GBA (S6) 03
Exam. Code: IFS

Indian Financial Systems
(Finance Specialisation)

SEMESTER- VI

BUSINESS ADMINISTRATION

BLOCK - 1

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BACHELOR OF BUSINESS ADMINISTRATION

INDIAN FINANCIAL SYSTEMS

DETAILED SYLLABUS

BLOCK-1

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COURSE INTRODUCTION

This course "**Indian Financial System**" has been structured to give the learners of BBA programme the basic idea about the financial system in our country. The Indian financial system consists of financial institutions, financial markets, financial instruments and financial services.

This course consists of 14 units and the course is devided two blocks.

Block 1 deals with concept of Financial System,Indian Financial System,Financial Market,Money market in India,Capital Market in India,Primary Markets on India,Secondary Markets in India ,

Block 2 deals with financial institutions, Mutual fund, Derivative Markets, Foregin Exchange Market in India, credit rating, Depository Services and Regulation of Financial markets in India.

Each unit of these blocks includes some along-side boxes to help you know some of the difficult, unseen terms. Some "EXERCISES" have been included to help you apply your own thoughts. You may find some boxes marked with: "LET US KNOW". These boxes will provide you with some additional interesting and relevant information. Again, you will get "CHECK YOUR PROGRESS" questions. These have been designed to self-check your progress of study. It will be helpful for you 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. you in making your learning more active and efficient. 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.

BLOCK INTRODUCTION

This is the first block of the course “Indian Financial System”. This block consists of seven units.

The first unit explains meaning and Components of Financial System, Functions of Financial System, Services Provided by the Financial System, Macro economic framework analysis for exploring the role of the financial system, Relationship between the financial system and economic development

The second unit is about structure of the Financial System in India, Financial System and Its Components: Financial Intermediaries or Institutions, Financial Markets, Financial Instruments and FinancialServices

The third unit describes about financial Markets-its Introduction, Advantages and disadvantages of the financial markets, Classification of Financial Markets, Functions of Financial Markets and Structure of Financial Markets

The fourth unit enlighten us with the concept of Money Market, Functions of Money Market, Structure of Indian Money Market, Money Market Instruments/Constituents,Defects of Indian Money Market and Reforms in Indian Money Market

The fifith unit explains meaning and Structure of Indian Capital Market: Industrial Securities Market, Government Securities Market,Long term Loan Market ;Capital Market Instruments and Capital Market Intermediaries

The sixth unit explains about meaning of Primary Market, Functions of Primary Market, 5 I s s u e Mechanism in Primary Market, Role of SEBI in Primary Market and Factors leading the growth of Primary Market Investment

The seventh unit explains Meaning of Secondary Market, Functions of Secondary Market, Relationship Between Primary market and Secondary Market, Differences between primary market and secondary market, Stock Exchanges of India, Bombay Stock Exchange (BSE), Over the Counter Exchange of India (OTCEI), National Stock Exchange (NSE) and Rules of SEBI regarding Stock

The structure of Block 1 is as follows :

UNIT 1 : The Financial System

UNIT 2 : Indian Financial System

UNIT 3 : Financial Market

UNIT 4 : Money Market in India

UNIT 5 : Capital Market in India

UNIT 6 : Primary Markets in India

UNIT 7 : Secondary Markets in India

UNIT 1: THE FINANCIAL SYSTEM

UNIT STRUCTURE

1.1 Learning Objectives

1.2 Introduction

1.3 Meaning and Components of Financial System

1.4 Functions of Financial System

1.5 Services provided by the Financial System

1.6 Macro economic framework analysis for exploring the role of the financial system

1.7 Relationship between the financial system and economic development

1.8 Let Us sum Up

1.9 Further Reading

1.10 Answers To Check Your Progress

1.11 Model Questions

1.1 LEARNING OBJECTIVES

After going through this unit you will be able to :

- explain the financial system and its importance
- explain the components and the functions of a financial system
- dicuss the role of the financial systems in the economic development

1.2 INTRODUCTION

In this unit we are going to learn the concept of financial system.To understand the concept of financial system, one should know some of the tools which will be discussed in various sections of this unit.

Financial system is a system, which facilitates the process of capital accumulation by transferring financial resources from savers to the investors. With financial resources, the investors create physical assets, viz. land, buildings, plants and machineries.

Let us now discuss the various aspects of financial system in the following sections.

1.3 MEANING AND COMPONENTS OF FINANCIAL SYSTEM

The word 'System' is a set of inter-related components working together to achieve some purpose. Human body, computer, TV, car, bank, and educational institutes are the examples of system. Financial system is a set of inter-related institutions, instruments and markets, which raise (savings) funds and channels them to their efficient use. In other words, financial system comprises of individuals (savers), intermediaries (financial institutions), markets (money and capital markets), and users (borrowers of money). Hence, financial system acts as an intermediary between the savers and users (investors). It provides the principal means by which savings are transformed into investments. It helps produce goods and services, which in turn improves standard of living. There are areas or people with surplus funds and there are those with a deficit. Van Horne defined the financial system as the purpose of financial markets to allocate savings efficiently in an economy to ultimate users either for investment in real assets or for consumption. Christy has opined that the objective of the financial system is to "supply funds to various sectors and activities of the economy in ways that promote the fullest possible utilization of resources without the destabilizing consequence of price level changes or unnecessary interference with
individual desires."

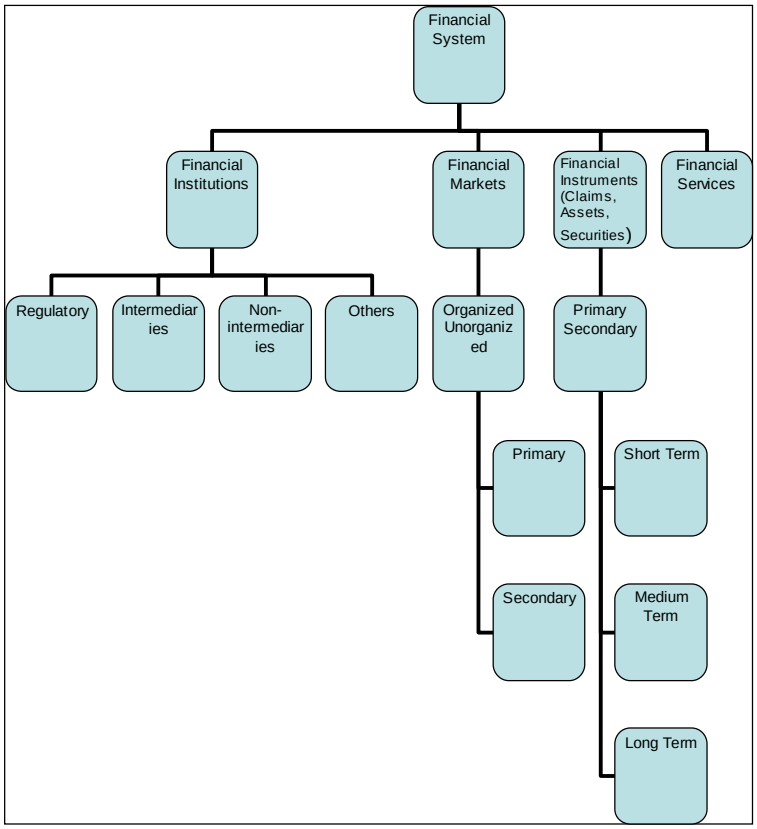
According to Robinson, the function of the system is "to provide a link between savings and investment for the creation of new wealth and to permit portfolio adjustment in the composition of the existing wealth."

From the above definitions, it may be said that the primary function of the financial system is the mobilisation of savings, their

distribution for industrial investment and stimulating capital formation to accelerate the process of economic growth.

A financial system functions as an intermediary and facilitates the flow of funds from the areas of surplus to the areas of deficit. In fact developed financial system is an indication of economic development of a country. Given its role in the allocation of resources, the efficient functioning of the financial system is of critical importance. Figure 1.1 shows the components of the financial system.

While an understanding of the financial system is useful to all informed citizens, it is particularly useful to the financial manager.The financial manager's task is to provide sufficient funds to meet the business needs. Therefore, a clear understanding of the financial system is of utmost importance. In other words, knowledge about the financial institutions that provide finance; the financial markets from which to raise funds and the different instrument available to raise the finance is required.



Let us now try to understand the various functions of the financial system in the following sections



CHECK YOUR PROGRESS

Q1: Define Financial System

.....

.....

Q2: Write the components of the financial system.

.....

.....

1.4 FUNCTIONS OF THE FINANCIAL SYSTEM

The financial system facilitates the transformation of savings into investment and consumption. The financial system performs the following interrelated functions that are essential to modern economy:

- It provides a payment system for the exchange of goods and services.
- It enables the pooling of funds for undertaking large scale enterprises.
- It provides a mechanism for transfer of resources.
- It provides a way for managing uncertainty and controlling risk.
- It generates information that helps in coordinating decentralized decision-making.
- It helps in dealing with the incentive problem when one party has an informational advantage.

We elaborate on these points in the paragraphs that follows.

(i) Payment System : Financial system helps for payment of goods and services. It provides a payment system for the exchange of goods and services. We find that majority of buyers and sellers of products or services prefer to pay or receive money through banks to avoid the risk of carrying cash in large amount.

(ii) Pooling of funds : Modern business organizations require large investments which are often beyond the means of an individual or groups of individuals. Financial markets and financial intermediaries which are an integral part of the financial system facilitate the pooling of household savings for financing business. Hence, we can also say that the financial system enables households to participate in large enterprises. Small savings are pooled together and transformed into large amounts which promoters of businesses can avail to meet their financial needs.

(iii) Maturity Transformation: The financial system offers alternative forms of deposits to savers with different maturity and provides these funds to borrowers for different maturity periods. Thus, it facilitates the transfer of financial resources across time and space.

(iv) Risk Management: The financial system helps to reduce the risk of savers. Financial institutions like banks and mutual funds mobilizes fund from savers and lend them to borrowers and thereby bears the risk of borrowing.

(v) Provision of Liquidity: The financial system provides a mechanism for an investor to sale securities whenever there is the need for cash.

(vi) Price Information: Financial markets provide information that helps in coordinating decentralized decision making. Price information such as interest rates and security prices are used by households or their agents in making their consumption-saving decisions and in deciding their wealth allocation portfolio.

(vii) Financial (services) Advice: Now-a-days financial services have occupied much important place in financial system. Under this the financial system provides advices and services to both savers and investors.

1.5 SERVICES PROVIDED BY THE FINANCIAL SYSTEM

- **Risk Sharing:** Financial system provides risk sharing by allowing savers to hold many assets. It also means financial system enables individuals to transfer risk. Financial markets can create instruments to transfer risk from savers to borrowers who do not like uncertainty in returns or payments to savers or investors who are willing to bear risk. The ability of the financial system to provide risk sharing makes savers more willing to buy borrowers' IOUs. This willingness, in turn, increases borrowers' ability to raise funds in the financial system.
- **Liquidity:** The second service that financial system provides for savers and borrowers is liquidity, which is the ease with which an asset can be exchanges for money to purchase other assets or exchanges for goods and services. Most of the savers view the liquidity as a benefit. If an individual need their assets for their own consumption and investment, they can just exchange it. Liquid assets allow an individual or firm to respond quickly to new opportunities or unexpected events. Bonds, stocks, or checking accounts are created by financial assets, which have more liquid than cars, machinery and real estate.
- **Information:** The third service of financial system is collection and communication of information or we can say that it is the facts about borrowers an expectations about returns on financial assets. The first informational role the financial system plays is to gather information. That includes finding out about prospective borrowers and what they will do with borrowed funds. Another problem that exists in most transactions is asymmetric information. This means that borrowers posses information about their opportunities or activities that they don't disclose to lenders pr creditors and can take advantage of this information. The second informational role that financial system plays is communication of information. Financial markets do that job by incorporating information into the prices of stocks, bonds, and

other financial assets. Savers and borrowers receive the benefits of information from the financial system by looking at asset returns. As long as financial market participants are informed, the information works its way into asset returns and prices.

1.6 MACRO ECONOMIC FRAMEWORK ANALYSIS FOR EXPLORING THE ROLE OF THE FINANCIAL SYSTEM

To understand the role of financial system in the economy, the following concepts and tools should be considered:

1. **National Income accounts:** National income accounts extend the accounting concept to the economy as a whole. National income accounts of the sector–of-origin reveal the contribution made by the different sectors of the economy to the national income and the portion of the national income they consume.
2. **Flow of Funds Accounts:** The national income accounts do not tell anything about monetary or financial transactions whereby one sector places its savings at the disposal of the other sectors of the economy by means of loans, capital transfers, etc. In fact, the national income accounts do not take into consideration the financial dimensions of economic activity and they describe product accounts as if they are operated through barter. The flow of funds accounts are meant to supplement national income and product accounts. The flow of funds accounts list the sources of all funds received and the uses to which they are put within the economy. They show the financial transactions among different sectors of the economy and the link between saving and investment aggregates with lending and borrowing by them.
3. **Saving and Investment:** One of the basic influences of financial development on growth is the saving and investment rate. Among the many roles of the financial system is the augmenting and channelising of savings into productive avenues for economic growth. A study of trends in saving and investment is necessary to evaluate the role of financial system in the economy.



CHECK YOUR PROGRESS

Q3: Write any two functions of Financial System

.....

.....

Q4: What is meant by National Income accounts:

.....

.....

1.7 RELATIONSHIP BETWEEN THE FINANCIAL SYSTEM AND ECONOMIC DEVELOPMENT

The development of any country depends on the economic growth the country achieves over a period of time. Economic growth deals about investment and production and also the extent of Gross Domestic Product in a country. Only when this grows, the people will experience growth in the form of improved standard of living, namely economic development.

The 'financial system' is concerned with the mobilization of the savings of the public and providing of necessary funds to the needy persons and institutions for enabling the production of goods and/or for provision of services and allows the exchange of funds between lenders, investors, and borrowers.

The financial system that facilitates the movement of finance from the persons who have surplus funds to the persons who need it is called as financial system.

The following are the role of financial system in economic development of a country.

1. **Savings-investment relationship:** To attain economic development, a country needs more investment and production. This can happen only when there is a facility for savings. As, such savings are channelized

to productive resources in the form of investment. Here, the role of financial institutions is important, since they induce the public to save by offering attractive interest rates.

2. **Financial systems help in growth of capital market:** Every business requires two types of capital namely, fixed capital and working capital. Fixed Capital is raised through capital market by the issue of debentures and shares. Public and other financial institutions invest in them in order to get a good return with minimized risks. For working capital, we have money market, where short-term loans could be raised by the businessmen through the issue of various credit instruments such as bills, promissory notes, etc.
3. **Foreign Exchange Market:** Foreign Exchange Market enables exporters and importers to receive and raise funds for settling transactions. It also enables banks to borrow from and lend to different types of customers in various foreign currencies.
4. **Government securities market:** Financial system enables the state and central governments to raise both short-term and long-term funds through the issue of bills and bonds which carry attractive rates of interest along with tax concessions.
5. **Financial system helps in Infrastructure and Growth:** The financial system play a crucial role by providing funds for the growth of infrastructure industries. As we know that, economic development of any country depends on the infrastructure facility available in the country. In the absence of key industries like coal, power and oil, development of other industries will be hampered.
6. **Financial system helps in development of Trade:** The financial system helps in the promotion of both domestic and foreign trade. The financial system not only helps the traders but also various financial institutions. Some of the capital goods are sold through hire purchase and installment system, both in the domestic and foreign trade. As a result of all these, the growth of the country takes place.
7. **Employment Growth is boosted by financial system:** The presence of financial system will generate more employment opportunities in the

country. The money market which is a part of financial system provides working capital to the businessmen and manufacturers due to which production increases, resulting in generating more employment opportunities.

8. **Financial system ensures balanced growth:** Economic development requires a balanced growth which means growth in all the sectors simultaneously.
9. **Role of financial system in attracting foreign capital:** Financial system promotes capital market. A dynamic capital market (we will discuss this concept in unit 5 of this course) is capable of attracting funds both from domestic and abroad.
10. **Financial system role in Electronic development:** Due to the development of technology and the introduction of computers in the financial system, the transactions have increased diversely which brought the changes for the all round development of the country.



1.8 LET US SUM UP

In this unit we have discussed the following:

- Financial system is a set of inter-related institutions, instruments and markets, which raise (savings) funds and channels them to their efficient use. It comprises of individuals (savers), intermediaries (financial institutions), markets (money and capital markets), and users (borrowers of money).
- A clear understanding of the financial system is of utmost importance to the financial manager whose task is to provide sufficient funds to meet the business needs.
- The financial system facilitates the transformation of savings into investment and consumption. The financial system (i) provides a payment system for the exchange of goods and services, (ii) enables the pooling of funds, (iii) provides a mechanism for transfer of resources, (iv) provides a way for managing uncertainty and risk, (v) generates information.

- The financial system facilitates the transformation of savings into investment and consumption. The financial system performs the following interrelated functions that are essential to modern economy:Payment System, Pooling of funds,Maturity Transformation,Risk Management,Provision of Liquidity, Price Information
- Services Provided by the Financial System are:Risk Sharing,Liquidity and Information
- The role of financial system in the economic development are Savings-investment relationship, Financial systems help in growth of capital market, Foreign Exchange Market, Government securities market, Financial system helps in Infrastructure and Growth, Financial system helps in development of Trade, Employment Growth is boosted by financial system, Financial system ensures balanced growth, Role of financial system in attracting foreign capital, Financial system role in Electronic development.



1.9 FURTHER READING

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3) Srivastava, R.M. (2009). *Management of Indian financial institutions.* New Delhi, Himalaya Publishing House.
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1.10 ANSWERS TO CHECK YOUR PROGRESS

Ans to QNo.1: According to Robinson, the function of the system is "to provide a link between savings and investment for the creation

of new wealth and to permit portfolio adjustment in the composition of the existing wealth.

Ans to QNo.2: The components of the financial system. are:Financial Intermediaries, financial Markets and Financial Instruments.

Ans to QNo.3: The functions of financial system are: 1. It provides a payment system for the exchange of goods and services.2. It enables the pooling of funds for undertaking large scale enterprises.

Ans to QNo. 4: National income accounts of the sector–of-origin reveal the contribution made by the different sectors of the economy to the national income and the portion of the national income they consume.



1.11 MODEL QUESTIONS

Q 1. Discuss in detail the functions performed by the financial system.

Q 2. Why is it necessary to study the financial system?

Q 3. Discuss the functions of the Financial System.

Q 4. What are the Services Provided by the Financial System

Q 5. Write short notes on:

a. National Income accounts

b. Flow of Funds Accounts

c. Saving and Investment

Q 6. Dusccuss how financial system helps in the economic development of a country.

*** **** ***

UNIT 2 : INDIAN FINANCIAL SYSTEM

UNIT STRUCTURE

2.1 Learning Objectives

2.2 Introduction

2.3 Structure of the Financial System in India

2.4 Financial System and Its Components

- 2.4.1 Financial Intermediaries or Institutions
- 2.4.2 Financial Markets
- 2.4.3 Financial Instruments
- 2.4.4 Financial Services

2.5 Let Us Sum Up

2.6 Further Reading

2.7 Answers to Check Your Progress

2.8 Model Questions

2.1 LEARNING OBJECTIVES

After going through this unit you will be able to:

- discuss the structure of the financial system in India
- discuss the different financial intermediaries
- describe various functions of financial market and instruments

2.2 INTRODUCTION

In the previous unit we have discussed in detail the concept of financial system. In this unit we will discuss about the 'Indian Financial System'.

Economic development of a nation, inter alia, depends on the rate of increase in savings and investment. When there is an increase in income, a part of it is saved and in course of time this savings is used in productive activities. In the accomplishment of this networking a well organized financial system is indispensable. The advent of liberalisation in 1990-91 integrated the different components of financial system and facilitated various new developments and role of finance become more and more important for

economy. This unit highlights role of finance, classification of finance, financial system and its components, financial intermediaries, financial markets and their functions.

2.3 THE STRUCTURTE OF THE FINANCIAL SYSTEM IN INDIA

As we have already discussed that, the financial system of a country is an important tool for economic development of the country, as it helps in creation of wealth by linking savings with investments. It facilitates the flow of funds from the households(savers) to business firms (investors) to aid in wealth creation and development of both the parties.

The financial system of a country is concerned with:

- Allocation and mobilization of savings
- Provision of funds
- Facilitating the financial transactions
- Developing financial markets
- Provision of legal financial framework
- Provision of financial and advisory services

The Indian financial system is broadly classified into two broad groups:

i) Organised sector and *(ii)* unorganised sector.

The financial system is also divided into users of financial services and providers. Financial institutions sell their services to households, businesses and government. They are the users of the financial services. The boundaries between these sectors are not always clear cut.

In the case of *providers* of *financial services,* although financial systems differ from country to country, there are many similarities.

(i) Central bank

(ii) Banks

(iii) Financial institutions

(iv) Money and capital markets and

(v) Informal financial enterprises.

i) Organised Indian Financial System

The organised financial system comprises of an impressive network of banks, other financial and investment institutions and a range of financial instruments, which together function in fairly developed capital and money markets. Short-term funds are mainly provided by the commercial and cooperative banking structure. Nine-tenth of such banking business is managed by twenty-eight leading banks which are in the public sector. In addition to commercial banks, there is the network of cooperative banks and land development banks at state, district and block levels. With around two-third share in the total assets in the financial system, banks play an important role. Of late, Indian banks have also diversified into areas such as merchant banking, mutual funds, leasing and factoring.

The organised financial system comprises the following sub-systems:

1. Banking system
2. Cooperative system
3. Development Banking system

(i) Public sector

(ii) Private sector

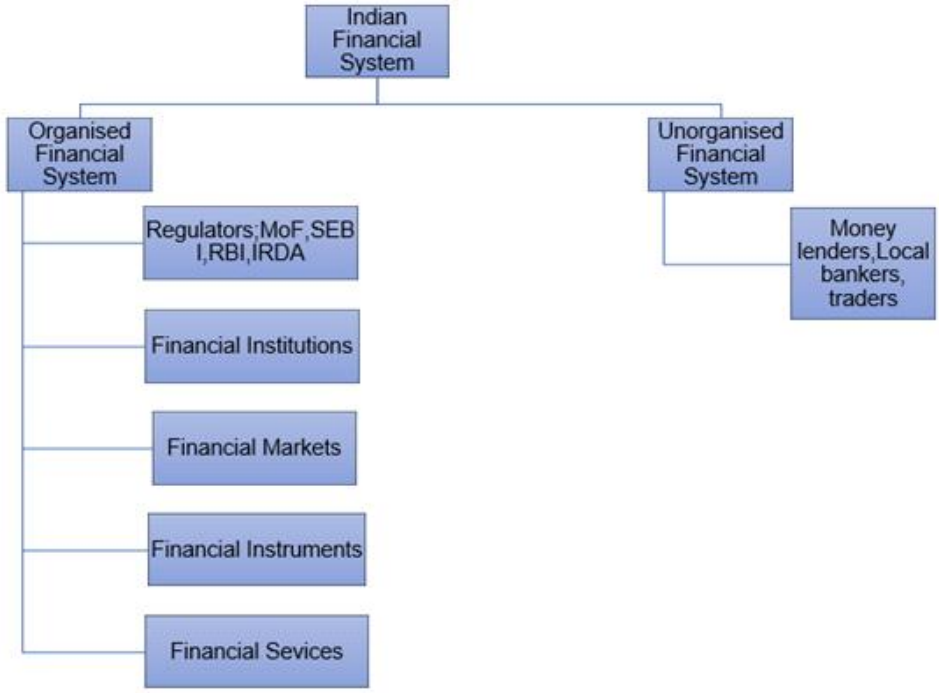
4. Money markets and
5. Financial companies/institutions.

Over the years, the structure of financial institutions in India has developed and become broad based. The system has developed in three areas - state, cooperative and private. Rural and urban areas are well served by the cooperative sector as well as by corporate bodies with national status. There are more than 4,58,782 institutions channellising credit into the various areas of the economy.

ii) Unorganised Financial System :

On the other hand, the unorganised financial system comprises of relatively less controlled moneylenders, indigenous bankers, lending pawn brokers, landlords, traders etc. This part of the financial system is not directly amenable to control by the Reserve Bank of India (RBI). There are a host of financial companies, investment companies, chit funds etc., which are also not regulated by the RBI or the government in a systematic manner.

However, they are also governed by rules and regulations and are, therefore within the orbit of the monetary authorities.



2.4 FINANCIAL SYSTEM AND ITS COMPONENTS

In the previous unit, i.e. in unit 1 we oulined the components of financial system, now let us describe the financial system and its components in detail. There are four components of the system: Intermediaries, markets, instruments and services. The term “Financial System” is comprised of two words- Finance and System. Finance means monetary resources comprising ownership funds and debts. System indicates a set of interrelated parts working together to achieve some purpose. An economy’s financial system exists to organize the settlement of payments, to raise and allocate finance, and to manage the risks associated with financing and exchange. A developed financial system is one that has a secure and efficient payment system, security markets and financial intermediaries that arrange financing, and derivative markets and financial institutions that provide access to risk management instruments**.**

The financing system has two general roles — to mobilize surplus

funds from people and organizations, and to allocate them among deficit people and organizations. An investor is an example of a surplus unit, whereas a borrower is an example of a deficit unit. Mobilizing funds generates returns for surplus units, which generally enhances their wealth and economic well-being. It also allows deficit units to enhance their productive and purchasing capacities, and thus improves an economy's production and consumption potential. Funds are mobilized either as debt or equity. Debt funds are supplied as a loan and generally the repayments are scheduled, whereas equity funds acquire part ownership of a business and their returns depend on the future profitability of the business.

The global financial system (GFS) is a financial system consisting of institutions and regulations that act on the international level, as opposed to those that act on a national or regional level. The main players are the global institutions, such as International Monetary Fund and Bank for International Settlements, national agencies and government departments, e.g., central banks and finance ministries, and private institutions acting on the global scale, e.g., banks and hedge funds.

Indian Financial System (IFS) refers to a set of institutional arrangement through which financial surplus of our economy are mobilised from surplus units and transferred to the deficit units. This institutional arrangements includes -

i) The conditions and mechanisms governing the production, distribution, exchange and holding of financial assets or instruments,
ii) Working of financial markets, and
iii) Organisation and operation of financial institutions.

Components of Financial System: There are four main components of the financial system, they are –

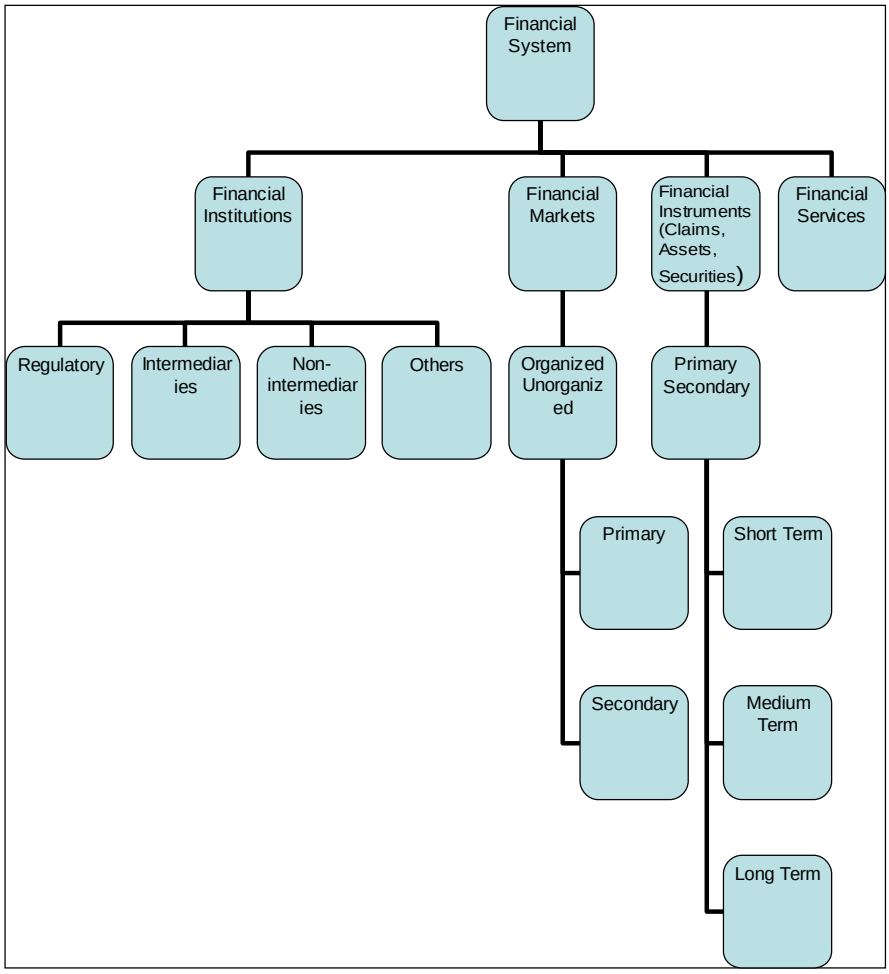


Fig 2.1 : Financial System

2.4.1 Financial Intermediaries or Institutions

The term financial intermediary may refer to an institution, firm or individual who performs intermediation between two or more parties in a financial context. Typically the first party is a provider of a product or service and the second party is a consumer or customer. A financial intermediary is typically an institution that facilitates the channeling of funds between lenders and borrowers indirectly. That is, savers (lenders) give funds to an intermediary institution (such as banks), and then that institution in turn gives those funds to spenders (borrowers). This may be in the form of loans or mortgages. Alternatively, they may lend the money directly via the financial markets which is known as financial disintermediation. In the indirect

process, known also as financial intermediation, funds are raised by deposit-taking institutions and then lent to borrowers. The funds raised are generally in the form of deposits.

Financial institutions or financial intermediaries act as half-way houses between the primary lenders and the final borrowers. They borrow funds (or accept deposits) from those who are willing to give up their current purchasing power and lend to (or buy securities from) those who require the funds for meeting the current expenditures. Financial institutions are generally divided into two categories - banks and non-bank financial institutions. The main difference is that the banks possess while the non-bank do not possess the demand deposits or credit creating power. Banking institutions can be divided into various categories according to their functions i.e. commercial banks, development banks, investment banks, cooperative banks and regional rural banks. On the other hand, non-banking finance companies can be categorized as loan and finance companies, leasing and hire-purchase companies, housing finance companies, insurance companies, chit funds and mutual benefit funds and other residual finance companies.

2.4.2 Financial Markets

Financial markets are markets which cater to the financial needs of individuals, firms and institutions required for short as well as for long period. Financial markets could also mean:

- The mechanism that facilitate the parking of surplus money of individuals, firms and investment bankers to earn return.
- Organizations that facilitate the trade in financial products i.e. Stock exchanges facilitate the trade in stocks, bonds and warrants.

  Hence, financial market is a mechanism that allows people to easily buy and sell (trade) financial securities (such as stocks and bonds), commodities (such as precious metals or agricultural

goods), and other fungible items of value at low transaction costs and at prices that reflect the efficient market hypothesis. Financial markets facilitate:

- The raising of capital (in the capital markets);
- The transfer of risk (in the derivatives markets); and
- International trade (in the currency markets)..

Financial market include different sub- markets-

- Money markets, which provide short term debt financing and investment
- The capital markets consist of primary markets and secondary markets. Newly issued securities are bought or sold in primary markets. Secondary markets allow investors to sell securities that they hold or buy.
- Commodity markets, which facilitate the trading of commodities.
- Derivatives markets, which provide instruments for the management of financial risk.
- Futures markets, which provide standardized forward contracts for trading products at some future date.
- Insurance markets, which facilitate the redistribution of various risks.
- Foreign exchange markets, which facilitate the trading of foreign currencies.

However, the financial markets are broadly and commonly divided into two types -

i) **Money Market -** The money market is the market which deals with short-term funds in the economy. It refers to the institutional arrangements facilitating borrowings and lending of short-term funds. It is the market in which financial institutions, mainly banks lend and borrow money or near money assets from each other, trade in securities, treasury bills and other financial instruments such as certificates of deposits or enter into agreements such as Repos and Reverse Repos. In a money market, funds can be borrowed for a short period varying from a day, a week, a

month or 3 to 6 months, sometimes up to one year and against different types of instruments, such as, treasury bills, bill of exchange, bankers' acceptances, and bonds etc., called "near money".

The basic functions of money market are-

- To provide efficient mechanism for adjustment of liquidity positions of commercial banks, non-bank financial institutions, business firms and other investors.
- To provide a platform for the central bank of the country to control and manage the money supply and the liquidity in the economy.
- To bridge between short term surpluses and deficits.
- To provide a realistic price for short term money.

Participants who enters into the transactions in the money market are-

- Central Government
- State Government
- Public Sector Undertaking
- Scheduled Commercial Banks
- Private Sector Companies
- Provident Funds
- Life Insurance Companies
- General Insurance Companies
- Mutual Funds
- Non-banking Financial Companies
- Primary Dealers

ii) Capital Market - The term capital market refers to the institutional arrangements for facilitating the borrowing and lending of long-term funds. A capital market may be defined as an organised mechanism for effective and efficient transfer of money capital or financial resources from the investing parties, i.e. individuals or institutional savers to the entrepreneurs engaged in industry or commerce on the business would either be in the private or public sectors of an economy. All the long term capital needs

are met by the capital market. Capital market is a central coordinating and directing mechanism for free and balanced flow of financial resources into the economic system operating in a country.

Functions of Capital market

- Provides a platform for raising long term funds
- Act as an intermediaries between buyers and sellers of securities
- Facilitate an organized trading mechanism for stock and securities.
- Provide a standard price for the securities.
- Nexus between savings and investment.

Classification of Capital market

Capital markets consist of:

a. Stock markets, which provide financing through the issuance of shares or common stock, and enable the subsequent trading thereof.

b. Bond markets, which provide financing through the issuance of Bonds, and enable the subsequent trading thereof.

c. Derivative market where derivative products like stock futures, index futures and options are traded. Financial derivative is an agreement between two parties for buying or selling an underlying asset (Stock or index) whose value is derived from the underlying financial assets or claim.



CHECK YOUR PROGRESS

Q 1: What is meant by Financial Market?

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Q2: Which of the following is not a money market participant?

(a) State Government (b) Public Sector Undertaking

(c) Scheduled Commercial Banks (d) Stock Exchange

Q 3: Which of the following is a capital market instrument?

(a) Certificates of Deposits (b) Equity Share

(c) Commercial Paper (d) Treasury Bills

In terms of the access, the financial market can be classified as primary market and secondary market.

a. Primary market is the market where initial issues are sold and bought. When a company issues shares for the first time, it is trade through primary market .This market is also known as new issue market (NIM). The primary market is facilitated by the intermediaries like issue managers, issuing banks, registrars, book-runners etc. who intermediate between investors and issuers.

b. The secondary market consists of stock exchanges and over the counter exchanges. In the secondary market the secondhand issues are sold and bought and securities change hands from one investor to another. Stock brokers play an important role as the intermediaries between stock exchanges and the investors. Functioning of the capital market is regulated by the Securities and Exchange Board of India (SEBI).



ACTIVITY 2.1

Visit a stock broking firm and observe the functions performed by it. On return list them out.

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2.4.3 Financial Instruments

The financial instruments are the claims to money and perform some functions of money. Financial instruments denote any form of funding

medium - mostly those used for borrowing and investing in financial markets, e. g. bills of exchange, bonds, etc. They have high degree of liquidity but are not as liquid as money.

From the intermediary point of view, financial instruments can be categorized into two types -

i) **Primary or Direct instruments -** They are the financial claims against real-sector units created by real-sector units as ultimate borrowers for raising funds to finance their deficit spending, they are the obligation of ultimate borrowers. The examples are bills, bonds, equities, book debts etc.

ii) **Secondary or Indirect Instruments -** they are financial claims issued by financial institutions against themselves to raise funds from the public. These assets are the obligations of the financial institutions. The examples are bank deposits, life insurance policies, units of Unit Trust of India etc.

LET US KNOW



Financial instruments can also be categorized by form depending on whether they are cash instruments or derivative instruments:

- Cash instruments are financial instruments whose value is determined directly by markets. They can be divided into securities, which are readily transferable, and other *cash* instruments such as loans and deposits, where both borrower and lender have to agree on a transfer.
- Derivative instruments are financial instruments which derive their value from some other financial instrument or variable. They can be divided into exchange-traded derivatives and over-the-counter (OTC) derivatives.

Alternatively, financial instruments can be categorized by "asset class". They are -

- Equity based (reflecting ownership of the issuing entity) or
- Debt based (reflecting a loan the investor has made to the issuing entity). If it is debt, it can be further categorized into short term (less than one year) or long term.

Foreign Exchange instruments and transactions are neither debt nor equity based and belong in their own category.

Further, instruments can be categorized into two types by its "market class". They are-

a) **Money Market Instruments**-instruments traded in the money market. Important instruments in this market are-

- **Call money /Notice money**-call money or call deposits are those moneys which are lent on condition to repay on call. Notice money refers to the money lent and repaid on a certain day's notice from the lenders. The period of these transactions varies between overnight and to a maximum of fourteen days.
- **Term money**-Transactions between inter-bank participants for a period of more then 14 days are called term money.
- **Certificates of Deposits**- Certificate of deposit is a money market instrument issued in dematerialized form or as a usance promissory note, against funds deposited at a bank or other eligible financial institution for a specified period. These are issued by scheduled commercial banks (excluding regional rural banks and local area banks) and all India financial institutions that have been permitted by RBI. The maturity period of certificates of deposits issued by the banks should not be less than 7 days and more then one year while for certificates of deposits issued by the financial institutions is not less then one year and more than three years.
- **Commercial Paper-** Commercial paper (CP) is an instrument issued by corporates, primary dealers and all India financial institutions to raise short-term resources .CPs are issued in the form of promissory note for maturities between minimum of

7days and a maximum up to one year from the date of issue. These can also be issued in dematerialized form through any of the depositories approved by and registered with SEBI. Issuer of the CPs has to obtain prior permission from the RBI for the issue. CP may be issued to individuals, banks, other corporate bodies, Non-resident Indians and foreign institutional Investors. CPs are issued at a discount to the face value as determined by the issuer.

- **Bill Re-discounting Schemes (BRDS) -** This is a money market scheme where by banks may raise funds by issue of Usance promissory notes in convenient lots and maturities matching the genuine trade bills discounted by them. This instrument promotes liquidity in the money market. BRDS transaction can be done for a minimum period of 15 days and maximum period of 90days. The bank borrowing under this scheme issues a Usance promissory note to the lender as well as a certificate to the effect that the bank holds genuine bills equal to the amount of the transactions on its book.
- **Inter-Bank Participation Certificates (IBPCs)-** IBPCs are instruments issued by scheduled commercial banks only to raise funds or to deploy short –term surplus. IBPCs are of two types- with risk sharing and without risk sharing. The minimum period shall be 91days and maximum period 180 days in case of IBPCs on risk sharing basis and in the case of IBPCs under non-risk sharing basis the total period is limited to 90 days. IBPCs are not transferable and cannot be redeemed before due date. Interest rates are determined between the issuing bank and participatory bank.
- **Collateralized Borrowing and Lending (CBLO) -** CBLO is a discounted instrument available in electronic book entry form for the maturity period ranging from one day to 90 days against securities which are placed with the Clearing Corporation of India either as margin or otherwise.. This is an instrument for those

entities who have either been phased out from inter-bank call money market or have been given restricted participation in terms of ceiling on call borrowing and lending transactions and who do not have access to the call money. Banks, financial institutions, NBFCs (Non- Bank Financial Corpotrations), insurance companies, mutual funds, primary dealers, non-government provident funds, corporates etc. are eligible to deal in CBLO.

- **Treasury Bills** (T-bills) - Treasury bill is a very common short term money market instrument issued by the Government of India through the RBI. T-bill is issued at a maturity period of 14 days, 28 days, 91 days, 182 days and 364 days. It is issued at a discount to its face value which is usually Rs.100/-.The discount rate is determined by the RBI on the basis of the bid submitted by the participants in the auction. Auctions are normally conducted every week. T-bills are used by the RBI as credit control tool.

b) Capital market Instruments- Instrument issued to raise long term funds is called capital market instruments. They are-

Bonds- Bonds are debt instruments issued by corporate bodies, governments or development financial institutions to raise long term finance. These are fixed interest bearing instruments. They can be issued with or without security. Bonds are negotiable instruments governed by the law of contract and are generally transferable by endorsement.

Debentures- A debenture is also a debt instrument issued by a company for raising funds from the public and institutions and offers to pay interest on the funds borrowed by the company. The maturity of these instruments ranges between one to ten years. Debentures are governed by provisions of the company law and are transferable only by registration. On the basis of security, debentures can classified as secured (secured by a charge on the fixed assets of the company) and Unsecured (not secured by any charge on assets). On the basis of convertibility,

they can be classified as Non-convertible, Partly convertible, Fully Convertible, and Optionally Convertible.

Equity Shares- According to the Companies Act, 1956, equity share is a part of the total capital of the company. Equity shareholders entitled for a share of profit (Dividend) of the company and the voting right. However, they also bear the risk of corporate performance. Shares are ownership instruments but transferable. Shares are issued by the companies to raise funds required for long term in the primary capital market while the secondhand shares are traded in the secondary market through stock exchanges.

Preference Shares- Preference shares are the shareholders who assume only limited risks and entitled to a predetermined dividend .They have no voting rights. Holders of preference shares enjoy the preference to receive their capital over the equity shareholders. These instruments are issued when there is a need for long term funds and at the same time shareholders do not want to dilute the ownership in the company. Though these types of shares are marketable, they are not widely traded on account of a fixed dividend.

Global Depository Receipts (GDR) - Global Depository Receipts, also known as GDRs, are internationally traded equity instruments issued against equity shares .They represent a fixed ratio of Indian shares quoted on BSE (Bombay Stock Exchange). GDRs are issued by international depository and denominated in US Dollars. They are negotiable certificates and they are freely traded in the overseas financial markets including Europe and USA.

American Depository Receipts (ADR)-American Depository Receipts, popularly called ADRs are similar kind of instrument like GDR. However, ADRs are traded in US markets mostly. They are denominated in US Dollars. These instruments are issued in accordance with the scheme for issue of Foreign Currency

Convertible Bonds and Ordinary Shares (through Depository Receipt Mechanism) Scheme, 1993 and guidelines issued by the Central Government there under from time to time.

2.4.4 Financial Services

The industry that has grown up to encourage people to put their money into investment and which provides the facilities for doing so is called the "Finacial Services Sector". Simply put, all types of activities involved in the transformation of surplus in to investments, transfer of financial resources, financial innovation are called financial services. The scope of the financial services is very wide, unlimited and dynamic. However, banking services are not covered under financial services because of their independent legal interpretation. The main distinction between banking and financial services is bank offers current account, cheque facility and credit creation which can not be offered other than a banking company. Financial Services may be divided into two groups - Fund based activities and Non-fund-based activities.

Fund-based activities

- Leasing
- Hire Purchase
- Venture Capital
- Consumer Financing
- Underwriting or investment in securities
- Dealing in money market
- Dealing in Forex market
- Real Estate Financing
- Housing finance
- Insurance
- Mutual funds etc.

Non-fund based activities

These financial services do not directly involve funds –

- Merchant banking(issue management, placement of securities)
- Portfolio Management
- Industrial investment Consultancy and Project Advisory Services
- Broking and Portfolio Investment Services
- Risk management
- Bill Discounting,
- Factoring
- Depository and Custodian services
- Credit rating etc.



CHECK YOUR PROGRESS

Q 4: State whether following statements are true or false-

a) Treasury Bills are issued by corporate bodies.

b) The market where the first issue of a company is sold is called primary market.

c) GDRs are denominated in US Dollars.



LET US KNOW

The basic elements of Indian Financial System were laid down during British rule. After independence, the government adapted the banking system for the economic development of the country. Moreover, the government formed a number of specialized institutions to meet the credit needs of industry, agriculture, small business etc. The government nationalised fourteen major commercial banks in 1969 and six more in 1980 with the objective of providing credit to the weaker section of the society.



ACTIVITY 2.2

Go to a leading bank and collect the booklets of their services and products and find out the electronic services it offers and list them below

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2.5 LET US SUM UP

In this unit we have discussed the following points:-

- Financial system through its components provides the solutions for each need and requirements of the surplus holders and the ultimate users.
- The financing process allows prospective users of funds to compete for them and creates the incentive for funds to be supplied.
- The globalization process and the technology upgradation has given the dynamism to the financial system due to which many new financial services, financial products and financial solutions have made their place in the financial system in recent decades.



2.6 FURTHER READING

1) Batra G.S. (2002). *Financial services and markets.* New Delhi, Deepand Deep Publication Pvt. Ltd.

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3) Srivastava, R.M. (2009). *Management of Indian financial institutions.* New Delhi, Himalaya Publishing House.

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5) Pathak, Bharati V (2006). *The Indian Financial System : Markets, institutions and services.* New Delhi, Pearson Education Ltd.

2.7 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: Financial markets are markets which cater to the financial needs of individuals, firms and institutions required for short as well as for long period.

Ans to Q No 2: (d) Stock Exchange

Ans to Q No 3: (b) Equity Share

Ans to Q No 4: (a) False (b) True (c) True

2.8 MODEL QUESTIONS

Q 1: What do mean by financial system? Briefly discuss the component of Indian financial system.

Q 2: What are the instruments traded in the money market?

Q 3: Distinguish between money market and capital market.

Q 4: State the salient features of money market instruments.

Q 5: Disuss the various components of financial system

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UNIT 3: FINANCIAL MARKETS

UNIT STRUCTURE

3.1 Learning Objectives

3.2 Introduction

3.3 Financial Markets-An Introduction

3.4 Advantages and disadvantages of the financial markets

3.5 Classification of Financial Markets

3.6 Functions of Financial Markets

3.7 Structure of Financial Markets

3.8 Let Us sum Up

3.9 Further Reading

3.10 Answers To Check Your Progress

3.11 Model Questions

3.1 LEARNING OBJECTIVES

After going through this unit you will be able to :

- discuss the meaning of financial markets and its advantages and disadvantages.
- outline the functions and classifications of the financial market
- describe the functions of the regulatory institutions in the financial system

3.2 INTRODUCTION

In this unit we are going to learn the concept of financial markets. Under financial market, we will come to know about classification of financial market, functions of financial market and differences between money market and capital market.

At the end of this unit we will get a fair idea on financial intermediaries and its structure, we will also discuss the concept of financial instruments.

3.5 FINANCIAL MARKETS-AN INTRODUCTION

A financial market is a market for creation and exchange of financial assets. Financial market exists wherever financial transactions take place. A financial transaction is said to have taken place when a financial asset is created or transferred. For instance, issue of equity shares by a company, deposit of money in a bank and so on.

A financial market is a market in which people and entities can trade financial securities, commodities and other fungible assets at prices that are determined by pure supply and demand principles. Markets work by placing the two counterparts, buyers and sellers, at one place so they can find each other easily, thus facilitating the deal between them. Financial Market refers to a marketplace, where creation and trading of financial assets, such as shares, debentures, bonds, derivatives, currencies, etc. take place. It plays a crucial role in allocating limited resources, in the country's economy. It acts as an intermediary between the savers and investors by mobilising funds between them.

3.4 ADVANTAGES AND DISADVANTAGES FINANCIAL MARKETS

Some of the advantages and disadvantages of the financial markets are as follows:

ADVANTAGES OF FINANCIAL MARKETS

1. It gives a platform to buyers and the sellers, to meet in order to trade in the assets. The prices for trading which are determined by the market forces i.e., demand and supply in the market. So It helps in the determination of the prices of securities.
2. It helps in the mobilization of the savings of the investors as the investor can put his money in most productive uses.
3. For the traders, the financial market platform provides the potential buyer and seller of their securities, which help them in saving their time and money in finding the potential buyer and seller.
4. In the financial market, investors can sell their securities readily and

convert them into cash, thereby providing liquidity to the tradable assets.

DISADVANTAGES OF FINANCIAL MARKETS

1. Prices in the financial market may not indicate stock's true intrinsic value because of some macroeconomic forces like the taxes etc.
2. There are certain factors that change the prices of the securities suddenly. So there is a risk involved when trading in the financial market.

3.5 CLASSIFICATION OF FINANCIAL MARKETS

There are different ways of classifying financial markets. Financial markets may be classified under five heads, viz., Maturity of Securities (claim), Seasoning of Claim, Timing of delivery, Type of claim and Organization structure.

(i) Maturity of Securities: One way of classifying financial markets is by the maturity of claims. The market for short-term financial claims is called **money market** and the market for long-term financial claims is called the **capital market**. The money market is a wholesale debt market for low-risk, highly-liquid, short-term instrument. Funds are available in this market for periods ranging from a single day up to a year. This market is dominated mostly by government, banks and financial institutions. Since short-term financial claims are invariably debt-claims, the money market is the market for short-term debt instruments. On the other hand, the capital market is designed to finance the long-term investments. It deals with long-term securities such as debentures, loans and shares.

(ii) Seasoning of Claim: A second way of classifying financial markets is based on whether the claims represent new issues or outstanding issues. The market where the issuers of securities sell new claims to the initial buyers is referred to as the **primary market** and the market where issuers trade securities previously issued is called the

secondary market. For example, Mr. X had bought 100 shares of ONGC from a public offer (primary market) and now he sells them to Mr Y. Mr. Y has thus purchased securities in the secondary market.

(iii) Timing of Delivery: A third way to classify financial markets is by the timing of delivery. A cash or spot market is one where the delivery occurs immediately and a forward or futures market is one where the delivery occurs at a predetermined time in the future.

(iv) Type of claim: Another way to classify financial markets is into debt market and equity market. The debt market is the financial market for fixed claims (debt instruments) and the equity market is the financial market for residual claims (equity instruments).

(v) Organization Structure: A fifth way of classifying financial markets is by the nature of its organizational structure. These are Exchange market and Over the Counter market. An exchange-traded market is characterized by a centralized organization structure with standardized procedures. An over-the-counter market is a decentralized market with customized procedures.



CHECK YOUR PROGRESS

Q1: Define financial markets

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Q2: On what basis the fiancial markets are classified

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3.6 FUNCTIONS OF FINANCIAL MARKETS

From the earlier sections, we find that financial markets play a

key role in allocating resources in an economy by performing the following functions.

- **Facilitates Price Discovery**: The interaction that takes place between numerous buyers and sellers in the financial market helps in determining the price of financial assets. Thus, it facilitates price information.
- **Provides Liquidity**: Financial markets provide liquidity to investors. It enables investors to sell their financial assets whenever they wish to. The liquidity provided by financial markets acts as a motivator for investors to hold financial assets.
- **Reduces the Cost of Transaction**: The cost incurred in the sale and purchase of financial assets is the cost of transaction. The two major costs associated with transactions are search cost and information cost. Search cost includes the monetary expenses incurred on advertising and non-monetary expenses in the form of effort and time spent in identifying a seller or a buyer. Information cost includes the cost incurred in evaluating the investment merits of financial assets. All these costs are reduced because financial markets provide convenience and relatively inexpensive services in linking small savers to large borrowers.
- **Promotes Savings and Investments**: Financial markets encourage savings and investments by providing price information, liquidity and reduced transaction cost.

3.7 STRUCTURE OF FINANCIAL MARKET

There are different types of financial markets and their characterization depends on the properties of the financial claims being traded and the needs of the different market participants. We recognize several types of markets, which vary based on the type of the instruments traded and their maturity. A common breakdown is the following:

a. **Money Market:** The money market enables economic units to

manage their liquidity positions through lending and borrowing short-term loans, generally under 1 year. It facilitates the interaction between individuals and institutions with temporary surpluses of funds and their counterparts who are experiencing a temporary shortage of funds.One can borrow money within a quite short period of time via a standard instrument, the so-called “call money”. Apart from the “call money” market, banks and other financial institutions use the so-called “Interbank market” to borrow funds within a longer period of time, from overnight to several weeks and up to one year. Retail investors and smaller trading parties do not participate on the Interbank market. While some of the trading is performed by banks on account of their clients, most transactions occur in case a bank experiences extra liquidity, a surplus of funds, while another has a shortage of liquidity.

b. **Capital market:** The capital market aids raising of capital on a long-term basis, generally over 1 year. It consists of a primary and a secondary market and can be divided into two main subgroups – Bond market and Stock market.The Bond market provides financing by accumulating debt through bond issuance and bond trading. The Stock market provides financing by sharing the ownership of a company through stocks issuing and trading

Financial markets are classified as (i) primary markets and (ii) secondary markets.

Primary market is also known as a direct market, whereas as secondary market is called an indirect market. The primary market deals in the new financial claims or new securities deals in the new financial claims or new securities and, therefore, they are also known as the new issues markets.

On the other hand, secondary markets deal in securities already issued or existing or outstanding. The primary markets mobilise savings and they supply fresh or additional capital to business units. Although secondary markets do not contribute directly to the supply of additional capital, they do so indirectly by rendering securities

issues on the primary markets liquid. Stock markets have both the primary and secondary market segments. The institutional structure of the primary markets differs form that of the secondary markets. We will get a detailed understanding of primary and secondary markets in unit 5 and 6 respectively of this cousre.

c. **Derivatives Market:** The derivatives market is the financial market that trades in the securities that derive its value from some specified underlying asset. Derivatives do not have a physical existence but emerge out of the contracts between two parties. These underlying assets may be debentures, shares, currencies, etc. The derivative contracts' value is determined by the market price of an underlying item. This market trades in the derivatives which include futures and forward contracts, swaps, options, etc.

d. Forex Market: The forex market is not a physical entity but is a network of communication among banks, brokers and forex dealers. This is the market where all kinds of currencies are traded. It is the highest liquid market as cash is liquid. It includes market dealings like spot market, forward market, etc.



CHECK YOUR PROGRESS

Q3: Define Derivatives market

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Q4: Define Money market and Capital market

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3.8 LET US SUM UP

In this unit we have discussed the following:

- A financial market is a market for creation and exchange of financial

assets. Financial market exists wherever financial transactions take place. Financial markets may be classified under four heads, viz., maturity of securities (claim), seasoning of claim, timing of delivery, type of claim and organization structure.

- Financial markets facilitates price discovery, provides liquidity, reduces the cost of transaction and, promotes savings and investments.
- Money market deals in short-term financial assets and capital market deals in long-term financial assets.
- Financial Markets is the market where the traders are involved in the buying and selling of the financial assets like shares, bonds, derivatives, commodities, currencies, etc.



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1) Batra G.S. (2002). *Financial services and markets.* New Delhi, Deepand Deep Publication Pvt. Ltd.

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3.10 ANSWERS TO CHECK YOUR PROGRESS

Ans to QNo. 1. A financial market is a market in which people and entities can trade financial securities, commodities and other fungible assets at prices that are determined by pure supply and demand principles.

Ans to QNo. 2. Financial markets may be classified under five heads, viz., Maturity of Securities (claim), Seasoning of Claim, Timing of delivery, Type of claim and Organization structure.

Ans to QNo. 3. The derivatives market is the financial market that trades in

the securities that derive its value from some specified underlying asset.

Ans to QNo. 4. The money market enables economic units to manage their liquidity positions through lending and borrowing short-term loans, generally under 1 year. The capital market aids raising of capital on a long-term basis, generally over 1 year.



3.11 MODEL QUESTIONS

Q 1: What is a financial market? How do you classify them?

Q 2: Define money market

Q 3: Define capital market

Q 4: Discuss the functions of Financial markets.

Q 5: Write the advantages and disadvantages of the financial markets

Q 6: Explain the structure of Financial Markets

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UNIT 4 : MONEY MARKET IN INDIA

UNIT STRUCTURE

4.1 Learning Objectives

4.2 Introduction

4.3 Meaning and features of Money Market

4.4 Functions of Money Market

4.5 Structure of Indian Money Market

4.6 Money Market Instruments/Constituents

4.7 Defects of Indian Money Market

4.8 Reforms in Indian Money Market

4.9 Let Us Sum Up

4.10 Further Reading

4.11 Answers To Check Your Progress

4.12 Model Questions

4.1 LEARNING OBJECTIVES

After going through this unit you will be able to:

- discuss the structure of Indian Money Market
- explain the instrument of Indian Money Market
- explain the reforms in Indian Money Market

4.2 INTRODUCTION

The Money Market is a very important segment of the Indian financial system. It is the market where short term monetary assets are dealt in to raise short term requirements of funds and/ or to park short term surpluses. The main characteristic of the Money Market is the liquid nature. The money market transactions may range from overnight to one year. It has minimum transaction cost. This unit encompass the structure of the Money Market that has undergone vast changes in the last decade. In this unit, we are going to discuss the different instruments and the defect of Indian Money Market. The unit also discuss the bill market. Thus, you will be able to

understand through this unit the structure, instrument as well as the defect of the Indian money market.

4.3 MEANING AND FEATURES OF MONEY MARKET

Meaning of the Indian money market:

The money market is the market which deals with short term funds in the economy. It refers to the institutional arrangements facilitating borrowings and lending of short term funds.

The money market is a market for short-term funds, which deals in financial assets whose period of maturity is upto one year. It should be noted that money market does not deal in cash or money as such but simply provides a market for credit instruments such as bills of exchange, promissory notes, commercial paper, treasury bills, etc. The Indian money market consists

of Reserve Bank of India, Commercial banks, Co-operative banks, and other specialised financial institutions. The Reserve Bank of India is the leader of the money market in India.Some Non-Banking Financial Companies (NBFCs) and financial institutions like LIC,GIC, UTI, etc. also operate in the Indian money market.

Features of the Indian money market:

The following are the important features of the money market in India –

1) The money market is purely for short-term funds or assets called near money.
2) All the instruments of the money market deal only with financial assets that are financial in nature. Also, such instruments have maturity period up to one year.
3) It deals assets that can convert into cash readily without much loss and with minimum transaction cost.Generally, transactions take place through oral communication (for eg. phone or mobile).
4) The exchange of relevant documents and written communications take place subsequently. There is no formal place for the trading (like a stock exchange).

5) The components of a money market are the Central Bank, ommercial Banks, Non-banking financial companies, discount houses,and acceptance house. Commercial banks are dominant player of this market.

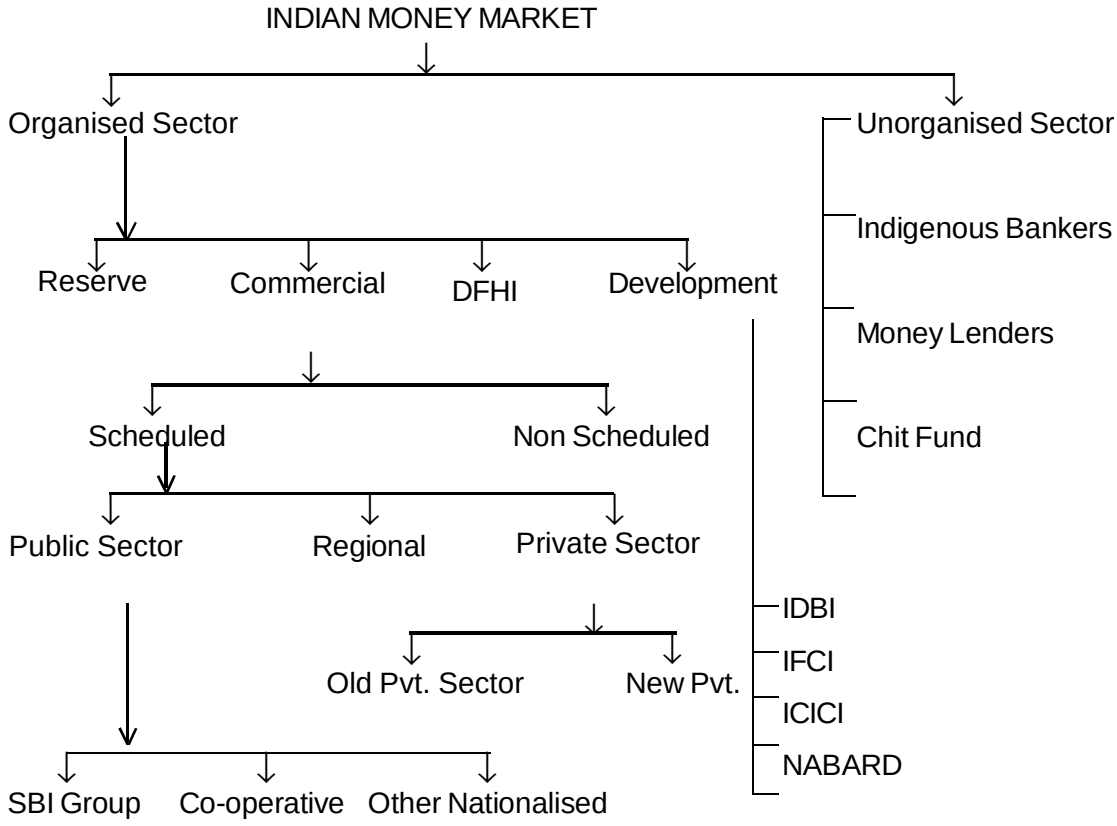
4.4 FUNCTIONS OF MONEY MARKET

The following are some of the functions of money market:

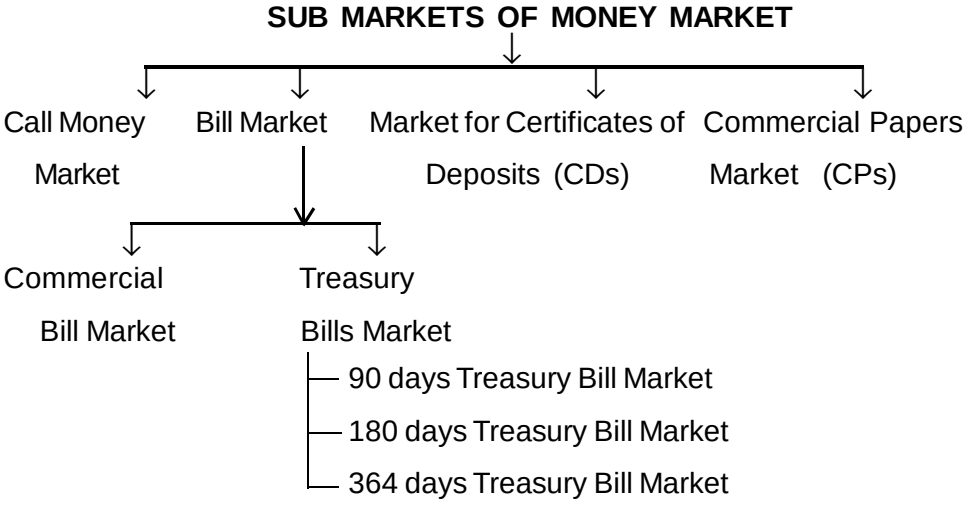
1. To cater to the short-term financial needs of the economy.
2. To provide efficient mechanism of liquidating for commercial banks, non-banking financial institutions, business firms and other investors.
2. To bridge between short term surpluses and deficits.
3. To provide a realistic price for short term money.
4. To provide a platform for the Central bank of the country to control and manage the money supply.

4.5 STRUCTURE OF INDIAN MONEY MARKET

The Money Market is the close substitutes for money with the short term time span from overnight to year. The Indian Money Market consists of both organised and unorganised segment. The organised segment includes the Reserve Bank of India, State Bank of India, Public Sector as well as Private Sector Banks, Regional Rural Bank, Commercial Banks including Foreign Banks, Non-Scheduled Commercial Banks and other Non-Bank Financial Intermediaries such as LIC, GIC, and UTI etc. On the other hand, the unorganised segment consists of indigenous bankers, money lenders and other non-bank financial intermediaries.



Indian money market can be divided into various sub-markets depending on their nature and scope of the transactions and the features of the instruments.





CHECK YOUR PROGRESS

Q 1: Mention two unorganised sectors of Indian Money Market.

i).....

ii) .....

4.6 MONEY MARKET INSTRUMENTS/ CONSTITUENTS

Money Market instruments mainly include Government securities, securities issued by private sector and banking institutions—

1. Government Securities
2. Money at Call and Short Notice
3. Inter-Bank Participation certificate
4. Treasury Bills
5. Certificates of Deposits
6. Commercial Bills
7. Commercial Paper
8. Repo

1. Government Securities: The Reserve Bank of India issues securities on behalf of the Government. The term Government Securities includes Central Government Securities, State Government Securities and Treasury Bills.

The different types of Government Securities are -

Dated Securities	**Zero Coupon Bonds**	**Partly Paid Stock**	**Floating Rate Bonds**	**Bonds with Call/ Put Option**	**Capital Indexed Bonds**
Issued at face value	Issued at discount to the face value	Issued at face value, but paid in installments over a period	Issued at face value	Abond issued at call and put option	Issued at face value
Interest or coupon rate is fixed at the time of issuance, and remains constant till redemption of the security	Do not carry any interest rate	Interest or coupon rate is fixed at the time of issuance, and remains constant till redemption of the security	Interest rate is fixed as a percentage over a predefined benchmark rate which may be Treasury bill, bank rate etc at the time of issuance	This bond is due for redemption in 2012 and carries a coupon of 6.72%	Interest rate is fixed as a percentage over the wholesale price index at the time of issuance.
The tenure of security is fixed	The tenure of security is fixed	The tenure of security is fixed	The tenure of security is fixed	This bond has been priced in line with 5 year bonds	The tenure of security is fixed
The security is redeemed at par (face value) on its maturity date	The security is redeemed at par (face value) on its maturity date	The security is redeemed at par (face value) on its maturity date	The security is redeemed at par (face value) on its maturity date	This bond has been priced in line with 5 year bonds	The principal redemption is linked to the Wholesale Price Index.

The Government dated securities can be purchased for a minimum amount of Rs. 10,000/- and the Treasury bills of Rs. 25,000/- and in multiple thereof. The State Government Securities can be purchased for a minimum amount of Rs.1,000/-.

2. ***Money at Call and Short Notice:*** Call money or call deposits are that money which is lent on condition to repay on call. Notice money refers to the money lent and repaid on a certain day's notice from the lenders. Banks borrow for a variety of reasons to maintain their cash reserve ratio, heavy payments, to maturity mismatch etc. Money at short notice is for a maturity upto 14 days. The main participants are banks and all

India financial institutions as permitted by RBI.

A minimum size of Rs. 20 crores for each transaction was permitting the participation of the corporate in the call money market. The Discount and Finance House of India (DFHI) enhanced the activity of Call Money Market and Short-term Deposit Market. It allows lending and borrowing of funds. The borrowers are essentially the banks. It can operate outside the purview of the provision of the ceiling rates fixed by the Indian Banks Association. The different participants that lend fund in the market are like GIC, IDBI, NABARD etc. The private Mutual funds were also participating in the market. The DFHI ascertains the settlement between the lender and the borrower about the availability of fund and the amount needed and the exchanges. It also provides advice regarding the interest rates applicable to them.

Here, the call rates are more volatile as they are determined by the interaction of demand and supply of funds in the market which is based on the maintenance of Cash Reserve Ratio by the banks. There are two call rates maintained in India i.e. Inter-bank call rate and the lending rate of DFHI.

3. ***Inter-Bank Participation Certificate:*** Inter-Bank Participation Certificates are instruments issued by scheduled commercial banks only to raise funds or to deploy short term surplus. This instrument is issued as per RBI guidelines for two purposes:

   a. on risk sharing basis

   b. without risk sharing

   Inter-Bank Participation without risk sharing can have tenure of 90 days only where, the issuing bank as borrowing and the participating bank advances to the banks. In case of risk sharing basis, the lender bank shares losses with the borrowing banks by mutually determining the interest rate. The tenure may be for 90 to 180 days.

4. ***Treasury Bills:*** Treasury Bills are discounted securities issued at a discount face value as per the short term requirement of the Government of India. RBI issues Treasury Bills on a prefixed day and at a fixed amount. There are four types of Treasury Bills:

   a. 14-day Tbill maturity is in 14 days.

   b. 91-day Tbill maturity is in 91 days.

c. 182-day Tbill maturity is in 182 days.

d. 364-day Tbill maturity is in 364 days.

These are highly liquid money market instruments. It is a zero default risk bearing paper. It helps in deployment of idle funds for very shorts periods as well.

5. ***Certificates of Deposits:*** These are issued according to the guidelines of the Reserve Bank of India in dematerialized form or Usance Promissory Note for the fund deposited at a bank or other financial institution. It is a negotiable money market instrument whose minimum deposit should be Rs.1 lakh and the multiples of Rs. 1 lakh thereafter. The maturity period of Certificates of Deposits should not be less than 15 days and not more than 1 year. But, it should not be less than 1 year and exceed 3 years for financial institution.
6. ***Commercial Bills:*** These are the bills accepted by the buyer for goods and services on credit from the seller and which may be kept upto the due date and encased by the seller or may be endorsed to a third party. The bills being bills of exchange may be discounted with the banks or financial institutions. These bills may again be the rediscounted at the bank.
7. ***Commercial Papers (CP):*** It is an additional unsecured money market instrument to the investors as a source of short term borrowing. This instrument is issued in the form of a promissory note or dematerialized form. Every issuer has to appoint an Issuing and Paying Agent (IPA) for the issue of commercial papers and only a scheduled bank can act as an IPA for issuance of CP. The investor are given the Issuing and Paying Agent (IPA) certificate as well as issued physical certificates or arrangement is made for crediting the CP to the investor's account with a depository. The CP issued for a maturity period between a minimum of 7 days and a maximum up to one year from the date of issue in the denomination of Rs. 5 lakh or multiples thereof. The main purposes of introducing CP are—

a. To enable the high level corporate borrowers such as leasing and financing of companies, manufacturing and financial institutions etc.

b. To diversify the sources of short term borrowing

c. To provide instrument for bank and financial institution in the money market.

8. Repo: This money market instrument helps in collateralised short- term borrowing and lending through sale or purchase operation in debt instruments. Here the securities are sold by the holders to the investors with an agreement to repurchase them at a predetermined rate and date.

On the other hand, under the reverse repo transactions, securities are purchased with a simultaneous commitment to resell at a predetermined rate and date.



CHECK YOUR PROGRESS

Q 2: Mention three types of Government Securities.

i) .....

ii) .....

iii) .....

Q 3: Mention four types of Treasury Bills.

i) .....

ii) .....

iii) .....

iv) .....

4.7 DEFECTS OF INDIAN MONEY MARKET

Money market is the market for lending and borrowing of short term funds. A well developed money market denotes an implementation of effective monetary policy. But the Indian money market suffers from many weaknesses.

1. Lack of integration: The Indian Money Market is divided into two sectors viz, the organised and unorganised money market. But both the markets

are completely separate from each other. They are working independently and have little effect on each other. RBI is fully effective in controlling the organised sector. But, it has very less control on the unorganised sector.

2. ***Lack of rational interest rates structure:*** The Indian Money Market exist too many interest rates. For example, the deposit and lending rates of commercial banks, the borrowing rate of Government etc. In the past these created excess demand for credit and the RBI had to rely often on cash reserve ratio. Though the RBI has tried to bring rationality in the interest rates, the situation in the Indian money market is still not effective.
3. ***Existence of Unorganised Money Market:*** The existence of the unorganised sector in money market still prevails in Indian Money Market. The indigenous banker does not make any distinction between short term and long-term finance. They have no coordination with each other and have no link with other banking sectors. They do not follow any sound banking regulations. The RBI has no control over these bankers.
4. ***Absence of an organised bill market:*** In Indian Money Market, there is an absence of adequate bill market. There is an absence of commercial bill market or a discount for short term commercial bills. There are many factors responsible for the underdeveloped bill market such as (i) relying more on cash transaction, (ii) cash credit of commercial bank, (iii)seller's limited use of bills, (iv) imposition of heavy stamp duty, (v) absence of acceptance houses etc.
5. ***Shortage of funds in the Money Market:*** The lack of banking habit, inadequate banking facility, less saving habit, etc created have shortage of fund in the money market. On the other hand, the increasing demand for loanable funds in the money market far exceeds its supply.
6. ***Inadequate banking facility***: Now-a-days, the commercial banks have opened many new branches of banking facilities. But, it still leaves much scope for further development. In a developing country like India, people live below poverty line and have less saving habit. Their savings are very small and they do not have much access to banking facilities till now.

7. ***Seasonal Stringency of Money:*** During the part of the year the interest rates become high due to the increasing demand for funds in the money market for the operation in the agricultural sector. Basically, it is seen in the period from October to June.



CHECK YOUR PROGRESS

Q 4: Mention four defects of Indian Money Market.

i) .....

ii) .....

iii) .....

iv) .....

4.8 REFORMS IN INDIAN MONEY MARKET

The major drawback of India Money Market is its high volatility. Gradually the money market transaction is increasing. But, on the recommendation of the Sukhmoy Chakravarty Committee (on the review of the working of the Monetary System) and the Narasimham committee (on the Report on the working of the financial system in India, 1991), RBI initiated a series of reform in Indian Money Market. The following are some of the measures undertaken:

1. ***Introducing new money market instrument:*** Many new money market instruments are introduced like Commercial Papers, Certificates of Deposits, 182-day Treasury, 364-day Treasury etc. The Discount and Finance House have also developed. These facilitate different short term borrowings to the different borrowers to collect fund as and when required to maintain their financial position.
2. ***Relaxation of interest rate regulations:*** The all types of interest rates like lending as well as deposit rates of the banks and financial institution are controlled and regulated by RBI. But, gradually the interest rates of the bank loans are controlled by the market forces which result

decontrolled of it.

3. ***Remitting the stamp duties:*** In August 1989, Government remitted the stamp duty. But, it is not effective till it discourages the cash credit system in favour of using the bill system.
4. ***Sector specific refinance:*** Export credit refinance and general refinance are two refinance schemes that are in operation in the current financial system. The refinance is used by the central bank to control credit conditions and the liquidity positions in the system. But if the excessive funds supplies into the system do not result any the development then it could be highly distorted one.
5. ***Introduction of repo:*** This is used by the banks for short term liquidity through sale or purchase of debt instruments. It is an agreement to repurchase them at a predetermined rate and date between the RBI and commercial banks.
6. ***Introducing Money market Mutual Funds:*** The Money Market Mutual Funds were introduced in April 1991. The collection of the small savings invested generate short term avenues to the different investors.
7. ***Setting the Discount and Finance House in India:*** The DFHI equilibrated the surplus of fund and the deficit amounts of the banks. The DFHI helps in lending and borrowing of funds to the different banks as well as financial institutions.



CHECK YOUR PROGRESS

Q 5: Mention five measures to improve the Indian Money Market.

i).....

ii) .....

iii) .....

iv) .....

v) .....



4.9 LET US SUM UP

In this unit we have discussed the following -

- Money Market is a market for short term funds. Money is raised and deployed for short term in this market.
- The Money Market is the close substitutes for money with the short term upto one year.
- A minimum size of Rs. 20 crores for each transaction was permitted in the participation of the corporate in the call money market.
- The maturity period of Certificates of Deposits should not be less than 15 days and not more than 1 year.
- On the recommendation of the Sukhmoy Chakravarty Committee and the Narasimham committee, RBI initiated a series of reform in Indian Money Market.
- To provide safety, liquidity and return, MMMFs are formed which collect the small savings of a large number of savers and invest them in the capital market.
- Under the reverse repo transactions, securities are purchased with a simultaneous commitment to resell at a predetermined rate and date.



4.10 FURTHER READING

1) Batra G.S. (2002). *Financial services and markets.* New Delhi, Deep and Deep Publication Pvt. Ltd.

2) Mishkin,Frederic S. (2007) *Financial Markets and Institutions*. New Delhi, Pearson Education Ltd.

3) Srivastava, R.M. (2009). *Management of Indian financial institutions.* New Delhi, Himalaya Publishing House.

4) Khan, M. Y. (2007). *Indian Financial System.* New Delhi. Tata McGraw Hill.

4.11 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: Two unorganised sectors of Indian Money Market are:

i. Indigenous Bankers

ii. Money Lenders

Ans to Q No 2: Three types of Government Securities are:

i. Dated Securities

ii. Zero Coupon Bonds

iii. Partly Paid Stock

Ans to Q No 3: Four types of Treasury Bills are:

i. 14-day Tbill maturity is in 14 days.

ii. 91-day Tbill maturity is in 91 days.

iii. 182-day Tbill maturity is in 182 days.

iv. 364-day Tbill maturity is in 354 days.

Ans to Q No 4: Four defects of Indian Money Market are:

i. Lack of integration

ii. Lack of rational interest rates structure

iii. Existence of Unorganised Money Market

iv. Inadequate banking facility

Ans to Q No 5: Five measures to improve the Indian Money Market are:

i. Introducing new money market instrument

ii. Relaxation of interest rate regulations

iii. Remitting the stamp duties

iv. Sector specific refinance

v. Introduction of repo

4.12 MODEL QUESTIONS

Q 1: What do you understand by Money Market? What are the constituents of the Indian Money Market?

Q 2: Discuss the different Money Market instruments?

Q 3: Discuss the defects of Indian Money Market?

Q 4: What are the measures to improve the Indian Money Market?

Q 5: Write short notes on:

a. Government Securities

b. Bills Rediscounting

c. Money Market Mutual Funds

d. Treasury Bills

e. Certificates of Deposits

f. Commercial Paper

g. Gilt-edged (Government) Securities

h. Bill Market.

*** **** ***

UNIT 5: CAPITAL MARKET IN INDIA

UNIT STRUCTURE

5.1 Learning Objectives

5.2 Introduction

5.3 Meaning and Structure of Indian Capital Market

- 5.3.1 Industrial Securities Market
- 5.3.2 Government Securities Market
- 5.3.3 Long term Loan Market

5.4 Capital Market Instruments

5.5 Capital Market Intermediaries

5.6 Let Us Sum Up

5.7 Further Reading

5.8 Answers to Check Your Progress

5.9 Model Questions

5.1 LEARNING OBJECTIVES

After going through this unit you will be able to:

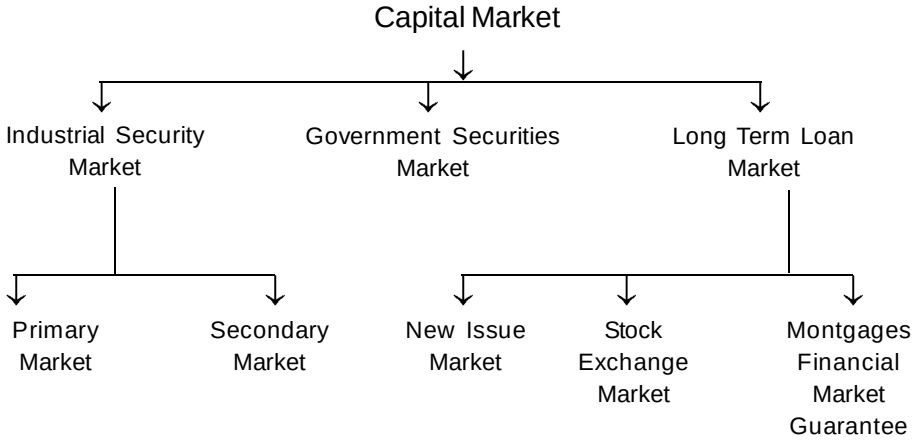
- discuss the meaning of Capital Market
- explain the structure of capital market
- explain the instrument and intermediaries of Capital Market

5.2 INTRODUCTION

The corporate bodies require funds for different projects in different times. They raise their funds depending on the preference of the investors and the regulatory framework. The business need two types of finance viz short term finance and long term finance. The capital market meets the long term requirements of fund. Through this unit, you will be able to know about the meaning of capital market and its instrument. The unit also, discusses about the capital market intermediaries. Thus, you will able to understand through this unit, the meaning, instrument and capital market intermediaries.

5.3 MEANING AND STRUCTURE OF INDIAN CAPITAL MARKET

Capital market is the market where long-term funds are traded. Capital market deals with securities with long term maturity. Instruments like shares, debentures, bond etc. are issued in the capital market for raising long term capital. The Indian capital market has the following structure:



5.3.1 Industrial Securities Market

Industrial securities market deals with the securities such as equity shares, preference shares etc., issued by the corporate houses. This market can further be classified in to: a) New Issue Market or Primary Market and b) Secondary Market or Stock Exchanges.

New issue market is the market where the securities which are issued for the first time or come to the market for the first time are bought and sold. The players in the new issue market are merchant bankers, underwriters, registrars to the issue collecting and coordinating bankers etc.

Secondary market or stock exchanges is the place where buying and selling of existing or second hand securities (securities which are once sold in the new issue market) takes place. This market provides liquidity and transferability to the securities. At present there are 25 stock exchanges working throughout the country.

3.3.2 Government Securities Market

Government Securities Market also called Gilt-Edged securities market. In this market long term securities issued by the government are traded. These securities are issued by the central government, state government; semi-government authorities like city corporation, port trust etc. electricity board, all India and state level financial institution and public sector enterprises are traded.

5.3.3 Long term Loan Market

This is the market where development banks and commercial banks supply long term loan to the corporate houses. This market can further be classified in to :

a) Term loan market

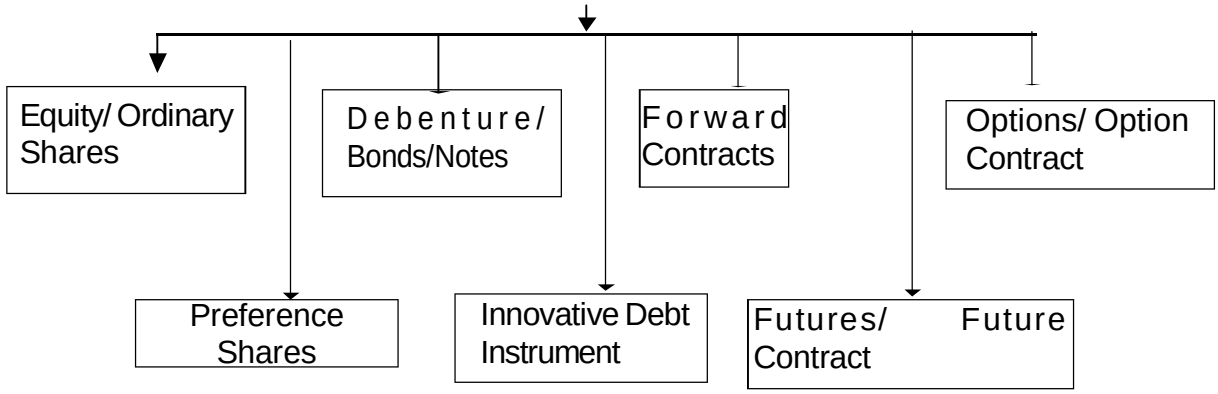
b) Mortgage market

c) Financial guarantee market.

5.4 CAPITAL MARKET INSTRUMENTS

The capital market instrument can be classified into three categories as pure, hybrid and derivatives. The pure instrument means equity shares, preference shares and debentures or bonds without mixing features. The hybrid instrument means combining of equity with bond, preference share and equity. Derivatives are nothing but contract which derive their values from the value of one or more of other assets i.e. financial instrument. Futures and options belong to the categories of derivatives.

CAPITAL MARKET INSTRUMENT IN INDIA



a) Equity or Ordinary Shares: It represents the ownership capital. It is of several types:

Authorized equity share capital: The maximum amount of share capital that a company can raise is its authorized share capital.

Issued capital: It is that portion of the capital which is offered by the company to the investors.

Subscribed capital: It is the part of issued capital which is subscribed by the investors.

Paid-up capital: It is the capital that is paid by the shareholders.

The main features include limited liability, residual claim to income, right to control, pre-emptive rights.

b) Preference Shares: It has certain characters of equity share and debentures. It carries a fixed rate of interest. It has preferential right to get dividend in comparison to equity share. The preference shareholders can get cumulative dividends i.e. all unpaid dividend are payable. It does not carry any voting right. But, if the preference shares are not paid for more than two years with respect of cumulative shares, the preference shareholders entitled to vote.

c) Debentures or Bonds or Notes: The debenture holders are long term creditors. The debenture holders get fixed rate of interest and the principal amount repay at stipulated time. Three types of debentures are found presently in India as:

i. Convertible debenture after 36 months,

ii. Optionally convertible debenture within 36 months,

iii. Compulsorily convertible with 18 months

d) Innovative Debt or Instrument: The debenture may be compulsory, optional or convertible. Call option gives the opportunity to the company to redeem the bonds prematurely. The firms issue such bonds and in favorable condition, they refund it.

A warrant gives the right to subscribe the equity shares at a certain period.

The zero coupon bonds do not carry any coupon rate and sold at discount from their maturity value.

The deep discount bond issued at discount over its face value far less than the yield to maturity.

Floating rate bonds are bonds whose interest rate are not fixed and it is the percentage point more than the benchmark rate. The benchmark rate is interest rate on treasury bills, bank rate, and maximum rate on term deposit.

e) Forward Contracts: It is the contract based on specified price to buy or sale at a specified future date of an asset. The buyer assumes a long position and agrees to buy at a specified future date at a specified price to buy and the other party gets short position to sell the asset on the same date at specified price. These are traded outside the stock exchange.

f) Futures or Future Contracts: It is an agreement between two parties to buy or sale an asset at a certain time in the future, at a certain price. It solves the different problems associated with the forward market. It reduces the counter party risk as seen in forward contract.

The future contracts are traded on an organized stock market whereas forward contract are traded on Over the Counter in nature. The future contracts are standardized contract which follow daily settlement. The forward contracts are customized contract terms and settlement done at the end of the period.

g) Options or Option Contracts: In forward contract and future contract, the parties committed themselves to do something whereas in case of option contract the parties get option the right to do something. The

forward contract and future contract does involve any charge any cost. But the option contract requires an up front payment. The option contracts are of two types, call option and put option. In case of call option the holder get the right not obligation to buy an asset by a certain date for a certain price. In case of put option the holder gets the right not obligation to sell an asset by a certain date for a certain price.

5.5 CAPITAL MARKET INTERMEDIARIES

The financial markets have two components, the money market and the capital market. The capital market consists of two components, the securities market and other forms of lending and borrowing. The securities market which is divided again into two parts as primary market and secondary market.

The primary market deals with the sale of new securities. The following are the primary market intermediaries:

a. Merchant Banker or Lead Managers
b. Underwriter
c. Debenture Trustees
d. Registrars and Share Transfer Agents
e. Bankers to issue

The capital market intermediaries are vital link between investor, issuer and the regulator. Securities and Exchange Board of India Act, 1992 was made to protect, secure and promote the interest of the investors. It is responsible in constant monitoring for good government practices of the intermediaries.

The secondary market deals with the trading of securities initially offered. The following are the secondary market intermediaries:

a. Portfolio manager
b. Stock brokers
c. Sub-Brokers
d. Custodian

PRIMARY MARKET INTERMEDIARIES:

A. MERCHANT BANKER OR LEAD MANAGERS:

Merchant bankers are body corporate who are engaged in issue of securities. It acts as manager or advisor or consultant to issuing company. A merchant banker requires compulsory registration under the regulation 3 of SEBI (Merchant Bankers) Regulations, 1992. These activities mainly includes determining the composition of capital structure, compliance with procedural formalities, appointment of registration, listing of securities, arrangement of underwriting, selection of brokers and bankers, publicity and advertisement agent , private placement of securities, advisory services, etc. The merchant bankers are responsible to make all efforts to protect the interest of investors. The merchant bankers has to exercise due diligence, high standards of integrity, dignity. The merchant bankers are also responsible in providing adequate information without misleading about the applicable regulations and guidelines. It is now mandatory for all public issues to be managed by merchant bankers functioning as the lead managers.

B. UNDERWRITER:

An underwriter may be an individual, broker, merchant banker, financial institution or banks. The underwriting is an agreement between the issuing company and the assuring party through an agreement to take up shares or debentures or other securities to a specified extent in case public subscription does not amount to the expected level. Thus, in case any short-fall, it has to be made good by underwriting arrangements by the underwriter as per the agreement.

The underwriter shall not derive any benefit from underwriting the issue other than commission as specified in the agreement. If an underwriter is being called upon to subscribe the shares of a company has to subscribe such securities within 45 days of receipt of such intimation as per to the agreement. The underwriter has to appoint a compliance officer who is responsible for compliance of the Act. The compliance officer is required to report to SEBI and is responsible for complying the notification, guidelines, instruction issued by SEBI.

C. DEBENTURE TRUSTEES:

The issuing company has to make proper arrangements and comply with the legal requirements for the investor. The company renders these services to the investors for a fee under an agreement executing as trust deed with the trustee who are generally banks and financial institution and file the same with the Registrar of Companies. The main duties of debenture trustees are mainly possession of trust property in accordance with the trust deed, taking periodical report from the body corporate, enforce security of interest, protection of the debenture holders, inspect books of account, inform SEBI if any breach of trust deed etc.

Every debenture trustees is required to appoint a compliance officer. He is responsible for monitoring the compliance of the Act, rules and regulations. He is responsible for redressal of investor grievances.

D. REGISTRARS AND SHARE TRANSFER AGENTS:

The Registrars and Share Transfer Agents are very important intermediaries in mobilizing new capital, maintaining records, deciding the basis of allotment etc for the investors. They are very useful in case of share transfer, sale, as it helps in liquidity to the investors of their investment. They also provide this service to the existing companies. But this responsibility decreases as depository system comes into play. But unless and until the old system is completely eliminated and the shareholding totally switch over to dematerialized system, the share transfer agents will have to play their role.

The 'Registrar to an issue 'means, any person that appointed by the company or group of individuals carry out such activities on its behalf i.e. collecting applications, maintain records, determine the basic for allotment of securities, finalizing the list from the same, process and dispatch of allotment letters etc.

The 'Share Transfer Agents' means, any person who maintain records of holder of securities on behalf of any body corporate. They deal all matters connected with it, like redemption, transfer of securities etc. It may be the department of a body corporate performing the activities at any time the total number of holders of its securities issued exceed one lakh.

The Registrars and Share Transfer Agents shall have to maintain high standards of integrity, due diligence, adequate care, in the conduct of its business. They have to make reasonable effort to avoid misrepresentation, conflict and disclosure of its interest. They are also responsible in maintaining the continuity the data and records.

E. BANKERS TO ISSUE:

The Chapter I of SEBI (Bankers to an Issue) Regulations, 1994, deals with Banker to an issue. The Banker to an issue means a schedule bank carrying on all or any of the following activities:

A. Acceptance of application and application monies.
B. Acceptance of allotment or call monies.
C. Refund of application monies.
D. Payment of dividend or interest warrant.

The banks may render different function like, mobilizing of capital, issuing of securities, collection of application for securities etc. The banks are responsible in maintaining the records and furnish prompt information. But the company has to an agreement with the banks. Under Regulation 12, the banker to an issue has to maintain the date, name amount of monies refund, dividend and interest warrant paid; time, number of application received to the investor.



CHECK YOUR PROGRESS

Q 1: Mention three primary market intermediaries.

i) .....

ii) .....

iii) .....

SECONDARY MARKET INTERMEDIARIES:

A. PORTFOLIO MANAGER:

The word 'portfolio' means the total holdings of securities belonging to any person and the portfolio manager is the person who under an

arrangement with the client, advises or directs the management and administration of such portfolio of securities. The portfolio manager has to enter into an agreement on behalf of a client and it contains:

1. The investment objectives,
2. Area of investment,
3. Type of instrument,
4. Custody of securities,
5. Procedure of client's account etc.

Registration of portfolio manager:

a) The applicant is a body corporate and have infrastructure like adequate office space,

b) The principal officer of the applicant has professional qualification like law, finance, accountancy, management from a recognized university.

c) It has the capital requirement. The portfolio manager must have capital requirement of not less than networth of fifty lakhs rupees.

d) The grant of certificate to the applicant is in the interest of investors.

e) The applicant has minimum of two persons having at least five years of experience as portfolio manager or stock broker etc.

The portfolio manager act in a fiduciary capacity with regard to the clients funds under the provision of Reserve Bank of India, 1934. He shall pledge or give loan on securities on behalf of the client depending on the written permission of the client. He can not earn any direct or indirect benefits out of the clients fund or securities. The portfolio manager has to maintain high standard of integrity, fairness, due diligence. But he should not make any statement to any act, practice, unfair competition. The portfolio manager is responsible to appoint a compliance officer responsible for monitoring the compliance of the Act.

B. STOCK BROKERS AND SUB-BROKERS:

Stock brokers are members of recognized stock exchanges who buy and sell or otherwise deal in securities. For a broker to deal in securities on a recognized stock exchange, it is obligatory that he should be registered

as a stock broker with SEBI. The stock broker facilitates transaction of securities in the secondary market. The stock broker has to enter into an agreement with his client before buying and selling of securities. One must have a client account with a registered broker or sub- broker to buy or sell of securities and has to do the transaction through such broker or sub-broker. Broker or sub-broker charges brokerage commission for facilitating transaction.

The sub-brokers act as agent on behalf of the stock broker. The sub-brokers assist the investor in buying and selling the securities. Both broker and the sub-brokers hold a certificate of registration granted by SEBI. Both broker and the sub-brokers has to follow disciplinary proceedings under the rules, bye-laws etc. The SEBI observe before granting the certificate of Registration, about the applicant's eligibility to be admitted as a member of a stock exchange or not. The SEBI also take into account the availability of necessary infrastructure like adequate office space etc. Where an application does not fulfill the requirement may be rejected by SEBI and communicated within 30 days to the concerned stock exchange and to the applicant stating the grounds of refusals. But, SEBI can also reconsider an application.

The sub-broker has to forward an application in Form-B accompanied with letter in Form-C from a stock broker to a recognized stock exchange with whom he is to be affiliated as a member. But the applicant is eligible for registration like:

A) Incase of an individual, he should not less than 21 years of age, has not convicted of any offence and fit and proper. He should pass at least 12th standard or equivalent examination.

B) In case of body corporate or partnership firm, the directors or partners may comply with the requirements as stated by SEBI.

The sub-broker has the maintain different obligations like payment of fees as per Schedule III, agreement with the stock broker, abode the code of Conduct of Schedule II, all rules and regulation of stock exchange etc. Under Regulation 17 and 18, the sub-broker has to maintain the books of account.

Every broker has to appoint compliance officer who shall be responsible for monitoring the compliance of the act, rules, regulation etc issued by SEBI.

C. CUSTODIAN:

Custodian of securities means any person who provides custodial services in relation to securities of a client or safe keeping of gold or gold related instrument. They operate their function through opining custodial account. It is an account of a client maintained by a custodian of securities in respect of securities. Any person proposes to carry such business as custodian of securities has to make an application to SEBI for grant of a certificate for registration. The applicant fulfils the capital requirement specified under regulation 7(1), a net worth of a minimum of rupees fifty cores. The applicant must have necessary infrastructures and follow all rules and regulation approved under any law for the time being in force relating to securities, gold or gold related instrument. The applicant should be competent person and the grant of certificate is in the interest of investor. Custodian has the duty to inspected their affairs through the inspecting officer such as books, securities etc.

Networth: It means the aggregate value of paid-up equity capital plus free reserved which is aggregate value of loose and differed expenditure not written off.



CHECK YOUR PROGRESS

Q 2: Mention three secondary market intermediaries.

i) .....

ii) .....

iii) .....



5.6 LET US SUM UP

In this unit we have discussed the following aspects -

- The word 'portfolio' means the total holdings of securities belonging to any person and the portfolio manager is the person who under an

arrangement with the client, advises or directs the management and administration of such portfolio of securities.

- The capital market instrument can be classified into three categories as pure, hybrid and derivatives.
- Three types of debentures are found presently in India as convertible debenture after 36 months, optionally convertible debenture within 36 months and compulsorily convertible with 18 months
- The capital market consists of two components, the securities market and other forms of lending and borrowing.
- Merchant bankers are person who engaged in issue of securities. It acts as manager or advisor or consultant to issuing company.
- The underwriting is an agreement between the issuing company and the assuring party through an agreement to take up shares or debentures or other securities to a specified extent in case public subscription does not amount to the expected level.
- The stock broker has to enter into an agreement with his client before buying and selling of securities
- Security Exchange Board of India is the regulator of capital Market in India.



5.7 FURTHER READING

1)) Batra G.S. (2002). *Financial services and markets.* New Delhi, Deep and Deep Publication Pvt. Ltd.

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5.8 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: The three primary market intermediaries are-

i. Merchant Banker or Lead Managers

ii. Underwriter

iii. Debenture Trustees

Ans to Q No 2: The three secondary market intermediaries are-

i. Portfolio manager

ii. Stock brokers and Sub-Brokers

iii. Custodian

5.9 MODEL QUESTIONS

Q 1: Discuss the role and obligation of portfolio manager.

Q 2: What is meant by merchant banker? Discuss its role as a primary market intermediary.

Q 3: What is meant by capital market? What are different primary market intermediary.

Q 4: Write short notes:

a. Custodian

b. Underwriter

c. Debenture Trustees

d. Registrars and Share Transfer Agents

e. Bankers to issue

f. Stock brokers and Sub-Brokers.

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UNIT 6: PRIMARY MARKETS IN INDIA

UNIT STRUCTURE

6.1 Learning Objectives

6.2 Introduction

6.3 Meaning of Primary Market

6.4 Functions of Primary Market

6.5 Issue Mechanism in Primary Market

6.6 Role of SEBI in Primary Market

6.7 Factors leading the growth of Primary Market Investment

6.8 Let Us Sum Up

6.9 Further Reading

6.10 Answers To Check Your Progress

6.11Model Questions

6.1 LEARNING OBJECTIVES

After going through this unit you will be able to :

- explain the meaning of Primary Market
- discuss the functions of Primary Market
- discuss issue mechanism in Primary Market
- describe the role of SEBI in Primary market

6.2 INTRODUCTION

In this unit we are going to discuss the concept of primary market and its different functions. From the previous units we came to know that financial markets are broadly categorized into money market and capital market. Securities market is divided into primary market and secondary market.In this unit we will discuss on priamry market in India.

A system that aims at establishing and providing a regular, smooth, efficient and cost effective linkage between depositors and investors is known as Financial System. Financial Markets perform a crucial role in the financial system as facilitating organizations. Financial markets provide the link between suppliers of funds and demanders of loans. There are

different ways of classifying the financial markets. One such classification consists of dividing the financial market into (i) Primary market (ii) Secondary market.

The primary market facilitates the transfer of investible funds of the savers to the corporates, which need them for productive purposes. The Primary Market, also called the New Issues Market, is of vital importance in the economv of a country, as it leads to better utilisation of otherwise inactive or dormant monetary resources in the economy.

6.3 MEANING OF PRIMARY MARKET

Primary market is the market of new issue .Shares available for the first time is offered through new issue market. The issuer may be a new company or an existing company. These issues may be public issue of new shares or existing shares. Primary market comprises of a market where investors apply directly to the issuer/company for allotment and pay application money to the issuer's/company's account. Primary market is where an issuer/company makes its contact directly with the public at large while raising fund. The primary market provides a direct link between the prospective investors and the company.

In simple words, the primary market creates new securities and offers them for sale to the public.

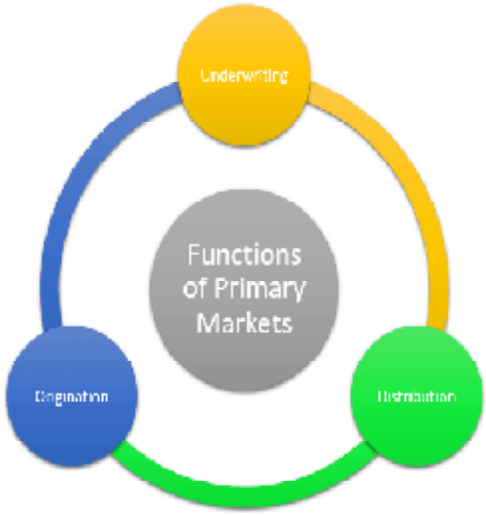
So, Primary market can be defined as the part of capital market where the issuance of new securities is done. The securities are offered to public and are sold for the first time. Also, sellers and buyers can negotiate without any intermediary. This market is also known as new issues market.

This market normally features long term equity capital. Companies and government bodies buy these securities from investment banks and also from security dealers. When the primary issue is done the securities are issued directly by the company to the investors. The companies which receive the primary issues use them for setting up new businesses and also modernizing or expanding the current business.

6.4 FUNCTIONS OF PRIMARY MARKET

The main function of primary market is to facilitate the transfer of resources from savers to entrepreneurs seeking to establish new ventures or to expand or diversify existing ones. The primary market is a complex of institutions consisting of issuing companies, investment bankers and brokers.

The general functions of primary market can be grouped into three services: (i) Origination, (ii) Underwriting and (iii) Distribution.



Origination: The term origination refers to the work of investigation, analysis and processing of new issues for raising funds. The proposal is analyzed in terms of the nature of the security, the size of the issue, and timing of the issue and floatation method of the issue. This function is mainly carried by the lead managers of the issue.

Underwriting: Underwriting is a contract by means of which a person gives an assurance to the issuer to the effect that the former would subscribe to the securities offered in the event of non-subscription by the person to whom they were offered. In other words, the underwriter takes up an agreed portion of the unsubscribed part of the public issue . The person who assures is called an underwriter. The underwriters directly do not buy and sell securities; they stand as back-up supporters and underwriting is done for a commission. However, at present

underwriting is not mandatory.

Distribution: The success of an issue depends on the issues being acquired by the investing public. The sale of securities to the ultimate investors is referred to as distribution. This function is mainly performed by brokers and dealers in securities, who maintain regular and direct contact with the investors.



CHECK YOUR PROGRESS

Q1: What do you mean by Primary Market?

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.....

Q2: What are the functions of Primary Market?

.....

.....

6.5 ISSUE MECHANISM IN PRIMARY MARKET

The success of an issue depends mainly on its issue mechanism. The methods by which new issues are made are given below:

(i) Public issue through prospectus: A common method followed by companies to raise capital through the issue of securities is by means of a prospectus inviting subscription from the investing public. Under this method, the issuing companies themselves offer directly to the general public a fixed number of shares at a stated price. This method has the advantage that the transaction is carried through publicity to reach the entire public. It ensures that the share ownership is widely-diffused, thereby contributing to the prevention of concentration of wealth and economic power. The main disadvantage of this method is that it is highly expensive as the floatation cost is very high.

(ii) Book Building Method: The essence of the book building method is that the pricing of the issues is left to the investors. The issuing company incorporates all the details of the issue proposal in the offer document on the lines of the public issue method including the minimum price. The investors are required to quote the number of securities and the price at which they wish to acquire.It is a pricing mechanism wherein new issues are priced on the basis of demand feedback. Under this system, the price of the new issue is based on real time feedback from the investors. The mechanism adopted under the Book Building is as follows:

- A draft prospectus containing all information, except the price and the number of securities, is filed by the Company with SEBI.
- A lead merchant banker to the issue is appointed as Book Runner.
- The Book Runner will circulate copies of the prospectus amongst the institutional investors and underwriters inviting offeres for subscription to the security.
- The Book Runner maintains a record of the offers received from the institutional investors and underwriters mentioning the price they are ready to pay and the number of securities they intend to buy.
- On the basis of these offers, the Company and the book runner will determine the price of the security. The price so determined, will be the same for both placement position and the public issue.
- Thereafter, the Underwriting Agreement is entered into and prospectus is filed with the Registrar of Companies.
- One-day prior to the public issue, institutional investors are required to submit application forms along with money to the extent the securities are proposed to be allotted to them.

Initially, the book-building process was optional to the companies, but gradually, an element of compulsion has been introduced.

(iii) Placement Method: Under this method, a company offers shares privately only to a few investors, namely, financial institutions, corporate bodies and high net worth individuals that is, less than 50 in number. This is referred to as private placement of securities.

The issue is placed through letter of offer, giving information regarding the issue. Private placement has become the most significant method of mobilizing funds by Indian companies. The advantages of this method are (i) private placement of securities is subject to much less compliance than the public issue;(ii) it is cost effective as compared to public issue and (iii) it is time effective as deals can easily and directly negotiated with a few investors. The main disadvantage is that as securities are offered to a select group , it may lead to the concentration of shares into a few hands .Hence this method lacks transparency.

6.6 ROLE OF SEBI IN THE PRIMARY MARKET

Since SEBI (Securities and Exchange Board of India) became a statutory body in 1992, the Government initiated a series of measures to strengthen the role of SEBI as the regulatory authority of the Capital Market. Most of the powers which were earlier the Government had under the various securities were delegated to SEBI. The following are some of the measures taken by SEBI for the development of primary market:

i. SEBI has been entrusted with the responsibilities to look after the interest of investors for providing them with adequate and full disclosures in the prospectus used for raising equity capital.

ii. SEBI has made it mandatory that all companies issuing equity capital must furnish all the risk factors associated with the issue. These risk factors may cover aspects such as management/ promoters' track record, specific economic aspect affecting the industry in which the issuer company operates, supply of raw materials, the state of statutory approvals, and financial data.

iii. One of the most important changes in the primary market introduced by SEBI is related to fixing the basis of allotment of shares on oversubscription The new method introduced popularly is known as the 'proportional method of share allotment'. This means that the

allotment of shares to each category (classified by number of shares applied for) are in same proportion as the aggregate of shares applied for from such category, to the aggregate number of shares applied in the whole issue.

iv. SEBI removed the earlier condition of compulsory underwriting for all public issues. Underwriting has become a voluntary work. It has become the promoters'/issue managers option on whether or not to get the proposed public issue underwritten partly or fully.

6.7 FACTORS LEADING THE GROWTH OF PRIMARY MARKET INVESTMENT

The following are some of the factors that leads to the growth of primary market investement:

- I*ndustrial Growth:* The industrial growth and exhausting production capacities in the industry has necessitated further expansion of industrial capacities. It induced the companies to mobilize resources for further investment in future.
- *Buoyancy of the secondary market:* Buoyancy of the secondary market led all-round rise in prices of shares. This factor induced the investors put higher amount of their savings in investment in the primary market.
- *Fiscal incentives:* The fiscal incentives given to investors in schemes of mutual funds and reduction in capital gain tax attracted investors in the primary market.
- *Tightening of norms:* On-going process of improving the quality of issues and tightening of norms relating to merchant bankers and credit rate agencies probably created more confidence among investors.



CHECK YOUR PROGRESS

Q3: What is Book Building Method?

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.....

Q4: Write the factors that accelerate the primary market investment.

.....

.....



6.8 LET US SUM UP

- In the primary market , shares are offered for the first time. The primary market provides a direct link between the prospective investors and the company.
- The general functions of Primary market can be grouped into three services: (i) Origination, (ii) Underwriting and (iii) Distribution.
- The methods by which new issues are made are : (i) Public issue through prospectus, (ii) Book Building Method, (iii) Placement Method.
- Book Building has been adopted by SEBI to determine the amount of premium to be charged by a company.
- SEBI ataken some measures for the development of primary market.SEBI has brought several reforms in the new issues market during recent years.
- The factors that leads to the growth of primary market investement:Industrial Growth, Buoyancy of the secondary market, Fiscal incentives and Tightening of norms.



6.9 FURTHER READING

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6.10 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No.1: Primary market is where an issuer/company makes its contact directly with the public at large while raising fund.

Ans to Q No.2: (i) Origination, (ii) Underwriting and (iii) Distribution.

Ans to Q No.3: In book building method the pricing of the issues is left to the investors. The issuing company incorporates all the details of the issue proposal in the offer document on the lines of the public issue method including the minimum price.

Ans to Q No.4: The factors that leads to the growth of primary market investement:Industrial Growth, Buoyancy of the secondary market, Fiscal incentives and Tightening of norms

6.11 MODEL QUESTIONS

Q 1: What do you mean by primary market.

Q 2: Write main functions of the primary market.

Q 3: Write two major reforms that SEBI has brought for the primary market.

Q 4: Discuss the issue mechanism in primary market.

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UNIT 7: SECONDARY MARKETS IN INDIA

UNIT STRUCTURE

7.1 Learning Objectives

7.2 Introduction

7.3 Meaning of Secondary Market

7.4 Functions of Secondary Market

7.5 Relationship Between Primary market and Secondary Market

7.6 Differences between primary market and secondary market

7.7 Stock Exchanges of India

7.8 Bombay Stock Exchange (BSE)

7.9 Over the Counter Exchange of India (OTCEI)

7.10 National Stock Exchange (NSE)

7.11 Rules of SEBI regarding Stock exchange

7.12 Let Us Sum Up

7.13 Further Reading

7.14 Answers To Check Your Progress

7.15 Model Questions

7.1 LEARNING OBJECTIVES

After going through this unit you will be able to :

- explain the meaning and functions of Secondary Market
- explain the history of Stock Exchanges
- explain the historical background of Bombay Stock Exchange
- analyse the functioning of Counter Exchange of India
- describe about National Stock Exchange of India

7.2 INTRODUCTION

In the previous unit we discussed about the primary market. In this unit we are going to discuss the concept secondary market and its different functions. You will also get a fair idea on the concept of Stock Exchange of India, Bombay Stock Exchange, and National Stock

Exchange. At the end of this unit we will discuss on rules of SEBI regarding stock exchange.Also we will discuss the relationship between Relationship Between Primary market and Secondary Market.

The secondary market of securities is an important component of the capital market. It is the market where shares, bonds, debentures and other securities are traded.Once these securities are floated, subscribed to and issued to the public, they are traded in the secondary market, which is called **'Stock Market'.**

Let us now discuss about the secondary markets in the following sections.

7.3 MEANING OF SECONDARY MARKET

The secondary market is the market of existing shares, bonds and preference shares. It is the market where investors can buy and sell securities. This process takes place in the stock exchanges through the help of brokers. This secondary market is often referred as the stock market. Secondary market comprises of the buyers and sellers of shares and debentures subsequent to the original issue. For example, having subscribed to the share or debenture of the company, if one wishes to sell the same, it will be done in the secondary market. Similarly one can also buy the share or debenture of a company from the secondary market (if the company is listed on the stock exchange) without having to wait for that company to come out with a new public issue.

7.4 FUNCTIONS OF SECONDARY MARKET

The following are some of the functions of secondary market:

i. **Maintains active trading:** Shares traded on the stock exchanges, enable the investors to buy and sell securities. The stock exchanges provide liquidity to the existing shares. By and large, at the stock exchange , a seller has a ready purchaser and a purchaser has a ready seller at a price determined at the exchange.

ii. **Ensures safe and fair dealing:** The rules and regulations of the stock exchanges provide measures of safety to the investors. Transactions are conducted under competitive conditions enabling investors to get a fair deal.

iii. **Continuous price formation:** The stock exchanges help in the process of continuous price formation. Price is determined by the transactions that flow from investors' demand and suppliers' preferences. The traded prices are made known to public.

iv. **Performance inducer:** The prices of stocks reflect the performance of the traded companies. This makes the corporate more concerned with its public image and tries to maintain good performance.

v. **Self-regulating organization**: The stock exchanges monitor the integrity of the members, brokers, listed companies and clients. Continuous internal audit safeguards the investors against unfair trade practices.

vi. **Economic Barometer**: The secondary market, through the help of the stock exchange play the role of a barometer, namely, an indicator of the state of health of the nation's economy as a whole. The trend of price movements in the market is indicated by calculating stock market indices. Their movements and levels are indicative of the economic health of the nation to a great extent because movements of prices of shares are influenced by macro economic factors such as growth of GDP, financial and monetary policies, tax changes, political environment, etc.

7.5 RELATIONSHIP BETWEEN PRIMARY MARKET AND SECONDARY MARKET

The following are the relationship between primary and secondary market:

i. The primary market or new issue market cannot function without the secondary market. The secondary market provides liquidity for the issued securities. The issued securities are traded in the

secondary market offering liquidity to the stocks at a fair price.

ii. The stock exchanges through their listing requirements, exercise control over the primary market. The company seeking for listing on the respective stock exchange has to comply with all the rules and regulations given by the stock exchange.

iii. The primary market provides a direct link between the potential investors and the company. By providing liquidity and safety, the stock markets encourage the public to subscribe to the new issues.

7.6 DIFFERENCES BETWEEN THE PRIMARY MARKET AND SECONDARY MARKET

The following table shows the differences between primary and secondary market.

Points of Differences	**Primary Market**	**Secondary market**
Issues of securities	Primary market deals with new issues of new or existing companies	Deals in existing securities
Location	No fixed geographical location needed	Needs a fixed place to house the secondary market activities , viz. trading
Transfer of securities	Securities are created and transferred from corporate to investors for the first time.	Securities are transferred from one investor to another through the stock exchange mechanism.
Feature	**Primary Market**	**Secondary market**
Administration	Has no tangible form of administrative set-up.	Has a definite administrative set-up that facilitates trading in securities.
Regulation	Subject to regulations from outside the company- SEBI, Stock Exchanges etc	Subject to regulation both from within and outside the stock exchange framework.
Price movement	Stock price movement in secondary market influences pricing of new issues	Both macro and micro factors influence the stock price movement.

7.7 STOCK EXCHANGES OF INDIA

The stock exchanges are the most perfect type of market for securities whether of government and semi-government bodies or other public bodies as also for shares and debentures issued by the joint stock companies. In the stock exchanges, the purchases and sales of shares are made in conditions of free competition. The bargains that are struck in the trading system by the members of the stock exchanges are the fairest prices determined by the basic laws of supply and demand.

Definition of stock exchange:

Stock exchange means any body or individuals whether incorporated or not, constituted for the purpose of assisting, regulating or controlling the business of buying, selling or dealing in securities. It is an association of member brokers for the purpose of self – regulation and protecting the interests of its members. It can operate only if it is recognized by the Government under the Securities Contract (Regulation) Act, 1956. The recognition is granted under Section 3 of the Act by the Ministry of Finance, Central Government. The Securities Contract (Regulation) Act, 1956 is the basis for operation of the stock exchanges in India.

LET US KNOW



The Indian stock market is one of the oldest in Asia. The origin of the stock market in India goes back to the end of the eighteenth century when long-term negotiable securities were first issued. However, the real beginning occurred in the middle of the nineteenth century after the enactment of the Companies Act in 1850, which introduced the features of limited liability and generated investor interest in corporate securities. A significant event in the development of the stock

market in India was the formation of the 'Native Shares and Stock Brokers' Association at Bombay in 1875, which is today the Bombay Stock Exchange. Then the second stock exchange 'Ahmedabad Stock Exchange' was set up in 1894. Both the Exchanges were organized as voluntary non-profit making associations of brokers to regulate and protect their interests. The Bombay Securities Contracts Act of 1925 used to regulate trading in securities. Under this Act, the Bombay Stock Exchange was recognized in 1927 and Ahmedabad in 1937. During the war boom, a number of stock exchanges were organized even in Bombay, Ahmedabad and other centres, but they were not recognized. Soon after, it became a Central subject and The Securities Contract (Regulation) Act, became law in 1956, which is the basis for operation of the stock exchanges in India.

Subsequently, 25 stock exchanges were set up and recognized by the central government, the most important development being the establishment of the National Stock Exchange (NSE) in 1994.Within a short period, it emerged as the largest stock exchange in the country, and even surpassed the Bombay Stock Exchange which was historically the leading stock exchange in India.

TRADING ON EXCHANGES

Investors can carry out their operations i.e. buying and selling of securities through brokers and sub-brokers. A broker is an enrolled member of stock exchange who is authorized to the stock exchange trade. He has to be registered with SEBI. A sub-broker is affiliated to the members (brokers) of the stock exchange and registered with SEBI as sub-brokers.

Buying and selling of shares is an agreement between the broker/ sub-broker and the investor. The broker charges a fee , which is between 0.50 per cent and 1per cent of the value of transaction, for executing the transaction in the stock exchanges.

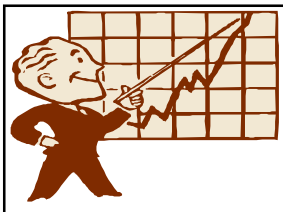
Every stock exchange has certain listed securities which are traded on it. Investors who wish to purchase or sell these securities need to place their orders with the members/brokers of the exchange. There are two ways of organizing the trading activity: the open outcry system and the screen-based system.

- **Open Outcry System**: This system involves shouting and using of signals by traders on the trading floor of the exchange which has several trading posts for different securities.
- **Screen-based System**: In this system, the trading ring is replaced by the computer screen whereby, a large number of participants, geographically spread can trade simultaneously at high speeds.

SETTLEMENT

The process of fulfillment of the obligations of the trade by the parties to the transactions is known as 'settlement'. This implies payment of funds to the seller and delivery of securities to the buyer. Though trading in shares takes place on all stock exchange working days, all settlements need not take place automatically. Settlement may be on a cash basis or by a forward contract.

- **Cash settlement** means that the sale and purchase of shares noted down by the brokers will be finalized through the act of receiving cash by the seller and the receipt of share documents by the buyer. Thus, the delivery of assets takes place on the settlement day.
- **In forward contracts of settlement**, the transactions recorded are renewed by a carry forward contract. Payment for sale and delivery of share certificate do not take place.



CHECK YOUR PROGRESS

Q1: What do you mean by Secondary Market

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Q2: What are the functions of Secondary Market?

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Q3: What do you mean by Stock Exchange?

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7.8 BOMBAY STOCK EXCHANGE (BSE)

The origin of the Bombay Stock Exchange dates back to 1875. It was organized under the name of "The Native Stock and Share Brokers Association" as a voluntary and non-profit making organization. It was recognized on a permanent basis in 1957. This premier stock exchange is the oldest stock exchange in Asia. The Bombay Stock Exchange Limited has the greatest number of listed companies in the world, with 4700 listed as of August 2007 .On 31 December 2007, the equity market capitalization of the companies listed on the BSE was US$ 1.79 trillion, making it the largest stock exchange in South Asia and the 12th largest in the world.

The main objectives of the organization are (i) to safeguard the interest of investing public; (ii) to promote, develop and maintain well-regulated market for dealing in securities; and (iii) to establish and promote just practices in securities transactions.

In March 1995, the Bombay Stock Exchange introduced screen based trading called BOLT (BSE on-line trading).The BOLT is designed to get best bids and offers from brokers as well as the best but and sell orders from the order book. There is a separate surveillance department in the stock exchange. The surveillance department aims at providing free and fair market price. The surveillance can be classified into price surveillance and pre-monitoring. BSE places a great deal of emphasis on Information Technology for its operations and performance. The 'Operations & Trading Department' at BSE continuously upgrades the hardware, software and networking systems, thus enabling BSE to

enhance the quality and standards of service provided to its members, investors and other market intermediaries. The capacity of the BOLT platform stands presently enhanced to 80 lakh orders per day.

The securities traded in the BSE are classified into three groups, namely, specified shares or 'A' group and non-specified securities. The latter is divided into 'B1' and 'B' groups. Group 'A' contains the companies with large outstanding shares, good track record and large volume of business in the secondary market. Relatively liquid securities come under the 'B1' group and the remaining shares are placed under the 'B' group.

7.9 OVER THE COUNTER EXCHANGE OF INDIA (OTCEI)

OTCEI (OTC exchange of India) is a different kind of stock exchange. The acronym OTC stands for 'Over The Counter', a phrase coined to describe the situation , many years ago, when investors could buy and sell securities over the counters of their local banks. Today the OTC market refers to a way of trading, securities through a network of broker-dealers spread over different locations and linked to each other by telephones, telexes, faxes and computers.

The Over the Counter Exchange of India (OTCEI) was started in India in 1992. Its operations had been fully computerized. It has a network of counters linked by an electronic communication system. The minimum capital requirement for a company to be listed on the OTCEI is Rs 3 crores and the maximum is Rs 50 crores.

The main objectives of the exchange are the followings:

i. To provide a market for the smaller companies that can not afford the listing fees of the larger exchanges.
ii. To create a fully decentralized and transparent market.

Players in the OTCEI Market:

There are the following players in the OTCEI market:

- Companies whose securities are traded on the OTCEI.

- Investors who deal through the OTCEI counters.
- Members and dealers: Instead of the brokers who function on the traditional stock exchanges, OTCEI will have two players, namely, members and dealers.

OTCEI was started with facilities very new to the Indian market, like screen based trading, nation wide coverage etc. Even though, the OTCEI was established to help small companies to raise capital later it started listing large capitalization companies. In spite of its initial glamour, it needed lot of improvement in upgradation of infrastructure and technology. This paved the way for the starting of the National Stock Exchange.

7.10 NATIONAL STOCK EXCHANGE (NSE)

The National Stock Exchange came much after the Bombay Stock Exchange but within a short period, it emerged as the largest stock exchange in the country, and even surpassed the Bombay Stock Exchange which was historically the leading stock exchange in India.

After the formation of the Securities Market regulator, the Securities and Exchange Board of India (SEBI), attention were drawn towards the inefficiencies of the bourses and the need was felt for better regulation, discipline and accountability.

A Committee recommended the creation of a second stock exchange in Mumbai called the **"National Stock Exchange**". The Committee suggested the formation of an exchange which would provide investors across the country a single, screen based trading platform, operated through a VSAT network. It was on this recommendation that setting up of NSE as a technology driven exchange was conceptualized. NSE has set up its trading system as a nation-wide, fully automated screen based trading system. It has written for itself the mandate to create a world-class exchange and use it as an instrument of change for the industry as a whole through competitive pressure. NSE was incorporated in 1992 and was given recognition as a stock exchange in

April 1993. It started operations in June 1994, with trading on the Wholesale Debt Market Segment. Subsequently it launched the Capital Market Segment in November 1994 as a trading platform for equities and the Futures and Options Segment in June 2000 for various derivative instruments.

NSE was set up with the objectives of:

(a) Establishing a nationwide trading facility for all types of securities;

(b) Ensuring equal access to investors all over the country through an appropriate communication network;

(c) Providing a fair, efficient and transparent securities market using electronic trading system;

(d) Enabling shorter settlement cycles and book entry settlements; and

(e) Meeting international benchmarks and standards.

Ownership and Management

The NSE is owned by a set of leading financial institutions, banks, insurance companies and other financial intermediaries. It is managed by a team of professional managers and the trading rights are with trading members who offer their services to the investors.The Board of NSE comprises of senior executives from promoter institutions and eminent professionals, without having any representation from trading members.

Market Segments and Products

NSE provides an electronic trading platform for of all types of securities for investors under one roof - Equity, Corporate Debt, Central and State Government Securities, Treasury Bills, Commercial Paper (CPs), Certificate of Deposits (CDs), Warrants, Mutual Funds (MFs) units, Exchange Traded Funds (ETFs), Derivatives like Index Futures, Index Options, Stock Futures, Stock Options, Futures on Interest Rates etc., which makes it one of the few exchanges in the world providing trading facility for all types of securities on a single exchange. The Exchange provides trading in 3 different segments viz., Wholesale Debt Market (WDM) segment, Capital Market (CM) segment and the Futures & Options (F&O) segment.

The following are the achievements of NSE:

i. **NSE as a trend setter:** The anonymous order matching system adopted by NSE is one of the best in the world. In terms of geographical reach of the real time trading facilities to the nooks and corners of the country, the Indian capital market is way ahead of most of the global capitals. Investors can trade from close to 400 cities/towns across the country.

ii. **The Concept of a Demutualised Exchange:** The NSE happens to be the first truly demutualised stock exchange of the world. It means separation of exchange ownership and management from the trading rights of members.

iii. **Settlement Guarantee:** The concept of a settlement as it is prevalent today was almost unknown in India until 1995. NSE had set up National Securities Clearing Corporation Ltd. (NSCCL) for this purpose. This has helped NSE in providing a seamless integration of two important functions, that is , trading and settlement with full guarantee.

iv. **Depository with dematerialization:** NSE is the first in the country to set up a depository where ownership records would be maintained in the dematerialized form. The Indian depository is unique in the world as it has full data on investor holdings.

7.11 RULES OF SEBI REGARDING STOCK EXCHANGES

Under Section 11 (1) of the SEBI Act, following are the powers of SEBI to protect and promote the interests of investors in securities:

- **Stock Exchange Regulation**: SEBI is empowered to regulate the regulate the business in stock exchanges and any other securities market. It works to prohibit fraudulent and unfair trade practices in securities market. SEBI performs functions like calling for information, undertaking inspection, conducting enquiries and audits of the stock exchanges, intermediaries, and self-regulatory organizations in these securities market.

- **Stock Brokers Regulation:** SEBI is empowered to register and regulate the working of stockbrokers, sub-brokers, share transfer agents underwriters etc. who may be associated with securities market in any manner.
- **Investor Protection:** SEBI is empowered to initiate all the steps for promoting investor education and training of intermediaries in securities market. For this purpose it would work towards prohibiting insider trading in securities, besides regulating substantial acquisition of shares and take-over of companies.



CHECK YOUR PROGRESS

Q4: Pick the correct alternative from the following :

i. Primary and secondary markets
   (a) compete with each other
   (b) complement each other
   (c) function independently

ii. In private placement
   (a) shares are offered through letter of offer
   (b) shares are offered through prospectus
   (c) shares are offered through brokers

iii. The underwriter has to take up
   (a) the fixed portion of the issue capital
   (b) the agreed portion of the unsubscribed part
   (c) the agreed portion or can refuse it

iv. Under screen –based system
   (a) this system involves shouting and using of signals by traders on the trading floor
   (b) this involves selling of shares by banks (c) the tradingring is replaced by the computer screen .

v. The Bombay Stock Exchange was recognized on a permanent

basis in

(a) 1957 (b) 1956 (c) 1950

vi. To be listed on the OTCEI, the minimum capital requirement for a company is

(a) Rs 5 crores (b) Rs 3 crores (c) Rs 1 crores



7.12 LET US SUM UP

- The secondary market is the market of existing shares, bonds and preference shares. It is the market where investors can buy and sell securities.
- In the stock exchanges, the purchases and sales of shares are made in conditions of free competition.
- A significant event in the development of the stock market in India was the formation of the 'Native Shares and Stock Brokers' Association at Bombay in 1875, which is today the Bombay Stock Exchange.
- The OTCEI was established with the purpose of providing a fair trade platform for the shares of small capitalization companies.
- National Stock Exchange is an exchange which provides investors across the country a single, screen based trading platform, operated through a VSAT network.



7.13 FURTHER READING

1) Batra G.S. (2002). *Financial services and markets.* New Delhi, Deepand Deep Publication Pvt. Ltd.
2) Mishkin,Frederic S. (2007) *Financial Markets and Institutions.* New Delhi, Pearson Education Ltd.
3) Srivastava, R.M. (2009). *Management of Indian financial institutions.* New Delhi, Himalaya Publishing House.
4) Khan, M. Y. (2007). *Indian Financial System.* New Delhi. Tata McGraw Hill.
5) Pathak, Bharati V (2006). *The Indian Financial System : Markets,*

institutions and services. New Delhi, Pearson Education Ltd.

7.14 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No.1: The secondary market is the market of existing shares, bonds and preference shares. It is the market where investors can buy and sell securities.

Ans to Q No.2: i. Maintains active trading, ii. Ensures safe and fair dealing, iii. Continuous price formationm, iv. Performance inducer, v.Self-regulating organization, vi. Economic Barometer.

Ans to Q No.3: The stock exchanges are the most perfect type of market for securities whether of government and semi-government bodies or other public bodies as also for shares and debentures issued by the joint stock companies.

Ans to Q No.3: i. (b) ii. (a) iii (b) iv. (c) v.(a) vi. (b)

7.15 Model QUESTIONS

Q 1: What is meant by secondary market.

Q 2: Write four main functions of the secondary market.

Q 3: Is there any relationship between the primary and secondary market? Explain.

Q 4: Give a brief account of the history of stock exchanges in India .

Q 5: Explain the trading process on stock exchanges.

Q 6: Is there any difference between the Bombay Stock Exchange and National Stock Exchange.

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