale of new shares to a group of big investors like banks and FIs by the issuer, helped by Merchant/Investment Bankers.

- Different from IPO/FPO as unlike a large number of investors contributing small amounts in IPO under PP a small number of investors contribute huge amounts

- More **Cost and Time Effective** but **less Transparent than IPO.**

- 2Channels of PP

1. **Qualified Institutional Placement (QIP)** Under this shares are bought by Qualified Institutional Buyers (QIBs) or the Institutional investors who possess expertise and financial strength to invest large amounts in market.

- **QIBs** include public FIs, Commercial Banks, Mutual Funds and FIIs.

2. **Preferred Stock/Preference Shares** Their holders get preferences like a fixed rate of dividend & claims during liquidation before these are paid to ordinary shareholders.

Secondary Equity Market

- Deals with sale and purchase of existing shares in the Stock Market.
- Speculation or expectation about future movement in share prices plays an important role in the market.
- Speculation can be crucial for capital formation if it is rational i.e. if it rewards efficient and penalize inefficient firms.
- Irrational Speculation can lead to volatility in financial markets.

- Speculators who buy shares expecting a rise in share prices are called **Bulls** while the ones who sell shares expecting a fall in share prices are called **Bears**.

- **Market Capitalization (M Cap) of a company**

= Number of outstanding shares of the company in the Stock market*Share Price

- M Cap of a Stock Exchange is the sum of M Cap of all companies listed on SE.

•**Stock Exchanges in India**:

1. National Stock Exchange (NSE):

- Set up in 1992 & started operation from 1994.
- About 1700 Companies are listed and NSE's M Cap is about $1. 47 Trillion.

2. Bombay Stock Exchange (BSE):

- Oldest Stock Exchange of Asia & set up in 1875
- Also world's top exchange i.t.o Listed Companies with abt. 5, 500 Companies listed.
- M Cap ($1.49 Trillion) is also highest among Indian SEs.

3. Over The Counter Exchange of India (OTCEI)

- Set up in 1990 to help small enterprises to raise funds on lines of NASDAQ in USA.
- 115 companies listed, most of which are not eligible to be listed at NSE or BSE.

- **Stock Market Index (SMI):** Use to reflect the performance of selected companies in a SE. Companies selected on the basis of M Cap and representation from different economic sectors.

Some important SMIs in Indian Capital Market

1. **CNX Nifty:** Reflects performance of 50 largest companies i.t.o M Cap listed at NSE.
2. **CNX Nifty Junior**: Reflects performance of next 50 largest companies after CNX Nifty.
3. **Sensitivity Index (SENSEX):** Reflects performance of 30 largest companies i.t.o M Cap listed at BSE.

- SENSEX considered as the most important index b'coz it provides long time-series data on share prices with base year of 1979.

Capital Market Reforms Since 1990

1. **Regulatory Framework**: Securities & Exchange Board of India (**SEBI**) set up in 1990 and given Statutory status in 1992 to make it an Independent Regulator of the capital market.

- SEBI plays 2 basic roles of **Investor Protection** and **Development of Capital Markets**.
- All Capital market participants (fund raisers, all investors- institutional &retail or foreign etc.) must be registered with SEBI & it can also suspend or cancel their registration.

2. Disclosure and Investor Protection (DIP)

Guidelines: All primary issuers are required by SEBI to disclose information on various aspects such as track record of profitability and risk factors. After getting listed, companies have to publish unaudited financial results.

3. Free Pricing in Primary markets: Since 1992, Price of primary issues like IPO can be freely decided by issuer with underwriter.

- SEBI does not play any direct role but requires the disclosures of the parameters while deciding the issue price.

4. Modernization of Trading Infrastructure:

- **Screen Based Trading System (SBTS)** introduced which electronically matches demand & supply of shares based on price or time priority.
- It has improved informational efficiency like better price discovery and liquidity with increase in the number of participants.

5. Shortening of Settlement Cycles (SC):

- Settlement is the process whereby buyer of the share makes payment & seller delivers share. It is done by **Clearing Houses**.

- After decrease in SC from 2 weeks before 1991 We are currently under **Rolling Settlement on T+2 Basis** under which trades executed during the day are uniformly settled within 2 working days after trading.

6. **Dematerialization:** Under this reform, since 1996, share delivery is made through electronic book-entry into the **Demat account** of the buyer rather than physical delivery.

- It has reduced extra transaction cost (handling, transporting & storing certificates).

- **Depositories** facilitate dematerialization by holding and transferring electronic shares of investors.
- National Securities Depository Limited (NSDL) &Central Depository Services Limited (CDSL) are the two depositories in India established in 1996 &1998 respectively.

7. Integration of Indian Capital Market With the International Capital Market

- Since 1992, FIIs have been allowed to operate in the Indian Capital Market
- Indian firms have also been allowed to raise funds from international capital markets through issue of ADRs & GDRs or ECBs.

8. Trading in New Products like Futures and Options have been allowed in the Indian Capital Markets.