**LESSON: 4**

# FINANCIAL MARKETS IN INDIA

**4.0 Objective :**

The main objective of this lesson are to explain the:

* concept of financial market and importance
* role of financial markets in the economic developments of the country
* different types of financial markets
* features and instruments of money and capital markets

**STRUCTURE:**



## 4.1 Introduction

The usage and mobility of assets determine the economic development of any economy. The assets are broadly divided into physical and financial based on their distinct features. Physical assets are used to generate activity and result in positive or negative contribution to the society, whereas, financial assets help the physical assets to generate activity and smoothen the trade and transactions of an economy. The financial assets have specific properties that distinguish them from physical and intangible assets, which led to the emergence of financial markets.

A financial market is a place, where financial instruments are exchanged, which enhance the unique characteristics of the financial instruments. Financial markets provide the basic function of mobilizing the investments needed by corporate bodies. The financial instruments, which are traded in the financial markets, are categorized into claim instruments and currency instruments. The claim instruments are further divided into fixed and residual. The duration of the fixed claim instruments is very short, that is, less than a year, which is traded in the money market; while the fixed claims that have a maturity period of more than a year traded in the capital markets. The trading of different countries' currencies is conducted through the foreign exchange market.

Mutual fund is another investment alternate, which is of recent origin in India. Within a short span of time several financial institutions and banks have floated varieties of mutual fund schemes. The investors with limited funds can invest in the these mutual funds and can have the benefits of the stock market and money market investments as specified by the particular fund.

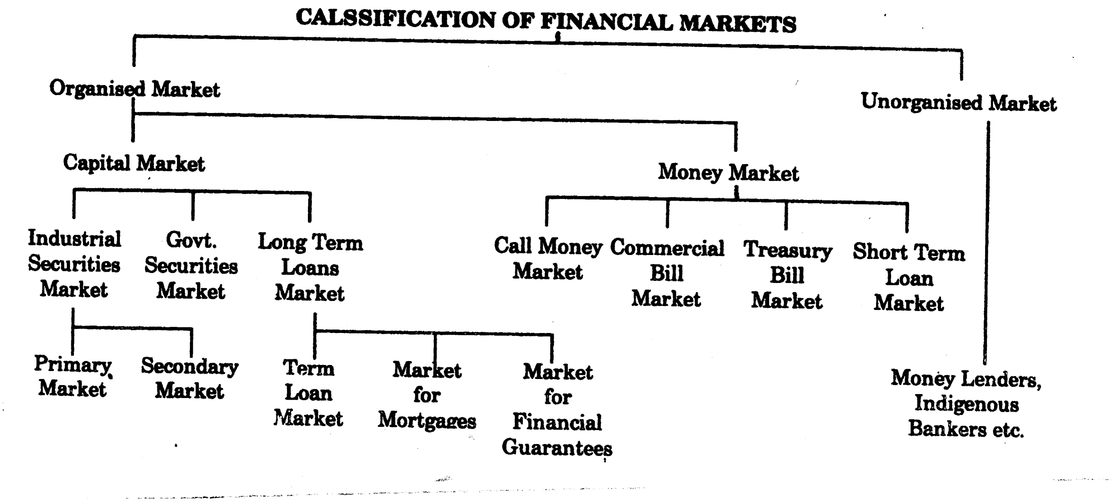
**4.2 Financial Markets:**

The growth and development of financial markets in India can be studied in three phases since Independence. The first two decades of the planning era constitute *a phase of transition.* Since, the nationalization of commercial banks and up to the liberalization of the economy, it is the *period of expansion and diversification.* The subsequent period after 1990s has been marked as period of *consolidation, innovation, and liberalization.* The first of these three phases witnessed strengthening of the banking system by a process of amalgamation of weak, small banks as also through development of major term lending institutions, with active intervention by the Reserve Bank of India. Special efforts were also made during this period to strengthen the cooperative financial structure. With the nationalization of banks during the year 1969 and the introduction of the Lead Bank scheme, it was witnesses an unprecedented geographical expansion and functional diversification of the commercial banking system. During the post liberalized period, which started from 1991, the stress on efficiency and competitiveness has been conducive to relaxations in the control mechanism and allowing for innovation, diversification, and healthy competition among banks and other financial institutions.

The Government of India implemented the economic reforms, with the object of improving efficiency and effectiveness of the financial system. With this the last two decades have seen a phenomenal expansion in the geographical coverage and financial spread of our financial system. The development of the financial sector is a major achievement and has contributed significantly to the increase in our savings rate, especially of the household sector. A vibrant, efficient, and innovative financial system is the key to the rapid and sustained growth of the economy.

### 4.3 Classification of Financial Markets:

The classification of financial markets in India is shown in Chart I




### 4.3.1 Unorganized Markets:

In the unorganized markets there are a number of moneylenders, indigenous bankers, traders, etc., whose activities are not controlled by the RBI. The regulations concerning their financial dealings inadequate and their financial instruments have not been standardized.

### 4.3.2 Organized Markets:

In case of organized markets, there are standardized rules and regulations governing their financial dealings by the Central Bank. These markets are subject to strict supervision and control by the RBI or other regulatory bodies. There is also a high degree of institutionalization and instrumentalization. These markets are classified into:

(i) Capital markets

(ii) Money markets

### 4.4 Capital Markets:

Capital markets are those markets, where productive capital is raised and made available for industrial purposes. It provides an avenue for investors and household sector to invest in financial assets, which are more productive than physical assets. A developed capital market can solve the problem of paucity of funds. It facilitates increase in production and productivity in the economy and hence enhances the economic welfare of the society. Indian capital market acts as an intermediary to mobilize savings and to channelize the same for productive use consistent with national priorities. This market supplies funds for financing the fixed capital requirement of trade and commerce as well as the long-term requirements of the Government. Capital markets are markets where productive capital is raised and made available for industrial purposes. It provides an avenue for investors and household sector to invest in financial assets, which are more productive than physical assets. A developed capital market can solve the problem of paucity of funds. It facilitates increase in production and productivity in the economy and hence enhances the economic welfare of the society. Indian capital market acts as an intermediary to mobilize savings and to channelize the same for productive use consistent with national priorities.

Capital market is divided into three kinds: They are:

(i) Industrial securities market,

(ii) Government Securities market, and

(iii) Long term loans market.

### 4.4.1 Industrial securities market:

It is the market where capital is arranged through the issue of equity, preference shares and debentures. These securities are issued through the primary market, which are traded in the secondary market. An efficient primary market prepares a base for effective and cost efficient mobilization of resources by bringing together the users and investors of funds. Thus, both the primary and secondary markets help each other and make the capital market efficient. The number of stock exchanges record a steep rise followed by sharp increase in the number of listed companies and the investors.

The Industrial Securities Market is classified into two categories:

(a) Primary market

(b) Secondary market

As a rule, only when a country's primary market is alone, it is possible to ensure a good degree of activity in the secondary market because it is the primary market, which ensures a continuous flow of securities to the secondary market. On the contrary, if secondary market is only active but not transparent and disciplined, it becomes difficult to develop and sustain the cult of equity and related investment in the primary market. This is because the liquidity, which the secondary market imparts to such investments in the hands of the investors, is adversely affected.

(a) *Primary Market:*

Primary market is a market for new issues or new financial claims. Hence, it is also called New Issue market. The primary market deals with those securities, which are issued to the public for the first time. In the primary market, borrowers exchange new financial securities for long-term funds. Thus, primary market facilitates capital formation. There are three ways by which a company may raise capital in a primary market. They are: Public issue, Rights issue and Private placement

The most common method of raising capital by new companies is through sale of securities to the public. It is called public issue. When an existing company wants to raise additional capital, securities are first offered to the existing shareholders on a pre-emptive basis. It is called rights issue. Private placement is a way of selling securities privately to a small group of investors.

*(b) Secondary Market*

Secondary market is a market for secondary sale of securities, which have already passed through the new issue market, are traded in this market. Generally, such securities are quoted in the Stock Exchange and it provides a continuous and regular market for buying and selling of securities. The stock exchanges in India are regulated under the Securities Contracts (Regulation) Act, 1956

### 4.4.2 Government Securities Market

It is otherwise called Gilt-Edged securities market. It is a market where Government securities are traded. In India there are many kinds of Government Securities — short-term and long-term. Long-term securities are traded in this market while short-term securities are traded in the money market. Securities issued by the Central Government, State Governments, Semi-Government authorities like City Corporations, Port Trusts etc. Improvement Trusts, State Electricity Boards, All India and State level financial institutions and public sector enterprises are dealt in this market.

The Government securities are in many forms. These are generally (i) Stock certificates or inscribed stock (ii) Promissory Notes (iii) Bearer Bonds that can be discounted. Government securities are sold through the Public Debt Office of the RBI while Treasury Bills (short term securities) are sold through auctions. Government securities offer a good source of raising inexpensive finance for the Government exchequer and the interest on these securities influences the prices and yields in this market. Hence this market also plays a vital role in monetary management.

### 4.4.3 Long-Term Loans Market:

Development banks and commercial banks play an important role in this market by supplying long-term loans to corporate customers. Long-term loans market may further be classified into:

(a) Term loans market

(b) Mortgages market

(c) Financial Guarantees market.

**(a) *Term Loans Market***

In India, many industrial financing institutions have been created by the Government both at the national and regional levels to supply long-term and medium term loans to corporate customers. These development banks dominate the industrial finance in India, which meet the growing, and varied long-term financial requirements of industries. They also help in identifying investment opportunities encourage new entrepreneurs and support modernization efforts.

***(b) Mortgages Market***

The mortgages market refers to those centers, which supply mortgage loan mainly to individual customers. A mortgage loan is a loan against the security of immovable property like real estate. The transfer of interest in a specific immovable property to secure a loan is called mortgage.

**(c) Financial Guarantees market**

It is the center where funds are provided against the guarantee of a reputed person in the finical circle. In case the borrower fails to repay the loan amount the liability falls on the shoulders of the guarantor. Mainly the commercial banks, development banks, governments and specilaised guarantee institutions like ECGC and DICGC provide these guarantees.

The growth in the Indian capital market is presented in the Table 1.1. The number of stock exchanges increased from 9 in 1980 to 23 today. All the exchanges are fully computerized and offer 100% online trading. Some 9,413 companies were available for trading on stock exchanges at the end of March 2003. The market capitalization grew ten fold between 1990-91 and 1999-2000. All India market capitalization is estimated at Rs. 6,31,921 crores at the end of March 2003. The trading volumes on exchanges have been

**Table 4.1 shows the upsurge of market capitalization, trading volume, and number of listed companies for the years 1990-2003.**

(Rs. in crores)

| At the End of Financial | No. of stock exchange | No.of brokers | No. of listed companies | Market capitalization | Turnover | SGL turnover | Derivatives turnoeve |
|---|---|---|---|---|---|---|---|
| 1990-91 | 20 | — | 6229 | 1,10,279 | — | — | — |
| 1991-92 | 20 | — | 6480 | 3,54,106 | — | — | — |
| 1992-93 | 22 | — | 6925 | 2,28,780 | — | — | — |
| 1993-94 | 23 | — | 7811 | 4,00,077 | 2,03,703 | — | — |
| 1994-95 | 23 | 6711 | 9077 | 4,73,349 | 1,62,905 | 50,569 | — |
| 1995-96 | 23 | 8476 | 9100 | 5,72,257 | 2,27,368 | 1,27,179 | — |
| 1996-97 | 23 | 8867 | 9890 | 4,88,332 | 6,46,116 | 1,22,941 | — |
| 1997-98 | 23 | 9005 | 9833 | 5,89,816 | 9,08,681 | 1,85,708 | — |
| 1998-99 | 23 | 9069 | 9877 | 5,74,064 | 10,23,382 | 2,27,228 | — |
| 1999-00 | 23 | 9192 | 9871 | 11,92,630 | 20,67,031 | 5,39,232 | — |
| 2000-01 | 23 | 9782 | 9954 | 7,68,863 | 28,80,990 | 6,98,121 | 4038 |
| 2001-02 | 23 | 9687 | 9644 | 7,49,248 | 8,95,817 | 15,55,653 | 1,03,847 |
| 2002-03 | 23 | 9519 | 9413 | 6,31,921 | 9,86,908 | 19,55,731 | 4,42,343 |

***Source:*** **Chartered Secretary, April 2004**

**4.5 Money Market:**

A money market is a mechanism in which short-term funds are lent and borrowed, and through which a large part of the financial transactions of a particular country or of the world are cleared. It has two components—call money market and bill market. *Call money market* is that part of national money market where day-to-day surplus fund, mostly of banks, is traded in. It is a centre where the borrower and lender of money, and near money assets are brought together. *RBI introduced Bill market* in 1952. Under this, RBI made advances to schedule commercial banks in the form of demand loans against their promissory notes. The main objective of the bill market is to reduce the reliance on cash credit arrangement. Therefore, bill market scheme promotes an active market so that other banks could share the lending activities of the bank.

A free money market is a sensitive barometer of current situation in the financial markets. A liberal attitude has been carried out to develop the money market since 1990s. The money market can be classified as *organized money market* and *unorganized money market.* The organized money market comprises of commercial banks and financial institutions, which are under the control of the Reserve Bank of India and the unorganized money market comprises of indigenous bankers. The most important money market instruments are government securities, treasury bills, commercial paper, and certificate deposits. Government securities are usually known as "gilt-edged" securities as the repayments are fully secured. These instruments encompass all bonds and treasury bills issued by the government for the purpose of raising public loans.

### *4.5.1 Characteristics of money market:*

The following are the characteristics of money market:

(i) It is a market for short-term funds for not exceeding a period of one year.

(ii)It deals with those assets, which can be converted into cash immediately.

(iii)There is no formal place for money market and transactions generally take place over telephone or fax messages.

(iv) Transactions are made without the help of brokers.

(v) The commercial bank plays generally a dominant role in this market.

(vi) It establishes the link between the RBI and banks.

(vii) The inter-bank markets match the deficits and surplus of banks.

### 4.5.2 Money Market Instruments:

The money market instruments are subdivided into four. They are:

(i) Call money market
(i) Commercial bills market
(ii) Treasury bills market

(iii) Short-term loan market.
(iv) Inter Bank Call Money
(vi) Commercial Papers
(vii) Certificate of Deposits
(viii) Repurchase Option**:**
(ix) Money market mutual funds**:**

*(i) Call Money Market*

The call money market is a market for extremely short period loans say one day to fourteen days. The loans are repayable on demand at the option of either the lender or the borrower. In India, call money markets are associated with the presence of stock exchanges and hence, they are located in major industrial towns. The special feature of this market is that the interest rate varies from day-to-day and even from hour-to-hour and centre-to-centre. It is very sensitive to changes in demand and supply of call loans.

*(ii) Commercial Bills Market*

It is a market for Bills of Exchange arising out of genuine trade transactions. In the case of credit sale, the seller may draw a bill of exchange on the buyer. The buyer accepts such a bill promising to pay at a later date the amount specified in the bill. The seller need not wait until the due date of the bill. Instead, he can get immediate payment by discounting the bill.

In India the bill market is under-developed. The RBI has taken many steps to develop a sound bill market. The RBI has enlarged the list of participants in the bill market. The Discount and Finance House of India was set up in 1988 to promote secondary market in bills. In spite of all these, the growth of the bill market is slow in India. There are no specialized agencies for discounting bills.

*(iii) Treasury Bills Market*

It is a market for treasury bills, which have 'short-term' maturity. A treasury bill is a promissory note or a finance bill issued by the Government. It is highly liquid because the Government guarantees its repayment. Treasury bills are short-term borrowings of the government.

These Treasury bills are classified into four categories:

*(a) 14-day Treasury bills:* These were introduced in the year 1997 to cater the needs of investing the surplus funds of state government, foreign central bank, etc. The amount outstanding was more than Rs. 3 thousands at the end of March 2006, of which the share of state government was more than 90 percent.

*(b) 91-day treasury bills:* There are two types of 91-day treasury bills, which are ordinary treasury bills and ad hoc treasury bills. The ordinary bills are issued to the public and other financial institutions for meeting the short-term financial requirements of the central government. These bills are freely marketable; can be bought and sold at any time; and have a secondary market, whereas, the 'Ad hoc' Treasury bills are issued in favor of the RBI. The holder of these bills can always sell them back to the RBI.

(c) 182-*day treasury bills:* The RBI also introduces these bills, which are initially on monthly basis. The RBI does not purchase these bills before the maturity period but the investors in the secondary market through the Discount and Finance House of India (DFHI) can sell them.

*(d) 364-day treasury bills:* These were introduced in April 1992, which are sold through auction, once in a fortnight. The 364-day treasury bills have become popular due to their higher yield with liquidity and safety. These bills are not rediscount able with the Reserve Bank of India.

*(iv) Short-Term Loan Market*

It is a market where short-term loans are given to corporate customers for meeting their working capital requirements. Commercial banks play a significant role in this market. Commercial banks provide short-term loans in the form of cash credit and overdraft. Overdraft facility is mainly given to business people whereas cash credit is given to industrialists. Overdraft is purely a temporary accommodation and it is given in the current account itself. But cash credit is for a period of one year and it is sanctioned in a separate account.

(v) Inter Bank Call Money**:**

The inter bank call money market is the core of the formal money market. Banks borrow from the call money market in order to meet sudden demand for funds for payments and to obtain funds to meet any likely shortfalls in their cash reserves to meet the Cash Reserve Ratio (CRR) stipulation. In India, inter bank call money market is the single most important source for banks for getting overnight and short-term funds.

(vi) Commercial Paper:

Commercial paper is an unsecured promissory note issued with a fixed maturity by a company approved by the Reserve Bank of India. The maturity period ranges from 15 days to less than a year. Since it is a short-term debt, the issuing company is required to meet dealers' fees, rating agency fees and any other relevant charges. Commercial Paper (CP) has gained popularity all over the world because it provides funds at a relatively cheaper cost. Another important feature of CP is that through this instrument the firm may raise large amount of funds, which is not possible through a single bank.

*Eligibility for issue of commercial paper:* In India, the emergence of CP has added a new dimension to the money market. The RBI has relaxed the initial guidelines, which were laid down for the issue of CPs. The following are the guidelines governing the issue of commercial paper:

(i) The CP has to be issued at a discount in the form of promissory note,
(ii) The interest on CP is always front-ended and the maturity value is always equal to face value.
(iii) The issuing firm must have a net worth of at least Rs. 4 crores and the company should have fund based working capital limit of Rs. 4 crores.
(iv) The company maintains a current ratio of 1.33:1 and debt-equity ratio not more than 1.5:1.
(v) It must have a credit rating of P2/A2 or higher from the CRISIL/ICRA of not less than two months old.

(vi) The company must be listed in stock exchanges but the Government companies are exempted from this stipulation.

(vii) The issue of a CP also bears the expenses of stamp duty and requires obtaining the approval of the Reserve Bank for each issue of the commercial paper.

(viii) Now the RBI has abolished the facility of stand by arrangement as a result, it is no longer mandatory for banks to automatically restore the cash credit limits of corporate bodies.

(ix) CP can be issued to any person or corporate body registered or incorporated in India

(x) The issuing company is required to appoint a bank to verify the signature of the issuing company who has signed on the CP.

(xi) CP is generally issued at a discount and is freely transferable by endorsement

(xiii) The face value of a single commercial paper should not be less than Rs. 25 lakh and in multiples of Rs. 5 lakh thereafter.

(xv) The minimum size of an issue is Rs. 1 crore and the minimum unit of subscription is Rs. 25 lakh.

*Advantages of Commercial Papers:*

The advantages of the CPs lies in the simplicity they offer and the flexibility to the company to raise funds in the money market wherever it is favourable. One can raise funds from the inter-corporate market, which is not under the control of any monetary authority. Also the CPs provides cheaper finance to the borrowers and at the same time offer good rate of return to the investors.

(vii) Certificate of Deposits (CDs):

This is a bearer certificate and is negotiated in the market, which can be issued by the commercial banks at a discount. The CDs were introduced in June 1989 and the RBI is no longer a control on maturity period and interest rate and thus the instrument has now become a market-determined one. The RBI guidelines for the issue of CDs are listed below:

*Reserve Bank of India guidelines on CDs:*

(i) The denomination of the CDs should be in multiples of Rs. 5 lakh subject to the condition that the minimum size of an issue to a single investor is Rs. 25 lakh.

(ii) CDs can be issued to individuals, corporations, trusts, associations, etc. and the non-resident Indians can also subscribe the CDs but only on non-repatriation basis.

(iii) The maturity period of CDs should not be less than 3 months and not more than a year. The minimum lock-in-period is 15 days for CDs.

(iv) Banks have to maintain CRR and SLR on the price of issue of CDs

(v) The CDs are issued in the form of usual promissory notes payable on fixed date without any grace period and they are freely transferable by endorsement and delivery.

(vii) Banks cannot grant loans against the CDs and neither can they buy their own CDs before maturity.

(viii) Repurchase Option:

The major development in the government security market is the introduction of a repurchase facility. It includes the acquisition of funds through the sale of agreed securities and is simultaneously committed to repurchase it at a predetermined price, generally within a period of 14'days to year. Thus, it is a collateral borrowing and represents a liability to the seller at the purchase price, and reflects the conceptual obligations to transfer funds to the banks on the date of maturity of agreement.

(ix) Money market mutual funds:

In order to create an additional short-term avenue for investment and to bring money market instrument within the reach of individuals and smaller bodies, the Reserve Bank of India set up money market mutual funds (MMMFs) in April 1991. The MMMFs invariably and excessively invest their investing resources in very high quality money market instruments. Recently, some liquid schemes of private sector mutual funds have started offering 'cheque writing' facility. Such facility provides more liquidity to unit holders and hence has been advocated in the interest of the savers investors.

**4.6 Financial Derivatives Market**:

With the economic liberalization, the economy opened for multinationals and private encouragement, which is driven more towards the free market economy. This complex nature of structure in the economy exposes the clients to various risks. Therefore, there is an imperative need for the corporate clients to protect their operating profits. In this context, derivatives occupy an important place as a risk reducing market. Financial derivatives derive their value from underlying securities. They are financial contracts. In India stock exchanges have introduced index-based derivatives to facilitate hedging of risk exposures and speculations with high leverage. Derivatives are short term in nature with less than a year to expiration issued by investors. Companies in the process of financing their activities issue long-term derivatives. Options and futures are the examples for short-term derivatives. Warrants and convertibles are the examples for long-term derivatives.

**4.7.Foreign Exchange Market:**

Foreign exchange is the process of converting home currencies into foreign currencies and vice versa. The market where foreign exchange transactions take place is called a foreign exchange market. In fact, it consists of a number of dealers, banks and brokers engaged in the business of buying and selling foreign exchange. It also includes the central bank of each country and the treasury authorities that enter into this market as controlling authorities. The Foreign Exchange Maintenance Act controls those engaged in the foreign exchange business. (FEMA)

### 4.7.1 Functions of Foreign Exchange Market

The following are most important functions of the foreign exchange market:

(i) To make necessary arrangements to transfer purchasing power from one country to another.

(ii) To provide adequate credit facilities for the promotion of foreign trade.

(iii) To cover foreign exchange risks by providing hedging facilities.

In India, the foreign exchange business has a three-tiered structure consisting of:

(i) Trading between banks and their commercial customers.

(ii) Trading between banks through authorized brokers.

(iii) Trading with banks abroad.

In India the Brokers play a significant role in the foreign exchange market. Apart from the authorized dealers, the RBI has permitted licensed hotels and individuals, known as authorized moneychangers to deal in foreign exchange business. The FEMA helps to smoothen the flow of foreign currency and to prevent any misuse of foreign exchange, which is a scarce commodity.

### 4.8 Summary

A financial market is a system where the exchange of financial instruments takes place. Financial system consisting of financial instruments, financial intermediaries, and financial markets provide the mechanism for channeling funds to the industry. It is a set of complex, closely connected institutions, agents, practices, markets, transactions, claims and liabilities in the economy Financial markets are broadly divided into money market and capital, derivatives market and foreign exchange market The recent economic reforms encompassed a series of measures to promote investors protection and encourage the growth of financial markets. The financial institutions and markets compete for a limited pool of savings by offering different instruments. The money and capital markets increase competition between suppliers.The capital market enables contractual savings and collective investment institutions to play a more active role in the financial system. .

### 4.9 Keywords:

Financial Assets: these are shares, debentures, lease obligations, borrowings from banks, financial institutions, etc.

Financial derivatives: where buyers take delivery on payment of cash is called financial derivatives.

### 4.10. Self Assessment Questions

1. What do you mean by Financial Markets? Discuss the importance of financial markets.
2. Distinguish between Money Market and Capital Market.

3. Bring out the features of Money Market.
4. Explain the various instruments of Money Market.
5. Describe the structure of Indian Money Market and point out its deficiencies.
6. What is Capital Market? Explain the characteristics of Indian Capital Market.
7. State the functions of Foreign Exchange Market.

## 4.11. Further Readings


1. Brigham, E.F. Fundamentals of Financial Management, Dryden Press, Chicago.
2. James C. Van Horne, Financial Management and Policy, Prentice Hall of India, New Delhi.
3. Pandey, I.M., Financial Management, Vikas publishing Home, New Delhi
4. Prasanna Chandra, Financial Management: Theory and Practice, Tata Mc Graw Hill, New Delhi.
5. Gordon E , and Natarajan K Financial Markets and Services, Himalaya Publishing House, Mumbai.
6. Kulkarni P V and Satyaprasad B G., Financial Management, Himalaya Publishing House, Mumbai.


**KSNR**