CHAPTER

5 THE CAPITAL MARKET

INTRODUCTION

The process of industrial development requires, as one of its accompanying structural changes, the development of a capital market. The capital market should be capable of meeting the requirements of credit and finance of the private entrepreneurs. The capital market should also help in sustained national industrial development.

The capital market provides an alternative mechanism of reallocating resources; it channelises household savings to the corporate sector and allocates funds among firm. In this process, it allows both firms and households to share risk. The capital market enables the valuation of firms on an almost continuous basis and it plays an important role in the governance of the corporate sector.

Indian capital market has been experiencing metamorphic changes. The changes have become more pronounced in the last couple of years with the advent of liberalisation pertaining to the industrial policy, licensing policy, financial services industry, interest rates, etc. The competition has become very intense and real, thus affecting the industrial sector and financial services industry. As a result of this, in the area of capital market, and more and more new financial instruments have been introduced by the companies accessing capital markets.

Sound development of various segments of the capital market is a pre-requisite for a well functioning financial system. The capital market in India has been modernised over the years and is now comparable with the international markets. There has been a visible improvement in trading and settlement infrastructure, risk management systems and levels of transparency. These improvements have brought about a reduction in the transaction costs and led to improvement in liquidity.

Over the years, the development banks have been playing a major role and continued actively to participate in the development of capital market. Thus, development banks, capital market and industry are interlinked and interdependent. The economic growth reflects the combined effort and strength of these institutions. As such, the capital market in the 1980s has emerged as a rapidly growing source of investible funds to the corporate sector.

LONG-TERM FINANCE AND INSTITUTIONAL DEVELOPMENT

The promotion of long-term finance and capital markets is essential to improve investment incentives consistent with external adjustment, as well as to avoid excessive reliance on short-term funds to finance investments — a practice which in the past led to liquidity crisis (and at times bankruptcies) of enterprises and financial institutions. Because of their expertise in development finance, the World Bank Group and, in particular, the International Finance Corporation have played a leading role in this area. In a supplementary role, recent fund technical and economic issues relating to policies aimed at lengthening the maturities of loans and deposits.

WHAT IS CAPITAL MARKET?

It is an organised market mechanism for effective and efficient transfer of money capital or financial resources from the investing class (a body of individual or institutional savers) to the entrepreneur class (individual or institutions engaged in industry business or service) in the private and public sectors of the economy.

In a very broad sense, it includes the market for short-term funds. H.T. Parikh has referred to it as, "*By capital market, I mean the market for all the financial instruments, short-term and long-term as also commercial, industrial and government paper.*"

In the words of Goldsmith, "the capital market of a modern economy has two basic functions: first the allocation of savings among users and investment; second the facilitation of the transfer of existing assets, tangible and intangible among individual economic units."

Grant defines capital market in a broad sense as "a series of channels through which the savings of the community are made available for industrial and commercial enterprises and for public authorities. It embraces not only the system by which the public takes up long-term securities directly or through intermediaries but also the elaborate network of institutions responsible for short-term and medium-term lending."

From the above definitions, it may be deducted that the function of capital market is the collection of savings and their distribution for industrial investment. Thus, capital formation is *sine qua non* of economic development. As such, the relationship between the market, instrument, and services are integrated as well as inter-dependent.

Capital market is generally understood as the market for long-term funds. The capital market provides long-term debt and equity finance for the government and the corporate sector. By making long-term investments liquid, the capital market mediates between the conflicting maturity preferences of lenders and borrowers. The capital market also facilitates the dispersion of business ownership and the reallocation of financial resources among corporations and industries.

DIMENSIONS OF CAPITAL MARKET

The Capital market is directly responsible for the following activities: (1) Mobilisation or concentration of national savings for economic development, (2) Mobilisation and import of foreign capital and foreign investment capital plus skill to fill up the deficit in the required

financial resources to maintain the expected rate of economic growth, (3) Productive utilisation of resources, and (4) Directing the flow to funds of high yields and also strive for balanced and diversified industrialisation.

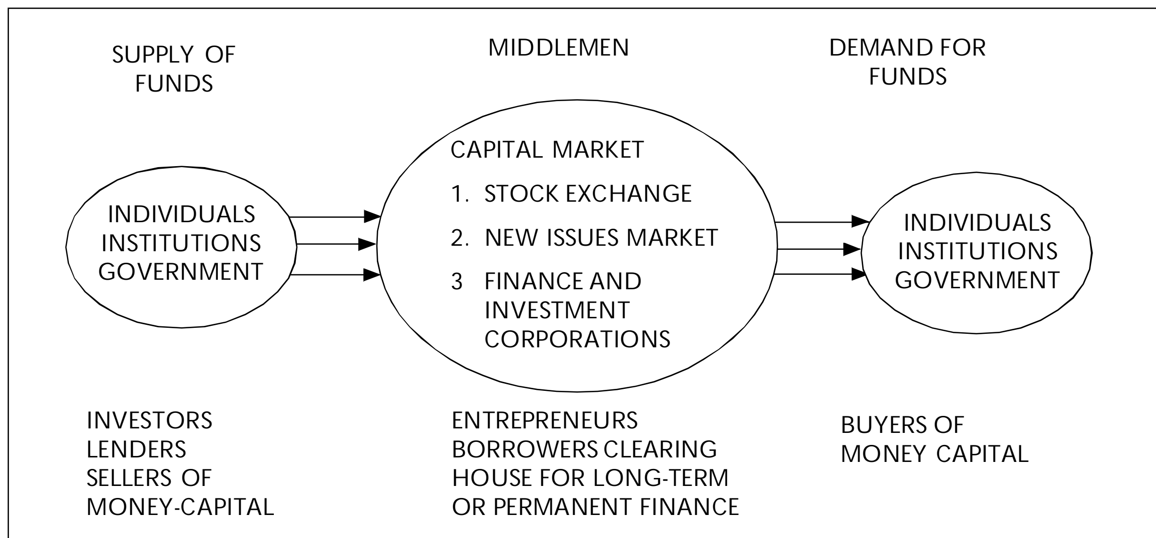


Figure 5.1: Capital Market Mechanism

CLASSIFICATION

The capital market comprises of two markets, *viz.*, the Primary market and the Secondary market.

THE PRIMARY MARKET

The primary market consists of new issues of capital (equity, debentures, bonds, etc.), by new/existing companies. In this case, the corporate body invites applications to its issue of equity or debentures by filling a prospectus or letter of offer. The application forms can be obtained from the bankers/merchant bankers of the issues, brokers, etc.

Investors subscribe to these issues by filling in the application forms and remitting the requisite amount to the designated banks (listed on the reverse of the application) within the time period for which the subscription list is open. The subscription list is generally kept open for three days.

The company in consultation with its merchant bankers and the Stock Exchange authorities is expected to finalise the list of successful applications within 10 weeks. Thereafter, the share/ debenture certificates are dispatched to the successful application while refund orders are posted to others.

If the amount paid on application is only half the face/nominal value, the company must mention the date by which the successful applicants are required to pay the balance. The company normally gives an allotment advice and after remittance of the first/final call, the fully paid share certificate is sent to the investor.

In case the applicant does not hear from the company regarding allotment/refund, he can approach the merchant bankers to the issue and the securities and Exchange Board of India, lodging a written complaint giving particulars of the application form no., the bank at which the application was lodged, etc.

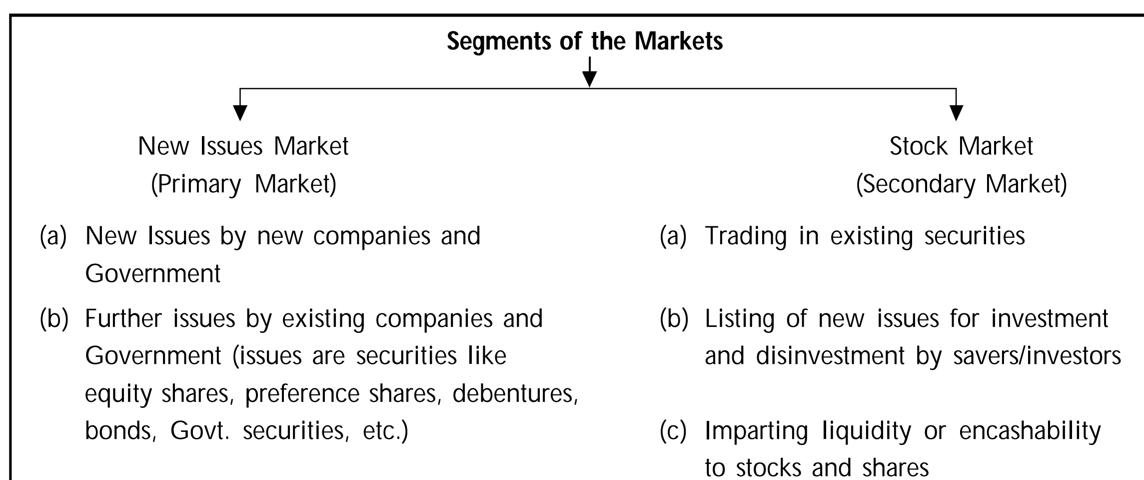
The securities are listed by the concerned exchange once the company complies with the listing agreement of the exchange. Once the shares/debentures are listed, market forces decide the price of the same — the investors' perception of the company, its management, the industry potential, the general economic environment, etc. This is so far as the working of the primary market. There are at present 26 recognised stock exchanges (including the over The Counter Exchange of India) in India.

A major development in the Indian Primary market has been the introduction of 'Screenbased book building' where securities are auctioned through an anonymous screen-based system and the price at which securities are sold is discovered on the screen. This eliminates the delays, risks and implementation difficulties associated with traditional procedures.

THE SECONDARY MARKET

The secondary market is where listed securities are bought and sold. Shares are normally issued having a face value of ` 10 or ` 100. The trading is normally done in what are known as market lots. For a share of face value ` 10, the market lot is 50 or 100 and for ` 100, the market lot is 1 or 5 shares respectively.

In the secondary market one can buy and sell securities, invest and disinvest or channel funds from one company to another or one type of security into another.



The secondary market is thus an important adjuct of the primary market. The activity in these two markets is inter-linked and the indicators are also related although separate in themselves and the starting link is listing of issues on the Stock Markets.

In the secondary market, the move to an electronic trading system has resulted in transparency in trades, better price discovery and lower transaction costs. The efficiency of the market has improved through faster execution of trades. The operational efficiency of the stock market has also been strengthened through improvements in the clearing and settlement practices and the risk management process. Almost the entire delivery of securities now takes place in dematerialised form.

CAPITAL MARKET STRUCTURE

An important segment of the organised financial system comprises of the new issues market and stockmarket. The term capital market is a wide term, encompassing all long-term claims of money-lendings and borrowings. It thus includes all term lendings by banks and financial institutions and long-term borrowings from foreign markets and new issues by companies and raising of all resources from public through issue of new securities, deposits, loans, etc.

As the chart 5.1 shows, capital market includes issues of two major categories — marketable and non-marketable. Whether marketable or not, these are issued by government and government departments, companies, public sector units, mutual funds, UTI, etc. LIC and GIC sell policies and collects savings from public, which are not marketable. The other non-marketable securities or claims are issued by post offices as savings certificates, deposit receipts, etc., non-securitised loans and advances of banks and financial institutions, deposits with banks and companies and securities of private limited companies and finance company deposits/loans, chit fund etc. The marketable securities are issued through the new issues market and are traded through the stock market.

The contributors to new issues are promoters, collaborators, if any, employees, NRIs, banks, FIs, Mutual Funds and the public at large. The players through whom these issues are managed are mainly merchant bankers, registrars, brokers, mutual funds, etc., which are dealt with in detail in later chapters. The ancillary functions and complementary to the above are those of underwriters, collecting bankers, printers, advertising agents etc. The main players in the stock market, namely, brokers, investment consultants, portfolio managers, investment managers, etc., are also discussed in later chapters.

The capital market study should authentically encompass both the marketable and non-marketable segments. In view of the fact that demand and supply forces and trading activity is confined only to the segment of marketable securities, this book is using the term 'Capital Market' in the sense of marketable securities. Thus, more prominent issuers of such securities are public limited companies and, government and the more popular instruments traded in the market are equity, debentures, bonds, etc., which are discussed in this book. UTI and the mutual fund schemes being popular for trading, they are also dealt with. Briefly the major players — instruments and activity in capital market are covered from the point of management.

CONSTITUENTS OF CAPITAL MARKET

The constituents of the capital market comprise of development banks, specialised financial institutions, investment institutions, state level development banks, mutual funds, lease companies, financial service companies, commercial banks and other specialised institutions were set up by development banks for the growth of the capital market, notably, SEBI, SHCI, CRISIL, IICRA, the I-Sec, AMC, OTCEI and the National Stock Exchange.

HIGHLIGHTS

(*i*) There has been an accelerated growth of the long-term capital market in India in the recent years. But the absolute size in relation to the economy is still small and the institutional structure inadequate.

(*ii*) In this purpose, we must reach out and activate the potential investors in parts of the country other than the western region and in rural and semi-urban areas. This could be done, if a few large reliable national level private sector investing or promoting companies are established, which would have the capability of establishing branches in several centres and in training and appointing its own agents in the smaller towns.

(*iii*) The desirability of introducing the new instruments. In this, the non-voting shares and the equity warrant may be considered. With the introduction of non-voting shares in a company, the controlling groups could be persuaded by the regulatory authorities to reduce their holdings correspondingly.

(*iv*) Supply of venture capital is high risk business, but the reward would also be high. Government must allow private investing agencies to be set up which could supply this capital to new ventures.

(*v*) In relation to demand, the flow of institutional funds into the housing sector has been quite meagre. The housing finance system that we build up must facilitate an adequate flow of institutional finance to the housing sector as one of the priority sectors.

(*vi*) "Commercial Paper" having maturity period ranging from 30 days to a year may be introduced, as it would relieve pressure in the long-term or medium-term funds.

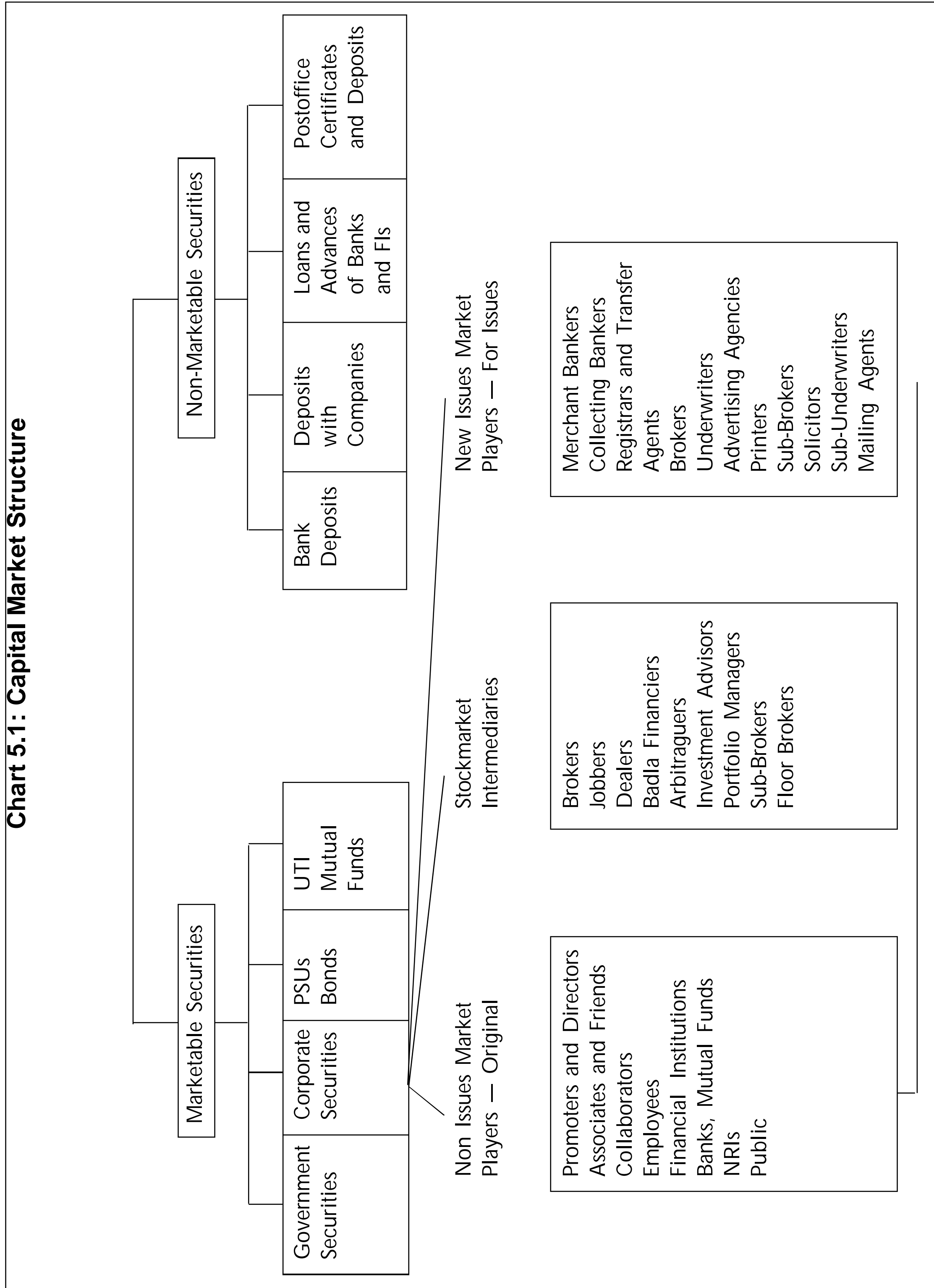


Chart 5.1: Capital Market Structure

The healthy growth of the capital market rests on broad-basing and mature development of the banking system in the country. As such, both are complementary and supplementary. The term capital market is used to designate activities in long-term credit, which is characterised by securities. It comprises of specialised financial institutions including investment and trust companies, banks, stock exchanges and other institutions.

The capital market is classified into two categories, *viz.,* organised and unorganised. With the emerging of development banks, commercial banks, Life Insurance, Unit Trust, the unorganised sector seems to have become isolated. In the organised sector, development banks are the key institutions.

ROLE OF THE CAPITAL MARKET

The capital market plays a vital role in providing liquidity and investment instruments. It fosters economic growth in various ways such as by augmenting the quantum of savings and capital formation and through efficient allocation of capital, which, in turn, raises the productivity of investment. It also enhances the efficiency of a financial system as diverse competitors *vie* with each other for financial resources. The domestic capital market can help financial stability by reducing currency mismatches. The capital market also provides an alternative means of long-term resources for development. It also improves economic efficiency by generating market determined interest rates that reflect the opportunity costs of funds at different maturities. Further, it adds to the financial deepening of the economy by enlarging the financial sector and promoting the use of innovative, sophisticated and cost-effective financial instruments, which ultimately reduce the cost of capital. Well-functioning capital markets also impose discipline on firms to excel in performance. And, also diffuse stress on the banking sector by diversifying credit risk across the economy.

The capital market also enables the valuation of firms on an almost continuous basis and plays an important role in the governance of the corporate sector.

IMPORTANCE OF CAPITAL MARKET

The pace of economic development is conditioned, among other things, by the rate of long-term investment and capital formation. And capital formation is conditioned by the mobilisation, augmentation and channelisation of investible funds. The capital market serves a very useful purpose by pooling the capital resources of the country and making them available to the enterprising investors. Well-developed capital markets augment resources by attracting and lending funds on a global scale. The Euro-currency and Euro-bond markets are international finance markets in terms of both the supply and demand for funds.

The increase in the size of the industrial units and business corporations due to technological developments, economies of scale and other factors has created a situation wherein the capital at the disposal of one or few individuals is quite insufficient to meet the growing investment demands. A developed capital market can solve this problem of paucity of funds. An organised capital market can mobilise and pool together even the small and scattered savings and augment the availability of investible funds. While the rapid growth of joint stock companies has been made possible to a large extent by the growth of capital markets, the growth of joint stock business has in its turn, encouraged the development of capital markets.

A developed capital market provides a number of profitable investment opportunities for the small savers/investors.

THE INDIAN CAPITAL MARKET TODAY

The Indian capital market is second in size only to that of the USA, in terms of availability of industrial securities. The Indian capital market offers good potential for further expansion in terms of absorption of large capital flows. It is noteworthy that despite problems faced on account of irregularities in security transactions earlier this year, the Indian stock markets have shown creditable business resilience and recovery. As per the review published by *Fortune International* in its Autumn Special 1992 number, the Indian capital market has appreciated by 44 per cent in US dollar terms an appreciation rate which was second only to that of the Philippines at 71%. Comparable statistics for other emerging markets are: South Korea (–)24 per cent, Indonesia (–) 5 per cent, Singapore 5 per cent, Malaysia 9 per cent, Hong Kong 39 per cent, etc. It is true that the price-earning ratio of 29 is comparatively high when compared with the prevailing ratios in the afore-mentioned markets. But it needs mention that in the Indian market, the PE ratio is influenced to a very large extent by 4 or 5 leading scrips. If one leaves out these scrips, the PE ratio would certainly compare favourably with those prevailing in other emerging markets. In fact, considering that active trading is confined to few hundred scrips, it is conceivable that with substantial inflow of foreign capital, many of the currently dormant scrips, mainly of medium-sized corporate bodies, would show growth potential.

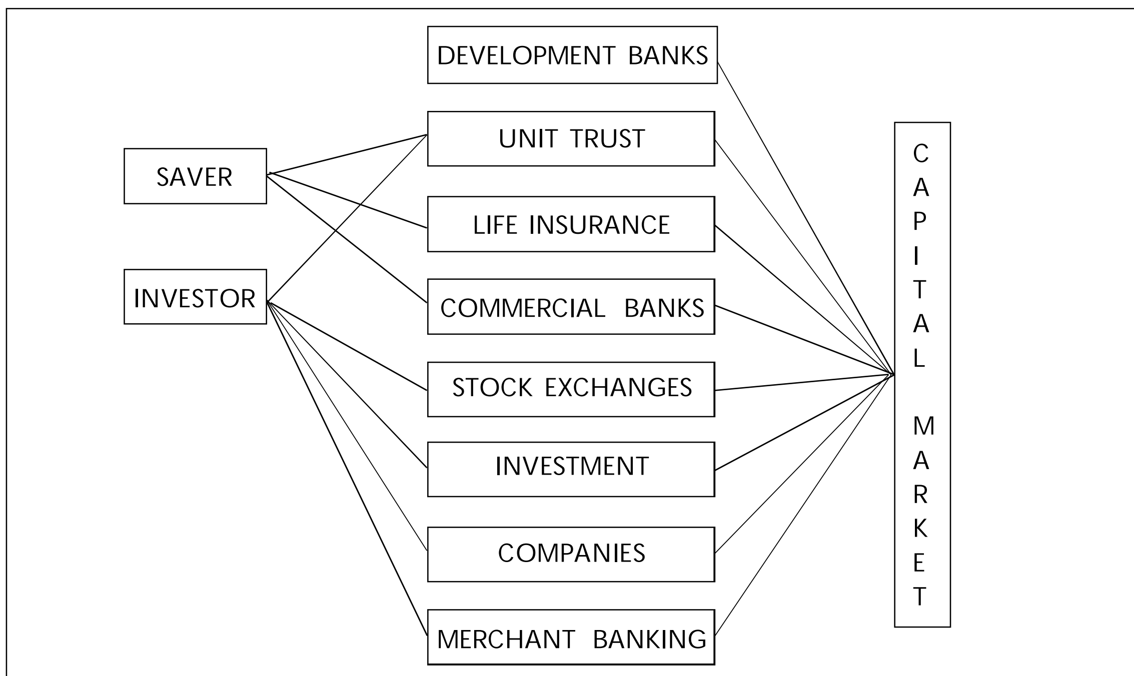


Figure 5.2

There are a couple of areas where some improvement will be necessary. The first is the factor of a long time between the transaction and the actual registration of transfer of securities at present. Secondly, the reporting and controlling system will have to be geared up to ensure compliance with the stipulations regarding upper limit for investment in a domestic company (24%) and by a particular investor (5%). The Reserve Bank authorities confirm that steps are being taken to overcome these problems.

Following the recommendations of Chakravarty Committee Report, (1985) on Monetary System, the RBI during the year, began the auction of 182 days treasury bills in the money market. The objective of this measure has been to broadbase the development of money market by introducing new instruments, create an active secondary market, bring the interest rates on treasury bills to the market level and gradually reduce the monetisation of public debt.

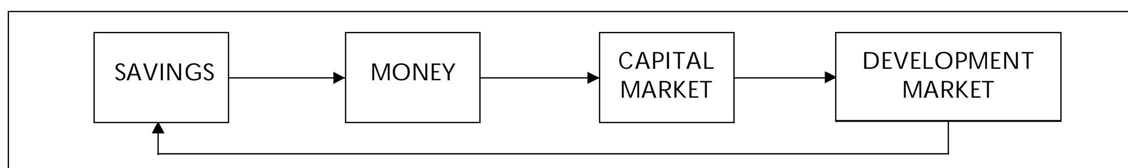


Figure 5.3

The steady increase in the capital formation, which is slightly higher than the level of gross domestic savings, indicates that the development banks have been playing a significant promotional role in mobilising resources and channelling savings into productive investment. The enlargement of their coverage will definitely accelerate the growth process.

Over the years, the corporate sectors, share of internal resources increased from 31.9 per cent during the period 1985-86 to 1989-90 to 60.7 per cent during 2000-01 to 2004-05. As such, the dependence on market-based financing declined from 18.2 per cent to 8.6 per cent respectively. The share of capital market related instruments (Debentures and Equity capital) in total external financing, peaked at 26.0 per cent during 1990-91 to 1994-95. It was around 14.3 per cent in 2005-06.

As a result, the debt-equity ratio declined sharply from 88.4 per cent to 61.6 per cent during the same period. This has enabled to corporate sector to significantly improve their profitability and their resilience.

Table 5.1: Pattern of Sources of Funds for Indian Corporates.

(Per cent to total)

Item	*1985-86 to 1989-90*	*1990-91 to 1994-95*	*1995-96 to 1999-2000*	*2000-01 to 2004-05*	*2005-06*
1	*2*	*3*	*4*	*5*	*6*
1. Internal Sources	31.9	29.9	37.1	60.7	43.6
2. External Sources of which:	68.1	70.1	62.9	39.3	56.4
(a) Equity capital	7.2	18.8	13.0	9.9	17.0

(b) Borrowings of which:	37.9	32.7	35.9	11.5	24.4
(i) Debentures	11.0	7.1	5.6	–1.3	–2.7
(ii) From Banks	13.6	8.2	12.3	18.4	23.8
(iii) From FIs	8.7	10.3	9.0	–1.8	–2.4
(c) Trade dues & other current liabilities	22.8	18.4	13.7	17.3	14.7
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
Memoranda:					
(i) Share of Capital Market Related Instruments (Debentures and Equity Capital)	18.2	26.0	18.6	8.6	14.3
(ii) Share of Financial Intermediaries (Borrowings from Banks and FIs)	22.2	18.3	21.3	16.6	21.4
(iii) Debt-Equity Ratio	88.4	85.5	65.2	61.6	43.0

Note: Data pertain to a sample of non-government non-financial public limited companies.
Source: Article on "Finances of Public Limited Companies", RBI Bulletin (various issues).

CAPITAL MARKET INSTRUMENTS

The following instruments are being used for raising resources:

1. Equity shares
2. Preference shares
3. Non-voting equity shares
4. Cumulative convertible preference shares
5. Company fixed deposits
6. Warrants
7. Debentures/bonds
8. Secured premium notes (SPNs)
9. Euro Convertible Bonds (ECBs)/Global Depository Receipts (GDRs).

CAPITAL MARKET DEVELOPMENTS

The capital market has passed through a phase of substantial adjustment and advancements over the years. A significant development was the entry of public sector enterprises in the power and telecommunication sectors in the capital market to raise larger resources by issue of tax free bonds. Although this did not have any crowding out effect on the private sector borrowers, they faced stiffer competition in the market and had to come out with more attractive features attached to their issues.

The drop in the stock prices experienced during the years 1997-2003 also the marked a corrective phase, following the boom in 1985-86. However, it is seen as a temporary phase which would in no way deter the long-term development of the market. High rate of savings, increasing presence of households for investment in financial assets, increasing diversity of financial instruments and growing securitisation of the financial market have been the basic factors providing enduring strength to the capital market. Besides, the need to raise the rate of industrial growth would require larger financial resources to be raised from the market. The market capitalisation of equity shares quoted on stock exchanges was estimated to be around 70.5 per cent of GDP as at end March, 2005. This is a relatively low figure by international comparison. The share of market capitalisation in GDP stood at 591.9 per cent in Hong Kong, 220.2 per cent in Singapore, 145.5 per cent in UK, 117.7 per cent in Australia, 107.4 per cent in Japan, 106.9 per cent in USA, 90.0 per cent in Korea, 71.5 per cent in Thailand, 57.2 per cent in Brazil, 39 per cent in Philippines, 30.4 per cent in Mexico and 27.1 per cent in Argentina as at end March, 2005. The average price-earning (PE) ratio in India is currently in the range of 9 to 10 compared to 91 in Japan, 67 in South Korea, 32 in Malaysia and 15 in USA and Hong Kong. The lower size of market capitalisation and PE ratio in India are thus indicative of the potential for further development of the capital market in India.

INSTITUTIONAL INVESTMENT IN INDIAN CAPITAL MARKET

Indian capital market had been kept insulated from global capital markets and cross-border movement of capital all these years, as a matter of policy. Recent changes have made the economy more open to the international markets. Access to India's markets has been made easier for foreign capital, technology and goods. It is natural that the Indian Capital market should have been thrown open to the overseas investors.

In the past, overseas investments had been mainly in the shape of direct foreign investment in specific approved industrial ventures. The capital market was open to non-resident Indians and, more recently, to overseas corporate bodies of Indian nationals in a restricted way. In conformity with various policy measures taken during the past year and a half, which cover India's external trade, collaboration and technology policies, financial restructuring, etc., the Government has since announced a new policy, welcoming Foreign Institutional Investors (FIIs) to invest in the Indian capital market, both primary and secondary.

The salient features of the recently announced policy are:

1. Foreign institutional investors (FIIs) including pension funds, mutual funds, investment trusts, asset management companies, nominee companies and incorporated/institutional portfolio managers or their attorneys (providing discretionary and non-discretionary portfolio management services) would be welcome to make investments under the new guidelines.
2. Investment in all securities traded on the primary and secondary markets, including the equity and other securities/instruments of companies which are listed/to be listed on the stock exchanges in India including the OTC Exchange of India is permitted. The instruments would include shares, debentures, warrants and schemes floated by domestic mutual funds. Government may even add further categories of securities from time to time.

3. FIIs would be required to obtain an initial registration with Securities & Exchange Board of India (SEBI) to enter the market. Nominee companies, affiliated and subsidiary companies of an FII will be treated as separate FIIs for registration and may seek separate registration with SEBI.
4. Since there are foreign exchange controls in force, FIIs shall also seek various permissions under FEMA from the Reserve Bank of India. Both SEBI and RBI registrations will be under a single window approach.
5. FIIs seeking initial registration with SEBI shall be required to hold a registration from the Securities Commission, or such other regulatory organisations for the stockmarket in their country of domicile/incorporation.
6. SEBI's initial registration would be valid for five years. RBI's general permission under FEMA (Foreign Exchange Management Act, 1999) to the FII will also hold good for five years. Both will be renewable for similar five-year periods later on.
7. Under the FERA permission, FII will be able to buy, sell and realise capital gains on investments made through the initial corpus remitted to India, subscribe/renounce rights offerings of shares, invest on all recognised stock exchanges through a designated bank branch and appoint a domestic custodian for custody of the investments.
8. The general permission from the RBI will enable the FII to:
   (*a*) Open foreign currency account(s) in a designated bank. (There can be more than one account in the same bank branch, in different currencies, if so required by the FII for its operational purposes).
   (*b*) Open a special non-resident rupee account to which all receipts from the capital inflows, sale proceeds of shares, dividends and interest could be credited.
   (*c*) Transfer sums from the foreign currency accounts to the rupee account and vice versa, at the market rates of exchange.
   (*d*) Make investments in securities in India out of the balances in the rupee account.
   (*e*) Transfer repatriable (after tax) proceeds from the rupee account to the foreign currency accounts.
   (*f*) Repatriate the capital, capital gains, dividends, incomes received by way of interest, etc., and any compensation received towards sale/renouncement of rights offerings of shares subject to the designated branch of a bank/the custodian being authorised to deduct withholding tax on capital gains and arranging to pay such tax and remitting the net proceeds at market rates of exchange.
   (*g*) Register FII's holdings without any further clearance under FEMA.
9. There would be no restriction on the volume of investment — minimum or maximum — for the purpose of entry FIIs, in the primary/secondary market and also on the lock-in period prescribed for the purpose of such investments made by FIIs. However, portfolio investments in primary or secondary markets will be subject to a ceiling of 24% of issued share capital for the total holdings of all registered FIIs in any one company. Conversions, out of the fully and partly convertible debentures issued by the company will also be taken into account for the purpose. The holding of a single

FII in any company would be subject to a ceiling of five per cent of total issued share capital, for which purpose, holdings of an FII group will be counted as holdings of a single FII.

10. The maximum holding of 24% for all non-resident portfolio investments, including those of the registered FIIs, will also include NRI corporate and non-corporate investments, but will not include: direct foreign investments (which are permitted up to 51% in all priority areas) and investments by FIIs through the following alternatives: Offshore single/regional funds, global depository receipts and Euro-convertibles.
11. Disinvestment will be allowed only through stock exchanges in India including the OTCEI. In exceptional cases, SEBI may permit sales other than through stock exchanges, provided the sale price is not significantly different from the stock market quotations, where available.
12. All secondary market operations would be only through the recognised intermediaries on the Indian stock exchange, including OTCEI. FIIs would not be expected to take delivery of purchased and give delivery of sold securities.
13. FIIs can appoint as custodian an agency approved by SEBI to act as a custodian of securities and for confirmation of transactions in securities, settlement of purchase and sale and for information reporting. Such a custodian shall establish separate accounts for detailing on a daily basis the investment capital utilisation and securities held by each FII for which it is acting as custodian. The custodian will report to the RBI and SEBI semi-annually, as part of their disclosure and reporting guidelines.
14. RBI may at any time request by an order, a registered FII to submit information regarding the records of utilisation of the inward remittances of investment capital and the statement of its securities transactions. RBI and/or SEBI may also at any time conduct a direct inspection of the records and accounting books of a registered FII.
15. FIIs investing under this scheme will benefit from a concessional tax regime of a flat tax rate of 20% on dividend and interest income and a tax rate of 10% on long-term (one year or more) capital gains.

The capital market in the present decade has magnificently responded to meet the evergrowing capital needs of both the private and public sectors. Despite the ten-fold increase in the total capital raised from the market in the short span of seven years by the private sector alone, the total mobilisation was only 5% of the net household savings. There is no reason why the share of the household savings flowing into the capital market should not increase substantially. The other factor which must be kept in view is that yield and earnings on equities in India are far higher than in most other countries where stock exchanges are fairly developed. Given the improvement in the general economic environment and better corporate results which are likely to follow in the wake of the massive investments in plant and technology that has taken place in the last five years, interest in corporate securities is likely to widen.

The capital market has also undergone a sea change with its scale and scope of its activities also diversified in a multi-directional way. With the establishment of new institutions, the edifice of the capital market is strengthened and broad-based. With the significant increase in savings, many investment avenues have opened up in recent years. The review shows that the capital market in India has grown on its own impetus. The changes brought about in it since independence

have strengthened it. The potential of the Indian capital market is immense which can help a great deal in establishing a welfare state in India by tapping public savings, engendering a sense of public participation as also management accountability to the public.

Financial innovation has brought undoubted benefits to the customers of financial services. The markets have shown that they can adapt quickly and flexibly to changing circumstances; they will probably continue to do so. Achieving the objective of bringing immediate benefits to individual firms requires continued alertness to ensure that risks are adequately assessed and controlled and are priced appropriately. The technology which has nurtured these innovations is also available to help in controlling them, for efficient markets require not only the absence of distorting restrictions but also good information on which to base decisions and allocate resources. Experience has proved that no amount of fiscal and financial incentives alone, or even easy availability of finance, can bring success in industrialisation efforts, unless other inputs like resourceful entrepreneurship, latest and efficient technology/know-how, professionalised management, well-motivated and skilled manpower coupled with project counselling facilities and extension services are available at every stage during the life-cycle of a project. In its promotional and developmental role, it has been, and continues to be, the endeavour of development banks to provide these non-financial inputs to the best possible extent, consistent with their resources and capability. This apart, the development banks will continue to play a significant role in widening the savings market and capital market, and at the same time providing equal opportunities to employ the savings protectively thereby increasing employment, raising the level of income, reducing poverty and improving the standard of living of the people.

In South Asia, India is the only capital market capable of growing into an international centre with its inherent strength which very few markets possess. Both Singapore and Hong Kong are highly developed, but they do not possess inherent strength. With the centre of financial gravity shifting to the Middle East, India is sure to command increasing interest. But this can happen only if we are able to re-design our complex structure of regulations affecting the flow of capital. This would call for a new vision and a new strategy. We would have to emerge out of the maze we have built for ourselves. A new order is emerging. We have opened up our closed economy on a selective basis. We have to cast our sight to a new horizon. Let us hope that we will be able to see the new vision and endeavour to achieve it in the coming years.

STRENGTHENING THE CAPITAL MARKET

The Abid Hussain Committee on development of capital market has suggested creation of two-tier stock exchanges along with a number of fiscal measures to streamline the stock market for bringing stability and restoring investors' confidence.

It has recommended long-term policy measures to bolster the capital market so that industries with a proven track-record could meet their financial needs from the growing capital market.

The public sector financial institutions could then be made to cater to the needs of the newly emerging companies for survival and sustenance during their nascent phase.

During the stock exchange boom of 1985-86, a number of listed companies disappeared overnight giving rise to the 'fly-by-night' phenomenon. The Committee noted that most of these companies were largely promoted by merchant banks, which were found to have received commission in the process.

The Committee recommended that all the companies should go through the registered merchant banks when they went public. The merchant banks should scrutinise the new companies entering the capital market, besides certifying that they were viable. This would act as a safeguard on the listing of new companies.

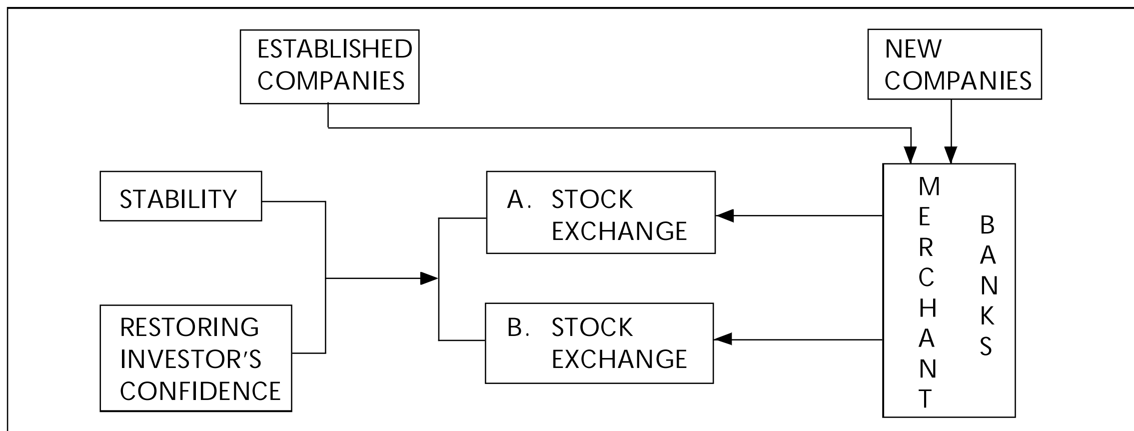


Figure 5.4: Development of Capital Market: Structural Changes.

Yet another major recommendation dealt with the development of market makers, not prevalent in the exchanges now. The report proposed that merchant banks enter into a tie-up with the brokers to quote a cost-effective floor price.

To finance the buying or selling of shares, it called for provision of institutional financing through commercial banks.

The Committee recommended simplification of procedures involved in transferring of shares, which are considered to be complicated and cumbersome at present.

This included the creation of a network of corporations akin to the proposed Stock Holding Corporation of India (SHCL) under the leadership of the IDBI so that private investors could freely transfer the shares.

The report urged that a highly reputed national level institution be set up to undertake multiple membership in stock exchanges throughout the country.

The Committee also underlined the need to open new instruments such as non-voting shares with higher dividends than the voting shares. This would remove the fear of capture of managements of the companies as harboured by some efficiently run units.

In case dividends were not declared for three consecutive years, these non-voting shares would automatically be declared as voting shares, thereby providing an element of control over the management for those non-voting shares.

This would also facilitate Non-Resident Indians (NRIs) to come forward and participate in portfolio investment in the Indian market.

For the profit-making public sector companies, entering the capital market with tax concessions, the Committee suggested unitisation by which a public financial institution would act as an intermediary in creating units through selling of 25% of the share capital. As and when there are dividends, the value of these units would automatically go up.

The Committee also suggested that guidelines be evolved for the proper utilisation of mutual funds for equity raising instead of buying debentures as had been done by the State Bank of India and the Canara Bank in some cases.

Apart from making equity a worthwhile investment, it is important that the share base itself is widened. At present, the market for shares is limited to only urban areas and that too to a few major cities. There is considerable scope for raising resources from semi-urban markets and even in the rural sector. The equity culture is almost absent in these areas. There is an acute need to educate the public about the advantages of equity holding as also to provide facilities for purchases and sale of securities. For this purpose, the following steps have been necessary:

(*i*) Investment trusts or mutual funds have to be set up in semi-urban and even rural areas to be run on the same lines as the UTI to garner resources.

(*ii*) The number of stock exchanges for cash transactions has to be increased.

(*iii*) The financial institutions who also undertake underwriting operations have to undertake a publicity campaign to inculcate public interest in equity investment.

CAPITAL MARKET IN THE PROCESS

The important task of the economy has always been to strengthen the capital market largely through stimulation of private investment. This could be achieved by effecting structural changes to the capital market, widening the scope of fiscal incentives and to impart some mobility to it. It is also equally important to protect the value of savings held in the form of fixed interest securities, which is the mainstay of fixed income earners. This will help in strengthening the capital market and improve the economy.

The Indian capital market has developed to a large extent but is still in a process of evolution. Various measures have been taken, specially to develop a healthy and mature capital market. These include implementation of Dave Committee recommendations for phased liberalisation of stock market operations, opening up of the stock exchange membership to financial institutions and corporate bodies, encouraging banks and financial institutions to go in for mutual funds, finalisation or rating symbols by CRISIL to guide investors, the setting up of the DFHI to create an active secondary market and most important of all, the establishment of SEBI to regulate stock exchanges so as to promote a healthy and orderly securities market. However, one more area which requires serious attention is the scope for a multi-tier market.

Over time, while the Securities market has expanded manifold, the structure and working of the market has remained unchanged. At present though, various securities traded in the stock exchanges are different in nature they are all subject to the same listing requirements. The size, liquidity, floating stock, volume of trade, company's performance, etc., of listed companies differ widely, still they are all treated at par. The existing uniform listing requirements are neither suitable to the investor, who is not aware of the differences in securities, nor to the issuing companies whose needs are diverse.

The SEBI, in its approach paper, has referred to its plans to seek and promote a multi-tier market structure, with different tiers having distinct characteristics suited to the differing needs of issuers and investors. Each tier would have its own listing requirements. The primary objective of such a structure would be to ensure that the market is attractive to issuers of different sizes and is suited to their needs to impart liquidity to issues and to provide appropriate incentives to elicit good response from the investors.

There is no doubt that there is need for a multi-tier market. However, as a first step, it would be advisable to have a two-tier market. It has been suggested that public issues below ` 3 crore should form one tier of the market, while those above ` 3 crore can form the other elevated tier of the market. Such bifurcation would help the smaller companies to mobilise resources at a lower cost, with less stringent requirements, and provide a way for companies to gradually move up to the elevated market as they grow. The higher tier would be subject to stringent requirements of disclosure to stock exchanges and investors. These shares would obviously be more liquid. The investors on their part would be aware of the relative liquidity and risk and the reward profile of alternative investments.

The idea behind the introduction of a two-tier market is to insulate the general public from the relatively high risk shares in the lower market. This should be possible since only those persons having the capacity to take risks and the necessary expertise to make professional judgement would operate in this market. Mainly financial institutions, banks and their subsidiaries and brokers would actively participate in this market. The companies with relatively few shareholders, with no recent trading history or those having only local or regional investor interest, would be attracted to this lower tier of the market. The envisaged two tiers of the market would continue to form part of the existing securities exchange market.

Another type of secondary securities market being envisaged is the Over The Counter (OTC) market. The difference between the two is that a securities exchange market operates on auction basis, whereas an OTC market functions on the negotiation principle. In an exchange market, many buyers and sellers compete for the best share price through agents, whereas in an OTC market, intermediaries (brokers/dealers) for one buyer and one seller seek each other and agree on a trade price. In the OTC market, there is no physical meeting place for buyers and sellers. Instead they find each other through an electronic network or by telephone or telex. There is no double auction method as practised by the exchanges. Instead the market in a stock is maintained by firms that act as dealers by establishing positions in a security.

An important and unique characteristic of the Indian capital market, that has been lost as a result of globalisation of the market, is the isolated nature of the markets. The Indian markets till now were neither linked to global markets nor were affected by ups and downs being experienced by global markets. As a result, the markets continued to remain buoyant even during Gulf War and other world crisis. However, now the markets re reportedly more volatile and more prone to economically beneficial happenings overseas. This would necessitate a need for greater intervention and stricter policing and hence there is a need to give greater freedom and more powers to SEBI, the supervising authority in the Indian Market.

The volume of capital market activity has increased substantially since the last decades (2000-2008) though in the most recent period, for various reasons, activity has been somewhat subdued both in the primary and secondary markets. The period has also witnessed some widening and deepening of the market and the emergence of new institutions, such as merchant banks

and mutual funds as well as new market instruments. Venture capital companies have also made their appearance but they have not grown anywhere near their potential, as exemplified in the U.S. or the need for them given the contribution they can make to convert innovative scientific ideas into commercial propositions and for their role in promoting technoentrepreneurship. This calls for proactive policies such as fiscal concessions and a supportive set of operational guidelines including encouraging foreign venture companies to set up in India.

The expansion of capital markets to meet successfully the challenges of the future requires the correction of some long standing systemic deficiencies stemming from institutional and procedural aspects of the functioning especially of secondary market institutions. This is being done and there is now a greater measure of transparency at a result of the requirement of fuller disclosure and the arrival on the scene of investment oriented research agencies. Reform of the stock exchanges is also under way. A depository system has been introduced and dematerialised trading is picked up. Computerised on-line trading between different markets is gathering momentum and the presence of the National Stock Exchange has made an enormous difference acting as it does as a pace setter for improved market procedures.

NEW INITIATIVES

Though the capital markets in India have evolved over a long period, they gathered considerable momentum only after various initiatives undertaken by the Government/securities and Exchange Board of India (SEBI) beginning the early 1990s. The activity in the market picked up from 2003-04 significantly reflecting effectiveness of the measures initiated to develop the market and restore investor confidence.

Various reforms initiated in the financial markets since the early 1990s have focussed on:

(i) removing the restrictions on pricing of assets;

(ii) building of institutional and technological infrastructure;

(iii) strengthening the risk management practices;

(iv) fine-tuning of the market microstructure;

(v) changes in the legal framework to remove structural rigidities; and

(vi) widening and deepening of the market with new participants and instruments.

Overseen by SEBI, the Indian capital market dealt in scrips of a large number of listed companies with a wide geographical outreach, providing a world class trading and settlement system, a wide range of product availability with a fast growing derivatives market and well laid down corporate governance and investor protection. The reforms in the capital market are aimed at enhancing the efficiency safety, integrity and transparency of the market. The key reform measures for the capital market are given below.

CAPITAL MARKET REFORM MEASURES

- With the repeal of the Capital Issues (Control) Act, 1947, companies were given freedom to price their issues. The book-building process in the new issue of capital was introduced with a view to further strengthen the price discovery process.

- In the secondary market, the floor-based open outcry trading system was replaced by electronic trading system in all the stock exchanges.
- The account period settlement system was replaced by rolling settlement, thus, reducing the scope for speculation. The rolling settlement cycle was shortened from T + 5 to T+ 3 with effect from April 1, 2002. This process was enabled by a shift to electronic book entry transfer system through depository mechanism.
- The risk management system was made more comprehensive with trading members being subject to margins based on trading volumes and some other parameters and exposure norms based on the capital deposited with the exchange. The mark-to-market margins based on 99 per cent value at risk were introduced to capture the risk profile of trading members.
- The Indian companies were allowed to raise funds from abroad, through American/ Global Depository Receipts (ADRs/GDRs), foreign currency convertible bonds (FCCBs) and External Commercial Borrowings (ECBs). The Reserve Bank allowed two-way funding of ADRs/GDRs in February 2002.
- Foreign institutional investors (FIIs) were allowed to participate in the capital market.
- For strengthening the process of information flows from the listed companies, several measures were introduced: *(i)* while sufficient disclosures are mandatory for the companies at the stage of public issue, the listed companies are also required under the listing agreement to make disclosures on a continuing basis; *(ii)* for ensuring quick flow of information to the public, the decision pertaining to dividend, bonus and right announcements or any material event are now required to be disclosed to the public within 15 minutes of the conclusion of the board meeting in which the decisions are taken; *(iii)* the accounting practices were streamlined with norms introduced for segment reporting, related party transactions and consolidated balance sheets.
- Insider trading was made a criminal offence. The regulations governing substantial acquisition of shares and takeovers of companies were also introduced aimed at protecting the interests of minority shareholders by making the takeover process more transparent.
- For providing market participants instruments for hedging and risk management, several types of derivative products on equities were introduced. Non-transparent products like 'badla' were banned.
- Measures to expand the market for corporate bonds: Exchange-traded currency and interest rate futures are to be launched and a transparent credit derivatives market is to be developed with appropriate safeguards;
- Tradability of domestic convertible bonds is to be enhanced through the mechanism of enabling investors to separate the embedded equity option from the convertible bond, and trade it separately;
- Development of a market-based system for classifying financial instruments based on their complexity and implicit risks is to be encouraged.
- Permanent Account Number (PAN): Requirement of PAN has been extended to all transactions in the financial market, subject to suitable threshold exemption limits.

- National market for securities: Empowered Committee of State Finance Ministers to be requested to work with the Central Government to create a pan-Indian market for securities that will expand the market base and enhance the revenues of the State Governments.

The impact of various reform measures could be seen in the primary as well as secondary segments of the capital market.

The reform in the Indian capital market would gain added significance in the context of a measure of internationalisation of Indian capital markets. For the Indian system to derive the full benefits and avert risks involved in the process, a structured and sequenced integration would be needed. The greater interaction of Indian and international markets would necessarily involve further improving our procedures and practices. Foreign investors are used to open trading systems within the framework of prudential regulation. Their markets are also characterised by adequate disclosure and research based information and severe penalties for insider trading. Our markets would need, both for their own development and to promote fruitful linkages with foreign capital market, to conform to these principles.

THE WAY FORWARD

The financial system in India has become more market-oriented in recent years. There has been a significant increase in financial institutions' market activities and exposures, as well as participation by non-financial corporations and households in the markets. Hence, market-based risks are becoming more relevant for financial stability.

The Reserve Bank closely monitors financial market developments considering their critical role, while simultaneously taking measures to further develop the various segments of the financial market under its purview. *viz.* the money market, the Government securities market and the foreign exchange market. The SEBI regulates the capital market. Various reforms initiated in the financial markets since the early 1990s have focussed on *(i)* removing the restrictions on pricing of assets; *(ii)* building of institutions and technological infrastructure; *(iii)* strengthening the risk management practices; *(iv)* fine-tuning of the market microstructure; *(v)* changes in the legal framwork to remove structural rigidities; and *(vi)* widening and deepening of the market with new participants and instruments. The Reserve Bank, in July 2005, set up a separate Financial Market Department (FMD) for exclusively monitoring the developments in the financial markets.

Financial markets during 2006-07, in general, witnessed orderly movements. There were some episodes of volatitiy in the latter part of the year arising from developments in international financial markets. There were also some shifts in domestic liquidity conditions on account of capital flows and volatility in cash balances of the Goverment.

CONCLUSION

The liberalisation in the primary capital market was mainly aimed at greater autonomy to corporates and better transparency for investors. These included free pricing norms for issues, removal of interest ceiling on debentures, abolition of the position of Controller of Capital Issues and dropping of mandatory conversion of debt to equity by term lending institutions. Statutory

powers were conferred on the Securities and Exchange Board of India (SEBI) and comprehensive measures were taken for investor protection in the form of laying down disclosure norms, allotment procedures, control over insider trading, rights issue norms, handling of investor complaints, etc. The OTCEI was set up in February 1992 to trade in the scrips of middle market corporates. The National Stock Exchange (NSE) has been set up recently, with nation-wide stock trading facilities, electronic display, efficient clearing and settlement facilities.

The Indian capital market has undergone a sea change in the post-independence era. More particularly, the Stock (Share) Operations have witnessed a spurt of activities with the liberalisation of the economy and active participation of development banks.

The important task of the economy is to strengthen the capital market largely through stimulation of private investment. This could be achieved by effecting structural changes to the capital market, widening the scope of fiscal incentives and to impart some mobility to it. It is also equally important to protect the value of savings held in the form of fixed interest securities, which is the mainstay of fixed income earners. This will help in strengthening the capital market and improve the economy.

In recent years, various reform measures for blending market to freedom and regulation of the market on prudential lines were introduced. The measures include abolishing government control over capital issues and pricing, allowing mutual funds to be set up in the private sector, freeing of interest rates on debentures, excluding financial instruments from the purview of wealth tax and permitting foreign institutional investment directly in the capital market. All-India development banks have promoted individually and collectively, new institutions to help investors and entrepreneurs.

Building a capital market more responsive to the needs of lenders and borrowers would require substantial improvements in the macro-econommic, legal, and regulatory environments.

To operate efficiently, capital market and financial institutions have to be guided by market forces rather than government directives. Competition needs to be strengthened by encouraging the entry of new and innovative providers of financial services and all the players of the capital market need to introduce discipline in their activities and transparency in their transactions.

Towards this end, the development banks have a lead responsibility and mutual funds, the merchant bankers and the stock exchanges have to play a crucial role with efficiency and credibility of a sound and vibrant capital market to promote investments and thereby accelerate the process of industrial development and at the same time push up exports to new heights.

The future of the capital market holds promise on account of the fact that India is expected to continue to grow aggressively at 8% plus for several years ahead. Further, the Indian growth story is domestically inclined (infrastructure, rural development, retail spending, etc.) and as such, external factors are likely to have rather less impact on the overall growth prospects. Moreover, the corporate India is gaining global credibility with improved visibility, productivity and performance. However, the global oil prices and possibility of rising interest rates pose constraining factors for sustained future rise.

SELF ASSESSMENT QUESTIONS

(1) Define the capital market. What is its role in the economy?

(2) What are the various constituents of capital market?

(3) Discuss in detail the growth and development in Indian Capital Market?

(4) Distinguish between Primary Market and Secondary Market.

(5) Discuss in detail the reforms in the Indian Capital Market.

(6) What role does NBFC play in stock market activities?

(7) Define the stock exchange. What are the function of stock exchange.

(8) Write a note on the BSE and NSE.

(9) What are the features of OTCEI?

(10) Discuss the role and function of SEBI.

(11) What is the online trading? What are its advantages?