FINANCIAL INSTITUTIONS AND MARKET
BBA 6th SEMESTER

CHAPTER 1: FINANCIAL MARKET

1.1 CONCEPT OF FINANCIAL MARKET
1.2 TYPES OF FINANCIAL MARKETS
1.3 MAJOR PARTICIPANTS AND PLAYERS IN FINANCIAL MARKETS
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1.1 CONCEPT OF FINANCIAL MARKET

A financial market is a market in which people trade financial securities, commodities, and other fungible items of value at low transaction costs and at prices that reflect supply and demand. Securities include stocks and bonds, and commodities include precious metals or agricultural products.

In economics, typically, the term *market* means the aggregate of possible buyers and sellers of a certain good or service and the transactions between them.

The term "market" is sometimes used for what are more strictly *exchanges*, organizations that facilitate the trade in financial securities, e.g., a stock exchange or commodity exchange. This may be a physical location (like the NYSE, BSE, NSE) or an electronic system (like NASDAQ). Much trading of stocks takes place on an exchange; still, corporate actions (merger, spinoff) are outside an exchange, while any two companies or people, for whatever reason, may agree to sell stock from the one to the other without using an exchange.

Trading of currencies and bonds is largely on a bilateral basis, although some bonds trade on a stock exchange, and people are building electronic systems for these as well, similar to stock exchanges.

1.2 TYPES OF FINANCIAL MARKETS

Within the financial sector, the term "financial markets" is often used to refer just to the markets that are used to raise finance: for long term finance, the *Capital markets*; for short term finance, the *Money markets*. Another common use of the term is as a catchall for all the markets in the financial sector, as per examples in the breakdown below.

- Capital markets which to consist of:
  - o Stock markets, which provide financing through the issuance of shares or common stock, and enable the subsequent trading thereof.
  - o Bond markets, which provide financing through the issuance of bonds, and enable the subsequent trading thereof.
- Commodity markets, which facilitate the trading of commodities.

 Money markets, which provide short term debt financing and investment.
 Derivatives markets, which provide instruments for the management of financial risk.
 Futures markets, which provide standardized forward contracts for trading products at some
future date; see also forward market.
 Foreign exchange markets, which facilitate the trading of foreign exchange.
 Spot market
 Interbanks market

The capital markets may also be divided into primary markets and secondary markets. Newly formed
(issued) securities are bought or sold in primary markets, such as during initial public offerings.
Secondary markets allow investors to buy and sell existing securities. The transactions in primary
markets exist between issuers and investors, while secondary market transactions exist among investors.
Liquidity is a crucial aspect of securities that are traded in secondary markets. Liquidity refers to the
ease with which a security can be sold without a loss of value. Securities with an active secondary
market mean that there are many buyers and sellers at a given point in time. Investors benefit from
liquid securities because they can sell their assets whenever they want; an illiquid security may force
the seller to get rid of their asset at a large discount.

1.3 MAJOR PARTICIPANTS AND PLAYERS IN FINANCIAL MARKETS

In the financial markets, there is a flow of funds from one group of parties (funds-surplus units) known
as investors to another group (funds-deficit units) which require funds. However, often these groups do
not have direct link. The link is provided by market intermediaries such as brokers, mutual funds,
leasing and finance companies, etc. In all, there is a very large number of players and participants in the
financial market. These can be grouped as follows:

The individuals: These are net savers and purchase the securities issued by corporates. Individuals
provide funds by subscribing to these securities or by making other investments.

The Firms or corporates: The corporates are net borrowers. They require funds for different projects
from time to time. They offer different types of securities to suit the risk preferences of investors'
Sometimes, the corporates invest excess funds, as individuals do. The funds raised by issue of securities
are invested in real assets like plant and machinery. The income generated by these real assets is
distributed as interest or dividends to the investors who own the securities.

Government: Government may borrow funds to take care of the budget deficit or as a measure of controlling the liquidity, etc. Government may require funds for long terms (which are raised by issue of Government loans) or for short-terms (for maintaining liquidity) in the money market. Government makes initial investments in public sector enterprises by subscribing to the shares, however, these investments (shares) may be sold to public through the process of disinvestments.

Regulators: Financial system is regulated by different government agencies. The relationships among other participants, the trading mechanism and the overall flow of funds are managed, supervised and controlled by these statutory agencies. In India, two basic agencies regulating the financial market are the Reserve Bank of India (RBI) and Securities and Exchange Board of India (SEBI). Reserve Bank of India, being the Central Bank, has the primary responsibility of maintaining liquidity in the money market' It undertakes the sale and purchase of T-Bills on behalf of the Government of India. SEBI has a primary responsibility of regulating and supervising the capital market. It has issued a number of Guidelines and Rules for the control and supervision of capital market and investors' protection.

Besides, there is an array of legislations and government departments also to regulate the operations in the financial system.

Market Intermediaries: There are a number of market intermediaries known as financial intermediaries or merchant bankers, operating in financial system. These are also known as investment managers or investment bankers. The objective of these intermediaries is to smoothen the process of investment and to establish a link between the investors and the users of funds. Corporations and Governments do not market their securities directly to the investors. Instead, they hire the services of the market intermediaries to represent them to the investors. Investors, particularly small investors, find it difficult to make direct investment. A small investor desiring to invest may not find a willing and desirable borrower. He may not be able to diversify across borrowers to reduce risk. He may not be equipped to assess and monitor the credit risk of borrowers. Market intermediaries help investors to select investments by providing investment consultancy, market analysis and credit rating of investment instruments. In order to operate in secondary market, the investors have to transact through share brokers. Mutual funds and investment companies pool the funds(savings) of investors and invest the corpus in different investment alternatives. Some of the market intermediaries are:

 Lead Managers
 Bankers to the Issue
 Registrar and Share Transfer Agents
 Depositories
 Clearing Corporations
 Share brokers
 Credit Rating Agencies
 Underwriters
 Custodians
 Portfolio Managers
 Mutual Funds
 Investment Companies

These market intermediaries provide different types of financial services to the investors. They provide expertise to the securities issuers. They are constantly operating in the financial market. Small investors in particular and other investors too, rely on them. It is in their (market intermediaries) own interest to behave rationally, maintain integrity and to protect and maintain reputation, otherwise the investors would not be trusting them next time. In principle, these intermediaries bring efficiency to corporate fund raising by developing expertise in pricing new issues and marketing them to the investors.

1.4 RESERVE BANK OF INDIA (RBI) AND ITS ROLE AS CENTRAL BANK

Reserve Bank of India (RBI) is the central bank of India. It came in to reality after challenging many difficulties. RBI came in to reality by the passing of Reserve Bank of India Act in 1934 and started its functions from 1935.

As a central bank, the Reserve Bank has significant powers and duties to perform. For smooth and speedy progress of the Indian Financial System, it has to perform some important tasks. Among others it includes maintaining monetary and financial stability, to develop and maintain stable payment system, to promote and develop financial infrastructure and to regulate or control the financial institutions.

Issuer of currency

Except for issuing one rupee notes and coins, RBI is the sole authority for the issue of currency in India.

The Indian government issues one rupee notes and coins.

RBI has two departments - the Issue department and Banking department. The issue department is dedicated to issuing currency

The Banking department of RBI looks after the banking operations. It takes care of the currency in circulation and its withdrawal from circulation. Issuing new currency is known as expansion of currency and withdrawal of currency is known as contraction of currency.

Banker to the Government
RBI acts as banker, both to the central government and state governments. It manages all the banking transactions of the government involving the receipt and payment of money. In addition, RBI remits exchange and performs other banking operations.
Managing Government Securities
Various financial institutions such as commercial banks are required by law to invest specified minimum proportions of their total assets/liabilities in government securities. RBI administers these investments of institutions.
The other responsibilities of RBI regarding these securities are to ensure -
- Smooth functioning of the market
- Readily available to potential buyers
- Easily available in large numbers
- Undisturbed maturity-structure of interest rates because of excess or deficit supply
- Not subject to quick and huge fluctuations
- Reasonable liquidity of investments
- Good reception of the new issues of government loans

Banker to Other Banks
The role of RBI as a banker to other banks is as follows:
- Holds some of the cash reserves of banks
- Lends funds for short period
- Provides centralized clearing and quick remittance facilities

RBI has the authority to statutorily ensure that the scheduled commercial banks deposit a stipulated ratio of their total net liabilities. This ratio is known as cash reserve ratio [CRR]. However, banks can use these deposits to meet their temporary requirements for interbank clearing as the maintenance of CRR is calculated based on the average balance over a period.
Controller of Money Supply and Credit
In a planned economy, the central bank plays an important role in controlling the paper currency system and inflationary tendency. RBI has to regulate the claims of competing banks on money supply and credit. RBI also needs to meet the credit requirements of the rest of the banking system.
RBI needs to ensure promotion of maximum output, and maintain price stability and a high rate of economic growth. To perform these functions effectively, RBI uses several control instruments such as
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- Open Market Operations
- Changes in statutory reserve requirements for banks
- Lending policies towards banks
- Control over interest rate structure
- Statutory liquidity ration of banks

Exchange Manager and Controller

RBI manages exchange control, and represents India as a member of the international Monetary Fund [IMF]. Exchange control was first imposed on India in September 1939 when World War II started and continues till date. Exchange control was imposed on both receipts and payments of foreign exchange.
According to foreign exchange regulations, all foreign exchange receipts, whether on account of export earnings, investment earnings, or capital receipts, whether of private or government accounts, must be sold to RBI either directly or through authorized dealers. Most commercial banks are authorized dealers of RBI.

Publisher of Monetary Data and Other Data

RBI maintains and provides all essential banking and other economic data, formulating and critically evaluating the economic policies in India. In order to perform this function, RBI collects, collates and publishes data regularly.

Developmental and Promotional role of RBI

Along with the routine traditional functions, central banks especially in the developing country like India have to perform numerous functions. These functions are country specific functions and can change according to the requirements of that country. The RBI has been performing as a promoter of the financial system since its inception. Some of the major development functions of the RBI are maintained below.

Development of the Financial System : The financial system comprises the financial institutions, financial markets and financial instruments. The sound and efficient financial system is a precondition of the rapid economic development of the nation. The RBI has encouraged establishment of main banking and non-banking institutions to cater to the credit requirements of diverse sectors of the economy.

Development of Agriculture : In an agrarian economy like ours, the RBI has to provide special attention for the credit need of agriculture and allied activities. It has successfully rendered service in this direction by increasing the flow of credit to this sector

Provision of Industrial Finance : Rapid industrial growth is the key to faster economic development. In this regard, the adequate and timely availability of credit to small, medium and large industry is very significant. In this regard the RBI has always been instrumental in setting up special financial institutions such as ICICI Ltd. IDBI, SIDBI and EXIM BANK etc.

Provisions of Training *:* The RBI has always tried to provide essential training to the staff of the
banking industry. The RBI has set up the bankers' training colleges at several places.
Collection of Data *:* Being the apex monetary authority of the country, the RBI collects process and
disseminates statistical data on several topics. It includes interest rate, inflation, savings and investments
etc. This data proves to be quite useful for researchers and policy makers.
Publication of the Reports : The Reserve Bank has its separate publication division. This division
collects and publishes data on several sectors of the economy. The reports and bulletins are regularly
published by the RBI. It includes RBI weekly reports, RBI Annual Report, Report on Trend and
Progress of Commercial Banks India., etc. This information is made available to the public also at
cheaper rates.
Promotion of Banking Habits : As an apex organization, the RBI always tries to promote the banking
habits in the country. It institutionalizes savings and takes measures for an expansion of the banking
network. It has set up many institutions such as the Deposit Insurance Corporation-1962, UTI-1964,
IDBI-1964, NABARD-1982, NHB-1988, etc. These organizations develop and promote banking habits
among the people.
Promotion of Export through Refinance: The RBI always tries to encourage the facilities for providing
finance for foreign trade especially exports from India. The Export-Import Bank of India (EXIM Bank
India) and the Export Credit Guarantee Corporation of India (ECGC) are supported by refinancing their
lending for export purpose.

1.5 COMMERCIAL BANKS AND THEIR ROLE (INDIA)

Commercial banks form a significant part of the country's Financial Institution System. Commercial
Banks are those profit seeking institutions which accept deposits from general public and advance
money to individuals like household, entrepreneurs, businessmen etc. with the prime objective of
earning profit in the form of interest, commission etc. The operations of all these banks are regulated
by the Reserve Bank of India, which is the central bank and supreme financial authority in India. The
main source of income of a commercial bank is the difference between these two rates which they
charge to borrowers and pay to depositers. Examples of commercial banks – ICICI Bank, State Bank
of India, Axis Bank, and HDFC Bank.

CLASSIFICATION OF COMMERCIAL BANKS

1 ***Scheduled banks :***- Banks which have been included in the Second Schedule of RBI Act 1934. They are categorized as follows:

o **Public Sector Banks** :- are those banks in which majority of stake is held by the government. Eg. SBI, PNB, Syndicate Bank, Union Bank of India etc.

o **Private Sector Banks** :- are those banks in which majority of stake is held by private indivisuals. Eg. ICICI Bank, IDBI Bank, HDFC Bank, AXIS Bank etc.

o **Foreign Banks** :- are the banks with Head office outside the country in which they are located. Eg. Citi Bank, Standard Chartered Bank, Bank of Tokyo Ltd. etc.

2 **Non-scheduled commercial banks** :- Banks which are not included in the Second Schedule of RBI Act 1934.

ACTIVITIES OF COMMERCIAL BANKS

1. Accelerating the Rate of Capital Formation: Commercial banks encourage the habit of thrift and mobilize the savings of people. These savings are effectively allocated among the ultimate users of funds, i.e., investors for productive investment. So, savings of people result in capital formation which forms the basis of economic development.

2. Provision of Finance and Credit: Commercial banks are a very important source of finance and credit for trade and industry. The activities of commercial banks are not only confined to domestic trade and commerce, but extend to foreign trade also.

3. Developing Entrepreneurship: Banks promote entrepreneurship by underwriting the shares of new and existing companies and granting assistance in promoting new ventures or financing promotional activities. Banks finance sick (loss-making) industries for making them viable units.

4. Promoting Balanced Regional Development: Commercial banks provide credit facilities to rural people by opening branches in the backward areas. The funds collected in developed regions may be channelised for investments in the under developed regions of the country. In this way, they bring about more balanced regional development.

5. Help to Consumers: Commercial banks advance credit for purchase of durable consumer items like Vehicles, T.V., refrigerator etc., which are out of reach for some consumers due to their limited paying capacity. In this way, banks help in creating demand for such consumer goods.

1.6 CAPITAL MARKET INSTRUMENTS

Capital market instruments are responsible for generating funds for companies, corporations and sometimes national governments. These are used by the investors to make a profit out of their respective markets.

There are a number of capital market instruments used for market trade, including –

- Stocks
- Bonds
- Debentures

- Treasury-bills
- Foreign Exchange
- Fixed deposits, and others

Capital market is also known as Securities Market because long term funds are raised through trade
on debt and equity securities. These activities may be conducted by both companies and governments.

This market is divided into:

- Primary Capital Market
- Secondary Capital Market

1.7 PRIMARY CAPITAL MARKET

The capital market is divided in two different markets. These are the primary capital market and
secondary capital market. The primary capital market is concerned with the new securities which are
traded in this market.
This market is used by the companies, corporations and the national governments to generate funds
for different purpose. The primary capital markets is also called the New Issue Market or NIM. The
securities which are introduced in the market are sold for first time to the general public in this
market.
This market is also known as the long term debt market as the money raised from this market provides
long term capital. The process of offering new issues of existing stocks to the purchasers is known as
underwriting. At the same time if new stocks are introduced in the market, it is called the Initial
Public Offering.
The act of selling new issues in the primary capital market follows a particular process. This process
requires the involvement of a syndicate of the securities dealers. The dealers who are running the
process get a certain amount for as commission.
The price of the security offered in the primary capital market includes the dealer,s commission
also.Again, if the issue is a primary issue, the investors get the issue directly from the company and no
intermediary is needed in the process. For the purpose, the investor needs to send the exact amount of
money to the respective company and after receiving the money, the particular company provides the
security certificates to the investors.
The primary issues which are offered in the primary capital market provide the essential funds to the
companies. These primary issues are used by the companies for the purpose of setting new businesses
or to expanding the existing business. At the same time, the funds collected through the primary

capital market, are also used for the modernization of the business. At the same time, the primary
capital market is also involved in the process of creating capital for the respective economy.

1.8 SECONDARY CAPITAL MARKET

This is the market wherein the trading of securities is done. Secondary market consists of both
equity as well as debt markets. Securities issued by a company for the first time are offered to the
public in the primary market. Once the IPO is done and the stock is listed, they are traded in the
secondary market. The main difference between the two is that in the primary market, an investor
gets securities directly from the company through IPOs, while in the secondary market, one
purchases securities from other investors willing to sell the same.
Equity shares, bonds, preference shares, treasury bills, debentures, etc. are some of the key
products available in a secondary market. SEBI is the regulator of the same.

CHAPTER 2: MONEY MARKET

2.1 MONEY MARKET CONCEPT
2.2 STRUCTURE OF ORGANIZED MONEY MARKET IN INDIA
2.3 FUNCTIONS OF MONEY MARKETS

2.1 MONEY MARKETCONCEPT

There are two kinds of markets where borrowing and lending of money takes place between fund scarce
and fund surplus individuals and groups. The markets catering the need of short term funds are called
Money Markets while the markets that cater to the need of long term funds are called Capital
Markets.Thus, money markets is that segment of financial markets where borrowing and lending of the
short-term funds takes place. The maturity of the money market instruments is one day to one year. In
our country, Money Markets are regulated by both RBI and SEBI.
Indian money market is divided into organized and unorganized segments. Unorganized market is old
Indigenous market mainly made of indigenous bankers, money lenders etc. Organized market is that
part which comes under the regulatory purview of RBI and SEBI. The nature of the money market
transactions is such that they are large in amount and high in volume. Thus, the entire market is
dominated by small number of large players. At the same time, the money market in India is yet
underdeveloped. The key players in the organized money market include Governments (Central and
State), Discount and Finance House of India (DFHI), Mutual Funds, Corporate, Commercial /
Cooperative Banks, Public Sector Undertakings (PSUs), Insurance Companies and Financial
Institutions and Non-Banking Financial Companies (NBFCs).

2.2 STRUCTURE OF ORGANIZED MONEY MARKET IN INDIA:

The organized money market in India is not a single market but is a conglomeration of markets of
various instruments. They have been discussed below:

Call Money / Notice Money / Term Money Market

Call Money, Notice Money and Term Money markets are sub-markets of the Indian Money Market.
These refer to the markets for very short term funds. Call Money refers to the borrowing or lending of
funds for 1 day. Notice Money refers to the borrowing and lending of funds for 2-14 days. Term
money refers to borrowing and lending of funds for a period of more than 14 days.

Treasury Bill (T – Bills): The bill market is a sub-market of the money market in India. There are two
types of bills viz. Treasury Bills and commercial bills. While Treasury Bills or T-Bills are issued by
the Central Government; Commercial Bills are issued by financial institutions.

***Commercial Bills*:** Commercial bills market is basically a market of instruments similar to Bill of
Exchange. The participants of commercial bill market in India are banks and financial institutions but
this market is not yet developed.

Certificate Of Deposits (CDs): Certificate of Deposit (CD) refers to a money market instrument,
which is negotiable and equivalent to a promissory note. All scheduled commercial banks excluding
Regional Rural Banks (RRBs) and Local Area Banks (LABs) and Select All India Financial
Institutions permitted by RBI are eligible to issue certificates of deposits.

Commercial Papers (CP): Commercial Paper (CP) is yet another money market instrument in India,
which was first introduced in 1990 to enable the highly rated corporates to diversify their resources
for short term fund requirements. ***Money Market Mutual Funds (MMMFs):*** Money Market Mutual
Funds (MMMFs) were introduced by RBI in 1992 but since 2000, they are brought under the purview
of the SEBI. They provide additional short-term avenue to individual investors.

***The Repo / Reverse Repo Market*:** Repo (repurchase agreement) was introduced in December 1992.
Repo means selling a security under an agreement to repurchase it at a predetermined date and rate.
Repo transactions are affected between banks and financial institutions and among bank themselves,
RBI also undertake Repo. IN 1996, Reverse Repo was introduced. Reverse Repo means buying a
security on a spot basis with a commitment to resell on a forward basis. Reverse Repo transactions are
affected with scheduled commercial banks and primary dealers.

Discount And Finance House Of India (DFHI): It was established in 1988 by RBI and is jointly owned by RBI, public sector banks and all India financial institutions which have contributed to its paid up capital. DFHI plays important role in developing an active secondary market in Money Market Instruments. From 1996, it has been assigned status of a Primary Dealer (PD). It deals in treasury bills, commercial bills, CDs, CPs, short term deposits, call money market and government securities.

2.3 FUNCTIONS OF MONEY MARKETS

Due to short maturity term, the instruments of money market are liquid and can be converted to cash easily and thus are able to address the need of the short term surplus fund of the lenders and short term borrowing requirements of the borrowers. Thus, the major function of the money markets is to cater to the short term financial needs of the economy. The other functions are as follows:

1. Money Markets help in effective implementation of the RBI's monetary policy
2. Money markets help to maintain demand and supply equilibrium with regard to short term funds
3. They cater to the short term fund requirement of the governments
4. They help in maintaining liquidity in the economy

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paid up capital. DFHI plays important role in developing an active secondary market in Money
Market Instruments. From 1996, it has been assigned status of a Primary Dealer (PD). It deals in
treasury bills, commercial bills, CDs, CPs, short term deposits, call money market and government
securities.

2.3 FUNCTIONS OF MONEY MARKETS

Due to short maturity term, the instruments of money market are liquid and can be converted to cash
easily and thus are able to address the need of the short term surplus fund of the lenders and short term
borrowing requirements of the borrowers. Thus, the major function of the money markets is to cater to
the short term financial needs of the economy. The other functions are as follows:

1. Money Markets help in effective implementation of the RBI's monetary policy
2. Money markets help to maintain demand and supply equilibrium with regard to short term funds
3. They cater to the short term fund requirement of the governments
4. They help in maintaining liquidity in the economy liquidity in the economy