A Study on Capital Markets and Its Instruments in India

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INTRODUCTION

Financial systems are of crucial signification to capital formation. That adequate capital formation is indispensable to a speedy development. The main function of financial system is the collection of savings and their distribution for industrial investment, their by stimulating the capital formation and, to that extent accelerating the process of economic growth. Financial innovation is the act of creating new financial instruments as well as new financial technologies, institutions, and markets. India's capital market was dormant till the mid-1980s. The long term needs of the corporate sector were by and large, met by the DFIs as well as other investment institutions namely LIC and UTI. Activities in the capital market were limited mainly due to the administered structure of interest rates and easy availability of credit loans from banks and financial institution. From being a marginal institution in the mid eighties, the securities market has emerged as the most important mechanism for allocating resources in the economy through numerous changes in financial innovation. The emerging significance of the security markets is eloquently borne out by the rapid expansion in the quantum of funds raised and the number of investors.

Key words; Capital market, innovations, investors, corporate sector

OBJECTIVE OF STUDY

- To know the conceptual frame work of capital market
- To study about different capital market innovations and risk faced by the investors
- To study the guidelines to protect the investors

METHODOLOGY

Secondary data has been taken for this study, which is gathered from different sources such as books, articles and internet.

Capital Market:
It is a market for long term funds. Its focus is on financing of fixed investment in contrast to money market which is the institutional source of working capital finance. The main participants in the capital market are mutual funds, insurance organizations, foreign institutional investors, corporate and individuals. India's capital market has been transformed into one of the dynamic capital markets of the world.
The capital market has two segments:
1. New issue market
2. Secondary Market

New issue market: new issue market is deals in new securities, that is securities which were not previously available and are offered to the investor for the first time. Capital formation occurs in the new issue market as it supplies additional fund to the corporate directly. It does not have any organizational setup located in any particular place and is recognized only by the specialist institutional services that it tenders to the borrower of capital fund at the time of any particular operation. It perform the functions like origination, underwriting and distribution

Secondary market: the secondary market is a market of old/existing securities, that is those already issued and granted secondary market quotation/listing. It plays only an indirect role in industrial financing by providing liquidity to investment already made. It has a physical existence and is located in a particular geographical area. The secondary market discharges several functions in the ordinary growth of capital formation.

The behavior of secondary market as reflected in the prices of the listed securities has a significant bearing on the level of activity in the new issue market in terms of its response to issue of capital. Similarly, the prices of new issues are generally influenced by the price movements in the stock markets.

Advantages of the capital market are:

- It improves the efficiency of transactions.
- They move money between the investors, i.e., people who supply capital and people in need of capital.
- Secondary markets create liquidity in the market.
- Securities like bonds pay interest to the investors, and most of the time, the interest so paid is higher than the bank interest rates.
- Securities like shares pay dividend income.
- There is a greater scope for growth of the value of investments as time passes.
- Instruments of capital market possess liquidity i.e. we can convert them into cash and cash equivalents when there is a need for funds immediately with lower transactional costs.
- Investment in shares provides investors with ownership rights, which allows them to have a say in the company's management decision.
- It promotes diversification by offering a wide range of investment types.
- Usually, the securities of the capital market can be used as collateral for getting loans from banks and financial institutions.
- There would be a few tax benefits that accrue whilst investing in the stock market.
- Holding on to a few securities may ensure superior long-term performance.

Disadvantages of the capital market are:

- Investing in the capital market is deemed to be very risky as the investment is highly volatile when it comes to the value i.e. the instruments of a capital market are subject to the market ups and downs.
- Such fluctuations make these kinds of investments unsuitable to provide a fixed income, especially retired employees who would usually prefer regular income.
- With the wide range of investment alternatives present in the capital market, an investor may not be able to decide what kind of investments to pursue thus making it difficult for an investor to invest without a piece of professional advice.
- If an investor invests in shares of a company, he would be considered having ownership rights. This may, prima facie sound like an advantage but, this means that the investor being the owner of the company would be the last party to receive any proceeds in case the company goes into liquidation or becomes bankrupt.
- Buying and selling of securities may involve a brokerage fee, commission, etc. increasing the cost of transactions.

Capital market instruments:

The third component of the financial system is capital market instrument. They represents claims on a stream of income and assets of another economic unit and are held as a store of value and for the return that is expected. The maturity and sophistication of the financial system, indeed, depends on the prevalence of a variety of securities to suit the investment requirement of heterogeneous investors. In a way they represent financial product innovation. The financial system also promotes financial product innovation.

There are two types of instruments that are traded in the capital market. They are as follows:

- Bonds: bonds are basic debt securities that are traded in the capital market. Companies issue bonds to raise capital as investors subscribe to them. Issuing bonds helps the company raise capital for the growth and expansion of the business at cheaper rates than banks and lending institutions. The bond issuer pays interest and returns the principal at the end of the duration. The government also issues bonds to raise money for government projects.

Debenture: A debenture is a creditor ship security. Their holders are entitled to a pre specified interest and first claim on the assets of the entity. They have no right to vote in the meetings of the company. A company can issue perpetual or redeemable debentures.

- Stocks: stocks are the right of ownership in a Company. The buyer of the shares is known as a shareholder. Investors buy and sell shares over a stock exchange like NSE and BSE.

Equity shares: they are ownership securities and represent risk capital. The owners of such securities bear the risk, are residual claimants on the income and assets and participate in management of the company.

Preference Shares: A preference share is a hybrid security and partakes the features of both equity and debentures. It combines both ownership and creditor ship privileges. The holders of such securities have preferential right over the equity holders in respect of fixed dividend as well as return of capital.

- Innovative debt instrument: A variety of debt innovative instrument emerge with the growth of capital market. New features are embedded in the debt instruments to make them more attractive to investor.

Participating debenture: the participate in the excess profits of the company after the payment of equity dividend

Convertible Debenture with Option: they are a derivative of convertible debentures with an embedded option. The coupon rate on the debentures is specified at the time of the issue. Both the company and the debenture holder can exit from the term of the issue.

Third Party Convertible Debenture: these include a warrant which entitles the holder to subscribe to the equity of another firm at a preferential price. Due to conversion option, the coupon rate of interest on such debentures is lower pure debenture.

Convertible Debenture Redeemable at Premium: they are issued at the face value with a put option which entitles the holders to sell the debentures at a premium.

Debt Equity Swaps: these are offers to swap debentures for equity.

Zero Coupon Convertible Notes: they can be converted into shares. On exercise of choice, all unpaid interest is to foregone. They are quite sensitive to changes in interest rates.

Zero Interest Fully Convertible Debentures: they carry no coupon rate of interest. The fully convertible debentures are automatically converted into shares after the lock-in period.

Capital market risk:

Sometimes referred to as investment risk, capital market risk is a term that refers to one of the risks associated with investing. Capital markets such as the stock, bond, foreign currency and derivatives markets are considered risky because of the constantly changing prices of the securities that are traded. In other words, security prices are volatile. Securities prices are not influenced just by their fundamentals, but also by broader market influences such as economic news, political developments, currency movements, unexpected events such as a massive earthquake, tsunami or general market panic. While debatable, some consider price volatility to be a proxy for risk. The risk of financial loss associated with either choosing to or being forced to sell a security when prices have declined is what is meant by capital market risk.

Types of investment risk:

1. Market risk

The risk of investments will decline value because of economic developments or other events that affect the entire market. The main types of market risk are equity risk, interest rate risk and currency risk.

- Equity risk – applies to an investment in shares. The market price of shares varies all the time depending on demand and supply. Equity risk is the risk of loss because of a drop in the market price of shares.
- Interest rate risk – applies to debt investments such as bonds. It is the risk of losing money because of a change in the interest rate. For example, if the interest rate goes up, the market value of bonds will drops
- Currency risk – applies when you own foreign investments. It is the risk of losing money because of a movement in the exchange rate.

2. Liquidity risk

The risk of liquidity is unable to sell the investment at a fair price. That means sell the investments at a lower price. In some cases, such as exempt market investments, it may not be possible to sell the investment at all.

3. Concentration risk

The risk of loss depends on money is concentrated in 1 investment or type of investment. When investments are diversify then risk spread over different types of investments, industries and geographic locations.

4. Credit risk

The risk that the government entity or company that issued the bond will run into financial difficulties and won't be able to pay the interest or repay the principal at maturity. Credit risk applies to debt investments such as bonds. That can evaluate credit risk by looking at the credit rating of the bond.

5. Reinvestment risk

The risk of loss from reinvesting is principal or income at a lower interest rate. Suppose you buy a bond paying 5%. Reinvestment risk will affect you if interest rates drop and you have to reinvest the regular interest payments at 4%. Reinvestment risk will also apply if the bond matures and you have to reinvest the principal at less than 5%. Reinvestment risk will not apply if you intend to spend the regular interest payments or the principal at maturity.

6. Inflation risk

The risk of a loss in your purchasing power because the value of your investments does not keep up with inflation. Inflation erodes the purchasing power of money over time – the same amount of money will buy fewer goods and services. Inflation risk is particularly relevant if you own cash or debt investments like bonds. Shares offer some protection against inflation because most companies can increase the prices they charge to their customers. Share prices should therefore rise in line with inflation. Real estate also offers some protection because landlords can increase rents over time.

7. Horizon risk

The risk that your investment horizon may be shortened because of an unforeseen event, for example, the loss of your job. This may force you to sell investments that you were expecting to hold for the long term. If you must sell at a time when the markets are down, you may lose money.

8. Foreign investment risk

The risk of loss when the investing in foreign countries. When you buy foreign investments, for example, the shares of companies in emerging markets, you face risks that do not exist in foreign country. For example - the risk of nationalization.

Understanding Market Risk:

Market (systematic) risk and specific risk (unsystematic) make up the two major categories of investment risk. The most common types of market risks include interest rate risk, equity risk, currency risk and commodity risk. This is also called systematic risk and is based on the day-to-day price fluctuation in the market. The market index Sensex and Nifty goes up and down throughout the day. And much time, it may affect the returns from a stock. For example, if the market is going down at a time, then it might pull down the prices of even some good stocks. Moreover, in the short term, market risks are higher compared to the long term.

Measuring Market Risk:

To measure market risk, investors and analysts use the value-at-risk (VaR) method. VaR modelling is a statistical risk management method that quantifies a stock or portfolio's potential loss as well as the probability of that potential loss occurring. While well-known and widely utilized, the VaR method requires certain assumptions that limit its precision. For example, it assumes that the makeup and content of the portfolio being measured is unchanged over a specified period. Though this may be acceptable for short-term horizons, it may provide less accurate measurements for long-term investments.

Beta is another relevant risk metric, as it measures the volatility or market risk of a security or portfolio in comparison to the market as a whole; it is used in the capital asset pricing model (CAPM) to calculate the expected return of an asset.

Understanding Interest Rate Risk:

The open market or global market interest rates changes time to time. And this can positively or adversely affect the stocks depending on the direction in which the interest rate is moving. For example, when the interest rates are high, a company might find it difficult to borrow money (at high rates). Further, the bond market declines as the interest rate increases, which may also affect the corporate bonds.

RBI Guidelines:

Specification of market risk factors

An important part of a PD's internal market risk measurement system is the specification of an appropriate set of market risk factors, i.e. the market rates and prices that affect the value of the PD's trading positions. The risk factors contained in a market risk measurement system should be sufficient to capture the risks inherent in the entire portfolio of the PD.

The guidelines should be kept in view:

For interest rates, there must be a set of risk factors corresponding to interest rates in each portfolio in which the PD has interest-rate-sensitive on-or-off-balance sheet positions. The risk measurement system should model the yield curve using one of a number of generally accepted approaches, for example, by estimating forward rates of zero coupon yields. The yield curve should be divided into various maturity segments in order to capture variation in the volatility of rates along the yield curve. For material exposures to interest rate movements in the major instruments, PDs must model the yield curve using all material risk factors, driven by the nature of the PD's trading strategies. For instance, a PD with a portfolio of various types of securities across many points of the yield curve and engaged in complex trading strategies would require a greater number of risk factors to capture interest rate risk accurately. The risk measurement system must incorporate separate risk factors to capture spread risk (e.g. between bonds and swaps), i.e. risk arising from less than perfectly correlated movements between Government and other fixed-income instruments.

Protection to Investors:

The extent to which savings can be mobilized for industrial investment depends, apart from the development of specific financial facilities, on the confidence of the investing public in industrial securities which, it turn, is dependent on the safeguards and protection available to them. Recognizing the importance of this requirement, along with the measures to strengthen and diversify the institutional structure, extensive legal reforms were carried out to provide protection to the investors.

- Companies act: The Companies Act 1956 underlying objective was the protection of the interest of prospective shareholders. The law was further tightened from time to time to plug the emerging loophole.
- Companies Issue (Control) Act : Companies Issue (Control) Act 1947 regulate the capital structure of the companies with a view to discouraging undesirable practices and aim at protecting the investors of new enterprises by examine the terms of new issues of capital.
- Securities Contract (Regulation) Act: Securities Contract (Regulation) Act 1956 provided for reforms in stock exchange trading methods and practice which were the subjects of controversy in the past.
- Monopolies and Restrictive Trade Practice Act: Monopolies and Restrictive Trade Practice Act 1970 ensure that the functioning of the economic system did not result in concentration of economic power. To control such Monopolistic and Restrictive Trade practice that was injuries to the Public welfare.
- Foreign Exchange Regulation Act: Foreign Exchange Regulation Act 1973 regulated foreign investment with the aim of diluting the equity holding in foreign companies. It was also a step in the direction of engendering confidence among the investing public in industrial securities.

SEBI Guidelines:

The securities market which emerged from the periphery to enter the mainstream of the financial market in India, has been one of the most significant institutional development since the mid eighties, especially since the beginning of the nineties. It has witnessed a spectacular growth both in terms of its ability to mobilize resources and to allocate it with some efficiency.

SEBI prohibits fraudulent and unfairly trade practice, including insider trading. It also regulates substantial acquisition of shares and takeovers. Safe guard the integrity of the markets, there is a comprehensive surveillance system. Tock exchangers are the frontline regulation for detection of market manipulation, price rigging and other regulatory breaches regarding capital market functioning.

Guideline for Primary market:
New company: A new company is one: (a) which has not completed twelve months commercial production and does not have audited results and (b) Where the promoters do not have a track record. These companies will have to issue shares only at par.

New company set up by Existing company: when a new company is being set up by existing companies with five year track record of consistent profitability and a contribution of at least 50% in the quantity of new company, it will be free to price its issue, that is it can issue its shares at premium.

Private and closely Held companies: The private and closely held companies having a track record of consistent profitability for at least 3 years shall be permitted to price their issues freely. The issue price shall be determined only by the issue in consultation with lead managers to the issue.

Existing Listed companies: The existing listed companies will be allowed to raise fresh capital by freely pricing expanded capital provided the promoter’s contribution is 50% on first Rs. 100 crore is issue, 40% on next Rs. 200 crore, 30% on next Rs. 300 crore and 15on balance issue amount.

Guideline for Secondary Market:
Stock Exchange: (a) Board of Directors of stock exchange has to reconstitute so as to include no members, public representative, and government representative to the extent of 50% of total number of members. (b) Capital adequacy norms have been laid down for members of various stock exchanges depending upon their turnover of trade and other factors.

Brokers: (a) Registration of brokers and sub brokers is made compulsory. (b) In order to ensure that brokers are professionally qualified and financially solvent, capital adequacy norms for registration of brokers have been evolved.

Foreign Intuitional Investors: (a) Foreign Intuitional Investors have been allowed to invest in all securities traded in primary and secondary markets. (b) The holding of single foreign institutional investors in a company will not exceeds the ceiling of 5% of the equity capital of a company

Bonus Issue: (a) Bonus is made out of free reserves built out of the genuine profits are share premium collected in cash only. (b) Reserves created by revaluation of fixed assets are not permitted to be capitalized.

Right Issue: (a) SEBI, on 13th august, 2008, reduced the time duration for a rights issue from 109 days to 43 days. (b) Right issue apply only to rights issue made by existing listed companies.
Debentures: (a) The amount of working capital debenture should not exceed 20% of the gross current assets. (b) The debt-equity ratio should not exceed 2:1.

Fully Convertible Debenture, Partly Convertible Debenture and Non-Convertible Debentures: (a) FCD, PCD, NCD issued for a period of more than 18 months are to be compulsorily credit rated. (b) The debentures converted within 18 months are treated as equity.

CONCLUSION

Capital market is one of the wide concepts. There is lot of subject to understand. Different types of innovation resulted to overall development of capital market and economy. Every innovation has its own loopholes. It creates complexity in the market. That means different variety of risk to be formed in the market. It will directly effect to the Investors, Companies, other Institutions, Government and public. Every problem has its own solutions. In this paper indicate that different types of risk can faced by the capital market. It highlighted only Market Risk. For overcome this problems their lot of guidelines provided by the RBI and SEBI to investors and related party. It suggest to investors and related party to safeguard their investments in primary market and secondary market.

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