CBSE CLASS 12 BUSINESS STUDIES

CHAPTER – 10

FINANCIAL MARKETS

REVISION NOTES

CONCEPT OF FINANCIAL MARKETS

- A business is a part of an economic system that consists of two main sectors
  (a) Households/ individuals who save funds and
  (b) Business enterprises, which invest these funds.

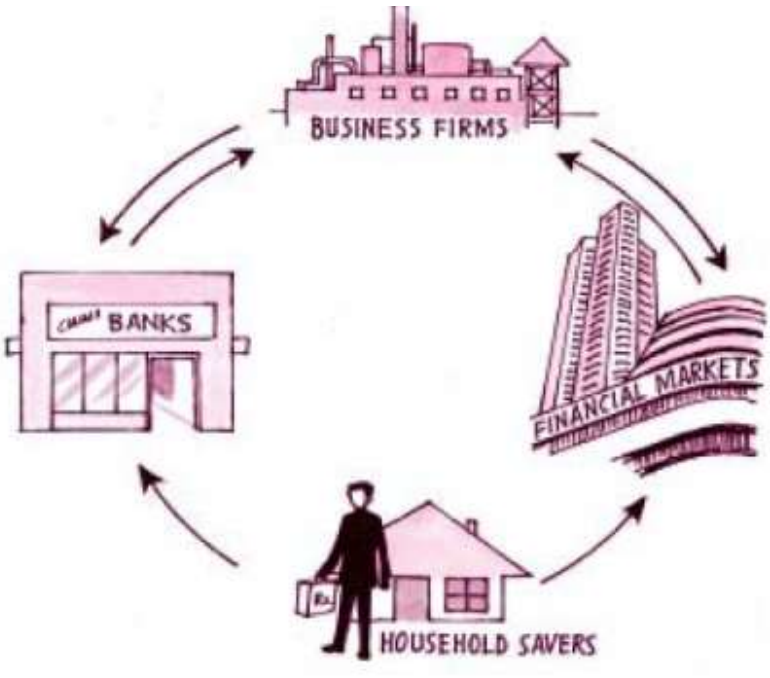
- A financial market helps to link the savers and the investors by mobilizing funds between them.

- The process by which allocation of funds is done is called **financial intermediation**

- Two major intermediaries, by which allocation of funds can be done are:
  (a) Banks or
  (b) Financial markets

Financial Markets are the institutional arrangements by which savings generated in an economy are channelized into avenues of investment by industry, business and the government**.**

Financial Market is a market for the creation and exchange of financial assets.



Financial System

FUNCTIONS OF FINANCIAL MARKETS

1. Mobilization of savings and channelling them into the most productive uses:

- Facilitates transfer of savings from the savers to the investors.
- Financial markets help people to invest their savings in various financial instruments and earn income.
- Facilitate mobilization of surplus funds into the most productive uses.

2. Facilitating Price Discovery:

- Price is determined from the forces of demand and supply, where business firms represent the demand and the households represent the supply components.
- The interaction between demand and supply helps to establish a price for the financial asset, which is being traded in that particular market.

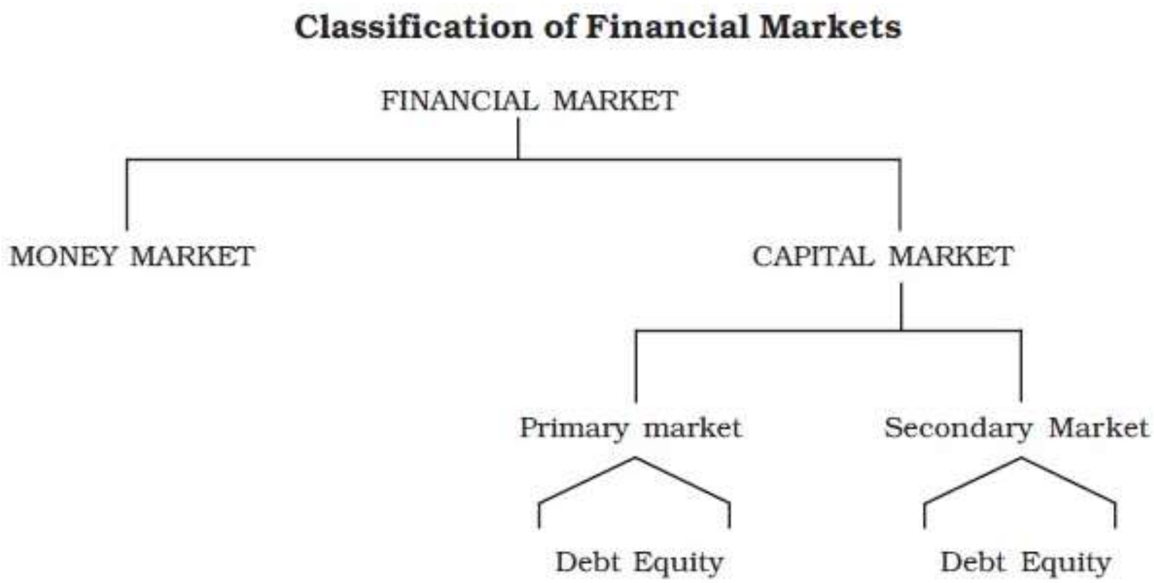
3. Financial markets provide liquidity to financial assets:

- By providing a ready market for the sale and purchase of financial assets, it facilitate easy liquidity to financial assets.
- Holders of the financial assets can readily sell and buy financial instruments from financial market.

4. Reduce the cost of transactions:

- It provide valuable information to buyers and sellers of financial assets, and helps in saving time, effort and money.
- Investors can buy/sell securities through brokers who charge a nominal commission for their services. This way financial markets facilitate transactions at a very low cost.

TYPES OF FINANCIAL MARKETS



I. MONEY MARKET

- Money Market is a market for financial instruments with a maturity period of less than one year.
- It is a market for low risk, unsecured and short term debt instruments that are highly liquid and are traded everyday.
- It is conducted over the telephone and through internet.
- It helps in raising short term funds and temporary deployment of excess funds for earning returns.

MONEY MARKET INSTRUMENTS

1. Treasure Bills:

- The RBI on behalf of the Central Government to meet its short-term requirement of funds issues treasury bills.
- It is also known as Zero Coupon Bonds, and is issued in the form of a promissory note It is issued at a price which is lower than their face value and are repaid at par.
- It is available for a minimum amount of Rs.25000 and in multiples thereof.

2. Commercial Paper:

- It is a short term unsecured promissory note issued by large credit worthy companies, in order to raise short term funds at lower rates of interest than market rates.
- It is a negotiable instrument transferable by endorsement and delivery with a fixed maturity period of 15 days to one year.
- The purpose of issuing commercial paper was to provide short-terms funds for seasonal and working capital needs

3. Call Money:

- It is short term finance repayable on demand, with a maturity period of one day to 15 days.
- It is used for interbank transactions. Commercial banks are required to minimum cash balance called as cash reserve ratio.
- Call Money is a method by which banks borrow from each other in order to maintain the cash reserve ratio as per RBI rules. The interest rate paid on call money loans is known as the call rate.

4. Certificate of Deposit:

- It is an unsecured negotiable instrument issued by Commercial Banks & Financial Institutions.
- It can be issued to individuals, corporations and companies for raising money for a short period.

5. Commercial Bill:

- It is a bill of exchange used to finance the working capital requirements of business firms.

- A seller of the goods draws the bill on the buyer for a credit sale. When the buyer accepts the bill it becomes marketable instrument and is called a trade bill. These bills can be discounted with a bank if the seller needs funds before the maturity of the bill.
- When a trade bill is accepted by a bank it is known as a commercial bill.

CAPITAL MARKET

- A capital market is a component of a financial market that allows long-term trading of debt and equity.
- The capital market consists of development banks, commercial banks and stock exchanges.
- An efficient capital market delivers correct information, minimize transaction cost and allocate capital.
- The Capital Market can be divided into two parts:
  a. Primary Market
  b. Secondary Market

DISTINCTION BETWEEN CAPITAL MARKET AND MONEY MARKET

BASIS	CAPITAL MARKET	MONEY MARKET
Participants	Financial Institutions, Banks, Corporate Entities, foreign investors, ordinary retail investors and individuals.	RBI, Banks, financial Institutions and finance companies.
Instruments	Equity shares, bonds, preferences shares, debentures, call money etc.	Treasury Bills, Trade Bills commercial paper, certificate of deposit.
Investment Outlay	Does not require a huge financial outlay.	Entails huge sum of money as the instruments are quite expensive.
Duration	Deals in medium and long term securities.	Deals in short term funds having a maturity period upto one year or may be even a single day.
Liquidity	Securities are considered as liquid investment as they are marketable in stock exchange	Money markets instruments are highly liquid as it is traded in The Discount Finance House of India.
Safety	Capital Market Instruments are riskier with respect to return and principle repayment.	Money market instruments are generally much safer with a minimum risk of default.
Expected Return	High return	Low return

The capital market can be divided into two parts:

1. Primary Market

2. Secondary Market

PRIMARY MARKET

The primary market is also known as the new issues market. It is a market for selling new securities, issued for the first time.

Primary market facilitate transfer of investible funds from savers to entrepreneurs.

Funds raised from the primary market are mainly used for setting up new projects, expansion, diversification, modernization of existing projects, mergers and take overs etc.

METHODS OF FLOATATION

1. Offer through Prospectus:

- It is the most popular method of raising funds which involves inviting subscription from the public through the issue of prospectus.
- A prospectus makes a direct appeal to investors to raise capital through an advertisement in newspapers and magazines.

2. Offer for Sale:

- In this method, securities to be issued are offered for sale through intermediaries like issuing houses or stock brokers.
- The company sells securities to intermediary or broker at an agreed price and the broker resells them to investors at a higher price.

3. Private Placements:

It refers to the process of allotment of securities by a company to institutional investors and some selected individuals.

4. Rights Issue:

- It refers to a method of issue in which new shares are offered to the existing shareholders in proportion to the number of shares they already possess.
- It is a right given to the existing shareholders to subscribe new shares.

5. e-IPOs:

- It is a method of issuing securities through an on-line system of stock exchange.
- A company proposing to issue capital to the public through the on-line system of the stock exchange has to enter into an agreement with the stock exchange. This is called an e-initial public offer.
- Registered brokers of SEBI, have to be appointed for the purpose of accepting applications and placing orders with the company.

SECONDARY MARKET

- The secondary market is also known as the stock market or stock exchange. It is a market for the purchase and sale of existing securities, i.e securities already sold in the primary market.
- It helps existing investors to disinvest and attract fresh investors to enter the market.
- Securities are required to be traded, cleared and settled within the regulatory framework prescribed by SEBI.

DIFFERENCE BETWEEN PRIMARY AND SECONDARY MARKETS

Primary Market (New Issue Market)	**Secondary Market (Stock Exchange)**
(i) There is sale of securities by new companies or further (new issues of securities by existing companies to investors).	(i) There is trading of existing shares only.
(ii) Securities are sold by the company to the investor directly (or through an intermediary).	(ii) Ownership of existing securities is exchanged between investors. The company is not involved at all.
(iii) The flow of funds is from savers to investors, i.e. the primary market directly promotes capital formation.	(iii) Enhances encashability (liquidity) of shares, i.e. the secondary market indirectly promotes capital formation.
(iv) Only buying of securities takes place in the primary market, securities cannot be sold there.	(iv) Both the buying and the selling of securities can take place on the stock exchange.
(v) Prices are determined and decided by the management of the company.	(v) Prices are determined by demand and supply for the security.
(vi) There is no fixed geographical location.	(vi) Located at specified places.

STOCK EXCHANGE

A Stock Exchange is an institution which provides a platform for buying and selling of existing securities. It is a market which, facilitates the exchange of a securities i.e. share, debenture etc. into money and vice versa.

"According to Securities Contracts (Regulation) Act 1956, stock exchange means any body of individuals, whether incorporated or not, constituted for the purpose of assisting, regulating or controlling the business of buying and selling or dealing in securities".

FUNCTIONS OF STOCK EXCHANGE

1. Providing Liquidity and Marketability to Existing Securities: It gives investors a platform to disinvest and reinvest their securities and thus provides both liquidity and easy marketability to already existing securities in the market.

2. Pricing of Securities: The forces of demand and supply of shares determine the share prices on a stock exchange.

3. Safety of Transaction: The membership of a stock exchange is well regulated and its dealings are well defined according to the existing legal framework.

4. Contributes to Economic Growth: A stock exchange is a market in which existing securities are traded, which leads to capital formation and economic growth.

5. Spreading of Equity Cult: The stock exchange play a vital role in ensuring wider share ownership by regulating new issues, better trading practices and taking effective steps in educating the public about investments.

6. Providing Scope for Speculation: Speculative activities are performed within the provisions of law and under restricted and controlled manner.

TRADING AND SETTLEMENT PROCEDURES

- Trading in securities is executed through an on-line, screen-based electronic trading system.

- Trading is done in the broker's office through a computer terminal. A stock exchange has its main computer system with many terminals spread across the country.
- Trading in securities is done through brokers who are members of the stock exchange.
- Every broker have access to a computer terminal that is connected to the main stock exchange.
- In this screen-based trading, a member logs on to the site and any information about the shares (company, member, etc.) and the price at which he/ she is willing to buy or sell is fed into the computer.
- The software is so designed that the transaction will be executed when a matching order is found from a counter party.
- The computer in the brokers office constantly matches the orders at the best bid and offer price.
- Those that are not matched remain on the screen and are open for future matching during the day.

Electronic trading systems or screen-based trading has certain advantages:

1. It ensures transparency as it allows participants to see the prices of all securities in the market while business is being transacted.

2.It increases efficiency of information being passed on, thus helping in fixing prices efficiently.

3. It increases the efficiency of operations, since there is reduction in time, cost and risk of error.

4. People from all over the country and even abroad who wish to participate in the stock market can buy or sell securities through brokers or members

5. A single trading platform has been provided as business is transacted at the same time in all the trading centres.

Steps in the Trading and Settlement Procedure

1. Selection of Broker : First a broker who is a member of a stock exchange has to be selected as they can only trade on the stock exchange.

2. Placing the order: An investor specifies the type and number of securities they want to buy or sell to a broker.

3. Executing the order: The broker will buy or sell the securities as per the instructions of the investor.

4. Settlement: Transactions on a stock exchange are carried out on either cash basis or a carry over basis (i.e. badla). The time period for which the transactions are carried forward is referred to as accounts which vary from a fortnight to a month. All transactions made during one account are to be settled by payment for purchases and by delivery of share certificates, which is a proof of ownership of securities by an individual.

DEMATERIALISATION AND DEPOSITORIES

Dematerialisation: This is a process where securities held by the investor in the physical form are cancelled and the investor is given an electronic entry or number so that she/he can hold it as an electronic balance in an account. This process of holding securities in an electronic form is called **dematerialization.**

Depository: The investor has to open a demat account with an organisation called a **depository.**

The Securities and Exchange Board of India (SEBI) has made it mandatory for the settlement procedures to be in demat form for certain securities. Holding shares in demat form is very convenient as it is just like a bank account, even transactions can be conducted online.

WORKING OF DEMAT SYSTEM

1. Identify a depository participant like bank, brokers etc.

2. Complete account opening formalities and documentation.

3. The physical certificate is to be given to the DP along with a dematerialisation request form.

4. If shares are applied in a public offer, simple details of DP and demat account are to be given.

5. If through broker, the DP is to be instructed to debit the account with the number of shares.

6. The broker then pay the person for the shares sold from the payment received.

7. All these transactions are to be completed within 2 days, in simple words, the settlement period for the delivery of shares and payment received from the buyer is on a T+2 basis.

DEPOSITORY

Depository: SEBI has developed a new system, to overcome the difficulties related to the transfer of shares in physical form. In this system trading in shares is made compulsory in electronic form through Depository services system and DEMAT Account,

Depository services :

- A bank keeps money of its customers in safely in the same way a depository also like a bank and keeps securities(e.g. shares, debentures, bonds, mutual funds etc.) safely in electronic form on behalf of the investors.
- In the depository a securities account can be opened and all shares can be deposited, they can be withdrawn/ sold at any time and instruction to deliver or receive shares on behalf of the investor can be given.
- At present there are two depositories in India: NSDL. (National Securities Depository Ltd.) and CDSL (Central Depository Services Ltd.). which are known as “Depository Participants”. (DPs)

Four players participate in this system.

1. The Depository: A depository is an institution, which holds the shares of an investor in electronic form. There are two depository institutions in India, NSDL and CDSL.

2. The Depository Participant: He opens the account of Investors and maintains record of securities

3. The Investor: Is a person who wants to invest in securities and other financial instruments.

4. The Issuing Company: The organization which issues the securities. This issuing company sends a list of the shareholders to the depositories.

NATIONAL STOCK EXCHANGE OF INDIA (NSE)

The National Stock Exchange is the latest, most modern and technology driven exchange.

It was incorporated in 1992 and was recognised as a stock exchange in April 1993. It started operations in 1994, with trading on the wholesale debt market segment.

The Board of NSE includes senior executives from promoter institutions and eminent professionals, without having any representation from trading members.

OBJECTIVES OF NSE

NSE was set up with the following objectives:

a. Establishing a nationwide trading facility for all types of financial instruments.

b. Ensuring equal and easy access to investors all over the country through an appropriate communication network.

c. Providing a fair, efficient and transparent securities market using electronic trading system.

d. Enabling shorter settlement cycles and book entry settlements.

e. Meeting international benchmarks and standards.

MARKET SEGMENTS OF NSE

(i) Whole Sale Debt Market Segment: It provides a trading platform for a wide range of fixed income securities that include central government securities, floating rate bonds, zero coupon bonds, treasury bills etc.

(ii) Capital Market Segment: The capital market segment of NSE provides an efficient and transparent platform for trading in equity, debentures, preference shares etc.

BSE (BOMBAY STOCK EXCHANGE LTD.)

BSE LTD. was established in 1875 and was Asia’s first Stock

Exchange. It was granted permanent recognition under the Securities Contract (Regulation) Act, 1956

SECURITIES AND EXCHANGE BOARD OF INDIA (SEBI)

SEBI was established by Government of India on 12 April 1988 as an interim administrative body to promote orderly and healthy growth of securities market and for investor protection. It was given a statutory status on 30 January1992 through an ordinance which was later replaced by an Act of Parliament known as the SEBI Act, 1992. It seeks to protect the interest of investors in new and second hand securities.

Purpose and Role of SEBI

1. To the issuers, it provide a market place.

2. To the investors, it should provide protection of their rights and interests.

3. To the intermediaries, it should offer a competitive, professionalized and expanding market

Objectives of SEBI

1. To regulate stock exchange and the securities market for its efficient functioning.

2. To protect the rights and interests of investors and to guide & educate them from fraudulent activities.

3. To prevent trade malpractices such as insider trading etc.

4. To regulate and develop a code of conduct and fair practices by intermediaries like brokers, merchant bankers etc.

Functions of SEBI

SEBI has two main tasks of regulation and development of securities markets and some protective functions also.

I. Regulatory Functions :

1. Registration of brokers and subbrokers and other players in the market.

2. Registration of collective investment schemes and Mutual Funds.

3. Regulation of stock brokers, portfolio exchanges, underwriters and merchant bankers and the business in stock exchanges and any other securities market.

4. Regulation of takeover bids by companies.

5. Calling for information by undertaking inspection, conducting enquiries and audits of stock exchanges and intermediaries.

6. Levying fee or other charges for carrying out the purposes of the Act.

7. Performing and exercising such power under Securities Contracts (Regulation) Act 1956, as may be delegated by the Government of India.

2. Development Functions :

1.Promotes training of intermediaries of the securities market .

2. Investor education

3. Promotion of fair practices code of conduct of all SRO‘s.

4. Conducting research & publish information useful to all market participants

III. Protective Functions

1. Prohibit fraudulent & unfair trade practices in secondary market (e.g. Price rigging & misleading statement).

2. Prohibit insider trading.

3. Educate investors Promote fair practice & code of conduct in securities market.

The Organisation Structure of SEBI

The SEBI also formed two advisory committees. They are the Primary Market Advisory Committee and the Secondary Market Advisory Committee. They provide the guidelines and policies of SEBI

The objectives of the two Committees are as follows:

a. To advise SEBI on issues relating to the regulation of intermediaries for ensuring investors protection in the primary market.

b. To advise SEBI on matters related to the development of primary market in India.

c. To advise SEBI on the disclosure requirements for companies.

d. To advise for changes in legal framework and to introduce simplification and transparency in the primary market.

e. To advise the board members in matters relating to the development and regulation of the secondary market in the country.