Capital Market Overview

Capital Market may be defined as a market dealing in medium and long-term funds. The Capital market is a market for financial investments that are direct or indirect claims to capital. Capital market embraces all forms of lending and borrowing, whether or not evidenced by the creation of a negotiable financial instrument. It has two components, the securities market and non-securities market.

We have seen that there are lot many securities exist in money market. Similarly securities exist in Capital Market too. The market where securities are traded known as Securities market. The Securities Market refers to the markets for those financial instruments/ claims/obligations that are commonly and readily transferable by sale. The Securities Market has two interdependent and inseparable segments, the new issues (primary) market and the stock (secondary) market.

Debt Market vs Derivative Market vs Commodity Market vs Equity Market

Now let's have a quick looks at the various markets and the instruments/securities associated with each.

1) Debt Market

The Wholesale Debt Market (WDM) segment of the National Stock Exchange provides a trading platform for a wide range of fixed income securities that includes central government securities, treasury bills (T-bills), state development loans (SDLs), bonds issued by public sector undertakings (PSUs), floating rate bonds (FRBs), zero coupon bonds (ZCBs), index bonds, commercial papers (CPs), certificates of deposit (CDs), corporate debentures, SLR and non-SLR bonds issued by financial institutions (FIs), bonds issued by foreign institutions and units of mutual funds (MFs). (This means that debt market deals not only with capital market securities, but also with money market securities).

Debt Instruments : Debt instrument represents a contract whereby one party lends money to another on pre-determined terms with regards to rate and periodicity of interest, repayment of principal amount by the borrower to the lender. Bonds and debentures are the major debt instruments.

Bonds and Debentures as debt instruments: A Bond is a loan given by the buyer to the issuer of the instrument. Companies, financial institutions, or even the government can issue bonds. Over and above the scheduled interest payments as and when applicable, the holder of a bond is entitled to receive the par value of the instrument at the specified maturity date. Bonds can be broadly classified into: Tax-Saving Bonds Regular Income Bonds. Also, note the below points which explains the difference between bonds and debentures.

- Debentures are bonds which have no collateral.
- Bonds are more secure than debentures, but the rate of interest is lower.
- Debentures are unsecured loans but carries a higher rate of interest.
- In bankruptcy, bondholders are paid first, but liability towards debenture holders is less.
- Debenture holders get periodical interest.
- Bond holders receive accrued payment upon completion of the term.
- In the Indian securities markets, the term 'bond' is used for debt instruments issued by the Central and State governments and public sector organizations and the term 'debenture' is used for instruments issued by private corporate sector.

Also read: National Land Records Modernization Programme (NLRMP)

2) Derivative Market [Financial Derivatives + Commodity Derivatives]

Derivative is a product whose value is derived from the value of one or more basic variables, called bases (underlying asset, index, or reference rate), in a contractual manner. The underlying asset can be equity, forex, commodity or any other asset. For example, wheat farmers may wish to sell their harvest at a future date to eliminate the risk of a change in prices by that date. Such a transaction is an example of a derivative. The price of this derivative is driven by the spot price of wheat which is the "underlying". Derivatives are securities under the SC(R)A and hence the trading of derivatives is governed by the regulatory framework under the SC(R)A. In the Indian context the Securities Contracts (Regulation) Act, 1956 (SC(R)A) defines "derivative" to include –

- A security derived from a debt instrument, share, loan whether secured or unsecured, risk instrument or contract for differences or any other form of
- security. A contract, which derives its value from the prices, or index of prices, of underlying securities.
- Derivative products initially emerged as hedging devices against fluctuations in commodity prices and commodity-linked derivatives remained the sole form of such products for almost three hundred years. The financial derivatives came into spotlight

in post-1970 period due to growing instability in the financial markets. However, since their emergence, these products have become very popular and by 1990s, they accounted for about two thirds of total transactions in derivative products.

- The following three broad categories of participants – hedgers, speculators, and arbitrageurs trade in the derivatives market.
- Derivative contracts have several variants. The most common variants are forwards, futures, options and swaps.

Also read: Universal Basic Income (UBI): Everything you need to know

Derivative contract instruments

1. **Forwards:** A forward contract is a customized contract between two entities, where settlement takes place on a specific date in the future at today's pre-agreed price.
2. **Futures:** A futures contract is an agreement between two parties to buy or sell an asset at a certain time in the future at a certain price. Futures contracts are special types of forward contracts in the sense that the former are standardized exchange traded contracts.
3. **Options:** Options are of two types – calls and puts. Calls give the buyer the right but not the obligation to buy a given quantity of the underlying asset, at a given price on or before a given future date. Puts give the buyer the right, but not the obligation to sell a given quantity of the underlying asset at a given price on or before a given date.
4. Warrants: Options generally have lives of up to one year, the majority of options traded on options exchanges having a maximum maturity of nine months. Longer dated options are called warrants and are generally traded over-the-counter.
5. LEAPS: The acronym LEAPS means Long-Term Equity Anticipation Securities. These are options having a maturity of up to three years.
6. Baskets: Basket options are options on portfolios of underlying assets. The underlying asset is usually a moving average or a basket of assets. Equity index options are a form of basket options.
7. **Swaps:** Swaps are private agreements between two parties to exchange cash flows in the future according to a prearranged formula. They can be regarded as portfolios of forward contracts. The two commonly used swaps are: Interest rate swaps: These entail swapping only the interest related cash flows between the parties in the same currency and Currency swaps: These entail swapping both principal and interest between the parties, with the cash flows in one direction being in a different currency than those in the opposite direction.
8. Swaptions: Swaptions are options to buy or sell a swap that will become operative at the expiry of the options. Thus a swaption is an option on a forward swap. Rather than have calls and puts, the swaptions market has receiver swaptions and payer swaptions. A receiver swaption is an option to receive fixed and pay floating. A payer swaption is an option to pay fixed and receive floating.

Also read: Paris Agreement: Simplified

3) Commodity Market [Commodity Derivatives]

Commodity derivatives work almost the same way as financial derivatives, however with some differences. In the case of financial derivatives, most of these contracts are cash settled. Even in the case of physical settlement, financial assets are not bulky and do not need special facility for storage. Due to the bulky nature of the underlying assets, physical settlement in commodity derivatives creates the need for warehousing. Similarly, the concept of varying quality of asset does not really exist as far as financial underlying is concerned.

4) Equity Market

Equity, also called shares or scripts, is the basic building blocks of a company. A company's ownership is determined on the basis of its shareholding. The BSE Sensex is the most popular index that tracks the movements of shares of 30 blue-chip companies on a weighted average basis. The rise and fall in the value of the Sensex, measured in points, broadly indicates the price-movement of the value of shares. SEBI is the regulator of equity market in India.

Non-Securities Market

Mutual funds, Bank Deposits, Provident Fund, Post – office savings, Insurance etc. forms part of non-securities market.

What is a Mutual Fund?

A Mutual Fund is a body corporate registered with SEBI (Securities Exchange Board of India) that pools money from individuals/corporate investors and invests the same in a variety of different financial instruments or securities such as equity shares, Government securities, Bonds, debentures, commercial paper etc. Mutual funds can thus be considered as financial intermediaries in the investment business that collect funds from the public and invest on behalf of the investors. Mutual funds issue units to the investors. The appreciation of the portfolio or securities in which the mutual fund has invested the money leads to an appreciation in the value of the units held by investors.