11 FINANCIAL MARKET

INTRODUCTION :

In an economy individuals, corporates, Government, etc. may have excess funds and may want to invest it. They are called investors. On the other hand there may be businessmen, corporates, Governments etc. which may need funds who are called as Borrowers. The investors lend money to the Borrowers through a market called as Financial Market.

11.1 FINANCIAL MARKET - MEANING

A Financial Market is a market where Financial assets i.e. Financial instruments are exchanged or bought and sold. Financial market helps in mobilisation of savings and convert it into investments. Thus financial market acts as an intermediary between investors and borrowers.

Financial instruments are documents in the form of legal agreement between two parties having a monetary value. It represents a financial asset to one party and a financial liability to another party e.g. securities like shares, bonds, debentures, derivatives, commercial papers etc. are financial instruments.

> ***Derivatives*** *- Is a financial instrument which derives its value from an underlying asset. The underlying assets can be shares/stock, bonds, currencies, commodities etc.*

Financial Market attracts funds from investors and channelises them to corporations. The term Financial Market represents the market which raises finance for long term via the Capital Market and short term via - the Money Market.

11.2 FUNCTIONS OF FINANCIAL MARKET

1. **Transfer of Resources :** Financial Market facilitates the transfer of real economic resources from lenders to ultimate users.
2. **Productive usage :** Financial Market allows productive use of the funds. In the hands of the investors their excess funds would have remained idle. Borrowers use these Funds for productive purposes.
3. **Enhancing Income :** Financial Market allows lenders to earn interest or dividend on their surplus funds, thus leading to the enhancement of the individual and the national income.
4. **Capital Formation :** Financial Market provides a channel through which savings flow to industrial and commercial organisations in the form of capital. This leads to capital formation.
5. **Price determination :** The financial instruments traded in a financial market get their prices from the mechanism of demand and supply. The investors are the suppliers of the funds and the corporates are the users. The interaction between the two and other market factors will help to determine the prices.
6. **Sale Mechanism :** Financial Market provides a mechanism for selling of a financial asset by an investor so as to offer the benefit of marketability and liquidity of such assets.
7. **Mobilizing Funds :** Idle funds in the hands of the investors can be productively used by corporates. Investors who have savings must be linked with corporates that require investment. So financial market enables the investors to invest their saving according to their choices and risk assessment. This will utilize idle funds and the economy will boom.
8. **Liquidity :** Financial market provides a mechanism for liquidating the financial instruments. This means at any given time, the investors can sell their financial instruments and convert them into cash. This is an important factor for investors who do not want to invest for a long period.
9. **Easy access :** Both investors and industries need each other. The financial market provides a platform where both the buyers and sellers can find each other easily.
10. **Industrial development :** Financial market helps in transforming savings into capital. Corporates use the funds of investors to undertake productive or commercial activities thereby leading to economic development.

11.3 TYPES OF FINANCIAL MARKET

Financial market is mainly classified as money market and capital market.

CLASSIFICATION OF FINANCIAL MARKET

- Money Market
  1. Call Money Market
  2. Certificate of Deposit Market
  3. Treasury Bill Market
  4. Commercial Bill Market
  5. Commercial Paper Market
- Capital Market
  - Government Securities Market <u>OR</u> Gilt edged market
  - Industrial Securities Market
    - Primary Market
    - Secondary Market

11.3.1 Money Market :

- **Meaning :** Money market is a market for lending and borrowing of funds for short term. It is a market wherein lending and borrowing of funds take place for a short period of time which varies from one day to a year. Also the financial instruments traded in this market can be converted into cash easily without any loss of time and value. It is an important part of the financial system that helps in fulfilling the short term and very short term requirements of companies, banks, financial institutions, government agencies etc. It is a market for financial assets which are close substitutes for money. The instruments like commercial paper, treasury bills etc. are traded in the money market.

- **Features of Money Market :**

  1) The funds borrowed and lent in money market are for short term. The maximum period for which the funds are traded in the market is one year.
  2) It is a wholesale market for short term debt as the transaction volume is large.
  3) Trading may take place over the telephone, after which written confirmation is done by way of e-mails.
  4) Participants of money market include RBI, commercial banks, mutual funds, financial institutions, primary dealers and corporates.
  5) There is an impersonal relationship between the participants of the money market.
  6) Money market has no geographical area i.e. there is no fixed place for carrying out transactions.
  7) The instruments of money market can be converted easily into cash or have very short maturity periods. Moreover, the returns on investment is also low.
  8) Major segments of money market are :

     a) Call money market

     b) Certificate of Deposits market

     c) Treasury Bill market

     d) Commercial Bill market

     e) Commercial papers market

- **Some Important Participants in Money Market :**

  1) Reserve Bank of India : It is the most important participant in the money market. Through the money market, RBI regulates money supply and implements its monetory policy. It issues government securities on behalf of the government and also underwrites them. It acts as an intermediary and regulator of the market.

  2) Central and State Government : Central Government is a borrower in the Money Market, through the issue of Treasury Bills (T-Bills). The T-Bills are issued through the Reserve Bank of India (RBI). The T-Bills represent zero risk instruments. Due to its risk free nature banks, corporates, etc. buy the T-Bills and lend to the government as a part of its short-term borrowing programme. The state governments issue bonds called as State Development Loans.

  3) Public Sector Undertakings (PSU) : Many listed government companies can issue commercial paper in order to obtain its working capital.

4) **Scheduled Commercial Banks :** Scheduled commercial banks are very big borrowers and lenders in the money market. They borrow and lend in call money market, short notice market, Repo and Reverse Repo market.

5) **Insurance Companies :** Both the general and life insurance companies are usual lenders in the money market. They invest more in capital market instruments. Their role in the money market is limited.

6) **Mutual Funds :** Mutual Funds offer varieties of schemes for the different investment objectives of the public. Mutual funds schemes are liquid schemes. These schemes have the investment objective of investing in money market instruments.

> ***Additional Information :*** *A mutual fund is a type of financial vehicle made up of a pool of money collected from many investors to invest in a securities such as stocks, bonds, money market instruments and other assets.*

7) **Non Banking Finance Companies (NBFCs) :** NBFCs use their surplus Funds to invest in government securities, bonds etc. (Example of NBFC - Unit Trust of India)

8) **Corporates :** Corporates borrow by issuing commercial papers which are nothing but short-term promissory Notes. They are the lender to the banks when they buy the certificate of deposit issued by the banks.

9) **Primary Dealers :** Their main role is to promote transactions in government securities. They buy as well as underwrite the government securities.

- **Instruments of Money Market :** In the money market, only those financial instruments are traded which are immediate substitute for money. Some of these instruments are explained as follows :

1) **Call money and Notice money :** Call money and Notice money market is an important segment of the money market in India. Under Call money, funds are lent or borrowed for very short periods i.e. one day. Under Notice money, funds are lent or borrowed for periods between 2 days to 14 days. Funds have to be repaid within a specified time on the receipt of notice given by the lender. When one bank faces temporary shortage of cash, then another bank with surplus cash lends money to it. Hence Call/ Notice money market is also called as interbank Call money market.

2) **Treasury Bills (T-Bills) :** Treasury Bills are short term securities issued by Reserve Bank of India on behalf of the Central Government of India to meet the government's short term funds requirement. Treasury Bills have three maturity periods - 91 days, 182 days and 364 days. These bills are sold to banks and individuals, firms, institutions, etc. These bills are negotiable instruments and are freely transferable. The minimum value of T-bills is ₹ 25,000 or in multiples of ₹ 25000. These are issued at a discount and repaid at par and hence they are also called Zero Coupon Bonds.

3) **Trade Bills/ Commercial Bills :** Bill of Exchange also called as Trade bills are negotiable instruments or bills drawn by a seller on the buyer for value of goods sold under credit sales. These have short-term maturity period generally of 90 days and can be easily transferred. If the seller wants immediate cash, he can discount the trade bills with Commercial banks i.e. sell it to banks for cash. When the trade bills are accepted by Commercial banks it is known as Commercial Bills. Banks can rediscount the bills any number of times till the maturity of the bill.

4) **Commercial Papers (CPs) :** Commercial Paper is an unsecured promissory note issued by highly rated companies, All India Financial Institutions, like SIDBI, Exim Bank etc. and Primary Dealers with a fixed maturity period which varies from 7 days to maximum 1 year. The minimum value of CP is ₹ 5 lakhs or in multiples of ₹ 5 lakhs. It is issued at a discount to the face value and are highly liquid as it gives better returns than normal bank deposits. Individuals, Banks, Mutual funds, Companies, etc. invest in Commercial Papers.

5) **Certificate of Deposits (CDs) :** These are unsecured negotiable promissory notes usually issued by Commercial Banks and Financial Institutions. It is a receipt of funds deposited in a bank for a fixed period at a specified rate of interest. It can be issued for a minimum value of ₹ 1 lakh or in multiples of ₹ 1 lakh. They can be issued at a discount to the face value. They have a maturity period of minimum 7 days and maximum 1 year. (Maximum maturity may be 3 years, if the CDs are issued by Financial Institutions.) CDs can be bought by individuals, companies, etc.

6) **Government Securities :** The marketable debts issued by the government or by semi-government bodies which represent claims on the government is known as government securities. These securities are issued by agencies such as Central Government, State Government, local self-government e.g. Municipalities etc. These securities are safe investment as payment of interest and repayment of principal amount are guaranteed by the government.

7) **Repo or Repurchase Agreement :** Repo is an agreement where the seller of a security, (i.e. one who needs money) agrees to buy it back from the lender at a higher price on a future date. Usually this agreement is made between RBI and commercial banks. Repo rate is the rate at which banks borrow from RBI and Reverse repo rate is the rate at which RBI borrows from banks. RBI uses the repurchase agreement to control the money supply in the economy. These agreements are the most liquid of all money market investments having maturity ranging from 24 hours to several months.

8) **Money Market Mutual Funds (MMMFs) :** A Mutual Fund which invests in Money market instruments like Call Money, Repos, T-bills, CDs, etc. is called as MMMFs. This type of Mutual Fund invest in debt instruments which mature in less than 1 year and have low risk. Individuals and corporates are allowed to invest in MMMFs.

Activity : Collect additional information about Treasury Bills and Commercial Bills.

11.3.2 Capital Market :

- **Meaning :** It is the market for borrowing and lending long term capital required by business enterprises. The financial assets dealt with in the capital market have long or indefinite maturity period. The capital market is a core of a country's financial system as it helps in mobilisation of resources.

As per SEBI, capital market is a market for long term debt and equity shares. In this market, the capital funds comprising of both equity and debt are issued and traded. This also includes private placement of debt and equity as well as organized markets like stock exchanges.

One of the important functions of the capital market is to provide ease of transactions for both the investors and companies.

- **Features of Capital Market :**

Following are the main features of the capital market :

1) **Link between investors and borrowers :** The capital market links investors with the borrowers of funds. It routes money from savers to entrepreneurial borrowers.

2) **Deals in medium and Long-term investment :** Capital market is a market where medium and long term financial instruments are traded. Through this market, corporates, industrial organizations, financial institutions access long-term funds from both domestic and foreign markets.

3) **Presence of Intermediaries :** Capital market operates with the help of intermediaries like brokers, underwriters, merchant bankers, collection bankers etc. These intermediaries are important elements of a capital market.

4) **Promotes capital formation :** Capital market provides a platform for investors and borrowers of long term funds to trade. This leads to capital formation in an economy as it mobilizes funds.

Capital formation is the net addition to the existing stock of an economy's capital.

5) **Regulated by government rules, regulations and policies :** Capital market operates freely. However, it is regulated by government rules, regulations and policies. e.g. SEBI is the regulator of Capital markets.

6) **Deals in marketable and non-marketable securities :** Capital market trades in both marketable and non-marketable securities. Marketable securities are securities that can be transferred. e.g. Shares, Debentures etc. and non-marketable securities are those which cannot be transferred. e.g. Term Deposits, Loans and Advances.

7) **Variety of Investors :** Capital market has a wide variety of investors. It comprises both individuals like general public and institutional investors like Mutual Funds, Insurance companies, Financial Institutions, etc.

8) **Risk :** Risk is very high here as the instruments have long maturity periods. However, the return on investments is very high.

- **Instruments in capital market :**

1) Equity shares.
2) Preference shares.
3) Debentures.
4) Bonds.
5) Government securities
6) Public Deposits

- **Types of Capital Market :**

Capital market is mainly classified as –

1) **Government Securities Market or Gilt edged markets -** In this market, Government and semi-government securities are traded.

2) **Industrial Securities Market -** In this market, industrial securities, i.e. shares and debentures of new or existing corporates are traded. This market is further divided into :

A) Primary or New Issues Market- here companies sell fresh shares, debentures, etc. for the first time to the public.

B) Secondary Market - here already existing shares, debentures, etc. are traded through the Stock Exchanges.

A. Primary Market :

In Primary market, companies sell their shares, Debentures, etc. for the first time to raise fresh capital. It exclusively deals with the issue of new securities, i.e. securities that are issued to investors for the very first time. Hence this market is also known as New Issues Market.

The main function of the primary market is to facilitate capital formation. It is a place where investors can invest their surplus funds profitably and companies can raise capital easily. On the basis of type of funds raised, Primary market can be classified as Equity market and Debt market. In Equity market, securities like Equity shares, Preference Shares, Rights Issue, etc. are issued. In Debt market, debentures, bonds, fixed deposits, etc. are issued.

Methods of Raising funds in the Primary market :

1) **IPO (Initial Public Offer) :** Initial Public Offer refers to the process of offering shares of a company to the public for the first time. Investors can directly buy the securities from the issuing company.

2) **FPO (Further/follow-on public offer) :** When a company issues shares to the public after an initial public offer (IPO) it is called further/ follow-on public offer.

3) **Rights Issue :** When a company is in need of additional funds, they can first collect it from their current investors by giving them an opportunity to buy the shares of the company. Such an issue of shares is called as Rights Issue as the existing shareholders are given the "right" to buy new shares before it is offered to the public.

4) **Private placement :** Private placement means when a company offers its securities to a select group of persons identified by Board excluding qualified institutional buyers and employees (i.e. financial institutions, Banks, Insurance companies, etc.) not exceeding 200. This helps the company raise the funds efficiently, quickly and economically.

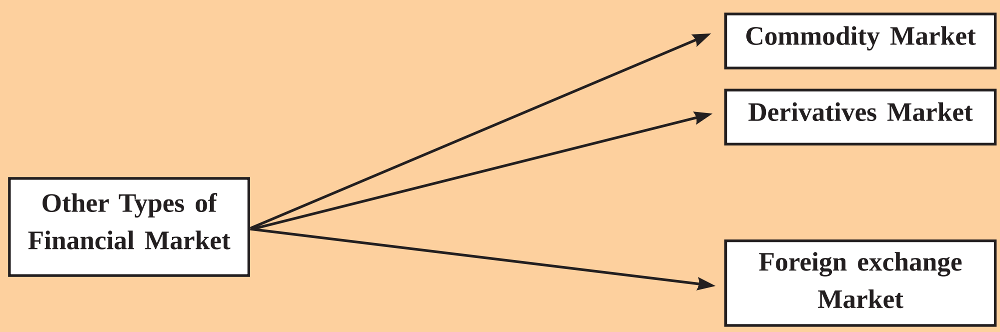
B. Secondary Market :

Secondary market is more commonly known as the stock market or the stock exchange. Here the previously issued securities are bought and sold by the investors. After IPO, when the shares are listed at the Stock Exchange, they can be traded in the secondary market. In this market the securities are traded between investors.

The main difference between the primary and the secondary market is that, in the primary market only new securities are issued, whereas in the secondary market the already existing securities are traded. There is no fresh issue in the secondary market.

Additional Information :

Other Types of Financial Market



a) **Commodity Market :** Market in which commodities are bought and sold between producers, traders, exporters and consumers.

b) **Derivatives Market :** In this market derivatives are traded. Derivatives can be classified as Future Contracts, Forward contracts, Options, Swaps, etc.

c) **Foreign exchange Market :** In this market foreign currencies are traded i.e. foreign currencies are bought with domestic currencies and foreign currencies are sold for domestic currencies.

11.4 DISTINCTION

1) Money Market and Capital Market

Points	Money Market	Capital Market
1) Meaning	It is a component of the financial market where short-term borrowing takes place.	It is a component of financial market where long-term borrowings takes place.
2) Time period	In money market, the instruments traded have maturity period of one year or less than one year.	In capital market, the instruments traded have maturity period of more than one year.
3) Instruments	Certificate of deposits, Repurchase agreements, Commercial paper, Treasury bills, etc. are the instruments traded in the money market.	Stocks, Shares, Debentures, Bonds, Securities of the government are the instrument of capital market.
4) Purpose of borrowing	Funds are borrowed to meet working capital requirements or for small investments.	Long term funds are required to establish new business, expand or diversify business or purchase of fixed assets.
5) Institutions	Participants in the market are Central banks, Commercial banks, Acceptance houses, Non-bank financial institution, Bill brokers, etc.	Stock exchanges, Commercial banks and Non-bank institutions, financial intermediaries, etc. are the participants in the market.
6) Risk	In the money market, risk factor is very less because maturity period of the instruments is less than one year.	In capital market, the risk is more as compared to in the money market. The reason behind this is the instruments have long maturity period.
7) Return on Investment	Return on investment in money market is less as they are highly liquid and safe.	Return on investment in capital market is comparatively high as they are more risky.
8) Role in Economy	This market increases liquidity of funds in the economy.	This market helps in mobilization of savings in the economy.

2) Primary Market and Secondary Market

Points	Primary Market	Secondary Market
1) Meaning	The issue of new shares by the company is done in the primary market.	The securities issued earlier are traded in the secondary market.
2) Mode of Investment	Direct investment in the securities. Securities are acquired directly from the company.	Indirect investment as the securities are acquired from other stakeholders.
3) Parties in action	The parties dealing in this market are company and investors.	The parties dealing in this market are only investors.
4) Intermediary	The underwriters are the intermediaries.	The security brokers are the intermediaries.
5) Value of security	The price of security in the primary market is fixed as it is decided by the company.	The price of security is fluctuating, depending on the demand and supply conditions in the market.

SUMMARY

- **Financial Market**

A Financial Market is a market in which people trade financial securities and derivatives at low transaction costs.

- **Functions of Financial Market**

1) Transfer of Resources
2) Productive usage
3) Enhancing Income
4) Capital Formation
5) Price determination
6) Sale Mechanism
7) Mobilizing Funds
8) Liquidity
9) Easy access
10) Industrial development

- **Money Market :**

Money market can be understood as the market for short term funds. It is a market wherein lending and borrowing of funds take place for a short term which varies from one day to a year.

- **Capital Market :**

It is the market for borrowing and lending long term capital required by business enterprises. The financial assets dealt with in the capital market have long or indefinite maturity period.

- **Primary Market :**

The most important type of capital market is the primary market. It is also known as new issue market.

- **Secondary Market :**

Secondary market is more commonly known as the stock market or the stock exchange. Here the previously issued securities are bought and sold by the investors.

EXERCISE

Q.1 A) Select the correct answer from the options given below and rewrite the statements.

1. A financial market is a market in which people trade .... and derivatives at low transaction costs.

   a) Gold b) Financial securities c) Commodities

2. When the trade bills are accepted by commercial banks it is known as ....

   a) Treasury bills b) Commercial bills c) Commercial papers

3. Money market is a market for lending and borrowing of funds for .... term.

   a) short b) medium c) long

4. Central Government is a borrower in the money market through the issue of ....

   a) Commercial Papers b) Trade Bills c) Treasury Bills

5. .... is the market for borrowing and lending long term capital required by business enterprises.

   a) Money Market b) Capital Market c) Gold Market

B) Match the pairs.

Group 'A'		Group 'B'	
a)	Financial market	1)	Long term fund
b)	Money market	2)	New issue market
c)	Primary market	3)	Trading of commodities
d)	Commercial paper	4)	Short term fund
		5)	Trading of financial securities
		6)	Share market
		7)	Unsecured promissory note
		8)	Secured promissory note

C) Write a word or a term or a phrase which can substitute each of the following statements.

1. A market where people trade financial securities and derivatives at low transaction cost.
2. A market which provides long term funds.
3. A market which provides short term funds.
4. A money market instrument used by bank when one bank faces temporary shortage of cash.
5. A bill which is issued by Reserve Bank of India on behalf of the Government of India.
6. A market which exclusively deals with the new issue of securities.

D) State whether the following statements are true or false.

1. A Financial Market is a market in which people trade financial securities and derivatives at high transaction costs.
2. Money market is the market for the long term funds.

3. Capital market is the market for the long term funds.
4. Primary market is also known as new issue market.
5. Secondary market is commonly known as stock market.
6. Commercial paper is a secured promissory note.
7. Treasury bills are issued by commercial banks.

E) Find the odd one.

1. Treasury Bills, Shares, Certificate of Deposit.
2. FPO, Private Placement, Commercial paper.
3. New Issues Market, Call Money Market, Secondary Market.

F) Complete the sentences.

1. Funds borrowed and lent in money market are for ___________ term.
2. When trade bills are accepted by commercial banks, it is known as _________
3. Unsecured negotiable promissory notes issued by a commercial bank is called as _______
4. New shares, debentures, etc. are traded in ____________ market.
5. In capital market the instruments traded have maturity period of more than ______ year.

G) Select the correct option from the bracket.

Group 'A'		Group 'B'	
a)	Money market	1)	____________________
b)	Zero risk instrument	2)	____________________
c)	_______________	3)	Capital market
d)	_______________	4)	Secondary market

(Buying and selling of existing securities, Treasury Bills, Funds for long term, Fund for short term)

H) Answer in one sentence.

1. What is financial market ?
2. What is call money market ?
3. What is Certificate of Deposits ?
4. What is Trade Bill ?
5. What is new issue market ?

I) Correct the underlined word/s and rewrite the following sentences.

1. In <u>Primary</u> market, already existing securities are traded.
2. Companies sell fresh shares for the first time to the public in <u>secondary market</u>.
3. In <u>Money</u> market, the instruments traded have maturity period of more than one year.
4. Financial market can be classified as capital market and <u>call money</u> market.

Q.2 Explain the following terms/concepts.

1. Financial market
2. Capital market
3. Money market
4. Call money market

5. Treasury bills
6. Commercial bills
7. Repurchase agreement
8. Primary market
9. Secondary market

Q.3 Study the following case / situation and express your opinion.

(1) Joy ltd. Company is a newly incorporated company. It wants to raise capital for the first time by issuing equity shares.

a. Should it go to primary market or secondary market to issue its shares ?

b. Should it offer its shares through public offer or rights issue ?

c. What will be the issue of Equity shares by Joy Ltd.Co. called as, IPO or FPO ?

(2) Mr. X is the CFO (Chief Financial Officer) of PQR Co. Ltd. which is a reputed company in the field of construction business. Often Mr. X has to decide on investing surplus funds of the company for short durations. And at times, he also has to decide the sources from where he can raise funds for short durations.

a. Assume on behalf of the company Mr. X has Rs. 5 lakhs and wants to invest for a short period. Should he buy Equity shares or Certificate of Deposit ?

b. The company has surplus funds and wants to invest it. However, he needs the money back in 4 months, so should he invest in Treasury Bills or Government Securities ?

c. Can the company issue Certificate of Deposit ?

Q.4 Distinguish between the following.

1. Primary market and Secondary market.
2. Money market and Capital market.

Q.5 Answer in brief.

1. State any four functions of financial market.
2. State any four features of money market.
3. State any four features of capital market.
4. Explain any 4 types of money market instruments.

Q.6 Justify the following statements.

1. Financial markets acts as link between investor and borrower.
2. Money market makes available short term finance through different instruments.
3. Capital market is useful for corporate sector.
4. There are many participants in money market.

Q.7 Answer the following questions.

1. Explain the functions of financial market.
2. State the instruments in money market.
3. State the features of capital market.

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