FINANCIAL MARKET

MEANING OF FINANCIAL MARKETS

Financial markets refer to the institutional arrangements for dealing in financial assets and credit instruments of different types such as currency, cheques, bank deposits, bills, bonds, etc.

Financial markets, may be broadly classified as negotiated loan markets and open markets. The negotiated loan market is a market in which the lender and the borrower personally negotiate the terms of the loan agreement, e.g. a businessman borrowing from a bank or from a small loan company. On the other hand, the open market is an impersonal market in which standardized securities are treated in large volumes. The stock market is an example of an open market.

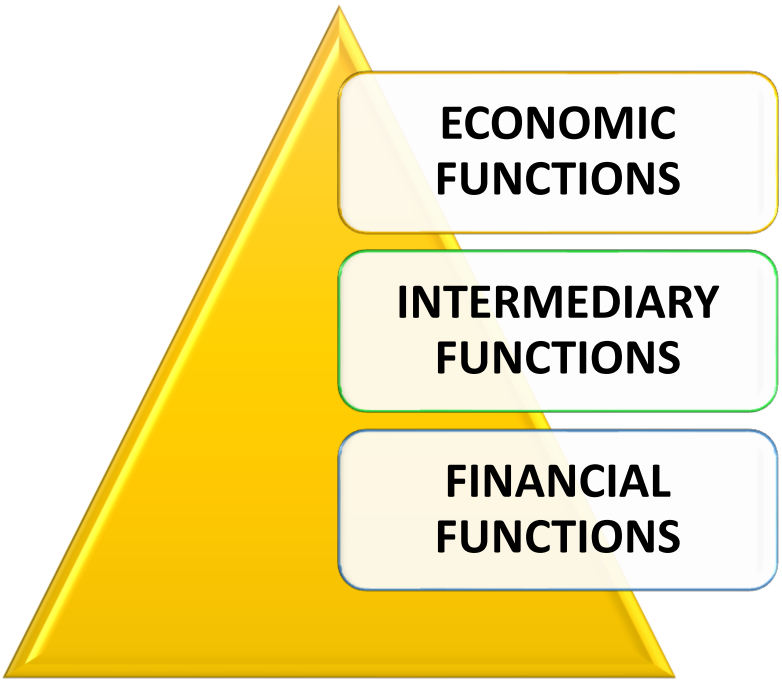
The financial markets in a nutshell, could mean:

1. Organization that facilitate the trade in financial products i.e. stock exchanges facilitate the trade in stocks, bonds and warrants.

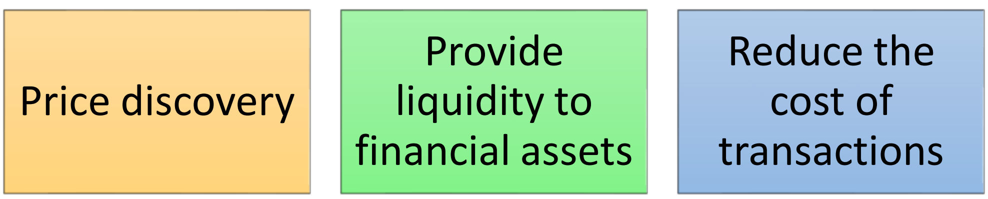
2. The coming together of buyers and sellers to trade financial products i.e. stocks and shares are traded between buyers and sellers in a number of ways.

3. The participants of these markets are financial institutions, agents, brokers, dealers, borrowers, lenders, savers and other who are inter linked by the laws, contracts and communication networks.

FUNCTIONS OF FINANCIAL MARKETS



1. **ECONOMIC FUNCTIONS:**
   Financial markets provide the following three major economic functions:



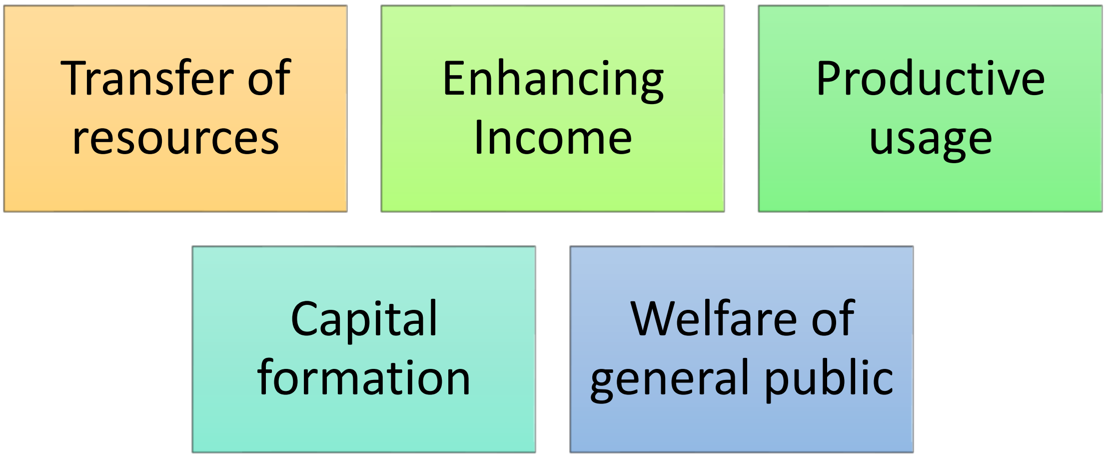
(a) Price discovery: The forces of demand and supply help to establish a price for a commodity or service in the market. In financial markets, interaction between buyers and sellers of financial instruments determine the price of a traded product. At the same time the required return from the investment of funds is determined by the participants in a financial market. The inducement for firms to acquire funds depends on the required rate of return that investors demand. It is these functions of financial markets that signal how the funds available from those who want to lend or invest funds will be allocated among those needing funds and raise those funds by issuing financial instruments. This is called price discovered process.

(b) Provide liquidity to financial assets: An attractive feature where circumstances either force or motivate an investor to sell is that financial markets provide a mechanism for an investor to sell a financial asset. In doing so, they provide liquidity to financial asset. Without liquidity, the owner will be forced to hold a debt instrument till it matures and an equity instrument till the company is either voluntarily or otherwise liquidated. While all financial markets provide some form of liquidity, the degree of liquidity is one of the factors that characterise different financial markets.

(c) Reduce the cost of transactions: One of the other important functions of financial market is that it reduces the search and information costs of transacting by providing valuable information about securities to the investors being traded in the market. It helps to save time, effort and money that both buyers and sellers of a financial asset would have to otherwise spend to try and find out each other. The presence of organised and efficient market reflect the aggregate information collected by all market participants.

2. INTERMEDIARY FUNCTIONS:

The intermediary functions of a financial markets include the following:



(a) Transfer of Resources: Financial markets facilitate the transfer of real economic resources from lenders to ultimate borrowers. It give lenders the choice of different investments and thus helps to channelise surplus funds into the most productive use.

(b) Enhancing Income: Financial markets allow lenders to earn interest or dividend on their surplus invisible funds, thereby, increasing their incomes and as a result, enhancing national income finally.

(c) Productive Usage: Financial markets allow the productive use of the funds borrowed. Borrowers will have to use borrowed funds productively, if invested in new assets, and hence increasing their income and gross national product finally.

(d) Capital Formation: Financial markets provide a channel through which new saurings flow into capital formation of a country. In other words, different components of financial markets help an accelerated growth of industrial and economic development of a country, thus contributing to raising the standard of living of the well being.

(e) Welfare of general public: Financial markets by facilitating transfer of real resources, it serves the economy and thus, assist in achieving the desired national objectives.

3. FINANCIAL FUNCTIONS:

These functions are listed below:

(a) To provide the borrowers with funds which they need to carry out their various investment plans.

(b) To provide the lender with earning assets so as to enable them to earn wealth by deploying their funds in productive form.

(c) To provide liquidity in the market through which the claims against money can be resold at any time, and thus, reconverting them into current funds.

TYPES OF FINANCIAL MARKETS

The financial market is a structure that allows buyers and sellers to exchange their financial transactions. Financial markets can be found in nearly every nation in the world. The financial market comprises all banking and non-banking financial institutions, procedure and practices followed in these markets and financial instruments for facilitating the flow of funds.

- **Based on Market Levels**
  - Primary market
  - Secondary market
- **Based on security**
  - Capital market
  - Money market
  - Commodity Market
  - Derivatives market
  - Insurance market
  - Foreign exchange market
  - Market for financial guarantees
  - Government securities market

BASED ON MARKET LEVELS

(a) PRIMARY MARKET:

Primary market also known as new issue market deals with new issue of securities. In primary market, the government or corporate sector issues securities that change hands from the issuer to owner. The essential function of a primary market is to facilitate the transfer of investible funds from savers to entrepreneurs seeking to establish new enterprises or to expand existing ones through the issue of securities for the first time. The securities issued in primary market include all long-term financial instruments such as equity shares, debentures, bonds, preference shares etc. The investors in this market are banks, financial institutions, insurance companies, mutual funds and individuals. As the new issue market directs the flow of savings into long term investments, it is of paramount importance for the economic growth and industrial development of a country. The availability of financial resources for corporate enterprises, to a great extent, depends upon the status of the new issue market of the country. The securities may be issued in any of the following methods:

- Offer through prospectus
- Offer for sale
- Private placement
- Right Issue
- Preferential Issue
- e-IPOS

(i) Offer through prospectus: It involves inviting subscription by making a direct appeal to investors through an advertisement in newspapers and magazines.

(ii) Offer for sales: It involves issuing of securities to investors through intermediaries like issuing houses or stock brokers.

(iii) Private placement: It involves allotment of securities by a company to institutional investors and some selected individuals.

(iv) Right issue: It refers to offer of new shares by a company to the existing shareholders.

(v) Preferential issue: It refers to preferential allotment of securities to promoters etc. at a price unrelated to prevailing market price.

(vi) e-IPOS: It involves issue of capital to the public through on-line system of the stock exchanges.

(b) SECONDARY MARKET:

Secondary market is the market for existing claims or financial assets. In other words, secondary market is the market for the sale and purchase of previously issued or second hand securities. This market imparts liquidity to investments and enhances the marketability of securities. But it does not directly contribute to capital formation. In this market, securities are sold by existing investors to other investors through intermediary called broker, and within the regulatory framework prescribed by SEBI. Thus, liquidity offered by secondary market encourages even those investors to invest in securities who want to invest for small period of time as there is option of selling securities at their convenience. Secondary market is also known as the stock market or stock exchange.

Stock exchange or secondary market performs the following important functions.

1. It provides a place where shares and stock are converted into cash.

2. It provides a ready market for trading in securities.

3. The investors can evaluate the worth of their holdings from the prices quoted at different exchanges for those securities.

4. Stock exchanges play an important role in mobilising surplus funds of investors.

5. Stock exchanges ensure safety in dealings which brings confidence in the minds of all concerned parties and helps in increasing various dealings.

6. Duly listed securities can be purchased at stock exchanges.

7. Stock exchanges provide a platform for raising public debts. The stock exchanges are also organised markets of government securities.

BASED ON SECURITY:

(1) Capital Market:

The term 'capital market' refers to the institutional arrangements for facilitating the borrowing and lending of long term funds i.e. both debt and equity. In a widest sense, it is the mechanism which makes the long term finance available for industrial and commercial enterprises and public authorities. It is concerned with those private savings of individuals as well as corporate, that are turned into investments through new capital issues and also new public loans leading to growth and development of the economy. The capital market consists of development banks, commercial banks and stock exchanges.

According to V.K. Bhalla, "Capital market can be defined as the mechanism which channelises saving into investment or productive use. Capital market allocates the capital resources amongst alternative uses. It intermediates flow of savings of those who save a part of their income from those who want to invest it in productive assets.

An ideal capital market is one where finance is available at reasonable cost. The development of capital market in a country dependent of capital market in a country dependent upon the availability of savings, proper organisation of its constituent units and entrepreneurship qualities of its people. It is essential that financial institutions are sufficiently developed and that market operations are free, fair, competitive and transparent. Capital market should work as per government rules and policies and must facilitate the movement of capital to the point of highest yield. It should also be efficient in respect of the information that it delivers, minimise transaction costs and allocate capital most productively. Capital market is further categorised into two parts:

(a) Stock/Equity Market: Stock market allow investors to buy and sell shares in publicly traded companies. They are one of the most vital area of market economy which provide financing through the issuance of shares or common stock and enable the subsequent trading thereof. This market can be split into two main sub markets:

(i) Primary market where new issue are first offered.

(ii) Secondary market where subsequent trading is done. An example of a secondary equity market for shares is the Bombay stock exchange.

(b) Bond/Debt Market: The market where funds are borrowed and lent is known as debt market. Arrangements are made in such a way that the borrowers agree to pay the lender the original amount of the loan plus some specified amount of interest. Bonds are used by companies to finance a variety of projects and activities.

(2) **Money Market:**

The money market is the place or mechanism where short term instruments that matures in a year are traded. Generally, money market is the source of finance for working capital. It enables the raising of short term funds for meeting the temporary shortages of cash and obligations and the temporary deployment of excess funds for earning returns. Thus, the money market brings together the lenders who have short term investible funds and the borrowers who are in need of short term funds.

According to the McGeraw Hill Directory of Modern Economics, "Money market is the term designed to include the financial institutions which handle the purchase, sale and transfer of short term credit instruments. The money market includes the entire machinery for the channelizing of short term funds. Concerned primarily with small business needs for working capital, individual's borrowings and government short-term obligations, it differs from the long term or capital market which devotes its attention to dealings in bonds, corporate stocks and mortgage credit."

Thus, money market is a market where low risk, unsecured and short term debt instruments that are highly liquid are issued and actively traded everyday. It has no physical location. Negotiation between the parties may be carried through telephone, telegraph or mail. The major participants in the money market are Reserve Bank of India (RBI), Commercial Banks, Non-Banking finance companies, State Governments, Large corporate houses, mutual funds etc.

In nutshell, money market is simply an arrangement that brings about a direct or indirect contact between the lender and the borrower and ensures that the money market instruments can be conveniently converted into money without incurring much losses.

(3) Commodity Market:

Commodity market are markets where raw or primary products are exchanged. The raw commodities are traded on regulated commodities exchanges in which they are bought and sold in standardized contracts. This market serves the purpose of allowing two individuals to exchange the rights to goods without visual inspection. Thus, commodity market are institutions where investors trade, sell and buy shares of raw materials that are used in the manufacture of other goods.

Commodities are typically sold as future contracts, meaning the investor is buying commodities that have yet to be produced. These are agreement to buy or sell at an agreed price on a specific date. Commodities market are commonly used by the investors as a hedge against inflation. But commodity market has disadvantages also:

(i) Commodities can lose value when inflation is low or negative, because inflation is a measure of prices.

(ii) Commodity market has historically been as volatile as the equity market and entails risk for the investor.

(iii) During economic downturns, consumer spending can reduce demand for all goods, including those made from commodities.

In nutshell, open and organized market place where ownership titles to standardized quantities or volumes of certain commodities at a specified price and to be delivered on a specified date are trade by its members.

(4) **Derivative Market:**

Derivative markets is market where exchange of derivative take place. Derivative markets are based upon another market which is known as underlying market, including individual stock markets (eg. stock of Co-XYZ), stock indices (eg. NASDAQ 100 stock index) and currency markets (i.e. the FOREX market). Derivative market can take many different forms, some of which are traded in the usual manners, but some of which are traded quite differently (i.e. not the same as their underlying market). The following are the most often traded types of derivative market:

-Future Market

-Options Market

-Warrants Market

-Contract for difference (CFD) Market

-Spread betting

Different derivative markets for a single underlying market usually have different sizes, values and margin requirements. Various derivatives instruments are traded in these markets as speculative instruments or to reduce the risk of one's other positions.

(5) Insurance Market:

Insurance market also specializes in the re-distribution of various risks. According to Financial Times Lexicon, the Insurance market is simply the "buying and selling of insurance." Consumers or various groups buy insurance for risk management from insurers offerings. Coverage for specific risks. To cater to the varying needs of the insured, a variety of policies are offered by the insurance organisations prevailing in insurance market.

(6) Foreign Exchange Market:

A market in which participants are able to buy, sell, exchange and speculate on currencies. Foreign exchange market are made up of Banks, commercial companies, central banks, investment management firms, hedge funds and retail forex brokers and investors. The Forex market is considered to be the largest financial market in the world in which every day on average, one and one half trillion dollars' worth of currencies are bought and sold. Foreign exchange market is not a single exchange, but is constructed of a global network of computers that connects participants from all parts of the world. Foreign exchange markets against international trade and investment by enabling currency conversion.

According to Encyclopedia Britannica, "Foreign exchange in the system by which commercial nations discharge their debts to each other."

According to Hartly Wethers, "Foreign exchange is the art and science of international monetary exchange."

Foreign exchange market is unique because of following characteristics:

1. Its huge trading volume representing the largest asset class in the world leading to high liquidity.

2. It has large geographical dispersion.

3. Variety of market factors affect exchange rates.

4. Low margins of relative profit compared with other markets of fixed income.

5. The use of leverage to enhance profit and loss margins and with respect to account size.

The nutshell, foreign exchange means the value of one country's currency against another and that is the primary way that currencies are traded in pairs in foreign exchange market. The major currencies are considered to be U.S. dollar, the Euro, the Japanese Yen, the British Pound, the Swiss France and Australian, Canadian and New Zealand dollars.

(7) Market For Financial Guarantees

Creditors or Suppliers of funds are always at risk of non-payment of loans by the debtors. In order to minimise the risk, they always insist on some guarantee by the third person so that in case, the principal debtors make a default in the repayment of loans, the guarantor becomes the debtor i.e. the guarantor becomes liable for repayment of loan capital. Debtors, in some cases raise loans against the security of tangible assets from the creditors. But still creditors demand additional security in the form of a guarantee because full amount due in respect of a loan may not be recovered from the security. The guarantor can be renowned person or special state guarantee organisation. Guarantee can be oral or written but mostly creditors insist on written guarantee.

Types Of Guarantees

Various types of guarantees that exist in financial markets are explained below:

(i) **Secured guarantees:** Such type of guarantees are backed by tangible assets from the guarantor. When both the principal debtor as well as the guarantor fail to repay the loan amount the creditors will have right to charge such security.

(ii) **Specific guarantees:** It refers to the guarantee given for a particular single loan transaction.

(iii) **Continuing guarantees:** When the guarantee is given for a number of transactions in a particular period.

(iv) **Explicit guarantee:** The agreement clearly states the liability of the guarantor fin case of non-payment of amount due by the principal debtor.

(v) **Implicit guarantee:** Where the liability of the guarantor to pay is implied in case of default by the principal debtor. For example. A person endorsing the bill or a promissory note is liable as a guarantor to pay to the holders in respect of the debt represented by the instrument.

(8) Government Securities Market

Government securities are the instruments issued by central government, state governments, semi-government bodies, public sector corporations and financial institutions such as IDBI, IFCI, State Financial Corporations (SFCs) etc. in the form of marketable debt. Government securities form an important part of the stock market in India. Today, funds mobilised through the issue of government securities account for more than 80% of the total amount of funds mobilised on the stock exchanges of India through the issue of all securities (including government and corporate). Funds mobilised are used to meet the short-term and long-term needs of the government. Central government securities are considered to be the safest amongst all type of securities as regard to the payment of interest and repayment of principal amount. They are also called gilt-edged securities. They are free of default-risk or credit risk. They are considered to be more liquid assets and ensure certainty of capital value not only at maturity but also before maturity. Since the date of maturity is mentioned in the securities, these are also known as dated government securities

Features of Government Securities Market

The main features of the government securities market in India are as follows:

(1) The government securities are the marketable debt instruments issued by central and state governments.

(2) Government securities occupy an important place in the financial market. Reserve Bank of India purchases and sells these securities in the open market in order to exercise monetary control in the country.

(3) Government securities carry a fixed rate of interest which is payable half-yearly. The rate of interest on government securities is generally lower as compared to the other securities.

(4) The face value of these securities is either 100 or 1000.

(5) Government securities are safest as regards the payment of interest and the repayment of principal amount.

(6) Interest on government securities is exempted from income-tax subject to the provisions of section 80-L of the Income-Tax Act, 1961. However, interest on securities of local authorities is not exempted from tax.

(7) Government-securities can be issued either in the form of stock certificate (SC), promissory note (PN) or hearer bond. But, out of these, promissory note is most common.

(8) Government securities are issued through Public Debt Office (PDO) of the RBL There are no listing requirements for them for listing on stock exchange. There is no need to issue prospectus. However, 'no objection' certificate is to be obtained from SEBI for primary issues which is generally granted in routine.

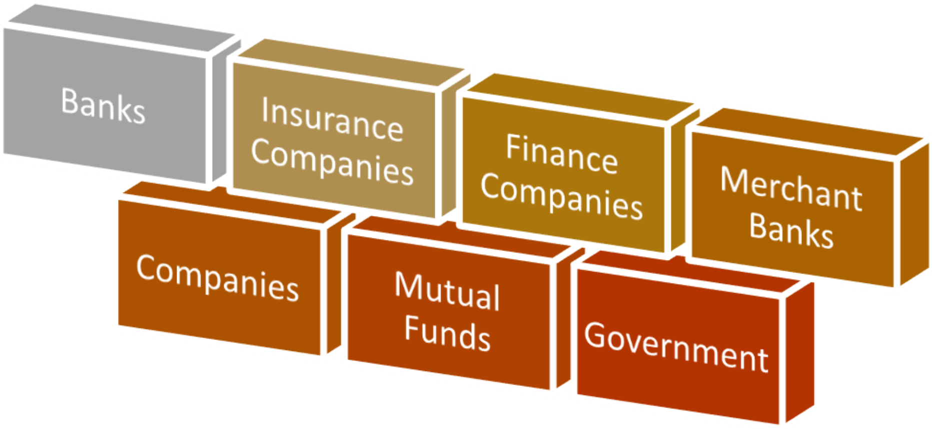
(9) The government securities market is an over-the counter market where there is one- to-one correspondence between the buyer and the seller without using the services of brokers.

(10) Institutional investors are the main participants in the government securities market. But since December, 2001, the RBI allowed individuals also to buy government securities in a non-competitive environment. The minimum amount for bidding has been fixed at 10,000, and in multiples of 10,000.

(11) Brokers and dealers play very limited role in marketing of government securities because banks can approach RBI directly for these securities.

MAJOR PLAYERS IN FINANCIAL MARKET

The major players or main participants in the financial market are as follows:



1. Banks: Banks play a major role in the capital market and money market. They are the largest provider of funds to business houses and corporates through accepting deposites from public.

2. Insurance Companies: These companies issue contracts to individuals or firms with a promise to refund them in future in case of any event. In return, insurance companies receive money from individuals or firms in the form of premiums. The funds so collected are further reinvested in financial markets in the form of debt, equities, properties etc.

3. Finance Companies: Various finance companies engage in short to medium term financing for business by collecting funds by issuing debentures and borrowings from general public.

4. Merchant Banks: These banks funded by short term borrowings, lend mainly to corporations for foreign currency and commercial bills financing.

5. Companies: The surplus funds generated from business operations are invested in money market instruments, commercial bills and stock of other companies. Whenever, they need funds, companies reconvert these securities into cash by trading in stock exchanges.

6. Mutual Funds: Mutual funds acquire funds mainly from general public and invest them in money market securities, commercial bills and shares on behalf of the investors.

7. Government: Government plays an important role in the financial markets. Their authorized dealers basically look after the demand supply operations in financial market and works to fill in the gap between the demand and supply of funds.