

CHAPTER-10

FINANCIAL MARKET



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Financial market is the place where financial assets are bought and sold. Financial market act as an intermediary between two group who perform savings and investment functions.

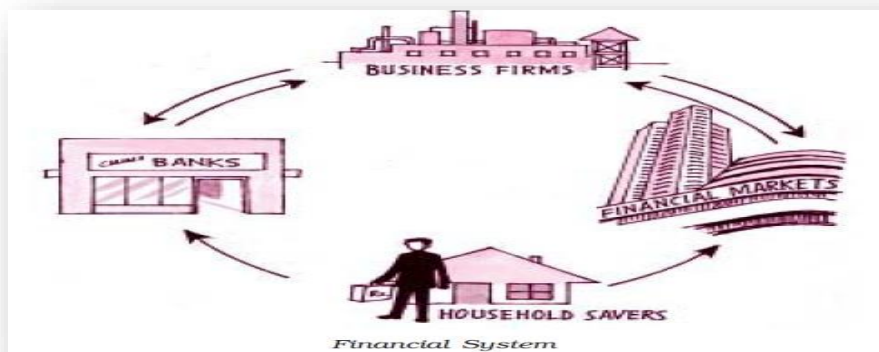
Financial market is defined as

“ an organizational frame work with in which financial instruments can be bought and sold.” Financial markets deal in financial assets such as deposits, shares, debentures, funds, commercial paper and so on

Financial market acts as a linking pin between the savers and investors by mobilizing funds between them. This function of financial market is known as **allocative function**.

Allocation of funds: There are two alternatives through which allocation of funds can be done – **banks and financial markets**. Households (savers) can deposit their surplus funds with banks. Banks then lend these funds to business firms. Household savers can also invest their savings in financial market directly by purchasing shares and debentures offered by business firms

The process by which allocation of funds is done through banks and financial markets is called **financial intermediation**



FUNCTIONS OF FINANCIAL MARKET

A financial market is a market for the creation and exchange of financial assets. The important functions of financial market are

1. Mobilise savings and channelize them into most productive purposes

A financial market facilitates transfer of savings from people (savers) to investors. It offers the savers different investment avenues and help to channelize surplus funds into productive purpose.

2. Facilitating Price discovery:-

The financial market helps in establishing the price of financial assets. The interaction between the suppliers of funds and business firms (investors) determine the price of financial assets.

3. Providing liquidity to financial assets:-

Financial market provides liquidity to financial assets. It makes the financial assets liquid, so that they can easily be converted into

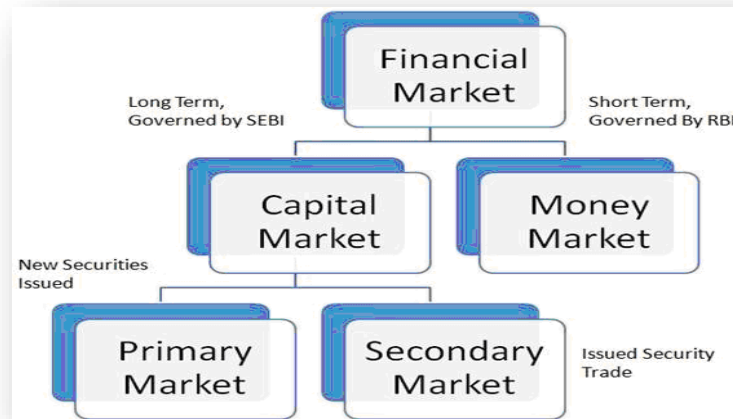
cash whenever required.

4. **Reducing the cost of transaction:** The valuable information about the securities is provided through financial market. It helps the buyers and sellers of financial securities in saving time, efforts and money in the dealings.

Classification of Financial market

Financial market consists of two major segments

1. **Capital market-** which is a market for medium and long term funds and
2. **Money market-** which is a market for short term funds



MONEY MARKET:

Money market is the market for short term funds. Short term funds are meant for the use for a period up to one year. It constitutes a major source of working capital finance. Money market securities are close substitutes for money. It is a market where low risk, unsecured and short term debt instruments that are highly liquid are issued and traded everyday. Money market has no physical location, but its activity is conducted through the telephone and internet.

Features of money market

- **Participants:** The participants of the money market are RBI, Commercial banks, financial companies and financial institutions
- **Instruments:** The instruments dealt with in the money market are bill of exchange, treasury bills, Certificate of deposits, commercial papers
- **Investment outlay:-** Huge sums of money are being transacted in the money market.
- **Duration:-** It is a market for short term instruments having a maturity period of less than one year.
- **Liquidity:** Money market instruments enjoy a high degree of liquidity
- **Safety:-** Short term duration ensures greater safety
- **Physical location:** No physical location, activities are conducted over telephone or internet
- **Returns:** Less return compared to capital market
- **Unsecured:** Money market instruments are unsecured

The Indian money market consists of two segments:- **The organized market** and **unorganized market**. The organized market is under the control of **Reserve Bank of India**. Other important players are commercial banks, LIC, General Insurance Corporation, UTI, Public and private Companies etc. The unorganized sector consists of indigenous bankers

and money lenders.

MONEY MARKET INSTRUMENTS

1. **Treasury Bills (T- Bills)/ Zero coupon Bonds:-** These Bills are issued by Reserve Bank of India (RBI) on behalf of the Government of India. These are short term credit instruments for a period of less than one year. Treasury bills are negotiable instruments and freely transferable. It does not carry interest. They are issued at a price which is lower than their face value and repaid at par. Treasury bills are available for a minimum amount of Rs. 25000 and in multiple thereof.
2. **Commercial paper:-** In India Commercial paper have been introduced in 1989 on the recommendations of Vagal Committee. It an Unsecured promissory note with a fixed maturity period of 15 days to one year. It is sold at a discount and redeemed at par. The original purpose of commercial paper was to provide short term funds for seasonal and working capital funds. It is a negotiable instrument transferable by endorsement and delivery. Fund raised through commercial paper are used to meet the flotation cost. This is known as bride financing.
3. **Call money:-** Call money is a short term finance repayable on demand, with a maturity of one day to 15 days. The day to day surplus funds, mostly of banks are usually trades as call money. Banks may borrow money when they face with temporary shortage of funds. Similarly bank with surplus of funds can also lend for short time period. The interest rate paid for call money loans is known as the call rate. This market is also known as “over the telephone market”. Call money is a method by which banks borrow mutually to maintain CRR (Cash Reserve Ratio), CRR is the minimum balance a commercial bank should maintain with RBI.
4. **Certificate of Deposit (CD):-** Certificate of deposit is unsecured, negotiable, short term instruments issue by commercial banks and development financial institutions. The period of these deposits ranges between 91 days to one year. Only banks can issue such a certificate.. The major difference between CD's and Fixed deposits is that CDs are transferable and tradable and FDs are not.
5. **Commercial bill/ trade Bill/ Bill of exchange :-** A commercial bill is a bill of exchange to finance the working capital requirements of business firms. The trader who has received a bill can discount it with his bankers. The bank in turn can rediscount these bills in the commercial bill markets. Rediscounting provides short term liquidity to such banks. When a trade bill is accepted by a commercial bank it is known as a commercial bill.



CAPITAL MARKET

This is the market for medium and long term funds. Financial assets with a maturity of more than year is a part of capital market. It is a market for long term capital. The capital market provides long term debt and equity finance for the government and the corporate sector. A wide variety of instruments is used to raise funds in the capital market. These instruments are ownership securities (Equity shares and preference shares) and creditor ship securities (debentures and bonds). The capital market consists of development banks, commercial banks and stock exchanges.

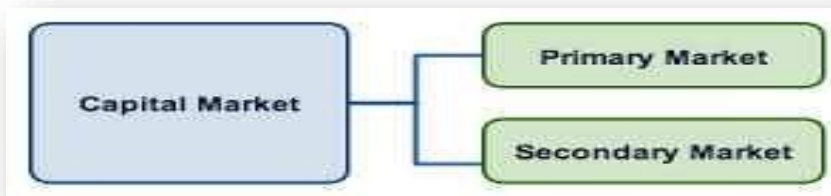
Features of capital market

- **Participants:** The participants of capital market are financial institutions, banks, corporates entities, foreign investors, stock exchanges etc.
- **Instruments:** the main instruments traded in the capital market are – equity shares, debentures, bonds, preference shares etc.
- **Investment outlays:** it requires less investments as value of securities is generally low
- **Duration:** capital market deals with medium term and long term securities
- **Liquidity:** High liquidity
- **Safety:-** Capital market instruments risky both in return and principal repayment.
- **Return:** Capital market instruments yield a high return

Distinction between money market and capital market

Money Market	Capital Market
1. It is a market for short term instruments having a maturity period of less than one year.	1. It is a market for medium and long term instrument having a period of maturity more than 1 year.
2 It helps to meet working capital needs	2. It helps in meeting fixed Capital needs
3. The participants of money market are RBI, Commercial banks, financial companies and financial institutions	3. The participants of capital market are private companies, foreign investors, banks, Private and public companies and financial institutions
4. The instruments deal with money market is bill of exchange treasury bills, Certificate of deposits, commercial papers.	4. The instruments deal with capital market are equity shares, preference shares, debentures, bonds etc.
5. It is a whole sale market. The instruments have large face value	5. It is a retail market. The instruments have small face value
6. It is normally take place over telephone and other ways	6. Capital market transactions normally take place at stock exchange.
7. Money market instruments yield only a less return	7. Capital market instruments yield a high return.
8. The market regulator is the Central Bank of the country. RBI is the market regulator in India.	8. There is a separate regulator in the capital market. In India SEBI is the market regulator.
9. Money market instruments are much safer with minimum risk of default.	9. Capital market instruments risky both in return and principal repayment.

The Capital market can be divided into two segments (1) Primary Market (2) Secondary market.



(1) PRIMARY MARKET/ NEW ISSUE MARKET (NIM): It deals with new securities being issued for first time. It is the market for newly issued financial assets. In primary market, if new companies are issuing securities it is known as a “ **Initial Public offerings** “(IPO) and existing companies are issuing shares it is known as “ **seasoned equity Offerings** (SEO)”. The investors in this market are banks, financial institutions, Insurance companies, mutual funds and individuals. A company can raise capital through the primary market in the form of equity shares, preference shares, debentures and deposits.

Methods of Flotation

There are various methods of floating new issues in the primary market. They are:

1. **Offer through Prospectus:-** This is the most popular method of raising funds by public companies in the primary market. This involves inviting subscriptions from the public through issue of prospectus. The prospectus can be described as a notice, circular or an advertisement, which is printed and published by the company to inform and invite the public regarding the issue.

The main objects of prospectus are:

- * To inform public about formation of company
- * To invite public to subscribe its securities.
- * To induce public to invest in its securities.



Here the company directly invites the public to subscribe shares and the investors can directly apply for shares.

2. **Offer for sale:-** under this method, securities are not issued directly to the public, but are offered for sale through intermediaries like issuing houses or stock brokers. Thus the intermediaries act as a connecting link between the company and investors.. In this case the company sell securities en block at an agreed price to brokers who in turn, resell them to the investing public.
3. **Private Placement:-** Private placement is the allotment of securities by a company to institutional investors and some selected individuals. It means sale of securities privately to friends, relatives, promoters, directors etc. Companies that do not wish to disclose information to the public resort to this type of market. This method is highly economical as there is no need of any kind of advertisement.
4. **Right issue:** This is a privilege given to existing shareholders to subscribe to the new share issue according to the terms and conditions of the company. It is the right of the existing shareholders to subscribe additional shares when there is fresh issue. The right is known as pre-emptive right. It is considered to be in expensive.
5. **E-IPOs :-** A company wishes to issue capital to the public through online system

should enter into an agreement with the stock exchange. This method of new issue is called e- IPOs. SEBI appointed brokers should receive the applications and forwarded to the company. A registrar to the issue should be appointed. He should have electronic connectivity with the exchange.

SECONDARY MARKET

The secondary market is also known as the stock market or stock exchange. Secondary market is the market for the purchase and sale of second hand or existing securities . These securities are already floated in the primary market. It helps existing investors to disinvest and fresh investors to enter the market. It also provides liquidity and marketability to existing shareholders. Securities are traded, cleared and settled within the regulatory provisions prescribed by SEBI. In India The National Stock Exchange (NSE), Bombay Stock Exchange(BSE), Over The Counter Exchange of India(OTCEI), Regional Stock exchanges and the Depositories are the major components of the secondary market.



DIFFERENCE BETWEEN PRIMARY MARKET AND SECONDARY MARKET

Primary Market	Secondary Market
1. It deals with new securities	1. It deals with existing securities
2. Securities are sold only once	2. It provides regular and continuous market
3. Investors can only purchase securities	3. Investors could purchase and sell securities from stock exchanges
4. It provides capital to the companies	4. Issuing company does not have any direct role
5. It does not have any physical existence	5. Stock Exchanges have physical existence
6. It links the issuing company and investors	6. Transactions are made between investors.

STOCK EXCHANGE

Stock exchange is an organized market where the second hand securities are bought and sold. Securities include shares, debentures and bonds issued by companies and government. Stock exchanges help companies raise finance, provide liquidity and safety of investment to the investors and enhance the credit worthiness of individual companies. Stock exchange is described as the mart of the world.

Meaning

According to securities Contract (regulation) Act 1956 “ Stock Exchange is an association, organization or body of individuals, whether incorporated or not established for the purpose of assisting , regulating and controlling business in buying , selling and dealing in securities”

_FUNCTIONS OF STOCK EXCHANGE

- 1. Provide liquidity and marketability to existing securities:**The basic function of stock exchange is the creation of a continuous market where securities are bought and sold. This provides liquidity and easy marketability to already existing securities

in the market.

2. **Pricing securities**_: Stock exchanges serve as a **barometer of the economy** which indicates market prices of securities. A stock exchange is a mechanism of constant valuation through which the prices of securities are determined.
3. **Safety of transaction**_: Stock exchanges have different measures and mechanisms to ensure fair dealings and protection of the interest of the investors.
4. **Contributes to economic growth**:- Stock exchanges help in enhancing economic growth by allocating savings to the most efficient avenues of production.
5. **Mobilisation of savings**_: A stock exchange helps in mobilizing surplus funds of individuals and institutions for investment in securities. Wide publicity of stock exchange operation promotes savings and investment.
6. **Spreading of equity cult**: The stock exchange can play a vital role in ensuring wider share ownership by regulating new shares, better trading practices and taking effective steps in educating the public about investments.
7. **Providing scope for speculation**_: The stock exchange provides sufficient scope within the provisions of law for speculative activity in a restricted and controlled manner.

TRADING AND SETTLEMENT PROCEDURE



Till a few years ago trading on a stock exchange took place through a 'public outcry or auction system.' In the trading ring brokers assembled in a face to face manner and made a bargain on price of securities. The members were called by the name brokers.

At present, trading in stock exchange is carried on with the help of computers. This is popularly known as '**On line trading**'. Stock exchanges have its main computer system with many terminals. In the case of screen based system there is no need for buyers and sellers to meet at a physical location to trade. They can trade through the computerized trading screens available with the trading members. Buy and sell orders received from different brokers are automatically matched and matching orders are executed.

Advantages of electronic trading system/ screen based Trading / Online Trading

1. **It ensures Transparency** : The investors can check the exact price at which the transactions occurred. It ensures transparency
2. **Efficient Information**:- The computer screen instantly displays the share price, capital market developments that influences share prices etc. This increases the efficiency of information
3. **Efficient operation**: Since it reduces time, cost and effort it increases the efficiency of operation.
4. **Wide coverage**:- This system enables a large number of participants to trade with each other. People from all over the country can buy or sell securities through brokers and members without knowing each other.
5. **A single platform**:- All the trading centres spread all over the country have been brought into one trading platform. i.e. The stock exchange on the computer.

The following steps are involved in the screen based trading for buying and selling of securities.

1. **Select a broker and enter into agreement with him.** The investor should furnish certain other details. These include PAN (permanent Account Number), date of Birth, address, education qualifications, occupation, residential status, bank account number. etc.
2. **The investor have to open a 'demat' account with a Depository Participant (DP).** DP may be a broker, bank or financial institution. This account is necessary for holding and transferring securities in the 'demat' form.
3. **The investor places an order** with the broker to buy or sell shares. An order confirmation slip is issued to the investor by the broker.
The broker will go online and connect to the main stock exchange and match the share with best price.
4. **Execution of order** through the computer terminal. The broker will issue a trade confirmation slip to the investor.
5. Within 24 hours of trade, the broker **issues a contract note.** It contains the number of shares bought or sold, its price, date and time of deal and brokerage charges
6. The investor has to deliver the share sold or pay cash for the share bought. This should be done after receiving the contract note. This is called Pay in day.
7. After that the broker settles the transaction on T + 2 day. The settlement cycle is on T +2 day on a rolling settlement. This is called the pay –out day. The broker has to make payment to the investor within 24 hours of the pay out day.
8. Effecting changes in the demat accounts. I.e. Add/delete the number of shares purchased/sold in the demat account.

Depository: The depository is an organization where securities of a shareholder are held in electronic form. This is same as a bank holding money of depositors. The depository holds electronic custody of securities and makes arrangements for transfer of ownership of securities on the settlement day by means of book entries. In India there are two depositories National Securities Depositories Ltd (**NSDL**) and Central Depository service Limited (**CSDL**).



Depository participant (DP): A DP is an agent of the depository and functions as the connecting link between depository and investors. A DP is responsible for maintaining the investors' securities account with the depository and handles the account in accordance with the instructions of the investor

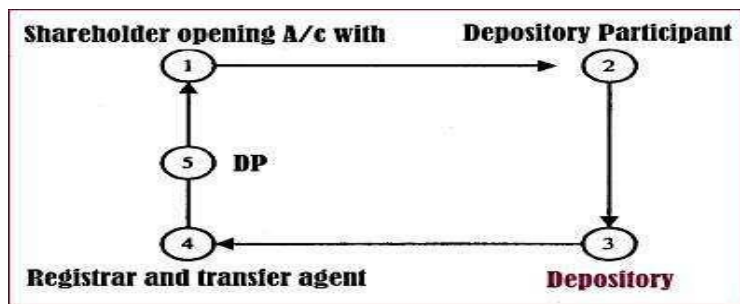
Dematerialisation/ Scrip less trading

Dematerialisation is a process by which paper share certificate are converted into electronic form. It is an electronic record of share ownership. To trade in dematerialized form, a ' demat account' is to be opened. Only registered shareholders can apply for dematerialization. Once the shares are dematerialized, they will be credited to the investors account with the depository

Working of Demat System

1. Select and approach a certified DP (Depository Participant) and submit account opening form along with necessary documents

2. The physical share certificate along with dematerialization request form (DRF) is to be given to the DP.
3. DP intimates the depository of the request through electronic media.
4. DP submits the share certificate along with DRF to the registrar.
5. Registrar validates request, updates records and informs depository.
6. Depository credits the DP account and inform the DP
7. DP updates the investor account and informs the investor.



Dematerialisation process

*** **Rematerialisation:** Rematerialisation known as 'remat'. reverse of demat. ie .Getting physical certificate from the electronic securities.



Stock market index: A stock market index is a barometer of market behavior. It can also be used as a benchmark for evaluating portfolios of investors. It reflects market direction and indicates day to day fluctuation in stock prices. In Indian markets the BSE SENSEX and NSE NIFTY are important indices

Some important Global Stock Market indices are DOW JONES, NASDAQ ,S and P 500 Index, FTSE 100 etc.

Stock exchange in India

There are 23 stock exchanges in India including National stock exchange (NSE) and Over The Counter Exchange Of India (OTCEI).Out of these Bombay Stock Exchange is the oldest one. (1875)

National Stock Exchange (NSE)

The National Stock exchange of India Ltd (NSE) is an Indian's largest stock exchange located at Mumbai. NSE was incorporated in 1992 and was recognized as a stock exchange in 1993 under Securities Contracts (Regulation) Act 1956. NSE was set up by IDBI, ICICI, IFCI, LIC and other financial institutions.

NSE is a public limited company and it has nationwide coverage and therefore functioning across the country. NSE launched **capital market segments in 1994** and futures and options(**derivatives**) in 2000.

Features of NSE

1. NSE is a public limited company
2. NSE is an integrated stock market system with nation wide coverage.

3. NSE has two segments. Viz wholesale debt market and capital market.
4. NSE has ring less screen based trading system (Online trading System)
5. NSE index is called Nifty.
6. NSE is the first exchange in the world to use satellite communication technology for trading.

Objective of NSE

1. Establish nationwide trading facility for all types of securities (both capital and money market securities)
2. Ensure equal access to all investors all over the country through communication network.
3. Provide fair, efficient, speedy and transparent transaction using electronic trading system.
4. Enable shorter settlement cycles and book entry settlement.
5. Meet International benchmarks and standards.
6. NSE provides a fully automated screen based trading system with national reach.

Market segments of NSE



NSE has two segments

1. **Whole sale debt market Segment (WDM):** provides trading facilities in whole range of debt investments (money market instruments such as T-bills, Commercial bills, Commercial paper, Certificate of deposit etc.). Membership to WDM limited to only corporates.
2. **Capital market Segments:** Provides trading facilities in capital market instruments such as shares, debentures, bonds etc.

Some Common stock market terms

Bourses - Another name for stock market.

Bull: An optimistic trader , expects a rise in prices and make profits.

Bear:- A pessimistic trader, expects a decrease in prices

Badla:- It is a carry forward system of settlement particularly in BSE.

Penny stocks: securities with no values, But whose trading results in speculation.

Odd Lot Trading : Trading in multiples of 100 stocks or less.

OVER THE COUNTER EXCHANGE OF INDIA (OTCEI)

The OTCEI is a company which commenced trading in 1992. It is subject to the provisions of companies act 1956. It was set up to address the problems of small investors and small business enterprises. It is fully computerized, transparent, single window exchange. This exchange is established on the lines of NASDAQ (National association of securities Dealers Automated Quotations) , the OTC exchange in USA. It has been promoted by UTI, ICICI, IDBI,IFCI,LIC,GIC,SBI etc.

Features of OTC exchange

1. It has nationwide network.
2. It does not have trading ring (no geographical place)
3. It provides electronic based trading.
4. It offers more transparency and quick trading facilities to investors.
5. It provides greater liquidity of the securities of small companies.

Objectives/ Advantages of OTCEI

1. To provide a nationwide investor base to small companies
2. To enable small companies to raise capital at low cost.
3. It offers transparent dealings in securities
4. It offers quick trading facilities to investors.
5. It ensures liquidity to securities listed in OTC exchange
6. It provide a single trading platform for investors throughout the country.
7. It offers freely and quick settlement and delivery system.

BSE(Bombay Stock Exchange)



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Bombay stock Exchange (BSE) is the oldest Stock exchange in Asia. It was launched in the year 1875 in the name of “ **the Native Share & Stock Brokers Association**”. Currently about 6000 companies have been listed in BSE. In 1957, the BSE become the first stock exchange to be recognized by the Indian Government . In 1986 , it developed the BSE Sensex Index .The trading platform of BSE is known as **BSE On Line Trading (BOLT)**system(introduced in 1995).

Objective of BSE

1. To provide an efficient and transparent market for trading in equity , debt instrument, derivatives and mutual funds.
2. To provide a trading platform for equities for small and medium enterprises.
3. It safeguards market integrity through electronically driven exchange.
4. To confirm an international standard

Common features of NSE and OTCEI

1. **Nationwide coverage:** Both the NSE and OTCEI provide nationwide reach to investors
2. **Screen based trading:** Transaction at NSE/OTC are fully computerized
3. **Ring less:** The companies of NSE/OTC dealers are linked to the central computer of the NSE/OTC through a satellite network.
4. Both have headquarters at **Mumbai**
5. **Incorporate bodies:** NSE and OTC both have been established as companies.
6. Both NSE and OTCEI **ensures transparency** in dealing securities.

SENSEX :The Sensex is the benchmark index of the BSE. Since BSE has been leading exchange of the Indian secondary market, the SENSEX has been an important indicator of the Indian stock market. If Sensex rises, it indicates the market is doing well. It is also a measure of the state of the Indian economy. The SENSEX ,launched in 1986, is made up of 30 of the most activity traded stocks in the market

SEBI(SECURITIES AND EXCHANGE BOARD OF INDIA)

Securities and Exchange Board of India (SEBI) is the regulatory and developmental agency of Indian capital market. It was established in 1988 and was given statutory status through the securities Exchange Board of India Act 1992. SEBI was to set up to protect the interest of investors promote the development of stock market and regulate it. Its headquarters is at Mumbai.

Reasons for the establishment of SEBI: The capital market has witnessed a tremendous growth during 1980's. This leads to a variety of malpractices on the part of companies, brokers, merchant bankers, investment consultants etc. These malpractices and unfair trading practices had eroded investors' confidence and multiplied investors' grievances. Therefore government of India decided a separate regulatory body known as SEBI, so as to control malpractices and unfair trade practices in the security market.



Objectives of SEBI

SEBI is meant to be a supervisory body for regulating and promoting the securities market of India. The main objectives of SEBI are as follows

1. To promote fair dealings by the users of securities
2. To protect the rights and interest of investors
3. To prevent trading malpractices
4. To regulate and develop a code of conduct and fair practices by intermediaries like brokers, merchant bankers etc.
5. To stimulate competitors and encourage innovation

Functions of SEBI

Functions of SEBI are classified as protective functions, regulatory functions and developmental functions. These functions reveal the objectives of SEBI, such as to protect, develop and regulate the market. Because of these functions SEBI is often called watch dog of capital market.

I. Protective Functions

1. Prohibition of fraudulent and unfair practices relating to securities market like making misleading statement, price rigging etc.
2. Prohibiting insider trading in securities

3. Undertaking steps for investor protection
4. Promotion of fair practices and code of conduct in securities market.

II. Development Functions

1. Promote investor education programmes
2. Promote training of intermediaries
3. Promote online trading
4. Promote fair practices in capital market
5. Conduct researches on capital market and publish useful information
6. Permit primary market operations through stock exchanges

III. Regulatory Functions

1. Register of brokers and sub brokers and other players in the market
2. Registration of collective investment schemes and mutual funds
3. Regulation of stock brokers, portfolio exchanges, underwriters and merchant bankers
4. Levying fees or other charges for carrying out the purposes of the Act.
5. Collect information about functioning of stock exchanges and undertake inspection, enquires and audit of them.

**** **price rigging:** price rigging is the process of creating artificial demand for securities in order to increase their market value.

**** **Insider trading:** Insiders are those persons closely related to the company such as directors, managers etc. who can very easily know the price sensitive information about the company. Based on that they either sell or buy securities of such a company. Their transactions is called insider trading.



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