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Education for All

Dr. Babasaheb Ambedkar Open University

(Established by Government of Gujarat)

NAAC ACCREDITED A++ GRADE 3.55/4

BBA
SEMESTER - 5
BBAMJR/F/503
FINANCIAL MARKET & INSTRUMENTS

Message for the Students

Dr. Babasaheb Ambedkar Open (University is the only state Open University, established by the Government of Gujarat by the Act No. 14 of 1994 passed by the Gujarat State Legislature; in the memory of the creator of Indian Constitution and Bharat Ratna Dr. Babasaheb Ambedkar. We Stand at the seventh position in terms of establishment of the Open Universities in the country. The University provides as many as 54 courses including various Certificate, Diploma, UG, PG as well as Doctoral to strengthen Higher Education across the state.

On the occasion of the birth anniversary of Babasaheb Ambedkar, the Gujarat government secured a quiet place with the latest convenience for University, and created a building with all the modern amenities named 'Jyotirmay' Parisar. The Board of Management of the University has greatly contributed to the making of the University and will continue to this by all the means.

Education is the perceived capital investment. Education can contribute more to improving the quality of the people. Here I remember the educational philosophy laid down by Shri Swami Vivekananda:

> ***"We want the education by which the character is formed, strength of mind is Increased, the intellect is expand and by which one can stand on one's own feet".***

In order to provide students with qualitative, skill and life oriented education at their threshold. Dr. Babaasaheb Ambedkar Open University is dedicated to this very manifestation of education. The university is incessantly working to provide higher education to the wider mass across the state of Gujarat and prepare them to face day to day challenges and lead their lives with all the capacity for the upliftment of the society in general and the nation in particular.

The university following the core motto 'स्वाध्यायः परमं तपः does believe in offering enriched curriculum to the student. The university has come up with lucid material for the better understanding of the students in their concerned subject. With this, the university has widened scope for those students who are not able to continue with their education in regular/conventional mode. In every subject a dedicated term for Self Learning Material comprising of Programme advisory committee members, content writers and content and language reviewers has been formed to cater the needs of the students.

Matching with the pace of the digital world, the university has its own digital platform Omkar-e to provide education through ICT. Very soon, the University going to offer new online Certificate and Diploma programme on various subjects like Yoga, Naturopathy, and Indian Classical Dance etc. would be available as elective also.

With all these efforts, Dr. Babasaheb Ambedkar Open University is in the process of being core centre of Knowledge and Education and we invite you to join hands to this pious *Yajna* and bring the dreams of Dr. Babasaheb Ambedkar of Harmonious Society come true.

Prof. Ami Upadhyay
Vice Chancellor,
Dr. Babasaheb Ambedkar Open University,
Ahmedabad.

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BBA

SEMESTER - 5

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Financial Markets & Instruments

BLOCK-1

BLOCK-2

BLOCK-3

BBA SEMESTER-5

Financial Markets & Instruments

BLOCK: 1

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Unit - 1
Introduction to Financial Market

1.1 Introduction

1.2 Meaning and Definition of Financial System

1.3 Characteristics of Financial System

1.4 Functions of Financial System

1.5 Classification of Financial Market

Exercise

1.1 Introduction :

In today's world, much economic development has occurred due to industrialization. Because of it, there has also been an increase in human well-being. In the development of trade and commerce, transportation and communication tools play a crucial role, leading to a significant increase in business and trade activities. The trade of the world's countries has expanded from the national level to the international level. New forms of business, from sole proprietorship and partnership firms, became sole proprietorship, partnership, and public company forms.

After the policy of liberalization, an industrially developing country like India had to convert small savings into capital to maintain the size of its industries. To increase the volume of such small savings and convert them into capital, new investment instruments and sources were forced to be increased. A common person saves in the present to meet future needs, which must be rationally invested to earn returns (such as interest or dividends), creating a need for a system that increases the value of these investments. Along with the development of industries, investment of these savings started taking place in company shares, debentures, mutual funds, life insurance, pension funds, and provident funds.

Investors make these investments as part of their tax savings or to gain additional benefits. Progressive increases in savings are extremely necessary for the development of the country. To maintain and enhance saving and investment processes, a robust financial system is essential in the country. The sounder and stronger a country's financial system is, the more dynamic and significant its development will become. An important characteristic of an ideal financial process is a progressive increase in savings and its profitable investment. (Incremental Increase in Savings and Profitable Investing): The financial system acts as a link between savers and investors.

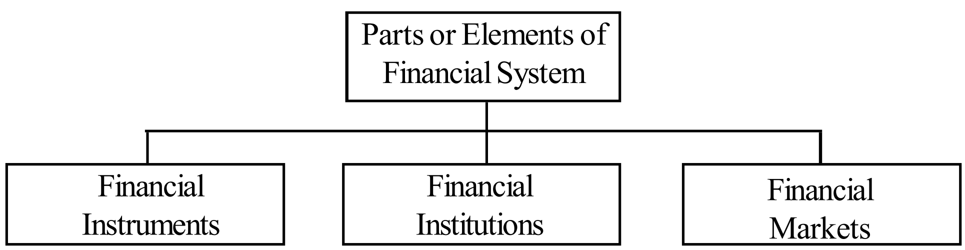
Therefore, the country's economy is responsible for producing and selling goods and services and for the people's well-being. The financial system ensures that money (funds) for the production of goods and services is available on time, according to need, and at the right time.

1.2 Meaning and Definition of Financial System :

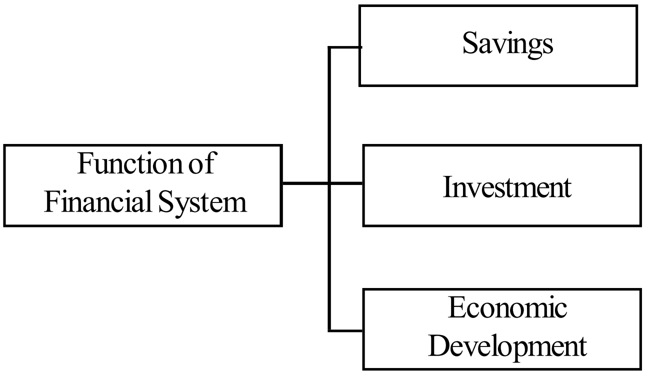
Definition of Financial System:

- "Financial system is an arrangement of a group of institutions through which available savings (financial surplus) in the economy are kept dynamic." **- Prof. H. B. Gupta**
- "Every country's financial system is made of specific and non-specific institutions, organized-unorganized financial markets and financial instruments and services, which makes the transfer of funds easy. Procedures and systems adopted in the markets and financial internal relations are also parts of this system." **-Prof. L. M. Bhole**
- "Financial system is made of various institutions, markets and instruments which have appropriate relations with each other and which provide major mediums through which savings are converted into investment." **- According to Prof. Chandra**

From the above definitions, the following conclusions can be drawn:



Function of Financial System:



Objective: To keep the development of the country fast-paced.

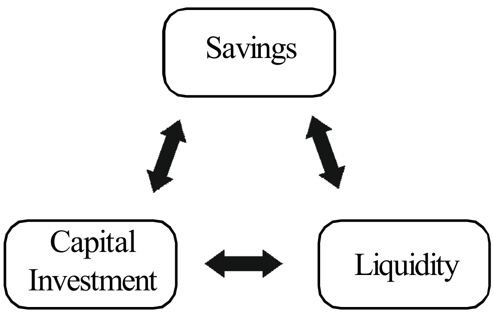
Result: To increase the well-being and prosperity of the country.

1.3 Characteristics of Financial System :

- Group of Elements: Financial system is mainly a group of 3 elements: Instruments, Institutions (Financial and Non-financial), and Markets.
- Every part is complementary to each other.
- This system follows policies and procedures.
- The main function of the system is to convert savings into capital investment so that economic development becomes fast-paced and the well-being of the public increases.
- Financial institutions perform the work of an intermediary between savers and investors.
- Thus, economic development is a coordination of different factors and the development of any country is attributed to its financial system.

1.4 Functions of Financial System :

There are mainly 3 functions of the financial market which are classified below:



Providing motivation for growth in savings:

Various individuals, institutions, businessmen, and the government continue to engage in many financial activities within the economy. These activities generate income for individuals, institutions, businessmen, and the government in various forms. They use these incomes to fulfil their present and future needs. Out of total needs, they keep a small part of income as savings to fulfill future uncertain needs. The financial system is responsible for collecting small savings from the entire economy, earning additional returns on them, and providing a system for security. An efficient financial system operating on the basis of policy rules and standards provides a guarantee of appropriate and safe returns. This system ensures the future well-being of individuals, society, institutions, and businessmen by saving more and making appropriate investments, which encourages growth in savings among investors.

Investment of Capital:

The economic growth of the economy depends on the efficiency of the country's financial system. Apart from that, another important factor is that limited savings and allocation of investment should be proportional, protective, and for efficient alternative activities so that a necessity arises to achieve a sustainable and high economic growth rate. This is also an important function of the country's financial system, which provides various sources of capital investment (banks, insurance companies, and stock markets) to investors. Individuals and institutions can earn returns by investing in one or many of these instruments (Portfolio) on the basis of their needs, expected returns, and risk-taking capacity. The base of these sources available in the economy depends on the efficiency of the financial system within it; for example, the development of an industrial country like America is attributed to its capital investment and money market there. A country's development opportunities increase as its money market becomes more developed.

Liquidity of Savings:

The third important aspect is the liquidity of savings. Providing liquidity, along with capital investment opportunities, for small savings collected in the economy is also an important task of the money market. If the instruments of capital investment do not possess sufficient liquidity and it takes time for investors to return money back at the time of need, they will stay away from investment. This creates obstacles to long-term economic development. Therefore, a crucial function of the financial system is to provide liquidity for investments, which requires it to establish the necessary infrastructure.

Development of Indian Financial System:

India is the second largest nation in the world by population and seventh largest by area. Geographically, it has many conveniences. Therefore, its economic development depends on many factors. India's financial system can be divided into 3 stages according to time:

- Time before Republican India
- Time after Republican India and before the policy of liberalization
- Time after the policy of liberalization

1. Time before Republican India:

During this time, elements like currency, small savings, and the stock market were not in the economy. Standardization of currencies had not occurred. The exchange of gold had increased in place of silver. Gradually, a paper-based currency system came into existence, whose currency notes were issued by commercial banks. In 1861, the Paper Currency Act was passed. At that time, the right to issue currency was with the government. The responsibility of paper currency was with the Controller of Currency. RBI was established in the year 1935. It was the central bank of the country. Gradually, the banking system became an important part of the financial system, but its efficiency was weak. In this stage, the banking system was unorganized. Different banks invested in various financial assets. Commercial banks invested in various industries. Only big industrialists had access to bank services. For savings, the role of the post-office department was important. To contribute to the economic development of the country, the first stock exchange was established in 1877 in Mumbai. Through that medium, a sufficient amount of savings and capital flowed into the private and public industrial sectors. Along with the development of the country, securities also slowly started gaining acceptance. Treasury bills were issued for the first time in 1917 by RBI. The system to discount these bills was also started.

2. **Time after Republican India and before the policy of liberalization:**

The time after independence is evidence of the rapid development of the Indian financial system. In all three parts of the Indian financial system, the rate of growth has remained fast and effective. Various institutions were established to achieve the long-term objectives of the financial system, which include promoting savings and investment. In which mainly:

- 1948 - IFCI (Industrial Finance Corporation of India)
- 1955 - ICICI (Industrial Credit and Investment Corporation)
- 1964 - IDBI (Industrial Development Bank of India)
- 1982 - NABARD (National Bank for Agriculture and Rural Development)

At this time, the following laws were made to appoint different sub-types of the financial system:

- Capital Issue Act (1947)
- Banking Regulation Act (1949)
- Securities Contract Act (1956)
- SEBI (Security Exchange Board of India) (1988)

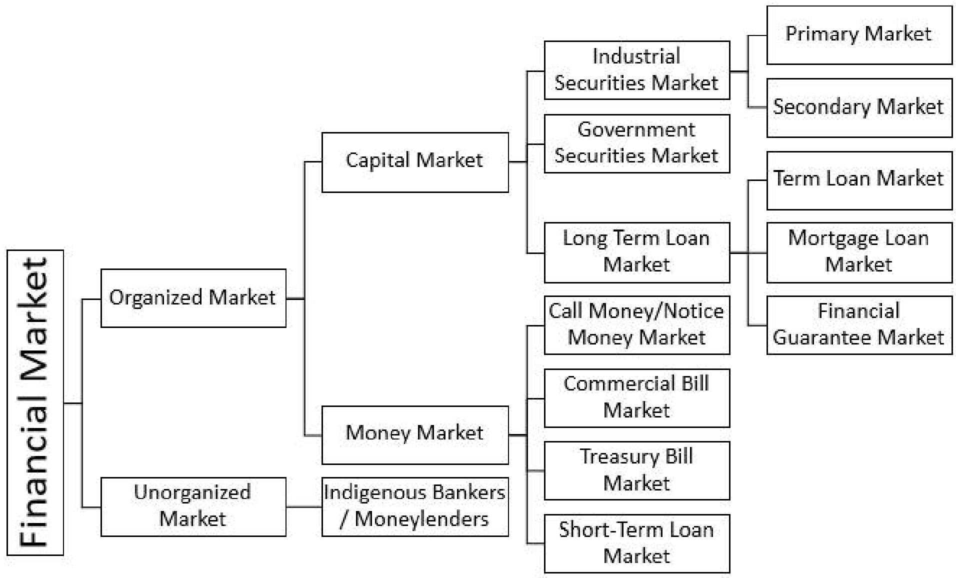
3. **Time after the policy of liberalization:**

New economic policy was announced by the Central Government in June 1991. Thereafter, based on the report given by the committee formed in that connection, reforms were implemented to make the Indian financial sector efficient and effective, which are as follows:

- Establishment of OTC for registration of small securities in 1992.
- Establishment of various credit rating institutions like CRISIL, ONICRA, ICRA etc.
- Establishment of NSE in 1993.
- Establishment of NSDL (National Securities Depository Ltd) in 1996 for effective distribution and allocation of securities and for change of ownership, in coordination with IDBI, UTI, and NSE.
- After all these effective steps, the new Companies Act, 2013 was implemented.

➢ These reforms have done the work of providing a new direction to the economy.

1.5 Classification of Financial Market :



Financial markets primarily have two parts: **Organized Market** and **Unorganized Market.**

Organized Market:

An institution or department manages these markets based on specific policy rules or standards. The entrance and exit of all elements of these markets, or their activities, are under the control and supervision of various regulatory institutions. From these rules, the following characteristics of the organized market can be derived:

- The market remains operational according to standardized rules.
- There is control of some special institution over the transactions of the market.
- The elements of the market are responsible to the respective regulatory institution.

The organized market is divided into two parts: **Capital Market** and **Money Market.**

Capital Market:

The capital market works to satisfy the long-term financial needs of industries.

The time limit of securities (instruments) traded in this market is more than one year. This market provides long-term financial stability to industries. This market is different from the perspective of liquidity and maturity. It becomes advantageous in satisfying all types of long-term needs in businesses and industries. The financial needs of business industries are of two types, according to the time period:

- **Working Capital:** For day-to-day transactions.
- **Fixed Capital:** For the need of fixed assets.

The money market satisfies the needs of the first type of capital, known as working capital. Various instruments available in the capital market satisfy the needs of long-term fixed capital. These instruments give mobility to small savings. The financial system expects coordination among various intermediaries to keep these savings dynamic. The financial services system connects these intermediaries, including individual investors, mutual funds, and financial institutions. These intermediaries offer long-term investment opportunities for savers and provide long-term capital to various industries. To provide guidance and maintain control over the huge workings of the capital market and its innumerable intermediaries, the Securities and Exchange Board of India (SEBI) has been appointed. SEBI supervises, plans, and controls the functioning of the capital market through its key components, namely the Indian stock exchanges.

With the progressive development of the Indian economy, as the needs for capital increased, capital investment of more savings became mandatory to fulfill that. Keeping these needs in mind, the number of stock exchanges, which was 7 in 1946, became 23 in 2019, and in that also, two units - BSE (1887) and NSE (1992) - are of global standard. In a country like India where the number of small savers and industrialists is specific, to satisfy their needs, the OTCEI (Over the Counter Exchange of India) institution was established in the year 1990. These markets provide buying-selling opportunities for 3 types of securities:

1. **Industrial Securities Market:** This type of security relates to the industrial sector. This type of security helps industries raise long-term capital. In this market, there are three main types of securities: Equity share capital, or owners' capital; preference shares; and debentures or bonds. Companies use any of the above-mentioned securities according to their need. The

industrial securities market divides into two parts based on the needs and efficiency of the company and investors:

a. Direct / Primary Market: When securities of the industrial market are issued for the first time by industries so that the company can perform capital formation, the market in which they are issued is called the primary market. In the primary market, the initial capital need of the industry is satisfied in 3 ways: through private investment, through public investment (IPO), and through rights shares.

i. Through Private Investment: By this method, industrialists-traders collect capital from their relatives and acquaintances. Here, invitation is not given to the general public for investment in business, and advertisement is also not given for security investment and allocation.

ii. Through Public Investment (IPO): Through public issue, companies perform distribution of their ownership rights among the general public through securities. For this, companies issue a Prospectus. Through this advertisement, invitation is given to the general public to buy securities. This method of selling securities among the general public is called IPO (Initial Public Offerings).

iii. Through Rights Shares: Apart from securities distributed through public investment, when companies have a need for additional capital, the opportunity to subscribe first to this type of shares is given by the company to its existing investors. If the existing investor refuses to buy those shares, then the general public is given the opportunity to subscribe to them. This way of raising capital is called rights shares.

b. Secondary Market: This is such a type of market where securities bought and sold for the first time in the direct market acquire liquidity. This means that after the initial allotment is completed, the buying and selling of securities occurs repeatedly in this market. In the direct market, securities are provided by the company to investors for consideration, while in the indirect market, the company makes no contribution between buyer and seller. The company only records in its records those who have become new buyers of the security through buying-selling in the indirect market. The Security Contract (Regulation) Act, 1956, regulates these exchanges in India. In these exchanges, the buying and selling processes occur only for those securities that are listed and comply with the exchange's rules. Securities are registered in exchanges subject to the rules of the securities exchanges.

2. Government Securities Market (GILT Edge Securities):

The Indian political system is three-tiered: central government, state government, and local self-government. For the implementation of government policies in these three tiers and the economic requirements of social and regional development, the government cannot fulfill them solely through taxes. Therefore, government entities partially issue securities, known as "gilt-edge securities," to meet additional financial requirements. The government repays these securities, making the risk of losing money negligible; hence, they are called "gilt-edge" securities. We refer to the market where these securities are bought and sold as the Gilt-Edge Securities Market.

These types of securities are bought and sold directly by investors from the government without the role of any intermediary. Since government financial requirements are on a very large scale, small investors do not invest in such securities. However, commercial banks invest in them on a large scale to fulfill their SLR (Statutory Liquidity Ratio) requirements.

The Government of India issues securities from the time to time as follows:

- o Securities with Fixed Coupon Rate.
- o Securities with Variable Coupon Rates.
- o Zero Coupon Bonds.
- o Securities with Repayment made in specified Instalments.

3. Long Term Loan Market:

Companies feel the need for capital for business expansion or to obtain future profitable opportunities, which cannot be entirely fulfilled by owned capital. An industry takes help from Commercial Banks or Development Banks for its financial requirements. Companies obtain this help in the form of loans, which are mostly long-term loans.

This type of loan market is divided into 3 sub-sections.

- **Term Loan Market:**

  To accelerate and sustain the pace of economic development, arrangements are made to provide medium and long-term loans to the corporate world at the state and national levels for the development of the industrial sector. The banks that carry out this loan-lending activity are known as financial development institutes. In India, such institutions include IDBI, IFCI, ICICI, and SBI.

  These types of institutions play a role not only in providing financial facilities to the industrial world but also from the search for investment opportunities to business plans, assistance in business mechanization, guidance, and evaluation. Such banks move beyond traditional banking and are associated with merchant banking. They perform both banking and consultancy activities.

- **Mortgage Loan Market:**

  The approach of banks regarding loans is traditional, in which institutions keep assets (immovable) as a mortgage from the borrower during loan lending. These mortgaged assets are pledged in two forms.

  - Banks acquire the original title documents of the assets and they are returned at the time of loan repayment. This type of lending provides security of the principal to the lender.
  - The right to use the asset remains with the borrower, while the ownership right of the asset remains with the lender until the loan is repaid; it remains in the name of the lender and is transferred to the borrower's name after payment.
  - Often, a mortgage burden is created more than once on mortgaged assets, which is called a sub-mortgage.

  The Indian Mortgage Market is an important part of Indian banking and financial services, in which housing and consumer services are vital. Prominent institutions in this field include SBI, HDFC, LIC, and ICICI.

  With the development of industry and business and changes in consumer needs, this mortgage lending business is no longer limited to housing services but has extended to cinema halls, hospitals, restaurants, and consumer goods. Thus, in various forms, the capital market fulfills the requirements of money acquisition and investment.

- **Financial Guarantee Markets:** This type of market has a three-tier structure.

  - o Money Lender
  - o Money Borrower
  - o Guarantor

A guarantor is a person or institution known and acceptable to both parties. Who increases the creditworthiness of the borrower? If the borrower defaults on payment on the maturity date, this responsibility must be fulfilled by the guarantor.

India's guarantee market is well-organized, in which commercial banks and development banks provide services. Such services are available for both individual customers and the industrial world. For individual customers, such services are provided by commercial banks, and for industries, these services are provided by development banks.

Furthermore, institutions having specialized services in the economy, like the country's ECGC (Export Credit Guarantee Corporation) (1957), are operational with the objective of encouraging exporters. This institution provides guarantees to financial institutions and banks so they can provide credit to exporters and contribute to the country's development.

Additionally, it provides Credit Insurance to exporters and Overseas Investment Insurance against investments in joint ventures of foreign companies.

Another such institution is DICGC (Deposit Insurance and Credit Guarantee Corporation), which was established from January 1, 1961, under the Deposit Insurance Act, 1961. The main objective of this institution is to function as the most efficient deposit, insurer, and credit-providing institution ready to satisfy the needs of its stakeholders.

Money Market:

A money market is one in which financial assets and securities are bought and sold for one year or less. This is a short-term market whose duration is one day to one year. The securities traded here are called a substitute for money. Such securities are converted into money within a fixed time limit.

Since the money market is different from the capital market, the Reserve Bank of India (RBI) is active in maintaining control over it.

Characteristics of Money Market:

- **Group of Short-term Securities:** The life of securities presented in this market is from 1 day to 1 year. Companies use this to fulfill their working capital requirements or to fulfill contingent requirements.
- **Minimum Cost:** Certain costs are inevitable for obtaining money; the existence of cost is different in long-term capital sources. Its calculation and use are important in financial management; since the duration of these securities is less, the cost is very low.
- **Physical Locations:** The existence of stock markets is essential for the functionality of capital market transactions, but there is no such separate arrangement in money market transactions.
- **Unorganized Market:** The money market is divided into two parts: Organized and Unorganized. Organized markets operate in the economy through the Central Bank via commercial, cooperative, and private banks. While the unorganized market includes individual money lenders (Moneylenders, Shroffs), etc., who shape their working style according to people's needs.
- **Seasonal Financial Needs:** The Indian economy is season-based, so the demand for goods and services keeps fluctuating according to seasons. Therefore, the need for money changes at certain intervals; thus, the use of the money market is essential to meet such seasonal needs.
- **Government Measures:** The government maximally utilizes the money market to implement the effects of its planning measures in the economy.

The government has formed various committees to meet industry needs and achieve economic goals:

- Chakravarty Committee (1985)
- Vaghul Committee (1987)
- Narasimham Committee (1991)

Based on the recommendations of these committees, improvements continued to be made in the working style and instruments of the money market, which played an important role in the country's development.

Money Market Instruments:

➢ **Call Money Market:**

In this market, the transfer of money is limited to banks. The duration is short, i.e., 1 to 14 days. This arrangement is for those banks that have funds available for the short term (1 to 14 days) and those who have short-term needs. Therefore, it is also called the Inter-Bank Call Notice Market. Help from the stock exchange is taken in this market, so this facility is limited to large cities.

There were restrictions on entry into this market, which were relaxed for non-banking institutions after the recommendation of the Vaghul Committee. Institutions like DFHI, UTI, and LIC are important institutions in this market.

➢ **Commercial Bill Market / C-Bill Market:**

This market is extremely useful as a short-term instrument in the field of trade and industry. The inclusion of this instrument in the Indian money market is centuries old. However, professional use has increased since the year 1990. The existence of this type of financial instrument arises in two ways.

Trade bills are born as a result of debtor-creditor relationships arising from purchase-sale transactions for goods. In another type, two parties write bills to each other to satisfy their short-term needs, where one person writes the bill while the other accepts it.

This bill is called an Accommodation Bill or a Financial Bill. An important characteristic of this type of instrument is its Self-Liquidation; that is, the bill comes to an end upon completion of the term. The term of such instruments is generally 90 days.

The market for these bills was limited to banks, but after the recommendation of the Narasimham Committee, the provision for discounting bills was implemented by the Central Bank in 1970. These types of bills are exempted from government stamp duty, which increases their liquidity.

➢ **Treasury Bill Market / T-Bill Market:**

The government uses these instruments to meet its short-term financial needs. It is an important instrument for banks and financial institutions to satisfy SLR (Statutory Liquidity Ratio) requirements.

Individuals, firms, companies, and banks in India buy and sell these securities

Important characteristics of these instruments are as follows:

- High short-term liquidity
- Fixed return
- Minimum transaction cost
- Regular auction
- Refinance facility

Treasury bills can be of different time limits, such as 91 days, 182 days, 364 days, etc. Ad-hoc Treasury Bills are issued by the RBI, which creates an asset for the RBI against which the bank issues new currency.

➢ **Short Term Loan Market:**

The industrial world uses these instruments to meet its short-term (working capital) capital needs. Commercial banks control these instruments in the market. In this market, services like cash credit lending and bank overdraft are provided by banks. This type of loan is a very popular instrument for obtaining short-term money in trade and business.

Exercise

Q.1 Select the correct option from the given options for the questions below and answer.

1. Financial system plays the role of intermediary between which parties?

   (a) Money market and Capital market

   (b) Capital market and Investors

   (c) Savers and Capital market

   (d) Savers and Investors

2. Financial system:

   (a) Inspires for savings (b) Brings mobility in savings

   (c) Invests funds (d) All of the above

3. Money market and Capital market:

   (a) Arrange funds for long-term and short-term.

   (b) Arrange funds for short and medium-term.

   (c) Provide funds for short and long-term.

   (d) None of the above.

4. Which instrument(s) are not included in the capital market?

   (a) Call money notice (b) Treasury bill

   (c) Short term loan (d) All of the above

5. SEBI is:

   (a) A professional institution (b) A regulator

   (c) A voluntary institution (d) All of the above

6. How many total stock exchanges are located in India?

   (a) 20 (b) 22 (c) 25 (d) 23

7. Which of the following is not an industrial security?

   (a) Equity share (b) Bond

   (c) Commercial bill (d) Right shares

8. Important difference between money market and capital market:
   (a) In terms of duration (b) In terms of purpose
   (c) In terms of financial instruments (d) All of the above
9. Which is the regulatory body of the capital market?
   (a) SEBI (b) RBI
   (c) Income Tax Department (d) All of the above
10. Which security is first offered for purchase by a company to its existing partners?
   (a) Equity share (b) Preference share
   (c) Right shares (d) All of the above

Answers: 1. (d) 2. (d) 3. (a) 4. (d) 5. (b) 6. (d) 7. (c) 8. (a) 9. (a) 10. (c)

Q.2 Write short answers to the given questions:

1. What are the two important functions of the financial system?
2. What is a direct market?
3. What is an indirect market?
4. What is meant by self-liquidated?
5. Any two differences between capital market and money market.

Q.3 Write detailed answers to the given questions:

1. Define financial system and describe its functions.
2. Explain the classification of the financial market.
3. Discuss the important instruments of the money market.
4. Give the difference between money market and capital market.

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Unit - 2
Classification of Financial Markets

2.1 Introduction :

Financial markets are an important part of an economy, as they help to channel funds from surplus to deficit units. In the real world, households and individuals save money, while businesses and governments need money for production, infrastructure, and development. As an example, when a company like Reliance Industries wishes to develop, it raises cash from the financial markets rather than depending primarily on its internal resources. Financial markets are the means of allocating these funds efficiently and guaranteeing the best possible use of resources. Similarly, when an investor purchases shares or bonds, he anticipates returns in the form of dividends, interest, or capital appreciation.

Financial markets trade in financial products like shares, bonds, Treasury bills, and other securities. These are ownerships or debts, and they contribute to capital formation, liquidity, and economic growth.

A financial market can be defined as a physical or electronic marketplace where financial assets like shares, bonds, currencies, and short-term securities are bought and sold between participants. The participants are people, companies, banks, financial institutions, and governments. These markets mobilize and direct savings into productive uses, which contributes to economic growth and development.

To understand the importance of classification, consider the following two situations:

- A small trader in Surat needs ₹2 lakh for three months to purchase inventory.
- A manufacturing company needs ₹50 crore for 10 years to set up a new plant.

Now, the question is whether small traders and manufacturing companies will be approaching the same market. The answer to this question will be no, as the small trader requires short-term funds for working capital, while the manufacturing company requires long-term funds for capital investment. The nature, time, purpose, and risk of these financial needs are completely different. Therefore, it is impractical or efficient for both to rely on the same financial market. This difference in time, purpose, and risk makes it necessary to classify financial markets into different categories, such as the money market, the capital market, the primary market, the secondary market, and the organized and unorganized markets.

Financial markets perform several important functions:

- Mobilization of savings
- Allocation of capital
- Facilitating investment
- Providing liquidity
- Price discovery of securities

2.2 Money market :

2.2.1. Meaning:

The money market is that part of the financial market which deals with the lending and borrowing of short-term funds, having a maturity of less than one year. It is largely utilized by banks, companies and governments to manage their short-term liquidity needs. It is very important in preserving liquidity and proper functioning of the financial institutions.

For example, if a bank is faced with a shortage of funds due to excessive withdrawals it can borrow from the money market to meet its immediate obligations. It is fundamental to the operation of the financial system and to the meeting of short-term financial needs. In practice, the money market allows institutions with short-term financial shortages to borrow and those with surplus capital to invest.

The main function of the money market is providing short term loans to the institutions to meet their working capital needs and temporary liquidity imbalances. The money market is characterized by a high degree of liquidity. This implies that the instruments may be converted into cash in a short period of time with minimal risk of loss. In addition, the instruments traded in this market are usually believed low risk, given to their short maturity and the good credit quality of the issuers. It might be called the temporary finance market.

2.2.2. Features of Money Market

1. **Short Term Duration:**

   All the instruments in the money market are of short duration, generally less than a year. This allows investors to receive their money back fast and lowers uncertainty. For example: A company may issue Commercial Paper for 6 months to cover its working capital needs and investors get their money back in that short term.

2. **High Liquidity:**

   Money market instruments may be converted easily into cash at any time without any loss. This is important to institutions who require immediate financing. For example: If there is unexpected demand from consumers, a bank can immediately sell its Certificate of Deposit (CD) in the market to acquire instant cash.

3. **Low Risk:**

   As these instruments are often issued by trustworthy institutions like governments or well-established companies, the possibility of default is relatively minimal.

   For example, government-issued Treasury Bills are regarded highly secure since the government guarantees repayment.

4. **Dominance of Financial Institutions:**

   The money market is generally utilized by banks, financial organizations and major companies as transactions involve huge sums of money. For example, commercial bank may spend Rs 100 crore in money market instruments which is not practical for small investors.

5. **Regulated Market:**

The central bank (as in RBI) controls the money market and assures smooth operation and stability of the money market. It also helps to regulate inflation & liquidity.

For example, as inflation rises, the RBI increases the repo rate, which increases borrowing cost and reduces surplus money in the market.

2.2.3. Advantages of Money Market

1. **Ensures Liquidity:**

   The money market is particularly significant in supplying liquidity to the financial system since it provides short-term cash as and when necessary. Banks and other financial organizations regularly experience temporary cash shortages as a result of sudden withdrawals or payments. A bank short of cash at the close of the day might borrow in the call money market to meet its reserve requirements.

2. **Supports Monetary Policy:**

   Central banks like the Reserve Bank of India employ money market instruments to regulate the money supply in the economy. They can control inflation and economic stability by raising or lowering liquidity. Hence, the money market is a key instrument of economic control.

   For example: when inflation is strong, the RBI increases the repo rate, making borrowing costlier and taking surplus money out of circulation.

3. **Safe Investment Options:**

   Money market products are regarded as secure as they are issued by governments or highly trusted entities. This makes them suitable for risk-averse investors who desire capital protection over large profits. For instance, during uncertain economic situations, investors favor Treasury bills because the government guarantees repayment.

4. **Efficient use of surplus fund:**

   Institutions can invest extra funds in money market instruments and receive returns instead of keeping upon idle cash. This guarantees the funds are spent productively, even for short periods of time. For Example: The company that has surplus cash for 3 months may invest in Commercial Paper or Certificates of Deposit to generate interest instead of keeping its money idle.

5. **Flexibility in Investment:** Money market securities include flexible timeframes to maturity and investment alternatives. Investors can pick products that suit their short-term needs and reinvest simply after maturity.

   For example: An investor can select a 30-day or 90-day instrument depending on when they need the cash again.

6. **Promotes Financial Stability:**

   The money market makes sure that there are no lack of liquidity and no financial crises by keeping the flow of funds going between institutions. It helps the banking and financial system to work smoothly. For example, in times of acute financial strain banks borrow from the money market to prevent default and to preserve stability

2.2.4. Disadvantages of Money Market

1. **Low Returns:**

   Money market instruments yield lower returns than capital market instruments since they have less risk. These returns are not enough for investors searching for larger earnings.

   The returns from Treasury bills or CDs are substantially lower than the returns from equity shares.

2. **Limited Access:**

   The money market is controlled by banks, financial institutions and major corporations because of the high level of investment required. Small investors have trouble getting in directly.

   For example, many money market instruments need investment in lakhs and crores which is not possible for regular investors.

3. **Not suitable for long term Investment:**

   Money market products are for short-term purposes and cannot be utilized for long-term wealth growth. Those looking for growth over many years can invest in capital markets instead.

For example: Repeatedly investing in 30-day instruments will not build as much wealth as investing in long-term equities.

4. **Inflation Risk:**

   Returns on money market instruments may not keep pace with inflation, reducing the actual worth of money. This has an impact on purchasing power over time.

   For Example: If an investor makes 4% return but inflation is 6% then the real return is negative.

5. **Limited Variety of Instruments:**

   The money market has fewer sorts of investment opportunities as compared to the capital market. This restricts the chances for investors to diversify. For example: T-Bills, CP, CD, etc. are mostly selected by investors as opposed to the capital markets that provide shares, bonds, mutual funds and more.

6. **Dominance of Financial Institutions:** The money market is dominated by banks and major financial institutions, which limits the participation of individuals as well small investors. This leads to an imbalance in access and benefits. The commercial banks and mutual funds are the major players in the money market and there is minimal space for ordinary investors.

2.3 Capital Market :

2.3.1. Meaning:

The capital market is that section of the financial market that handles long-term funds with a maturity duration of over one year. It is vital for economic growth since it allows for investments in business, infrastructure, and long-term initiatives. The money market deals with short-term liquidity, and the capital market deals with long-term capital generation and wealth growth. It links investors prepared to invest for longer periods with businesses and governments requiring money to grow and develop. When a firm like Reliance or Infosys wishes to expand operations, build up new factories or invest in technology, it gets money from the capital market by issuing shares or bonds.

2.3.2. Features of Money Market

1. **Long term Duration:**

   The capital market instruments are designed for long-term investment, often longer than one year. This enables investors to take advantage of long-term growth and compounding rewards.

   For example, an investor acquiring equity shares of a corporation may retain them for 5 to 10 years to earn capital gains and dividends.

2. **Higher Risk and Return:**

   Capital market instruments are riskier than money market instruments, but they also provide the potential for bigger returns. For example, equities shares might have fluctuate in price daily, but over a period they give far larger returns than fixed deposits or Treasury Bills.

3. **Capital Formation Function:**

   The capital market plays a critical role in mobilizing funds and channelling them into productive ventures. This helps economic growth and industrial development. For example, corporations utilize money from an IPO to grow production, invest in infrastructure or develop new goods.

4. **Wide Participation:**

   The capital market comprises involvement from individuals, institutional investors, mutual funds, insurance companies and international investors. For example, a regular investor can invest ₹5,000 in shares, yet a mutual fund might invest crores in the same firm.

5. **Price determination based on Market:**

   The prices of the capital market securities are regulated by the demand and supply.

   For example, if a business is doing well, and people are expecting it to grow, then the demand for the firm's shares will go up, and so will the price.

6. **Liquidity through Secondary Market:**

   Investments are of a long-term nature in the capital market but can be turned into cash by means of the secondary market. For example, shares listed on the NSE or BSE can be sold at any point during the trading hours.

7. **Link with economic conditions:**

   The success of the capital market is closely associated with the entire economy.

   For example, with economic expansion stock markets rise, while during recession or crisis markets may drop drastically.

2.3.3. Advantages of Capital Market

1. **Promotes Economic growth:**

   The capital market offers long term finance for industry, infrastructure and development projects which contributes to economic progress. For example, firms that raise cash through stock might increase output and create jobs.

2. **Wealth Creating Opportunity:**

   The investors can earn substantial returns over time, through capital appreciation and dividends.

   For example, early investors in firms like Infosys or HDFC Bank have made handsome gains throughout the years.

3. **Multiple Investment options:**

   The capital market offers diversification through a range of instruments such as shares, bonds, debentures and mutual funds. For example, an investor may buy some shares for growth and some bonds for stability.

4. **Provides Liquidity to Investors:**

   Investments are flexible. The investors can purchase and sell assets on the secondary market.

   For example, a shareholder can sell shares to the stock market when he needs finances.

   For example, a shareholder can sell shares to the stock market when he needs finances.

5. **Encourages savings and Investment Habits:**

   The capital market encourages people to invest their savings instead of leaving them idle.

   For instance, people invest in SIP or shares to increase their wealth over a period.

6. **Efficient allocation of resources:**

   Funds flow into productive areas with higher yielding and growth potential.

   For example, technology and renewable energy, these are emerging businesses that draw greater investment.

7. **Transparency and Regulation:**

   The capital market is governed by the agencies such as SEBI which ensures the transparency and protects interest of the investors. Before issuing shares, corporations must publish financial statements.

2.3.4 Disadvantages of Capital Market

1. **High risk and volatility:**

   The prices of securities fluctuate frequently due to market conditions, leading to potential losses. For example, stock markets may fall sharply during economic crises or global events.

2. **Requires Knowledge and Expertise:**

   To invest in the capital market, you must know about financial concepts, company performance, and market trends. For instance, a beginner investor might lose money by making bad investment choices.

3. **Uncertain Returns:**

   Returns are not guaranteed and rely on market success and company profitability.

   For example, firms may not declare dividends in the case of losses.

4. **Possibility of Market Manipulation:**

   Market efficiency can be affected by unfair actions like insider trading or price manipulation. For example, misleading rumors might artificially drive share values up or down.

5. **Economic and Political sensitivity:**

   The capital market is influenced by changes in government policy, inflation, interest rates and global events. For example, financial markets react instantly to budget announcements or international crises.

6. **Speculative Nature:**

   Volatility increases with a lot of short-term speculation by investors, rather than long term investment. For example, price movement-based day trading can lead to either significant profits or major losses.

7. **Risk of capital Loss:**

   Investors may lose part or entire investment if the company performs poorly or market declines. For example, investing in weak companies may result in significant losses.

2.4 Primary Market :

2.4.1 Meaning

Investors initially receive new securities in the primary market, a sector of the financial market. The primary market, also known as the new issue market, introduces shares, debentures, and bonds to the public for the first time. The primary market's principal aim is to help firms, governments, and institutions acquire new capital directly from investors to expand their businesses, build infrastructure, or meet other long-term financial demands. In this market, funds go directly from the investors to the issuing firm rather than to the secondary market, where securities are transferred between the investors. The main market is where securities are issued through Initial Public Offering (IPO), Follow-on Public Offering (FPO), rights issue, and private placement. These techniques assist institutions in raising cash according to their requirements and market circumstances. For example, when a firm goes public with an IPO, the investors buy the shares directly. The company uses the received money for expansion, debt repayment, or technology development.

2.4.2 Features of Primary Market

1. **First - Time Issue of Securities:**

   The main market solely deals with the issue of new securities for the first time. This is not the secondary market, where securities already issued are exchanged. Investors get a chance to put money into the firm in the early stages of its public offering. For example, Zomato's IPO shares were sold to investors for the first time before listing on the stock exchange.

2. **Direct Flow of Funds to Issuer:**

   In the primary market, funds collected from investors go directly to the issuing company or government. This ensures that the capital raised is used for productive purposes such as expansion or development. For example, a company raising funds through an IPO may use the money to build new factories or invest in research and development.

3. **Capital Formation Function:**

   The primary market is an important centre for capital formation. It converts savings into investment. It adds to the growth of company and economic development.

   Startups and expanding firms need the primary market to raise the funding to scale their operations.

4. **Regulated and Transparent Process:**

   The primary market is governed by institutions like SEBI for maintaining fairness and transparency. A prospectus is a document companies must publish with financial and operational information. For instance, corporations must provide thorough information about their performance, risks and future-plans prior to issuing shares.

5. **No Immediate Liquidity:**

   Securities acquired in the primary market cannot be sold immediately until they are listed in the stock exchange. That means investors are locked-in for a length of time. For instance, investors who acquire IPO shares have to wait until the listing day to sell them on the secondary market.

6. **Multiples Methods of Issue:**

   There are several ways of offering securities in the main market, such as IPO, rights issue, bonus issue and private placement. That gives firms freedom to raise financing. For example, an established corporation may give its existing shareholders extra shares through a rights issue.

2.4.3 Advantages of Primary Market

1. **Facilitates Business Expansion:**

   The primary market is the opportunity for companies to raise considerable sums of capital for expansion and development initiatives. This aids in the development of production and improvement of business operations. For instance, a manufacturing firm may utilize IPO proceeds to develop a new production plant.

2. **Opportunity to Invest at Initial Price:**

   An investor has the chance to buy assets at the original offering price, which might be below future market values. This can lead to possible benefits after listing. For instance, several IPO investors make money when the stock price goes up on the day of listing.

3. **Transparent Investment Information:**

   Strict regulations ensure that investors receive accurate and complete information before investing. This reduces the risk of fraud and builds confidence. For example, companies must disclose financial statements and risks in the prospectus.

4. **Contributes to Economic development:**

   The funds mobilized in the main market are utilized for productive purposes and for the expansion of industries, employment generation and infrastructure development. For example, corporations that invest in infrastructure projects help national growth.

5. **Fair Pricing Mechanism:**

   The pricing of securities is determined through systematic methods like book building, ensuring fairness for both investors and issuers. For example, demand from investors helps determine the final IPO price.

6. **Diversification Opportunities for Investors:**

   Investors can participate in new companies and industries, allowing them to diversify their investment portfolio. For example, investors can invest in emerging sectors like fintech or renewable energy through IPOs.

2.4.4 Disadvantages of Primary Market

1. **High Risk for Investors:**

   The future success of a company is unknown, and hence investing in newly issued securities is risky. Investors may not know all about the future. For example, some IPOs may perform badly after listing and incur losses.

2. **Lack of Immediate Liquidity:**

   Investors cannot sell stocks immediately after buying them until the stock exchange lists the securities. This reduces flexibility. For example, the shares from IPOs can only be sold on the listing day.

3. **Information Asymmetry:**

   Despite legal restrictions, investors may not receive complete information on the company's future performance or hazards. For example, firms may make optimistic estimates that may not be met.

4. **Complex and Time-Consuming Process:**

   The process of issuing securities is long and difficult, and requires several processes including approvals, documentation and compliance. Companies must go through regulatory hurdles before launching an IPO.

5. **Risk of Overpricing:**

   Companies may price their securities higher than their actual value, which may lead to losses for investors after listing. For example, some IPOs list at a price lower than the issue price.

6. **Dependence on Market Conditions:**

   The success of a primary issue depends on market conditions and investor sentiment. During economic downturns, issues may fail. For example, IPOs launched during a recession may receive a poor response.

7. Limited Participation in Allocation:

Often, investors may not get full allocation of shares due to oversubscription. This limits their investment opportunity. For example, popular IPOs are often oversubscribed, and investors receive only a small portion of shares.

2.5 Secondary Market :

2.5.1 Meaning:

Investors buy and sell securities in the secondary market, which is part of the financial market. The secondary market trades in previously issued financial goods, such as shares, bonds, and debentures. This is why it is also called the stock market or the aftermarket. The business that issues the bonds does not obtain any cash in this market; instead, investors buy and sell bonds. It is mostly used for getting cash, finding prices, and changing who owns a commodity on the secondary market. As well as stock platforms (NSE and BSE), there are also over-the-counter (OTC) markets that are part of the secondary market. This is very important for building trust among investors, who now know they can sell their goods whenever they want. In the case of Infosys, an investor who buys shares on NSE does so from another investor and not from the company itself.

2.5.2 Features of Secondary Market

1. Trading of Existing Securities:

In secondary markets, only securities that were issued in main markets are traded. The main market is not the same as this. Securities are bought and sold by investors, not the seller. You can sell your IPO shares on NSE and BSE.

2. Continuous Trading Facility:

Assets can be bought and sold on the secondary market 24 hours a day, seven days a week. People can get in and out of the market at any time. Since the stock market is open at certain times, investors can buy stocks all day.

3. Provides Liquidity to Investors:

One of the most important features is liquidity, as investors can easily convert their investments into cash whenever required. This increases the attractiveness of investing in financial markets. For example, an investor holding shares can sell them instantly in the market to meet urgent financial needs.

4. **Price Discovery Mechanism:**

   In the market, forces of supply and demand set the prices of stocks. This shows the real market value of securities based on the information that is available. For example, if a company performs well, demand for its share's increases, leading to a rise in price.

5. **No Direct Role of Issuing Company:**

   The corporation that issues the stock does not trade on the secondary market and does not get any money from trading. For example, when shares of Reliance are traded on NSE, the company does not get any money from these transactions.

6. **Regulated Market Structure:**

   Authorities like SEBI keep an eye on the secondary market to make sure it is open, fair, and safe for investors. For example, SEBI monitors trading activities to prevent fraud and insider trading.

7. **Facilitates of Transfer of Ownership:**

   The secondary market lets one investor sell their shares to another, which keeps the financial system running smoothly. For example, when shares are sold, ownership is transferred electronically through demat accounts.

2.5.3 Advantages of Secondary Market

1. **Provides Liquidity to Investors:**

   The secondary market enables investors to convert their investments into cash fast, making financial assets extremely liquid. This flexibility fosters greater engagement. For example, an investor can sell shares anytime on the stock exchange to meet personal financial needs.

2. **Ensures Price Transparency:**

   Prices for securities are publicly disclosed, allowing investors to make informed judgments based on market trends and corporate performance. For example, stock prices are displayed in real-time on trading platforms.

3. **Investor Protection and Regulation:**

   Strict restrictions protect investors from fraud and unethical tactics while assuring safe trading. For example, SEBI has guidelines and grievance mechanisms for investor protection.

4. **Continuous Investment opportunities**

   Investors are afforded continuous opportunities to acquire and dispose of securities at various price points through the secondary market. For example, investors can take advantage of price fluctuations to earn profits.

5. **Facilitates Economic Growth:**

   The secondary market indirectly supports economic development and capital formation by enhancing investor participation and liquidity. For example, active trading increases investor confidence and encourages more investments.

2.5.4 Disadvantages of Secondary Market

1. **High Volatility:**

   Prices in the secondary market are subject to frequent fluctuations as a result of fluctuations in demand, supply, and external factors. This increases uncertainty for investors. For example, stock prices may fall sharply during economic crises or global events.

2. **Speculative Activities:**

   There is more danger and market instability because many investors speculate instead of making long-term investments. For example, day trading based on short-term price movements can lead to high gains or losses.

3. **Risk of Financial Loss:**

   The investors may lose money if they make bad financial choices or the market is not doing well. For example, buying shares at a high price and selling them at a lower price results in loss.

4. **Market Manipulation:**

   Unethical practices such as insider trading or spreading false information can influence prices.

   For example, rumors about a company may artificially increase or decrease share prices.

5. **Requires Continuous Monitoring:**

   To make smart choices, investors need to keep an eye on market trends, business performance, and the economy on a regular basis. For example, active investors monitor stock prices daily to manage their portfolio.

6. **Influence of External Factors:**

   Events happening around the world, changes in politics, and the economy can all have a big effect on the market. For example, stock markets react quickly to changes in government policies or international crises.

2.6 Organised and Unorganised Market :

2.6.1 Organised Market

2.6.1.1 Meaning:

The organized financial market refers to a structured and formally regulated system where financial transactions take place under the supervision of regulatory authorities such as the Reserve Bank of India (RBI) and the Securities and Exchange Board of India (SEBI). These markets operate through established institutions such as stock exchanges, commercial banks, insurance companies, and financial intermediaries.

The main objective of the organized financial market is to ensure transparency, efficiency, and investor protection in financial transactions. It adheres strictly to a well-defined framework of rules, procedures, and legal systems.

For example, stock exchanges like NSE and BSE are part of the organized financial market, where buying and selling of securities take place in a regulated environment.

2.6.1.2 Features of organised Market

1. **Regulated by Authorities:**

   Organized financial markets are governed by regulatory bodies such as RBI and SEBI, which ensure proper functioning and protect investor interests. These authorities set rules and monitor activities to prevent fund and malpractices. For example, SEBI regulates stock exchanges and ensures that companies follow disclosure norms before issuing securities.

2. **Standards Rules and Procedures:**

   All transactions in organized markets follow predefined rules and procedures, ensuring uniformity and fairness. This reduces confusion and enhances efficiency.

   For example, buying shares requires following a standard process through brokers and demat accounts.

3. **High Level of Transparency:**

   Information about prices, transactions, and company performance is publicly available, allowing investors to make informed decisions. For example, companies listed on stock exchanges must publish financial statements regularly.

4. **Formal Institutional Structure:**

   Organized markets operate through formal institutions such as banks, stock exchanges, and financial intermediaries. These institutions provide a systematic environment for transactions.

   For example, banks provide loans and accept deposits under regulated guidelines.

5. **Legal Framework and Documentations:**

   Transactions are legally enforceable and supported by proper documentation, reducing the chances of disputes. For example, ownership of shares is recorded electronically in demat accounts, ensuring security and authenticity.

6. **Investor protection Mechanism:**

   Regulatory authorities provide systems to protect investors from fraud and unfair practices, increasing confidence in the market. For example, SEBI provides grievance redressal mechanisms for investors.

7. **Use of technology:**

   Organized markets use advanced technology for trading, settlement, and record keeping, improving efficiency and speed. For example, online trading platforms allow investors to buy and sell shares instantly.

2.6.1.3 Advantages of organised Market

1. **Strong Investor Protection:**

   The presence of regulations and legal systems ensures that investors are protected from fraud and exploitation. This builds trust in the financial system. For example, strict SEBI guidelines prevent companies from misleading investors.

2. **Transparency in Transactions:**

   Open access to information allows investors to make informed decisions based on reliable data. This reduces uncertainty and risk. For example, real-time stock prices are available on trading platforms.

3. **Systematic functioning:**

   Structured procedures and institutions ensure smooth and efficient functioning of financial activities. For example, stock exchanges use automated systems for quick trade execution.

4. **Access to large Scale Capital:**

   Organized markets enable companies to raise large amounts of capital from the public, Supporting business expansions. For example, companies raise funds through IPOs in stock exchanges.

5. **Builds Investor Confidence:**

   Regulation and transparency increase investor confidence, encouraging participation in financial markets. For example, investors prefer regulated markets over informal ones due to safety.

6. **Reduce risk of malpractices:**

   Strict monitoring minimizes unfair practices such as fraud and manipulation. For example, insider trading is strictly prohibited and penalized.

2.6.1.4 Disadvantages of organised Market

1. **Complex Procedures:**

   Transactions in organized financial markets involve multiple steps, detailed documentation, and strict compliance requirements, which make the overall process complicated for participants. This may create difficulty especially for new or small investors. For example: Opening a demat account requires completion of KYC verification, submission of documents, and adherence to formal procedures.

2. **Higher Transactions Costs:**

   Participants in organized markets must bear various costs such as brokerage charges, taxes, and compliance-related expenses, which increase the total cost of transactions. This may reduce overall return on the investment.

   For example: Investors are required to pay brokerage fees and taxes while buying or selling shares through stock exchanges.

3. **Time-consuming Processes:**

   Due to regulatory requirements and formal procedures, certain activities in organized markets may take more time to complete. This can delay investment decisions or fund-raising activities.

   For example: The approval process for an IPO involves multiple stages such as regulatory clearance, documentation, and verification before final issuance.

4. **Strict Regulations:**

Organized financial markets operate under strict rules and regulations, which may limit flexibility for participants and increase compliance burden. While these rules ensure safety, they may restrict ease of operations.

For example: The companies must follow strict disclosure norms and regulatory guidelines before issuing securities.

5. **Extensive Documentation Requirements:**

Participants are required to maintain proper records and complete various documentation processes, which may be time-consuming and complex for some users.

For example: The financial transactions require submission of identity proof, address proof, and other verification documents.

2.6.2 Unorganised Market

2.6.2.1 Meaning:

The unorganized financial market refers to an informal financial system that operates without strict regulation or supervision by government authorities. It includes moneylenders, indigenous bankers, chit funds, and local financiers who provide financial services based on personal relationships and informal agreements.

This market mainly operates in rural and semi-urban areas where formal banking services are limited. While it provides easy access to funds, it lacks transparency and legal protection.

For example, a local moneylender providing loans to farmers without formal documentation is part of the unorganized financial market.

2.6.2.2 Features of Unorganised Market

1. **Lack of Formal Regulation:**

Unorganized markets operate without strict rules or supervision, increasing the risk of unfair practices. For example, moneylenders are not always governed by regulatory authorities.

2. **Easy and Quick access to fund:**

   Loans are provided quickly without lengthy procedures or documentation. For example, a farmer may obtain a loan from a local lender within a few hours.

3. **Flexible terms and conditions:**

   Borrowers and lenders can negotiate interest rates and repayment terms based on mutual understanding. For example, repayment may be adjusted based on seasonal income.

4. **Relations based transactions:**

   Financial dealings depend on personal trust rather than formal contracts.

   For example, loans may be given based on familiarity with the borrower.

5. **Lack of Transparency:**

   There is no proper record keeping, leading to lack of clarity in transactions.

   For example, loan terms may not be documented properly.

6. **Absence of formal documentation:**

   Transactions often occur without written agreements, increasing risk of disputes.

   For example, verbal agreements are common in informal lending.

2.6.2.3 Advantages of Unorganised Market

1. **Quick availability of Funds:**

   Borrowers can get money immediately without delays, making it useful in emergencies.

   For example, farmers can quickly obtain loans during urgent situations.

2. **Less Documentation:**

   No complex paperwork is required, making the process simple and accessible.

For example, loans can be obtained without formal financial records.

3. **Flexible Repayment Options:**

   Borrowers can negotiate repayment terms based on their financial situation.

   For example, repayment can be made after harvest season.

4. **Suitable for Small Borrowers:**

   Individuals requiring small amounts can easily access funds without formalities.

   For example, small shopkeepers borrow small sums for daily operations.

5. **Convenient and Time Savings:**

   The process is quick and simple compared to formal banking systems.

   For example, no waiting time for approvals.

2.6.2.4 Disadvantages of Unorganised Market

1. **High Interests Rate**

   The borrowers are often charged very high interest rates, increasing financial burden.

   For example, moneylenders may charge interest rates much higher than banks.

2. **Risk of Exploitation:**

   Lack of regulation allows lenders to impose unfair conditions on borrowers.

   For example, lenders may demand excessive repayment or collateral.

3. **No Legal Protection:**

   Borrowers have limited legal recourse in case of disputes. For example, informal agreements cannot be easily enforced in court.

4. Lack of Transparency:

Terms and conditions may not be clearly communicated, leading to misunderstandings.

For example, hidden charges may be imposed without prior notice.

5. Possibility of Unfair Practices:

Without regulation, practices such as coercion or manipulation may occur.

For example, lenders may use pressure tactics for recovery.

6. No formal Recording:

Absence of proper records increases risk of disputes and financial mismanagement.

For example, borrowers may not have proof of repayment.

Exercise :

Q.1 Short Questions

1. What is meant by financial market?
2. Define money market.
3. What is capital market?
4. What is primary market?
5. What is secondary market?

Q.2 Long Questions (8 Marks)

1. Explain the meaning and functions of financial market.
2. Describe the features of money market.
3. Explain the features of capital market in detail.
4. Discuss the advantages and disadvantages of primary market.
5. Explain the features and functions of secondary market.

Q.3 Fill in the Blanks

1. Financial markets help in __________ of savings.

2. Money market deals with __________ term funds.
3. Capital market deals with __________ term funds.
4. Primary market is also known as __________ issue market.
5. Secondary market is also called __________ market.

Answer (1. Mobilization, 2. Short, 3. Long, 4. New, 5. Stock)

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Unit - 3
Indian Money Market

3.1 Introduction:

The money market is an important part of the Indian financial system. The logical planning of the money market contributes significantly to the economic development of the country. Trade and industries play a significant role in economic development. The development of trade and industry depends on the timely availability of their financial needs. Furthermore, these financial needs are of two types: long-term and short-term.

The capital market fulfills long-term needs. For example, the stock market serves as a secondary market for instruments that raise long-term capital for companies and the government. The money market satisfies short-term needs. Therefore, we can assert that the money market facilitates short-term money transactions.

The money market is for short-term credit where the duration for lending is available for 1 day, 1 week, 3 months, or up to 6 months. The money market provides an opportunity to earn interest to those who have surplus funds for short-term investment. In this way, it establishes coordination between profitability and liquidity. Liquidity directly relates to this market. The money market uses various financial instruments to provide credit facilities. The financial assets used here are identified as "financial options" or "financial equivalents." Forward markets and stock markets are also associated with the money market. When brokers of the markets need money for a short period, the money market satisfies their needs.

This chapter will seek answers to the following questions: What is the money market, which holds importance in the economy? Of which institutions is it comprised? What kind of structure does it have? And, what are its instruments?

3.2 Meaning and Definition of Money Market :

The money market is one for short-term funds. The maturity period in the money market ranges from one night to one year, and the instruments used in this market are equivalent to money. This market provides a balanced method for the short-term demand and supply of money. During this process, the money market also allows for central bank intervention, which can influence the volume and price of liquidity in the management of monetary policy. In the transmission chain of monetary policy, the money market is the first and most important stage. In the money market, lenders and borrowers include individuals, firms, indigenous bankers, banks, other financial institutions, companies, and occasionally the government as well. The instruments used for the exchange of money are known as money market instruments. Such instruments include Treasury bills, bills of exchange, commercial papers, certificates of deposit, repos, etc. However, the money market is not a complete market that transacts using only one type of instrument. It is composed of various sub-markets, like the call money market, the Treasury bills market, the bills market, etc.

The descriptive definition given by the Reserve Bank of India regarding the money market is as follows: 'The money market is a place for transacting short-term financial assets.' The money market is a system where financial institutions, other institutions, and individuals with surplus short-term lending funds interact with those who demand money for short-term needs, including other institutions, individuals, and the government.

According to Crowther: "Money market is the various institutions and firms dealing in short-term credit."

Shree Madan and Nadler state in their book: "Money market is a system through which short-term funds are lent and borrowed and through which most of the financial transactions of a specific country of the world are settled."

3.3 Functions of Money Market :

1. Financial Assistance to Trade and Industry:

The money market provides short-term credit arrangements for business entities for domestic and foreign trade. The short-term funds are provided to traders through bills of exchange. A system has also been established to discount these bills. This means that businesses develop by obtaining funds through commercial bills, and overall, the country's economic growth occurs. Funds are used in the form of working capital in the short term to keep the production process free from obstacles.

2. Opportunity for Profit Creation:

As stated earlier, an important role is played by commercial banks in the money market. Deposits are accepted from customers by these banks and are given in the form of credit to other customers and especially to trade and industry. Investments are made in the money market from the profit generated by the difference between deposits accepted and credit given in this way. Through this investment, market liquidity increases. And banks can satisfy their needs by immediately converting financial assets into cash when they need them, and there is no need to take credit from the central bank at high interest rates. Thus, the money market provides commercial banks with the opportunity to generate income and reduce interest costs.

3. Dynamism of RBI's Functions:

In any country, the supreme authority and responsibility regarding the banking system lie with the central bank of that country. The contribution of central banks is important in developing the economic system of the country. The reason for the effective and efficient result of the central bank is the effective and efficient administration of the money market. Therefore, the country whose money market is fully developed contributes well to economic development. In short, the achievement of the rapid and result-oriented objectives of RBI's functions depends on the money market.

4. Assistance to Government:

The government obtains its financial requirements through various instruments. But this market performs significant work in fulfilling the short-term financial needs of the government. The use of low-cost instruments like Treasury Bills is useful for the government. For example, in December 2019, 91-day

Treasury Bills of Rs. 10,000 crore, 182-day of Rs. 4,000 crore, and 364-day of Rs. 3,000 crores, totalling Rs. 17,000 crore, were used by the government.

3.4 Characteristics of Money Market :

1. **Control of RBI:** The money market works under the control of RBI. Every activity, party, and instrument of the money market is bound by the instructions of RBI.

2. **For Short-term Needs:** Business entities have two types of capital needs. Long-term capital, which is necessary to acquire fixed assets, and short-term working capital. These short-term needs are fulfilled by the money market.

3. **Maturity Period:** This market is for specific needs. Here, the maturity period is from one day to 365 days.

4. **Substitute for Money:** Financial assets used in this market are also identified as a substitute for money or equivalent to money. Because these assets can be sold immediately.

5. **Minimum Cost:** Short-term funds are used in this market. Their cost is lower than the cost of long-term sources of acquisition.

6. **Part of Financial System:** The main parts of the financial system include financial intermediaries, financial services, financial instruments, and financial markets. The money market is included as a sub-part of financial markets.

7. **Implementation of Monetary Policy:** Economic planning is done for the economic development of the country, and monetary policy is formulated as part of economic planning. After the formulation of monetary policies, its effective and efficient implementation takes place in the money market.

8. **Different Financial Instruments:** Considering the scope of the money market, information is obtained about different types of financial instruments, including Call Money, Treasury Bills, Commercial Paper, Commercial Bills, Certificates of Deposit, etc.

9. **Various Parties:** There are mainly two parties in the money market: borrower and lender. Borrowing parties include producers, traders, and the government. Lending parties include commercial banks, the central bank, etc.

10. **Types of Market:** Two types of financial markets can be made: organized market and unorganized market. Functions of the money market take place in both types of markets.

11. **Brokers:** In this type of market, both the borrower and lender come into direct contact. Therefore, there is generally no need for brokers or agents.

3.5 Characteristics of a Developed / Ideal Money Market :

1. **Development of Organized Banking System:**

   A developed organized banking structure should be in the country. Commercial banks mostly satisfy the short-term credit needs of the economy. Their credit policy affects the entire money market. The banking system is an important medium reflecting the deficit or surplus of money. The financial transactions occurring across the country eventually result in the deficit or surplus of money in banks. Therefore, the development of an organized and well-arranged banking system in the country is a prerequisite for a developed money market.

2. **Existence of Central Bank:**

   A central bank is established in every country so that the country's economy remains stable, is not affected by any kind of interference, and is not influenced by any political or personal views. India's central bank is RBI. In any country in the world, the central bank is the regulatory institution for the money market. Successful implementation of monetary policy is an important characteristic of a developed money market, and that implementation depends on the central bank. The central bank provides money at the time of a liquidity crisis in the market. Likewise, it withdraws money when credit increases. In this way, the central bank performs the task of keeping the market balanced.

3. **Adequacy of Money Market Instruments:**

   The money market is a market used for transacting money for the short term, which is possible only through its instruments. In a developed money market, sufficient instruments / credit instruments such as short-term government securities, promissory notes, bills of exchange, commercial papers, certificates of deposit, and treasury bills should be available. The absence of such instruments is an obstacle to the development of the market.

4. Existence of Sub-markets:

A developed money market is composed of various sub-markets. Various sub-markets like Treasury Bills market, Call Money market, Bills market, etc., make transactions easy and fast through short-term instruments. Also, they increase the efficiency of the money market. The London money market is considered the most developed money market in the world, which is composed of diverse sub-markets.

5. Sufficient Money Fund:

In a developed money market, the availability of instruments alone is not sufficient. But to meet the short-term demand for money, there must also be sufficient money funds. The arrangement of money should be made from within the country and from abroad. Without sufficient money funds, sub-markets of the money market also cannot be developed.

3.6 Importance of Money Market :

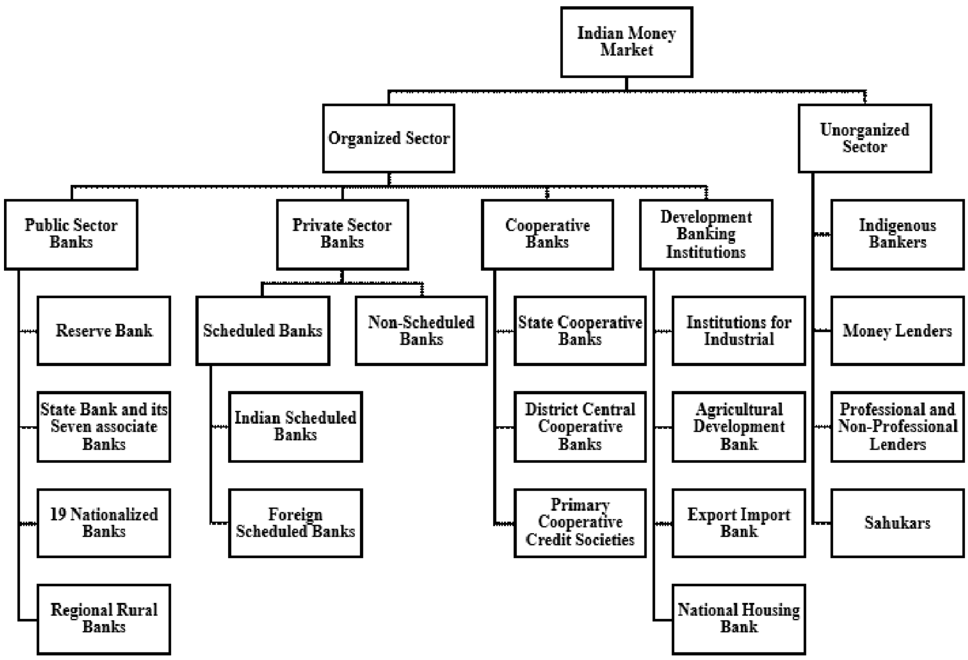
1. The money market provides an arrangement to satisfy short-term needs for both parties by establishing contact, directly or indirectly, between those seeking lending opportunities and those with lending needs.
2. The money market provides an opportunity to do business, especially to banks and other business entities, with minimum cash reserves. Because if the need to obtain more cash arises, it can be obtained from the money market. Therefore, banks do business with minimum cash reserves, meaning they can increase profitability by doing maximum lending.
3. Those having a lendable surplus get an opportunity to earn income by investing for the short term without putting their liquidity at risk. This type of investment is considered liquid. It serves as a second line of investment. For example, investment made in Treasury Bills or Bills of Exchange is considered collateral. Cash can be raised by selling, discounting, or using these instruments as security. In this way, the money market makes the functioning of the country's financial system easy.
4. The money market plays an important role in making the central bank's monetary policy effective. The Reserve Bank's monetary policy can only be effective if its decisions reach every economic unit in the economy. Without a money market, the central bank of any country cannot successfully implement monetary policy.

5. The money market helps in achieving development with stability. With its help, the central bank helps in achieving economic development by increasing the supply of money.

6. Due to the money market, the movement of money from one region to another region and from one country to another country becomes easy.

7. The money market increases the capital formation of the economy. Because the money market makes the investment of lendable surplus possible. Since the short-term investment satisfies short-term capital needs, it is natural that it increases capital formation.

3.7 Role and Structure of Money Market :



The Indian money market is not an organized, well-developed market like other money markets of the world (London and New York). Furthermore, a lack of an integrated money market is also seen. An important characteristic of the Indian money market is that its bifurcation has occurred. That is, it is divided into two parts: the organized sector and the unorganized sector.

In the organized sector, the Reserve Bank, the State Bank of India and its subsidiary banks, nationalized commercial banks, private banks, specialized financial institutions, cooperative banks, and exchange banks perform operations. The unorganized sector includes indigenous shroffs, sahukars, and non-banking companies. The RBI maintains check and control over the banks and institutions working in the organized sector. But the Reserve Bank has no control over the institutions of the unorganized sector. In our country's money market, short-term instruments are not available in sufficient quantity. Different sectors in the Indian money market exhibit varying interest rates. Generally, interest rates of the unorganized sector are much higher than the organized sector. Moreover, as interest rates are determined according to the local situation of demand and supply, inequality is also seen in the money markets of Mumbai, Kolkata, and Chennai.

The Indian money market integrates the structure of sub-markets. There is a free exchange of money between submarkets. The unorganized sector of the money market is composed of indigenous bankers, indigenous shroffs, sahukars, and those doing the business of lending in rural areas. There is no legal association among those doing business in lending in this sector. This sector does not have any permanent contact with the organized sector. Uniformity is also not seen in the working method of each. Each has a different working method. Each lending institution sets its interest rates, which are often very high. Because the Reserve Bank controls it, no audit is performed. And they never report their operations to the Reserve Bank or the government. Whenever the Reserve Bank imposes strict controls, this sector becomes more active. Sub-markets do not exist in the unorganized sector.

The use of credit instruments is relatively very low. Yet, the fact is that this sector provides lending on a large scale to various economic activities in many areas in the Indian economy. However, with the development of the organized sector, the importance of the unorganized sector is decreasing. By opening more branches of nationalized banks, commercial banks, and cooperative banks in rural areas, the functional area of the organized market is increasing.

3.8 Instruments / Components of Money Market :

1. Call Money:

Call money is an instrument providing credit for a short duration ranging from 1 day to 15 days. Since the lender can get the money back at a very short notice through this instrument, this sub-market of the money market is also known as "Money at Call and Short Notice". The interest rate is determined on the basis of demand and supply. Lending institutions in this sub-market include exchange banks, commercial banks, UTI, LIC, GIC, DFHI, IDBI, NABARD, etc. Out of these, LIC, UTI, IDBI, and NABARD can lend but cannot obtain credit. In India, the development of this sub-market is more in Mumbai, Kolkata, Chennai, and Delhi.

2. **Treasury Bill:**

The Treasury Bills are the instrument used to satisfy the short-term money requirement of the central government. Treasury Bills are issued by RBI on behalf of the government. Treasury Bills are purely financial bills. Their duration is of 91 days, 182 days, or 364 days. Parties in this sub-market of the money market include RBI, SBI, Commercial Banks, State Governments, DFHI, STCI, as well as financial institutions like LIC, GIC, NABARD, UTI, IDBI, ICICI and IFCI. Furthermore, companies and the general public are also included in it. Due to low interest rates, investors are less enthusiastic in this sub-market because of low returns on investment.

3. **Certificate of Deposit (CD):**

The beginning of Certificates of Deposit in India was made in 1989, which are issued by scheduled commercial banks. The minimum value of a CD is fixed at Rs. 1 lakh. Additional deposits can be issued in multiples of Rs. 1 lakh. CD is a negotiable instrument whose operation happens on the basis of guidelines issued by RBI. The duration of CDs issued by banks is fixed from 7 days up to 364 days, and for financial institutions from 1 year to 3 years.

4. **Commercial Paper (CP):**

The commercial papers were introduced in the Indian financial market in 1990. Companies can issue commercial papers in the form of promissory notes with a duration of 7 days to 1 year after obtaining prior permission from RBI to satisfy their short-term requirements. CPs can be issued only by recognized companies that follow pre-determined rules. The tangible net worth of the company should be at least Rs. 4 crore, and fund-based working capital should be Rs. 10 crore. The minimum value limit for issuing CPs should be Rs. 25 lakh and thereafter in multiples of 25.

5. **Commercial Bills:**

The commercial bill market is an important sub-market of the money market. One can get immediate money by discounting bills in banks arising from actual transactions of purchase and sale of goods. These commercial bills are a document ordering a specific person to pay a specific amount at a specific time according to his order. If the seller of goods does not have a requirement for money, he can wait until the maturity period and recover money by presenting it for acceptance. But if the seller of goods has an immediate need for money, he can get money by discounting it in banks or other recognized financial institutions.

6. **Inter-Bank Participation Certificate:**

A Participation Certificate is a certificate through which, if any bank has provided large credit and needs money, it can raise money by issuing this certificate. Since the buyers of such certificates are also commercial banks and the issuers are also commercial banks, this instrument is known as an Inter-Bank Participation Certificate. This certificate is issued for a time limit of 30 days to 180 days.

7. **Repos (Repurchase Agreements):**

Repurchase agreements are an instrument for the short term, i.e., of a duration of 1 day to 14 days. Banks can transact money among themselves with the help of repos. The Reserve Bank of India manages liquidity in the money market with the help of repos. When a shortage of liquidity arises, it purchases repos by auction. If liquidity has increased in the economy, it tries to pull it back on a temporary basis by using a reverse repo. The repo rate and reverse repo rate announced by the Reserve Bank are the minimum rates of interest.

8. **Money Market Mutual Funds (MMMFs):**

Individual savings are in the form of money. Therefore, to use these savings in the money market, this instrument was introduced in the Indian money market in 1991. These types of mutual funds mobilize the savings of money savers and invest them in short-term instruments. Due to this arrangement, small investors get appropriate opportunities regarding the investment of savings, and because of that, the liquidity of the money market increases.

3.9 Reforms in Money Market :

To make recommendations for the development of India's money market, the Government of India appointed the Chakravarty Committee (1985) and Vaghul Committee (1987). Based on the recommendations given by these two committees, in 1990, RBI also made reforms in the Bill Market scheme which came into effect in 1952. In that, a provision was made that the bill must represent the sale or dispatch of goods. So in that sense, bills must be genuine. Secondly, an arrangement was made so that the rediscounting of bills could take place in institutions.

Exercise:

Q.1 Answer the following questions in detail.:

1. What is Money Market? Discuss its characteristics and functions in detail.
2. What is called a Developed Money Market?
3. Explain the importance of Money Market.
4. Explain the meaning of Money Market and explain its components.
5. Show the importance of Money Market.
6. Draw and explain the structure of the Indian Money Market.

Q.2 Answer the following questions in short.

1. Give names of different instruments of the money market.
2. Which banks' contribution is significant in the money market?
3. By which institution is control maintained over the money market?
4. What can be the duration of Treasury Bills?
5. What is Commercial Paper?
6. Give the definition of Money Market.
7. What is the minimum and maximum maturity period for lenders and borrowers in the money market?
8. Explain MMMFs as an instrument.
9. "Existence of sub-markets is a characteristic of a developed money market." Explain.

Q.3 Multiple Choice Questions (MCQS)

1. Money market is:
   - (a) Organized short-term money market
   - (b) Unorganized long-term market
   - (c) Organized long-term market
   - (d) None of the above

2. Money market is associated with which of the following?

   (a) Monetary Policy (b) Short-term funds

   (c) Reserve Bank of India (d) All of the above

3. Which of the following is a money market instrument?

   (a) Debenture (b) Preference share

   (c) Call money (d) Equity share

4. From which year did the implementation of Commercial Paper start in India?

   (a) 1988 (b) 1989 (c) 1987 (d) 1990

5. Which of the following instruments is like a Promissory Note?

   (a) Treasury Bills (b) Certificate of Deposit

   (c) Commercial Bill (d) Commercial Paper

6. Which of the following institutions can lend and obtain in the Call Money market?

   (a) Commercial Banks (b) UTI

   (c) LIC (d) NABARD

7. Treasury Bills are:

   (a) Issued by Government on behalf of RBI

   (b) Issued by RBI on behalf of Government

   (c) Issued by RBI on behalf of Commercial Bank

   (d) None of the above

8. What is the minimum value of a Certificate of Deposit?

   (a) 1 crore (b) 10 thousand (c) 10 (d) 1 lakh

9. "Money market means various institutions and firms dealing in short-term credit." Who gave this definition?

   (a) Mr. Crowther (b) RBI

   (c) Mr. Madan (d) Mr. Nadler

10. Money market is:

    (a) Completely one market

    (b) A market composed of various sub-markets

    (c) Both of the above

    (d) None of the above

Answers:

1. (a)	2. (d)	3. (c)	4. (d)	5. (d)
6. (a)	7. (b)	8. (d)	9. (a)	10. (b)

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Unit - 4
Money Market Instruments

4.1 Introduction:

The two integral parts of the Indian financial system are the Capital Market and the Money Market. To fulfill the country's long-term planning and accelerate economic development, the growth of trade and industry is essential, which is determined by the fulfillment of their financial needs. These financial needs are of two types: long-term and short-term. The capital market fulfills the long-term needs of trade and industry, while the money market meets their short-term requirements.

The money market is a market for short-term credit whose duration ranges from 1 day, 1 week, and 1 month to 1 year. Here, various instruments cater to the financial needs of trade and industry at different times. Since the financial assets used in this market are converted into money in the short term, they are known as a Substitute for Money or Near Money. These types of instruments possess more liquidity than capital market instruments. The financial market uses the following instruments or securities, as we observed in the previous unit. We will now discuss financial instruments in detail here.

4.2 Definition of Money Market :

- **According to the Reserve Bank of India:**

  "Money market is a place where primarily short-term capital needs are satisfied and lenders get income on their short-term funds. Where individuals, financial institutions gather for this task and sometimes the government is also involved."

➢ **According to Crowther:**

"Money market is the name of a group of different firms and institutions that exchange instruments as a substitute for various types of money."

4.3 Characteristics of Money Market :

The money market is a group of many institutions and individuals possessing the following characteristics:

1. **It is a group:** The money market is a group of different parties, including individuals, traders, industries, banks (commercial and cooperative banks), financial institutions, central banks, etc. In this scenario, one party is the creditor and the other is the lender.

2. **For short-term financial needs:** The main characteristic of the money market is to fulfill the short-term capital needs of trade and industry. This type of capital requirement mainly exists as working capital in business. The money market fulfills trade and industry's needs through various financial instruments.

3. **Maturity period:** Trade and industry utilize the financial instruments of this market to fulfill short-term requirements. The maturity time limit of these instruments ranges from 1 day up to 365 days.

4. **Substitute for money:** Businesses use the instruments of this market to meet their extremely short-term working capital needs. For example, the durations can be 1 day, 30 days, or 90 days. Within this time limit, payment of these instruments is to be returned, which gives them liquidity. As these instruments are quickly converted into cash, they are considered a substitute for money or near money.

5. **Part of financial system:** The financial system of the economy is a structure of two types of markets (capital market and money market). Which remains functional through its sub-markets. The financial market itself is a sub-part of a large structure within which the objective is to fulfill the needs of trade and industry through the use of various instruments at various levels.

4.4 Instruments of Money Market :

RBI is the supreme authority of the money market, which monitors, regulates, and guides the instruments, intermediaries, and working methods of the market.

The money market functions through various intermediaries like LIC, UTI, GIC, DFHI and Banks which fulfill the short-term needs of industry and trade by using the following instruments:

4.4.1 Call / Notice Money Market:

According to the RBI Circular dated 01/07/2008, Call / Notice money functions mean:

"Call Money means deals in Overnight funds."

"Notice Money means deals in funds for 12-14 days."

That is, an instrument used to provide credit for a very short duration of 1 day to 15 days. Since the lender can get the money back in a very short duration through this instrument, this market is also known as "Money at Call and Short Notice". This instrument is most widely used in the money market.

Parties participating in this market mainly include commercial banks, exchange banks, the Unit Trust of India, LIC, the Discount and Finance House of India, etc. Among these, banks are at the forefront in providing and taking this type of credit. Institutions that have short-term lendable funds invest in money at call and short notice so they get a double benefit. First, they earn interest income through the investment of surplus money, and second, since the investment is highly liquid, it serves the purpose of cash.

Apart from commercial and cooperative banks, institutions like LIC, UTI, and DFHI also possess vast funds, which provide them an opportunity to invest in such instruments. Borrowers in the call money market also include commercial banks, stock market brokers, etc. Institutions like UTI, LIC, and GIC can only function as lenders and cannot act as borrowers. Here, banks have a double role as borrowers and lenders because they must maintain a Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR) in the situation of money payment (clearing). Therefore, this market is also called the inter-bank transaction market. After the establishment of DFHI, its role in the call money market is increasing progressively.

Objectives: Money is borrowed through call money by banks for two reasons:

1) To fulfill short-term (temporary) financial payment / needs.
2) To fulfill RBI policies (CRR / SLR) applicable to banks.

Characteristics:

1. **Duration of credit:** The credit duration for these types of instruments is generally from 1 day up to a fortnight (15 days), which is an extremely short period.
2. **Inter-bank structure:** Maximum use of this type of instrument is done by banks to fulfill their short-term financial needs or for maintaining RBI rules; hence it is known as the inter-bank call money market.
3. **Two parties:** Two main parties are seen in this market - Lenders (UTI, LIC, GIC) and Lenders & Borrowers (Banks, stockbrokers, institutions).
4. **RBI Control:** Since the main objective here is the fulfillment of banks' financial needs, RBI removed the intermediary system from the year 1978.
5. **Interest rate:** Initially, interest rates for these instruments were determined by the Indian Bankers' Association. But after accepting the recommendations of the Vaghul Committee, interest rates began to be determined based on demand and supply, keeping in mind the seasonal demand for money.

Participants: Apart from commercial and cooperative banks, financial institutions like LIC and UTI were also allowed entry into this market after 1970. Lenders such as IDBI, NABARD, and GIC also joined this list after the 1990 liberalization. Thus, two types of parties are included in the call money market:

- Lenders: LIC, UTI, GIC, NABARD, IDBI, etc.
- Lenders and Borrowers: Commercial banks, cooperative banks, DFHI, etc.

Large-scale changes are noted in the interest rates in the call money market, due to which it is also called a "Volatile Market". RBI is the market regulator and ensures that abnormal situations do not arise in the market. To perform this function, it takes help from two institutions - STCI (The Securities Trading Corporation of India) and DFHI (The Discount and Finance House of India).

Advantages:

1. **Maximum liquidity:** This type of market provides banks and financial institutions the facility of credit and payment at any time, acting as a substitute for cash. Being a highly liquid instrument, it is very popular.

2. **High profitability:** The banks and financial institutions have very large financial funds, which they invest in such instruments for the short term at high rates to get high profitability.
3. **Fulfillment of CRR and SLR:** Every bank has to follow the policies of its regulator, RBI, where fulfillment of CRR and SLR is primary. They fulfill these rules through the use of these instruments.
4. **Safe credit:** Entry of brokers is prohibited by RBI in this type of market, and RBI itself functions as a regulator, providing credibility to call money market operations. Credit in this market is extremely short-term and liquid, becoming highly secure with RBI intervention.
5. **RBI Supervision:** The operations of this market depend on demand and supply according to the rules of economics, and since RBI has control over both factors, the functioning of the call money market remains entirely subject to the central bank.

4.4.2 Treasury Bill Market (T-Bill Market):

Call money is an instrument to fulfill the extremely short-term (1 to 15 days) needs of banks. Similarly, the short-term financial needs of the central government are fulfilled through Treasury Bills. The maximum time limit for this instrument is 364 days.

There are mainly two types of bills in the money market:

- Commercial Bill (C-Bill)
- Finance Bill

A. Commercial Bill: These are bills arising from actual transactions of purchase and sale of goods, also known as Bills of Exchange.

B. Finance Bill: These are bills that do not arise from actual purchase-sale transactions of goods but are created to fulfill financial needs, also called Treasury Bills. This is a type of government promissory note that the government issues to fulfill its financial deficit. On behalf of the government, this function is performed by the central bank (RBI).

Characteristics:

i. Financial Bill: This type of bill does not arise from trade transactions but from financial needs; hence it is called a financial bill.

ii. **Time limit:** The time limit for instruments bought and sold in this market is from 1 day to 364 days.

iii. **RBI Intermediation:** These instruments are not directly bought or sold in the market by the government, but the central bank (RBI) performs this function on behalf of the government.

iv. **High liquidity:** With the support of the government and the central bank, these credits become very safe and liquid because the central bank manages the buying and selling process.

v. **Fixed return:** Investors are assured of a fixed return in these instruments.

vi. **Bill of exchange:** Being government instruments, they are called bills of exchange in commercial language, receiving endorsement and acceptance from the government.

Types based on Objectives:

- **General / Regular Bills:** When bills are issued to fulfill the short-term needs of the government, they are called general bills. The general public and financial institutions can invest in these through auction. Since a secondary market is available and resale is possible, they are also called marketable securities.

- **Special Purpose Bills:** These are special bills issued in favor of RBI, so they are not auctioned in the open market. Instead, the central bank issues currency notes against them. Resale of these bills is not possible due to the absence of a secondary market.

Types based on Time:

- **91-Day Bills:** Issued by the central bank for the central governments short-term needs. Until 1965, they were issued by the central bank through tender or weekly auction. After 1965, they are issued on a TAPE basis during the week, meaning the sale price is announced from time to time. Until 1970, the market for 91-day bills was limited. Due to the lack of a discounting house, one had to keep the investment until full maturity. But after the establishment of DFHI, this situation has progressively improved.

- **182-Day Bills:** Introduced in the market from November 1968 on the recommendation of the Chakravarty Committee. Their minimum value was 1 lakh and in its multiples. Initially issued on a monthly auction basis, the power to buy and sell these bills is now given to DFHI.

- **364-Day Bills:** Issued with the help of RBI to meet the government's financial deficit. Large financial institutions like LIC, GIC, and UTI, who have funds for about a year, can invest in these instruments.

Parties:

RBI, commercial banks, LIC, GIC, NABARD, and DFHI are active in this market. Institutions like commercial banks and DFHI open a general account with the central bank called SGL (Subsidiary General Ledger). Every transaction of Treasury Bills is automatically recorded in this ledger. Investors without this SGL facility can buy and sell bills through DFHI.

Advantages:

1. **Completely safe investment:** Being backed by the government and functioning under central bank supervision, it is considered extremely safe.
2. **High liquidity:** The maturity period is as short as 364 days, and since they are traded in the secondary market, they possess high liquidity, attracting investors.
3. **Ideal short-term investment option:** Large commercial banks and institutions can earn good returns by efficiently investing their non-productive financial funds in these bills.
4. **Fulfillment of legal rules:** Commercial banks can fulfill RBI rules like SLR and CRR using these instruments, increasing their stability.
5. **Government deficit fulfillment:** The government periodically needs large funds for its plans, and the deficit is covered by having the central bank issue these short-term instruments.

4.4.3 Commercial Bill Market (C-Bill Market):

Another important sub-market of the money market is the commercial bill market. This market arises from actual purchase-sale transactions of goods; in Indian languages, it is called "Bill of exchange."

A creditor-debtor relationship is born due to purchase-sale in the market. Since it is not possible to conduct every transaction in cash, this is a letter/

document guaranteeing that payment will be made in the future (credit transactions). It is also known as a trade bill of exchange.

According to the Indian Negotiable Instruments Act 1881: "A bill of exchange is a written document 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."

Characteristics:

1. It is a type of bill of exchange where one person writes to another, and the other person accepts it.
2. It is a document containing an order to pay a fixed amount to a certain person (bearer) by a certain person.
3. This document is negotiable, meaning it can be transferred in favor of another person.
4. The origin of this document is due to the purchase and sale of goods.
5. If the seller of goods (acceptor of the document) needs money, they can get immediate funds by discounting it in a bank.

In 1970, based on the Narasimham Committee recommendation, RBI made a provision for rediscounting bills known as BRS (Bills Rediscounting Scheme). In this, an arrangement for rediscounting Bill of exchanges was made with banks and financial institutions.

Types of Bills of Exchange:

A. Demand Bills and Time Bills: In demand bills, payment must be made immediately when the maker presents it to the acceptor; no time is mentioned, and maturity depends on the maker's wish. In time bills, the maturity time is fixed, and it must be paid when the time is completed.

B. Trade Bills and Financial Bills: Bills written due to credit sale transactions in business are trade bills. A seller can fulfill short-term needs by discounting these in a commercial bank. Financial bills are also called accommodation bills; no actual trade occurs here, but parties write and accept bills for each other's financial needs and fulfill them by discounting in a bank.

C. Inland Bills and Foreign Bills: Bills written within the country's boundaries and paid within the country are inland bills. Foreign bills, which arise from import-export trade, are written abroad and can be paid in any country, including India.

Advantages: These instruments serve as a substitute for cash or are useful as borrowing tools to satisfy short-term business needs.

1. **Central bank control:** Discounting facilities exist in the financial market where commercial banks perform this task, and rates are fixed by RBI, maintaining its control.
2. **Immediate return:** An acceptor can discount the bill of exchange early with commercial banks, providing immediate liquidity.
3. **Self-liquidating:** Creation and dissolution dates are mentioned beforehand; it dissolves automatically on the maturity date when the payer pays the holder.
4. **Negotiable instrument:** Ownership can be transferred more than once.
5. **Bank assurance:** Discounting by banks under RBI control makes it a very safe and popular investment in trade and industry.

4.4.4 Commercial Paper Market:

RBI accepted recommendations from various committees to enhance the financial system's dynamism and ensure the success of the liberalization policy. One such recommendation by the Vaghul Committee (1987) was accepted in March 1989 and implemented from January 1, 1990. This allowed companies to raise money by issuing Commercial Paper (CP). Companies with special credit create these to meet short-term (3 to 6 months) working capital requirements.

Initially, companies with a net worth over Rs. 5 crore could issue these in multiples of Rs. 25 lakh for at least Rs. 4 crore. They needed a current ratio of 1.33:1 and a company rating. Since 1996, primary dealers were also allowed to issue these.

New RBI Guidelines (July 2000):

- National-level financial institutions were allowed to issue CPs.
- The amount for investors was reduced from Rs. 4 crore to Rs. 25 lakh, in multiples of Rs. 5 lakh.
- The time limit was changed from 7 days to 1 year.
- 100% of working capital could be raised through CPs.

- The requirement for the current ratio was abolished.
- The company must be registered in one or more stock exchanges.
- FEMA-related companies issuing CPs must take permission.
- CPs are given directly to investors by companies or through banks/ merchant banks.

Advantages:

1. **Pre-determined standards:** Issued according to RBI standards, increasing stability and credibility.
2. **Working capital fulfillment:** Companies fulfill their short-term working capital needs through this important instrument.
3. **Free investment opportunity:** Individuals, financial institutions, banks, and companies can invest and earn income.
4. **Primary dealer permission:** Primary dealers are allowed entry to increase the scope of investors.

4.4.5 Certificate of Deposit (CD):

Financial system success is related to the number and size of instruments. A Certificate of Deposit is a receipt of funds deposited in a bank that can be easily sold in the money market. It is an investment with a fixed time and duration, started in 1989. Two types of deposits are accepted by banks:

1. Fixed Deposit: This type of deposit is not a negotiable instrument. Therefore, it cannot be transferred in favor of another person.
2. Certificate of Deposit (CD): This is a negotiable instrument. Through this instrument, commercial banks obtain funds for a fixed period. It cannot be converted into cash before maturity; however, if an investor needs cash, they can generate it through endorsement or by direct delivery.

Features:

- Banks and financial institutions receive funds in the form of deposits for a fixed short-term period.
- These deposits are not paid by banks before the date of maturity.
- This is a negotiable instrument that can be transferred from one person to another.

- The duration of this type of instrument is 3 months to 1 year.
- These instruments (deposits) are permitted to be issued after certain regulatory norms are met.

Norms/Guidelines:

- **Negotiable Instrument:** Certificate of Deposit is a negotiable instrument of the money market. It is issued against an amount deposited in a bank or financial institution for a specific period in dematerialized form or as a promissory note.
- **Permission to Issue CD:** According to RBI regulations, registered commercial banks (excluding Regional Rural Banks and Local Area Banks) and Indian financial institutions permitted by the RBI can issue CDs.
- **Limit of Amount:** Commercial banks can issue Certificates of Deposit according to their financial requirements and the amounts fixed by financial institutions.
- **Minimum Amount:** The minimum size of a CD is fixed at ₹1 lakh. This means an amount less than ₹1 lakh will not be accepted from individual investors, and additional amounts will also be in multiples of ₹1 lakh.
- **Investors:** Individual investors, corporations, companies, trustees, etc., can be investors who can invest in CDs issued by banks.
- **Maturity Period:** The maturity period of a Certificate of Deposit can range from a minimum of 7 days to a maximum of 1 year, and these securities can be in dematerialized form.
- **Provision of CRR and SLR:** Banks have to maintain CRR (Cash Reserve Ratio) and SLR (Statutory Liquidity Ratio) reserve provisions in proportion to the issued price of the CD.
- **Buyback and Loan Provision:** Loans cannot be granted against CDs by banks and financial institutions. Similarly, this type of security cannot be bought back before the maturity date. However, RBI can provide relaxation in this through a special circular.

4.4.6 Collateralised Borrowing and Lending Obligation (CBLO)

The success of short-term sources of funds depends on two factors: the liquidity and safety of the instruments. Considering both these factors, a new instrument was developed which became popular as CBLO. The credit for the development of this instrument goes to an organization named **CCIL (The Clearing Corporation of India Ltd.).**

Definition: CBLO is an instrument that is based on collateralized securities for borrowing and lending and is secured.

Features:

- It is a financial instrument approved by the Central Bank (RBI).
- It is a financial instrument in which government investments are provided as collateral security.
- The borrower of funds is responsible for returning the borrowed money along with interest on a fixed future date.
- The lender of funds gains the right to receive the lent money back along with interest on a fixed future date.

Objective:

The development of this instrument was intended for parties who are excluded from using the Call/Notice Money market or who have restrictions regarding the use of Call/Notice Money.

Membership:

Parties who have authorization for REPO can hold CBLO membership according to RBI approval. These members include nationalized banks, private banks, foreign banks, financial institutions, insurance companies, NBFCs, pension funds, etc.

Approved Collateral Securities:

Securities of the Central Government, including Treasury Bills, which are approved by CCIL from time to time, are included here as collateral securities.

Operations:

All CBLO transactions are operated by Clearcorp Dealing Systems (India) Limited, a subsidiary of CCIL.

CBLO has been developed by CCIL since December 20, 2002, after RBI approval according to the following norms:

- **Financial Instrument:** This is a money market instrument on which no restrictions are placed regarding the secondary market and minimum amount.
- **Time Limit of Instrument:** The duration of this instrument ranges from 1 day to 1 year.

Rules for Issuance and Trading:

- CBLOs are to be issued only in electronic book form.
- The trading rate of CBLO is determined by market participants.
- Its trading can be done without any investment time lag.
- CCIL remains active for the trading operations of these instruments and for the maximum satisfaction of the parties.
- Borrowing Limit: The borrowing limit will be determined at the beginning of the day based on the securities deposited by the borrower in the CCIL's CSGL (Constituent Subsidiary General Ledger) account. The borrowing amount is determined after subtracting a fixed amount (fixed percentage/haircut) from the value of the deposited securities. The borrower can withdraw within this determined limit.
- Risk: Since this type of security is entirely based on collateral security, the risk involved is the same as the risk associated with government securities.

4.5 Money Market Intermediaries :

There are two integral parts of the financial market - the money market and the capital market. The effective functioning of both these markets depends on the functioning of their sub-divisions. The money market operates through its vast instruments such as Treasury Bills, Commercial Papers, and Commercial Bills. To reach these instruments to their investors, various intermediaries are required, who are known as money market intermediaries.

Intermediaries are individuals, institutions, or groups that act as mediators between two or more parties regarding financial operations. These intermediaries are banking and non-banking institutions that provide opportunities for savers/ investors to invest in various instruments. Some such important intermediaries are as follows:

A. The Discount and Finance House of India (DFHI)

B. Money Market Mutual Fund (MMMF)

C. Intermediary (Reserve Bank of India)

A. The Discount and Finance House of India (DFHI)

This institution was established by the Reserve Bank of India in 1988 to boost money market activities. This institution started its operations on July 28, 1988. The existence of this institution is credited to the joint cooperation of the Reserve Bank of India, public sector banks, and Indian financial institutions.

This institution was started with a huge capital of ₹200 crore. In this, the proportion of the above three institutions is 5: 3: 2. To encourage the operations of this institution, all banks under the RBI have been included in the refinancing process.

Functions:

- To serve as a specialized intermediary of the money market.
- To provide liquidity to money market instruments by refinancing them.
- To work on the expansion of the secondary market for the expansion of money market instruments.
- To work on mobilizing the funds of commercial banks, financial institutions, and companies toward the money market.
- To act as a lender and borrower of Call Money and as a buyer and seller of Treasury Bills (91 days, 182 days, 365 days).

B. Money Market Mutual Fund (MMMF)

In the financial system, the conversion of capital into investment is an important task. This capital exists in the economy as small savings held by individual investors. It is necessary to collect these together and give them the form of an investment. For this purpose, mutual funds become an effective tool. This type of mutual fund converts savings into investments and invests them in short-term instruments. In the year 1991, a committee was formed for the implementation of the MMMF system. It submitted a scheme regarding the matter to the RBI, and based on that, this scheme was announced in 1992. Through this, short-term money market instruments were included in the portfolio of MMMF.

C. Intermediary (Reserve Bank of India)

The central bank of the country is known as the Reserve Bank of India (RBI). It was established on April 1, 1935, with a capital of ?5 crore. Its share capital is divided into shares of ?100 each.

RBI was nationalized in 1949, and from then on, the responsibility of its management was entrusted to the Bank's BOD (Board of Directors).

Operations:

- As Banker to the Government: RBI serves as the banker to the Central and State governments, performing functions as the government's banker, agent, and advisor from time to time.
- Management of Government Securities: Various financial institutions and commercial banks invest their funds in government securities to fulfill legal provisions. RBI manages these securities on behalf of the government.
- As Banker to Other Bankers: RBI performs the following tasks as a banker to other banks:
  - Cash reserves of banks are maintained.
  - Help regarding short-term credit is provided to banks by the RBI.
  - It provides a system for the rapid transfer of money in the economy.
- As Regulator of Money Supply and Credit: On behalf of the government, RBI acts as a controller over cash and credit in the economy. In this context, it assists the Central Government in maintaining control over the economy by determining interest rates and the supply of cash.
- As Manager and Regulator of Foreign Exchange: It represents India before the International Monetary Fund (IMF). Restrictions are placed on the inflow and outflow of foreign exchange, the management of which is done by the RBI.

Thus, the Reserve Bank of India, besides being the bank of banks, is an integral part of the financial market. It provides a significant contribution by performing the tasks of development and expansion of various financial market instruments.

Exercise :

Q.1 Select the correct option from the given choices and answer.

1. Money market is:

   (a) Organized short-term market

   (b) Unorganized market

   (c) Organized and unorganized market

   (d) Short-term organized and unorganized market

2. The operation of the money market is associated with which of the following?

   (a) Monetary Policy (b) RBI Policy

   (c) Short-term funds (d) All of the above

3. Treasury Bills are:

   (a) Issued by the Central Government on behalf of the RBI.

   (b) Issued by the RBI on behalf of commercial banks.

   (c) Issued by the RBI on behalf of the Central Government.

   (d) None of the above

4. Which of these is a negotiable instrument?

   (a) Commercial Paper (b) Commercial Bill

   (c) Treasury Bills (d) All of the above

5. In which year was Commercial Paper implemented?

   (a) 1987 (b) 1988 (c) 1989 (d) 1990

6. The institution that gave birth to and developed CBLO is:

   (a) CCIL (b) CCLI

   (c) CCEL (d) None of the above

Answers: 1. (a) 2. (c) 3. (c) 4. (d) 5. (d) 6. (a)

Q.2 Answer the following questions in brief:

1. Give names of different instruments of the money market.
2. State the reasons for the development of CBLO.
3. What was the main objective of MMMF?
4. What are the 3 main functions of the RBI?
5. What is CCIL?

Q.3 Answer the following questions in detail:

1. Discuss the meaning, features, and functions of the money market in detail.
2. Discuss the meaning, features, and advantages of Call Money.
3. Write a detailed note on Commercial Paper.
4. Discuss Commercial Bills and their types.
5. Provide an explanation about CBLO.

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BBA SEMESTER-5

Financial Markets & Instruments

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Unit - 5
Capital Market

5.1 Introduction :

The capital market is broader than the securities market and includes all financial instruments for lending and borrowing money, whether they have a discount note (negotiable instrument) or not. The capital market is the market that provides long-term funds for borrowing by business units and for lending. A market that makes financial investments claiming capital directly or indirectly is a capital market.

Institutions and the system jointly compose the capital market, providing medium-term and long-term funds to business units, the government, and individuals. The capital market shows all facilities and institutional arrangements for borrowing and lending medium and long-term funds. The capital market also has a process for transferring securities. It is composed of those who demand funding and those who provide it. The capital market is a primary place for obtaining money externally.

5.2 Meaning and Characteristics of Capital Market :

Meaning:

A capital market is a place where people and organizations buy and sell financial instruments for a long period of time. It helps businesses and governments raise money by offering shares or bonds to the public. At the same time, it provides investors an opportunity to invest their savings and earn returns over time. In simple terms, it connects those who need funds with those who have extra money to invest.

It plays an important role in the growth of an economy because it supports long-term investments like building infrastructure, expanding industries, and creating employment. By providing a platform for raising and investing funds, it helps in the smooth flow of money within the financial system.

Definition:

"Capital market is a market for long-term funds where financial instruments such as shares, debentures, and bonds are traded between investors and borrowers."

Characteristics:

1. **Source of Long-term Funds:**

   The capital market provides money to satisfy the long and medium-term needs of business. In this market, all financial instruments possess long-term maturity and most of the instruments are given as part of capital. This market provides money for the development of business and expansion plans, which are for a long time. Generally, the time of securities issued in this market is long, therefore, investors who want to invest for a long term invest in this market.

2. **Participants:**

   There are many participants in this capital market. It includes intermediaries such as insurance companies, investment companies, pension funds, non-financial business units, individuals, and the government. To make the market more efficient, it is always beneficial and desirable to have a larger number of participants. Having a large number of participants indicates that no group of individuals has dominance over the price.

3. **Size of Investment:**

   In the capital market, small and medium investors contribute to the funds. Therefore, the application value of securities is kept low so that more and more investors can apply. This matter becomes helpful in broadening the scope of the capital market. Because of it, there is an increase in the number of participants, which is necessary for an effective market. In this context, 'SEBI' has also introduced guidelines regarding share allotment on a proportional basis to retail individual investors.

4. **Sub-markets:**

The capital market has two sub-divisions. One is the market for government securities and the second is the market for industrial securities. In the government securities market, transactions of securities issued by the government take place, and in the industrial securities market, transactions of shares or debentures and bonds issued by industries take place. The government securities market is called the primary market. In the primary market, trading of newly issued securities takes place, and the industrial securities market is called the secondary market. In the secondary market, transactions involving previously issued securities take place.

5. **Instruments of Capital Market:**

In the capital market, transactions of various instruments such as shares, debentures, bonds, and depositories take place. Generally, these instruments are for a long time period. Apart from this, it also includes various government securities. The choice of which instrument to use to raise funds depends on various factors such as the risk associated with the project, the attitude of managers regarding ownership structure, the effect of taxes in context of the security, etc.

6. **Regulator:**

In India, the regulation of the capital market is done by 'SEBI'. SEBI frames various policies and rules in context of the capital market. For the safety of investors, SEBI provides guidelines regarding which requirements those working in the market will have to satisfy. Management of securities is done according to the provisions of the Companies Act of 1956, Foreign Exchange Act, and other applicable laws. It is necessary for the issuer of securities to follow every provision applicable for the eligibility of issuing securities.

7. **Broker:**

Brokers play an important role in the development and effective working of the capital market. The broker becomes helpful in completing transactions easily. Brokers take brokerage for their services. For them, it is a means of generating income. Brokers also have to work according to SEBI's guidelines. SEBI maintains control over brokers. Brokers must register to provide their services legally.

In our country, the capital market has developed well. It works under the guidelines of SEBI. Trading of various securities such as shares, debentures, bonds, and depositories takes place in this market.

5.3 Functions of Capital Market :

1. Function of Allocation:

The capital market provides a platform to take the savings of innumerable investors towards various productive investments. This is one important function of the capital market. It distributes funds through a system of incentives and penalties. Distribution of funds pushes industrial growth forward, which ultimately results in the economic growth and development of the country.

2. Function as an Indicator:

The capital market does not just perform the function of an indicator showing the development of the economy, but presents an idea of the condition of total wealth through the increase and decrease of security prices. Change in price mostly depends on the performance of the respective company and the entire industry. The effect of the company's results ultimately falls on the price of the company's security.

3. Function of Liquidity:

The capital market provides a platform to the buyer and seller of securities at an agreed price through mutual understanding. Because of this, the security which is traded becomes liquid. Liquidity is the most important characteristic of a security and it makes the security attractive. This characteristic encourages investors more to invest in securities, which broadens the scope of the market and becomes helpful in developing the capital market.

4. Function of Saving and Investment:

In the capital market, long-term investments are quickly converted into liquid funds. Through that, confidence is created among investors and it makes savings and investments fast. It attracts investors holding unregistered savings to invest in the securities of companies.

5. Function of Transfer:

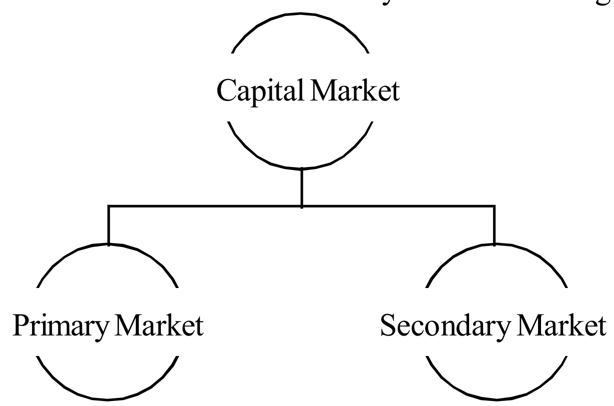
The capital market helps in the transfer (change of ownership) of transferable assets, tangible and intangible assets, and individual wealth to an individual or group. Investors can easily transfer their securities with the help of market intermediaries.

6. Function of Mergers:

The capital market encourages managers to buy out companies or perform mergers to put inefficient companies into the hands of capable companies. Because of that, the efficiency of the company improves. The capital market provides a platform to various companies so that their stake in target companies increases.

5.4 Structure of Indian Capital Market :

The capital market works through two major parts, namely the Primary Market and the Secondary Market. Both are closely connected and together they ensure that funds are raised as well as smoothly circulated among investors.



1. Primary Market (New Issue Market)

The primary market serves as the initial stage for the creation and public offering of securities. Whenever a company plans to expand its business, launch a new project, or meet long-term financial needs, it raises money through this market. Governments also use this market to borrow funds for development activities like infrastructure, public services, and welfare schemes.

In this market, investors purchase securities directly from the issuer. This means the money paid by investors goes straight to the company or government. Because of these factors, the primary market plays a key role in capital formation, which supports economic growth and development.

The primary market employs various methods to raise funds. A company may invite the general public to invest through a public issue, offer shares to existing shareholders through a rights issue, or sell securities to a selected group of investors through private placement. Typically, the market determines the price of securities in advance or through a book-building process based on demand.

Investment decisions in the primary market are often based on trust and available information. Investors study company reports, financial statements, and future plans before putting their money in. Since the securities are new, there is no past trading history available, which makes careful evaluation important. Once the securities are issued and allotted, they are listed for trading, which leads to their movement into the secondary market.

2. Secondary Market (Stock Market)

The secondary market is where securities that have already been issued are traded among investors. After buying shares or bonds in the primary market, investors may choose to sell them later. This buying and selling takes place in the secondary market.

In this market, the company that originally issued the securities does not receive any money. Instead, transactions happen between buyers and sellers. The market is vital for boosting investor confidence, even if the company doesn't receive funds directly. People are more willing to invest when they know they can sell their securities whenever they need money.

One of the most important functions of the secondary market is providing liquidity. It allows investors to convert their investments into cash quickly and conveniently. The price of securities in this market keeps changing based on demand and supply, company performance, economic conditions, and investor expectations. This continuous price movement helps in determining the true value of securities.

The secondary market also ensures transparency and fairness in trading. Regulatory bodies closely monitor organized systems to protect investor interests during transactions. It also helps in the proper distribution of funds, as investors can shift their investments from one company to another depending on performance and returns.

5.5 Capital Market Reforms in India :

The capital market in India has developed step by step over many years. It did not become modern overnight. Different reforms were introduced at different times to remove weaknesses, improve efficiency, and build trust among investors. Looking at these reforms period by period helps in understanding how the system has evolved into its present form.

1. Pre-1991 Period (Controlled and Underdeveloped Phase)

The government highly controlled the capital market before 1991. Companies had to follow strict rules even to decide the price of their shares. This system, often known as the Controller of Capital Issues regime, limited the freedom of companies to raise funds. Trading practices were outdated and mostly manual. Transactions were carried out through open outcry systems, where brokers physically gathered to trade. This led to delays, lack of proper records, and chances of manipulation. Settlement of trades used to take a long time, which reduced investor confidence.

There was no strong and independent regulator at that time. As a result, issues like insider trading, price rigging, and lack of transparency were common concerns. Investors had very limited access to reliable information, and protection mechanisms were weak. Due to all these problems, the capital market remained narrow in scope, with limited participation from the public.

2. **1991 to Early 2000s (Liberalization and Major Structural Reforms)**

The economic reforms of 1991 brought a turning point. The focus shifted towards making the capital market more open, competitive, and transparent. A key step was strengthening the role of Securities and Exchange Board of India, which was given statutory powers to regulate the market. It introduced clear rules for companies, stock exchanges and intermediaries. This helped in reducing unfair practices and improving investor protection. The introduction of screen-based trading was another major reform. With the setting up of National Stock Exchange, trading became fully electronic. This reduced human errors, improved speed, and made price information available to everyone at the same time.

One of the most important changes was the shift from physical share certificates to electronic form through dematerialization. Institutions like National Securities Depository Limited and Central Depository Services Limited made it possible to hold and transfer securities digitally. This removed risks like loss, theft, and fake certificates. During this phase, foreign institutional investors were allowed to invest in Indian markets. This increased the flow of funds and improved the global image of the Indian capital market.

3. **2000 to 2010 (Technological Growth and Product Diversification)**

After building a strong base, the next phase focused on improving systems and introducing new financial products. The settlement system became faster and more reliable. The shift to shorter settlement cycles reduced the waiting time for completing transactions. This improved liquidity and reduced risk.

Online trading platforms started becoming popular, allowing investors to buy and sell securities from their homes. This increased participation, especially from small investors. New instruments like derivatives, including futures and options, were introduced. These provided opportunities for better risk management and also attracted more participants to the market. Mutual funds and other investment channels also expanded during this period. Regulations were further tightened to ensure that companies provide accurate and timely information, which improved transparency.

4. **2010 onwards (Modern, Digital, and Investor-Centric Phase)**

From 2010 onwards, the capital market has moved towards greater modernization and stronger investor focus. Technology has become the backbone of the system. Mobile trading apps, online platforms, and digital processes have made investing simple and widely accessible. The investors can now trade and track their investments in real time. Settlement systems have become even faster, improving the ease of buying and selling securities. Risk management systems have also been strengthened to prevent market instability.

Investor protection has received special attention. Strict disclosure requirements ensure that companies share all important information. Awareness programs help people understand investment risks and make informed decisions. There is also a strong emphasis on corporate governance. Companies are expected to follow ethical practices, maintain transparency, and be accountable to investors. Regulatory supervision has become more active to ensure fair and smooth functioning of the market.

Over time, the capital market in India has changed from a slow and restricted system into a modern and dynamic one. Each phase of reform has addressed specific weaknesses and added strength to the system. Today, it offers better transparency, faster transactions, and stronger protection for investors, making it an important pillar of economic development.

5.6 Role of SEBI in Capital Market :

The securities and Exchange Board of India acts as the main authority that keeps the capital market disciplined, fair, and reliable. Each of its roles is explained below with more clarity and depth:

1. **Protecting Investors' Interests:** SEBI's first responsibility is to protect people who invest their money in shares, bonds, and other securities. Many investors lack in-depth market knowledge, making them susceptible to deception. SEBI makes strict rules that companies must follow before collecting money from the public. For instance, companies are required to explicitly disclose risks, their financial status, and the intended use of the funds. If any company or broker cheats investors, SEBI can take legal action, impose fines, or ban them from the market. This protection builds trust and encourages more participation.

2. **Regulating Stock Exchanges and Market Intermediaries:** The capital market involves many participants like stock exchanges, brokers, portfolio managers, and investment advisors. SEBI gives them licenses and sets rules for their work. It ensures that brokers do not misuse clients' money and that stock exchanges follow proper systems for trading. Regular inspections and audits are conducted to check whether these entities are following the rules. This reduces malpractice and keeps the system organized.

3. **Promoting Transparency and Disclosure:** Transparency means providing clear and complete information. SEBI makes it compulsory for companies to regularly share their financial performance and important updates. For instance, companies must publish quarterly results, disclose major decisions like mergers or expansion plans, and inform them about any risks. This helps investors understand the real position of a company before investing. Without transparency, investors would be making blind decisions.

4. **Preventing Fraud and Unfair Practices:** Unfair activities like insider trading, where someone uses secret information for personal gain, can harm ordinary investors. SEBI closely monitors market activities using advanced technology to detect unusual price movements or suspicious transactions. If such practices are found, strict penalties are imposed. This ensures that no one takes advantage of hidden information or manipulates prices unfairly.

5. **Regulating New Issues and IPOs:** When companies want to raise funds from the public through shares, they must follow SEBI guidelines. SEBI carefully reviews documents like the prospectus to ensure that all important information is disclosed. It checks whether the company is genuine and whether the issue is priced fairly. This reduces the chances of fraud and protects investors from investing in weak or misleading offers.

6. **Promoting Fair Practices in the Market:** SEBI ensures that all investors, whether small or large, are treated equally. It prevents practices where big players might try to influence prices or take unfair advantage. Rules are designed so that everyone gets equal access to information and opportunities. This creates confidence among investors and encourages wider participation in the market.

7. **Educating Investors:** Many people lose money because they invest without proper knowledge. SEBI runs awareness programs, publishes educational materials, and uses digital platforms to guide investors. It explains basic concepts like risk, return, diversification, and fraud prevention. By spreading awareness, SEBI helps individuals make smarter and safer investment decisions.

8. **Developing the Capital Market:** Apart from controlling the market, SEBI also works towards its growth. It introduces new systems and reforms to improve efficiency. For example, it has supported online trading, faster settlement cycles, and new financial products. These developments make investing more convenient and attract both domestic and foreign investors.

9. **Grievance Redressal Mechanism:** Investors may face problems such as delay in share transfer, non-receipt of dividends, or disputes with brokers. SEBI provides a structured system where complaints can be filed and resolved. It ensures that companies and intermediaries respond to these complaints within a time limit. This instills a sense of security in investors, as they know their issues will receive attention.

10. **Monitoring and Enforcement:** SEBI continuously watches the market to ensure rules are followed. It has the power to investigate suspicious cases, inspect records, and take strict action against violators. Penalties may include heavy fines, suspension from trading, or cancellation of licenses. This strong enforcement discourages wrong practices and maintains discipline in the market.

5.7 Conclusion :

The capital market plays a key role in connecting people who have savings with those who need funds for long-term purposes like business growth and development. It includes both the primary market, where new securities are issued, and the secondary market, where these securities are traded. By offering investment options like shares and debentures, it helps channel savings into productive use. Over time, various reforms in India have made the system more modern, transparent, and efficient. Changes such as electronic trading and better regulations have improved the overall functioning and increased investor confidence.

At the same time, the role of Securities and Exchange Board of India is very important in maintaining discipline and fairness in the market. SEBI safeguards investors, regulates market participants, and enforces adherence to established rules. By preventing fraud, promoting transparency, and spreading awareness, SEBI helps in building trust among investors. Overall, a well-regulated and developed capital market supports economic growth and provides better opportunities for both companies and investors.

Exercise :

Q.1 Answer the following questions in detail.

1. What is capital market? Explain characteristics of capital market.
2. Describe the functions of capital market.
3. Discuss the structure of Indian capital market in detail.
4. Explain different phases of reforms of capital market in India.
5. Describe the role of SEBI in capital market.

Q.2 Write a note on :

1. Primary Market
2. Secondary Market
3. Liberalization and Major Structural Reforms of Capital Market
4. Technological Growth and Product Diversification Phase of Capital Market Reforms
5. Modern, Digital, and Investor-Centric Phase of Capital Market Reforms

Q.3 Multiple Choice Questions (MCQS)

1. What is the main purpose of a capital market?

   A) To provide short-term loans B) To manage foreign exchange

   C) To control inflation D) To facilitate long-term funding

Answer: D) To facilitate long-term funding

2. Which of the following is a feature of the capital market?

   A) Deals only in cash transactions

   B) Provides long-term investment options

   C) Operates only through banks

   D) Has no risk involved

Answer: B) Provides long-term investment options

3. Which instrument is commonly traded in the capital market?

   A) Shares and Debentures B) Treasury Bills

   C) Demand Drafts D) Fixed Deposits

Answer: A) Shares and Debentures

4. One major function of the capital market is:

   A) Issuing currency

   B) Mobilizing savings into investments

   C) Fixing interest rates

   D) Controlling imports

Answer: B) Mobilizing savings into investments

5. The capital market helps in economic development by:

   A) Increasing taxes B) Reducing employment

   C) Providing funds for growth D) Limiting industrial expansion

Answer: C) Providing funds for growth

6. The Indian capital market is broadly divided into:

   A) Primary and Secondary market

   B) Rural and Urban market

   C) Public and Private sector

   D) Wholesale and Retail market

Answer: A) Primary and Secondary market

7. The primary market deals with:

    A) Trading of existing securities

    B) Foreign exchange transactions

    C) Short-term loans

    D) Issue of new securities

Answer: D) Issue of new securities

8. The secondary market is also known as:

    A) New Issue Market   B) Money Market

    C) Stock Market   D) Commodity Market

Answer: C) Stock Market

9. Which of the following is a part of the Indian capital market structure?

    A) Insurance companies   B) Stock exchanges

    C) Commercial banks only   D) Government treasury

Answer: B) Stock exchanges

10. Capital market reforms in India mainly started after:

    A) 1950   B) 1980   C) 2005   D) 1991

Answer: D) 1991

11. One important reform in the capital market was:

    A) Introduction of electronic trading

    B) Removal of banks

    C) Ban on foreign investment

    D) Reduction in number of companies

Answer: A) Introduction of electronic trading

12. Which organization regulates the capital market in India?

    A) RBI   B) IMF   C) SEBI   D) World Bank

Answer: C) SEBI

13. One key role of SEBI is:

    A) Printing currency B) Protecting investors

    C) Providing loans D) Fixing tax rates

Answer: B) Protecting investors

14. SEBI helps in preventing:

    A) Unfair trade practices B) Inflation

    C) Government spending D) Export decline

Answer: A) Unfair trade practices

15. Investor education programs are conducted by:

    A) Banks only B) Private companies

    C) RBI only D) SEBI

Answer: D) SEBI

****

Unit - 6
Primary Market

6.1 Introduction :

When we discuss the financial systems, we often imagine banks, stock exchanges, and large corporations. But have you ever wondered how companies actually raise money from the public for the first time? How does a business transform from a private idea into a publicly funded enterprise? The answer lies in what we call the primary market.

In this chapter, we will explore the concept of the primary market in a simple, engaging, and structured way, just like a classroom discussion. Let us begin with a basic thought.

Suppose an entrepreneur has a brilliant business idea say, launching an electric vehicle company. To turn that idea into reality, they need funds such as for machinery, employees, research, marketing, and infrastructure. Initially, they may rely on personal savings or loans. But as the business grows, these sources become insufficient. At this stage, the company needs access to a larger pool of capital.

This is where the primary market plays a crucial role.

What is the Primary Market?

The primary market is the segment of the financial market where new securities are issued for the first time. It is also known as the new issue market. In this market, companies directly sell shares, debentures, or bonds to investors to raise fresh capital.

Let's simplify this further.

" When a company sells its shares for the first time, it is dealing in the primary market.

" The money collected goes directly to the company, not to any existing investor.

The primary market acts as a bridge between investors who have surplus funds and organizations that need capital.

Let me ask you a simple question. Have you heard people talking about applying for IPOs like "this company is coming to the market"?

That excitement is actually about the primary market. When a company launches an IPO (Initial Public Offering), it is entering the primary market to raise funds from the public.

Features of the Primary Market

To understand it better, let's look at its key features:

- **New Securities Only:** Only fresh issues are traded here.
- **Direct Interaction:** Investors deal directly with the issuing company.
- **No Physical Location:** It does not have a fixed place like a stock exchange.
- **Regulated Market:** In India, it is regulated by the Securities and Exchange Board of India (SEBI).

Primary Market in Indian Context

In India, the primary market has evolved significantly over the past few decades. Earlier, the process of issuing shares was lengthy, paperwork-heavy, and less transparent. But with digitalization and regulatory reforms, the system has become more efficient, investor-friendly, and transparent.

Key developments include:

- Introduction of online applications (ASBA system)

- Stronger disclosure norms
- Increased retail investor participation
- Rise of startup IPOs and SME platforms

Today, India is one of the fastest-growing capital markets in the world, and the primary market plays a vital role in this growth.

6.2 Meaning and Functions of the Primary Market :

The concept of the primary market forms the foundation of capital formation in any modern economy. After understanding the introductory framework in the previous section, it is now essential to develop a deeper and more structured academic understanding of what the primary market truly represents and how it functions within the broader financial system.

6.2.1 Meaning of the Primary Market

The primary market, also referred to as the new issue market, is that segment of the capital market in which new securities are created and issued to investors for the first time. These securities may include equity shares, preference shares, debentures, bonds, and other financial instruments.

In technical terms, the primary market facilitates the transfer of funds from surplus units (investors) to deficit units (corporate entities, governments, or institutions) through the creation of new financial claims.

Key Elements in the Definition

To understand the meaning more precisely, let us break it into essential components:

1. **Creation of Securities:** Unlike the secondary market, the primary market deals only with newly issued securities.
2. **Direct Fund Flow:** Funds move directly from investors to the issuing entity.
3. **Capital Formation Function:** The funds raised are used for productive purposes such as expansion, modernization, or new projects.
4. **Initial Transaction:** It represents the first stage in the life cycle of a security.

Thus, the primary market is not merely a place but a mechanism or process through which capital is raised.

Each participant contributes to the efficiency and credibility of the primary market.

6.2.2 Functions of the Primary Market

The primary market performs several vital functions in the financial system. These functions are not only theoretical but also have practical implications for economic growth and development.

1. **Capital Formation**

   The most important function of the primary market is capital formation. It mobilizes savings from individuals and institutions and channels them into productive investments.

   When companies issue securities, they collect funds that are used for setting up new projects, expanding existing operations, modernizing technology, repaying existing liabilities. This process contributes directly to economic development.

2. **Resource Allocation**

   The primary market facilitates efficient allocation of financial resources. Funds are directed toward sectors and companies that demonstrate growth potential and profitability.

   In a well-functioning market, capital flows to its most productive uses, thereby increasing overall economic efficiency.

3. **Price Discovery Mechanism**

   In modern financial systems, especially through book-building methods, the primary market helps in determining the fair price of securities. This ensures that companies receive appropriate valuation and investors pay a reasonable price.

4. **Development of Financial Markets**

   A strong primary market contributes to the development of a capital market ecosystem. It supports the growth of the secondary market by providing a continuous supply of new securities.

5. **Investor Participation and Wealth Creation**

   The primary market offers investors an opportunity to invest in companies at an early stage. If the company performs well, investors can benefit from capital appreciation. This promotes a culture of investment and financial inclusion.

6. **Economic Growth and Infrastructure Development**

   Governments and public sector enterprises use the primary market to raise funds for infrastructure projects such as roads, railways, energy, and telecommunications.

   Thus, the primary market plays a direct role in national development.

6.2.3 Participants in the Primary Market

The functioning of the primary market involves multiple stakeholders, each playing a specific role:

- **Issuing Company:** The entity that requires funds.
- **Investors:** Individuals, institutions, or foreign investors who provide capital.
- **Merchant Bankers:** Intermediaries who manage the issue process.
- **Underwriters:** Entities that guarantee subscription.
- **Regulatory Authorities:** In India, the Securities and Exchange Board of India (SEBI) ensures transparency and fairness.

6.3 Methods of Issuing Securities :

After understanding the meaning and functions of the primary market, it is essential to understand the methods through which companies actually raise capital. These methods represent the operational side of the primary market and explain how securities reach investors.

The regulatory framework established by the Securities and Exchange Board of India (SEBI) governs the issuance of securities in the Indian financial system. Over time, these methods have evolved to ensure transparency, efficiency, and investor protection.

6.3.1 Classification of Methods of Issuing Securities

The methods of issuing securities in the primary market can be broadly classified into the following categories:

1. Public Issue
2. Rights Issue
3. Private Placement
4. Offer for Sale
5. Book Building Method

Each of these methods has distinct features, procedures, and suitability depending on the company's objectives and financial position.

6.3.1.1 Public Issue

A **public issue** refers to the process by which a company offers its securities to the general public for subscription. It is one of the most widely used methods of raising capital.

Public issues can be further divided into:

- Initial Public Offer (IPO)
- Follow-on Public Offer (FPO)

Features of Public Issue

- Open to all categories of investors
- Requires detailed disclosure through a prospectus
- Regulated strictly by SEBI
- Helps in listing securities on stock exchanges

For Example: The Life Insurance Corporation of India (LIC) launched one of the largest IPOs in Indian history in 2022. The government used the public issue route to divest its stake and raise substantial funds.

6.3.1.2 Rights Issue

A rights issue is a method of issuing securities in which existing shareholders are given the right to purchase additional shares in proportion to their existing holdings.

This method is commonly used when companies need additional capital but prefer to maintain control within the existing shareholder base.

Features of Rights Issue

- Offered only to existing shareholders
- Shares are usually issued at a discounted price
- Helps avoid dilution of ownership control

For Example: Reliance Industries Limited launched a massive rights issue in 2020 to reduce debt and strengthen its balance sheet.

6.3.1.3 Private Placement

Private placement refers to the sale of securities to a select group of investors such as institutional investors, banks, mutual funds, or high-net-worth individuals.

Unlike public issues, private placements are not open to the general public and involve fewer regulatory requirements.

Features of Private Placement

- Faster and less complex process
- Lower cost of issuance
- Limited disclosure requirements
- Suitable for raising funds quickly

For Example: HDFC Bank has frequently used private placement to raise capital from institutional investors to support its expansion plans.

6.3.1.4 Offer for Sale (OFS)

Offer for Sale is a method where existing shareholders (such as promoters or the government) sell their shares to the public.

In this case, the company does not receive funds; instead, the proceeds go to the selling shareholders.

Features of OFS

- Used mainly for disinvestment by promoters or government
- Conducted through stock exchange platforms
- Transparent bidding process

For Example: The Government of India has used the OFS route multiple times to reduce its stake in Coal India Limited.

6.3.1.5 Book Building Method

The book building method is a modern technique used for price discovery in public issues. Instead of fixing a price in advance, a price band is provided, and investors bid within that range.

The final issue price is determined based on demand.

Features of Book Building

- Market-driven price determination
- Transparent bidding process
- Efficient allocation of securities

For Example: Zomato's IPO used the book building process to determine its issue price.

6.4 Initial Public Offering (IPO) :

The Initial Public Offering (IPO) represents a life cycle of a company. It is the stage at which a privately held company transitions into a publicly listed entity by offering its shares to the general public for the first time. In the context of the primary market, the IPO is one of the most significant mechanisms for capital formation, investor participation, and market expansion.

This section provides a comprehensive understanding of IPOs, including their meaning, objectives, process, regulatory framework, advantages, limitations, and practical insights with Indian case references.

6.4.1 Meaning of IPO

An Initial Public Offering (IPO) is the first sale of equity shares by a company to the public. Through an IPO, a company invites investors to subscribe to its shares, thereby raising capital and becoming eligible for listing on a recognized stock exchange.

Key characteristics of an IPO include:

- First-time public issuance of shares
- Transition from private to public ownership
- Compliance with regulatory disclosure norms
- Listing of shares on stock exchanges

Thus, an IPO is both a financing mechanism and a strategic transformation tool.

6.4.2 Objectives of an IPO

Companies launch IPOs for multiple strategic and financial reasons. The major objectives include:

1. **Raising Capital:** To finance expansion, new projects, acquisitions, or debt reduction.
2. **Enhancing Corporate Image:** Listing improves visibility, credibility, and brand recognition.
3. **Providing Liquidity:** Early investors and promoters get an opportunity to partially or fully exit.
4. **Market Valuation:** Establishes a transparent market-based valuation of the company.
5. **Employee Incentives:** Enables stock-based compensation such as ESOPs.

6.4.3 Types of IPO

IPOs can be broadly classified into two categories:

(a) Fixed Price Issue

Under this method, the company fixes a specific price at which shares are offered to investors. Investors know the price in advance before subscribing.

(b) Book Building Issue

Under this method, a price band is provided, and investors bid within the range. The final price is determined based on demand.

The book-building method is more widely used in modern capital markets due to its efficiency in price discovery.

6.4.4 IPO Procedure

The IPO process is systematic, regulated, and involves multiple stages. Understanding this process is essential from both academic and practical perspectives.

Step 1: Appointment of Merchant Bankers

The company appoints merchant bankers (lead managers) who guide the IPO process, ensure compliance, and manage the issue.

Step 2: Preparation of Draft Red Herring Prospectus (DRHP)

A detailed document containing financial, operational, and risk-related information is prepared and submitted to the regulatory authority.

Step 3: Regulatory Approval

The regulatory body reviews the document to ensure adequate disclosure and investor protection.

Step 4: Price Determination

The price is decided either through a fixed price method or book building process.

Step 5: Marketing

The company and its advisors promote the IPO to attract investors.

Step 6: Subscription Period

Investors apply for shares during the open period of the IPO.

Step 7: Allotment of Shares

Shares are allocated based on demand and subscription levels.

Step 8: Listing on Stock Exchange

The shares are listed and become available for trading in the secondary market.

6.4.5 Advantages of IPO

From the company's perspective:

- Access to large-scale capital
- Enhanced corporate reputation
- Improved transparency and governance

From the investor's perspective:

- Opportunity to invest at an early stage
- Potential for capital appreciation
- Portfolio diversification

6.4.6 Disadvantages of IPO

Despite its benefits, IPOs involve several challenges:

- High cost of issuance (legal, regulatory, underwriting fees)
- Disclosure requirements leading to loss of confidentiality
- Market risk and price volatility
- Pressure from shareholders for performance

6.5 Book Building Process :

The book-building process is a modern and sophisticated mechanism used in the primary market for determining the price of securities, particularly during an IPO. As discussed in the previous section, pricing is a critical element in the success of an issue. The book building method enhances efficiency, transparency, and market-driven price discovery.

This section provides a detailed understanding of the concept, mechanism, steps, advantages, limitations, and practical applications of the book building process, with reference to Indian capital markets.

6.5.1 Meaning of Book Building

Book building is a process of price discovery in which investors bid for shares within a specified price band. Based on the demand at various price levels, the final issue price is determined.

Unlike the fixed price method, where the price is predetermined, book building allows the market to decide the price through investor participation.

Thus, book building can be defined as a demand-driven pricing mechanism used in the primary market.

6.5.2 Concepts in Book Building

To understand the process clearly, it is important to become familiar with the following terms:

- Price Band: The range within which investors can place bids (e.g., ₹ 100-₹ 120).
- Cut-off Price: The final price at which shares are allotted.
- Bid: An offer made by investors indicating quantity and price.
- Order Book: A record of all bids received.
- Floor Price: Minimum price in the band.
- Cap Price: Maximum price in the band.

6.5.3 Procedure of Book Building

The book building process involves several stages. Let us examine each stage in a systematic manner:

Step 1: Appointment of Book Running Lead Managers (BRLMs)

The issuing company appoints merchant bankers who act as intermediaries and manage the entire process.

Step 2: Determination of Price Band

A price band is decided based on company valuation, market conditions, and investor expectations.

Step 3: Filing of Prospectus

A draft prospectus containing relevant details is filed with the regulatory authority.

Step 4: Bidding Period Opens

Investors submit bids specifying the number of shares and the price within the band.

Step 5: Collection of Bids

All bids are recorded in the order book, reflecting demand at different price levels.

Step 6: Price Discovery

The final price (cut-off price) is determined based on the highest price at which the entire issue can be sold.

Step 7: Allotment of Shares

Shares are allotted to investors at the cut-off price.

Step 8: Listing of Shares

The shares are listed on the stock exchange and become available for trading.

6.5.4 Categories of Investors in Book Building

In India, shares are allocated among different categories of investors:

- Qualified Institutional Buyers (QIBs): Large financial institutions like banks, mutual funds, and insurance companies that invest significant funds in securities.
- Non-Institutional Investors (NIIs): High-net-worth individuals or entities investing amounts above the retail limit but not classified as institutional investors
- Retail Individual Investors (RIIs): Individual investors who invest small amounts in securities within the prescribed retail limit.

6.5.5 Advantages of Book Building

The book building process offers several advantages:

1. Efficient Price Discovery which reflects real market demand
2. Transparency had built Bidding process open and systematic
3. It Reduced Under-pricing or Overpricing
4. It benefits in Better Allocation of Shares

6.5.6 Limitations of Book Building

Despite its advantages, the method has certain limitations:

- Complexity for small investors
- Possibility of manipulation by large investors
- Dependence on market sentiment

6.6 Red Herring Prospectus :

The Red Herring Prospectus (RHP) is one of the most important documents in the primary market, particularly in the context of public issues and book building. It serves as a comprehensive source of information for investors, enabling them to make informed investment decisions.

In academic terms, the Red Herring Prospectus represents a critical disclosure document that ensures transparency, accountability, and investor protection in the capital market.

6.6.1 Meaning of Red Herring Prospectus

A Red Herring Prospectus is a preliminary prospectus filed by a company with the regulatory authority before the issue of securities. It contains all material information about the company, except the final price and the number of shares to be issued.

The term "red herring" originates from the red-coloured warning printed on the cover page, indicating that the document is not final and is subject to changes.

Thus, an RHP can be defined as a preliminary disclosure document used during the book building process.

6.6.2 Legal Definition

Under the Companies Act, 2013, a Red Herring Prospectus is defined as a prospectus that does not include complete particulars of the price or the quantum of securities offered.

It must be filed with the Securities and Exchange Board of India (SEBI) before the issue opens for subscription.

6.6.3 Objectives of Red Herring Prospectus

The RHP serves multiple objectives in the primary market:

1. Providing Information: Offers detailed information about the company's business, financials, risks, and management.
2. Ensuring Transparency: Enables investors to assess the credibility and performance of the company.
3. Facilitating Price Discovery: Supports the book building process by providing necessary data.
4. Investor Protection: Reduces information asymmetry between issuers and investors.

6.6.4 Importance for Investors

For investors, the RHP is an essential document because it:

- Provides complete information about the company
- Helps assess risks and returns
- Supports informed investment decisions

6.6.5 Limitations of Red Herring Prospectus

Despite its importance, the RHP has certain limitations:

- Complex and lengthy document
- Difficult for small investors to interpret
- Does not include final price details

6.7 Follow-on Public Offer (FPO) :

After understanding the concept of the IPO, it is important to examine another significant method of raising capital in the primary market-namely, the Follow-on

Public Offer (FPO). While an IPO marks the first entry of a company into the capital market, an FPO represents a subsequent issuance of shares by a company that is already listed on a stock exchange.

This section provides a detailed academic analysis of FPOs, including their meaning, types, objectives, process, advantages, limitations, and practical relevance in the Indian context.

6.7.1 Meaning of FPO

A Follow-on Public Offer (FPO) refers to the issuance of additional shares by a company that is already publicly listed. Through an FPO, the company raises further capital from investors after its initial public offering.

Thus, an FPO can be defined as a subsequent public issue of shares by an already listed company.

6.7.2 Objectives of FPO

Companies launch FPOs for various strategic and financial reasons:

1. Expansion of Business Operations: To finance new projects, acquisitions, or capacity expansion.
2. Debt Reduction: To improve financial stability by repaying existing loans.
3. Strengthening Capital Base: To enhance the company's financial structure.
4. Regulatory Compliance: To meet minimum public shareholding requirements.

6.7.3 Types of FPO

FPOs can be broadly classified into two categories:

(a) Dilutive FPO

In a dilutive FPO, the company issues new shares, thereby increasing the total number of outstanding shares. Consequently, the ownership percentage of existing shareholders diminishes.

(b) Non-Dilutive FPO

In a non-dilutive FPO, existing shareholders (such as promoters) sell their shares to the public. In this case, the total number of shares remains unchanged, and the proceeds go to the selling shareholders.

6.7.4 Process of FPO

The process of an FPO is similar to that of an IPO but involves comparatively fewer complexities since the company is already listed.

Step 1: Board Approval

The company's board of directors approves the decision to raise funds through an FPO.

Step 2: Appointment of Intermediaries

Merchant bankers, legal advisors, and other intermediaries are appointed.

Step 3: Preparation of Offer Document

A prospectus or offer document is prepared with updated financial and operational details.

Step 4: Regulatory Approval

The document is submitted for regulatory review to ensure compliance.

Step 5: Pricing of Issue

The price is determined either through a fixed price method or book building process.

Step 6: Subscription Period

Investors apply for shares during the issue period.

Step 7: Allotment and Listing

The shares are allotted and credited to investors, and trading begins on the stock exchange.

For Example: Yes Bank launched an FPO in 2020 to strengthen its financial position. The Yes Bank FPO demonstrates how FPOs can be used as a tool for financial restructuring and recovery.

6.7.5 Advantages of FPO

From the company's perspective:

- Easier and faster than IPO

- Lower cost of issuance
- Enhances capital structure

From the investor's perspective:

- Opportunity to invest in an established company
- Lower risk compared to IPOs
- Better availability of historical data for analysis

6.7.6 Limitations of FPO

- Dilution of existing shareholding (in dilutive FPO)
- Possible decline in share price due to increased supply
- Dependence on market conditions

6.7.7 Difference Between IPO and FPO

Basis	IPO	FPO
Stage	First issue	Subsequent issue
Company Status	Unlisted	Listed
Risk Level	Higher	Relatively lower
Information Availability	Limited	More extensive

6.8 Rights Issue and Private Placement :

After examining public issues (IPO and FPO), it is essential to understand alternative methods of raising capital that are widely used by companies namely, Rights Issues and Private Placement. These methods differ significantly from public issues in terms of target investors, regulatory requirements, cost, and speed.

This section provides a comprehensive understanding of both methods, their meaning, features, process, advantages, limitations, and practical relevance in the Indian context.

6.8.1 Rights Issue

Meaning of Rights Issue

A Rights Issue is a method of raising capital in which a company offers additional shares to its existing shareholders in proportion to their current holdings. The shareholders are given a "right" (but not an obligation) to subscribe to these shares.

Thus, a rights issue can be defined as a preferential offer of shares to existing shareholders. For example, Reliance Industries Limited launched one of the largest rights issues globally in 2020.

Key Features of Rights Issue

- Offered only to existing shareholders
- Shares are usually issued at a discount to market price
- Proportionate allocation (e.g., 1:4 means 1 share for every 4 held)
- Shareholders can renounce (transfer) their rights in favor of others

Objectives of Rights Issue

1. To raise additional capital without involving new investors
2. To maintain control within existing shareholder base
3. To reduce financial leverage by avoiding debt

Process of Rights Issue

The process of a rights issue generally involves the following steps:

1. Board Approval: The company's board of directors approves the proposal for issuing rights shares.
2. Determination of Rights Ratio and Price: The company decides the proportion (e.g., 1:2) and the price at which shares will be offered to existing shareholders.
3. Preparation of Offer Letter: A detailed offer document is prepared containing terms, conditions, and timelines of the issue.
4. Dispatch of Rights Entitlement: Rights entitlements are sent to existing shareholders, informing them of their eligibility.
5. Subscription by Shareholders: Shareholders may accept, reject, or renounce their rights within the specified period.
6. Allotment of Shares: Shares are allotted to the shareholders who have subscribed to the rights issue.

Advantages of Rights Issue

- Cost-effective compared to public issues
- Preserves ownership structure
- Faster process with fewer regulatory requirements

Limitations of Rights Issue

- Limited to existing shareholders
- May not raise sufficient capital if shareholders do not subscribe
- Can signal financial stress in some cases

6.8.2 Private Placement

Meaning of Private Placement

Private Placement refers to the issuance of securities to a select group of investors such as financial institutions, banks, mutual funds, or high-net-worth individuals, rather than to the general public.

Thus, it can be defined as a non-public offer of securities to a limited number of sophisticated investors.

Key Features of Private Placement

- Limited number of investors
- Faster and simpler process
- Lower regulatory compliance compared to public issues
- Customized terms and conditions

Objectives of Private Placement

1. To raise funds quickly
2. To reduce cost of issuance
3. To attract strategic investors

Process of Private Placement

1. Identification of Potential Investors: The company selects a specific group of investors such as institutions or high-net-worth individuals.

2. Negotiation of Terms: The company and investors mutually decide the price, quantity, and conditions of the issue.
3. Approval from Board and Shareholders: Necessary approvals are obtained as per legal and regulatory requirements.
4. Issuance of Securities: Securities are allotted directly to the selected investors.
5. Filing with Regulatory Authorities: The company submits required documents to authorities (e.g., Securities and Exchange Board of India) for compliance.

Advantages of Private Placement

- Speed and flexibility
- Lower cost compared to public issues
- Access to experienced and strategic investors

Limitations of Private Placement

- Limited investor base
- Reduced transparency compared to public issues
- Possible concentration of ownership

6.8.3 Comparison: Rights Issue vs Private Placement

Basis	Rights Issue	Private Placement
Target Investors	Existing shareholders	Selected investors
Ownership Impact	Maintained	May change
Cost	Low	Low to moderate
Speed	Moderate	Fast
Transparency	High	Moderate

Exercise :

This section is designed to reinforce conceptual clarity, analytical ability, and exam readiness for BAOU learners. The questions are structured in increasing order of difficulty and aligned with typical university examination patterns.

Q.1 Very Short Answer Questions

1. Define the primary market.
2. What is meant by an Initial Public Offering (IPO)?
3. State the meaning of book building.
4. What is a Red Herring Prospectus?
5. Define Follow-on Public Offer (FPO).
6. What is a rights issue?
7. Define private placement.
8. What is meant by price band?
9. What is a cut-off price?
10. Name the regulatory authority of the primary market in India.

Q.2 Short Answer Questions

1. Explain the features of the primary market.
2. Distinguish between primary market and secondary market.
3. Explain the objectives of an IPO.
4. Describe the role of merchant bankers in an IPO.
5. Explain the concept of price discovery in book building.
6. State the contents of a Red Herring Prospectus.
7. Explain the advantages of a rights issue.
8. Discuss the features of private placement.
9. Differentiate between fixed price issue and book building issue.
10. Explain the types of FPO.

Q.3 Long Answer Questions

1. Explain the meaning and functions of the primary market in detail.
2. Describe the methods of issuing securities in the primary market.
3. Explain the complete process of an IPO with suitable examples.
4. Discuss the book building process with a numerical illustration.
5. Explain the role and importance of the Red Herring Prospectus.

6. Differentiate between IPO and FPO with examples.
7. Explain rights issue and private placement in detail.
8. Discuss the advantages and limitations of the primary market.

Q.4 Case-Based Questions

1. A company plans to raise funds but wants to retain control within existing shareholders. Which method should it choose? Explain with reasons.
2. An investor is confused between investing in an IPO and buying shares from the stock market. Explain the difference and guide the investor.
3. A company sets a price band of ?200-?240 for its IPO. Explain how the final price will be determined under the book building process.
4. A listed company wants to raise additional capital quickly with minimal regulatory requirements. Suggest the most appropriate method and justify your answer.

Q.5 Fill in the Blanks

1. The primary market deals with __________ securities.
2. IPO is the __________ issue of shares.
3. Book building helps in __________ discovery.
4. RHP does not contain __________ details.
5. FPO is issued by __________ companies.

Q.6 True or False

1. Primary market deals with existing securities. (False)
2. IPO is the first issue of shares to the public. (True)
3. Book building is a fixed price method. (False)
4. Rights issue is offered to new investors only. (False)
5. Private placement is open to the general public. (False)

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Unit - 7
Secondary Market

7.1 Introduction, Meaning :

Investors receive the securities that a company issues for the first time in the primary (capital) market. After the company's shares are listed, their trading takes place in the secondary market. The main difference between the two is that in the primary market, an investor obtains new securities directly from the company, while in the secondary market, they purchase them from other investors who wish to sell them.

Meaning: The secondary market is one where the purchase and sale of securities previously issued by the company take place. The secondary market carries out the purchase and sale of securities previously issued by government, semi-government, and private companies.

According to the Securities Contracts (Regulation) Act, 1956: "Secondary Market (Stock Exchange) means an organized association, institution, or group of individuals established for the purpose of assisting, regulating, and controlling the business of buying and selling of securities".

7.2 Functions of Secondary Market :

The primary objectives of the secondary market are to provide a mechanism for the purchase and sale of securities and to provide the facility of capital acquisition to companies. To fulfill these objectives, the secondary market performs the following functions:

1. **Economic Barometer:** The secondary market is a reliable tool for measuring the economic condition of the country. The prices of securities (shares) reflect every major change occurring in the country and the economy. An increase or decrease in share prices indicates the boom or recession cycles of the economy. The secondary market is also known as a mirror of the economy or economic development, which indicates the economic situation of the country.

2. **Pricing of Securities:** The value of securities is determined in the secondary market based on demand and supply factors. The value of the securities of profitable and growth-oriented companies is higher because there is more demand for them. The value of securities is useful for investors, the government, and creditors. Investors can know the value of their investments, creditors can measure the value of credit, and the government determines taxes on the value of securities.

3. **Safety of Transactions:** Only listed securities are traded in the secondary market. Stock exchange officials include the company's name in the purchase-sale list only after verifying the company's financial liquidity. Companies that are listed have to follow strict rules. Thus, the stock market provides an assurance of safety to investors.

4. **Contribution to Economic Development:** Purchase and sale of securities of various companies take place in the stock market. In this process of disinvestment and reinvestment, most investors help in making value-adding investments, and through this purchase, capital formation and economic development gain momentum.

5. **Encouragement to Equity Share Investors:** The stock market encourages investment in securities by regulating investors and providing education regarding investment.

6. **Liquidity:** The main function of the stock market is to provide a ready market for the sale and purchase of securities. Investors can convert their investments into cash whenever they desire, thanks to the stock market. Investors can make long-term investments without hesitation because, due to the stock market, they can convert long-term investments into short-term and medium-term ones.

7. **Proper Investment of Capital:** Shares of profit-making companies are quoted at high prices so that such companies can easily collect new capital from the stock market. General people hesitate to invest in loss-making companies. Therefore, the stock market provides the facility for investors to make profitable investment of their capital.

8. **Promotion of Savings and Investment:** The stock market provides attractive opportunities for investment in various securities. These attractive opportunities encourage people to save more and to invest in company securities instead of investing in unproductive assets like gold, silver, etc.

7.3 Control over Secondary Market :

Strict control over the proceedings of the secondary market is necessary. Therefore, at the beginning of 1956, the Central Government passed the Securities Contracts (Regulation) Act to grant recognition to stock exchanges. There is also a provision for every stock exchange to frame appropriate laws for the regulation and control of its operations, subject to government approval. It is necessary for every stock exchange to provide information related to necessary matters to the government from time to time. In extraordinary/abnormal situations, the government has been given wide powers regarding the listing of securities, making or amending laws, withdrawing recognition, or taking over the governing board of the stock exchange.

Under this act, the government also passed the Securities Rules 1957, which included matters like recognition of stock exchanges, submission of periodic returns and annual returns by recognized stock exchanges, and recognized matters. It provides information about the stock exchange, its members, and the requirements for listing securities. In addition, the responsibility for the regulation of the secondary market remains with the Department of Economic Affairs, Government of India, the Department of Company Affairs, and the Reserve Bank of India.

The Securities and Exchange Board of India (SEBI) was established under Section 3 of the SEBI Act of 1992 for the regulation of the secondary market, to protect the interests of investors in securities, and to promote the development of the secondary market. In India, there is a three-tier structure for control over the secondary market.

1. **Ministry of Finance:**

   The Stock Exchange Division of the Ministry of Finance has powers related to the implementation of the provisions of the Securities Contracts (Regulation) Act 1956 and granting licenses for trading in other areas. According to the SEBI Act, the Ministry of Finance has powers to oversee SEBI. It also has the power to approve the appointment and nomination of the chief officials of the stock market.

2. **Securities and Exchange Board of India (SEBI):**

   The Securities and Exchange Board of India was established in the year 1988. But it obtained statutory powers on 30th January 1992. Under the SEBI Act, various types of powers are in the hands of SEBI.

Role of SEBI Departments:

Various departments are established under SEBI which are specifically for the management of the secondary market, which are as follows:

a. **Market Intermediaries Registration and Supervision Department:** This department manages the registration, supervision, and inspection of equity, equity derivatives, debt, and debt-related intermediaries.

b. **Market Regulation Department:** This department is responsible for formulating new policies, safe exchange, clearing and settlement with subsidiaries and market institutions, and supervision of deposits.

c. **Derivatives and New Products Department:** This department is responsible for the supervision of transactions, trading related to new products, and policy changes.

3. Governing Board:

The governing board consists of elected member directors and government-nominated public representatives. The responsibility for maintaining the rules of the stock market lies with the governing board. There are 13 members in the governing board of a stock exchange. Out of these, 6 members are selected by the members of the stock exchange. The Central Government appoints more than three members, the governing board appoints three public representatives, SEBI appoints two to three persons, and the stock exchange appoints one Executive Director. The members of the governing board select the President and Vice-President, for which the approval of the Central Government is not required.

7.4 Recognition of Stock Exchange :

Any stock exchange can apply to the Central Government in the prescribed manner to obtain recognition. Every application must contain prescribed details, such as rules regarding the constitution of the stock exchange, the constitution of the governing board and management power and its method of transaction, powers and duties of the office bearers of the stock exchange, admission of various types of members to the stock exchange, qualifications for membership, expulsion and re-entry, the process for registration of partnership as a member of the stock exchange and nomination and appointment of authorized representatives, etc.

After accepting the application, if the Central Government is satisfied after conducting the necessary investigation and obtaining information, and if it feels that:

- The rules of the stock exchange when applying for registration are consistent with the conditions suggested for keeping investors safe.
- The stock exchange is ready to comply with any other conditions (including conditions regarding the number of members) which the Central Government has determined after consultation with the governing board of the stock exchange and after considering the securities traded by the stock exchange.
- It is in the public interest to grant recognition to the exchange of shares, then it can grant recognition.

7.5 Listing of Securities :

When a company is listed on the stock exchange, a security listing agreement is entered into between the company and the stock exchange. The main objective of the listing agreement is to ensure that companies are following good corporate governance. Listing a security involves adding the company's security to the stock exchange's purchase-sale list. When a private company wants to give shares or debentures to the general public, it is necessary for it to be listed on the stock exchange. Listed securities provide market liquidity and undergo regulation in a well-organized manner, instilling trust in investors.

Section 73(1) of the Companies Act 1956, Amendment 1988, mandates that a company adhere to specific requirements for stock market listing. For instance, upon non-compliance with the listing agreement, the applicant, promoters, and/or group companies become defaulters. In addition, companies also have to comply with the Securities Contracts (Regulation) Act 1956, Securities Contracts (Regulation) Rules 1957, SEBI Act 1992, SEBI (Issue of Capital and Disclosure Requirements) 2009, certain conditions suggested under these, any other circulars, clarifications, guidelines issued by the authorized power, etc. The listing agreement is entered into as per the directions given by SEBI to the stock exchange governing board from time to time. The stock exchange suggests improvements to the companies. The security listing agreement includes 51 clauses, including clause number 49 related to corporate governance.

7.6 Rules for Listing of Securities :

A company that wants to list its shares on the stock exchange must comply with the following requirements:

1. Permission for listing shares must be given in the company's Memorandum of Association or Articles of Association.
2. The company must have issued at least 49 percent of its share capital to the public for subscription.
3. The prospectus must contain necessary information related to the subscription opening date, acceptance of share applications, etc.
4. Allotment of shares must be done in a proper and fair manner. In the case of

over-subscription of shares, the basis of allotment should be determined by the company after discussing with the office bearers of the recognized stock exchange where the shares are proposed to be listed.

5. If the money from rejected share applications is not returned to investors within 30 days of the subscription's closing, the application money must be paid with interest.

6. In the case of book building, the allotment will come within 15 days after the conclusion of the issue; if the company fails to do so, it must pay the money to investors with interest.

7. The company's shares become available for trading in the stock market only after the company enters into a listing agreement by paying the prescribed fee and depositing the necessary documents and details.

8. It is mandatory for a listed company to notify the stock exchange of the publication of its half-yearly results and changes occurring in its share capital structure.

7.7 Registration of Brokers :

The share brokers are members of the stock exchange who carry out the purchase and sale of securities for themselves or for their clients. According to the Securities Contracts (Regulation) Act 1956, the qualifications for becoming a member of the stock exchange throughout India are as follows:

1. The minimum age prescribed for members is 21 years.
2. He/she must be an Indian citizen.
3. He must not have been declared insolvent.
4. He must not have been convicted for fraud or dishonesty.
5. He must not be engaged in any other business connected with a company.
6. He must have the minimum required educational qualification - passed the standard 12th examination.

Additionally, SEBI grants membership to companies and partnership firms. To become a share broker in India, a person or company or partnership firm must obtain a registration certificate from SEBI by paying the prescribed fee and following the suggested rules. If a person has already obtained admission as a member in one stock exchange, then according to SEBI laws, no separate registration is required for operating in more than one stock exchange. But, for this purpose, they will have to take the approval of such other stock exchanges. Strict criteria for membership of share brokers like capital adequacy, past performance, education, and experience are included so that quality services are ensured.

A broker has to follow the code of conduct determined by SEBI. In addition, there are also sub-brokers in the stock market who are appointed by the broker and act as an authorized person on behalf of the broker, but he is not a direct member dealing with the stock market. It is necessary for sub-brokers to register with SEBI, and they receive commission as an authorized person of the broker. Typically, a broker and a sub-broker formalize their agreement on a 10 rupee judicial stamp paper.

The agreement generally clarifies the powers and responsibilities of the broker and sub-broker. If any broker is involved in manipulation or in changes occurring in prices or provides false information, there is a possibility of his registration being suspended. If the rules are not followed, the registration can also be canceled.

7.8 Development of Stock Market in India :

The stock market in India has been a journey from a small group of people to an electronic stock market. The 18th century marked the inception of the Indian stock market with the introduction of long-term discount bond securities. However, the actual origin of the stock market can be considered after the mid-19th century.

The passage of the Companies Act in A.D. 1850 sparked interest among investors in companies, thanks to facilities like limited liability. The Bombay Stock Exchange, which is now known as the Stock Brokers Association, was the first stock exchange in India. It opened in 1875. The formation of the Ahmedabad Stock Exchange (1894), Calcutta Stock Exchange (1908), and Madras (Chennai) Stock Exchange (1937) marked an important step forward.

Until A.D. 1960, the Calcutta Stock Exchange (CSE) largely dominated the secondary market. The Calcutta Stock Exchange and the Bombay Stock Exchange listed most of the companies registered in India. In 1961, the Calcutta Stock Exchange listed 576 out of 1203 companies, while the Bombay Stock Exchange listed 297.

In the 1960s, the popularity of the Bombay Stock Exchange increased. After the liberalization of the Indian economy in 1991, stock markets entered an era of reforms. The Indian stock market follows a three-tier structure:

- National Stock Exchange of India Limited (NSE)
- Regional Stock Exchanges
- Over The Counter Exchange of India (OTCEI)

The NSE was established in 1994 as the first automated screen-based exchange in India. The formation of NSE was a revolution for the Indian stock market. Subsequently, all major stock exchanges started electronic trading. Now, with the technological revolution, traders/investors sitting in any part of the world can buy and sell shares during the working hours of the stock market. OTCEI was formed in 1992 to enable small and medium-sized enterprises.

After India's independence, 23 stock exchanges were added, but now only 5 remain, and the rest have been listed as inactive exchanges by SEBI.

List of Active Stock Exchanges in India:

- Bombay Stock Exchange
- National Stock Exchange of India
- NSE International Exchange
- Calcutta Stock Exchange
- India International Exchange (INX)

7.9 Stock Exchanges of India :

1. Bombay Stock Exchange (BSE):

The Bombay Stock Exchange, or Mumbai Stock Market (BSE), is the leading and oldest stock market in Asia. It was established in A.D. 1887 with the formation of the Native Share and Stock Brokers Association. BSE is a very active stock market in India. It has the highest number of securities listed. About 70 to 80 percent (% of the transactions occurring in the stock markets of India take place in BSE. More than 5000 companies are listed on BSE. BSE is a national stock market because BSE has started allowing its members to set up computer terminals outside Mumbai city (East Mumbai).

In the year 1986, BSE started its sensitivity index, in which the base year is 1978-79. This is an index of 30 companies. In the year 2005, BSE was given the status of a new public company named Bombay Stock Exchange Limited. BSE has computerized its trading system by introducing BOLT (Bombay Online Trading) from March 1995. The average daily turnover of BSE is Rs. 200 crore. It provides depository services through its Central Depository Services Limited (CDSL).

2. National Stock Exchange of India:

An important step in the Indian capital market was the formation of the National Stock Exchange of India Limited (NSE) in the year 1992. Though it was recognized as a stock market in the year 1993, trading started on it in the year 1994. It was the first stock market in India in which trading started electronically. NSE is a leading stock market in terms of technology, systems, and transactions. NSE is the largest and most modern stock market in India.

In terms of total and average daily turnover of equity shares, the National Stock Exchange (NSE) is the largest stock market in India. In addition, it has the third-largest stock market in the world, after two exchanges operating in the USA. NSE has a screen-based trading system. In it, trading is screen-based with completely automated order machines. The system available in NSE provides complete transparency of trade to the trading members and participants. NSE started its own index CNX Nifty, which is now known as Nifty 50, in 1996. It includes 50 companies.

7.10 Trading Methods in Stock Market :

A few years ago, in the stock markets of India, share brokers used to trade securities by shouting at fixed times in the stock market or by various hand signals. Now, in place of this old traditional method, online screen-based electronic trading practice has come into existence. All stock markets in India have online trading practice. The National Stock Exchange and Over the Counter Exchange have adopted screen-based online trading practice right from the beginning of their establishment.

The Mumbai Stock Market and the National Stock Exchange have introduced nationwide self-operated complete screen-based trading practice. The screen-based trading practice of the National Stock Exchange is known as NEAT - National Exchange for Automated Trading, and the screen-based trading practice of the Mumbai Stock Market is known as BOLT - BSE Online Trading.

Due to the internet trading practice, investors can buy and sell their securities online. In online trading, investors place their purchase and sale orders for securities through a broker using the internet. The process of purchasing and selling securities in online trading can be described as follows:

1. Opening a Demat Account: A Demat account must be opened with a Depository Participant because purchase-sale transactions of Demat securities can take place over the internet.

2. Purchase-Sale Order: The investor or client has to give the order for the securities which are to be sold to the broker. At the time of placing the order, price etc. per script of purchase-sale must be clearly stated. There are two types of orders in the purchase and sale of securities:

   - Limit Order: In a limit order, the order is executed at the price indicated by the client. The purchase or sale price is determined. Retail investors and fund houses place this type of order.

   - Market Order: In which the order is executed at the price that was last stated on the security's trading screen or at the price at which the security is being demanded in the market.

3. Execution of Order: As soon as the broker receives the order from the client, the broker executes the order. The broker places the order in the stock market and carries out the transaction through online trading on behalf of the client from his own office.

4. Contract Note: After the transaction for the purchase and sale of securities is completed according to the client's order, the broker records this in a document called a contract note. The contract note verifies the date of the transaction. Generally, the broker sends the contract note to the client within 24 hours of the transaction taking place. The contract note states the name of the security, its number, transaction price, order number, brokerage,

applicable taxes, and other relevant details. The contract note is a document of the transaction that has taken place.

5. Settlement of Transaction: The settlement of transactions of purchase and sale of securities takes place through the settlement house in the Mumbai Stock Market. The National Securities Clearing Corporation Limited (NSCCL) maintains the settlement of transactions in the National Stock Exchange. The settlement of the transaction takes place on the day after the transaction or trade occurs.

6. Payment of Amount and Delivery of Securities: If the client has purchased securities, then the payment of the amount for that must be made before the Pay-in day. If securities have been sold, the delivery of securities must be given before the Pay-in day. If the client has purchased securities, the delivery of securities is made to him on the Pay-out day. If securities have been sold, the client receives the money on the Pay-out day. Pay-in day means the day on which the seller of securities delivers the sold securities to the stock market through an intermediary. Pay-out day is when the stock market delivers securities to the buyer and pays the seller.

7. Informing the Client of Settlement: In case of sale of securities, the broker will pay the amount to the client through the bank, and in case of purchase of securities, the broker will directly pay the amount from the client's bank account. Information regarding the settlement of the transaction is given to the client through the Demat account.

7.11 Need for Depository Establishment in India :

All transactions of securities in India take place in dematerialization form. Dematerialization means conversion of securities into electronic form. The depository system paves the way for dematerialization of shares. A depository is an institution that holds securities in electronic form at the request of the investor.

The depository eliminates the risk associated with physical shares. Previously, the purchaser had to check whether their securities had been safely transferred to their account or not and had to ensure that the security had not been stolen or lost. After the arrival of the depository system, such risks have reduced to a significant extent because the transfer of securities takes place electronically. The depository system also streamlines administrative tasks related to trade and accelerates the transfer of shares. From the year 1998, Demat, or electronic trading, was made mandatory for institutional investors, due to which the trade value in the Indian market increased. The depository system has increased foreign investors' confidence in trading in the Indian stock market by reducing instances of fake, delayed, and unethical transfers.

7.12 Difference between Demat Shares and Physical Shares :

Demat shares are held by the depository on behalf of the investor. Investors themselves hold physical shares. Ownership of Demat shares is done electronically. Physical shares are in the form of paper. Demat shares can be converted into physical shares at the request of the investor. This process is known as rematerialization. The intermediary functioning as a link (interface) between the seller of securities as well as the purchaser of securities (investor) is known as a Depository Participant, where investors open an account and give necessary instructions regarding investment.

Demat shares do not have folio numbers, distinctive numbers, or certificate numbers found in physical shares. Demat shares are fungible, meaning any security is equal and interchangeable. Stamp duty is not applicable on Demat shares being transferred from one account to another, but the depository participant collects transaction fees as well as asset holding charges. However, in terms of benefits of share ownership, there is no difference between physical shares and Demat shares. No matter in what form the investor holds shares, he is entitled to equal benefits.

7.13 Advantages of Depository System :

1. **Easy Transfer of Securities at Low Cost:** Due to the depository service, the transfer of securities happens quickly. Paperwork is reduced. Problems associated with physical share transfer are removed, e.g., fake transfer, defective delivery. In addition, the investor saves on brokerage costs, postage costs, stamp duty, etc. Due to the depository, trading for even a single share can take place.

2. **Fast Settlement of Transactions:** Due to the depository, the settlement of transactions is fast. The depository participant carries out the transfer of securities quickly. Immediately along with the settlement of the transaction,

securities or cash is received. The investor does not need to correspond with the company. Settlement of securities transactions in the stock market between various parties takes place through electronic methods.

3. **Facility to Pledge:** It provides the facility to pledge securities and to take loans against securities.

4. **Facility to Freeze or Close Account:** If for some reason the account needs to be kept closed for a short time, it provides the facility to freeze the account for that much time. The account can also be closed as per requirement.

5. **Recording and Storage of Information:** Every transaction associated with securities is recorded in the Demat account. Information remains safe and is stored in a way that it can be obtained whenever required.

6. **Link between Investor and Settlement House:** It provides service as a link between the investor and the settlement house in transactions and settlement of deals occurring in the stock market.

7. **Services through Internet:** The depository provides services at reasonable rates through its depository participants to investors via the internet. It provides the latest information on the account to the client.

Glossary

- **SEBI -** Securities and Exchange Board of India
- **NSE -** National Stock Exchange of India Limited
- **OTCEI -** Over the Counter Exchange of India
- **Corporate Governance -** System related to company governance
- **NEAT -** National Exchange for Automated Trading (NSE's screen-based trading practice)
- **BOLT -** BSE Online Trading (Mumbai Stock Market's screen-based trading practice)
- **NSCCL -** National Securities Clearing Corporation Limited
- **CDSL -** Central Depository Services Limited

Exercise :

Q.1 Fill in the blanks :

1. After the shares of a company are listed, their trading takes place in ___________. (Secondary Market / Capital Market)
2. The Securities Contracts (Regulation) Act was passed in ________. (1956 / 1957)
3. There are ____ members in the governing board of the stock market. (13 / 23)
4. Dematerialization means conversion of securities into __________ form. (Electronic / Physical)
5. In the security listing agreement, clause number of _________________ is also included. (Corporate Governance / Stamp Paper)

Answers:

1. Secondary Market
2. 1956
3. 13
4. Electronic
5. Corporate Governance

Q.2 Answer the following questions in short.

1. What is the meaning of Secondary Market?
2. State any two functions of the Secondary Market.
3. By what name is India's first stock market, 'Stock Brokers Association', now known?
4. What is the sensitivity index of BSE?
5. What is Dematerialization?
6. What is Rematerialization?
7. What are Pay-in and Pay-out?

Q.3 Answer the following questions in detail.

1. Write the meaning of Stock Market and explain its functions.
2. State the provisions regarding control over the Secondary Market.
3. State the development of Stock Market in India.
4. State the rules for listing of securities.
5. State the methods of trading in the stock market.

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Unit - 8
Equity and Debt Instrument

8.1 Introduction :

In the modern business environment, finance plays a central and indispensable role in determining the success and growth of an organization. Every business, whether small or large, requires funds not only at the time of establishment but also throughout its life cycle for expansion, modernization, diversification, and day-to-day operations. Without adequate financial resources, even the most innovative business ideas cannot be implemented effectively.

At this point, an important question arises regarding where companies obtain these funds. The answer to this question lies in understanding the concept of financial instruments, particularly equity and debt instruments.

Broadly, companies raise long-term finance through two major sources, which are equity capital and debt capital. These two sources differ significantly in their nature, cost, risk, and impact on business control. Equity represents ownership in the company, whereas debt represents borrowed funds that must be repaid within a specified period along with interest.

To understand this distinction more clearly, consider a simple example.

Suppose a businessman wants to start a business but lacks sufficient funds. He has two options. First, he may invite others to invest in his business and offer them a share in ownership. This is known as equity financing. Alternatively, he may borrow money from a bank or financial institution and agree to repay it with interest. This is known as debt financing.

Both these sources are essential for maintaining a balanced capital structure. A company cannot rely entirely on equity because it may lead to dilution of ownership and higher cost. Similarly, excessive reliance on debt may increase financial risk due to fixed interest obligations. Therefore, an optimal mix of equity and debt is necessary for efficient financial management.

In recent years, both equity and debt markets have witnessed significant development in India and globally. Increased participation of retail investors, advancements in digital trading platforms, and regulatory reforms have made these markets more accessible and transparent. As a result, understanding equity and debt instruments has become not only academically important but also practically relevant.

This chapter aims to provide a comprehensive understanding of equity and debt instruments, their features, types, advantages, limitations, and their role in financial decision-making.

8.2 Meaning of Equity Share :

Equity shares form the foundation of corporate ownership. They provide companies with permanent capital while offering investors an opportunity to participate in business growth. However, they also involve higher risk due to uncertain returns.

8.2.1 Concept and Definition

Equity shares represent the ownership capital of a company. When a company issues equity shares, it invites investors to become part-owners of the business. The holders of such shares are called equity shareholders, and they bear both the risks and rewards associated with the company's performance.

In academic terms, an equity share can be defined as:

A unit of ownership interest in a company that entitles the holder to a residual claim on income and assets, along with voting rights in corporate decisions.

This means equity shareholders are the ultimate owners of the company.

8.2.2 Key Characteristics of Equity Shares

To understand equity shares clearly, let us examine their essential features:

1. **Permanent Capital:** Equity shares constitute a permanent source of finance. The company is not required to repay this capital during its lifetime, except in the case of liquidation.
2. **Residual Claim on Income:** Equity shareholders receive dividends only after all other claims (such as interest on debt and preference dividends) are satisfied. Hence, their income is uncertain but potentially higher.
3. **Residual Claim on Assets:** In the event of liquidation, equity shareholders have the last claim on the company's assets. After paying all liabilities, whatever remains belongs to them.
4. **Voting Rights and Control:** Equity shareholders possess voting rights, enabling them to participate in important decisions such as appointment of directors, approval of financial statements, and policy changes.
5. **Limited Liability:** The liability of equity shareholders is limited to the amount invested. They are not personally liable for the company's debts.
6. **Transferability:** Equity shares are generally transferable and can be bought or sold on stock exchanges, providing liquidity to investors.
7. **Variable Return:** There is no fixed rate of dividend. Returns depend on the profitability of the company.

8.2.3 Equity Shares in Indian Context

In India, equity shares are widely traded on stock exchanges such as NSE and BSE. The expansion of digital platforms has led to a notable rise in retail participation.

Important features in the Indian system include:

- Dematerialization of shares (Demat form)
- Online trading platforms
- Regulatory oversight by SEBI
- Availability of small investment options (low face value shares)

Example: Companies such as Reliance Industries, TCS, and Infosys actively trade in the market and possess large equity bases.

8.3 Types of Equity Shares :

Equity shares can be classified in multiple ways based on rights, features, and purpose of issuance. Understanding these classifications is important for exams as well as for practical investment decisions.

8.3.1 Classification Based on Voting Rights

(a) Equity Shares with Voting Rights: These are the most common type of shares. Shareholders have full voting rights in company decisions such as electing directors and approving policies.

(b) Equity Shares with Differential Voting Rights (DVRs): These shares carry either lower or higher voting rights compared to ordinary shares. In return, they may offer higher dividends.

Example: Some companies issue DVR shares to raise funds without diluting control.

8.3.2 Classification Based on Ownership

(a) Promoter Shares: Held by founders or promoters of the company. These shares usually carry significant control over management decisions.

(b) Public Shares: Held by general investors including retail investors, institutions, and foreign investors.

8.3.3 Classification Based on Issue Purpose

(a) Rights Shares: Offered to existing shareholders in proportion to their holdings. This helps maintain ownership structure.

(b) Bonus Shares: Issued free of cost to existing shareholders from accumulated profits or reserves.

(c) Employee Stock Option Shares (ESOPs): Issued to employees as part of compensation to motivate and retain talent.

8.3.4 Classification Based on Return

(a) Growth Shares: These shares do not pay regular dividends but focus on capital appreciation.

(b) Income Shares: These shares provide regular dividends but may have limited growth potential.

8.3.5 Classification Based on Market Capitalization

(a) Large-Cap Shares: Issued by well-established companies with stable performance.

(b) Mid-Cap Shares: Issued by growing companies with moderate risk and return.

(c) Small-Cap Shares: Issued by smaller companies with high growth potential but higher risk.

8.3.6 Summary Table (Quick Revision)

Basis	Types
Voting Rights	Normal Shares, DVR Shares
Ownership	Promoter Shares, Public Shares
Purpose	Rights Shares, Bonus Shares, ESOPs
Return	Growth Shares, Income Shares
Size	Large-cap, Mid-cap, Small-cap

8.4 Advantages and Limitations of Equity Financing :

Equity financing is one of the most widely used sources of long-term capital. It provides ownership-based funding and plays a vital role in the capital structure of a company. However, like any financial decision, it has both advantages and limitations. A clear understanding of these aspects is essential for examination as well as practical decision-making.

8.4.1 Advantages of Equity Financing

(A) Advantages to the Company

1. Permanent Source of Capital: Equity capital is not repayable during the lifetime of the company. It remains invested permanently, providing long-term financial stability.
2. No Fixed Financial Obligation: The company is not legally bound to pay dividends every year. Dividends are paid only when sufficient profits are available.
3. Improves Creditworthiness: A higher equity base increases the company's borrowing capacity, as lenders feel more secure.
4. No Charge on Assets: Unlike debt, equity financing does not create any mortgage or charge on company assets.
5. Flexibility in Financial Management: Companies can reinvest profits instead of distributing dividends, which supports growth and expansion.
6. Public Confidence and Reputation: Listed equity shares enhance the visibility and credibility of the company in the market.

(B) Advantages to Investors

1. Higher Return Potential: Equity shareholders can earn higher returns through dividends and capital appreciation.
2. Ownership and Voting Rights: Investors become owners of the company and can participate in decision-making.
3. Capital Appreciation: Share prices may increase over time, providing wealth creation opportunities.
4. Liquidity: Equity shares can be easily bought and sold in stock exchanges.

8.4.2 Limitations of Equity Financing

(A) Limitations to the Company

1. High Cost of Capital: Equity is generally more expensive than debt, as investors expect higher returns.

2. Dilution of Ownership and Control: Issuing new shares reduces the control of existing shareholders.
3. Risk of Overcapitalization: Excessive equity may lead to inefficient use of funds and reduced profitability.
4. Dividend is Not Tax Deductible: Unlike interest on debt, dividends are not tax-deductible expenses.
5. Market Pressure and Expectations: Public companies face pressure to perform and maintain share prices.

(B) Limitations to Investors

1. Uncertain Returns: Dividend payments are not fixed and depend on company performance.
2. Residual Claim: Equity shareholders are paid after all other obligations, making their position risky.
3. Price Volatility: Share prices fluctuate due to market conditions, creating uncertainty.
4. Risk of Loss: In case of business failure, equity investors may lose their entire investment.

8.5 Meaning of Debt Instruments :

Debt instruments are financial tools used by companies or governments to raise funds by borrowing from investors. Instead of offering ownership like equity shares, the issuer promises to repay the borrowed amount (principal) along with interest after a specified period. Thus, debt instruments represent a creditor relationship between the investor and the issuer.

In simple terms, when an investor purchases a debt instrument, they are lending money rather than becoming an owner. The issuer is legally bound to pay a fixed or predetermined rate of interest, irrespective of its profit or loss. This makes debt instruments different from equity, where returns are uncertain and depend on company performance.

A key feature of debt instruments is the fixed maturity period, which means the borrowed amount must be repaid after a certain time. During this period, the investor receives regular interest income. Examples of debt instruments include debentures, bonds, government securities, and corporate bonds.

Debt instruments are generally considered safer than equity because investors have a priority claim over company assets in case of liquidation. However, they also involve risks such as defaults and interest rate fluctuations. Despite these risks, investors widely use them due to their stability and predictable returns.

In the Indian financial system, debt instruments play a crucial role in financing government projects, infrastructure development, and corporate expansion. With increasing awareness and digital access, participation in debt markets is gradually growing among investors.

8.6 Debentures and Bonds :

8.6.1 Debentures

A debenture is a long-term debt instrument issued by a company to raise funds from the public. It represents a formal acknowledgment of a loan taken by the company, along with a promise to repay the principal amount after a specified period and to pay interest at a fixed or predetermined rate. Debenture holders are treated as creditors of the company and do not have any ownership rights or voting power in management decisions.

Debentures may be either secured or unsecured in nature. Secured debentures are backed by the assets of the company, which provides an additional layer of safety to investors. In contrast, unsecured debentures depend entirely on the creditworthiness and reputation of the issuing company. Another important classification is based on convertibility. Convertible debentures can be converted into equity shares after a certain period, while non-convertible debentures remain purely debt instruments throughout their tenure.

Debentures usually carry a fixed rate of interest, which is payable regardless of whether the company earns profits or not. This makes them a stable source of income for investors. However, the arrangement creates a financial obligation for the company, requiring regular interest payments. Companies in India widely use debentures to finance expansion, modernization, and other long-term projects.

8.6.2 Bonds

A bond is a debt instrument through which governments, public sector organizations, or large corporations raise funds by borrowing from investors. It represents a contractual agreement in which the issuer promises to pay periodic interest, known as the coupon, and to repay the principal amount at maturity. Unlike equity, bondholders are not owners but lenders to the issuer.

Bonds are generally considered safer than equity investments, especially when issued by the government. Government bonds, also known as government securities, carry minimal risk because they are backed by the sovereign guarantee. Corporate bonds, on the other hand, may carry varying levels of risk depending on the financial strength of the issuing company.

There are different types of bonds designed to meet various investment needs. Fixed-rate bonds provide a constant interest rate, while floating-rate bonds have interest rates that change with market conditions. Zero-coupon bonds are issued at a discount and do not pay periodic interest, and inflation-indexed bonds help protect investors against inflation.

In the Indian financial system, bonds play a crucial role in financing public expenditure and infrastructure development. With increasing digital access and regulatory support, participation in the bond market is gradually expanding, making it an important component of the overall financial market.

8.7 Government Securities :

Government securities, commonly known as G-Sec, are debt instruments issued by the central or state governments to raise funds for public expenditure and development activities. These securities represent a formal borrowing by the government from investors, with a commitment to repay the principal amount along with interest after a specified period. The government backs them with a sovereign guarantee, making them one of the safest investment options.

Government securities are issued for various purposes such as financing infrastructure projects, managing fiscal deficits, and supporting economic development. Since governments require large amounts of funds for long-term projects like roads, railways, defence, and social welfare programs, G-Sec plays a crucial role in mobilizing public savings and channelling them into productive uses.

These securities are available in different forms depending on their maturity and structure. Treasury Bills (T-Bills) are short-term government securities with a maturity of less than one year, while government bonds are long-term instruments with maturities ranging from several years to decades. Treasury Bills are issued at a discount and redeemed at face value, whereas government bonds usually carry a fixed interest rate paid periodically.

Government securities may also include special instruments such as inflation-indexed bonds, which protect investors against inflation by adjusting returns based on price levels, and floating-rate bonds, where the interest rate varies according to market conditions. These variations provide flexibility and cater to different types of investors.

One of the most important features of government securities is their low risk. The government backs them, significantly reducing the likelihood of default. This makes them highly attractive to risk-averse investors such as banks, insurance companies, and pension funds. However, corporate bonds or equity investments generally offer higher returns than government securities.

In India, government securities are issued by the Reserve Bank of India (RBI) on behalf of the government. Investors can purchase these securities through banks, primary dealers, or online platforms such as RBI Retail Direct. In recent years, the government has taken several initiatives to increase retail participation in the G-Sec market by simplifying access and improving transparency.

Despite their safety, government securities are not entirely risk-free. They are subject to interest rate risk, which means their market value may fluctuate with changes in interest rates. Inflation risk is another concern, as rising prices may reduce the real returns earned by investors.

Overall, government securities play a vital role in the financial system by providing a secure investment option, supporting government financing needs, and contributing to economic stability. They form the backbone of the debt market and serve as a benchmark for other financial instruments.

8.8 Corporate Bonds :

Companies issue corporate bonds, which are long-term debt instruments, to raise funds for various business purposes such as expansion, modernization, acquisition, or working capital requirements. When a company issues a corporate bond, it borrows money from investors and promises to repay the principal amount along with interest at a predetermined rate and time. Thus, corporate bondholders are creditors of the company and not owners.

Corporate bonds play a significant role in the financial system as they provide an alternative to bank loans and equity financing. Companies prefer issuing bonds because it allows them to raise large amounts of capital without diluting ownership or control. For investors, corporate bonds offer a relatively stable source of income in the form of periodic interest payments.

These bonds may be classified based on various features. Some corporate bonds carry a fixed rate of interest, while others have a floating rate linked to market conditions. Certain bonds may be convertible into equity shares after a specified period, whereas non-convertible bonds remain purely debt instruments. Companies may also issue secured bonds backed by assets or unsecured bonds that depend on the company's creditworthiness.

One of the key factors influencing corporate bonds is credit rating. Credit rating agencies such as CRISIL, ICRA, and CARE evaluate the financial strength and repayment capacity of the issuing company. Bonds with higher ratings are considered safer but usually offer lower returns, while lower-rated bonds carry higher risk but may provide higher interest.

Compared to government securities, corporate bonds generally offer higher returns because they carry a higher level of risk. The possibility of default, where a company fails to meet its repayment obligations, is one of the main risks associated with these instruments. Therefore, investors must carefully analyse the financial position and credibility of the issuing company before investing.

In India, the corporate bond market has been growing steadily with increased participation from institutional investors such as mutual funds, insurance companies, and pension funds. The government and regulatory bodies have introduced reforms to improve transparency, liquidity, and accessibility in the corporate bond market.

Online platforms and digital trading systems have also made it easier for retail investors to participate.

Despite their advantages, corporate bonds face certain challenges such as lower liquidity compared to equity markets and limited awareness among small investors. However, with ongoing financial reforms and increasing investor education, the corporate bond market is expected to grow further and play a more significant role in the economy.

Thus, corporate bonds serve as an important source of long-term finance for companies while offering investors an opportunity to earn stable returns with moderate risk.

8.9 Advantages and Disadvantages of Debt Instruments :

Debt instruments are widely used in financial markets due to their stability and predictable returns. However, like any financial tool, they have both advantages and risks. Understanding these aspects is essential for both investors and companies.

8.9.1 Advantages of Debt Instruments

1. **Fixed and Stable Income:** Debt instruments provide a fixed rate of interest, which ensures regular and predictable income for investors. This makes them suitable for individuals seeking financial stability.
2. **Priority Claim on Assets:** In case of liquidation, debt holders are given priority over equity shareholders in receiving repayment, making them relatively safer.
3. **No Dilution of Ownership:** For companies, issuing debt does not affect ownership or control, as lenders do not have voting rights.
4. **Tax Benefits:** Interest paid on debt instruments is tax-deductible, which reduces the overall cost of borrowing for companies.
5. **Lower Cost of Capital:** Compared to equity, debt is generally a cheaper source of finance due to fixed interest payments.

8.9.2 Disadvantages of Debt Instruments :

1. **Default Risk:** There is a possibility that the issuer may fail to pay interest or repay the principal amount.

2. **Interest Rate Risk:** Changes in market interest rates can affect the value of debt instruments, especially in secondary markets.

3. **Inflation Risk:** Fixed returns may lose value in real terms due to rising inflation.

4. **Liquidity Risk:** Some debt instruments may not be easily tradable, making it difficult for investors to convert them into cash quickly.

5. **Reinvestment Risk:** Investors may not be able to reinvest interest income at the same rate in the future.

Exercise :

Q.1 Very Short Answer Questions

1. Define equity share.
2. What is meant by debt instrument?
3. What is a debenture?
4. Define bond.
5. What are government securities?
6. What is meant by corporate bond?
7. What is fixed interest?
8. What is maturity period?
9. Who are equity shareholders?
10. What is credit rating?

Q.2 Short Answer Questions :

1. Explain the features of equity shares.
2. Distinguish between equity and debt instruments.
3. Explain types of equity shares.
4. Discuss advantages of equity financing.
5. Explain the meaning of debentures.
6. Describe the role of bonds in financial markets.
7. Explain government securities in brief.

8. What are corporate bonds?
9. State the advantages of debt instruments.
10. Explain risks associated with debt instruments

Q.3 Long Answer Questions

1. Explain the meaning and characteristics of equity shares in detail.
2. Discuss the advantages and limitations of equity financing.
3. Explain the concept of debt instruments with examples.
4. Describe debentures and bonds in detail.
5. Explain the features and importance of government securities.
6. Discuss the role of corporate bonds in financial markets.
7. Explain advantages and risks of debt instruments in detail.
8. Compare equity financing and debt financing.

Q.4 Case-Based Questions

1. A company wants to raise funds without losing control over management. Which source of finance should it choose? Explain with reasons.
2. An investor prefers stable income with low risk. Should they invest in equity or debt instruments? Justify your answer.
3. A company is facing financial stress and unable to pay interest on its bonds. What risk does this situation represent? Explain.
4. An investor is confused between investing in government bonds and corporate bonds. Compare both and suggest the better option.

Q.5 Multiple Choice Questions (MCQs)

1. Equity shareholders are:

   (a) Creditors (b) Owners (c) Employees (d) Lenders

2. Debt instruments provide:

   (a) Fixed income (b) Variable income

   (c) No income (d) Bonus shares

3. Debenture holders are:

   (a) Owners (b) Creditors (c) Directors (d) Managers

4. Government securities are considered:

   (a) Risky (b) Safe (c) Unstable (d) Speculative

5. Corporate bonds are issued by:

   (a) Government (b) Individuals (c) Companies (d) Banks only

Answers: 1-(b), 2-(a), 3-(b), 4-(b), 5-(c)

Q.6 Fill in the Blanks

1. Equity shareholders have __________ claim on assets.
2. Debt instruments involve __________ repayment.
3. Bonds carry __________ interest.
4. Government securities are issued by __________.
5. Debenture holders are __________ of the company.

Q.7 True or False

1. Equity shareholders are creditors. (False)
2. Debt instruments provide fixed returns. (True)
3. Bonds are ownership instruments. (False)
4. Government securities are risk-free. (True)
5. Corporate bonds carry higher risk than government bonds. (True)

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BBA SEMESTER-5

Financial Markets & Instruments

BLOCK: 3

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Unit - 9
Merchant Banking

9.1 Introduction :

In India, the State Bank of India first started Merchant Banking. Merchant Banking includes the task of providing non-banking services to commercial and industrial firms. Commercial banks maintain a separate department for Merchant Banking. This department provides advice and assistance to organizers or entrepreneurs starting new industrial ventures.

Furthermore, it also gives advice for the expansion of existing plants and for the diversification of products in production. The department obtains government approval from the start of a project until its completion. It prepares market survey reports. It provides advice regarding the economic size of the plant, machinery for the selection of production processes, etc.

It also performs the task of obtaining credit from different financial institutions.

It also helps in obtaining sources of foreign exchange. It acts as a manager in issuing shares and also does the underwriting of shares.

9.2 Meaning and History of Merchant Banking :

A Merchant Bank is a unit that acts as an intermediary between the issuers and buyers of securities in the direct market. Any person who provides services as a manager, advisor, expert, or corporate advisor in the management of security creation, which includes the arrangement of buying, selling, or subscribing to securities, is called a Merchant Banker.

"Merchant Banker means any person who is engaged in the business of issue management either by making arrangements regarding selling, buying, or subscribing to securities or acting as manager, consultant, or advisor or rendering corporate advisory services in relation to such issue management."

9.2.1 Characteristics of Merchant Bank:

1. A merchant banker is an important part of providing financial services in the financial system; therefore, it can also be identified as a financial intermediary. A Merchant Banker provides services to individual and corporate clients. A Merchant Banker primarily emphasizes the buying and selling of public issues and private placements in the primary market. Additionally, it deals in transactions such as large-sized block deals and private equity deals in the secondary market.

2. Merchant Bankers primarily provide non-fund-based services, such as management of securities (issues), portfolio management, corporate counselling, etc. Furthermore, Merchant Bankers also provide fund-based services such as underwriting of public issues. Merchant Banker institutions are known as Non-Banking Finance Companies (NBFC) in India, whereas they are known as Investment Bankers in the USA and Issue Houses in the UK.

   In India, Merchant Bankers are formed by banks, financial institutions, large-scale stock broking firms, and private firms. In India, Merchant Bankers are classified into four activities.

9.2.2 History of Merchant Bank:

The importance of merchant banking services increased particularly when there was an unusual increase in the number and size of securities issued in the direct market in India. A foreign bank, National Grindlays Bank, initiated merchant banking in 1967. The law amendment in the mid-80s allowed commercial banks to offer merchant banking services. SBI launched the first Merchant Banking Division in 1972.

Considering the boom in new issues, Merchant Banking departments were started by the Bank of India, Bank of Baroda, Canara Bank, Punjab National Bank, Euro Bank, etc. In India, financial institutions like IDBI (Industrial Development Bank of India) and IFCI (Industrial Financial Corporation), and private sector consultant firms like DPS Financial Institution, J.M. Financial and Investment Services Ltd., have started providing merchant banker services through a separate department and separate subsidiary companies.

9.3 Registration of Merchant Banker in the Stock Market and the SEBI Act - 1992 :

Generally, to perform activities as a banker in connection with any issue, a commercial bank must obtain a certificate of registration from SEBI.

Activities of a Merchant Banker:

- Preparing the prospectus regarding the issue.
- Providing other details/information related to the issue.
- Determining the financial structure of the issue.
- Forming a group of financiers for the issue.
- Final allotment and refunding the money of unallotted shares.

Certificate of Registration: The formation of Merchant Banks in India is done under the SEBI Act of 1988. Its rules are framed under the SEBI Act. The provisions of SEBI are as follows:

1. **Authority of SEBI:** Any person or body corporate in India who carries out merchant banking business does so by taking permission from SEBI.

Therefore, forms are submitted (to follow rules at a high standard set by SEBI) along with prescribed forms and important documents.

2. **Authority regarding Time Limit:** Initially, permission is given to the Merchant Banker for 3 years. Thereafter, renewal is done based on its criteria.

3. **Financial Condition:** The minimum net worth of a Merchant Banker is Rs. 5 crores.

4. **Management of Securities Issue:**

- A) The fundamental service of a Merchant Banker in India is the management of securities issues. The following rules must be followed regarding this:

Size of Issue	Number of Lead Managers
1) Up to 50 crores	Not more than 2
2) Above 50 crores but not more than 100 crores	Not more than 3
3) Above 100 crores but not more than 200 crores	Not more than 4
4) Above 200 crores but not more than 400 crores	Not more than 5
5) Above 400 crores	As many as the Board agrees upon

- B) In every guaranteed issue, the lead commercial banker must take a guarantee of a minimum 5% of the total guarantee commitment or Rs. 25 lakhs, whichever is less.

- C) The lead manager is fully responsible for the allotment of securities to investors and ensuring timely refunds.

5. **Integrity and Fairness:** To maintain integrity and fairness in their transactions, Merchant Bankers must take care of the following:

   A) They independently examine the points mentioned in the prospectus. Thereafter, they give the certificate regarding the issue to SEBI.

   B) They act like professional competitors in the process.

   C) They maintain the capital adequacy ratio.

D) They maintain records of every transaction and submit them when demanded by SEBI.

6. **Authorized Activities:** A Merchant Banker has the authority to perform the following activities:

   1. Issue management.
   2. Underwriting.
   3. Corporate advisory regarding mergers, acquisitions, and financial restructuring, etc.
   4. Portfolio management services.

7. **Classification of Merchant Bankers:** Merchant Bankers are appointed according to the SEBI Act 1988, and thus classification is done by SEBI:

Category	Financial Soundness (Net Worth)	Authority of Activities	Fees Paid
1.	Minimum Rs. 5 crore net worth	Issue management as Lead Manager, Advisor and Consultant; Portfolio Manager; Compulsory Underwriter/Broker	Rs. 2.50 lakh for the first two years and Rs. 1 lakh in the third year.
2.	Minimum Rs. 50 lakhs	Co-manager; Advisor; Issue management and Portfolio management	Rs. 1,50,000 for the first two years and Rs. 50,000 in the third year.
3.	Minimum Rs. 20 lakhs	Advisor, Consultant to Issue Management	
4.	Net worth not required	Only the role of Advisor	

8. **Regarding SEBI Reports:** In cases of public issues and rights issues, the Merchant Banker must provide two of the following reports on the first day of the issue:

   1. 3-day report.

2. 18-day report (in the prescribed format).

9. **Voting Rights of Securities Issue:** There are voting rights in debt issues at the time of rights issues in the offer document before public issues. SEBI has given the authority for this voting.

9.4 Types of Merchant Bank:

Merchant banking services are generally provided by commercial banks, financial institutions, securities brokers, and independent financial advisory firms.

Types of Merchant Banks:

1. **Commercial Banks:** State Bank of India, Canara Bank, Bank of Baroda. They provide services through SBI Capital Market, Canbank Financial Services Ltd., and BOB Financial Services Ltd.
2. **Financial Institutions:** IDBI, IFCI, ICICI. Financial institutions provide merchant banking services through a separate department.
3. **Securities Broking Firms:** DSP Financial Consultant, J.M. Financial & Investment Services Ltd., Credit Capital Finance Corporation, etc.
4. **Independent Financial Advisory Firms:** Mitcon in Maharashtra, GITCO in Gujarat. These firms provide merchant banker services independently on a professional basis.

9.5 Functions of a Merchant Banker:

In India, the banking business is divided into two parts:

1. Banking Finance Companies
2. Non-Banking Finance Companies (NBFC)

Thus, in India, Merchant banking is a specialized financial service regulated by SEBI. Some merchant bankers may be NBFCs, but merchant bankers are not necessarily classified as NBFCs.

No.	Functions	Description
1)	Pre-investment Study	For new projects or the expansion/ diversification of old companies, the Merchant Bank conducts pre-investment studies.

2)	Project Management	They provide advisory services and turnkey projects for multiple purposes locally and globally, including detailed reports on financial, economic, and technical evaluations.
3)	Issue Management	Preparing proposal documents for SEBI, management of securities, publication, and providing services for minimum subscription, allotment, refunds, underwriting, and registration.
4)	Project Counselling	Includes identification of project ideas, project report registration, clearance processes, identifying partners for joint ventures, and assistance in loan approval and working capital finance.
5)	Corporate Counselling	Provided based on client demand, solves problems arising during a company's life, like value-based management, valuation of securities, merger/acquisition deals, block deals, private equity, etc.
6)	Capital Restructuring & Reviving Sick Units	Provides services to achieve optimal equity-debt ratios for over-capitalized or under-capitalized firms. If accumulated losses exceed 50% of net worth, they help in the revival of such sick units.

In addition to these, Merchant Banks provide services in loan approval, improvement of working capital, bill discounting, factoring and forfaiting services, lease financing, venture financing, share broking, and mutual fund activities.

9.6 Role of Merchant Bank in the Capital Market :

When a company comes to the market with public issues, rights issues, and buyback procedures, it is mandatory to appoint merchant bankers.

1. **Supporting the Issue Process:** They help in the entire process from the prospectus to the refund of excess application money.
2. **Demonstration and Coordination:** They simplify the process by coordinating with registrars, underwriters, and bankers.
3. **Pricing of Issue and Market Function:** They help determine the estimated price for opening the issue and provide market support to make the issue smooth.
4. **Following SEBI Guidance/Guidelines:** They must follow the Code of Conduct determined by SEBI.
5. **Prohibition:** They cannot borrow money from the market and cannot participate in the business of buying and selling securities on a commercial basis.
6. **Lead Manager Director:** Depending on the size of the public issue, one or more merchant bankers can be appointed.
7. **Control on Purchase of Shares:** There is a restriction on acquiring company shares for any merchant banker or their partner, director, or officer who is providing issue services.

9.7 Pre-issue and Post-issue Responsibilities of Merchant Banker :

Pre-issue Responsibilities	**Post-issue Responsibilities**
1) Submission of documents by Merchant Banker	1) Providing post-issue observation reports
2) Giving underwriting/guarantee	2) Provision for redressal of investor grievances
3) Documents to be submitted by the issuing company	3) Coordination with intermediaries
4) Appointment as Lead Manager	4) Obtaining issue guarantee
5) Appointment of intermediaries	5) Verification of bankers on the issue
6) Appointment of underwriting brokers	6) Verifying the content of post-issue advertisements

7) Making the proposal document available	7) Determining basis of allotment
8) Submitting 'No Complaint' certificate	8) Allotment of shares on a proportional basis
9) Determining mandatory collection centres	9) For assurance
10) Appointing authorized collection agents	
11) Agreement with depositories	

9.8 Advantages and Disadvantages of Merchant Bankers :

9.8.1 Advantages of Merchant Banker

1. **Professional Expertise and Advisory Services:** Merchant bankers are highly qualified financial experts who possess deep knowledge of capital markets, investment strategies, and corporate finance. They continuously analyze market trends, government policies, and economic conditions to provide accurate and reliable advice. Their guidance helps companies in making important decisions such as expansion, diversification, mergers, acquisitions, and capital structuring. This professional expertise reduces financial risks and improves the overall quality of decision-making.

2. **Smooth and Efficient Capital Raising:** Merchant bankers play a crucial role in raising funds for companies through public issues, private placements, and other financial instruments. They manage the entire process, including preparation of the prospectus, pricing of securities, regulatory approvals, and marketing of the issue. Their involvement ensures that the process is smooth, well-organized, and successful, thereby increasing investor participation and minimizing the chances of failure.

3. **Project Counseling and Feasibility Analysis:** Before undertaking any new project, merchant bankers conduct detailed feasibility studies to determine its viability. They analyze technical, financial, and market aspects to ensure that the project is practical and profitable. By preparing comprehensive project reports and cost-benefit analyses, they help companies

avoid investing in risky or unprofitable ventures, thus ensuring efficient utilization of resources.

4. **Corporate Restructuring and Strategic Support:** Merchant bankers assist companies in restructuring their business operations through mergers, acquisitions, takeovers, and amalgamations. They evaluate the financial position of companies, determine appropriate valuations, and manage negotiations and legal procedures. This support helps organizations improve efficiency, reduce costs, expand market share, and achieve long-term growth.

5. **Assistance in Legal and Regulatory Compliance:** Merchant bankers ensure that companies comply with all legal and regulatory requirements, such as guidelines issued by regulatory authorities and provisions of company law. They handle documentation, filing, and approvals, reducing the risk of legal complications, penalties, or delays. This ensures that all financial activities are conducted in a transparent and lawful manner.

6. **Portfolio Management and Investment Services:** Merchant bankers also provide portfolio management services to investors by helping them select suitable investment options based on their risk appetite and financial goals. They diversify investments across various assets and continuously monitor performance to maximize returns while minimizing risks. This professional management enhances the efficiency and effectiveness of investments.

7. **Underwriting Services (Risk Reduction):** Merchant bankers often act as underwriters, guaranteeing that a company will receive a minimum level of subscription for its securities. If the public does not subscribe fully, the merchant banker purchases the remaining shares. This reduces the uncertainty and risk faced by the issuing company and ensures the success of the capital-raising process.

8. **Market Research and Proper Timing of Issue:** Merchant bankers conduct detailed market research and analyze investor behavior, economic conditions, and industry trends. Based on this analysis, they determine the most suitable time and pricing for issuing securities. Proper timing and pricing increase the chances of successful fund-raising and help companies achieve better financial outcomes.

9. **Saves Time and Managerial Effort:** The processes involved in financial activities such as public issues and mergers are complex and time-consuming. Merchant bankers handle all aspects of these processes, including documentation, coordination, and compliance. This allows company management to focus on core business operations, thereby improving overall efficiency and productivity.

10. **Enhances Credibility and Investor Confidence:** Association with a reputed merchant banker enhances the credibility and reputation of a company in the financial market. Investors gain confidence knowing that the company's financial activities are managed by experts. This trust leads to better investor response, higher subscription rates, and long-term goodwill in the market.

9.8.2 Disadvantages of Merchant Banker

1. **High Cost of Services:** Merchant bankers charge significant fees for their services, including advisory fees, underwriting commissions, and management charges. These costs can be quite high, particularly for small and medium-sized enterprises, and may reduce the overall profitability of the company.

2. **Over Dependence on External Experts:** Companies may become overly dependent on merchant bankers for financial and strategic decisions. This reliance can weaken the company's internal capabilities and reduce its ability to make independent decisions, which may be harmful in the long run.

3. **Conflict of Interest:** There may be situations where merchant bankers prioritize their own financial benefits over the interests of their clients. They might recommend certain financial deals or products that provide higher commissions, leading to biased advice and suboptimal decisions for the company.

4. **Limited Access for Small Firms:** Merchant banking services are often more accessible to large corporations due to the scale and profitability of their transactions. Small and medium enterprises may find it difficult to access these services or may not receive the same level of attention and support.

5. **Complex and Lengthy Procedures:** The processes involved in merchant banking activities are often complex and involve extensive documentation, legal formalities, and regulatory approvals. This can make the procedures

difficult to understand and may result in delays in project execution or fund-raising.

6. **Risk of Wrong Advice or Misjudgment:** Despite their expertise, merchant bankers may sometimes make incorrect judgments or misinterpret market conditions. Such errors can lead to poor financial decisions, failed projects, or losses for the company.

7. **Confidentiality and Data Leakage Risk:** Companies are required to share sensitive information with merchant bankers, including financial data and business strategies. If this information is not handled properly, it may be leaked or misused, causing damage to the company's competitive position and reputation.

8. **Dependence on Market Conditions:** The success of financial activities managed by merchant bankers largely depends on market conditions, which are beyond their control. Economic downturns, market volatility, or changes in investor sentiment can negatively impact the outcome despite proper planning.

9. **Delays Due to Regulatory and Coordination Issues:** Merchant banking activities involve coordination with multiple regulatory authorities and institutions. Delays in approvals or communication gaps can slow down the execution of financial plans, increasing costs and affecting timelines.

10. **Not Suitable for Small-Scale Needs:** For small financial requirements or simple transactions, hiring a merchant banker may not be necessary. The cost and complexity involved may outweigh the benefits, making it more practical for businesses to handle such activities internally.

9.9 Conclusion :

Merchant banking plays a vital role in the modern financial system by acting as an important link between companies and investors. It provides a wide range of services such as financial advisory, capital raising, project management, underwriting, and corporate restructuring. With their professional expertise and knowledge of market conditions, merchant bankers help businesses make informed financial decisions, ensure compliance with legal requirements, and successfully execute complex financial transactions.

At the same time, merchant banking services involve certain limitations such as high costs, dependence on external experts, and risks related to market conditions and confidentiality. Therefore, while merchant bankers add significant value to financial management and business growth, companies must carefully evaluate their needs and choose reliable and experienced professionals.

In conclusion, merchant bankers are essential for facilitating efficient financial operations and supporting economic development, but their services should be used wisely to achieve maximum benefits with minimum risks.

Exercise :

Q.1 Long Answer Questions

1. Explain the meaning and history of merchant banking in detail.
2. Describe the process of registration of merchant bankers under the SEBI Act, 1992.
3. Explain the different types of merchant banking services with suitable examples.
4. Discuss the functions of merchant banking in detail.
5. Explain the role of merchant bankers in capital markets and economic development.
6. Describe the responsibilities of merchant bankers towards clients and regulatory authorities.
7. Explain the advantages and disadvantages of merchant bankers in detail.
8. Discuss the importance of merchant banking in modern business environment.
9. Explain how merchant bankers help in corporate restructuring and financial management.
10. "Merchant bankers act as financial intermediaries between investors and companies." Explain.

Q-2 Short Questions

1. Define merchant banking.

2. State any four features of merchant banking.
3. What is the role of SEBI in merchant banking?
4. List the types of merchant bankers.
5. What is underwriting?
6. State any four functions of merchant bankers.
7. What is portfolio management?
8. Define capital market.
9. What is corporate restructuring?
10. State any four responsibilities of merchant bankers.
11. What is project counseling?
12. Mention any four advantages of merchant bankers.
13. Mention any four disadvantages of merchant bankers.
14. What is an IPO?
15. What is meant by issue management?

Q.3 Multiple Choice Questions

1. Merchant banking mainly deals with:
   a) Retail banking
   b) Investment and advisory services
   c) Agricultural finance
   d) Personal loans

Answer: b

2. Merchant bankers are regulated by:
   a) RBI b) SEBI c) IRDAI d) NABARD

Answer: b

3. The SEBI Act was passed in:
   a) 1985 b) 1990 c) 1992 d) 2000

Answer: c

4. Which of the following is a function of merchant banking?

   a) Accepting deposits b) Issue management

   c) Providing savings accounts d) Currency printing

Answer: b

5. Underwriting means:

   a) Buying goods

   b) Guaranteeing subscription of securities

   c) Issuing loans

   d) Managing deposits

Answer: b

6. Merchant bankers help in:

   a) Selling groceries b) Raising capital

   c) Driving transport d) Manufacturing goods

Answer: b

7. Portfolio management is related to:

   a) Hiring employees b) Managing investments

   c) Production planning d) Marketing

Answer: b

8. IPO stands for:

   a) Initial Public Offer b) Internal Price Option

   c) Investment Public Order d) Income Planning Option

Answer: a

9. Which is NOT a function of merchant banking?

   a) Issue management b) Portfolio management

   c) Accepting savings deposits d) Advisory services

Answer: c

10. Merchant bankers act as:

    a) Traders b) Financial intermediaries

    c) Farmers d) Manufacturers

Answer: b

11. Merchant banking originated in:

    a) India b) USA c) Europe d) China

Answer: c

12. The first merchant bank in India was:

    a) SBI b) Grindlays Bank

    c) RBI d) ICICI

Answer: b

13. Merchant bankers mainly operate in:

    a) Money market b) Capital market

    c) Commodity market d) Foreign exchange market

Answer: b

14. Which of the following is a type of merchant banker?

    a) Private banker b) Issue manager

    c) Retail banker d) Savings banker

Answer: b

15. Which document is prepared during public issue?

    a) Invoice b) Prospectus c) Receipt d) Voucher

Answer: b

16. Merchant bankers are also known as:

    a) Investment bankers b) Retail bankers

    c) Central bankers d) Cooperative bankers

Answer: a

17. Which of the following is NOT a responsibility of merchant bankers?

    a) Due diligence b) Fair disclosure

    c) Accepting deposits d) Investor protection

Answer: c

18. Merchant banking services include:

    a) Loan recovery b) Issue management

    c) Cash deposits d) ATM services

Answer: b

19. SEBI stands for:

    a) Securities and Exchange Board of India

    b) Stock Exchange Board of India

    c) Securities Economic Board of India

    d) Stock Economic Bureau of India

Answer: a

20. Which service involves advising on mergers?

    a) Retail banking b) Merchant banking

    c) Cooperative banking d) Rural banking

Answer: b

21. Merchant bankers help in:

    a) Tax collection b) Wealth creation

    c) Currency printing d) Law enforcement

Answer: b

22. Which is a feature of merchant banking?

    a) Short-term loans b) Advisory services

    c) Accepting deposits d) Issuing currency

Answer: b

23. Book-building process is related to:

    a) Lending b) IPO pricing

    c) Taxation d) Savings account

Answer: b

24. Merchant bankers assist in:

    a) Production b) Marketing

    c) Financial planning d) Packaging

Answer: c

25. Which of the following is NOT a function of merchant banking?

    a) Underwriting b) Portfolio management

    c) Accepting deposits d) Corporate restructuring

Answer: c

****

Unit - 10
Credit Rating

10.1 Introduction :

A Credit rating is a financial service. Generally, financial assets are very complex and challenging securities; therefore, evaluating them is very difficult. Financial assets refer to shares and debenture certificates, which are managed through demat accounts. These indicate the issuer's ability to pay periodic interest and repay money upon maturity. Thus, the main purpose of credit rating services is to remove or reduce the risk for the issuer of the security.

10.2 Origin and History of Credit Rating :

A credit rating becomes very necessary when funds are to be raised in the form of debt. According to SEBI guidelines in India, if funds are to be raised for debt instruments like corporate debentures, bonds (long-term), and commercial papers (short-term), funds cannot be raised until a credit rating is obtained from a credit rating agency. This rating must be used within its usage limit.

Recognized credit rating agencies in India include: CRISIL, ICRA, CARE, SMERA etc. After obtaining a rating from these agencies, if it is for debentures, they should be issued within 2 months. If not used within the time limit after obtaining it from any agency, it will become useless. Thus, credit rating is given by experts in specific fields through recognized and approved specialized accredited financial firms. High returns are expected by measuring the intensity of accreditation regarding prestige in the company/business and financial cycles. SBI plays an important role in regulating credit rating agencies.

10.3 Meaning and Characteristics of Credit Rating Service :

A credit rating service is a method or law of assessment in the context of the solvency of the borrower of funds. The following Characteristics are given below:

1. The ratings given are alphabetical. E.g., A+, AA, BB+, P1, P3, indicating different ranks from high return to low return.
2. The agency describes the condition of the borrowing institution through its SWOT, management philosophy, and competitive strength.
3. The life of the credit rating obtained is very short. In a dynamic business world, ratings are given according to the economy, industries, and companies.
4. Financial institutions or NBFCs that are experts in their field and have obtained recognition from SEBI provide credit rating services.
5. Credit rating agencies do not create any relationship between the agency and the user of the rating. Credit rating and audit do not guarantee the department; the rating is an independent opinion.
6. Credit rating and audit are opinions based on expertise, honesty, and frank opinion.
7. Credit rating agencies provide information for investment decisions at a very low cost.

10.4 Development of Credit Rating in India :

The first Merchantile Credit Rating Agency was formed in New York in 1841. Messrs Henry Poor (USA) is considered a pioneer in credit rating. He started a credit rating in 1866 under the name Standard & Poor's. However, John Moody was the original founder of the concept in Moody's Investor Service in the USA. In 1909 and then in 1971, Don and Bradstreet followed him. Thus, Moody's Investor Service and Standard & Poor's are considered the two largest agencies in the world, functioning since 1916. Fitch Investor Service is their competitor, holding a 20% share in total share trading.

1. Credit rating started in India with the establishment of CRISIL in 1988.
2. ICRA (Investment Information & Credit Rating Agency of India) was established in India in 1990.
3. CARE (Credit Analysis and Research Agency of India) was established in India in 1993.
4. Duff & Phelps Credit Rating (DCR) is also a recognized agency in India, established in 1996. It merged with Fitch Rating Agency and is now known by the new name Fitch Ratings India Pvt. Ltd.
5. The fifth agency, Brickwork Ratings, was established in India in 2008. It provides services regarding ratings of IPOs, CDS, NCD, and permanent bonds, etc.
6. SMERA (SME Rating Agency of India Limited) was formed in 2011.
7. At the international level, Moody's Credit Rating Agency was formed in 1900.

10.5 SEBI Guidelines Regarding Credit Rating Agencies of India :

1. In 1999, rules regarding credit rating agencies were introduced by SEBI in India. These rules ensure transparency in the credit rating agency's process, making it easier for industries and investors.
2. Public financial institutions, commercial banks, and foreign banks operating in India are eligible.
3. Only foreign credit rating agencies and companies or institutions with a minimum net income of 100 crores are considered recognized or eligible.

4. Credit rating agencies must have a minimum net worth of 5 crores accordingly.

5. Credit rating agencies do not rate issues released by their promoters.

6. Employees, directors, chairmen of promoters, or directors (if they are members in a subsidiary company) are not permitted to rate such affiliated or subsidiary companies.

7. Promoters of rating agencies who hold a 10% or more stake in the rating agency cannot have their financial instruments or securities rated by these agencies.

8. If agencies fail to meet any condition, violate any legal provisions, or if the rating given by the rating agencies proves to be wrong, SEBI has the power to cancel the certificate and fine that agency.

10.5 Future and Challenges of Credit Rating Agencies in India :

Challenges of Credit Rating Institutions	**Suggestions Regarding the Future of Rating Agencies**
1) Conflict of interest	1) Remove conflicts of interest
2) Rating shopping (buying of ranks)	2) To improve the role of the regulator.
3) Low competition	3) The Ministry of Finance should demand a verification report.
4) Poor quality rating	4) Competition should occur between rating agencies.
5) Lack of independence for the rating committee.	5) The quality of rating should be improved.
	6) Different rating agencies should state their opinions for a single party.
	7) Credit rating agencies should receive legal protection.
	8) Rotation should occur in rating agencies.

10.7 Types of Credit Rating Agencies in India :

- Credit rating agencies are extensively useful mainly in developed countries such as the U.S.A., U.K., France, and Japan.
- They entered the Indian financial market very late. The first credit rating agency in India, CRISIL (Credit Rating Information Service of India Ltd.), was established in 1988.
- Thus, brief information of credit agencies working in India is as follows: CRISIL, ICRA, CARE, SMERA, etc.

1) CRISIL (Credit Rating Information Service of India Ltd.)

- In India, ICICI, UTI (Unit Trust of India), LIC (Life Insurance Corporation), GIC (General Insurance Corporation), and Asia Development Bank, etc., collectively established India's first credit rating agency, CRISIL, in 1988.
- It provides the following services:
  - o To accept proposals for the company's long-term debt debentures and short-term preference shares, commercial papers, and deposit instruments, etc.
  - o To regularly provide corporate reports in the context of both the public sector and the private sector.
  - o To conduct industry studies, including industry structure, estimated demand and supply, and market structure, which involves the study of the number of operations, intensity of competition, and size of operations, etc.
- CRISIL is India's first and largest credit agency. In 2012, CRISIL ranked 5,178 SMEs (Small and Medium Enterprises) and has rated approximately 10,000 SMEs.
- To provide opinions and facts for providing the credit quality of the company.
- CRISIL's rating symbols are as follows.

Debenture	S O (Capital Structural Appearance)	Fixed Deposit
AAA High Safety	AAA Best Safety	
AA High Safety	AA High Safety	FAAA High Safety

A Adequate Safety	A Adequate Safety	FAA High Safety
BBB Improved Safety	BBB Improved Safety	FA Adequate Safety
BB Inadequate Safety	BB Inadequate Safety	FB Inadequate Safety
B High Risk	B High Risk	FC High Risk
C Rank Risk	C Rank Risk	FD Default
D Default	D Default	

Short-term Instruments:	**Meaning**
P-1	Very Strong
P-2	Strong
P-3	Inadequate
P-4	Minimum
P-5	Expected instrument at maturity

2) ICRA (Investment Information and Credit Rating Agency of India Ltd.)

- ICRA was established in India in 1991 by IFCI, LIC, SBI, and selected banks, financial institutions, and financial service-providing companies.
- Its objectives are as follows:
  - To provide advice and guidance to investors or creditors.
  - To provide information by checking credit risk regarding debt instruments.
  - To provide symbolic demonstrations regarding current opinions on debt service capacity.
- ICRA performs credit rating for long-term, medium-term, and short-term debts, including debentures, bonds, preference shares, fixed deposits (FD), and commercial papers, etc.
- ICRA provides the following reports and various company investigations:
  - (1) Equity grading (2) Credit assessment (3) General assessment
- ICRA's credit rating symbols:

Long-term (Debentures)	Meaning
LAAA	(Best)
LAA	High Safety
LA	Adequate Safety
LBB	Improved Safety
LB	Inadequate Safety
LB	Degree of Risk
LC and LD	
Medium-term	**Meaning**
MAAA	Best Safety
MAA	High Safety
MA	Adequate Safety
MB	Inadequate Safety
MC	Degree of Risk
MD	Default
Short-term	**Meaning**
A1	Best Safety
A2	High Safety
A3	Adequate Safety
A4	Degree of Risk
A5	Default

3) CARE (Credit Analysis and Research Ltd.)

CARE was established in 1993 by IDBI (Industrial Development Bank of India), some nationalized banks, and some NBFCs. Its purpose is to provide credit ratings for all types of debt. CARE symbols are given similarly to ICRA.

4) SMERA (Small and Medium Enterprise Rating Agency)

SMERA was established in 2005 by SIDBI (Small Industrial Development

Bank of India). The purpose of the SMERA credit rating agency is to rate SMEs. It is associated with an international credit rating agency of the U.S.A. Fitch and Dun & Bradstreet (D & B) and many other financial institutions perform credit ratings for the public sector, private sector, and multinational banks. It received the "Outstanding Development Project Award - 2007" in Hanoi, Vietnam. This award was received from ADFIAP, whose full name is Association of Development Financing Institutions of Asia-Pacific.

5) **ONICRA (Online Individual Credit Rating Agency of India Ltd.)**

Mr. Sonu Mirchandani, the head of the ONIDA company, founded ONICRA in November 1993. Its purpose was to provide creditor credit to customers for purchasing cars or refrigerators. Since 2012, ONICRA has rated approximately 2,500 SME industries. CRISIL and ICRA have very high business. Some business units' ratings by CARE have failed. Therefore, the rating of the CARE agency has led to significant business losses and damages. The ratings have shown a lack of reliability and confidence.

10.8 Advantages of Credit Rating :

1. **Guidance to Investors**

Credit rating provides clear information about the creditworthiness of a company or financial instrument. It helps investors understand whether an investment is safe or risky. For example, a high rating like AAA indicates strong financial stability, while a low rating suggests higher risk. This guidance is especially useful for small investors who may not have expert knowledge of financial analysis.

2. **Reduction in Investment Risk**

By evaluating the issuer's ability to repay debt, credit rating reduces uncertainty and risk. Investors can avoid highly risky securities and select safer options. Although it does not eliminate risk completely, it significantly minimizes the chances of loss.

3. **Saves Time and Effort**

Analyzing a company's financial health requires technical knowledge and time. Credit rating agencies perform this analysis and present the results in a simple form. This saves investors from studying complex reports, balance sheets, and market conditions.

4. Improves the credibility of the Company

A good credit rating increases the trust and confidence of investors, lenders, and stakeholders. It acts as a certificate of financial strength and reliability, helping the company build a strong reputation in the market.

5. Easy and Cheaper Fundraising

Companies with high credit ratings can raise funds easily because investors are more willing to invest in them. They also enjoy lower interest rates on loans and bonds, reducing the cost of capital.

6. Encourages Financial Discipline

To maintain or improve their ratings, companies try to manage their finances efficiently. They focus on reducing debt, increasing profitability, and maintaining transparency. This leads to better corporate governance and financial discipline.

7. Facilitates Comparison

Credit ratings follow a standard scale (AAA, AA, A, BBB, etc.), making it easier to compare different investment options. Investors can quickly evaluate which investment is safer or riskier.

8. Promotes Market Efficiency

Credit ratings reduce information asymmetry, meaning both investors and issuers have access to similar information. This leads to fair pricing of securities and smooth functioning of financial markets.

9. Helpful for Financial Institutions

Banks, insurance companies, and mutual funds rely on credit ratings when making lending or investment decisions. It helps them manage risk and comply with regulatory requirements.

10. Supports Economic Development

By increasing investor confidence and facilitating the flow of funds, credit ratings help businesses grow. This leads to expansion of industries, job creation, and overall economic development.

10.9 Disadvantages of Credit Rating :

1. **Ratings Are Not Guarantees**

   Credit ratings are based on analysis and assumptions, not certainty. Even highly rated companies can default due to unexpected factors like economic crises, fraud, or mismanagement.

2. **Possibility of Bias and Conflict of Interest**

   Since companies pay rating agencies for their services, there may be pressure to assign favorable ratings. This can lead to biased or overly positive ratings, which reduce reliability.

3. **Delay in Updating Ratings**

   Credit ratings are not always updated immediately after changes in a company's financial condition. Sudden events such as losses or scandals may not quickly reflect, resulting in outdated ratings.

4. **Over-Reliance by Investors**

   Many investors depend completely on credit ratings without conducting their research. This blind reliance can result in poor investment decisions if the rating is inaccurate.

5. **Limited Scope of Evaluation**

   Credit ratings only focus on the ability to repay debt (credit risk). They do not consider other risks such as: Market fluctuations, Inflation, and Interest rate changes.

   Thus, a highly rated investment may still lose value due to these factors.

6. **Expensive Process**

   Obtaining a credit rating involves fees and compliance costs. Small and medium-sized companies may find it difficult to afford these expenses.

7. **Negative Impact of Downgrades**

   When a company's rating is downgraded, it can lead to: Loss of investor confidence, an Increase in borrowing costs, and a Fall in the market value of securities. This can harm the company's financial position.

8. Lack of Transparency in Methodology

The exact methods used by rating agencies are complex and not fully disclosed. Investors may not clearly understand how a particular rating is assigned.

9. Possibility of Rating Errors

Credit rating agencies rely on data provided by companies. If the data is incorrect or incomplete, the rating may also be inaccurate.

10. Herd Behavior in Financial Markets

Investors often react strongly to rating changes. A downgrade can lead to panic selling, while an upgrade may cause excessive buying. This creates volatility in the market. Credit rating is an essential tool that simplifies investment decisions and improves market efficiency, but it should be used carefully along with independent analysis due to its limitations and potential risks.

10.10 International Credit Rating Agencies :

Compared to the world's U.S.A. credit agencies, in comparison to S&P (Standard & Poor's), Indian credit agencies sometimes fail to provide the purpose of financial information. Henry Varnum Poor established the first credit rating agency in the world in the U.S.A. in 1860. Subsequently, in 1941, S&P became the world's largest credit rating agency. Moody's followed suit in the U.S.A., and John Knowles founded a credit agency named Fitch in 1913. International credit rating agencies mainly include Moody's, Standard & Poor's, and Fitch. In 2016-17, S&P was considered the world's largest credit agency. It is making many efforts to keep India's rating low. Therefore, S&P has been given the notation of 'Poor Standard'. India is placed in the category of such developed economies, so the country fails to fulfil the domestic application (gross).

India's Weak Rating:

Based on low per capita Gross Domestic Product and fiscal status by rating agencies, India is given a rating slightly above the base rating. In November 2016, S&P gave India a long-term rating of BBB and a short-term rating of A-3. The agency claims that India's rating has no room for improvement for the next two years. It blames India's weak fiscal position for the lack of improvement in India's rating.

According to it, improvement will not be possible until India's general government debt becomes less than 60% of the net domestic product. Rating agencies sometimes use the level of debt or the poor condition of banks as an excuse to avoid upgrading India's rating. While reviewing the government of India, S&P said there are two reasons behind keeping India's rating stable. The level of debt or credit is high relative to the Gross Domestic Product; in India, this ratio is 68.5 of GDP. According to the agencies, if brought below 60%, India's rating could go higher.

- India's lower-level per capita GDP which was $1700 in the year 2016.
- Slow investment environment.
- According to agencies, mainly the following factors are responsible for China's weak rating:
- The growth rate and its method decreased from 10% to 6.5%.
- In 2010, China's rating was increased from A+ to AA. Between 2009 and 2015, the credit ratio compared to GDP increased from 142% to 205%.
- During this time, the growth rate was 10.5%, which decreased to 6.5%.
- That is, despite the catchy pattern in China, the rating was not downgraded, while India's rating was kept stable.

10.11 Conclusion :

Credit rating plays a vital role in the modern financial system by providing an independent and objective assessment of the creditworthiness of borrowers such as companies, governments, and financial instruments. It helps investors make informed decisions by indicating the level of risk associated with different investment options. Credit ratings enhance transparency and efficiency in the financial markets by reducing information asymmetry between issuers and investors. They also assist organizations in raising funds more easily by building trust and credibility in the market. However, credit ratings are not foolproof. Credit ratings represent opinions based on available data, and limitations such as delayed updates, conflicts of interest, or unforeseen economic changes may influence them. Therefore, investors should use credit ratings as a guiding tool rather than the sole basis for decision-making. In conclusion, credit rating is an essential mechanism that supports investment decisions, promotes financial stability, and contributes to the overall development of capital markets, while also requiring cautious and informed use.

Exercise :

Q.1 Theoretical questions :

1. What is a Credit Rating Agency? State its characteristics.
2. State the brief history of the Credit Rating Agency.
3. Explain SEBI guidelines regarding credit rating in India.
4. Explain the role of credit rating in India.
5. Discuss in detail any rating agency of India.
6. Explain the Meaning and Characteristics of Credit Rating Service
7. Explain the Development of Credit Rating in India
8. Explain the Advantages of Credit Rating.
9. Explain the Disadvantages of Credit Rating

Q.2 Short Questions

1) What is Credit Rating?
2) State any credit rating agency of India.
3) State any two credit rating agencies working internationally.
4) "Credit rating agencies in India provide very in-depth and accurate ratings to investors." Discuss this statement critically.
5) "It is not possible to issue shares in India without a Merchant Banker." - Do you agree with this statement? Discuss it.
6) "Moodys and Fitch are popular credit rating agencies of India." - State whether this statement is true or false

Q.3 Multiple Choice Questions

(1) In which year were rules/regulations regarding credit rating agencies introduced by SEBI in India?

(A) 1998 (B) 1996 (C) 1995 (D) 1999

(2) Which of the following is a credit rating agency of India?

(A) Moody's (B) S&P's (C) Fitch (D) CRISIL

(3) Which of the following is NOT a credit rating agency of India?

(A) ICRA (B) CRISIL (C) CARE (D) Moody's

(4) Which of the following credit rating agencies was first established in India?

(A) CARE (B) SMERA (C) CRISIL (D) ICRA

(5) Which of the following does NOT have a stake in the formation of CRISIL?

(A) LIC (B) GIC (C) UTI (D) HDFC

(6) Which of the following is NOT included in the analysis of the rating method?

(A) Economic analysis (B) Financial analysis

(C) Business analysis (D) SWOT analysis

(7) Detailed analysis is an important method for rating financial instruments. Which of the following criteria can be in it?

(A) Economic analysis (B) Business analysis

(C) Financial analysis (D) All of the above

(8) When did the credit rating agency named S&P start?

(A) 1866 (B) 1890 (C) 1875 (D) 1880

(9) Where must all credit rating agencies wishing to rate financial instruments register first?

(A) ROC (B) RBI (C) SEBI (D) MCA

(10)____ is useful to provide protection to investors by providing best information in disclosure with best accounting standards and improved accounting information.

(A) Credit Rating Agency (B) Stock Market

(C) Bank (D) None of these

(11) What is CRISIL (Credit Rating and Information Service of India)?

(A) Credit Ranking Institution

(B) Stock Market Regulatory Institution

(C) Professional Institution

(D) None of these

(12) When was CRISIL (Credit Rating and Information Service of India) established?

(A) 1999 (B) 1992

(C) 1988 (D) None of the above

(13) When was ICRA (Investment Information and Credit Rating Agency of India Limited) established?

(A) 1988 (B) 1991 (C) 1982 (D) 1992

(14) What is the purpose of ICRA?

(A) To show equity-related risk to investors

(B) To show debt-instrument associated risk to investors

(C) Regarding preference share associated risk to investors

(D) None of the above

(15) When was CARE established?

(A) 1993 (B) 1994

(C) 1995 (D) None of the above

(16) Reconstruction is classified as follows?

(A) Internal and External (B) Capital Reconstruction

(C) Creditors' Reconstruction (D) All of the above

(17) What is ONICRA?

(A) Bank (B) Stock Market

(C) Credit Ranking Agency (D) Lender

(18) In which field can ONICRA perform credit ranking?

(A) Credit Card (B) Leasing

(C) Housing Finance (D) All of the above

(19) Which law has been enacted for slow companies (slow industrial units)?

(A) SIC ACT 1985 (B) Companies ACT 1956

(C) 1986 (D) None of the above

Answers to Multiple Choice Questions

1. (D),	2. (D),	3. (D),	4. (C),
5. (D),	6. (D),	7. (A),	8. (C),
9. (D),	10. (A),	11. (A),	12. (C),
13. (B),	14. (B),	15. (A),	16. (D),
17. (C),	18. (D),	19. (A),	

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Unit - 11
Derivatives Market

11.1 Introduction :

At the end of the twentieth century, there was rapid development of financial markets such as the stock market, money market, and foreign exchange market across the whole world. In the last decade and a half of the twentieth century, derivatives markets have rapidly developed in many stock markets around the world. The cash (spot) market serves as the origin of a derivatives market, which cannot function independently. It is a market derived from the spot market, and its instruments are known as derivatives (futures).

Transactions in financial instruments can provide protection against the financial risks inherent in cash transactions. Like the cash market, the derivatives market is also a part of the stock market. A derivative is a financial instrument whose value is determined based on the value of its underlying asset or security. The derivatives market is the market where transactions of financial instruments in the form of derivatives take place.

The derivatives market is an integral part of the stock market, in which it works subject to the strict rules, sub-rules, specific controls, and standards of the stock market index, interest rate, commodity, spot market, and clearing house. When changes occur in the prices of all these, changes also occur in the price of derivatives. The players in the derivatives market maintain a strict insistence on financial discipline. In India, as well, the derivatives market has been launched in stages on the Mumbai Stock Exchange and the National Stock Exchange under the supervision of SEBI. The transactions that occur in the derivatives market include hedging and speculation.

11.2 Meaning and Definition :

The word "derivative" is derived from "to derive," which generally means "to take from," meaning to be dependent on something else. Derivatives are an institutional framework, just like insurance. Just as insurance provides protection against risks like fire, flood, and theft, derivatives protect against unexpected risks of price changes in commodities, share prices, interest rates, and market uncertainty and instability. E.g., foreign currency rates, stocks, and government bonds, etc. Thus, humans' inherent tendency to avoid risk contributes to the growth of derivatives. It is essential for the existence of risk management because there is high instability in current financial markets. In this context, derivatives hold an important place as a tool for reducing risk.

The Securities Contracts (Regulation) Act 1956 defines derivatives in the context of India as follows:

1. Such a security that has come into existence from debt instruments, such as shares, loans (secured or unsecured), risk instruments, or contracts or any other type of securities.
2. Such a contract that determines its value from securities under an index of prices.
3. Derivatives are a system against risks of interest rates, exchange rates, and the hedging market.

11.3 Derivatives in the Perspective of the Economy :

Derivatives reduce risk and increase the assets included under them. Derivatives are a main source for future trading. These transactions are just like insurance facilities that provide protection against the risk of price fluctuations. Derivatives increase the liquidity of underlying assets, commodities, and the market. The derivatives market reduces transaction costs.

Derivatives increase the price discovery process. Derivatives provide a glimpse of the future along with the spot price. Derivatives help the investor in determining the risk and return of their portfolio. The derivatives market provides direction regarding the future movement of prices. Because of all these functions, they are becoming increasingly important in the world market as a tool for risk management. Derivative instruments can be used to reduce risk. Derivatives are used to separate risks and transfer them to parties who are willing to face them.

Derivatives offer cheaper, more convenient hedging than cash instruments. This advantage arises from the fact that when derivatives are used for hedging, actual delivery of the asset is not required for settlement. Only profit or loss is adjusted in the derivative market in a derivative contract.

11.4 Advantages of Derivatives Market :

The advantages of the derivative market are as follows:

1. Shows the trend of participants in the market.
2. Becomes helpful in the transfer of risk.
3. Provides a higher volume of trade.
4. Controlled environment.
5. Attracts entrepreneurs. In short, the derivative market increases savings and also increases investment in the long run. Due to the transfer of risk, the activities of the market participants can expand.

11.5 History of Derivatives Market :

Several centuries ago, derivatives emerged as a tool for price fluctuation transactions in the commodity market (a market for transactions of physical goods). In Japan, the first systematic commodity exchange came into existence in the early 1700s. The C.B.O.T (Chicago Board of Trade) was established in 1848 in the U.S. due to the problem of credit risk, and futures contracts emerged to provide a central location for negotiating forward contracts. The first futures contract took place in the 1860s. In 1919, the C.M.E (Chicago Mercantile Exchange) was established so that the price risk involved in commercial tasks could be avoided.

On May 16, 1972, the first financial futures contract came into existence. In 1982, trading for options and stock index futures started. The option contract is also as old as the futures contract. First, put and call options were discovered by an American financier, Russell Sage, in 1872. On April 26, 1973, C.B.O.E (Chicago Board Options Exchange) was established for the purpose of trading stock options. CBOT now provides 48 futures and options, and in the U.S., S&P 100, S&P 500, NASDAQ 100, NIKKEI 225, and N 225 are traded.

11.6 American Derivatives and European Derivatives :

European and American options are the most popular options among options. The style of an option is generally defined by the term through which the option can be used. The most popular options are either European or American style options. The difference between American and European options is related to when the options are used. A European option can be used only on the expiration date of the option. An American option can be used at any time before the expiration date. An option gives you the right to buy or sell a security at a specific price on a fixed date; there are many types of options including American and European options.

American Derivatives:

Meaning: An "American option" is an option contract that can be used anytime between its writing and expiration. First, option contracts became known in London in A.D. 1670 during the time of William and Mary. In the nineteenth century in America, put and call options on shares were sold as special rights by specific dealers over the counter. The security price was determined based on the closing market price from the day or week when the option was purchased. The expiration date was generally three months after purchase. It was not traded in the secondary market.

There are no general formulas for determining the price of American options, but models are available for approximate pricing. For example, models such as Roll-Geske-Whaley, Barone-Adesi and Whaley, the bilateral options model by Cox-Ross-Rubinstein, and Black's approximation are available for approximate pricing. Option contracts traded on futures exchanges are primarily of the American style. All stock and equity options are American options. Traditional monthly American options expire on the third Saturday of every month. Trading for them is closed before Friday. If it starts from the first Saturday of the month, it expires on the third Friday

Trading Process: Any stock involving options, index funds, and all exchange-traded funds (ETFs) trades on standard exchanges with American-style option contracts. American index options expire only on the third Friday of every month. This includes index options that expire weekly at the end of the trading day on Wednesday and Friday. It also includes quarterly options that trade until the last trading day of that quarter.

If an option is in the money and subject to use, it will be used if it expires one percent or more in the money, unless the option owner requests otherwise. The settlement price for exercise options is the closing price of the stock, ETF, or index. After-hours trading does not affect the price. American-style option contracts are very simple.

If a trader holds an in-the-money option during contract expiration, at the time of transfer of assets or stock, it will be exchanged for cash after the expiration of the option. There are two types. One is the American call option, and the other is the put option. An American call option gives you the right to buy a specific asset, while a put option gives you the right to sell it at a specific price. American-style options certainly give more flexibility, but this may depend on the exchange and the asset. For example, in India, you can get American call options for shares. However, American options are unavailable for index and currency options.

Therefore, in this case, you will have no option other than what is offered. For any American option, the value should always be higher than the payment because then we could buy the option, use it immediately, and make a profit. For a call option without any dividend payment, its initial strike price is not beneficial, so its value is equal to the corresponding European option. In this case, the value of American and European options is not identical. Let's see how this type of option works with the help of an American call option example.

Suppose you are expecting an increase in the share price of Company X in the future. So you buy 1,000 options of Company X at a strike price of Rs. 35 each. A few days before the option expiration date, the company's share price reaches Rs. 50. However, you expect that this price will fall soon, and you want to book a profit immediately. By booking profit, you can earn Rs. 15,000. Otherwise, in a European option, you would have to wait until the expiration date. By that time, there is a possibility of a decrease in price. An American-style option gives you the opportunity to use your right immediately and earn the best profit in the current situation. This principle also works for a put option. If you buy 1,000 put options from Company X at a strike price of Rs. 35 and Company X's share price hits 25 rupees shortly after, you will be able to use your rights immediately and get a profit of 10,000 rupees.

Premium on American Style Options: When an option is entered, a premium has to be paid to the broker, which is ultimately given to the option seller or 'writer'. This premium varies in different assets and also depends on other factors. It is generally a certain percentage of the security. For these options, a higher premium must be paid. Therefore, the potential for making a higher profit will vary.

European Derivatives:

Meaning: If an option contract can be used only on its maturity/settlement time, it is called a European option. The time duration for the use of a European option is pre-determined. Over-the-counter trades are primarily European options. Indexes are generally represented by European options. European options expire on the Friday before the third Saturday of every month. Therefore, they are closed for trading on the Thursday before the third Saturday of every month.

Trading Process: A European option is a form of option contract that limits its use until the expiration date of the contract. Although an American option can be used earlier, because its premium is often higher than a European option, investors can earn profit by selling the European option contract in the market before the contract expires, obtaining the net difference between the option initially obtained and the premium paid. In other words, even if the price of the underlying security increases early, the investor will not be able to use the option as soon as possible and will not be able to deliver or sell the shares. Instead, the option will only close at maturity through a call or put action. It is traded over the counter.

The value of European options is specifically calculated using the Black-Scholes or Black model formula. This is a simple equation with a closed-form solution that has become a standard in the financial community. European options stop trading until the market closes on the Thursday before the third Friday of the month. However, the settlement price is not determined until the market opens on Friday. If some significant event occurs between the close on Thursday and the open on Friday, the actual settlement price can become surprising. It can also take several hours during the session on Friday before the settlement prices are determined and released. Because it is the last period between the closing price of Thursday and the opening price of Friday to establish the settlement price on expiration, if options were issued at a money, the trader should hope for something significant to happen to increase the price of options in their Favor.

However, most of the time, options expire in profit. There is a possibility of the price being against the trader. It can double or triple the increase in profit to give a benefit to the trader. With European style options, one cannot change any shares on one's own in in-the-money options during expiration. Instead, the option owner receives the cash value, which is equal to the intrinsic value of the option. It can be beneficial to use the option before the dividend expires.

European Call and Put: Closing the option position before expiration can result in either a benefit or a loss for the trader, depending on market conditions; for example, if there is a significant increase in share prices, the trader can sell the current call option early, while if the stock price has decreased, the put option can be sold. Thus, as the share price increases and decreases, the price suggested by the premium increases and decreases. In this way, the investor will receive the net difference between the two premiums.

- **European Call Option:** Allows the owner to buy the security at the time of option expiration. The call option buyer hopes for a bull market in the asset, expecting that the market price will be higher than the call option's strike price by the expiration date. The strike price of the option is the price at which the contract of the asset is converted into shares. To profit from a call option, investors need the stock price to be higher than the strike price at the time of expiration so that it can cover the cost of the option premium.
- **European Put Option:** Allows the option holder to sell the security at the time of expiration. The put option buyer hopes for a price decrease on the asset, so that the market price will trade at less than the strike price of the option before or by the expiration of the contract. To profit from the put option, the investor must ensure that the stock price trades below the strike price at the time of expiration to cover the cost of the option premium.

Closing European Option before Term: Many investors do not prefer to wait for the expiration of a European option. Instead, they can sell the option contract back in the market before its expiration. The price depends on the premium value, its intrinsic value, and the time value of the option. Intrinsic value is the price as per assumption, which is the difference between the given price and market price if the contract is in-, out-, or at-the-money.

It is important to note here that investors generally do not have a choice to buy an American or European option. Specific shares or funds are offered in only one form or the other, not both. Additionally, most indexes use European options because it reduces the accounting quantity required through brokerage. Many brokers use the Black-Scholes Model (BSM) to value European options.

Difference: The difference between the two options is due to their use. Many things are identical in American and European options. But the difference is also significant. Therefore, it is necessary to understand which style applies in trading. Where an American and European option are identical, such as having the same strike price, etc., then the American option will be at least as much as the European one. However, it is more valuable. Its price difference becomes a guide for the upcoming strike probability.

In practice, one can calculate the Black-Scholes price of any European option that is equivalent to an American option (except for the term of strike). The difference between the two prices can then be used to calibrate a more complex American option model. To account for the high value of American options, there are specific situations where it is advantageous to exercise the American option before the expiration date. It can arise in many ways. For example, an in-the-money call option on a stock is used just before the stock pays a dividend, which reduces its value more than the time value of the option. A gold put option will be used first, then a put option for a bankrupt asset.

11.7 Derivatives Market in India :

The commodity futures market in India has existed since 1875. The government banned futures trading for many commodities in the 1960s and 1970s. Even though there was a long tradition of forward markets in India, the government banned forward trading in the 1960s. Derivatives were not known as options and futures but as 'Teji-Mandi'; based on the power given under Section 16 of the Securities Contracts (Regulation) Act, the government had banned all forward trading of securities through a notification issued in 1969.

Forward contracts in the foreign exchange rate of the rupee (foreign exchange market) received approval from the RBI. It is used on a large scale. Futures trading is permitted in 41 commodities. There are 8 commodity exchanges in India. The Forward Markets Commission under the Ministry of Food and Consumer Affairs acts as the regulator.

In the case of capital markets, the indigenous 125-year-old 'Badla' system was very popular among the broker and investor community. The influx of foreign institutional investors and numerous scams led to the outlawing of the Badla system in the 1990s. Foreign Institutional Investors (FII) were not favourable to this system, and they emphasized sufficient risk-management tools. Therefore, the Securities and Exchange Board of India (SEBI) decided to introduce financial derivatives in India.

However, many legal obstacles arose. It is mentioned in the preamble of the Financial Securities Contracts (Regulation) Act that this law was to prevent undesirable transactions in securities, which were implemented by regulating their transaction and arrangement, banning options, and providing some other matters related to it. The first step was to lift the ban on all options of securities, as Section 20 of the Act explicitly forbade them. For which an ordinance was issued in 1995 by repealing Section 20 of the Securities S.C.R.A., yet it was found that there is no regulatory framework to manage the trading of derivatives. So, committees were formed, and thereafter, at the end of the recommendations of the committees, derivatives were included under the Securities Contracts (Regulation) Act SC(R)A. Necessary amendments were made to the Act. Thereafter, the bill was introduced in the Lok Sabha in 1998 and was approved after including certain amendments in 1999. Sub-clause (ia) was also introduced in Section 2(h) to include derivatives in the field of securities.

A group was formed under the chairmanship of Prof. R.J. Varma for reconsidering all measures for control of risks in the derivatives market. In March 2000, the government, by repealing the 1969 instruction, removed the three-decade-old ban on forward trading in securities. Trading of Nifty-based futures started on June 12, 2000, at NSE. The National Stock Exchange is a leading exchange for both equity and derivatives, on which more than 65% of contracts take place. The National Stock Exchange has provided training on derivatives to more than 11,200 investors. Financial derivatives came to light in the period of 1970. Today they hold a 75% share in financial market activity in North America and East Asia.

11.8 Types of Speculation :

There are two main types of speculation: (1) Constructive speculation and (2) Destructive speculation.

1. **Constructive Speculation:** : Transactions of buying or selling shares are done after studying a company's financial condition, the ratio between earnings per share and market price of the share, the company's reserve fund,

development programs adopted by the company, the company's product and its demand, profitability, the quality of company management, possibilities of future growth, the overall economic environment, government policy, and the demand and supply situation of that company's shares; this is known as constructive speculation. Constructive speculation involves taking calculated risks. This type of constructive speculation has great importance in the stock market. Constructive speculation, which is a blessing, attributes the benefits of the stock market to itself.

2. **Destructive Speculation:** Transactions of buying and selling shares in the stock market for earning profit from price fluctuations by following blindly without making any kind of calculations are known as destructive speculation. Buying or selling is done in large quantities based on astrology or rumors or by spreading false rumors oneself to make prices favourable to oneself. As a result, great upheaval occurs in prices. Either there is a sharp increase in prices or a sharp decrease. If there is a sharp increase in price, short sellers get into financial difficulties. And if there is a sharp decrease, those who have purchased in large quantities at high prices get into trouble.

11.9 Types of Speculators :

1. **Bulls (Tejiwala):** Speculators who buy shares believing that share prices will increase before the settlement date are known as bulls. The intention behind buying is not to take delivery of the shares but that profit can be earned by selling at a high price before the settlement day. If their expectations come true, they earn profit. If that doesn't happen, they have to bear a loss, or profit is not received. They are always known as optimistic speculators, and their position in the market is known as a long position. Example: A broker buys 3,000 shares of Colgate at the rate of Rs. 300. After five days, the price increases to Rs. 310, allowing the broker to sell the shares at a profit.

2. **Bears (Mandivala):** A bear sells shares in the expectation that share prices will fall by the settlement date fixed by the stock exchange and actually makes a purchase at a lower price when the price falls. The difference between these two selling at a high price and buying at a low price-is considered their profit. Sometimes, a deliberate attempt is made to reduce prices by increasing

supply through heavy selling so that a purchase can be made at a lower price. In stock market terminology, a bearish condition is known as a 'short position' (short- term). Bearish speculators are known as pessimists and they are future buyers. If the price falls before the settlement day as per the bear's expectation, they make a profit; however, if the price rises instead of falling, they have to bear a loss. Suppose a speculator, in expectation of a price fall, sells 5,000 shares of Tata Steel at a price of Rs. 500, and if the price falls to Rs. 490, they will make a profit of Rs. 5,000 times 10 = 50,000; but if the price rises to Rs. 510, they will suffer a loss of Rs. 50,000. When bears become active in the stock market, prices fall under the pressure of their selling, and when the price reduction occurs as per their expectation, they earn a profit by purchasing at low prices. If a wave of recession sweeps through the stock market, the buying of shares decreases; in such a situation, companies face difficulties in raising share capital. If the recessionary environment continues for a long time, it harms the industrial and economic development of the country.

3. **Stag:** Stags are members of the stock market who do not engage in the buying and selling of securities; instead, they apply to purchase shares when companies issue new capital, allowing them to earn a profit by selling after the shares are registered and high prices are quoted.

11.10 Types of Speculative Transactions :

Various types of speculative transactions take place, such as bulls and bears. There are two main types of transactions: (1) Cash market transactions, (2) Forward market transactions. In the stock market, preference shares, debentures, bonds, and other securities are less risky than equity shares. While equity shares are called risky securities, their prices fluctuate constantly. Speculation happens in equity shares because they are unsecured. Opportunities to earn profit arise through speculative transactions. Transactions in the stock market are basically classified into two classes.

(A) Spot Transactions (Cash Transactions): Spot transactions mean those transactions in which the seller has to deliver the security and the purchaser has to take delivery of the security by paying the price. Sometimes spot transactions are also divided into two types: (1) Cash transactions, in which the exchange of cash and securities has to be done immediately. And second

(2) Ready delivery transactions in which the settlement of the transaction has to be done within three to seven days. If the parties to the transaction do not reside in the same city or area, the days passed for sending securities by post, as well as for sending money, are not included in the above-mentioned time limit. Generally, settlement of spot transactions takes place according to the schedule determined by the stock exchange.

(B) Forward Transactions: Forward transactions can be done only in types of futures. A forward transaction is a contract to sell or buy securities while remaining subject to the rules and regulations of the stock market, in which the delivery of securities is to be given in the future on a fixed date. In forward transactions, the delivery of securities is not given immediately but is given within a period of about one month, within the time limit determined by the stock market. Speculation primarily drives such transactions, with no intention of immediately taking securities or making payment. Settlement of such transactions takes place according to the procedure and schedule determined by the Clearing House. Only those companies' shares that are in large numbers, are important, and in which public interest is sufficiently present, are placed in the forward list.

11.11 Traders in Derivatives Market :

There are three types of traders in the derivatives market.

(1) Hedgers: Those who have to face risks arising from and associated with the fluctuation of asset prices. Those who use derivatives as a tool to reduce the respective risk are called hedgers. Hedgers enter the forward market to reduce the risks present in the market.

(2) Speculators: Speculators hold an important place in the derivatives market because they provide the facility of hedging. They create liquidity in the market. By ensuring specific prices, they bear those risks that others are not ready to bear. While hedgers are interested in reducing or removing risk, speculators buy derivatives to gain profit. Speculators voluntarily take more risks. They desire to take a position in the market by placing a bet on the future price fluctuations. And in speculative ventures, they increase the probability of both gain and loss.

(3) Arbitrageurs: Arbitrageurs obtain profit from markets by taking advantage of price differences. To take advantage of price differences, they obtain profit from more markets simultaneously. For example, they obtain the benefit of price difference by purchasing from the market where the price is low and selling in the market where the price is high. Ensuring accurate and uniform prices to bring liquidity to the market also helps in increasing price stability.

11.12 Need of Financial Derivatives :

The three important types of price risks are as follows:

1. Market Risk
2. Interest Rate Risk
3. Exchange Rate Risk. Thus, structures like equity derivatives, interest rate derivatives, and financial derivatives have emerged to hedge these risks.

11.13 Types of Financial Derivatives :

Derivatives have become important in the money market in recent years. Forwards, futures, options, and swaps are the main types of financial derivatives.

Financial Derivative Market Transactions:

(1) Forward Contracts (Transactions): Forward, i.e., a forward transaction, is a contract between two parties in which the delivery of securities is to be given by the seller to the buyer on a specific future date against the payment of a price determined in the present. In a forward transaction, it takes place in the present. The price is also determined in the present only, but the delivery of securities is to be given on a specific future date determined in advance. Generally, in the case of transactions done in the spot market, forward transactions are done to obtain protection against the risk arising due to price fluctuations. Stock markets, commodity markets, and exchange markets frequently engage in such forward transactions.

Forward transactions in the stock market mean speculative transactions. Speculators do speculative transactions to earn profit from the fluctuations occurring in prices during the settlement period determined in the stock market. Some speculators purchase stocks in anticipation of a price increase, and if the price does rise, they profit at the end of the settlement period. The settlement of the purchase and sale transactions done by them will be done by the Clearing House on the settlement day through payment of the price difference. The profit will equal the price difference, but brokerage and other fees will be deducted.

A user (holder) who commits to purchasing at a predetermined price on a future date is referred to as being in a long-term position. On the other hand, a user (holder) who promises to sell at an agreed price on a future date is said to be in a short-term position. Long-term and short-term are present in this contract. A forward contract guarantees the supply of the asset on a future date. This contract is generally known as over-the-counter trading (OTC) or a 'Forward Rate Contract' (FRC). These contracts are completely privately arranged contracts; they are not standardized. Their sale happens face-to-face over the counter (OTC), not on exchanges. The parties in this contract can make changes according to their methodology, making it quite beneficial. Parties enter into this type of contract based on systems, and therefore, it is also called a 'customized contract'.

Features of a Forward Contract:

1. Forward contracts help mitigate risks arising due to fluctuations in foreign exchange rates.
2. No Down Payment: There must be a promise to deliver or receive the designated asset at an agreed price on a future date. The contracting parties do not need to make any payment at the time of the contract.
3. Settlement on Maturity Date: An important feature of a forward contract is that when the contract is signed, no change in money or commodity occurs. It always happens on the maturity date as per the contract.
4. Need for a Third Party: In a forward contract, a third party is needed as an intermediary, such as a bank or other financial institution.
5. Delivery: The delivery of the property is to be made on the maturity/ completion date of the contract.
6. Tailor-made: The quantity and settlement date can be changed according to the convenience of the buyer and seller.

Limitations of Forward Contracts:

1. It is a customized contract that has all the details of the contract; yet it is unprofessional.
2. There is a possibility of default in the transaction by any one party, and that leads to counterparty risk, which is a serious issue.

(2) Futures (Future) Contracts: Futures, like index options and stock options, are instruments of the derivatives market. A futures contract is a forward contract made subject to the rules, regulations, and specific standards of the stock market. A futures contract means a contract to give delivery of securities in the future at a price determined in the present, subject to the rules of the stock market.

Characteristics of Futures:

1. **Specific Period:** Delivery is to be given at a future time determined by the stock market.
2. **Fixed Price:** Delivery is to be given in the future, but the price is determined at the time of making the contract.
3. **Fixed Quantity:** Purchase and sale transactions happen in fixed quantities, i.e., standardization of quantity has been done.
4. **Standardization:** The contract is standardized.
5. **Settlement:** Settlement is done through delivery in cash as well as physical form.

Types of futures include stock index, interest rate futures, currency futures, bond index futures, and cost-of-living index futures.

Types of Futures Contracts:

1. **Index Futures:** Index futures mean futures transactions based on the index number of the stock market. In India, index-based futures transactions started in the Mumbai Stock Exchange from June 9, 2000, and in the National Stock Exchange on June 12, 2000. Futures transactions utilize the Nifty index of the National Stock Exchange. Index-based futures transactions become useful for any portfolio manager, investment company, or mutual fund to obtain protection against or reduce the emerging financial risk. The

index reflects the prices of many shares. In India, index futures with maturity periods of one, two, and three months are available.

2. **Stock Futures:** Stock futures mean futures transactions of individual shares. Futures transactions for certain recognized shares in Mumbai and the National Stock Exchanges started on November 9, 2001. Currently, transactions take place in the market for about 141 shares. These shares include BHEL, Infosys, Reliance, Hindustan Lever, TISCO, etc. Futures transactions of individual shares mean a contract to give delivery on a specific future date at a price determined in the present.

3. **Currency Futures:** This is a type of financial futures in which trading takes place regarding foreign currency; it is also called exchange rate futures. Trading in foreign currency regarding active futures was started in the early 1970s. The important currencies in which this trading is done are the Pound, the U.S. Dollar, the Mark, the Canadian Dollar, etc. An immediate effect of these contracts is seen in the spot market, which is called the inter-bank exchange market, and there is a parallel inter-bank forward market. Exporters, importers, banks, financial institutions, and large companies primarily use future currency contracts for hedging.

4. **Bond Index Futures:** Like stock index futures, these futures are also a type of contract that depends on bond indices. For example, indices regarding bond prices, prices of debt instruments, have an inverse relationship with interest rates. A similar relationship exists with the bond index. An important example of these futures is municipal bond futures, which depend on U.S. municipal bonds and are traded on the Chicago Board of Trade.

5. **Cost of Living Index Futures:** These futures are called inflation futures. They are based on the cost of living index, for example, consumer price index, wholesale price index, etc. Traders in the international money market in Chicago trade these futures based on the American consumer price index. In the 1980s and 1990s, the US had low inflation, so these contracts were not popular in the futures market. The cost-of-living index provides protection against unexpected inflation. Such contracts are useful for certain investors like provident funds, pension funds, mutual funds, large companies, and the government.

6. **Interest Rate Futures:** "An interest rate future is a contract to buy or sell a security on a predetermined future date at a price determined today." Settlement in interest rate futures happens in physical form. It includes the physical settlement of actually giving and taking delivery of bonds between the seller and buyer. Mutual funds and insurance companies, banks and primary dealers, brokers and retail investors can trade in interest rate futures.

Advantages of Futures Transactions:

1. Provides hedging facility to stock market players.
2. Trading volume increases in the market; as a result, the liquidity of securities increases.
3. Opportunities for arbitrage become brighter.
4. Since stock market players trade in the derivatives market after making many types of calculations, market trends can be predicted.
5. No big upheavals occur in market prices; stability of prices is relatively maintained.
6. More profit can be earned with less capital, meaning futures transactions affect cost.

Disadvantages of Futures Transactions:

1. Purchase and sale transactions take place only according to the quantity determined by the market, full protection cannot be obtained through hedging.
2. Encourages destructive speculation without calculations.
3. The derivatives market only reflects the spot market.
4. Strict market standards and financial discipline have to be followed.
5. The derivatives market has remained limited to Mumbai and the National Stock Exchanges; its scope needs to be expanded.

Trading in Futures Contracts: Trading in futures is more complex than trading in stocks; it requires intermediaries for the Clearing House, market marking, and margin.

- **Clearing House:** In a futures contract that is being traded, the Clearing House acts as an intermediary between the seller and the buyer. The Clearing House becomes both buyer and seller and acts on both sides of the contract. If any trader does not fulfil their duty, difficulty can arise. The Clearing House protects its interests by imposing a margin on traders.
- **Margin:** When an investor undertakes trading regarding futures, they have to provide an initial margin, which is about 10 percent of the contract value. It is determined by the exchange. Margin includes cash or cash equivalents. By this method, traders will fulfil the duties arising from the futures contract. Both parties have to register the margin because losses can occur to both in the future.
- **Marking to Market:** Settlement of forward contracts is done at their maturity. The task of marking futures contracts to market is performed periodically. Settlement regarding profit or loss in futures contracts is also done periodically. An important element of a futures contract is marking to market. For example, a long position is taken in a futures contract by investors on Monday morning, which matures on Friday afternoon, but its marking to market happens every day. The price determined by it is Rs. 100; when the trade closes on Monday, the futures price increases to Rs. 105. Marking to market creates three possible outcomes: (1) They will get a cash profit of Rs. 5. (2) The current price of 100 can be cancelled. (3) They will get a new futures contract of Rs. 105.

This future in the market means that the value of the futures contract is set to zero at the end of every trading day. In December 2010, the trading volume of the derivatives market was more than 50% of the volume of the spot market, and currently, that volume is many times more than the volume of the spot market. This short-term progress is significant. The future of derivatives in India looks promising.

(3) Option Contracts (Teji-Mandi Transactions): Teji-Mandi transactions mean those transactions in which one party, by giving a fixed premium to another party, acquires the right to declare their intention to buy or sell by a certain date. The decision is based on future trends in prices, and therefore, such Teji-Mandi transactions are known as speculative transactions. There are two parties in Teji-Mandi transactions: one is the option buyer and the other is the option seller. The option buyer purchases the option by paying the amount of the premium. The period for using the option is also fixed at the time of the transaction, if the buyer feels that the price will rise.

Types of Option Transactions:

There are mainly three types of option transactions:

1. **Call Option (Teji Option):** A call option is also known as the right to buy. When an option buyer feels that during a certain future period, the price of certain shares will rise, they will purchase a call option from a seller by paying a premium amount. The buyer's total profit will be calculated as the difference between the price announced for the intention to buy and the price set at the time of purchasing the option. If the paid premium and commission are deducted from it, the remaining amount will be considered their net profit. They won't use the option to purchase if the price decreases rather than increases. It's called a call option (Teji Option) because the buyer has the right to call or purchase a certain number of shares.

2. **Put Option (Mandi Option):** A put option is also known as the right to sell. When an option buyer feels that the price will fall during a certain future period, they will purchase a put option. If the price decreases according to expectation during the fixed term, they will declare their intention to sell by using the option to sell. It is not compulsory to sell; the put option buyer gets the right to put (or sell) a specified quantity to sales, and therefore it is also known as a put option.

3. **Double Option (Put and Call Option):** This type of option is also known as a double option. When an option buyer cannot predict the rise or fall in price, they purchase both call and put options and use the option that is favourable and profitable within the fixed term. If the price rises, they use the option to buy, and if the price falls, they use the option to sell; for these transactions, they have to pay a double premium.

For example, suppose on April 1st, the price of Tata Steel is Rs. 700 per share. A wants to take the benefit of a double option and therefore purchases both call and put options from B by paying a Rs. 5,000 premium. The quantity of purchase-sale is fixed at 1000 shares, and the last date for using the option is April 30th. Suppose on April 28th, the price falls to Rs. 600, and now there is no possibility of further fall; then they will declare the put option, i.e., the right to sell. By doing so, they will get the following benefits:

- Selling price on the date of purchasing the option: Rs. 700
- Less: Price on the date of using the option: Rs. 600
- Profit per share: Rs. 100
- Profit on 1000 shares: 1000 times 100 = Rs. 1,00,000
- Less: Premium: Rs. 5,000
- Net Profit: Rs. 95,000

If the price rises instead of falling, they will declare the option to buy. Since there is no benefit in the call option, they will let that option go, and if the price falls instead of rising, they will declare the option to sell.

Methods of Option Contracts:

1. **Index Option:** Fluctuations in the stock market index numbers also affect the value of their securities. If the index number decreases, the security value decreases. To get protection against a decrease in value, the necessity for hedging has arisen in stock markets, just like in forward markets. To help investors hedge their risks, SEBI has allowed the Mumbai Stock Exchange and National Stock Exchanges to offer index-based Teji-Mandi (options) transactions, marking an important step towards growth in the forward market. In India, index-based Teji-Mandi started from June 2001. In Teji-Mandi, a call option or put option serves as a safeguard against index fluctuations, rather than relying on stocks. The financial value of the index is also determined, such as 1 Index = Index times 100 Rupees. The Clearing House handles the settlement of deals in index-based option transactions. Since the transaction involves an index, delivery is unnecessary, and the index itself is not a security. Cash settlement is required, and the Clearing House supports the stock market in this regard.

2. **Stock Option:** Generally, index-based option transactions are more useful for institutional investors. Just like the index, the market price of shares of any specific company also fluctuates. In some shares, big upheavals occur in the short term; investing in such shares proves risky. If an investor has

purchased a large number of stocks (shares) and then the price falls, they have to bear a big loss. Stock option transactions in India started in July 2002. It is a contract occurring in the stock market in which the buyer, by paying a premium, purchases the option to buy or sell at the end of the contract term or before the term. The price of shares is fixed at the time of the deal. Generally, keeping in mind the market price prevailing on the day of the deal, the price of shares for the purpose of the deal is determined; it is known as the strike price. If Teji (call) is purchased and the price rises, they will declare the right of purchase at the strike price; if Mandi (put) is purchased and share prices fall, they will declare the right of sale at the strike price and earn profit. If no fluctuation occurs in the share price, they will not use the option. They will have to lose the premium amount.

Advantages of Teji-Mandi (Option) Transactions:

1. Option transactions give protection against a potential increase or decrease in prices. If they have made a purchase in the spot market and anticipate a price drop, they will buy Mandi (put). If the price actually falls, they will earn a profit in the option transaction by declaring their intention to sell. While a loss will occur in the spot transaction due to the price fall, in this way, the spot market loss will be offset by the profit made in the option transaction.

2. A big benefit can be obtained by paying a nominal amount of premium. Therefore, even individuals with limited resources can protect themselves against price fluctuations by taking on less risk.

3. Option contracts prevent prices from rising wildly or the market from crashing suddenly. When a rise in price occurs, bulls become active. Similarly, when there is a possibility of prices falling, bears become active. In this way, it helps in maintaining price stability.

4. Option transactions expand the market by providing artificial demand and supply.

5. A Clearing House is utilized; therefore, the fulfilment of the contract is guaranteed.

6. Option transactions increase the liquidity of the market.

Disadvantages of Teji-Mandi (Option) Transactions:

1. Option transactions nurture a person's gambling instinct.
2. If transactions in the stock market receive uncontrolled freedom, the volume of transactions happening only based on speculation increases.
3. Trading in option transactions is not an actual trade but only an artificial trade.
4. In option trading, there is a greater risk for the taker than for the one placing the bet.

(4) Swaps: A swap is a private agreement between two parties in which they exchange cash flows in the future according to a method determined currently. It is called a portfolio of forward contracts. Swaps trading is done over-the-counter (OTC) by swap dealers. Such dealers are large financial institutions or large brokerage houses. Currently, these dealers mark swaps to market so that risks arising due to the default of all parties can be reduced.

The important characteristics of swaps are as follows:

1. Fundamentally, a swap is nothing else but a combination of forwards. Therefore, it has all the properties of a forward contract.
2. A bilateral link is necessary in a swap, which involves two parties. Equal and opposite requirements should be in contact with each other.
3. **Necessity of an Intermediary:** The existence of two collaborators with opposite but equal requirements is necessary in a swap. This creates the necessity of an intermediary for both parties to connect. These intermediaries can also earn income by arranging the swap. Financial companies, especially banks, can play a major role in this innovative field due to their special position in the financial market and their knowledge regarding various requirements of customers.
4. **Settlement:** Although the principal amount mentioned in the swap contract is stated, there is no exchange. On the other hand, for the interest rate of the fixed rate, interest flows are exchanged through a fixed rate, and in this way, there are flows of cash flows instead of a single payment. For example, one

party agrees to pay interest to another party at a fixed rate, and at the same time agrees to receive floating rate interest from that same party.

5. **Long-term Contracts:** Generally, forwards are arranged only for the short term. Long-dated forward rate contracts are not preferred because they involve more risks, such as default risk, interest rate fluctuation risk, etc. But swaps are of long-term contracts, and they are just like long-term forward rate contracts. A swap in which two currencies are exchanged is called a cross-currency.

11.14 Difference between Forward and Futures Contracts :

A forward contract is standardized and is done in a methodology.

1. **Form of Contract:** A forward contract is not standardized everywhere. In that sense, it is a long contract where terms of the center, such as quantity, price, duration, date, delivery condition, etc., can be negotiated between parties according to their convenience. On the other hand, a futures contract is highly standardized, where all conditions of the contract are standardized, and the requirements of the parties in that contract cannot be changed.

2. **Existence of Secondary Market:** Since a forward contract is a customized contract, it is not standardized. Therefore, it cannot be traded on systematic exchanges. Consequently, there is no secondary market for forward contracts. But futures contracts can occur on systematic exchanges. Therefore, it has a secondary market.

3. **Settlement:** Settlement of a forward contract always occurs on the maturity date. But settlement of a futures contract is always done daily; regardless of the maturity date, it is determined in the market on a daily basis.

4. **Down Payment:** It is necessary to pay a down payment at the time of the contract during the period of the forward contract. However, in the case of a futures contract, a percentage of the contract price as 'margin money' has to be deposited by the contracting parties. It acts to support that contract.

5. **Delivery of Asset:** Delivery of the asset is essential on the maturity date of the contract in the case of a forward. Whereas a futures contract does not end with delivery. Parties only exchange the difference between them.

Difference between Forward and Futures Contracts

No.	Forward Contract	Futures Contract
1	It is a traditional contract between two parties.	It is a standardized contract between two parties.
2	The delivery period is determined according to the requirements of the parties.	Futures months are fixed, and they are determined by the stock exchange.
3	Quantity is determined according to the requirements of the parties.	The standardized quantity of trade is determined by the stock exchange, and deals have to be done in that quantity only.
4	Forward contracts are primarily designed for customized hedging and often involve actual delivery.	Generally, futures contracts are made for the purpose of hedging or speculation.
5	Settlement is done by giving delivery against payment of money.	Futures contracts are settled through daily mark-to-market adjustments, with final settlement through cash settlement or physical delivery depending on exchange rules.
6	Forward deals are not subject to strict controls and market norms.	They are subject to market norms and strict controls.

11.15 Price Difference Transactions/theory (Arbitrage) :

A company can register its shares in more than one stock exchange. If registration of a company's shares has been done in more than one stock exchange, a difference in the price of the same company's shares arises in the two markets. Speculators use this difference to make a profit. A purchase is made in the low-priced stock market, and a sale is made in the high-priced one. If a purchase is made in one market and a sale is made in another market simultaneously in this way, it is known as a price-difference deal.

For example, if the share price is Rs. 150 in the Mumbai Stock Exchange and Rs. 135 in the Delhi Stock Exchange, then a purchase will be made in the

Delhi Stock Exchange, and a sale will be made in the Mumbai Stock Exchange. The difference between the two prices (150 - 135 = Rs. 15) will be considered the speculator's profit. Types of arbitrage include futures-futures arbitrage and cash-futures arbitrage. Generally, when important information regarding quantity or a company becomes available to one market earlier than to another, a price difference arises due to demand and supply; these price differences facilitate the achievement of equilibrium between the prices of the two markets. When prices are low, demand rises, and when prices are high, sales rise. Consequently, supply will increase, and prices will be suppressed; this process will continue until the prices of both markets become almost equal.

A system of rapid communication of information between various markets is a prerequisite for the success of price-difference deals. Such a system of rapid information communication has been established with the help of P.T.I. in the stock exchanges of Ahmedabad, Mumbai, Delhi, Kolkata, and Chennai. Currently, due to the development of information technology, constant broadcasting of stock market information continues. Stock market information brokers can do price-difference deals by immediately obtaining information on prices quoted in such important markets. . You can also conduct price-difference deals between two scrips.

11.16 Exchange Trade and OTC Derivatives Market :

Compared to exchange-traded derivatives, OTC (Over the Counter) derivatives markets have seen a sharp increase of approximately 40 percent globally in one year. Transactions in the OTC market occur through telephone, fax, and other electronic media as opposed to the trading floor of the exchange. Information Technology (IT) has achieved rapid growth in OTC derivatives markets. OTC derivative contracts have more liquidity than exchange-traded contracts. However, the OTC derivatives market is categorized by rules for the prerequisite for formal stability and integrity, the absence of formal centralized limits or individual positions, the absence of advantage or regulatory authorities, etc. Furthermore, some features of OTC derivatives markets, such as gross/credit exposure, information asymmetry, the influence of OTC derivative activities on overall available credit, high liquidity of OTC derivative activities in large institutions, and the central role of OTC derivatives in the global financial system, give birth to volatility in markets, institutions, and financial trends. High-leveraging institutions and their OTC derivative positions are the main reason for it.

11.17 Derivatives Market in NSE :

The methodology of futures and options trading in derivatives is called the NEAT-F&O trading system. There are two types of users in the derivatives market on the NSE trading system: trading members and clearing members. Responsibility for tasks like order entry, order matching, and order and trade management rests with trading members, while the clearing member (CM) works with the objective of monitoring trading members using the trading workstation. For which they conduct deals. They can also determine the limit of the trading member's position. Currently, there are more than 200 derivatives members on the NSE. Before doing derivatives trading, an investor has to sign a client-broker agreement with a member of the derivatives segment. If an agreement has already been made for index futures trading, then a new agreement is not needed for options trading. An investor will have to pay a commission to their broker-member on the value of their contract (strike price plus premium).

11.18 Volatility Trading :

Volatility trading is becoming variable in expectation of price instability. An investor believes that the price of an asset will either significantly increase or decrease, but the direction of its price flow cannot be known. Besides this, it includes main predictions such as divestment, budget time, etc. Under that, two strategies, such as straddle and strangle, are included. In which both call and put options are taken on the same stock.

11.19 Conclusion :

Thus, derivatives are an instrument of the secondary market. Derivatives available in India in the field of foreign exchange are also very beneficial for users. Currently, its trading is happening over the counter. Thus, in the trading of derivatives, delivery of receiving or giving property does not have to be given; the cost of its transaction is low. The cost of trading derivatives is even lower than that of standard contracts. Examples of derivatives conducted through exchanges are traded on exchanges are the National Stock Exchange, Mumbai Stock Exchange, New York Stock Exchange, Nifty 500, Nikkei 225, etc. The derivatives market is the only place where we realise profit or loss from a derivative deal for settlement purposes.

Nevertheless, derivatives do not create any new risk. They only use techniques to avoid risks and transfer them to those people (who are willing to take them).

Exercise :

Q.1 Fill in the following blanks.

(1) An instrument whose value is determined based on other assets------------. (Derivative)

(2) A --------------(forward) contract is not standardized.

(3) The trader who promised to buy in a forward contract is called a ----------. (Long position)

(4) In an option deal, the seller is called a --------------. (Writer)

(5) Under financial derivatives, ---------- (Swaps) are called long-term deals.

Q.2 Multiple Choice Questions

(1) It indicates the right to buy or sell securities or other property at a specific time and price:

(a) swaps (b) Options (c) both (d) none of these

Ans. (b) Options

(2) Derivative is a -----------instrument.

(a) swaps (b) Secondary Market

(c) both (d) none of these

Ans. (b) Secondary Market

(3) Derivative products initially emerged as a tool of hedging regarding fluctuations in ------.

(a) swaps (b) Equity prices (c) both (d) none of these

Ans. (b) Equity prices

(4) A-------------- is a type of private agreement between two parties in which the exchange of cash flows is done in the future according to a specific method.

(a) swaps (b) options (c) both (d) none of these

Ans. (a) swaps

(5) Which of the following is an index derivative that receives its value from a stock index like Nifty or Sensex?

(a) Stock Index Futures (b) options

(c) both (d) none of these

Ans. (a) Stock Index Futures

(6) ------------means the purchase and sale of futures contracts so that protection against risks of changes coming in market prices can be received.

(a) Hedging (b) options (c) both (d) none of these

Ans. (a) Hedging

(7) -----------is considered a method to take advantage of the price difference between two markets.

(a) Arbitrage (b) options (c) both (d) none of these

Ans. (a) Arbitrage

(8) Financial derivatives are mainly used for ---------------

(a) Hedging risk (b) options

(c) both (d) none of these

Ans. (a) Hedging risk

(9) Instruments that are marked to market are

(a) Futures (b) options (c) both (d) none of these

Ans. (a) Futures

(10) In an option contract, if the option is used only on the maturity date, it is called-------

(a) European Options (b) swaps

(c) both (d) none of these

Ans. (a) European Options

Q.3 Answer the following questions in detail.

(1) Explain the meaning, definition, and necessity of derivatives.

(2) Write a detailed note: History of the derivatives market.

(3) Explain types of speculation.

(4) Explain the types of speculators.

(5) Explain types of speculative deals.

(6) State the meaning and characteristics of futures contracts.

(7) What is a forward contract? Clarify its characteristics.

(8) What are option contracts? Explain various types of option deals.

(9) Explain the advantages and disadvantages of option deals.

(10) Explain the advantages and disadvantages of futures contracts.

(11) Explain the difference between forward contracts and futures contracts.

(12) Write a short note: Derivatives market in NSE.

(13) Write a short note: Exchange trade and OTC derivatives market.

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Unit - 12
Foreign Exchange Market

12.1 Introduction :

The Foreign Exchange market, commonly known as Forex or FX. Forex is the worldwide platform where currencies are traded. It is the largest financial market globally, with daily trading volumes exceeding $5 trillion. Whether a person exchanges Japanese Yen for US dollars at an airport or a bank trades millions of dollars for Euros with another bank, both activities are part of the Forex market. This market is open to everyone, from large financial institutions handling billions of dollars to individual traders dealing with smaller amounts.

In Forex trading, one currency is always bought while another is sold. The value of a currency depends on what participants in the market are willing to pay for it. This value is known as the exchange rate. The exchange rate shows how much one unit of a currency is worth in terms of another currency and is constantly changing based on market demand and supply.

The foreign exchange market is one of the most important parts of the global financial system. The foreign exchange market establishes the institutional and operational framework for exchanging currencies between different nations, facilitating international economic transactions. In a world characterized by increasing globalization no country remains economically isolated. Nations engage in trade, investment tourism and financial flows across borders all of which necessitate the use of foreign currencies. The foreign exchange market facilitates these transactions efficiently and continuously.

The importance of the foreign exchange market extends beyond simple currency conversion. It plays a vital role in determining exchange rates, allocating international capital and transmitting economic signals across countries. Fluctuations in exchange rates affect export competitiveness, import costs, inflation and overall economic stability. Consequently, the functioning of the forex market has direct implications for both microeconomic decisions of firms and macroeconomic policy outcomes.

Unlike traditional markets that operate within a physical location, the foreign exchange market is decentralized and operates electronically across global financial centers. It functions twenty-four hours a day, reflecting the overlapping business hours of major financial hubs such as Asia, Europe, and North America. This continuous operation enhances liquidity and allows participants to respond promptly to global developments.

The scale and depth of the forex market also set it apart. It is widely regarded as the largest financial market in the world in terms of daily trading volume. Its participants range from central banks and multinational corporations to financial institutions and individual investors. The diversity of participants and the high volume of transactions contribute to market efficiency, though they also introduce elements of volatility and speculation.

This chapter aims to provide a comprehensive understanding of the foreign exchange market by examining its structure, participants, mechanisms of exchange rate determination, and institutional features such as spot and forward markets. It also highlights the role of the Reserve Bank of India (RBI) in regulating and stabilizing the forex market within the Indian context.

12.2 Meaning and structure of forex market :

The foreign exchange market may be defined as the market in which currencies are bought and sold against one another at agreed prices. It encompasses all transactions involving the exchange of one currency for another whether for immediate delivery or at a future date. The market exists to facilitate international trade and financial flows, while also providing mechanisms for managing currency-related risks.

Meaning:

The term "Forex" simply means foreign exchange. Unlike stock markets, Forex does not have a physical location or a central exchange. Instead, it operates electronically across a network of banks, institutions, and traders around the world. Anytime someone exchanges one currency for another whether through a bank, an online platform, or a currency counter they are participating in the Forex market.

It is a financial market where individuals, banks, companies and governments trade currencies for purposes like trade, investment, tourism and speculation.

It can also be defined as a decentralized over-the-counter (OTC) market where currency transactions occur electronically without a central physical exchange.

Key Features of the Forex Market:

- **High Liquidity:** The forex market is highly liquid, allowing participants to buy and sell currencies with minimal transaction costs.
- **Global Reach:** It operates across different countries and time zones.
- **Decentralization:** There is no central governing body or physical exchange.
- **Volatility:** Exchange rates can fluctuate significantly due to economic, political, and speculative factors.
- **Leverage:** Market participants often use borrowed funds to increase their trading positions, which can amplify both gains and losses.

Nature of the Forex Market:

The forex market is an over-the-counter (OTC) market, meaning that transactions are conducted directly between parties rather than through a centralized exchange. This feature distinguishes it from stock markets, which typically operate through organized exchanges. In the forex market, participants communicate and execute trades through electronic trading platforms, telecommunication networks, and financial intermediaries.

Another defining characteristic of the forex market is its global and continuous nature. Trading begins in the Asia-Pacific region, moves to European markets, and then to North American markets. As one market closes, another opens, ensuring that trading activity never ceases during weekdays. This continuous operation enhances liquidity and allows rapid adjustment to new information.

1. **Global and Decentralized Market:**

   The forex market operates worldwide without a central physical location. Trading takes place electronically across major financial centers like London, New York and Tokyo making it a decentralized (OTC - Over the Counter) market.

2. **Largest Financial Market:**

   Forex is the biggest financial market in the world in terms of trading volume. Daily transactions exceed trillions of dollars making it much larger than stock or commodity markets.

3. **24-Hour Market:**

   The forex market is open 24 hours a day, five days a week. Trading moves across time zones from Asia to Europe to America allowing continuous trading.

4. **Highly Liquid Market:**

   Liquidity means how easily assets can be bought or sold. Forex is extremely liquid because of the large number of participants (banks, institutions, traders) ensuring quick transactions with minimal price changes.

5. **Two-Way Market:**

   Forex allows both buying and selling currencies. Traders can profit whether the market goes up or down by taking long (buy) or short (sell) positions.

6. **Involves Currency Pairs:**

   Currencies are traded in pairs (e.g., USD/INR, EUR/USD). The value of one currency is always determined relative to another.

7. **Price Determined by Demand and Supply:**

   Exchange rates fluctuate based on market forces such as demand and supply economic indicators political stability and interest rates.

8. **High Leverage:**

   Forex trading often involves leverage, meaning traders can control large positions with a small amount of capital. While it increases profit potential it also increases risk.

9. **Presence of Various Participants:**

   Participants include central banks, commercial banks, multinational companies, hedge funds and individual traders. Each plays a role in market movement.

10. **Sensitive to Economic and Political Factors:**

    Forex markets react quickly to global news such as inflation rates, GDP growth, interest rate changes, elections and geopolitical events.

Structure of the Forex Market:

The structures of the foreign exchange (forex) market can be understood as a decentralized global system where currencies are traded continuously. Unlike stock markets, it does not operate through a single centralized exchange. Instead, it is made up of different layers of participants connected electronically.

1. **Decentralized Nature:**

   The forex market has no physical location. Trading happens through a global network of banks, financial institutions, and electronic platforms. This structure allows trading to occur 24 hours a day across major financial centers like London, New York, Tokyo, and Sydney.

2. **Hierarchical Structure:**

   The market is often described as having tiers based on access to liquidity and pricing:

- **Top Tier - Interbank Market:** This is the core of the forex market where large commercial banks and central banks trade directly with each other. Transactions here involve very large volumes and the most competitive exchange rates.

- **Second Tier - Financial**

  Hedge funds, investment firms, multinational companies, and insurance firms operate at this level. They participate for investment, hedging, and business-related currency needs.

- **Third Tier - Brokers and Dealers:**

  Forex brokers act as intermediaries between retail traders and the interbank market. They provide trading platforms, price quotes, and leverage to smaller participants.

- **Retail Market - Individual Traders:**

  Individual investors access the forex market through online trading platforms. Although their trade sizes are small compared to institutions, they make up a significant portion of daily trading activity.

  Liquidity and Price Formation:

  Prices in the forex market are determined by supply and demand. High liquidity especially in major currency pairs like EUR/USD ensures tight spreads and efficient pricing. Market makers and large banks play a key role in providing liquidity.

  Role of Technology:

  Modern forex trading relies heavily on electronic communication networks (ECNs) and algorithmic trading systems. These technologies connect participants globally and ensure rapid execution of trades. The structure of the forex market ensures that it remains efficient, flexible, and responsive to global economic conditions.

12.3 Market Segments :

The forex market is divided into different segments based on how transactions are executed:

Spot Market: Currencies are exchanged immediately at current market prices.

Forward Market: Contracts are made to exchange currencies at a future date at a predetermined rate.

Futures Market: Standardized contracts traded on exchanges, agreeing to buy or sell currency at a future date.

Options Market: Provides the right, but not the obligation, to exchange currency at a specified rate before a certain date.

12.4 Participants in the Forex Market :

The foreign exchange market comprises a diverse group of participants, each contributing to its functioning in different ways. These participants differ in terms of objectives, scale of operations, and influence on exchange rates.

1. **Commercial Banks:**

   Commercial banks are the most important participants in the forex market. They engage in currency trading both on their own behalf and on behalf of their clients. Banks facilitate international payments, provide foreign exchange services, and engage in speculative activities. Their large-scale transactions significantly influence exchange rate movements.

2. **Central Banks:**

   Central banks play a regulatory and stabilizing role in the forex market. They manage their country's currency and may intervene in the market to influence exchange rates. For example, a central bank may buy or sell foreign currency to stabilize its domestic currency or to achieve macroeconomic objectives such as controlling inflation.

3. **Corporations and Multinational Companies:**

   Corporations participate in the forex market primarily to facilitate international trade and investment. Exporters receive payments in foreign currencies, while importers need foreign currency to pay for goods and services. Multinational corporations also engage in forex transactions to manage risks associated with currency fluctuations.

4. **Financial Institutions:**

   Investment banks, hedge funds, mutual funds, and insurance companies are active participants in the forex market. These institutions engage in trading for profit, portfolio diversification, and risk management. Their activities contribute to market liquidity and price discovery.

5. **Brokers and Dealers:**

   Brokers act as intermediaries between buyers and sellers, facilitating transactions without taking ownership of the currencies. Dealers, on the other hand, buy and sell currencies on their own account. Both brokers and dealers play a crucial role in ensuring smooth market operations.

6. **Individuals:**

   Individuals participate in the forex market for various purposes, including travel, remittances, and investment. The rise of online trading platforms has enabled retail investors to engage in currency trading more easily.

7. **Governments and Public Sector Institutions:**

   Governments may participate in the forex market to manage foreign exchange reserves, repay international debt, or support national economic policies. Public sector institutions also engage in transactions related to international trade and development projects.

   These participants interact to create a dynamic and competitive environment that continuously determines exchange rates.

12.5 Exchange Rate Determination :

An exchange rate refers to the price of one country's currency in relation to another. For example, how many Indian Rupees are needed to buy one US Dollar. Exchange rates are extremely important because they affect international trade, investment decisions, tourism, and overall economic stability.

Exchange Rate System in India:

India follows a managed floating exchange rate system. This means the value of the Indian Rupee is largely determined by demand and supply in the market. However, the Reserve Bank of India intervenes when necessary to reduce extreme volatility and maintain stability in the forex market.

Demand and Supply Mechanism:

In most modern economies, exchange rates are mainly determined by the interaction of demand and supply of foreign currency in the market.

- Demand for a currency arises when foreigners need that currency. This typically happens when they want to:
  - Purchase goods and services (imports from that country).
  - Invest in financial assets like stocks or bonds.
  - Make direct investments in businesses.
- Supply of a currency occurs when residents of a country need foreign currency. This happens when they:
  - Import goods and services
  - Invest abroad

o Travel or send money overseas

If the demand for a currency is greater than its supply, its value rises-this is called appreciation.

If the supply of a currency exceeds demand, its value falls-this is known as depreciation.

Key Factors Influencing Exchange Rates:

Several economic and political factors influence the demand and supply of currencies:

1. Interest Rates:

Higher interest rates in a country tend to attract foreign investors looking for better returns. As more investors convert their money into that country's currency, demand increases, leading to appreciation.

2. Inflation Rates:

Countries with lower inflation usually have more stable purchasing power. Their goods remain competitively priced, which supports higher demand for their currency and strengthens its value.

3. Economic Growth:

A country experiencing strong economic growth becomes attractive to investors. Increased foreign investment raises demand for its currency, contributing to its appreciation.

4. Political Stability:

Stable governments and predictable policies build investor confidence. Countries with less political risk tend to receive more foreign capital, which supports their currency.

5. Balance of Payments:

The balance of payments records all international transactions of a country: A surplus means more foreign currency is coming in than going out, which strengthens the domestic currency. A deficit means higher outflows, which can weaken the currency.

6. Speculation and Expectations:

Market participants often act based on expectations about the future. If traders believe a currency will strengthen, they start buying it now, increasing demand and pushing its value up. Speculation can sometimes cause sharp and rapid movements in exchange rates.

An exchange rate represents the value of one currency in terms of another. It is a crucial variable in international economics, influencing trade, investment, and financial flows.

12.6 Spot and Forward Exchange Market :

Spot Exchange Market:

The spot market refers to transactions in which currencies are exchanged immediately at the prevailing market rate, known as the spot rate. Settlement typically occurs within two business days. This market is widely used for immediate international payments and is characterized by high liquidity and transparency.

Forward Exchange Market:

The forward market involves agreements to exchange currencies at a future date at a predetermined rate. These contracts are customized and negotiated between parties, allowing flexibility in terms and conditions.

Forward contracts serve as an important tool for hedging against exchange rate risk. For instance, an exporter expecting future payments in foreign currency can lock in the exchange rate to avoid potential losses due to currency depreciation.

Differences between Spot and Forward Markets:

- **Timing:** Spot transactions are immediate, while forward transactions occur in the future.
- **Purpose:** Spot market is used for current needs; forward market is used for risk management.
- **Rate:** Spot rate is the current market rate; forward rate is predetermined.

Both markets are essential for the efficient functioning of the forex system, providing flexibility and risk management options to participants.

12.7 Role of RBI in the Forex Market :

The Reserve Bank of India (RBI) is the central authority responsible for managing the foreign exchange market in India. Its role is crucial in maintaining stability, ensuring orderly market conditions, and supporting economic growth.

Regulation and Supervision:

The RBI acts as the main authority overseeing forex transactions in India. It operates under the Foreign Exchange Management Act (FEMA) and sets rules for how foreign exchange can be bought, sold, and transferred. By doing this, it ensures that all participants banks, companies, and individuals follow a structured and legal framework.

Exchange Rate Management:

India employs a managed floating exchange rate system, primarily influenced by market forces. However, the RBI intervenes when there is excessive volatility. It may buy or sell foreign currencies (mainly US dollars) to stabilize sharp fluctuations and prevent disorderly market conditions.

Custodian of Foreign Exchange Reserves:

The RBI maintains and manages India's foreign exchange reserves, which include foreign currencies, gold, and special drawing rights (SDRs). These reserves act as a buffer during economic uncertainty and help in maintaining confidence in the country's ability to meet international payment obligations.

Market Intervention:

When the rupee experiences rapid depreciation or appreciation, the RBI steps in to smooth movements. For example, it may sell dollars to support the rupee or purchase dollars to prevent it from strengthening too quickly. These actions help maintain balance in trade and investment flows.

Facilitating External Trade and Payments:

The RBI creates policies that simplify international trade and payments. It ensures that exporters and importers have access to foreign currency and promotes a stable environment for cross-border transactions.

Development of Forex Market:

The RBI encourages the growth of a transparent and efficient forex market in

India. It introduces new financial instruments, improves trading infrastructure, and promotes risk management practices such as hedging.

Monitoring Capital Flows:

The RBI closely tracks foreign investments, external borrowings, and remittances. By managing these flows, it helps protect the economy from sudden shocks caused by rapid inflows or outflows of capital.

12.8 Conclusion :

The forex market is crucial for global trade and finance, as it enables the conversion of various currencies. It is the biggest financial market globally and functions through different segments like spot, forward, and derivatives markets. Various players such as commercial banks, central banks, importers, exporters, investors, and speculators engage actively in the forex market. Foreign currency exchange rates are influenced by the demand and supply of those currencies, in addition to economic and political elements. The spot market handles immediate exchanges, while the forward market mitigates exchange rate risk for upcoming transactions.

Exercise :

Q.1 Theoretical Questions

1. Explain the concept and importance of the foreign exchange market.
2. Describe the structure and features of the forex market.
3. Discuss the role of various participants in the forex market.
4. Analyze the factors influencing exchange rate determination.
5. Differentiate between spot and forward exchange markets.
6. Evaluate the role of the Reserve Bank of India in the forex market.

Q.2 Multiple Choice Questions

1. The forex market operates as a:

   A) Centralized exchange B) Over-the-counter market

   C) Local market D) Commodity exchange

Answer: B) Over-the-counter market

2. Exchange rates are primarily determined by:

   A) Government orders B) Demand and supply

   C) Weather conditions D) Population size

Answer: B) Demand and supply

3. The largest participants in the forex market are:

   A) Individuals B) Commercial banks

   C) Tourists D) Students

Answer: B) Commercial banks

4. Spot transactions are settled:

   A) Immediately or within two days

   B) After one year

   C) After five years

   D) Never

Answer: A) Immediately or within two days

5. Forward contracts are mainly used for:

   A) Gambling B) Hedging risk

   C) Tax evasion D) Consumption

Answer: B) Hedging risk

6. The RBI intervenes in the forex market to:

   A) Increase inflation B) Stabilize exchange rates

   C) Reduce exports D) Eliminate imports

Answer: B) Stabilize exchange rates

7. What is the primary function of the forex market?

   A) Collection of taxes

   B) Exchange of foreign currencies

   C) Sale of goods

   D) Insurance services

Answer: B) Exchange of foreign currencies

8. Which is the largest financial market in the world?

   A) Capital Market B) Money Market

   C) Forex Market D) Commodity Market

Answer: C) Forex Market

9. Which of the following is a participant in the forex market?

   A) Commercial Banks B) Exporters

   C) Central Banks D) All of the above

Answer: D) All of the above

10. In which market are currencies exchanged immediately?

   A) Forward Market B) Spot Market

   C) Capital Market D) Futures Market

Answer: B) Spot Market

11. The forward exchange market is mainly used for:

   A) Currency printing B) Long-term investment

   C) Reducing exchange rate risk D) Tax collection

Answer: C) Reducing exchange rate risk

12. Exchange rates are mainly determined by:

   A) Government employees

   B) Demand and supply of currencies

   C) Population growth

   D) Weather conditions

Answer: B) Demand and supply of currencies

13. Which institution regulates the forex market in India?

   A) SEBI B) NABARD C) RBI D) LIC

Answer: C) RBI

14. Which of the following is NOT a segment of the forex market?

   A) Spot Market B) Forward Market

   C) Derivative Market D) Retail Market

Answer: D) Retail Market

15. Who uses the forex market for international trade payments?

A) Importers and Exporters B) Farmers

C) Teachers D) Doctors

Answer: A) Importers and Exporters

16. The forex market helps in:

A) Promoting international trade

B) Reducing global communication

C) Increasing unemployment

D) Stopping investments

Answer: A) Promoting international trade

17. Forex market is also known as:

A) Stock Market B) Foreign Exchange Market

C) Commodity Market D) Insurance Market

Answer: B) Foreign Exchange Market

18. Which currency is considered the most traded currency in the world?

A) Indian Rupee B) Japanese Yen

C) US Dollar D) Euro

Answer: C) US Dollar

19. The exchange rate means:

A) Interest charged by banks

B) Value of one currency in terms of another currency

C) Tax on imports

D) Government expenditure

Answer: B) Value of one currency in terms of another currency

20. A rise in demand for US dollars in India will:

A) Increase value of Rupee B) Decrease value of Dollar

C) Depreciate Indian Rupee D) Have no effect

Answer: C) Depreciate Indian Rupee

21. Which market deals with future delivery of currencies?

A) Spot Market B) Forward Market

C) Local Market D) Retail Market

Answer: B) Forward Market

22. Which of the following is a function of RBI in forex market?

A) Maintaining exchange rate stability

B) Issuing foreign trade licenses

C) Selling consumer goods

D) Conducting population census

Answer: A) Maintaining exchange rate stability

23. Forex market mainly facilitates:

A) Domestic trade only

B) International trade and investment

C) Agricultural production

D) Railway operations

Answer: B) International trade and investment

24. Which of the following is not affected by exchange rates?

A) Imports B) Exports

C) Foreign investment D) Rainfall

Answer: D) Rainfall

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Unit - 13
Mutual Funds and Financial Services

13.1 Introduction :

In modern times, we are witnessing significant development in the field of mutual funds. In the modern world, mutual funds are a very popular and preferred investment for investors. In recent years, the concept of mutual funds has gained wide acceptance in India through public sector banks and other private sector financial institutions; it is currently developing very rapidly. If we look at it this way, the concept of mutual funds is not entirely new; its driving force is the principle of safety. And the additional benefit in the capital rate of income received in the form of interest and dividends is exactly why the general public prefers mutual funds over bank deposits, life insurance policies, and bonds. Even small investors can gain entry into big companies through investment in mutual funds.

13.2 Meaning :

A mutual fund is an organization that invests money collected from many investors' savings into a portfolio designed to provide optimal returns for those investors. Professional and skilled managers, who are experienced and experts, carry out this work. Thus, mutual funds attempt to obtain returns by making their investment portfolio diversified through the multi-purpose investment of collected money, as a result of which investors can receive higher returns than other institutions. In simple words, mutual funds mean collecting savings from small investors and investing them in government securities or corporate securities to earn dividends and interest income. Mutual funds prove the proverb "every drop makes an ocean". For example, if an ordinary person invests their small savings of 1,000 rupees, and in this same way, 1,000-1,000 rupees are collected from a vast number of people, these savings will become a fund, which can be invested in many different shares and debentures to get good returns. Fundamentally, a mutual fund is the savings collected from people.

13.3 Definition :

According to the Mutual Regulation Act 1993 by the Securities and Exchange Board of India, a mutual fund is defined in this way: "A mutual fund is a fund established in the structure of a trust by a sponsor. In which the trustee sells units to the general public under one or more schemes, and raises money by investing in securities according to these rules". These mutual funds are known as Unit Trusts in the U.K. and as Open-Ended investment companies in the U.S.A.

13.4 History of Mutual Funds :

The history of trade shows that the Egyptians and Phoenicians sold shares in caravans and ships to reduce business risks. Many years later, in A.D. 1822, Société Générale de Belgique accepted the modern concept of risk sharing. In 1822, King William I of the Netherlands implemented the concept of closed-ended funds for a specific duration. At that time, a group consisting of some investors, individuals, and institutions collected the investable funds they had and handed over their management to fund managers. These professional and skilled managers invested the fund in certain securities and distributed the profit earned from it among the members of the fund; this concept of "Investment Trust" spread rapidly from Europe. However, looking at the reality, the Foreign and Colonial Government Trust of London, established in 1868, was a leader in the field of mutual funds at the time. In 1930, the U.S.A. raised a significant number of closed-end mutual funds. Both types of mutual funds, open-ended and closed-ended, became popular in India in 1980. Although first of all, in 1964, the Unit Trust of India issued them under the Unit Scheme 1964. Currently, there are more than 1,000 mutual funds in Britain. The United States formed the first such fund in 1893. Thereafter, other countries of the world also quickly implemented this idea.

13.5 Importance of Mutual Funds :

1. In modern times, mutual funds play a crucial role in the corporate world. We can describe the importance and benefits of mutual funds as follows:

   Mutual funds are very beneficial for those investors who face the following obstacles while making direct capital investment:

   (i) Those who have to stay away from the stock market due to having limited funds available for capital investment and small savings.

   (ii) Small investors who cannot afford the expensive services of professional experts and specialists.

   (iii) Small investors who have to pay brokerage to the stockbroker for purchases, which might not be affordable.

   (iv) Small investors are mostly unaware of the daily events happening in the stock market and corporate world.

(v) Similarly, information regarding changes in share prices is also not available on time to new investors.

(vi) When the share subscription shows a higher trend, it is often not possible for small investors to obtain shares. Thus, for the above reasons, mutual funds are a blessing for small investors.

2. Funds of small investors are collected through mutual funds so that investment can be made by creating a diversified portfolio.

3. The element of risk is certainly present in mutual funds as well, and only time determines when money might be lost in which company, but mutual funds create a balanced portfolio. As a result, the risk element decreases.

4. Through mutual funds, investors also get the benefit of safety and liquidity.

5. Fund managers have to follow the standards and guidelines determined by the government. Government rules in every country provide assurance of safety to the investor. For example, in India, this work is performed by the Securities and Exchange Board of India.

6. Investors also get certain income tax benefits on the investment made in mutual funds. In India, certain tax benefits are available on investments made in the Equity Linked Savings Scheme of mutual funds under Section 88 of the Income Tax Act, as well as on income received as dividends from mutual fund investments under Section 80(L) of the Income Tax Act.

7. Since mutual funds have large financial reserves, they get the benefit of size. Therefore, their operating expenses remain low, making more money available for investors.

8. Other benefits of mutual funds can include the option of reinvestment of dividends, the possibility of capital growth, a regular salary, etc.

13.6 Types of Mutual Funds :

The main types of mutual funds are:

(1) Closed-ended Fund and Open-ended Fund: If the time of the mutual fund and the investment of money to be made in it are specific and fixed, that fund is called a closed-ended fund. On the other hand, an open-ended fund is defined by having a time period and investment amount that are not fixed. For example, the entire Unit Trust of India - 1964 scheme is an open-ended fund in terms of time period and target amount.

- **OPEN-ENDED FUND:** This fund is the opposite of the closed-ended fund. This scheme allows for variable fund size and duration. Investors are free to buy and sell any number of units at any time. For example, the Unit Trust of India 1964 Unit Scheme is an open-ended scheme in both time and amount. Any person can buy units at any time and can sell them at any time according to their wish. Main features of an open-ended scheme are as follows:

  I. It is completely flexible in the context of an individual's investment or non-investment. One can enter freely in terms of investment in an open-ended fund and can also leave freely. It has no time limit. An investor can join whenever they wish and can also come out.

  II. These units cannot be sold in public. But repurchase and resale can take place in the fund at any time.

  III. Since units can be sold on any working day, the investor gets quick liquidity. In reality, the fund works like a bank account. In which a person can sell any number of units for cash.

  IV. The main objective of this fund is to generate income. The investor receives dividends, rights shares, or bonuses in exchange for the investment.

  V. Because units are not listed on the stock market, their price is linked to the Net Asset Value. This value is determined by the fund, and the price keeps changing from time to time.

  VI. Generally, the Net Asset Value is the same as its recorded price. The fund determines different prices for its purchase and sale.

  VII. The manager takes great care to organize the investment because the funds have to be returned at any time during the entire scheme. In short, the open-ended scheme exists continuously, and its fund keeps changing as it is based on the entry and exit of members.

- **CLOSED-ENDED FUND:** A closed-ended fund is one whose amount is already fixed and whose time period is also fixed before it is issued or purchased by the shareholder. The shareholder who invests in this fund cannot sell this fund investment until the fixed time duration. And only after the fixed time can they go and sell this fund investment in the stock market speculation market. In an open-ended fund, the investor can invest anytime and sell it anytime. In a closed-ended scheme, if the stock market experiences a loss when the fixed time period ends, the likelihood of the investor incurring a loss increases. In a continuously running fund, the likelihood of losses is reduced because investors can sell their investments immediately if they anticipate a decline in the stock market, thereby minimizing their risk. The main features of a closed-ended scheme are as follows:

  I. Time and amount are specifically fixed. That is, the investor is not free for sale until a specific time.

  II. These units can be sold in public. But repurchase and resale cannot take place in the fund at any time. The main objective of this fund is the benefit of capital growth.

  III. The fund is available during the entire scheme time, and the investment and management of the fund have to be done for efficiency and profitability by the fund manager only. Therefore, there is no need for the investor to maintain liquidity.

  IV. In a closed-ended scheme, the distribution of returns is done in a liquid manner to every unit holder.

  V. From the investor's perspective, the possibility of capital growth attracts them to this scheme.

(2) **Income-oriented Fund:** The objective of this fund is to make a proper distribution of income among investors at intervals of a certain time period. Therefore, the investment strategy of this fund is organized in that way. For this, this type of mutual fund invests money in securities that give a fixed income.

(3) **Growth-oriented Fund:** The objective of this fund is to increase the value of the capital invested by the investors in the fund. Therefore, this fund primarily invests investors' money in shares.

(4) Balanced Fund: Funds in which the investment of money is made in both shares and bonds are called balanced funds. This fund invests in equity shares when the economic environment is promising and in bonds when there is a possibility of loss.

(5) Money Market Mutual Fund: A money market mutual fund means a fund that invests in money market instruments. Such as Treasury bills, call money or notice money, commercial paper, commercial bills, etc. It works for the short term and is open-ended. In 1991, the Reserve Bank had formed a working group under the chairmanship of Shri D. Basu, the then Deputy Managing Director of the State Bank of India. Based on the recommendation of this working group, the Reserve Bank in 1992 gave permission to commercial banks for the establishment of money market mutual funds.

(6) Tax-Relief Fund: Some funds are established to obtain certain tax reliefs. For example, Unit Trust of India, Life Insurance Corporation, etc.

(7) Equity Fund: An equity fund invests its income/funds in shares of companies and faces the risks associated with such investments. The main purpose of this fund is to obtain the benefit of expected capital growth.

(8) Bond Fund: In this type of fund, the investment of funds is made in debentures and bonds; this fund gives a fixed income. But the possibility of getting more capital remains low because the risk is also low.

(9) Sector-Based Funds: In these funds, the investment of funds is made in specific sectors such as specific industry, mineral oil, gold-silver, land, gas company, and investment abroad. Moreover, sometimes funds of funds are also seen. Mostly, such funds are seen in Western countries.

(10) Income cum Growth Fund: The fund, which gives fixed and regular income by investing as well as ensures capital growth, is called an income and growth fund.

(11) Other types of funds: These funds include property funds, energy funds, funds for commodities, ethical funds, environmental offshore mutual funds, aggressive growth funds, index funds, leverage funds, and dual funds (which are managed by some companies in Britain). Such funds generally stay away from investing in undesirable activities, such as tobacco, intoxicating drinks, etc.

In modern times, mutual funds play a very important role in the development of the financial sector. Currently, significant and rapid development of mutual funds is taking place across the whole world. In countries like Britain, America, France, Germany, and Australia, thousands of mutual funds are working.

Other Types:

1. **Leverage Fund:** This fund is also called a borrowed fund; it is primarily used to increase the size of the mutual fund's value during portfolio allocation. When prices increase, the income-earning capacity of the fund also increases. Its benefits are distributed to the unit holders. This is taken only when the benefits of the borrowed fund are more than the cost of the borrowed fund.
2. **Dual Fund:** This is a closed-ended fund. It provides investment opportunities for two different types of investors. For this purpose, it sells two types of investment shares, i.e., income shares and capital shares. Investors who receive income from current investments can buy income shares. They receive all interest and dividends obtained from the entire investment portfolio. However, they are guaranteed a minimum annual dividend payment. Holders of capital shares receive all capital gains earned on those shares, and they are not entitled to receive any type of dividend. In this context, a dual fund is different from any balanced fund.
3. **Index Fund:** An index fund refers to a fund where the portfolio is designed in such a way that it reflects the structure of a broad-based market index. It holds securities in the same proportion as this index. The price of this index-linked fund increases whenever the market index increases. Because the portfolio is constructed to maintain the proper proportion of the index, it incurs low administrative costs and low transaction costs and requires only a small number of portfolio managers. Therefore, there will be less buying and selling of securities.
4. **Aggressive Growth Fund:** These funds are the opposite of bond funds. These funds are capital gain-oriented and thus the area of these funds is 'capital gain'. Therefore, in these funds, investment is generally made in speculative shares. They can also use specialized investment techniques like short-term trading.

5. **Offshore Mutual Fund:** An offshore mutual fund is a fund that is for non-resident investors. In other words, the sources of investment of these funds are foreign. Therefore, it is regulated by the provisions of other countries where that fund is registered. This fund allows for fee-free investment and returns in various countries.

6. **Funds of Funds:** These funds are such funds in which investment is made from one mutual fund scheme into another mutual fund scheme. In India, such types of funds are issued under the control of the Department of Economic Affairs, Ministry of Finance, and the RBI.

13.7 Money Market Mutual Funds :

The main characteristics of a money market fund scheme are as follows.

(1) Money market mutual funds can be established only by scheduled commercial banks and public financial institutions.

(2) And it is subject to the Reserve Bank.

(3) Such funds can be established as Money Market Deposit Accounts or Money Market Mutual Funds.

(4) The maximum limit of instruments raised through these funds should not be more than 2% of the fortnightly average of total deposits of the respective sponsoring bank for the year 1991-92.

(5) Units of Money Market Mutual Funds can be given only to individuals.

(6) Investment of funds collected by such funds will have to be made as follows: (a) Treasury Bills, (b) Call/Notice Money, (c) Commercial Paper, (d) Commercial Bill, (e) Certificate of Deposit.

(7) Units/shares of this fund will be exempt from stamp duty.

(8) Such funds can be established only after obtaining prior approval from the Reserve Bank.

(9) In 1996-97, eight mutual funds of banks/public financial institutions/private sector were given approval to establish Money Market Mutual Funds. Which include the following:

1. IDBI Mutual Fund
2. Kothari Pioneer Mutual Fund
3. Unit Trust of India
4. ANZ Grindlays Bank
5. ABN Amro Bank
6. Canara Bank
7. Bank of Madura Ltd.
8. Deutsche Bank

These funds have been given approval for the cheque book facilities for their investors.

(10) Since November 1999, a provision has been made that these funds are allowed to be established not in the form of a Money Market Deposit Account but as a separate identity in the form of a trust.

(11) Since March 2000, Money Market Mutual Funds have been covered under the jurisdiction of the regulations of the Securities and Exchange Board of India.

13.8 Reasons for the Development of Mutual Funds :

Since the 1980s, India's capital market has played a significant role in financing productive activities. This has led to the country's stock exchanges developing at a rapid pace. India recorded a significant increase in the number of stock exchanges between 1977 and 1989. Given the current rate of increase in the number of investors, experts estimate that the number of stock exchanges in the country, which was only about 8 in 1987, will exceed 50 by the end of this century.

Looking at the development of the capital market, it is very necessary that stock market services remain available quickly and efficiently to sustain it. These funds have a significant responsibility to sustain and maintain the health of the capital market. Rapid development of these funds has occurred due to advanced information centres available with mutual funds, their professional approach, and various services provided promptly by them to customers. Similarly, a new line of experts has emerged to provide necessary information and guidance to investors; because of that, investors have received encouragement to participate in the capital market. This factor has also given momentum to the development of mutual funds.

13.9 Development of Mutual Funds in India :

The first mutual fund in India was established in 1964 by the Unit Trust of India. In that year, the Unit Trust of India launched its most popular scheme to date. This fund has had a significant impact on stock market activities in its operations so far and has contributed importantly to bringing stability to it. Moreover, it has provided many types of schemes for various levels of investors and "income groups" and "age groups," and along with that, it has also tried to provide necessary support to the stock market. Of course, some regulatory provisions of the Companies Act 1956 prevented the initiation of any other mutual fund schemes. In 1987, the government made a necessary amendment in the Banking Regulation Act, due to which it became possible for public sector banks to start mutual funds by establishing subsidiary companies. The Reserve Bank first gave approval regarding this to the State Bank of India, and thereafter, Canara Bank also received permission to start a mutual fund. In subsequent years, many public sector banks such as Indian Bank, Punjab National Bank, Bank of India, Bank of Baroda, etc., established mutual funds. Since the investment made in these funds is safe, and reasonable and regular returns are received on it, and capital value grows, the flow of savings can be easily made available for investment. Thus, these funds bring stability to the price of shares. They provide safety and a certain income to investors and provide financial resources to entrepreneurs. Therefore, careful and efficient management of these funds is crucial to maintaining investor trust.

13.10 Future of Mutual Funds :

The future of mutual funds in India depends on the rate of economic development of the country, on the development of the capital market and capital structure, and on the government's policy towards the private sector. The government has given some relief and tax exemptions on investments made in these funds with the aim of encouraging them. Moreover, the efficiency of the banks starting these funds is also very good. Therefore, the measures implemented to ensure the success of these funds are progressing positively. Mutual funds have to play a greater role to provide encouragement so that small savings account holders invest more and more. Various performances can be evaluated based on the element of competition in mutual funds.

There are a limited number of mutual funds in India; therefore, if they are declared, it has a direct effect on the market. In contrast, in other countries with a large number of mutual funds, the declaration of investments does not significantly impact the market. SEBI declares investments.

13.11 Risk in Mutual Funds :

Mutual funds are not free from risks, because fundamentally, mutual funds also invest their funds in the stock market on such shares that are relatively volatile and are not risk-free. Therefore, the following risks are inherent in their transactions:

1. **Market Risks:** Generally, some risks are associated with every type of investment on shares. They are called market risks; these market risks can be reduced but cannot be completely removed even by good investment management. Share prices are subject to wide fluctuations in prices based on market conditions, over which no one has control. Additionally, every economy has to pass through a boom-recession. This stage of the business cycle affects market conditions to a large extent.

2. **Schematic Risk:** There are also some risks in the scheme. They all depend on the type of scheme. For example, risks are higher in a pure growth scheme. It is clear because if someone expects higher returns in the case of a growth scheme, then that person will have to take more risk.

3. **Investment Risk:** Whether the mutual fund will get money through shares or lose it depends on the investment advice of the Asset Management Company. If its investment advice goes wrong, the fund has to suffer a loss. The investment skills of various funds are different. Investors can observe this in the returns they receive.

4. **Business Risk:** Investment of mutual fund reserves is also made in shares of companies. If the company loses money or goes bankrupt, it can't pay dividends. In extreme cases, this can lead to bankruptcy. Although mutual funds can survive against such risk, their ability to pay income is affected.

5. **Political Risks:** Changing governments bring new economic ideologies and policies with them. Many economic decisions often have political motivations. Change in government brings the risk of uncertainty, which every player in the financial services industry has to face. Therefore, mutual funds are also not an exception to it.

13.12 Guidelines of Securities and Exchange Board of India (SEBI) on the Performance of Mutual Funds :

The Government of India declared comprehensive guidelines in February 1992 for all mutual funds established in the public sector, private sector, and joint sector. With respect to these guidelines, under a government announcement in January 1993, all mutual funds have been covered under the regulation of the Securities and Exchange Board of India (SEBI). These mutual funds will be established as trusts under the Indian Public Trust Act, and their management will be done separately by an Asset Management Company. The minimum capital adequacy of such an Asset Management Company must be Rs. 5 crore, out of which the minimum stake of fund sponsors must be about 40 percent. The Asset Management Company and trustees of the mutual fund will remain legally separate. Thereafter, in recent years, amendments have been made to regulations and guidelines regarding this to bring the performance of Indian mutual funds at par with developed countries and to make them more rational. Its purpose is to protect the interests of investors by making the entire system transparent, to put control on speculative activity, and to maintain financial discipline. Opportunities to invest in overseas securities are also given so that mutual funds can be made more transparent and investment opportunities can be increased.

13.13 Asset Management Company (AMC) - Asset Management Corporation :

Asset Management Corporation manages the funds of various schemes. AMC employs a large number of professionals to make investments, conduct research, and provide agent and investor services. In reality, the success of any mutual fund depends on the efficiency of the Asset Management Corporation. Asset Management Corporation submits a quarterly report regarding mutual fund operations to trustees who guide and control the Asset Management Corporation.

13.14 Management of Fund :

A mutual fund invites potential investors to join the fund by offering various schemes. This ensures that the requirements of various categories of investors are met. Resources of individual investors come together and it issues units/shares to investors for income of money, and the amount collected is invested in capital market instruments such as shares, debentures, treasury bills, commercial papers, money market instruments, etc. For the management of this fund, mutual funds receive a 1.25% annual fee of managed funds at the maximum standard prescribed by the SEBI Regulation Act 1993, and if the fund is more than 100 crore, then only 1% fee is received; they cannot take more than that. Each scheme incurs regular expenses such as custodial fees, the cost of dividend warrants, registration fees, and asset management fees. This expense cannot be more than 3% of assets in respective schemes every year. The remaining amount is completely returned to investors.

13.15 Net Asset Value :

Repurchase price is always linked with Net Asset Value. Net Asset Value is nothing but the market price of every unit of a specific scheme related to all assets of the scheme. In another way, it can be called the "intrinsic value" of every unit. This value is the true standard of the fund's performance. If the Net Asset Value is more than the original price of the unit, it clearly shows that the value of money invested in that unit has increased, and the fund has performed well. For example, Fortune Mutual Fund introduced a scheme named Crorepati Scheme. The size of the scheme is 100 crore. The price of every unit is Rs. 10. It has invested all funds in shares and debentures, and the market value of the investment comes to Rs. 200 crore. Now Net Asset Value = 200 crore / 100 crore x value of every unit. Now 2 times 10 = 20. Thus, the value of every unit of Rs. 10 will become Rs. 20. Therefore, Net Asset Value = 20. This Net Asset Value is the basis for determining repurchase price and re-issue price. An investor can raise funds at any time to find out the Net Asset Value. Some MFs publish Net Asset Value in two or three leading dailies or weeklies.

13.16 Facilities Available for Investors :

(1) Available facilities for repurchase: It is necessary for investors to compulsorily list units of specific period fund schemes on a recognized stock exchange. Such units can be sold or purchased at market price. But continuous running fund schemes are not listed, so they must be bought from the fund. Therefore, the fund keeps with itself the right to buy back units from its members. This process of the fund buying back units from investors is called a repurchase facility. It is available in both these schemes so that investors can get liquidity. The price determined for this purpose is called the repurchase price.

(2) **Re-issue facility:** In the case of re-issue facilities for continuously running fund schemes, units can be purchased only from the fund, not from the open market. Units purchased from investors are reassigned to people interested in buying again. The price determined for this purpose is called the re-issue price.

(3) **Re-investment facility:** At the time of payment, an investor is given the option to re-invest their entire investment once again for another term. Investors can remove adverse conditions of a scattered market at the time of returns by resorting to this re-investment facility. This applies in the case of specific period funds.

(4) **Scheme transfer facilities (Lateral Shifting):** Some mutual funds allow investors to transfer from one scheme to another with a view to providing the total scheme based on Net Asset Value. This is done without any discount and without any additional charge. This is a big benefit given to investors. This shifting is called 'Lateral Shifting'.

13.17 Establishment of Mutual Funds :

As said earlier, the first mutual fund in India was established in 1964 by the Unit Trust of India. And in subsequent years, many institutions have formed such funds. Among which the main institutions and funds established by them are as follows.

1. **Unit Trust of India:** Unit Trust of India has been a leader in the establishment of mutual funds. And it has started many types of schemes for various levels of investors as well as for various income groups and age groups.

2. **Mutual funds established by public sector banks:** These mainly include the following mutual funds: (1) State Bank of India Mutual Fund, (2) Canara

Bank Mutual Fund, (3) Indian Bank Mutual Fund, (4) Bank of India Mutual Fund, (5) Punjab National Bank Mutual Fund, (6) Bank of Baroda Mutual Fund.

3. **Mutual funds established by sector financial institutions:** These mainly include the following funds: (I) Life Insurance Corporation Mutual Fund, (II) General Insurance Corporation Mutual Fund, and (III) Industrial Development Bank of India Mutual Fund.

4. **Mutual funds established in the private sector:** Among these funds are the following mutual funds: (I) Kothari Mutual Fund, (II) Tata Mutual Fund, (III) Birla Mutual Fund, (IV) J.M. Mutual Fund.

5. **Foreign Mutual Funds:** Include (I) Morgan Stanley Mutual Fund, (II) Twentieth Century Mutual Fund.

13.18 Benefits of Mutual Funds :

Extraordinary development has occurred in the mutual fund industry in recent years. Generally, anyone can appreciate the revolution of the mutual fund industry, considering its importance for investors and the country's economy. Some important benefits of mutual funds are as follows:

1. **Channelizing savings for investment:** Funds work as a tool to increase people's savings by providing various schemes to various classes of customers for the development of the overall economy. Many schemes have been issued by mutual funds so that various types of requirements can be met. In this way, savings candidates are directed directly towards capital investments. In the absence of mutual funds, these savings would have remained idle. Thus, the entire economy benefits due to the increase in spending.

2. **Offering a wide portfolio investment:** Because of this offer, small and medium investors can enter into stock exchange operations with relatively negligible cost. If they invest in a few shares, they could get less profit due to lack of diversification. These investors can get the facility of a wide portfolio of investments through mutual funds. A mutual fund holds a balanced portfolio, which is free from risks. Thus, there is diversification in mutual fund portfolios.

3. **Providing better returns:** Collecting funds from a large number of customers enables receiving a large reserve on disposal of those funds.

Because of this large reserve, mutual funds will be able to make cheaper purchases and better sales than small and medium investors. Thus, they are able to implement better market rates and lower rates of brokerage. Therefore, they give good returns to their customers. They also take advantage of the large-scale economy and can reduce the cost of capital market participation. The costs of transactions of large investments are certainly less than those of small investments. In reality, all profits of the mutual fund are given to investors through dividends and capital gains. Most mutual funds started so far have given dividends at rates up to 12% p.a. and 17% p.a.; that is quite good returns.

4. **Providing expert investment services at low cost:** Management of the fund is generally entrusted to such professionals who are well-trained and have sufficient experience in the field of investment. Investment decisions of these professionals are always supported by information, knowledge, and experience. Thus, it ensures quality services in the best interest of investors. Due to the complex process of the securities market, investors cannot do all these works themselves, nor can they go to any professional manager managing individual portfolios. In such cases, they can take higher management fees. In the case of mutual funds, the intermediary fee is lowest at 1 percent.

5. **Providing research service:** A mutual fund can command wide resources, and therefore, it is possible to undertake indispensable study and research on corporate securities. Every fund maintains a large research team that continuously analyzes companies and industries and recommends that the fund buy or sell specific shares. Thus, investment is done completely based on thorough research. Since a lot of time, effort, and cost of research is involved, an individual investor will not be able to undertake this task. By investing in mutual funds, the investor gets the benefit of research done by the fund.

6. **Giving benefit in taxation:** Some funds give tax relief to their customers. Thus, apart from dividends, interest, and capitalization, investors also generate the benefits of tax exemption. For example, under Section 80L of the Income Tax Act, Rs. 10,000 dividend (Rs. 13,000 as UTI) received from mutual funds is deducted from total income. Some funds manage 88A

funds where an amount of up to 20% invested (subject to a maximum Rs. 25,000) is allowed to be deducted from tax payable. Under the Wealth Tax Act, investment in mutual funds up to Rs. 5 lakh is completely exempt from tax on all income on their investment. But all other companies will have to pay taxes, and they can declare dividends only from profits after tax. But mutual funds do not reduce tax at source from dividends. This is truly like a blessing for investors.

7. **Presenting flexible investment planning:** Some mutual funds have allowed investors to change from one unit scheme to another, and this relief is a good thing for investors. Income units can be swapped for growth units based on the performance of the reserves. No other investments offer such relief.

8. **Providing Reasonable Price and Liquidity:** Even very small investors can afford to invest in mutual funds. They provide an attractive and effective alternative for the direct purchase of shares. In the absence of mutual funds, small investors would not be able to participate in many investments with such nominal amounts. Due to liquidity, units can be sold at any time based on the Net Asset Value, and thus, an assurance of quick conversion into cash is given. Additionally, branches of the sponsor bank are always ready to provide loan facilities against unit certificates.

9. **Simplified Record Keeping:** With investment in 500 or more shares across three or four companies, an investor would have to maintain proper records of dividend payments and bonus issues. Records would also have to be kept regarding price changes, purchases or sales, brokerage, and other related matters. However, it is very tiring and takes a lot of time. One might forget to keep records of any rights issue and may end up losing it; therefore, record keeping is the biggest problem for small and medium investors. Now, a single investment source facility is also available. Mutual funds are capable of investing in more than 100 companies.

10. **Supporting the Capital Market:** Mutual funds play a significant role in supporting the development of the capital market. Mutual funds make the capital market active by fulfilling the demand for capital market instruments.

In other words, these mutual funds invest people's savings in capital markets. Thus, bank deposits invest funds in financial instruments such as stocks, shares, and bonds. Mutual funds also provide high liquidity for capital, and in this way, the market becomes active and stable. When foreign investors and speculators re-enter markets, mutual fund investors keep the market stable and liquid. In the absence of mutual funds, there remains a large fluctuation in prices due to the entry and re-entry of speculators in the stock market. Thus, it gives excellent support to the capital market and helps in the process of institution-building of the market.

11. **Encouragement to Industrial Development:** Economic development of any nation depends on its industrial development and agricultural development. All industrial units have to obtain funds through the capital market by issuing shares and debentures; mutual funds provide a large source of funds to the market, and in this way, industries are assured of the fulfilment of their capital requirements. With the entry of mutual funds, the demand for India's shares and bonds has increased. Thus, mutual funds provide financial resources to industries at market rates.

12. **Initial Public Offering (IPO):** In most cases of initial public offerings, small investors cannot obtain the company's IPO because applying for at least 500 shares is especially difficult for small investors. However, in mutual funds, there is a higher likelihood of receiving an allotment, as companies also guarantee a specific percentage of shares to mutual funds. Thus, by investing in mutual funds, investors can gain exposure to a variety of companies.

13. **Reducing Market Cost of New Issues:** Mutual funds help in reducing the marketing cost of new issues. Promoters used to allot a large portion of the initial public offering to mutual funds, and therefore they are saved from the marketing cost of such issues.

14. **Keeping the Money Market Active:** Small investors cannot participate directly in the money market; they invest in mutual funds, and mutual funds keep investment of money-on-money market instruments active. In fact, the availability of more money market instruments is a good sign for a developing money market, which is very necessary for the successful working of the Central Bank in the country. In this way, mutual funds provide resources.

13.19 Selection of Mutual Fundss :

Selection of a mutual fund depends on the efficiency of the fund by which it is managed through professionals of reserves. Therefore, investors have to be very careful in selecting funds. To evaluate the performance of any fund, it is essential to consider the following factors, and only then should it be decided to take a mutual fund:

1. **Objective of Fund:** First, one should see the objective of the fund, whether it is income-oriented or growth-oriented. Income-oriented funds are mainly supported by securities like debentures and bonds. While growth-oriented ones are supported by equities; it is clear that growth-oriented schemes are more risky than income-oriented schemes. And therefore, returns received from such schemes are not compared.

2. **Comparison of Scheme:** An investor should compare a particular scheme of one fund with a similar scheme of another fund and a plan should be made only after comparative analysis; its objective should also be consistent with the objective of that scheme.

3. **Consistency of Performance:** Mutual funds are meant to give stable and long-term returns and therefore, the investor should compare the performance of funds over a period of at least three years.

4. **Historical Background:** The success of any fund depends on the ability and integrity of the management. Which should include periodicity and experience. A good historical record is more favorable for trial than new funds.

5. **Fund Expense Ratio:** The fund expense ratio should be examined and it should be measured comparatively with others, whether it is high or low. It is necessary to check all aspects of whether the investor will get real returns.

6. **Capacity for Innovation:** The efficiency of fund managers should be tested by the innovative schemes they have introduced in the market so that various requirements of investors are met. It is natural that an investor will look for a fund that is capable of bringing innovations to the financial market.

7. **Service to Investors:** The most important factor to consider for service to investors is prompt and efficient service. Quick response to investors' questions, immediate dispatch of unit certificates, and immediate transfer of units; these services will create a permanent long impression in the minds of investors.

8. **Market Trends:** The stock market index and inflation rate move in the same direction, while interest rate and stock market index move in opposite directions. A wise investor should keep an eye on the stock market index, interest rate, and inflation rate. Of course, there is scientific logic behind it.

9. **Transparency of Fund Management:** The success of mutual funds depends to a large extent on the transparency of fund management. In these days of investor awareness, it is very important that complete details regarding the management of reserves by the fund should be declared. So that a good impression is formed permanently in the minds of investors.

13.20 Rights of Investors :

In the SEBI Regulations, 1993, there are specific provisions related to investor service. According to the above rules, investors are guaranteed certain rights. They are as follows:

1. **Unit Certificates:** Any investor has the right to receive their unit certificates upon allotment within 10 weeks from the date of closure of the scheme list. And in the case of a continuous fund, the closure of the initial offer is after 6 weeks of the date.

2. **Transfer of Units:** An investor is entitled to get a transfer within a period of 30 days from the date of registering the certificates, along with the relevant transfer form for unit certificates.

3. Refund of Application Money: If a mutual fund is not able to collect the statutory minimum fund, then for a specific period, funds of Rs. 20 crore, for continuous funds Rs. 50 crore, or 60% of the target amount, whichever is higher, must be refunded to the applicant within a period of 6 weeks from the date of completion of the subscription lists. If the refund is delayed beyond this period, every applicant is entitled to receive it back with interest at the rate of 15% p.a. for the period of delay.

4. **Audited Annual Report:** Every mutual fund is responsible to its investors to ensure that an audited annual report is published, and regarding each of its schemes, a semi-annual report is published through leading newspapers within 6 months and 3 months, respectively, from the date of completion.

13.21 Professional Banks and Mutual Funds :

With a view to providing wide choice opportunities to small investors, the Government of India has allowed banks to start subsidiary companies of mutual funds. Due to the following matters, banks have been urged to enter the field of mutual funds:

Reasons:

1. Banks are not able to give better returns to people investing with their savings and fixed deposit interest rates, while many financial intermediaries have entered the financial market with very attractive market instruments, giving mutual fund returns. Therefore, banks must become competitive and engage with financial intermediaries to retain these savings by entering the mutual fund market.

2. Due to banks' wide branch expansion programs and their increasing deposit mobility, total domestic savings have increased from 10% to 20% in the decade of the fifties. Banks can reach everyone in the country because they have branches in rural and urban areas. Therefore, mutual funds supported by banks would be more suitable for making effective and good use of savings for the capital market.

3. Indian investors, especially the small and middle classes, are not keen to invest any significant amount directly in capital market instruments. They also hesitate to invest indirectly through private financial intermediaries. If a bank supports such an intermediary, it can establish trust among investors, encouraging them to come forward for investment. Thus, banks have the advantage of "public trust," which is very necessary for the success of mutual funds.

4. Previously, banks were not allowed to take money from the capital market for funds or to invest their funds in the market. Now they have been given the green signal to enter this market and obtain maximum benefits.

5. Banks can provide a wide range of products/services in mutual funds by introducing innovative schemes and can expand professionalization in the mutual fund industry.
6. Commercial banks have extensive experience in the capital market, and therefore, managing mutual funds may not be a big problem for them.
7. The entry of banks will provide much-needed competition. The mutual fund industry, which was so far run by the monopoly of U.T.I., will also improve customer choice by expanding customer service through this competition.
8. The process of diversion of bank deposits into mutual funds will benefit the capital market as it will provide a sustainable domestic source of demand.
9. Banks can effectively serve investors through their nationwide network of branches. Hence, commercial banks have entered the mutual fund market without any hesitation.
10. Furthermore, the profitability of banks has been greatly affected due to many restrictions on their lending policies. They have been forced to find some other options to increase their profit by diversifying their activities. Mutual funds provide an excellent framework for diversification. Mutual funds are growing at a rapid pace across the world. In the U.S.A., mutual funds are known as bank deposits of the 1990s decade and are most popular there.

13.22 Conclusion :

Thus, mutual funds provide the triple benefits of investment safety, good returns, and quick liquidity. Investments in mutual funds are completely safe investments; these investments work as a medium between bank deposits and shares; the risk level in them is higher than bank deposits, so returns higher than bank deposits are also received, and the risk level is lower than shares, so lower returns are received than those. Mutual funds hold a balanced portfolio. Given the significant growth of mutual funds in India, it is clear that their future is very promising.

Exercise :

Q.1 Fill in the blanks below :

1. The fund's corpus and its specific time duration are already determined in -------- Fixed Period Fund (Closed-ended).

2. ----------------Fund invests in high liquidity securities like commercial paper. (Money Market Mutual)
3. The company that determines the mutual fund is called the---------- (Sponsor).
4. The intrinsic value of every unit of this mutual fund is nothing else but --------- (Net Asset Value).
5. ------------- (Mutual Fund) is the gateway for small investors to enter big companies.

Q.2 MCQs (Choose the correct option)

1. The most suitable fund for professional people:

   (a) Fixed fund (b) Growth Fund (c) both (d) none of these

Ans. (b) Growth Fund

2. The facility provided to transfer investors from one scheme to another under the same fund is called:

   (a) Fixed fund (b) Growth Fund

   (c) both (d) Lateral Shifting facility.

Ans. d) Lateral Shifting facility.

3. Mutual funds are popular in:

   (a) U.S.A. (b) India

   (c) Pakistan (d) all of the above

Ans. (a) U.S.A.

4. Under which security does the mutual fund investment method provide fixed income?

   (a) Fixed fund (b) Growth Fund

   (c) Income Fund Scheme (d) none of these

Ans. (c) Income Fund Scheme

5. In India, the company that actually works with the corpus of a mutual fund is called:

   (a) Fixed fund (b) Growth Fund

   (c) Asset Management Company (d) none of these

Ans. (c) Asset Management Company

Q.3 State whether the following statements are true or false:

1. Units of open-ended funds cannot be traded in public. True.
2. Roll-over facility is available only in the case of closed-ended funds. True.
3. Commercial banks can directly do mutual fund business. False.
4. RBI regulates the working of mutual funds in India. False.
5. Mutual funds can purchase shares of public limited companies. True.

Q.4 Answer the following questions in short:

1. What is a mutual fund? Give an example.
2. Discuss any two schemes that can be offered by mutual funds.
3. What are the special features of an open-ended fund?
4. Differentiate between income fund and growth fund.
5. What is a balanced fund?
6. What is the risk associated with mutual funds?
7. Describe the structure of mutual fund operations in India.
8. What is the meaning of the roll-over facility?
9. What is Net Asset Value? How is it calculated?

Q.5 Answer the following questions in short:

1. Define a mutual fund and describe various schemes.
2. What rights and facilities are available to a mutual fund investor?
3. Which factors should be considered before selecting a mutual fund?
4. To what extent are commercial banks in India suitable for doing mutual fund business?
5. State the factors to be considered at the time of selecting a mutual fund.
6. Explain the Asset Management Company (AMC) / Asset Management Corporation.
7. What is meant by Net Asset Value?

Q.6 Answer the following questions in detail:

1. Discuss Money Market and Mutual Fund.
2. Write a short note: open-ended mutual fund.
3. State the characteristics of specific-period mutual funds.
4. Discuss SEBI's guidelines about mutual funds.
5. State the importance of mutual funds.
6. Discuss the future of mutual funds.
7. Write a short note on the development of mutual funds.
8. State the risks of mutual funds in detail.
9. Discuss the facilities provided to investors in detail.
10. How many rights have been given to investors? Which ones? Explain.

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Unit - 14
Recent Trends and Regulatory Framework

14.1 Introduction :

The financial system in India has undergone many changes after independence and emerged as one of the dynamics, complex and vital financial structure of the world. The financial system of India is composed of institutions, market law practices and a regulatory body which is responsible for the creation, utilisation and regulation of funds.

The financial system of the country decides the economic condition of that nation. At the initial stage, India promoted government-controlled company for the larger interest of the people considering socio-economic goal as its priority. Hence, government adopted a protective policy for the public sector companies. However, after the adoption of globalization policy government insisted on competitiveness for quality of services. Hence after 1990s government tried to make the finance sector more competitive and compatible with the global standard. Now Indian financial system is equipped with the all features global financial system which will pave the way to make India as a developed nation by 2047. Digital transaction use of fintech, competitive banking sector flexible rule and regulation access of security market to the general public are some of recent trends in Indian financial system. Now India becomes the fifth largest economy with the help of robust financial system of the country. In India financial sector has five pillars namely financial institutions, financial market, financial instruments, financial services and financial regulator.

1) **Financial institution:** These entities are responsible for moving savings from fund providers to fund seekers. Therefore, it is accountable for the mobilization of savings to the deficit fund sector. It can be categorized into two classifications:

a. Banking Institution: This includes all banks operating within the country, such as public sector banks, private sector banks, foreign banks, regional rural banks, post office banks, and payment banks in India.

b. Non-Banking Institutions can be classified into the following subcategories as development institution and NBFC:

i. Development banking institutions: which provide long-term finance to the industrial sector for the economic growth of countries. The fundamental objective of these institutions is the growth of the country. For example, NABARD, SIDBI, EXIM Bank, IDBI, NHB, etc.

ii. Pure non-banking financial institution: an entity that engages in all financial activities except for accepting deposits and creating credit. Therefore, it is institutions that engage in funding activities without receiving deposits from the public. Mahindra and Mahindra Finance, Bajaj Finance Ltd, Tata Finance Ltd, Sundaram Finance, Muthoot Finance, etc.

2) **Financial Market:** The financial market serves as the platform for the development and trading of financial products. The "money market" and the "capital market" are two segments of the financial market. The capital market engages with the fund over an extended duration, while the money market interacts with the fund during a brief period. The capital market can be subdivided into the two categories described below:

a. The primary market manages initial public offerings. Therefore, investors can only purchase shares in the primary market when the company initially issues them.

b. Secondary market: This refers to the market for securities that have already been listed. Consequently, a broader market exists for investors to acquire assets from existing holders.

3) **Financial instrument:** A component of the financial system that pertains to various instruments exchanged inside the nation's financial framework. It comprises a range of hybrid securities and equity debt instruments.

4) **Financial services:** this refers to a segment of the financial system that encompasses the financial services provided by various market participants. It can be further categorized into two segments: "Fund-based services" and "fee-based services." Underwriting, leasing, hire purchase, and other services exemplify "fund-based services." In contrast, fee-based services encompass loan syndication, credit rating, and issue management services.

5) **Regulator: -**Regulation monitoring and supervision are the key aspects to the financial system of the country. Hence strong regulatory mechanism is required to manage and promote the financial system of the county.

14.2 Financial Market Regulations in India :

There are following major regulator in the financial system of the country.

1. **Reserve Bank of India:** The banking sector of our country is regulated by the RBI. The Reserve Bank of India (RBI), is supreme regulator body was established on April 1, 1935, pursuant to the RBI Act, 1934.It is responsible for the regulation of the banking system, the issuance of currency, the management of foreign exchange, and the preservation of financial stability. It was nationalized in 1949. Its headquarter is in Mumbai which is responsible for the management of monetary policy in order to promote economic development and maintain price stability. The fundamental functions of Reserve bank of India includes:

   (i) It is supreme monetary authority which conducts monetary policy formulation, implementation, and monitoring. Generally, RBI conducts monetary policy evaluations every two months

   (ii) Currency Issuer: The entity responsible for the issuance and exchange of currency, as well as the destruction of currency that is unsuitable for circulation.

   (iii) Banker to the Government: perform banking operations for the central and state administrations.

   (iv) Banker to Banks: Serves as the lender of last resort and oversees the banking accounts of all scheduled banks.

   (v) Financial System Regulator for banking and NBFC: Responsible for the monitoring and supervision of payment systems, non-banking financial companies (NBFCs), and commercial institutions.

(vi) Foreign Exchange Manager: It is also responsible for the administration of the Foreign Exchange Management Act (FEMA), 1999.

2. **SEBI:** The Securities and Exchange Board of India (SEBI) is the statutory apex regulator for the securities market in India. It was incorporated on April 12, 1992, under the SEBI Act 1992. Its primary responsibility is to safeguard investor interests, regulate market intermediaries, and foster the growth of the stock market while preventing malpractice. It is headquartered in Mumbai. It was established to facilitate transparent investment by the investors and protect their interests with a robust trading system and regulation. Its main function is to regulates the securities business, prohibits insider trading, protects and educate investors. It Functions as a quasi-legislative (drafts regulations), quasi-judicial (passes rulings), and quasi-executive (investigates/enforces) entity. It Consists of a Chairman and board members appointed by the Government of India, including representatives from the Union Ministry of Finance and the RBI.

   It regulates Foreign Portfolio Investors (FPIs), Mutual Funds, Stock Exchanges, and Commodities Markets. SEBI has been actively engaged in the recent past in the simplification of disclosure requirements to align with international standards and the proposal of incentives for retail investors, including increased coupon rates for corporate bonds.

3. **IRDAI:** The insurance regulatory and development agency of India (IRDAI) is a statutory, autonomous entity that was established in 1999 under the Ministry of Finance with the objective of regulating and promoting the insurance industry in India. It was established under the recommendation of Malhotra Committee. It's headquartered is located in Hyderabad and is responsible for the protection of policyholder interests, the establishment of industry standards, and the promotion of fair, transparent insurance practices. It facilitates the orderly expansion of the insurance sector, safeguard policyholders, and guarantee prompt settlements. It is also responsible for establishment of intermediary codes of conduct, regulates premium rates, licenses insurers, and supervises financial reporting. It is a10-member body, consisting of a chairman, five full-time members, and four part-time members, that is appointed by the Government of India. The scope of its regulation includes re-insurance companies, general insurance, and life insurance. It facilitates the resolution of grievances, ensures equitable practices, and streamlines claim procedures for policy holders.

4. **National Payment Corporation of India:** The Reserve Bank of India (RBI) and the Indian Banks' Association (IBA) established the National Payments Corporation of India (NPCI) in 2008 as the umbrella organization responsible for the operation of India's retail digital payment and settlement systems. This serves as the secure foundation for immediate, interoperable payments, including UPI, RuPay cards, IMPS, and FASTag. Some of the key examples of NPCI systems are UPI (Unified Payments Interface). It makes use of various applications such as Google Pay or PhonePe to make instantaneous payments between peers or merchants. It also manages Rupay cards through ATMs and terminals take domestic debit and credit cards. Now days IMPS (Immediate Payment Service), immediate interbank electronic fund transfers that are available on 24x7 basis. It also manages NETC (FASTag): Highway toll collection system which is deducting the toll from the customers' accounts through automated system. It also facilitates. AePS (Aadhaar-enabled Payment System) which uses Aadhaar authentication to provide banking services, thereby fostering financial inclusion.

14.3 Digital Trading Platforms :

Digital trading platforms are software-based systems that enable investors to purchase and sell financial instruments, including stocks, bonds, cryptocurrencies, and derivatives, through internet-connected devices. These platforms offer real-time market data, immediate order execution, comprehensive portfolio management tools, and lower fees by replacing traditional human brokers with automated systems.

The key characteristics of Digital Trading Platforms are Real-time Monitoring: Utilize live market data, statistics, and news to make well-informed decisions. Asset Diversity: Utilize a solitary interface to trade equities, ETFs, mutual funds, and cryptocurrencies. It utilize bracket, limit, stop-loss, and market orders to mitigate risk. It employs trading capabilities that are algorithmic, such as robot-advisors or automated programs (e.g., TradeStation). It also Utilize analytics to monitor performance and adjust portfolios.

14.4 FinTech and Financial Market :

Fintech (financial technology) employs software, artificial intelligence, and algorithms to automate and improve financial services for individuals and enterprises, resulting in enhanced efficiency, reduced costs, and greater accessibility to banking, lending, and investing opportunities. In simple words, fintech means the incorporation of technology into financial services to enhance efficiency, accessibility, speed, transparency, and client experience. It revolutionizes financial markets by facilitating digital payments, blockchain/cryptocurrency, robo-advisory services, and insurtech, while contesting conventional banking models with rapid, user-focused solutions.

Principal Fintech Domains: Key areas encompass digital payments (e.g., PayPal, Venmo), mobile banking (neobanks), automated investment management (Robo-advisors), lending platforms, and blockchain-based cryptocurrencies. Fintech companies, frequently challenging conventional banks, have diminished information asymmetry, streamlined mergers and acquisitions, and supply chain stability. Artificial Intelligence (AI) and machine learning (ML) are employed for fraud detection, customer assistance chatbots, risk assessment, and tailored financial planning. India exhibits a high fintech adoption rate of 87%, with an approximate market value of $50 billion. FinTech has revolutionized the loan industry. Conventional loan approval procedures were frequently protracted and necessitated extensive documentation. FinTech lending platforms increasingly employ artificial intelligence and data analytics to evaluate customers' creditworthiness and offer immediate loans with minimal documentation. This has enhanced financial accessibility, especially for small enterprises, startups, and individuals lacking a robust conventional credit history. The advent of "Buy Now, Pay Later" services has significantly broadened digital credit options for consumers.

In investment and wealth management, FinTech has democratized access to financial markets. Previously, investing in stocks and mutual funds necessitated the support of brokers and financial consultants. Currently, online trading and investment platforms like Zerodha, Groww, and Upstox enable individuals to trade directly via mobile devices. These platforms offer real-time market data, cost-effective trading, and intuitive interfaces, thus promoting increased public engagement in financial markets.

Insurance technology, referred to as InsurTech, is a swiftly expanding sector within FinTech. Insurance firms are progressively employing technology to enhance customer service, streamline claims processing, and mitigate fraud. Clients can now evaluate policies, acquire insurance, and file claims online. Artificial intelligence is utilized to evaluate risks and streamline claims processing more effectively.

Several sophisticated technologies have propelled the expansion of FinTech. Financial institutions extensively employ artificial intelligence and machine learning for fraud detection, customer care chatbots, credit scoring, and tailored financial recommendations. Big data analytics enables financial organizations to evaluate client behaviour and make informed business decisions. Cloud computing offers scalable and economical data storage solutions, whereas APIs facilitate secure connection between banking systems and external applications.

FinTech provides various benefits to the user and entities. It offers ease by allowing consumers to access banking services at any time and from any location via smartphones. Transactions are expedited and more efficient, minimizing waiting periods and documentation. Reduced operational expenses frequently lead to more affordable financial services for consumers. FinTech has significantly contributed to financial inclusion by providing banking and payment services to formerly marginalized people, particularly in rural regions.

Challenges: Notwithstanding its numerous advantages, FinTech encounters various obstacles. Cybersecurity threats and online fraud pose significant risks due to the management of sensitive financial data on digital platforms. Data privacy and protection have emerged as paramount concerns in the digital era. Regulatory authorities must consistently modify rules and regulations to accommodate emerging technologies and associated dangers. Furthermore, several individuals continue to possess insufficient digital literacy, constraining the accessibility of FinTech services in specific areas.

India has become one of the most rapidly expanding FinTech markets globally. Government initiatives like Digital India, Jan Dhan Yojana, Aadhaar, and UPI have established a robust framework for digital financial services. The Reserve Bank of India is crucial in overseeing FinTech operations, safeguarding financial stability, and protecting consumers. The RBI has implemented steps including digital lending guidelines and regulatory sandboxes to promote innovation while ensuring regulatory monitoring.

The prospects for FinTech seem exceptionally favourable in the Indian financial system. We anticipate that emerging developments, such as artificial intelligencedriven finance, embedded finance, open banking, and Central Bank Digital Currency (CBDC), will further revolutionize the financial sector. Financial services are expected to become further personalized, automated, and integrated into daily digital activities. India, characterized by its substantial population, increasing internet access, and robust digital infrastructure, is anticipated to maintain its position as a global leader in FinTech innovation.

In conclusion, FinTech has transformed the contemporary financial system by integrating finance with sophisticated technology. It has enhanced the efficiency, accessibility, and affordability of financial services, while fostering financial inclusion and economic growth. FinTech is continuously transforming the execution of financial processes through digital payments, internet banking, blockchain, and artificial intelligence. Despite the significance of issues like cybersecurity and regulatory compliance, the ongoing expansion and innovation in FinTech are anticipated to be crucial for the future advancement of the worldwide economy.

14.5 Investor Protection Measures :

One of the key areas of the financial system of any country is associated with investor protection. Investor protection means all measures encompass legislative, legal, and operational safeguards aimed at shielding investors against fraud, market manipulation, and broker default. Essential measures encompass stringent regulatory supervision by entities such as SEBI, the Investor Education and Protection Fund (IEPF), Investor Protection Funds (IPFs) for indemnification, obligatory disclosures, and initiatives for investor awareness.

Essential Investor Safeguards: The Securities and Exchange Board of India (SEBI) regulates and supervise market intermediaries, including brokers, transfer agents, and portfolio managers, while supervising stock exchanges to mitigate unfair trade practices and fraud. The Investor Protection Fund (IPF) was instituted by stock exchanges, such as the NSE and BSE, to indemnify investors in the event of a broker's default or failure to remit payments, in accordance with directives from the Ministry of Finance. The Investor Education and Protection Fund (IEPF) is a governmental fund established under the Firms Act, wherein firms remit unclaimed profits, matured deposits, and shares after a period of seven years for potential reclamation by investors. The following steps have been taken to protect investors:

i. Disclosure and Transparency norms: Now SEBI enforces the strong disclosure mandates for the corporate houses. Presently, there is a thorough disclosure required, including financial statements and significant events, to assist investors while making investment decisions.

ii. Strict restriction for insider trading: There is a serious penalty for purchase of shares on the basis on leakage of price sensitive information.

iii. Grievance Redressal Mechanisms: Digital platforms such as SCORES allow investors to submit grievances directly against corporations or intermediaries.

iv. Safe Trading Practices: Now there is a mandatory PAN utilization directive issued by the government. Presently shares are being transferred to Demat accounts, and online transaction verification is possible, which ensures transparency. There are a number of investors; education training is conducted by the SEBI to create awareness. Periodic campaigns and Niveshak Shivirs (investor camps) are organized to inform stakeholders about market dangers and fraudulent schemes.

14.6 Recent Trends and Conclusion :

Hence, from the above, we can say that now the financial system of India has become one of the most vibrant robust and vital systems in the world. There are the following recent trends in the financial sector of our country: -

(i) There has been an increase in the share of banking businesses in the private sector. Currently the government is putting stress on competitiveness in the banking sector instead of just protection policy. Hence, private banks are increasing the market share in the banking sector and setting a new standard of customer services in India.

(ii) Financial integration in India: - Integration of 100 percent of the population with the banking channel was a big channel in India. According to Nachiketa, more committees are now involved in payments, and small finance banks have started operating. Small finance banks are playing a major role in providing finance to small traders. Under the PM Jan Dhan Yojana, more than 56 crore deprived people are now integrated with the banking system of the country.

(iii) Implementation of insolvency and bankruptcy code 2016: There are several legal reforms taken by the government to strengthen the financial sector. The

Insolvency and Bankruptcy Code 2016 was introduced by the government to solve the problem of creditors and entrepreneurs after the company's insolvency. Under this provision now, in case the company becomes insolvent, the whole settlement will be done within 330 days in any case.

(iv) Introduction of Goods and Services Tax Act: In 2017, unified comprehensive destination-based tax is introduced to ensure a transparent tax structure of the country. This regime brings revolutionary change in the economy of the country to make our country globally more competitive.

(v) An increase in the merchant banking business and the concept of a universal bank become popular. Now the banking company is providing all kinds of financial services under one roof; along with the traditional banking facility, it also provides merchant banking services and insurance.

(vi) Strong and consolidated public sector banks due to a series of mergers and amalgamations: The government has announced a series of mergers and amalgamations among the public sector banks between 2017 and 2020. Hence, now smaller public sector banks merged with the comparatively larger public sector banks. In this way, now public sector banks have become stronger, and some of them, like State Bank of India, PNB, and Bank of Baroda, have emerged as global banks.

(vii) Digital settlement system: Now in the capital market, the settlement cycle is reduced to T+1 days. Now trading is done in online mode and accessible to the general public in a simpler manner.

(viii) UPI and digital payment: In India now payment is mainly done through the digital mode by using mobile apps only. Further, now the general public is mainly using the UPI payment system in India. In 2025-26 the total volume of transactions through UPI is approximately 24,000 crore rupees. Hence, we can understand the level of popularity of the unified payment interface.

(ix) An increase in the public participation in commodity and option trading: Now the general public is doing the commodity trading due to simplifications and an increase in transparency in the digital era.

(x) There is an increase in the demand for wealth management and Asset Management services: Nowadays, in the financial sector, there is a remarkable increase in the client for wealth management services. Due to interest of the general public, there is a huge surge in the demand for mutual fund advisors and asset management companies.

(xi) Wider use of AI and fintech application: - Now with the use of fintech applications and other AI tools, transactions become simple in the financial sector. Now management took business decisions with the help of automated software on the basis of available data.

Hence, we can say that our present financial system is robust equipped with all digital and technological features and flexible regulation, and transparency, which will make India a developed nation.

Exercise:

Q.1 Multiple Choice Questions (MCQS):

1. Which legislation granted statutory powers to SEBI?

   A) RBI Act, 1934 B) SEBI Act, 1992

   C) Companies Act, 2013 D) Banking Regulation Act, 1949

2. The Monetary Policy Committee (MPC) was established under which amendment?

   A) RBI Amendment Act, 2014

   B) RBI Amendment Act, 2016

   C) Finance Act, 2015

   D) Banking Laws Amendment, 2012

3. UPI (Unified Payments Interface) was launched in:

   A) January 2014 B) November 2015

   C) April 2016 D) August 2017

4. India completed the transition to T+1 settlement for ALL listed securities by:

   A) January 2022 B) June 2022

   C) January 2023 D) March 2023

5. Which platform is designed as a unified digital marketplace for insurance, similar to UPI for payments?

   A) Bima Vahak B) Bima Vistaar

   C) Bima Sugam D) Arogya Sanjeevani

6. The Account Aggregator (AA) framework was launched in:

   A) March 2019 B) September 2021

   C) November 2020 D) January 2022

7. NPCI was established in which year?

   A) 2004 B) 2006 C) 2008 D) 2010

8. SEBI's SCORES is an online platform for:

   A) Algo-trading approvals B) Investor grievance redress

   C) IPO filings D) NBFC licensing

9. India's RBI launched the retail e-Rupee (CBDC) pilot in:

   A) September 2022 B) November 2022

   C) December 2022 D) February 2023

10. The BRSR (Business Responsibility and Sustainability Reporting) framework was made mandatory for the top 1,000 listed companies from:

    A) FY 2021-22 B) FY 2022-23

    C) FY 2023-24 D) FY 2024-25

Answers:-

1. Answer: B) SEBI Act, 1992

2. Answer: B) RBI Amendment Act, 2016

3. Answer: C) April 2016

4. Answer: C) January 2023

5. Answer C) Bima Sugam

6. Answer: B) September 2021

7. Answer: C) 2008

8. Answer: B) Investor grievance redress

9. Answer: C) December 2022

10. Answer: B) FY 2022-23

Q.2 Short answer question :

1. What is the role of the Monetary Policy Committee of the RBI?
2. Define a Non-Performing Asset (NPA). How it effects the banking industry of the country?
3. What is the role of SEBI for protection of investors in India
4. What is UPI? Explain in brief
5. Describe the function of NPCI in India
6. What is digital platform for online trading? Explain in brief.

Q.3 Essay type question

1. Discuss the recent regulatory reforms introduced by the Reserve Bank of India (RBI) to strengthen India's financial system. Include specific initiatives such as the Digital Lending Guidelines, CBDC pilot, and Scale-Based NBFC Regulation in your answer.
2. Analyse the evolution of India's fintech ecosystem and the regulatory challenges it poses.
3. What are the recent trends of the Indian financial system? Explain in brief.
4. Explain the various regulators of the financial system of the country.
5. IRDAI's "Insurance for All by 2047" vision represents an ambitious agenda for India's insurance sector. Discuss the key regulatory reforms introduced by IRDAI to achieve this vision and the structural challenges that remain.

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યુનિવર્સિટી ગીત

સ્વાધ્યાયઃ પરમં તપઃ
સ્વાધ્યાયઃ પરમં તપઃ
સ્વાધ્યાયઃ પરમં તપઃ

શિક્ષણ, સંસ્કૃતિ, સદ્ભાવ, દિવ્યબોધનું ધામ,
ડૉ. બાબાસાહેબ આંબેડકર ઓપન યુનિવર્સિટી નામ;
સૌને સૌની પાંખ મળે ને સૌને સૌનું આભ,
દશે દિશામાં સ્મિત વહે, હો દશે દિશે શુભ-લાભ. ?

અભણ રહી અજ્ઞાનના શાને, અંધકારને પીવો ?
કહે બુદ્ધ આંબેડકર કહે, તું થા તારો દીવો;
શારદીય અજવાળાં પહોંચ્યાં ગુર્જર ગામે ગામ
ધ્રુવતારકની જેમ ઝળહળે એકલવ્યની શાન.

સરસ્વતીના મયૂર તમારે ફળિયે આવી ગહેકે
અંધકારને હડસેલીને ઉજાસનાં ફૂલ મહેંકે;
બંધન નહીં કો' સ્થાન સમયનાં જવું ન ઘરથી દૂર,
ઘર આવી મા હરે શારદા દૈન્યતિમિરનાં પૂર.

સંસ્કારોની સુગંધ મહેંકે,મન મંદિરને ધામે
સુખની ટપાલ પહોંચે સૌને પોતાને સરનામે;
સમાજ કેરે દરિયે હાંકી શિક્ષણ કેરું વહાણ,
આવો કરીએ આપણ સૌ
ભવ્ય રાષ્ટ્રનિર્માણ...
દિવ્ય રાષ્ટ્રનિર્માણ...
ભવ્ય રાષ્ટ્રનિર્માણ

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