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# UNIT 1 FINANCIAL SYSTEM

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## Objectives

After studying this unit, you should be able to:

- understand the meaning of the terms 'Financial System' and 'Financial Markets';
- appreciate the relationship between Financial System and Financial Markets;
- classify the Financial Markets; and
- familiarise yourself with Global Financial Markets.

## Structure

- 1.1 Financial System
- 1.2 Financial Markets: An Introduction
- 1.3 Role of Financial Markets
- 1.4 Functions of Financial Markets
- 1.5 Classification of Financial Markets
- 1.6 Indian Money and Capital Markets
- 1.7 Securities Markets
- 1.8 Globalisation of Financial Markets
- 1.9 Classification of Global Financial Markets
- 1.10 Summary
- 1.11 Self Assessment Questions
- 1.12 Further Readings

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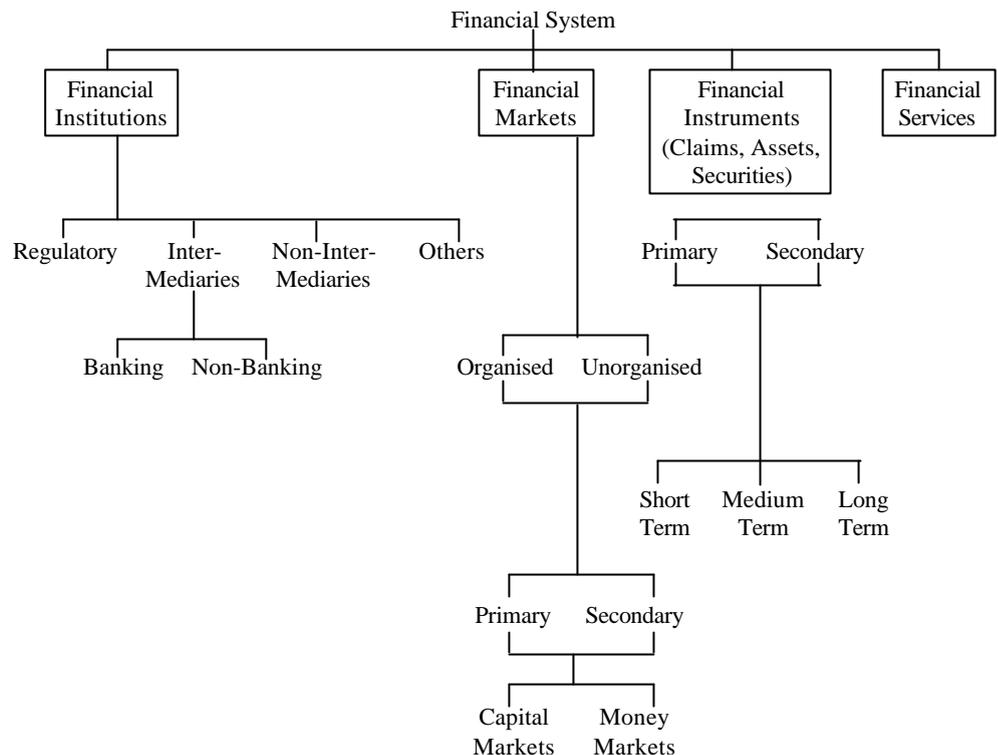
## 1.1 FINANCIAL SYSTEM

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The word 'system' in the term 'Financial System' implies a set of complex and closely connected or intermixed institutions, agents, practices, markets, transactions, claims and liabilities in the economy. Finance is the study of money, its nature, creation, behaviour, regulations and administration. Therefore, Financial System includes all those activities dealing in finance, organised into a system. Financial system plays a crucial role in the functioning of the economy because it allows transfer of resources from savers to investors. The financial system consists of financial institutions, financial markets, financial instruments and the services provided by the financial institutions. Figure 1.1 gives a birds eyeview of the financial system of an economy.

As stated earlier, the financial system comprises of four major components. These components are:

- 1) Financial Institutions
- 2) Financial Markets
- 3) Financial Instruments
- 4) Financial Services



**Figure: 1.1 : Financial System-Variou Parts and Types of Classification**

**Source:** Bhole, L.M., Financial Institutions and Markets: Structure, Growth and Innovations, Tata McGraw-Hill Publishing Company Ltd., New Delhi

Financial Institutions mobilise the savings either directly or indirectly through financial markets, by using various financial instruments and in the process utilising the services of various financial services providers. Before we go on to the main topic of this course, i.e. Financial Services, let us, briefly, know about the four components of the financial system.

1) **Financial Institutions:** These are institutions which mobilise and transfer the savings or funds from surplus units to deficit units. As can be seen from Figure 1.1 these institutions can be classified into, Regulatory, Intermediaries, Non-intermediaries and Others. These institutions unlike commercial Organisations deal with only financial assets like; deposits, securities, loans, etc. These institutions participate in financial markets and mobilise the savings from the surplus units either directly or indirectly. A detailed discussion on these participant institutions is given in unit 2 of this course.

2) **Financial Markets:** This is a place or mechanism where funds or savings are transferred from surplus units to deficit units. These markets can be broadly classified into money markets and capital markets. Money market deals with short-term claims or financial assets (less than a year) whereas capital markets deal with those financial assets which have maturity period of more than a year This classification is artificial as both these markets perform the same function of transferring surplus funds to needy units. Another classification could be primary markets and secondary markets. Primary markets deal in new issue of securities whereas secondary markets deal with securities which are already issued and available in the market. Primary markets by issuing new securities mobilise the savings directly. Secondary markets provide liquidity to the securities and thereby indirectly help in mobilising the savings. A detailed discussion on the financial markets is available in subsequent sections of this unit itself.

3) **Financial Instruments:** As already stated, the commodities that are traded or dealt in a financial market are financial assets or securities or financial instruments. There is a variety of securities in the financial markets as the requirements of lenders and borrowers are varied. Financial assets represent a claim on the repayment of principal at a future date and/or payment of a periodic or terminal sum in the form of interest or dividend. Some of the examples of these financial instruments are equity shares, preference shares debentures, bonds, etc.

4) **Financial Services:** Financial services include the services offered by both types of companies – Asset Management Companies and Liability Management Companies. The former include the leasing companies, mutual funds, merchant bankers, issue/portfolio managers. The latter comprises the bill discounting houses and acceptance houses. The financial services help not only to raise the required funds but also ensure their efficient deployment. They help to decide the financing mix and extend their services upto the stage of servicing of lenders. In order to ensure an efficient management of funds, services such as bill discounting, factoring of debtors, parking of short term funds in the money market, e-commerce and securitisation of debts are provided by the financial services firms. Besides banking and insurance, this sector provides specialised services such as credit rating, venture capital financing, lease financing, factoring, mutual funds, merchant banking, stock lending, depository, credit cards, housing finance, book building, etc. These services are provided by stock exchanges, specialised and general financial institutions, banks and insurance companies, and are regulated by the Securities and Exchange Board of India (SEBI), Reserve Bank of India and the Department of Banking and Insurance, Government of India, through a plethora of legislations. As the main focus of this course is on financial services, you will have an opportunity to know more about these financial service companies and the services offered by them in the subsequent Units and Blocks.

Financial institutions and financial markets facilitate the functioning of the financial system through financial instruments. In order to fulfil the tasks assigned, they require a number of services of financial nature. Financial services are, therefore, regarded as the fourth element of the financial system. An efficient and well ordered functioning of the financial system depends a great deal on the range of financial services extended by the providers and their efficiency and effectiveness.

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## 1.2 FINANCIAL MARKETS : AN INTRODUCTION

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The term 'market' usually brings to mind a geographical place where people exchange goods and services. However, it is a narrow view of market and does not reflect that the term market includes mechanisms also. Financial market, like any other market; facilitates the exchange of financial assets among the dealers. In other words, it refers to place or mechanism where financial assets are sold and purchased. Further, financial market transaction may be at specific place or location, e.g. stock exchange or the same may be just through a particular mechanism like telephone, telex, or any other electronic media.

Financial markets facilitate trading in financial assets. These assets are also referred to as financial instruments or securities. Unlike goods or services, financial assets are not consumed. These are claims against the money and enable their holders, upon disposing off the claims, to obtain consumable goods or services. Since financial assets are not consumed, what is bought and sold is their use for a particular period of time.

In other markets, goods and services are exchanged through price mechanism. Similarly in the financial markets, the price for the use of investible funds is the

interest paid on a loan. The interest payable depends upon various factors like; size of the fund, length of the period of loan, risk involved, etc. Thus, the rate of interest, often known as *discount rate*, is the rate charged to obtain present funds in exchange for future funds.

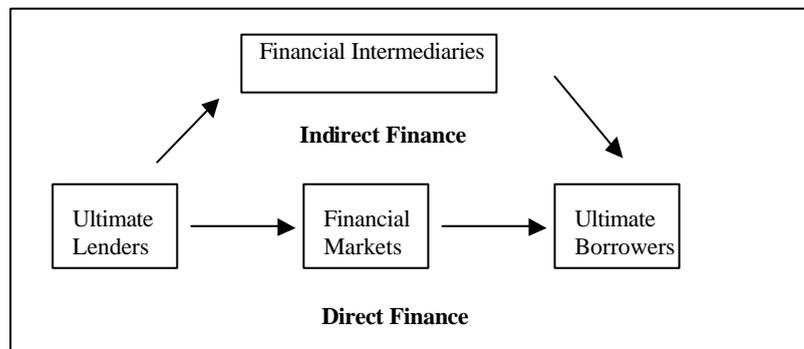
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### 1.3 ROLE OF FINANCIAL MARKETS

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All the countries, irrespective of their state of development, need funds for their economic development and growth. In the economy, these funds are obtained from the savers or ‘surplus units (the units which have more income than their consumption) which may be household individuals, business firms, public sector units, Central Government, State Governments, Local Governments, Semi-Governments, etc. There are certain investors or deficit units whose consumption or investment is more than their current income. Therefore, Financial markets play a significant role in transferring these surplus from savers (lenders) to ‘borrowers (investors). This process is known as ‘transmission mechanism’.

In an economy, flow of surplus funds from surplus units to deficit units is essential for desired achievement of national goals and priorities. Thus, this flow must be in right direction and for productive purposes. For this, appropriate financial instruments and opportunities must be available. The financial markets provide the platform for such flow’ where each saver can find and exchange the appropriate financial assets as per his requirement. So, the efficiency of financial market depends upon how efficiently the flow of funds is managed in an economy. Further, the financial market must induce people to become producers/entrepreneurs and motivate individuals and institutions to save more.



**Figure : 1.2: Flow of funds from lenders to borrowers**

The Figure 1.2 is simplified form of the flow of funds from saving-surplus units (ultimate lenders) to saving-deficit units (ultimate borrowers). The flow of funds move from left to right, either directly through financial markets or indirectly through financial institutions. Against such flow, the ultimate borrowers issue the liabilities (also known as primary securities) to the ultimate lenders.

The financial markets not only help in the fast growth of industry and economy but also contribute to the society’s well being and raising of the standard of living. So financial markets should grow at a fast rate. Moreover, they should be efficient and more diversified. As rightly pointed out by a financial expert, “The more varied the vehicle by which savings can flow from ultimate savers to ultimate users of funds, the more efficient the financial markets or an economy tend to be”.

In brief, the financial market plays a significant role in the allocation of the economy’s savings in efficient production of goods and services, and thus, assist in achieving the desired national objectives.’

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## 1.4 FUNCTIONS OF FINANCIAL MARKETS

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Functions of a financial market can be classified into two categories: Economic Functions, and Financial Functions.

### a) Economic Functions

- It facilitates the transfer of real economic resources from lenders to ultimate borrowers.
- Lenders earn interest/dividend on their surplus invisible funds, thereby increasing their earnings, and as a result, enhancing national income finally.
- Borrowers will have to use borrowed funds productively, if invested in new assets, and hence increasing their income and gross national products finally.
- By facilitating transfer of real resources, it serves the economy and finally the welfare of the general public.
- It provides a channel through which new savings flow into capital formation of a country.

### b) Financial Functions

- It provides the borrowers with funds which they need to carry out their plans.
- It provides the lenders with earning assets so that their wealth may be held in a productive form without the necessity of direct ownership of real assets.
- It provides liquidity in the market through which the claims against money can be resold at any time, and thus, reconverting them into current funds.

In addition to the above, the financial markets perform three more economic functions:

**First**, the interaction of buyers and sellers in a financial market determines the price of the traded asset; or equivalently, the required return on a financial asset is determined. The inducement for firms to acquire funds depends on the required rate of return that investors demand, and it is this feature of financial markets that signals how the funds in the economy should be allocated among financial assets. This is called the price discovered process.

**Second**, financial markets provide a mechanism for an investor to sell a financial asset. Because of this feature, it is said that a financial market offers liquidity, an attractive feature when circumstances either force or motivate an investor to sell. In the absence of liquidity, the owner will be forced to hold a debt instrument till it matures and an equity instrument till the company is, either voluntarily or otherwise, liquidated. While all financial markets provide some form of liquidity, the degree of liquidity is one of the factors that characterise different markets.

The **third** economic function of a financial market is that it reduces the search and information costs of transacting. Search costs represent explicit cost, such as the money spent to advertise the desire to sell or purchase a financial asset, the implicit costs such as the value of time spent in locating a counterpart. The presence of some form of organised financial market reduces search costs. Information costs are those entailed with assessing the investment merits of a financial asset, that is, the amount and the likelihood of the cash flow expected to be generated. In an efficient market, prices reflect the aggregate information collected by all market participants.

The financial markets not only help in transfer of savings from new industry/production, but also provide opportunities for financial investment, to earn income on

surplus. In other words, these markets perform both financial and non-financial functions. The financial markets enable financing of not only physical capital formation, i.e., tangible fixed assets and inventories, but also of consumption expenditure. That's why, financial markets manage the flow of funds not only between individual savers and investors but also between institutional savers and investors.

**Activity 1**

i) What do you mean by the term Financial Market?

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ii) List out the economic and Financial Functions of a financial market?

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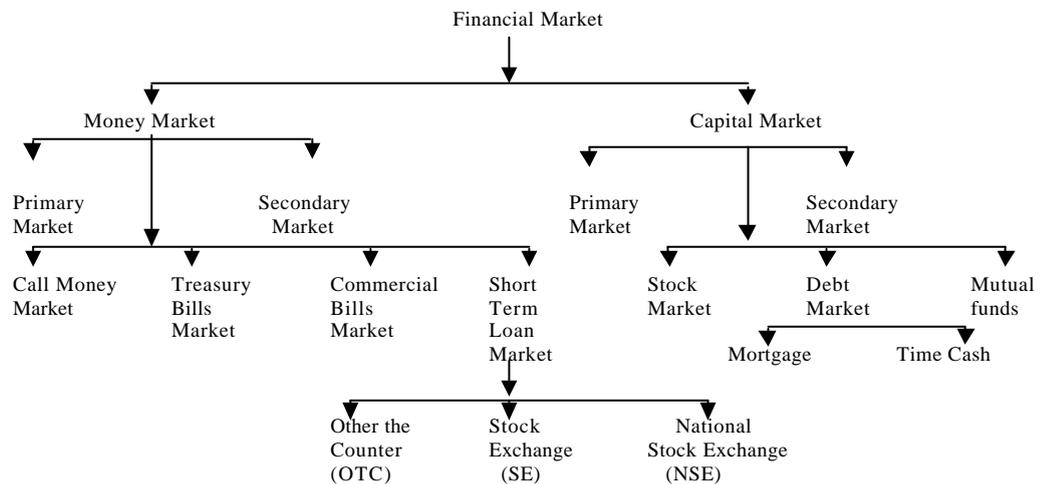
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## 1.5 CLASSIFICATION OF FINANCIAL MARKETS

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The financial market comprises: all banking and non-banking financial institutions, procedure and practices followed in these markets, and financial instruments for facilitating the flow of funds. The classification of financial markets in an economy is shown in Figure 1.3. From the Figure 1.3, you can see two classification of financial markets. They are:

- 1) Primary and Secondary Markets; and
- 2) Money and Capital Market.



**Figure 1.3 : Structure of Financial Market**

**1) Primary and Secondary Markets**

Primary market deals with the new issues of securities while the markets for existing claims (financial assets) are known as Secondary Markets. In the primary market, the government or corporate sector issues securities that change hands from the issuer to owner. In a secondary market, there is no additional flow of funds for further investments. The transactions in the secondary market do not result in fresh

capital being made available to the producers as they deal in existing securities. The secondary market renders a very important service to them.

If there is no active secondary market, most of the long term industrial securities would become nearly permanent investment in the hands of investors. Without organised market, the investors would have to make personal efforts for the sale and purchase of their securities. In the case of an inactive secondary market, the sellers would have to incur losses because true worth of the securities is not known. If there is no liquidity and marketability then investors would not have invested their funds in the securities. Consequently, the companies would have faced a lot of problems in raising funds by issuing shares and debentures. Consequently the level of industrial development would have been lower. Thus, active secondary market stimulates the activity in the primary market also. The level of development in the secondary market determines the efficiency and growth of the primary market.

## 2) Money and Capital Markets

**a) Money Market :** The money market is the place or mechanism where short term instruments that mature in a year or earlier are traded. The money market facilitates short-term financing and assures the liquidity of short-term financial assets. The money market is a main place for Central bank activities. The money market is significant in indicating changes in short-term interest rates, monetary policy and availability of short-term credit.

The focus of money market is on providing a means by which individuals, institutions and government are able to rapidly adjust their actual liquidity position to the amount desired. It is a medium through which holders of temporary cash surpluses meet those with temporary cash deficits. Hence, an individual with a temporary excess of investible funds is able to use the money market as a place, where his funds may be stored/invested for a short period of time and yield return on them. Similarly, individuals, institutions and government with a temporary shortfall of liquidity can raise funds in the money market for a short period of time. The money market assures borrowers that they can obtain short-term funds quickly and it assures lenders that they can convert their short term financial assets into cash. The central bank which is responsible for regulating and controlling the money supply in economy conducts most of its operations in the money market. The risk of capital losses (money risk) and risk of default are minimised in the money market. Money risk is low because the money market instruments are short-term in nature. This is so, because a change in interest rates does not effect their prices very much as the assured maturity is discounted over a short period of time. The risk of default or credit risk is low because money market instruments are mostly the liabilities of the government, central bank and commercial banks.

Money market meets the working capital requirements of industry, trade and commerce. Long term requirements of industries are not met by the money market instruments. The money market consists of specialised sub-markets and it consists of central banks, commercial banks, cooperative banks, saving banks, discount houses, acceptance houses, bill market, bullion market, etc. Some of the institutions may not be developed in money markets in some countries. The central bank occupies a pivotal position in the money market. It is regarded as 'presiding deity' of money markets. Its function is not only that of a watchdog of the monetary system but also of a promotional and development banker. The Central bank through quantitative credit control measures like bank rate, open market operations, reserves ratio and qualitative controls like; margin requirements, moral suasion, consumer credit control, regulates money and credit supply in a country.

The existence of a well-developed money market ensures that the money market instruments can be conveniently converted into money without incurring much losses. The money market provides various kinds' of credit instruments which suits the various investors and thus augment the supply of funds.

**b) Capital Market :** Capital market is a market in which lenders or investors provide long term funds in exchange for financial assets offered by borrowers or holders. The primary purpose of capital market is to direct the flow of savings into long term investments (mostly for a period of one year and above). The distinction between the money and capital market is based on the difference in the period of maturity of the financial assets. The distinction of one year between money and capital market is arbitrary but one year dividing point is mostly accepted. The demand for long term funds comes from individuals, institutions, central government, state-governments, local self-government and private corporate sector. Funds are raised through issue of shares, debentures and bonds which constitute the new issue market. Apart from raising funds directly from savers, the deficit units obtain long term funds from public financial institutions and investment institutions also. The supply of funds mainly comes from individuals (household sector), institutions, banks and industrial financial institutions.

The capital market plays a significant role in the financial system. Savings and investment are vital for economic development and growth of an economy. Generally, units which save and invest are different, capital market provides a bridge by which savings of surplus units are transmitted into long term investments by deficit units.

The pace of economic development alongwith other things depends upon the rate of long term investment and capital formation in a country. The rate of capital formation depends upon the rate of savings, rate of investment and financial markets. The capital market plays a vital role in mobilising the savings and making them available to the enterprising investors. The primary capital market helps government and industrial concerns in raising funds by issuing various kinds of securities. The secondary market provides liquidity to the outstanding/existing securities.

An active capital market; through its price mechanism allocates the scarce financial resources to the most productive uses at a low cost. The system of allocation of funds works through incentives and penalties. Usually, the cost of capital is comparatively low for the large and efficient companies as their securities are subject to lesser risk. Share of high growth companies command a premium in the market while the companies with poor performance face problems in selling their securities and may have to issue securities at a discount to raise additional funds. The specified shares are much/more attractive than the non-specified shares.

As you can see from Figure 1.3, there exists a primary and secondary market for moneymarket instruments. Similarly there exists a primary and secondary market for capital market instruments. All securities whether short-term or long-term are initially traded in the primary market and then in the secondary market.

### **Comparison of Money Market and Capital Market**

Money Markets and Capital markets differ in a number of respects. Money market primarily exists as a means of liquidity adjustment. In contrast, capital markets principal function is to serve as a link between long term investors and long term borrowers.

Money markets and Capital market instruments also differ in terms of risk. Money market instruments generally carry low default (credit risk) and low market risk. Money market financial instruments are of high quality and short maturity which reduces the price fluctuations because of changes in interest rate. In contrast, both default and market risk in capital market instruments are often substantial. Capital

market instruments include bonds, debentures, preference shares and equity shares. Investment in equity issues are much more risky in comparison to the debentures of same company. The quality of debt instruments, risk wise, ranges from government securities and highly rated corporate issues with limited default risk to unrated bonds and debentures of small and new ventures with substantial default risk. In addition, capital market instruments are long term in nature, with the result that interest rate risk, purchasing power risk, market risk, financial risk and business risk also rises in these instruments.

Money market is dominated by one set of financial institutions, i.e., commercial banks and the central bank. Commercial bank's activities are subject to monetary control. The rates and prices of capital market instruments are much more complex. In capital market, no single institution may dominate the market as commercial banks dominate in money market. No doubt, certain monetary policy influences are transmitted to capital market. This market is comparatively more sensitive to inflationary pressures, corporate profits and liquidity, business activity, economic, social and political environment of a country.

The money market instruments are short term in nature and their maturity is measured in days, weeks or months. Maturity period of capital market instruments is comparatively long and is usually measured in years and the instruments like equity shares have no defined maturity period till the company is going on.

There is no essential difference between capital and money markets regarding transferring of resources as both perform the same functions, i.e., transferring resources from the economic surplus units to deficit units. There is a close nexus between money and capital markets. Commercial banks are active in money market while non-banking financial institutions and public financial institutions are active in capital market. There is a considerable degree of overlap in the function of different financial institutions, e.g., commercial banks are primarily short term lenders (financing working capital) they also make a considerable volume of term loans having a maturity period of more than one year. Non-banking financial institutions are primarily long term lenders, they all have the need for participation to a limited degree in money market in order to adjust their liquidity positions. Financial institutions operate on both sides of the market borrowing and lending and participate in both money and capital market.

There is a substantial flow of funds between capital and money markets. This is because lenders and borrowers of funds have access to both capital and money market. Most of the suppliers of funds prefer to operate in both the markets. Within the framework of their investment policies, they have an access to both the markets and they invest where the best opportunities exist. Investors simultaneously invest in various investment opportunities like; savings bank, units, fixed deposits, national saving certificate schemes, life insurance, government and industrial securities, real estate, bullion, etc. Short and long term rates of interest are interdependent. Generally, rise in interest rate in money market influences long term interest rates also. Hence, in practice it is difficult to categories the institutions as belonging to money or capital market.

## Activity 2

Identify the various Sub-Markets in the Financial Market.

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Differentiate between:

i) Money Market and Capital Market.

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ii) Primary Market and Secondary Market.

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## **1.6 INDIAN MONEY AND CAPITAL MARKETS**

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### **a) Indian Money Market**

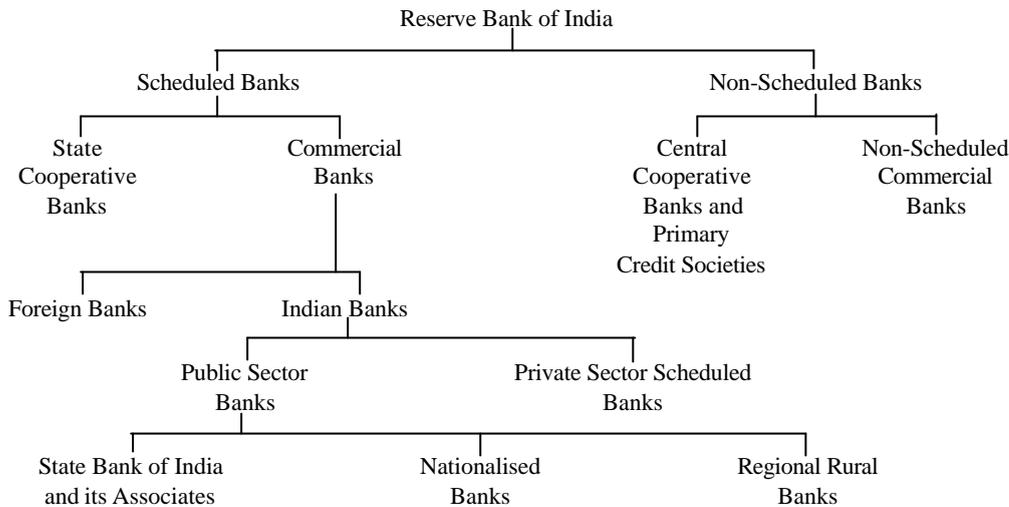
The Indian Money Market is divided into organised and unorganised markets. The unorganised money market consists of indigenous bankers and money lenders. The unorganised money market differs from organised market in many respects like organisation, operations, interest rate structure, etc. The indigenous bankers and money lenders are active in the small towns and villages, and partly in big cities, where farmers, artisans, small traders does not have an access to the modern banks. Generally, they advance loan against collateral security and/or to people who are personally known to them. They are outside the control of the Central Bank. The rates of interest differ in the unorganised sector from those in the organised sector.

The organised money market in India consists of Reserve Bank of India, State Bank of India and its subsidiaries, commercial banks, finance corporations, bill market and bullion market. Mumbai, Kolkata and Delhi are the principal centers of the organised money markets. The presence of head office of Reserve Bank of India, some of the commercial banks, leading stock exchanges, well organised market for gilt edged securities, bullion market have made Mumbai the prominent centre of finance.

The banking system is the most dominant force in the Indian money market. The banks can be broadly classified into two parts: scheduled banks and non-scheduled banks. The scheduled banks consist of state cooperative banks and scheduled commercial banks. Scheduled commercial banks comprise both foreign banks and Indian banks. The scheduled banks have both public sector banks and private sector banks. The scheduled banks, constitute the largest banking group in terms of offices/branches, deposits and advances in India. The share of non-scheduled banks is very small in term of aforementioned banking indicators. Within the Scheduled commercial banks the public sector banks, i.e., State Bank of India and its subsidiaries, and twenty nationalised banks account for the major portion of the banking business and State Bank of India is the biggest bank among the public sector banks. Thus, government owns the major part of the banking business in India.

The nationalisation of major 14 banks in July, 1969, whose deposits were more than Rs. 50 crores, failed to solve some of the problems of rural finance. A new category of banks called Regional Rural Banks (RRBs) was conceived in 1976. The Regional Rural Banks are primarily sponsored by commercial banks. Their primary objective is to provide credit for agriculture purpose, to small entrepreneurs engaged in trade and industry and other productive activities in rural areas. They also cater to the needs of weaker sections of the society.

The Reserve Bank of India, being the Central Bank in India occupies the pivotal position in the organised money market. The Reserve Bank of India, has wide powers to control money and credit through various monetary and credit instruments. Figure 1.4 provides a view of Indian Organised Money Market.



**Figure 1.4: Indian Organised Money Market**

The committee to review the working of the monetary system (Chakravarty Committee) observed that the Reserve Bank of India has the responsibility to stabilise the domestic economy, but it does not enjoy ‘authority’ and autonomy commensurate with that responsibility. The Reserve Bank of India’s authority is curbed by the directives and guidelines from the Ministry of Finance.

The banks, in India, also participated in the anti-poverty programmes like; Integrated Rural Development Programme (IRDP), Training of Rural Youth for Self-Employment (TRYSEM), Scheme for Self-Employment to Educated Unemployed Youth (SEEUY), Scheme of Self-employment Programme for Urban Poor (SEPUP).

### **b) Indian Capital Market**

Like money market, the capital market in India is also divided into the organised and unorganised sectors. Indigenous bankers and money lenders constitute the unorganised sector of the capital market. The organised capital market consists of non-banking institutions and public financial institutions. The development banks alongwith finance provide consultancy, technical know-how and training, i.e. finance and promotion simultaneously. Thus, development banks are considered as ‘gap fillers’.

The development banks derive most of their funds from the government and the Central Bank of the country. They were not strongly linked with the saving units in our economy but recently they have changed their strategy. In a developing country like India, where there exist certain bottlenecks, the development banks perform the following tasks:

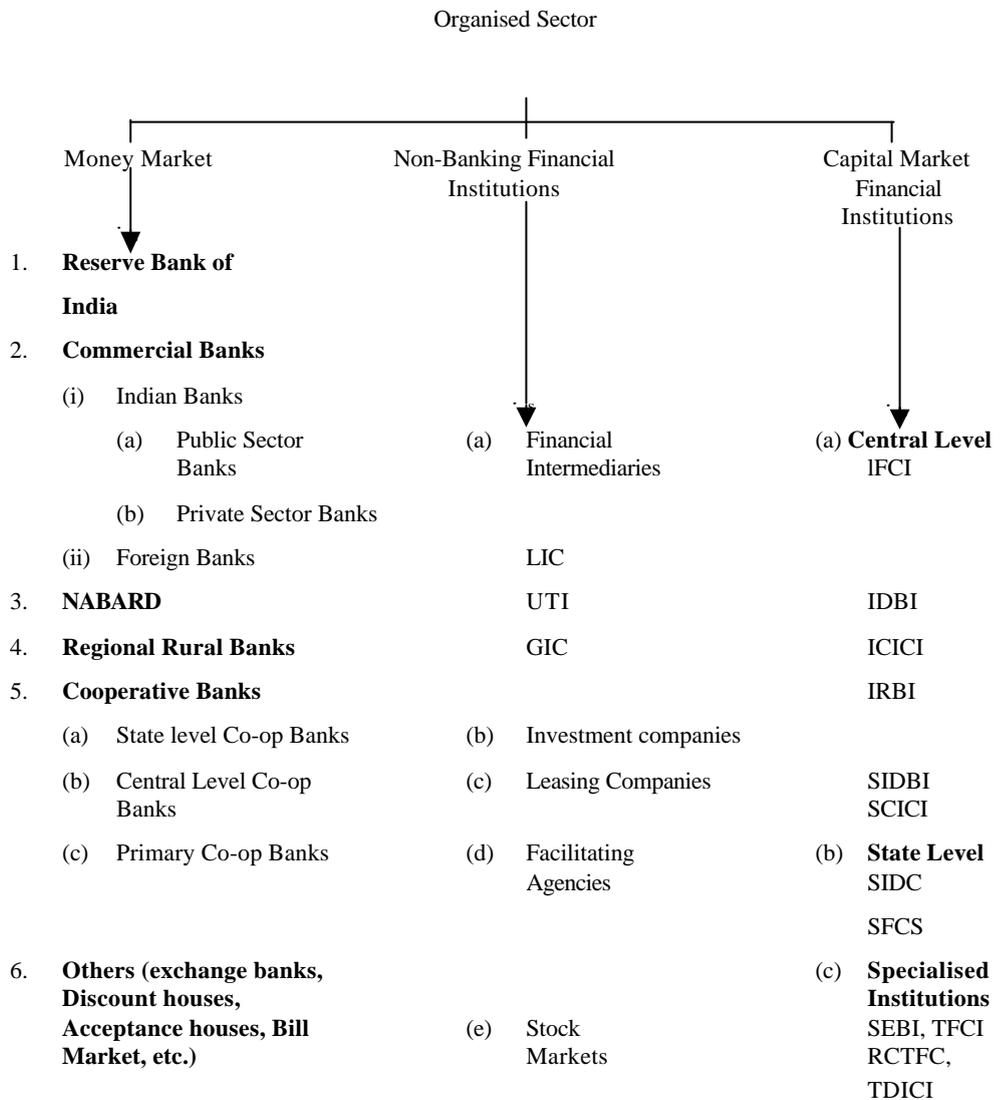
- a) Stimulating the capital market;
- b) Providing risk capital and seed capital;
- c) Direct subscription and underwriting the issues;
- d) Promoting broad-based entrepreneurship;
- e) Encourage new industries, modernising the existing industries, encouraging export promotion and import substitution industries; and
- f) Promoting backward area and regional development.

After independence, the first development bank, Industrial Finance Corporation of India (IFCI) was established in 1948. At the same time, the necessity to establish

similar institutions was recognised at provincial levels and to facilitate the setting up of such institutions, the State Financial Corporation (SFC) Act was passed in 1951. In 1955, the Industrial Credit and Investment Corporation of India (ICICI) was established with the main object to enlarge underwriting facilities for public issue of capital, foreign currency loans and direct subscription to share and debentures. At the state level, after 1960, a number of state governments set up SIDCs to undertake developmental and promotional function. In 1964, the Industrial Development Bank of India (IDBI) was established to operate as the central coordinating agency for industrial finance. Apart from these development banks, non-banking institutions like; Unit Trust of India (UTI), Life Insurance Corporation of India (LIC), General Insurance Corporation (GIC), Investment Companies, the Financing and the Leasing Companies are also actively participating in the capital market.

In order to provide a forceful direction to the process of rural development, the National Bank for Agriculture and Rural Development (NABARD) was established in 1982. The Export-Import Bank of India (EXIM Bank) was also established in 1982 to cater to the financial needs of the importers and exporters for financing international trade. Figure 1.5 presents a picture of Indian Financial Market.

**Figure 1.5: Financial Market in India**



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## 1.7 SECURITIES MARKETS

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The security market plays a vital role in facilitating the free flow of funds from the surplus to deficit units and provides liquidity, marketability, safety, etc., to the investors and accelerates the rate of capital formation.

A financial security is a legal instrument that represents either an ownership or a creditorship claim. The ownership securities are equity shares and preference shares while creditorship securities are bonds and debentures. A debt security is used to raise a loan and promises to repay the borrowed money. The owner of a debt security is a creditor. Securities can be classified into:

- a) Government Securities, and
- b) Industrial Securities.

The Government securities are issued by Central Government, State Governments and Local Self Governments which includes the authorities like; Municipalities, Autonomous Institutions like; Port Trusts, Improvement Trusts, State Electricity Boards, Metropolitan Authorities, Public Sector Corporations and other Government Agencies like; IDBI, IFCI, SFCs, SIDCs, Housing Boards, etc. The government securities market happens to be an overwhelmingly significant part of the stock market in India. As in UK it is much larger than the industrial securities market. Certain Government agencies like; IDBI, Reserve Bank of India, NABARD, BIFR implement the government's various lending operations.

The instruments of raising funds in the industrial securities market are bonds, debentures, preference shares and equity shares. The size of the industrial securities market in India is relatively much smaller because of investment habits, level of education and industrial structure. During 1983-84, the household sector's savings contributed more than 80 per cent of the total savings in India. The investment of the household sector in the form of industrial securities in the same year was 0.36 per cent of the total savings in India. Thus, industrial securities are not a popular mode of investing their savings among individuals. The size of industrial securities market is relatively much smaller than that of the other industrialised countries.

The securities market, like financial markets, is divided into primary or new issue market and secondary market. The new issues of government and private corporate sectors are floated in the primary market. The secondary market provides liquidity to the outstanding securities or existing securities.

In the primary market, new issues are traded through public offer, offer for sale, private placement and right issues. The underwriters also play a vital role in floating the new issues. Once these new issues are floated and subscribed by the public, then these are traded in the secondary market. The securities market consists of organised stock exchanges and over the counter exchange. The stock exchange is a place where members on their own or on behalf of their clients buy and sell securities. Stock exchanges are auction markets. The exchange neither buys nor sells the securities but merely provides a trading place, where members through bids and offers, trade in securities. In the stock exchange, only listed securities which are permitted by the governing body of the stock exchange are traded. Upto June, 1996 there are 23 recognised stock exchanges. A detailed discussion on stock exchanges and the trading of various instruments in these exchanges is given in Block 2 of this course.

### **Over the Counter Exchange of India (OTCEI)**

'Over The Counter' (OTC) market is an informally organised group of brokers and dealers. It handles both primary issues and secondary transactions especially of those

securities which are not listed in stock exchanges. The Over the Counter market is a negotiated market, because prices are settled through individual bargaining between buyers and sellers. In OTC market the business is not conducted at any one place designated as market place. Some stocks trade in the Over the Counter Market because the company is small or unknown or the company simply does not wish to list the security on a stock exchange or stock is closely held. Thus, over the counter market is the only place where certain stocks can be purchased or sold. Small companies or companies that do not meet exchange listing requirements are traded in over the counter market that have limited marketability and liquidity. The market is not well organised. Recently SEBI has taken steps to activate this market and OTCEI is established.

### **National Stock Exchange (NSE)**

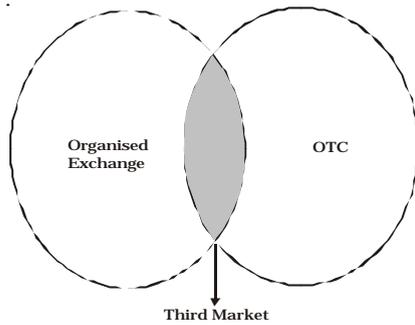
The total systems solutions adopted by NSE involves a technology which is the state-of-art. The base line software adopted by the NSE is already functioning in a number of exchange, viz., Vancouver, Mexico, Istanbul, and Caracas. This software has been developed and improved significantly by the NSE with the help of Tata Consultancy Services. The satellite communication network that is in the process of implementation will enable NSE not only to integrate the national market but also provide access to investors abroad as and when it is facilitated by policy changes. The brokers can sit in their own offices and trade on the system which offers versatile trading solutions. The trading software provides all the options which are available on a trading floor or through telephone trades. The screen provides entire market information at the press of a button which the existing telephone trade or trading floor cannot provide instantaneously. As the system provides for concealment of the identity of a market information continuously on a real time basis, it is a significant improvement over all the existing traditional trading systems. The screen gives all the required information about the depth of the market, the types of orders floating into the system, the best buy order value, the best buy price, the best sell price, the order value available at the best sells price, the last traded price, all previous trade that have taken place, outstanding orders of the concerned trading member, etc. Informations are dynamically updated. As market participants sit in their own offices they have all advantages of the back office support and facility to get in touch with their constituents.

### **Third Market**

Till 1970, the New York Stock Exchange required its members to trade in listed stock and to charge fixed commission. For large institutions, this was very expensive due to required minimum commission. Brokerage firms that were not members of the exchange faced no restriction on the commissions. They could charge and thus compete effectively for large trades in listed stocks of NYSE. Such transactions were said to take place in the **third market**. More generally, the term 'third market' refers to the trading of any exchange listed security in the OTC market. Later on their rules were relaxed and member of an organised stock exchange can deal in the third market.

The third market refers to Over the Counter Trading in listed stock. Shares traded are the same as those traded on the stock exchange.

Prices are fixed through negotiations and dealers have no responsibility of making the market. The existence of such a market is enhanced today by the fact that their trading hours are not fixed unlike organised exchange and they continue their activities when trading is halted in the exchange. The relationship in organised exchanges and OTC is depicted in Figure 1.6.



**Figure 1.6 : Relationship between Organised Exchanges and OTC**

The main customers of third market are institutional investors such as investment institutions, insurance companies, pension fund, mutual fund. Such investors believe that they can reduce their costs, get better prices, more rapid transactions in the third market than at organised exchanges. Small brokers/dealers who are not members of an organised exchange are also active in the third market. They can buy and sell the listed stock at negotiated prices. Private individual and small odd lot customers also transact business through the third market. The services offered by the third market are very less in comparison to the organised market, i.e., securities research, safety, etc. Thus, these overhead costs tend to be lower. These cost savings are usually reflected in lower net costs to the investors. As might be expected, some large stock transactions are conducted in third market in order to benefit from lower commissions.

#### **Fourth Market**

The fourth market refers to institutions and wealthy investors who directly buy and sell Securities among themselves and completely dispense with the brokerage services. Since these are direct deals, only two partners (buyers and sellers) and perhaps the third party who helped in finalising the deals are involved. The fourth market is eventually a communication network among block traders. These members in the fourth market are usually one individual and a few persons who communicate the buy and sell desires of their clients to block traders and thus facilitate direct deal to a negotiated price. Many institutions have dispersed with brokers and exchange all together for transactions in listed stocks. Trade of such type, where buyer and seller deal directly with each other and/or through some person(s) is called *fourth market*.

The main advantages of the fourth market are less commission, better price through direct negotiation, and rapid execution of the deal. These advantages suggest that the role of fourth market may become more wide spread in the future, especially as the role of financial services and big financial institutions grows.

In the United States, these transactions are facilitated by computer communications system Instill. This system automatically provides quotation and executions. The subscriber can enter the limit order in the computer where it can be noted by other subscriber who can, in turn, express their desire to take it, whenever two orders are matched the system automatically records the transaction and sets up the paper work for its completion. Subscriber can also use the system to find partners for a trade and then conduct negotiations by telephone. A monitor system exists in U.K. and is called Ariel.

Unlike other well developed capital markets, the Indian capital market has not developed in that manner. The capital market has become almost synonymous with

equity market. The debt market which is many times bigger than equity market in developed countries such as the U.S., U.K., and Japan, has hardly developed in India. The government securities market is confined only to banks and institutions and to some extent provident funds. Bulk of the investment in government securities has been to meet the statutory requirements. A genuine government securities market could not be developed in India until recently due to the fact that the yields of government securities are not market related. With the increasing alignment of yield rates on government securities with market rates, government securities are being absorbed even by corporate investors who have temporary liquid funds to manage.

The corporate debt market has not grown in the country because of several reasons. Since the term lending institutions have been providing loans for more than four decades on relatively concessional terms, co-operatives have been relying more on institutions for all their debt financing. Government and RBI regulations relating to interest rates, maturity pattern of debt, etc., also discouraged growth of genuine corporate bond market. With liberalisation in these areas, there are possibilities that the corporate bond market may grow once liquidity in debt market grows.

There are three more preconditions for healthy growth of liquidity in debt market. Insofar as organizational form of the debt market is concerned, NSE has now provided it for both government bonds as also private sector bonds. NSE is keen to develop a viable and vibrant market in the whole range of debt instruments including Commercial papers and Certificate of deposits. Since NSE system provides for effective delivery versus-payment mechanism.

The second major requirement for the development of a healthy market is the presence of active bond dealers who not only act as intermediaries but also make markets in the debt instruments. The Indian debt market lacks depth as it does not have resourceful and mature dealers in debt instruments. We do not have large and active dealers who can take positions in the market and be active market makers. All our brokerage firms are too small to make their presence felt in the bond market. They have limited resource base mainly due to their small equity base. Besides, as they are involved in several activities like equity trading, underwriting, etc., their financial resources are too thinly spread. Even in regard to equity trade they do not have capability of taking delivery of scrips in the market and wait for the funds to come from FII clients who insist on delivery versus-payment. The problem has become more acute as brokerage firms do not have credit lines from banks for all their activities. Brokerage funding has been discouraged for long. Banks have recently started lending money to brokers in a small way but the margins that they ask for lending against securities are too high.

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## **1.8 GLOBALISATION OF FINANCIAL MARKETS**

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Globalisation means the integration of financial markets throughout the world into an international financial market. Because of the globalisation of financial markets, entities in any country seeking to raise funds need not be limited to their domestic financial market. Nor are investors in a country limited to the financial assets issued in their domestic market. The factors that have led to the integration of financial markets are:

- 1) deregulation or liberalisation of markets and the activities of market participants in key financial centers of the world;
- 2) technological advances for monitoring world markets, executing orders, and analyzing financial opportunities; and
- 3) increased institutionalisation of financial markets.

These factors are not mutually exclusive. Global competition has forced governments to deregulate or liberalise various aspects of their financial markets so that their financial enterprises can compete effectively around the world. Technological advances have increased the integration and efficiency of the global financial market. Advances in telecommunication systems link market participants throughout the world with the result that orders can be executed within seconds. Advances in computer technology, coupled with advanced telecommunications systems, allow the transmission of real-time information on security prices and other key information to many participants in many places. Therefore, many investors can monitor global markets and simultaneously assess how this information will impact the risk/reward profile of their portfolios. Significantly improved computing power allows the instant manipulation of real-time market information so that attractive investment opportunities can be identified. Once these opportunities are identified, telecommunications systems permit the rapid execution of orders to capture them.

The shifting of the roles of the two types of investors, retail and institutional investors, in financial markets is the third factor that has led to the integration of financial markets. The U.S. financial markets have shifted from being dominated by retail investors to being dominated by institutional investors. Retail investors are individuals, while institutional investors are financial institutions such as pension funds, insurance companies, investment companies, commercial banks, and savings and loan associations.

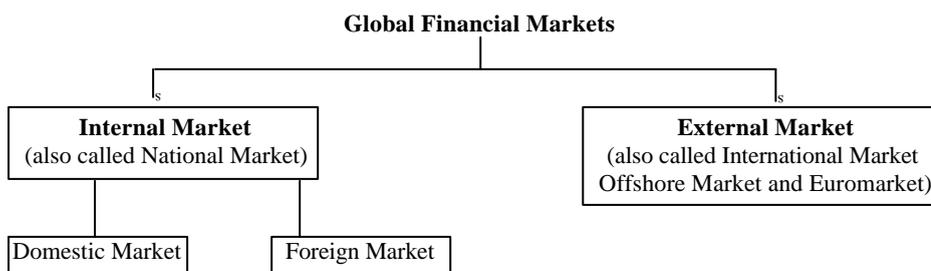
The shifting of the financial markets in the U.S. and other major industrialised countries, from dominance by retail investors to institutional investors is referred to as the institutionalisation of financial markets. Unlike retail investors, institutional investors have been more willing to transfer funds across national borders to improve the risk/reward opportunities of a portfolio that includes financial assets of foreign issuers. The potential portfolio benefits associated with global investing have been documented in numerous studies, which have heightened the awareness of investors about the virtues of global investing. Moreover, investors have not limited their participation in foreign markets to those of developed economies. There has been increased participation in the financial markets of developing economies, popularly referred to as emerging markets. Indian Financial markets too have been globalised in 1990's to a good extent.

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## 1.9 CLASSIFICATION OF GLOBAL FINANCIAL MARKETS

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While there is no uniform system for classifying the global financial markets, Figure 1.7 provides a schematic presentation of an appropriate classification system. From the perspective of a given country, financial markets can be classified as either internal or external.



**Figure: 1.7 Classification of Global Financial Markets**

The internal market, also called the national market, can be decomposed into two parts, the domestic market and the foreign market. The domestic market is where issuers domiciled in the country where the securities are issued and where those securities are subsequently traded.

The foreign market of a country is where the securities of issuers not domiciled in the country are sold and traded. The rules governing the issuance of foreign securities are those imposed by regulatory authorities where the security is issued. For example, securities issued by non-U.S. corporation in the United States must comply with the regulations set forth in U.S. securities law. A non-Japanese corporation that seeks to offer securities in Japan must comply with Japanese securities law and regulations imposed by the Japanese Ministry of Finance. Nicknames have been used to describe the various foreign markets. For example, the foreign market in the U.S. is called the “Yankee market”. The foreign market in Japan is nicknamed the “Samurai market”, in the United Kingdom the “Bulldog market”, in the Netherlands the “Rembrandt market”, and in Spain the “Matador market”.

The external market, also called the international market, includes securities with the following distinguishing features; at issuance they are offered simultaneously to investors in a number of countries; and they are issued outside the jurisdiction of any single country. The external market is commonly referred to as the offshore market, or more popularly, the Euromarket.

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## 1.10 SUMMARY

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Financial system includes all those activities dealing in Finance, organised into a system. The financial system consists of Financial Institutions, Financial Markets, Financial Instruments and the Financial Services. Financial Institutions include both regulatory and intermediary institutions. Financial markets include both primary and secondary markets.

A financial market is a place or mechanism where funds or savings are transferred from surplus units to deficit unit. These markets can be broadly classified into money markets and capital markets. Money markets deal with short term claims or financial assets, whereas capital markets deal with those financial assets which have maturity period of more than a year. The functions of financial markets can be classified into two categories: Economic and Financial. From the perspective of a given country the global financial markets can be classified as either internal or external.

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## 1.11 SELF ASSESSMENT QUESTIONS

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- 1) What do you mean by ‘Financial System’? Explain the various components of Financial system.
- 2) What is a Financial Market? Explain its role and Function.
- 3) Explain the meaning of ‘Capital Market’ and ‘Money Market’. Also bring out the similarities and the difference between these two markets.
- 4) Write a detailed account of Indian Money and Capital Markets.
- 5) What are factors that led the Indian Financial Markets into Global Financial Markets?

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## 1.12 FURTHER READINGS

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