

UNIT-II CHAPTER 5

CAPITAL MARKET

INTRODUCTION

Capital Market is a market where buyers and sellers engage in trade of financial securities like bonds, stocks etc. The process of buying and selling is undertaken by participants such as individuals and institutions. Generally this market trades mostly in long-term securities. Capital market consists of primary markets and secondary markets. An ideal capital market is one where finance is available at reasonable cost. This chapter deals with the features and functions of capital market. The Indian Capital Market Evolution and Growth is discussed in this chapter.

I. CHOOSE THE CORRECT ANSWERS

- Capital market do not provide**
 a) Short term Funds b) Debenture Funds
 c) Equity Funds d) Long term Funds
- When the NSEI was established**
 a) 1990 b) 1992
 c) 1998 d) 1997
- Primary market is a market where securities are traded in the**
 a) First Time b) Second Time
 c) Three Time d) Several Times
- Participants in the capital market includes**
 a) Individuals b) Corporate
 c) Financial Institutions d) All the above
- How many times a security can be sold in a secondary market?**
 a) Only One Time b) Two Time
 c) Three Times d) Multiple Times

ANSWERS

1	a)	2	b)	3	a)	4	d)	5	d)
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II. VERY SHORT ANSWER QUESTIONS:

- What is Capital Market?**
 ❖ Capital Market is a market where buyers and sellers engage in trade of financial securities like bonds, and stocks.

❖ Capital market forms an important core of a country's financial system.

2. Write a note on OTCEI.

- ❖ The OTCEI was set up by a premier financial institution.
- ❖ It was made up to allow the trading of securities across the electronic counters throughout the country.
- ❖ It addresses some specific problems of both investors and medium-size companies.
- ❖ Some of the greatest strengths of OTCEI are transparency of transactions, quick deals, faster settlements and better liquidity.

3. What is Mutual Fund?

- ❖ Financial institutions that provide facilities for channeling savings of small investors into avenues of productive investments are called 'Mutual Funds'.
- ❖ A mutual fund company invests gives them the benefit of diversified investment portfolio and a reasonable return.
- ❖ The benefits of mutual fund are high return, easy liquidity, safety and tax benefits to the investors.

4. Who are the Participants in a Capital Market?

The participants of the capital market includes:

- ❖ Individuals
- ❖ Corporate Sectors
- ❖ Government Banks
- ❖ Other Financial Institutions.

5. How is price determined in a Capital Market?

The price of the securities is determined based on the demand and supply prevailing in the capital market for securities.

III. SHORT ANSWER QUESTIONS:

1. What are the various kinds of Capital Market? Explain.

The capital market is divided into two i.e., primary market and secondary market.

I. Primary Market

- ❖ Primary market is a market for new issues or new financial claims.
- ❖ It is also called New Issue Market.
- ❖ The primary market deals with those securities which are issued to the public for the first time.
- ❖ In the primary market, borrowers exchange new financial securities for long term funds.
- ❖ Primary market facilitates capital formations.
- ❖ There are three ways by which a company may raise capital in a primary market. They are:

(i) Public Issue:

- ❖ The most common method of raising capital by new companies is through sale of securities to the public. It is called public issue.

(ii) Rights Issue:

- ❖ When an existing company wants to raise additional capital, securities are first offered to the existing shareholders on a pre-emptive basis. It is called rights issue.

(iii) Private Placement:

- ❖ Private placement is a way of selling securities privately to a small group of investors.

II. Secondary Market

- ❖ Secondary Market may be defined as the market for old securities, in the sense that securities which are previously issued in the primary market are traded here.

- ❖ The trading takes place between investors who follow the original issue in the primary market.
- ❖ It covers both stock exchange and over-the counter market.

2. Explain any two functions of capital Market.

(i) Savings and Capital Formation

- ❖ In capital market, various types of securities help to mobilize savings from various sectors of population (Individuals, Corporate, Govt., etc.).
- ❖ The twin features of reasonable return and liquidity in stock exchange are definite incentives to the people to invest in securities.
- ❖ This accelerates the capital formation in the country.

(ii) Industrial Growth

- ❖ The stock exchange is a central market through which resources are transferred to the industrial sector of the economy.
- ❖ The existence of such an institution encourages people to invest in productive channels.
- ❖ Thus it stimulates industrial growth and economic development of the country by mobilizing funds for investment in the corporate securities.

3. Write a note on National Clearance and Depository System (NCDS).

- ❖ Under this system the settlement of transactions is done through a book entry.
- ❖ It contains the following three segments
 - ❖ National Trade Comparison and Reporting System which prescribes the terms and conditions of contract for the securities market.
 - ❖ NCS aims at determining the net cash and stock liability of each broker on a settlement date
 - ❖ National Depository System which arranges to provide for the transfer of ownership of securities in exchange on payment by book entry on electronic ledgers without any physical movement of transfer deed.

4. Discuss about evolution and growth of Indian capital Market.

- ❖ The period between 1947 and 1973 marked the development of infrastructure for capital market.
- ❖ During this period, a network of development financial institutions such as IFCI, ICICI, IDBI and UTI, SFCs and SIDCs were established.
- ❖ During the period between 1980 and 1992, debenture emerged as a powerful instrument of resource mobilization in the primary market.
- ❖ In this period many number of stock exchanges came into existence and the public sector bonds were introduced.
- ❖ SEBI introduced many new financial services such as credit rating.
- ❖ A number of committees were constituted in order to suggest measures to revamp and restructure the working of the secondary market and cause buoyancy in the primary market.
- ❖ Some of these committees were: Committee on Organization and Management of Stock Exchange, Working group on the Development of the Capital Market, A Study Group for Guidelines Relating to Valuation and New Instruments, A High Powered Study Group on Establishment of New Stock Exchange, A Committee on Trading in Public Sector Bonds and Units of Mutual Funds.

5. Explain about Factoring and Venture Capital Institutions.

i. Factoring:

- ❖ Factoring is an arrangement whereby a financial institution provides financial accommodation on the basis of assignment/sale of account receivables.
- ❖ The factoring institutions collect the book debts for and on behalf of its clients.
- ❖ E.g : SBI Factors and Commercial Services Private Limited, a subsidiary of State Bank of India.
- ❖ E.g: Canbank Factors Limited, a subsidiary of Canara Bank.

ii. Venture Capital Institutions:

- ❖ Venture capital financing is a form of equity financing designed especially for funding new and innovative project ideas.
- ❖ Venture capital funds bring into force the hi-technology projects which are converted into commercial production.
- ❖ E.g: Risk Capital Foundation of IFCI, Venture Fund of IDBI, SIDBI, Technology Development and Infrastructure Corporation of India (TDICI).

IV. LONG ANSWER QUESTIONS:

1. Discuss the characters of a Capital Market.

Following are the nature/characteristic of a capital market:

(i) Securities Market

The dealings in a capital market are done through the securities like shares, debentures, etc. The capital market is thus called securities market.

(ii) Price

The price of the securities is determined based on the demand and supply prevailing in the capital market for securities.

(iii) Participants

There are many players in the capital market. The participants of the capital market include individuals, corporate sectors, Govt., banks and other financial institutions.

(iv) Location

Capital market is not confined to certain specific locations, although it is true that parts of the market are concentrated in certain well-known centres known as Stock Exchanges. It has its impact in the overall economy, wherever suppliers and users of capital get together and do business.

(v) Market for Financial Assets

Capital market provides a transaction platform for long term financial assets

2. Briefly explain the functions of capital market.

The following are the functions of Capital Market.

(i) Savings and Capital Formation

- ❖ In capital market, various types of securities help to mobilize savings from various sectors of population (Individuals, Corporate, Govt., etc.).
- ❖ The twin features of reasonable return and liquidity in stock exchange are definite incentives to the people to invest in securities.
- ❖ This accelerates the capital formation in the country.

(ii) Permanent Capital

- ❖ The existence of a capital market/stock exchange enables companies to raise permanent capital.
- ❖ The investors cannot commit their funds for a permanent period but companies require funds permanently.
- ❖ The stock exchange resolves this dash of interests by offering an opportunity to investors to buy or sell their securities, while permanent capital with the company remains unaffected.

(iii) Industrial Growth

- ❖ The stock exchange is a central market through which resources are transferred to the industrial sector of the economy.
- ❖ The existence of such an institution encourages people to invest in productive channels.
- ❖ Thus it stimulates industrial growth and economic development of the country by mobilizing funds for investment in the corporate securities.

(iv) Ready and Continuous Market

- ❖ The stock exchange provides a central convenient place where buyers and sellers can easily purchase and sell securities.
- ❖ Easy marketability makes investment in securities more liquid as compared to other assets.

(v) Reliable Guide to Performance

- ❖ The capital market serves as a reliable guide to the performance and financial position of corporate, and thereby promotes efficiency.

(vi) Proper Channelization of Funds

- ❖ The prevailing market price of a security and relative yield are the guiding factors for the people to channelize their funds in a particular company.
- ❖ This ensures effective utilisation of funds in the public interest.

(vii) Provision of Variety of Services

- ❖ The financial institutions functioning in the capital market provide a variety of services such as grant of long term and medium term loans to entrepreneurs, provision of underwriting facilities, assistance in promotion of companies, participation in equity capital, giving expert advice etc.

(viii) Development of Backward Areas

- ❖ Capital Markets provide funds for projects in backward areas.
- ❖ This facilitates economic development of backward areas.
- ❖ Long term funds are also provided for development projects in backward and rural areas.

(ix) Foreign Capital

- ❖ Capital markets makes possible to generate foreign capital. Indian firms are able to generate capital funds from overseas markets by way of bonds and other securities.
- ❖ Government has liberalised Foreign Direct Investment (FDI) in the country.
- ❖ This not only brings in foreign capital but also foreign technology which is important for economic development of the country.

(x) Easy Liquidity

- ❖ With the help of secondary market investors can sell off their holdings and convert them into liquid cash.
- ❖ Commercial banks also allow investors to withdraw their deposits, as and when they are in need of funds.

3. Explain the various types of New Financial Institutions.

(i) Venture Fund Institutions

- ❖ Venture capital financing is a form of equity financing designed especially for funding new and innovative project ideas. V
- ❖ Venture capital funds bring into force the hi-technology projects which are converted into commercial production.
- ❖ They include Risk Capital Foundation of IFCI, Venture Fund of IDBI, SIDBI, Technology Development and Infrastructure Corporation of India (TDICI), and others.

(ii) Mutual Funds

- ❖ Financial institutions that provide facilities for channeling savings of small investors into avenues of productive investments are called 'Mutual Funds'.
- ❖ A mutual fund company invests the funds pooled from shareholders and gives them the benefit of diversified investment portfolio and a reasonable return.
- ❖ Specialized financial institution like LIC, UTI, etc., beside commercial banks such as SBI, and Canara Bank are carrying out the business of mutual funds.
- ❖ The benefits of mutual fund are high return, easy liquidity, safety and tax benefits to the investors.

(iii) Factoring Institutions

- ❖ "Factoring" is an arrangement whereby a financial institution provides financial accommodation on the basis of assignment/sale of account receivables.
- ❖ The factoring institutions collect the book debts for and on behalf of its clients.
- ❖ Some of the factoring institutions operating in India are SBI Factors and Commercial Services Private Limited, a subsidiary of State Bank of India and Canbank Factors Limited, a subsidiary of Canara Bank.

(iv) Over the Counter Exchange of India (OTCEI)

- ❖ The OTCEI was set up by a premier financial institution to allow the trading of securities

across the electronic counters throughout the country.

- ❖ It addresses some specific problems of both investors and medium-size companies.
- ❖ Some of the greatest strengths of OTCEI are transparency of transactions, quick deals, faster settlements and better liquidity.

(v) National Stock Exchange of India Limited (NSEI)

- ❖ NSEI was established in 1992 to function as a model stock exchange.
- ❖ The Exchange aims at providing the advantage of nation-wide electronic screen based "scripless" and "floorless" trading system in securities.
- ❖ The institution is expected to allow for an efficient and transparent system of securities trading.

(vi) National Clearance and Depository System (NCDS)

- ❖ Under the scripless trading system, settlement of transactions relating to securities takes place through a book entry.
- ❖ The entire scripless trading system comprises the following three segments:
 - a. National Trade Comparison and Reporting System which prescribes the terms and conditions of contract for the securities market
 - b. National Clearing System which aims at determining the net cash and stock liability of each broker on a settlement date
 - c. National Depository System which arranges to provide for the transfer of ownership of securities in exchange on payment by book entry on electronic ledgers without any physical movement of transfer deed

(vii) National Securities Depositories Limited

- ❖ The NSDL was set up in the year 1996 for achieving a time bound dematerialization as well as rematerialization of shares.
- ❖ The establishment of NSDL is expected to alleviate the problems of post trade transactions in the secondary market.

(viii) Stock Holding Corporation of India Limited (SHCIL)

- ❖ Stock Holding Corporation of India Limited (SHCIL) aims at serving as a central securities depository in respect of transactions on stock exchanges.
- ❖ The Corporation also takes up the administration of clearing functions at a national level.

ADDITIONAL QUESTIONS:

I. CHOOSE THE CORRECT ANSWERS:

1. The capital market is also called as _____.
a) Securities Market b) Spot Market
c) Primary Market d) None
2. The method of raising capital by new companies through sale of securities to the public is known as _____.
a) Private Issue b) Right Issue
c) Public Issue d) None
3. The Existing company raise additional capital by which one of the following method?
a) Private Issue b) Right Issue
c) Public Issue d) None
4. Credit Rating was introduced by _____.
a) SIDBI b) WTO
c) TDICI d) SEBI
5. National Stock Exchange of India Limited was established in the year _____.
a) 1992 b) 1982
c) 1977 d) 1968
6. Which of the following are Hard Commodities?
a) Gold b) Oil
c) Rubber d) All the above
7. The NSDL was set up in the year _____.
a) 1992 b) 1982
c) 1996 d) 1968
8. Money market where debt and stocks are traded and maturity period is more than a year is classified as _____.
a) Global Market b) Capital Market
c) Counter Market d) Long term market
9. Type of market in which securities with less than one year maturity are traded, is classified as _____.
a) Money Marekt b) Capital Market
c) Counter Market d) Long term market
10. The short term financial instruments traded in money market is commonly called as _____.
a) Bonds b) Commercial Papers
c) Shares d) Debentures
11. Assertion (A): Marginal cost and differential cost do not convey the same meaning in all the circumstances.
Reason (R): Differential cost increases or decreases due to change in fixed cost.
Codes:
(A) (A) is true but (R) is false
(B) (A) is false but (R) is true
(C) (A) and (R) are correct and (R) is correct explanation of (A).
(D) Both (A) and (R) are correct, but (R) is not the correct explanation of (A).
12. Assertion (A): When a company earns profit prior to its incorporation, it is called capital profit.
Reason (R): Capital profit cannot be used for distribution as dividend to the shareholders.
In the context of the above statements, which one of the following is correct?
Codes:
(A) (A) is correct, but (R) is wrong.
(B) Both (A) and (R) are correct.
(C) (A) is wrong, but (R) is correct.
(D) Both (A) and (R) are wrong.
13. Assertion (A): Only the relevant costs should be taken into consideration for decision making.
Reason (R): All variable costs are relevant costs and all fixed costs are irrelevant costs.
In the above statements, which one alternative of the following is correct?
Codes:
(A) Both (A) and (R) are correct.
(B) Only (A) is correct, but (R) is wrong.
(C) Only (R) is correct, but (A) is wrong.
(D) Both (A) and (R) are wrong.

14. Statement I : Canbank Factors Limited collect the book debts for and on behalf of its clients.

Statement II. The factoring institutions provides financial accommodation on the basis of assignment or sale of account receivable.

- (A) (A) is true but (R) is false
 (B) (A) is false but (R) is true
 (C) (A) and (R) are correct and (R) is correct explanation of (A).
 (D) Both (A) and (R) are correct, but (R) is not the correct explanation of (A).

15. Assertion (A): When the existing company wants to raise additional capital, securities are first offered to the existing shareholders.

Reason(R): Rights offer is a dividend of subscription rights to buy additional securities in a company made to the company's existing security holders.

- (A) (A) is true but (R) is false
 (B) (A) is false but (R) is true
 (C) (A) and (R) are correct and (R) is correct explanation of (A).
 (D) Both (A) and (R) are correct, but (R) is not the correct explanation of (A).

16. Match the Following:

List I	List II
a) NCDS	i. Over the Counter Exchange of India
b) NSEI	ii. Stock Holding Corporation of India Limited
c) SHCIL	iii. National Stock Exchange of India Limited
d) OTCEI	iv National Clearance and Depository System

- a) b) c) d)
 a) 4 3 1 2
 b) 3 4 1 2
 c) 3 2 1 4
 d) 4 3 2 1

17. Match List I and List II

List I	List II
a.WTO	i. Provides loans to address short term BOP
b.RBI	ii. multilateral trade negotiating body
c. IMF	iii. facilitating lending and borrowing for reconstruction and development
d. IBRD	iv. Central Bank of India

- a) b) c) d)
 a) 2 4 1 3
 b) 4 3 2 1
 c) 3 2 4 1
 d) 1 2 3 4

18. Match List I and List II

List I	List II
a. authorised capital	i. A registered Capital
b. Issued Capital	ii. Which is issued for public
c. Subscribed Capital	iii. Which is purchased by the capital
d. Paid-up Capital	iv. That part has been paid by the shareholders

- a) b) c) d)
 a) 1 2 3 4
 b) 4 3 2 1
 c) 1 3 4 1
 d) 2 3 4 1

ANSWERS									
1	a)	2	c)	3	b)	4	d)	5	a)
6	d)	7	c)	8	b)	9	a)	10	b)
11	c)	12	b)	13	b)	14	c)	15	c)
16	d)	17	a)	18	a)				

II. VERY SHORT ANSWER QUESTIONS:

1. Write a note on derivatives market.

- ❖ Derivatives market facilitates the trading in financial instruments such as futures contracts and options used to help control financial risk.
- ❖ The instruments derive their value mostly from the value of an underlying asset that can come in many form – stocks, bonds, commodities, currencies or mortgages.

2. What is Foreign Exchange Market?

- ❖ The FEM abets the foreign exchange trading
- ❖ It is the largest, most liquid market in the world with an average traded value of more than \$5 trillion per day.
- ❖ It includes all of the currencies in the world and any individual, company or country can participate in it.

III. SHORT ANSWER QUESTIONS:**1. Write a note on Mutual Funds.**

- ❖ Financial institutions that provide facilities for channeling savings of small investors into avenues of productive investments are called mutual funds.
- ❖ A mutual fund company invests the funds pooled from shareholders and give them the benefit of diversified investment portfolio and a reasonable return.

2. What are the ways by which company may raise capital in a primary market.**(i) Public Issue:**

The most common method of raising capital by new companies is through sale of securities to the public. It is called public issue.

(ii) Rights Issue:

When an existing company wants to raise additional capital, securities are first offered to the existing shareholders on a pre-emptive basis. It is called rights issue.

(iii) Private Placement:

Private placement is a way of selling securities privately to a small group of investors.

I. Primary Market

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- ❖ It is also called New Issue Market.
- ❖ The primary market deals with those securities which are issued to the public for the first time.
- ❖ In the primary market, borrowers exchange new financial securities for long term funds. Thus, primary market facilitates capital formations. There are three ways by which a company may raise capital in a primary market. They are:

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- ❖ It covers both stock exchange and over-the counter market.

IV. LONG ANSWER QUESTIONS:**1. Explain the kinds of Capital Market.**