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Financial System

SEMESTER-III

ECONOMICS

BLOCK- 1

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COURSE INTRODUCTION

Financial System is the fourth course of third semester of the M.A. in Economics programme of this University. The financial system refers to a set of institutional arrangement through which financial resources of the economy are mobilized from surplus to deficient units, channelizes the funds raised in productive activities, creating assets for people and contributes to the development of the economy. Financial system is a complex, well integrated set of subsystems, which comprises financial assets, financial institutioins, financial markets and financial services. This course covers all the subsystems of the financial system in a systematic manner so that learners can understand and go depth into the concepts of Financial system. This course comprises of 15 units and has been divided into two blocks. The first block comprises eight units and the second block comprises seven units.

BLOCK INTRODUCTION

This is the first block of the course and it comprises of eight units. The first unit of the course discusses the basics of financial system. This unit will help you to understand the meaning of the term financial system, objectives of the financial system, structure and nature of financial system, role of financial system and the interlinkage between financial system and economic development. The second unit deliberates on the constituents of financial system. Important concepts discussed in the unit include different components of a financial system such as financial instruments, financial markets & financial institutions; functions of financial system and importance of a financial system. The third unit will introduce you to the concept of money market. In this unit we will discuss the meaning, characteristics, structure, functions and instruments of money market. The fourth unit deals with the Treasury Bills and Commercial Papers. This unit explains about the meaning, features, types and role of Treasury Bills, Commercial Papers and Commercial Bills. Also a brief introduction to the concept of Certificate of Deposit is included in this unit. The fifth unit discusses about the call money market. This unit will help you to understand the meaning of call money market, role of call money and issues associated with monetary policy intervention in the money market. The sixth unit will help you to acquire knowledge about the capital market. In this unit we will discuss the meaning and functions of capital market, about the primary & secondary capital market, participants in the primary capital market and instruments of raising funds in the capital market. The seventh unit deals with the price determination in the money market. This unit will help you to understand the concept of Initial Price Offerings, determination of Offer Price of Initial Price Offerings and concept of book building with its merit and limitations. The eight unit of the course discusses about the secondary market. This unit will help you to understand the meaning, types & importance of secondary market and distinction between primary and secondary market. Apart from it, functions of secondary market & stock market, demutualization of stock exchange and stock market index are also discussed in this unit, which are very important to understand the secondary market.

While going through a unit, you will notice some along-side boxes, which have been included to help you to know some of the difficult, unseen terms. Again, we have included some relevant concepts in “LET US KNOW” along with the text. And, at the end of each section, you will get “CHECK YOUR PROGRESS” questions. These have been designed to self-check your progress of study. It will be better if you solve the problems put in these boxes immediately after you go through the sections of the units and then match your answers with “ANSWERS TO CHECK YOUR PROGRESS” given at the end of each unit.

UNIT 1: INTRODUCTION TO FINANCIAL SYSTEM

UNIT STRUCTURE

1.1 Learning Objectives

1.2 Introduction

1.3 Meaning and Concept of Financial System

1.4 Objectives of Financial System

1.5 Structure of Financial System

1.6 Nature of Financial System

1.7 Role of Financial System

1.8 Financial System and Economic Development

1.9 Let Us Sum Up

1.10 Further Reading

1.11 Answers to Check Your Progress

1.12 Model Questions

1.1 LEARNING OBJECTIVES

After going through this unit, you will be able to –

- know the meaning, concept and structure of financial system
- explain the role/function of financial systems
- understand how financial systems helps in economic development

1.2 INTRODUCTION

For economic development to take place, a well-organized financial system is essential for any country. Financial system is itself a part of the overall economic system of a country. The strength of an economy is indicated by the strength of its financial system and vice-versa. The growth and development of an economy is a reflection of the growth and development of its financial system. Financial system provides an efficient mechanism by which savings are effectively transformed into investments. It also serves as an indicator to show to what extent the funds are mobilized effectively and to what extent the mobilized funds are deployed productively.

Thus a financial system is a complex, well integrated set of sub-systems of financial institutions, markets, instruments and services which facilitates the transfer and allocation of funds efficiently and effectively. The function of a financial system is to generate savings and invest it for capital formation which ultimately leads to economic growth. Therefore, a sound and efficient financial system can contribute to economic growth and development primarily in two ways namely-

- By providing a spectrum of financial assets to meet diverse preferences of ultimate savers.
- By raising the productivity of capital through efficient allocation.

In this unit we will basically discuss about the concept of Financial System.

1.3 MEANING AND CONCEPT OF FINANCIAL SYSTEM

The financial system refers to a set of institutional arrangement through which financial resources of the economy are mobilized from surplus to deficient units, i.e. from savers to borrowers.

The term Financial System comprises two terms, “Finance” and “System”. Finance means resources comprising ownership fund and borrowed fund while System indicates a set of complex and closely connected or interlinked components. So, financial system is a complex, well integrated set of subsystems, which comprises

- Financial assets
- Financial institutions
- Financial markets
- Financial services

These subcomponents of a financial system mobilizes resources for financing economic development, channelizes the funds raised in productive activities, creating assets for people and contributes to the development of the economy. The components of a financial system can be depicted by following diagram:

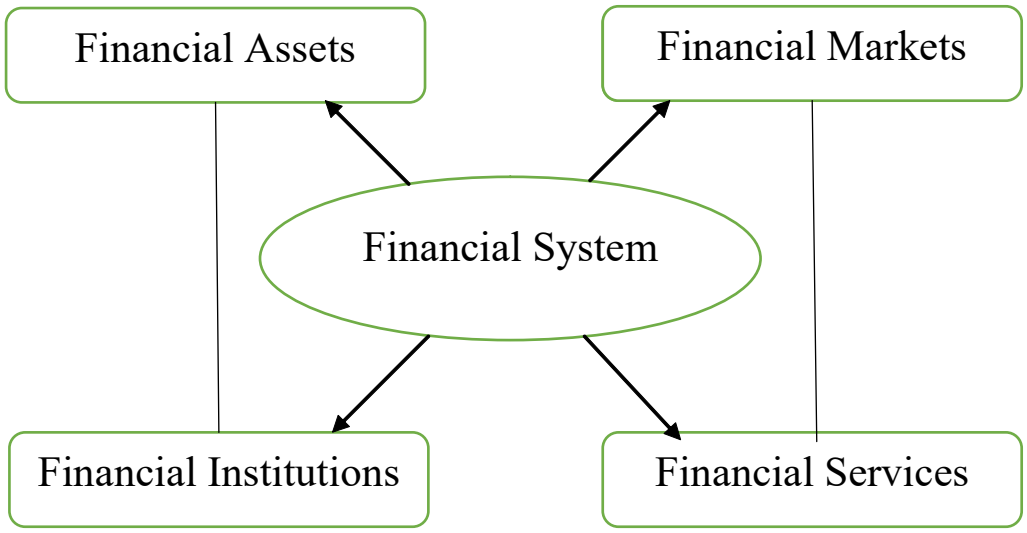


Figure1.1: Financial System

In simple words, financial system deals with money, credit and finance. Although they are very closely associated with each other, but they are also somewhat different from each other. First “Money” works as a medium of exchange or means of payment. Secondly ‘Credit” or “Loan” is a sum of money to be returned with interest and finance is the management of money, in relation to companies, organizations and government.

Thus, financial system is such a system which aims at establishing and providing smooth, regular, cost effective and efficient linkage between depositors and investors.

1.4 OBJECTIVE OF FINANCIAL SYSTEM

The main objectives of a financial system of a country is to serve as a financial agent of socio-economic development in various fields, such as trade, industry, commerce and agriculture for facilitating the process of economic growth. This objective is achieved by providing support in following areas.

- Trade, commerce, industry and agriculture.
- Rural development
- Development of backward areas
- Housing, education, and health sectors
- Building infrastructure

- Provision for refinance facility
- Support for promotion of liquidity
- Research and development etc.



CHECK YOUR PROGRESS

Q 1: What is meant by Financial System? (Answer in about 20 words)

.....

.....

Q 2: State the objectives of financial system of a country. (Answer in about 40 words)

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1.5 STRUCTURE OF FINANCIAL SYSTEM

The structure of financial system is a framework or pattern or design, which is made by different components as shown below:

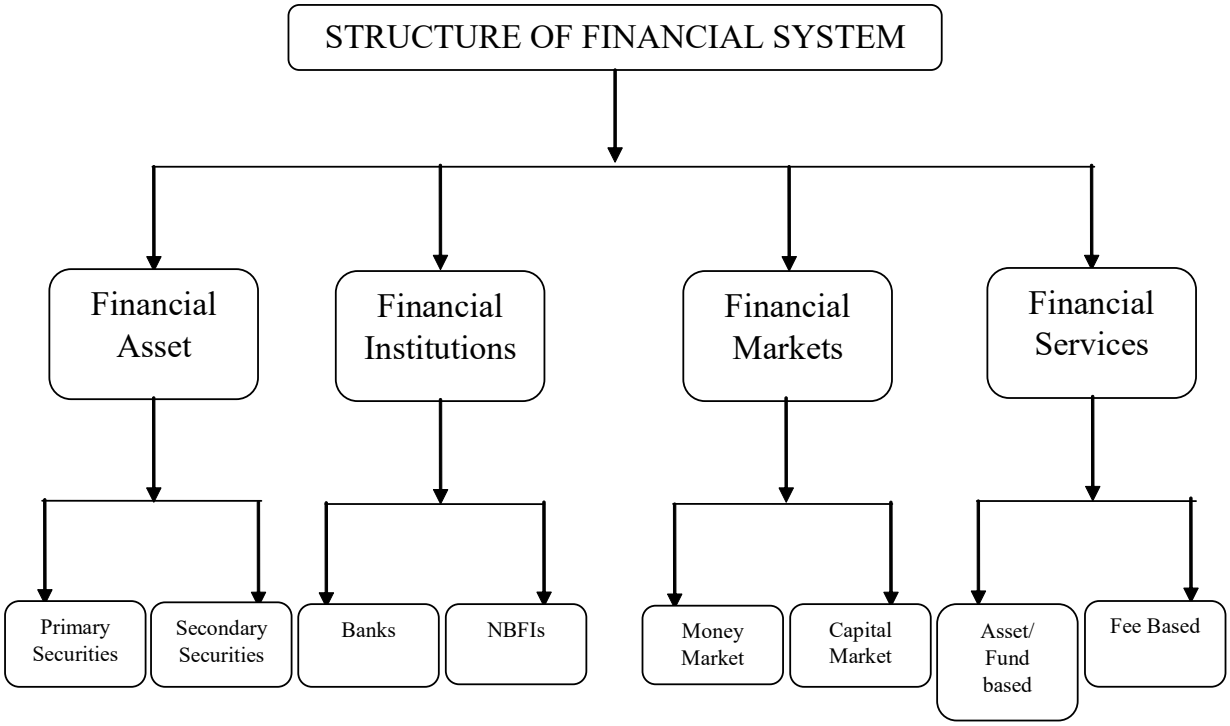


Figure1.2: Structure of Financial System

- **Financial assets** refer to those assets which are issued by the financial institution (FIs) or financial claims to raise funds from the public directly or indirectly. They are generally sub-divided under two broad heads- primary securities and secondary securities.

  The primary securities are financial claims against real-sector units. Bills, bond, equities are the examples of primary securities.

  The secondary securities are those financial claims which are issued by the financial institution against themselves to raise funds from the public. Currency, bank deposits, life insurance policies, units of UTI, IDBI bonds etc. are the examples of secondary securities.

- **Financial institutions** are business organizations engaged in the mobilization of saving from savers and channelizing the accumulated saving into profitable investments. They transform saving into capital. Financial institutions are those institutions which deal with the purchase and sell of financial assets. They are intermediary between surplus units and deficit spenders. They are generally classified under two heads- Banking and Non-banking financial institutions (NBFIs).The examples are banks, insurance companies, unit trust, investment companies, provident fund etc.

- **Financial market** is the market where financial assets are traded by the financial institutions. They are broadly sub-divided under two heads- money market and capital market.

  Money market deals with short term funds and capital market deals with medium and long term funds.

  The financial markets can be both- Organized or Unorganized. Financial markets are the most integral component of the financial system. It acts as the facilitating organization in the saving investment process.

- **Financial services** constitute an important components of the financial system. The efficiency of the financial system depends to a great extent upon the quality and variety of financial services.

Financial services refer to those activities of financial institutions which are concerned with the designing and delivery of financial products and advice to individual and business houses.

The different components consisting the structure of financial system discussed above depend on each other and interact on a regular basis. The smoother the interaction, the higher the efficiency of the financial system. Savings are mobilized by the financial institutions by the issue of financial instruments, which are traded in the financial markets.

1.6 NATURE OF FINANCIAL SYSTEM

A financial system plays a vital role in the economic growth of a country. It is an intermediary between the flow of funds belonging to those who save a part of their income and those who invests in productive assets. It mobilizes and allocates scarce resources of a country. Therefore, a financial system creates a sound economic environment, which in turn influences the firm's investing and financial decisions. Thus a financial system helps in-

- Financial system helps in transferring financial resources from one person to another. It includes financial markets, financial intermediaries, financial assets and services, which facilitates fund transfer within the economy.
- A financial system helps in allocating resources lying ideal with people into productive means. That is, a financial system obtains funds from savers and provides it to those who need it for development purposes.
- Diversification of risk in an economy is an important feature of a financial system. A sound financial system allocates funds in various sources because of which risk is diversified.
- The financial system helps to transform savings into investment and consumption. Financial system provides means and mechanism of transforming resources from those who have an

excess of income over expenditure to those who can make productive use of the same. It provides various income generating investment options to people.

- A financial system helps in maintaining liquidity in an economy. It helps in free movement of funds from households to corporate which results in availability of funds for investment.
- The different components of the financial system are closely interrelated and do change continuously. These components of the financial system do not function in isolation. Their interaction helps in the smooth functioning of financial system.
- There is the presence of strong, active, large sized non-banking financial institutions comprising stock markets, debt market, insurance components, mutual funds etc. in a financial system.
- The co-existence of both formal and informal financial sector is another important nature of a financial system. This co-existence of two sector is known as “Financial Dualism”. Formal financial sector is well-organized and regulated, where as the informal financial sector is un-organized, non-institutional and non-regulated.
- In a developed financial system, there is strong and effective system of supervision, inspection, auditing and prudential norms.
- There is high level of current and capital account convertibility, minimum restrictions on foreign investment and repatriation of earnings in a financial system.
- There is effective and quick enforcement of financial contacts, recovery of debts and property rights in a developed financial system.
- The transaction cost and information cost in a well-developed financial system are low.
- There is a high degree of financial innovation in a financial system.

1.7 ROLE OF FINANCIAL SYSTEM

The financial system as a whole plays an important role in the smooth functioning of a modern complex economy and helps in promoting economic

development. The financial system helps in accelerating the volume of production, capital accumulation and growth by encouraging savings, mobilizing them and allocating them in alternative uses. Each of these functions is important and the role played by the financial system depends on how well it performs each of these functions. The major role/functions of the financial system are discussed under the following heads.

- **Acts as an intermediary**: A financial system acts as an intermediary between savers and investors by mobilizing saving from savers and providing it to investors for investment. Thus, a financial system creates a link between savers and investors by which there is growth of the economy due to increased investment.
- **Channelizes funds:** Another important role performed by financial system is that it channelizes flow of accumulated funds into profitable investment. In this way, financial system creates necessary capital for undertaking large scale investment.
- **Provides an efficient Payment system**: Financial system provides an efficient payment system for the exchange of goods and service and also ensures that funds move safely, quickly and in a timely manner. An efficient payment and settlement system contribute to the effectiveness of a financial system and thus overall economic growth can be achieved more quickly.
- **Transfer of financial resources:** Financial system facilitates transfer of financial resources across time and geographical boundaries. It also helps in creating an environment for trans-border flow of funds.
- **Controlling risks and uncertainties:** Financial system helps in managing and controlling uncertainty and risk. There are basically three basic means of controlling risk and uncertainty. These are-
  - Diversification of investment
  - Insurance
  - Hedging

  Financial system reduces risk by laying down rules governing the operations of the system. Risk reduction is achieved by holding

diversified portfolios and screening of borrowers. Risk is traded in the financial markets through financial instruments such as derivatives.

- **Generates information:** Another important role played by financial system is that it generates price related information. Financial markets disseminate information for enabling participants to develop an informed opinion about investment-disinvestment information of holding a particular asset. This information dissemination enables a quick valuation of financial assets.
- **Setting up of a Financial Structure:** Financial system helps in creation of a financial structure which facilitates lower transaction costs and higher returns. This has a beneficial influence on the rate of return to savers. It also reduces the cost of borrowing and encourage people to save more.
- **Monitors corporate performance**: By selecting the projects to be funded, financial system inspires the operators to monitor the performance of their investment. In this regard, both the financial markets and financial institutions helps corporate to perform profitability.
- **Provides facilities for Portfolio adjustment:** Another important role performed by financial system is that both the financial market and financial institution provide portfolio adjustment facilitates, Portfolio adjustment facilitates include services of providing a quick, cheap and reliable way of buying-selling a wide variety of financial assets.
- **Facilitates Financial deepening and broadening:** Financial system promotes the process of financial deepening and broadening. Financial deepening implies an increase of financial assets as a percentage of the Gross Domestic Product (GDP) on the other hand financial broadening implies increasing the number and variety of participants and instruments.



CHECK YOUR PROGRESS

Q 3: Show the structure of financial system. (Answer in about 30 words)

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Q 4: Discuss in brief the nature of financial system. (Answer in about 40 words)

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Q 5: Mention the various element/components of a financial system. (Answer in about 20 words)

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Q 6: Briefly explain the various roles played by a financial system. (Answer in about 50 words)

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Q 7: Mention the two broad categories of a financial market. (Answer in about 30 words)

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1.8 FINANCIAL SYSTEM AND ECONOMIC DEVELOPMENT

Economic development of a country cannot be thought of without the involvement of finance. An, efficient financial system can accelerate the process of economic development, or we can say, development and growth of financial system is a pre-condition of economic development and growth. Financial system provides diverse services through an array of instruments

and institution. The contribution of a financial system to the economy depends upon the quantity and quality of its services and efficiency with which it provides them. The components of a financial system serve as a driving force in transferring the country's saving towards productive uses, which ultimately increases the output in the economy. A good financial system helps in increasing savings, capital formation, investments, proper channelization of resources, technological development and which ultimately increases the rate of economic development. The various ways in which a financial system affects economic development can be discussed under the following heads-

- **Encouraging and motivating savings:** Financial system helps in accelerating the volume and rate of savings in the economy. By offering various financial services (such as the ease of access, nearness, better return of financial products), financial system can increase the growth of banking habits among people, which ultimately encourages and accelerates the saving rate of the economy.
- **Stimulates capital formation:** Financial system stimulates the process of capital formation through generation of saving, collection of saving and by channelization of the collected savings for productive utilization.
- **Increases investment:** A financial system helps to increase the volume of investment. It becomes possible for the deficit spending units to undertake more investment because financial system enables them to have command over capital.
- **Leads to balanced economic growth**: Usually the private entrepreneurs set up units at those places which are already developed. It causes regional imbalance in economic development. Operators of financial system (financial institutions) give priority in giving assistance to units set up in backward areas and even change lower interest rates on lending in these areas. Thus a financial system helps in balanced economic growth of a country by developing the backward areas.

- **Maintains financial discipline:** A well developed financial system plays a pivotal role in imposing financial discipline by which it can provide guidance in management of companies along with corporate governance policies in the economic system. Good corporate governance is regarded as a safe guard to maintain risk within acceptable limit and to ensure economic development.
- **Leads to employment generation:** Financial system helps in creating employment opportunities by financing new and existing industrial units through financial institutions. They help in creating employment opportunities in backward areas by encouraging the setting up of unit in those areas.
- **Influences real sector activities:** Financial systems influences real sectors activities through its functional ability. The reduction in information and transaction costs lead to development of financial market and intermediaries. Financial markets and institutions influence the rate of capital accumulation and technological innovations which are pre-requisites of economic development.
- **Facilitates Infrastructural development:** Infrastructural facilities (i.e. transport, power and communications) are the basic requisites of economic development of a country. In this regard a good financial system lays the priorities for infrastructural development and investment is made keeping in mind national requirements.
- **Development of risk management services:** Development of financial system increases the demand for more risk management services. Financial system meets this demand by helping the increase in trading services and by development of new risk management services.
- **Channelizes resources:** Various components of financial system help in proper distribution of resources toward the highest yield oriented investment for a given degree of risk. So, financial system channelizes the scarce resources towards productive uses, helping in economic development.

- **Accelerates industrialization:** Economic development of any country depends upon the level of industrialization. The setting up of more industrial units will generate direct and indirect employment opportunities, make available goods and services in the country and help in increasing the standard of living of the people. By providing requisite financial, managerial, technical help; a financial system through its financial institutions can set up new industrial units in those areas where private entrepreneurs are reluctant to take risk of investment. By doing so, financial institutions provide sufficient fund for industrialization of these areas and thereby economic development is accelerated.
- **International competitiveness:** By providing various financial services (such as leasing, hire purchase, factoring mutual funds, venture capital, merchant banking, credit rating etc.) a financial system can contribute a lot toward economic development of a country. It is found that the countries whose financial system has a diverse set of financial arrangements are able to maintain international competitiveness through updating their productive capacities.



CHECK YOUR PROGRESS

Q 8: How a well developed financial system and economic development is linked with each other? (Answer in about 40 words)

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1.9 LET US SUM UP

- Financial system refers to a set of well knitted and inter-related activity or services that work collectively for the achievement of some pre-

determined purpose or goal needed for economic development of a country. It is a set of institutional arrangements through which financial resources of the economy are mobilized from surplus to deficit units.

- The main objective of financial system of an economy is to serve as an financial agent of socio-economic development of various sector, such as trade, industry, commerce, agriculture, innovation and research etc.
- The structure of a financial system comprises the various components of financial system viz. Financial Asset, Financial Institutions, Financial Markets and Financial Services.
- Financial Asset refers to those assets which are issued by the financial institutions as financial claims to raise fund from the public directly or indirectly. They are divided as primary securities and secondary securities. Examples of primary securities and secondary securities are bills, bonds, equity etc. and secondary securities are currency, bank deposits, life insurance policies, UTI bonds etc.
- Financial Institutions are those institutions which are engaged in purchase and sell of financial assets. They are divided into two categories, Bank and Non-banking financial institutions (NBFIs). Examples are banks, insurance companies, provident funds etc.
- Financial Markets are the markets where financial assets are traded by the financial institutions. They are subdivided into money market and capital market, former deals with short term funds whereas the later deals with medium and long term funds. Financial markets are also divided into organized and unorganized sectors.
- Financial Services refer to those activities of the financial institutions which are concerned with the designing and delivery of financial products. Example of financial services are leasing, hire purchase, mutual funds, venture capital etc.
- So far as nature of financial system is concerned-
  - Financial system forms part of the overall economic development.

- Financial system consists of financial assets, financial institutions, financial markets and financial services.
- Elements of financial system are closely inter-related and do change continuously.
- Financial system facilitates growth and economic development through savings and investments.
- Co-existence and co-operation between formal and informal sector are important features of a financial system.
- There is a high degree of financial innovation in a financial system.

- The roles played by financial system are
  - It acts as an intermediary
  - Channelizes funds
  - Provides payment system and transfer of financial resources
  - Provides a way for controlling risk and uncertainty
  - Generates information
  - Helps in creation of financial structure which facilitates lower transaction costs and higher returns
  - Monitors corporate performance
  - Offers portfolio adjustment facilities
  - Promises the process of financial deepening and broadening
  - Provides liquidity to assets
- Presence of an efficient financial system accelerates the process of economic development by various ways. Such as,
  - Accelerates the rate of saving
  - Stimulates the process of capital formation
  - Channelizes scarce resources towards productive uses
  - Increases investment
  - Imposes and maintains financial discipline
  - Develops a risk management services
  - Influences real sector activities
  - Ensures balanced regional development
  - Accelerates industrialization
  - Creates employment opportunities

- Creates infrastructure facilities.



1.10 FURTHER READING

- Nag, R. (2011). *Indian Financial System***.** Guwahati: Book Land.
- Sarma, A. (2013). *Elements of Monetary System*. Guwahati: Chandra Prakash.
- Gupta, K. S., Guota, N. & Chopra, A. (2017). *Money, Banking and Finance*. Ludhiyana: Kalyani Publication.



1.11 ANSWERS TO THE CHECK YOUR PROGRESS

Ans to Q No 1:

Financial system is a set of institutional arrangements through which financial resources of a country are mobilized from surplus to deficit units.

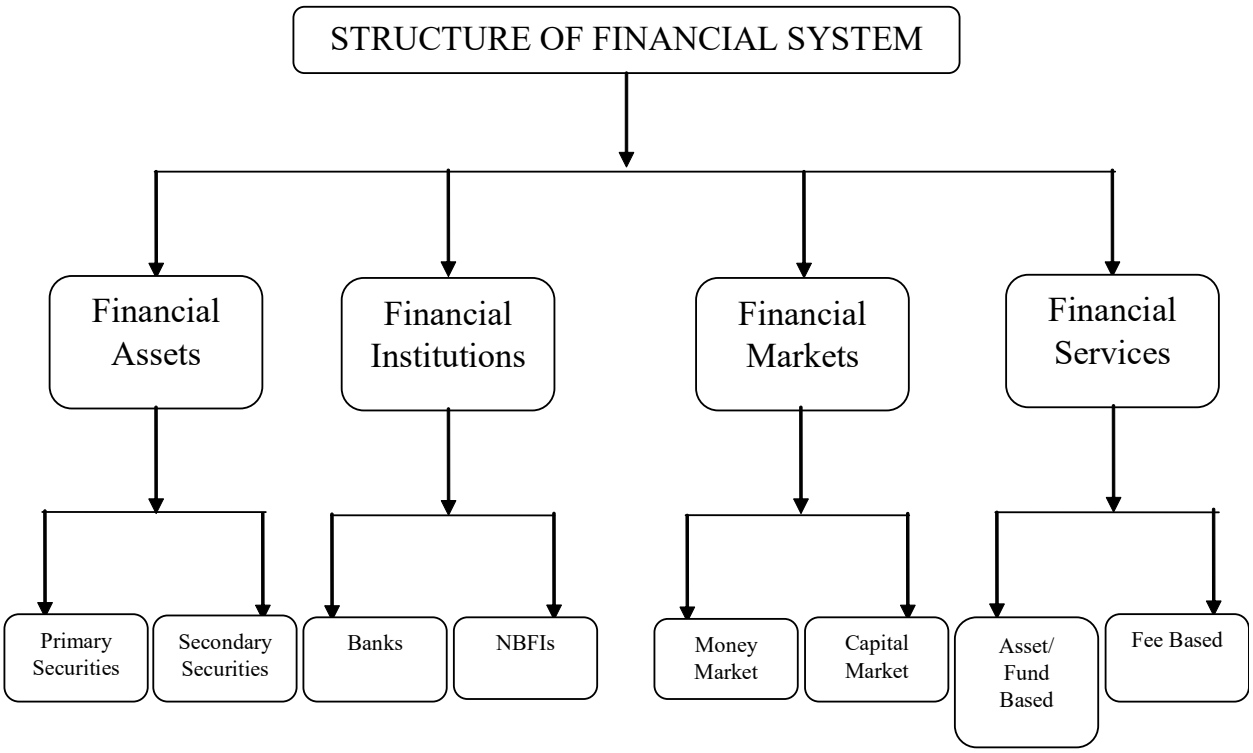
Ans to Q No 2:

The main objectives of a financial system are to serve as an agent of socio-economic development in various areas. Such as-

- To give support to trade, commerce, industry and organization
- To give support to rural development and backward areas
- To give support to housing, education, health, and infrastructure
- To make provision for refinance facility and give support for promotion of liquidity
- To help in price control and to research and development etc.

Ans to Q No 3:

The financial system as a whole operates through four major components. The structure of the financial system is shown below-



Ans to Q No 4:

The nature of financial system is that-

- Financial system forms part of the overall economic development
- Financial system consists of four elements i.e. financial asset, financial institution, financial market and financial service, by which it aims at establishing and providing smooth, regular, cost effective and efficient linkage between deposits and investments
- Elements of financial system are closely interrelated and do not change continuously
- It facilitates growth and economic development through savings and investment
- Co-existence and co-operation between formal and informal financial sector is an important feature of financial system of most developing countries.

Ans to Q No 5:

The major components or elements of the financial system are- Financial Assets, Financial Institutions, Financial Markets, and Financial Services.

Ans to Q No 6:

The role played by the financial system are-

- It helps the flow of funds from surplus to deficit units
- It acts as a intermediary between savers and investor through mobilizing saving
- It channelizes the flow of funds into profitable investment
- It provides a payment system for the change of goods and services
- It facilitates transfer of financial resources
- It provides a way for controlling risk and uncertainty
- It helps in creation of financial structure
- It monitors corporate performance
- It offers portfolio management facilities
- It promotes the process of financial deepening and broadening.

Ans to Q No 7:

Financial market is the market where financial assets are traded by the financial institutions. They are broadly sub divided in two heads- money market (deals with short term finance) and capital market (long term finance).

Ans to Q No 8:

There is a strong inter linkage between financial system and economic development as supply of finance affects the standard of living, level of National Income and employment of a country. Existence of an efficient financial system can accelerate the process of economic development in many ways, such as-

- Encouraging and motivating saving by deepening and widening the financial structure
- Channelizing the accumulated saving towards the most profitable investment, which increases capital productivity
- Facilitating the working of industrial sector, enhancement of trade and commerce, increasing employment opportunities with balanced regional development etc.



1.12 MODEL QUESTIONS

Short Questions (Answer each question in about 150 words)

Q 1: Write five functions of financial system.

Q 2:. What are the major components of financial system?

Q 3: Write short notes on-

a) Financial market

b) Financial services

Long Questions (Answer each question in about 300-500 words)

Q 1:. Explain the importance and functions of the financial system in an economy.

Q 2: Explain the concept of a financial system. Discuss the components of the financial system.

Q 3: Explain the role played by a financial system in an economy.

Q 4: Explain the inter-relationship between financial system and economic development.

*** ***** ***

UNIT 2 : CONSTITUENTS OF FINANCIAL SYSTEM

UNIT STRUCTURE

2.1 Learning Objectives

2.2 Introduction

2.3 Components of Financial System

- 2.3.1 Financial Instruments
- 2.3.2 Financial Markets
- 2.3.3 Financial Institutions

2.4 Functions of Financial System

2.5 Importance of Financial System

2.6 Let Us Sum Up

2.7 Further Reading

2.8 Answers To Check Your Progress

2.9 Model Questions

2.1 LEARNING OBJECTIVES

After going through this unit, you will be able to –

- know the concept of Financial System
- understand the various components of a Financial System
- know the differences between the Money Market and Capital Market
- learn about the different functions of a Financial System
- understand the importance of a Financial System in economic development.

2.2 INTRODUCTION

Economic growth and development of an economy basically depends upon a well developed and efficiently managed financial system. The term financial system means a set of sub-systems of financial institutions, financial markets, financial instruments and services which as a whole helps in mobilising resources from the surplus units of an economy and channelising the same to the deficit units. In fact, it refers to a set of

institutional arrangements through which various financial surpluses of an economy are mobilised from most of the surplus units and the same is transfer to the various categories of deficit spenders. The institutional arrangement includes all conditions and mechanism which govern the production, distribution, exchange, holding of financial assets or instruments etc. Besides, it covers some other area, like, working of financial markets, organisation of various financial instruments as well as the operation of such financial institutions.

The term 'System', which is used in case of financial system actually indicates a set of complex, intimately connected and interlinked instruments, agents, practices, transactions, markets, claims as well as various liabilities of the economy as a whole. As such, any modern economy which basically deals with money and credit is crucially dependent on the financial system. It is to be noted here that, the financial system is a broader concept as compared to the payments system. The financial system covers both cash and credit transactions where as the payments system deals with only cash payments. In the earlier unit we have already discussed about the concept of Financial System and in this unit we will discuss basically the constituents of Financial System in detail.

2.3 COMPONENTS OF FINANCIAL SYSTEM

There are basically three main components of financial system of a country and they are as in the following –

- Financial Instruments or Assets
- Financial Markets
- Financial Institutions.

Of course, in India, there are four components of financial system which can be stated as in the following –

- Financial Instruments or Assets
- Financial Markets
- Financial Institutions
- Financial Services.

A detailed explanation of the main three components, i.e., financial instruments, financial markets and financial institutions of financial system is given below –

2.3.1 Financial Instruments

The financial instruments or assets or securities are the claims which represent the future income and wealth of others. They are actually some claims against a person or an instrument for the payment of a sum of money at a specified future date. In fact, financial instruments are the 'Monetary Contracts' between parties. They are such a type of instruments which can be traded, modified and settled. These instruments or assets are the claims to money and perform some functions of money. They have high degree of liquidity, but are not as liquid as money itself.

To full-fill the various objectives of different investors of an economy, various types of instruments or securities are issued by the companies and financial institutions. These securities are basically classified into two broad categories and they are –

(a) Primary or direct assets or instruments

(b) Secondary or indirect assets or instruments

- **Primary or direct assets :** The primary assets or instruments are issued directly by the ultimate borrowers of funds to the ultimate savers or investors. In fact, the primary assets are the obligations of the ultimate borrowers and they create these assets in order to raise funds for financing their own deficit spending. The examples of primary assets are bills, bonds, equity shares, preference shares, book debits etc.
- **Secondary or indirect assets :** Secondary assets or instruments are not issued directly by the ultimate borrowers. Actually, these assets are the obligations of financial institutions as they are issued by the institutions to the ultimate savers or investors. In other words, secondary assets are the claims issued by financial institutions against themselves to raise

funds from the public. Life insurance policies, bank deposits, units of mutual funds, units of Unit Trust of India, IDBI bonds etc are the examples of secondary assets.

Depending upon the nature of claim or return, financial instruments may be further classified as in the following –

- **Equity Based -** Equity based instruments are those instruments which represent ownership of an asset, such as, equity shares, preference shares etc.
- **Debt-Based :** The debt-based financial assets are like, debentures, bonds, treasury bills, commercial bills etc.
- **Derivatives-Based :** Derivative based instruments are those which are derived from value of an underlying financial instruments. These include forwards, futures, options, swaps or mix of these all.

The most important financial instruments are - Cash or currency, Equity shares, Preference shares, Debentures or Bonds and Derivatives. All these instruments perform a significant role in diverting funds of an economy from the lenders to the borrowers through financial markets and financial intermediaries. It is to be noted here that each instrument differs from each other in terms of its marketability, risk, return, liquidity, transction costs etc. Since, 1990's, there has been a tremendous growth in new financial instruments which are issued by both the corporate sector and financial institutions. The most important among such new innovative financial instruments are - Equity Warrants, Secured Premium Notes, Collable Bonds, Deep Discount Bonds, Inflation adjusted Bonds, Easy Exit Bond with a Floating Interest Rate, Regular Income Bonds, Retirement Bonds, Index Bonds, Growth Bonds, Capital Bonds, Floating or Variable Rate Bonds etc.

At present in India, the most commonly used financial instruments comprise corporate equities, government and corporate bonds, bills, hundis currency, various types of deposits in commercial banks, post office savings deposits, compulsory deposits, deposits

with non-banking companies, provident fund contributions, pension funds, units of the UTI, life insurance policies, deposits with investment trust and investment funds, chit funds etc.

It is thus clear that in every modern economy financial instruments play a very important role specially in performing the basic functions of money.



CHECK YOUR PROGRESS

Q 1: What is meant by financial system?
(Answer in about 30 words)

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Q 2: What are the components of financial system?
(Answer in about 20 words)

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Q 3: What are the broad classification of financial instruments?
(Answer in about 30 words)

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2.3.2 Financial Markets

Another important component or constituent of financial system of a country is the financial markets. In a financial system, all kinds of operations take place through the various financial markets. The financial markets generally deal with various financial assets and instruments of different types like currency, bank deposits, cheques, drafts, bills, bonds etc.

Classification of Financial Markets : The financial markets are classified on the basis of some specific factors which can be stated as in the following–

- **Primary and Secondary Financial Markets :** Financial Markets are classified as (a) **Primary Market** and **(b) Secondary Market** on the basis of the nature of claims.

  Primary market is such a form of market in which newly issued credit instruments are bought and sold.

  Secondary market, on the other hand, is a market in which previously issued credit instruments are bought and sold.

- **Money Market and Capital Market :** Financial markets are also classified on the basis of term or period for which credit is supplied. On this basis, they are classified as–
  - Money market and
  - Capital market
  - **Money market :** Money market generally deal with short term credit requirements of the borrowers. Of course, under some circumstances, money markets may supply long term credit depending upon the specific needs of the borrowers.
  - **Capital market :** The capital market deal with the long term credit requirements of the borrowers. Just like money market, capital market may sometimes supply short-term credit to the borrowers depending upon the demands of the deficit spenders.

- **Organised and Un-organised Money Market and Capital Market :** On the basis of institutional arrangements, financial markets are also classified as Organised or Un-organised. In short, on this basis, both money market and capital markets are classified as (a) Organised and Un-organised money market and (b) Organised and Un-organised capital market.
  - **Organised and Un-organised money market :** The organised segment of the money market includes inter-bank call money market, co-llateral loan market, bill market, acceptance market etc. This category of money market actually includes different categories of banks

and non-bank financial institutions, such as, post offices, investment companies, savings and loan institutions, investment trusts, mutual funds, chit funds etc.

The un-organised segment of the money market includes indigenous bankers, hundis, money lenders etc. Besides, quasi-govt, bodies and large companies sometimes supply their surplus funds to the money market through the intermediation of banks.

- **Organised and Un-organised capital market :** The organised part of the capital market generally comprise of stock market, the loans from the banks and the non-bank financial institutions.

The un-organised segment of the capital market consist of the borrowings from indigeneous bankers, money lenders and such other related institutions.

Among the above noted classifications of financial markets, money market and capital market play a very inportant role in the functioning of a financial system. As such, a detailed explanation of these two markets is given below –

- **Money Market :** The term money market is used to mean financial institutions which deal with short-term funds in the economy. In fact, it refers to the institutional arrangements that facilitate borrowing and lending of short-term funds. Generally, in a money market, funds can be borrowed for a short period, such as, it may be a day, a week, a month or 3 to 6 months. The different types of instruments of money market are like, bills of exchange, bankers acceptances, bonds etc. and all these are also called as 'Near money'. Crowther defined money market as, "The collective name given to the various grades of near money."

It is to be noted here that the borrowers in the money market are generally merchants, traders, manufacturers,

business concerns, brokers and even government institutions. On the other hand, the lenders in the money market include the Central Bank of the country, the commercial banks, insurance companies and financial concerns.

- **Capital Market :** The term capital market refers to the institutional arrangements for facilitating the borrowing and lending of long-term funds. In broad sense, it consists of a series of channels through which the savings of the community are made available for industrial and commercial enterprises and also for public authorities. It deals with various private savings of individuals and corporate sector and invests them through new capital issues. Thus, a capital market may be defined as an organised mechanism for effective and efficient transfer of financial resources from the investing parties, that is, various categories of savers to the entrepreneurs engaged in industry or business either be in the private or public sectors of an economy.

Distinction Between Capital Market and Money Market : Money market and capital market are the most essential parts of the financial system of a country. But, a distinction between these two markets is essential as capital market deals with long-term funds and money market with short term funds. Of couse, these two markets are closely related to each other as the same institution in many a times, deal with short-term and long-term funds. The basic differences between these two markets are given below–

- **Maturity period of Funds :** The maturity period of funds of money market is less than one year as it basically deals with the short-term funds.

  On the other hand, the capital market deals with long-term funds due to which maturity period of funds is minimum one year or more.
- **Variations in Instruments :** The various financial instruments employed in the money market are- promissory notes, treasury

bills, commercial papers, bills of exchange, certificates of deposits etc.

Contrary to this, the long term securities used by the capital market are- equities, bonds, debentures, government bonds, securities of the government etc.

- **Operating Institutions :** The operating institutions in the money market include some institutions like central bank, commercial banks, non-bank financial intermediaries and the bill brokers.

  On the other hand, institutions operating in the capital market include stock exchanges, insurance companies, mutual funds, leasing companies, investment trust, investment banks etc.

- **Dominant Institution :** The most prominent institution in the money market is the commercial banks, whereas, the dominant institution in the capital market is the stock exchange market.

- **Degree of Risk :** In the money market, the degree of risk is very small as the maturity of loans of such market is generally less than one year,

  In contrast, the degree of risk in the capital market is relatively high due to long-term maturity of funds and wide variations in the prices of securities.

- **Nature of Influence of Central Bank :** The central banking operations and policies have direct and significant influence upon the money market.

  Contrary to this, the influence of central banking actions upon capital market is indirect and limited.

- **Variations in Basic Functions :** The basic function of money market is to make liquidity adjustment.

  On the other hand, the basic function of the capital market is to put the capital to the long-term productive and secure uses.

- **Purpose of Borrowing :** Generally, the businessmen and industrial enterprises seek short-term credit from the money market for meeting their working capital requirements.

  Contrary to this, the capital market basically meets the long-term capital requirements of industry for the purpose of acquiring fixed capital
- **Extent of Regulation :** In case of money market, there is greater degree of regulation by the central bank upon the commercial banks.

  On the other hand, in case of capital market, the degree of regulation by any institution is relatively low and limited.

Functions of Financial Markets : The financial markets perform many important functions in an economy and the most important among them can be stated as follows –

- Financial markets create and allocate credit to the various sectors of an economy.
- These markets serve as intermediaries in the process of mobilisation of savings.
- These markets provide all possible convenience as well as benefits to all categaries of lenders and borrowers.
- Financial markets also enable various categories of economic units to exercise their time preference.
- These markets are also very helpful for the purpose of separation, distribution, diversification and reduction of risk.
- These markets also provide facilities for transformation of various financial claims so as to suit the preferences of both the savers as well as the borrowers.
- Another important function of financial markets is that they provide efficient and easy payment mechanism.
- These markets are also helpful for increasing liquidity of financial claims through securities trading.
- Besides, the financial markets perform the portfolio management function in a much better way.

- These markets are also very reliable for promoting economic development through a balanced regional and sectoral allocation of all investible funds.

Efficiency in Financial Markets : A financial market includes both money market and capital market. The financial markets are said to be efficient when they are able to satisfy some basic conditions of an economy which can be stated as in the following–

- The prices of various assets are determined freely by the forces of demand for and supply of funds under the conditions of perfect competition.
- The market operates at the least cost level.
- There is no wastage in the use of various resources.
- Rescurces of the economy as a whole are allocated in the most socially productive purposes.

The efficiency of financial markets may take various forms and the most important among them are given below–

- **Valuation Efficiency :** The valuation efficiency is said to be achieved when the market price of a financial asset is equal to its intrinsic value or investment value. The valuation efficiency can only be achieved when the financial markets are perfectly competitive.
- **Operational or Functional Efficiency** : The financial markets are said to be functionally and operationally efficient when they fullfil some specific conditions like, minimisation of administrative and transactions costs, provision of giving maximum facilities and convenience to both borrowers and lenders, provision of getting fair return by financial intermediaries from their resources.
- **Allocational Efficiency :** Allocational efficiency is achieved by the financial markets when they are able to channelise their resources into those investment projects or uses where marginal efficiency of capital is the maximum.

- **Information Efficiency :** A financial market is able to achieve information efficiency when the people of the economy as a whole can acquire maximum gains by using various commonly available information in the economy.
- **Insurance Efficiency :** The term insurance efficiency means the degree of hedging against future contingencies. As such, when the degree of hedging and reducing risk is high, the degree of information efficiency is also high.



CHECK YOUR PROGRESS

Q 4: What is meant by financial markets? (Answer in about 30 words)

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Q 5: Explain briefly the concepts of money market and capital market? (Answer in about 40 words)

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Q 6: Point out the basic conditions for achieving efficiency in financial markets? (Answer in about 40 words)

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2.3.3 Financial Institutions

The financial institutions are the intermediaries who facilitate smooth functioning of the financial system and act as medium between the savers and the borrowers. The principal economic activity of the financial institutions is the purchase and sale of financial assets. In fact, these institutions act as half-way house or intermediaries between the primary lenders and the final borrowers. Generally, all sorts of banks act as intermediaries as they accept

deposits from various categories of depositors or savers and lend these funds to other section of customers, i.e., borrowers. Similarly, some other institutions, like GIC, LIC, Mutual funds etc. also mobilise various savings and lend these funds to the deficit spenders.

It is to be noted here that in a financial system, there are various categories of financial institutions which are operating in the money market and capital market. The prominent financial institutions of the money market include central bank, commercial banks, co-operative banks, specialised financial institutions, the non-banking financial institutions, discount houses, acceptance houses etc.

In contrast, the various financial institutions of the capital market include joint stock companies, central and state governments, local authorities, port trust, improvement trust etc. and all these institutions work on the demand side of the capital market. The various owners of financial claims like, individual investors, financial intermediaries such as commercial banks, insurance companies, specialised financial institutions, investment trusts, providend funds etc. work on the supply side of capital market. Of course, the most vital institution in the capital market is the stock exchange market.

Generally, financial institutions are classified into two broad categories and they are –

- Banking Institutions and
- Non-Banking Financial Institutions.

The main difference between these two types of institutions is that the banks posses the credit creating power, while the non-bank financial institutions do not posses such power.

The financial institutions actually deal with securities as they only buy primary securities and sell the secondary securities. They absorb primary securities in their asset portfolios and produce secondary securities to finance them. In fact, these institutions virtually transmute primary securities into secondary securities. As such, the essence and the success of financial institutions basically lie on the degree of asset transformation.

The securities produced by the financial institutions are far more acceptable to surplus units than the primary securities produced by deficit spenders. The basic reasons behind such accptalibitiy of surplus units can be stated as follows –

- **Low Risk :** All categories of lenders are interested in minimising all kinds of risks which are basically involved with their investments. As there is regulation of government on the organisation and workings of major financial institutions, hence, they can reduce the risks of their creditors.
- **Greater liquidity :** The financial institutions can offer much greater liquidity in their secondary secutities to their lenders, specifically, the demand deposits of banks are perfectly liquid and they can be drawn without any notice. Even time deposits can also be drawn under some conditions which involves some loss of interest.
- **Convenience :** The financial institutions also provide convenience to their various categories of lenders. As the deposits they sell are standardised and information about them are easily available, hence, these institutions can help their lenders to sell their secondary secutities when the lenders want to do so.
- **Other Services :** The financial institutions also, provide some other services to their lenders, As for example, banks are specialise in selling deposits with particular features along with some other services, like transfer of funds, collect cheques for their clients, offer of safe-deposit lockers to their dominant lenders etc.

These are the various reasons due to which the various surplus units prefer to lend to financial institutions rather than directly to deficit spenders.

Economic basis of financial institutions : The financial institutions are able to offer better financial facilities to both the lenders

and borrowers. The true economic basis of financial institutions lies upon some basic factors, like –

- Law of large scale and
- Economies of scale in portfolio management
- **Law of large scale :** The various financial institutions like, banks, insurance companies, unit trusts etc. generally operate on the assumption that there are large numbers of customers. They also run on the assumption that all the creditors will not put forward their claims for cash at the same time. Again, they receive regularly interest payments on loans and investments. Having such knowledge, banks keep in cash only a small fraction of their demand liabilities and invest the rest of funds.
- **Economies of scale in portfolio management :** As the average size of the asset portfolios of banks, insurance companies and such other related organised sectors of the financial institutions are quite large in value, they get the benefit of economies of scale in portfolio management. In other words, financial institutions with their large asset portfolios can earn interest even on very short-term funds and can construct the maturity structure of their assets as desired.

Functions of Financial Institutions : In every economy, the financial institutions perform many important functions and the most important among them can be stated as follows–

- The most vital function of financial institutions is that they issue claims to their customers, but these claims have some such characteristics which are different from those of their own assets. As for example, banks accept deposits as liability and convert them to some other assets which are known as loans.
- Another important function of these institutions is that they choose and manage portfolios whose risk is very low and their return is high. Thus, financial institutions are able to reduce transaction costs.

- The financial institutions also perform functions like distribution of risk through diversification.This reduces the risk for savers as in the case of mutual funds.
- Another function of financial institutions is that they offer all savers alternative forms of deposits according to their liquidity preferences. Again, these institutions provide loans to borrowers which have requisite maturities.
- The financial institutions also play their important role in providing large amounts of finance on the basis of economies of scale in lending and borrowing.



CHECK YOUR PROGRESS

Q 7: Point out the broad two classifications of financial institutions? (Answer in about 30 words)

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Q 8: What are the economic basis of financial institutions? (Answer in about 40 words)

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Q 9: Explain briefly the most important functions of financial institutions? (Answer in about 40 words)

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2.4 FUNCTIONS OF FINANCIAL SYSTEMS

A financial system performs many vital functions in every economy and all such functions can be stated as follows–

- Inducement to Save
- Mobilisation of Savings

- Allocation of Funds
- Serving Production, Trade and Investment.

A detailed discussion of these functions of financial system is given below–

- **Inducement to Save :** The most important function of the financial system is that it induces the savings habits of various categories of people (savers) of the country. It provides a wide array of financial assets as strores of value which are aided by the services of financial markets and intermediaries of all kinds. All these institutions offer ample choice of portfolios with attractive combinations of income, safety and yields. As such, the potential savers can choose easily such an asset portfolio that can assure them higher return along with liquidity and safety.

  Besides, with financial progress and innovations in financial technology, the scope of portfolio choice has improved. Under such circumstances, the savings - income ratio of the economy is positively elastic with respect to both financial assets and financial institutions. It means that financial progress generally induces larger and larger savings out of the same level of real income.

  The influence upon the willingness to save of the people can be increased by an efficient functioning of the financial system. The most important measures that can be taken by the financial system for the purpose of inducing willingness to save are like lowering down the risk of default and market riskiness of financial assets along with further improvement of their yield and liquidity. In this way, diversity of financial assets along with the more efficient operations of the financial institutions can significantly promote savings of the economy as a whole.

- **Mobilisation of Savings :** Another most important function of financial system is the mobilisation of savings. Generally, savings are done by millions of individual households and firms in various amounts both for short period and long period. All such, savings are basically mobilised through an highly efficient mechanism of financial system. Actually,

mobilisation of savings takes place when savers move into financial assets, like, currency, bank deposits, post office savings deposits, life insurance policies, bills, bonds, equity share etc.

When public buy primary securities, it make its surpluses available directly to the deficit spenders which represent direct mobilisation of savings as well as allocation of credit. Similarly, when the public buy secondary securities, it entrust its savings to financial institutions and these institutions again allocate it among various categories of competing borrowers. Thus, mobilisation of savings takes place through an efficient functioning of financial system.

- **Allocation of Funds :** Another important function of financial system is to allocate the mobilised savings in an efficient and equitable way to the different categories of borrowers and for different uses. With the passage of time, the financial system is automatically improved and as such new financial assets become available. Again, the financial markets tend to be organised in a better way and new innovative financial institutions are brought into existence. Under such circumstances, mobilised savings are allocated to most productive uses and also to proper uses. As financial institutions act as the bridge between the savers and investors or lenders and borrowers, hence available financial resources are allocated by them to such uses which assure relatively higher return, greater liquidity as well as least risk. Thus, financial system helps an economy to allocate its available resources through which the investor can get best return and thus the process of economic development of the economy as a whole can be raised.
- **Serving Production, Trade and Investment :** Serving production trade and investment is the most important function of financial system. It is a well known fact that production requires various kinds and amounts of capital (funds) for different purposes. The required capital for production may be short-term working capital to finance current operations of business or medium-term capital for buying other tools and equipment or long-term capital for making fixed investment in physical plant.

It is known to all that shortage of any kind of capital generally affects adversely the productive activity of firms or any production units. The financial system helps firms in raising funds for meeting its various requirements. In short, a well-developed financial system facilitates the flow of savings throughout the economy and thereby induces the flow of funds in that direction where returns of investment is highest. It means that financial system helps in maximisation of returns from all sorts of resources.

2.5 IMPORTANCE OF FINANCIAL SYSTEM

The financial system of any country comprises of organised and un-organised financial markets, banking and non-banking financial institutions and various financial instruments. It facilitates transfer of resources from those who have surplus of funds to those who can make productive use of the funds. In fact, economic development of any country is influenced directly or indirectly by the financial system of any country. In other words, a financial system is very very important for an economy as it can enlarge the rate of capital accumulation and production potential to pay the way for a smooth and steady growth of the economy as a whole.

The role of financial system in economic development can be discussed as in the following–

- **Increase in the rate of savings :** The financial system plays a very important role of generating savings from the various surplus units of the economy. Generally, the financial markets and financial institutions provide different type of assets to the individual savers which provide high return and liquidity with a very low degree of risk. As such, the willingress to save and capacity to save of all categories of savers increases significantly.
- **Mobilisation of savings :** Another important role of financial system is that it helps mobilisation of savings which is very essential for faster rate of economic development. Because, financial system provide various means and mechanism of transfering resources from those who have an excess of income over expenditure to those who can

make productive use of the same resources. The commercial banks and investment institutions mobilise savings of different categories of people and channelise them to productive uses.

- **Raising the Rate of Investment :** Financial system is also very useful for raising the rate of investment of an economy. The financial institutions and financial markets place huge amount of investible resources at the disposal of business firms which had been saved by other people. As different varieties of financial assets have different degrees of risks prospects and yields, they enable the entrepreneurs to make optional choice about investment. Besides, the financial institutions bring into contact a large number of ultimate lenders (savers) and a large number of deficit spenders or investors which again results in an increase in the rate of investment.
- **Allocation of Resources :** Financial system is also very helpful for having rational and optimum allocation of available resources of an economy. The various institutions of financial system allocate surplus resources of an economy in such a way that all investments can assure the highest possible return.
- **Maximisation of Production :** The financial system is very conducive for developing the whole circumstances of an economy which ensures the maximisation of production. The various productive activity of an economy requires long-term capital for acquisition of land, buildings and machinery, the medium term capital for buying tools and equipments, short-term capital for financing the current operations of the projects. The institutions of money market and capital market provide diverse types of financial assets to corporate and non-corporate business enterprises and thus help the economy to get maximum return or production.
- **Balanced Economic Growth :** A good financial system helps in development of backward areas by providing special assistance to entrepreneurs for setting up new units in less developed areas. Financial institutions, like IDBI, IFCI, ICICI etc. generally give priority in giving assistance to projects set up in backward areas and even charge

lower rate of interest on various lendings. Thus, a financial system helps in balanced economic growth of a country by developing the backward areas.

- **Expansion of Banking Sector :** Banking sector is the key factor for all round development of an economy. As all kinds of financial transactions (except through cash) take place by the intermediation of banking and non-banking institutions, the expansion of trade, industry and other activities in the economy must lead to the activities in the economy must lead to the expansion of the banking sector. In short, the expansion of financial system strengthens the whole banking sector of an economy.
- **Effective Working of Monetary Policy :** A well developed financial system is also very useful for achicving the basic objectives of monetary policy, like, price stability, exchange stability, maximisation of employment, economic growth etc. Contrary to this, if the financial system of an economy is relatively weak, the monetary policy in the country is not likely to be sucessful in realising its objectives.
- **Mobilisation of Resources by Government :** Another most important role of financial system is that it develops the environment where the various development programmes can be initiated by the Government. If in an economy, the financial system is well-developed, then under such a situation, the government can have easy access to short-term and long-term capital at low rates of interest through loans from the commercial banks. Besides, the government can issue various bonds in the stock exchnage market which have varying maturity period. In short, mobilisation of resources is facilitated for the government sector where there prevails a well-developed financial system.

It is thus clear that a well-developed financial system can help an economy from different aspects and more specifically it can help in fastening the rate of economic development and growth of the economy as a whole.



CHECK YOUR PROGRESS

Q 10: How a financial system can help in mobilisation of savings? (Answer in about 40 words)

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Q 11: Explain briefly how a financial system can be helpful for better allocation of resources ? (Answer in about 40 words)

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Q 12: How a financial system can help an economy to maximise its production ? (Answer in about 30 words)

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2.6 LET US SUM UP

- The term financial system means a set of sub-systems of financial institutions, financial markets, financial instruments and services which help in mobilising resources from the surplus units of an economy and channelising the same to the deficit spenders. In fact, it refers to a set of institutional arrangements through, which various financial surpluses of an economy are mobilised from most of the surplus units and transferred the same to various deficit spenders.
- In case of financial system, the term 'system' means a set of complex, intimately connected and interlinked institutions, agents, practices, transactions, markets, claims and also the various liabilities of the economy as a whole.

- The 'term' financial system is a broader concept as compared to payments system. Because, financial system covers both cash and credit transactions, where as the payments system deals with only cash payments.
- In an economy, there are basically three components of financial system and they are Financial Instruments or Assets, Financial Markets and Financial Institutions.
- The financial instruments or assets or securities are actually some claims against a person or an institution for the payment of a sum of money at a specified future date. These are some such instruments which can be traded, modified and settled. These instruments are the claims to money and perform some functions of money.
- The financial instruments are broadly classified into major two categories, viz., Primary or direct assets and Secondary or indirect assets.

  The primary assets are issued directly by the ultimate borrowers of funds to the ultimate savers or investors whereas the Secondary assets are the obligations of financial institutions as they are issued by the institutions to the ultimate savers or investors.
- The most important financial instruments are like, cash or currency, equity shares, preference shares, debentures or bonds, derivatives etc. These instruments help in diverting funds from lenders to the borrowers through financial markets and financial intermediaries.
- The second important component of financial system is the financial markets and with the help of these markets, all kinds of operations take place in case of every financial system.
- The most important classification of financial market is Money market and Capital market. Money market deals with short-term credit requirements of the borrowers and the capital market deals with the long term credit requirements of the borrowers.
- The most important function of money market is to help the commercial banks, business corporations and other non-bank financial institutions for the adjustment of their liquidity position.

- The most important function of the capital market is that it helps in the generation and mobilisation of savings and thereby efficient allocation of these savings to the highly productive uses.
- The basic difference between money market and capital market is that the maturity period of funds of money market is less than one year. Contrary to this, capital market deals with long-term funds due to which maturity period of funds is minimum one year or more.
- Financial markets create and allocate credit to the various sectors of an economy. They serve as intermediaries in the process of mobilisation of savings, These markets also helpful for separation, distribution, diversification and reduction of risk.
- The valuation efficiency of financial markets is achieved only when the market price of a financial asset is equal to its intrinsic value or investment value. These markets can achieve allocational efficiency when they are able to channelise their resources into those investment projects or uses where marginal efficiency of capital is maximum.
- The financial institutions act as half way houses or intermediaries between the primary lenders and the final borrowers. The principal economic activity of the financial institutions is the purchase and sale of financial assets. In fact, financial institutions act as a middlemen between the savers and the borrowers.
- The various financial institutions which are operating in the money market include the central bank, commercial banks, co-operative banks, specialised financial institutions, the non-banking financial institutions, discount houses, acceptance houses etc.
- The various financial institutions of capital market are like, joint stock companies, central and state governments, local authorities, port trust, improvement trust etc.
- The financial institutions are classified as Banking institutions and Non-banking financial institutions. The basic difference between these two types of institutions is that the former posses the credit creating power, while the latter do not posses such power of creating credit.

- The various reasons due to which the surplus units prefer to lend to financial institutions rather than directly to deficit spenders are like, low risk, greater liquidity, better convenience etc. There are some other reasons also like, transfer of funds, collect cheques for their clients, offer of safe-deposit lockers to their dominant lenders etc.
- The financial institutions can provide better financial facilities to both the lenders and borrowers. Law of large scale and economies of scale in portfolio management are the two basic economic basis due to which these institutions can offer better financial facilities to their lenders and borrowers.
- The most important function of financial institutions is that they choose and manage portfolios whose risk is very low and their return is very high. In fact, they are able to reduce transaction costs.
- A financial system performs many vital functions in every economy and the most important among them are like, (1) Inducement to save, (2) Mobilisation of savings, (3) Allocation of funds, (4) Serving production, trade and investment etc. It induces the flow of funds in that directions where returns of investment is the highest.
- A well-developed financial system plays a very important role in every economy. In fact, it plays a very vital role in fastening the rate of economic development of a country.



2.7 FURTHER READING

1) Verma, K. N. (2015). *Monetary System*. New Delhi: Vishal Publishing Company.
2) Paul, R. R. (2011).*Money, Banking and Public Finance.* Ludhiana: Kalyani Publishers.
3) Gupta, S. B. (2012). *Monetary Economics.* New Delhi: S. Chand & Company LTD.

2.8 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: The term financial system means a set of sub-systems of financial institutions, financial markets, financial instruments and services which help in mobilisation of resources from the surplus units of an economy and channelise them to the deficit spenders.

Ans to Q No 2: There are three basic components of a financial system and they are–

(a) Financial Instruments or Assets

(b) Financial Markets and

(c) Financial Institutions.

Ans to Q No 3: The financial instruments are broadly classied into two categories and they are–

(a) Primary or direct assets or instruments, and

(b) Secondary or indirect assets or instruments.

The primary assets are issued directly by the ultimate borrowers to the ultimate investors and the secondary assets are issued by the instititutions to the ultimate investors.

Ans to Q No 4: The term financial markets means those markets which basically deal with various financial assets and instruments of different types like, currency, bank deposits, cheques, drafts, bills, bonds etc. In a financial system, all kinds of operations take place through these markets.

Ans to Q No 5: Money markets generally deal with short term credit requirements of the borrowers. Of course, sometimes they may supply long-term credit depending upon the specific needs of the borrowers. The capital markets deal with the long-term credit needs of the borrowers. These markets may also sometimes supply short-term credit depending upon the demand of the deficit spenders.

Ans to Q No 6: For achieving efficiency in financial markets, the basic conditions to be satisfied are–

(a) Prices of assets are to be determined freely under the conditions of perfect competition,

(b) The market operates at the least cost devel,

(c) There is no wastage in the use of resources,

(d) Resources are allocated in the most socially productive purposes.

Ans to Q No 7: The financial institutions are broadly classified as–

(a) Banking institutions and

(b) Non-Banking financial institutions.

The basic difference between these two institutions is that the former posses the credit creating power, while the latter do not posses such power.

Ans to Q No 8: The financial institutions can offer better financial facilities to both the lenders and borrowers. The true economic basis of the financial institutions are–

(a) Law of large scale and

(b) Economies of scale in portfolio management.

These two are the basic economic basis of financial institutions due to which they can offer better financial facilities to their lenders and borrowers.

Ans to Q No 9: The various important functions of financial institutions are–

(a) Issue of claims to their customers,

(b) They choose and manage portfolios, the risk of which is low and return is high,

(c) They help in distribution of risk through diversification,

(d) They offer alternative forms of deposits to the savers depending upon their liquidity preferences,

(e) On the basis of economies of scale, they can provide large amounts of funds to their customers.

Ans to Q No 10: A financial system is very helpful for mobilisation of savings which is very essential for every economy. Generally, a financial system provide various means and mechanism of trasferring resources from the excess income holders of an economy to those who want to make productive use of the same resources. The commercial banks and investment institutions take the vital role in mobilising savings and channelise them to productive uses.

Ans to Q No 11: A financial system helps an economy for having better allocation of resources. The financial markets and financial institutions of a financial system act as the bridge between the savers and investors. As such, available financial resources of the economy are allocated by them to such uses which assure relatively higher return, greater liquidity and least risk.

Ans to Q No 12: The financial system is very conducive for maximisation of production of an economy. The institutions of money market and capital market provide diverse types of financial assets, viz., long-term capital, medium-term capital and short-term capital to corporate and non-corporate business enterprises to purshase various tools and equipments which are necessary for productive activity and thus help the economy to maximise its production.



2.9 MODEL QUESTIONS

Short Questions (Answer each question in about 150 words)

Q 1: What is meant by financial system? Explain briefly the various components of financial system.

Q 2: Explain briefly the various functions of financial system.

Q 3: What are the financial instruments or assets? Distinguish between primary instruments or assets and secondary instruments or assets.

Long Questions (Answer each question in 300-500 words)

Q 1: What are the two broad classifications of financial markets? Explain the various functions of both the money market and capital market.

Q 2: Discuss the role or importance of financial system in an economy.

Q 3: What is meant by financial institutions? Explain elaborately the various functions of financial institutions.

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UNIT 3: THE MONEY MARKET

UNIT STRUCTURE

3.1 Learning objectives

3.2 Introduction

3.3 Characteristics of Money Market

3.4 Functions of Money Market

3.5 Instruments of Money Market

3.6 Let Us Sum Up

3.7 Further Reading

3.8 Answers to Check Your Progress

3.9 Model Questions

3.1 LEARNING OBJECTIVES

After going through this unit, you will be able to –

- know the meaning of Money market
- explain the different functions that a Money market performs in a modern economy
- describe the various instruments of Money market.

3.2 INTRODUCTION

Financial markets are structurally classified on the basis of term of credit, i. e., whether the credit is supplied for a short period (Money market) or long period (Capital market). Money market refers to the various firms and institutions that deal in short-term securities known as 'near money'. 'Near money' means short-term securities which could be encashed in a short period of time. It deals with trade bills, promissory notes and government papers which are drawn for short period. In short, Money market is a mechanism through which short-term funds are loaned and borrowed and through which a large part of financial transactions of a particular country or of the world are cleared.

In the earlier unit we have already discuss about the concept of money market. In this unit we will discuss in details about the money market and its instruments.

3.3 LEARNING OBJECTIVES

A money market is a market for financial assets that are close substitutes for money. It is a market for overnight to short-term funds and instruments having a maturity period of one or less than 1 year.

A well functioning money market leads to the development of a market for longer-term securities. The money market is not a physical location like the stock market; but its activities are conducted over telephone. The money market constitutes a very important segment of the Indian financial system.

Characteristics of the Money Market are as follows:

- It deals in financial assets or instruments that are close substitutes for money and could be converted into cash within a period of one year.
- Dealing in money market may be conducted with or without the help of brokers or intermediaries.
- It is not a single homogeneous market but consists of several sub-markets, each market dealing with a specific short-term credit instrument.
- One of the important features of money market is honour where the creditworthiness of the participants is important.
- The main dealers of money market are : Reserve Bank of India (RBI), Discount and Finance House of India (DFHI), mutual funds, insurance companies, banks, corporate investors, Non Banking Finance Companies (NBFCs), state governments, provident funds, primary dealers, Securities Trading Corporation of India (STCI), Public Sector Understanding (PSUs), and Non-Resident Indians.
- It is a need based market wherein the demand and supply of money shape the market.
- Though the functions of money markets in different countries are broadly the same, the instruments, institutions and practices of these markets vary considerably from country to country.

- Money market instruments are issued at a discounted price to face value.

Structure of Indian Money Market:

The Indian money market cannot be considered as an integrated unit. It can be broadly divided into two different parts, i.e., the unorganised and organised segments.

Unorganised segment of the Indian money market consists of unregulated non-bank financial intermediaries, indigenous bankers and money lenders which exist even in the small towns and big cities. Their lending activities are mostly restricted to small towns and villages. The persons who normally borrow from this unorganised sector include farmers, artisans, small traders and small scale producers who do not have any access to modern banks.

On the other hand, the organised segments of the Indian money market consists of the Reserve Bank of India, the State Bank of India with its seven associates, twenty nationalised commercial banks, other scheduled and non scheduled commercial banks, foreign banks and Regional Rural banks. It is called organized because it is systematically coordinated by the RBI.



CHECK YOUR PROGRESS

Q 1: What is meant by a money market? (Answer in about 20 words)

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Q 2: What is meant by a Capital market? (Answer in about 20 words)

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Q 3: State any two characteristics of money market in India. (Answer in about 20 words)

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3.4 FUNCTIONS OF MONEY MARKET

As discussed above, the money market is an avenue for borrowing and lending of the short-term funds. It helps in shifting huge sums of money between banks as well as it provides a means by which the surplus of funds of the cash rich corporations and other institutions can be used by banks, corporations and other institutions which need short-term money.

A money market is generally expected to perform the following broad functions:

- **Use of surplus funds:** It provides profitable investment channels for short-term surplus funds which help to enhance the profit of financial institutions. In this way, it also helps in rational allocation of resources.
- **Provides funds:** This is done by discounting trade bills through commercial banks, discount houses, brokers and acceptance houses. By providing various kinds of credit instruments which are suitable and attractive for different sections, a money market augments the supply of funds.
- **Helps in proper implementation of monetary policy:** It provides a non-inflationary way to finance government deficits and allow governments to implement monetary policy through open market operations and provide market based reference point for setting interest rate. Thus, a well organized money market helps in the successful operation of central banking policies as well as implementation of the monetary policies.
- **Helps in financial mobility:** Mobility in the flow of funds is essential for the development of commerce and industry in an economy. And also through quick transfer of funds from one place to another, it helps to avoid the regional gluts and stringencies of funds.
- **Provides funds to the government:** The money market helps the government in borrowing short-term funds at low interest rates on the basis of treasury bills for financing government projects for public welfare and infrastructural development.

- **Economy in use of cash:** As the money market deals in near-money assets and not money proper, it helps in economizing the use of cash. It provides a convenient way of transferring funds from one place to another without physical movement of cash, thereby immensely helping commerce and industry in the country.
- **Promotes liquidity and safe investment opportunities:** One of the important functions of the money market is that it promotes liquidity and safety to the entire country. Its instruments are issued by entities with good credit score which makes them safe investment options.
- **Provides funds for industries:** Money market contributes to the growth of industries by providing short-term loans to meet their working capital requirements through the system of finance bills, commercial papers, etc.
- **Provides assistance to commercial bank:** Developed money market helps the commercial banks to become self-sufficient as the latter can secure short-run loans from the former during emergency.

3.5 INSTRUMENTS OF MONEY MARKET

The instruments traded in the Indian money market are:

- Call/ Notice money market
- Treasury Bills (T- Bills)
- Certificate of Deposits (CDs)
- Commercial Papers (CPs)
- Commercial Bills (CBs)
- Collateralized Borrowing and Lending Obligation (CBLO)
- **Call loan/Notice Market:**The call money market is a market for very short-term finance repayable on demand, with a maturity period varying between one day and a fortnight (Fortnight shall be on a reporting Friday basis and is a mean of the period from Saturday to the second following Friday, both days inclusive). When money is borrowed or lent for a day, it is known as call (overnight) money. Intervening holidays and/or Sundays are excluded in this case. The

interest rate paid on call money loans is known as call rate. It is a highly volatile rate that varies from day-to-day and sometimes even from hour-to-hour. The funds move quickly between lenders and borrowers in case of call money. So it is considered the second most liquid asset after cash. When money is borrowed or lent for more than a day and up to 14 days, it is known as notice money. Short notice money is also considered to be a highly liquid asset, trailing after cash and call money.

No collateral securities are required to cover these transactions. Commercial Banks borrow money from other banks to maintain a minimum cash balance known as the cash reserve requirement (CRR). This inter-bank borrowing has led to the development of the call money market. The Reserve Bank intervenes in the call money market indirectly in two ways -

- by providing lines of finance / additional funding to the DFHI and other call money dealers and
- by conducting repo auctions

- **Treasury Bills (T-Bills):** A Treasury bill is basically an instrument of short-term borrowing by the Government of India maturing in less than a year. However, treasury bills carry zero risk, i.e., they are zero risk instruments. Therefore, the returns one gets on them are not attractive. Currently, there are 3 types of treasury bills issued by the Government of India via auctions, which are 91-day, 182-day and 364-day treasury bills. Treasury bills are available for a minimum amount of Rs. 25,000 and in multiple thereof. This instrument form the most important segment of the money market as it is used by the government to raise short term funds to overcome from seasonal or temporary gaps between its receipts and expenditure.

  Treasury bills are issued by the Central government at a lesser price than their face value and repaid at par. The interest earned by the buyer will be the difference of the maturity value of the instrument and the buying price of the bill, which is decided with the help of bidding done via auctions. For example, suppose an investor

purchases 91-day Treasury bill with a face value of Rs. 1, 00,000 for Rs. 96,000. By holding the bill until the maturity date, the investor receives Rs. 1, 00,000. The difference of Rs. 4000 between the proceeds received at maturity and the amount paid to purchase the bill represents the interest received by him.

- **Certificate of Deposits (CDs):** A Certificate of Deposit or CD, functions as a deposit receipt for money which is deposited with a financial organization or commercial bank. However, a Certificate of Deposit is different from a Fixed Deposit (FD) Receipt in two aspects. The first aspect of difference is that a CD is only issued for a larger sum of money. Secondly, unlike FDs, a Certificate of Deposit is transferable and tradable. First announced in 1989 by RBI, Certificate of Deposits have become a preferred investment choice for organizations in terms of short-term surplus investment as they carry low risk while providing interest rates which are higher than those provided by Treasury bills and term deposits. Certificate of Deposits are also relatively liquid, which is an added advantage, especially for issuing banks.

  Like treasury bills, CDs are also issued at a discounted price and their tenure ranges between a span of 7 days up to 1 year. However, banks issue Certificates of Deposits for durations ranging from 3 months, 6 months and 12 months. They can be issued to individuals (except minors), trusts, companies, corporations, associations, funds, non-resident Indians, etc. They are issued by banks at relatively high interest rates during periods of tight liquidity when the deposit growth of banks is slow but the demand for credit is high. They help to mobilize a large amount of money for short periods.

- **Commercial Papers (CPs):** Commercial Papers are short-term promissory note, negotiable and transferable by endorsement and delivery with a fixed maturity period. The Working Group on Money Market in 1987 suggested the introduction of the commercial papers (CP) in India. The Reserve Bank introduced commercial papers in

January 1990 with a view to enabling highly rated corporate borrowers to diversify their sources of short-term borrowings and to provide an additional instrument to investors. Subsequently, primary dealers and all-India financial institutions were also permitted to issue CP to enable them to meet their short-term funding requirements for their operations. Commercial papers have been in vogue in the United States since the 19th century and have become popular in money markets all over the world since the 1980s. Corporate, primary dealers (PDs) and the All-India Financial Institutions (FIs) are eligible to issue CP. A corporate would be eligible to issue CP provided –

- The tangible net worth of the company, as per the latest audited balance sheet, is not less than Rs. 4 crore
- Company has been sanctioned working capital limit by bank/s or all-India financial institution/s; and
- The borrowal account of the company is classified as a Standard Asset by the financing bank/s/ institution/s

All eligible participants shall obtain the credit rating for issuance of Commercial Paper either from Credit Rating Information Services of India Ltd. (CRISIL) or the Investment Information and Credit Rating Agency of India Ltd. (ICRA) or the Credit Analysis and Research Ltd. (CARE) or the FITCH Ratings India Pvt. Ltd. or such other credit rating agency (CRA) as may be specified by the Reserve Bank of India from time to time, for the purpose. CP can be issued for maturities between a minimum of 7 days and a maximum of up to one year from the date of issue. However, the maturity date of the CP should not go beyond the date up to which the credit rating of the issuer is valid. CP can be issued in denominations of Rs.5 lakh or multiples thereof. It is sold at a discount and redeemed at par. Commercial papers are actively traded in secondary market. Depending upon the issuing company a CP is also known as a finance paper, industrial paper or corporate paper.

It will be easy for you to understand the process of CPs with the help of this example: Suppose a company needs long term finance to buy some machinery. In order to raise the long-term funds in the capital market the company will have to incur floatation costs (costs associated with floating of an issue are brokerage, commission, printing of applications and advertising, etc.). Funds raised through commercial paper are used to meet the floatation costs. This is known as Bridging Financing.

- **Commercial Bill:** A commercial bill is a bill of exchange used to finance the working capital requirements of business firms. It is a short-term, negotiable and self-liquidating instrument which is used to finance the credit sales of firms. It enhances the ability to make payment on a fixed date when goods are bought on credit. When goods are sold on credit, the buyer becomes liable to make payment on a specific date in future. The seller could wait till the specified date or make use of a bill of exchange. The seller (drawer) of the goods draws the bill and the buyer (drawee) accepts it. Such bills are called trade bills. When trade bills are accepted by commercial banks, they are called commercial bills. The bank discounts this bill by keeping certain margin and credit the proceeds. Banks, when in need, can also get such bills rediscounted by financial institutions such as LIC, UTI, GIC, ICIC, and IRBI. The maturity period of the bills varies from 30 day, 60 days, or 30 days, depending on the credit extended in the industry.

  Commercial bill is an important tool to finance credit sales. It may be (a) a demand bill or (b) a usance bill. A demand bill is payable on demand ie, immediately at sight or at presentation to the drawee. A usance bill is payable after a specified time. If the seller wishes to give same time for payment, the bill would be payable at a future date. These bills can either be clean bills or documentary bills. In a clean bill, documents are enclosed and delivered against acceptance by the drawee, after which payments are over. In the case of a documentary bill, documents are delivered against

payment accepted by drawee and documents of the file are held by bankers till the bill is paid.

Commercial bills can be inland bills or foreign bills. Inland bills must (a) be drawn in India and must be payable in India and (b) drawn upon any person resident in India. Foreign bills, on the other hand, are (a) drawn outside India and may be payable in and by a party outside India, or may be payable in India or drawn on a party in India.

A related classification of commercial bills is export bills and import bills. While export bills are drawn by exporters in any country outside India, import bills are drawn on importers in India by exporters abroad.

The indigenous variety of commercial bill of exchange for financing the movement of agricultural produce called is a “hundi”. It has a long tradition of use in India. It is in vogue among indigenous bankers for raising money as remitting funds or to finance inland trade.

CBs ensure improved quality of lending and efficiency in money management. It is fully secured for investment since it is transferable by endorsement and delivery and it has high degree of liquidity. The Bills market is highly developed in industrial countries but it is very limited in India. In India, the bill market has not developed due to (i) Cash credit scheme is still the main form of bank lending, (ii) Big buyers in the corporate sector are still unwilling to use the payment mode of commercial bills, and (iii) an absence of an active secondary market.

Many measures have been taken by RBI in order to strengthen Commercial Bill Market. Some of them are as follows:

- Setting up the Discount and finance House of India (DFHI)
- Enlarging the numbers of financial institutions to provide funds for smooth functioning of CBs.
- Regulation of stamp duties.

- **Collateralized Borrowing and Lending Obligation (CBLO):** The Collateralized Borrowing and Lending Obligation (CBLO) market is a segment of money market which is operated by the Clearing Corporation of India Ltd. (CCIL). Here also, financial entities can avail short term loans by providing prescribed securities like the call money market.

  Unlike the call money market, the lenders and borrowers use collateral for their activities in the CBLO market. The borrowers of fund are providing collateral in the form of government securities and lenders are receiving it at the time of giving loans.

  The uniqueness of CBLO is that lenders and borrowers use collateral for their activities. For example, borrowers of fund have to provide collateral in the form of government securities and lenders will get it while giving loans. There is no such need of a collateral under the call money market.



CHECK YOUR PROGRESS

Q 4: What is meant by call money? (Answer in about 10 words)

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Q 5: Define call rate. (Answer in about 10 words)

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Q 6: How is Certificate of Deposits different from Fixed deposits? (Answer in about 40 words)

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Q 7: In what denominations a Treasury Bill can be issued? (Answer in about 20 words)

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Q 8: What is meant by Commercial paper? (Answer in about 20 words)

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Q 9: Who can issue Commercial paper? (Answer in about 20 words)

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Q 10: What is the full form of CRISIL? (Answer in about 30 words)

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.....

Q 11: What is meant by demand bill and usance bill?

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3.6 LET US SUM UP

- Financial markets are structurally classified on the basis of term of credit as Money market and Capital market.
- Money market is a short term credit market which deals with relatively liquid and quickly marketable assets, such as short-term govt securities treasury bills, bills of exchange etc. It is a market for overnight to short-term funds and instruments having a maturity period of one or less than 1 year.
- Money market helps in shifting huge sums of money between banks as well as it provides a means by which the surplus of funds of the cash rich corporations and other institutions can be used by banks, corporations and other institutions which need short-term money.
- The call money market is a market for very short-term finance repayable on demand, with a maturity period varying between one day and a fortnight.
- A Treasury bill is basically an instrument of short-term borrowing by the Government of India maturing in less than a year.

- There are 3 types of treasury bills issued by the Government of India via auctions, which are 91-day, 182-day and 364-day treasury bills.
- Certificate of Deposits have become a preferred investment choice for organizations in terms of short-term surplus investment as they carry low risk while providing interest rates which are higher than those provided by Treasury bills and term deposits. Certificate of Deposits are also relatively liquid, which is an added advantage, especially for issuing banks.
- Commercial Papers are short-term promissory note, negotiable and transferable by endorsement and delivery with a fixed maturity period. CP can be issued for maturities between a minimum of 7 days and a maximum of up to one year from the date of issue.
- A commercial bill is a bill of exchange used to finance the working capital requirements of business firms. It is a short-term, negotiable and self-liquidating instrument which is used to finance the credit sales of firms.
- CBs ensure improved quality of lending liquidity, and efficiency in money management. It is fully secured for investment since it is transferable by endorsement and delivery and it has high degree of liquidity.



3.7 FURTHER READING

- Paul, R.R. (2011). *Monetary Economics*. Ludhiana: Kalyani Publisher
- Pathak, B.V. (2013). *The Indian Financial System*. Singapore: Pearson



3.8 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: A money market is a component of financial market where short- term borrowing can be issued for one year or less.

Ans to Q No 2: A capital market is a component of financial market that allows long-term trading of debt and equity- backed securities usually the assets are held for more than one year.

Ans to Q No 3: The important two characteristics of money market are:

- It deals in financial assets or instruments that are close substitutes for money and could be converted into cash within a period of one year.
- It is not a single homogeneous market but consists of several sub-markets, each market dealing with a specific short-term credit instrument.

Ans to Q No 4:. When money is borrowed or lent for a day, it is known as call (overnight) money.

Ans to Q No 5:. The interest rate paid on call money loans is known as call rate.

Ans to Q No 6: A Certificate of Deposit is different from a Fixed Deposit (FD) Receipt in two aspects. The first aspect of difference is that a CD is only issued for a larger sum of money. Secondly, unlike FDs, a Certificate of Deposit is transferable and tradable.

Ans to Q No 7: Treasury bills are available for a minimum amount of Rs. 25,000 and in multiple thereof.

Ans to Q No 8: Commercial Papers are short-term promissory note, negotiable and transferable by endorsement and delivery with a fixed maturity period.

Ans to Q No 9: Corporate, primary dealers (PDs) and the All-India Financial Institutions are eligible to issue Commercial paper.

Ans to Q No 10: The full form of CRISIL is Credit Rating Information Services of India Ltd.

Ans to Q No 11:A demand bill is payable on demand i.e., immediately at sight or at presentation to the drawee. And a usance bill is payable after a specified time. If the seller wishes to give same time for payment, the bill would be payable at a future date.



3.9 MODEL QUESTIONS

Short questions (Answer each question in about 150 words)

Q 1: How does Reserve Bank intervene in the call money market?

Q 2: State the major types of Treasury bills. How Treasury bills are important for the government?

Q 3: Whether all the corporate would automatically be eligible to issue Commercial paper?

Q 4: Write a difference between Inland bills and Foreign bills.

Q 5: What is meant by "Hundi"?

Long questions (Answer each question in about 300-500 words)

Q 1: Write down the important features of Money market. Also give a scenario of the structure of Indian money market.

Q 2: Explain the various important functions of Money market.

Q 3: Write in brief about the various instruments of Money market.

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UNIT 4: TREASURY BILLS AND COMMERCIAL PAPERS

UNIT STRUCTURE

4.1 Learning Objectives

4.2 Introduction

4.3 Treasury Bills

- 4.3.1 Meaning and Definition
- 4.3.2 Features of Treasury Bills
- 4.3.3 Types of Treasury Bills
- 4.3.4 Role of Treasury Bills

4.4 Commercial Papers

- 4.4.1 Meaning and Definition
- 4.4.2 Features of Commercial Paper
- 4.4.3 Types of Commercial Paper
- 4.4.4 Role of Commercial Paper

4.5 Commercial Bills

- 4.5.1 Meaning and Definition
- 4.5.2 Features of Commercial Bills
- 4.5.3 Types of Commercial Bills
- 4.5.4 Role of Commercial Bills

4.6 Certificate of Deposit

4.7 Let us Sum Up

4.8 Further Reading

4.9 Answers to Check Your Progress

4.10 Model Questions

4.1 LEARNING OBJECTIVES

After going through this unit, you will be able to –

- know about money market instruments
- learn the concepts of treasury bills and commercial papers
- explain about commercial bills and certificate of deposits.

4.2 INTRODUCTION

In the previous chapters we have studied about money market and its functions. As we know financial markets deal in financial assets and instruments of various kinds such as currency, deposits, cheques, bills and bonds, etc. Two most important instruments of money market are treasury bills and commercial papers. In this unit, we discuss about their concepts, features and role in the economy. In addition we also study about certificate of deposit.

The money market offers a variety of securities with maturity period ranging from a few days to one year. Generally, all these securities are safe investments. In the earlier unit, we have already discussed that in the money market the following instruments are traded—

- Treasury bills (T-bills)
- Call/ notice money market—Call (overnight) and short notice (up to14 days)
- Commercial Papers (CPs)
- Certificate of Deposits (CDs)
- Commercial Bills (CBs)
- Collateralized Borrowing and Lending Obligation (CBLO)

We have also discussed that Treasury bills, call money market and certificate of deposit provide liquidity for governments and banks while commercial paper and commercial bills provide liquidity for the commercial sector and intermediaries. In this unit, we will discuss some of the selective instruments of money market in details.

4.3 TREASURY BILLS

Treasury bills, or T-bills, are the most marketable short-term money market securities. Governments issue them to borrow money for a short period. T-bills are instrument of the governments to tide over short-term liquidity shortfalls. These bills are used by the government to raise short-term funds to bridge seasonal or temporary gaps between its receipts (revenue and capital) and expenditure. **T-bills** are issued with maturities

that range from 1 month to 1 year. They are sold at a discount, i.e., the government sells them for less than par value (face value) and, when they mature, buys them back at par value. Thus, T-bills are repaid at par on maturity. The difference between the purchase price (amount paid by the tender at the time of purchase which is less than the face value) and the amount received on maturity represents the interest amount on T-bills and is known as the discount. In the financial market, T-bills are considered to be the **safest investments** because they are given by the governments. However, their exceptional safety means a lower return than provided by corporate bonds, certificates of deposit and money market funds. Also, a tender does not automatically get back all of his investment if he encashes out **the T-bills** before the maturity date.

4.3.1 Meaning and Definition

A treasury bill is a promissory note or a finance bill issued by the governments under discount for a specified period stated therein. It is a short dated government security, yielding no interest but issued at a discount on its redemption price. The government promises to pay the specified amount mentioned therein to the bearer of the instrument on the due date. T-bills is purely a finance bill since it does not arise out of any trade transaction. It does not require any 'grading' or 'endorsement' or 'acceptance' since it is a claim against the government. Thus, it is highly liquid as its repayment is guaranteed by the government.

Treasury bill may be defined as 'the short-term money market instrument, issued by the central bank on behalf of the government at a discount to curb temporary liquidity shortfalls'. T-bills are known as discount instruments. This means that only the face value of the instrument is paid at maturity. The discounting is done by adopting the following formula –

Secondary market value

of a short-term security = Present value of the security's value at maturity

$$= \frac{\text{Maturity Proceeds}}{\{1 + \left(\text{current market yield X } \frac{\text{days lefto maturity}}{\text{days in year}}\right)\}}$$

4.3.2 Features of Treasury Bills

The important features of treasury bills are—

- **Duration:** T-bills are short-term instruments of money market. They are issued for different time period ranging from 1 month to 1 year.
- **Form:** They are issued either in physical form as a promissory note or in dematerialized form. The purchases and sales of the later are effected through the Subsidiary General Ledger (SGL) account.
- **Liquidity:** They are highly liquid as they are of shorter tenure and there is a possibility of inter-bank repos in them.
- **Return:** They have an assured yield, low transaction cost, and are eligible for inclusion in the securities for SLR purposes. There is no risk of default.
- **Eligibility:** All general public and state governments are eligible to invest. Any individual, firm, company, trust, bank, insurance company, financial institution, provident fund and state government can invest in treasury bills.
- **Denomination:** T-bills are available in various denominations.
- **Availability:** T-bills are negotiable securities. They are available in both financial markets, i.e, in primary and secondary markets.
- **Auction:** The ordinary treasury bills are issued through auction.
- **Issue Price:** T-bills are sold at a discount but redeemed at par. They are issued at less than face value and at maturity buyers get the par value.
- **Day Count:** The day count is 364 days in a year for treasury bills.

4.3.3 Types of Treasury Bills

There are two types of treasury bills, namely (i) ordinary or regular and (ii) ad hoc treasury bills popularly known as 'ad hocs'.

Ordinary treasury bills are issued to the public, banks and other financial institutions with a view to raising resources for the Central Government to meet its short-term financial needs. These are issued through auction. This means that investors, particularly large banks, submit bids for the price or rate at which they would be willing to buy a given face value of bills, and the bills are issued to these bidders according to a predetermined procedure. These bills are freely marketable and they can be bought and sold at any time. They also have a secondary market.

Ad hoc means 'for the particular end or case at hand'. Thus, **Ad hoc treasury bills** are issued in favour of the central banks only. They are not marketable and not sold to the general public (or banks). They are not sold through tender or auction. They can be purchased by the central bank only. The Ad hoc treasury bills also provide investment outlets to state governments, semi-government departments and foreign central banks for their temporary surpluses.

4.3.4 Role of Treasury Bills

The treasury bills play important role in the growth of the money market. T-bills play a vital role in the cash management of the government. Being risk free, their yields at varied maturities serve as short-term benchmarks and help in pricing different floating rate products in the market. The T-bills market is the preferred central bank tool for market intervention to influence liquidity and short-term interest rates. The development of the T-bills market is a pre-condition for effective open market operations. The following are some important roles of T-bills—

- **Liquidity:** Investments in T-bills are highly liquid because they can be converted into cash at any time. There is secondary market for T-bills also.

- **Safety:** Investments in T-bills are highly safe because the payment of interest and repayment of principal are assured by the Government. There is zero risk of default.
- **Ideal Short-term Investment:** Idle cash can be profitably invested for a very short period in treasury bills. Financial intermediaries can put their temporary surpluses in these instruments and earn income.
- **Ideal Fund Management:** Treasury bills are available on top as well through periodical auctions. They are also available in the secondary market. Fund managers of financial institutions build the portfolio of T-bills in such a way that the dates of maturities of them may match with the dates of payment on their liabilities. Thus, T-bills help financial managers in managing the funds effectively and profitably.
- **Statutory Liquidity Requirement:** The commercial banks have to maintain SLR to comply with the directives of the central bank. In measuring SLR, investments in T-bills are taken into account. T-bills are eligible securities for the purpose of SLR. Similarly, in maintaining cash reserve ratio, T-bills are helpful as they can be readily converted into cash.
- **Source of Short-term Funds:** In order to meet temporary budget deficits, the government can easily raise funds by issuing T-bills. This is a source of cheap finance to the government as the discount rates are very low.
- **Non Inflationary Monetary Tool:** T-bills enable the central government to support its monetary policy. For instance, if there is excess liquidity in the economy they can be absorbed by issuing T-bills. The issue of T-bills does not lead to any inflationary pressure.
- **Hedging:** T-bills can be used as a hedge against heavy interest rate fluctuations in the call money market. When the call rates are very high, money can be raised against T-bills quickly and

can be invested in the call money market and vice versa. They can be used in ready forward transactions.



CHECK YOUR PROGRESS

Q.1: State whether True(T) or False (F)

(i) Treasury bills are short-term monetary instrument. (T/ F)

(ii) The T-bills are issued at face value. (T/ F)

(iii) There is no secondary market for T-bills. (T/ F)

Q.2: State the basic difference between ordinary and ad hoc T-bills? (Answer in about 50 words)

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Q.3: Why investment in the T-bills is safe? (Answer in about 50 words)

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4.4 COMMERCIAL PAPER

The corporate or financial intermediaries can raise short-term fund by issuing commercial papers. Generally, the companies do not like to borrow short-term money from banks. If they face shortfall in working capital they prefer to use commercial paper. These corporations primarily issue commercial papers to meet their short-term liabilities such as accounts payable, for financing of payroll and inventories and meeting other short-term liabilities. Corporations issue commercial papers at a discount from the face value. The discounts usually depend on the prevailing interest rates and reputation of the issuer. Commercial paper is not backed by any form of collateral and thereby making it a form of unsecured debt. As a result, only firms with higher debt ratings will easily find buyers without having to offer a substantial discount. Maturities on commercial paper last several

days and rarely range longer than nine months or 270 days. Commercial papers provide a better return than treasury bills as the corporations have a higher risk of default than the government.

4.4.1 Meaning and Definition

Commercial paper is a money market instrument with a maturity period less than one year. It is issued as an unsecured promissory note or in a dematerialized form at a discount. The discount is freely determined by market forces. The paper is usually priced between the lending rate of scheduled commercial banks and a representative money market rate. It may be defined as "An unsecured short-term promissory note, negotiable and transferable by endorsement and delivery with a fixed maturity period. It is generally issued at a discount by the leading creditworthy and highly rated corporate to meet their working capital requirements. Depending upon the issuing company, a commercial paper is also known as a finance paper, industrial paper or corporate paper". Another common definition is "Commercial paper is a money market security issued (sold) in the commercial paper market by large corporations to obtain funds to meet short-term debt obligations and is backed only by an issuing bank or company promise to pay the fresh amount on the maturity date specified on the note". In the market there are primary dealers and satellite dealers. Commercial papers can be issued to individuals, banks, companies, and other registered corporate bodies and unincorporated bodies. They are issued in various denominations. Small investors can only access commercial papers indirectly through their broker or money market funds. The following formulas are used for estimation of discounted price of commercial paper—

Price = Face Value/ [1 + Yield X (No. of Days to maturity/ 365)]

Again,

Yield = (Face Value – Price)/ (Price X No. of Days to maturity) X 365 X100

4.4.2 Features of Commercial Papers

The following are the characteristics of commercial papers—

- **Nature:** Commercial papers are a short-term unsecured money market tool with a promissory note and a set maturity.
- **Purpose:** These are issued only to meet short-term obligations such as a new project or working capital needs.
- **Issuer:** The corporate or financial intermediaries can issue commercial papers. Companies with high quality debt rating could easily raise funds by issuing commercial papers. A company can directly issue the paper to investors or it can be done through banks or dealers.
- **Duration:** The commercial papers can be issued for a minimum of 7 days to a maximum of one year. The average maturity period of commercial papers range from 1 to 3 months. Rarely it ranges from 9 month to 1 year.
- **Denomination:** They are issued in various denominations. In India it starts from Rs.5 lakhs.
- **Investors:** The investors in commercial papers are individuals, banks, companies, and other registered corporate bodies and unincorporated bodies. For small retail investors it is difficult to buy commercial paper as the price is comparatively very high.
- **Issue Price:** They are issued at a discount but redeemed at par.
- **Guarantee:** The issuer guarantees the buyers to pay a fixed amount in future in terms of liquid cash and no assets.
- **Return:** The commercial paper offers a fixed rate of interest.

4.4.3 Types of Commercial Paper

Commercial papers are classified on two bases, namely, Uniform Commercial Code and Security. According to the Uniform Commercial Code, commercial papers are classified into four types—

- **Draft:** It is a third party paper confirming the payment. In this case an individual gives a written guidance to another to pay a stipulated sum to a third party.
- **Check:** It is a unique draft where the drawee is a bank. It is either payable on demand to a person specified or to the holder.
- **Promissory Note:** It is most popular form of commercial paper and is a written pledge to pay money. In it an individual is promised to pay a particular amount to another individual or bank.
- **Certificates of Deposit:** It is an acceptance by the bank of the acquisition of a specified sum of money from a depositor for a specific time. In this type, confirmation of the receipt of deposit is done by a bank and promises to repay the amount with interest after maturity.

Again, according to security, commercial papers are two types—

- **Unsecured Commercial Paper:** These are traditional papers and allotted without any security.
- **Secured Commercial Paper:** These are assured by other financial assets and are also known as Asset-Backed Commercial Papers.

4.4.4 Role of Commercial Paper

The following are some important roles of commercial papers—

- **Fund Requirement:** The money raised by commercial paper is generally very large. Technically, it provides more funds to the issuer compared to other sources. It is beneficial when dealing with a substantial sum of money and does not require the use of cash.
- **Convenient and Cheap Financing:** The commercial papers provide a convenient financing method because it allows issuers to avoid the hurdles and expense of applying for and securing continuous business loans. It does not require the securities that trade in the money market to be registered. It is a cheap

financing option as it does not require any collateral. The cost of commercial paper to the issuing firm is lower than the cost of commercial bank loans.

- **Freely Transferable:** It is freely transferable in nature and so it has a high liquidity value. A wide flexible maturity range gives it extra flexibility. Even some financial institutions provide their customers the facility to write checks and to make transfers online with commercial paper fund account in the same manner as a cash or money market account.
- **Highly Secure:** A commercial paper is highly secure and reliable. It does not contain any restrictive condition.
- **High Return:** Investment in commercial papers is beneficial for the investors as they get a higher interest rate than they get from any guaranteed instruments. The interest rate tends to rise along with economic growth of a country. One commercial paper company can save extra funds and can earn good return. This instrument is a good alternative for retail fixed income investors who are looking for a better rate of return on their money.
- **Continuous Source of Funds:** Commercial papers produce a continuous source of funds. The issuing firm can customize the maturity range according to the firm's requirement and matured papers can be paid by selling new commercial paper.



CHECK YOUR PROGRESS

Q.4: State whether True (T) or False (F)

(i) Commercial paper is a long-term financial instrument. (T/ F)

(ii) Commercial papers provide higher return than treasury bills. (T/ F)

(iii) Commercial papers are sold at face value. (T/ F)

Q.5: What is the main purpose of issuing commercial paper? (Answer in about 40 words)

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Q.6: Who can issue commercial paper? (Answer in about 40 words)

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4.5 COMMERCIAL BILLS

Commercial bill is an instrument that helps business firms to get advance payment for the invoices they raise after making sales to their customers. By purchasing or discounting of commercial bills the banks provide the business firms the working capital requirements. The commercial bills arise out of a genuine trade transaction, i.e, credit transaction. As soon as goods are sold on credit, the seller draws a bill on the buyer for the amount due. The buyer accepts the bill and promises to make the payment on the due date. Such bills are called trade bills. The buyer may approach the banks for acceptance of the bill. When trade bills are accepted by commercial banks, they are called commercial bills. The bank charges a commission for the acceptance of the bills and promises to make the payment in case of default of the buyer. The bank discounts the bill by keeping a certain margin and credits the proceeds.

4.5.1 Meaning and Definition

Commercial bills are issued by the seller (drawer) to the buyer (drawee) for the sale value of goods delivered by him. It may be defined as “A commercial bill is a short-term, negotiable and self-liquidating instrument with low risk. It enhances the liability to make payment on a fixed date when goods are bought on credit”. The maturity period of the commercial bills varies from 30 days, 60 days, or 90 days, depending on the credit extended in the industry. The commercial bills have secondary markets.

4.5.2 Features of Commercial Bills

- **Nature:** Commercial bill is a short-term, negotiable and self-liquidating instrument.
- **Marketable:** Commercial bills can be traded by offering the bills for rediscounting.
- **Discounting:** Banks provide credit to their customers by discounting commercial bills. The credit is repayable on maturity of the bill. In case of need for funds, banks can rediscount the bills in the money market and get ready money.
- **Liquidity:** Commercial bills ensure improved quality of lending, liquidity, and efficiency in money management.
- **Safety:** It is fully secure for investment since it is transferable by endorsement and delivery and it has high degree of liquidity.

4.5.3 Types of Commercial Bills

There are various types of commercial bills –

- **Demand Bill and Usance Bill:** A demand bill is payable on demand, i.e, immediately at sight or on presentation to the drawee. A usance bill is payable after a specified time.
- **Clean Bill and Documentary Bill:** In a clean bill, documents are enclosed and delivered against acceptance by the drawee, after which it becomes clear. In the case of documentary bill, documents are delivered against payment accepted by the drawee and documents of the file are held by bankers till the bill is paid.
- **Inland Bill and Foreign Bill:** Inland bills are those drawn upon a person resident of the country and payable in the country. Foreign bills draw outside the country or they may be payable either in or outside the country.
- **Export Bill and Import Bill:** Export bills are drawn by exporters in any country while import bills are drawn on importers by exporters outside.

- **Indigenous Bill:** These bills are those drawn and accepted according to native custom or usage of trade.

4.5.4 Role of Commercial Bills

Commercial bill is an important tool to finance credit sales. Following are the advantages of commercial bills –

- **Liquidity:** They are highly liquid assets. Bills can be readily converted into cash by rediscounting them in case of necessity of funds.
- **Certainty of Payment:** These bills impose strict financial discipline on businessmen to keep their words.
- **Ideal Investment:** It enables financial institutions to invest their surplus funds profitably by selecting bills of different maturities.
- **High Yield:** It gives higher yield to the investors than T-bills.



CHECK YOUR PROGRESS

Q.7: State whether True(T) or False (F)

(i) Commercial bills arise out of credit transaction. (T/ F)

(ii) Commercial bills are negotiable. (T/ F)

(iii) Indigenous bills are based on modern practice. (T/ F)

Q.8: What is the fundamental characteristic of commercial bill? (Answer in about 40 words)

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Q.9: How the commercial bill arouse? (Answer in about 40 words)

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4.6 CERTIFICATE OF DEPOSIT

Certificates of deposit (CDs) are unsecured, negotiable, short-term instruments in bearer form, issued by commercial banks and development financial institutions. These are time deposits of specific maturity similar to

fixed deposits and are subject to SLR and CRR. The difference is that the certificates of deposit being in bearer form are transferable and tradable while fixed deposits are not. The CD is an agreement between the depositor and the bank where a predetermined amount of money is fixed for a specified time period. Since, CD is a government backed security, the investors principal amount is kept safe. This is a less risky investment option than stocks or bonds. It offers a higher rate of interest compared to other savings account. The investor also gets a grace period of 7 days to decide whether or not to reinvest the matured amount.

Features of CDs

- **Eligibility:** Only the scheduled commercial banks and financial institutions permitted by the authority could issue CD.
- **Maturity Period:** The maturity period of CDs issued by banks should be no less than 7 days and not more than 1 year while CDs of financial institutions have the maturity period range 1 year to 3 years.
- **Transferability:** Physical CDs are freely transferable by endorsement and delivery.
- **Denomination:** Minimum amount of a CD should be Rs.1 lakh and in multiples of Rs.1 lakh thereafter.



CHECK YOUR PROGRESS

Q.10: State whether True (T) or False (F)

(i) Certificate of deposit is a transferable instrument. (T/ F)

(ii) All banks and financial institutions could issue certificate of deposit. (T/ F)

Q.11: What is meant by certificate of deposit? (Answer in about 40 words)

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Q.12: What is the basic difference between certificate of deposit and fixed deposit? (Answer in about 40 words)

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4.7 LET US SUM UP

- Treasury bills provide liquidity for governments and banks while commercial paper provides liquidity for the commercial sector and intermediaries.
- Treasury bill are the short-term money market instrument, issued by the central bank on behalf of the government at a discount to curb temporary liquidity shortfalls.
- Treasury bills are sold at a discount, i.e., the government sells them for less than par value (face value) and, when they mature, buys them back at par value. The difference between the purchase price (amount paid by the tender at the time of purchase which is less than the face value) and the amount received on maturity represents the interest amount on T-bills.
- A commercial paper is an unsecured short-term promissory note, negotiable and transferable by endorsement and delivery with a fixed maturity period. It is generally issued at a discount by the leading creditworthy and highly rated corporate to meet their working capital requirements.
- Maturities on commercial paper last several days and rarely range longer than nine months or 270 days.
- The commercial papers provide a convenient financing method because it allows issuers to avoid the hurdles and expense of applying for and securing continuous business loans.
- A commercial bill is a short-term, negotiable and self-liquidating instrument with low risk. It enhances the liability to make payment on a fixed date when goods are bought on credit.

- Trade bills are accepted by commercial banks are called commercial bills. The bank accepted the bills and promises to make the payment in case of default of the buyer. The bank discounts the bill by keeping a certain margin and credits the proceeds.
- Certificates of deposit (CDs) are unsecured, negotiable, short-term instruments in bearer form, issued by commercial banks and development financial institutions.



4.8 FURTHER READING

- Abadie, M. J. (1993). *Investing in Treasury Bills.* England: Longmeadow Press
- Gurusamy, S. (2009). *Indian Financial System.* New Delhi: Tata McGrow-Hill Education Private Limited
- Gupta, S. B. (2004). *Monetary Economics.* New Delhi: S. Chand & Company Ltd.
- Pathak, B. V. (2012). *The Indian Financial Sysytem*. Singapore: Pearson
- Steiner, B. (2011). *Key Financial Market Concepts.* London: Pearson



4.9 ANSWERS TO CHECK YOUR PROGRESS

Ans. To Q.1: (i) True (ii) False (iii) False

Ans. To Q.2: Ordinary T-bills are sold to the public through auction. They are freely marketable and they can buy and sell at any time and they have secondary market. But Ad hoc treasury bills are issued in favour of the central banks only. They are not marketable and not sold to the general public through tender or auction.

Ans. To Q.3: Investments in T-bills are highly safe because the payment of interest and repayment of principal are assured by the Government. There is zero risk of default. They are helpful from liquidity point as they can be converted into cash at any time.

Ans. To Q.4: (i) False (ii) True (iii) False

Ans. To Q.5: Commercial papers are issued by companies to meet short-term obligations such as a new project or working capital needs. They don't prefer to go to banks for business loans in short-term, instead issues commercial paper as it is convenient and cheap.

Ans. To Q.6: The corporate or financial intermediaries could issue commercial papers. As these papers are not backed by any form of collateral so only firms with higher debt ratings will easily find buyers without having to offer a substantial discount.

Ans. To Q.7: (i) True (ii) True (iii) False

Ans. To Q.8: The main characteristic of commercial bill is that it arises from credit sale. It is a short-term, negotiable and self-liquidating instrument with low risk.

Ans. To Q.9: The commercial bills arise out of a genuine trade transaction, i.e, credit transaction. As soon as goods are sold on credit, the seller draws a bill on the buyer for the amount due. The buyer accepts the bill and promises to make the payment on the due date. Such bills are called trade bills. When trade bills are accepted by commercial banks, they are called commercial bills.

Ans to Q.10: (i) True (ii) False

Ans to Q.11: Certificates of deposit (CDs) are unsecured, negotiable, short-term instruments in bearer form, issued by commercial banks and development financial institutions.

Ans to Q.12: The difference between the certificates of deposit and fixed deposit is that the former being in bearer form is transferable and tradable while fixed deposits are not.



4.10 MODEL QUESTIONS

Short Questions (Answer each question in about 150 words)

Q.1: Define a treasury bill.

Q.2: Write a note on discounting of treasury bills.

Q.3: What is meant by commercial paper?

Q.4: Evaluate the role played by commercial papers.

Q.5: Explain the types of commercial bills.

Easy type Questions (Answer each question in about 300-500 words)

Q.1: What is meant by Treasury bill? Explain their types and features.

Q.2: Discuss the role of treasury bills in an economy.

Q.3: Explain the features of commercial papers.

Q.4: Discuss the types of commercial bills.

Q.5: What is meant by certificate of deposit? Mention its features.

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UNIT 5: CALL MONEY MARKET

UNIT STRUCTURE

5.1 Learning Objectives

5.2 Introduction

5.3 Call Money Market

5.4 Call and Notice Money

5.5 Role of Call Money

5.6 Monetary Policy Intervention in the Money Market

5.7 Let Us Sum Up

5.8 Further Reading

5.9 Answer to Check Your Progress

5.10 Model Questions

5.1 LEARNING OBJECTIVES

After going through this unit, you will be able to –

- know what is a call money market and its features
- know who are the participants in the call money market
- understand how call money market functions in India.
- analyse the role of call money
- discuss the difference between call and notice money
- understand and describe the instruments of monetary policy the RBI uses to intervene in the money market.

5.2 INTRODUCTION

Call money market deals in short term financial assets, which are close substitutes for money and are repayable on demand. It deals with day-to-day surplus funds of banks. The participants in the Indian Call Money Market are Indian and Foreign Commercial Banks, Co-operative banks, Discount and Finance House of India Ltd. (DFHI) and Securities Trading Corporation of India (STCI) as both lenders and borrowers. On the other hand, Unit Trust of India (UTI), LICI, NABARD

can participate only as lenders. Call money is also known as call loans. Call loans are availed through auctions or negotiation on call rates.

Call money market is the most active and sensitive part of the organised money market in India. It is centered mainly at Mumbai, Kolkata and Chennai. The main function of the market is to redistribute the pool of day-to-day surplus funds of banks among other banks which have a temporary deficit of cash. In this unit we will discuss about the call money market in details.

5.3 CALL MONEY MARKET

Call money market is the most active and sensitive part of the formal money market. It deals in one-day loans (called call loans or call money) which may or may not be renewed the next day. The participants of call money market are mostly the banks. Therefore, it is also called inter-bank call money market.

The call money market occupies a very crucial place in Indian money market, where the day-to-day surplus funds are traded. The borrowing side is limited exclusively to banks, which are temporarily short of funds. On the lending side also, there are mostly banks who are temporarily excess in cash. As a special case, in our country, LIC and UTI are also allowed to place on call their short term funds and earn interest on them. All others have to keep their funds in term deposits of minimum 15 days with banks in order to earn interest. The banks are prohibited from paying interest on deposits made for less than 15 days. Such deposits are treated as current account deposits.

Formerly, companies as well as quasi-government bodies and individuals with large short-term surplus were allowed to place such funds on call with banks. Those funds were known as 'house money'. Finance brokers used to act as intermediaries between borrowing banks and lending houses. But, this system does not exist now.

India's leading bank State Bank of India (SBI) is always on the lenders' side of the market. It acts as the 'lender of intermediate resort.' Whereas the RBI as the country's Central Bank is the 'lender of last resort.'

The call money market is highly sensitive and competitive. It registeres very quickly the pressures of demand and supply for funds operating in the money market. Thus, it acts as the best available indicator of the liquidity position of the organized money market. Therefore, the RBI has to take due notice on the functioning of the Indian money market by adjusting its day-to-day monetary policy. The market experiences some regular seasonal changes. It is generally tighter during the busy season (October-April) than during the slack season (May-September). The peak of the busy season is April and in this month the market is much strained before the final dates of quarterly tax payments by the firms.

The call money market operates through brokers who keen in constant touch with banks in the city and bring the borrowing and lending banks together. The main function of the market is to redistribute the pool of day-to-day surplus funds of banks among other banks in temporary deficit of cash.

The call money rate of interest is highly volatile. The call money rate is the rate at which the short term funds are borrowed and lent in the money market. The pressures of excess demand push it up easily and of excess supply pull it down easily. In other words, demand and supply of liquidity affect the call money rate. A tight liquidity condition leads to a rise in call money rate and vice versa.



CHECK YOUR PROGRESS

Q.1 : What is meant by call money market.
(Answer in about 20 words)

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Q.2 : Who are the participants in the call money market ?
(Answer in about 40 words)

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Q.3 : How does call money market operate?
(Answer in about 60 words)
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5.4 CALL AND NOTICE MONEY

Call money and notice money markets are sub-markets of the Indian Money Market. These refer to the markets for very short term funds-

- Call money refers to the borrowing or lending of funds for one day.
- Notice money refers to the borrowing and lending of funds for 2-14 days.

It is to be mentioned here that there is another sub-market which is known as term money market. It refers to the borrowing and lending of funds for a period of more than 14 days.

The basic features of call and notice money may be summarised as follows -

- Scheduled commercial banks (excluding regional rural banks or RRBs), co-operative banks (other than land development banks) and primary dealers (PDs) are permitted to participate in call and notice money markets both as borrowers and lenders.
- Eligible participants are free to decide on interest rates in call/ notice money market.
- The call/notice money transaction can be executed either on NDS-call (Negotiated Dealing System Call), a screen-based, negotiated electronic trading system managed by the clearing corporation of India (CCIL) or over the counter (OTC) through bilateral communication.
- Deals in the call/notice/term money market can be done from 9-00 am to 5-00 pm on each business day or as specified by RBI from time to time.



NDS- Negotiated Dealing System is an electronic trading platform operated by the Reserve Bank of India to facilitate the issuing and exchange of government securities and other types of money market instruments. The aim is to reduce - Box inefficiencies resulting from telephone orders and manual paper-work.

OTC- Over the counter trading is done directly between two parties, without the supervision of an exchange



CHECK YOUR PROGRESS

Q.4 : What are the various sub-markets of money market ? (Answer in about 30 words)

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Q.5 : What are the basic features of call and notice money ? (Answer in about 60 words)

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5.5 ROLE OF CALL MONEY

Call money, also known as 'money at call' is a short term financial loan that is payable immediately, and in fall, when the lender demands it. Call money does not have to follow a fixed schedule like a term loan, which has a set maturity and payment schedule. Thus, call money is a short-term, interest paying loan from 1 to 14 days made by a financial institution to another financial institution. Due to the short term nature of the loan, it does not feature regular principal and interest payments, which long-term loans might. The interest charged on a call loan between financial institutions is refered to as the call loan rate.

The role of call money may be understood by the following points-

- Call money allows banks to earn interest, known as the call loan rate, on their surplus funds.
- Call money is typically used by brokerage firms for short term funding needs.
- Brokerage firms use call money to maintain margin accounts for the benefit of their customers who wish to withdraw their investments.
- The call money is the second most liquid asset that may appear on a balance sheet, behind cash.

- If the lending bank calls the funds, then the broker can issue a margin call, which will typically result in the automatic sale of securities in a client's account (to convert the securities to cash) in order to make the repayment to bank.



CHECK YOUR PROGRESS

Q.6 : What are the basic difference between call loans and term loans ? (Answer in about 40 words)

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Q.7 : Discuss briefly the role of call money in an economy. (Answer in about 60 words)

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5.6 MONETARY POLICY INTERVENTION IN THE MONEY MARKET

THE MONEY MARKET :

Monetary policy is the policy adopted by the monetary authority of a country that controls either the interest rate payable on very short term borrowing or the money supply. In other words, monetary policy is the macroeconomic policy laid down by the central bank. It involves management of money supply and interest rate and in the demand side economic policy used by the government of a country to achieve macroeconomic objectives like inflation, consumption, growth and liquidity.

The money market is an organised exchange market where participants can lend and borrow short term, high quality debt securities with average maturities of one year or less. The markets enable governments, bank and other large institutions to sell short term securities to fund their short term cash flow needs. It also allows individual investors to invest small amounts of money in a low risk market. Some of the instruments traded in this market include treasury bills, certificates of deposit, commercial paper, federal funds, bills of exchange and asset backed securities.

Thus, money market is a market where money and highly liquid marketable securities are bought and sold. It is not a place like the stock market but an acitivity and all the trading is done through telephones. One of the important features of money market is honour of commitment and creditworthiness.

Monetary Policy Intervention

Monetary policy refers to the use of monetary instruments under the control of the Central Bank to regulate magnitudes such as interest rates, money supply and availability of credit with a view to achieving the ultimate goal of the economic policy. In India, Reserve Bank of India (RBI) is vested with the responsibility of regulating monetary policy. It has issued regulations over time covering different money market products- call money, repo rate, commercial paper, certificates of deposit and other debt instruments with original maturity of less than one year. So, now let us take a look at the various instruments of monetary policy which are used by RBI to intervene in the money market.

- Open Market Operations : The open market operations mean the sale and purchase of short term securities by the RBI itself directly in the open market. To control inflation and tackle the problem of excess liquidity due to foreign exchange inflows the RBI sells Government Securities. This is a direct and effective way to increase or decrease the supply of money in the market. It has also a direct effect on the ongoing rate of interest in the market.
- Bank rate : One of the most effective instruments of monetary policy is the bank rate. A bank rate is essentially the rate at which the RBI lends money to commerical banks without any security or collateral. It is also the standard rate at which the RBI will buy or discount bills of exchange and other such commercial instruments.

  So, now if the RBI were to increase the bank rate, the commercial banks would also have to increase their lending rates. And this will help control the supply of money in market and vice-versa.

- Reserve Ratio : The central bank can control the money market by setting a necessary reserve ratio, which would restrict the ability of the commercial banks to increase the money supply by loaning out money. There are two components of this instrument of monetary policy, namely- The Cash Reserve Ratio (CRR) and the Statutory Liquidity Ratio (SLR).

  The cash reserve ratio (CRR) is the portion of deposits with the commercial banks that it has to deposit to the RBI. The RBI will adjust the said percentage to control the supply of money available with the bank.

  The statutory liquidity ratio (SLR) is the percentage of total deposits that the commercial banks have to keep with themselves in form of cash reserves or gold. So, increasing the SLR will mean the banks have fewer funds to give as loans thus controlling the supply of money in the economy.
- Liquidity Adjustment Facility : The Liquidity Adjustment Facility (LAF) is an indirect instrument for monetary control. It controls the flow of money through repo rates and reverse repo rates. The repo rate is actually the rate at which commercial banks and other institutes obtain short term loans from the central bank. And, the reverse repo rate is the rate at which the RBI parks its funds with the commercial banks for short time periods. So the RBI constantly changes these rates to control the flow of money in the market according to the economic situations.
- Moral Suasion : This is an informal method of monetary control. The RBI, being the central bank of the country enjoys a supervisory positiion in the banking system. If there is a need it can urge the commercial banks to exercise credit control at times to maintain the balance of funds in the market. This method is actually quite effective since banks tend to follow the policies set by RBI.



CHECK YOUR PROGRESS

Q.8 : What is meant by monetary policy? (Answer in about 30 words)

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Q.9 : What are the instruments used by the RBI to intervene the money market ? (Answer in about 20 words)

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Q.10 : Explain briefly the components of reserve ratio. (Answer in about 50 words)

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5.7 LET US SUM UP

- The Call money market is an essential part of the Indian money market, where the day-to-day surplus funds are traded. The money market is a market for short term financial assets that are close substitutes of money.
- The loans are of short term duration varying from 1 to 14 days, are traded in call money market. The money that is lent for 1 day is called 'Call Money', and if it exceeds 1 day, but less than 15 days, it is referred to as 'Notice Money.' The money lent for 15 days or more is knwon as 'Term Money.'
- As per the RBI guidelines, the participants in the call money market include scheduled commercial banks excluding the regional rural banks (RRBs), Development Financial Institutions, Co-operative banks (Other than land development banks) and Primary

Dealers (PDs) both as lenders and borrowers. The UTI and LICI are allowed to participate as lender only.

- The call money rate is the rate at which the short term funds are borrowed and lent in the money market.
- Call money refers to the borrowing or lending of funds for one day.
- Notice money refers to the borrowing or lending of funds for two to fourteen days.
- Being the central bank, the RBI employs various instruments of monetary policy to regulate the money market in India. Those are- Open Market Operations, Bank Rate, Reserve Ratio, Liquidity Adjustment Facility and Moral Suasion.



5.8 FURTHER READING

1) Gupta, S.B. (1999). *Monetary Economics- Institutions, Theory and Policy.* New Delhi : S Chand and Company Ltd.

2) Jhingan, M.L .(2004), *Moneytary Economics*. New Delhi : Vrinda Publicatioins (P) Ltd.

3) Paul, R.R. (2008). *Moneytary Economics.* Ludhiana : Kalyani Publisher.



5.9 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No. 1 : The call money market is an essential part of the Indian money market, where day-to-day surplus funds (mostly of banks) are traded. The loan are of short term duration (1 to 14 days) are dealt in call money market.

Ans to Q No. 2 : Participants in the call market are banks and related entities specified by the central bank, e.g. RBI in India scheduled commercial banks (excluding RRBs), co-operative banks (other than land development banks) and Primary Dealers (PDs) who

are permitted to participate as both borrowers and lenders. As per the new regulations, payment banks are also allowed to participate in call money market as both borrowers and lenders. The UTI and LICI are also given permission to participate but only as lender.

Ans to Q No. 3 : In call money market, day to-day surplus funds are traded. The borrowing side is limited to the banks, which are temporarily short of funds. On the lending side also, there are mostly banks with temporarily excess of funds. SBI, the leading bank in India, is always on the lenders side of the market. It acts as the 'lender of intermediate resort'. The call money market operates through broker who keep in constant touch with banks and their duty is to keep the borrowing and lending banks together.

Ans to Q No. 4 : Call money, Notice money and Term money markets are the sub markets of Indian money market. Call money refers to the borrowing or lending of funds for 1 day, Notice money for 2-14 days and for more than 14 days is called Term money market.

Ans to Q No. 5 : The basic features of call and notice money are as follows-

- Scheduled commercial banks (excluding RRBs), co-operative banks (Other than land development banks) and primary delares (PDs) are the participants of call and notice money markets both as borrowers and lenders.
- Eligible participants are free to decide on interest rates in the market.
- The call and notice money transactions can be executed either on Negotiated dealing system call or Over The Counter (OTC) through bilateral communication.
- The market is generally open from 9.00 am to 5.00 pm on each business day or as specified by RBI from time to time.

Ans to Q No. 6 : The basic difference between call loans and term loans are-

- A call loan is a loan that the lender can demand to be repaid at any time. On the other hand, a term loan is a monetary loan

that is repaid in regular payments over a set period of time.

- Call loan does not have to follow a fixed schedule whereas term loan has a set maturity and payment schedule.

Ans to Q No. 7 : The role of call money in an economy may be summarized as follows-

- Call money is a short term and interest earning financial loan.
- It is typically used by brokerage firms for short term funding needs.
- Call money is used by brokerage firms to maintain margin accounts for the benefit of their customers.
- It is the second most liquid asset that may appear on a balance sheet, behind cash.
- Call money helps the bank to fill the gaps or temporary mismatches in fund.
- Call money helps to meet the CRR and SLR mandatory requirements as stipulated by the RBI.

Ans to Q No. 8 : Monetary policy is the macroeconomic policy laid down by the central bank. It involves management of money supply and interest rate and the demand side economic policy used by the government of a country to achieve macroeconomic objectives like inflation, consumption, growth and liquidity.

Ans to Q No. 9 : The Principal instruments used by the RBI to intervene money market are- Open Market Operations, Bank Rate Policy, Reserve Ratio System, Liquidity Adjustment Facility (LAF) and Moral Suasion.

Ans to Q No. 10 : There are two components of reserve ratio- Cash Reserve Ration (CRR) and Statutory Liquidity Ratio (SLR)

The Cash Reseve Ratio (CRR) is the portion of deposits with the commercial banks that it has to deposit to the RBI. The RBI will adjust the said percentage to control the supply of money available with the bank.

The Statutory Liquidity Ratio (SLR) is the percentage of total deposits that the commercial banks have to keep with themselves

in form of cash or gold. So, increasing the SLR will mean the banks have fewer funds to give loans and thus, the RBI controls the supply of money in the economy.



5.10 MODEL QUESTIONS

Short questions (Answer in about 150 words)

Q.1. Discuss briefly the basic features of call money market.

Q.2. Explain why call money is regarded as the most active segment of money market.

Q.3. Write a short note on the call money market in India.

Long questions (Answer in about 300-500 words)

Q.1. Mention the basic objectives of Call Money Market. Why do banks borrow to participate in the call money market ?

Q.2. Discuss briefly the functioning of call money market.

Q.3. What is meant by money market? Also discuss the various instruments used by the RBI to intervene the Indian money market.

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UNIT 6: THE CAPITAL MARKET

UNIT STRUCTURE

6.1 Learning Objectives

6.2 Introduction

6.3 Meaning and Functions of the Capital Market

6.4 Primary Capital Market

6.5 Participants of the Primary Capital Market

6.6 Instruments of the Primary Market for Raising Funds

6.7 Let Us Sum Up

6.8 Further Reading

6.9 Answers to Check Your Progress

6.10 Model Questions

6.1 LEARNING OBJECTIVES

After going through this unit, you will be able to –

- know the meaning of capital market
- explain the functions of the capital market
- understand the meaning of primary and secondary capital market
- know about the participants in the primary capital market
- explain the instruments of raising funds in the capital market.

6.2 INTRODUCTION

The term 'market' in economics refers to an institutional arrangement for facilitating the exchange of goods and services. Financial market, as such is an institutional complex that facilitates the buying and selling of financial assets. For economic progress and optimal allocation of resources a financial market is of immense importance. It may be defined as a mechanism of transmission of funds to the deficit spenders from units having surplus funds and the two are interconnected by a mechanism of rules and communication network. Financial institutions, agents, brokers, dealers, borrowers and lenders are the participants in the financial market. The financial assets exchanged may include deposits, loans, government bonds,

corporate stocks and bonds and the like. Financial markets are conventionally categorised into money and capital markets on the basis of the maturity period of financial assets exchanged in the two markets. The money market includes transactions of financial claims having a short-term maturity of a period of one year or less. On the other hand, capital market involves transactions of financial claims of maturity period of above one year. In this unit, we will discuss about the capital market, its features and its functions.

6.3 MEANING AND FUNCTIONS OF THE CAPITAL MARKET

The part of the financial system that is concerned with the borrowing and lending of long-term capital requirements is the capital market. The phrase 'long term' refers to a term of anything beyond one-year time. The fund exchanges of term maturity of a year or less is classified as the money market. Yet, the money and capital markets are essentially performing the same basic function of transferring funds for productive investment from surplus lenders to deficit borrowers.

The arrangements in the capital market consists of the individual savers and investors as well as the institutional providers of long-term capital like the insurance companies, commercial banks, investment trust, mutual funds, specialised financial institutions and the like on the supply side. On the other hand, the demand side of long-term funds is associated with the requirement for acquiring working capital, inventories and fixed assets. Accordingly, a well-developed and efficient capital market is essential for the economic development of a country.

Finance is considered to be the main lever that helps the wheels of any economy to move forward. A developed and versatile financial system is core to the progress of an economy. In this context the capital market is of immense significance through the provisioning of financial flows to the productive sectors of the economy. The functions of a capital market are discussed as below.

- **Acts as a link between lenders and borrowers:** The primary securities issued by the borrowers are bought by the lenders either directly or through financial intermediaries. Accordingly, the capital market establishes a link between the savers or the units with surplus funds and the units with paucity of funds for productive uses. The capital market augments the generation of savings and directs the same onto productive uses.
- **Provides inducement to save:** A developed capital market is essential for pooling the savings into a vast reservoir of funds for further investment in productive ventures. The capital market is a mechanism to divert the surplus savings of the people so that idle savings, wasteful uses or investment in unproductive or less productive assets are minimized. It provides strong incentives such that present consumption becomes more costly than future consumption, inducing people to save more.
- **Promotes capital formation:** Capital market can, not only augment savings but, also, can direct the flow of the same for investment in the most productive ventures. The producers are in need of two different types of capital, namely, the short term or working capital requirements and the long term or the fixed capital requirements. While the first need is taken care of by the functioning of the money market; the second requirement is taken care of by the primary capital market. The capital market is basically divided into primary and secondary capital markets, which is discussed in the following section. Producers raise funds from the investing public for investment in their ventures through the primary market. Savings mobilisation for enhancing investment leads to capital formation and ultimately leads to the economic development of the country.
- **Protects the interest of the investors:** A developed capital market is versatile in that it provides a wide variety of avenues for investors to choose from in terms of yields, term of maturities and liquidity. Now, an efficient capital market is indeed necessary to attract investors because without the protection of the interest of the investors it will not be successful in raising capital.

- **Speeds up economic growth and development:** Capital market increases production and productivity in the economy by making funds available for long period of time. This helps in meeting the financial requirements of business houses. Increased production leads to an increase in employment and development of infrastructure.
- **Stability in Stock prices:** The operations of the stock market and the various institutions operating in the capital market brings forth stability in the prices of the stocks and securities and curbing out the speculative activities. They ensure the optimal allocation of capital in reasonable rate of interest.
- **Provides continuous availability of funds:** Capital market is a liquid market as it makes fund available on continuous basis. Both buyers and sellers can easily buy and sell securities as they are continuously available.

Considering the importance of the capital market in the context of the economic development of a country it is rightly said that the capital market is a mark of the development of a country. In the context of the underdeveloped countries it is thus identified that the lack of an organised and well-developed capital market inhibits the process of economic growth in such countries.



CHECK YOUR PROGRESS

Q.1 : What is meant by capital market?
(answer in about 20 words)

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6.4 PRIMARY CAPITAL MARKET

Capital market is basically divided into two segments, the primary and the secondary capital market. The primary market is concerned with the raising of funds for investment in the enterprises, both new or previously existing enterprises. For the initiation of new enterprises or for expansion

or diversification of existing ones, capital for the purpose of investment becomes necessary. In this context, the enterprises may raise the required venture capital or initial capital through the primary market. In other words, the buying and selling of new securities for the first time falls in the ambit of the primary capital market. Accordingly, the primary market is also called the new issue market (NIM). A large number of financial intermediaries' function in this segment of the capital market offering a wide number of services which are crucial to the functioning and development of the capital market. The secondary capital market, on the other hand, is the market of already existing securities. It facilitates the buying and selling of existing securities from the first holder to the second and subsequent holders. The secondary market, its working and structure is beyond the scope of the present chapter.

The fundamental distinction between the primary and secondary capital market is that the primary market deals in new offerings of securities to the public that were not previously available. However, the secondary market deals in already existing securities. Secondly, the primary market helps enterprises raise funds for investment. But in the secondary market the corporates whose securities are traded have no role as such because the transaction takes place between investors alone.



CHECK YOUR PROGRESS

Q 2: Define a primary capital market (answer in about 20 words)

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Q 3: Distinguish between the primary and secondary capital market (answer in about 30 words)

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6.5 PARTICIPANTS OF THE PRIMARY CAPITAL MARKET

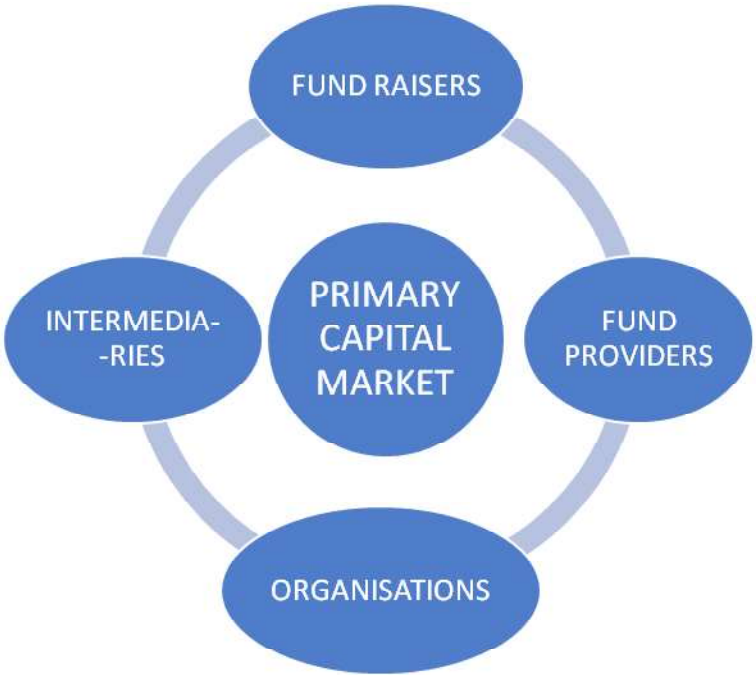


Figure 6.1: Participants of the Primary capital market

To understand the working of the primary capital market the knowledge of the participants in this segment of the capital market is of immense importance. The participants of the primary market are primarily classified into the demand side and the supply side of long-term fund requirements and the different intermediaries that help as the conduit of the same between the two parties. On the demand side we have the corporate enterprises and the various local, state or the central governments that need long term funds for acquiring working capital, inventories or their fixed capital assets. On the supply side we have the investors of long-term funds. The investors are indeed the pivot which drives the wheel of the new issue market. It is them who makes the transfer of funds to the needy investors possible. Investors may be either institutional or non-institutional or retail investors. The institutional investors include the mutual funds, insurance companies, etc who invest the funds of individuals in the capital market.

In the organisational structure of the NIM as well as the secondary capital market we need to mention the stock exchange and the providers of

the depository and custodial services. The stock exchange is a place where the securities issued by the companies are listed and traded. The stock exchanges are the core of the working of the capital market as such. Again, the expansion of the size and working of the primary market and secondary market raises the amount of paper work delaying the activities of the same as well as raises the risk of theft of securities, forged certificates, wrong signatures and the likes. So, depositories were initiated for the safe keeping and efficient trade of securities, which are kept in electronic formats. For instance, we have the National Stock Depository Limited (NSDL) or the Central Depository Services India Limited which are registered depositories in India.

Besides the above the primary capital market organisation consists of a number of intermediary institutions and agencies whose functions are core to the working of the primary market. The various categories of these are discussed below.

- **Lead managers:** In the primary capital market, a lead manager is appointed by the enterprises for managing all the activities associated with an effective sale of the new issues of enterprises to the public. The activities assigned for the same are for instance, drafting of prospectus, marketing of the public issue, advisory services relating to appointment of underwriters, registrars , advertising agents, etc and advising these institutions and agencies on related matters, preparation of the budget of expenses involved with the new issue and most significantly planning the suitable time of the issue. They have a significant role to play in attracting the public to invest their funds in the new issue of the respective enterprise. Lead managers can be the merchant banking division of the different financial institutions, subsidiaries of commercial banks, foreign banks, the private sector banks or other private agencies.
- **Register to the issue:** These represents an intermediary in the public issues who are appointed in consultation with the lead managers. As the name suggests, registers to issue are concerned

with all activities of new issue management. Aptitude, proficiency, infrastructure, etc. are criterion on which registers may be appointed by an enterprise. Their functions include collection of the share applications from the collection centres and keeping a record of the same, preparing the basis of the allotment among applicants and finalising the list of the same and dispatching the allotment letters and other related documents to shareholders.

- **Underwriters**: Underwriting is an activity practised in the primary market irrespective of the country in consideration. This consists of the respective underwriting institution to guarantee that in case of non-subscription of the issues of any company it will subscribe the same. Thus, the underwriting is like providing an insurance against the risk of non-subscription or inadequate subscription of the company shares issued to the public. Especially in case of new enterprises whose shares may not be able to attract the investors otherwise, benefit the most, from underwriting by reputed institutions. Underwriting is done in lieu of commissions. To reduce the burden of underwriting the underwriters may further sub-underwrite. A related term with underwriting is prewriting. Here, on a commission basis promotional measures are taken to attract large investing institutions prior to making the issues open for public subscription. Underwriting services are conducted by investment banks, insurance companies, commercial banks and term lending institutions.
- **Banks :** The role of banks in new issues may be diverse and is very significant. They may perform the role of collection agents, coordinating agents, merchant bankers or even brokers, all in lieu of commissions for their services.
- **Brokers:** The brokers and the network of brokers spread throughout any economy are agents to the investors. They play an imperative role in the execution of buying and selling of securities and charge commissions in return of their services. The role of brokers is significant in both the primary and secondary capital market.

- **Advertising Agents:** These are intermediaries in the issue that are responsible for promotion of the issue so that it can be successfully carried out. They carry out massive promotion measures through the use of both print and electronic media.



CHECK YOUR PROGRESS

Q 4: Define a primary capital market (answer in about 20 words)

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Q 5: Differentiate between the primary and secondary capital market (answer in about 30 words)

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6.6 INSTRUMENTS OF THE PRIMARY MARKET FOR FUNDS RAISING

This section deals with those financial assets which enable transfer of funds for investment in the capital market in India. Unlike as in the money market, capital market instruments have a maturity of more than a year. The principal capital market instruments are described below:

- **Government securities:** Government securities market is a very significant segment of the stock market in India. These include the securities issued by the central government, state governments and the semi-government authorities like the city corporations, municipalities, state electricity boards or the government agencies like housing boards, NABARD, etc. In any given year, the government, whether it is the central or state governments, to meet its short term or long term needs or even for conversion or refinancing of maturing securities issue such securities. Government bonds may be in the form of promissory notes, stock certificates or bearer bonds. Stock certificates is sent to the applicant directly by the public debt office and interest thereof are remitted by money order or

interest warrant drawn on any treasury office or bank as stipulated by the applicant. But they are not easily transferrable. Promissory notes are easily transferrable and so more popular among the investors. Bearer bonds as the name suggest are bearer instruments, the bearer being the owner. A unique feature of the government securities market must necessarily be mentioned here. These are an ideal financial instrument which are secure and guarantees the certainty of income and capital. Thus, the government securities market is also called the gilt-edged market.

- **Industrial Securities:** Business concerns raise their capital for long-term and medium-term requirements by using different instruments. These instruments have varied features to satiate the investors preferences. Under this head we shall discuss the three major types of securities, viz. equity shares, preference shares and debentures.
  - **Equity shares:** These are also most commonly referred to as ordinary shares. The investors in ordinary shares are fractional owners of the company, they have a claim on the assets and earnings of the company and accordingly they enjoy voting rights and the rights to receive dividends. The existence of a developed secondary market for shares makes this type of financial instrument liquid as the investors can resell their shares in the secondary market.
  - **Preferences shares:** The preference shareholders do not enjoy voting rights. But as the name suggests these shareholders enjoy a priority on the assets and earnings of the company. For instance, after the claims of the creditors are met these shareholders are entitled to the income before the equity shareholders. But it needs to be noted that preference shareholders are only entitled to a fixed dividend paid regularly. There have been several types of modifications on these type of shares for which we observe different types of preference shares which are discussed here.

- **Cumulative and non-cumulative preference shares:** If the dividend to be paid against preference shares is not or cannot be paid on grounds like low or inadequate profit and if the dividends are accumulated to be paid in subsequent years then it is a cumulative preference share. Otherwise it is a non-cumulative preference share.
- **Convertible and non-convertible preference shares:** If at the time of issue there was included the right to convert preference shares into ordinary shares at the end of a definite period as per the terms and conditions fixed, it is called a convertible preference share and otherwise it is a non-convertible preference share.
- **Redeemable and non-redeemable preference shares:** Redeemable preference shares are a type of preference share. A company issues them to shareholders and later redeems them. This means the company can buy back the shares at a laterdate. No- redeemable preference shares do exist, although companies cannot redeem them.
- **Participating and non-participating preference shares:** Preference shareholders as mentioned above earn a fixed dividend even in the instance of the company making high profits. However, terms and conditions at the time of issue may entitle certain preference shareholders to be paid higher dividends in such instance after the claims of equity and preference shareholders are met. This is then called participating preference shares. Of course, preference shares otherwise are non-participating.

➢ **Debentures or Bonds:** These are securities with a fixed rate of return, having a fixed maturity and income certainty.

The debenture is a document which is an evidence of the lender creditor relationship. Debentures are classified into various forms which are discussed below

- **Secured or unsecured debentures:** Debentures may be secured by the mortgage of whole or part of the tangible physical assets of the company in which case it is called secured and otherwise it is called unsecured debentures.
- **Bearer bonds and registered bonds:** Debentures on which dues are payable to the bearer of the bond and are transferrable by mere delivery are the bearer bonds. However, in case of registered bonds the dues are payable only to the registered holders that is whose name appears on the debenture certificate and is recorded in the companies register of debenture holder.
- **Redeemable and perpetual debentures:** Debentures that are redeemable at certain time period are called redeemable debentures. The debentures that are issued subject to redemption under circumstances of certain specific events that are not normally conceived to happen are called perpetual shares.
- **Convertible and non-convertible debentures:** Debentures that are converted to equity shares after a certain period are called convertible and otherwise non-convertible debentures. There may be debentures that are partly convertible and the convertible portion is converted to equity shares at the end of the maturity period.

- **Hybrid instruments:** Corporates are issuing various innovative security that has features of the above-mentioned capital market instruments. Some of such hybrid instruments includes the **secured premium notes** which are redeemable after a notice

period of four to seven years and have detachable warrants that enable the holders to get equity shares. There may also be **equity shares with detachable warrants** which are separate entities registered separately with the stock exchanges and traded separately. Warrants are actually an attraction medium attached which enables the issuer to pay low interest or dividends due to it. The holders therefore can apply for the warranted shares at some predetermined date and specified price. **Tracking stocks** also called designer stock is a security issued by a company to track the performances of a division of it. The parent company's financial statements are here treated as a separate entity. If the division shows good performance the value of its stock rises and vice versa irrespective of the parent company's performance. There may also be **disaster bonds** which are also called catastrophe bonds which are issued in case of a catastrophe. It is insurance linked. In case of a catastrophic loss then the issuers repayment obligation may be deferred or completely ruled out. Certain bonds have the option of paying the interest in the initial years through issue of new bonds and are called pay-in-kind bonds. Some bonds are characterised by easy liquidity by allowing the holders to get ready encashment in the case of the need to withdraw or redemption or the feature of buy back to the investor. These are **easy exit bonds**.

- **Derivatives:** These are a complex set of capital market instruments of which examples may be stated of futures, options and swaps. The value of the derivatives, which are contracts between two parties, are derived from their values form other financial assets that are called underlying. They are also termed as deferred delivery or deferred payment instruments. Options are contracts where the sellers are bound to sell the assets agreed at the time of contract as per the terms set in the contract. Futures are forward contracts between parties which are characterised with fixed terms of exchange. Swaps are agreements between two parties to exchange cash flows on a determined date or in many cases multiple dates.



CHECK YOUR PROGRESS

Q 6: Define equity shares.

(answer in about 50 words)

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Q 7: What are the different instruments used by businesses to raise funds in the new issue market. (answer in about 20 words)

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6.7 LET US SUM UP

- The financial market can be classified into money and capital market on the basis of the term maturity of funds lend and borrowed.
- Capital market is that component of the financial market that is concerned with the borrowing and lending of long-term capital requirements.
- Capital market is of immense significance to economic development, as it boosts savings and enhances capital formation.
- Capital market is classified into primary and secondary capital market.
- Primary capital market is the market of new issue.
- Primary market working is carried out by a varied set of institutional complexes. It consists of the suppliers of funds and the enterprises that demand the same and also a lot of other institutions that carries out the functions necessary for the transmission of funds between the two.
- Primary market participant institutions include the lead managers, registers to the issue, bankers, brokers, underwriters and advertising agents each having their own set of unique significant functions to make a fresh issue successful.

- Business concerns raise capital through three major types of securities, viz., ordinary shares, preference shares and debentures. Besides, various innovative hybrid instruments are now used for the purpose.



6.8 FURTHER READING

- Bhole, L.M. (2008). *Financial Institutions and Markets Structure, Growth and Innovations.* New Selhi :Tata McGraw Hill Publishing Company Limited
- Baye, R.M. & Jansen, D.W. (1996). *Money, Banking and Financial Markets*. New Delhi :A.I.T.B.S Publishers and Distributors.



6.9 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: Capital market is a part of the financial market of the financial system of a country which is concerned with the borrowing and lending of long-term capital requirements.

Ans to Q No 2: The primary market is concerned with the buying and selling of new securities with the purpose of investment in enterprises.

Ans to Q No 3: The primary market deals in new offerings of securities but the secondary market deals in existing securities. Secondly, the primary market helps enterprises raise funds but the enterprises have no role in the other.

Ans to Q No 4: The activity of providing guarantee to any new issue of securities that in case of non-subscription or inadequate subscription the underwriter institution will subscribe the securities is called underwriting.

Ans to Q No 5: The major participants in the new issue market are the lead managers, brokers, bankers, advertising agents, underwriters, etc.

Ans to Q No 6: The equity shares are financial assets used by the business to raise investible funds and entitle owners of the shares to a claim

over the assets and earnings of the company and they enjoy voting rights and the rights to receive dividends.

Ans to Q No 7: Businesses raise funds through a wide variety of instruments including ordinary shares, preference shares, debentures and also hybrid instruments.



6.10 MODEL QUESTIONS

Short Questions (Answer each question in about 150 words)

Q 1: What is meant by capital market?

Q 2: Differentiate between the money and capital market.

Q 3: State the functions of lead managers.

Q 4: Differentiate between ordinary and preference shares.

Q 5: What is meant by government securities?

Long Questions (Answer each question in about 300-500 words)

Q 1: Mention the functions of capital market.

Q 2: How does the capital market help in economic development of a country?

Q 3: Discuss the structure of the participating institutions in the primary capital market.

Q 4: Elaborate on the wide variety of instruments used by businesses to raise funds in the capital market.

Q 5: Discuss the different types of preference shares.

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UNIT 7: PRICE DETERMINATION IN THE MONEY MARKET

UNIT STRUCTURE

7.1 Learning Objectives

7.2 Introduction

7.3 Initial Public Offerings

- 7.3.1 Follow-on Public Offering
- 7.3.2 Rights Issue
- 7.3.3 Private Placement Market
- 7.3.4 Preferential Issue

7.4 Book Building

- 7.4.1 The Process of Book Building
- 7.4.2 Book Building Options and Guidelines
- 7.4.3 Book Building Process Merits
- 7.4.4 Book Building Process Limitations

7.5 Let us Sum up

7.6 Further Reading

7.7 Answers to Check Your Progress

7.8 Model Questions

7.1 LEARNING OBJECTIVES

After going through this unit, you will be able to –

- understand the concept of primary market and its participants
- explain the concept of Initial Price Offerings (IPO)
- understand the determination of offer price of IPO
- describe the concept of book building with its merits and limitations.

7.2 INTRODUCTION

Before an in-depth analysis to the Initial Price Offerings (IPO) and Book Building Process it is important to understand the concept of Primary

market and its participants, because both IPO and Book Building Process are related to it.

Primary market is a segment of financial market that deals with new issues and mobilises fresh funds. Therefore it is also called the new issue market. In the primary market, particularly in India, funds are mobilised through prospectus, rights issues and private placement by government companies, non-government public limited companies, private sector undertakings, banks and financial institutions. Primary Market has three categories of participants: issuer of securities, investors in securities and intermediaries (who render service to both issuer and investors). There are various intermediaries to an issue such as merchant banker, registrar to the issue, bankers to the issue etc and it is mandatory to issue all new initial public offerings in dematerialised form.

In India prior to 1992, the new issues market was regulated by the Controller of Capital Issues (CCI) under the Capital Issues (Control) Act, 1947. However, in 1992 the act was repealed and the controls in raising of resources from the market were removed, allowing both new and existing companies to decide the price of their issue themselves. Hence the free pricing regime emerged with unrealistic projections and the shares were sold for very high premiums. This hampered the functioning of primary market and most of the issues were quoted below their offer price on the day of listing at the stock exchange. In the period of 1992-96, due to these unrealistic projections the free market turned into a free falling market. As such the regulators brought strict regulations for the intermediaries and laid guidelines for full disclosure for investor projections about the issue price in the prospectus, and also the risk factors in the offer document.

The primary issues are listed in the new issue market in three ways: Public Issue, Rights Issue and Private Placement. Under Public Issue the primary issues are made through Initial Public Offering (IPO) and Follow-on Public Offering (FPO). Again under Private Placement the issues are made through Private Placement, Preferential Issue and Qualified Institutions Placement. In this unit we will particularly discuss about the initial public offerings and book building process in details.

7.3 INITIAL PUBLIC OFFERINGS

Initial Public offerings refers to the offering of fresh issue of securities or sale of existing securities or both, for the first time to the public by an unlisted company. SEBI has laid down certain entry norms for raising funds through Initial Public Offerings. There are three entry norms as laid by SEBI. These entry norms were made so that the investors can take informed decisions and their interests are protected in case of information asymmetry and do not fall into problems of moral hazard and adverse selection.

In the Entry Norm I, a company desiring to tap the primary market needs to have net tangible assets of atleast Rs 3 crores for complete 3 years and not more than 50 per cent is held in monetary assets. Besides the net worth of the company desiring to tap primary market should be atleast Rs 1 crore in three years and out of the preceding five years there should be distributable profits in atleast three years. Further, if a company changes its name then atleast 50 percent revenue for the preceding one year should be earned from the new activity and the issue size should not exceed 5 times the pre-issue net worth. SEBI has provided two alternative routes viz. Entry Norm II and Entry Norm III to a company not meeting the requirements of Entry Norm I.

According to Entry II, Issues should be made through book building and atleast 50 percent of the issue to be mandatorily allotted to Qualified Institutional Buyers. Further, the minimum post-issue face value capital shall be Rs 10 crore or compulsory market making for atleast 2 years. Again according to Entry III, the project should be appraised and participation by Financial Institutions should to the extent of 15 percent.



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Qualified Institutional Buyers are those buyers who are the sophisticated investors like accredited investors, banks, trust funds etc requiring less regulatory protection than the unsophisticated regular investors.

Further the company need to have atleast 1000 prospective allottees in its issue. A company desiring to tap the primary market needs to disclose certain information in the offer document relating to earnings per share, pre-issue of earnings per share for the preceding three years etc and also other information relating to credit rating, risks in relation to first issue, internal and external risk factors, funding plans etc. Before filing the offer document with the registrar of companies (ROC) and stock exchanges (SE), a company has to file a draft offer document with SEBI atleast 21 days before filing offer document. Based on the offer document SEBI might specify changes, if any and it has to be compiled by the issuer or the lead merchant banker before the offer document is filed with the registrar of companies and stock exchanges. The merchant banker has to compile all the requirements of the disclosure and investor protection (DIP) guidelines while submitting the offer document to SEBI. The draft offer document is made available for 21 days on SEBI website for public comments from the filing of the draft offer.

The issuer is allowed to price the issue freely, but they have to justify the issue price in the prospectus. To determine the issue price there are two ways:

- Fixed Price Method and
- Book Building Method

Fixed price method is the method in which the issuer in consultation with the merchant banker decides the price of the issue. On the other hand, book building method is the process in which the issuer and the merchant banker stipulate a floor price based on market forces. The final price can be any price above the floor price and is usually the price at which the entire issue is exhausted. The issue price is also called the cut-off price. Some issuers can also go for differential pricing. The final prospectus is filed with the registrar of companies. The final prospectus has details of the final issue price and also the issue size. The bids are then segregated under different categories viz. Firm allotment, qualified institutional buyers, non-institutional buyers and retail investors, once there is closure of the issues.

For a company to make a public or rights issue of debt instruments it has to fulfil two conditions:

- It should obtain credit rating which is no less than investment grade from atleast two SEBI registered credit rating agencies. Further, it should not be in the list of willful defaulters of the Reserve Banks.
- The company should not have defaulted payment of interest or repayment of principal for a period of more than six months.

Further, the issuer company should not allot any non-convertible debt instrument pursuant to a public issue in case the proposed allottees are less than fifty. Besides, the IPOs are quoted at a premium to their offer price on getting listed.



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Offer Document: It refers to the prospectus in case of public issue and letter of offer in case of right issue.

Public Issue: It refers to an invitation by a company to the public to subscribe to the securities offered by them through a prospectus.

Differential Pricing: It refers to the pricing of an issue where there is a price difference between a category of share with other category of share.

Firm Allotment: It refers to the allotment to the investors on firm basis.

7.3.1 Follow-on Public Offering

Follow-on Public Offering also known as subsequent public offering refers to the offer of sale of securities by a listed company. The listed companies can issue Follow-on Public Offerings to finance growth plans and is easier for them to raise funds through Follow-on Public Offerings.

7.3.2 Rights Issue

The Right Issue refers to the issue of new shares to its existing share holders with the preemptive rights to subscribe to the new issue on a pro-rata basis. There are four options open to the share holders in case of rights:

- The first option is to buy new shares at the offered price
- The second option is to renounce his rights and sell them in the open market
- The third option is to renounce a part of his rights and exercise the remainder
- The fourth option is to not to exercise any of the three options and choose to do nothing.

Usually the rights issues are kept open for atleast 30 days but not more than 60 days. There are number of reasons why companies offer shares on a rights basis. It usually the most favoured means of mobilising capital for the corporate sector or to expand, diversify, restructure their balance sheet or raise the promoter stake.

7.3.3 Private Placement Market

Besides public issues and rights issue, companies can raise funds through private placement as well. Private placement refers to direct sale of securities that are newly issued to small number investors through merchant bankers. Usually the investors are high net worth individuals. There is certain advantage of raising funds through private placement like the time and cost involved in issue through private placement is lesser than that of public issues and rights issue. Besides, the private placement issues can be tailor-made to suit the requirements of both the issuer and investor. Due to its flexibility private placement is a preferred way for raising resources by the companies. Some of the major issuers of privately placement securities are financial institutions, banks, central level undertakings and state level undertakings. The companies willing to list privately placed bonds has to adhere to the Companies Act and SEBI guidelines that regulate them and have to make disclosures accordingly. Besides, they also need to comply with the listing agreement of stock exchanges and credit rating is also compulsory for privately placed debt issues.

7.3.4 Preferential Issue

Many companies also opt for preferential issues for raising funds by allotting shares to various strategic groups that includes promoters, foreign partners, technical collaborators and private equity funds. Preferential issue refers to the issue of shares by listed companies to a select group of persons which are under Section 81 of the Companies Act, 1956. A company can make preferential issue of equity shares, partly or fully convertible debentures or any other financial instruments convertible or exchanged with equity shares at a later date. Preferential issue can be offered by a listed company, only when its entire shareholding is held in dematerialised form. When making preferential issue, the company needs to keep the entire pre-preferential allotment shareholding under lock-in. Preferential allotment is usually preferred in bullish market as it enables quick fund raising at low cost and also bringing on board a company's business partners.



CHECK YOUR PROGRESS

Q 1: Define Initial Public Offering. (Answer in about 20 words)

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Q 2: Why does SEBI has certain entry norms for raising funds through Initial Public Offerings? (Answer in about 40 words)

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Q 3: Distinguish between Fixed price method and Book building method. (Answer in about 40 words)

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Q 4: Define Follow-on Public Offering. (Answer in about 20 words)

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7.4 BOOK BUILDING

The mechanism of determining offer price under Controller of Capital Issues (CCI) regime was to offer the share at fixed price. However the pattern of pricing changed with the free pricing era and there was unrealistic pricing structure, which led to inefficient functioning of the capital market. As such an alternative method of book building slowly came into existence. Booking Building is a recognised mechanism for raising capital. SEBI has certain guidelines to define the book building process. It defines the book building as a process by which demand for the securities which is proposed to be issued by a corporate body is elicited and built-up. Further, the price for such securities needs to be assessed for quantum and also be issued by the means of a notice, circular, advertisement, information or offer document.

7.4.1 The Process of Book Building

The book building means the auctioning of shares where a book is being built. Investors can watch the book being built which shows the bid price and also number of shares being bid for both in the BSE and NSE. In the process of book building the company appoints a book runner usually a merchant banker who prepares and submits the draft documents to the SEBI and also obtains an acknowledgement card. It is the job of the issuer and book runner to decide and offer shares at a price within a specified price range. The issuer arrives at the cut-off rate and the final allocation is based on the bids received by the book runner and the lead manager. The issuer and the book runner may impose restrictions on the number of shares that can be allotted to each client. The final prospectus is filed with the Registrar of Companies along with the procurement agreement and then the placement portion opens from subscription. The placement portion closes one day before it is opened for public issue portion.

The price determined in the book building process is applicable to the public portion. In case the public portion remains

oversubscribed, the allotment is made on a proportionate basis. On the situation where the public portion remains undersubscribed, then the shortfall is distributed amongst those opting for placement.

The concept of book building was first introduced by SEBI in the year 1999 with the moving price band, which a reintroduced in book built IPOs. Price band includes the floor and cap price and denotes the range of bidding. The floor and the cap of the price band can vary not more than 20 percent, which states that it is not more than 120 per cent of the floor price. If there is a revision of price it has to be informed to the stock exchanges and public through press release, website and terminals of the syndicate members.

Book Building can be of two types:

- **Open Book:** It refers to the system of book building where during the bidding period; there is an online display of the demand and bids.
- **Closed Book:** It refers to a system of book building, where the book is not made public. The investors bid without having any information on the bids that is submitted by other bidders.

A book can be built under entry Norm-II, under which the book-built issue shall not offer less than 50 percent to the qualified institutional buyers and less than 25 percent to the retail investors. The remaining of the issue can be allotted to the non-institutional buyers. The basis of allotment is finalised by the Book Running Lead Managers (BRLM) within two weeks from the date of closure of the issue. The listing on the stock exchanges is done within 7 days from the finalisation of the issue.

7.4.2 Book Building Options and Guidelines

Securities can be issued through book building can be done either through: 75 per cent book building or 100 per cent book building.

In 75 percent book building the issue can be categorised into: placement portion and public portion. Placement portion is the

portion of the issue by the method of book building is offered to the public through the syndicate which has entities like underwriters, merchant bankers, financial institutions, brokers and individuals of high net worth. The investors can have a share in public portion and can also have it through syndicate members. The corporate that are eligible to make an issue to the public can also resort to 75 percent book building option adhering to SEBI Guidelines.

The SEBI also grants 100 percent book building in which the issuer is permitted to opt for 100 percent book building without offloading any portion of the issue in the market. Under the 100 percent book building, the entire issue is offered at a single stage, without the mandatory fixed price offering.

In the book building process, the companies need to follow the guidelines specified by the SEBI. The book building process was approved by SEBI with effect from November 1, 1995.

According to SEBI guidelines, the 100 percent book building issue was available to those issuers making an issue capital of and above Rs 100 crore. But the guidelines were reformed in 1998-99 due to its restrictive nature, because of which no issue was floated under the mechanism. Under the new guidelines the ceiling of issue size under book building was reduced to 25 crore from 100 crore. The issuers were free to choose from the existing or modified book building. Again in April, 2000, the guidelines were modified by SEBI for 100 percent one-stage book building process, under which a maximum of 60 percent of the issue was to be allotted to institutional investors and at least 15 percent to non-institutional investors applying for more than 1000 shares. The remaining 25 percent needs to be allotted on pro-rata basis to small investors. Further, modifications in guidelines were introduced by SEBI in 2004. SEBI also reintroduced the moving price band in book built IPOs which can move 50 percent either upwards and downwards depending on the demand and direction of the book being built. Again, SEBI revised the book building guidelines on August 2005 by removing

the discretionary allotment of QIBs. SEBI imposed 10 percent margin on discretionary allotment of QIBs while bidding for shares in an IPO.

7.4.3 Book Building Process Merits

Following are the merits of book building:

- It enables the issuers to reap benefits that arise from price and demand discovery.
- Book building also lowers the cost and time for making public issues.
- The investors are also benefited as they can trust the price at which the syndicate members have purchased the shares.

7.4.4 Book Building Process Limitations

The book building method has its own limitations which are as follows:

- The book building process in India is still dependent on good faith. It relies on interaction among firms, merchant bankers and investors, which is absent in India.
- In developed markets, the issue price is arrived at few hours before the issue opens. But for the Indian Scenario no such provision is available.
- There is also lack of transparency and absence of strong regulation at critical steps of book building process.
- The issues may not succeed in inviting the desired response as the price fixed for the public portion and the placement portion is the same.
- Many issues have been listed below their issue price. As such it is not a good price discovery mechanism. And the issuers may have to sell at cheaper price.
- The role of retail investors decreases in determining the price.

- The limits fixed on pricing are fungible and can also be altered depending on the market conditions.
- Although the retailer investors are not able to discover price, book building is thrust upon them.



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Moving Price Band: It refers to the price band in which depending on the demand and direction on which the book is being built the range can be moved upwards or downwards.

Public Portion: It refers to that portion which is offered to the public.



CHECK YOUR PROGRESS

Q 5: Why Book- Building came into existence? (Answer in about 60 words)

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Q 6: Distinguish between open and closed book building. (Answer in about 60 words)

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Q 7: How is a book being built under entry Norm-II? (Answer in about 80 words)

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7.5 LET US SUM UP

- Primary market is a segment of financial market that deals with new issues and mobilises fresh funds. Therefore it is also called the new issue market.
- Prior to 1992, the new issues market was regulated by the Controller of Capital Issues (CCI) under the Capital Issues (Control) Act, 1947.

However, in 1992 the act was repealed and the controls in raising of resources from the market were removed, allowing both new and existing companies to decide the price of their issue themselves.

- The primary issues are listed in the new issue market in three ways: Public Issue, Rights Issue and Private Placement. Under Public Issue the primary issues are made through Initial Public Offering (IPO) and Follow-on Public Offering (FPO). Again under Private Placement the issues are made through Private Placement, Preferential Issue and Qualified Institutions Placement.
- Initial Public Offering refers to the offering of fresh issue of securities or sale of existing securities or both for the first time to the public by an unlisted company.
- SEBI has laid down certain entry norms for raising funds through Initial Public Offerings.
- There are three entry norms as laid by SEBI. These entry norms were made so that the investors can take informed decisions and their interests are protected in case of information asymmetry and do not fall into the problems of moral hazard and adverse selection.
- The mechanism of determining offer price under Controller of Capital Issues (CCI) regime was to offer the share at fixed price. However the pattern of pricing changed with the free pricing era and there was unrealistic pricing structure, which led to inefficient functioning of the capital market. As such an alternative method of book building slowly came into existence.
- Booking Building is a recognised mechanism for raising capital. SEBI has certain guidelines to define the book building process. It defines the book building as a process by which demand for the securities which is proposed to be issued by a corporate body is elicited and built-up. Further, the price for such securities needs to be assessed for quantum and also be issued by the means of a notice, circular, advertisement, information or offer document.



7.6 FURTHER READING

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- Pathak, B. V. (2012). *The Indian Financial Sysytem*. Singapore: Pearson
- Smith, P.F. (1971). *Economics of Financial Institutions & Markets*. Prentice Hall
- Grabble, J.O. (2004). *International Financial Markets*. New York: Elsevier.



7.7 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: Initial Public Offering refers to the offering of fresh issue of securities or sale of existing securities or both for the first time to the public by an unlisted company.

Ans to Q No 2: SEBI has laid down certain entry norms for raising funds through Initial Public Offerings so that the investors can take informed decisions and their interests are protected in case of information asymmetry and do not fall into the problems of moral hazard and adverse selection.

Ans to Q No 3: Fixed price method is the method in which the issuer in consultation with the merchant banker decides the price of the issue. On the other hand, book building is the process in which the issuer and the merchant banker stipulate a floor price based on market forces.

Ans to Q No 4: Follow-on Public Offering also known as subsequent public offering refers to the offer of sale of securities by a listed company.

Ans to Q No 5: The mechanism of determining offer price under Controller of Capital Issues (CCI) regime was to offer the share at fixed price. However the pattern of pricing changed with the free pricing era and

there was unrealistic pricing structure, which led to inefficient functioning of the capital market. As such an alternative method of book building slowly came into existence.

Ans to Q No 6: Open Book refers to the system of book building where during the bidding period; there is an online display of the demand and bids. On the other hand, Closed Book refers to a system of book building, where the book is not made public. The investors bid without having any information on the bids that is submitted by other bidders

Ans to Q No 7: A book can be built under entry Norm-II, under which the book-built issue shall not offer less than 50 percent to the qualified institutional buyers and less than 25 percent to the retail investors. The remaining of the issue can be allotted to the non-institutional buyers. The basis of allotment is finalised by the Book Running Lead Managers (BRLM) within two weeks from the date of closure of the issue. The listing on the stock exchanges is done within 7 days from the finalisation of the issue.



7.8 MODEL QUESTIONS

Short Questions (Answer each question in about 150 words)

Q 1: Discuss the entry norms laid by SEBI for Initial Public Offering.

Q 2: Discuss the two methods to determine issue price?

Q 3: What are the conditions that a company needs fulfil to make a public or rights issue of debt instruments?

Q 4: Discuss the process of Rights Issue.

Q 5: What is meant by private placement? Discuss the process briefly.

Q 6: Define Book building according to SEBI guidelines.

Q7: State the difference between 75 percent and 100 percent book building options.

Q 8: Briefly explain the merits of Book Building Methods.

Q 9: Briefly explain the limitations of Book Building Methods.

Long Questions (Answer each question in about 300-500 words)

Q 1: Discuss the process of Initial Public Offerings.

Q 2: What is meant by preferential Issue? When can companies make preferential issues?

Q 3: Discuss the process of book building.

Q 4: Discuss briefly the book building guidelines.

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UNIT 8: THE SECONDARY MARKET

UNIT STRUCTURE

8.1 Learning Objectives

8.2 Introduction

8.3 Concept of Secondary Market

- 8.3.1 Types of Secondary Market
- 8.3.2 Importance of Secondary Market
- 8.3.3 Distinction between Primary and Secondary Market

8.4 Functions of Secondary Market

8.5 Instruments of Secondary Market

8.6 Functioning of Stock Market

- 8.6.1 Listing of Securities
- 8.6.2 Trading Arrangement and Settlement

8.7 Demutualization of Stock Exchange

8.8 Stock Market Index

8.9 Let Us Sum Up

8.10 Further Reading

8.11 Answers to Check Your Progress

8.12 Model Questions

8.1 LEARNING OBJECTIVES

After going through this unit, you will be able to –

- know the meaning and functions of secondary market
- distinguish between primary market and secondary market
- describe the importance of the stock market
- explain the transaction procedure in the stock market
- know the meaning of demutualization of the stock market

8.2 INTRODUCTION

Capital market, one of the two main constituents of financial market, is classified into two, namely, primary market and secondary market. In the previous unit you have already learnt about the primary market. In this unit,

you will be familiarized with the concept of another division of capital market- the secondary market.

8.3 CONCEPT OF SECONDARY MARKET

Secondary market is a market in which already issued financial instruments such as bonds and stocks are traded. Both the equity market and debt market are available in the secondary market. Equity shares, bonds, preference shares, treasury bills are the main products of secondary market. In this market investors sell securities they own through IPO (Initial Public Offering) in primary market or purchase shares that are not new. That is, here both the buyer and sellers are the investors. It is an alternative market for an existing asset. After being offered in the primary market, the securities are listed and then these are traded in the secondary market. The companies that issue securities in the primary market get listed in the stock exchange. Secondary market provides a continuous and regular market for the secondary trade of already existing securities purchased by investors directly from the companies in the primary market. Therefore, it is also known as 'after market'. Secondary market indirectly contributes to the supply of capital by making already existing securities more liquid. In India SEBI (Securities and Exchange Board of India) is the regulator of secondary market.

The main advantages of secondary market are as follows –

- Secondary market gives liquidity to all investors. The seller can easily sell the securities according to his requirements.
- It acts as an alternative source of saving.
- In secondary market huge volume of transaction take place. It reduces the transaction costs.
- Safety of the investments made by the investors in secondary market is ensured by heavy regulations imposed by the government.
- Price is flexible in secondary market. Market forces of demand and supply determines price of securities.

8.3.1 Types of Secondary Market

Secondary market can be divided into four on the basis types of transactions done between buyers and sellers-

- Direct Search Market
- Broker Market
- Dealer Market
- Auction Market
- **Direct Search Market:** Both the buyer and seller themselves get involved in search of each other. They do not take any help in doing so. Transactions are not held frequently. This distracts the brokers to get interested in the market. It is considered the least efficient secondary market.
- **Broker Market:** In this market, the brokers are involved in the transaction between the buyers and the sellers. They provide detailed information about the prices of the stock, which will be bought/sold. This market is more efficient than the direct search market.
- **Dealer Market:** There is fixed bidding of the stocks in this market. The dealers trade the inventories of stocks they own. It is considered more efficient than the broker market.
- **Auction Market:** Both the buyers and sellers negotiate and bargain for the price of the stocks in this market. Here, a person acts as an arbitrator between the buyers and sellers and he is considered as a specialist. The arbitrator is also a dealer of certain stocks.

8.3.2 Importance of Secondary Market

The importances of secondary market are as follows:

- **A Good Exit Strategy for IPO Investors:** Due to higher liquidity, the risk premium in secondary market is less. Usually, an investor can sell the stock as fast as possible. He gets the current market price which lowers the perceived risk. The value

of traded final assets gets increased. Thus, it becomes a great exit route for IPO investors.

- **Freedom to Trade:** Secondary market is an organized place for buyers and sellers to come together and transact the stocks. It provides a safe environment to the investors and they can freely buy and sell the stocks.
- **Opportunities for further transactions:** The secondary market provides an opportunity for the investors to sell their stocks if they are unwilling to own the stocks in future. So, without any hesitation and anxiousness, they can purchase stocks from the primary market and sell them whenever necessary.
- **Helps in Economic Growth:** In secondary market, there is no restriction in the choice of the investors. Therefore, investors are free to purchase any stocks which will help the whole economy to grow. Thus, this market can enhance the better productive investment for prosperity and economic growth of a country as a whole.
- **Place of Monitoring and Control:** Secondary market act as a channel in providing information regarding the demand of stocks of the investors in the market. The investors also get the information about any downfall or upward movement in the market. This makes them aware of the profit or loss of the concerned stock and they can take action accordingly.

8.3.3 Distinction between Primary and Secondary Market

There exist some differences between primary and secondary markets so far as types of deal, propensity, fluctuation of price etc. are concerned. Distinctions between the two markets are discussed on the following grounds –

- **Type of deal**: In primary market, direct transaction between companies and investors has takes place. Companies sell their new stocks and bonds for the first time and the investors buy the stocks directly from the companies. This is termed as Initial Public Offering (IPO) in financial term.

On the contrary, in secondary market transaction happens indirectly. Investors buy securities from other investors through stock exchange. That is, buying and selling takes place only between investors.

- **Parties involved**: In primary market, investment bankers are usually engaged to purchase the shares from an initial public offering (IPO).
  In secondary market, on the other hand, brokers are engaged to purchase the stocks from the investors.
- **Frequency of selling a security**: In primary market, security is sold only once while in secondary market a security can be sold multiple times.
- **Fluctuation of price**: Price is fixed in primary market. But, in secondary market, price of shares fluctuates regularly. Price depends on the forces of demand and supply.
- **Organizational structure**: There is no specific geographical location for primary market. Secondary market, on the other hand, has physical existence.
- **Gainer of the sale proceeds:** The issuing company gains the sale proceeds in primary market. In secondary market, the investors who sell the shares gain the amount on the sale of shares.



CHECK YOUR PROGRESS

Q.1: Who will gain the sale proceeds in secondary market? (Answer in about 20 words)

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Q.2: Who regulates secondary market in India? (Answer in 20 words)

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Q.3: What are the main advantages of secondary market? (Answer in about 40 words)

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8.4 FUNCTIONS OF SECONDARY MARKET

A well-organized secondary market performs several useful functions. All the functions of secondary market are done in stock exchange. A stock exchange or stock market is a market in which buying and selling of previously issued securities are done systematically. Important functions of a stock exchange are given as follows –

- **Continuous Market for Securities**: Stock market provides a ready and continuous market opportunity for securities. It helps the investors to invest in good securities and in case of any risk, it enables people to switch over from one security to another. Thus, it helps to make capital more mobile and more easily accessible.
- **Evaluation of Securities**: The performances of the companies are well reflected in the prices of securities which integrates the demand and supply of securities effectively. Stability of the companies can also be understood by the prices. Thus, investors are in a better position to take decision and invest according to their requirement.
- **Mobilizes Savings**: Attractive opportunities of investment are offered in the stock market. This opportunity attracts people to invest in securities and thereby enables the availability of funds. Thus, stock exchange facilitates mobilisation of savings and funds. The savings of the public are mobilized through mutual funds, investment trust and various other securities. Even a little amount can also be invested in mutual funds and investment trust.
- **Healthy Speculation**: The stock exchange encourages healthy speculation. The businessmen speculate and earn profits from fluctuations in prices of securities. The price of security is based on

supply and demand position. It creates a healthy trend in the market. Any artificial scarcity is prevented due to the rules and regulations of the market.

- **Protection of Investors**: Both the listing of securities and controlling of activities of the stock exchange protect the funds of the investors in stock exchange. Transactions in stock exchange take place under well defined rules and regulations.
- **Helps in Capital Formation**: Stock exchange plays a pivotal role in capital formation of the country. Companies raise funds either by issuing more shares through rights shares or bonus shares. The company can also go for diversification and raise more funds. Thus, they are able to generate more capital and this promotes economic growth in the country.
- **Liquidity:** Institutions like bank can invest their idle funds in the stock exchange and earn profit even within a short period. When necessity arises, these securities can immediately be sold for raising funds. Thus, stock exchange provides liquidity for which securities can be easily converted into cash.
- **Economic Barometer**: Stock exchange acts as an economic indicator of conditions prevailing in the country. The index of prices of various securities maintained by stock exchange indicates booms and depression. A strong government will have an upward trend in the stock market whereas an unstable government with heavy borrowings will have a downward trend in the stock market. So, generally every government adopts policies to make the stock exchange dynamic.
- **Control of Companies**: If a company wishes to trade in stock exchange, the company must get their securities listed in the exchange. The listed companies have to follow certain rules and satisfy certain conditions. They have to submit their annual report and audited balance sheet to the stock exchange. Only genuine companies can transact. Thus, stock exchange controls the companies and the interest of the investing public is protected.

- **Attracts Foreign Capital**: Due to dynamism and higher return on capital, stock exchange is capable of attracting more foreign funds. This may increase the exchange rate of the currency if more trade is undertaken by the government.



CHECK YOUR PROGRESS

Q.4: What is meant by stock exchange? (Answer in about 20 words)

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Q.5: State whether True (T) or False (F) : Stock exchange facilitates the flow of savings into the most productive and profitable channels.

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Q.6: Explain the role of secondary market in capital formation. (Answer in about 30 words)

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8.5 INSTRUMENTS OF SECONDARY MARKET

The financial product traded in secondary market is known as "instrument". Generally shares and bonds are dealt in secondary market. The shares traded in secondary market are equity shares, right shares, bonus shares and preference shares. Preference shares are of two types, namely, cumulative preference share and cumulative convertible preference share.

The bonds that are traded in secondary market are- zero coupon bond, convertible bond and treasury bills.

The instruments (i.e. shares and bonds) dealt in secondary market can be categorised into three –

- Fixed Income Instruments
- Variable Income Instruments

- Hybrid Income Instruments
- **Fixed Income Instruments**: It mainly consists of debt instruments. In this instrument, a regular form of payment like interest is ensured. On maturity the principal is repaid. Debentures, bonds, term/fixed deposit, life insurance or annuity pension plan and preference shares are the examples of fixed income instruments.
- **Variable Income Instruments**: In this instrument, the investors get an effective rate of return determined by various market forces. This instrument exhibits both higher risks and higher rewards to the investors. For example equity and derivative.
- **Hybrid Income Instrument**: In this instrument, two or more different financial instruments are combined. That is, hybrid instrument is created by combining the features of other instruments such as equity, preference and bonds. For example mutual fund, convertible debentures.



CHECK YOUR PROGRESS

Q.7: What are the instruments in secondary market? (Answer in about 20 words)

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Q.8: Distinguish between fixed income instrument and hybrid income instrument.(Answer in about 40 words)

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8.6 FUNCTIONING OF STOCK EXCHANGE

Functioning of secondary market takes place in the stock exchange. Stock exchange is a market place for buyers and sellers trading in existing securities. These can be brokers, agents, individuals. The companies first issue shares for public in primary market and after listing of these securities in the stock exchange, the securities are traded in secondary market. That is, only listed securities are traded in the stock market. Listing of securities

is the first step in trading procedure on stock exchange. Then, trading arrangement and settlement procedure are executed.

8.6.1 Listing of Securities

Listing of securities implies registration of securities of a company for trading in a stock exchange. If a public limited company wishes to issue shares to the public, it must get its shares listed in a stock exchange. It is known as listing of securities. On stock market, only the listed securities are traded. In other words, registration of the companies in the stock exchange is mandatory for trading in the stock exchange. The company, desirous of listing its securities in a stock exchange, has to satisfy certain conditions according to Companies Act. Then, the companies get their securities listed in stock exchange for trading. Offering of company's shares to the public for subscription is the first condition of listing. Only then it will be allowed to list its securities in the stock exchange. The company has to offer 60% of its minimum equity capital for public subscription. When a stock exchange is satisfied with all the aspect of a company including financial soundness, the name of the company is included in listed securities. The objectives of listing of securities of the companies in the stock exchange are as follows-

- To ensure proper management and effective control of dealings in securities.
- To protect the interest of the stakeholders and investors.
- To avoid concentration of economic power.
- To provide ready marketability and liquidity to securities.
- To mobilize savings for economic development.
- To provide free negotiability to stocks.

Listing provides an exclusive privilege to securities. Stock exchange provides transparency in transactions of listed securities.

Listed securities are divided into two- cleared or specified or Group A securities and non-cleared or unspecified or Group B securities. Cleared securities, after fulfilling certain conditions, are

included in the cleared list by the governing body of that exchange. Generally cleared securities are few in number. But they are actively traded in the stock exchange.

8.6.2 Trading Arrangement and Settlement

In the stock market, buying and selling of securities are done simultaneously. That is, when an investor purchases a certain number of shares, there is another investor who sells the shares. On receipt of shares and money by the buyer and seller respectively, the trade is settled in the stock exchange. Investors give orders to the broker to execute their transaction in the stock market. There are three phases in a stock market transaction, namely, trading, clearing and settlement. The stock exchange uses an electronic order matching to match buy and sell orders from different traders. Thus, each trade is executed. After matching of two orders, a trade is executed and then, the clearing process takes place. Clearing is the process of updating the accounts of the trading parties and arranging for the transfer of money and securities. It identifies the number of shares and amount of money received to the buyer and the seller respectively. The entire process is managed by clearing houses. After clearing, the next step is settlement i.e. fulfilment of the financial obligation identified in the clearing step.

The procedure of transaction i.e. trading arrangement and settlement in stock exchanges may be different. But, generally following steps are carried out in a trading procedure of stock exchange:

- **Selection of Broker**: The first step is the selection of broker. Individuals cannot trade in their individual capacity in the stock exchange. Transaction can be done through broker only. The brokers are the members of the stock exchange. They can be an individual or a partnership or a company or a financial institution. In India, the brokers must be registered under SEBI (Securities and Exchange Board of India). After appointment of

broker, an individual can trade shares in the stock exchange. Brokers involve in purchasing or selling of securities on behalf of the investors.

- **Opening of a Demat Account:** All securities are now in electronic format and that is why, it is mandatory that an investor must open a dematerialized account (Demat) account to hold and trade in securities. The investor or his/her broker opens a Demat account with the depository participant. Central Depository Services Ltd (CDSL) and National Depository Services Ltd (NSDL) are the two depository participants in India.
- **Placing the Order:** The investor places the order to buy or sell a particular security at a fixed or at the best possible price. The order can be placed with the broker or the individual can transact online if the broker provides such services.
- **Executing the Order:** It is the transaction whereby the seller agrees to sell and the buyer agrees to buy a security in a legally enforceable transaction. On receiving the order from the investor, the broker executes it and makes the bargain. As per the instruction of the investor, the broker executes the order i.e., he buys or sells the securities. The broker prepares a contract note for the order executed. It contains all the information about the transaction like the number of shares traded, the price, date and time of transaction etc.
- **Reporting the deal:** After making the bargain, the details of the deal are recorded by the broker and reported to the investor.
- **Settlement:** It means actual transfer of securities. It is the actual exchange of money and securities between the parties of a trade on the settlement date. This is the last step in the trading of securities done by the broker on behalf of his clients. There are two types of settlement of transaction depending upon the nature of transaction, they are –
  - **On the spot settlement:** Settlement is done immediately. In this ready delivery transaction, payment has to be made

immediately on the transfer of the securities or within a minimum period of time. Generally, this settlement follows the T+2 pattern. That is, if trade is taking place on Tuesday, it gets settled by Thursday.

- **Forward Settlement:** In this settlement, it is decided that settlement will take place on a fixed date in future. Both the parties agree to it.



CHECK YOUR PROGRESS

Q.9: What is meant by listing of securities? (Answer in about 20 words)

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Q.10: Write the objectives of listing. (Answer in about 40 words)

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8.7 DEMUTUALIZATION OF STOCK EXCHANGE

Demutualization of stock exchange is a process in which the stock exchange is converted into a public company. The conversion process is done by converting the interest of the members into shareholdings. These holdings can then be traded like the shares of a company. That is, in demutualization process, shareholders become the member of a company. Thus, Demutualized stock exchange is that exchange which is owned by share holders, having the status of public limited company and having the share capital. It provides scope of corporate and effective governance.

Generally, a mutually dependent, co-operative structure is the characteristic feature of stock exchange. Demutualization changes three aspects of stock exchange, namely, ownership, objectives and corporate governance. A flexible governance structure promoting decisive action, more participation of the investors in the governance of the exchange, greater flexibility and access to global markets are some of the positive outcome of demutualization of stock exchange.

8.8 STOCK MARKET INDEX

A stock market index is a statistical measure which shows changes taking place in the stock market. It is calculated by taking the values of the stocks. To compute the stock market index some similar stocks are selected from amongst the listed stocks in the exchange and grouped together. The criterion used for similarity of stocks may be the type of industry, market capitalization or the size of the company. Then prices of the selected stocks are used to compute the index. So, changes in the price of the selected stocks may affect the overall value of the index. Generally weighted average is taken to compute the index.

Stock market index reflects overall conditions of the stock market and direction of price movement of the products. It helps the investors to analyze the market performance by comparing current price level with the past prices. It facilitates the investors in identifying the general pattern of the market and to take decision regarding his investment. NSE Nifty, BSE Sensex are two examples of stock market indices in India.



8.9 LET US SUM UP

- Secondary market is a market in which already issued financial instruments such as bonds and stocks are traded. Both the equity market and debt market are available in the secondary market.
- There are four types of secondary market - Direct Search Market; Broker Market; Dealer Market and Auction Market.
- Secondary market performs several useful functions like mobilization of savings, evaluation of securities, continuous market for security, capital formation, providing liquidity etc. It acts as barometer of the economy.
- Functioning of secondary market is taken place in stock exchange.
- Listing of securities is the first step in trading procedure on stock exchange.

- Trading and Settlement procedure in stock exchange consists of the following stages: Selection of broker, Opening of Demat Account, Placing the order, Execution of the order, Reporting the deal and Settlement of trade.
- Demutualization of stock exchange is a process in which the stock exchange has been converted into a public company. The conversion process is done by converting the interest of the members into shareholdings.
- A stock market index is a statistical measure which shows changes taking place in the stock market. It is calculated by taking the values of the stocks.



8.10 FURTHER READING

- Gupta, S. B. (2004). *Monetary Economics.* New Delhi: S. Chand & Company Ltd.
- Pathak, B. V. (2012). *The Indian Financial Sysytem*. Singapore: Pearson
- Paul.R.R.(2004). *Money, Banking and Public Finance.* New Delhi: Kalyani Publishers
- https://efinancemanagement.com
- https://accountlearning.com



8.11 ANSWERS TO CHECK YOUR PROGRESS

Ans. to Q. No. 1: The selling investor gains the sale proceeds in secondary market.

Ans. to Q. No.2: Securities and Exchange Board of India (SEBI) regulates secondary market in India.

Ans. to Q. No.3: The main advantages of secondary market are as follows–

- Secondary market gives liquidity to all investors.
- It acts as an alternative source of saving.

- In secondary market huge volume of transaction are taken place. It reduces the transaction costs.
- The government imposes heavy regulations on secondary markets. It helps to ensure the safety of the investments made by the investors.
- Price is flexible.

Ans. to Q. No 4: A stock exchange is a market in which buying and selling of previously issued securities are done systematically.

Ans. to Q. No 5: True.

Ans. to Q. No 6: Stock exchange plays a pivotal role in capital formation of the country. Companies are raising funds either by issuing more shares through rights shares or bonus shares. The company can also go for diversification and raise more funds. Thus, they are able to generate more capital and this promotes economic growth in the country.

Ans. to Q. No 7: Listing of securities means registration of securities of a company for trading in a stock exchange.

Ans. to Q. No 8: The objectives of listing of securities of the companies in the stock exchange are as follows-

- To ensure proper management and effective control of dealings in securities.
- To protect the interest of the stakeholders and investors.
- To avoid concentration of economic power.
- To provide ready marketability and liquidity to securities.
- To mobilize savings for economic development.
- To provide free negotiability to stocks.



8.12 MODEL QUESTIONS

Short Questions (Answer each question in about 150 words)

Q.1: What is meant by demutualization of stock exchange?

Q.2: What are the products deal with in secondary market?

Q.3: What is initial public offering (IPO)?

Easy type Questions (Answer each question in about 300-500 words)

Q. 1: Assess the importance of secondary market in an economy.

Q. 2: Write the difference between primary market and secondary market on basis of source of the purchase, type of deal and fluctuation of price.

Q. 3: Explain the procedure of transaction in stock exchange.

Q. 4: How is stock market index computed?

*** ***** ***

Name of the Paper: Course Code:

Centre for Internal Quality Assurance (CIQA)
Krishna Kanta Handiqui State Open University
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Learner's Feedback on Course

Dear Learner,

Regarding the course as mentioned above, we would like to know your opinions and comments so as to improve the quality of self learning materials in future. Please respond to the following statements by ticking the number you feel most reflect your opinion. After completion of the additional comments, please detach the page and send/mail the same to us at the address given below.

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1. Approximately how many hours did you spend for studying the units in the course? | | | |
2. Please give your opinions (by √ mark) to the following items based on your reading of the block:

Sl. No.	Statements	Strongly Agree	Agree	Neither Agree nor Disagree	Disagree	Strongly Disagree
I.	The SLMs of the course fulfil the learning objectives set out in the beginning of each unit					
II.	The units of the SLM could satisfy my academic needs and expectations					
III.	The Unit writers have excellent knowledge about the course contents					
IV.	Language and contents of the units were presented at a level which I could readily understand					
V.	Ample opportunity for participation in the activities provided in the units					
VI.	Used enough Illustrations (Diagrams, tables etc.) for conceptual clarity					
VII.	Quality of content is engaging, relevant, and up-to-date					
VIII.	The self check questions are very helpful					
IX.	The Possible/model questions and the answers to check my progress have benefited me a lot					

Additional Comments: *(Please feel free to provide your open comments)*

1. Which aspects of the SLM, according to you, worked well?

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2. What sort of changes/improvements do you feel KKHSOU could implement to improve the overall quality of the SLM?

Thank you for taking the time to complete this form.

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