1

INDIAN FINANCIAL SYSTEM

Unit Structure

1.1 INTRODUCTION

Any nation's ability to expand its economy depends on the presence of a sound financial system. The financial system is responsible for providing the capital inputs required for the production of products and services, which in turn help to improve the welfare and standard of life of a nation's citizens. As a result, the phrase "financial system" is more inclusive and includes both the financial markets and the institutions that support them. Money and monetary assets are the main assets traded in the financial system. The financial system's job is to mobilize savings in the form of cash and other monetary assets and invest them in profitable endeavors. An efficient financial system allows funds to flow freely to more productive activities, promoting investment. As a result, the financial system mediates between savers and investors, promoting faster economic development.

1.2 FINANCIAL SYSTEM FUNCTIONS

1. Provision of liquidity

The provision of money and monetary assets for the creation of goods and services is the primary duty of the financial system. There shouldn't be a lack of funding for profitable endeavors. Liquidity is the term used to describe money and other monetary assets in financial terminology. Cash, money, and other assets that are easily and without risk convertible into cash are referred to as having "liquidity." As a result, all operations inside a financial system include liquidity, either through the provision of liquidity or through the selling of liquidity. In fact, in India the RBI has been vested with the sole power of creating coins and currency notes. Through a process known as "credit creation," commercial banks can also generate money (deposits), and other financial organizations also deal in currencies. The economy is also at risk from an excess of money. As the head of the Indian financial system, the Reserve Bank of India (RBI) is responsible for regulating all financial institutions in the country and controlling the money supply and the issuance of credit by banks. By bolstering the institutional framework and encouraging savings and investment in the nation, it must assume responsibility for creating a strong financial system.

2. Mobilization of Savings

The financial system's ability to mobilize savings and direct them towards beneficial endeavours is another crucial function. The financial system should provide the right incentives to draw savings and make them accessible for more profitable endeavours. Asa result, the financial system makes it easier for saving to become investment and consumption. In this activity, the financial institutions must have a dominating position.

3. Size Transformation Function

The savings of millions of small investors are typically in the form of a small unit of capital that cannot be invested successfully unless it is converted into a credit unit of a visible size. The great majority of small consumers' deposits are collected by banks and other financial intermediaries, which then use those funds to lend a sizable amount of money to other customers. As a result, this size translation function is thought to be one of the financial system's most crucial components.

4. Maturity Transformation Function

The maturity transition function is one more crucial aspect of the financial system. The financial intermediaries collect deposits from public in different maturities according to their liquidity preference and lend them to the borrowers in different maturities according to their requirement and encourage the economic activities of a country.

5. Risk Transformation Function

With their small savings holdings, the majority of small investors are risk-averse. As a result, they are hesitant to invest directly in the stock market. Financial intermediaries, on the other hand, collect savings from individual savers and distribute them across various investment units using their extensive knowledge and expertise. Individual investors' risks are thus distributed. This risk transformation function encourages industrial growth. Furthermore, various risk-mitigation tools, such as hedging, insurance, and the use of derivatives, are available in the financial system.

1.3 FINANCIAL CONCEPTS

Understanding the financial system necessitates knowledge of the following concepts:

A. Financial Assets

B. Financial Intermediaries

C. Financial Markets

D. Financial Interest Rates or Financial Rate of Return

E. Financial Instruments

A. Financial Assets

Any financial transaction should involve the creation or transfer of a financial asset. As a result, the financial asset is the basic product of any financial system. A financial asset is one that is used for production, consumption, or asset creation. For example, A purchases equity shares, which are financial assets because they will generate income in the future. In this context, it is critical to understand the distinction between financial assets and physical assets. Physical assets, unlike financial assets, are not useful for further production of goods or earning income. For example, X may buy land and buildings, as well as gold and silver. Because they cannot be used for further production, these are physical assets. Many tangible assets are only useful for consumption. It is worth noting that the nature of the asset is determined by the investment objective. For example, if a house is purchased for residential use, it becomes a physical asset. When purchased for the purpose of hiring, it becomes a financial asset.

A1. Classification of Financial Assets

Financial assets can be classified in a variety of ways depending on the circumstances.One such classification is as follows:

a. Valuable Assets or Marketable Assets

b. Non-tradable Assets or Non-Marketable Assets

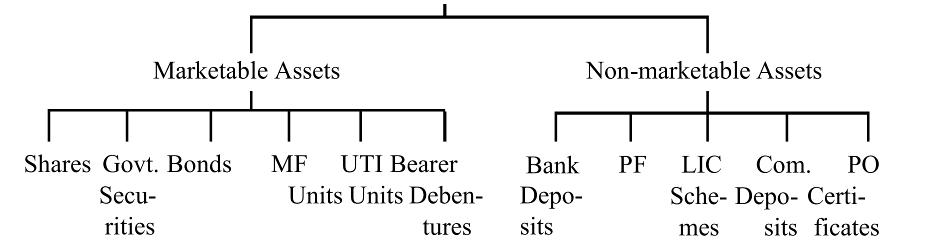
a. Valuable Assets or Marketable Assets

Marketable assets are those that can be transferred from one person to another with little difficulty. Shares of publicly traded companies, government securities, bonds issued by public sector undertakings, and so on are examples.

b. Non-tradable Assets or Non-Marketable Assets

On the other hand, if the assets cannot be easily transferred, they fall into this category. Bank deposits, provident funds, pension funds, national savings certificates, insurance policies, and so on are examples.

CHART 1.1
FINANCIAL ASSETS



Yet another classification is as follows:

a) **Money or Cash Asset** - The RBI and the Ministry of Finance, Government of India, issue all coins and currency notes in India. Furthermore, commercial banks can create money by issuing credit. Liquid cash is not provided when loans are approved. Instead, an account in the borrower's name is opened, and a deposit is made. It is also a type of financial asset.

b) **Debt Asset** - Debt assets are issued by a variety of organisations in order to raise debt capital. Debt capital has a set repayment schedule for interest and principal. There are various methods for raising debt capital. For instance, debentures, term loans, working capital advances, and so on.

c) **Stock Asset** - Business organisations issue stock to raise fixed capital. There are two kinds of stock: equity and preference. Equity shareholders are the true owners of the company, and they reap the benefits of ownership while also bearing the risks. Preference shareholders, on the other hand, receive a fixed dividend rate (as in the case of a debt asset) while retaining some equity characteristics.

B. FINANCIAL INTERMEDIARIES

The term financial intermediary refers to any organisation that mediates and facilitates financial transactions for both individual and corporate clients. As a result, it refers to all types of financial and investing institutions that facilitate financial transactions in financial markets. They may work in the organised or unorganised sectors. They can also be divided into two types:

B1. **Capital Market Intermediaries** - These intermediaries primarily provide long-term funds to individuals and businesses. They include term lending institutions such as financial corporations and investing institutions such as LIC.

B2. Money Market Intermediaries - Money market intermediaries only provide short-term financing to private and business clients. These include cooperative banks, commercial banks, etc.

C. FINANCIAL MARKETS

Usually speaking, a financial market cannot be identified by a single area or locality. A financial transaction is considered to have occurred in the financial market wherever it occurs. Because financial transactions are so common across the economy, financial markets are therefore widespread in nature. For instance, issuing equity shares, receiving a loan from a term lender, depositing money in a bank, buying debentures, selling shares, and so forth.

Nonetheless, the centres and arrangements that enable the purchase and sale of financial assets, claims, and services might be referred to as financial markets. Sometimes, such as in the case of a stock exchange, we do discover the existence of a particular site or location for a financial market.

C1. Unorganised Markets or Independent Markets

Many moneylenders, local bankers, traders, etc. lend money to the general population in these markets. The general public also makes deposits with indigenous banks. Also, there are private financial firms, chit funds, etc., whose operations are not regulated by the RBI. By releasing Non-Banking Financial Companies (Reserve Bank) Instructions, 1998, the RBI recently took action to bring private finance organisations and chit funds under its rigorous oversight. To integrate the unorganised sector into the organised economy, the RBI has already taken some action. They haven't had any luck. Their financial tools have not been standardised, and the restrictions governing their financial activities are still insufficient.

C2. Organised Markets or Structured Markets

Standardized rules and regulations that govern financial transactions are in place in organised markets. A significant amount of institutionalization and instrumentalization is also present. The RBI or other regulatory authorities have stringent oversight over andcontrol over these markets.

These organised markets can be divided into another two categories. As follows:

(i) Capital market

(ii) Money market

(i) **Capital Market** - Financial assets with a protracted or undetermined maturity are traded on the capital market. It often deals with long-term securities having maturities longer than a year. Three categories further split the capital market:

(a) **Industrial Securities Market** - It is a market for industrial securities, specifically (i) Equity shares or ordinary shares, (ii) Preference shares, and (iii) Debentures or bonds, as the name already suggests. It is a market where business concerns can issue the proper instruments to raise capital or debt. It can be broken into two further categories. As follows:

(1) Primary Market: A primary market is one where new financial claims or issues are traded. Thus, it is also known as the New Issue Market. Securities that are first issued to the public are dealt with in the primary market. Borrowers trade brand-new financial instruments for long-term funds in the primary market. As a result, capital formation is facilitated by the primary market. In a primary market, a corporation may raise money in one of threemethods. As follows:

(A) Public issue,

(B) Rights issue,

(C) Private placement are among the options.

The public sale of securities is the most typical way for new businesses to raise financing. It's known as a public issue. Securities are first issued on a pre-emptive basis to the current shareholders when an established company needs to raise more money. It's known as a rights issue. Selling stocks privately to a select group of investors is done through a private placement.

(2) Secondary Market: Secondary market is a market for secondary sale of securities. In other words, securities which have already passed through the new issue market are traded in this market. Generally, such securities are quoted in the Stock Exchange and it provides a continuous and regular market for buying and selling of securities. This market consists of all stock exchanges recognized by the Government of India. The stock exchanges in India are regulated under the Securities Contracts (Regulation) Act, 1956. The Bombay Stock Exchange is the principal stock exchange in India which sets the tone of the other stock markets.

(b) **Government Securities Market -** Alternatively, it is known as the Gilt-edged Securities Market. Government securities are traded on this market. Both short-term and long-term government securities are available in India. This market is where long-term securities are traded, whereas the money market is where short-term securities are traded. Improvement Trusts, State Electricity Boards, All India and State level financial institutions, public sector firms, and securities issued by the Central Government, State Governments, semi-government bodies like City Corporations, Port Trusts, etc. are all traded in this market. Government securities are issued in 100-rupee bills. Half-yearly interest payments are due, and there are tax exemptions as well. Since the majority of institutional investors choose to hold these securities until maturity, the secondary market for these securities is quite small. There are numerous types of government securities. They often include: (i) Stock certificates or inscribed stock (ii) Promissory notes (iii) Bearer Bonds which can be depreciated. Government Securities are marketed by the Public Debt Office of the RBI, whereas Treasury Bills (short-term securities) are offered through auctions. The government exchequer can raise money for a reasonable price by selling government securities, and the interest paid on these securities affects the market's prices and yields. As a result, this market is essential for managing money.

(c) **Long Term Loan Market –** Development bank and commercial bank play a significant role in this market by supplying long term loans to corporate customers. Long term loan market may further be classified into (a) Term Loan Market (b) Mortgages Market (c) Financial Guarantees Markets.

(1) Term Loan Market - To provide long- and medium-term loans to corporate customers directly as well as indirectly, the government of India has established numerous industrial financing organisations at the national and regional levels. The bulk of India's industrial financing is provided by these development banks. These organisations include IDBI, IFCI, ICICI, and other state-owned financial firms. By offering long-term loans, these banks satisfy the industries' expanding and diverse long-term financial needs. They also support initiatives to modernise, foster new business ventures, and find investment opportunities.

(2) Mortgages Market - The centres that primarily provide mortgage loans to individual customers are referred to as the mortgage market. A mortgage loan is a loan taken out in exchange for real estate or other immovable property as security. Mortgage refers to the sale of a specific immovable property's interest to fund a debt. This mortgage may be a legal or equitable mortgage. Once more, it might be a first or second charge. A legal mortgage is made when the borrower formally transfers ownership of the property to the lender, but an equitable mortgage is created by simply depositing title deeds to properties as collateral. Legitimate mortgages are less dangerous. Similar to the first charge, the mortgagee receives the mortgager's interest in the specific property as security from the mortgager. When a property is mortgaged to a second party after having previously been mortgaged to one creditor, it incurs a second charge. The mortgagee has the option to further assign his interest in the collateral. A sub- mortgage is what is used in this situation. There may be a primary market and a secondary market for mortgages. The primary market is where credit is first extended, and the secondary market is where existing mortgages are sold and resold at marketrates.

(3) Financial Guarantees Market - A guarantee market is a location where financing is offered in exchange for the guarantee of a well-known figure in the financial community. A guarantee is a contract that releases a third party from responsibility in the event of their default. From the perspective of the creditor, a guarantee serves as security. The guarantor is responsible for loan repayment in the event that the borrower defaults. As a result, the guarantor needs to be well-known to both the lender and the borrower, and he also needs to be able to pay off his debt. Despite the fact that there are numerous varieties of guarantees, the most popular kinds are I performance guarantees and (ii) financial guarantees. The payment of earnest money, retention money, advance payments, contract non-fulfillment, etc. are all covered by performance guarantees. In India, the market for financial guarantees is well organised. The financial guarantees in India relate to: (i) Deferred payments for imports and exports (ii) Medium and long-term loans raised abroad (iii) Loans advanced by banks and other financial institutions.

Commercial banks, development banks, federal and state governments, and other specialised guarantee organisations like the Export Credit Guarantee Corporation and the Domestic Investment Credit Guarantee Corporation offer the majority of these guarantees (Deposit Insurance and Credit Guarantee Corporation). Both individual and business customers have access to this financial solution with a guarantee. This guarantee service is crucial for any financial system's smooth operation.

Importance of Capital Market

Capital formation and economic progress are hampered by a lack of a capital market. If money wasn't transferred through the capital market, resources would be idle. The following succinct summary of the capital market's significance is provided:

(1) The capital market is a crucial resource for putting the economy's savings to good use. People's savings are mobilised for further investment, preventing their loss to wasteful spending.

(2) It encourages saving and promotes capital development by offering reasonable interest rates as the cost of capital.

(3) It gives investors, especially those in the household sectors, a way to put money into financial investments that are more fruitful than those in tangible assets.

(4) It makes it easier for the economy to produce more goods and services, which improves the economic well-being of society. As a result, it makes it easier for people who can use money in productive and profitable ways to raise overall national income to "shift stream of command over capital to the point of highest yield."

(5) The activities of various entities on the capital market stimulate economic expansion. They direct the quantitative and qualitative flow of money and ensure the wise distribution of limited resources.

(6) A stable capital market with knowledgeable intermediaries encourages consistency in the values of the securities used to represent capital funds.

(ii) **Money Market -** A market for short-term loans or financial assets is known as a money market. It is a market where short-term funds are lent and borrowed. It does not actually deal in cash or money, despite what the name suggests. Yet, it actually deals with close substitutes for money or close replacements for money, such as trade bills, promissory notes, and government papers drawn for a brief length of time that does not exceed one year. These short-term financial products are easily convertible into cash without incurring any losses and with minimal transaction costs. The money market is where most short- term money asset transactions take place. It gives lenders with liquidity or cash and satisfies the short-term needs of borrowers. It is the location where people, organisations, and the government borrow short-term surplus money that are available to financial institutions and individuals.

The word "money market" does not specifically relate to one location where short-term funds are transacted. All people, organisations, and middlemen who work with short-term funds are included. Via phone, telegraph, mail, and agents, transactions between borrowers, lenders, and middlemen are carried out. In a money market, there is no requirement for direct communication or physical presence between the two parties.

Features of Money Market

The general characteristics of a money market are as follows:

- The near money market is solely for short-term investments or financial assets.
- It only pertains to financial assets with a maturity of up to one year.
- It exclusively deals with assets that can be quickly and easily turned into cash without incurring losses and with the least amount of transaction costs.
- The majority of transactions involve oral conversation over the phone. Subsequently, pertinent papers and written communications can be traded. A formal setting like a stock exchange or capital market is not there.
- Transactions must be carried out without the assistance of brokers.

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2

THE ROLE OF CENTRAL BANK - RBI

Unit Structure

2.1 INTRODUCTION

A study of financial institutions in India should appropriately begin with a brief discussion of the functions, role, working, and policy of the Reserve Bank of India (RBI or Bank). The RBI, as the central bank of the country, is the nerve centre of the Indian monetary system. As the apex institution, the RBI has been guiding, monitoring, regulating, controlling, and promoting the destiny of the IFS since its inception. The purpose of this chapter is to help the reader to understand the functioning of the RBI by highlighting the major aspects of its working.

2.2 CENTRAL BANKING

The pattern of central banking in India was based on the Bank of England. England had a highly developed banking system in which the functioning of the central bank as a banker's bank and their regulation of money supply set the pattern. The central bank's function as 'a lender of last resort was on the condition that the banks maintain stable cash ratios as prescribed from time to time. The effective functioning of the British model depends on an active securities market where open market operations can be conducted at the discount rate. The effectiveness of open market operations however depends on the member banks' dependence on the central bank and the influence it wields on interest rates. Later models, especially those in developing countries showed that central banks play an advisory role and render technical services in the field of foreign exchange, foster the growth of a sound financial system and act as a banker to government.

2.3 ORGANIZATION AND MANAGEMENT

The RBI is quite young compared with such central banks as the Bank of England, Riksbank of Sweden, and the Federal Reserve Board of the USA. However, it is perhaps the oldest among the central banks in the developing countries. It started functioning from 1 April 1935 in terms of the Reserve Bank of India Act, 1934.1twasaprivate shareholders' institution till January 1949. After which it became a state-owned institution undo* the Reserve Bank (Transfer to Public Ownership) of India Act, 1948. This Act empowers the Central Government, in consultation with the Governor of the Bank, to issue such directions to it as they might consider necessary in the public interest Further, the Governor and all the Deputy Governors of the Bank are appointed by the Central Government The Bank is managed by the Central Board of Directors, four Local Boards of Directors, and the Committee of the Central Board of Directors. The functions of the Local Boards are to advise the Central Board on such matters as are referred to them; they are also required to perform such duties as are delegated to them. The final control of the Bank vests in the Central Board which comprises the Governor, four Deputy Governors, and fifteen Directors nominated by the Central Government. The Committee of the Central Board consists of the Governor, the Deputy Governors, and such other Directors as may be present at a given meeting. The internal organizational set-up of the Bank has been modified and expanded from time to time in order to cope with the increasing volume and range of the Bank's activities. The underlying principle of the internal organization is the functional specialization with adequate coordination. In order to perform its various functions, the Bank has been divided and sub-divided into a large number of Departments. Apart from the Banking and Issue Departments, there areat present twenty Departments and three training establishments at the Central Office of the Bank.

2.4 THE ROLE AND FUNCTIONS

The RBI functions within the framework of mixed economic planning. The legal, economic, and institutional factors in India have rendered the issue of the independence of the central bank almost irrelevant. With regard to framing various policies, it is necessary to maintain close and continuous collaboration between the Government and the RBI. In the event of a difference of opinion or conflict, the Government view or position can always be expected to prevail. Given this environment or setting, the Bank performs a number of functions which are discussed in the following sections.

1. NOTE ISSUING AUTHORITY

The RBI has, since its inception, the sole right or Authority or monopoly of issuing currency notes other than one rupee notes and coins, and coins of smaller denominations. The issue of currency notes is one of its basic functions. Although one rupee coins and notes, and coins of smaller denominations are issued by the Government of India, they are put into circulation only through the RBI. The currency notes issued by the Bank are legal tender everywhere in India without any limit. At present, the Bank is sues notes in the following denominations: Rs. 2,5,10,20,50,100, and 500. The responsibility of the Bank is not only to put currency into, or withdraw it from, the circulation but also to exchange notes and coins of one denomination into those of other den ominations as demanded by the public. All affairs of the Bank relating to note issue are conducted through its Issue Department In order to discharge its currency functions, the Bank maintains (at present) 14 local offices and the currency chests in which the stock of new and reissuable notes, and rupee coins are stored. The total number of currency chests at the end of March 1990 was 3791. Of these, 17 chests were with the RBI, 2745 with the SBI and associate banks, 622 with nationalized banks, 402 with tr easuries, and 5 with Jammu and Kashmir Bank. As stated elsewhere, the currency even today forms the major part of the money supply in India. The currency as percentage of money supply (M t 195051,71.1% in 196061,51.0% in 1975= currency + demand deposits with banks) was 69.2% in 76, and 59,0% in 198889. The composition of currency in 1987 was: small coins=Rs. 440 crores; rupee coins=Rs. 423 crores; rupee notes=Rs. 300 crores; and Bank notes=Rs. 28,743 crores. The volume of note issue (including one rupee notes) has increased from Rs. 1114 crores in 1952 to Rs. 29043 crores in 1987. The Bank can issue notes against the security of gold coins and gold bullion, foreign securities, rupee coins, Government of India securities, and such bills of exchange and pro missory notes as are eligible for purchase by' the Bank. The RBI notes have a cent per cent backing or cover in these approved assets. Earlier, i.e. till 1956, not less than 40 per cent of these assets was t bulli on and sterling/ o consist of gold coin and foreign securities. In other words, (he proportional reserve system of note issue existed in India till 1956. Thereafter, this system was abandoned and a minimum value of gold coin and bullion and foreign securities as a part of total approved assets came to be adopted as a cover for the note issue.

2. GOVERNMENT BANKER

The RBI is the banker to the Central and State Governments. It provides to the Governments all banking services such as acceptance of deposits, withdrawal of funds by cheques, receipts collection of payments on behalf of and the Government, transfer of funds, making payments on Government behalf, and management of the public debt. The Bank receives Government deposits flee of interest, and it is not entitled to any remuneration for the c ad hoc onduct of the ordinary banking business of the Government. The deficit or surplus in the Central Government account with the RBI is managed by the creation and cancellation of Treasury bills (known as treasury bills). As a banker to the Government, the Bank can make “ways and means advances” (i.e. temporary advances made in order to bridge the temporary gap between receipts and payments) to both the Central and State Governments. The maximum maturity period of these advances is three months. However, of ad hoc in practice, the gap between receipts and payments in respect of the Central Government is met by the issue treasury bills, while the one in respect of the State Governments is met by the ways and means advances. The ways and means advances to t b he State Governments are subject to some limits. These advances are of the following types: (a) Normal or clean advances i.e. advances without any collateral security; ( ) Secured advances, i.e. those which are secured against the pledge of Central Governm ent securities; and (c) Special advances, i.e. those granted by the Bank at its discretion. The interest rate charged by the Bank on these advances did not, till May 1976, exceed the Bank rate. Thereafter, the Bank has been operating a graduated scale of i nterest based on the duration of the advance. ‘ Apart from the ways and means advances, the State Governments have made heavy use of the overdrafts from the RBI. An overdraft refers to drawls of credit by the State Governments from the RBI in excess of the credit (ways and means advances) limits granted by the RBI. In other words, overdrafts 8687 are unauthorized ways and means advances drawn by the State Governments on the RBI. At present, overdrafts up to arid inclusive of the seventh day are charged at the Bank rate and from .the eighth day onwards at 3 per cent above the Bank rate. The management of the States' overdrafts has gradually become one of the major responsibilities of the RBI on account of the persistence of large proportions of those overdrafts. The issue, management, and administration of the public (Central and State Governments) debt are among themajor functions of the RBI as the banker to the Government. The Bank charges a commission from the Governments for rendering this service.

3. BANKERS' BANK

The RBI, like all central banks, can be called a banker's Bank because it has a very special relationship with commercial and co-operative banks, and the major part of its business is with these banks. The Bank controls the volume of reserves of commercial banks and thereby determines the deposits/credit creating ability of the banks. The banks hold a part or all of their reserves with the RBI. Similarly, in times of their needs, the banks borrow funds from the RBI. It is, therefore, called the bank of last resort or the lender of last resort. On the whole, the RBI is the ultimate source of money and credit in India.

4. SUPERVISING AUTHORITY

The RBI has vast powers to supervise and control commercial and cooperative banks with a view to developing an adequate and a sound banking system in the country. It has, in this field, the following powers: (a) to issue licenses for the establishment of new banks; (b) to issue licenses for the setting up of the bank branches; (c) to prescribe minimum requirements regarding paid-up capital and reserves, transfer to reserve fund, and maintenance of cash reserves and other liquid assets; (d) to inspect the working of banks in India as well as abroad in respect of their organizational set-up, branch expansion, mobilization of deposits, investments, and credit portfolio management, credit appraisal, region-wise performance, profit planning, manpower planning and training, and so on; (e) to conduct ad hoc investigations from time to time into complaints, irregularities, and frauds in respect of banks; (f) to control methods of operations of banks so that they do not fritter away funds in improper investments and injudicious advances, (g) to control appointment, reappointment, termination of appointment of the Chairman and chief executive officers of the private sector banks; and (h) to approve or force amalgamations.

5. EXCHANGE CONTROL AUTHORITY

One of the essential functions of the RBI is to maintain the stability of the external value of the rupee. It pursues this objective through its domestic policies and the regulation of the foreign exchange market. As far as the external sector is concerned, the task of the RBI has the following dimensions: (a) to administer the

foreign Exchange Control (b) to choose the exchange rate system and fix or manage the exchange rate between the rupee and other currencies; (c) to manage exchange reserves; and (d) to interact or negotiate with the monetary authorities of the Sterling Area, Asian Clearing Union, and other countries, and with international financial institutions such as the IMF, World Bank and Asian Development Bank. The RBI administers the Exchange Control in terms of the Foreign Exchange Regulation Act (FERA), 1947 which has been replaced by a more comprehensive Foreign Exchange Regulation Act, 1973. The objective of exchange control is primarily to regulate the demand for foreign exchange within the limits set by the available supply. This is sought to be achieved by conserving foreign exchange, by using it in accordance with the plan priorities, and by controlling flows of foreign capital. In India, during most of the years since 19S7, foreign exchange earnings have been far less than the demand for foreign exchange, with the result that the latter had to be rationed in order to maintain exchange stability. This is done through Exchange control which is imposed both on receipts and payments of foreign exchange on trade, invisible and capital accounts. The problem of foreign exchange shortage has been so persistent and acute that the scope of exchange control in India has steadily widened and the regulations have become progressively more elaborate o ver the years. The Bank administers the control through authorized foreign exchange dealers. FERA lays down that the exchange rates used for the conduct of foreign exchange business must be those which are fixed by the RBI. The arrangements or the system under which exchange rate is fixed by the RBI has undergone many changes over the years. Till about 1971 as a member of the IMF, India had an exchange rate system of “managed flexibility.” This arrangement changed during 1970s as a result of international monetary crisis in 1971. Since 1975, the exchange rate of the rupee has been fixed in terms of the “basket of currencies”. The different exchange rate systems in India will be discussed in detail in chapter 21 on foreign exchange market. The RBI is the custodian of the country’s foreign exchange reserves, and it is vested with the responsibility of managing the investment and utilization of the reserves in the most advantageous manner. The RBI achieves this through buying and selling of foreign exchange from and to scheduled banks which are the authorized dealers in the Indian foreign exchange market The Bank also manages the investment of reserves in gold accounts abroad and the shares and securities issued by foreign governments and international banks or financial institutions.

6. PROMOTER OF THE FINANCIAL SYSTEM

Apart from performing the functions already mentioned, the RBI has distinguished itself by rendering "developmental" or "promotional" services which have strengthened the country's banking and financial structure. This has helped in the mobilization of savings and directing credit flows to desired channels, thereby helping to achieve the objective of economic development with social justice. It has played a major role in deepening and widening the financial system. As has been preempting credit for certain sectors at a part of its promotional role, the Bank concessional rates. In the money market, the RBI has continuously worked for the integration of its unorganized and organized sectors by trying to bring indigenous bankers into the mainstream of the banking business. In order to improve the quality of finance provided by the money market, it introduced two Bill Market Schemes, one in 1952, and the other in 1970. With a view to increasing the strength and viability of the banking system, it carried out a programme of a ma lg am actions and mergers of weak banks with the strong ones. When the Social Control of banks was introduced in 1968, it was the responsibility of the RBI to administer the country for achieving the desired objectives. After the nationalization of banks, the RBI's responsibility to develop banking system on the desired lines has increased. It has been acting as a leader in sponsoring and the implementing the Lead Bank scheme. With the help of a statutory provision for licensing the branch expansion of banks, the RBI has been trying to bring about an appropriate geographical distribution of bank branches. In order to ensure the security of deposits with banks, the RBI took initiative in 1962 in creating the Deposits Insurance Corporation. The RBI has rendered yeoman's service in directing an increased flow of credit to the agricultural sector. It has been entrusted with the task of providing agricultural credit in terms of the Reserve of India Act, 1934. The importance with which the Bank RBI takes this function is reflected in the fact that the since 1955, it has appointed a separate Deputy Governor in charge of rural credit It has undertaken systematic stuas of the problem of rural cred it and has generated basic data and information in this area. This was first done in 1954 by conducting an All India Rural Credit Survey. And that was followed by the stu A the s of the All India Rural Credit Review Committee in 1968, the Committee to Review arrangements for Institutional Credit for Agriculture and Rural Development in 1978, and the Agricultural Credit Review Committee in 1986. As a part of its efforts to increase the supply of agricultural credit, the Bank has been striving to strengthen the cooperative banking structure through provision of finance, supervision, and inspection. It provides the co-operative banks (through the State Co-operative Banks) short term finance at a concessional rate for seasonal agricultural operations and marketing of crops. It subscribes to the debentures of Land Development Banks. It operates the National Agricultural Credit (Long-Team Operations) Fund, and foe National Agricultural Credit (Stabilization) Fund, through which it provides long- term and medium-term finance to cooperative institutions. It established the Agricultural Refinance Cooperation (now known as NABARD) in July, 1963 for providing medium-term and long-term finance, for agriculture. It also helped in establishing an Agricultural Finance Corporation. The role of the Bank in diversifying the institutional structure for providing industrial finance has been equally commendable. All the Special Development Institutions at the Central and State levels and many other financial institutions were either created by the Bank on its own or it advised and rendered help in setting up these institutions. The UTI, for example, was originally an associate institution of the RBI. A number of institutions providing financial and other services such as guarantees, technical consultancy, and so on have come into being on account of the efforts of the RBI. Through these institutions, the RBI has been providing short-term and long-term funds to the agricultural and rural sectors, to small scale industries, to medium and large industries, and to the export sector. It has helped to develop guarantee services in respect of loans to agriculture, small industry, exports, and sick units. It also co-ordinates the efforts of banks, financial institutions, and Government agencies to rehabilitate sick units. The Bank has evolved and put through practice the consortium, cooperative, and participatory approach to lending among banks, and other financial institutions, and among other financial institutions. By developing the culture of inter-institutional participation, of expertise pooling, and of geographical presence, it has helped to upgrade credit delivery and service capability of the financial system. By issuing appropriate guidelines in 1977 regarding the transfer of loan accounts by the borrowers, it has evolved mutually acceptable system of lending, so that the banking business should grow in a healthy manner and without cutthroat competition.

2.5 REGULATOR OF MONEY AND CREDIT

The function of formulating and conducting monetary policy is of paramount importance for any central bank. Monetary policy refers to the use of techniques of monetary controlat the disposal of the central bank for achieving certain objectives.

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3

STOCK EXCHANGES OF THE COUNTRY AND PRIMARY MARKETS

Unit Structure

3.1 INTRODUCTION

Markets are gathering places for customers and sellers to exchange goods. This definition holds true across all marketplaces and is universal. More discussion regarding the capital market will be covered in this course. It is a location where various sorts of capital are traded. Individuals like you are frequently the lenders or the capital suppliers. The recipients of capital are businesses and numerous other institutions. The market is structured in a variety of ways. The market can be broadly split into two categories: (a) the short-term capital market, also known as the money market, and (b) the long-term capital market, also known as the stock market. The institutional market and the direct market are two other market classifications.

If you can only spare a small portion of your surplus funds, you'll need to hunt for quick savings. You must seek out institutional support for such savings because the amount available in such situations is typically quite minimal. In other words, people don't engage with the money market, which focuses on short-term capital, directly. People frequently contact an institution for this reason. Your short-term surplus can be saved in a mutual fund or bank deposit, both of which provide money market plans.

If you have extra cash that you can spare for a while, you should seek for investments with a longer time horizon. Once more, you can visit a business that sells long-term products or you can engage with the market directly. In other words, you can put your money in a long-term fixed deposit, a mutual fund programme, or by purchasing assets directly from the market. There are two ways you might approach the market when you want to handle it on your own. Accordingly, the markets are divided into primary and secondary markets. The corporation pursues investors in its primary market in order to raise money. They have the option of asking for loan, equity, or a combination of the two types of funding. Today, trading in the primary market is fairly easy. Similar to opening a fixed deposit, you must fill out an application for the issue and then deposit the required amount. Brokers and sub-brokers will typically assist you in obtaining forms and directing you as you fill them out. The most crucial thing is to make sure your investments align with your goals. Financial newspapers and magazines also provide in-depth articles on major market issues here to aid small investors. If the company accepts your application forms after you submit them, you will receive a certificate or credit in your depository. If there are too many applicants for the offer, the business may reject some of the applications. You will receive a refund of your initial investment in such circumstances.

There will be competition for the best problems because the price in the primary market is fixed. Many investors who are directly willing to deal with the market are forced to turn to the secondary market due to the uncertainty of securing an allocation. It is a location where investors buy from and sell to one another. The market is active since there are many vendors and buyers. Prices for securities fluctuate in response to changes in supplyand demand. There is a secondary market for a variety of securities, including debt, equity, and others. Thanks to advancements in information and computing technologies, investing in the secondary market has also grown simpler. You must establish an account with one of the stock exchanges of your choice's participants. The steps to opening an account. The process to open an account is reasonably straightforward and resembles creating a savings bank account with your banker in several ways. You can place orders for buying and selling over the phone, and you frequently receive an immediate confirmation of your transaction. You may purchase and sell securities on the internet these days. More information about the stock market's structure and the buying and selling of shares by investors will be included in this unit.

3.2 PRIMARY MARKET

The primary market is where brand-new issues are created, whereas the secondary market is where current issues are traded. This explains why the Secondary Market is also known as the Stock Market and the Primary Market is also known as the New Issues Market. There are three ways to create new issues in the primary market: public issue, rights issue, and private placement. The sale of securities to the general public is a public issue. Securities are sold through a rights issue to current shareholders and bondholders. Selling shares privately to a chosen group of investors is known as private placement. Equity shares, completely convertible debentures (FCD), partially convertible debentures (PCD), and nonconvertible debentures (NCD) are the securities issued by non-government public limited companies most frequently in the primary market.

Bonds and equity shares are issued by government corporations. India's primary market has seen a significant increase in activity after the Controller of Capital Issue was abolished. Issues are made in the primary market either "at par" or "at premium." The "Guidelines on Capital Issues" or "Guidelines for Disclosure and Investors Protection" published by the

Securities and Exchange Board of India (SEBI) regulate the pricing of new Issues. These comprehensive guidelines address every aspect of capital offerings. The pricing of new issues was governed by the Controllers of Capital Issues (CO) pricing formula prior to the adoption of the ordinance no. 9 of 1992, which repealed the Capital Issues (Control) Act.

According to the recommendations of the Malegam Committee, all issues by a new firm must be made at par, and for existing companies, the issue price must be justified.

- The last three years' earnings per share (EPS) and a comparison of the pre-issue price to earnings (P/E) ratio to the industry's P/E ratio.

A minimum return on increasing net worth is required to maintain pre-issue EPS. Latest Net Asset Value. By issuing GDRs and ADRs, a corporation can also obtain funding from the global financial markets.

3.3 PRINCIPAL STEPS OF A PUBLIC ISSUE

A draught prospectus is created with information on the company, the history of the promoters, the management, the terms of the offering, the specifics of the project, the sources of funding, past financial results, expected profitability, and other information. Additionally, in a document known as a "placement memorandum," a venture capital firm must disclose the specific conditions under which funds are to be raised in the proposed issue. Some of the steps are as follows :

- The underwriters are chosen because they agree to take on the risk and contribute to the shortfall should the issuance not receive enough interest. They are eligible to receive a commission on the amount underwritten for this pledge, up to a maximum of 2.5%.

- The appointment of bankers: Bankers serve as the collecting agents and handle the monies obtained during the public issue through their branch network. A "bridge loan" is a short-term loan that the Banks offer to cover the time between the issuance date and the day the issue proceeds become available after allotment.

- The appointment of registrars is the first step in the allocation process. Registrars process application forms, total the funds collected during the Issue, and start the allotment process.

- Brokers are appointed to the Issue for the purpose of marketing it. These brokers must be recognised members of the Stock Exchanges. They are qualified for a 1.5% maximum brokerage.

- Draught prospectus along with copies of the agreements with the Lead Manager, Underwriters, Bankers, Registrars, and Brokers to the issue are filed with the Registrar of Companies in the state where the company's registered office is located.

- Application form printing and distribution: The prospectus and application forms are printed and distributed to all merchant bankers, underwriters, and brokers involved in the offering.
- Initial listing application submission: A letter including the details and a statement of intent to list the shares on the exchange is sent to the stock exchanges where theissue is planned to be listed.
- Statutory notice: The prospectus and the start and close dates for the issue are published in significant English daily and regional media.
- Application processing: Following the conclusion of the public offering, each application form is carefully examined, the results are calculated, and shares are subsequently allocated in accordance with these applications.
- Establishing the underwriter's liability: If the issue is fully subscribed, the underwriters are responsible for making up the difference if they haven't raised the full amount that was committed to them under the underwriting agreement.
- Share allotment: Following the Issue's minimum level of subscription, SERI's allotment process is started.
- Listing of the Issue: Following allocation, the shares must be listed mandatorily on the regional stock exchange and optionally on other stock exchanges.

3.4 STOCK MARKET IN INDIA

From scattered and small beginnings in the 19th Century, India' s stock market has risento great heights. By 1990, we had 19 Stock Exchanges in the country and by 2002 there were 23 Stock Exchanges as listed in the later sections of this unit. You might be interested in knowing more about the origin and the growth of stock market in India. What functions does it perform? What is the form of organization of stock exchanges in India? How are these administered? We shall, now, address to these and other questions.

Origin and Growth Organizations and institutions, whether they are economic, social or political, are products of historical events and exigencies. The events continually replace and/or reform the existing organizations, so as to make them relevant and operational incontemporary situations. It is, therefore, useful to briefly acquaint ourselves with the origin and growth of the stock market in India. Stock exchanges of India in a rudimentary form originated in 1800 and since that time have developed through six broad stages.

1800-1865 : The East India Company and few commercial banks floated shares sporadically, through a very small group of brokers. According to a newspaper in 1850, in Bombay during 1840-1850 there were only half a dozen recognised brokers. The year 1850 marked a watershed. A wave of company flotations took over the market ; the number of brokers spurted to 60. The backbone of industrial growth and the resulting boom in share flotation was the legendary personality of the financial world, Premchand Roychand.

In 1860 the stock market created a unique history. The entire market was gripped by what is known as 'share mania'. The American Civil War created cotton famine. Indian cotton manufacturers exploited this situation and exported large quantities of cotton. The resulting increase in export earnings opened opportunities for share investments. New companies started to come up. Excessive speculation and reckless buying became the order of the day. This mania lasted upto 1865. It marks the end of the first phase in the Indian stock exchange history because with the cessation of the Civil War, demand for Indian cotton slumped abruptly. The share became worthless pieces of paper. To be exact, on July 1, 1865 all shares ceased to exist because all time bargains which had matured could not be fulfilled.

1866-1900: We find another distinct phase during 1866-1900. The mania effect haunted the stock exchange of Bombay during these 25 years. Above everything else, it led to foundation of a regular market for securities. Since the market was established in Bombay, it soon became and still is the leading and the most organized stock exchange in India. A number of stock brokers who geared up themselves, set up a voluntary organization in 1887, called Native Share and Stockbrokers Association. The brokers drew up codes of conduct for brokerage business and mobilized private funds for industrial growth. It also mobilized funds for government securities (gilt edged securities), especially of the Bombay Port Trust and the Bombay Municipality. A similar organization was started at Ahmedabad in 1894.

1901-1913: Political developments gave a big fillip to share investment. The Swadeshi Movement led by Mahatma Gandhi encouraged the indigeneous trading and business class to start industrial enterprises. As a result, Calcutta became another major centre of share trading. The trading was prompted by the coal boom of 1904- 1908. Thus the third stock exchange was started by Calcutta stock brokers. During Inter-war years demand for industrial goods kept increasing due to British involvement in the World Wars. Existing enterprises in steel and cotton textiles, woolen textiles, tea and engineering goods expanded and new ventures were floated. Yet another stock exchange was started at Madras in 1920.

The period 1935-1965 can be considered as the period of development of the existing stock exchanges in India. In this period industrial development planning played the pivotal role of expanding the industrial and commercial base of the country. Two more stock exchanges were set up, at Hyderabad in 1943 and at Delhi in 1947. At the time of Independence seven stock exchanges were functioning located in the major cities of the country. Between 1946 and 1990, 12 more stock exchanges were set up trading the shares of 4843 additional listed companies.

There are 23 stock exchanges in the country, 23 of them being regional ones with allocated areas. Three others set up in the reforms era, viz., National Stock Exchange (NSE), the Over the Counter Exchange of India Limited (OTCEI), and Interconnected Stock Exchange of India Limited (ISE) have mandate to nationwide trading network. The ISE is promoted by 15 regional stock exchanges in the country and has been set up at Mumbai. The ISE provides a member-broker of any of these stock exchanges an access into the national market segment, which would be in addition to the local trading segment available at present. The NSE and OCTEI, ISE and majority of the regional stock exchanges have adopted the Screen Based Trading System (SBTS) to provide automated and modern facilities for trading in a transparent, fair and open manner with access to investors across the country. 9,877 companies were listed on the stock exchanges as on 31 March 1999, and the market capitalization was 5,30,772 crore. The number of primary listed companies at various stock exchanges in India was 9,644 as on end of March, 2002. The market capitalisation at NSE was Rs. 6,36,861 crore by March 2002. The following are the names of the various stock exchanges in India.

- The Bombay Stock Exchange
- The Ahmedabad Stock exchange Association
- Bangalore Stock Exchange
- The Calcutta Stock Exchange Association
- Cochin Stock Exchange
- The Delhi Stock Exchange Association
- The Guwahati Stock Exchange
- The Hyderabad Stock Exchange
- Jaipur Stock Exchange Kanara Stock Exchange
- The Ludhiana Stock Exchange Association
- Madras stock Exchange Madhya Pradesh Stock Exchange
- The Magadh Stock Exchange
- Mangalore Stock Exchange
- Pune Stock Exchange
- Saurashtra Kutch Stock Exchange
- The Uttar Pradesh Stock Exchange Association
- Vadodara Stock Exchange
- Coimbatore Stock Exchange
- Over The Counter Exchange of India
- The National Stock Exchange of India
- Inter-connected Stock Exchange of India Limited

Role and Functions

The history of stock exchanges in foreign countries as well as in India shows that the development of joint stock enterprise would never have reached its present stage but for the facilities which the stock exchanges provided for dealing in securities. Stock exchanges have a very important function to fulfil in the country's economy. In Union of India vs. Allied International Products Ltd (1971) 41 Comp Cas 127 (SC) : (1970) 3 SCC 5941], the Supreme Court of India has enunciated the role of the stock exchanges in these words: "A Stock Exchange fulfils a vital function in the economic development of a nation: its main function is to `qualify' capital by enabling a person who has invested money in, say a factory or a railway, to convert it into cash by disposing off his shares in the enterprise to someone else. Investment in joint stock companies is attractive to the public, because the value of the shares is announced day after day in the stock exchanges, and shares quoted on the exchanges are capable of almost immediate conversion into money. In modern days a company stands little chance of inducing the public to subscribe to its capital, unless its shares are quoted in an approved stock exchange. All public companies are anxious to inform the investing public that the shares of the company will be quoted on the stock exchange".

The stock exchange is really an essential pillar of the private sector corporate economy. It discharges three essential functions in the process of capital formation and in raising resources for the corporate sector. They are :

First, the stock exchange provides a market place for purchase and sale of securities viz.,shares, bonds, debentures, etc. It, therefore, ensures the free transferability of securities which is the essential basis for the joint stock enterprise system. The private sector economy cannot function without the assurance provided by the stock exchange to the owners of shares and bonds that they can be sold in the market at any time. At the same time those who wish to invest their surplus funds in securities for long-term capital appreciation or for speculative gain can also buy stocks of their choice in the market.

Secondly, the stock exchange provides the linkage between the savings in the household sector and the investment in corporate economy. It mobilizes savings, channelises them as securities into those enterprises which are favoured by the investors on the basis of such criteria as future growth prospects, good returns and appreciation of prevalence on the Indian scene of such interventionist factors as industrial licensing, provision of credit to private sector by public sector development banks, price controls and foreign exchange regulations. The stock exchanges discharge this function by laying down a number of regulations which have to be complied with while making public issues e.g. offering at least the prescribed percentage of capital of the public, keeping the subscription list open for a minimum period of three days, making provisions for receiving applications at least at the centres where there are recognised stock exchanges and allotting the shares against applications on a fair and unconditional basis with the weightage being given to the applications in lower categories, particularly those applying for shares worth Rs.500 or Rs.1,000, etc. Members of stock exchanges also assist in the floatation of new issues by acting as managing brokers/official broker of new issue. In that capacity, they, inter alia, try to sell these issues to investors spread all over the country. They also act as under- writers to new issues. In this way, the broker community provides an organic linkage between the primary and the secondary markets. 14 Securities Market in India Thirdly, by providing a market quotation of the prices of shares and bonds, a sort of collective judgement simultaneously reached by many buyers and sellers in the market-the stock exchanges serves the role of a barometer, not only of the state of health of individual companies, but also of the nation's economy as a whole. It is often not realised that changes in share prices are brought about by a complex set of factors, all operating on the markets simultaneously. Share values as a whole are subject to secular trends set by the economic progress of the nation, and governed by factors like general economic situation, financial and monetary policies, tax changes, political environment, international economic and financial developments, etc. These trends are influenced to some extent by periodical cycles of booms and depressions in the free market economies. As against these long-term trends, the day-to-day prices are influenced by another variety of factors notably, the buying or selling of major operators, the buying and selling of shares by the investment financial institutions such as the U.T.I. or L.I.C. which have in recent years emerged as the largest holders of corporate securities, speeches and pronouncements by ministers and other government spokesmen, statements by company chairmen at annual general meetings and reports of bonus issues or good dividends by companies, etc., whilethese factors, both long-term and short-term, act as macro influences on the corporate sector and the level of stock prices as a whole, there is also a set of micro influences relating to prospects of individual companies such as the reputation of the management, the state of industrial relations in the enterprises, the volume of retained earnings and the related prospects of capitalization of reserves, etc., which have a bearing on the level of prices. In the complex interplay of all these forces, which leads to day-to-day quotation of prices of all listed securities, speculation plays a crucial role. In the absence of speculative operations, every purchase by an investor has to be matched by a sale of the same security by an investor-seller, and this may lead to sharp fluctuation in prices. With speculative sale and purchases taking place continuously, actual sale and purchase by investors on a large scale are absorbed by the market with small changes in prices. There are always some professional operators who are hoping that the prices would rise. There are others predicting that prices will fall. Both these groups acting on their respective assumption buy or sell continuously in the market. Their operation helps to bring about an orderly adjustment of prices. Without these speculative operations, a stock exchange can become a very mechanical thing. However, excessive speculation endangers market equilibrium and must be discouraged through appropriate safeguards. The regulatory authorities should always take necessary precautionary measures to prevent and penalize excessive speculation and to discipline trading. A fact which needs to be emphasized is that the stock exchanges in India also serve the joint sector units as also to some extent public sector enterprises. There is substantial private participation in the share capital of a number of government companies such as Balmer Lawrie, Andrew Yule, Gujarat State Fertilizers Corporation, Gujarat Narmada Fertilizers Corporation, State Bank of India, ICICI, etc. In recent times some of the Central public sector companies have gone in for public debentures through the stock exchanges. Also, there are some public sector companies like VSNL which have made their share capital open for public subscription. Another important function that the stock exchanges in India discharge is of providing a market for gilt-edged securities i.e. securities issued by the Central Government, State government, Municipalities, Improvement Trusts and other public bodies. These securities are automatically listed on the stock exchanges when they are issued and transactions in these take place regularly on the stock exchanges.

Membership, Organisation and Management

By virtue of the century-old tradition, stock exchanges is a highly organized and smooth functioning network in the world. The membership of stock exchanges initially comprised of individuals and partnership firms. Later on companies were also allowed to become members. A number of financial institutions are now members of Indian stock exchanges. Over the years, stock exchanges have been organized in various forms. For example, while the Bombay Stock Exchange, Ahmedabad Stock Exchange and M.P. (Indore) Stock Exchange were organised as voluntary non-profit making association of persons, the Calcutta Stock Exchange, Delhi Stock Exchange, U.P. (Kanpur) Stock Exchange, Ludhiana Stock Exchange, Cochin Stock Exchange, Gauhati Stock Exchange, Jaipur Stock Exchange, and Kanara (Mangalore) Stock Exchange were organised as public limited companies. Quite a few others have been organised as companies limited by guarantee. The internal governance of every stock exchange rests in a Governing Board Comprising Members of the Board and Executive Director/President. Members of the Governing Board include brokers and non-brokers. Governing Bodies of stock exchanges also have government nominees. The Executive Director/President is expected to ensure strict compliance by all members of the exchange of rules/by laws, margin regulations and trading restriction, etc. Subject to the previous approval of SEBI, under the law, Governing Bodies of stock exchanges have wide powers to make bye-laws. Governing Bodies can admit, punish, censure and also expel any member, any partner, any remisier, and authorised clerk and employee. It has the power to adjudicate disputes. Above all, it has the power to make, amend, suspend and enforce rules, by-laws, regulations and supervise the entire functioning of a stock exchange.

Trading System Trading system differ from exchange to exchange. In the next few pages, the trading system followed by the National stock Exchange is described. Students desire to know more about the trading system of other exchanges in India as well as outside India can visit respective web sites of stock exchanges. NSE operates on the 'National

Exchange for Automated Trading' (NEAT) system, a fully automated screen based trading system, which adopts the principle of an order driven market. NSE consciously opted in

favour of an order driven system as opposed to a quote driven system. This has helped reduce jobbing spreads not only on NSE but in other exchanges as well, thus reducing transaction costs. Till the advent of NSE, an investor wanting to transact in a security not traded on the nearest exchange had to route orders through a series of correspondent brokers to the appropriate exchange. This resulted in a great deal of uncertainty and high transaction costs. NSE has made it possible for an investor to access the same market andorder book, irrespective of location, at the same price and at the same cost.

Market Types

The NEAT system has four types of market. They are :

Normal : All orders which are of regular lot size or multiples thereof are traded in the Normal Market. For shares which are traded in the compulsory dematerialised mode, the market lot is one share. Normal market consists of various book types wherein orders are segregated as Regular lot orders, Special Term orders, Negotiated Traded orders and Stop Loss orders depending on their order attributes.

Odd Lot Market : All orders whose order size is less than the regular lot size are traded in the odd-lot market. An order is called an odd lot order if the order size is less than regular lot size. These orders do not have any special terms attributes attached to them. In an odd-lot market, both the price and quantity of both the orders (buy and sell) should exactly match for the trade to take place. Currently the odd lot market facility is used for the Limited Physical Market as per the SEBI directives.

Spot Market : Spot orders are similar to the normal market orders except that spot ordershave different settlement periods vis-à-vis normal market. These orders do not have any special terms attributes attached to them. Currently the Spot Market is being used for the Automated Lending & Borrowing Mechanism (ALBM) session.

Auction Market : In the Auction Market, auctions are initiated by the Exchange on behalfof trading members for settlement related reasons.

There are 3 participants in this market :

Initiator : The party who initiates the auction process is called an initiator.

Competitor : The party who enters orders on the same side as of the initiator is called a Competitor.

Solicitor : The party who enters orders on the opposite side as of the initiator is called a Solicitor.

Order Books The NSE trading system provides complete flexibility to members in the kinds of orders that can be placed by them. Orders are first numbered and time-stampedon receipt and then immediately processed for potential match. Every order has a distinctive order number and a unique time stamp on it. If a match is not found, then the orders are stored in different `books'. Orders are stored in price-time priority in various books in the following sequence: - Best Price - Within Price, by time priority. Price priority means that if two orders are entered into the system, the order having the best price gets the higher priority. Time priority means if two orders having the same price are entered,the order that is entered first gets the higher priority.

The Capital Market segment has following types of books:

Regular Lot Book : The Regular Lot Book contains all regular lot orders that have none ofthe following attributes attached to them.

– All or None (AON)

- Minimum Fill (MF)
- Stop Loss (SL)

Special Terms Book : The Special Terms book contains all orders that have either of the following terms attached:

- All or None (AON)

- Minimum Fill (MF) (Note : Currently, special term orders i.e. AON and MF are not available on the system as per the SEBI directives.)

Negotiated Trade Book : The Negotiated. Trade book contains all negotiated order entries captured by the system before they have been matched against their counterparty trade entries. These entries are matched with identical counterparty entries only. It is to be noted that these entries contain a counterparty code in addition to other order details.

Stop-Loss Book : Stop Loss orders are stored in this book till the trigger price specified in the order is reached or surpassed. When the trigger price is reached or surpassed, the order is released in the Regular lot book. The stop loss condition is met under the following circumstances:

SELL ORDER - A sell order in the Stop loss book gets triggered when the last traded price in the normal market reaches or falls below the trigger price of the order.

BUY ORDER - A buy order in the Stop Loss book gets triggered when the last traded price in the normal market reaches or exceeds the trigger price of the order.

Odd Lot Book : The Odd lot book contains all odd lot orders (orders with quantity less than marketable lot) in the system. The system attempts to match an active odd lot orderagainst passive orders in the book. Currently, pursuant to a SEBI directive, the Odd Lot Market is being used for orders which have a quantity less than or equal to 500 (Qty more than the market lot) for trading. This is referred as the Limited Physical Market (LPM).

Spot Book : The Spot lot book contains all spot orders (orders having only the settlement period different) in the system. The system attempts to match an active spot lot order against the passive orders in the book. Currently the Spot Market book type is being used for conducting the Automated Lending & Borrowing Mechanism (ALBM) session.

Auction Book : This book contains orders that are entered for all auctions. The matchingprocess for auction orders in this book is initiated only at the end of the solicitor period.

Order Matching Rules The best buy order is matched with the best sell order. An order may match partially with another order resulting in multiple trades. For order matching, the best buy order is the one with the highest price and the best sell order is the one with the lowest price. This is because the system views all buy orders available from the pointof view of a seller and all sell orders from the point of view of the buyers in the market. So, of all buy orders available in the market at any point of time, a seller would obviously like to sell at the highest possible buy price that is offered. Hence, the best buy order is the order with the highest price and the best sell order is the order with the lowest price. Members can proactively enter orders in the system which will be displayed in the system till the full quantity is matched by one or more of counter-orders and result into trade(s)or is cancelled by the member. Alternatively, members may be reactive and put in orders that match with existing orders in the system. Orders lying unmatched in the system are `passive' orders and orders that come in to match the existing orders are called `active' orders. Orders are always matched at the passive order price. This ensures that the earlier orders get priority over the orders that come in later.

Order Conditions

A Trading Member can enter various types of orders depending upon his/her requirements. These conditions are broadly classified into three categories: time related conditions, price-related conditions and quantity related conditions.

Time Conditions

- **DAY** - A Day order, as the name suggests, is an order which is valid for the day on which it is entered. If the order is not matched during the day, the order gets cancelled automatically at the end of the trading day.

- **GTC** - A Good Till Cancelled (GTC) order is an order that remains in the system until it is cancelled by the Trading Member. It will therefore be able to span trading days if it does not get matched. The maximum number of days a GTC order can remain in the system isnotified by the Exchange from time to time.

- **GTD** - A Good Till Days/Date (GTD) order allows the Trading Member to specify the days/date up to which the order should stay in the system. At the end of this period the order will get flushed from the system. Each day/date counted is a calendar day and inclusive of holidays. The days/date counted are inclusive of the day/date on which the order is placed. The maximum number of days a GTD order can remain in the system is notified by the Exchange from time to time.

- **IOC** - An Immediate or Cancel (IOC) order allows a Trading Member to buy or sell a security as soon as the order is released into the market, failing which the order will be removed from the market. Partial match is possible for the order, and the unmatched portion of the order is cancelled immediately.

Price Conditions

- **Limit Price/Order** - An order which allows the price to be specified while entering the order into the system.

- **Market Price/Order** - An order to buy or sell securities at the best price obtainable at the time of entering the order.

- **Stop Loss (SL) Price/Order** - The one which allows the Trading Member to place an order which gets activated only when the market price of the relevant security reaches or crosses a threshold price. Until then the order does not enter the market. SELL ORDER A sell order in the Stop Loss book gets triggered when the last traded price in the normal market reaches or falls below the trigger price of the order. BUY ORDER A buy order in the Stop Loss book gets triggered when the last traded price in the normal market reaches or exceeds the trigger price of the order. e.g. If for stop loss buy order, the trigger is Rs. 93.00, the limit price is Rs. 95.00 and the market (last traded) price is Rs. 90.00, then thisorder is released into the system once the market price reaches or exceeds Rs. 93.00. This order is added to the regular lot book with time of triggering as the time stamp, as a limit order of Rs. 95.00

Quantity Conditions

- **Disclosed Quantity (DQ)** - An order with a DQ condition allows the Trading Member to disclose only a part of the order quantity to the market. For example, an order of 1000 with a disclosed quantity condition of 200 will mean that 200 is displayed to the market at a time. After this is traded, another 200 is automatically released and so on till the fullorder is executed. The Exchange may set a minimum disclosed quantity criteria from time to time.

- **MF** - Minimum Fill (MF) orders allow the Trading Member to specify the minimum quantity by which an order should be filled. For example, an order of 1000 units with minimum fill 200 will require that each trade be for at least 200 units. In other words, there will be a maximum of 5 trades of200 each or a single trade of 1000. The Exchange may lay down norms of MF from time to time.

- **AON** - All or None orders allow a Trading Member to impose the condition that only the full order should be matched against. This may be by way of multiple trades. If the full order is not matched it will stay in the books till matched or cancelled.

3.5 STOCK MARKET INFORMATION SYSTEM

Stock exchange quotations and indices published in daily newspapers are the main source of information on stock exchange trades and turnover. Dailies like Economic Times, Financial Express, Business Standard, Business Line, Times of India and Hindustan Times publish daily quotations and indices. As for Bombay Stock Exchange quotations published in Economic Times, information on equity shares, starting from the first column, is presented in the following order: Company's name; previous day's closing price in brackets; all the daily traded prices as published by the BSE ; key financial parameters such as earnings per share (EPS), cash earnings per share (CPS), cash P/E (price to earnings ratio), return on net worth (RN W) and gross profit margin (GPM) etc. on different days; P/E ; and the high and low prices in the preceding 52 weeks. The first traded price is the day's opening price. If only one such price is recorded, it is also the day's closing price. If there are two prices, then the middle quote is either the high or low price. If there are four prices, then one of the middle quotes is the day's high and the other, the low. If there are no transactions in a company's share on any day, the previous day's closing price is presented in brackets. The EPS is the average net profit after tax per equity share and the CPS the average cash profit (after adding back depreciation) per share. The cash P/E is the ratio of the day's closing price to the cash earnings per share as distinct from the P/E ratio, which relates price to the net profit per share. PE values are not printed when earnings are either nil or negative. The RNW is the net profit as a percentage of the net worth and measures the return earned on the shareholders' fund i.e. equity capital plus reserves. The GPM is the gross profit margin (before depreciation and tax) as a percentage of gross sales and measures the company's profit margin which is available to absorb depreciation charges arising from capital expenditure, tax payments, dividend distribution and profit ploughback. All the figurers are taken from the latest available results (audited / unaudited) of the company. The 52-week high and low prices of each share are worked out every day on the basis of the highest and lowest points scaled during the immediately preceding 52 weeks. The high and low prices are adjusted for bonus and rights issue of equity shares. If any of the day's traded price is a yearly high or low, the entire line, including the name of the company, is shown in bold types, with a 'H' attached to the high value or `L' attached to the low value. Whenever there is a significant change in the day's closing value as compared to the previous closing, it is shown in bold types with a `plus' or `minus' sign as the case may be, after the closing value. For specified shares, a three per cent change and for non-specified shares a 15 per cent change is treated as significant. Whenever a share goes ex-divided or ex-bonus or ex-rights, it is indicated by notation XD or XB or XR, as the case may be placed next to its closing price. Symbol of face values other than

Rs. 10. Are also indicated along with the names. Since Indian regulations allow stock splits, a number of firms have face value other than Rs. 10. For debentures, the information starting from the first column, is presented in the following order: the nominal rate of interest on the face value, company name, face value, previous day's closing price, the day's opening price, yield to maturity (YTM) and yield (both annualized). The yield is nominal interest expressed in percentage terms of closing value. The YTM adjusts the nominal return for the maturity period, frequency of interest payments, manner of principal repayment, redemption premium, if any, and thereby enables investors to compare different investment options in debentures on a uniform scale. If there are no quotations for a company's debenture on a day, the opening price is shown as nil, and the closing price the same as the previous day's closing. Besides these quotations share price indices are also published in different dailies. Bombay Stock Exchange's 30- share 'Sensex' and 100 –share `National' indices are quite popular. In addition, NSE-50 (Nifty) has also become popular with institutional and retail investors in recent times. Besides these, there are other indices also which include The Economic Times Index of Ordinary Share Price, Business Standard Index of Ordinary Shares Price and a few others. Reserve Bank of India also publishes Share Price Index.

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4

SECONDARY MARKETS

Unit Structure

4.1 SECONDARY MARKET - MEANING

A secondary market is a platform wherein the shares of companies are traded among investors. It means that investors can freely buy and sell shares without the intervention of the issuing company. In these transactions among investors, the issuing company does not participate in income generation, and share valuation is rather based on its performance in the market. Income in this market is thus generated via the sale of the shares from one investor to another.

Some of the entities that are functional in a secondary market include –

1. Retail investors.
2. Advisory service providers and brokers comprising commission brokers and securitydealers, among others.
3. Financial intermediaries including non-banking financial companies, insurancecompanies, banks and mutual funds.

4.2 NATURE OF SECONDARY MARKET

1. Gives liquidity to all investors. Any seller in need of cash can easily sell the security dueto the presence of a large number of buyers.
2. Very little time lag between any new news or information on the company and the stock price reflecting that news. The secondary market quickly adjusts the price to any new development in the security.
3. Lower transaction costs due to the high volume of transactions.
4. Demand and supply economics in the market assist in price discovery.
5. An alternative to saving.

6. Secondary markets face heavy regulations from the government as they are a vital source of capital formation and liquidity for the companies and the investors. High regulations ensure the safety of the investor's money.

Functions of Secondary Market

1. **Economic Barometer:** A stock exchange is a reliable barometer to measure the economic condition of a country. Every major change in country and economy is reflected in the prices of shares. The rise or fall in the share prices indicates the boom or recession cycle of the economy. Stock exchange is also known as a pulse of economy or economic mirror which reflects the economic conditions of a country.

2. **Pricing of Securities:** The stock market helps to value the securities on the basis of demand and supply factors. The securities of profitable and growth oriented companies are valued higher as there is more demand for such securities. The valuation of securities is useful for investors, government and creditors. The investors can know the value of their investment, the creditors can value the creditworthiness and government can impose taxes on value of securities.

3. **Safety of Transactions:** In stock market only the listed securities are traded and stock exchange authorities include the companies names in the trade list only after verifying the soundness of company. The companies which are listed they also have to operate within the strict rules and regulations. This ensures safety of dealing through stock exchange.

4. **Contributes to Economic Growth:** In stock exchange securities of various companies are bought and sold. This process of disinvestment and reinvestment helps to invest in most productive investment proposal and this leads to capital formation and economic growth.

5. **Spreading of Equity Cult:** Stock exchange encourages people to invest in ownership securities by regulating new issues, better trading practices and by educating public about investment.

6. **Providing Scope for Speculation:** To ensure liquidity and demand of supply of securities the stock exchange permits healthy speculation of securities.

7. **Liquidity:** The main function of stock market is to provide ready market for sale and purchase of securities. The presence of stock exchange market gives assurance to investors that their investment can be converted into cash whenever they want. The investors can invest in long term investment projects without any hesitation, as because of stock exchange they can convert long term investment into short term and medium term.

8. **Better Allocation of Capital:** The shares of profit making companies are quoted at higher prices and are actively traded so such companies

can easily raise fresh capital from stock market. The general public hesitates to invest in securities of loss making companies. So stock exchange facilitates allocation of investor's fund to profitable channels.

9. **Promotes the Habits of Savings and Investment:** The stock market offers attractive opportunities of investment in various securities. These attractive opportunities encourage people to save more and invest in securities of corporate sector rather than investing in unproductive assets such as gold, silver, etc.

4.3 ORGANIZATION OF STOCK EXCHANGES

The first organized stock exchange in India was started in Bombay in 1875 with the formation of the "Native share and Stock Brokers Association". Thus the Bombay Stock Exchange is the oldest one in the country. With the growth of Joint stock companies, the stock exchanges also made a steady growth and at present these are 23 recognized stock exchanges with about 6000 stock brokers.

1. Traditional Structure of stock Exchanges The stock exchanges in India can be classifiedinto two broad groups on the basis of their legal structure.

They are:

1. Three stock exchanges which are functioning as association of person viz., BSE, ASE and Madhya Pradesh Stock Exchange.

2. Twenty stock exchanges which have been set up as companies, either limited by guarantees or by shares.

3. **They are**

1. Bangalore Stock Exchange 2. Bhubaneswar Stock exchange 3. Calcutta Stock Exchange 4. Cochin Stock Exchange 5. Coimbatore Stock Exchange 6. Delhi Stock Exchange 7. Gauhati Stock Exchange 8. Hyderabad Stock Exchange 9. Interconnected Stock Exchange 10. Jaipur Stock Exchange 11. Ludhiana Stock

Exchange 12. Madras Stock Exchange 13. Magadh Stock Exchange 14. Mangalore Stock Exchange 15.National Stock Exchange 16.Pune Stock Exchange 17.OTCEI

2. Demutualization of Stock Exchanges The transition process of an exchange from a ―mutually-owned association to a company ―owned by Shareholders‖ is called demutualization. Demutualization is transforming the legal structure, of an exchange from a mutual form to a business corporation form. In a mutual exchange, the three functions of ownership, management and trading are intervened into a single group. It means that the broker members of the exchange are owners as well as traders on the exchange and further they themselves manage the exchange. These three functions are segregated from one another after demutualization. The demutualised stock exchanges in India are;

1. The National Stock Exchange (NSE)

2. over the Counter Exchange of India (OTCEI)

3. Corporatization of Stock Exchanges The process of converting the organizational structure of the stock exchange from a non-corporate structure to a corporate structure is called Corporatization of stock exchanges. As stated earlier, some of the stock exchanges were established as Association in India of like BSE, ASE and MPSE. Corporatization of these exchanges is the process of converting them into incorporated companies.

Management: The recognized stocks exchanges are managed boards consist of elected member directors from stock broker members, public representatives and government nominees nominated by the SEBI. The government has also powers to nominate Presidents and Vice-presidents of stock exchanges and to approve the appointment of thechief Executive and public representatives. The major stock exchanges are managed by the Chief Executive Director and the smaller stock exchanges are under the control of a Secretary.

Membership: To become a member of a recognized stock exchange, a person must possess the following qualifications:

- He should be a citizen of India,
- He should not be less than 21 years of age,
- He should not have been adjudged bankrupt or insolvent,
- He should not have been convicted for an offence involving fraud or dishonesty,
- He should not be engaged in any other business except dealing in securities,
- He should not have been expelled by any other stock exchange or declared a defaulterby any other stock exchange.

4.4 REGULATORY FRAMEWORK FOR STOCK EXCHANGE IN INDIA

The growth of security market of a country is influenced by the legislative measures taken by that country from time to time. The policy change has great impact on the minds of public which ultimately affects their saving habits. For effective mobilization of funds, it is necessary that the interest of the potential investors should be protected adequately. In the pre-independence, the earliest legislation relating to stock market was introduced in the 19* Century. This legislation was passed in 1865 but it lost its impact due to outbreak of the American Civil War. Thereafter, the Atly Stock Exchange Enquiry Committee was set-up in 1923. This committee in its report, emphasized on necessity of the Stock Exchanges' framing and maintaining a systematic set of rules and regulations in the interest of the general investing public and of the trade itself. The next step towards special legislation for controlling stock markets was Bombay Securities Contracts Control Act, 1925. This Act gave certain powers to government in regard to recognition of Stock exchanges etc. but this act proved ineffective-in regulating security trading and government control there under was nominal, practically. The Bombay Security Contracts Control Act remained in force till the Securities Contract (Regulation) Act, 1956 enacted by the Central Government. The main Acts which effect the Securities markets are Companies Act, 1956, Capital Issues Control Act, 1947, Securities Contract (Regulation) Act, 1956, Securities Contract (Regulation) Rules 1957 and Securities and Exchange Board of India Act, 1992, which was set up as a Securities and Exchange Board of India (SEBI) on April 1988. It took almost four years for the government to bring about a separate legislation in the name of Securities and Exchange Board of India Act, 1992 conferring statutory powers. The Act charged to SEBl with comprehensive powers over practically all aspects of capital market operations. The Securities and Exchange Board of India (SEBI), has emerged as an important constituent of the system that now exists to regulate, control and monitor the Indian Financial System (IFS) as certain powers of some other constituents of this system have been delegated to the SEBl.

Companies Act, 1956

After Independence, the Government of India passed various legislations so that investors can have confidence while investing their savings. With a view to protect the interest of a large number of shareholders and creditors on healthy lines and to help the attainment of the ultimate ends of social and economic policy of the Government, the Companies Act, 1956 was passed. It was not enacted purely from legalistic point of view but it was also passed on the changing social needs of the country. The Companies Act, 1956 which together with its amendments, is the substantive law in our country today and contains a large number of new and startling provisions for public control over the functioning of joint stock companies.

The following are the basic objectives of the Companies Act, 1956:

(a) Minimum assured standard of business integrity and conduct in the promotion andmanagement of companies;

(b) Full and fair disclosure of all reasonable information relating to the affairs of thecompany;

(c) Effective participation and control by shareholders and the protection of theirlegitimate interests;

(d) Enforcement of proper performance of their duties by the company management; and

(e) Power of intervention and investigation into the affairs of companies; they are managed in a manner prejudicial to the interest of the shareholders or to the public interest. A company has to operate with in the legal framework prevailing in the country. The Companies Act deals with the formation and management of new companies. With the growth of joint stock companies, the capital market has taken a new turn in the development of the country.

The Capital Issues (Control) Act, 1947

Another ingredient of regulatory legislation is the Capital Issues (Control) Act, 1947, 3 which prescribes the approval of the Controller of Capital Issues for all issues of capital. It is one of the major instruments through which the Government regulates the working of capital market particularly the new issues. Capital issues control was first introduced

under the Defence of India Rule 94-A which was promulgated on 17* May, 1943 under the Defence of India Act, 1939, Capital Issue Control was retained after the War and Defence Rule 94-A was replaced by the Capital Issues (Continuance of Control) Act, in April, 1947. The main objective of this pragmatic step was to ensure those investments in the country in the various sectors of economy which takes place in a planned manner and in accordance with the priorities laid down in the plans. Despite of it, this legislationhad the following objectives:

a) To protect the investing public;

b) To ensure that investments by the corporate sector were in accordance with the plans and that they were not wasteful and in non-essential channels;

c) To ensure that the capital structure of companies was sound and in the public interest;

d) To ensure that there was no undue congestion of public issues in any part of the year;and

e) To regulate the volume, terms and conditions for foreign investment. For the purpose of achieving the above objectives, an office of the Controller of Capital Issues (CCI) was set-up.

It was entrusted with the responsibility of regulating the capital issues in the Country. The CCI was vested with the powers to approve the kinds of instruments, size, timing and premium of issues. The Capital Issues (Control) Act, (CICA) is only of historical interest now as it was repealed by the Capital Issues (Control) Repeal Act 1992. It played an important part in the functioning of the Indian capital market for as many as 45 years since 1947, and its provisions have now become the powers and functions of the SEBI. Itwas administered by the Controller of Capital Issues (CCI) in the Ministry of Finance, Department of Economic Affairs, Government of India. While the Securities (Control) Repeal Act, (SCRA) mainly regulates the secondary market. The CICA mostly regulates theprimary or new issue market for securities. The Act required companies to obtain prior approval or consent for issues of capital to the public, and for pricing of public and right issues. It empowered the Government of India (GOI) to regulate the timing of new issues by private sector companies, the composition of securities to be issued, interest (dividend) rates, which can be offered on debentures and preference shares, the timing and frequency of bonus issues, the amount of prior allotment to promoters, floatation costs, and the premium to be charged on securities.

The Securities Contract (Regulation) Act, 1956

It was proved over time that the provision in Capital Issues (Control) Act were totally inadequate to regulate the growing dimensions of capital market activity. The government realized the necessity of creating a broad based and a more secure environment for the business to grow. This led to the enactment of Companies Act and Securities Contracts (Regulation) Act in 1956. These legislations contained several provisions relating to the issue of prospectus, disclosure of accounting and financial information and listing of securities etc. The Securities Control (Regulation) Act, 1956 came into force throughout India on 20 Feb, 1957. This Act permits only those exchanges which have been recognized by the Central Government to function in any notified state or area. It prescribes the requirements which a company must comply with before its shares can be listed on any recognized stock exchange in the country. There is no statutory obligation that every public limited company should get its shares listed on a recognized stock exchange. However, a company declaring in the prospectus, its intention of applying for enlistment, is bound Under Section 73 of the Companies Act, to make a listing application to the stock exchange concerned. It is also bound to abide by the prescribed requirements in order to have its shares admitted to dealings failing which; it has to refund the application money to those who have subscribed for the share capital. Further, the Government reserves the powers under section 21 of the Securities Contracts (Regulation) Act, 1956 to compel a Public Limited Company when it is so necessary or expedient, in the interest of the trade or of the public to comply with the prescribed requirements and list its shares on a recognized stock exchange. The objective of the Securities Contracts (Regulation) Act (SCRA) is to regulate the working of stock exchanges or secondary market with a view to prevent undesirable transactions or speculation in securities, and thereby, to build up a healthy and strong investment market in which the public could invest with confidence. It empowers the GOl to recognize and derecognize the stock exchanges, to stipulate laws and by-laws for their functioning, and to make the listing of securities mandatory on stock exchanges by Public Limited Companies (PULCOs). It prohibits securities transactions outside the recognized stock exchanges. It lays down that all contracts in securities except short delivery contracts, can be entered only between and through the members of recognized stock exchanges. It prescribes conditions or requirements for listing of securities on recognized stock exchanges. It empowers the GOI to supersede the governing bodies of stock exchanges, to suspend business on recognized stock exchanges, to declare certain contracts illegal and void under certain circumstances, to prohibit contracts in certain cases, to license the security dealers, and to lay down penalties for contravention of the provision of the

Act. It is administrated by the Ministry of Finance, Department of Economic Affairs, GOI. This Act aims at having a strong and healthy investment market so that members of the public may invest their savings with full confidence.

The Reserve Bank of India (RBI)

The financial system deals in other people's money and, therefore, their confidence, trust and faith in it is crucially important for its smooth functioning. Financial regulation is necessary to generate, maintain and promote this trust. One reason why the public trustmay be lost is that some of the savers or investors or intermediaries may imprudently take too much risk, which could engender defaults, bankruptcies, and insolvencies. A regulation is needed to check prudence in the system. The modern trading technology and the possibility of high leveraging enable market participants to take large stake which are disproportionate with their own investments. There are frequent instances of dishonest, unfair, fraudulent, and unethical practices or activities of the market intermediaries or agencies such as brokers, merchant bankers, custodians, trustees, etc. The regulation becomes necessary to ensure that the investors are protected; that disclosure and access to information are adequate, timely, and equal; that the participants measure upto the rules of the market place; and that the markets are both fair and efficient. To regulate financial system, RBI has special role and responsibility. The RBI, as the central bank of the Countiy, is the centre of Indian financial and monetary system. Asthe apex institution, it has been guiding, monitoring, regulating, controlling, and promoting the destiny of the Indian Financial System (IFS) since its inception. It started functioning from April 1, 1935 on the terms of the Reserve Bank of India Act, 1934. It was a private shareholders' institution till January, 1949, after which, it became a State-owned institution under the Reserve Bank (Transfer to Public Ownership) of India Act, 1948. This Act empowers the Central Government, in consultation with the Governor of the Bank, to issue such directions to it as they might consider necessary in the public interest. Further, the Governor and all the Deputy Governors of the Bank are appointed by the Central Government. The Bank is managed by a Central Board of Directors; four Local Boards are to advise the Central Board on matters referred to them. They are also required to perform duties as are delegated to them. The final control of the Bank vests in the Central Board which comprises the Governor, four Deputy Governors, and fifteen Directors nominated by the Central Government. The committee of the Central Board consists of the Governor, the Deputy Governor and such other Directors as may be present at a given meeting.

Securities and Exchanges Board of India (SEBI) Act, 1992

The year 1991 witnessed a big push being given to liberalization and reforms in the Indian financial sector. For sometime thereafter, the volume of business in the primary and secondary securities markets increased significantly. As part of the same reform process, the globalization or internationalization of the Indian financial system made it vulnerable to external shocks. The multi-crore securities scam rocked the IFS in 1992. All these developments impressed on the authorities the need to have in place a vigilant regulatory body or an effective and efficient watchdog. It was felt that the then existing regulatory framework was fragmented, ill-coordinated, and inadequate and that there was a need for an autonomous, statutory, integrated organization to ensure the smooth functioning of the IFS. The SEBI came into being as a response to these requirements. The SEBI was established on April 12, 1988 through an administrative order, but it became astatutory and really powerful organization only since 1992. The CICA was repealed and the office of the CCl was abolished in 1992, and SEBl was set-up on 21 February, 1992 through an ordinance issued on 30 January, 1992. The ordinance was replaced by the SEBI Act on 4 April, 1992. Certain powers under certain sections of SCRA and CA have been delegated to the SEBI. The regulatory powers of the SEBI were increased through the Securities Laws (Amendment) Ordinance of January, 1995 which were subsequently replaced by an Act of Parliament. The SEBI is under the overall control of the Ministry ofFinance, and has its head office at Mumbai. It has become now a very important constituent of the financial regulatory framework in India. The philosophy underlying the creation of the SEBI is that multiple regulatory bodies for securities industry i.e. the regulatory systems get divided, causing confusion among market participants as to who is really in command. In a multiple regulatory structure, there is also an overlap of functions of different regulatory bodies. Through the SEBI, the regulation model which issought to be put in place in India, is one in which every aspect of securities market regulation is entrusted to a single highly visible and independent organization, which is backed by a statute, and which is accountable to the Parliament and in which investors can have trust.

4.5 DEFECTS IN WORKING OF INDIAN STOCK EXCHANGE

1. **Speculative activities:** Most of the transactions in stock exchange are carry forward transactions with a speculative motive of deriving benefit from short term price fluctuation. Genuine transactions are only less. Hence market is not subject to free interplay of demand and supply for securities.

2. **Insider trading:** Insider trading has been a routine practice in India. Insiders are those who have access to unpublished price-sensitive information. By virtue of their position in the company they use such information for their own benefits.

3. **Poor liquidity:** The Indian stock exchanges suffer from poor liquidity. Though there are approximately 8000 listed companies in India, the securities of only a few companies are actively traded. Only those securities are liquid. This means other stocks have very low liquidity.

4. **Less floating securities:** There is scarcity of floating securities in the Indian stock exchanges. Out of the total stocks, only a small portion is being offered for sale. The financial institutions and joint stock

companies control over 75% of the scrips. However, they do not offer their holdings for sale. The UTI, GIC, LIC etc. indulge more in purchasing than in selling. This creates scarcity of stocks for trading. Hence, the market becomes highly volatile. It is subject to easy price manipulations.

5. **Lack of transparency:** Many brokers are violating the regulations with a view to cheating the innocent investing community. No information is available to investors regarding the volume of transactions carried out at the highest and lowest prices. In short, there is no transparency in dealings in stock exchanges.

6. **High volatility:** The Indian stock market is subject to high volatility in recent years. The stock prices fluctuate from hour to hour. High volatility is not conducive for the smooth functioning of the stock market.

7. **Dominance of financial institutions:** The Indian stock market is being dominated by few financial institutions like UTI, LIC, GIC etc. This means these few institutions can influence stock market greatly. This actually reduces the level of competition in the stock market. This is not a healthy trend for the growth of any stock market.

8. **Competition of merchant bankers:** The increasing number of merchant bankers in the stock market has led to unhealthy competition in the stock market. The merchant bankers help the unscrupulous promoters to raise funds for non- existent projects. Investors are the ultimate sufferers.

9. **Lack of professionalism:** Some of the brokers are highly competent and professional. At the same time, majority of the brokers are not so professional. They lack proper education, business skills, infrastructure facilities etc. Hence they are not able to provide proper service to their clients.

SEBI measures for Secondary Market

SEBI has introduced a wide range of reforms in the secondary market. These can be discussed under the headings, namely, Governing Body of the stock exchange. Infrastructure Development of the stock exchange, Settlement and Clearing, Debt Market Segment, Price Stabilization, Delisting, Brokers; and insider trading.

Governing Body of the stock exchange

1. The Board of directors of stock exchange has to be reconstituted so as to include non- members, public representatives, government representatives to the extent of 50% of total number of members.

2. Capital adequacy norms should be complied with regard to members of various stock exchanges on the basis of their turnover of trade.

3. Working hours of stock exchanges should be from 12 noon to 3 p.m.

4. All recognized stock exchanges should report about their transactions within 24 hours.

Infrastructure Development of Stock Exchange

Sufficient infrastructure should be available in any stock exchange to facilitate trade. For example, National Stock Exchange, (NSE) was set up with sophisticated screen-based trading. SEBI grants recognition only to those new stock exchanges which have online screen-based trading facility.

Settlement and Clearing

SEBI has withdrawn carry forward transactions and introduced certain modified regulations. All stock exchanges should follow the practice of weekly settlement. Apart from this, SEBI has instructed all stock exchanges to set up clearing houses, clearing corporations or settlement guarantee fund for ensuring prompt settlement of the transactions. SEBI has allowed institutional investors, foreign investments, stock brokers to avail the facility of warehousing of trade.

Debt Market Segment

NSE has a wholesale debt market segment to enable the traders to trade in debt instruments. SEBI has allowed the listing of debt instruments of those companies which have not even listed their equity shares previously. Foreign institutional investors have been permitted to invest up to 100 percent of the funds in debt instruments of Indian companies.

Price Stabilization

SEBI keeps a constant watch over the unusual fluctuations in prices. It has instructed the stock exchanges to monitor the prices of newly listed securities. When there is an abnormal price variation in newly listed securities, SEBI would impose additional margin on purchase of such securities. SEBI has also introduced adequate measures to prevent price rigging and circular trading.

Delisting

SEBI has streamlined the norms for delisting of securities from stock exchanges. In case of voluntary delisting from regional stock exchanges, the company would offer to buy the shares from shareholders of the region. Moreover, it also stipulates that the listing fee forthree years be paid by the company concerned at the time of delisting.

Brokers SEBI has regulated the functioning of brokers through the following measures:

1. Each broker and sub-broker should get their names registered with the stock exchange.

2. Capital adequacy norms have been fixed for the brokers in order to ensure their professional competence, financial solvency, etc.

3. A code of conduct has been laid down for their discharge of duties, resulting in the execution of orders, issue of contract note, breach of trust, being fair to clients; and rendering investment advice.

4. Audit of the books of brokers and filing of audit report with SEBI have been made compulsory.

5. Brokers should preserve the books of accounts and other records for a minimum period of five years. SEBI has the right to inspect the books, records and documents of thebrokers.

6. Brokers should disclose transaction price and brokerage separately in the contract notes issued to their clients to ensure transparency in the broker-client relationship.

7. Brokers cannot underwrite more than 5% of public issue.

Overview of National Stock Exchange (NSE)

National Stock Exchange of India Limited (NSE) is the leading stock exchange of India, located in Mumbai, Maharashtra. NSE was established in 1992 as the first dematerialized electronic exchange in the country. NSE was the first exchange in the country to provide a modern, fully automated screenbased electronic trading system which offered easy trading facilities to investors spread across the length and breadth of the country.

Historical Overview

National Stock Exchange was incorporated in the year 1992 to bring about transparencyin the Indian equity markets. Instead of trading memberships being confined to a group of brokers, NSE ensured that anyone who was qualified, experienced and met the minimum financial requirements were allowed to trade. In this context, NSE was ahead of its time when it separated ownership and management of the exchange under SEBI's supervision. Stock price information which could earlier be accessed only by a handful ofpeople could now be seen by a client in a remote location with the same ease. The paperbased settlement was replaced by electronic depository-based accounts and settlement of trades was always done on time. One of the most critical changes involved a robust risk management system that was set in place, to ensure that settlement guarantees would protect investors against broker defaults. NSE was set up by a group of leading Indian financial institutions at the behest of the Government of India to bring transparency to the Indian capital market. Based on the recommendations laid out by the Pherwani committee, NSE was established with a diversified shareholding comprising domestic and global investors. The key domestic investors include Life Insurance Corporation, State Bank of India, IFCI Limited , IDFC Limited and Stock Holding Corporation of India Limited. Key global investors include Gagil FDI Limited, GS Strategic Investments Limited, SAIF II SE Investments Mauritius Limited, Aranda Investments (Mauritius) Pte Limited and PI Opportunities Fund I.[10] The exchange was incorporatedin 1992 as a tax-paying company and was recognized as a stock exchange in 1993 under the Securities Contracts (Regulation) Act, 1956, when P. V. Narasimha Rao was the Prime Minister of India and Manmohan Singh was the Finance Minister. NSE commenced operations in the Wholesale Debt Market (WDM) segment in June 1994. The capital market (equities) segment of the NSE commenced operations in November 1994, while operations in the derivatives segment commenced in June 2000. NSE offers trading, clearing and settlement services in equity, equity derivative, debt, commodity derivatives, and currency derivatives segments. It was the first exchange in India to introduce an electronic trading facility thus connecting the investor base of the entire country. NSE has 2500 VSATs and 3000 leased lines spread over more than 2000 cities across India. NSE was also instrumental in creating the National Securities Depository Limited (NSDL) which allows investors to securely hold and transfer their shares and bonds electronically. It also allows investors to hold and trade in as few as one share or bond. This not only made holding financial instruments convenient but more importantly, eliminated the need for paper certificates and greatly reduced incidents involving forged or fake certificates and fraudulent transactions that had plagued the Indian stock market. The NSDL's security, combined with the transparency, lower transaction prices and efficiency that NSE offered, greatly increased the attractiveness of the Indian stock market to domestic and international investors. NSE EMERGE NSE EMERGE is NSE's new initiative for Small and medium-sized enterprises (SME) & Start-up companies in India.

These companies can get listed on NSE without an Initial public offering (IPO). This platform will help SME's & Startups connect with investors and help them with the raising of funds.[12] In August 2019, the 200th company listed on NSE's SME platform. Markets NSE offers trading and investment in the following segments: Equity: Equity, Indices, Mutual fund, Exchange-traded funds, Initial public offerings, Security Lending and Borrowing etc. Derivatives: Equity Derivatives Currency derivatives, Commodity Derivatives, Interest rate futures Debt: Corporate bonds Overview of Bombay Stock Exchange The BSE, formerly known as the Bombay Stock Exchange Ltd. is an Indian stock exchange located at Dalal Street, Mumbai. Established in 1875, it is Asia's oldest stock exchange. The BSE is the world's 10th largest stock exchange with an overall market capitalization of more than US$2.2 trillion on as of April 2018. Historical Overview While BSE Ltd is now synonymous with Dalal Street, it was not always so. In 1850s, five stock brokers gathered together under Banyan tree in front of Mumbai Town Hall, where Horniman Circle is now situated. A decade later, the brokers moved their location to another leafy setting, this time under banyan trees at the junction of Meadows Street and what was then called Esplanade Road, now Mahatma Gandhi Road. With a rapid increase in the number of brokers, they had to shift places repeatedly. At last, in 1874, the brokers found a permanent location, the one that they could call their own. The new place was, aptly, called Dalal Street (Brokers' Street). The brokers group became an official organization known as "The Native Share & Stock Brokers Association" in 1875. On August 31, 1957, the BSE became the first stock exchange to be recognized by the Indian Government under the Securities Contracts

Regulation Act. In 1980, the exchange moved to the Phiroze Jeejeebhoy Towers at Dalal Street, Fort area. In 1986, it developed the S&P BSE SENSEX index, giving the BSE a means to measure the overall performance of the exchange. In 2000, the BSE used this index to open its derivatives market, trading S&P BSE SENSEX futures contracts. The development of S&P BSE SENSEX options along with equity derivatives followed in 2001 and 2002, expanding the BSE's trading platform. Historically an open outcry floor trading exchange, the Bombay Stock Exchange switchedto an electronic trading system developed by CMC Ltd. in 1995. It took the exchange only 50 days to make this transition. This automated, screen-based trading platform called BSE On-Line Trading (BOLT) had a capacity of 8 million orders per day. Now BSE has raised capital by issuing shares and as on 3 May 2017 the BSE share which is traded in NSE only closed with Rs.999. The BSE is also a Partner Exchange of the United Nations Sustainable Stock Exchange initiative, joining in September 2012. BSE established India INX on 30 December 2016. India INX is the first international exchange of India. BSE launches commodity derivatives contract in gold, silver. Today BSE provides an efficient and transparent market for trading in equity, currencies, debt instruments, derivatives, mutual funds. BSE SME is India's largest SME platform which has listed over 250 companies and continues to grow at a steady pace. BSE StAR MF is India's largest online mutual fund platform which process over 27 lakh transactions per month and adds almost 2 lakh new SIPs ever month. BSE Bond, the transparent and efficient electronic book mechanism process for private placement of debt securities, is the market leader with more than Rs 2.09 lakh crore of fund raising from 530 issuances. (F.Y.2017-2018).

Recent Trends

Keeping in line with the vision of Shri Narendra Modi, Hon'be Prime Minister of Inida, BSE has launched India INX, India's 1st international exchange, located at GIFT CITY IFSC in Ahmedabad. Indian Clearing Corporation Limited, a wholly owned subsidiary of BSE, acts as the central counterparty to all trades executed on the BSE trading platform and provides full innovation, guaranteeing the settlement of all bonafide trades executed. BSE Institute Ltd, another fully owned subsidiary of BSE runs one of the most respected capital market educational institutes in the country. BSE has also launched BSE Sammaan, the CSR exchange, is a 1st of its kind initiative which aims to connect corporate with verified NGOs BSE's popular equity index - the S&P BSE SENSEX - is India's most widely tracked stock market benchmark index. It is traded internationally on the EUREX as well as leading exchanges of the BRCS nations (Brazil, Russia, China and South Africa)

Overview of OTC Exchange of India

The OTC Exchange of India (OTCEI), also known as the Over-the-Counter Exchange of India, is based in Mumbai, Maharashtra. It is India's first exchange for small companies, as well as the first screen-based nationwide stock exchange in India. OTCEI was set up to access high-technology enterprising promoters in raising finance for new product development in a cost-effective manner and to provide a transparent and efficient trading system to investors. OTCEI is promoted by the Unit Trust of India, the Industrial Credit and Investment Corporation of India, the Industrial Development Bank of India, the Industrial Finance Corporation of India, and other institutions, and is a recognized stock exchange under the SCR Act. The OTC Exchange Of India was founded in 1990 under the Companies Act 1956 and was recognized by the Securities Contracts Regulation Act, 1956 as a stock exchange. The OTCEI is no longer a functional exchange as the same has been de-recognized by SEBI vide its order dated 31 Mar 2015. Features of the Over-The- Counter Exchange of India (OTCEI) The OTCEI has some special features that make it a unique exchange in India as well as being a growth catalyst for small- to medium-sized companies.

The following are some of its unique features:

1. Stock Restrictions: Stocks that are listed on other exchanges will not be listed on the OTCEI and conversely, stocks listed on the OTCEI will not be listed on other exchanges.

2. Minimum Capital Requirements: The requirement for the minimum issued equity capital is 30 lakh rupees, which is approximately $40,000.

3. Large Company Restrictions: Companies with issued equity capital of more than 25 crore rupees ($3.3 million) are not allowed to be listed.

4. Member Base Capital Requirement: Members must maintain a base capital of 4 lakh rupees ($5,277) to continue to be listed on the exchange.

Over-The-Counter Exchange of India (OTCEI) Listing Requirements Though the requirements of the OTCEI make it easier for small- to mid-cap sized companies to be listed, there are still some requirements that companies must meet before being allowed to be listed. Listing does require sponsorship from members of the OTCEI and it needs to have two market makers. In addition, once a company is listed, it cannot be delisted for at least three years, and a certain percentage of issued equity capital needs to be kept by promoters for a minimum of three years. This percentage is 20%.

Transactions on the Over-The-Counter Exchange of India (OTCEI) The transactions on the OTCEI revolve around the dealers. Dealers operate in a few capacities, the two most important being as a broker and as a market maker. As a broker, the dealer transacts on behalf of buyers and sellers. As a market maker, the dealer has to ensure the availability of the shares for transaction purposes as well as to ensure that the price remains reasonable through supply and demand levels. In addition to the dealers, the OTCEI also has custodians. The custodian, or settler, is the individual that performs the multitude of administrative tasks necessary for the proper functioning of the OTCEI. These tasks include validating and storing documents as well as facilitating daily clearing transactions. The last group of players consists of the registrars and transfer agents that make sure the correct transfer and allotment of shares take place.

Recent Trends OTC Exchange of India introduced certain new concepts in the Indian trading system:

1. Screen based nationwide trading known as OTCEI Automated Securities IntegratedSystem or OASIS

2. Market Making

3. Sponsorship of companies

4. Trading done in share certificates

5. Weekly Settlement Cycle

6. Short Selling

7. Demat trading through National Securities Depository Limited for convenient paperless trading

8. Tie-up with National Securities Clearing Corporation Ltd for Clearing. Listing of Securities- Meaning Listed Securities are shares, debentures or any other securities that is traded through an exchange such as BSE, NSE, etc. When a private company decides to go public and issue shares, it will need to choose an exchange on which to be listed. To do so, it must be able to meet that exchange's listing requirements and pay both the exchange's entry and yearly listing fees. Listing requirements vary by exchange and include minimum stockholder's equity, a minimum share price and a minimum number of shareholders. Exchanges have listing requirements to ensure that only high quality securities are traded on them and to uphold the exchange's reputation among investors.

Merits of Listing Securities Listing offers advantages to both the investors as well as the companies. Merits of listing of Securities to investors

1. It provides liquidity to investments. Security holders can convert their securities into cash by selling them as and when they require.

2. Shares are traded in an open auction market where buyers and sellers meet. It enables an investor to get the best possible price for his securities.

3. Ease of entering into either buy or sell transactions.

4. Transactions are conducted in an open and transparent manner subject to a well defined code of conduct. Therefore investors are assured of fair dealings.

5. Listing safeguards investor’s interests. It is because listed companies have to provide clear and timely information to the stock exchanges

regarding dividends, bonus shares, new issues of capital, plans for mergers, acquisitions, expansion or diversification of business. This enables investors to take informed decisions.

6. Listed securities enable investors to apply for loans by providing them as collateral security.

7. Investors are able to know the price changes through the price quotations provided bythe stock exchanges in case of listed securities.

8. Listing of shares in stock exchanges provides investors facilities for transfer, registration of rights, fair and equitable allotment. 9. Share holders are provided due notice with regard to book closure dates, and they can take investment decisions accordingly.

Merits of listing to companies

1. Listed securities are preferred by the investors as they have better liquidity.

2. Listing provides wide publicity to the companies since their name is mentioned in stock market reports, analysis in newspapers, magazines, TV news channels. This increases the market for the securities. As Hasting has observed,

3. Listing provides a company better visibility and improves its image and reputation.

4. It makes future financing easier and cheaper in case of expansion or diversification of the business.

5. Growth and stability in the market through broadening and diversification of its shareholding. 6. Listing attracts interest of institutional investors of the country as well as foreign institutional investors. 7. Listing enables a company to know its market value and this information is useful in case of mergers and acquisitions, to arrive at the purchase consideration, exchange ratios etc. 8. By complying with the listing requirements, the operations of the company become more transparent and investor friendly. It further enhances the reputation of the company. Demerits of listing Securities Listing is not without its limitations.

The following are the limitations of listing:

1. Listing might enable speculators to drive up or drive down prices at their will. The violent fluctuations in share prices affect genuine investors.

2. In case of excessive speculation, share prices might not reflect its fundamentals. The stock markets may fail to be the true economic barometer of an economy's performance.

3. In case of bear markets share prices might be hammered down, and the standing of a company might be lowered in the eyes of the investors,

shareholders, bankers, creditors,employees etc.

4. Listing of securities may induce the management and the top level employees to indulge in 'insider trading'by getting access to important information. Such actions adversely affect the common security holders.

5. The management might enter into an agreement with brokers to artificially increase prices before a fresh issue and benefit from that. Common public might be induced to buy shares in such companies, ultimately the prices would crash and the common investors would be left with worthless stock of securities.

6. Listing requires disclosing important sensitive information to stock exchanges such as plans for expansion, diversification, selling of certain businesses, acquisition of certain brands or companies etc. Such information might be used by the competitors to gain advantage.

7. Outsiders might acquire substantial shares in the company and threaten to take over the company or they might demand hefty compensation to sell their shares.

8. Stock exchanges in India still suffer from shortcomings. Listed securities might be utilized by scamsters to indulge in scams.

Objectives of Listing The major objectives of listing are

1. To provide ready marketability and liquidity of a company's securities.
2. To provide free negotiability to stocks.
3. To protect shareholders and investors interests.
4. To provide a mechanism for effective control and supervision of trading.

Listing requirements

A company which desires to list its shares in a stock exchange has to comply with thefollowing requirements:

1. Permission for listing should have been provided for in the Memorandum of Association and Articles of Association.

2. The company should have issued for public subscription at least the minimum prescribed percentage of its share capital (49 percent).

3. The prospectus should contain necessary information with regard to the opening of subscription list, receipt of share application etc.

4. Allotment of shares should be done in a fair and reasonable manner. In case of over subscription, the basis of allotment should be decided by the company in consultation with the recognized stock exchange where the shares are proposed to be listed.

5. The company must enter into a listing agreement with the stock exchange. The listing agreement contains the terms and conditions of listing. It also contains the disclosures that have to be made by the company on a continuous basis.

Minimum Public Offer A company which desires to list its securities in a stock exchange, should offer at least sixty percent of its issued capital for public subscription. Out of this sixty percent, a maximum of eleven percent in the aggregate may be reserved for the Central government, State government, their investment agencies and public financial institutions. The public offer should be made through a prospectus and through newspaper advertisements. The promoters might choose to take up the remaining forty percent for themselves, or allot a part of it to their associates.

Fair allotment Allotment of shares should be made in a fair and transparent manner. In case of over subscription, allotment should be made in an equitable manner in consultation with the stock exchange where the shares are proposed to be listed. In case,the company proposes to list its shares in more than one exchange, the basis of allotment should be decided in consultation with the stock exchange which is located in the place in which the company's registered office is located.

Listing Procedure

1. **Decision about listing on the Exchange:** The company compares the benefits of a presence on the Exchange (the "profit" of the listing) with the challenges connected withit (primarily the disclosure obligations of its presence on the Exchange, but also one-off and ongoing expenses). If the company considers that the benefits outweigh the costs of listing, it may then decide to apply for a listing on the Exchange.

2. **Selection of the contributors:** The first and most important task during the preparatory phase is the selection of the contributing players. Investment firms have a dual role. On the one hand, they carry out advisory services, the preparation of the issue process, and the transaction itself, while on the other hand they offer/sell the securities to the public. In a public offering, they also provide an underwriting guarantee on behalf of the issuer. Fees are generally charges in accordance with these main services. Choosing the right investment firm is of paramount importance since this is the player who will assist the issuer during the entire listing process and who organises this multiplayer and complex negotiation. It is reasonable to select the advising bank (or banks) based on a tender, and selecting the other players together with the advising bank is recommended. The issuer has to make preparations even prior to the selection of the advisor and needs to have knowledge of the qualification criteria and the requirements expected during the selection and listing process. Auditors' responsibility is far larger and far more complex in the case of a public company and transactions resulting in an increase in the number of shareholders. In addition to the traditional audit services, the

auditor prepares a more detailed financial report (the so-called long form report) in the preparation of a listing, and its tasks often include an assessment (but not a certification) of the management's earnings forecasts. Legal advisors deal with the examination of the legal status, significant contracts and legal relationships of the issuer, as well as with the documentation of shareholder rights (statutes, deed of foundation, shareholders' agreements etc.). Legal advisors' main task is to prepare a final report. The role of lawyers is very important in the preparation of a public offering, subscription and underwriting contracts linked to the sale of shares. Given that at this stage of the process the interests of the issuer and of the lead manager may differ, both parties often have their own legal counsel. Marketing and PR advisors provide assistance with the distribution of shares during the public offering and with marketing the securities to potential buyers. These advisors participate in organising road shows preceding the sale of the shares and in providing logistic services. If the company intends to make a simple listing on the Exchange, it is not necessary to involve all of the players listed above – the respective regulation does not require the contribution of an advisor in this case. Still, if a package of new or existing shares is to be sold to the public, contribution of an investment firm has to be involved.

3. **Preparations for listing on the Exchange:** The Company shall prepare not only for the listing, but for the maintenance associated with listing on the Exchange. It is necessary that an appropriate level of investor relations and a harmonisation of the internal corporate processes among the different business units are ensured. It is particularly important in the case of a public offering, but also useful in a simple listing, to devise an appropriate marketing campaign at this stage.

4. **Preparation of a prospectus:** The most important document of a listing is the so-called prospectus. The prospectus shall contain all relevant information on the economic, market, financial and legal situation of the company (and their likely developments in the future), giving investors the widest possible range of information to ensure proper decision-making. The prospectus shall explicitly contain a statement that the shares are to be listed on an Exchange and shall indicate as a prime risk factor, if no investment firms participated in its compilation. The prospectus prepared for a listing on the BSE shall be submitted for approval to the Central Bank of Hungary, which shall make a decision within 20 working days. Issuing the Prospectus can only be done following the MNB's approval. As a consequence of Hungary 's EU membership and on the basis of a "single passport", the BSE also accepts prospectuses approved by the supervisory authority of any other EU member state. The provisions regarding the contents of the prospectus are determined by the respective EU regulation.

5. **Compilation of the listing documentation:** This documentation basically consists of an application, different statements and additional

documents (to assist in this, the Exchange has compiled an application form).

6. **Official submission of the listing documentation to the Exchange (application for listing):** In order to ensure smoother administration, it is recommended that an unofficial draft version of the application be submitted to the Exchange for a preliminary assessment prior to the official submission of listing documentation. This shall be followed by the official submission of the papers already agreed upon.

7. **Public notice of new listing applications:** Subsequent to the receipt of the application, the Exchange issues a public notice informing the market of the receipt of the application.

8. **Review of the application:** The Exchange has 10 Exchange days to review the application and must make a decision within 30 calendar days of its receipt. If necessary, the Exchange may request the issuer to submit any missing documents, and the issuer shall appropriately supplement the documentation within ten working days – in such cases, the deadline for the assessment by the Exchange shall be extended by the period needed to submit the missing documents.

9. **Publications on the Exchange website regarding the listing:** The documents relevant to investors shall be published at least two Exchange days before the listing. 10. If the documentation is complete and appropriate, a decision on listing shall be made (otherwise, the application shall be rejected). 11. First trading day Trading in the shares officially commences on the Exchange.

Delisting of Securities

Delisting of securities means removal of the securities of a listed company from the stockexchange. It may happen either when the company does not comply with the guidelines of the stock exchange, or that the company has not witnessed trading for years, or that itvoluntary wants to get delisted or in case of merger or acquisition of a company with/by some other company. So, broadly it can be classified under two head:

1. compulsory delisting.

2. Voluntary delisting.

Compulsory delisting refers to permanent removal of securities of a listed company from a stock exchange as a penalizing measure at the behest of the stock exchange for not making submissions/comply with various requirements set out in the Listing agreement within the time frames prescribed. In voluntary delisting, a listed company decides on its own to permanently remove its securities from a stock exchange. This happens mainly due to merger or amalgamation of one company with the other or due to the non- performance of the shares on the particular exchange in the market.

A stock exchange may compulsorily delist the shares of a listed company under certain circumstances like:

1. Non-compliance with the Listing Agreement for a minimum period of six months.

2. Failure to maintain the minimum trading level of shares on the exchange.

3. promoters', Directors' track record especially with regard to insider trading, manipulation of share prices, unfair market practices (e.g. returning of share transfer documents under objection on frivolous grounds with a view to creating scarcity of floating stock, in the market causing unjust aberrations in the share prices, auctions, close-out, etc.

4. The company has become sick and unable to meet current debt obligations or to adequately finance operations, or has not paid interest on debentures for the last 2-3 years, or has become defunct, or there are no employees, or liquidator appointed, etc

Where the securities of the company are delisted by an exchange under this method, thepromoter of the company shall be liable to compensate the security-holders of the company by paying them the fair value of the securities held by them and acquiring their securities, subject to their option to remain security-holders with the company. In such acase there is no provision for an exit route for the shareholders except that the stock exchanges would allow trading in the securities under the permitted category for a period of one year after delisting. Companies may upon request get voluntarily delisted from any stock exchange other than the regional stock exchange, following the delisting guidelines. In such cases, the companies are required to obtain prior approval of the holders of the securities sought to be delisted, by a special resolution at a General Meeting of the company. The shareholders will be provided with an exit opportunity by the promoters or those who are in the control of the management.

The SEBI (Delisting of Securities) Guidelines 2003

The SEBI (Delisting of Securities) Guidelines 2003 is the regulating Act framing the guidelines and the procedure for delisting of securities. Under this the prescribed procedure is:

1. The decision on delisting should be taken by shareholders though a special resolution in case of voluntary delisting & though a panel to be constituted by the exchange comprising the following in case of compulsory delisting: Two directors/ officers of the exchange (one director to be a public representative). One representative of the investors. One representative from the Central government (Department of Company Affairs) / regional director/ Registrar of Companies. Executive Director/ secretary of the Exchange

2. Due notice of delisting and intimation to the company as well as other Stock Exchanges where the company's securities are listed to be given. 3. Notice of termination of the Listing Agreement to be given.

3. making an application to the exchange in the form specified, annexing a copy of the special resolution passed by the shareholders in case of voluntary delisting.

4. Public announcement to be made in this regard with all due information.

❖❖❖❖

5

EMERGING MARKETS AND PRODUCTS

Unit Structure

5.0 LEARNING OBJECTIVES

After studying this unit, you will be able:

- To discuss the concept of Emerging Markets and Products
- To understand alternate finance products and players
- To explain Crowdfunding
- To discuss Product to product finance
- To describe Interest-free financial products
- To understand Thematic indexes

5.1 INTRODUCTION

An economy of a developing country that is expanding and becoming increasingly integrated with international markets is known as an emerging market economy. Countries possessing some but not all of a developed market's features are categorised as emerging market economies.

Strong economic development, high per capita income, liquid equities and debt markets, accessibility to foreign investors, and a stable regulatory structure are some traits of developed markets.

An emerging market economy often integrates more into the global economy as it grows. This implies that it may result in higher trade volume, foreign direct investment, and increased liquidity in the local debt and equity markets. It can create cutting-edge regulatory and financial entities. Currently, significant emerging market nations include Saudi Arabia, China, Brazil, Mexico, Russia, and Pakistan.

A significant transition from a low income, less developed, frequently pre-industrial economy to a modern, industrial economy with a greater standard of living is occurring in an emerging market economy.

5.2 CONCEPT OF EMERGING MARKETS AND PRODUCTS

"Emerging markets" is a term that refers to an economy that experiences considerable economic growth and possesses some, but not all, characteristics of a developed economy. Emerging markets are countries that are transitioning from the "developing" phase to the "developed" phase.

Characteristics of Emerging Markets

Some common characteristics of emerging markets are illustrated below:

1. Market volatility

Political unrest, changes in external prices, and/or supply-demand shocks as a result of natural disasters are the main causes of market volatility. Investors are subjected to the risk of changing currency rates and market performance.

2. Growth and investment potential

Because they can offer a high rate of return on investment, emerging markets are frequently appealing to overseas investors. Countries sometimes require a sizable injection of cash from foreign sources during the transition from an agriculture-based economy to a sophisticated economy due to a lack of native capital.

By utilising their comparative advantage, these nations concentrate on exporting inexpensive items to wealthy countries, which increases GDP growth, stock prices, and investment profits.

3. High rates of economic growth

Emerging market governments frequently enact laws that encourage industrialisation and rapid economic expansion. Such measures result in lower unemployment, greater per capita disposable income, increased investments, and improved infrastructure. On the other hand, developed nations with early industrialisation, like the USA, Germany, and Japan, have low rates of economic growth.

4. Income per capita

Due to their reliance on agricultural industries, emerging markets typically have low-middle per capita incomes in comparison to other nations. Income per capita rises with GDP as the economy pursues industrialization and manufacturing activity. Higher economic growth is also encouraged by lower average wages.

Is India an Emerging market?

India's 7.3% growth in the Financial Year 23 made it a "Star" among the emerging market economies.

India's foreign policies up until a few years ago were primarily defensive. In order to open up the economy and make India an appealing location for foreign investors, the government has implemented a number of adjustments to the foreign direct investment (FDI) policy after realising the need for a relaxation of foreign investment laws.

The government cleared the path for an internationally acclaimed investment structure in India with the implementation of legislation governing real estate investment trusts, alternative investment funds, and infrastructure investment trusts by the Securities and Exchange Board of India.

According to the S&P, the global macroeconomic performance during the upcoming quarters indicates that growth will slow down due to tightening financial circumstances brought on by central banks raising interest rates. It further stated that the majority of leading and sentiment indicators also pointed to slower growth.

It stated, "We are now expecting a mild recession in the US," adding that rising rates, increased European energy insecurity, and the lingering effects of COVID-19 are affecting growth almost everywhere. This suggests that central banks' aggressive rate increases to combat inflation may not prevent generating a sharp downturn. Though the numbers have not yet fully converged, this economic slowdown may be the biggest predicted on record.

Risk factors in an emerging economy:

Political unrest is a major factor in the development of the emerging economy. An emerging economy's development is impacted by rising geopolitical, shifting societal attitudes, and environmental threats. For instance, the Turkish economy has suffered as a direct result of the Syrian refugee crisis.

Since their stocks can be unpredictable and a variety of factors, including inflationary pressures, rising interest rates, and indications of a global economic slowdown, could have a negative impact on the investment environment in such markets, emerging markets are riskier than most developed economies. However, these emerging nations also offer the potential for rapid economic growth and higher returns on investment. India is also a safe bet among its peers due to its strong, diversified, and well-regulated financial system as well as its favourable demographics.

5.3 ALTERNATE FINANCE PRODUCTS AND PLAYERS

Crowdfunding, product-to-product financing, interest-free financial products, and theme indexes are only a few examples of alternative finance products and players.

The following financial products are examples of alternative finance products:

5.3.1 Crowdfunding:

Crowdfunding is a method of raising capital to sponsor endeavours and companies. Fundraisers can use online platforms to gather money from a sizable audience. Startups and expanding enterprises most frequently use crowdfunding as a means of obtaining alternative capital.

GoFundMe:

One example of crowdfunding is GoFundMe. Although GoFundMe is best known for being utilised for more altruistic causes, companies can also benefit from the site. It is a donation-based crowdfunding organisation. For corporations and charitable groups with service-based projects, this is a fantastic choice.

How Does Crowdfunding Work?

Websites that facilitate communication between fundraisers and the public are known as crowdfunding platforms. The crowdfunding platform can be used to solicit and collect financial pledges.

If the fundraising campaign is successful, crowdfunding platforms typically charge fundraisers a fee. Platforms for crowdfunding are required to offer a safe and simple service in exchange.

A funding strategy that is all-or-nothing is used by many platforms. This implies that if you meet your goal, you will receive the money, and if not, everyone will receive their money back with no repercussions or financial loss.

There are several different sorts of crowdsourcing, which are described here. This article offers unbiased guidance to help you comprehend the three forms of crowdfunding that profitable SMEs and start-ups most frequently use: equity, peer-to-peer, and rewards crowdfunding.

There are followings type of Crowdfunding:

Peer-to-peer lending:

With the idea that interest will be added to the loan, the public lends money to a business. It is fairly comparable to regular bank borrowing, with the exception that you borrow from several investors instead.

Equity crowdfunding:

Sale of a portion of a company to several investors in exchange for capital. The concept is comparable to the purchase or sale of common stock on a stock exchange or to a venture capitalist.

Rewards-based crowdfunding:

A non-financial reward, such as goods or services, is typically expected in compensation for a person's contribution when they donate to a cause or business.

Donation-based crowdfunding:

Individuals donate small amounts to meet the larger funding aim of a specific charitable project while receiving no financial or material return.

Profit-sharing / revenue-sharing:

Businesses may accept investment from the public in exchange for a share of their future earnings or sales.

Debt-securities crowdfunding:

Investors buy bonds or other debt securities that the company has issued.

Hybrid models:

Give companies the option to combine components of several crowdfunding models.

5.3.2 Product to Product finance :

A financial product is a tool that enables someone to save money, make an investment, or borrow money.

Contracts that are purchased and sold on a market are, in essence, what financial products are. This is a rather broad description because financial products, also known as financial vehicles, are varied and come in many different shapes and sizes.

The fundamental idea behind a financial product is that it enables you to change your fiat currency into something that can be exchanged for other goods and services on a market. There are various categories under which financial items might be placed.

There are 4 major types of financial products **bought and sold on markets:**

1. Securities,
2. Derivatives,
3. Commodities
4. Currencies.

Securities:

An instrument used to directly finance businesses, banks, public institutions, or governments is known as a security. Securities essentially represent a right to something, such as an asset or a contract.

According to the quantity of securities that they have, security is guaranteed anything. Long-term or short-term securities are available, and the funds utilised to buy them are used to directly finance various companies.

Stocks:

Stocks, which represent a share of ownership in a company, are likely the most popular type of security. You purchase a stake in a corporation when you purchase a stock.

Typically, stock ownership includes the ability to vote on certain company matters. You are entitled to a piece of the value of the entire company because stocks reflect ownership. To raise money for operations, businesses sell stock to private investors.

Depending on the state of the market, the value of stocks may increase or decrease. The main way that investors make money is by purchasing stocks, holding them until their value rises, and then selling them for a profit.

Bonds:

Bonds are essentially loans that an individual makes to a business, a government, or a public organisation. Bonds are sold by firms to fund operations, similar to stocks.

Bonds are regarded as long-term investments, and their typical maturity dates range from 20 to 35 years. Bond markets are less risky than stock markets, but as a result, they offer lower returns because the primary way to profit from bonds is through interest payments rather than capital gains.

Mutual Funds:

A unique sort of financial vehicle called a mutual fund consists of a number of investors pooling their capital to buy securities.

The advantage of mutual funds is that they enable investors to pool their assets to purchase more than one thing.

Since mutual funds can contain a variety of financial products, including cash instruments, the debt of insurance firms, foreign exchange, shares, and derivatives, they can be difficult to categorise.

Derivatives:

A derivative is a class of security that derives its value from a single or collection of single securities. A derivative is a contract between a buyer and a seller, and its price fluctuates in response to changes in the value of the underlying asset (known as the benchmark).

Commodities:

A sort of financial product known as a commodity denotes ownership or a share of a certain tangible good or raw material.

As a rule, trading in commodities entails things like precious metals (gold, silver, platinum) or natural resources (coal, oil, natural gas, etc.), but it is also possible to trade in so-called "soft" commodities, such as agricultural goods or cattle.

Currencies

Since currencies can be exchanged on a market, even though they are typically not thought of as a separate asset class or financial product, we are included them in this list. On foreign exchanges (or cryptocurrency exchanges), currencies are swapped, allowing users to change one sort of currency into another. Since various nations and organisations need to deal with one another, currency trading is essentially a requirement.

5.3.3 Interest-free financial products:

Loans that have no interest due are known as interest-free loans. Only the original principal must be paid back to the lender in the case of interest-free loans. To give protection in the event that they are unable to make loan payments, many customers opt to get loan protection insurance.

The Reserve Bank of India (RBI) is now looking into the idea of providing interest-free banking in the nation in order to increase financial inclusion in the nation.The Reserve Bank of India (RBI) is now looking into the idea of providing interest-free banking in the nation in order to increase financial inclusion in the nation..

Instead of providing cash loans under the interest-free banking system, the lender purchases and leases the item for which a loan is needed, earning rental income in the process. Islamic banking follows a similar tenet, and a few foreign lenders, including the National Development Bank and others, have been in contact with the regulator to request permission to establish an Islamic Bank in the nation.

These lenders think that this type of banking can be useful in helping to provide credit, particularly to those parts of the small and medium enterprise segment that banks might not feel particularly comfortable lending to due to the credit risk associated or the little amount of loans.

5.3.4 Thematic indexes:

Sector indices focus on a single sector, whereas thematic indices choose companies from a variety of sectors that fit a theme. Usually, a sector index will focus on the banking, chemical, or construction industries.

Investment managers use the data they have obtained from researching megatrends to establish a thematic index when developing strategies for global thematic investment.

The goal of thematic investing is to identify long-term structural patterns that will result in strong economic growth and a positive return on investment. After identifying these tendencies, it's critical to have a way to monitor the development and performance of the strategy. Thematic investment moves from study and planning to actual investment in this way. This transition is made possible using a topical index. Investors can target their investments appropriately and have a way to gauge their performance by monitoring the performance of businesses related to the subject they have chosen.

Every mutual fund has an underlying asset that generates income. The underlying assets in the case of large-cap funds are the equities of several of India's largest corporations based on market capitalization. Similar to this, thematic funds have underlying assets that are stocks of firms that are connected by a predetermined theme.

Thematic funds differ from traditional investment strategies like those focused on market capitalization (large-cap, mid-cap, small-cap), style (value & growth), or sectoral investing because of this (pharma, technology, infrastructure). As long as it links to the topic, it makes investments across a range of industries and market caps. Additionally, according to SEBI, 80% of total assets must be invested in equities and equity-related securities of a specific subject.

Who Should Invest in Thematic Funds?

Investors with High-Risk Appetite:

One of the riskiest types of mutual fund is thematic funds. That's because the range of investing opportunities is constrained when a portfolio is constructed with a theme in mind. It would have to invest only in those stocks that are related to that theme.

Investors Seeking Returns in the Long Term:

Sometimes it takes time for a theme to reach its full potential. For instance, since the early 1990s, we have known that software and internet technology have enormous promise. But it's only now, 20 years later, that we can truly see these concepts in action. As a result, turning these topics into profitable investments takes time and perseverance. Thematic funds may be a smart choice for you if you're an investor searching for solid returns over the long term. At the beginning of their investment adventure, novice investors are advised against investing straight into thematic funds.

Well-Informed and Evolved Investors:

A thematic fund's portfolio comprises of stocks from companies in various industries relevant to its topic. Not every investor would be familiar with how each of these sectors is developing. You can decide whether certain sectors can help you earn good returns when you have a basic understanding of them in relation to the fund's subject. Thematic funds are thus a good option for investors who routinely read the news and have a talent for researching a wide range of industries. Investors can decide whether to invest in a theme by keeping tabs on many regions and gaining insightful information.

Taxation on Thematic Funds:

- **Short Term Capital Gain Tax (STCG):** If you sell your investments within 1 year, the gains are classified as Short-Term Capital Gain (STCG), and you need to pay 15% tax on them.

- **Long Term Capital Gain Tax (LTCG):** Whereas any thematic investment held for more than one year, the gains are classified as taxed Term Capital Gain (LTCG). Gains of up to 1 lakh in a financial year are tax-free. Beyond 1 lakh, the gains are taxed at a rate of 10%.

5.4 SUMMARY

- "Emerging markets" is a term that refers to an economy that experiences considerable economic growth and possesses some, but not all, characteristics of a developed economy.
- India's 7.3% growth in the Financial Year 23 made it a "Star" among the emerging market economies.
- Political unrest is a major factor in the development of the emerging economy.
- Startups and expanding enterprises most frequently use crowdfunding as a means of obtaining alternative capital.
- The fundamental idea behind a financial product is that it enables you to change your fiat currency into something that can be exchanged for other goods and services on a market.
- Sector indices focus on a single sector, whereas thematic indices choose companies from a variety of sectors that fit a theme.

5.5 UNIT END QUESTIONS

A. Descriptive Questions:

Short Answers:

1. What are Emerging Markets? Discuss its characteristics.

2. Enumerate **Risk factors in an emerging economy**.

3. Discuss alternate finance products and players.

4. How Does Crowdfunding Work?

5. Who Should Invest in Thematic Funds?

B. Fill in the blanks:

1. Loans that have no interest due are known as……………..

2. …………….. is a major factor in the development of the emerging economy.

3. …………….. is a method of raising capital to sponsor endeavours and companies.

4. STCG stands for ………………..

5. Gains of up to ……………. in a financial year are tax-free in thematic funds.

Answers:

1- interest-free loans, 2- Political unrest, 3- Crowdfunding, 4- Short-Term Capital Gain, 5- 1 lakh

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6

DERIVATIVES

Unit Structure

6.0 INTRODUCTION

The past decade has witnessed the multiple growths in the volume of international trade and business due to the wave of globalization and liberalization all over the world. As a result, the demand for the international money and financial instruments increased significantly at the global level. In this respect, changes in the interest rates, exchange rates and stock market prices at the different financial markets have increased the financial risks to the corporate world. Adverse changes have even threatened the very survival of the business world. It is, therefore, to manage such risks; the new financial instruments have been developed in the financial markets, which are also popularly known as financial derivatives.

The basic purpose of these instruments is to provide commitments to prices for future dates for giving protection against adverse movements in future prices, in order to reduce the extent of financial risks. Not only this, they also provide opportunities to earn profit for those persons who are ready to go for higher risks. In other words, these instruments, indeed, facilitate to transfer the risk from those who wish to avoid it to those who are willing to accept the same.

Today, the financial derivatives have become increasingly popular and most commonly used in the world of finance. This has grown with so phenomenal speed all over the world that now it is called as the derivatives revolution. In an estimate, the present annual trading volume of derivative markets has crossed US $ 30,000 billion, representing more than 100 times gross domestic product of India.

Financial derivatives like futures, forwards options and swaps are important tools to manage assets, portfolios and financial risks. Thus, it is essential to know the terminology and conceptual framework of all these financial derivatives in order to analyze and manage the financial risks.

The prices of these financial derivatives contracts depend upon the spot prices of the underlying assets, costs of carrying assets into the future and relationship with spot prices. For example, forward and futures contracts are similar in nature, but their prices in future may differ. Therefore, before using any financial derivative instruments for hedging, speculating, or arbitraging purpose, the trader or investor must carefully examine all the important aspects relating to them.

6.2 DEFINITIONS OF DERIVATIVES

The term "Derivative" indicates that it has no independent value, i.e., its value is entirely derived from the value of the underlying asset. The underlying asset can be securities, commodities, bullion currency, livestock or anything else. In other words, derivative means forward, futures, option or other hybrid contract of predetermined fixed duration, linked for the purpose of contract fulfilment to the value of a specified real or financial asset or to an index of securities. The Securities Contracts (Regulation) Act 1956 defines"derivative" as under:

"Derivative" includes:

- Security derived from a debt instrument, share, loan whether secured or unsecured, risk instrument or contract for differences or any other form of security.
- A contract which derives its value from the prices, or index of prices of underlyingsecurities.

The above definition conveys that: The derivatives are financial products. Derivative is derived from another financial instrument/contract called the underlying. In the case of Nifty futures, Nifty index is the underlying. A derivative derives its value from the underlying assets. Accounting Standard SFAS 133 defines a derivative as, 'a derivative instrument financial derivative or other contract with all three of the following characteristics: It has

(1) one or more underlying, and

(2) one or more notional amount or payments provisions or both. Those terms determinethe amount of the settlement or settlements.

It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contract that would be expected to have a similar responseto changes in market factors.

Its terms require or permit net settlement. It can be readily settled net by means outside the contract or it provides for delivery of an asset that puts the recipients in a position not substantially different from net settlement.

The term "financial derivative" relates with a variety of financial instruments which include stocks, bonds, treasury bills, interest rate, foreign currencies and other hybrid securities. Financial derivatives include futures, forwards, options, swaps, etc. Futures contracts are the most important form of derivatives, which are in existence long before the term 'derivative' was coined. Financial derivatives can also be derived from a combination of cash market instruments or other financial derivative instruments. In fact, most of the financial derivatives are not revolutionary new instruments rather they are merely combinations of older generation derivatives and/or standard cash market instruments.

In the 1980s, the financial derivatives were also known as off-balance sheet instruments because no asset or liability underlying the contract was put on the balance sheet as such. Since the value of such derivatives depend upon the movement of market prices of the underlying assets, hence, they were treated as contingent asset or liabilities and such transactions and positions in derivatives were not recorded on the balance sheet. However, it is a matter of considerable debate whether off-balance sheet instruments should be included in the definition of derivatives. Which item or product given in the balance sheet should be considered for derivative is a debatable issue.

6.3 FEATURES OF A FINANCIAL DERIVATIVES

As observed earlier, a financial derivative is a financial instrument whose value is derived from the value of an underlying asset; hence, the name 'derivative' came into existence. There are a variety of such instruments which are extensively traded in the financial markets all over the world, such as forward contracts, futures contracts, call and put options, swaps, etc. A more detailed discussion of the properties of these contracts will be given later part of this lesson. Since each financial derivative has its own unique features, in this section, we will discuss some of the general features of simple financial derivative instrument. The basic features of the derivative instrument can be drawn from the general definition of a derivative irrespective of its type. Derivatives or derivative securities are future contracts which are written between two parties (counter parties) and whose value are derived from the value of underlying widely held and easily marketable assets such as agricultural and other physical (tangible) commodities, or short term and long term financial instruments, or intangible things like weather, commodities price index (inflation rate), equity price index, bond price index, stock market index, etc. Usually, the counter parties to such contracts are those other than the original issuer (holder) of the underlying asset. From this definition, the basic features ofa derivative may be stated as follows:

1. A derivative instrument relates to the future contract between two parties. It means there must be a contract-binding on the underlying parties and the same to be fulfilled in future. The future period may be short or long depending upon the nature of contract, for example, short term interest rate futures and long term interest rate futures contract.

2. Normally, the derivative instruments have the value which derived from the values of other underlying assets, such as agricultural commodities, metals, financial assets, intangible assets, etc. Value of derivatives depends upon the value of underlying instrument and

which changes as per the changes in the underlying assets, and sometimes, it may be nil or zero. Hence, they are closely related.

3. In general, the counter parties have specified obligation under the derivative contract. Obviously, the nature of the obligation would be different as per the type of the instrument of a derivative. For example, the obligation of the counter parties, under the different derivatives, such as forward contract, future contract, option contract and swap contract would be different.

4. The derivatives contracts can be undertaken directly between the two parties or through the particular exchange like financial futures contracts. The exchange- traded derivatives are quite liquid and have low transaction costs in comparison to tailor-made contracts. Example of exchange traded derivatives are Dow Jones, S&P 500, Nikki 225, NIFTY option, S&P Junior that are traded on New York Stock Exchange, Tokyo Stock Exchange, National Stock Exchange, Bombay Stock Exchangeand so on.

5. In general, the financial derivatives are carried off-balance sheet. The size of the derivative contract depends upon its notional amount. The notional amount is the amount used to calculate the pay off. For instance, in the option contract, the potential loss and potential payoff, both may be different from the value of underlying shares, because the payoff of derivative products differs from the payoff that their notional amount might suggest.

6. Usually, in derivatives trading, the taking or making of delivery of underlying assets is not involved; rather underlying transactions are mostly settled by taking offsetting positions in the derivatives themselves. There is, therefore, no effective limit on the quantity of claims, which can be traded in respect of underlying assets.

7. Derivatives are also known as deferred delivery or deferred payment instrument. It means that it is easier to take short or long position in derivatives in comparison to other assets or securities. Further, it is possible to combine them to match specific, i.e., they are more easily amenable to financial engineering.

8. Derivatives are mostly secondary market instruments and have little usefulness in mobilizing fresh capital by the corporate world; however, warrants and convertibles are exception in this respect.

9. Although in the market, the standardized, general and exchange-traded derivatives are being increasingly evolved, however, still there are so many privately negotiated customized, over-the-counter (OTC) traded derivatives are in existence. They expose the trading parties to operational risk, counter-party risk and legal risk. Further, there may also be uncertainty about the regulatory status of such derivatives.

10. Finally, the derivative instruments, sometimes, because of their off-balance sheet nature, can be used to clear up the balance sheet. For

example, a fund manager who is restricted from taking particular currency can buy a structured note whose coupon is tied to the performance of a particular currency pair.

6.4 PRODUCTS OF DERIVATIVES

In this section, we discuss a range of derivatives products that derive their values from the performance of five underlying asset classes: equity, fixed-income instrument, commodity, foreign currency and credit event. However, given the speed of financial innovation over the past two decades, the variety of derivatives products have grown substantially. Thus, a few key examples will be discussed below:

Equity Derivatives :

Equity futures and options on broad equity indices are perhaps the most commonly citedequity derivatives securities. Way back in 1982, trading of futures based on S&P's composite index of 500 stocks began on the Chicago Mercantile Exchange (CME). Options on the S&P 500 futures began trading on the CME in the following year. Today, investors can buy futures based on benchmark stock indices in most international financial centres. Index futures contract enable an investor to buy a stock index at a specified date for a certain price. It can be an extremely useful hedging tool.

For example : An investor with a stock portfolio that broadly matches the composition ofthe Hang Seng index (HSI), he will suffer losses should the HSI record a fall in market value in the near future. Since he means to hold the portfolio as a long term strategy, he is unwilling to liquidate the portfolio. Under such circumstances, he can protect his portfolio by selling HSI futures contracts so as to profit from any fall in price. Of course, ifhis expectations turned out to be wrong and the HSI rose instead, the loss on the hedge would have been compensated by the profit made on the portfolio. Some investors prefer to purchase options on futures (or "futures options") instead of straight futures contracts. The option strike price is the specified futures price at which the future is traded if the option is exercised. For some market participants, the pricing of an option reveal valuable information about the likely future volatility of the returns of the underlying asset.

One commonly cited example is the Chicago Board Options Exchange Market Volatility Index (VIX index), which is calculated based on a range of options on the S&P 500 index. When investors are concerned about a potential drop in the US stock market, they buy the VIX index as an insurance against losses in the value of their portfolio. The more investors demand, the higher the price of the VIX. As such, the VIX can be viewed as an "investor fear gauge".

Other commonly traded equity derivatives are equity swaps. Under an equity swap contract, an investor pays the total return on a stock to his counterparty and receives in return a floating rate of interest. With this equity swap, the investor can hedge his equity position without giving up ownership of his share. At the same time, the party receiving equity return enjoys exposure without actually taking ownerships of shares.

6.5 INTEREST RATE DERIVATIVES

One of the most popular interest rate derivatives is interest rate swap. In one form, it involves a bank agreeing to make payments to a counterparty based on a floating rate in exchange for receiving fixed interest rate payments. It provides an extremely useful tool for banks to manage interest rate risk. Given that banks' floating rate loans are usually tied closely to the market interest rates while their interest payments to depositors are adjusted less frequently, a decline in market interest rates would reduce their interest income but not their interest payments on deposits. By entering an interest rate swap contract and receiving fixed rate receipts from counterparty, banks would be less exposed to the interest rate risk. Meanwhile, interest rate futures contract allows a buyer to lock in a future investment rate.

Commodity Derivatives

The earliest derivatives markets have been associated with commodities, driven by the problems about storage, delivery and seasonal patterns. But modern day commodity derivatives markets only began to develop rapidly in the 1970s. During that time, the break-up of the market dominance of a few large commodity producers allowed price movements to better reflect the market supply and demand conditions. The resulting price volatility in the spot markets gave rise to demand of commodity traders for derivatives trading to hedge the associated price risks.

Foreign Exchange Derivatives

The increasing financial and trade integration across countries have led to a strong rise in demand for protection against exchange rate movements over the past few decades. A very popular hedging tool is forward exchange contract. It is a binding obligation to buy or sell a certain amount of foreign currency at a pre-agreed rate of exchange on a certain future date. Consider a Korean shipbuilder who expects to receive a $1 million payment from a US cruise company for a boat in 12 months. Suppose the spot exchange rate is 1,200 won per dollar today. Should the won appreciate by 10 per cent against the dollar over the next year, the Korean shipbuilder will receive only 1,090 millions of won (some 109 millions of won less than he would have received today). But if the shipbuilder can hedge against the exchange risk by locking in buying dollars forwards at the rate of say 1,100 won per dollar. For thinly trade currencies or currencies of those countries with restrictions on capital account transactions, the profit or loss resulting from the forwards transaction can be settled in an international currency. This is the so-called non-deliverable forwards contract, and very often they are traded offshore. Another type of foreign exchange derivatives are cross-currency swaps. This involves two parties exchanging payments of principal (based on the spot rate at inception) and interest in different currencies. According to many market participants, having a liquid cross- currency swap market is an important for local currency bond market developments.

This is because such instruments allow foreign borrowers in local bond markets to swapback their proceeds to their own currencies while hedging against the interest rate risk.

Credit Derivatives

A credit derivative is a contract in which a party (the credit protection seller) promises a payment to another (the credit protection buyer) contingent upon the occurrence of a credit event with respect to a particular entity (the reference entity). A credit event in general refers to an incident that affects the cash flows of a financial instrument (the reference obligation). There is no precise definition, but in practice, it could be filing for bankruptcy, failing to pay, debt repudiation or moratorium.

The fastest growing type of credit derivatives over the past decade is credit default swap (CDS). In essence, it is an insurance policy that protects the buyer against the loss of principal on a bond in case of a default by the issuer. The buyer of CDS pays a periodic premium to the seller over the life of the contract. The premium reflects the buyer's assessment of the probability of default and the expected loss given default. In its simplest form, the CDS is written with respect to one single reference entity, the so called single- name CDS. Some data providers compile indices of a basket of single-name CDSs of similar ratings (e.g., the S&P US Investment Grade CDS Index consists of 100 equally weighted investment grade US corporate credits). These index trenches give investors the opportunity to take on exposures to specific segments of the CDS index default loss distribution.

Participants and Functions

Banks, financial institutions, corporate, brokers and individuals are the participants of the derivative market in India. It is observed that financial derivatives are those assets whose values are determined by the value of some other assets, called as the underlying. Presently, there are bewilderingly complex varieties of derivatives already in existence, and the markets are innovating newer and newer ones continuously. Now let us discuss the various participants and economic functions of derivative market in the following sub-sections:

Participants in a Derivative Market : The derivatives market is similar to any other financial market and has following three broad categories of participants:

- **Hedgers:** These are investors with a present or anticipated exposure to the underlying asset which is subject to price risks. Hedgers use the derivatives markets primarily for price risk management of assets and portfolios. Example: An importer has to pay US $ to buy goods and rupee is expected to fall to Rs. 50/$ from Rs. 48/$, then the importer can minimize his losses by buying a currency future at Rs. 49/$.

- **Speculators:** These are individuals who take a view on the future direction of the markets. They take a view whether prices would rise or fall in future and accordingly buy or sell futures and options to try and make a profit from the future price movements of the underlying asset. Example: If you will the stock price of Reliance is expected to go up to Rs. 400 in 1 month, one can buy a 1 month future of Reliance at Rs. 350 and make profits.

- **Arbitragers:** These are the third important participants in the derivatives market. They take positions in financial markets to earn risk less profits. The arbitragers take short and long positions in the same or different contracts at the same time to create a position which can generate a risk less profit.

Economic Function of the Derivative Market : The derivatives market performs a number of economic functions. In this section, we discuss some of them.

- **Detection of Prices:** Prices in an organized derivatives market reflect the perception of the market participants about the future and lead the prices of underlying to the perceived future level. The prices of derivatives converge with the prices of the underlying at the expiration of the derivative contract. Thus derivatives help in discovery of future as well as current prices.

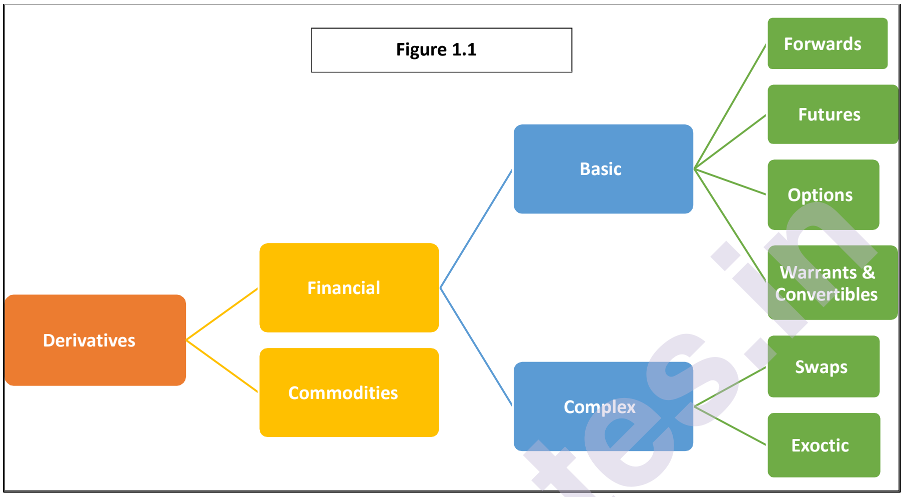
- **Transfer of Risk:** The derivatives market helps to transfer risks from those who have them but do not like them to those who have an appetite for them.

- **Liquidity and Volume Trading:** Third, derivatives due to their inherent nature are linked to the underlying cash markets. With the introduction of derivatives, the underlying market witnesses higher trading volumes. This is because of participation by more players who would not otherwise participate for lack of an arrangement to transfer risk.

- **Encourages participating more people:** An important incidental benefit that flows from derivatives trading is that it acts as a catalyst for new entrepreneurial activity. The derivatives have a history of attracting many bright, creative, well- educated people with an entrepreneurial attitude. They often energize others to create new businesses, new products and new employment opportunities, the benefit of which are immense. In a nut shell, derivatives markets help increase savings and investment in the long run. Transfer of risk enables market participants to expand their volume of activity.

Types of Derivatives

It is observed that financial derivatives are those assets whose values are determined by the value of some other assets, called as the underlying. Presently, there are bewilderingly complex varieties of derivatives already in existence, and the markets are innovating newer and newer ones continuously. For example, various types of financial derivatives based on their different properties like, plain, simple or straightforward, composite, joint or hybrid, synthetic, leveraged, mildly leveraged, customized or OTC traded, standardized or organized exchange traded, etc., are available in the market.



Due to complexity in nature, it is very difficult to classify the financial derivatives, so in the present context, the basic financial derivatives which are popular in the market havebeen described in brief. The details of their operations, mechanism and trading, will be discussed in the forthcoming respective units. In simple form, the derivatives can be classified into different categories which are shown in the Figure 1.1.

One form of classification of derivative instruments is between commodity derivatives and financial derivatives. The basic difference between these is the nature of the underlying instrument or asset. In a commodity derivatives, the underlying instrument is a commodity which may be wheat, cotton, pepper, sugar, jute, turmeric, corn, soybeans, crude oil, natural gas, gold, silver, copper and so on. In a financial derivative, the underlying instrument may be treasury bills, stocks, bonds, foreign exchange, stock index, gilt-edged securities, cost of living index, etc. It is to be noted that financial derivative is fairly standard and there are no quality issues whereas in commodity derivative, the quality may be the underlying matters. However, the distinction between these two from structure and functioning point of view, both are almost similar in nature.

Another way of classifying the financial derivatives is into basic and complex derivatives. In this, forward contracts, futures contracts and option contracts have been included in the basic derivatives whereas swaps and other complex derivatives are taken into complex category because they are built up from either forwards/futures or options contracts, or both. In fact, such derivatives are effectively derivatives of derivatives.

Popular Derivative Instruments : The most popularly used derivatives contracts are Forwards, Futures, Options and Swaps, which we shall discuss in detail later. Here we take a brief look at various derivatives contracts that have come to be used.

- **Forwards:** A forward contract is a customized contract between two entities, where settlement takes place on a specific date in the future at today's pre-agreed price. The rupee-dollar exchange rates is a big forward contract market in India with banks, financial institutions, corporate and exporters being the market participants.

- **Futures:** A futures contract is an agreement between two parties to buy or sell an asset at a certain time in the future at a certain price. Futures contracts are special types of forward contracts in the sense that the former are standardized exchange-traded contracts. Unlike forward contracts, the counterparty to a futures contract is the clearing corporation on the appropriate exchange. Futures often are settled in cash or cash equivalents, rather than requiring physical delivery of the underlying asset. Parties to a Futures contract may buy or write options on futures.

- **Options:** An option represents the right (but not the obligation) to buy or sell a security or other asset during a given time for a specified price (the "strike price"). Options are of two types - calls and puts. Calls give the buyer the right but not the obligation to buy a given quantity of the underlying asset, at a given price on or before a given future date. Puts give the buyer the right, but not the obligation to sell a given quantity of the underlying asset at a given price on or before a given date.

- **Swaps:** Swaps are private agreements between two parties to exchange cash flows in the future according to a prearranged formula. They can be regarded as portfolios of forward contracts. Swaps generally are traded OTC through swap dealers, which generally consist of large financial institution, or other large brokerage houses. There is a recent trend for swap dealers to mark to market the swap to reduce the risk of counterparty default. The two commonly used swaps are:

▪ **Interest rate swaps:** These entail swapping only the interest related cashflows between the parties in the same currency.

▪ **Currency swaps:** These entail swapping both principal and interest between the parties, with the cash flows in one direction being in a different currency than those in the opposite direction. Swaps may involve cross-currency payments (U.S. Dollars vs. Mexican Pesos) and cross market payments, e.g., U.S. short-term rates vs. U.K. short-term rates.

6.6 OTHER TYPES OF FINANCIAL DERIVATIVES

- **Warrants:** Options generally have lives of up to one year, the majority of options traded on options exchanges having a maximum maturity of nine months. Longer-dated options are called warrants and are generally traded over-the-counter.

- **LEAPS:** The acronym LEAPS means Long-term Equity Anticipation Securities. These are options having a maturity of up to three years.

- **Baskets:** Basket options are options on portfolios of underlying assets. The underlying asset is usually a moving average of a basket of assets. Equity index options are a form of basket options.

Exchange-Traded Vs. OTC Derivatives Markets

Derivatives that trade on an exchange are called exchange traded derivatives, whereas privately negotiated derivative contracts are called OTC contracts. The OTC derivatives markets have witnessed rather sharp growth over the last few years, which have accompanied the modernization of commercial and investment banking and globalization of financial activities. The recent developments in information technology have contributed to a great extent to these developments. While both exchange-traded and OTC derivative contracts offer many benefits, the former have rigid structures compared to the latter. It has been widely discussed that the highly leveraged institutions and their OTC derivative positions were the main cause of turbulence in financial markets in 1998. These episodes of turbulence revealed the risks posed to market stability originating in features of OTC derivative instruments and markets.

The first exchange-traded financial derivatives emerged in 1970's due to the collapse of fixed exchange rate system and adoption of floating exchange rate systems. As the system broke down currency volatility became a crucial problem for most countries. To help participants in foreign exchange markets hedge their risks under the new floating exchange rate system, foreign currency futures were introduced in 1972 at the Chicago Mercantile Exchange. In 1973, the Chicago Board of Trade (CBOT) created the Chicago Board Options Exchange (CBOE) to facilitate the trade of options on selected stocks. The first stock index futures contract was traded at Kansas City Board of Trade. Currently the most popular stock index futures contract in the world is based on S&P 500 index, traded on Chicago Mercantile Exchange. During the mid-eighties, financial futures became the most active derivative instruments generating volumes many times more than the commodity futures. Index futures, futures on T-bills and Euro-Dollar futures are the three most popular futures contracts traded today. Other popular international exchanges that trade derivatives are LIFFE in England, DTB in Germany, SGX in Singapore, TIFFE in Japan, MATIF in France, Eurex etc.

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7

INTERMEDIARIES

Unit Structure

7.0 LEARNING OBJECTIVES

After studying this unit, you will be able:

- To discuss Intermediaries Mutual funds
- To analyse Insurance firms
- To understand Hedge funds
- To explain Commercial banks
- To discuss Investment banks

7.1 INTRODUCTION

A commercial bank, investment bank, mutual fund, or pension fund are examples of organisations that serve as the middleman between two parties in a financial transaction. Consumers as a whole gain from financial intermediaries' safety, liquidity, and economies of scale in the banking and asset management industries. Disintermediation is significantly less of a concern in other areas of finance, such as banking and insurance, even though it does threaten to abolish the financial intermediary in other areas, such as investing.

Deposits from the general public are not accepted by a non-bank financial intermediary. The middleman may offer leasing, factoring, insurance policies, or other financial services. In order to manage and increase their funds, many intermediaries participate in securities exchanges and use long-term strategies. The actions of financial intermediaries and the expansion of the financial services sector can both reveal a nation's overall economic soundness.

Financial middlemen transfer money from those with extra capital to those that need it. The method minimises the cost of doing business and produces effective markets. An investment in insurance, stocks, bonds, real estate, and other assets, for instance, might help a financial advisor establish a connection with a client.

7.2 MUTUAL FUNDS

Modern financial systems depend heavily on mutual funds, which have exploded in growth during the past 20 years. In addition to the organisations with that name in Canada and the USA, they also include a large number of thrift and related organisations there, as well as unit trusts, investment trusts, building societies, and friendly societies in the UK. Since the early nineteenth century, mutual funds have been created to give groups of modest investors access to diversification options that they otherwise wouldn't have. Prior to the invention of mutual funds, only institutional investors or extremely wealthy individuals could successfully diversify their portfolios due to the search, transaction, and other fixed expenses of investing. The typical small investor was forced to make due with an under-diversified portfolio and accept the risk that came with it. Such investors were given the chance to pool their resources through mutual funds and invest in a diverse portfolio that none of them could have done on their own.

The majority of funds have a particular area of expertise, such as growth stocks, income-producing stocks, small-company stocks, short-term or long-term bonds, tax-exempt bonds, precious metals, overseas equities, and the like. A money market fund, which focuses on high-quality, short-term securities with market returns on cash equivalents and allows check writing, is another option for investors.

Existing Growth of Mutual Funds (Since May 2014)

In September 2012, SEBI adopted a number of progressive steps in response to India's low mutual fund penetration, particularly in Tier II and Tier III towns. These procedures were put in place to increase security and transparency for the benefit of numerous stakeholders. Additionally, SEBI's plan was to increase mutual fund penetration and "re-energize" the Indian mutual fund business. During the course, measures were taken to counter the negative trend because of the global financial crisis. However, the situation improved significantly after the new government was formed at the centre.

Structure

The Fund Sponsor the Fund's sponsor The Fund Sponsor is the top tier of the three-tiered organisational structure for Indian mutual funds. A fund sponsor is defined by SEBI regulations as any individual or entity that has the authority to create a mutual fund with the intention of profiting from fund management. The management of the fund is entrusted to an associate company. A sponsor might be compared to the publicist for the affiliated company. A sponsor must get in touch with SEBI to submit a request for permission to launch a mutual fund. However, a sponsor cannot operate independently. Once SEBI accepts the commencement, a Public Trust is established in compliance with the Indian Trust Act, 1882, and is registered with SEBI. After the trust has been properly established, trustees are selected to manage the trust, protect the interests of unit holders, and follow SEBI's mutual fund criteria. Trustee registration with SEBI is required. The sponsor then creates an asset management company that must abide by the Companies Act of 1956 in order to regulate the handling of money. Due to the fact that the sponsor is the primary entity promoting the mutual fund company and that the mutual funds will manage public funds, SEBI has specified qualifications for the fund sponsor. The sponsor's net worth must have improved over the past five years, and they must have at least five years of experience in the financial services sector. The AMC's capital contribution cannot be less than the sponsor's net worth as of the previous year. The sponsor must show financial success in at least three of the previous five years, including the most recent. At least 40% of the net worth of the asset management company must be owned by the sponsor.

Although it may seem obvious, a sponsor's role is crucial and necessitates the highest level of credibility. According to the strict and strict standards, the sponsor is required to have sufficient liquidity and to be dependable in order to return investors' money in the case of a financial crisis or meltdown.

Therefore, any organisation that satisfies the aforementioned criteria may be referred to as the mutual fund's sponsor.

Trust and Trustees

Trust and trustees make up the second tier of the Indian mutual fund structure. Trustees, often known as the guardians of the fund, are frequently staff members of the fund sponsor. As implied by their name, they play a critical role in maintaining investors' trust and keeping track of the fund's success. The fund sponsor creates a trust in the interests of the trustees through the use of a trust document. Trustees manage the trust on behalf of the investors and are answerable to them. They might be seen as the primary custodians of finances and assets. Trustees can be appointed either by a trustee company or a board of trustees. The trustees keep an eye on the Mutual Fund's operations and make sure that SEBI (Mutual Fund) regulations are followed. They also monitor the systems, procedures, and general operation of the asset management company. Without the trustees' approval, AMC is not allowed to launch any schemes in the market. The trustees are expected to provide SEBI with a report detailing the AMC's operations every six months. SEBI has also put in place stricter transparency standards in an effort to prevent any kind of conflict of interest between the sponsor and the AMC. Therefore, trustees must act independently and in a proper manner in order to safeguard the investors' hard-earned money. It is a requirement for trustees to register with SEBI. Further regulating their registration, SEBI has the authority to revoke or suspend the registry if any conditions are found to have been breached.

Asset Management Companies

Asset management companies make up the mutual fund system's third layer. It is a certain kind of company that was established under the Companies Act and is registered with SEBI. An AMC's function is to maintain a list of various mutual fund schemes that abide by investor and market expectations. The trust's investment manager or fund manager is the asset management company. A little charge is paid to the AMC for managing the fund. The AMC is in charge of all activities involving the funds. It begins various plans and puts them into action. Along with the trustee and sponsor, it also creates mutual funds and manages their expansion. The AMC must supervise investments and provide investors with services. Along with other elements like brokers, auditors, bankers, registrars, lawyers, etc., it engages in business with them and solicits their services. To ensure that there is no competition between the AMCs, several restrictions have been placed on the firms' ability to conduct business.

Custodian

A custodian is one such company in responsibility of keeping the assets of the Mutual Fund secure. They manage the mutual fund's investment account, are registered with SEBI, and ensure that the securities are delivered and transferred. Custodians also allow investors the ability to upgrade their holdings at specific times and assist them in keeping track of their investments. They also compile and keep account of dividends, interest, and bonus payments paid on mutual fund assets.

Distributors/Intermediaries:

Distributors take on the role of brokers, directing customers and investors to mutual fund plans or other investment alternatives that will match their objectives. Distributors generally advertise the mutual fund offerings of the AMCs that they have contracts with. The distributor is required to have an AMFI registration number and to have successfully completed the National Institute of Securities Market (NISM) accreditation programme. An investor's financial advisor may occasionally be a distributor. Banks, brokers, brokerage firms, financial institutions, and others may distribute the mutual fund scheme. The distributor is qualified to join numerous mutual fund companies' panels.

Registrar and Transfer Agent (RTA):

Investor records must be maintained by RTAs. In addition to buying, selling, and redeeming money, investors often update personal information and tell them of the worth of their portfolios. The mutual fund company finds it challenging to maintain such a record. It is therefore transferred to other organisations, who are required to register with SEBI.

One example of an RTA is Computer Age Management Services (CAMS) and KARVY, which control 80% of the RTA industry in India. In their offices, they serve as Investor Service Centers (ISCs), collecting, logging, storing, and managing paperwork.

RTAs assist the mutual fund organisation in lowering record-keeping expenses.

It provides a thorough breakdown of the investments they have made across a number of mutual schemes, regardless of the AMC.

The RTAs' facilities act as an AMC branch office.

Auditors:

The Trustees appoint the auditor for the schemes, while the AMC appoints the auditor for the AMC. Auditing the AMC's and its schemes' financial records is the auditing firm's main duty. In order to protect the interests of the unitholders, it is necessary to ensure that all transactions are honest and fair. The AMC auditor is unable to examine the AMC's schemes. The auditor needs to be a capable individual. The auditor ought to be a neutral party who works independently and impartially.

Fund Accountants:

The fund accountant's job is to take care of all the accounting requirements of the mutual fund and its schemes, as the title would imply. The following are the duties of the fund accountant:

a. Calculating Net Asset Value of the schemes.
b. Recording of the transactions of the fund and the schemes.
c. Calculating the dividened to be distributed .
d. Review , research,analyseis, reconciliation and rectification of the accounting records.
e. Prepareing financial statements,financial reports ,tax reports etc in a timely manner.
f. Providing the required and adequate information to the auditor.
g. Providing periodic accounting and financial information about the performance of the fund.

Collecting Bankers:

A banker is chosen by the AMC to assist with money collection and transfer. The banks offer scheme-specific accounts to ensure that the unit holder's money is allocated to the preferred schemes. The investor must directly deliver the application and required funds to the designated collecting banker or bankers, as well as to AMC, RTA, or both. The aspect of the fund's inflow and outflow is examined by the collecting bank.

7.3 INSURANCE FIRMS

Insurance Firms:

Most individuals have insurance of some type, whether it is for their life, their home, or their car. Insurance policies are intended to protect against the possibility of financial losses, both large and minor, that may be caused by harm to the insured or their property or by liability for harm or injury to a third party.

How Insurance Works:

There are many various kinds of insurance policies available, and almost any person or organisation can find an insurance firm that will insure them—for a fee, of course). Auto, health, homeowners, and life insurance are the most popular categories of personal insurance plans. Most Americans have at least one of these insurance policies, and car insurance is mandated by law.

Types of Insurance:

There are many different types of insurance. Let’s look at the most important:

Health Insurance:

A business and a customer enter into a contract for health insurance. In exchange for the payment of a monthly premium, the corporation offers to cover all or part of the insured person's medical expenses.

Home Insurance:

Your home, which is your biggest asset, can be safeguarded with homeowner's insurance. Learn more about the extent of the liability, interior versus outside damage, on-property injuries, and other topics.

Auto Insurance:

It's crucial to safeguard your investment when you purchase or lease a car. Having auto insurance can give you peace of mind in the event that you are in an accident or your car is stolen, vandalised, or suffers natural disaster damage.

Life Insurance:

A contract for life insurance is made between the policyholder and the insurer. In return for the premiums paid by the policyholder during their lifetime, a life insurance policy promises that the insurer will pay a certain amount to designated beneficiaries after the insured passes away.

Travel Insurance:

Travel insurance is a type of insurance that covers the costs and losses associated with traveling. It is useful protection for those traveling domestically or abroad.

7.4 HEDGE FUNDS

In the context of investment, the term "hedging" refers to safeguarding against risks. Accredited investors including banks, insurance companies, High Net Worth Individuals (HNIs) and their families, endowments, and pension funds contribute money to a hedge fund. This is the rationale behind the fact that these funds frequently act as foreign investment companies or private investment partnerships. Unlike other mutual funds, they are not required to periodically reveal their NAV or to register with SEBI.

Hedge funds are mutual funds that are professionally and privately managed. Because of this, they are frequently a little more expensive. As a result, only those who are financially secure can afford and use them. Because the management buys and sells assets at a breakneck pace to keep up with market fluctuations, you must not only have excess funds but also be a risk-taker who doesn't back down from a challenge.

As you are aware, risks increase as structural complexity increases. Hedge funds therefore have a much higher expense ratio than traditional mutual funds (charge to the fund management). It might be 15% to 20% of your earnings. So, until you have a lot of experience in the sector, we advise first-time depositors to stay away from these funds.

Even then, everything is up to the fund manager. Consequently, investing in hedge funds may cause you to have sleepless nights if you don't have complete faith in your fund management.

What are the Features & Benefits of Hedge Funds?

The relatively new Indian hedge fund market received a green light from the Securities and Exchange Board of India (SEBI) in 2012, allowing alternative investment funds (AIF). These characteristics apply to them:

High Net-Worth Investors

Hedge funds are only open to accredited or qualified investors. High net worth individuals (HNIs), banks, insurance firms, endowments, and pension funds make up the majority of them. Investors investing in these funds must have a minimum ticket size of Rs 1 crore.

Diverse Portfolio

Hedge funds have a wide range of investments in their portfolio, including stocks, real estate, shares, bonds, and derivatives. Yes, they must cover all asset classes; the mandate is the sole restriction.

Higher Fees

Both the management fee and expense ratio concepts are used in their work. The global standard is "Two and Twenty," which entails a set fee of 2% and a profit share of 20%. The management fee for hedge funds in India ranges from well below 2% to below 1%. Additionally, the profit sharing typically ranges from 10% to 15%.

Higher Risks

Hedge fund investment strategies put money at risk of enormous losses. Lock-in periods for investments are typically quite lengthy. Leverage used by these funds has the potential to significantly reduce investment returns.

Taxation

Hedge funds in Category III AIF are still not eligible for pass-through tax treatment. This suggests that the investment fund level is where revenue from these funds is taxed. As a result, the tax liability won't be passed on to the unit-holders. This puts them at a competitive disadvantage with other mutual funds, which is bad for business.

Regulations

Hedge funds are not required to register with the securities markets regulator, and they are not subject to any reporting obligations, such as a requirement to disclose net asset values on a regular basis (NAV).

How do Hedge Funds work?

Hedge fund returns speak more to the fund manager's abilities than to the state of the markets. The asset managers here try their hardest to minimise or eliminate market exposure while still producing solid returns. They operate in niche market segments where greater diversification helps to lower risks. Among the tactics employed by hedge fund managers are:

Sell short

Here, the manager can sell shares in anticipation of future price declines and buy them back at a lower cost.

Use arbitrage

The price of the securities may occasionally be inconsistent or ineffective. Managers take advantage of this.

Invest in an upcoming event

Examples of significant market events that may have an impact on a manager's investment choices include acquisitions, mergers, and spin-offs.

Invest in securities with high discounts

Some businesses that are experiencing financial difficulty or perhaps insolvency will sell their securities for an absurdly low price. After considering the options, the management might decide to purchase.

Types of Hedge Funds:

Hedge funds target select investments and pools of securities primed for gains. Four common types of hedge funds include:

- **Global macro hedge funds:**

Global macro hedge funds, which are actively managed, aim to profit from significant market fluctuations brought on by political or economic events. After considering the options, the management might decide to purchase.

- **Equity hedge fund:**

An equity hedge fund may invest in profitable stocks globally or only in a single nation, protecting itself against equity market declines by selling short expensive equities or stock indices.

- **Relative value hedge fund :**

A relative value hedge fund looks to take advantage of short-term price discrepancies between linked securities by capitalising on spread or price inefficiencies.

- **Activist hedge fund:**

An activist hedge fund invests in companies with the intention of increasing the stock price by demanding that expenses be reduced, assets be reorganised, or the board of directors be replaced.

7.5 COMMERCIAL BANKS AND INVESTMENT BANKS

Commercial bank is the term used for a normal bank to distinguish it from an investment bank. This is what people normally call a "bank". The term "commercial" was used to distinguish it from an investment bank. Since the two types of banks no longer have to be separate companies, some have used the term "commercial bank" to refer to banks which focus mainly on companies. In some English-speaking countries outside North America, the term "trading bank" was and is used to denote a commercial bank. During the great depression and after the stock market crash of 1929, the U.S. Congress passed the Glass-Steagal Act 1930 (Khambata 1996) requiring that commercial banks only engage in banking activities (accepting deposits and making loans, as well as other fee-based services), whereas investment banks were limited to capital markets activities. This separation is no longer mandatory. It raises funds by collecting deposits from businesses and consumers via checkable deposits, savings deposits, and time (or term) deposits. It makes loans to businesses and consumers. It also buys corporate bonds and government bonds. Its primary liabilities are deposits and primary assets are loans and bonds. Commercial banking can also refer to a bank or a division of a bank that mostly deals with deposits and loans from corporations or large businesses, as opposed to normal individual members of the public (retail banking).

THE FUNCTIONS OF COMMERCIAL BANK

A: General Functions:

1. **Receiving Deposits:** The first and foremost function of commercial bank is to receive or collect deposits from the public in different forms of accounts e.g. current, savings, term deposits. No interest is charged in the current account, lower rate of interest is charged in the savings account and comparatively higher interest rates charged in fixed deposits. Thus, commercial bank builds up customer network.

2. **Accommodation of loans and advances:** Commercial Bank attaches much importance to providing loans and advances at a higher rate than the deposit rates and thus earns profits on it. Working capital is accommodated to the borrower for expansion and smooth running of business. In the similar manner, commercial bank extends financial accommodation for the development of agriculture and industry. Credit accommodation is provided to the entrepreneurs for reviving sick and old industries as per Govt. directives. Thus, commercial bank also extends welfare services to the people at large.

3. **Creation of Loan Deposits:** Commercial Bank not only receives deposits from public and accommodates loans to public but also creates loan deposits. For example: while disbursing loans as per sanction stipulation, the amount of loan is credited to the borrower's account. The borrower may not withdraw the full amount at a time. The residual amount i.e. balance left in the account creates loan deposits.

4. **Creation of medium of exchange:** Central Bank has got exclusive right to issue notes. On the other hand, Commercial Bank creates medium of exchange by issuing cheques. Like notes, cheque is transferrable being popularly used in the banking transactions.

5. **Contribution in foreign trade:** Commercial Bank plays a vital role in expediting foreign exchange and foreign trade business e.g. import, export etc. It contributes greatly in the economy through import finance and export finance and thus, earn foreign exchange for the country.

6. **Formation of capital:** Commercial Bank extends financial assistance for the formation of capital in the trade, commerce and industry in the country which expedites its economic development.

7. **Creation of Investment Environment:** Commercial Bank plays a significant role in creating investment environments in the country.

B. Public Utility Functions: In modern banking, commercial bank executes public utility services:

1. **Remittance of Money:** Remittance of money to the public from one place to another is one of the functions of commercial bank. Remittance is affected in the form of demand draft, telegraphic transfer etc. through different branches and correspondents' home and abroad.

2. **Help in trade and commerce:** Commercial Bank helps expand trade and commerce. In inland and foreign trade customers are allowed credit accommodation in the form of letter of credit, bill purchased and discounted etc.

3. **Safe custody of valuables:** Commercial Bank introduces „locker services to the customers for safe custody of valuables e.g. documents, shares, securities etc.

4. **Help in Foreign Exchange business:** While opening letter of credit, commercial bank obtains credit report of the suppliers and thus help expedite import and export business.

5. **Act as a Referee:** Commercial Bank acts as a referee for and on behalf of the customers.

6. **Act as an Adviser:** Commercial Bank provides valuable advice to the customers on different products, business growth and development, feasibility of business and industry.

7. **Collect utility service bills:** As a social commitment, Commercial Bank collects utility service bills e.g. water, electricity, gas, telephone etc. from the public.

8. Purchase and sale of prize bonds, sanchaya patra, shares etc. Commercial Bank undertakes to purchase and sale of prize bonds, sanchaya patra, shares etc. as a part of social commitment.

9. **Help people travel abroad:** Commercial Bank helps customers in traveling abroad through issuance of traveller's cheques, drafts, cash etc. in favour of the customers.

C. Agency Functions: Besides above stated functions, commercial bank acts as a representative of the customers.

1. **Collection and payment:** Commercial Bank is engaged in collection and payment of cheque, bill of exchange, promissory notes, pension, dividends, subscription, insurance premium, interest etc. on behalf of the clients.

2. **Purchase and sale of shares and securities:** Commercial Bank is entrusted with the responsibility of purchase and sale of shares and securities on behalf of the customers.

3. **Maintenance of secrecy:** Maintenance of secrecy is one of the most important functions of commercial bank.

4. **Act as a trustee:** Commercial Bank acts as a trustee on behalf of the customer.

5. **Economic Development and Welfare activities:** Commercial Bank contributes much for the welfare and economic development of the country.

Prof. Syers, defined banks as "institutions whose debt—usually referred to as 'bank deposits'—are commonly accepted in final settlement of other people's debts". According to Banking Regulation Act of 1949, "Banking means the accepting for the purpose of lending or investment of deposits of money from the public, repayable on demand or otherwise, and withdrawal by cheque, draft, order or otherwise". From the above definitions we can analyse that the primary functions of banks are accepting of deposits, lending of these deposits, allowing deposits to withdraw through cheque whenever they demand. The business of commercial banks is primarily to keep deposits and make loan and advances for short period up to one or two years made to industry and trade either by the system of overdrafts of an agreed amount or by discounting bills of exchange to make profit to the shareholders. From the above discussion, we can say that the following are the functions of commercial banks.

1. Receiving deposits from the public. The primary function of commercial banks is receiving of deposits in the form of savings bank account, current account and term deposits from the savers usually from the public. People usually prefer to deposit their savings with the commercial banks because of safety, security and liquidity. The aggregate deposits of scheduled commercial banks in India rose rapidly from Rs. 822 crores in 1951 to Rs. 3,763 crores in 1967. The total deposits of commercial banks were Rs. 4,661 crores in 1969 that increased to Rs. 34,237 crores by 735 per cent by 1979. The total deposits of commercial banks increased in the decade of 1981 to 1991 from Rs. 40,413 crores to Rs. 2,00,569 crores by 5 times. Out of which the proportion of current, saving and fixed deposits were Rs. 6,286, Rs.11,805 and Rs. 22,322 crores which is almost 1: 2: 3 ratios increased to Rs. 30,335, Rs. 56,152 and Rs. 114082 crores i.e., almost 5 times during one decade with almost same proportion. The total deposits with commercial banks by the end of 2005 increased to Rs. 21,00,000 crores.

2. Giving loans and advances. The second major function of the commercial banks is giving loans and advances to the all types of persons, particularly to businessmen and investors, against personal security, gold and silver and other movable and immovable assets. The bank advances loans in the form of cash credit, call loans, overdraft and discounting bills of exchange to businessmen. After reforms in banking sector and establishment of new private sector banks and

foreign banks, the other commercial banks also started giving loans and advances not only to their traditional businesses but also for vehicles, housing, consumer durables, etc. by increasing the base of lending activities.

3. Use of cheque system and credit cards. The commercial banks will allow the depositors of the bank to withdraw and make payment of their amount in their bank account through cheques. Now the banks are allowed to use debit and credit cards for making their payments.

4. Credit creation. Credit creation is one of the most important functions of the commercial banks. Like other financial institutions, they aim at earning profits. For this purpose, they accept deposits and advance loans by keeping small cash in reserve for day-to-day transactions. When a bank advances a loan, it opens an account in the name of the customer and does not pay him in cash but allows him to draw the money by cheque according to his needs. By granting a loan, the bank creates credit or deposit.

5. Financing foreign trade. The commercial banks finance foreign trade of its customers by accepting foreign bills of exchange and collecting them from foreign banks. It also transacts other foreign exchange business and buys and sells foreign currency.

6. Transfer of funds. Commercial banks will help the customers to transfer their money from one account to another account, from one place to another place through cheques. Now the transfer of funds from one place to another place, or from one party account to another party account or one bank to another bank is done through Electronic Fund Transfer (EFT). This facility helps in transferring funds from one bank to another bank or to another party account easy. The technology like MICR helps the banks to have innovative banking like anywhere banking, anytime banking, and virtual banking and so on.

7. Agency functions. The commercial banks act as agents for customers to buy and sell shares, securities on their behalf. It pays subscriptions to insurance premiums, mutual funds, rent, water taxes, electricity bills etc on behalf of its clients. It also acts as a trustee and executor of the property and will of its customers.

8. Miscellaneous functions. The miscellaneous functions performed by the commercial banks are: it provides safety locker facility, making and receiving payments on behalf of its depositors, issuing letters of credit and traveller's cheques etc.

Advances. A bank makes investments for the purpose of earning profits. First it keeps primary and secondary reserves to meet its liquidity requirements. Banks invest in securities either for fulfilment of SLR/CRR requirements or for earning profit on the idle funds. Banks invest in "approved securities" (predominantly Government securities) and "others" (shares, debentures and bonds). The values/rates of these securities are subject to change depending on the market conditions. Some securities are transacted frequently and some are held till maturity. The Ghosh Committee recommended that "a bank's investment portfolio should be bifurcated into two parts, namely, 'permanent investment' and 'current investment'. The committee recommended that banks should make necessary provision for the depreciation in the value of current investment and there is no need to provide for permanent investment.

RBI has also advised the banks to classify the existing investment in approved securities into two categories. Initially from the accounting year 1992-93, banks should not keep more than 70% of their investment in permanent category, and 30% of the portfolio as current investments to facilitate valuing all the investments on fully 'marked to market' basis. Guidelines were laid down for transfer of approved securities from 'current' to 'permanent' and 'vice versa' in 1992. These guidelines ensure that latent losses are provided for at the time of such transfer. In 1993 the entire investment portfolio of banks other than investments classified as 'permanent' has to be classified into six categories for the purpose of valuation. The valuation will be done for each category of investments. While net depreciation has to be provided by debit to the profit and loss account, net gains have to be ignored. Permanent investments can be carried at book value. Premium will have to be amortized over the life of the investment but discount cannot be recognized as income. In between 1993 to 1998 the said minimum ratio of 30 per cent has been increased in a phased manner to 60 per cent as on March 31, 1998. It has further been decided to increase the ratio to 70 per cent for the year ending March 31, 1999. New private sector banks are required to market their entire investments in approved securities since March 31, 1997.

OBJECTIVES OF A COMMERCIAL BANK

1. To establish as an institution for maximizing profits and to conduct overall economic activities.

2. To collect savings or idle money from the public at a lower rate of interests and lend this public money at a higher rate of interests.

3. To create propensity of savings amongst the people.

4. To motivate people for investing money with a view to bringing solvency in them.

5. To create money against money as an alternative for enhancing supply of money.

6. To build up capital through savings.

7. To expedite investments.

8. To extend services to the customers.

9. To maintain economic stability by means of controlling money market.

10. To extend co-operation and advices to the Govt. on economic issues.

11. To assist the Govt. for trade& business and socio-economic development

What is Investment Banking?

Investment banking is focused on supporting companies, institutions, and other significant organisations (such as governments) with their financial management. It is made to give customers a wide range of options to help them achieve financially.

Investment banks aid their main clients by issuing stocks, creating money, and underwriting equity and debt securities. Additionally, investment banks are frequently involved in mergers and acquisitions.

Investment banking is set up to benefit big businesses. Issuing stock for companies, specifically during an initial public offering, is one of the most significant tasks investment banks conduct (IPO). Money flow can become perplexing when a corporation first makes its stock accessible to the public. Investment banks intervene to assist in handling the situation.

Investment banks also serve as counsellors, assisting companies and other organisations in deciding whether doing business with other companies is a good idea. Investment banks serve as counsellors to their clients, assisting them in determining the wisdom of purchasing or merging with another business.

Because investment banking is a highly specialised sector that typically requires more education or experience, careers in this field are frequently more competitive than those in commercial banking. In this industry, some well-liked job options include:

The most senior management of an investment bank is known as a managing director. You manage a section or a department as a managing director, and you also find new clients.

Vice president: A vice president oversees analysts and associates and helps manage daily client relations. The continual development of financial models and presentations is also overseen by vice presidents.

Associate: An analyst who collaborates with customers to write deal proposals and deliver marketing presentations is known as an associate. Associates frequently travel to present agreements, so their success depends on their ability to establish and keep positive relationships.

Trading expert: A trading expert maintains stock holdings and conducts business concerning the assets of a corporation. In order to ensure that they are able to give their clients sound advise, this position demands good analytical and forecasting abilities.

A stock market analyst evaluates opportunities and makes investment recommendations based on customer needs. Analysts can find solid investments with the use of research and industry knowledge.

The basic difference between investment bank and commercial bank are indicated below:

1. An investment bank is a type of financial intermediary created to offer companies consulting and investment services. A bank called Commercial Bank was founded to offer banking services to the general people.

2. Commercial banks give uniform services whereas investment banks offer services tailored to the needs of the customer.

3. In comparison to an investment bank, a commercial bank has a larger customer base.

4. The performance of the stock market affects the investment bank, but the commercial bank's interest rate is influenced by economic expansion and loan demand.

5. The investment bank acts as a banker for people, organisations, and governments. However, a commercial bank serves as a banker for all of the nation's residents.

6. Fees and commissions are how the investment bank makes money. In contrast to Commercial Bank, who makes money via interest and fees.

7.6 SUMMARY

- The Fund Sponsor is the top tier of the three-tiered organisational structure for Indian mutual funds.
- A custodian is one such company in responsibility of keeping the assets of the Mutual Fund secure.
- The primary difference between these two financial intermediaries is the audience they cater to as well as their area of business. While commercial banks serve all the citizens of the country and its main business is to accept deposits and grant loans.
- Investment banks deal in securities and so its primary activity is to trade in financial assets and provide advisory services.
- The relatively new Indian hedge fund market received a green light from the Securities and Exchange Board of India (SEBI) in 2012, allowing alternative investment funds (AIF).

7.7 UNIT END QUESTIONS

A. Descriptive Questions:

Short Answers:

1. Discuss the various types of insurance.

2. Write note on Hedge funds.

3. Explain the various types of Hedge funds.

4. Difference between commercial and investment bank.

5. Discuss about Objectives of a commercial bank**.**

6. What is Investment Banking?

B. Fill in the blanks:

1. In September 2012, …………. adopted a number of progressive steps in response to India's low mutual fund penetration, particularly in Tier II and Tier III towns.

2. ………….. and trustees make up the second tier of the Indian mutual fund structure.

3. A ……………… looks to take advantage of short-term price discrepancies between linked securities by capitalising on spread or price inefficiencies.

4. A ……………. oversees analysts and associates and helps manage daily client relations.

5. ……………. aid their main clients by issuing stocks, creating money, and underwriting equity and debt securities.

Answers:

1- SEBI, 2- Trust, 3- relative value hedge fund, 4- Vice president, 5- Investment banks

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8

FIXED INCOME SECURITIES - I

Unit Structure

8.0 LEARNING OBJECTIVES

After studying this unit, you will be able:

- To understand Fixed income securities
- To discuss characteristics of Bond
- To analyze Types of Bonds and Coupon types
- To explain Computation of different yields and bond price
- To understand the relationship between yield and price
- To discuss Floaters and inverse floaters

8.1 INTRODUCTION

An economy of a developing country that is expanding and becoming increasingly integrated with international markets is known as an emerging market economy. Countries possessing some but not all of a developed market's features are categorised as emerging market economies.

Strong economic development, high per capita income, liquid equities and debt markets, accessibility to foreign investors, and a stable regulatory structure are some traits of developed markets.

An emerging market economy often integrates more into the global economy as it grows. This implies that it may result in higher trade volume, foreign direct investment, and increased liquidity in the local debt and equity markets. It can create cutting-edge regulatory and financial institutions. Currently, significant emerging market nations include Saudi Arabia, China, Brazil, Mexico, Russia, and Pakistan.

A crucial transition from a low income, less developed, frequently pre-industrial economy to a modern, industrial economy with a greater standard of living is occurring in an emerging market economy.

8.2 FIXED INCOME SECURITIES

An investment that offers a return in the form of regular, set interest payments as well as the ultimate repayment of principal at maturity is referred to as a fixed-income security. A fixed-income security's payments are predetermined, as opposed to variable-income securities, whose payments fluctuate depending on some underlying factor, such as short-term interest rates.

Fixed-Income Securities are debt products that offer investors fixed interest payments in the form of coupon payments. The invested money is returned to the investor at maturity, while interest payments are normally made every two years. The most popular type of fixed-income securities are bonds. Businesses raise funds by selling investors fixed-income products.

8.3 MEANING AND CHARACTERISTICS OF BONDS

The bond market, also known as the debt market or credit market, is a financial exchange where investors can trade in debt instruments issued by both governments and corporations. Bonds are frequently issued by governments to raise money for debt repayment or infrastructure development. When they need to finance corporate expansion initiatives or support ongoing operations, publicly traded corporations issue bonds.

The primary market and secondary market are the two main divisions that make up the bond market. The main market, often known as the "new issues" market, is where strictly all transactions between bond issuers and bond buyers take place. Essentially, the primary market results in the production of entirely new debt securities that have never been made available to the general public.

Securities that have already been sold in the primary market are then acquired and sold at a later time in the secondary market. These bonds are available for purchase from brokers, who serve as a middleman between the buyers and sellers. Among many other product formats, these secondary market issues may be packaged as pension funds, mutual funds, or life insurance policies.

Characteristics

Most bonds share some common basic characteristics including:

- Face value is the amount of money the bond will be worth when it matures. It also serves as the benchmark for the bond issuer for determining interest payments.
- Coupon rate is the interest rate, represented as a percentage, that the bond issuer will charge on the bond's face value.
- The dates on which the bond issuer will pay interest are known as coupon dates. Annual or semi-annual coupon payments are typical periods.
- The bond's maturity date is the day on which it will reach maturity and the bond's issuer will pay the bondholder the bond's face value.
- Issue price is the price at which the bond issuer originally sells the bonds.
- The main determinants of a bond's interest rate are two characteristics: credit quality and length.
- If the issuer has a low credit rating, there is a higher danger of default, and these bonds typically trade at a discount.
- Credit rating agencies determine and publish credit ratings. Bond maturities might be anything from one day to over 30 years. The likelihood of negative outcomes increases with bond maturity or length.
- Bonds with longer maturities also typically have less liquidity. Bonds with a longer duration to maturity often carry a higher interest rate due to these characteristics.
- When considering the riskiness of bond portfolios, investors typically consider the duration (price sensitivity to changes in interest rates) and convexity (curvature of duration).

8.4 TYPES OF BONDS

Types of Bonds:
1. Government Securities Bonds:
2. Corporate:
3. Convertible:
4. Zero-Coupon:
5. Inflation-Linked:
6. RBI Bonds:
7. Sovereign Gold Bonds:

1. Government Securities Bonds:

A debt instrument issued by the central or state governments of India is a government securities bond.

Government securities (G-Sec), which primarily offer long-term investments between 5 and 40 years, include Government Bonds in India.

State Development Loans are another name for the bonds that the state government issues.

These government securities were created by the Indian government to allow small investors to invest modest sums and earn interest while taking less risks.

These bonds have semi-annual interest payments that can be either fixed or floating. However, the majority of government bonds are offered at a set interest rate.

2. Corporate:

Companies issue corporate bonds to borrow money from investors for a set period of time while charging them a set interest rate throughout that time.

Companies typically sell bonds to investors to fund new projects or to expand their operations in order to develop in the future.

Instead of getting a loan from the banks, the company seeks investors to invest their money in exchange for a particular rate of return over a set period of time.

Investors receive the face value and interest rate after the term is over.

Investors that wish to earn a set interest rate for the course of their investment prefer this type of bond.

3. Convertible:

These provide both the benefits of debt and equity, but not simultaneously.

The bondholders can convert this into a specified number of stocks, becoming shareholders of the company and receiving all the rewards provided to shareholders.

After buying convertible bonds, investors can gain from both debt and equity securities.

4. **Zero-Coupon:**

It is also known as a "pure discount bond" since, until the bond matures, the invested funds do not provide a regular interest rate.

The face value of the bond, which is returned to the investor when it matures, is included in the annual returns on the principal amount.

5. Inflation-Linked:

This kind of bond is designed to reduce the inflation risk of an investment that is primarily issued by the government and protects against inflation.

Bonds that are linked to inflation see their principal and interest rates fluctuate in line with inflation.

6. RBI Bonds:

The variable rate saving bonds 2020 (FRSB) that the RBI issues are also known as RBI bonds. 7-year taxable bonds with an interest rate that fluctuates throughout the course of the bond's term.

As a result, rather than being paid at maturity, the interest rate is reset every six months, with the first reset occurring on January 1, 2021.

When interest rates in the economy increase, the floating interest rate may as well.

7. Sovereign Gold Bonds:

The central government issues these bonds to investors who wish to invest in gold but do not want to carry physical gold around with them.

This bond's interest income is not subject to taxation. Because it is being offered by the government, it is also regarded as a highly secured bond.

After the first five years, investors who choose to redeem their investment may do so; however, doing so will merely change the date on which future interest payments are made.

8.5 COUPON TYPES

A coupon bond is a specific kind of bond that has attached coupons and makes periodic interest payments (usually annually or semi-annually) throughout its life as well as its par value upon maturity. The yield on these bonds at the time of issuance is indicated by the coupon rate, which is included with the bonds. Bonds with higher coupon rates provide investors with larger returns on their capital.

Such bonds were issued in the form of bearer certificates. This means that the physical possession of the certificate was sufficient proof of ownership. No records of the original or any subsequent buyer of the bond was retained by the issuer. They came to be known as “bearer bonds” because anyone bearing the appropriate coupon could present it to the issuer’s agent and receive the interest payment. The coupons were printed on the bond, from which they could be detached and presented for payment.

Since most bonds are issued electronically without physical certificates, physical forms of bonds are rare. Even so, the term "coupon" is still in use, although it only refers to the nominal yield of the bond.

How Does a Coupon Bond Work?

The issuer of the bond agrees to make annual or semi-annual interest payments equal to the coupon rate to investors. These payments are made until the bond's maturity.

Formula for Calculating the Coupon Rate

Where:

C = Coupon rate

i = Annualized interest

P = Par value, or principal amount, of the bond

Coupon Types – Fixed Rate and Floating Rate Bonds

A zero-coupon bond is a specific variety of fixed-rate bond. In this instance, there is no interest paid from the time the bond is issued until it matures. they "pay" a set coupon of 0% as a result. This does not imply that bondholders receive no return because zero-coupon bonds are frequently offered at a discount but are fully repaid when they mature. Investors will therefore profit throughout the course of the bond's existence from this discrepancy between the purchase and redemption prices.

Most bonds are fixed-rate bonds, which are very common.

Bonds with fluctuating rates are an alternative to fixed-rate bonds. In contrast to fixed-rate bonds, the coupon formula used in this case determines the coupon amount every month throughout the duration of the bond. Frequently, these coupon calculations are presented as LIBOR or some comparable reference rate plus or minus a spread. By doing so, the LIBOR or another comparable reference rate's future development or trajectory will determine the real interest payments, which are not known in advance. Therefore, interest rate payments are either floating or variable. For this reason, these bonds are also known as "floating-rate notes," or FRNs.

8.6 COMPUTATION OF DIFFERENT YIELDS AND BOND PRICE

Daily monitoring of bond prices is valuable for determining the trajectory of interest rates and, more broadly, the future of the economy. Not surprisingly, they play a significant role in a properly managed and diversified investment portfolio. Bond yields and prices are always subject to price fluctuations, particularly during times of rising or falling interest rates. Let's talk about the connection between bond yields and prices.

If you purchase a bond right away, its face value will be its price, and its yield will be equal to its coupon rate. In other words, if you purchase a bond with a three-year interest rate of 1%, you will receive just that. You will receive the bond's face value back after it matures. You are not interested in its value at any point in the future unless you intend to sell it.

Calculating a Bond's Dollar Price:

A bond's dollar price and cash flows are correlated by a yield. The principle repayment and coupon payments make up a bond's cash flows. When a bond reaches its maturity date at the end of its term, the principal is returned.

The yield on a bond is the discount rate that can be applied to bring the bond's price and the present value of all of its cash flows into balance. In other words, the present value of all the cash flows is added to determine the price of a bond. The same discount rate is used to value each cash flow in the present. The yield is the discount factor.

8.7 RELATIONSHIP BETWEEN YIELD AND PRICE

Bonds :

Bonds are a significant component of the financial market and serve as a vital source of money for governments and businesses. Understanding the idea of bond yield is crucial when dealing in fixed-income instruments. Debt-oriented funds, such as short-term mutual funds, invest in bonds in the mutual fund industry to give investors short- to medium-term investment horizons and a chance to generate significant returns.

RELATIONSHIP OF THE BOND PRICE AND YIELD :

Bond prices and yields have a significant but opposing link. Bond yields are higher than coupon rates when the bond price is less than the bond's face value. Bond yields are lower than coupon rates when the bond price is greater than the bond's face value. As a result, the bond yield computation is based on the bond's price and coupon rate. The yield increases as the bond price decreases, and decreases when the bond price increases. Let's examine the reasons why this is the case:

1. When interest rates fall, it causes a fall in the value of the related investments. However, bonds that have been issued will not be affected in such a way. They will keep paying the same coupon rate as issued from the beginning, which will now be at a higher rate than the prevailing interest rate. This higher coupon rate makes these bonds attractive to investors willing to buy these bonds at a premium.

2. Conversely, when interest rates rise, newer bonds will pay investors better interest rates than existing bonds. Here, the older bonds are less attractive and will drop their prices as compensation and sell at a discounted price.

Inverse Relationship Between Bond Prices and Bond Yields

Bond yields and prices are inversely correlated, thus when bond prices increase, their yield decreases (and vice versa).

Notably, the environment of current interest rates is the component that probably has the most impact on bond yields.

As a general rule, if interest rates rise, bond prices fall because of the inverse relationship between yields and interest rates (and vice versa).

- Bond yields rise as interest rates rise because market bond prices decline (i.e. higher coupon).
- Bond yields fall as market prices for bonds rise in response to declining interest rates (i.e. lower coupon).

8.8 FLOATERS AND INVERSE FLOATERS

Floater :

A floating rate note (FRN), also known as a floater, is a bond or other type of debt instrument whose interest payment is variable and linked to a predefined benchmark index, such as the London Inter-bank Offer Rate (LIBOR), that adapts to the state of the market.

A fixed-rate note, which offers the same interest rate throughout its full maturity, can be compared to a floating-rate note.

A fixed income security called a floater makes coupon payments in accordance with a reference rate. The coupon payments are modified in response to changes in the current market interest rates. The value of the coupons is increased to reflect an increase in interest rates as they occur.

A floater typically pays less interest than a comparable fixed-rate note of the same maturity since it is based on short-term interest rates, which are normally lower than long-term interest rates. Investors may ask for a higher interest rate, such as the three-month T-bill rate + 0.75%, if they believe the issuer's creditworthiness is declining.

A floater is more beneficial to the holder as interest rates are rising because it allows a bondholder to participate in the upward movement in rates since the coupon rate of the bond will be adjusted upwards. Investors who choose floaters are willing to accept a lower initial rate in exchange for the possibility of a higher rate if market rates rise.

What Is an Inverse Floater?

A bond or other type of paper that has a coupon rate that is inversely correlated to a benchmark rate is known as a "inverse floater." Inverse floaters alter their coupon payments in response to changes in interest rates. An inverse floater is often referred to as a reverse floater or an inverse floating rate note.

These bonds are typically issued by governments and businesses, who sell them to investors in order to raise money. While businesses might use the money from a bond issue to create a new plant or purchase equipment, governments might utilise these cash to construct roads and bridges. Investors of an inverse floater will receive cash payments in the form of periodic interest payments, which will adjust in the opposite direction of the prevailing interest rate.

How an Inverse Floater Works?

In contrast to a floating-rate note (FRN), which is a fixed income security that issues coupon payments that are correlated to a reference rate, an inverse floating rate note (or inverse floater) operates in a completely different manner. A floating-rate note's coupon payments are modified in response to shifts in the market's benchmark interest rate. The coupon's value rises in response to an increase in interest rates.

As their reference or benchmark interest rates, floating-rate notes may use the London Interbank Offered Rate (LIBOR), Euro Interbank Offer Rate (EURIBOR), the prime rate, or the U.S. Treasury rate.

The coupon rate on a note with an inverse floater varies in opposition to the benchmark interest rate. By dividing fixed-rate bonds into two classes—a floater, which moves in direct correlation with some interest rate index, and an inverse floater, which represents the fixed-rate bond's residual interest after deducting the floating rate—inverse floaters are created.

Calculating an Inverse Floater

Given that the rate is subtracted from the coupon payment, when the reference rate rises, the coupon rate will also rise. The noteholder will receive less money if the interest rate is greater since more will be withheld. Similarly, as interest rates fall, the coupon rate increases because less is subtracted.

An inverse floater's coupon rate can be calculated using the following general formula:

Floating rate = Fixed rate – (Coupon leverage x Reference rate)

The coupon leverage is the multiple by which the coupon rate will change for a 100-basis point (bps) change in the reference rate. The fixed-rate is the maximum rate the floater can realize.

Special Considerations:

Inverse floaters significantly increase interest rate risk, just like any investments that use leverage. The market price and yield of the inverse floater both rise in response to a decline in short-term interest rates, amplifying the price movement of the bond.

On the other hand, when short-term interest rates increase, the bond's value may drastically decline, leaving holders with a security that only pays minimal interest. Consequently, interest rate risk is increased and has a high level of volatility.

8.9 SUMMARY

- The bond market, also known as the debt market or credit market, is a financial exchange where investors can trade in debt instruments issued by both governments and corporations.
- The primary market and secondary market are the two main divisions that make up the bond market.
- The variable rate saving bonds 2020 (FRSB) that the RBI issues are also known as RBI bonds. 7-year taxable bonds with an interest rate that fluctuates throughout the course of the bond's term.
- A coupon bond is a specific kind of bond that has attached coupons and makes periodic interest payments (usually annually or semi-annually) throughout its life as well as its par value upon maturity.

8.10 UNIT END QUESTIONS

A. Descriptive Questions:

Short Answers:

1. What Bonds? Discuss its characteristics.
2. Explain the different types of bonds.
3. Differentiate between primary market and secondary market.
4. Write note on inverse floater.
5. Discuss the Inverse Relationship Between Bond Prices and Bond Yields.

B. Fill in the blanks:

1. …………… is the amount of money the bond will be worth when it matures.

2. A …………… issued by the central or state governments of India is a government securities bond.

3. LIBOR stands for………….

4. A floating rate note (FRN), also known as a…………...

5. The central government issues ……………. bonds to investors who wish to invest in gold but do not want to carry physical gold around with them.

Answers:

1- Face value, 2- debt instrument, 3- London Inter-bank Offer Rate, 4- floater, 5- **Sovereign Gold Bonds**.

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9

FIXED INCOME SECURITIES - II

Unit Structure

9.0 LEARNING OBJECTIVES

After studying this unit, you will be able:

- To analyse Fixed income securities
- To discuss Spot rates and forward rates
- To explain Zero coupon yield curve
- To discuss Theories of term structure of interest rates.
- To describe Fixed income risk measures: duration, modified duration, convexity and price value of basis point

9.1 INTRODUCTION

The term "spot rates" describes the interest rates on financial instruments that are traded on the stock exchanges and are due "on the spot." These might include overnight bank loans, commercial paper, or short-term securities like Treasury bills. The fair value of a financial instrument, such as a bond, is frequently calculated using spot rates as a benchmark.

On the other hand, forward rates are interest rates that are established now but won't be paid until a later time. They show a spot rate's anticipated future worth at a specific time. on instance, if the spot rate on a 1-year Treasury bond is 2% right now, the 1-year forward rate for the same bond could be 2.5%, suggesting that higher interest rates are anticipated over the course of the next year.

9.2 SPOT RATES AND FORWARD RATES

Forward Rate vs. Spot Rate:

In many markets, "ahead rate" and "spot rate" have slightly different exact definitions. A forward rate, on the other hand, refers to the price or yield for the same product or instrument at a specific future date. In speaking, a spot rate refers to the current price or bond yield.

A spot rate is the price for a commodity that is being exchanged right away, or "on the spot," in the markets for commodities futures. The settlement price for a transaction that won't happen until a future date is known as a forward rate.

Spot Rate :

The price stated in real-time for the immediate settlement of a contract is known as a spot rate or spot price. The current cost to buy or sell a commodity, security, or currency is represented by the spot rate in commodities markets.

Since the contract's delivery date often falls within two business days of the transaction date, a spot rate is linked to an item's immediate necessity. Any price variations between the Settlement Date and the Delivery Date shall not affect the Contract's completion at the agreed-upon Spot Rate. Buyers and sellers who agree to a spot rate contract are sacrificing potentially advantageous future market conditions in order to reduce the risk of price fluctuation.

Forward Rate :

A forward rate is a set price that is agreed upon by all parties for the delivery of a good at a particular future date. If a buyer thinks the price of a good will increase in the future beyond the forward rate, using forward rates could be considered speculative. As an alternative, dealers employ forward rates to reduce the chance that the price of a good will drop significantly in the future.

How Do You Calculate the Forward Rate?

By comparing the anticipated future yields of two bonds, the forward rate for a bond is determined. The yield that will be obtained if the funds from the bond maturing sooner are reinvested to match the term of the bond due later is known as the forward rate.

The steps to calculate the forward rate are:

1. Determine the expected future return of the two-year bond. This is calculated as ((1 + rate) ^ term). In this example, the value is 1.15562.
2. Determine the expected future return of the one-year bond. This is calculated as ((1 + rate) ^ term). In this example, the value is 1.065%.

3. Divide the results obtained in steps 1 and 2. In this example, the result is 1.0851%.

4. Divide the result obtained in step 3 by the difference in the number of periods between the two bonds, then subtract 1 from the result. In this example, 1.0851% is divided by 1 (2 years - 1 year), and 1 is subtracted. The result of 8.5% is the one-year forward rate.

9.3 ZERO COUPON YIELD CURVE

An accrual bond, also known as a zero-coupon bond, is a financial security that doesn't pay interest but trades at a significant discount, making money when it matures and is redeemed for its full face value.

Zero-Coupon Bonds :

Some bonds are issued as zero-coupon securities right away, while others become zero-coupon securities after being decoupled from their coupons and repackaged as zero-coupon securities by a financial institution. Zero-coupon bonds are more prone to market fluctuations than coupon bonds because they deliver the entire payment at maturity.

A corporate or governmental entity can raise capital by issuing bonds. Investors buy bonds when they are issued, effectively lending money to the issuing entity. Throughout the bond's existence, the investors receive a return in the form of semi-annual or yearly coupon payments.

These bonds are issued at a significant discount and, when they mature, pay back the par value. The investor's return is calculated as the difference between the purchase price and par value. The investor will be paid the amount of their initial investment plus interest that has been accrued at a specified yield and compounded semi-annually.

Pricing a Zero-Coupon Bond:

The price of a zero-coupon bond can be calculated as:

Price = $M \div (1 + r)^n$

where:

- M = Maturity value or face value of the bond
- r = required rate of interest
- n = number of years until maturity

The price of the bond decreases as the remaining time to maturity increases, and vice versa. Zero-coupon bonds often have lengthy maturity dates, with initial maturities of at least ten years. Investors can plan for long-term objectives, such saving for a child's college education, using these long-term maturity dates. An investor can make a small initial investment that will rise over time thanks to the bond's substantial discount.

9.4 THEORIES OF TERM STRUCTURE OF INTEREST RATES

Theories of term structure of interest rates:

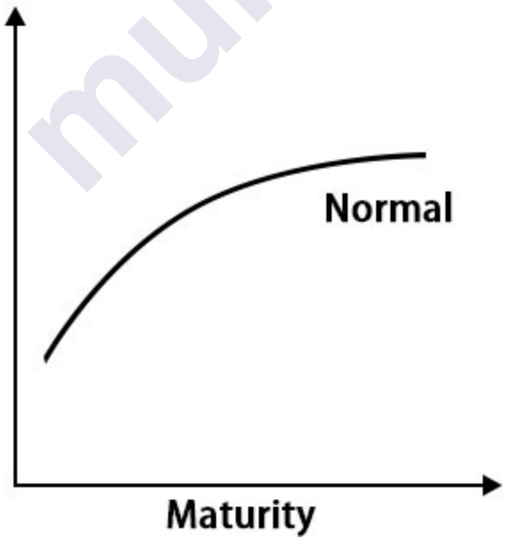
The graph that shows the correlation between interest rates (or yields on bonds) and a variety of different maturities is known as the interest rate structure. The graph is referred to as a "yield curve" itself. By enabling easy comparison of yields depending on time and anticipating the future trajectory of rates, the term structure of interest rates plays a significant role in every economy.

Types of Term Structure of Interest Rates :

- Normal/Positive Yield
- Steep
- Inverted/Negative Yield
- Humped/Bell-Shaped
- Flat

1 – Normal/Positive Yield

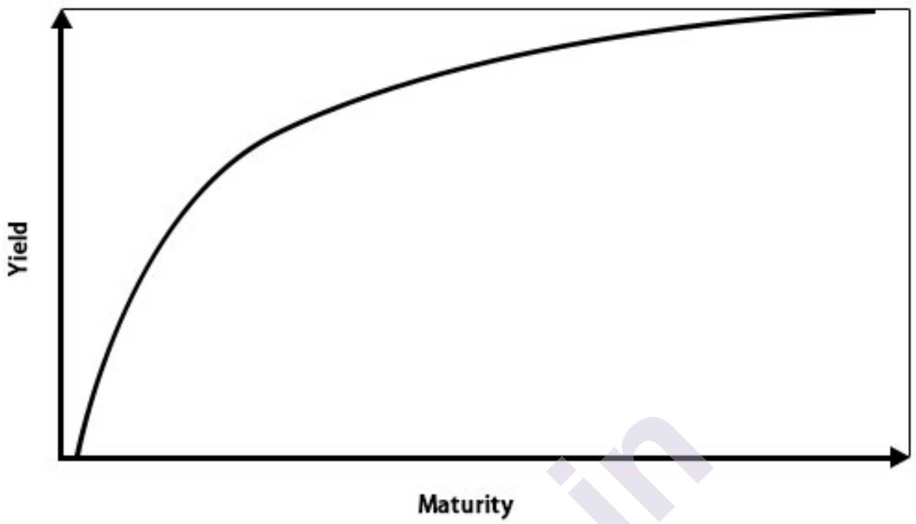
The slope of the typical yield curve is upward. This is valid for securities with longer maturities, which are more exposed to risk than short-term securities. Therefore, a rational investor would expect more compensation (yield), leading to a typical yield curve with a positive slope.



Bond yields or interest rates are plotted against X-axis while time horizons are plotted on Y-Axis.

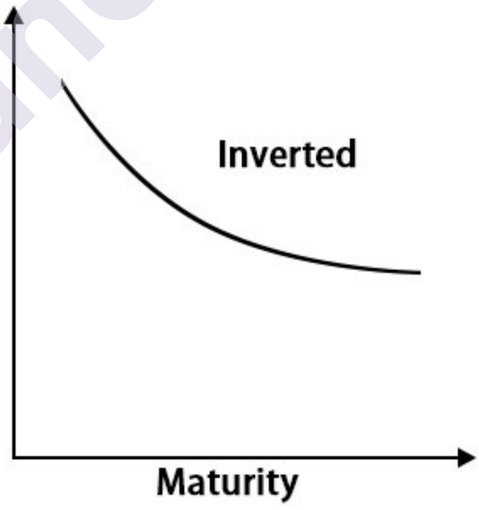
2 – Steep

The only difference between the steep yield curve and the standard yield curve is the rate at which interest rates climb for long-maturity securities relative to short-maturity instruments.



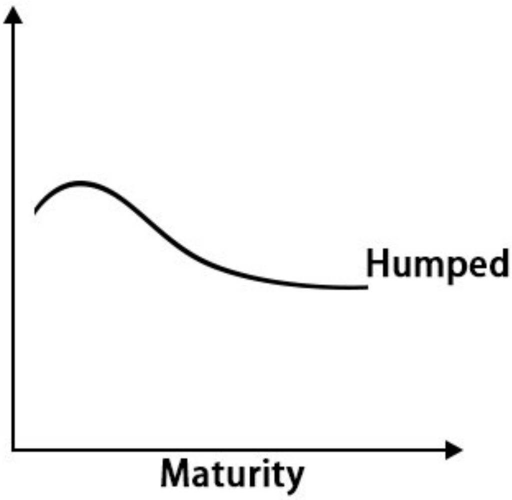
#3 – Inverted/Negative Yield :

When there is a strong likelihood that long-maturity yields would eventually fall below short-maturity yields, the curve becomes inverted. An key sign of the impending economic recession is an inverted yield curve.



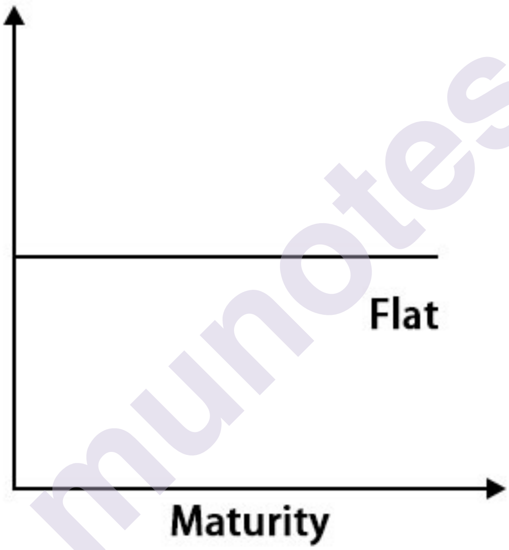
4 – Humped/Bell-Shaped

This type of curve is atypical and very infrequent. It indicated that yields for medium-term maturity are higher than both long and short terms, eventually suggesting a slowdown.



5 – Flat

Similar returns for long-, medium-, and short-term maturities are shown by a flat curve.



Term Structure Theories :

The background theories are essential to any study of term structure. They are important for comprehending the causes and mechanisms underlying the yield curves' structure.

- 1 – The Expectations Theory/Pure Expectations Theory
- 2 – Liquidity Preference Theory
- 3 – Market Segmentation Theory/Segmentation Theory
- 4 – Preferred Habitat Theory

1- The Expectations Theory/Pure Expectations Theory :

According to expectations theory, future short-term rates can be predicted from current long-term rates. By combining the returns of various bonds, it simplifies the return on a single bond. A 3-year bond, for instance, would produce about the same return as three 1-year bonds.

2 – Liquidity Preference Theory

- The more widely accepted view of investors' desires for liquidity is improved by this theory. Investors tend to favour short-term assets because they offer greater liquidity than long-term securities, which can keep money locked up for an extended period of time. This theory's main arguments are as follows:
- The price change for long-term debt securities is greater than for short-term debt securities;
- Liquidity restrictions on long-term bonds prevent the investor from selling the bond whenever he wants; and
- The investor needs an incentive to make up for the various risks he is exposed to, particularly price risk and liquidity risk.
- Less liquidity leads to an increase in yields, while more liquidity leads to falling yields, thus defining the shape of upward and downward slope curves.

3 – Market Segmentation Theory/Segmentation Theory

- This theory relates to a market's supply-demand dynamics. The following factors influence the yield curve's shape:
- Investor preferences for long-term and short-term securities.
- The maturities of an investor's assets and obligations are matched as closely as possible. Any discrepancy can result in a loss of wealth or income.
- Varied supply and demand curves are created by securities with different maturities, and these curves ultimately give rise to the final yield curve.
- High demand and little supply cause interest rates to rise.

4 – Preferred Habitat Theory

According to this hypothesis, an investor's preferences may change depending on their level of risk tolerance. If they are fairly compensated for their risk exposure, they can also opt to invest in bonds that are not generally their preference.

These were some of the key hypotheses that determined the yield curve's structure, however this list is not all-inclusive. Additionally, theories like the substitutability theory and Keynesian economic theory have been put forth.

Conclusion :

The term structure of interest rates is one of the most potent predictors of economic well being. All recessions in the past have been linked to inverted yield curves, showing how important a role they play in the credit market. Yield curves aren’t ever constant. They keep changing, reflecting the current market mood, helping the investors and financial intermediaries stay on top of everything.

9.5 FIXED INCOME RISK MEASURES: DURATION, MODIFIED DURATION, CONVEXITY AND PRICE VALUE OF BASIS POINT

Duration :

Two tools are used to control the risk exposure of fixed-income investments: duration and volatility. The duration gauges how sensitive the bond is to fluctuations in interest rates.

Duration of a Bond

The "duration" of the bond is what Canadian economist Frederick Robertson Macaulay called the effective-maturity idea in 1938. As a result, he proposed that this duration be calculated as the weighted average of the dates until maturity of each coupon, or principal payment, made by the bond. The following is the Macaulay formula for duration:

$$D=\sum i=1T(1+r)tC+(1+r)t$$

$$\sum i=1T(1+r)tt*C+(1+r)tT*F$$

Where,

D=The bond’s MacAulay duration

T=the number of periods until maturity

i=the ith time period

C=the periodic coupon payment

r=the periodic yield to maturity

F=the face value at maturity

Modified duration :

An expression expressing the quantifiable change in a security's value in response to an interest rate change is called modified duration. Modified duration is based on the idea that bond prices and interest rates fluctuate in opposing directions. This equation is used to calculate the impact of a 100 basis point (1% change) in interest rates on bond prices.

Formula and Calculation of Modified Duration:

$$\text{Modified Duration} = \frac{\text{Macaulay Duration}}{1 + \frac{\text{YTM}}{n}}$$

where**:**

Macaulay Duration=Weighted average term tomaturity of the cash flows f rom a bond

YTM=Yield to maturity

n=Number of coupon periods per year

The modified duration is a development of the Macaulay duration that enables investors to gauge how sensitive a bond is to interest rate changes. The weighted average period of time until a bondholder receives cash flows is determined by Macaulay duration. The Macaulay duration must be determined before the modified duration can be determined. The Macaulay duration is calculated as follows:

$$\text{Macaulay Duration} = \frac{\sum_{t=1}^{n}(PV\times CF)\times t}{\text{Market Price Of Bond}}$$

Where:

$PV\times CF$=Present value of coupon at period t

t= time to each flow in years

n = Number of coupon periods per year

Here, (PV) * (CF) is the present value of a coupon at period t, and T is equal to the time to each cash flow in years. This calculation is performed and summed for the number of periods to maturity.

What Are Duration and Convexity?

Two strategies are used to control the risk exposure of fixed-income investments: duration and convexity. The duration gauges how sensitive the bond is to fluctuations in interest rates. Convexity refers to the relationship between an interest rate change's impact on a bond's yield and price.

Investors use a statistic called duration to assess a bond's price sensitivity to changes in interest rates when dealing with coupon bonds. Fixed-income investors need a mechanism to calculate the average maturity of a bond's promised cash flow because coupon bonds make a series of payments during their tenure. This figure may then be used to calculate the bond's actual maturity. This is achieved through the length, enabling fixed-income investors to manage their portfolios' level of uncertainty more efficiently.

Convexity in Fixed Income Management

Given a change in yields, the curved line depicts the change in prices. By using the duration statistic, a straight line that is perpendicular to the curve represents the estimated change in price. The discrepancy between the duration estimate and the actual price movement is shown in the darkened area. As previously mentioned, the error in forecasting the change in bond price increases as interest rates move more dramatically.

By measuring the change in length as interest rates vary, convexity, a measure of the curvature of the changes in a bond's price in proportion to changes in interest rates, corrects for this mistake. The equation reads as follows:

C= f″(B(r))

BDr2

Where:

f″=Second order derivative

B=Bond price

r=Interest rate

D=Duration

What Does Price Value of a Basis Point Mean?

The term "price value of a basis point" (PVBP) is used to quantify how a change in yield of one basis point impacts the price of a bond. The term "price value of a basis point" can also refer to the dollar value of a basis point, the value of a basis point, or the basis point value (BPV).

Price Value of a Basis Point (PVBP):

One way to gauge a bond's price sensitivity is by looking at its basis point price value. This is frequently determined by evaluating the absolute change in a bond's price if the necessary yield increases by one basis point (BPS). PVBP, then, is the change in a bond's price caused by a.01% (one basis point) change in yield. Whether the needed yield increases or decreases by one basis point, price volatility remains constant.

A higher basis point price value indicates a larger change in the bond's price as a result of an interest rate adjustment. The modified duration can be used to determine PVBP as Modified duration x Dirty Price x 0.0001. The modified duration calculates how much a bond's price will vary proportionally to a change in yield. It is merely a measurement of the cash flows of a fixed income security's weighted average maturity. Modified duration rises as yields decline, and a higher modified duration denotes a security's increased interest-rate sensitivity. The whole price paid for a bond on the date of purchase, including accumulated interest, is known as the "dirty price," which is taken into account in the formula.

9.6 SUMMARY

- The price stated in real-time for the immediate settlement of a contract is known as a spot rate or spot price.
- Zero-coupon bonds are more prone to market fluctuations than coupon bonds because they deliver the entire payment at maturity.
- Zero-coupon bonds often have lengthy maturity dates, with initial maturities of at least ten years.
- Bond yields or interest rates are plotted against X-axis while time horizons are plotted on Y-Axis.
- The "duration" of the bond is what Canadian economist Frederick Robertson Macaulay called the effective-maturity idea in 1938.

9.7 UNIT END QUESTIONS

A. Descriptive Questions:

Short Answers:

1. Write note on Price Value of a Basis Point.

3. Differentiate between Spot rate and Forward rate.

4. Write note on Zero coupon yield curve.

5. What do you mean by Duration and Convexity?

B. Fill in the blanks:

1. A ………….. is the price for a commodity that is being exchanged right away.

2. An accrual bond, also known as a ……………. bond.

3. A key sign of the impending economic recession is an ……….. yield curve.

4. ………………. type of curve is atypical and very infrequent.

5. Yield curves are not always ………..

Answers:

1- spot rate, 2- zero-coupon, 3- inverted, 4- Humped/Bell-Shaped, 5- constant.

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10

FOREIGN EXCHANGE MARKET

Unit Structure

10.0 LEARNING OBJECTIVES

After studying this unit, you will be able to:

- Illustrate the concept of Foreign Exchange Market Structure.
- Explain the concept of Risk Management in Foreign Exchange Market.
- Illustrate the concept of Foreign Capital.

10.1 INTRODUCTION

After the Second War and the IMF par value system came into existence, we became part of the new world system. Countries had exchange control and various sorts of trade restrictions. It was after the Seventies that gradually a scheme of flexible exchange rates came into existence among leading developed countries. Gradually the developed countries started freeing their exchange rates and also moved towards their system off free trade. The World Trade Organization, of which we are a member, is now introducing all over the world a free trade system. After the advent of

Economic Reforms from 1991-1992, we have moved over to currency, convertibility on current account. The importance of the World Bank as financier has diminished considerably. The world is now dependant on private capital imports. Even the role of the IMF has diminished with most countries adopting currency convertibility. Capital flows are moving on a large scale dependent on incentives. Most countries have lifted trade barriers and reduced import duties. The WTO is introducing system in which domestic subsidies have to be removed and uniform and low import duties have now to become the standard. There is no place for tariff barriers and non-tariff barriers are also now getting lifted. The world's industries are now organized largely in terms of multinational corporations whose operations transcend many countries. International demonstration effects are working powerfully in determining the living styles in all countries

In June 1991, Indian government initiated Programme of macroeconomic stabilization and structural adjustment supported by IMF and the World Bank. As part of this Programme a new industrial policy was announced on July 24, 1991 in the Parliament, which has started the process of full-scale liberalization and intensified the process of integration of India with the global economy. A Foreign Investment Promotion Board (FIPB), authorized to provide a single window clearance has been set up. India became a signatory to the convention of MIGA for protection of foreign investments. Companies with more than 40 per cent of foreign equity are now treated on par with fully Indian owned companies. New sectors such as mining, banking, telecommunications, high-way construction, and management have been thrown Open to private, including foreign owned companies.

10.2 FOREIGN EXCHANGE- INTRODUCTION

When you are trading Forex you are trading one currency against another. An example would be when you are trading your Dollars for Euros. Most people have experienced this when visiting another country with a different currency. Because the rate for which you can trade your money fluctuates over time, it is also possible to earn money with currency trading. The only rule you have to follow says 'buy low, sell high'. Of course this is not as easy as it sounds as you never know in advance what would be considered 'low' and 'high'. However, if you know which factors influence the rate of a currency, you can make predictions about the future rate of this currency. An important aspect to know when trading is called the 'spread' of the currency. This is the difference between the rate to buy and the rate to sell the currency.

Every nation has its central bank which is responsible for the wellbeing of the economy. Central banks watch some economic factors that affect the economy and adjust their economic policy accordingly. These factors are announced regularly and the exact time of the announcement is known in advance. These factors are the fundamental indicators of the economy. The most important central banks are FED of USA, ECB of European Union, BOJ of Japan and BOE of United Kingdom. There are many fundamental indicators but there are few of them that are called the "market movers". They are called so because when they are announced they provide to the market the necessary steam to move. That happens because they have a great impact on economy and to traders' positions also. As I say earlier fundamentals are important economic indicators that influence the direction of the market. Forex fundamentals are thus important economic numbers that represent the state of the economy of a certain country/region and therefore the underlying currency. There are thousands of fundamentals but most of them have very limited influence. For instance, typically, when a Fundamental analyst is asked to predict the Forex market rates, would look at existing and expected interest rates, GDP growth rates, inflationary trends, weather changes affecting agricultural output, international trade balances, exchange rate policies of the countries involved, capital market status etc. before saying, "I believe given these indicators, the Forex market ought to be behaving in this way" and would conclude whether a currency is likely to appreciate or depreciate visa-via the other one.

10.2.1 Foreign Exchange Market Structure

Foreign Exchange market is a market where foreign currencies are bought and sold. It is simply a virtual place where buyers and sellers meet for purchasing, selling and exchanging currencies of different countries with one another.

This market is also termed as Forex market or currency market. Foreign exchange market is an international decentralized market which does not have any physical existence. This market determines the exchange rate for every currency. Forex market is the largest and highly liquid market in the world where trillions of dollars' changes hand each day.

The market is open for 24 hours a day and 5 days in a week excluding holidays. It is one of the key financial markets that facilitate the international payments system. Forex market has 2 tiers: Interbank market and over the counter market. Interbank market is one where large banks exchange currencies with each other whereas over the counter market is one where individuals and companies trade. This global market is highly risky in nature as it is not regulated by any central body. Spot market, Future market, Forward market, Option market and Swap market are major types of foreign exchange market.

The structure of foreign exchange market is composed of different participants who are the main players and occupies different positions. These participants are commercial banks, central banks, immigrants, importers, exporters, tourists and investors.

Commercial banks are important organs of foreign exchange market which are termed as "market makers". These banks trade in foreign currencies for themselves and also for their clients. Commercial banks quote the foreign exchange rate on a daily basis for purchasing and selling of foreign currencies. They act as a clearing house by facilitating the carrying off of differences in between the demand and supply of these currencies. Currencies are purchased from broker by commercial banks for selling them to buyers. Central bank is the apex body in foreign exchange market which has power to regulate operations related to trading of foreign currency. It directly intervenes in the functioning of forex market to avoid aggressive fluctuations. For controlling fluctuations, currency is sold off when it is overvalued and purchased in case it is undervalued. Central bank ensure that an exchange rate is at optimum that fulfils the needs of national economy, Broker in foreign exchange market work as an intermediary in between the commercial bank and central bank and also in between the commercial banks and buyers. These persons carry a large source of information about market. Brokers only facilitate the currency trade but do not get themselves involved in market transactions. They work on a commission basis where the task of striking the deal in-between the seller and buyer do. These are real buyers and sellers of foreign currencies who trade in foreign exchange market with the help of brokers. They approach commercial banks for purchasing and selling off currencies. Importer, exporters, tourist, immigrants and investors are some of these peoples.

10.3 RISK MANAGEMENT IN FOREIGN EXCHANGE MARKET

Managers and even treasurers are sometimes inclined to believe that they can predict FX rate movements. Some of the smartest firms on the planet spend hundreds of millions of dollars to hire in-house economists and leverage technology such as Artificial Intelligence etc. to try to predict FX rates, and no one succeeds over time.

Treasurers must accept that, even if certain developing currencies may look like a one way bet for significant time periods, the future is unknowable, This why treasurers need to follow a clear FX policy that spells out how they must hedge the business' FX risk.

Once the policy has been set, which is normally an infrequent activity; treasuries need to identify the FX exposures that must be hedged. This is the most critical part of FX risk management inaccurate exposure data will lead to wrong hedging which will increase, rather than reduce, volatility.

FX exposures are derived from FX cash flow forecasts. Cash flow forecasting is the foundational requirement for all treasury operations – treasury cannot be managed effectively and safely without cash flow forecasts.

The FX cash flow forecast is typically different from the 12 month cash flow which is normally in base currency. For FX risk management, we need to know the cash flows expected in each currency. In some cases, the 12 month cash flow may be in transaction currency, in which case this can be used for FX risk management as well as for the subsidiaries and group's short term funding and liquidity. When forecasting FX cash flows, it is important to identify the economic exposure currency, particularly if it's different from the invoice currency. A local currency invoice may hide a currency clause or automatic reprising of a commodity globally priced in USD. This is referred to as indirect FX risk. When the invoice currency is the same as the risk currency, it is referred to as a direct FX risk.

10.4 EXCHANGE RATE DETERMINATION

Exchange rate determination refers to the process by which the value of one currency is established in relation to another currency. Exchange rates are important because they affect international trade, investment, and capital flows.

A central objective of theoretical models of exchange rate determination ought to be a clearer understanding of the economic mechanisms governing the actual behaviour of exchange rates in the real world and of the relationships between exchange rates and other important economic variables. In surveying theoretical models of exchange rate determination, therefore, it is appropriate to examine the empirical regularities that have been characteristic of the behaviour of exchange rates and other related variables under floating exchange rate regimes. It is also relevant to discuss the minimum requirements for any theoretical model of exchange rate determination to be consistent with these empirical regularities

Using the concept of the "real exchange rate" (defined as the price of a unit of foreign money in terms of domestic money, divided by the ratio of the home consumer price index to the foreign consumer price index), these facts may be summarized in the following characteristic: Monthly changes in nominal exchange rates are closely correlated with monthly changes in real exchange rates, and cumulative changes in real exchange rates over a period of a year have been quite large. Fourth, during the recent period of floating exchange rates, there may have been a weak general tendency for countries that experienced sharp deteriorations in their current accounts subsequently to experience depreciation in the nominal and real foreign exchange value of their currencies. There also may have been a weak general tendency for countries that experienced sharp appreciations in nominal and real foreign exchange values of their currencies subsequently to experience deterioration in their current accounts. It has not been the case, however, that exchange rates have adjusted rapidly to eliminate current account imbalances, nor has there been strong correlation between exchange rate changes and either levels of changes in current account balances that has held up consistently over time and across countries, These facts may be summarized in the following characteristic: There is no strong and systematic relationship between movements in nominal or real exchange rates and current account balances that allows for an explanation of a substantial fraction of actual exchange rate movements.

10.5 FOREIGN CAPITAL

Foreign investment refers to investments made by the residents of a country in the financial assets and production processes of another country. The effect of foreign investment, however, varies from country to country. It can affect the factor productivity of the recipient country and can also affect the balance of payments. Foreign investment provides a channel through which countries can gain access to foreign capital. It can come in two forms: FDI and foreign institutional investment (FII). Foreign direct investment involves in direct production activities and is also of a medium- to long-term nature. But foreign institutional investment is a short-term investment, mostly in the financial markets. FII, given its short-term nature, can have bidirectional causation with the returns of other domestic financial markets such as money markets, stock markets, and foreign exchange markets. Hence, understanding the determinants of FII is very important for any emerging economy as FII exerts a larger impact on the domestic financial markets in the short run and a real impact in the long run. India, being a capital scarce country, has taken many measures to attract foreign investment since the beginning of reforms in 1991.

10.5.1 Foreign Direct Investment (FDI)

Foreign direct investment (FDI) is an investment from a party in one country into a business or corporation in another country with the intention of establishing a lasting interest. Lasting interest differentiates FDI from foreign portfolio investments, where investors passively hold securities from a foreign country. A foreign direct investment can be made by obtaining a lasting interest or by expanding one's business into a foreign country.

An investment into a foreign firm is considered an FDI if it establishes a lasting interest. A lasting interest is established when an investor obtains at least 10% of the voting power in a firm.

The key to foreign direct investment is the element of control. Control represents the intent to actively manage and influence a foreign firm's operations. This is the major differentiating factor between FDI and a passive foreign portfolio investment.

For this reason, a 10% stake in the foreign company's voting stock is necessary to define FDI. However, there are cases where this criterion is not always applied. For example, it is possible to exert control over more widely traded firms despite owning a smaller percentage of voting stock.

A foreign direct investment (FDI) is an investment made by a firm or individual in one country into business interests located in another country. Generally, FDI takes place when an investor establishes foreign business operations or acquires foreign business assets in a foreign company. However, FDIs are distinguished from portfolio investments in which an investor merely purchases equities of foreign-based companies. Foreign direct investments are commonly made in open economies that offer a skilled workforce and above-average growth prospects for the investor, as opposed to tightly regulated economies. Foreign direct investment frequently involves more than just a capital investment. It may include provisions of management or technology as well. The key feature of foreign direct investment is that it establishes either effective control of or at least substantial influence over the decision-making of a foreign business.

The Bureau of Economic Analysis (BEA), which tracks expenditures by foreign direct investors into U.S. businesses, reported total FDI into U.S. businesses of $4.46 trillion at the end of 2019. Manufacturing represented the top industry, with just over 40% of FDI for 2019.

Foreign direct investments can be made in a variety of ways, including the opening of a subsidiary or associate company in a foreign country, acquiring a controlling interest in an existing foreign company, or by means of a merger or joint venture with a foreign company.

The threshold for a foreign direct investment that establishes a controlling interest, per guidelines established by the Organisation of Economic Co-operation and Development (OECD), is a minimum 10% ownership stake in a foreign-based company. However, that definition is flexible, as there are instances where effective controlling interest in a firm can be established with less than 10% of the company's voting shares

Foreign direct investments are commonly categorized as being horizontal, vertical or conglomerate. A horizontal direct investment refers to the investor establishing the same type of business operation in a foreign country as it operates in its home country, for example, a cell phone provider based in the United States opening stores in China.

A vertical investment is one in which different but related business activities from the investor's main business are established or acquired in a foreign country, such as when a manufacturing company acquires an interest in a foreign company that supplies parts or raw materials required for the manufacturing company to make its products.

A conglomerate type of foreign direct investment is one where a company or individual makes a foreign investment in a business that is unrelated to its existing business in its home country. Since this type of investment involves entering an industry in which the investor has no previous experience, it often takes the form of a joint venture with a foreign company already operating in the industry.

10.5.2 Foreign Institutional Investors (FII)

Foreign Institutional Investors (FII) are an investment fund or a gathering of investors. Such a fund is registered in a foreign country, i.e. not in the country it is investing in. Such institutional investors mostly involve hedge funds, mutual funds, pension funds, insurance bonds, high-value debentures, investment banks etc.

We use this term FII for foreign players investing funds in the financial market of India. They play a big role in the development of our economy. The amount of funds they invest is very considerable.

So when such FII's buy shares and securities the market is bullish and trends upwards. The opposite may also happen when they withdraw their funds from the markets. So they have considerable sway over the market.

There are many ways for a foreign investor to invest in a country. The most direct method, of course, is Foreign Direct Investment. However, there are other ways to enter an economy, like Foreign Institutional Investors.

A foreign institutional investor (FII) is an investor or investment fund investing in a country outside of the one in which it is registered or headquartered. The term foreign institutional investor is probably most commonly used in India, where it refers to outside entities investing in the nation's financial markets.1the term is also used officially in China. FIIs can include hedge funds, insurance companies, pension funds, investment banks, and mutual funds. FIIs can be important sources of capital in developing economies, yet many developing nations, such as India, have placed limits on the total value of assets an FII can purchase and the number of equity shares it can buy, particularly in a single company.3 This helps limit the influence of FIIs on individual companies and the nation's financial markets, and the potential damage that might occur if FIIs fled en masse during a crisis.

FIIs are allowed to invest in India's primary and secondary capital markets only through the country's portfolio investment scheme. This scheme allows FIIs to purchase shares and debentures of Indian companies on the nation's public exchanges.

10.6 CENTRAL BANK INTERVENTION IN FOREIGN EXCHANGE MARKET

There exists a plethora of studies analysing the role of Central Bank's intervention in the foreign exchange market. However, there is a lack of literature comprehensively analysing the effectiveness of Central Bank's intervention in the forex market under a managed float exchange rate regime. The analysis becomes even more nuanced when the central bank (CB) has other objectives (like inflation targeting) and/or when it does not reveal the band of the managed float. This makes a modest attempt to understand the nuances of such intervention when the CB tries to maintain the exchange rate within a desired band along with keeping a check on the domestic inflation level as foreign capital flows in. Economic theory tells us that intervention in the forex market by the CB is contingent upon the country's exchange rate regime. Theoretically, the CB needs (does not need) to intervene if the country follows a fixed (flexible) exchange rate regime. Such behaviour on part of the CB of a country becomes pivotal when we allow for capital flows ending up in the 'impossible trinity' of the Mundell-Fleming framework1 . When foreign capital flows into an economy, broadly two things can happen. If the country follows a flexible exchange rate regime (no intervention by the CB) capital flows would lead to an appreciation of the domestic currency which in turn may lead to current account deficit. However, if the country follows a fixed exchange rate regime, the CB would intervene by buying up foreign exchange to keep the exchange rate unchanged leading to an increase in the foreign exchange reserve of the country . Following the 'impossible trinity', it is obvious that the CB would give-up fixed exchange rate regime if the economy prefers an independent monetary policy along with free capital flows. However, capital flows can lead to inflationary situations if the CB does not take any sterilization measures. Thus, majority of the countries, particularly the developing ones, find it apt to follow a managed float regime which helps them to keep exchange rates within a desired band3 along with mitigating inflationary pressures that may arise due to partial intervention. Hence, the role of the CB becomes a mix of intervention and non-intervention depending on the desired and realized values of the exchange rates.

- Zone of no intervention (within a desired band),
- Zone of intervention when the exchange rate tends to reach the lower value of the band and
- Zone of intervention when the exchange rate tends to reach the upper value of the band. Accordingly, the number of regimes in the TVAR model is chosen to be three. Further, as discussed later, Likelihood Ratio (LR) tests reject the null hypothesis of linear VAR model against both two-regime and three-regime TVAR models. In this we consider the case of India and analyze the effectiveness of the interventions of the Reserve Bank of India (RBI) in influencing the Indian Rupee-US Dollar (Re/$) exchange rate4 . The stated aim of RBI is to dampen the fluctuations of the exchange rate. However, it has regularly intervened in the forex market through sale and purchase of foreign currency. Interestingly, the details are not made public. Still, the bulging foreign exchange reserve held by RBI5 speaks volumes about its intervention in the forex market.

Characteristics of the Foreign Exchange Market

The international business context requires trading and investing in assets denominated in different currencies. Foreign assets and liabilities add a new dimension to the risk profile of a firm or an investor's portfolio: foreign exchange risk. This chapter has two goals. First, this chapter introduces the terminology used in foreign exchange markets. Second, this chapter presents the instruments used in currency markets.

- **Most Liquid Market in the World**

Currency spot trading is the most popular FX instrument around the world, comprising more than 1/3 of the total activity. It is estimated that spot FX trading generates about $1.5 trillion a day in volume, making it the largest most liquid market in the world.

Compare that to futures $437.4bn and equities $191bn and you will see that foreign exchange liquidity towers over any other market. Even though there are many currencies all over the world, 80% of all daily transactions involve trading the G-7 currencies i.e. the “majors.”

When compared to the futures market, which is fragmented between hundreds of types of commodities, and multiple exchanges and the equities market, with 50,000 listed stocks (the S&P 500 being the majority), it becomes clear that the futures and equities provides only limited liquidity when compared to currencies.

Liquidity has its advantages, the primary one being no manipulation of the market. Thin stock and futures markets can easily be pushed up or down by specialists, market makers, commercials, and locals. Spot FX on the other hand takes real buying/selling by banks and institutions to move the market. Any attempted manipulation of the spot FX market usually becomes an exercise in futility.

Thus, surveys have indicated that there is more foreign exchange trading in dollars in London than in the United States, and more foreign exchange trading in marks than in Germany. However, the bulk of trading in London, about 85 percent, is accounted for by foreign-owned (non-U.K. owned) institutions, with U.K.-based dealers of North American institutions reporting 49 percent, or three times the share of U.K.-owned institutions there.

- **Most Dynamic Market in the World**

Foreign exchange market is the most dynamic market in the world. Regardless of which instrument you are trading – be it stocks, municipal bonds, U.S. treasuries, agricultural futures, foreign exchange, or any of the countless others – the attributes that determine the viability of a market as an investment opportunity remain the same.

Namely, good investment markets all possess the following characteristics- liquidity, market transparency, low transaction costs, and fast execution. Based upon these characteristics, the spot FX market is the perfect market to trade.

- **It is a Twenty-Four Hour Market**

During the past quarter century, the concept of a twenty-four-hour market has become a reality. Somewhere on the planet, financial centres are open for business, and banks and other institutions are trading the dollar and other currencies, every hour of the day and night, aside from possible minor gaps on weekends. In financial centres around the world, business hours overlap; as some centres close, others open and begin to trade. The foreign exchange market follows the sun around the earth.

The International Date Line is located in the western Pacific, and each business day arrives first in the Asia-Pacific financial centres first Wellington, New Zealand, then Sydney, Australia, followed by Tokyo, Hong Kong, and Singapore. A few hours later, while markets remain active in those Asian centres, trading begins in Bahrain and elsewhere in the Middle East.

The twenty-four hour market means that exchange rates and market conditions can change at any time in response to developments that can take place at any time. It also means that traders and other market participants must be alert to the possibility that a sharp move in an exchange rate can occur during an off hour, elsewhere in the world.

However, foreign exchange activity does not flow evenly. Over the course of a day, there is a cycle characterized by periods of very heavy activity and other periods of relatively light activity. Most of the trading takes place when the largest number of potential counterparties is available or accessible on a global basis.

Market liquidity is of great importance to participants. Sellers want to sell when they have access to the maximum number of potential buyers/ and buyers want to buy when they have access to the maximum number of potential sellers.

- **Market Transparency**

Price transparency is very high in the FX market and the evolution of online foreign exchange trading continues to improve this, to the benefit of traders. One of the biggest advantages of trading foreign exchange online is the ability to trade directly with the market maker. A reputable forex broker will provide traders with streaming, executable prices. It is important to make a distinction between indicative prices and executable prices.

Furthermore, trading online directly with the market maker means traders receive a fair price on all transactions. When trading equities or futures through a broker, traders must request a price before dealing, allowing for brokers to check a trader's existing position and 'shade' the price a few pips depending on the trader's position.

Online trading capabilities in FX also create more efficiency and market transparency by providing real time portfolio and account tracking capability. Traders have access to real time profit/loss on open positions and can generate reports on demand, which provide detailed information regarding every open position, open order, margin position and generated profit/loss per trade.

- **International Network of Dealers**

The market is made up of an international network of dealers. The market consists of a limited number of major dealer institutions that are particularly active in foreign exchange, trading with customers and with each other. Most, but not all, are commercial banks and investment banks. These dealer institutions are geographically dispersed, located in numerous financial centres around the world. Wherever located, these institutions are linked to, and in close communication with, each other through telephones, computers, and other electronic means.

At a time when there is much talk about an integrated world economy and "the global village," the foreign exchange market comes closest to functioning in a truly global fashion, linking the various foreign exchange trading centres from around the world into a single, unified, cohesive, worldwide market.

Foreign exchange trading takes place among dealers and other market professionals in a large number of individual financial centres New York, Chicago, Los Angeles, London, Tokyo, Singapore, Frankfurt, Paris, Zurich, Milan, and many, many others. But no matter in which financial centre a trade occurs, the same currencies, or rather, bank deposits denominated in the same currencies, are being bought and sold.

- **Most Widely Traded Currency is the Dollar**

The dollar is by far the most widely traded currency. According to the 1998 survey, the dollar was one of the two currencies involved in an estimated 87 percent of global foreign exchange transactions, equal to about $1.3 trillion a day. In part, the widespread use of the dollar reflects its substantial international role as "investment" currency in many capital markets, "reserve" currency held by many central banks, "transaction" currency in many international commodity markets, "invoice" currency in many contracts, and "intervention" currency employed by monetary authorities in market operations to influence their own exchange rates.

In addition, the widespread trading of the dollar reflects its use as a "vehicle" currency in foreign exchange transactions, a use that reinforces, and is reinforced by, its international role in trade and finance. For most pairs of currencies, the market practice is to trade each of the two currencies against a common third currency as a vehicle, rather than to trade the two currencies directly against each other. The vehicle currency used most often is the dollar, although by the mid-1990s the Deutsche mark also had become an important vehicle, with its use, especially in Europe, having increased sharply during the 1980s and '90s.

- **"Over-The-Counter" Market with an "Exchange-Traded" Segment**

Until the 1970s, all foreign exchange trading in the United States (and elsewhere) was handled "over-the-counter," (OTC) by banks in different locations making deals via telephone and telex. In the United States, the OTC market was then, and is now, largely unregulated as a market.

Buying and selling foreign currencies is considered the exercise of an express banking power. Thus, a commercial bank or Securities & brokerage firms in the United States do not need any special authorization to trade or deal in foreign exchange.

There are no official rules or restrictions in the United States governing the hours or conditions of trading. The trading conventions have been developed mostly by market participants. There is no official code prescribing what constitutes good market practice.

However, the Foreign Exchange Committee, an independent body sponsored by the Federal Reserve Bank of New York and composed of representatives from institutions participating in the market, produces and regularly updates its report on Guidelines for Foreign Exchange Trading. These Guidelines seek to clarify common market practices and offer "best practice recommendations" with respect to trading activities, relationships, and other matters.

Although the OTC market is not regulated as a market in the way that the organized exchanges are regulated, regulatory authorities examine the foreign exchange market activities of banks and certain other institutions participating in the OTC market.

As with other business activities in which these institutions are engaged, examiners look at trading systems, activities, and exposure, focusing on the safety and soundness of the institution and its activities. Examinations deal with such matters as capital adequacy, control systems, disclosure, sound banking practice, legal compliance, and other factors relating to the safety and soundness of the institution.

The OTC market accounts for well over 90 percent of total U.S. foreign exchange market activity, covering both the traditional products (spot, outright forwards, and FX swaps) as well as the more recently introduced (post-1970) OTC products (currency options and currency swaps). On the "organized exchanges," foreign exchange products traded are currency futures and certain currency options.

- **Determinants of FDI**

There are various factors that influence the FDI inflows into a country. The investors consider and evaluate various aspects of a country before investing in it. The relative importance of these determinants of FDI varies not only between countries but also between different types of FDI. Traditionally, the determinants of FDI include the following:

- **Size of the Market**

The developing countries possess substantial markets where the consumers demand for certain goods far exceed the available supplies. This demand potential is a big draw for many foreign enterprises. In many cases, the establishment of a low cost marketing operation represents the first step by a multinational company into the market of the country. This establishes a presence in the market and provides important insights into the ways of doing business and possible opportunities in the country.

- **Political Stability**

In many countries, the institutions of government are still evolving and there are unsettled political questions. Companies will generally be unwilling to contribute large amounts of capital into an environment where some of the basics political questions have not yet been resolved.

- **Macro-Economic Environment**

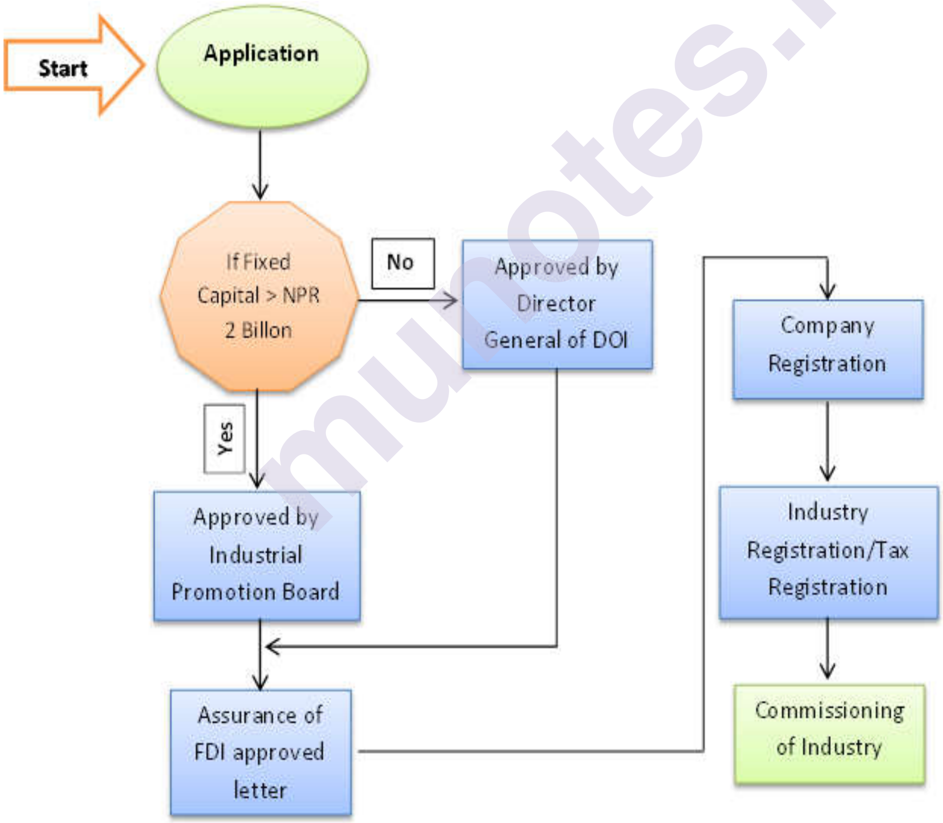
Instability in the level of prices and exchange rate enhance the level of uncertainty, making business planning difficult. This increases the perceived risk of making investments and therefore adversely affects the inflow of FDI

- **Legal and Regulatory Framework**

The transition to a market economy entails the establishment of a legal and regulatory framework that is compatible with private sector activities and the operation of foreign owned companies. The relevant areas in this field include protection of property rights, ability to repatriate profits, and a free market for currency exchange. It is important that these rules and their administrative procedures are transparent and easily comprehensive.

- **Access to Basic Inputs**

Many developing countries have large reserves of skilled and semi-skilled workers that are available for employment at wages significantly lower than in developed countries. This provides an opportunity for foreign firms to make investments in these countries to cater to the export market. Availability of natural resources such as oil and gas, minerals and forestry products also determine the extent of FDI.



- **Global Financial Markets and Instruments**

International economic management relied on the dominant power to lead the system. The concentration of power facilitated management by confining the number of actors whose agreement was necessary to establish rules, institutions, and procedures and to carry out management within the agreed system. That leader was, of course, the United States. As the world's foremost economic and political power, the United States was clearly in a position to assume the responsibility of leadership. The United States had emerged from the Second World War as the strongest economy in the world, experiencing rapid industrial growth and capital accumulation. The U.S. had remained untouched by the ravages of World War II and had built a thriving manufacturing industry and grown wealthy selling weapons and lending money to the other combatants; in fact, U.S. industrial production in 1945 was more than double that of annual production between the pre-war years of 1935 and 1939. In contrast, Europe and Japan were militarily and economically shattered. As the Bretton Woods Conference convened, the relative advantages of the U.S. economy were undeniable and overwhelming.

Shortcoming of Foreign Capital

- Unbalanced Growth Foreign capital tends to lopsided rather than balanced growth. In many cases it was observed that the foreign speculation was in these sectors and areas not in the priority list consequently the basic and key industries could not develop.

- Political Strings Many times the foreign capital has certain restrictive strings attached to it, with a motive to earn profits the borrowing country's monetary fiscal, industrial and commercial policies must be conform to the requirement and conditions of the donor country.

- Obsolete Technology there are instances of obsolete machines and technology being passed on to the Indian partners by the foreign collaborators. In some cases technology have been imported not quite appropriate to the Indian situation.

- Adverts Effect on Balance of Payment the foreign collaborations' effect on India's balance of payments has been negative. The main reason for this was high re maintenance abroad, high level of imports and low level of exports.

- Decline in Domestic construction in the Economy Domestic producers suffer because of the established by industries financed by foreign capital. They are unable to compete with foreign enterprises.

- Increase in Foreign Dependency Yearning for foreign capital and through its foreign technology and technicians increases our dependence on external sources. It moreover increases the exposure of the borrowing country towards the instability of the donor country.

- Setback to Indigenous Development of knowledge Foreign technology accompanies foreign capital. It has an adverse effect on the development of Indian technology and research.

- Uncertainty it is often observed that foreign capital becomes scarce when it is needed the most. This happens because foreign capital can be repatriated at any time. Thus an element of uncertainty looms large in respect of foreign capital.

- Favouritism it is often observed that in residential countries, foreign companies reserve higher managerial and technical posts for their own national thus denying adequate opportunity of training to people in developing countries. Usually, this foreign business avoid revealing important technical and trade secrets to the people or government of the developing country.

10.7 SUMMARY

- As mentioned earlier, the objectives of this are to find out when does RBI intervene to influence the Re/$ exchange rate and examine whether RBI has been successful in attaining its goal of bringing the Re/$ exchange rate within a desired band along with keeping a check on the domestic inflation level as FII comes in. To do so, we have employed a three regime threshold VAR (TVAR) model where the threshold variable is taken as the past values of difference between Re/$ exchange rate and its long run trend value, which can be explained as an exchange rate cycle13. Two threshold values, specifying three different regimes, are considered as unknown and estimated along with other parameters.

- As a nonlinear model, TVAR allows different parameters in different regimes, which can capture impact of RBI's intervention (either through OMO or CRR) on INF, Re/$ exchange rate and net FII inflow depending upon the regime itself. However, it must be noted that both OMO and CRR are endogenous in nature and are not exogenously chosen by RBI. As discussed earlier, the existing studies find conflicting results on the effectiveness of RBI's intervention in the forex market.

- According to our understanding, such results are obtained predominantly because of inappropriate econometric modelling which fail to capture the nuances of a managed float regime. We have considered a linear VAR model considering the above mentioned variables and compare the results with those of TVAR analysis so as to compare the effectiveness of linear and non-linear models in comprehensively capturing the nuances of CB intervention in forex market under a managed float exchange rate regime.

- In this section we present the estimation results of our analyses. We begin with the results of linear VAR models. Two different VAR models have been estimated14 separately by taking either OMO or DCRR along with other three variables, mentioned above. In these models, it is clear that all the four variables are positively affecting their future values implying existence of significant auto correlation. Apart from that, it has been found that there is a positive impact of OMO on inflation.

- This result is trivial, as higher OMO implies higher purchase of securities by RBI leading to increase in the supply of Re in the economy and hence, in turn, causing higher inflation. The estimated coefficient is 0.00197 (significant at 10% level). As per the impact of exchange rate is concerned, it has been found that ERS is positively affecting FII (significant at 5% level). This implies that a depreciation of Indian rupee will increase the inflow of FII into the economy. On the other regression, where we have considered DCRR as an instrument of RBI, we have found an increase in ERS will significantly increase FII and reduce DCRR. Further, DCRR negatively affects ERS. The estimated coefficient is -0.93927 which is significant at 1% level.

10.8 UNIT END QUESTIONS

A. Descriptive Questions

1. What is Foreign Exchange?
2. Define the term Market Structure?
3. What is term of Exchange Rate?
4. Define Foreign Direct Investment?
5. What is Foreign Institutional Investors?
6. Explain the concept of Foreign Exchange Market Structure.
7. Explain the concept of Risk Management in Foreign Exchange Market.
8. Illustrate the concept of Exchange Rate Determination.
9. Illustrate the concept of Foreign Capital.
10. Examine the Central Bank Intervention in Foreign Exchange Market.

10. Fill in the Blanks

1. The foreign direct investment include ………….
2. The Treaty of Rome was signed in the year ………….
3. In ……….. year Austria join the European Union.
4. The foreign policy decision-makers rely on for spreading information through………….
5. FDI stands for……………

Answers

1- Tangible goods, 2-1957, 3-1995, 4- Media, 5- Foreign Direct Invetsment

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