FINANCIAL MARKETS AND SERVICES

UNIT - I

INDIAN FINANCIAL SYSTEM

A financial system is a complex, well-integrated set of sub-systems of financial institutions, markets, instruments and services which facilitates the transfer and allocation of funds, efficiently and effectively.

Formal and Informal Financial Systems

The financial systems of most developing countries are characterized by co-existence and co-operation between the formal and informal financial sectors. This co-existence of two sectors is commonly referred to as "Financial Dualism."

The formal financial sector is characterised by the presence of an organised, institutional and regulated system which meets the needs of the modern spheres of economy.

The informal financial sector is an unorganised, non-institutional and non-regulated system dealing with the traditional and rural-spheres of the economy.

The Indian Financial System (IFS)

The IFS can be broadly classified into the formal (Organised) FS and the informal (Unorganised) FS. The formal FS comes under the purview of the Ministry of Finance (MOF), RBI and Securities Exchange Board of India (SEBI) and other regulatory bodies.

The informal FS consists of :-

i, Individual money lenders ex:- relatives, landlords, storeowners etc.

ii, Groups of persons operating as "funds" or "associations". These groups function under a system of their own rules.

iii, Partnership firms consisting of finance, investment & chit fund companies.

COMPONENTS OF THE FORMAL FINANCIAL SYSTEM

The formal FS consists of four segments or components. These are:- i, Financial Institutions, ii, Financial markets iii, Financial Instruments and iv, Financial Services.

i, Financial Institutions (FIs) :- FIs can be classified as banking and non-banking FIs. Banking institutions are creators of credit while non-banking institutions are purveyors of credit. FIs can be term-finance institutions such as IDBI, ICICI, SIDBI etc. They can be specialised finance institutions like EXIM, NABARD, NHB etc. Investment institutions in the business of mutual funds and insurance activity are also FIs.

ii, Financial Markets :- FMs are a mechanism enabling participants to deal in financial claims. The markets provide a facility to set a price for such claims. FMs are classified as money market and capital market. MM deals in short-term securities, whereas CM deals in Long-term securities. FMs are also classified as primary and secondary markets. Primary market deals in new issues and secondary market is meant for trading in existing securities.

INDIAN FINANCIAL SYSTEM

- Formal (Organised
  - Financial Institutions
    - Banking Insts.
    - Non-Banking Insts.
    - Mutual Funds
    - Insurance Companies.
  - Financial Markets
    - Capital Market
      - Equity Market
        - Primary Market
        - Secondary Market
        - Derivatives Market
      - Debt Market
    - Money Market
      - Treasury Bill
      - Call Money
      - Commercial Bills
      - Comm. Papers
      - Certificate of Deposits
  - Financial Instruments
    - Term
      - Short
      - Medium
      - Long
    - Type
      - Primary Securities
      - Secondary Securities
  - Financial Services
    - Custodial
    - Credit Rating
    - Depositories
    - Factoring
    - Forfeiting
    - Merchant Banking
    - Leasing
    - Hire Purchase
    - Portfolio Mgt.
    - Underwriting.
- Informal (Unorganised
  - Money lenders
  - Traders
  - Landlords
  - local bankers

iii. <u>Financial Instruments</u> (or Securities) :- It is a claim against a person or institution for the payment at a future date a sum of money and/or a periodic payment in the form of interest or dividend.

Financial securities may be primary or secondary securities.

Financial instruments differ in terms of marketability, liquidity, return, risk, reversibility and transaction cost. They help the Fin. markets & Fin. Intermediaries to perform the important role of transferring funds from lenders to borrowers.

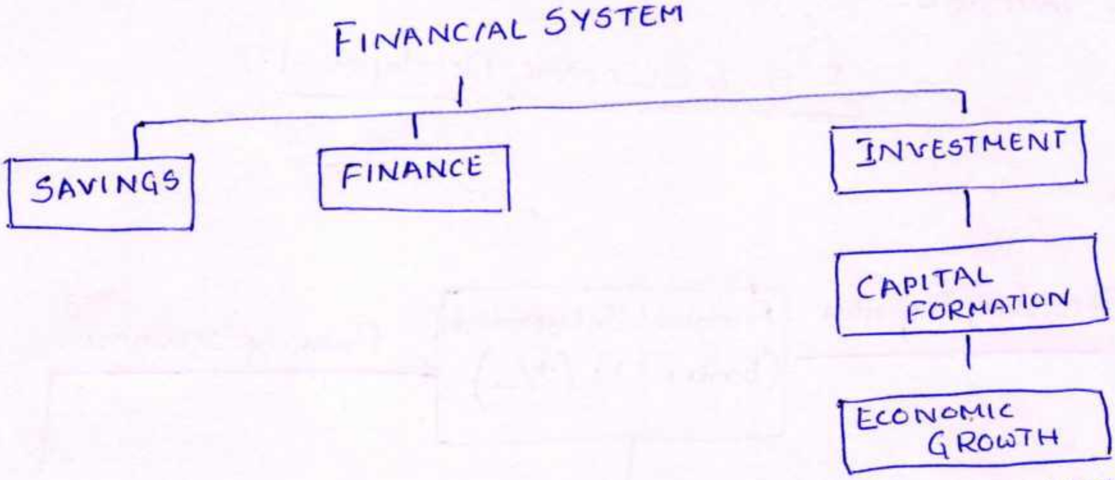
iv. <u>Financial Services</u> :- Fin. Services rendered by Fin. intermediaries bridge the gap between lack of knowledge on the part of investors and increasing sophistication of Fin. instrustments and markets. These services like merchant banking, leasing, credit rating etc. are vital for creation of firms, industrial expansion and economic growth.

These four sub-systems do not function in isolation. They are interdependent and interact continuously with each other. Their interaction leads to the development of a smoothly functioning financial system.

Fin. insts. mobilise savings by issuing different types of fin. instruments which are traded in financial markets. To facilitate the credit allocation process, they specialisation and render specialized financial services.

FINANCIAL SYSTEM & ECONOMIC DEVELOPMENT

The Indian Financial System comprises of network of banks, other financial and investment institutions offering wide range of products and services which together function in fairly developed capital and money markets. As such FS has come to occupy an important role in the process of economic development.



Capital formation is the most crucial factor in economic growth of the under developed countries. The process of capital formation involves three distinct but interdependent activities

i, Savings :- Savings are the excess of income over consumption. As the size of national income increases, the volume of savings are expected to grow. Total savings are composed of public savings and private savings.

ii, INVESTMENT :- The level of investment depends on the decision of entrepreneurs to invest. These are governed by the expectations of entrepreneurs about their future earnings and the prevailing rate of interest.

iii, <u>FINANCE</u> :- It is the link between savings and investment by proving the mechanism through which savings of large number of savers are pooled together and are put into the hands of those able and willing to invest. The mechanism includes a wide variety of institutions which cater, on the one hand, to the safety, liquidity and profitability needs of the savers and on the other hand, to the different types of requirements of working capital and fixed capital of the investors.

<u>F.S & Economic Development.</u>

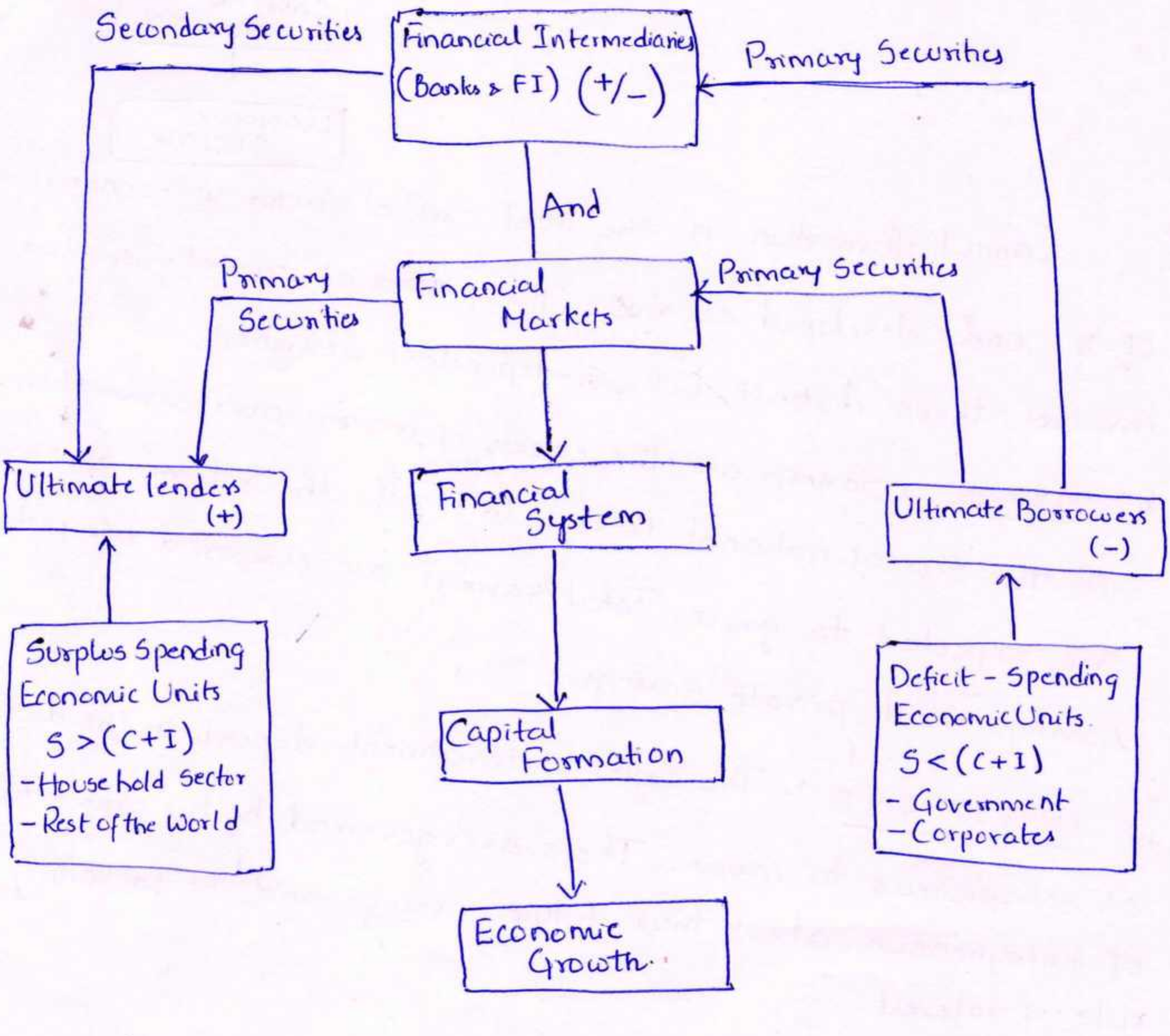


Fig. illustrates that surplus-spending economic units lend funds to financial intermediaries and financial markets - two important components of the Financial System. FIs issue secondary securities like deposits, insurance policies, Mutual Fund Units and so on to the ultimate lenders. The Ultimate borrowers may acquire funds either by issuing primary securities to FIs or by issuing primary securities in the financial markets. This transfer of funds through the Financial System leads to capital formation and economic development.

Besides linking savings and investment, FS helps in accelerating the rate of savings and investment by offering diversified financial services and instruments. This promotes larger production of goods and services in the economy, leading to Economic growth & development.

The FS plays a significant role in the process of economic development of a country in the following ways.

- Mobilising Savings
- Promoting Investments
- Encouraging Investment in Financial Assets
- Allocating Savings on the basis of National Priorities
- Creating Credit
- Providing a spectrum of financial assets
- Financing Trade, Industry & Agriculture
- Encouraging Entrepreneurial Talents
- Providing Financial Services
- Developing Backward Areas.

FINANCIAL MARKETS

There is no specific place or location to indicate a financial market. Wherever a financial transaction takes place, it is deemed to have taken place in the financial market. Ex:- issue of equity shares, granting of loan, deposit of money into a bank, purchase of debenture, sale of shares etc. Hence, financial markets are pervasive in nature.

However, financial markets can be referred to as those centers and arrangements which facilitate buying and selling of financial assets, claims and services.

Classification of Financial Markets

FINANCIAL MARKETS

- Capital Market
  - Industrial Securities Market
    - Primary Market
    - Secondary Market
  - Govt. Securities Market
  - Long-Term loan Market
    - Term loan Market
    - Market for Mortgages
    - Market for Fin. Guarantees
- Money Market
  - Call Money Market
  - Commercial Bill Market
  - Treasury Bill Market
  - Short-Term loan Market

Capital Market :- It is a market for financial assets which have a long or indefinite maturity. It deals with L.T securities which have a maturity period of above one year.

Money Market :- It is a market for dealing with financial assets and securities which have a maturity period of upto one year. It is a market for purely S.T funds.

Money Market Vs Capital Market.

Money Market	Capital Market.
i, It is a market for S.T. loanable funds for a period of not exceeding one year.	i, It is a market for L.T funds exceeding a period of one year.
ii, Supplies funds for financing current business operations, working capital requirements of industries, S.T requirements of the Govt.	ii, Supplies funds for financing the fixed-capital requirements of trade & commerce as well as L.T requirements of the Govt.
iii, Deals in instruments like treasury bills, bills of exchange, commercial papers, certificate of deposits etc	iii, Deals in instruments like shares, debentures, Govt. bonds etc.
iv, Each single M.M instrument is of large value.	iv, Each single C.M instrument is of small amount.
v, Central bank & commercial banks are the major institutions in MM	v, Development banks & Insurance Comps. play a dominant role in C.M.
vi, M.M instruments generally do not have secondary market.	vi, C.M instruments generally have secondary market.
vii, Transactions mostly take place on-line and there is no formal place.	vii, Transactions take place at a formal place viz. Stock Exchange.
viii, Transactions have to be conducted without the help of brokers.	viii Transactions have to be conducted only through authorised dealers.

MONEY MARKET

Money market is a market for short-term loans or financial assets. It is a market for the lending and borrowing of short-term funds. It is a place where S.T surplus funds at the disposal of financial institutions and individuals are borrowed by individuals, institutions and also the Government. It includes all individuals, institutions and intermediaries dealing with S.T funds.

Definitions:-

→ RBI defines the money market as "a market for S.T financial assets that are close substitutes for money, facilitates the exchange of money for new financial claims in the primary market and also for financial claims already issued, in the secondary market."

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

MONEY MARKET INSTRUMENTS

A variety of instruments are available in a developed money market.

i. Call Money or Short notice money :- Call money refers to extremely short period loans, say 1 to 14 days. These loans are repayable on demand at the option of either the lender or the borrower. These loans are given to brokers and dealers in stock exchange. Also, banks with surplus funds lend to other banks with deficit funds in the call money market. Moreover, commercial banks can quickly borrow from call market to meet their statutory liquidity requirements.

ii, Commercial Bills :- A commercial bill is one which arises out of a genuine trade transaction. i.e credit transaction. As soon as goods are sold on credit, the seller draws a bill on the buyer for the amount due. The buyer accepts it agreeing to pay the amount mentioned therein after a certain specified date. A bill of exchange is a 'self-liquidating' paper and negotiable. It is drawn always for a short period ranging between 3 months and 6 months.

Def :- "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"

iii, Treasury Bills :- TB represents S.T borrowing of the Government. They are very popular and enjoy a high degree of liquidity since they are issued by the Govt.

A TB is nothing but a promissory note issued by the Govt. under discount for a specified period stated therein. The Govt. promises to pay the specified amount to the bearer of the instrument on the due date. The period does not exceed a period of one year. It is purely a finance bill since it does not arise out of any trade transaction. TBs are issued only by the RBI on behalf of the Govt. TBs are issued for meeting temporary Govt. deficits.

On the basis of period, TB are classified into :-

- 91 days TBs
- 182 days TBs
- 364 days TBs.

In India, there are two types of TBs :-

i, Ordinary or Regular

ii, Adhocs.

iv. Commercial Papers :-(CPs) :- CP is a new instrument used for financing working capital requirements of corporate enterprises.

A CP is an unsecured promissory note issued with a fixed maturity by a company approved by RBI, negotiable by endorsement and delivery, issued in bearer form and issued at such discount on the face value as may be determined by the issuing company.

Issuers :- Pvt. sector comps, public sector units, non-banking companies etc

Investors :- Individuals, banks, corporates and also NRIs.

Features :- → CP is a S.T money market instrument with a fixed maturity
→ It is a certificate for an unsecured corporate debt of S.T maturity
→ CP is issued at a discount to face value, but it can also be issued in interest bearing form.
→ CP can be issued directly by a company to investors or through banks/Merchant bankers.

Advantages :- – Simplicity
– Flexibility
– Diversification.
– Easy to raise L.T Capital
– High returns

v. Certificate of Deposits (CDs) :- CDs are short term deposit instruments issued by banks and financial institutions to raise large sums of money.
CDs are issued in the form of Usance Promissory Notes. They are negotiable and are in marketable form bearing specific face value and maturity. The CDs are transferrable from one party to another.

Issuers :- Commercial banks, financial institutions etc.

Subscribers :- Individuals, corporations, trusts, Associations & NRIs.

Features:-

- Document of title to time deposit
- Unsecured negotiable pronotes
- Freely transferable by endorsement & delivery
- Issued at discount to face value
- Repayable on a fixed date without grace days
- Subject to stamp duty like usance promissory notes.

Advantages:-

- Convenient to depositors as CDs enable them to earn high return from S.T surpluses.
- CDs offer maximum liquidity as they can resell their certificates
- For issuing bank, it is a vehicle to raise resourses in times of need.

NEW ISSUE MARKET
(OR)
PRIMARY MARKET

The industrial securities market in India consists of Primary market (or New issue market) and Secondary market (or Stock Exchange).

<u>Primary Market</u> :- It deals with the new securities which were not previously available to the investing public i.e., the securities that are offered to the investing public for the first time. Primary market deals with raising of fresh capital by companies. ~~either for cash or for~~ ~~conside~~ The new issue market encompasses all institutions dealing in fresh claims. These claims may be in the form of equity shares, preference shares, rights issues, deposits etc. All financial institutions which contribute, underwrite and directly subscribe to the securities are part of new issue market.

<u>Secondary Market</u> :- It is a market for old securities i.e those which have been already issued and listed on a stock exchange. The securities are purchased and sold continuously among investors without the involvement of companies. Stock exchanges provides not only free transferability of shares but also makes continuous evaluation of securities traded in the market.

DISTINCTION BETWEEN NEW ISSUE MARKET AND STOCK EXCHANGE

i, <u>Functional Difference</u> :- The new issue market deals with new securities which are issued for the first time for public subscription. The Stock exchange provides a ready market for buying and selling of old securities.

ii, Organisational Difference :- The SE have physical existence and are located in particular geographical areas. The SE is a place where dealers meet regularly at appointed time announced by the market. It is a well established organisation with rules and regulations for a smooth conduct of the business.

The new issue market enjoys neither any tangible form nor any administrative organisational set up nor is subject to any centralised control for the execution of the business. It renders service to the lenders and borrowers of funds at the time of any particular operation and the services are entirely taken up by banks, brokers & underwriters.

iii, Nature of contribution to Industrial Finance :- The new issue market provides the issuing company with funds for starting a new enterprise or for either expansion or diversification of an existing one by making a direct link between companies which require funds and the investing public. So, the contribution of new issue market is direct. The role of SE in providing capital is indirect as it provides marketability to the shares.

Relationship.

→ The new issues first placed in new issue market can be disposed off subsequently in the stock exchange.

→ The companies which makes new issues apply for listing of shares on a recognised stock exchange.

→ Two markets are economically an integral part of a single market i.e industrial securities market.

Thus, the two markets are complimentary in nature.

FUNCTIONS OF PRIMARY MARKET

Primary market plays an important role of mobilising the funds from the savers and transfer them to borrowers for production purposes, an important pre requisite of economic growth. It is not only a platform for raising finance to establish new enterprises but also for expansion/ diversification/ modernisation of existing units.

Main functions are :-

i. Origination :- It refers to the work of investigation, analysis and processing of new project proposals. It starts before an issue is actually floated in the market. There are two aspects in this function

a. A study of the technical, economic and financial viability to ensure soundness of the project

b. Advisory services which improve the quality of issue and ensure its success like - Type of issue, Magnitute of issue, Timing, Pricing and Methods of issue.

The function of Origination is done by merchant bankers who may be commercial banks, FIs or private firms.

ii. Underwriting :- It is an agreement whereby the underwriter promises to subscribe to a specified number of shares or debentures or a specified amount of stock in the event of public not subscribing to the issue. If the issue is fully subscribed, then there is no liability for the underwriter. If a part of share issues remain unsold, the underwriter will buy the shares. Thus, underwriting is a guarantee for the marketability of shares.

Methods of Underwriting

→ Standing behind the issue :- Under this method, the underwriter guarantees the sale of a specified no. of shares within a specified period. Otherwise, the underwriter buys the balance in the issue.

→ Outright Purchase :- The underwriter makes outright purchase of shares and resells them to the investors

→ Consortium Method :- In case of large issues, underwriting is jointly done by a group of underwriters. They form a syndicate for this purpose.

Advantages :-

→ The issuing company is relieved from the risk of finding buyers for the issue.

→ The comp. is assured of getting minimum subscription

→ Underwriters take the burden of distribution of shares (securities)

→ They provide expert advice with regard to timing of issue, pricing of the issue, size and type of securities to be issued etc.

→ Public confidence on the issue is enhanced when underwriting is done by reputed underwriters.

Institutional Underwriters :- LIC, UTI, IDBI, ICICI, Comm. banks etc.

Non Institutional Underwriters :- Brokers.

iii, Distribution :- It is the function of sale of securities to ultimate investors. This service is performed by brokers and agents who maintain a regular and direct contact with the ultimate investors.

SECONDARY MARKET (STOCK EXCHANGES)

The market where existing securities are traded is referred to as the secondary market or stock market. In stock market, purchases and sales of securities whether of Govt. or Semi-Govt. bodies or other public bodies and also shares and debentures issued by joint stock companies are effected.

Definition:- As per the Securities Contracts Regulation Act, 1956 " a Stock exchange is an association, organisation or body of individuals whether incorporated or not, established for the purpose of assisting, regulating and controlling business in buying, selling and dealing in securities."

Functions/Services of Stock Exchange :- The SE occupies a pivotal position in the financial system. It performs several economic functions and renders invaluable services to the investors, companies and to the economy as a whole.

i, Liquidity and Marketability of Securities :- Securities can be converted into cash at any time according to the discretion of the investor by selling them at the listed price. They facilitate buying and selling of securities by providing continuous marketability. SE create a ready outlet for dealing in securities

ii, Safety of Funds :- SE have to function under strict rules and regulations and the bye-laws to ensure safety of investible funds. Over trading, illegitimate speculation are prevented through carefully designed set of rules.

iii, Supply of Long-Term Funds :- When securities are traded in SE one investor is substituted by another, but the company is assured of L.T availability of funds.

iv, Flow of Capital to Profitable Ventures :- The prices quoted in S.Es indicate the relative profitability and performance of companies. Funds tend to be attracted towards securities of profitable companies and this facilitates the flow of capital into profitable channels.

v, Motivation for improved Performance :- The performance of a comp. is reflected on the prices quoted in the stock market. These prices are more visible in the eyes of the public. This public exposure makes a company conscious of its status in the market and it acts as a motivation to improve its performance further.

vi, Promotion of Investment :- S.E mobilise the savings of the public and promote investment through capital formation.

vii, Reflection of Business Cycle :- Booms and depressions can be identified through the dealings on the SE and suitable monetary and fiscal policies can be taken by the Govt.

viii, Marketing of New Issues :- If the new issues are listed in SE, they are readily acceptable to the public. Thus, it helps in marketing of new issues als

ix Miscellaneous Services :- SE supplies securities of different kinds with different maturities and yields. It enables the investors to diversify their risks by a wider portfolio of investment. It also inculcates savings habit among the people and paves way for capital formation. It guides investors in choosing securities.

LISTING OF SECURITIES

Listing of securities means that the securities are admitted for trading on a recognised SE. Hence, listing is the very basis of SE operations. Securities become eligible for trading only through listing.

Listing is compulsory for those companies which intend to offer shares to the public for subscription by means of issuing a prospectus. SEBI insists on listing for granting permission to a new issue by a public limited company. Fin. Institutions do ~~insist~~ insist on listing for underwriting new issues. Thus listing becomes unavoidable.

Advantages :-

i. Facilitates Buying and Selling of Securities :- Constant marketing facilities are assured for listed securities

ii. Ensures liquidity :- Securities can be converted into cash readily at quoted prices and thus listing ensures liquidity.

iii. Offers wide publicity :- Names of listed companies are frequently mentioned in StockMarket reports, T.V & newspapers.

iv. Assures Finance :- Listing adds to the prestige of the company and it enables the company to raise necessary finance.

v. Enables Borrowing :- Borrowings are made easier against listed comps. securities as they are preferred as collaterals securities by Banks.

vi. Protects Investors :- Regulatory measures protect the interest of investors.

Dis Advantages :-

→ Leads to Speculation
→ Degrades Company's reputation
→ Discloses Vital Information to Competitors.

LISTING FORMALITIES

The Company concerned must apply in the prescribed form along with the following documents and details :-

i, Certified copies of Memorandum & Articles of Association, Prospectus, Underwriting Agreements, agreements with promoters etc.

ii, Specimen copies of shares & debenture certificates, letter of call, allotment etc.

iii, Copies of B/s and audited accounts for the last 5 years.

iv. Copies of offer for sale or advertisements offering any securities or sale during the last 5 years

v. Certified copies of agreements with managerial personnel.

vi, Particulars of bonus & dividends paid during last 10 years

vii, A Statement showing dividends or interest in arrears if any.

viii. A brief history of the company since its inception (incorporation).

ix Particulars regarding its capital structure

x Particulars of shares & debentures for which permission is applied for.

xi A Statement showing the distribution of shares with a list of highest 10 holders.

xii Particulars of shares forfeited

xiii Certified copies of agreements with IFC, ICICI etc if any.

xiv Listing agreement with the necessary initial and annual listing fee.

SECURITIES AND EXCHANGE BOARD OF INDIA (SEBI)

The Government felt the need for setting up an apex body to develop and regulate the stock market in India. Eventually, the SEBI was set up on April12, 1988. To start with, SEBI was set up as a non-statutory body. It took almost four years for the govt. to bring about a separate legislation called SEBI Act 1992. The Act, conferred SEBI comprehensive powers in all aspects of capital market operations.

Objectives :-

According to the preamble of the SEBI Act, the primary objective of the SEBI is to promote healthy and orderly growth of the securities market and secure investor protection. The objectives of SEBI are :-

i, To protect the interest of investors so that there is a steady flow of savings into the capital market

ii, To regulate the securities market and ensure fair practices by the issuers of securities so that they can raise resources at minimum cost.

iii, To promote efficient services by brokers, merchant bankers and other intermediaries so that they become competitive & professional.

Functions :-

I Regulatory Functions :

→ Regulation of SE and self-regulatory organisations

→ Registration and regulation of stock-brokers, sub brokers, registrar to issues, merchant bankers, underwriters, portfolio managers and others who are associated with securities market.

→ Registration and regulation of the working of collective investment schemes including mutual funds.

→ Prohibition of fradulant and unfair trade practices in securities market
→ Prohibition of insider trading in securities
→ Regulating aquisition of shares and take over of companies.

II Developmental Functions
→ Promoting investor's education
→ Training of intermediaries
→ Conducting research and publish information useful to market participants.
→ Promoting of fair practices and code of conduct for self-regulatory Orgs.

POWERS :- SEBI has been vested with the foll. powers.
→ To call periodic returns from recognised SEs.
→ To call any information from SEs or their members
→ To direct enquiries to be made in relation to affairs of SEs
→ To grant approval to bye-laws of recognised SEs.
→ To make or amend bye-laws of SEs.
→ To compel listing of securities by public companies.
→ To control and regulate SEs
→ To grant registration to market intermediaries
→ To levy fees or other charges for carrying out the purpose of regulation.
→ To grant license to dealers in securities.