FINANCIAL MARKETS AND INSTITUTIONS

(Specialisation in Finance)

V SEMESTER

BBA

CORE COURSE: BBA5 B11

2019 Admission onwards

UNIVERSITY OF CALICUT

School of Distance Education
Calicut University- P.O,
Malappuram - 673635, Kerala.

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UNIVERSITY OF CALICUT

School of Distance Education

Study Material

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FINANCIAL MARKETS AND INSTITUTIONS

(Specialisation in Finance)

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Syllabus

BBA5B11 -(Elective 2) FINANCIAL MARKETS AND INSTITUTIONS

Lecture Hours per week: 5 Credits: 4

Internal: 20, External: 80

Objectives:

To provide basic knowledge about the structure, organisation and working of financial system in India.

Course Outcome: The course helps to understand different aspects and components of financial Institutions and financial markets. This will enable the students to take rational decisions on financial market and institutions.

Module I : Financial System: Meaning and components of financial system: financial markets, financial assets and financial intermediaries. Financial market and capital formation in India. **10 Hours**

Module II : Money Market: meaning, importance and role of money market – call money market- treasury bills market – discount market – commercial paper market – certificate of deposit – money market in India –RBI regulation on money market. **15 Hours**

Module III : Capital Market: meaning and classification – Government securities market –Industrial loan market – Mortgage market – Credit guarantee market – bond market – DFIs in India: IFCI, SFCs, IDFC, ICICI, SIDBI and NBFCs – role of DFI in industrial development in India. **15 Hours**

Module IV : Industrial Securities Market: Primary market – meaning, importance and functions – methods of floating new issues– pricing of issues and book building process. Secondary market and stock exchanges - role and functions – trading mechanism – settlement system – capital market institutions in India: NSE, BSE, NSDL, CDSL, SHCL and STCIL and STCI. Capital market regulations: SEBI – role and functions.

25 Hours

Module V: Derivate Market: Financial derivatives: meaning and functions – classification of derivative instruments – price fixing and insurance contracts – Forwards and Futures: stock and stock index futures – Options and swaps: uses and classifications - derivative markets in India. **15 Hours**

Reference Books:

1. Kohn, Meir: Financial Institutions and Markets, Tata McGraw Hill.
2. Bhole L.M: Financial Institutions and Markets, Tata McGraw Hill.
3. Desai, Vasantha: The Indian Financial System, Himalaya Publishing House.
4. Machiraju.R.H: Indian Financial System, Vikas Publishing House.
5. Khan M.Y: Indian Financial System, Tata McGraw Hill.
6. Varshney, P.M., & D. K. Mittal, D.K.: Indian Financial System, Sulthan Chand & Sons.
7. Gordon E. &Natarajan K.: Financial Markets & Services, Himalaya Publishers.

MODULE I
FINANCIAL SYSTEM

The economic development of a nation is reflected by the progress of the various economic units, broadly classified into corporate sector, government and household sector. There are areas or people with surplus funds and there are those with a deficit. A financial system or financial sector functions as an intermediary and facilitates the flow of funds from the areas of surplus to the areas of deficit. A Financial System is a composition of various institutions, markets, regulations and laws, practices, money manager, analysts, transactions and claims and liabilities.

Financial system comprises of set of subsystems of financial institutions, financial markets, financial instruments and services which helps in the formation of capital. It provides a mechanism by which savings are transformed to investment.

The word "system", in the term "financial system", implies a set of complex and closely connected or interlinked institutions, agents, practices, markets, transactions, claims, and liabilities in the economy. The financial system is concerned about money, credit and finance -the three terms are intimately related yet are somewhat different from each other. Indian financial system consists of financial market, financial instruments and financial intermediation.

Meaning of Financial System

A financial system functions as an intermediary between savers and investors. It facilitates the flow of funds from the areas of surplus to the areas of deficit. It is concerned about the money, credit and finance. These three parts are very closely interrelated with each other and depend on each other.

A financial system may be defined as a set of institutions, instruments and markets which promotes savings and channels them to their most efficient use. It consists of individuals (savers), intermediaries, markets and users of savings (investors).

In the worlds of Van Horne, ***"financial system allocates savings efficiently in an economy to ultimate users either for investment in real assets or for consumption".***

According to Prasanna Chandra, ***"financial system consists of a variety of institutions, markets and instruments related in a systematic manner and provide the principal means by which savings are transformed into investments".***

Thus financial system is a set of complex and closely interlinked financial institutions, financial markets, financial instruments and services which facilitate the transfer of funds. Financial institutions mobilise funds from suppliers and provide these funds to those who demand them. Similarly, the financial markets are also required for movement of funds from savers to intermediaries and from intermediaries to investors. In short, financial system is a mechanism by which savings are transformed into investments.

Functions of Financial System

The financial system of a country performs certain valuable functions for the economic growth of that country. The main functions of a financial system may be briefly discussed as below:

1. **Saving function:** An important function of a financial system is to mobilise savings and channelize them into productive activities. It is through financial system the savings are transformed into investments.

2. **Liquidity function**: The most important function of a financial system is to provide money and monetary assets for the production of goods and services. Monetary assets are those assets which can be converted into cash or money easily without loss of value. All activities in a financial system are related to liquidity-either provision of liquidity or trading in liquidity.

3. **Payment function:** The financial system offers a very convenient mode of payment for goods and services. The cheque system and credit card system are the easiest methods of payment in the economy. The cost and time of transactions are considerably reduced.

4. **Risk function**: The financial markets provide protection against life, health and income risks. These guarantees are accomplished through the sale of life, health insurance and property insurance policies.

5. **Information function:** A financial system makes available price-related information. This is a valuable help to those who need to take economic and financial decisions. Financial markets disseminate information for enabling participants to develop an informed opinion about investment, disinvestment, reinvestment or holding a particular asset.

6. **Transfer function:** A financial system provides a mechanism for the transfer of the resources across geographic boundaries.

7. **Reformatory functions:** A financial system undertaking the functions of developing, introducing innovative financial

assets/instruments services and practices and restructuring the existing assets, services etc., to cater the emerging needs of borrowers and investors (financial engineering and re-engineering).

8. Other functions: It assists in the selection of projects to be financed and also reviews performance of such projects periodically. It also promotes the process of capital formation by bringing together the supply of savings and the demand for investible funds.

Role and Importance of Financial System in Economic Development

1. It links the savers and investors. It helps in mobilizing and allocating the savings efficiently and effectively. It plays a crucial role in economic development through saving-investment process. This savings – investment process is called capital formation.

2. It helps to monitor corporate performance.

3. It provides a mechanism for managing uncertainty and controlling risk.

4. It provides a mechanism for the transfer of resources across geographical boundaries.

5. It offers portfolio adjustment facilities (provided by financial markets and financial intermediaries).

6. It helps in lowering the transaction costs and increase returns. This will motivate people to save more.

7. It promotes the process of capital formation.

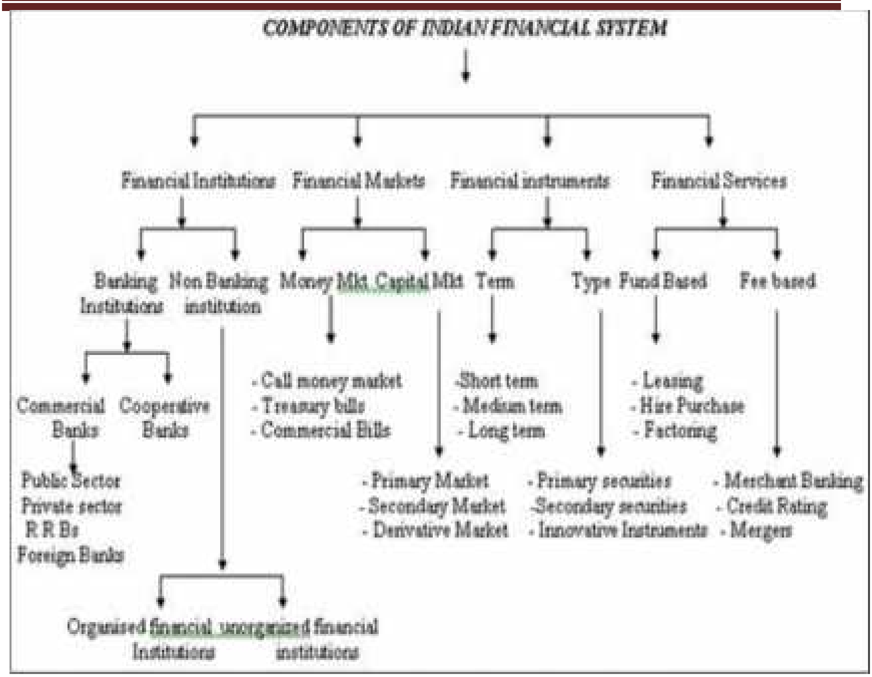
8. It helps in promoting the process of financial deepening and broadening. Financial deepening means increasing financial assets as a percentage of GDP and financial broadening means building an increasing number and variety of participants and instruments.

In short, a financial system contributes to the acceleration of economic development. It contributes to growth through technical progress.

Structure of Indian Financial System

Financial structure refers to shape, components and their order in the financial system. The Indian financial system can be broadly classified into formal (organised) financial system and the informal (unorganised) financial system. The formal financial system comprises of Ministry of Finance, RBI, SEBI and other regulatory bodies. The informal financial system consists of individual money lenders, groups of persons operating as funds or associations, partnership firms consisting of local brokers, pawn brokers, and non-banking financial intermediaries such as finance, investment and chit fund companies.

The formal financial system comprises financial institutions, financial markets, financial instruments and financial services. These constituents or components of Indian financial system may be briefly discussed as below:



I. Financial Institutions

Financial institutions are the participants in a financial market. They are business organizations dealing in financial resources. They collect resources by accepting deposits from individuals and institutions and lend them to trade, industry and others. They buy and sell financial instruments. They generate financial instruments as well. They deal in financial assets. They accept deposits, grant loans and invest in securities. Financial institutions are the business organizations that act as mobilises of savings and as purveyors of credit or finance. This means financial institutions mobilise the savings of savers and give credit or finance to the investors. They also provide various financial services to the community. They deal in financial assets such as deposits, loans, securities and so on.

On the basis of the nature of activities, financial institutions may be classified as:

(a) Regulatory and promotional institutions,

(b) Banking institutions, and

(c) Non-banking institutions.

1. Regulatory and Promotional Institutions:

Financial institutions, financial markets, financial instruments and financial services are all regulated by regulators like Ministry of Finance, the Company Law Board, RBI, SEBI, IRDA, Dept. of Economic Affairs, Department of Company Affairs etc. The two major Regulatory and Promotional Institutions in India are Reserve Bank of India (RBI) and Securities Exchange Board of India (SEBI). Both RBI and SEBI administer, legislate, supervise, monitor, control and discipline the entire financial system. RBI is the apex of all financial institutions in India. All financial institutions are under the control of RBI. The financial markets are under the control of SEBI. Both RBI and SEBI have laid down several policies, procedures and guidelines. These policies, procedures and guidelines are changed from time to time so as to set the financial system in the right direction.

2. Banking Institutions:

Banking institutions mobilise the savings of the people. They provide a mechanism for the smooth exchange of goods and services. They extend credit while lending money. They not only supply credit but also create credit. There are three basic categories of banking institutions. They are commercial banks, co-operative banks and developmental banks.

3. Non-banking Institutions:

The non-banking financial institutions also mobilize financial resources directly or indirectly from the people. They lend the financial resources mobilized. They lend funds but do not create credit. Companies like LIC, GIC, UTI, Development Financial Institutions, Organisation of Pension and Provident Funds etc. fall in this category. Non-banking financial institutions can be categorized as investment companies, housing companies, leasing companies, hire purchase companies, specialized financial institutions (EXIM Bank etc.) investment institutions, state level institutions etc.

Financial institutions are financial intermediaries. They intermediate between savers and investors. They lend money. They also mobilise savings.

II. Financial Markets

Financial markets are another part or component of financial system. Efficient financial markets are essential for speedy economic development. The vibrant financial market enhances the efficiency of capital formation. It facilitates the flow of savings into investment. Financial markets bridge one set of financial intermediaries with another set of players. Financial markets are the backbone of the economy. This is because they provide monetary support for the growth of the economy. The growth of the financial markets is the barometer of the growth of a country’s economy.

Financial market deals in financial securities (or financial instruments) and financial services. Financial markets are the centres or arrangements that provide facilities for buying and selling of financial claims and services. These are the markets in which money as well as monetary claims is traded in. Financial markets exist wherever financial transactions take place. Financial transactions include issue of equity stock by a company, purchase of bonds in the secondary market, deposit of money in a bank account, transfer of funds from a current account to a savings account etc. The participants in the financial markets are corporations, financial institutions, individuals and the government. These participants trade in financial products in these markets. They trade either directly or through brokers and dealers.

In short, financial markets are markets that deal in financial assets and credit instruments.

Functions of Financial Markets:

The main functions of financial markets are outlined as below:

1. To facilitate creation and allocation of credit and liquidity.

2. To serve as intermediaries for mobilisation of savings.

3. To help in the process of balanced economic growth.

4. To provide financial convenience.

5. To provide information and facilitate transactions at low cost.

6. To cater to the various credits needs of the business organisations.

Classification of Financial Markets:

There are different ways of classifying financial markets. There are mainly five ways of classifying financial markets.

1. Classification on the basis of the type of financial claim: On this basis, financial markets may be classified into debt market and equity market.

Debt market: This is the financial market for fixed claims like debt instruments.

Equity market: This is the financial market for residual claims, i.e., equity instruments.

2. Classification on the basis of maturity of claims: On this basis, financial markets may be classified into money market and capital market.

Money market: A market where short term funds are borrowed and lend is called money market. It deals in short term monetary assets with a maturity period of one year or less. Liquid funds as well as highly liquid securities are traded in the money market. Examples of money market are Treasury bill market, call money market, commercial bill market etc. The main participants in this market are banks, financial institutions and government. In short, money market is a place where the demand for and supply of short term funds are met.

Capital market: Capital market is the market for long term funds. This market deals in the long term claims, securities and stocks with a maturity period of more than one year. It is the market from where productive capital is raised and made available for industrial purposes. The stock market, the government bond market and derivatives market are examples of capital market.

In short, the capital market deals with long term debt and stock.

3. Classification on the basis of seasoning of claim: On this basis, financial markets are classified into primary market and secondary market.

Primary market: Primary markets are those markets which deal in the new securities. Therefore, they are also known as *new issue markets*. These are markets where securities are issued for the first time. In other words, these are the markets for the securities issued directly by the companies. The primary markets mobilise savings and supply fresh or additional capital to business units. In short, primary market is a market for raising fresh capital in the form of shares and debentures.

Secondary market: Secondary markets are those markets which deal in existing securities. Existing securities are those securities that have already been issued and are already outstanding. Secondary market consists of stock exchanges. Stock exchanges are self-regulatory bodies under the overall regulatory purview of the Govt. /SEBI.

4. Classification on the basis of structure or arrangements: On this basis, financial markets can be classified into organised markets and unorganized markets.

Organised markets: These are financial markets in which financial transactions take place within the well-established exchanges or in the systematic and orderly structure.

Unorganised markets: These are financial markets in which financial transactions take place outside the well-established exchange or without systematic and orderly structure or arrangements.

5. Classification on the basis of timing of delivery: On this basis, financial markets may be classified into cash/spot market and forward / future market.

Cash / Spot market: This is the market where the buying and selling of commodities happens or stocks are sold for cash and delivered immediately after the purchase or sale of commodities or securities.

Forward/Future market: This is the market where participants buy and sell stocks/commodities, contracts and the delivery of commodities or securities occurs at a pre-determined time in future.

6. Other types of financial market: Apart from the above, there are some other types of financial markets. They are foreign exchange market and derivatives market.

Foreign exchange market*:* Foreign exchange market is simply defined as a market in which one country's currency is traded for another country's currency.

It is a market for the purchase and sale of foreign currencies.

Derivatives market*:* The derivatives are most modern financial instruments in hedging risk. The individuals and firms who wish to avoid or reduce risk can deal with the others who are willing to accept the risk for a price. A common place where such transactions take place is called the derivative market. It is a market in which derivatives are traded. In short, it is a market for derivatives. The important types of derivatives are forwards, futures, options, swaps, etc.

III. Financial Instruments (Securities)

Financial instruments are the financial assets, securities and claims. They may be viewed as financial assets and financial liabilities.

Financial assets represent claims for the payment of a sum of money sometime in the future (repayment of principal) and/or a periodic payment in the form of interest or dividend. Financial liabilities are the counterparts of financial assets. They represent promise to pay some portion of prospective income and wealth to others. Financial assets and liabilities arise from the basic process of financing.

Some of the financial instruments are tradable/ transferable. Others are non-tradable/non-transferable. Financial assets like deposits with banks, companies and post offices, insurance policies, NSCs, provident funds and pension funds are not tradable. Securities (included in financial assets) like equity shares and debentures, or government securities and bonds are tradable. Hence they are transferable. In short, financial instruments are instruments through which a company raises finance.

The financial instruments may be capital market instruments or money market instruments or hybrid instruments. The financial instruments that are used for raising capital through the capital market are known as capital market instruments. These include equity shares, preference shares, warrants, debentures and bonds. These securities have a maturity period of more than one year.

The financial instruments that are used for raising and supplying money in a short period not exceeding one year through money market are called money market instruments. Examples are treasury bills, commercial paper, call money, short notice money, certificates of deposits, commercial bills, money market mutual funds.

Hybrid instruments are those instruments which have both the features of equity and debenture. Examples are convertible debentures, warrants etc.

Financial instruments may also be classified as cash instruments and derivative instruments. Cash instruments are financial instruments whose value is determined directly by markets. Derivative instruments are financial instruments which derive their value from some other financial instrument or variable.

Financial instruments can also be classified into primary instruments and secondary instruments. Primary instruments are instruments that are directly issued by the ultimate investors to the ultimate savers. For example, shares and debentures directly issued to the public. Secondary instruments are issued by the financial intermediaries to the ultimate savers. For example, UTI and mutual funds issue securities in the form of units to the public.

Characteristics of Financial Instruments

The important characteristics of financial instruments may be outlined as below:

1. Liquidity: Financial instruments provide liquidity. These can be easily and quickly converted into cash.

2. Marketing: Financial instruments facilitate easy trading on the market. They have a ready market.

3. Collateral value: Financial instruments can be pledged for getting loans.

4. Transferability: Financial instruments can be easily transferred from person to person.

5. Maturity period: The maturity period of financial instruments may be short term, medium term or long term.

6. Transaction cost: Financial instruments involve buying and selling cost. The buying and selling costs are called transaction costs. These are lower.

7. Risk: Financial instruments carry risk. This is because there is uncertainty with regard to payment of principal or interest or dividend as the case may be.

8. Future trading: Financial instruments facilitate future trading so as to cover risks due to price fluctuations, interest rate fluctuations etc.

IV. Financial Services

The development of a sophisticated and matured financial system in the country, especially after the early nineties, led to the emergence of a new sector.

This new sector is known as financial services sector. Its objective is to intermediate and facilitate financial transactions of individuals and institutional investors. The financial institutions and financial markets help the financial system through financial instruments. The financial services include all activities connected with the transformation of savings into investment. Important financial services include lease financing, hire purchase, instalment payment systems, merchant banking, factoring, forfaiting etc.

Growth and Development of Indian Financial System

At the time of independence in 1947, there was no strong financial institutional mechanism in the country. The industrial sector had no access to the savings of the community. The capital market was primitive and shy. The private and unorganised sector played an important role in the provision of liquidity. On the whole, there were chaos and confusions in the financial system.

After independence, the government adopted mixed economic system. A scheme of planned economic development was evolved in 1951 with a view to achieve the broad economic and social objective. The government started creating new financial institutions to supply finance both for agricultural and industrial development. It also progressively started nationalizing some important financial institutions so that the flow of finance might be in the right direction. The following developments took place in the Indian financial system:

1. Nationalisation of financial institutions: RBI, the leader of the financial system, was established as a private institution in 1935. It was nationalized in 1949. This was followed by the nationalisation of the Imperial bank of India. One of the important mile stone in the economic growth of India was the nationalisation of 245 life insurance Corporation in 1956. As a result, Life Insurance Corporation of India came into existence on 1st September, 1956.

Another important development was the nationalisation of 14 major commercial banks in 1969. In 1980, 6 more banks were nationalized. Another landmark was the nationalisation of general insurance business and setting up of General Insurance Corporation in 1972.

2. **Establishment of Development Banks:** Another landmark in the history of development of Indian financial system is the establishment of new financial institutions to supply institutional credit to industries. In 1949, RBI undertook a detailed study to find out the need for specialized institutions. The first development bank was established in 1948. That was Industrial Finance Corporation of India (IFCI). In 1951, Parliament passed State Financial Corporation Act. Under this Act, State Governments could establish financial corporation's for their respective regions. The Industrial Credit and Investment Corporation of India (ICICI) were set up in 1955. It was supported by Government of India, World Bank etc. The UTI was established in 1964 as a public sector institution to collect the savings of the people and make them available for productive ventures. The Industrial Development Bank of India (IDBI) was established on 1st July 1964 as a wholly owned subsidiary of the RBI.

On February 16, 1976, the IDBI was delinked from RBI. It became an independent financial institution. It co-ordinates the activities of all other financial institutions. In 1971, the IDBI and LIC jointly set up the Industrial Reconstruction Corporation of India with the main objective of reconstruction and rehabilitation of sick industrial undertakings. The IRCI was converted into a statutory corporation in March 1985 and renamed as Industrial Reconstruction Bank of India. Now its new name is Industrial Investment Bank of India (IIBI).

In 1982, the Export-Import Bank of India (EXIM Bank) was set up to provide financial assistance to exporters and importers. On April 2, 1990 the Small Industries Development Bank of India (SIDBI) was set up as a wholly owned subsidiary of IDBI. The SIDBI has taken over the responsibility of administrating the

Small Industries Development Fund and the National Equity Fund.

3. **Establishment of Institution for Agricultural Development**: In 1963, the RBI set up the Agricultural Refinance and Development Corporation (ARDC) to provide refinance support to banks to finance major development projects, minor irrigation, farm mechanization, land development etc. In order to meet credit

needs of agriculture and rural sector, National Bank for Agriculture and Rural Development (NABARD) was set up in 1982. The main objective of the establishment of NABARD is to extend short term, medium term and long term finance to agriculture and allied activities.

4. **Establishment of institution for housing finance**: The National Housing Bank (NHB) has been set up in July 1988 as an apex institution to mobilise resources for the housing sector and to promote housing finance institutions.

5. **Establishment of Stock Holding Corporation of India (SHCIL)**: In 1987, another institution, namely, Stock Holding Corporation of India Ltd. was set up to strengthen the stock and capital markets in India. Its main objective is to provide quick share transfer facilities, clearing services, support services etc. to investors.

6. **Establishment of mutual funds and venture capital institutions**: Mutual funds refer to the funds raised by financial service companies by pooling the savings of the public and investing them in a diversified portfolio. They provide investment avenues for small investors who cannot participate in the equities of big companies.

Venture capital is a long term risk capital to finance high technology projects. The IDBI venture capital fund was set up in 1986. The ICICI and the UTI have jointly set up the Technology Development and Information Company of India Ltd. in 1988 to provide venture capital.

7. **New Economic Policy of 1991:** Indian financial system has undergone massive changes since the announcement of new economic policy in 1991. Liberalisation, Privatisation and Globalisation has transformed Indian economy from closed to open economy. The corporate industrial sector also has undergone changes due to delicensing of industries, financial sector reforms, capital markets reforms, disinvestment in public sector undertakings etc.

Since 1990s, Government control over financial institutions has diluted in a phased manner. Public or development financial institutions have been converted into companies, allowing them to issue equity/bonds to the public. Government has allowed private sector to enter into banking and insurance sector. Foreign companies were also allowed to enter into insurance sector in India.

Weaknesses of Indian Financial System

Even though Indian financial system is more developed today, it suffers from certain weaknesses. These may be briefly stated below:

1. **Lack of co-ordination among financial institutions:** There are a large number of financial intermediaries. Most of the financial institutions are owned by the government. At the same time, the government is also the controlling authority of these institutions. As there is multiplicity of institutions in the Indian

financial system, there is lack of co-ordination in the working of these institutions.

2. **Dominance of development banks in industrial finance**: The industrial financing in India today is largely through the financial institutions set up by the government. They get most of their funds from their sponsors. They act as distributive agencies only. Hence, they fail to mobilise the savings of the public. This stands in the way of growth of an efficient financial system in the country.

3. **Inactive and erratic capital market:** In India, the corporate customers are able to raise finance through development banks. So, they need not go to capital market. Moreover, they do not resort to capital market because it is erratic and inactive. Investors too prefer investments in physical assets to investments in financial assets.

4. **Unhealthy financial practices**: The dominance of development banks has developed unhealthy financial practices among corporate customers. The development banks provide most of the funds in the form of term loans. So there is a predominance of debt in the financial structure of corporate enterprises.

This predominance of debt capital has made the capital structure of the borrowing enterprises uneven and lopsided. When these enterprises face financial crisis, the financial institutions permit a greater use of debt than is warranted. This will make matters worse.

5. **Monopolistic market structures**: In India some financial institutions are so large that they have created a monopolistic market structures in the financial system. For instance, the entire life insurance business is in the hands of LIC.

The weakness of this large structure is that it could lead to inefficiency in their working or mismanagement. Ultimately, it would retard the development of the financial system of the country itself.

6. **Other factors:** Apart from the above, there are some other factors which put obstacles to the growth of Indian financial system. Examples are:

a. Banks and Financial Institutions have high level of NPA.

b. Government burdened with high level of domestic debt.

c. Cooperative banks are labelled with scams.

d. Investors confidence reduced in the public sector undertaking etc.,

e. Financial illiteracy.

MODULE II

MONEY MARKET

Financial Market deals in financial instruments (securities) and financial services. Financial markets are classified into two, namely, money market and capital market**.**

Meaning of Money Market

Money market is a segment of financial market. It is a market for short term funds. It deals with all transactions in short term securities. These transactions have a maturity period of one year or less. Examples are bills of exchange, treasury bills etc. These short term instruments can be converted into money at low transaction cost and without much loss. Thus, money market is amarket for short term financial securities that are equal to money.

According to Crowther, **"***Money market is a collective name given to various firms and institutions that deal in the various grades of near money*".

Money market is not a place. It is an activity. It includes all organizations and institutions that deal in short term financial instruments. However, sometimes geographical names are given to the money market according to the location, e.g. Mumbai Money Market.

Characteristics of Money Market

The following are the characteristics of money market:

1. It is a market for short term financial assets that are close substitutes of money.

2. It is basically an over the phone market.

3. It is a wholesale market for short term debt instruments.

4. It is not a single market but a collection of markets for several instruments.

5. It facilitates effective implementation of monetary policy of a central bank of a country.

6. Transactions are made without the help of brokers.

7. It establishes the link between the RBI and banks.

8. The players in the money market are RBI, commercial banks, and companies.

Functions of Money Market

Money market performs the following functions:

1. Facilitating adjustment of liquidity position of commercial banks, business undertakings and other non-banking financial institutions.

2. Enabling the central bank to influence and regulate liquidity in the economy through its intervention in the market.

3. Providing a reasonable access to users of short term funds to meet their requirements quickly at reasonable costs.

4. Providing short term funds to govt. institutions.

5. Enabling businessmen to invest their temporary surplus funds for short period.

6. Facilitating flow of funds to the most important uses.

7. Serving as a coordinator between borrowers and lender of short term funds.

8. Helping in promoting liquidity and safety of financial assets.

Importance of Money Market

A well developed money market is essential for the development of a country. It supplies short term funds adequately and quickly to trade and industry. A developed money market helps the smooth functioning of the financial system in any economy in the following ways:

1. **Development of trade and industry**: Money market is an important source of finance to trade and industry. Money market finances the working capital requirements of trade and industry through bills, commercial papers etc. It influences the availability of finance both in the national and international trade.

2. **Development of capital market**: Availability funds in the money market and interest rates in the money market will influence the resource mobilisation and interest rate in the capital market. Hence, the development of capital market depends upon the existence of a developed money market. Money market is also necessary for the development of foreign exchange market and derivatives market.

3. **Helpful to commercial banks**: Money market helps commercial banks for investing their surplus funds in easily

realisable assets. The banks get back the funds quickly in times of need. This facility is provided by money market.

Further, the money market enables commercial banks to meet the statutory requirements of CRR and SLR. In short, money market provides a stable source of funds in addition to deposits.

4. **Helpful to central bank**: Money market helps the central bank of a country to effectively implement its monetary policy. Money market helps the central bank in making the monetary control effective through indirect methods (repos and open market operations). In short, a well developed money market helps in the effective functioning of a central bank.

5. **Formulation of suitable monetary policy**: Conditions prevailing in a money market serve as a true indicator of the monetary state of an economy. Hence it serves as a guide to the Govt. in formulating and revising the monetary policy. In short, the Govt. can formulate the monetary policy after taking into consideration the conditions in the money market.

6. **Helpful to Government**: A developed money market helps the Govt. to raise short term funds through the Treasury bill floated in the market. In the absence of a developed money market, the Govt. would be forced to issue more currency notes or borrow from the central bank. This will raise the money supply over and above the needs of the economy. Hence the general price level will go up (inflationary trend in the economy). In short, money market is a device to the Govt. to balance its cash inflows and outflows.

Thus, a well developed money market is essential for economic growth and stability.

Characteristics of a Developed Money Market

In every country some types of money market exists. Some of them are highly developed while others are not well developed. A well developed and efficient money market is necessary for the development of any economy. The following are the characteristics or prerequisites of a developed and efficient money market:

1. Highly developed commercial banking system: Commercial banks are the nerve centre of the whole short term funds. They serve as a vital link between the central bank and the various segments of the money market. When the commercial banking system is developed or organized, the money market will be developed.

2. Presence of a central bank: In a developed money market, there is always a central bank. The central bank is necessary for direction and control of money market. Central bank absorbs surplus cash during off-seasons and provides additional funds in busy seasons. This is done through open market operations.

Being the bankers' bank, central bank keeps the reserves of commercial banks and provides them financial accommodation in times of need. If the central bank cannot influence the money market it means the money market is not developed.

In short, without the support of a central bank a money market cannot function.

3. Existence of sub markets: Money market is a group of various sub markets. Each sub market deals in instruments of varied maturities. There should be large number of submarkets. The larger the number of sub markets, the broader and more developed will be the structure of money market. Besides, the sub market must be interrelated and integrated with each other. If there is no co-ordination and integration among them, different interest rates will prevail in the sub markets.

4. Availability of credit instruments: The continuous availability of readily acceptable negotiable securities (near money assets) is necessary for the existence of a developed money market. In addition to variety of instruments or securities, there should be a number of dealers (participants) in the money market to transact in these securities. It is the dealers in securities who actually infuse life into the money market.

5. **Existence of secondary market**: There should be active secondary market in these credit instruments. The success of money market always depends on the secondary market. If the secondary market develops, then there will be active trading of the instruments.

6. **Availability of ample resources**: There must be availability of sufficient funds to finance transactions in the sub markets. These funds may come from within the country and outside the country. Under developed money markets do not have ample funds. Thus availability of sufficient funds is essential for the smooth and efficient functioning of the money market.

7. **Demand and supply of funds:** Money market should have a large demand and supply of funds. This depends upon the number of participants and also the Govt. policies in encouraging the investments in various sectors and monetary policy of RBI.

8. **Other factors:** There are some other factors that also contribute to the development of a money market. These factors include industrial development, volume of international trade, political stability, trade cycles, foreign investment, price stabilisation etc.

Components / Constituents / Composition of Money Market (Structure of Money Market)

Money market consists of a number of sub markets. All submarkets collectively constitute the money market. Each sub market deals in a particular financial instrument. The main components or constituents or sub markets of money markets are as follows:

1. Call money market
2. Commercial bill market
3. Treasury bill markets
4. Certificates of deposits market
5. Commercial paper market
6. Acceptance market
7. Collateral loan market

I. Call Money Market

Call money is required mostly by banks. Commercial banks borrow money without collateral from other banks to maintain a minimum cash balance known as cash reserve ratio (CRR). This interbank borrowing has led to the development of the call money market.

Call money market is the market for very short period loans. If money is lent for a day, it is called call money. If money is lent for a period of more than one day and upto 14 days is called *short notice money*. Thus call money market refers to a market where the maturity of loans varies between 1 day to 14 days.

In the call money market, surplus funds of financial institutions, and banks aretraded. There is no demand for collateral security against call money.

In India call money markets are mainly located in big industrial and commercial centres like Mumbai, Kolkata, Chennai, Delhi and Ahmadabad.

Participants or Players in the Call Money Market

1. Scheduled commercial banks and RBI

2. Non-Scheduled commercial banks

3. Co-operative banks

4. Foreign banks

5. Discount and Finance House of India

6. Primary dealers

The above players are permitted to operate both as lenders and borrowers.

(1) LIC (2) UTI (3) GIC (4) IDBI (5) NABARD (6) Specific mutual funds, etc.

The above participants are permitted to operate as lenders

2. Commercial Bill Market

Commercial bill market is another segment of money market. It is a market in which commercial bills (short term) are bought and sold. Commercial bills are important instruments. They are widely used in both domestic and foreign trade to discharge the business obligations (or to settle business obligations).

Discounting is the main process in this market. Hence commercial bill market is also known as *discount market*.

There are specialized institutions known as discount houses for discounting commercial bills accepted by reputed acceptance houses. RBI has permitted the financial institutions, mutual funds, commercial banks and cooperative banks to enter in the commercial bill market.

3. Treasury Bills Market

Treasury bill market is a market which deals in treasury bills. In this market, treasury bills are bought and sold. Treasury bill is an important instrument of short term borrowing by the Govt. These are the promissory notes or a kind of finance bill issued by the Govt. for a fixed period not extending beyond one year. Treasury bill is used by the Govt. to raise short term funds for meeting temporary Govt. deficits. Thus it represents short term borrowings of the Govt.

Advantages or Importance of Treasure Bill Market

Advantages to the Issuer / Govt.

1. The Govt. can raise short term funds for meeting temporary budget deficit.

2. The Govt. can absorb excess liquidity in the economy through the issue of Tbills in the market.

3. It does not lead to inflationary pressure.

Advantages for the Purchaser/ Investor

1. It is a ready market for purchasers or investors.

2. It is a safety instrument to invest.

3. Treasury bills are eligible securities for SLR requirement.

4. The market provides hedging facility.

4. Certificates of Deposits Market

CD market is a market which deals in CDs. CDs are short term deposit instruments to raise large sums of money. These are short term deposits which are transferable from one party to another. Banks and financial institutions are major issuers of CD. These are short term negotiable instruments.

Advantages of CD Market

1. It enables the depositors to earn higher return on their short term surplus.

2. The market provides maximum liquidity.

3. The bank can raise money in times of need. This will improve their lending capacity.

4. The market provides an opportunity for banks to invest surplus funds.

5. The transaction cost of CDs is lower.

5. Commercial Paper Market

Commercial Paper Market is another segment of money market. It is a market which deals in commercial papers. Commercial papers are unsecured short term promissory notes issued by reputed, well established and big companies having high credit rating. These are issued at a discount. Commercial papers can now be issued by primary dealers and all India financial institutions.

They can be issued to (or purchased by) individuals, banks, companies and other registered Indian corporate bodies. (Investors in CP)

Role of RBI in the Commercial Paper Market

The Working Group on Money Market (Vaghul Committee) in 1987 suggested the introduction of the commercial Paper (CP) in India. As per the recommendation of the committee, the RBI introduced commercial papers in January 1990. The Committee suggested the following:

(a) CP should be issued to investors directly or through bankers.

(b) The CP issuing company must have a net worth of not less then Rs. 5 crores.

(c) The issuing company's shares must be listed in the stock exchange.

(d) The minimum amount of issue should be Rs. 1 crore and the minimum denomination of Rs. 5 lakhs

(e) The CPs issuing cost should not exceed 1% of the amount raised.

(f) RBI is the sole authority to decide the size of issue and timing of issue.

(g) The instrument should not be subject to stamp duty at the time of issue and there should not be any tax deduction at source.

(h) The interest on CP shall be a market determined.

(i) The issuing companies should get certification of credit rating for every six months and ‘A’ grading enterprises may be permitted to enter the market.

6. Acceptance Market

Acceptance Market is another component of money market. It is a market for banker’s acceptance. The acceptance arises on account of both home and foreign trade. Bankers acceptance is a draft drawn by a business firm upon a bank and accepted by that bank. It is required to pay to the order of a particular party or to the bearer, a certain specific amount at a specific date in future. It is commonly used to settle payments in international trade. Thus acceptance market is a market where the bankers’ acceptances are easily sold and discounted.

7. **Collateral Loan Market**

Collateral loan market is another important sector of the money market. The collateral loan market is a market which deals with collateral loans. Collateral means anything pledged as security for repayment of a loan. Thus collateral loans are loans backed by collateral securities such as stock, bonds etc. The collateral loans are given for a few months. The collateral security is returned to the borrower when the loan is repaid. When the borrower is not able to repay the loan, the collateral becomes the property of the lender. The borrowers are generally the dealers in stocks and shares.

Money Market Instruments

Money market is involved in buying and selling of short term instruments. It is through these instruments, the players or participants borrow and lend money in the money market. There are various instruments available in the money market. The important money market instruments are:-

1. Call and short notice money

2. Commercial bills

3. Treasury bills

4. Certificate of deposits

5. Commercial papers

6. Repurchase agreements

7. Money market mutual funds.

8. ADR/GDR

These instruments are issued for short period. These are interest bearing securities. These instruments may be discussed in detail in the following pages.

1. Call and Short Notice Money

These are short term loans. Their maturity varies between one day to fourteen days. If money is borrowed or lent for a day it is called call money or overnight money. When money is borrowed or lent for more than a day and up to fourteen days, it is called short notice money.

Surplus funds of the commercial banks and other institutions are usually given as call money. Banks are the borrowers as well as the lenders for the call money. Banks borrow call funds for a short period to meet the cash reserve ratio (CRR) requirements. Banks repay the call fund back once the requirements have been met. The interest rate paid on call loans is known as the call rate. It is a highly volatile rate. It varies from day to day, hour to hour, and sometimes even minute to minute. Features of Call and Short Notice Money

1. These are highly liquid.

2. The interest (call rate) is highly volatile.

3. These are repayable on demand.

4. Money is borrowed or lent for a very short period.

5. There is no collateral security demanded against these loans. This means they are unsecured.

6. The risk involved is high.

2. Commercial Bills

When goods are sold on credit, the seller draws a bill of exchange on the buyer for the amount due. The buyer accepts it immediately. This means he agrees to pay the amount mentioned therein after a certain specified date. After accepting the bill, the buyer returns it to the seller. This bill is called trade bill.

The seller may either retain the bill till maturity or due date or get it discounted from some banker and get immediate cash. When trade bills are accepted by commercial banks, they are called commercial bills. The bank discounts this bill by deducting a certain amount (discount) and balance is paid.

A bill of exchange contains a written order from the creditor (seller) to the debtor (buyer) to pay a certain sum, to a certain person after a certain period.

According to Negotiable instruments Act, 1881, a bill of exchange is 'an instrument in writing containing an unconditional order, signed by the maker, directing a certain person to pay a certain sum of money only to, or to the order of a certain person or to the bearer of the instrument'.

Features of Commercial Bills

1. These are negotiable instruments.

2. These are generally issued for 30 days to 120 days. Thus these are short term credit instruments.

3. These are self liquidating instruments with low risk.

4. These can be discounted with a bank. When a bill is discounted with a bank, the holder gets immediate cash. This means bank provides credit to the customers. The credit is repayable on maturity of the bill. In case of need for funds, the bank can rediscount the bill in the money market and get ready money.

5. These are used for settling payments in the domestic as well as foreign trade.

6. The creditor who draws the bill is called drawer and the debtor who accepts the bill is called drawee.

Types of Bills

Many types of bills are in circulation in a bill market. They may be broadly classified as follows:

1. Demand Bills and Time Bills:- Demand bill is payable on demand. It is payable immediately on presentation or at sight to the drawing. Demand bill is also known as *sight bill*. Time bill is

payable at a specified future date. Time bill is also known as *usance bill*.

2. Clean Bills and Documentary Bills: When bills have to be accompanied by documents of title to goods such as railway receipts, bill of lading etc. the bills are called documentary bills. When bills are drawn without accompanying any document, they are called clean bills. In such a case, documents will be directly sent to the drawee.

3. Inland and Foreign Bills :- Inland bills are bills drawn upon a person resident in India and are payable in India. Foreign bills are bills drawn outside India and they may be payable either in India or outside India.

4. Accommodation Bills and Supply Bills :- In case of accommodation bills, two parties draw bills on each other purely for the purpose of mutual financial accommodation. These bills are then discounted with the bankers and the proceeds are shared among themselves. On the due dates, the parties make payment to the bank. Accommodation bills are also known as **'wind bills' or 'kite bills**'. Supply bills are those drawn by suppliers or contactors on the Govt. departments for the goods supplied to them. These bills are not considered as negotiable instruments.

3. Treasury Bills

Treasury bills are short term instruments issued by RBI on behalf of Govt. These are short term credit instruments for a period ranging from 91 to 364. These are negotiable instruments. Hence, these are freely transferable. These are issued at a discount. These are repaid at par on maturity. These are considered as safe investment.

Thus treasury bills are credit instruments used by the Govt. to raise short term funds to meet the budgetary deficit. Treasury bills are popularly called Tbills. The difference between the amount paid by the tenderer at the time of purchase (which is less than the face value), and the amount received on maturity represents the interest amount on T-bills and is known as the discount.

Features of T-Bills

1. They are negotiable securities.

2. They are highly liquid.

3. There is no default risk (risk free). This is because they are issued by the Govt.

4. They have an assured yield.

5. The cost of issue is very low. It does not involve stamp fee.

6. These are available for a minimum amount of Rs. 25000 and in multiples thereof**.**

Types of T-Bills

There are two categories of T-Bills. They are:

1. Ordinary or Regular T-Bills: These are issued to the public, banks and other institutions to raise money for meeting the short term financial needs of the Govt. These are freely marketable. These can be bought and sold at any time.

2. **Ad hoc T-Bills**: These are issued in favour of the RBI only. They are not sold through tender or auction. They are purchased by the RBI on tap. The RBI is authorised to issue currency notes against there.

On the basis of periodicity T-bills may be classified into four. They are as follows :

1. 91-Day T-Bills

2. 14-Day T-Bills

3. 182-Day T-Bills: - These were introduced in November 1986 to provide short term investment opportunities to financial institutions and others.

4. 364-Day T-Bills

4. Certificate of Deposits (CDs)

With a view to give investor's greater flexibility in the development of their short term surplus funds, RBI permitted banks to issue Certificate of Deposit. CDs were introduced in June 1989. CD is a certificate in the form of promissory note issued by banks against the short term deposits of companies and institutions, received by the bank. Simply stated, it is a time deposit of specific maturity and is easily transferable. It is a document of title to a time deposit. It is issued as a bearer instrument and is negotiable in the market. It is payable on a fixed date. It has a maturity period ranging from three to twelve months. It is issued at a discount rate varying between 13% to 18%. The discount rate is determined by the issuing bank and the market. All scheduled banks except Regional Rural Banks and scheduled co-operative banks are eligible to issue CDs to the extent of 7% of deposits. It can be issued to individuals, corporations, companies, trusts, funds and associations. CDs are issued by banks during period of tight liquidity, at relatively high interest rate. Banks rely on this source when the deposit growth is low but credit demand is high. They can be issued to individuals, companies, trusts, funds, associates, and others. The main difference between fixed deposit and CD is that CDs are easily transferable from one party to another, whereas FDs are non-transferable.

Features of CDs

1. These are unsecured promissory notes issued by banks or financial institutions.

2. These are short term deposits of specific maturity similar to fixed deposits.

3. These are negotiable (freely transferable by endorsement and delivery)

4. These are generally risk free.

5. The rate of interest is higher than that on T-bill or time deposits

6. These are issued at discount

7. These are repayable on fixed date.

8. These require stamp duty.

Guidelines for Issue of CDs

CDs are negotiable money market instruments. These are issued against deposits in banks or financial institutions for a specified time period. RBI has issued several guidelines regarding the issue of CDs. The following are the RBI guidelines:

1. CDs can be issued by scheduled commercial banks (excluding RRBs and Local Area Banks) and select all-India financial institutions.

2. Minimum of a CD should be Rs. 1 lakh i.e., the minimum deposit that could be accepted from a single subscriber should not be less than Rs. 1 lakh and in the multiples of Rs. 1 lakh thereafter.

3. CDs can be issued to individuals, corporations, companies, trusts, funds, and associations. NRIs may also subscribe to CDs, but only on a repatriable basis.

4. The maturity period of CDs issued by banks should not be less than 7 days and not more than one year. Financial institutions can issue CDs for a period not less than one year and not exceeding 3 years from the date of issue.

5. CDs may be issued at a discount on face value. Bankers/Fls are also allowed to issue CDs on a floating rate basis provided that the rate is objective, transparent and market based.

6. Banks have to maintain the appropriate CRR and SLR requirements, on the issue price of CDs.

7. Physical CDs are freely transferable by endorsement and delivery. Dematted CDs can be transferred as per the procedure applicable to other demat securities. There is no lock in period for CDs.

8. Bank/Fls cannot grant loans against CDs. They cannot buy back their own CDs before maturity.

9. Bankers/Fls should issue CDs only in the dematerialised form. However, according to the depositories Act, 1996 investors have the option to seek a certificate in physical form.

10. Since CDs are transferable, the physical certificate may be presented for payment by the last holder.

5. Commercial Papers (CPs)

Commercial paper was introduced into the market in 1989-90. It is a finance paper like Treasury bill. It is an unsecured, negotiable promissory note. It has a fixed maturity period ranging from three to six months. It is generally issued by leading, nationally reputed credit worthy and highly rated corporations. It is quite safe and highly liquid. It is issued in bearer form and on discount. It is also known as *industrial paper* or *corporate paper*. CPs can be issued in multiples of Rs. 5 lakhs subject to the minimum issue size of Rs. 50 lakhs. Thus a CP is an unsecured short term promissory note issued by leading, creditworthy and highly rated corporates to meet their working capital requirements. In short, a CP is a short term unsecured promissory note issued by financially strong companies.

Advantages of Commercial Paper

1. These are simple to issue.

2. The issuers can issue CPs with maturities according to their cash flow.

3. The image of the issuing company in the capital market will improve. This makes easy to raise long term capital

4. The investors get higher returns

5. These facilitate securitisation of loans. This will create a secondary market for CP.

Disadvantages of Commercial Papers

1. It cannot be repaid before maturity.

2. It can be issued only by large, financially strong firms.

6. Repurchase Agreements (REPO)

REPO is basically a contract entered into by two parties (parties include RBI, a bank or NBFC. In this contract, a holder of Govt. securities sells the securities to a lender and agrees to repurchase them at an agreed future date at an agreed price. At the end of the period the borrower repurchases the securities at the predetermined price. The difference between the purchase price and the original price is the cost for the borrower. This cost of borrowing is called repo rate. A transaction is called a Repo when viewed from the perspective of the seller of the securities and reverse when described from the point of view of the suppliers of funds. Thus whether a given agreement is termed Repo or Reverse

Repo depends largely on which party initiated the transaction.

Thus Repo is a transaction in which a participant (borrower) acquires immediate funds by selling securities and simultaneously agrees to repurchase the same or similar securities after a specified period at a specified price. It is also called *ready forward contract*.

7. Money Market Mutual Funds (MMMFs)

Money Market Mutual Funds mobilise money from the general public. The money collected will be invested in money market instruments. The investors get a higher return. They are more liquid as compared to other investment alternatives.

The MMMFs were originated in the US in 1972. In India the first MMMF was set up by Kothari Pioneer in 1997. But this did not succeed.

Advantages of MMMFs

1. These enable small investors to participate in the money market.

2. The investors get higher return.

3. These are highly liquid.

4. These facilitate the development of money market.

Disadvantage of MMMFs

1. Heavy stamp duty.

2. Higher flotation cost.

3. Lack of investors education.

8. American Depository Receipt and Global Depository Receipt

ADRs are instruments in the nature of depository receipt and certificate. These instruments are negotiable and represent publicly traded, local currency equity shares issued by non - American company. For example, an NRI can invest in Indian Company's shares without bothering dollar conversion and other exchange formalities.

If the facilities extended globally, these instruments are called GDR. ADR are listed in American Stock exchanges and GDR are listed in other than American Stock exchanges, say Landon, Luxembourg, Tokyo etc.,

Structure of the Indian Money Market

In the Indian money market RBI occupies a key role. It is the nerve centre of the monetary system of our country. It is the leader of the Indian money market. The Indian money market is highly disintegrated and unorganized. The Indian money market can be divided into two sectors - unorganized and organised. In between these two, there exists the co-operative sector. It can be included in the organised sector. The organised sector comprises of RBI, SBI group of banks, public sector banks, private sector banks, development banks and other financial institutions.

The unorganised sector comprises of indigenous bankers, money lenders, chit funds etc. These are outside the control of RBI. This is the reason why Indian money market remains underdeveloped.

Features or Defects of the Indian Money Market

The features or defects of the Indian money market are as follows:

1. **Existence of unorganised segment**: The most important defect of the Indian money market is the existence of unorganised segment. The unorganised segment comprises of indigenous bankers, moneylenders etc. This unorganised sector does not follow the rules and regulations of the RBI. Besides, a higher rate of interest prevails in the unorganised market.

2. **Lack of integration:** Another important drawback of the Indian money market is that the money market is divided into different sections. Unfortunately these sections are loosely connected to each other. There is no co-ordination between the organised and unorganised sectors. With the setting up of the RBI and the passing of the Banking Regulations Act, the conditions have improved.

3. **Disparities in interest rates**: Interest rates in different money markets and in different segments of money market still differ. Too many interest rates are prevailing in the market. For example, borrowing rates of Govt. lending rate of commercial banks, the rates of co-operative banks and rates of financial institutions. This disparity in interest rates is due to lack of mobility of funds from one segment to another.

4. **Seasonal diversity of money market**: The demand for money in Indian money market is of seasonal in nature. During the busy season from November to June, money is needed for financing the marketing of agricultural products, seasonal industries such as sugar, jaguar, etc. From July to October the demand for money is low. As a result, the money rates fluctuate from one period to another.

5. **Absence of bill market:** The bill market in India is not well developed. There is a great paucity of sound commercial bills of exchange in our country. As a matter of habit, Indian traders resort to hundies rather than properly drawn bill of exchange.

6. **Limited instruments:** The supply of short term instruments like commercial bills, treasury bills etc. are very limited and inadequate.

7. **Limited number of participants**: The participants in the Indian money market are limited. Entry in the money market is tightly regulated.

8. **Restricted secondary market:** Secondary market for money market instruments is mainly restricted to rediscounting of commercial bills and treasury bills.

9. **No contact with foreign money markets**: Indian money market has little contract with money markets in other countries. In totality it can be concluded that Indian money market is relatively underdeveloped.

Players or Participants in the Indian Money Market

The following are the players in the Indian money market:

1. Govt.

2. RBI

3. Commercial banks

4. Financial institutions like IFCI, IDBI, ICICI, SIDBI, UTI, LIC etc.

5. Discount and Finance House of India.

6. Brokers

7. Mutual funds

8. Public sector undertakings

9. Corporate units

Recent Developments in the Indians Money Market

The recent developments in the Indian money market may be briefly explained as below:

1. Integration of unorganised sector with the organised sector : RBI has taken many steps to bring the institutions in the unorganised sector within its control and regulation. These

institutions are now slowly coming under the organised sector. They started availing of the rediscounting facilities from the RBI.

2. Widening of call money market: In recent years, many steps have been taken to widen the call money market. The number of participants in the call money market is increasing. LIC, GIC, IDBI, UTI and specialised mutual funds have been permitted to enter into this market as lenders only. The DFHI and STCI have been permitted to operate both as lenders and borrowers.

3. Introduction of innovative instruments: New financial instruments have been introduced in the money market. On the recommendation of the Chakkraborty Committee, the RBI introduced 192 days T-bills since 1986. A new instrument in the form of 364 days T-bills was introduced at the end of April 1992. Again, new instruments such as CDs, CPs, and interbank participation certificates have been introduced. Necessary guidelines also have been issued for the operation of these instruments.

4. Introduction of negotiable dealing system : As negotiable dealing system has been introduced with a view to facilitating electronic bidding in auctions and secondary market transactions in Govt. securities and dissemination of information.

5. Offering of market rates of interest: In order to popularise money market instruments, the ceiling on interest rate has been abolished. Call money rate, bill discounting rate, inter bank rate etc. have been freed from May 1, 1989. Thus, today Indian money market offers full scope for the play of market forces in determining the rates of interest.

6. Satellite system dealership: The satellite system dealership was launched in 1996 to serve as a second tier to primary dealers in retailing of Govt. securities. RBI has decided to allow players

such as provident funds, trusts to participate in government bond auctions, on a non-competitive basis.

7. Promotion of bill culture: All attempts are being taken to discourage cash credit and overdraft system of financing and to popularise bill financing. Exemption from stamp duty is given on rediscounting of derivative usance promissory notes arising out of genuine trade bill transactions. This is done to promote bill culture in the country.

8. Introduction of money market mutual funds: Recently certain private sector mutual funds and subsidiaries of commercial banks have been permitted to deal in money market instrument. This has been done with a view to expand the money market and also to develop secondary market for money market instruments.

9. Setting up of credit rating agencies: Recently some credit rating agencies have been established. The important agencies are the Credit Rating Information Services of India Ltd (CRISIL), Investment Information and Credit Rating Agency of India (IICRA) and, Credit Analysis and Research Ltd. (CARE). These have been set up to provide credit information through financial analysis of leading companies and industrial sectors.

10. Adoption of suitable monetary policy: In recent years the RBI is adopting a more realistic and appropriate monetary and credit policies. The main objective is to increase the availability of resources in the money market and make the money market more active.

11. Establishment of DFHI: The DFHI was set up in 1988 to activate the money market and to promote a secondary market for all money market instruments.

12. Setting up of Securities Trading Corporation of India Ltd. (STCI) : The RBI has set p the STCI in May 1994. Its main objective is to provide a secondary market in Govt. securities. It has enlarged the T-bill market and the call market and provided an active secondary market for T-bills. Because of these recent developments, the Indian money market is developing.

Discount and Finance House of India

The DFHI was set up in April 1988 as a specialised money market institution. It was set up as for the recommendations of the Vaghal Committee. DFHI was given the specific task of widening and deepening the money market. The DFHI was set up jointly by the RBI, public sector banks and financial institutions.

Main Objectives of DFHI

1. To provide liquidity to money market instruments.

2. To provide safe and risk free short term investment avenues to institutions.

3. To facilitate money market transactions of small and medium sized institutions that are not regular participants in the market.

4. To integrate the various segments of the money market.

5. To develop a secondary market for money market instruments.

Functions and Role of DFHI

1. To discount, rediscount, purchase and sell treasury bills, trade bills of exchange, commercial bills and commercial papers.

2. To play an important role as a lender, borrower or broker in the interbank call money market.

3. To promote and support company funds, trusts and other organisations for the development of short term money market.

4. To advise Government, banks, and financial institutions involving schemes for growth and development of money market.

5. To undertake buy back arrangements in trade bills and treasury bills as well as securities of local authorities, public sector institutions, Govt. and commercial and non-commercial houses.

MODULE III
CAPITAL MARKET

There are many persons or organizations that require capital. Similarly, there are several persons or organizations that have surplus capital. They want to dispose of (or invest) their surplus capital. Capital market is a meeting place of these two broad categories of persons or organizations.

Meaning and Definition of Capital Market

Capital market simply refers to a market for long term funds. It is a market for buying and selling of equity, debt and other securities. Generally, it deals with long term securities that have a maturity period of above one year.

Capital market is a vehicle through which long term finance is channelized for the various needs of industry, commerce, govt. and local authorities.

According to W.H. Husband and J.C. Dockerbay, *"the capital market is used to designate activities in long term credit, which is characterised mainly by securities of investment type"*.

Thus, capital market may be defined as an organized mechanism for the effective and smooth transfer of money capital or financial resources from the investors to the entrepreneurs.

Characteristics of Capital Market

1. It is a vehicle through which capital flows from the investors to borrowers.

2. It generally deals with long term securities.

3. All operations in the new issues and existing securities occur in the capitalmarket.

4. It deals in many types of financial instruments. These include equity shares, preference shares, debentures, bonds, etc. These are known as securities. It is for this reason that capital market is known as 'Securities Market'.

5. It functions through a number of intermediaries such as banks, merchant bankers, brokers, underwriters, mutual funds etc. They serve as links between investors and borrowers.

6. The constituents (players) in the capital market include individuals and institutions. They include individual investors, investment and trust companies, banks, stock exchanges, specialized financial institutions etc.

Functions of a Capital Market

The functions of an efficient capital market are as follows:

1. Mobilise long term savings for financing long term investments.

2. Provide risk capital in the form of equity or quasi-equity to entrepreneurs.

3. Provide liquidity with a mechanism enabling the investor to sell financial assets.

4. Improve the efficiency of capital allocation through a competitive pricing mechanism.

5. Disseminate information efficiently for enabling participants to develop an informed opinion about investment, disinvestment, reinvestment etc.

6. Enable quick valuation of instruments – both equity and debt.

7. Provide insurance against market risk through derivative trading and default risk through investment protection fund.

8. Provide operational efficiency through: (a) simplified transaction procedures, (b) lowering settlement times, and (c) lowering transaction costs.

9. Develop integration among: (a) debt and financial sectors, (b) equity and debt instruments, (c) long term and short term funds.

10. Direct the flow of funds into efficient channels through investment and disinvestment and reinvestment.

Distinguish between Money Market and Capital Market

Money market	**Capital market**
Short term funds	1. Long term funds
2. Operational/WC needs	2. FC/PC requirements
3. Instruments are: bills, CPs, T-bills, CDs etc.,	3. Shares, debentures, bonds etc., are main instruments in capital market
4. Huge face value for single instrument	4. Small face value of securities

5. Central and coml. banks are major players 6. No formal place for transactions 7. Usually no role for brokers	5.Development banks, investment institutions are major players 6.Formal place, stock exchanges 7. Brokers playing a vital role

Importance of Capital Market

The importance of capital market is outlined as below:

1. Mobilisation of savings: Capital market helps in mobilizing the savings of the country. It gives an opportunity to the individual investors to employ their savings in more productive channels.

2. Capital formation: Large amount is required to invest in infrastructural foundation. Such a large amount cannot be collected from one individual or fewindividuals. Capital market provides an opportunity to collect funds from a large number of people who have investible surplus. In short, capital market plays a vital role in capital formation at a higher rate.

3. Economic development: With the help of capital market, idle funds of the savers are channelized to the productive sectors. In this way, capital market helps in the rapid industrialization and economic development of a country.

4. Integrates different parts of the financial system: The different components of the financial system includes new issue market, money market, stock exchange etc. It is the capital market which helps to establish a close contact among different parts of the financial system. This is essential for the growth of an economy.

5. Promotion of stock market: A sound capital market promotes an organized stock market. Stock exchange provides for easy marketability to securities. A readymade market is available to buyers and sellers of securities.

6. Foreign capital: Multinational Corporations and foreign investors will be ready to invest in a country where there is a developed capital market. Thus capital market not only helps in raising foreign capital but the foreign technology also comes within the reach of the local people.

7. Economic welfare: Capital market facilitates increase in production and productivity in the economy. It raises the national income of the country. In this way, it helps to promote the economic welfare of the nation.

8. Innovation: Introduction of a new financial instrument, finding new sources of funds, introduction of new process etc. are some of the innovations introduced in capital market. Innovation ensures growth.

Special Features of the Indian Capital Market

Indian capital market has the following special features:

1. Greater reliance on debt instruments as against equity and in particular, borrowing from financial institutions.

2. Issue of debentures specifically, convertible debentures with automatic or compulsory conversion into equity without the normal option given to investors.

3. Floatation of Mega issues for the purpose of take over, amalgamation etc. and avoidance of borrowing from financial

institutions for the fear of their discipline and conversion clause by the bigger companies, and this has now become optional.

4. Avoidance of underwriting by some companies to reduce the costs and avoid scrutiny by the FIs. It has become optional now.

5. Fast growth of mutual funds and subsidiaries of banks for financial services leading to larger mobilisation of savings from the capital market.

Components of Capital Market

There are four main components of capital market. They are: (a) Government Securities Market, (b) Financial Institutions, (c) Primary market, and (d) Secondary Market

These components of capital market may be discussed in detail in the following pages:

Government Securities Market

This is another constituent of the capital market. The govt. shall borrow funds from banks, financial institutions and the public, to finance its expenditure in excess of its revenues. One of the important sources of borrowing funds is issuing Govt. securities. Govt. securities are the instruments issued by central government, state governments, semi-government bodies, public sector corporations and financial institutions such as IDBI, IFCI, SFCs, etc. in the form of marketable debt. They comprise of dated securities issued by both central and state governments including financial institutions owned by the government.

These are the debt obligations of the government. Govt. securities are also known as *Gilt-edged securities.* Gilt refers to gold. Thus govt. securities or gilt-edged securities are as pure as gold. This implies that these are completely risk free (no risk of default).

Govt. securities market is a market where govt. securities are traded. It is the largest market in any economic system. Therefore, it is the benchmark for other market. Government securities are issues by:

- Central Government
- State Government
- Semi-Government authorities like local government authorities, e.g., city corporations and municipalities
- Autonomous institutions, such as metropolitan authorities, port trusts, development trusts, state electricity boards.
- Public Sector Corporations
- Other governmental agencies, such as SFCs, NABARD, LDBs, SIDCs, housing boards etc.

Characteristics of Gilt-edged Securities Market

a. Gilt-edged securities market is one of the oldest markets in India. The market in these securities is a significant part of Indian stock market. Main characteristics of government securities market are as follows:

b. Supply of government securities in the market arises due to their issue by the Central, State of Local governments and other semi-government and autonomous institutions explained above.

c. Government securities are also held by Reserve Bank of India (RBI) for purpose and sale of these securities and using as an important instrument of monetary control.

d. The securities issued by government organisations are government guaranteed securities and are completely safe as regards payment of interest and repayment of principal.

e. Gilt-edged securities bear a fixed rate of interest which is generally lower than interest rate on other securities.

f. These securities have a fixed maturity period.

g. Interest on government securities is payable half-yearly.

h. Subject to the limits under the Income Tax Act, interest on these securities is exempt from income tax.

i. The gilt-edged market is an ‘over-the-counter’ market and each sale and purpose has to be negotiated separately.

j. The gilt-edged market is basically limited to institutional investors.

Financial Institutions

Financial institutions are the most active constituent of the Indian capital market. There are special financial institutions which provide medium and long term loans to big business houses. Such institutions help in promoting new companies, expansion and development of existing companies etc. The main special financial institutions of the Indian capital are IDBI, IFCI, ICICI, UTI, LIC, NIDC, SFCs etc.

New Financial Instruments in the Capital Market

With the evolution of the capital market, new financial instruments are being introduced to suit the requirements of the market. Some of the new financial instruments introduced in recent years may be briefly explained as below:

1. **Floating rate bonds:** The interest rate on these bonds is not fixed. It is a concept which has been introduced primarily to take care of the falling market or to provide a cushion in times of falling interest rates in the economy. It helps the issuer to hedge the loss arising due to interest rate fluctuations. Thus there is a provision to reduce interest risk and assure minimum interest on the investment.

In India, SBI was the first to introduce FRB for retail investors.

2. **Zero interest bonds:** These carry no periodic interest payment. These are sold at a huge discount. These can be converted into equity shares or non-convertible debentures

3. **Deep discount bonds**: These bonds are sold at a large discount while issuing them. These are zero coupon bonds whose maturity is very high (say, 15 years). There is no interest payment. IDBI was the first financial institution to offer DDBs in 1992.

4. **Auction related debentures**: These are a hybrid of CPs and debentures. These are secured, redeemable, non-convertible instrument. The interest on them is determined by the market. These are placed privately with bids. ANZ Grindlays designed this new instrument for Ashok Leyland Finance.

5**. Secured Premium Notes:** These are issued along with a detachable warrant. This warrant gives the holder the right to apply for, or seek allotment of one equity share, provided the SPN is fully paid. The conversion of detachable warrant into equity shares is done within the time limit notified by the company.

There is a lock in period during which no interest is paid for the invested amount. TISCO was the first company to issue SPN (in 1992) to the public along with the right issue.

6. O**ption bonds:** Option bonds can be converted into equity or preference shares at the option of the investor as per the condition stated in the prospectus. These may be cumulative or non-cumulative. In case of cumulative bonds the interest is accumulated and is payable at maturity. In case of non-cumulative bonds, interest is payable at periodic intervals.

7. **Warrants:** A share warrant is an option to the investor to buy a specified number of equity shares at a specified price over a specified period of time. The warrant holder has to surrender the warrant and pay some cash known as 'exercise price' of the warrant to purchase the shares. On exercising the option the warrant holder becomes a shareholder. Warrant is yet to gain popularity in India, due to the complex nature of the instrument.

8. **Preference shares with warrants:** These carry a certain number of warrants. These warrants give the holder the right to apply for equity shares at premium at any time in one or more stages between the third and fifth year from the date of allotment.

9. **Non-convertible debentures with detachable equity warrants:** In this instrument, the holder is given an option to buy a specified number of shares from the company at a predetermined price within a definite time frame.

10. **Zero interest fully convertible debentures**: On these instruments, no interest will be paid to the holders till the lock in

period. After a notified period, these debentures will be automatically and compulsorily converted into shares.

11. **Fully convertible debentures with interest**: This instrument carries no interest for a specified period. After this period, option is given to apply for equities at premium for which no additional amount is payable. However, interest is payable at a predetermined rate from the date of first conversion to second / final conversion and equity will be issued in lieu of interest.

12. **Non-voting shares:** The Companies Bill, 1997 proposed to allow companies to issue non-voting shares. These are quasi - equity instruments with differential rights. These shares do not carry voting right. Their divided rate is also not predetermined like preference shares.

13. **Inverse float bonds**: These bonds are the latest entrants in the Indian capital market. These are bonds carrying a floating rate of interest that is inversely related to short term interest rates.

14. **Perpetual bonds:** These are debt instruments having no maturity date. The investors receive a stream of interest payment for perpetuity.

Non-Banking Financial Institutions

These are the financial institutions which are not permitted to carry on the banking activities as per Banking Regulation Act, 1949 and RBI regulations.

These institutions have been established by special legislations to provide finance to specified categories of industries or persons.

Classification of Non-Banking Financial Institutions

Non-banking financial institutions can be classified to three. They are :

1. All-India Financial Institutions or All-India Development Banks or Specialised Financial Institutions

2. State Level Financial Institutions

3. Investment Institutions

These may be described in the following pages:

A. All-India Financial Institutions

Government of India has nationalised 20 commercial anks (excluding subsidiaries of SBI) so far. A number of financial institutions have also been set up to supply finance to industry and agriculture. Unfortunately, these commercial banks and financial institutions fail to provide long term finance to industries. With the objective of giving term loans, Govt. has set up some specialised financial institutions. These specialised financial institutions are called development banks. The development banks have to sacrifice business principles of conventional financial institutions and pay due regard to public interest so as to act as an instrument of economic development in conformity with national objectives, plans and priorities.

Development banks are expected to act as catalysts in performing developmental and promotional functions. As regards banking obligations, it is supposed to undertake the primary task of providing financial assistance in different forms. These are something more than pure financial institutions.

Development banks are viewed as financial intermediary supplying medium and long term funds to bankable economic development projects and providing related services. They are expected to mobilise large capital from other sources.

Accordingly, the task of economic transformation and rapid industrialisation can best be handled only through development banks rather than through the normal process of governmental machinery.

Important development or specialised financial institutions may be discussed as follows:

Industrial Finance Corporation of India (IFCI)

The IFCI is the first Development Financial Institution in India. It is a pioneer in development banking in India. It was established in 1948 under an Act of Parliament. The main objective of IFCI is to render financial assistance to large scale industrial units, particularly at a time when the ordinary banks are not forth coming to assist these concerns. Its activities include project financing, financial services, merchant banking and investment.

Till 1993, IFCI continued to be Developmental Financial Institution. After 1993, it was changed from a statutory corporation to a company under the Indian Companies Act, 1956 and was named as IFCI Ltd with effect from October 1999.

Functions of IFCI

Functions of IFCI can be classified into three:

(a) Financial assistance

(b) Promotional activities, and

(c) Financial Services.

(a) Financial Assistance: IFCI renders financial assistance in one or more of the following forms:

1. Guaranteeing loans raised by industrial concerns which are repayable within a period of 25 years.

2. Underwriting the issue of stock, shares, bonds or debentures by industrial concerns but must dispose of such securities within 7 years.

3. Granting loans or advances to or subscribing to debentures of industrial concerns, repayable within 25 years.

4. Acting as agent for the Central Govt. and for the World Bank in respect of loans sanctioned by them to industrial concerns.

5. Granting loans to industrial units

6. Guaranteeing deferred payments by importers of capital goods, which are able to obtain this concession from foreign manufacturers.

7. Guaranteeing loans raised by industrial concerns from scheduled banks or state co-operative banks.

8. Guaranteeing with the prior approval of the Central Govt. loans rose from any bank or financial institution in any country outside India by industrial concerns in foreign country.

(b) Promotional Activities: The IFCI has been playing a very important role as a financial institution in providing financial assistance to eligible industrial concerns. It is playing a promotional role too. It has been creating industrial opportunities. It discovers the opportunities for promoting new enterprises. It helps in developing small and medium scale entrepreneurs by providing them guidance through its specialized agencies in identification of projects, preparing project profiles, implementation of the projects etc. It acts as an instrument of accelerating the industrial growth and reducing regional industrial and income disparities.

(c) Financial Services: The following financial services are provided by IFCI.

(i) Corporate counselling for financial reconstruction

(ii) Assistance in settlement of terms and conditions with foreign collaborators.

(iii) Revival of sick units

(iv) Financing of risky projects

(v) Merchant banking services

The IFCI has promoted ICRA Ltd, a credit rating agency to help investors undertake investment decisions. It has also established Management Development Institute (MDI) with the objective of imparting training in modern management techniques to entrepreneurs, govt. officers, and people from public and private sector.

Industrial Development Bank of India (IDBI)

The IDBI was established on July 1, 1964 under an Act of Parliament. It was set up as the central co-ordinating agency, leader of development banks and principal financing institution for industrial finance in the country. Originally, IDBI was a wholly owned subsidiary of RBI. But it was delinked from RBI w.e.f. Feb. 16, 1976.

IDBI is an apex institution to co-ordinate, supplement and integrate the activities of all existing specialised financial institutions. It is a refinancing and re-discounting institution operating in the capital market to refinance term loans and export credits. It is in charge of conducting techno-economic studies. It was expected to fulfil the needs of rapid industrialisation.

The IDBI is empowered to finance all types of concerns engaged or to be engaged in the manufacture or processing of goods, mining, transport, generation and distribution of power etc., both in the public and private sectors.

Assistance

The composition of assistance given by IDBI may be broadly grouped as direct assistance, indirect assistance and Promotional activities.

Direct Assistance: Direct assistance takes the form of loan/soft loans, underwriting/subscriptions to shares and debentures and guarantees.

Indirect Assistance: It provides assistance to tiny, small and medium enterprises indirectly by way of refinance of loans granted by SFCs, commercial banks, co-operative banks and regional rural banks, through discounting of bills of exchange arising out of the sale of indigenous machinery on deferred payment basis and seed capital assistance to new entrepreneurs through SFCs etc.

Promotional Activities: These include the following:

(a) Assistance for the development of backward areas: This is provided through direct financial assistance at concessional terms and through concessional refinance assistance to projects located in specified backward areas/districts.

(b) Assistance by way of seed capital scheme: This is to help technician entrepreneurs who have technically feasible and economically viable projects but do not have sufficient capital.

(c) A large range of consultancy services: Another promotional scheme is the setting up of TCOs with the principal idea of providing different types of consultancy services to small and medium enterprises, Government departments, commercial banks and others engaged in industrial development. It also provides assistance to voluntary agencies for setting up of science and technology entrepreneurship parks etc., under its network of promotional activities.

In order to boost capital market as well as to play its catalyst role in development and promotional activities for the benefit of industry, IDBI has set up Small Industries Development Fund, Stockholding Cooperation of India, SEBI, National Stock Exchange of India, OTC Exchange of India,

Entrepreneurship Development Institute of India, SCICI, TFCI, mutual fund and commercial bank.

Functions of IDBI

1. It co-ordinates the operation of other institutions providing term finance to industries.

2. It provides assistance to medium and large industries by way of direct finance and refinance of industrial loans.

3. It extends resource support to all India and state level financial institutions and other financial intermediaries.

4. It renders services like asset credit equipment finance, equipment leasing and bridge loans.

5. It also undertakes merchant banking.

6. It provides technical and administrative assistance to industrial concerns.

7. It guarantees deferred payments due from any industrial concern. It guarantees loans raised by industrial concerns from any financial institution.

8. It promotes and develops key industries which are necessary to meet the overall needs of the economy.

9. It undertakes techno-economic studies and surveys on its own with a view to promoting the establishment of new enterprises.

Industrial Credit and Investment Corporation of India (ICICI)

ICICI was set up in 1955 as a public limited company. It was to be a private sector development bank in so far as there was no participation by the Government in its share capital. It is a diversified long term financial institution and provides a comprehensive range of financial products and services including project and equipment financing, underwriting and direct subscription to capital issues, leasing, deferred credit, trusteeship and custodial services, advisory services and business consultancy.

Objectives of ICICI

The main objective of the ICICI was to meet the needs of the industry for long term funds in the private sector. Other objectives include:

(a) To assist in the creation, expansion and modernisation of industrial enterprises in the private sector.

(b) To encourage and promote the participation of private capital, both internal and external, in such enterprises; and

(c) To encourage and promote private ownership of industrial investment and expansion of markets.

Functions of ICICI

1. It sanctions rupee loans for capital assets such as land, building, machinery etc, for long term, and foreign exchange loans for import of machinery and equipment.

2. It guarantees loans from other private investment sources.

3. It subscribes to ordinary or preference capital and underwrites new issues of securities.

4. It renders consultancy services to Indian industry in the form of managerial and technical advice.

5. It also undertakes financial services such as deferred credit, equipment leasing, instalment sale etc.

As already mentioned, the ICICI was initially created to provide finance to industrial units in the private sector only. Subsequently its scope of operations was extended to include public and joint sectors and also the co-operative projects.

It has also set up an Asset Management Company for its mutual fund. It has set up a Commercial Bank (India's first internet bank). Recently, ICICI has merged with ICICI bank.

State Level Financial Institutions

Some financial institutions are working at the state level. The important state level institutions are State Financial Corporations and State Industrial Development Corporations.

State Finance Corporations (SFCs)

The Govt. after independence realised the need of creating a financial corporation at the state level for catering to the needs of industrial entrepreneurs.

As a result, the Govt of India after consultation with the State governments and the Reserve Bank of India, introduced State Finance Corporations bill in the Parliament in 1951. SFC Act came into existence with effect from August 1, 1952.

The Act permitted the State Governments. to establish financial corporation's for the purpose of promoting industrial development in their respective states by providing financial assistance to medium and small scale industries.

Functions of State Finance Corporations

The main function of the SFCs is to provide loans to small and medium scale industries engaged in the manufacture, preservation or processing of goods, mining, hotel industry, generation or distribution of power, transportation, fishing, assembling, repairing or packaging articles with the aid of power etc.

Other functions are follows:

1. Granting loans or advances or subscribing to shares and debentures of the industrial undertaking repayable within twenty years.

2. Guaranteeing loans raised by the industrial concerns repayable within twenty years.

3. Underwriting of the shares, bonds and debentures subject to their disposal in the market within seven years.

4. Guaranteeing deferred payments for the purchase of capital goods by industrial concerns within India.

5. Providing loans for setting up new industrial units as well as for expansion and modernisation of the existing units.

6. Discounting the bills of small and medium scale industries

Kerala Financial Corporation (KFC)

KFC has been incorporated under the SFC Act 1951. It provides financial assistance for starting of new industrial units, expansion, diversification or modernisation of existing units. Assistance is also available for setting up of Tourist Hotel in tourists centres and district head quarters, for the developmentof industrial estates and for the purchase of vehicles for transport undertakings.

Concessional terms are offered to industrial units in the backward districts and for small scale units.

Functions of Kerala Financial Corporation

1. To grant long term loans to new and existing small scale industrial units.

2. To underwrite shares and debentures floated in the open market.

3. To guarantee deferred payments to machinery suppliers for indigenous machinery purchased by borrowers in Kerala.

4. To guarantee the loan raised by industrial concerns in public market.

5. To provide liberalised financial assistance to entrepreneurs under ‘Techno crafts Assistance Scheme’. The corporation is financing 90% of the cost of fixed assets accepted as security subject to a maximum of Rs. 5 lakhs. It gives financial assistance to professionals, Ex-servicemen technocrats, women entrepreneurs etc. It gives working capital assistance up to a certain limit to SSI units.

Non-Banking Financial Corporation (NBFC)

Financial intermediaries are that institution which link lenders and borrows. The process of transferring saving from savers to investors is known as financial intermediation. Commercial banks and cooperative credit societies are called “finance corporations”, or “finance companies”. These finance companies with very little capital have been mobilizing deposits by offering attractive interest rates and incentives and advance loans to wholesale and retail traders, small industries and self-employed persons. They grant unsecured loans at very rates of interest. These are non-banking companies performing the functions of financial intermediaries. They cannot be called banks.

A Non-Banking Financial Company (NBFC) is a company registered under the Companies Act, 1956 and is engaged in the business of loans and advances, acquisition of shares, securities, leasing, hire-purchase, insurance business, and chit business.

Functions of Non-Banking Financial Corporations:

The functions performed by Non-Banking Financial Corporations may be described as under:

• They are able to attract deposits of huge amounts by offering attractive rates of interest and other incentives. Half of the deposits are below two years time period.

•They provide loans to wholesale and retail merchants' small industries, self empl oyment schemes.

• They provide loans without security also. Hence they are able to charge 24 to 36 per cent interest rate.

• They run Chit Funds, discount hundies, provide hire-purchase, leasing finance, merchant banking activities.

• They ventures to provide loans to enterprises with high risks. So they are able to charge high rate of interest. They renew short period loans from time to time. They therefore become long period loans.

• They are able to attract deposits by offering very high rate of interest. In the process many companies sustained losses and went into liquidation. The bankruptcy of many companies adversely affected middle-class and lower income people. There is no insurance protection for deposits as in the case of bank deposits.

• The finance companies are able to fill credit gaps by providing lease finance, hire purchase and instalment buying. They provide loans to buy scooter, cars, TVs and other consumer durables. Such extension of functions makes them almost commercial banks. The only difference is that Non-Banking Financial Corporations cannot introduce cheque system. This is the difference b/w the two

Difference between banks & Non-Banking Financial Corporations:

Non-Banking Financial Corporations are doing functions similar to that of banks; however there are a few differences:

1) A Non-Banking Financial Corporations cannot accept demand deposits,

2) It is not a part of the payment and settlement system and as such cannot issue cheques to its customers,

3) Deposit insurance facility of DICGC is not available for Non-Banking Financial Corporations depositors unlike in case of banks

Different types of Non-Banking Financial Corporations:

There are different categories of Non-Banking Financial Corporations 's operating in India under the supervisory control of RBI. They are:

1. Non-Banking Financial Companies (NBFCs)

2. Residuary Non-banking Finance companies (RNBCs).

3. Miscellaneous Non-Banking Finance Companies (MNBCs)

Residuary Non-Banking Company is a class of Non-Banking Financial Corporations, which is a company and has as its principal business the receiving of deposits, under any scheme or arrangement or in any other manner and not being Investment, Leasing, Hire-Purchase, Loan Company. These companies are required to maintain investments as per directions of RBI, in addition to liquid assets. The functioning of these companies is different from those of NBFCs in terms of method of mobilization of deposits and requirement of deployment of depositors' funds. Peerless Financial Company is the example of RNBCs.

Miscellaneous Non-Banking Financial Companies are another type of Non- Banking Financial Corporations and MNBC means a company carrying on all or any of the types of business as collecting, managing, conducting or supervising as a promoter or in any other capacity, conducting any other form of chit or kuri which is different from the type of business mentioned above and any other business similar to the business as referred above.

Type of Services provided by Non-Banking Financial Corporations**:**

Non-Banking Financial Corporations provide range of financial services to their clients. Types of services under non-banking finance services include the following:

1. Hire Purchase Services
2. Leasing Services
3. Housing Finance Services
4. Asset Management Services
5. Venture Capital Services
6. Mutual Benefit Finance Services (Nidhi) banks.

The above type of companies may be further classified into those accepting deposits or those not accepting deposits.

1. Hire Purchase Services

Hire purchase the legal term for a conditional sale contract with an intention to finance consumers towards vehicles, white goods etc. If a buyer cannot afford to pay the price as a lump sum but can afford to pay a percentage as a deposit, the contract allows the buyer to hire the goods for a monthly rent. If the buyer defaults in paying the instalments, the owner can repossess the goods. Hire purchase is a different form of credit system among other unsecured consumer credit systems and benefits. Hero Honda Motor Finance Co., Bajaj Auto Finance Company is some of the Hire purchase financing companies.

2. Leasing Services

A lease or tenancy is a contract that transfers the right to possess specific property. Leasing service includes the leasing of assets to other companies either on operating lease or finance lease. An NBFC may obtain license to commence leasing services subject to, they shall not hold, deal or trade in real estate business and shall not fix the period of lease for less than 3 years in the case of any finance lease agreement except in case of computers and other IT accessories. First Century Leasing Company Ltd., Sundaram Finance Ltd. Is some of the Leasing companies in India.

3. Housing Finance Services

Housing Finance Services means financial services related to development and construction of residential and commercial properties. An Housing Finance Company approved by the National Housing Bank may undertake the services /activities such as Providing long term finance for the purpose of constructing, purchasing or renovating any property, Managing public or private sector projects in the housing and urban development sector and Financing against existing property by way of mortgage. ICICI Home Finance Ltd., LIC Housing

Finance Co. Ltd., HDFC is some of the housing finance companies in our country.

4. Asset Management Company

Asset Management Company is managing and investing the pooled funds of retail investors in securities in line with the stated investment objectives and provides more diversification, liquidity, and professional management service to the individual investors. Mutual Funds are comes under this category. Most of the financial institutions having their subsidiaries as Asset Management Company like SBI, BOB, UTI and many others.

5. Venture Capital Companies

Venture capital Finance is a unique form of financing activity that is undertaken on the belief of high-risk-high-return. Venture capitalists invest in those risky projects or companies (ventures) that have success potential and could promise sufficient return to justify such gamble. Venture capitalist not only provides finance but also often provides managerial or technical expertise to venture projects. In India, venture capitals concentrate on seed capital finance for high technology and for research & development. Industrial Credit and Investment corporation ventures and Gujarat Venture are one of the first venture capital organizations in India and SIDBI, Industrial development bank of India and others also promoting venture capital finance activities.

6. Mutual Benefit Finance Companies (MBFC's)

A mutual fund is a financial intermediary that allows a group of investors to pool their money together with a predetermined investment objective. The mutual fund will have a fund manager who is responsible for investing the pooled money into specific securities/bonds. Mutual funds are one of the best investments ever created because they are very cost efficient and very easy to invest in. By pooling money together in a mutual fund, investors can purchase stocks or bonds with much lower trading costs than if they tried to do it on their own. But the biggest advantage to mutual funds is diversification.

There are two main types of such funds, open-ended fund and close-ended mutual funds. In case of open-ended fund, the fund manager continuously allows investors to join or leave the fund. The fund is set up as a trust, with an independent trustee, who keeps custody over the assets of the trust. Each share of the trust is called a Unit and the fund itself is called a Mutual Fund. The portfolio of investments of the Mutual Fund is normally evaluated daily by the fund manager on the basis of prevailing market prices of the securities in the portfolio and this will be divided by the number of units issued to determine the Net Asset Value (NAV) per unit. An investor can join or leave the fund on the basis of the NAV per unit.

In contrast, a close-end fund is similar to a listed company with respect to its share capital. These shares are not redeemable and are traded in the stock exchange like any other listed securities. Value of units of close-end funds is determined by market forces and is available at 20-30% discount to their NAV.

MODULE IV

INDUSTRIAL SECURITIES MARKET

Primary Market /New Issue Market (NIM)

Every company needs funds. Funds may be required for short term or long term. Short term requirements of funds can be met through banks, lenders, institutions etc. When a company wishes to raise long term capital, it goes to the primary market. Primary market is an important constituent of a capital market.

In the primary market the security is purchased directly from the issuer.

Meaning of Primary Market

The primary market is a market for new issues. It is also called new issue market. It is a market for fresh capital. It deals with the new securities which were not previously available to the investing public. Corporate enterprises and Govt. raises long term funds from the primary market by issuing financial securities.

Both the new companies and the existing companies can issue new securities on the primary market. It also covers raising of fresh capital by government or its agencies.

The primary market comprises of all institutions dealing in fresh securities. These securities may be in the form of equity shares, preference shares, debentures, right issues, deposits etc.

Functions of Primary Market

The main function of a primary market can be divided into three service functions. They are: origination, underwriting and distribution.

1. Origination: Origination refers to the work of investigation, analysis and processing of new project proposals. Origination begins before an issue is actually floated in the market. The function of origination is done by merchant bankers who may be commercial banks, all India financial institutions or private firms.

2. Underwriting: When a company issues shares to the public it is not sure that the whole shares will be subscribed by the public. Therefore, in order to ensure the full subscription of shares (or at least 90%) the company may underwrite its shares or debentures. The act of ensuring the sale of shares or debentures of a company even before offering to the public is called underwriting. It is a contract between a company and an underwriter (individual or firm of individuals) by which he agrees to undertake that part of shares or debentures which has not been subscribed by the public. The firms or persons who are engaged in underwriting are called underwriters.

3. Distribution: This is the function of sale of securities to ultimate investors. This service is performed by brokers and agents. They maintain a direct and regular contact with the ultimate investors.

Methods of Raising Fund in the Primary Market (Methods of Floating New Issues)

A company can raise capital from the primary market through various methods. The methods include public issues, offer for sale, private placement, right issue, and tender method.

a. Public Issues

This is the most popular method of raising long term capital. It means raising funds directly from the public. Under this method, the company invites subscription from the public through the issue of prospectus (and issuing advertisements in news papers). On the basis of offer in the prospectus, the investors apply for the number of securities they are willing to take. In response to application for securities, the company makes the allotment of shares, debentures etc.

Types of Public Issues: Public issue is of two types, namely, initial public offer and follow-on public offer.

Initial Public Offering (IPO): This is an offering of either a fresh issue of securities or an offer for sale of existing securities or both by an unlisted company for the first time in its life to the public. In short, it is a method of raising securities in which a company sells shares or stock to the general public for the first time.

Follow-on Public Offering (FPO): This is an offer of sale of securities by a listed company. This is an offering of either a fresh issue of securities or an offer for sale to the public by an already listed company through an offer document.

Methods of Determination of Prices of New Shares

Equity offerings by companies are offered to the investors in two forms –

(a) Fixed price offer method, and

(b) Book building method.

Fixed Price Offer Method

In this case, the company fixes the issue price and then advertises the number of shares to be issued. If the price is very high, the investors will apply for fewer numbers of shares. On the other hand, if the issue is under-priced, the investors will apply for more number of shares. This will lead to huge over subscription.

The main steps involved in issue of shares under fixed price offer method are as follows:

1. Selection of merchant banker

2. Issue of a prospectus

3. Application for shares

4. Allotment of shares to applicants

5. Issue of Share Certificate

Book-building Method

It was introduced on the basis of recommendations of the committee constituted under the chairmanship of Y.H. Malegam in October, 1995. Under this method, the company does not price the securities in advance. Instead, it offers the investors an opportunity to bid collectively. It then uses the bids to arrive at a consensus price. All the applications received are arranged and a final offer price (known as cut off price) is arrived at. Usually the cut off price is the weighted average price at which the majority of investors are willing to buy the securities. In short, book building means selling securities to investors at an acceptable price with the help of intermediaries called Book-runners. It involves sale of securities to the public and institutional bidders on the basis of predetermined price range or price band. The price band cannot exceed 20% of the floor price. The floor price is the minimum price at which bids can be made by the investors. It is fixed by the merchant banker in consultation with the issuing company. Thus, book building refers to the process under which pricing of the issue is left to the investors.

Today most IPOs in India use book-building method. As per SEBI's guidelines 1997, the book building process may be applied to 100 per cent of the issue, if the issue size is 100 crores or more.

b. Offer for Sale Method

Under this method, instead of offering shares directly to the public by the company itself, it offers through the intermediary such as issue houses / merchant banks / investment banks or firms of stock brokers.

Under this method, the sale of securities takes place in two stages. In the first stage, the issuing company sells the shares to the intermediaries such as issue houses and brokers at an agreed price. In the second stage, the intermediaries resell the securities to the ultimate investors at a market related price. This price will be higher. The difference between the purchase price and the issue price represents profit for the intermediaries. The intermediaries are responsible for meeting various expenses. Offer for sale method is also called bought out deal. This method is not common in India.

c. Private Placement of Securities

Private placement is the issue of securities of a company direct to one investor or a small group of investors. Generally the investors are the financial institutions or other existing companies or selected private persons such as friends and relatives of promoters. A private company cannot issue a prospectus. Hence it usually raises its capital by private placement. A public limited company can also raise its capital by placing the shares privately and without inviting the public for subscription of its shares. Company law defines a privately placed issue to be the one seeking subscription from 50 members. In a private placement, no prospectus is issued. In this case the elaborate procedure required

in the case of public issue is avoided. Therefore, the cost of issue is minimal. The process of raising funds is also very simple. But the number of shares that can be issued in a private placement is generally limited.

Thus, private placement refers to the direct sale of newly issued securities by the issuer to a small number of investors through merchant bankers.

d. Right Issue

Right issue is a method of raising funds in the market by an existing company. Under this method, the existing company issues shares to its existing shareholders in proportion to the number of shares already held by them. Thus a right issue is the issue of new shares in which existing shareholders are given pre-emptive rights to subscribe to the new issue on a pro-rata basis.

According to Section 81 (1) of the Companies Act, when the company wants to increase the subscribed capital by issue of further shares, such shares must be issued first of all to existing shareholders in proportion of their existing shareholding. The existing shareholders may accept or reject the right.

Shareholders who do not wish to take up the right shares can sell their rights to another person. If the shareholders neither subscribe the shares nor transfer their rights, then the company can offer the shares to public. A company making right issue is required to send a circular to all existing shareholders. The circular should provide information on how additional funds would be used and their effect on the earning capacity of the company. The company should normally give a time limit of at least one month to two months to shareholders to exercise their rights before it is offered to the public. No new company can make right issue.

Promoters offer right issue at attractive price often at a discount to the market price due to a variety of reasons. The reasons are: (a) they want to get their issues fully subscribed to, (b) to reward their shareholders, (c) it is possible that the market price does not reflect a share's true worth or that it is overpriced, (d) to increase their stake in the companies so as to avoid preferential allotment.

e. Other Methods of Issuing Securities

Apart from the above methods, there are some other methods of issuing securities. They are:

1. **Tender method**: Under tender method, the issue price is not predetermined. The company announces the public issue without indicating the issue price. It invites bids from various interested parties. The parties participating in the tender submit their maximum offers indicating the maximum price they are willing to pay. They should also specify the number of shares they are interested to buy. The company, after receiving various offers, may decide about the price in such a manner that the entire issue is fairly subscribed or sold to the parties participating in the tender.

2. **Issue of bonus shares:** Where the accumulated reserves and surplus of profits of a company are converted into paid up capital,

it is called bonus issue. It simply refers to capitalization of existing reserves and surpluses of a company.

3. **Offer to the employees**: Now a days companies issue shares on a preferential basis to their employees (including whole time directors). This attracts, retains and motivates the employees by creating a sense of belonging and loyalty. Generally shares are issued at a discount. A company can issue shares to their employees under the following two schemes: (a) Employee stock option scheme and (b) employee stock purchase scheme.

4. **Offer to the creditors**: At the time of reorganization of capital, creditors may be issued shares in full settlement of their loans.

5. **Offer to the customers**: Public utility undertakings offer shares to their customers.

Procedure of Public Issue

Under public issue, the new shares/debentures may be offered either directly to the public through a prospectus (offer document) or indirectly through an offer for sale involving financial intermediaries or issue houses. The main steps involved in public issue are as follows:

1. Draft prospectus: A draft prospectus has to be prepared giving all required information. Any company or a listed company making a public issue or a right issue of value more than Rs. 50 lakh has to file a draft offer document with SEBI for its observation. The company can proceed further after getting observations from the SEBI. The company can open its issue within 3 months from the date of SEBI's observation letter.

2. Fulfilment of Entry Norms: The SEBI has laid down certain entry norms (parameters) for accessing the primary market. A

company can enter into the primary market only if a company fulfils these entry norms.

3. Appointment of underwriters: Sometimes underwriters are appointed to ensure full subscription.

4. Appointment of bankers: Generally, the company shall nominate its own banker to act as collecting agent. The bankers along with their branch network process the funds procured during the public issue.

5. Initiating allotment procedure: When the issue is subscribed to the minimum level, the registrars initiate the allotment procedure.

6. Appointment of brokers to the issue: Recognised members of the stock exchange are appointed as brokers to the issue.

7. Filing of documents: Documents such as draft prospectus, along with the copies of the agreements entered into with the lead manager, underwriters, bankers, Registrars, and brokers to the issue have to be filed with the Registrar of Companies.

8. Printing of prospectus and application forms: After filing the above documents, the prospectus and application forms are printed and dispatched to all merchant bankers, underwriters and brokers to the issue.

9. Listing the issue: It is very essential to send a letter to the stock exchange concerned where the issue is proposed to be listed.

10. Publication in news papers: The next step is to publish an abridged version of the prospectus and the commencing and closing dates of issues in major English dailies and vernacular newspapers.

11. Allotment of shares: After close of the issue, all application forms are scrutinised tabulated and then the shares are allotted against those applications received.

Players or Participants (or Intermediaries) in the Primary market/Capital Market

There are many players (intermediaries) in the primary market (or capital market). Important players are as follows:

1. **Merchant bankers:** In attracting public money to capital issues, merchant bankers play a vital role. They act as issue managers, lead managers or comanagers (functions in detail is given in following pages)

2. **Registrars to the issue**: Registrars are intermediaries who undertake all activities connected with new issue management. They are appointed by the company in consultation with the merchant bankers to the issue.

3. **Bankers:** Some commercial banks act as collecting agents and some act as co-ordinating bankers. Some bankers act as merchant bankers and some are brokers. They play an important role in transfer, transmission and safe custody of funds.

4. Brokers: They act as intermediaries in purchase and sale of securities in the primary and secondary markets. They have a network of sub brokers spread throughout the length and breadth of the country.

5. **Underwriters**: Generally investment bankers act as underwriters. They agreed to take a specified number of shares or debentures offered to the public, if the issue is not fully subscribed by the public. Underwriters may be financial institutions, banks, mutual funds, brokers etc.

Defects of the Indian Primary Market

The Indian primary market has the following defects:

1. The new issue market is not able to mobilise adequate savings from the public. Only 10% of the savings of the household sector go to the primary market.

2. The merchant bankers do not play adequate attention to the technical, managerial and feasibility aspects while appraising the project proposal. In fact, they do not seem to play a development role. As a result, the small investors are duped by the companies.

3. There is inordinate delay in the allotment process. This will discourage the small investors to approach the primary market for investing their funds.

4. Generally there is a tendency on the part of the investors to prefer fixed income bearing securities like preference shares and debentures. They hesitate to invest in equity shares. There is a risk aversion in the new issue market. This stands in the way of a healthy primary market.

5. There is a functional and institutional gap in the new issue market. A wholesale market is yet to develop for new issue or primary market.

6. In the case of investors from semi-urban and rural areas, they have to incur more expenses for sending the application forms to centres where banks are authorized to accept them. The expenses in connection with this include bank charges, postal expenses and so on. All these will discourage the small investors in rural areas.

Over the years, SEBI, and Central Government have come up with a series of regulatory measures to give a boost to new issue market.

Secondary Market

The investors want liquidity for their investments. When they need cash, they should be able to sell the securities they hold. Similarly there are others who want to invest in new securities. There should be a place where securities of different companies can be bought and sold. Secondary market provides such a place.

Meaning of Secondary Market

Secondary market is a market for old issues. It deals with the buying and selling existing securities i.e. securities already issued. In other words, securities already issued in the primary market are traded in the secondary market. Secondary market is also known as stock market. The secondary market operates through ‘stock exchanges’.

In the secondary market, the existing owner sells securities to another party. The secondary markets support the primary markets. The secondary market provides liquidity to the individuals who acquired these securities. The primary market gets benefits greatly from the liquidity provided by the secondary market. This is because investors would hesitate to buy the securities in the primary market if they thought they could not sell them in the secondary market later.

In India, stock market consists of recognised stock exchanges. In the stock exchanges, securities issued by the central and state governments, public bodies, and joint stock companies are traded.

Stock Exchange

In India the first organized stock exchange was Bombay Stock Exchange. It was started in 1877. Later on, the Ahmadabad Stock Exchange and Calcutta Stock Exchange were started in 1894 and 1908 respectively. At present there are 24 stock exchanges in India. In Europe, stock exchanges are often called *bourses*.

Meaning and Definition of Stock Exchange/ Security Exchange

It is an organized market for the purchase and sale of securities of joint stock companies, government and semi- govt. bodies. It is the centre where shares, debentures and govt. securities are bought and sold.

According to Pyle, **"***Security exchanges are market places where securities that have been listed thereon may be bought and sold for either investment or speculation".*

The Securities Contract (Regulation) Act 1956, defines a stock exchange as *"an association, organisation or body of individuals whether incorporated or not, established for the purpose of assisting, regulating and controlling of business in buying, selling and dealing in securities".*

According to Hartley Withers, *"a stock exchange is something like a vast warehouse where securities are taken away from the shelves and sold across the countries at a price fixed in a catalogue which is called the official list".*

In short, stock exchange is a place or market where the listed securities are bought and sold.

Characteristics of a Stock Exchange

1. It is an organized capital market.

2. It may be incorporated or non-incorporated body (association or body of individuals).

3. It is an open market for the purchase and sale of securities.

4. Only listed securities can be dealt on a stock exchange.

5. It works under established rules and regulations.

6. The securities are bought and sold either for investment or for speculative purpose.

Economic Functions of Stock Exchange

The stock exchange performs the following essential economic functions:

1. Ensures liquidity to capital: The stock exchange provides a place where shares and stocks are converted into cash. People with surplus cash can invest in securities (by buying securities) and people with deficit cash can sell their securities to convert them into cash.

2. Continuous market for securities: It provides a continuous and ready market for buying and selling securities. It provides a ready market for those who wish to buy and sell securities

3. Mobilisation of savings: It helps in mobilizing savings and surplus funds of individuals, firms and other institutions. It directs the flow of capital in the most profitable channel.

4. Capital formation: The stock exchange publishes the correct prices of various securities. Thus the people will invest in those

securities which yield higher returns. It promotes the habit of saving and investment among the public. In this way the stock exchange facilitates the capital formation in the country.

5. Evaluation of securities: The prices at which transactions take place are recorded and made public in the forms of market quotations. From the price quotations, the investors can evaluate the worth of their holdings.

6. Economic developments: It promotes industrial growth and economic development of the country by encouraging industrial investments. New and existing concerns raise their capital through stock exchanges.

7. Safeguards for investors: Investors' interests are very much protected by the stock exchange. The brokers have to transact their business strictly according to the rules prescribed by the stock exchange. Hence they cannot overcharge the investors.

8. Barometer of economic conditions: Stock exchange reflects the changes taking place in the country's economy. Just as the weather clock tells us which way the wind is blowing, in the same way stock exchange serves as an indicator of the phases in business cycle-boom, depression, recessions and recovery.

9. Platform for public debt: The govt. has to raise huge funds for the development activities. Stock exchange acts as markets of govt. securities. Thus, stock exchange provides a platform for raising public debt.

10. Helps to banks: Stock exchange helps the banks to maintain liquidity by increasing the volume of easily marketable securities.

11. Pricing of securities: New issues of outstanding securities in the primary market are based on the prices in the stock exchange. Thus, it helps in pricing of securities.

Thus stock exchange is of great importance to a country. It provides necessary mobility to capital. It directs the flow of capital into profitable and successful enterprises. It is indispensable for the proper functioning of corporate enterprises. Without stock exchange, even govt. would find it difficult to borrow for its various schemes. It helps the traders, investors, industrialists and the banker. Hence, it is described as the business of business.

Benefits of Stock Exchange

A. **Benefits to Investors**

1. The stock exchange plays the role of a friend, philosopher and guide to investors by providing information about the prices of various securities.

2. It offers a ready market for buying and selling securities.

3. It increases the liquidity of the investors.

4. It safeguards the interests of investors through strict rules and regulations.

5. It enables the investors to know the present worth of their securities.

6. It helps investors in making wise investment decisions by providing useful information about the financial position of the companies.

7. The holder of a listed security can easily raise loan by pledging it as a collateral security.

B. **Benefits to Companies**

1. A company enjoys greater reputation and credit in the market. Image of the company goes up.

2. A company can raise large amount of capital from different types of securities.

3. It enjoys market for its shares.

4. The market price for shares and debentures will be higher. Due to this the bargaining power of the company increases in the events of merger or amalgamation.

C. Benefits to Community and Nation

1. Stock exchange encourages people to sell and invest their savings in shares and debentures.

2. Through capital formation, stock exchange enables companies to undertake expansion and modernization. Stock exchange is an ‘Alibaba Cave’ from which business community draw unlimited money.

3. It helps the government in raising funds through sale of government securities.

This enables the government to undertake projects of national importance and social value.

4. It diverts the savings towards productive channels.

5. It helps in better utilisation of the country’s financial resources.

6. It is an effective indicator of general economic conditions of a country.

Listing of Securities

A stock exchange does not deal in the securities of all companies. Only those securities that are listed are dealt with the stock exchange. For the purpose of listing of securities, a company has to apply to the stock exchange. The stock exchange will decide whether to list the securities of the company or not. If permission is granted by the stock exchange to deal with the securities therein, then such a company is included in the official trade list of the stock exchange.

This is technically known as listing of securities. Thus listing of securities means permission to quote shares and debentures officially on the trading floor of the stock exchange. Listing of securities refers to the sanction of the right to trade the securities on the stock exchange. In short, listing means admission of securities to be traded on the stock exchange. If the securities are not listed, they are not allowed to be traded on the stock exchange.

Objectives of Listing

The main objectives of listing are:

1. To ensure proper supervision and control of dealings in securities.

2. To protect the interests of shareholders and the investors.

3. To avoid concentration of economic power.

4. To assure marketing facilities for the securities.

5. To ensure liquidity of securities.

6. To regulate dealings in securities.

Advantages of Listing

A. Advantages to Company:-

1. It provides continuous market for securities (securities include shares, debentures, bonds etc.)

2. It enhances liquidity of securities.

3. It enhances prestige of the company.

4. It ensures wide publicity.

5. Raising of capital becomes easy.

6. It gives some tax advantage to the company.

B. Advantages to Investors:-

1. It provides safety of dealings.

2. It facilitates quick disposal of securities in times of need. This means that listing enhances the liquidity of securities.

3. It gives some tax advantage to the security holder.

4. Listed securities command higher collateral value for the purpose of bank loans.

5. It provides an indirect check against manipulation by the management.

Disadvantages of Listing

1. It leads to speculation

2. Sometimes listed securities are subjected to wide fluctuations in their value. This may degrade the company's reputation.

3. It discloses vital information such as dividends and bonus declared etc. to competitors.

4. Company has to spend heavily in the process of placing the securities with public

Classification of Listed Securities

The listed shares are generally divided into two categories - Group A shares (cleared securities) and Group B shares (non-cleared securities).

Group A shares represent large and well established companies having a broad investor base. These shares are actively traded. Forward trading is allowed in Group A shares. These facilities are not available to Group B shares. These are not actively traded. Carry forward facility is not available in case of these securities.

Requirements of Listing (Procedure of Listing)

Any company intending to get its securities listed at an exchange has to fulfil certain requirements. The application for listing is to be made in the prescribed form. It should be supported by the following documents:

a) Memorandum and Articles.

b) Copies of all prospectuses or statements in lieu of prospectuses.

c) Copies of balance sheets, audited accounts, agreements with promoters, underwriters, brokers etc.

d) Letters of consent from SEBI.

e) Details of shares and debentures issued and shares forfeited.

f) Details of bonus issues and dividends declared.

g) History of the company in brief.

h) Agreement with managing director etc.

i) An undertaking regarding compliance with the provisions of the Companies Act and Securities Contracts (Regulation) Act as well as rules made therein.

After the application is made to the stock exchange the listing committee of the stock exchange will go into the details of the application. It has to ensure that the company fulfils the conditions or criteria necessary for listing

Procedure for Dealing at Stock Exchange (Trading Mechanism or Method of Trading on a Stock Exchange)

Outsiders are not allowed to buy or sell securities at a stock exchange. They have to approach brokers. Dealings can be done only through brokers. They are the members of the stock exchange. The following procedure is followed for dealing at exchanges:

1. **Selection of a broker:** An individual cannot buy or sell securities directly at stock exchange. He can do so only through a broker. So he has to select a broker through whom the purchase or sale is to be made. The intending investor or seller may appoint his bank for this purpose. The bank may help to choose the broker.

2. **Placing an order**: After selecting the broker, the next step is to place an order for purchase or sale of securities. The broker also guides the client about the type of securities to be purchased

and the proper time for it. If a client is to sell the securities, then the broker shall tell him about the favourable time for sale.

3. **Making the contract:** The trading floor of the stock exchange is divided into different parts known as trading posts. Different posts deal in different types of securities. The authorised clerk of the broker goes to the concerned post and expresses his intention to buy and sell the securities. A deal is struck when the other party also agrees. The bargain is noted by both the parties in their note books. As soon as order is executed a confirmation memo is prepared and is given to the client.

4. **Contract Note:** After issue of confirmation memo, a contract note is signed between the broker and the client. This contract note will state the transaction fees (commission of broker), number of shares bought or sold, price at which they are bought or sold, etc.

5. **Settlement:** Settlement involves making payment to sellers of shares and delivery of share certificate to the buyer of shares after receiving the price. The settlement procedure depends upon the nature of the transactions. All the transactions on the stock exchange may be classified into two- ready delivery contracts and forward delivery contracts.

a. Ready delivery contract: A ready delivery contract involves the actual payment of the amount by the buyer in cash and the delivery of securities by the seller. A ready delivery contract is to be settled on the same day or within the time period fixed by the stock exchange authorities.

b. Forward delivery contracts: These contracts are entered into without any intention of taking and giving delivery of the securities. The traders in forward delivery securities are interested in profits out of price variations in the future. Such transactions are settled on the settlement days fixed by the stock exchange authorities. Such contracts can be postponed to the next settlement day, if both the parties agree between themselves. Such postponement is called ‘Carry over’ or ‘badla’. Thus ‘carry over’ or ‘badla’ means the postponement of transaction from one settlement period to the next settlement period.

Rolling Settlement

Rolling settlement has been introduced in the place of account period settlement. Rolling settlement system was introduced by SEBI in January 1998.

Under this system of settlement, the trades executed on a certain day are settled based on the net obligations for that day. At present, the trades relating to the rolling settlement are settled on T + 2day basis where T stands for the trade day. It implies that the trades executed on the first day (say on Monday) have to be settled on the 3rd day (on Wednesday), i.e., after a gap of 2 days.

This cycle would be rolling and hence there would be number of set of transactions for delivery every day. As each day’s transaction are settled in full, rolling settlement helps in increasing the liquidity in the market. With effect from January 2, 2002, all scrips have been brought under compulsory rolling mode.

Members in a Stock Exchange

Only members of the exchange are allowed to do business of buying and selling of securities at the floor of the stock exchange. A non-member (client) can buy and sell securities only through a broker who is a member of the stock exchange. To deal in securities on recognised stock exchanges, the broker should register his name as a broker with the SEBI.

Brokers are the main players in the secondary market. They may act in different capacities as a principal, as an agent, as a speculator and so on.

Types of Members in a Stock Exchange

The various types of members of a stock exchange are as follows:-

1. **Jobbers** :- They are dealers in securities in a stock exchange. They cannot deal on behalf of public. They purchase and sell securities on their own names. Their main job is to earn profit due to price variations.

2. **Commission brokers** :- They are nothing but brokers. They buy and sell securities no behalf of their clients for a commission. They are permitted to deal with non-members directly. They do not purchase or sell in their own name.

3. **Tarawaniwalas** :- They are like jobbers. They handle transactions on a commission basis for their brokers. They buy and sell securities on their own account and may act as brokers on behalf of the public.

4. **Sub-brokers :-** Sub brokers are agents of stock brokers. They are employed by brokers to obtain business. They cannot carry on business in their own name. They are also known as remisiers.

5. **Arbitrageurs :-** They are brokers. They buy security in one market and sell the same in another market to get opportunistic profit.

6. **Authorised clerks :-** Authorised clerks are those who are appointed by stock brokers to assist them in the business of securities trading.

Speculation

Speculation is an attempt to make capital gain from the price movement of the scrips in the security market over a short span of time. Those who engaged in such type of transactions are called speculators. They buy and sell securities frequently and are not interested in keeping them for long term. Speculation involves high risks. If the expectation of speculators comes true he can make profit but if it goes wrong the loss could be detrimental.

Type of Speculators

The following on the different kinds of speculators:

1. **Bull**: A bull or Tejiwala is a speculator who buys shares in expectation of selling them at higher prices in future. He believes that current prices are lower and will rise in the future.

2. **Bear**: A bear or Mandiwala is a speculator who sells securities with the intention to buy at a later date at a lower price. He expects a fall in price in future.

3. **Lame duck**: A lame duck is a bear speculator. He finds it difficult to meet his commitments and struggles like a lame duck. This happens because of the nonavailability of securities in the market which he has agreed to sell and at the same time the other party is not willing to postpone the transaction.

4. **Stag**: Stag is a member who neither buys nor sells securities. He applies for shares in the new issue market. He expects that the price of shares will soon increase and the shares can be sold for a premium.

5. **Wolf**: Wolf is a broker who is fast speculator. He is very quick to perceive changes in the market trends and trade fast and make fast profit.

Speculative Transactions

Some of the speculative dealings are as follows:

1. **Option deals**: This is an arrangement or right to buy or sell securities at a predetermined price on or before a specified date in future.

2. **Wash sales**: It is a device through which a speculator is able to reap huge profits by creating a misleading picture in the market. It is a kind of fictitious transaction in which a speculator sells a security and then buys the same at a higher price through another broker. Thus he creates a false or misleading opinion in the market about the price of a security.

3. **Rigging**: If refers to the process of creating an artificial condition in the market whereby the market value of a particular security is pushed upon. Bulls buy securities, create demand for the same and sell them at increased prices.

4. **Arbitrage**: It is the process of buying a security, from a market where price is lower and selling at in another market where price is higher.

5. **Cornering**: Sometimes speculators make entire or a major share of supply of a particular security with a view to create a scarcity against the existing contracts. This is called cornering.

6. **Blank transfer**: When the transferor (seller) simply signs the transfer form without specifying the name of the transferee (buyer), it is called blank transfer.

In this case share can further be transferred by mere delivery of transfer deed together with the share certificate. A new transfer deed is not required at the time of each transfer. Hence, expenses such as registration fees, stamp duty, etc can be saved.

7. **Margin trading**: Under this method, the client opens an account with his broker. The client makes a deposit of cash or securities in this account. He also agrees to maintain a minimum margin of amount always in his account. When a broker purchases securities on behalf of his client, his account (client's account) will be debited and vice versa. The debit balance, if any, is automatically secured by the client's securities lying with the broker. In case it falls short of the minimum agreed amount, the client has to deposit further amount into his account or he has to deposit further securities. If the prices are favourable, the client may instruct his broker to sell the securities. When such securities are sold, his account will be credited. The client may have a bigger margin now for further purchases.

Factors Influencing Prices on Stock Exchange

The prices on stock exchange depend upon the following factors:

1. Financial position of the company
2. Demand and supply position
3. Lending rates
4. Attitudes of the FIIs and the developments in the global financial markets.
5. Govt. Policies (credit policies, monetary policies, taxation policies etc.)
6. Trade cycle
7. Speculation activities

Defects of Stock Exchanges (or Capital Market) in India

The Indian stock market is suffering from a number of weaknesses. Important weaknesses are as follows:

1. **Speculative activities**: Most of the transactions in stock exchange are carry forward transactions with a speculative motive of deriving benefit from short term price fluctuation. Genuine transactions are only less. Hence market is not subject to free interplay of demand and supply for securities.

2. **Insider trading:** Insider trading has been a routine practice in India. Insiders are those who have access to unpublished price-sensitive information. By virtue of their position in the company they use such information for their own benefits.

3. **Poor liquidity**: The Indian stock exchanges suffer from poor liquidity. Though there are approximately 8000 listed companies in India, the securities of only a few companies are actively traded. Only those securities are liquid. This means other stocks have very low liquidity.

4**. Less floating securities**: There is scarcity of floating securities in the Indian stock exchanges. Out of the total stocks, only a small portion is being offered for sale. The financial institutions and joint stock companies control over 75% of the scrips. However, they do not offer their holdings for sale. The UTI, GIC, LIC etc. indulge more in purchasing than in selling. This creates scarcity of stocks for trading. Hence, the market becomes highly volatile. It is subject to easy price manipulations.

5. **Lack of transparency**: Many brokers are violating the regulations with a view to cheating the innocent investing community. No information is available to investors regarding the volume of transactions carried out at the highest and lowest

prices. In short, there is no transparency in dealings in stock exchanges.

6. **High volatility**: The Indian stock market is subject to high volatility in recent years. The stock prices fluctuate from hour to hour. High volatility is not conducive for the smooth functioning of the stock market.

7. **Dominance of financial institutions**: The Indian stock market is being dominated by few financial institutions like UTI, LIC, GIC etc. This means these few institutions can influence stock market greatly. This actually reduces the level of competition in the stock market. This is not a healthy trend for the growth of any stock market.

8. **Competition of merchant bankers**: The increasing number of merchant bankers in the stock market has led to unhealthy competition in the stock market. The merchant bankers help the unscrupulous promoters to raise funds for non-existent projects. Investors are the ultimate sufferers.

9. **Lack of professionalism**: Some of the brokers are highly competent and professional. At the same time, majority of the brokers are not so professional.

They lack proper education, business skills, infrastructure facilities etc. Hence they are not able to provide proper service to their clients.

Difference between Primary and Secondary Market

Primary Market	**Secondary Market**
1. It is a market for new securities.	1. It is a market for existing or second hand securities

2. It is directly promotes capital formation.	2. It is directly promotes capital formation.
3. Investors can only buy securities. They cannot sell them.	3. Both buying and selling of securities takes place
4. There is no fixed geographical location.	4. There is a fixed geographical location (stock exchanges)
5. Securities need not be listed.	5. Only listed securities can be bought and sold
6. It enables the borrowers to raise capital	6. It enables the investors to invest money in securities and sell and encash as they need money

Major Stock Exchanges in India

At present there are 24 recognised stock exchanges in India. Brief descriptions of major SEs are given below:

1. **Bombay Stock Exchange (BSE)**

BSE is the leading and the oldest stock exchange in India as well as in Asia. It was established in 1887 with the formation of "The Native Share and Stock Brokers' Association". BSE is a very active stock exchange with highest number of listed securities in India. Nearly 70% to 80% of all transactions in the India are done alone in BSE. Companies traded on BSE were 3,049 by March,

2006. BSE is now a national stock exchange as the BSE has started allowing its members to set-up computer terminals outside the city of Mumbai (former Bombay). It is the only stock exchange in India which is given permanent recognition by the government.

In 2005, BSE was given the status of a fully fledged public limited company along with a new name as "Bombay Stock Exchange Limited". The BSE has computerized its trading system by introducing BOLT (Bombay on Line Trading) since March 1995. BSE is operating BOLT at 275 cities with 5 lakh (0.5 million) traders a day. Average daily turnover of BSE is near Rs. 200 crores.

Some facts about BSE are:

- BSE exchange was the first in India to launch Equity Derivatives, Free Float Index, USD adaptation of BSE Sensex and Exchange facilitated Internet buying and selling policy.
- BSE exchange was the first in India to acquire the ISO authorization for supervision, clearance & Settlement
- BSE exchange was the first in India to have launched private service for economic training
- Its On-Line Trading System has been felicitated by the internationally renowned standard of Information Security Management System.

Bombay Online Trading System (BOLT)

BSE online trading was established in 1995 and is the first exchange to be set up in Asia. It has the largest number of listed companies in the world and currently has 4937 companies listed on the Exchange with over 7,700 traded instruments.

The only thing that an investor requires for online trading through BSE is an online trading account. The trading can then be done within the trading hours from any location in the world. In fact, BSE has replaced the open cry system with automated trading. Open cry system is a common method of communication between the investors at a stock exchange where they shout and use hand gestures to communicate and transfer information about buy and sell orders. It usually takes place on the 'pit' area of the trading floor and involves a lot of face to face interaction. However, with the use of electronic trading systems trading is easier, faster and cheaper; and is less prone to manipulation by market makers and brokers/dealers.

The Bolt system has enabled the exchange to meet the following objective:

- Reduce and eliminate operational inefficiencies inherent in manual systems
- Increases trading capacity of the stock exchange
- Improve market transparency, eliminate unmatched trades and delayed reporting
- Promote fairness and speedy matching
- Provide for on-line and off-line monitoring, control and surveillance of the market
- Smooth market operations using technology while retaining the flexibility of conventional trading practices
- Set up various limits, rules and controls centrally
- Provide brokers with their trade data on electronic media to

interface with the Broker's Back Office system

- Provide a sophisticated, easy to use, graphical user interface (GUI) to all the users of the system
- Provide public information on scrip prices, indices for all users of the system and allow the stock exchange to do information vending
- Provide analytical data for use of the Stock Exchange

2. National Stock Exchange (NSE)

Formation of National Stock Exchange of India Limited (NSE) in 1992 is one important development in the Indian capital market. The need was felt by the industry and investing community since 1991. The NSE is slowly becoming the leading stock exchange in terms of technology, systems and practices in due course of time. NSE is the largest and most modern stock exchange in India. In addition, it is the third largest exchange in the world next to two exchanges operating in the USA.

The NSE boasts of screen based trading system. In the NSE, the available system provides complete market transparency of trading operations to both trading members and the participates and finds a suitable match. The NSE does not have trading floors as in conventional stock exchanges. The trading is entirely screen based with automated order machine. The screen provides entire market information at the press of a button. At the same time, the system provides for concealment of the identity of market operations. The screen gives all information which is dynamically updated. As the market participants sit in their own offices, they have all the advantages of back office support, and facility to get in touch with their constituents. The trading segments of NSE are:

- Wholesale debt market segment,
- Capital market segment, and
- Futures & options trading.

NEAT

NSE uses satellite communication expertise to strengthen contribution from around 400 Indian cities. It is one of the biggest VSAT incorporated stock exchange across the world.

NSE is the first exchange in the world to use satellite communication technology for trading. Its trading system, called National Exchange for Automated Trading (NEAT), is a state of-the-art client server based application. At the server end all trading information is stored in an in memory database to achieve minimum response time and maximum system availability for users. It has uptime record of 99.7%. For all trades entered into NEAT system, there is uniform response time of less than one second.

Stock Indices (indexes)

Indexes are constructed to measure the price movements of shares, bonds and other types of instruments in market. A stock market index is a measurement which indicates the nature, direction and the extent of day to day fluctuations in the stock prices. It is a simple indication of the trends in the market and investors expectations about future price movements. The stock market index is a barometer of market behaviour. It functions as an indicator of the general economic scenario of a country. If stock market indices are growing, it indicates that the overall general economy of country is stable if however the index goes down it shows some trouble in economy.

Construction of Stock Index: A stock index is created by choosing high performing stocks. Index can be calculated by two ways by considering the price of component stock alone. By considering the market value or size of the company called market capitalization method. Two main stock index of India are Sensex and Nifty.

Any of the following methods can be used for calculating index

- Weighted capitalisation method - full market capitalisation and free float market capitalisation.
- Price weighted index method
- Equal weighting method

The important indices in India:

- BSE Sensex
- S&P CNX Nifty
- S&P CNX 500
- BSE 500
- BSE 100
- BSE 200/Dollex
- BSE IT
- BSE CG
- BSE FMCG

- S&P CNX Defty

BSE SENSEX

The 'BSE Sensex' or 'Bombay Stock Exchange' is value-weighted index composed of 30 stocks and was started in January 1, 1986. The Sensex is regarded as the pulse of the domestic stock markets in India. It consists of the 30 largest and most actively traded stocks, representative of various sectors, on the Bombay Stock Exchange. These companies account for around fifty per cent of the market capitalization of the BSE

S&P CNX NIFTY

The Standard & Poor's CRISIL NSE Index 50 or S&P CNX Nifty nicknamed Nifty 50 or simply Nifty (NSE: ^NSEI), is the leading index for large companies on the National Stock Exchange of India. The Nifty is a well diversified 50 stock index accounting for 23 sectors of the economy. It is used for a variety of purposes such as benchmarking fund portfolios, index based derivatives and index funds. Nifty is owned and managed by India Index Services and Products Ltd. (IISL), which is a joint venture between NSE and CRISIL. IISL is India's first specialized company focused upon the index as a core product. IISL has a marketing and licensing agreement with Standard & Poor's.

Dematerialisation (Demat Shares)

According to SEBI guidelines, all foreign financial institutions, financial institutions' mutual funds and banks will have to compulsorily settle their trades only in dematerialised form. Dematerialisation implies conversion of a share certificate from its physical form to electronic form. It is a process by which the physical share certificates of an investor are taken back by the company and an equivalent number of securities are credited in electronic form at the request of the investor.

Dematerialisation requires an investor to open an account with a depository participant. Financial institutions, banks, stock brokers etc. can act as depository participants. A depository participant acts as custodian of the electronic accounts of the clients and takes care of trading and settlement thereof. In this system an account is opened in a computerized electronic form.

Securities are received and delivered from this account through computerized electronic form.

Advantages of Dematerialisation

Advantages to the company

(a) No need of issuing share certificates

(b) Reduces the chances of fraud

(c) Reduces the cost of handling.

(d) Provides better facilities to communicate with each and every member of the company.

Advantages to investor

(a) Provides liquidity in the matter of settlement of transactions.

(b) Eliminates bad deliveries.

(c) Reduces trading costs.

(d) Provides paperless trading.

Advantages to government

(a) Helps in quick settlement of transactions.

(b) Avoids unnecessary frauds.

Rematerialisation

Rematerialisation is the process of converting dematted shares back into physical shares. It is the process of conversion of electronic holdings of securities into physical certificate form. In short, the process of withdrawing securities from the Depository is called rematerialisation.

Depository Services

A depository is an organization which holds securities in electronic book entries at the request of the shareholder through the medium of a depository participant. A depository keeps the scrips on behalf of the investors. It undertakes the custodian role. A depository participant is an agent of the depository through which it interfaces with the investor. A depository can be compared to a bank. Investors can avail the services offered by a depository. To utilize the services offered by a depository, the investor is required to open an account called ‘demat account with the depository. The demat account is opened through a depository participant. Thus it is very similar to the opening of an account with any of the branches of a bank in order to utilize the services of that bank. The objective is to allow for the faster, convenient and easy mode of affecting the transfer of securities. Thus, financial services relating to holding, maintaining and dealing securities in electronic form by a financial intermediary known as depository are called depository services.

Constituents of Depository System

There are four players in the depository system. They are :

(1) Depository Participant,

(2) Investor (Beneficial owner),

(3) Issuer, and

(4) Depository.

Depository Participant: DP is an agent of the depository. If an investor wants to avail the services offered by the depository, the investor has to open an account with a DP. It function as a bridge between the depository and the owners. A DP may be a financial institution, bank, custodian, a clearing corporation, a stock broker or a "NBFC.

I**nvestor (Beneficial Owner)**: He is the real owner of the securities who has lodged his securities with the depository in the form of a book entry.

Issuer: This is the company which issues the security.

Depository: It is a firm which holds the securities of an investor in electronic form in the same way a bank holds money. It carries out the transaction of securities by means of book entry, without any physical movement of securities.

National Securities Depository Ltd. (NSDL)

NSDL was registered by SEBI on June 7, 1996 as India's first depository to facilitate trading and settlement of securities in the dematerialized form. It was promoted by IDBI, UTI and NSE (National Stock Exchange). The objective is to provide electronic depository facilities for securities traded in the equity and debt markets in the country. NSDL has been set up to cater to the demanding needs of the Indian capital markets.

Functions / Services of NSDL

The following are the functions or services of NSDL :

1. Maintenance of individual investors' beneficial holdings in an electronic form.

2. Trade settlement

3. Automatic delivery of securities to the clearing corporation

4. Dematerialisation and rematerialisation of securities.

5. Allotment in the electronic form in case of IPOs.

6. Distribution of dividend

7. Facility for freezing / locking of investor accounts

8. Facility for pledge and hypothecation of securities.

9. Internet based services such as SPEED-c and IDeAS

Central Depository Services (India) Ltd. (CDSL)

The CDSL is the second depository set up by the Bombay Stock Exchange and co-sponsored by the SBI, Bank of India, Union bank of India, and Centurian Bank. The CDSL commenced operations on March 22, 1996. The CDSL was set up with the objectives of providing convenient, dependable and secure depository services at affordable cost to all market participants. All leading stock exchanges such as Bombay Stock Exchange, National Stock Exchange, and Kolkata Stock Exchange etc. have established connectivity with CDSL.

Stock Holding Corporation of India Limited

Stock Holding Corporation of India Limited (SHCIL) is an Indian custodian and depository participant, based in Mumbai, Maharashtra. SHCIL was established in 1986 as a public limited company and is a subsidiary of IFCI. It is also responsible for e-stamping system around India. It is also authorised by Reserve Bank of India as Agency Bank to distribute and receive Govt. of India savings/relief bond 2003 along with nationalized banks.

The State Trading Corporation of India Limited

STC was incorporated in 1956 as CPSE. It is functioning under the administrative control of Ministry of Commerce & Industry. STC has been in international trade for over six decades. Till 1990, the basket of STC's trade predominantly comprised bulk agro products, such as, rice, wheat, castor oils, sugar, edible oils, etc. However, to meet the challenges posed by liberalisation and globalisation of trade policies, STC diversified into new areas of trade over last two decades which included bullion, hydrocarbons, metals, minerals, ores, fertilisers and petro-chemicals. Recently, STC has stopped undertaking any new business activity and is currently continuing as a non-operative company for the time being.

STCI Finance Ltd

STCI Finance Ltd (formerly Securities Trading Corporation of India Limited), is a Systemically Important Non-Deposit taking NBFC registered with Reserve Bank of India (RBI). Presently STCI Finance Ltd is classified as a loan NBFC.

In May 1994, STCI Finance Limited was promoted by RBI with the main objective of fostering an active secondary market in

Government of India Securities and Public Sector bonds. RBI owned a majority stake of 50.18% in the paid up share capital of the company. In 1996, the Company was accredited as the first Primary Dealer in the India. As one of the leading Primary Dealers in the country, the Company was a market maker in government securities, corporate bonds and money market instruments. Its other lines of activities included trading in interest rate swaps and trading in equity - cash & derivatives segment. The Company enjoyed a successful track record of achieving profits during consecutive years spanning nearly a decade. RBI divested its entire shareholding in STCI in two stages- first in 1997 to bring it down from 50.18% to 14.41% and the balance in 2002 to the existing shareholders. Bank of India became the largest shareholder in the company with 29.96% stake.

In order to diversify into new activities, the Company hived off its Primary Dealership business to its separate 100% subsidiary, STCI Primary Dealer Limited (STCI-PD) in June 2007. Since year 2007, the Company has been undertaking lending and investment activities with its main focus on lending/ financing activities. With growth in the size of the Look Book, the lending activity became the core business of the Company and STCI Finance Limited was classified as a Loan NBFC . With a view to reflecting the lending/ financing business of the Company, the name of the Company was changed from Securities Trading Corporation of India to ‘STCI Finance Limited’ with effect from October 24, 2011.

STCI Finance Limited is a diversified mid-market B2B NBFC offering its product and services across multiple locations in the areas of Capital Markets, Real Estate, Corporate Finance and Structured Finance.

Securities Exchange Board of India (SEBI)

Securities and Exchange Board of India (SEBI) is the nodal agency to regulate the capital market and other related issues in India. It was established in 1988 as an administrative body and was given statutory recognition in January 1992 under the SEBI Act 1992 which came into force on January 30, 1992. Before that, the Capital Issues (Control) Act, 1947 was repealed. SEBI has been constituted on the lines of Securities and Exchange Commission of USA.

SEBI is consisting of the Chairman and 8 Members (one member representing the Reserve Bank of India, two members from the officials of Central Government and five other public representatives to be appointed by the Central Government from different fields). Securities and Exchange Board of India has been playing an active role in the Indian Capital Market to achieve the objectives enshrined in the Securities and Exchange Board of India Act, 1992.

The major objective of the SEBI may be summarised as follows:

1. To provide a degree of protection to the investors and safeguard their rights and to ensure that there is a steady flow of funds in the market.

2. To promote fair dealings by the issuer of securities and ensure a market where they can raise funds at a relatively low cost.

3. To regulate and develop a code of conduct for the financial intermediaries and to make them competitive and professional.

4. To provide for the matters connecting with or incidental to the above.

Section 11 of the SEBI Act deals with the powers and functions of the SEBI as follows:

- It shall be the duty of Board to protect the interests of the investors in securities and to promote the development of and to regulate the securities market by measures as deemed fit.

- To achieve the above, the Board may undertake the following measures :

1. Regulating the business in stock exchanges;

2. Registering and regulating the working of stock brokers, sub-brokers, share transfer agents, bankers to an issue, merchant bankers, underwriters, portfolio managers;

3. Registering and regulating the working of the depositories, participants, credit rating agencies;

4. Registering and regulating the working of venture capital funds and collective investment schemes, including mutual funds;

5. Prohibiting fraudulent and unfair trade practices relating to securities markets;

6. Promoting investors education and training of intermediaries of securities markets;

7. Prohibiting insider trading in securities;

8. Regulating substantial acquisition of shares and take-over of companies; and

9. Calling for information from undertaking, inspection, concluding inquiries and audits of the stock exchanges, mutual funds, other persons associated with the securities market intermediaries and self-regulatory organisations in the securities market.

In order to attain these objectives, Securities and Exchange Board of India has issued Guidelines, Rules and Regulations from time to time. The most important of these is the “SEBI (Disclosure and Investor Protection) Guidelines, 2000″. The provisions of these Guidelines, 2000 are aimed to protect the interest of the investors in securities.

Role of SEBI in Primary Market

The primary market is under the control of Securities and Exchange Board of India. Securities and Exchange Board of India has an important role to keep the primary market healthy and efficient. It has been taking several measures for the development of primary market in India. In the meantime it is attempting to protect the interest of investors. It is issuing guidelines in respect of new issues of securities in the primary market. The role being played by the Securities and Exchange Board of India in the primary market can be understood from the following points:

1. The prime objective of establishing Securities and Exchange Board of India was to protect the interests of investors in securities, promoting the development of, and regulating the securities markets.

2. The Securities and Exchange Board of India Act came into force on 30th January, 1992. With its establishment, all public issues are governed by the rules and regulations issued by Securities and Exchange Board of India.

3. Securities and Exchange Board of India was formed to promote fair dealing in issue of securities and to ensure that the capital markets function efficiently, transparently and economically in the better interests of both the issuers and investors.

4. The promoters should be able to raise funds at a relatively low cost. At the same time, investors must be protected from the unethical practices. Their rights must be safeguarded so that there is a ready flow of savings into the market.

There must be proper regulation and code of conduct and fair practice by intermediaries to make them competitive and professional. These are taken care of by Securities and Exchange Board of India.

5. Since its formation, Securities and Exchange Board of India has been instrumental in bringing greater transparency in capital issues. Under the umbrella of Securities and Exchange Board of India, companies issuing shares are free to fix the premium provided that adequate disclosure is made in the offer documents. Securities and Exchange Board of India has become a vigilant watchdog with the focus towards investor protection.

6. The Securities and Exchange Board of India introduced the concept of anchor investor on June 18, 2009 to enhance issuer's ability to sell the issue, generate more confidence in the minds of retail investors and better price discovery in the issue process. Anchor investors are qualified institutional buyers that buy a large chunk of shares a day before an IPO opens. They help arriving at an appropriate benchmark price for share sales and generate confidence in retail investors. A retail investor is one who can bid in a book-built issue or applies for securities for a value of not more than Rs. 1,00,000.

Primary Market Reforms by the SEBI:

The Securities and Exchange Board of India (SEBI) has introduced various guidelines and regulatory measures for capital issues for healthy and efficient functioning of capital market in India. The issuing companies are required to make material disclosure about the risk factors, in their offer documents and also to get their debt instruments rated. Steps have been taken to ensure that continuous disclosures are made by firms so as to enable to investors to make a comparison between promises and performance. The merchant bankers now have greater degree of accountability in the offer document and the issue process. The due diligence certificate by the lead manager regarding disclosure made in the offer document, has been made a part of the offer document itself for better accountability and transparency on the part of the lead managers.

New reforms by Securities and Exchange Board of India, in the primary market, include improved disclosure standards. Introduction of prudential norms and simplifications of issue rocedures. Companies are now required to disclose all material facts and specific risk factors associated with their projects while making public issues. SEBI has also introduced a code for advertisement for public issues for ensuring fair and true picture. In order to reduce the cost of issue, the underwriting of issues has been made optional subject to the conditions that if the subscription is less than 90% f the amount offered, the entire amount collected would be refunded to the investors.

The book-building process in the primary market has been introduced with a view to further strengthen the price fixing process. Indian companies have been allowed to raise funds from abroad by issue of ADR/GDR/FCCB, etc.

Role of SEBI in Secondary Market

Since its birth, Securities and Exchange Board of India has been playing an active role to make the secondary market healthy and efficient. It will issue guidelines for the proper functioning of the secondary market. It has the power to call periodical returns from stock exchanges. It has the power to prescribe maintenance of certain documents by the stock exchanges. It may call upon the exchange or any member to furnish explanation or information relating to the affairs of the stock exchange or any members.

Recent Developments in the Secondary Market (Steps taken by SEBI and Govt to reform the Secondary Market)

In recent years several steps have been taken to reform the secondary market with a view to improve the efficiency and effectiveness of secondary market. Some of the developments in this direction are as follows:

1. Regulation of intermediaries: Strict control is being exercised on the intermediaries in the capital market with a view to improve their functioning. The intermediaries such as merchant bankers, underwriters, brokers, sub-brokers etc. must be registered with the Securities and Exchange Board of India. To improve their financial adequacy, capital adequacy norms have been fixed.

2. Insistence on quality securities: Securities and Exchange Board of India has announced recently revised norms for companies accessing the capital market so that only quality securities are listed and traded in stock exchanges. Further, participation of financial institutions in the capital is essential for entry into the capital market.

3. Prohibition of insider trading: Now Securities and Exchange Board of India (Insider Trading) Amendment Regulations, 2002

have been formed giving more powers to Securities and Exchange Board of India to curb insider trading. An insider is prevented from dealing in securities of any listed company on the basis of any unpublished price sensitive information.

4. Transparency of accounting practices: To ensure correct pricing and wider participation, greater efforts are being taken to achieve transparency in trading and accounting practices. Brokers are asked to show their prices, brokerage, service tax etc. separately in the contract notes and their accounts.

5. Strict supervision of stock market operations: The Ministry of Finance and Securities and Exchange Board of India supervise the operations in stock exchanges very strictly. The Securities and Exchange Board of India monitors the operations of stock exchanges very closely in order to ensure that the dealings are conducted in the best interest of the overall financial environment in the country in general and the investors in particular. Strict rules have been framed with regard to recognition of stock exchanges, membership, management, maintenance of accounts etc. Again, stock exchanges are inspected by the officers of the Securities and Exchange Board of India from time to time.

6. Discouragement of manipulations: The Securities and Exchange Board of India is taking all steps to prevent price manipulations in all stock exchanges. It has given instructions to all stock exchanges to keep special margins in addition to normal ones on the scrips which are subject to wide price fluctuations. The Securities and Exchange Board of India itself insists upon a special margin of 25% or more (in addition to the regular margin) on purchases of scrips which are subject to sharp rise in prices. All stock exchanges have been directed to suspend trading in scrip in case any one of the stock exchanges suspends trading in

that scrip for more than a day due to price manipulation or fluctuation.

7. Prevention of price rigging: Greater powers have been given to Securities and Exchange Board of India under Securities and Exchange Board of India (Prohibition of fraudulent and unfair trade practices relating to security markets) Regulations, 1995 to curb price rigging.

8. Protection of investors' interests: Stock exchanges are given instructions to take timely action for the redressal of grievances of investors. For this purpose, the Securities and Exchange Board of India issues "Investors Guidance Service' to guide and educate the investors about grievances and remedies available. It also gives information about various investment avenues, their merits, tax benefits available etc. Disciplinary Action Committees have been set up in each stock exchange to take up complaints against companies, brokers etc. The Securities and Exchange Board of India itself takes up complaints against companies, brokers etc. Further, each stock exchange is under a legal obligation to create an investor protection fund.

9. Free pricing of securities: Now any company is free to enter the capital market to raise the necessary capital at any price that it wants. Recently, the Securities and Exchange Board of India has permitted companies to issue shares below the face value of Rs. 10 and liberalised the norms for initial public offerings.

10. Freeing of interest rates: Interest rates on debentures and on PSU bonds were freed in August 1991 with a view to raising funds from the capital market at attractive rates depending on the credit rating.

11. Setting up of credit rating agencies: Credit rating agencies have been set up for awarding credit rating to the money market

instruments, debt instruments, deposits and equity shares also. Now all debt instruments must be compulsorily credit rated by a credit rating agency so that the investing public may not be deceived by financially unsound companies.

12. Introduction of electronic trading: The OTCEI has started its trading operations through the electronic media. Similarly, BSE switched over to electronic trading system in 1995, called BOLT. Again, NSE went over to screen based trading with a national network.

13. Establishment of OTC / OTCEI / NSE: To overcome delay, price rigging, manipulation etc., OTC/ OTCEI and NSE have been established. OTC markets are fully automated exchanges where trading would be carried out through network of telephone/ computers/ tellers spread throughout the country.

14. Introduction of depository system: To avoid bad delivery, forgery, theft, delay in settlement and to speed up the transfer of securities, the depository system has been approved by the Parliament on July 23, 1996.

15. Buy back of shares: Now companies have been permitted to buy back their own shares.

16. Disinvestment of shares of PSUs: To bring down the Govt. holding and to push up the privatisation process, the disinvestment programme has been implemented. A Disinvestment Commission has been established for this purpose.

17. Stock watch system: The Securities and Exchange Board of India introduced a new stock watch system to trace out the source of undesirable trading if any in the market. The stock watch system simply works as a mathematical model which keeps a constant watch on the market movements.

18. Trading in derivatives: L.C. Gupta Committee which had gone into the question of introduction of derivative trading, has recommended introducing trading in index futures to start with and then trading in options. Recently, future funds also have been permitted to trade in derivatives.

19. Stock lending mechanism: To make the capital market active by putting idle stocks to work, stock lending scheme has been introduced by the Securities and Exchange Board of India.

20. International listing: The big event in the history of Indian capital market is the listing company's share on an American stock exchange.

21. Rolling settlement: In July 2001, Securities and Exchange Board of India made rolling settlement on a T + 5 cycles compulsory in 414 stocks and the rest of the stocks should follow it from January 2002. But now T + 2 rolling settlement have been introduced for all securities.

22. Margin trading: Another development in the secondary market is the introduction of margin trade.

Secondary Market Reforms by the SEBI:

Since the establishment of Securities and Exchange Board of India (SEBI) in 1992, the decade's old trading system in stock exchanges has been under review. The main deficiencies of the system were found in two areas: (i) the clearing and settlement system in stock exchanges whereby physical delivery of shares by the seller and the payment by the buyer was made, and (ii) procedure for transfer of shares in the name of the purchaser by the company. The procedure was involving a lot of paper work, delays in settlement and nontransparency in costs and prices of the transactions. The prevalence of 'Badla' system had often been identified as a factor encouraging speculative activities. As a part of the process of establishing transparent rules for trading, the 'Badla' system was discontinued in December 1993. The Securities and Exchange Board of India directed the stock exchanges at Mumbai, Kolkata, Delhi and Ahmadabad to ensure that all transactions in securities are concluded by delivery and payments and not to allow any carry forward of the transactions.

The floor-based open outcry system has been replaced by on-line electronic system. The period settlement system has given way to the rolling settlement system. Physical share certificates system has been outdated by the electronic depository system. The risk management system has been made more comprehensive with different types of margins introduced. FII's have been allowed to participate in the capital market. Stringent steps have been taken to check insider trading. The interest of minority shareholders has been protected by introducing takeover code. Several types of derivative instalments have been introduced for hedging.

As a result of the reforms/initiatives taken by Government and the Regulators, the market structure has been refined and modernized. The investment choices for the investors have also broadened. The securities market moved from T+3 settlement periods to T+2 rolling settlement with effect from April 1, 2003. Further, straight through processing has been made mandatory for all institutional trades executed on the stock exchange. Real time gross settlement has also been introduced by RBI to settle inter-bank transactions online real time mode.

MODULE V

DERIVATE MARKET

Derivatives are so called because they are financial instruments whose value is derived from the value of an underlying financial instrument (a treasury bill, a bond or a note) or an individual equity or an equity index or an interest rate or a commodity (e.g.gold) or credit risk. The primitive and simplest form of derivatives is the forward contract (also known as the forefather of the derivatives). We have financial derivatives (e.g.forwards, futures, options, swaps or mix of these), equity derivatives, commodity derivatives, interest rate options and swaps, credit derivatives etc. derivatives have become very common due to the gradual liberalisation, globalisation of business and securities markets all ovr the world in recent years.

Definition of derivatives

Literal meaning of derivative is that something which is derived. Now question arises as to what is derived? From what it is derived? Simple one line answer is that value/price is derived from any underlying asset. The term ‘derivative’ indicates that it has no independent value, i.e., its value is entirely derived from the value of the underlying asset. The underlying asset can be securities, commodities, bullion, currency, livestock or anything else. The Securities Contracts (Regulation) Act 1956 defines ‘derivative’ as under:

‘Derivative’ includes–

Security derived from a debt instrument, share, loan whether secured or unsecured, risk instrument or contract for differences or any other form of security. A contract which derives its value from the prices, or index of prices of underlying securities. There are two types of derivatives. Commodity derivatives and financial derivatives. Firstly derivatives originated as a tool for managing risk in commodities markets. In commodity derivatives, the underlying asset is a commodity. It can be agricultural commodity like wheat, soybeans, rapeseed, cotton etc. or precious metals like gold, silver etc. The term financial derivative denotes a variety of financial instruments including stocks, bonds, treasury bills, interest rate, foreign currencies and other hybrid securities. Financial derivatives include futures, forwards, options, swaps, etc.

Features of Financial Derivatives

1. **It is a contract**: Derivative is defined as the future contract between two parties. It means there must be a contract-binding on the underlying parties and the same to be fulfilled in future. The future period may be short or long depending upon the nature of contract, for example, short term interest rate futures and long term interest rate futures contract.

2. **Derives value from underlying asset**: Normally, the derivative instruments have the value which is derived from the values of other underlying assets, such as agricultural commodities, metals, financial assets, intangible assets, etc. Value of derivatives depends upon the value of underlying instrument and which changes as per the changes in the underlying assets, and sometimes, it may be nil or zero. Hence, they are closely related.

3. **Specified obligation:** In general, the counter parties have specified obligation under the derivative contract. Obviously, the nature of the obligation would be different as per the type of the instrument of a derivative. For example, the obligation of the counter parties, under the different derivatives, such as forward contract, future contract, option contract and swap contract would be different.

4. **Direct or exchange traded**: The derivatives contracts can be undertaken directly between the two parties or through the particular exchange like financial futures contracts. The exchange-traded derivatives are quite liquid and have low transaction costs in comparison to tailor-made contracts. Example of exchange traded derivatives are Dow Jons, S&P 500, Nikki 225, NIFTY option, S&P Junior that are traded on New York Stock Exchange, Tokyo Stock Exchange, National Stock Exchange, Bombay Stock Exchange and so on.

5. **Related to notional amount:** In general, the financial derivatives are carried off-balance sheet. The size of the derivative contract depends upon its notional amount. The notional amount is the amount used to calculate the payoff. For instance, in the option contract, the potential loss and potential payoff, both may be different from the value of underlying shares, because the payoff of derivative products differ from the payoff that their notional amount might suggest.

6. **Delivery of underlying asset not involved:** Usually, in derivatives trading, the taking or making of delivery of underlying assets is not involved, rather underlying transactions are mostly settled by taking offsetting positions in the derivatives themselves. There is, therefore, no effective limit on the quantity of claims, which can be traded in respect of underlying assets.

7. **May be used as deferred delivery:** Derivatives are also known as deferred delivery or deferred payment instrument. It means that it is easier to take short or long position in derivatives in comparison to other assets or securities. Further, it is possible to combine them to match specific, i.e., they are more easily amenable to financial engineering.

8. **Secondary market instruments:** Derivatives are mostly secondary market instruments and have little usefulness in mobilizing fresh capital by the corporate world, however, warrants and convertibles are exception in this respect.

9. **Exposure to risk:** Although in the market, the standardized, general and exchange-traded derivatives are being increasingly evolved, however, still there are so many privately negotiated customized, over-the-counter (OTC) traded derivatives are in existence. They expose the trading parties to operational risk, counter-party risk and legal risk. Further, there may also be uncertainty about the regulatory status of such derivatives.

10. **Off balance sheet item:** Finally, the derivative instruments, sometimes, because of their off-balance sheet nature, can be used to clear up the balance sheet. For example, a fund manager who is restricted from taking particular currency can buy a structured note whose coupon is tied to the performance of a particular currency pair.

Functions of Derivatives

The primary function of the derivatives is to transfer price risks associated with fluctuation in assests values. The derivative provide three important econmic functions.

- Risk management

- Price discovery.
- Transactional efficiency.

PLAYERS IN DERIVATIVE MARKET

There are three major players in the derivatives market.

1. **Hedgers :** hedgers include,

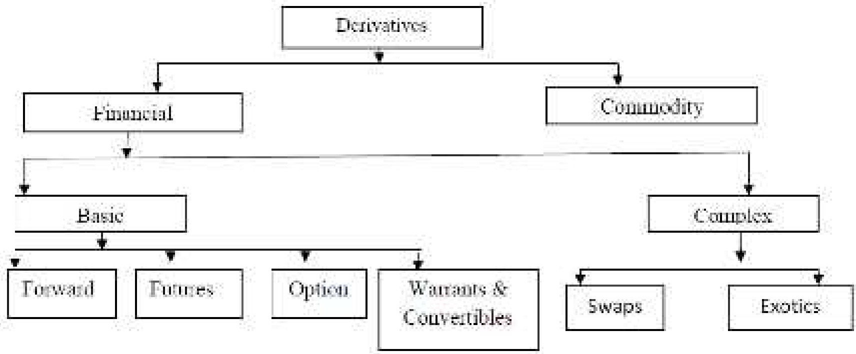
- The marginal players who take an exposure and therefore want protection.
- Traders who trade in products and are therefore exposed to risk and want protection. Hedgers seek to protect themselves against price changes in a commodity in which they have an interest.

2. **Speculators**: In any market prices move up and down depending upon the demand for and supply of the goods but in a competitive market it also moves based on the ability of the players to predict the movements and their risk apetite. These players are called speculators.speculators are prepared to assume risk in return for quick and large profits.

3. **Arbitrageurs:** The arbitrageurs look for opportunities for market money out of price mismatches in two different markets. They are specialised in making purchases and sales in different markets at the same time and profis by the difference in prices between the two centres.

Types of financial derivatives

Derivatives are of two types: financial and commodities.



One form of classification of derivative instruments is between commodity derivatives and financial derivatives. The basic difference between these is the nature of the underlying instrument or asset. In a commodity derivative, the underlying instrument is a commodity which may be wheat, cotton, pepper, sugar, jute, turmeric, corn, soyabeans, crude oil, natural gas, gold, silver, copper and so on. In a financial derivative, the underlying instrument may be treasury bills, stocks, bonds, foreign exchange, stock index, gilt-edged securities, cost of living index, etc. It is to be noted that financial derivative is fairly standard and there are no quality issues whereas in commodity derivative, the quality may be the underlying matter. However, despite the distinction between these two from structure and functioning point of view, both are almost similar in nature.

The most commonly used derivatives contracts are forwards, futures and options.

Forwards

A forward contract is a customised contract between two entities, where settlement takes place on a specific date in the future at today's pre-agreed price. For example, an Indian car manufacturer buys auto parts from a Japanese car maker with payment of one million yen due in 60 days. The importer in India is short of yen and suppose present price of yen is Rs. 68. Over the next 60 days, yen may rise to Rs. 70.

The importer can hedge this exchange risk by negotiating a 60 days forward contract with a bank at a price of Rs. 70. According to forward contract, in 60 days the bank will give the importer one million yen and importer will give the banks 70 million rupees to bank.

Futures

A futures contract is an agreement between two parties to buy or sell an asset at a certain time in the future at a certain price. Futures contracts are special types of forward contracts in the sense that the former are standardised exchange-traded contracts. A speculator expects an increase in price of gold from current future prices of Rs. 9000 per 10 gm. The market lot is 1 kg and he buys one lot of future gold (9000 × 100) Rs. 9,00,000. Assuming that there is 10% margin money requirement and 10% increase occur in price of gold. The value of transaction will also increase i.e. Rs. 9900 per 10 gm and total value will be Rs. 9,90,000. In other words, the speculator earns Rs. 90,000.

Options

Options are of two types– calls and puts. Calls give the buyer the right but not the obligation to buy a given quantity of the underlying asset, at a given price on or before a given future date. Puts give the buyer the right, but not the obligation to sell a given quantity of the underlying asset at a given price on or before a given date.

Features of options.

- Only the buyer or the owner has the right to exercise the option.
- The buyer has limited liability.
- An option is created only when two parties. i.e, a buyer and a writer/ seller, strike a deal.
- Option holders do not carry any voting right and are not entitled to receive any dividend or interest payment.
- Options have high degree of risk to the option writers/sellers.
- Options allow the buyer to earn profit from favourable market conditions.
- Options provide flexibility to the investors (buyers) who have every right to either purchase or sell before or at a certain future date.
- No certificates are issued by the company.

Styles of Options

Options are traded basically in three styles:

a) American style option: It can be exercised by the holder of the option any time between the purchase date and expiration date.

b) European style option: It can be exercised only on the expiration date by the holder of the option. The expiry and the exercise date coincides with each other.

c) Capped options: It has a predetermined cap price which is below the strike price for a put option and above the strike price for a call option.

Components of Options

There are two components of options.

1. **Call Option**: The owner/ buyer has the right to purchase and the writer/seller has the obligation to sell specified number of securities of the underlying stocks at a specified price prior to the option expiry date. A call option when it is written against the assest owned by the option writer is called a covered option, and the one written without owing the asest is called naked option.

The value of call option ar expiration= Maximum [share price-Exercise price,o]. i.e. maximum of share price – Exercise price or zero.

2. **Put Option:** The owner or buyer has the right to sell and the writer/ seller has the obligation to buy specified number of the underlying shares at a specified price prior to the expiry date of option. The profit of put option buyer is limited since the share price cannot fall below zero.

Value of put option at expiration= Maximum[Exercise price-Share price.0]

Warrants

Options generally have lives of upto one year, the majority of options traded on options exchanges having maximum maturity of nine months. Longer-dated options are called warrants and are generally traded over-the-counter.

Leaps

The acronym LEAPS means long term equity anticipation securities. These are options having a maturity of upto three years.

Baskets

Basket options are options on portfolios of underlying assets. The index options are a form of basket options.

Swaps

Swaps are private agreements between two parties to exchange cash flows in the future according to a prearranged formula. They can be regarded as portfolios of forward contracts. The two commonly used swaps are:

•**Interest rate swaps**: These entail swapping only the interest related cash flows between the parties in the same currency

•**Currency Swaps**: These entail swapping both principal and interest on different currency than those in the opposite direction.

Swaptions

Swaptions are options to buy or sell a swap that will become operative at the expiry of the options. Thus a swaptions is an option on a forward swap. Rather than have calls and puts, the swaptions market has receiver swaptions and payer swaptions. A receiver swaption is an option to receive fixed and pay floating. A payer swaption is an option to pay fixed and receive floating.

Stock index futures

Stock index futures, also referred to as equity index futures or just index futures, are futures contracts based on a stock index. Futures contracts are an agreement to buy or sell the value of the underlying asset at a specific price on a specific date. In this case, the underlying asset is tied to a stock index. Index futures, however, are not delivered at the expiration date. They are settled in cash on a daily basis, which means that investors and traders pay or collect the difference in value daily. Index futures can be used for a few reasons, often by traders speculating on how the index or market will move, or by investors looking to hedge their position against potential future losses.

Uses of Stock index futures

1. Speculation

To make money, speculators use index futures by taking long or short position. Such positions are taken on the assumption that the index would go up or down, if a person belives that the market would go up in the futures, he may buy futures.

2. Funds lending by Arbitrageur

For an arbitrageur willing to employ funds, the methodology involves first buying shares in the cash market and selling index futures. The quantity of shares to be ought is decided on the basis of their weightage in the index and the order is put through the system simultaneously using the programe trading methods. At the same time a sell position is taken in the futures market.

3. Securities lending

An arbitrageur can earn returns by lending securities in the market. The methodology involoved is first selling shares in cash market and buying index futures using the cash received in some risk free investment, and finally buying the same shares and setting the futures position at the expiration.

4. Strategic arbitrage

An arbitrageur need not hold his position till the date of maturity. The basis does not remain uniform. It keeps on changing. This is due to the volatility in the market. The arbitrageur may keep track of the basis and unwind his position as soon as appropriate opportunity is seen and take advantage of changes in the basis is short intervals.

5. Hedging

Stock index futures can be effectively used for hedging purposes. They can be used while taking a long or short position on a stock and for portfolio hedging against unfavorable price movements.

Difference between futures and options

Basis for Comparison	**Futures**	**Options**
Meaning	Futures contract is a binding agreement, for buying and selling of a financial instrument at a predetermined price	Options are the contract in which the investor gets the right to buy or sell the financial instrument at a set price, on or before a certain date,

	at a future specified date.	however the investor is not obligated to do so.
Obligation of buyer	Yes, to execute the contract.	No, there is no obligation.
Execution of contract	On the agreed date.	Anytime before the expiry of the agreed date.
Risk	High	Limited
Advance payment	No advance payment	Paid in the form of premiums.
Degree of profit/loss	Unlimited	Unlimited profit and limited loss.

Difference between Forwards and Options

Forwards	**Options**
1. Both buyer and seller have obligations 2. Customized contract 3. Not traded in stock exchange	1. Only the seller has an obligation 2. Standardized contract 3. Trade in stock exchanges 4. The buyer pays premium to the seller, while the seller deposits margin initially with

4. There is no premium and margin 5. Expiry date depends upon the transactions	subsequent deposits made depending on the market

Stock Market Derivatives in India

In India, derivatives are traded on organized exchanges as well as on OTC markets. Derivatives in financial securities were introduced in the national stock exchange (NSE) AND THE Bombay stock exchange (BSE) in 2000. Commodity derivatives were introduced in the year 2003 with the establishment of the multi commodity exchange, the national multi commodity exchange and the national commodity and derivatives exchange ltd.

Let us examine the important stock market derivatives in India.

1. Index futures:-

The first derivative product traded on the BSE and NSE was index futures. This was introduced in 2000.

a. Index futures at NSE

NSE is now one of the prominent exchanges amongst all emerging markets, in terms of equity derivatives turnover. The index futures trading at NSE commenced on 12/06/2000 on S&P CNX Nifty index.

b. Index futures at BSE

The index futures trading at BSE commenced on 09/06/2000 on BSE sense over a period of time (2000-2012) many indices have been made available for index futures trading.

2. Stock futures or Futures on individual securities

Futures on individual securities introduced in November 2001. These are cash settled. These do not involve deliver of the underlying assets. Today, the most preferred product on the exchanges in single stock futures. This accounts for 55% of total volume.

3. Index options

Index options are financial derivatives based on stock indices such as the S&P 500 or the Dow Jones Industrial Average. Index options give the investor the right to buy or sell the underlying stock index for a defined time period. Since index options are based on a large basket of stocks in the index, investors can easily diversify their portfolios by trading them. Index options are cash settled when exercised, as opposed to options on single stocks where the underlying stock is transferred when exercised.

a. Index options at NSE: The index options were allowed for trading on S&p CNX nifty index on june 4 2001. Sonce its inception, index options at NSE has been growing in overall equity derivative market.

b. Index options at BSE: BSE commenced trading in index option on Sensex on june 1 2001. BSE launched the chhota (mini) sensex on june 1 2008. With a small or mini market lot of 5, it allows, for comparatively lower capital outlay, lower trading cost, more precise hedging and flexible trading.

4. Stock options or options on individual securities.

Options on individual securities were introduced in July 2001. These are cash settled. These do not involve physical delivering of the underlying asset.

Other derivatives in India

Apart from the futures and options on stock indices and individual stocks, there are some other derivative in India. Such derivatives may be briefly discussed below.

1. Commodity derivatives

The forward contract regulation Act governs commodity derivatives in the country.

The FCRA specifically prohibits OTC commodity derivatives, therefore, at present, India trades only exchange traded commodity futures.

2. Interest rate derivatives

The NSE launched short term and long term interest rate futures in June 2003.

However, the trading activity in interest rate futures was very thin. The major reason for this low volume of trading in interest rate futures is the existence of well developed OTC market for interest rate swaps and forward rate agreements.

3. Currency derivatives

India has been trading forward contracts in currency, for the last several years. Recently, the reserve bank of India ha also allowed options in the over the counter market. The OTC currency market in the country is considerably large and well developed.

4. Credit derivatives

Since 2003, the RBI has been looking into the introduction of credit derivatives and on may 17, 2007, it allowed banks to enter into single entity credit default swaps. Credit derivatives allow lenders to buy protection against default by borrowers. It is the transfer of the credit risk from one party to another without transferring the underlying.

5. Weather derivatives

SEBI is planning to allow trading in weather derivatives. It is a financial instrument to reduce risk associated with adverse or unexpected weather conditions, eg, in agriculture sector. Weather derivative was pioneered by enron in US in 1997.

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