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POST GRADUATE DIPLOMA IN FINANCIAL MANAGEMENT

FINANCIAL MARKETS

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Financial Markets

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II	**Capital Markets -** Industrial securities, Primary markets, Secondary markets, Stock exchanges, Stock market index - Buying and selling securities on the stock exchanges - Stock exchange terms.	25%
III	**Money Market -** Call money markets - Commercial Bill market, - Markets for commercial papers and Certificate of deposits, The discount market, Government securities market, - treasury bills.	25%
IV	**Foreign exchange market** Nature, Organization and Participants, Exchange rates, devaluation and depreciation, Currency convertibility. Market for futures, Options and other Derivatives	25%

Reference Books :

1) Financial Markets and Institutions - L. M. Bhole
2) Financial Markets - Dr. P. K. Bandgar

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MODULE - I

1

FINANCIAL SYSTEM

Unit Structure

1.1 INTRODUCTION

- This Unit presents bare elements of a financial system.
- It discusses the constituents, economic developmental contribution and constraints, and performance criteria of the financial system and certain concepts in its development.

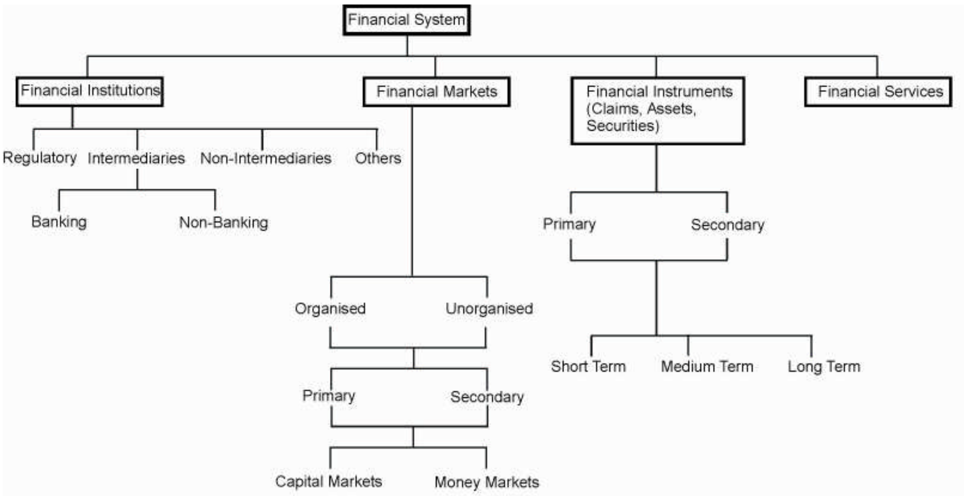
1.2 STRUCTURE OF A FINANCIAL SYSTEM

The financial system or financial sector of any country consists of specialised and non-specialised financial institutions, of organised and unorganised financial markets, of financial instruments and services which facilitate transfer of funds. Procedures and practices adopted in the markets, and financial interrelationships are also parts of the system. These parts are not always mutually exclusive; for example, financial institutions operate in financial markets and are, therefore, a part of such markets.

The word "system" in the term "financial system", implies a set of complex and closely connected or interlinked institutions, agents, practices, markets, transactions, claims and liabilities in the economy. The financial system is concerned about money, credit and finance-the three terms are intimately related yet are somewhat different from each other. Money refers to the current medium of exchange or means of payment. Credit or loan is a sum of money to be returned, normally with interest; it refers to a debt of economic unit. Finance is a monetary resources comprising debt and ownership funds of the state, company or person. Figure 1.1 presents the typical structure of a financial system in any economy.

Financial Institutions are business organisations that act as mobilisers and depositories of savings and as purveyors of credit or finance. They also provide various financial services to the community. They differ from non-financial (industrial and commercial) business organisations in respect of their dealings, i.e. while the former deal in financial assets such as deposits, loans, securities and so on, the latter deal in real assets such as machinery, equipment, stocks of goods, real estate and so on. The distinction between the financial sector and the "real sector" should not be taken to mean that there is something unproductive (ephemeral) about finance. At the same time, it means that the role of financial sector should not be overemphasised. The activities of different financial institutions may be either specialised or they may overlap; quite often they overlap. Yet we need to classify financial institutions and this is done on the basis of their primary activity or the degree of their specialisation with relation to savers or borrowers with whom they customarily deal or the manner of their creation. In other words, the functional, geographic, sectoral scope of activity or the type of ownership are some of the criteria which are often used to classify a large number and variety of financial institutions which exist in the economy. However, it should be kept in mind that such classification is likely to be imperfect and tentative.

According to one classification, financial institutions are divided into banking and non-banking institutions. The banking institutions have quite a few things in common with the non-banking ones, but their distinguishing character lies in the fact that, unlike other institutions. they participate in the economy's payments mechanism, i.e., they provide transactions services, their deposit liabilities constitute a major part of the national money supply, and they can, as a whole, create deposits or credit, which is money.



Banks, subject to legal reserve requirements, can advance credit by creating claims against themselves, while other institutions can lend only out of resources put at their disposal by the savers. The distinction between the two has been highlighted by Sayers by characterising the former as "creators" of credit, and the latter as mere "purveyors" of credit. While the banking system in India comprises the commercial banks and co-operative banks, the examples of non-banking financial institutions are Life Insurance Corporation (LIC), Unit Trust of India (UTI) and Industrial Development Bank of India (IBDI).

Financial institutions are also classified as intermediaries and non-intermediaries. As the term indicates, intermediaries intermediate between savers and investors; they lend money as well as mobilise savings; their liabilities are towards the ultimate savers; while their assets are from the investors or borrowers. Non-intermediary institutions do the loan business but their resources are not directly obtained from the savers. All banking institutions are intermediaries. Many non-banking institutions also act as intermediaries and when do so they are known as Non-Banking institutions also act as intermediaries and Insurance Corporation (GIC) are some of the NBFIs in India. Non-intermediary institutions like IDBI, Industrial Finance Corporation (IFC), and National Bank for Agriculture and Rural Development (NABARD) have come into existence because of governmental efforts to provide assistance for specific purposes, sectors and regions. Their creation as a matter of policy has been motivated by the philosophy that the credit needs of certain borrowers might not be otherwise adequately met by the usual private institutions. Since they have been set up the government, we can call them Non-Banking Statutory Financial Organisations (NBSFO).

Financial markets are the centres or arrangements that provide facilities for buying and selling of financial claims and services. The corporations, financial institutions, individuals and governments trade in financial products in these markets either directly or through brokers and dealers on organised exchanges of off-exchanges. The participants on the demand and supply sides of these markets are financial institutions, agents, brokers, dealers, borrowers, lenders, savers and others who are interlinked by the laws, contracts, covenants and communication networks.

Financial markets are sometimes classified as primary (direct) and secondary (indirect) markets. The primary markets deal in the new financial claims or new securities and, therefore, they are also known as new issue markets. On the other hand, secondary markets deal in securities already issued or existing or outstanding. The primary market mobilise savings and supply fresh or additional capital to business units. Although secondary markets do not contribute directly to the supply of additional capital, they do so indirectly by rendering securities issued on the primary markets liquid. Stock markets have both primary and secondary market segments.

Very often financial markets are classified as money markets and capital markets, although there is essential difference between the two as both perform the same function of transferring resources to the producers. This conventional distinction is based on the differences in the period of maturity of financial assets issued in these markets. While money markets deal in the short-term claims (with a period of maturity of one year or less), capital markets do so in the long-term (maturity period above one year) claims. Contrary to popular usage, the capital market is not only co-existence with the stock market; but it is also much wider than the stock market. Similarly, it is not always possible to include a given participant in either of the two (money and capital) markets alone. Commercial banks, for example, belong to both. While treasury bills market, call money market, and commercial bills markets are examples of money market, stock market and government bonds markets are examples of capital market.

Keeping in view different purposes, financial markets have also been classified into the following categories:

a. Organised and unorganised

b. Formal and informal

c. Official and parallel and

d. Domestic and foreign.

There is no precise connotation with which the words unorganised and informal are used in this context. They are quite often used interchangeably. The financial transactions which take place outside the well-established exchanges or without systematic and orderly structure or arrangements constitute the unorganised markets. They generally refer to the markets in villages or rural areas, but they exist in urban areas also. Interbank money markets and most foreign exchange markets do not have organised exchanges. But they are not unorganised markets in the same way the rural markets are. The informal markets are said usually involve families and small groups of individuals lending and borrowing from each other. This description cannot be strictly applied to the foreign exchange markets, but they are also mostly informal markets.

As mentioned earlier, financial systems deal in financial services and claims or financial assets or securities or financial instruments. These services and claims are many and varied in character. This is so because of the diversity of motives behind borrowing and lending. The stage of development of the financial system can often be judged from the diversity of financial instruments that exist in the system.

The financial assets represent a claim to the payment of a sum of money sometime in the future (repayment of principal) and / or a periodic (regular or not so regular) payment in the form of interest or dividend. With regard to bank deposit or government bond or industrial debenture, the holder receives both the regular periodic payments and the repayment of the principal at a fixed date. Whereas with regard to ordinary share or perpetual bond, only periodic payments are received (which are regular in the case of perpetual bond but may be irregular in the case of ordinary share).

Financial securities are classified as primary (direct) and secondary (indirect) securities. The primary securities are issued by the ultimate investors directly to the ultimate savers as ordinary shares and debentures, while the secondary securities are issued by the financial intermediaries to the ultimate savers as bank deposits, units, insurance policies, and so on. For the purpose of certain types of analysis, it is also useful to talk about ownership securities (viz., shares) and debt securities (viz. debentures, deposits).

Financial instruments differ from each other in respect of their investment characteristics which, of course, are interdependent and interrelated. Among the investment characteristics of financial assets of financial products, the following are important:

1. Liquidity

2. Marketability

3. Reversibility

4. Transferability

5. Transaction Costs

6. Risk of default or the degree of capital and income uncertainty and a wide array of other risks

7. Maturity period

8. Tax Status

9. Options such as call-back or buy-back options

10. Volatility of prices and

11. The rate of return-nominal, effective and real.

1.3 SUMMARY

- The financial system or financial sector of any country consists of specialised and non-specialised financial institutions, of organised and unorganised financial markets, of financial instruments and services which facilitate transfer of funds. Procedures and practices adopted in the markets, and financial interrelationships are also parts of the system. These parts are not always mutually exclusive; for example, financial institutions operate in financial markets and are, therefore, a part of such markets.
- The word "system" in the term "financial system", implies a set of complex and closely connected or interlinked institutions, agents, practices, markets, transactions, claims and liabilities in the economy. The financial system is concerned about money, credit and finance-the three terms are intimately related yet are somewhat different from each other.
- Financial Institutions are business organisations that act as mobilisers and depositories of savings and as purveyors of credit or finance. They also provide various financial services to the community. They differ from non-financial (industrial and commercial) business organisations in respect of their dealings, i.e. while the former deal in financial assets such as deposits,

loans, securities and so on, the latter deal in real assets such as machinery, equipment, stocks of goods, real estate and so on.

1.4 QUESTIONS

1. What are financial markets? Explain their basis.
2. Explain the constituents of financial markets.
3. State the functions of financial markets.

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2

INDIAN FINANCIAL SYSTEM

Unit Structure

2.1 BACKGROUND

The politico-economic background of the financial development in India has been determined by the nature our mixed economic system. The objectives of this system with respect to growth, sectoral priorities, distribution have influenced the functioning and development of IFS. Some of the marked characteristics of Indian economy during the past 50 years are continuous inflation, increasing internal (fiscal) and external deficits, industrialisation, urbanisation and significant structural transformation. Functioning within this context, all sectors of the economy, including the financial markets, have undergone significant changes. Further, there has been a close interaction between the financial and economic systems.

2.2 INDIAN FINANCIAL SYSTEM AT PRESENT

A striking feature of the IFS is its prodigious growth in the past 50 years in terms of size, diversity, sophistication, and complexity. Money supply, savings, bank deposits and credit, primary and secondary issues and so on have increased tremendously, the supportive factor being the continuous and high rate of inflation. While the prices in 1996 were about 18times the prices in 1950, the commercial banks' deposits, to take just one example, in 1997 were more than 618 times their deposits in 1951. The bank deposits have increased from Rs. 909 crore in 1951 to Rs. 5, 61, 982 crore at the end of March 1997. This is a very remarkable growth indeed, particularly as, with the passing years, it occurred on an expanding base.

The quantitative growth of the IFS has been accompanied by significant diversification and innovations in respect of an array of financial institutions, instruments, and services. India has witnessed all types of financial innovations, during the past 50 years. A large number of totally new institutions catering to almost every sector have been set up since 1950. As a result, today we have a highly diversified structure of financial institutions. Similarly, a large number of new financial instruments have come to be introduced, as a result of which we now have a fairly diversified portfolio of financial claims. Further, significant reorganisation, gloabalisation, privatisation, deregulation, automation, computerisation, changes in ownership, consolidation and mergers of financial institutions have been effected. A veritable financial revolution appears to have occurred in India, as elsewhere, over the years.

Table 1 reflects the richness, diversity, complexity and well-developed nature of the IFS as it stands today. It lists all the major financial institution, financial instruments and financial services which now exist in India. For the sake of clarity, only the major markets have been specifically mentioned. Table 1 only mentions only the main types of financial institutions and instruments, while their sub types are not mentioned. The commercial banks, co-operative banks, mutual funds, industrial debentures, preference shares, treasury bills, bank deposits, for example, have many sub types.

2.3 INDICATORS OF FINANCIAL DEVELOPMENT

The financial development of a country is usually studied by examining changes in the following indicators:

a. Finance ratio - measures the total issues of primary and secondary claims in relation to national income.

b. Financial Inter-relation Ratio (FIR) - ratio of financial assets to physical assets, and it indicates the relationship between financial structure and real assets structure of the economy.

c. New Issue Ratio (NIR) - ratio of primary issues to the physical capital formation and it indicates how far investment has been financed by direct issues to the savers by the investing sectors.

d. Intermediation Ration (IR) - ratio of secondary issues to primary issues. IR indicates the importance of financial institutions or intermediaries as mobilisers of funds relative to real sectors as direct mobilisers of funds. It indicates the institutionalisation of financing in the economy.

These four indicators of financial development for the span of more than 40 years (1951-94) are presented in Table 2. They have all increased significantly implying the growing importance of financial institutions in the economy and the growth of financial flows in relation to economic activity, both in the form of direct and indirect finance. The levels and changes in FIR indicate that the financial structure in India has grown more rapidly than the national income. Changes in FR indicate that there has been a marked rise in the institutionalisation of financing investment, and that separation between the acts of saving and investment has grown.

2.4 FLOW-OF-FUNDS ACCOUNTS

Flow-of-funds accounts (FOFA) of a country are also very useful in understanding the structure of financial institutions, assets-structure, financial behaviour and inter-relationships and the nature of financial development in that country. Before we turn to the study of flow-of-accounts in India, it would be useful to first understand the meaning and general nature of flow-of-accounts.

The Flow-of-Funds Accounts are financial counterpart of the National Income Accounts of the real sector of the economy. They contain all - sectoral and aggregate-sources and uses of funds for a given economy. The sources and uses of funds in the form of various financial claims for a selected number of sectors are presented in the form of matrix, and the complexity of the matrix depends upon the number of sectors and the number of types of assets/liabilities or securities chosen. The sectors are subdivisions of the economy and are more or less homogeneous in respect of their functional and operational characteristics. In India, for this purpose the economy is divided into six sectors, namely, banking, other financial institutions, private corporate business, Government, household and the rest of the World. In the USA, the number of sectors for this purpose is nine. The FOFA may be prepared and presented either for each quarter or year. In India, only the yearly Flow-of-Funds tables are available so far.

In order to avoid confusion, it is necessary to understand the interrelationships between the flows in the form of saving, investment, sources, uses, assets, liabilities, borrowing and lending. Roughly speaking, while uses, assets, lending and investment fall on one side; sources, liabilities, borrowing, and saving fall on the other side.

The FOFA matrix is prepared by examining the balance sheets of various sectors at the beginning and at the end of the period. The convention is to treat increase in assets as uses of funds and increase in liabilities as sources of funds. Thus, although constructed out of sectoral stock statements, these tables contain changes or flows of funds between two points of time. It may be noted that only net increases in assets are treated as use of funds; dept repayment or dis-saving, which are in fact, uses of funds are treated as negative sources of funds. In the same fact, sources of funds, are treated as negative uses. Further, the sectoral flows are also shown on the net basis i.e. while the inter-sectoral flows are included, intra-sectoral transactions are not recorded. For example, a loan from one household to another would not be reflected in the FOFA tables. The sources and uses of funds for each sector and for the entire economy must balance in theory. However, in practice they often do not balance and we get discrepancies for the sector totals and for aggregate totals. The lack of balance reflects the enormous difficulties in combining transactions and sectors in sources and uses matrix. Analytically, the lack of balance may evidence the nature of likely future developments. The distinguishing characteristic FOFA which emerges is that they present net flows of funds between sectors and between two points of time. To summarise, "the flow of funds is an interlocking, complete system that depicts the balanced sources and uses of funds for each sector, the inter-relationship among sectors, and the saving, investment, borrowing, lending and money flow totals for a 3-month or 1-year period."

The examples of FOFA matrices for India are presented in Table form relating to the years respectively. The position of any item in a column shows the place of the item in the particular sector's total assets (uses) and liabilities (sources). A sector's position in the row shows the share of that sector's holding of a particular asset or liability in the national total of assets/liabilities. Percentages of items to respective column totals are given in brackets. These tables can be interpreted to reveal a good deal of information regarding the institutional and assets structure in India over the span of 20 years. However, we mention below two or three important points only by way of illustration.

The total net financial flows have increased from Rs. 3771 crores to Rs. 113, 751 crores, i.e by 3116 percent during 1966-67 and 1987-88. In terms of their quantitative importance in 1987-88, different financial liabilities in India can be ranked in this descending order: currency and bank deposits, loans and advances; central Government securities, provident fund, securities of other financial institutions and corporate securities in the total liabilities have increased marginally, that of loans and advances, the Government securities has declined. While the share of banking and other financial institutions in the total sources of funds has increased, that of private corporate business, Government, and households has declined. The assets-wise distribution of financial savings of the household sector to be presented later also would show that now bank deposits, provident fund, other claims on the government, life insurance policies, deposits with companies, corporate securities and units are important in this descending order as media for household savings. The importance of contractual claims in India has increased over this period. Since this change has occurred in the face of inflation, the hypothesis that inflation discourages contractual savings needs to be reviewed. The top position of bank deposits in India throughout this period is in contrast with the developments in other countries, where the importance of banking system was observed to have declined with the financial development.

2.5 TRENDS IN SAVINGS AND INVESTMENT

At this point the major changes that have occurred in the savings and investment trends should be noted. We may do so by studying either the net saving and investments or gross saving and investment, the difference between the gross and net quantities being equal to fixed capital consumption allowance. In 1988-89 the gross domestic saving was 84 times and the investment 98 times of 1950-51. The rates of saving and capital formation (i.e. each of them as percent of GDP) have shown a remarkable increase from about 10% to 21 and 24 % respectively. These rates of increase in India have been higher than in many developing as well as developed countries. Thus, the IFS has amply fulfilled one of its basic functions, namely the promotion of saving and investments.

Also we understand that the major part of saving has been due to the household sector. The household sector saving as percentage of the total savings has increased from 74% in 1950-51 to 81% in 1988-89. The contribution of the private corporate and public sectors together with the national savings has not been even one fourth of that and it has remained at that low level. Thus India differs from many other countries where "household savings play a minor role, with corporations generally playing the dominant role in the accumulation of national surplus, with some tendency for governments to compensate where the corporations share falls below the median."

The household sector has been the only surplus sector in India, while the investment of private corporate and public sectors has always far exceeded their respective savings. A detailed study of the pattern of financing of investment of different sectors has shown that the dependence of the private corporate and public sectors on the household sector and financial institutions for the purpose of financing their investment, has increased substantially over time.

2.6 FINANCIAL INTEGRATION

The financial system has now become much more integrated than ever before. The dividing lines between the so-called "organised" and "unorganised" sectors, between the "busy" and "slack" seasons, are getting increasingly imperceptible. Among the factors that are behind greater integration are:

a. The Government entry in a very big way in the wholesale trading of a large number of commodities.

b. An unprecedented expansion of the network of rural branches of banks.

c. The transformation in the perception of the role of financial institutions.

d. The evolution of financial institutions as multifunction (mixed) institutions.

The banks and term lending financial institutions have become more integrated through such methods as the use of "participation certificates"; the adoption of "participation approach" to granting loans and offering financial services like underwriting and guaranteeing; and their activities in the markets for call loans, commercial bills, and so on. The refinance and rediscounting schemes of institutions like IDBI and NABARD, have also contributed to greater integration.

2.7 REGULATION AND DEREGULATION

The financial sector in India today, is almost entirely owned and controlled by the Government. One of the "commanding heights" of the economy is almost totally in the hands of the Government. This has been achieved in two ways:

a. Through the nationalisation, one after another, of financial institutions. This process started with the nationalisation of the RBI in 1949, followed by that of the Imperial Bank of India, the life insurance companies, commercial banks, and general insurance companies.

b. Through the creation of a host of new financial institutions in the public sector. This process began with the setting up of the IFC in 1949 followed by many other institutions mentioned earlier.

Apart from direct public ownership, the authorities closely monitor, regulate and control the policies of financial institutions in respect of personnel, expansion, and the pricing and distribution of credit. Almost every single rate of interest and return on financial claims is administered by the Government authorities. Further, the allocation of credit is effected mainly through direct credit controls, credit ceilings, and fixation of credit targets.

The policies of public ownership, administrative regulations and controls, and consolidation have led to the growth of monopolistic/oligopolistic market structures in the Indian financial sector. Financial markets in India are quite imperfect, and the institutional structure is characterized by a very high degree of centralisation and concentration.

The unparalleled Government control of financial institutions can hardly be said to have served the objectives of social justice. The Government-owned and Government controlled financial system has, in fact, promoted the interests of large private business organisations; it has helped rather than curbed the concentration of economic power in the hands of the powerful. It has, of course, helped the Government sector also to appropriate huge sums of money easily and at concessional cost. In fact, advancing credit to the Government sector has become, ipso facto, justifiable and desirable.

All this have, in the recent past, generated much discussion in India, as in other countries, regarding the restructure, deregulation and liberalization of the financial system. The authorities have therefore liberalized the financial systems in many ways. They have removed certain regulations in respect of the stock market (viz. regarding bonus issues, issues of fresh capital), and they have removed the interest rate ceiling in the call money market. Banks have been freed from ceiling on their lending rates; interest rates on CDS, CPS, participation certificates are market determined; the Credit Authorization Scheme has been discontinued.

It has been rightly pointed out in this context that financial regulation and deregulation have to be relevant to both time and space, and we cannot apply a priori, simplistic and borrowed ides to this subject. In India, regulation promoted financial and institutional development; it did not have the text-book effect of restructuring the growth of financial intermediation. But it has also meant high cost of branch expansion of banks, low quality and low return on assets, low profitability of banks, and so on. Therefore, liberalisation should be brought about through sequenced and structured steps rather than suddenly. It would help to effect slow and progressive freezing of interest rates, and discontinuation of the policy of direct credit allocation.

2.8 SUMMARY

- The politico-economic background of the financial development in India has been determined by the nature our mixed economic system.
- The objectives of this system with respect to growth, sectoral priorities, distribution have influenced the functioning and development of IFS.
- Some of the marked characteristics of Indian economy during the past 50 years are continuous inflation, increasing internal (fiscal) and external deficits, industrialisation, urbanisation and significant structural transformation.
- Functioning within this context, all sectors of the economy, including the financial markets, have undergone significant changes. Further, there has been a close interaction between the financial and economic systems.

2.9 QUESTIONS

Q1. Explain Indian Financial System at present.
Q2. Discuss on saving and investments in the financial markets.
Q3. Write explanatory notes on regulation and deregulation.

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3

REGULATORY INSTITUTIONS

Unit Structure

3.1 INTRODUCTION

Financial Sector in India has experienced a better environment to grow with the presence of higher competition. The Financial system in India is regulated by independent regulators in the field of banking, insurance, mortgage and capital market. Government of India plays significant role in controlling the financial markets in India.

Ministry of Finance, Government of India control the financial sector in India. Every year the Finance Ministry presents the annual budget. The Reserve Bank of India (RBI) is an apex institution in controlling the banking system in the country. It's monetary policy acts as a major weapon in India's financial market.

Securities Exchange Board of India (SEBI) is one of the regulatory authority of India's Capital Market.

Here in this Chapter a focus on major financial regulatory bodies in financial market is made.

The debt markets in India are regulated by two agencies ---- RBI and SEBI. In a notification issued by the Government on March 2, 2000, the area of responsibility between RBI and SEBI have been clearly delineated. In terms of this notification, the contracts for sale and purchase of government securities, gold related securities, money market securities and securities derived from these securities and ready forward contracts in debt securities shall be regulated by the RBI.

However, regulation of money market mutual funds, which predominantly invest in money markets, is done by the SEBI, which is the regulatory authority for the mutual fund industry. SEBI is the regulating agency for the stock markets and the member-brokers of the stock exchanges, and therefore, regulates the listing and trading mechanism of debt instruments. Regulation of corporate debt issuance is also under the purview of SEBI.

The issuance of debt instruments by the government is regulated by the Government Securities Act 2006. The issuance of corporate securities is regulated by the SEBI Guidelines for Disclosure and investor protection.

The Fixed Income Money Market & Derivatives Association of Indian (FIMMDA), formed in 1998, is the Self-regulatory Organisation for debt markets. Its objective is to enable market development by involving market participants in the creation of good market practices, uniform market conventions and high levels of integrity in the debt markets.

INDIAN DEBT MARKET: REGULATIONS AND SECURITY LEGISLATION

Reserve Bank of India	a) Regulates
	- Investment pattern of banks - Money Markets - NBFCs
	b) Prescribes capital adequacy norms and accounting policies for banks
SEBI	a) Regulates Securities Markets
	b) Protects investors' interest and stipulates disclosure guidelines
NSE	Expected to regulate secondary market activities in debt instruments
Companies Act, 1956	Requirements of a prospectus to be drawn up when a company issues new shares or debentures

Securities Contract (Regulation) Act, 1956	a) Listing of Securities
	b) Right of appeal against refusal to list securities
	c) Free transferability of securities

GOVERNMENT SECURITIES ACT, 2006

With a view to consolidating and amending the law relating to the Government Securities and its management by the Reserve Bank of India, the Parliament had enacted the Government Securities Act, 2006. The Act received the presidential assent on August 30, 2006. The Government Securities Act also provides that RBI may take regulations to carry out the purpose of the Act.

Government Securities Act, 2006 and Government Securities Regulations, 2007 have come into force with effect from December 1, 2007. The Government Securities Act applies to Government securities created and issued by the Central and State Governments. The new Act and Regulations would facilitate widening and deepening of the Government Securities market and its more effective regulation by the Reserve Bank.

GOVERNMENT SECURITIES REGULATIONS, 2007

Government Securities Regulations, 2007 have been made by the Reserve Bank of India to carry out the purpose of the Government Securities Act. The Government Securities Regulations provides for transfer of Government securities held in different forms.

a. Government security held in the form of Government Promissory Notes is transferable by endorsement and delivery.

b. A bearer bond is transferable by delivery and the person in possessions of the bond shall be deemed to be the holder of the bond.

c. Government Securities held in the form of Stock Certificates, Subsidiary General Ledger account including a constituent Subsidiary General Ledger Account & Bond Ledger Account are transferable, before maturity, by executive of forms – III, IV & V respectively appended to the Government Securities Regulations.

d. Government Securities held in subsidiary general ledger account including a constituent subsidiary general ledger account or bond ledger account, shall also be transferable by execution of a deed in an electronic form under digital signature.

3.2 SEBI (GUIDELINES FOR DISCLOSURE AND INVESTOR PROTECTION), 2000

SEBI Guidelines for issuance of corporate debentures is stipulated in Chapter X of the DIP, 2000. Some of its major provisions are:-

Requirement for Credit Rating

No company shall make a public issue or rights issue of debt instruments (whether convertible or not), unless credit rating is obtained from at least one credit rating agency registered with the board and disclosed in the offer document. Where ratings are obtained from more than one credit rating agencies, all the ratings including the unaccepted credit ratings, shall be disclosed in the offer document. All the credit ratings obtained during the three years (3) preceding the public or rights issue of debt instrument (including convertible instruments) for any listed security of the issuer company shall be disclosed in the offer document.

Requirement in respect of Debenture Trustee

No company shall issue a prospectus or a letter of offer to the public for subscription of the debentures, unless the company has appointed one or more debenture trustees for such debentures in accordance with the provisions of the Companies Act, 1956.

Creation of Debenture Redemption Reserves (DRR)

For the redemption of the debentures issued, the company shall create debenture redemption reserve in accordance with the Provisions of the Companies Act, 1956.

Distribution of Dividends

In case of the companies which have defaulted in payment of interest on debentures or redemption of debentures or in creation of security as per the terms of issue of the debentures, any distribution of dividend shall require approval of the Debenture Trustees and the Lead Institution, if any, dividends may be distributed out of profit of particular years only after transfer of requisite amount in DRR.

Redemption

The issuer company shall redeem the debentures as per the offer document.

Disclosures in Respect of Debentures

The offer document shall contain:

i. Premium amount on conversion, time of conversion.

ii. In case of PCDs/NCDs, redemption amount, period of maturity, yield on redemption of the PCDs/NCDs.

iii. Full information relating to the terms of offer or purchase including the name(s) of the party offering to purchase the khokhas (non-convertible portion of PCDs).

iv. The discount at which such offer is made and the effective price for the investor as a result of such discount.

v. The existing and future equity and long term debt ratio.

vi. Servicing behaviour on existing debentures, payment of due interest on due dates on term loans and debentures.

3.3 SEBI (ISSUE AND LISTING OF DEBT SECURITIES) REGULATIONS, 2008

Issue Requirements for Public Issues General Conditions

a. No issuer should make any public issue of debt securities if as on the date of filling of draft offer document and final offer document as provided in these regulations, the issuer or the person in control of the issuer, or its promoter, has been restrained or prohibited or debarred by the Board from accessing the securities market or dealing in securities and such direction in order is in force.

b. The following conditions have to be satisfied by an issuer for making any public issue of debt securities as on the date of filing of draft offer document and final offer document.

i. If the issuer has made an application to more than one recognised stock exchange, the issuer is required to choose one of them as the designated stock exchange. Further, where any of such stock exchanges have nationwide trading terminals, the issuer should choose one of them as designated stock exchange. For any subsequent public issue, the issuer may choose a different stock exchange subject to the requirements of this regulation.

ii. The issuer has to obtain in principle approval for listing of its debt securities on the recognised stock exchanges where the application for listing has been made.

iii. Credit rating has been obtained from at least one credit rating agency registered with SEBI and is disclosed in the offer document. If the credit ratings have been obtained from more than one credit rating agency, then all ratings including the unaccepted ratings have to be disclosed in the offer document.

iv. It has to enter into an arrangement with a depository registered with SEBI for dematerialisation of debt securities that are proposed to be issued to the public in accordance with the Depositories Act 1996 and regulations made there under.

c. The issuer should appoint one or more merchant bankers registered with SEBI at least one of whom should be a lead merchant banker.

d. The issuer should appoint one or more debenture trustees in accordance with the provision of Section 117 B of the Companies Act, 1956 and SEBI (Debenture Trustee) Regulations 1993.

e. The issuer should not issue debt securities for providing loan to or acquisition of shares of any person who is part of the same group or who is under the same management.

3.4 FILING OF DRAFT OFFER DOCUMENT

No issuer should make a public issue of debt securities unless a draft of offer document has to be filed with the designated stock exchange through the lead merchant banker. The draft offer document filed with the stock exchange has to be made public by posting the same on the website of the designated stock exchange for seeking public comments for a period of seven working days for the date of filing the draft offer document with such exchange. The draft offer document may also be displayed on the website of the issuer, merchant bankers.

The lead merchant bankers should ensure that the draft offer document clearly specifies names and contact particulars of the compliance officer of the lead merchant banker and the issuer including the postal and email address, telephone and fax numbers. The lead merchant banker should also ensure that all comments received on the draft offer document are suitably addressed prior to the filing of the offer document with the Registrar of Companies. A copy of the draft and final offer document should be forwarded to SEBI for its records, simultaneously with filing of these documents with the designated stock exchanges.

The lead merchant bankers should prior to filing of the offer document with the Registrar of Companies, furnish to SEBI a due diligence certificate as per the format provided in Schedule II of SEBI (Issue and Listing of Debt Securities) Regulations, 2008.

Electronic Issuance

An issuer proposing to issue debt securities to the public through the on-line system of designated stock exchange should comply with the relevant applicable requirements as may be specified by SEBI.

Price Discovery through Book Building

The issuer may determine the price of debt securities in consultation with the lead merchant banker and the issue may be at fixed price or the price may be determined through the book building process in accordance with the procedure as may be specified by SEBI

Minimum Subscription

The issuer may decide the amount of minimum subscription which it seeks to raise by issue of debt securities and disclose the same in the offer document. In the event of non-receipt of minimum subscription all application moneys received in the public issue shall be refunded forthwith to its applicants.

Listing of Debt Securities

An issuer desirous of making an offer of debt securities to the public has to make an application for listing to one or more recognised stock exchanges in terms of sub-section (1) Section 73 of the Companies Act, 1956 (I of 1956). The issuer has to comply with the conditions of listing of such debt securities as specified in the Listing Agreement with the Stock Exchanges where such debt securities are sought to be listed.

3.5 FIMMDA

The Fixed Income Money Market and Derivatives Association of India (FIMMDA), an association of Scheduled Commercial Banks, Public Financial Institutions, Primary Dealers and Insurance Companies was incorporated as a Company under Section 25 of the Companies Act, 1956 on June 3, 1998. FIMMDA is a voluntary market body for the bond, money and derivatives markets. FIMMDA has members representing all major institutional segments of the market. The membership includes Nationalised Banks such as State Bank of India, its associate banks and other nationalised banks; Private Sector Banks such as ICICI Bank, HDFC Bank, IDBI Bank, Foreign Banks such as Bank of America, ABN Amro, Citibank, Financial institutions such as IDFC, EXIM

Bank, NABARD, Insurance Companies like LIC, ICICI Prudential Life Insurance company, Birla Sun Life Insurance Company and all Primary Dealers.

The FIMMDA represents market participants and aids the development of the bond, money and derivatives market. It acts as an interface with the regulators on various issues that impact the functioning of these markets. It also undertakes developmental activities, such as, introduction of benchmark rates and new derivatives instruments etc. FIMMDA releases rates of various Government securities that are used by market participants for valuation purposes. FIMMDA also plays a constructive role in the evolution of best market practices by its members so that the market as a whole operates transparently as well as efficiently.

3.6 STOCK EXCHANGES IN INDIA

3.6 (a) NATIONAL STOCK EXCHANGE OF INDIA

In the year 1991 Pherwani Committee recommended to establish National Stock Exchange (NSE) in India. In 1992 the Government of India authorised IDBI for establishing this exchange.

In NSE, there is trading of equity shares, bonds and government securities. India's stock exchanges particularly National Stock Exchange (NSE) has achieved world standards in the recent years. The NSE India ranked its 3rd position since last four years in terms of total number of trading per calendar year.

Presently, there are 24 stock exchanges in India, out of which 20 have exchanges, National Stock Exchange (NSE), Over The Counter Exchange of India Ltd. (OTCEI), and Inter-connected Stock Exchange of India Ltd (ISE) have nation-wide trading facilities.

New NSE Reference Rates

Both MIBOR (Mumbai Inter Bank Offer Rate) and MIBID (Mumbai Inter Bank Bid Rate) are the two new references rates of National Stock Exchanges. These two new reference rates were launched on 15 June1998 for the loans of inter-bank call money market. Both MIBOR and MIBID work simultaneously. The MIBOR indicates lending rates for loans while MIBID is the rate for receipts.

3.6 (b) BOMBAY STOCK EXCHANGE (BSE)

BSE is one of the oldest stock exchanges in Asia and was established in the year 1875 in the name of "The Native Share and Stock Brokers Association."

BSE is located at Dalal Street, Mumbai, India. It got recognition in the year 1956 from the Government of India under Securities Contracts (Regulation) Act, 1956. Presently BSE SENSEX is recognised world-wide. Trading volumes have drawn the attention over the globe.

BSE INDICES

The well known index is BSE SENSEX. Others include BSE 500, BSEPSU, BSEMIDCAP, BSEMLCAP and BSEBANKEX.

BSE 100 Index:

The equity share of 100 companies from the list of 5 major stock exchanges such as Mumbai, Calcutta, Delhi, Ahmedabad and Madras are selected for the purpose of compiling the BSE National Index. The year 1983-84 is taken as the base year for this index. The method of compilation here is same as that of the BSE SENSEX.

BSE 200 Index:

The BSE 200 Index was launched on 27th May 1994. The companies under BSE 200 have been selected on the basis of their market capitalisation, volumes of turnover and other fundamental factors. The financial year 1989-90 has been selected as the base year.

BSE 500 Index:

BSE 500 Index consisting of 500 scrips is functioning since 1999. Presently BSE 500 Index represents more than 90% of the total market capitalisation on Bombay Stock Exchange Limited.

BSE PSU Index:

BSE PSU Index has been working since 4th June 2001. This index includes major Public Sector Undertakings listed in the Exchange. The BSE PSU Index tracks the performance of listed PSU stocks in the exchange.

RESERVE BANK OF INDIA

Reserve Bank of India is the apex monetary Institution of India. It is also called as the central bank of the country. The bank was established on April1, 1935 according to the Reserve Bank of India act 1934. It acts as the apex monetary authority of the country.

The preamble of the reserve bank of India is as follows:

"...to regulate the issue of Bank Notes and keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage."

3.7 MAJOR FINANCIAL INSTITUTIONS IN INDIA

This is a list on the major financial institutions in India and their respective date of starting operations.

Financial Institution	Date of Starting
Imperial Bank of India	1921
Reserve Bank of India	April 1, 1935
Industrial Finance corporation of India	1948
State Bank of India	July 1, 1955
Unit Trust of India	Feb. 1,1964
IDBI	July 1964
NABARD	July 12,1982
SIDBI	1990
EXIM Bank	January 1, 1982
National Housing Bank	July 1988
Life Insurance Corporation (LIC)	September 1956
General Insurance Corporation (GIC)	November 1972
Regional Rural Banks	Oct. 2, 1975
Risk Capital and Technology Finance Corporation Ltd.	March 1975
Technology Development & Information Co. of India Ltd.	1989
Infrastructure Leasing & Financial Services Ltd.	1988
Housing Development Finance Corporation Ltd. (HDFC)	1977

3.8 FOREIGN INVESTMENT PROMOTION BOARD

The Foreign Investment Promotion Board is a special agency in India dealing with the matters relating to Foreign Direct Investment. This special board was set up with a view to raise the volume of investment to the country. The sole aim of the board is to create a base in the country by which a larger volume of investment can be drawn to the country.

On 18 February 2003, the board was transferred to the Department of Economic Affairs (DEA) Ministry of Finance.

Important functions of the Board are as follows:

- Formulating proposals for the promotion of investment.
- Steps to implement the proposals.
- Setting friendly guidelines for facilitating more investors.
- Inviting more companies to make investment.
- To recommend the Government to have necessary actions for attracting more investment.
- With regards to the structure of the Foreign Investment Promotion Board, the board comprises the following group of secretaries to the Government:
- Secretary to Government Department of Economic Affairs, Ministry of Finance- Chairman.
- Secretary to Government Department of Industrial Policy and Promotion, Ministry of commerce and Industry.
- Secretary to Government, Department of Commerce, Ministry of Commerce and Industry.
- Secretary to Government, Economic Relations, Ministry of External Affairs.
- Secretary to Government, Ministry of Overseas Indian Affairs.
- In the recent years, particularly after the implementation of the new economic policy, the Government has undertaken many steps to attract more investors for investing in the country. The new proposals for the foreign investment are allowed under the automatic route keeping in view the sectoral practices.

3.9 SUMMARY

- Financial Sector in India has experienced a better environment to grow with the presence of higher competition. The Financial system in India is regulated by independent regulators in the field of banking, insurance, mortgage and capital market. Government of India plays significant role in controlling the financial markets in India.

- Ministry of Finance, Government of India control the financial sector in India. Every year the Finance Ministry presents the annual budget. The Reserve Bank of India (RBI) is an apex institution in controlling the banking system in the country. It's monetary policy acts as a major weapon in India's financial market.

- Securities Exchange Board of India (SEBI) is one of the regulatory authority of India's Capital Market.

3.10 QUESTIONS

Q1. Name the regulatory Institutions.

Q2. Explain the role and functions of SEBI, RBI.

Q3. Write explanatory notes on the following:

a. Financial Institutions of India.

b. Foreign Investment Promotion Board.

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MODULE - II

4

CAPITAL MARKETS

Unit Structure

4.0 LEARNING OBJECTIVES

After studying this unit, learner will be able to understand:

- The meaning, structure, components, players of capital markets.
- The learner will comprehend industrial securities market.
- The learner will understand the meaning of primary markets.
- The learner will understand the characteristics of primary markets, the meaning of IPO and how IPO is issued.
- The learner will also comprehend the process of book-building and the meaning of red herring prospectus.
- The learner will understand the meaning of secondary markets, need for secondary market, role of secondary market, equity and debt market.
- The learner will further understand the working of stock exchanges.

- The learner will understand how the shares are bought and sold in stock exchanges, gain knowledge on stock indices.

4.1 INTRODUCTION

Capital Market is a market for long-term sources of finance to the industrial and corporate sector. The development of a nation depends upon the rapid growth of industrialisation of a country. Asset formation is the crucial factor for prosperity of nation. The asset creation is based on supply of capital and technology. Capital alone will not create prosperity. The prosperity is the combination of Technology, Capital and Human Resources. The chemistry of these factors will definitely help the underdeveloped countries towards developed nation.

4.2 DEFINITIONS OF CAPITAL MARKET

According to Arun K. Datta the capital market may be defined as, "the capital market is a complex of institutions investment and practices with established links between the demand for and supply of different types of capital gains".

According to F. Livingston the capital market may be defined as, "In a developing economy, it is the business of the capital market to facilitate the main stream of command over capital to the point of the highest yield. By doing so, it enables, control over resources to pass into the hands of those who can employ them must effectively thereby increasing production capacity and spelling the national dividend."

4.3 IMPORTANCE OF CAPITAL MARKET

Capital market deals with long-term funds. These funds are subject to uncertainty and risk. It supplies long and medium term funds to the corporate sector. It provides the mechanism for facilitating capital fund transactions. It deals in ordinary shares, bond debentures and stocks and securities of the government. In this market the funds flow will come from savers. It converts financial assets into productive physical assets. It provides incentives to savers in the form of interest or dividend to the investors. It leads to capital formation. The following factors play an important role in the growth of the capital market:

1. A strong and powerful Central Government
2. Financial dynamics
3. Speedy industrialisation
4. Attracting Foreign Investment

5. Investments from NRIs
6. Speedy Implementation of policies
7. Regulatory changes
8. Globalisation
9. The level of savings and investment pattern of the household sectors
10. Development of financial theories
11. Sophisticated technological advances

4.4 FUNCTIONS OF CAPITAL MARKET

Capital market plays a vital role in the development by mobilising the savings to the needy corporate sector. In recent years there has been a substantial growth in the Capital Market. The Capital Market involves in various functions and significance. They are presented below:

i. Coordinator
ii. Motivation to savings
iii. Transformation to investments
iv. Enhances economic growth
v. Stability
vi. Advantages to the investors
vii. Barometer

i. Coordinator

The Capital Market functions as coordinator between savers and investors. It mobilises the savings from those who have surplus fund and divert them to the needy persons or organisations. Therefore, it acts as a facilitator of the financial resource. In this way it plays a vital role in transferring the surplus resources to deficit sectors. It increases the productivity of the industry which ultimately reflects in GDP and national income of the country. It increases the prosperity of the nation.

ii. Motivation of Savings

The Capital Market provides a wide range of financial instruments at all times. India has a vast number of individual savers and the crores of rupees are available with them. These resources can be attracted by the capital market with nature. The banks and non-banking financial institutions motivate the people to save more and more. In less developed countries, there is no efficient capital market to tap the savings. In underdeveloped countries there are very little savings due to various factors. In those countries they invest mostly in unproductive sector.

iii. Transformation of Investment

The Capital Market is a place where the savings are mobilised from various sources, is at the disposal of businessmen and the government. It facilitates lending to the corporate sector and the government. It diverts the savings amount towards capital formation of the corporate sector. It creates assets by helping the industry. Thus, it enhances the productivity and leads to industrialisation. The industrial development of the country depends upon the dynamic nature of the capital market. It also provides facilities through banks and non-banking financial institutions. The development of financial institutions made the way easy to capital market. The capital has become more mobile. The interest rate fall lead to an increase in the investment.

iv. Enhances economic growth

The development of the Capital Market is influenced by many factors like the level of savings with the public, per capita income, purchasing capacity, and the general condition of the economy. The capital market smoothens and accelerates the process of economic growth. The Capital Market consists of various institutions like banking and non-banking financial institutions. It allocates the resources very cautiously in accordance with the development of needs of the country. The balanced and proper allocation of the financial resources leads to the expansion of the industrial sector. Therefore, it promotes the balances regional development. All regions should be developed in the country.

v. Stability

The Capital Market provides a stable security prices in the stock market. It tends to stabilise the value of stocks and securities. It reduces the fluctuations in the prices to the minimum level. The process of stabilisation is facilitated by providing funds to the borrowers at a lower interest rate. The speculative prices in the stock market can be reduced by supply of funds. The flow of funds towards secondary market reduces the prices at certain level. Therefore, the Capital Market provides funds to the stock market at a low rate of interest.

vi. Advantages to the Investors

The investors who have surplus funds can invest in long-term financial instruments. In Capital Market, a number of long-term financial instruments are available to the investor at any time. Hence, the investors can lend their money in the Capital Market at reasonable rate of interest. The Capital Market helps the investors in many ways. It is the coordinator to bring the buyer and seller at one place and ensure the marketability of investments. The stock market prices are published in newspapers everyday which enables the investor to keep track of their investments and channelise them into most profitable way. The Capital Market safeguards the interest of the investors by compensating from the stock exchange compensating fund in case of fraud and default.

vii. Barometer

The development of the Capital Market is the indicator of the development of a nation. The prosperity and wealth of a nation depends, upon the dynamic capital market. It not only reflects the general condition of the economy but also smoothens and accelerates the process of economic growth. It consists a number of institutions, allocates the resources rationally in accordance with the development needs of the country. A good allocation of resources leads to expansion of trade and industry. It helps both public and private sector.

Generally, the corporate sector requires funds not only for meeting their long-term requirements of funds for their new projects modernisation, expansion and diversification programmes but also for covering their operational needs. Therefore, their requirement of capital is classified as given below:

a. Long-term capital
b. Short-term capital
c. Venture capital
d. Export capital

Long-term capital represents the amount of capital invested in the form of fixed assets. Fixed assets are such as land, building, plant and machinery necessary for every company at the initial stage of the commencement of the production. Heavy amount of capital is required by the companies when they are going for modernisation or expansion or diversification. Therefore, the requirement of long-term capital is supplied by the capital market. This is also referred to as Fixed Capital. Usually the corporate sector mobilises the fixed capital from the Capital Market through various long-term maturity financial instruments. Therefore, it provides adequate funds to the corporate sector by offering various financial instruments. They mobilise the funds through issue of Equity shares. Preference shares, debentures, bonds etc. These financial instruments have a longer maturity period and they are treated by the companies as permanent capital. Some instruments have no maturity until the close down of a business unit.

Short-term capital represents the amount of capital invested in current assets. The Current Assets consist of cash, bank balances, inventory, debtors etc. The short-term capital is required to meet the need of working capital of the corporate sector. Working capital is required for meeting the operating cost of the business concern. They are required to pay different amounts to different parties as per their schedule. Hence, they procure the working capital from the commercial banks. In India a majority of the corporate sector is funded by the banks through different modes of finance. The working capital is known as circulating capital. An adequate supply of working capital leads to smooth functioning of production of goods. There are some other avenues available to the corporate sector to meet the needs of the working capital.

Venture capital is the capital which invested in highly risky ventures. It is also known as seed capital. It is a quite recent entrant in the capital market. It has great significance in helping technocrat entrepreneurs at the commencement stage of the concern. It has technical expertise. But it lacks finance.

Export capital refers for making payment in International Trade. The payment of international trade involves in bills of exchange and other instruments.

4.5 PLAYERS IN THE CAPITAL MARKET

Capital Market is a market for long-term funds. It requires a well-structured market to enhance the financial capability of the country. The market consists of a number of players. They are categorised as:

1. Companies
2. Financial Intermediaries
3. Investors

1. Companies

Generally every public company can access the capital market. The companies which are in need of finance for their projects can approach the market. The capital market provides funds from the savers of the community. The companies can mobilise the resources for their long-term needs such as project cost, expansion and diversification of projects and other expenditure items. In India, the companies should get the prior permission from the SEBI (Securities Exchange Board of India) to raise the capital from the market. The SEBI is the most powerful organisation to monitor, control and guide the capital market. It classifies the companies for the issue of share capital as new companies, existing, and unlisted existing listed companies. According to its guidelines a company is a new company, if it satisfies all the following conditions:

a. The company shall not have completed 12 months of commercial operations.
b. Its audited operative results are not available.
c. The company may set-up by entrepreneurs with or without track record.

A company can be treated as existing listed company, if its shares are listed in any recognised stock exchange in India. A company is said to be an existing listed company if it is a closely held or private company.

2. Financial Intermediaries

Financial intermediaries are those who assist in the process of converting savings into capital formation in the country. A strong capital formation process is the oxygen to the corporate sector. Therefore, the intermediaries occupy a dominant role in the capital formation which ultimately leads to the growth of prospering to the community. Their role in this situation cannot be neglected. The government should encourage these intermediaries to build a strong financial empire for the country. They can also be called as financial architectures of the Indian digital economy. Their network cannot be ignored. Their financial capability cannot be measured. They take active role in the capital market. The major intermediaries in the capital market are:

a. Brokers
b. Stock-brokers and sub-brokers
c. Merchant Bankers
d. Underwriters
e. Registrars
f. Mutual Funds
g. Collecting agents
h. Depositories
i. Agents
j. Advertising agencies

3. Investors

The capital market consists of many number of investors. All types of investor's basic objectives are to get good returns on their investment. Investment means, just parking one's idle fund in a right parking place for a stipulated period of time. Every parked vehicle shall be taken away by its owners from parking place after a specific period. The same process may be applicable to the investment. Every fund owner may desire to take away the fund after a specific period. Therefore, safety is the most important factor while considering the investment proposal. The investors comprise the financial and investment companies and the general public companies. Usually, the individual savers are also treated as investors. Return is the reward to the investors. Risk is the punishment to the investors who wrongly made investment decision. Return is always chased by the risk. An intelligent investor must always try to escape the risk and capture the return. All rational investors prefer return, but most investors are risk averse. They attempt to get maximum capital gain. The return can be made available to the investors in two types and they are in the form of revenue or capital appreciation. Some investors will prefer for revenue receipt and others prefer capital appreciation. It depends upon their economic status and the effect of tax implications. The institutions and companies raise the resources from the market by designing various schemes to meet the needs and convenience of the investors. They schemes can be framed to attract all types of investors, who are selling in the capital market. The main objective of any type of investor are safety, profitability, liquidity and capital appreciation.

Distinction between Capital and Money Market

Money market is different from Capital Market on the basis of the following characteristics:

1. Period of time
2. Financial Instruments
3. Purpose of Loan
4. Risk
5. Market Regulation
6. Liquidity
7. Monitoring
8. Players

1. Period of time

The money market is a market for lending and borrowing of the short-term finance. The term short-term period refers to finance available for one year or less to the borrowers. Generally the borrowers will procure the fund for meeting their working capital requirements. Usually the working capital of the corporate sector is supplied by commercial banks and players of the money market. The capital market is a market where the long-term funds are available at reasonable rates of interest to the borrowers. Usually the fixed capital of the corporate sector will be met by the long-term nature of financial instruments. These financial instruments are available in the capital market only. The fund will be supplied to the corporate sector by capital market for the purpose of project expansion, diversification and other needs.

2. Financial Instruments

The companies generally raise the fund from market by issuing a number of financial instruments. The money market consists of short-term financial instruments such as call money, CDs, Bills and collateral loans etc. On the other hand, the main instruments are used in the capital market for long-term basis. These financial instruments such as shares, debentures and bonds are issued by the companies for their requirements.

3. Purpose of loans

The companies enter the money market to meet the needs of their short-term finance. The money market issues different types of financial instruments for one year period to meet the needs of working capital. The working capital arrangements will be adjusted by the money market while the fixed capital by the capital market. The long-term needs of finance will be adjusted by the capital market to the corporate sector.

4. Risk

Generally the financial markets involve some degree of risk. The level of degree of risk depends upon the nature of market. The money market involves less risk level while the capital markets consist of higher levels of risk. The money market maturity period is one year. On the other hand, capital market caters to the long-term credit needs for the corporate sector and arrangements will be made for fixed capital to but land or machinery.

5. Market Regulation

In India, the market is closely observed by the prudential authorities. It is necessary to regulate the market operations for better functioning of the financial system. In the capital market the institutions are not much regulated. The money market is regulated by RBI, SEBI and Ministry of Finance.

6. Liquidity

Liquidity is the most important factor in the money market. The role of money market is creation of liquidity. The money market is a ready market for its financial assets. The basic role of capital market is providing funds to work on long-term basis. The financial instruments which are available in the capital market are productive employment and generation of assets in the economy. Asset formation is made by the capital market.

7. Monitoring

The money market is closely associated with the Central Bank of the country. The Central Bank in India is RBI. The RBI is the supreme authority in the money market. It is directly linked with the Central Bank of India. But the capital market is regulated, observed and monitored by the SEBI. The RBI has less control on capital market.

8. Players

The important players in the money market are Central Bank, Acceptance house, Commercial Banks, non-banking financial institutions, Bill brokers etc. But in capital market stock exchanges, insurance companies, mortgage banks, non-banking institutions are important players. The secondary market for money market is not active in India. But the secondary market for capital market is very active. The investment in money market is highest safety whereas the investment in capital market is not so safe. The accessibility to money market by individual is not possible but capital market provides easy accessibility to the individuals.

4.6 THE GROWTH OF THE CAPITAL MARKET

The Indian financial system is both developed and integrated today. Integration has been through a participatory approach in granting loans as well as in saving schemes. The expansion in size and number of 59 institutions has led to a considerable degree of diversification and increase in the types of financial instruments in the financial sector which are wholly owned by the government. The development banks in the Indian financial system have witnessed vast changes in the planning periods. Now the development banks constitute the backbone of the Indian Capital Market. The relevant of the development banks in the industrial financial system is not merely qualitative, but they have overwhelming qualitative dimensions in terms of their promotional and innovational functions. The growth of the capital market is determined by the following factors:

1. Economic Development
2. Rapid Industrialisation
3. Level of savings and investment of the household sector
4. Technological advances
5. Corporate performance
6. Regulatory framework
7. Participation of foreign institutional investors in the capital market
8. Development of financial services
9. Liquidity factors
10. Political stability
11. Globalisation
12. Financial Innovation
13. Economic and financial sector reforms
14. International developments
15. Agency costs
16. Emergence of financial intermediaries
17. Specialisation among investment managers
18. Incentives
19. Speed in acquiring, processing and acting upon information
20. NRIs investment.

4.7 COMPONENTS OF THE CAPITAL MARKET

In a capital market, banks and financial institutions are the important components. They act as catalysts in the economic development of any country. These institutions mobilise financial savings from household, corporate and other sectors of the economy and channelise the into productive investments. They act as a Reservoir of resources of Financial Markets and form the backbone of the economic and financial system. The Banking industry has undergone a sea change during the last three decades. After the modernisation of banks, they not only lend for the Social and Economic causes but also participated in the development programmes of Central Government and State Government. The main components of the capital market in India are:

1. New-issue Market (Public issues) (Primary Market)
2. Secondary Market (Stock Market) these topics will be covered in forthcoming units. The Indian Capital Market is regulated by The Securities and Exchange Board of India (SEBI).

4.8 STRUCTURE OF CAPITAL MARKET IN INDIA

The structure of the capital market has undergone vast changes in recent years. The Indian capital market has transformed into a new appearance over the last four and half decades. Now it comprises an impressive network of financial institutions and financial instruments. The market for already issued securities has become more sophisticated in response to the different needs of the investors. The specialised financial institutions were involved in providing long-term credit to the corporate sector. Therefore, the premier financial institutions such as ICICI, IDBI, UTI, LIC and GIC constitute the largest segment. A number of new financial instruments and financial intermediaries have emerged in the capital market, Usually the capital markets are classified in two ways:

1. On the basis of issuer.
2. On the basis of instruments.

On the basis of issuer the capital markets can be classified again into two types

1. Corporate securities market.
2. Government securities market.

On the basis of financial instruments the capital markets are classified into two kinds:

1. Equity Market
2. Debt Market

Recently there has been a substantial development of the Indian Capital Market. It comprises various sub-markets. Equity market is more popular in India. It refers to the market for equity shares of existing and new companies. Every company shall approach the market for rising of funds. The equity market can be divided into two categories:

1. Primary Market
2. Secondary Market.

Debt Market represents the market for long-term financial instruments such as debentures, bonds etc.

4.9 NATURE AND CONSTITUENTS

The Capital Markets consist of a number of individuals and institutions. The Government is also an important player in the capital market. The players in the capital market channalise the supply and demand for the long-term capital. The constituents of the capital markets are, the stock exchange, commercial banks, cooperative banks, saving banks, development banks, insurance companies, investment trusts and companies etc.

4.10 INDUSTRIAL SECURITIES

Industrial Securities Market

As the very name suggests, it is a market for industrial securities namely:

1. Equity shares or ordinary shares
2. Preference Shares
3. Debentures or bonds. It is a market where industrial concerns raise their capital or debt by issuing appropriate instruments.

It can be further divided into two. They are:
a. Primary Market or New Issue Market
b. Secondary Market or Stock Exchange.

a. Primary Market

Primary Market is a market for new issues or new financial claims. Hence, it is also called New Issue Market. The primary market deals with these securities which are issued to the public for the first time. There are three ways by which a company may raise capital in a primary market. They are:

a. Public issue
b. Rights issue
c. Private Placement

The most common method of raising by new companies is through sale of securities to the public. It is called public issue. When an existing company wants to raise additional capital, securities are first offered to the existing shareholders on a pre-emptive basis. It is called rights issue. Private placement is a way of selling securities privately to a small group of investors.

b. 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 recognised 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.

SUMMARY

- Capital Market is a market for long-term sources of finance to the industrial and corporate sector.
- Capital market deals with long-term funds. These funds are subject to uncertainty and risk. It supplies long and medium term funds to the corporate sector. It provides the mechanism for facilitating capital fund transactions. It deals in ordinary shares, bond debentures and stocks and securities of the government. In this market the funds flow will come from savers. It converts financial assets into productive physical assets. It provides incentives to savers in the form of interest or dividend to the investors. It leads to capital formation.
- Capital market plays a vital role in the development by mobilising the savings to the needy corporate sector. In recent years there has been a substantial growth in the Capital Market. The Capital Market involves in various functions and significance.
- Generally, the corporate sector requires funds not only for meeting their long-term requirements of funds for their new projects modernisation, expansion and diversification programmes but also for covering their operational needs. Therefore, their requirement of capital is classified as given below:

a. Long-term capital

b. Short-term capital

c. Venture capital

d. Export capital

- Capital Market is a market for long-term funds. It requires a well-structured market to enhance the financial capability of the country. The market consists of a number of players. They are categorised as:

1. Companies
2. Financial Intermediaries
3. Investors

- The Indian financial system is both developed and integrated today. Integration has been through a participatory approach in granting loans as well as in saving schemes. The expansion in size and number of 59 institutions has led to a considerable degree of diversification and increase in the types of financial instruments in the financial sector which are wholly owned by the government.

In a capital market, banks and financial institutions are the important components. They act as catalysts in the economic development of any country. The main components of the capital market in India are:

1. New-issue Market (Public issues) (Primary Market)
2. Secondary Market (Stock Market) these topics will be covered in forthcoming units. The Indian Capital Market is regulated by The Securities and Exchange Board of India (SEBI).

- The structure of the capital market has undergone vast changes in recent years. The Indian capital market has transformed into a new appearance over the last four and half decades. Now it comprises an impressive network of financial institutions and financial instruments.
- The Capital Markets consist of a number of individuals and institutions. The Government is also an important player in the capital market. The players in the capital market channalise the supply and demand for the long-term capital. The constituents of the capital markets are, the stock exchange, commercial banks, cooperative banks, saving banks, development banks, insurance companies, investment trusts and companies etc.

CHECK YOUR PROGRESS

1. Fill in the blanks with appropriate words:

a. Capital Market is a market for long-term finance to the -------------------- and ---------------- sectors. (Industrial, banking, retailing, corporate)

b. Capital market supplies ---------------- and ----------- terms funds to the corporates. (long, short, medium, very-long)

c. The role of money market is creation of ------------------- (liquidity, time deposits, term deposits, foreign exchange).

d. Long-term capital represents the amount of capital invested in the form of ----------------. (fixed assets, immovable assets, movable assets, money markets)

e. Short-term capital represents the amount of capital invested in ----------- assets. (fixed, current, movable, immovable)

2. Answer in one sentence:

1. What is Capital Market?
2. What is venture Capital?
3. What is Export Capital?
4. What is meant by primary market?
5. What is meant by secondary market?
6. What is the role of industrial securities market?

3. Answer briefly:

1. Explain the functions of Capital Market.
2. Who are the players in Capital Market?
3. Explain the structure of Capital Market.
4. Comment on the components of capital market.
5. Write explanatory note on industrial securities market.

PRIMARY MARKET

1 INTRODUCTION

Capital market consists of primary and secondary market. Primary market is that part of the capital market that deals with the issuance of new securities. Primary market is otherwise called as New Issue Market (NIM). In the primary market the securities are purchased directly from the issuer. This is the market for new long-term or permanent capital. In other words, the money raised from the primary market provides long-term capital to the companies.

Primary market is a market which accelerates the process of capital formation in a country's economy. Primary market provides opportunity to corporates and the government to raise resources to meet their investment requirements and to discharge their obligations. The companies use these funds either for setting up of new businesses or to expand the existing ones. At the same time, the funds collected through the primary capital market, are also used for modernisation of business. The securities are issued in the primary market either at face value, or at a discount or premium. Companies will issue the securities either in domestic market or in the international market through American Depository Receipt (ADR) or Global Depository Receipt (GDR) or External Commercial Borrowings (ECB) route.

2 CHARACTERISTICS OF PRIMARY MARKET

Primary capital markets are those security markets where the equity and debt securities of corporations are offered to the investors for the first time. Important features of primary market are the following:

1. Primary market is the market for new long term capital.
2. In a primary market, the securities are issued for the first time by the company to investors.
3. In primary market securities are issued by the company directly to the investors.
4. In primary market the company receives the money and issues new security certificates to the investors.
5. In primary market it is difficult to accurately gauge the investor demand for a new security until several days of trading have occurred.
6. Primary market dost not include certain other sources of new long-term external finance, such as loans from commercial banks and other financial institutions.
7. Primary issues are used by companies for setting up new business for expanding or modernising the existing business or for providing permanent working capital.
8. The primary market performs the crucial function of facilitating capital formation in the economy.

3 KINDS OF ISSUES

There are different ways for offering new issues in the primary capital market. Primary issues made by Indian Companies can be classified as follows:

a. Public Issue
b. Rights Issue
c. Bonus Issue
d. Private Placement.

Public and rights issues involve a detailed procedure whereas private placements or preferential issues and bonus issues are relatively simple.

a. Public Issue

This is one of the important and commonly used methods for issuing new issues in the primary capital market. When an existing company offers its shares in the primary market, it is called public issue. It involves direct sale of securities to the public for a fixed price. In this kind of issue, securities are offered to the new investors for becoming part of shareholders' family of the issuer. If everybody can subscribe to the securities issued by a company, such an issue is termed as a public issue. In terms of the Companies Act of 1956, an issue becomes public if it is allotted to more than 50 persons. SEBI defined public issue as "an invitation by a company to public to subscribe to the securities offered through a prospectus." Public issue can be further classified into two:

1. Initial Public Offer (IPO)
2. Further Public Offer (FPO)

1. Initial Public Offer (IPO)

An IPO is referred simply an offering or flotation of issue of shares to the public for the first time. Initial Public Offer is the selling of securities to the public in the primary market. When an unlisted company makes either a fresh issue of securities or offers its existing securities for sale or both for the first time to the public, it is called an Initial Public Offer (IPO).

The sale of securities can either be through book building or through normal public issue. IPOs are made by companies going through a transitory growth period or by privately owned companies looking to become publicly traded. IPO paves the way for listing and trading of the issuer's securities in the stock exchanges. Initial Public Offering can be a risky investment. For the individual investor, it is tough to predict the value of the shares on its initial day of trading and in the near future since there is often little historical data with which to analyse the company.

2. Further Public Offer (FPO)

When an already listed company makes either a fresh issue of securities to the public or an offer for sale to the public it is called FPO is otherwise called as Follow on Offer.

3. DIFFERENCES BETWEEN IPO AND FPO

Often Initial Public Offer (IPO) and Further Public Offer (FPO) are used interchangeably. When the company offers its shares to the investors for the first time it is called initial public offering (IPO). At the time of IPO the companies' shares are not listed on any stock exchange. When an existing company subsequently issue more new shares in the primary market, it is called Further Public Issue (FPO) and is not considered to be an IPO.

b. Rights Issue

When a listed company which proposes to issue fresh securities to its existing shareholders existing as on a particular dated fixed by the issuer (i.e. record date), it is called as right issue. The rights are offered in a particular ration to the number of securities held as on the record date. The route is best suited for companies who would like to raise capital without diluting stake of its existing shareholders.

c. Bonus Issue

When an issuer makes an issue of shares to its existing shareholders as on a record date, without any consideration from them, it is called a bonus issue. The shares are issued to the existing shareholders out of company's free reserves or share premium account in a particular ratio to the number of securities held on a record date.

d. Private Placement

When a company offers its shares to t select group of persons not exceeding 49, and which is neither a rights issue nor a public issue, it is called a private placement. Often a combination of public issue and private placement can be used by the companies for the issue of securities in the primary market. Privately placed securities are often not publicly tradable and may only be bought and sold by sophisticated qualified investors. As a result, the secondary market is not liquid as in the case of a private issue. There are SEBI guidelines, which regulate the private placement of securities by a company.

Private placement is the fastest way for a company to raise equity capital. Private placement can be of two types viz., preferential allotment and qualified institutional placement.

4 PRINCIPAL STEPS OF A PUBLIC ISSUE

The new shares/debentures may be offered either directly to the public through a prospectus or indirectly through an offer for sale involving financial intermediaries or issuing houses.

1. Draft Prospectus
2. Fulfilment of Entry norms (EN)
3. Appointment of underwriters
4. Appointment of Bankers
5. Initiating allotment procedure
6. Brokers to the issue
7. Filing Documents
8. Printing of prospectus and application forms
9. Listing the issue
10. Publication in news papers
11. Allotment of shares
12. Underwriters Liability
13. Operational Listing.

5 REASONS FOR LISTING IN IPO

The following are the reasons for listing in IPO:

1. When a company lists its shares on a public exchange, it will almost invariably look to issue additional new shares in order to raise extra capital at the same time. The money paid by investors for newly-issued shares goes directly to the company (in contrast to a later trade of shares on the exchange, where the money passes between investors).

2. An IPO, permits a company to tap a wide pool of stock market investors to provide it with large volumes of capital for future growth. The company is never required to repay the capital, but instead the new shareholders have a right to future profits distributed by the company and the right to a capital distribution in case of dissolution.

3. The existing shareholders will see their shareholdings diluted as a proportion of the company's shares. However, they hope that the capital investment will make their shareholdings more valuable in absolute terms.

4. Once a company is listed, it will be able to issue further shares via a rights issue, thereby again providing itself with capital for expansion without incurring any debt. This regular ability to raise large amounts of capital from the general market, rather than having to seek and negotiate with individual investors, is a key incentive for many companies seeking to list.

Advantages Of IPO

IPO has a number of advantages. IPO helps the company to create a public awareness about the company as these public offerings generate publicity by inducing their products to various investors.

1. Increase in the capital: An IPO allows a company to raise funds for utilising in various corporate operational purposes like acquisitions, mergers, working capital, research and development, expanding plant and equipment and marketing.

2. Liquidity: The shares once traded have an assigned market value and can be resold. This is extremely helpful as the company provides the employees with stock incentive packages and the investors are provided with the option of trading their shares for a price.

3. Valuation: The public trading of the shares determines a value for the company and sets a standard. This works in favour of the company as it is helpful in case the company is looking for acquisition or merger. It also provides the shareholders of the company with the present value of the shares.

4. Increased Wealth: The founders of the companies have an affinity towards IPO as it can increase the wealth of the company, without dividing the authority as in case of partnership.

Disadvantages Of IPO

It is true that IPO raises huge capital for the issuing company. But, in order to launch an Initial Public Offering (IPO), it is also necessary to make certain investments. Drawbacks of IPO can be explained as follows:

1. Setting up an IPO does not always lead to an improvement in the economic performance of the company. A continuing expenditure has to be incurred after the setting up of an IPO by the parent company. A lot of expenses have to be incurred in the form of legal fees, printing costs and accounting fees, which are connected to the registering of an IPO. Such expenses might cost hundreds of US dollars. Apart from such enormous costs, there are other factors as well that should be taken into consideration by the company while introducing IPO.

2. Rules and regulations involved to set up public offerings and this entire process, on the other hand, involve a number of complexities which sometimes require the services of experts in relevant fields.

3. Some companies hire experts to do the needful to ensure a hassle-free execution of the task. After the IPO is introduced, the expenses become a routine in every activity involved. Besides, the CEO of the company would have to spend a lot of time in handling the SEC regulations or sometimes he hires experts to do the same. All these aspects, if not handled with efficiency, prove to be some major drawbacks related to the launch of IPOs.

4. Other disadvantages involve the public company's loss of confidentiality, flexibility, and control. SEC regulations require public companies to relate all operating details to the public, including sensitive information about their markets, profit margins, and future plans.

6 BOOK BUILDING

Book building is a process of price discovery mechanism used by corporates issuing securities. It is a mechanism used to discover the price of their securities. Book building is a common practice in developed countries and has recently been making inroads into emerging market as well, including India. As per the recommendations of Malegan Committee, SEBI introduced the option of book building in public issue in October, 1995. The option of book building was initially available only to those companies when their proposed public issue exceeded Rs. 100 crore. With effect from November 1996, the minimum size of the issue has been removed and any company can make a public issue through the book building process. However, issue of securities to the public through a prospectus for 100 percent book building process shall be available to a company only if their issue of capital shall be Rs. 25 crore and above.

Book building is a price discovery mechanism based on the bids received at various prices from the investors, for which demand is assessed and then the prices of the securities are discovered. In the case of normal public issue, the price is known in advance to the investors and the demand is known at the close of the issue. In case of public issue through book building, demand can be known at the end of everyday but price is known only at the close of the issue. Book building works on the assumption that the underwriting syndicate estimates demand and takes the allocation on their books, before the sale to investor who is a retail one.

Definition

Securities and Exchange Board of India defined Book Building as “a process undertaken prior to filing of prospectus with the Registrar of Companies by which a demand for the securities proposed to be issued by a body corporate is elicited and built up and the price for which such securities is assessed for the determination of the quantum of such securities to be issued by means of a notice, circular, advertisement, document or information memoranda or offer document.” The objective of book building is to find the highest market clearing price.”

The issuer company shall have an option of either reserving the securities for firm allotment or issuing the securities through book building process. The issue of securities through book building process shall be separately identified as “placement portion category” in the prospectus. The securities available to the public shall be separately identified as “net offer to the public”. The issuer proposing to issue capital through book building process has two options, viz 75 percent book building route and 100 percent book building route.

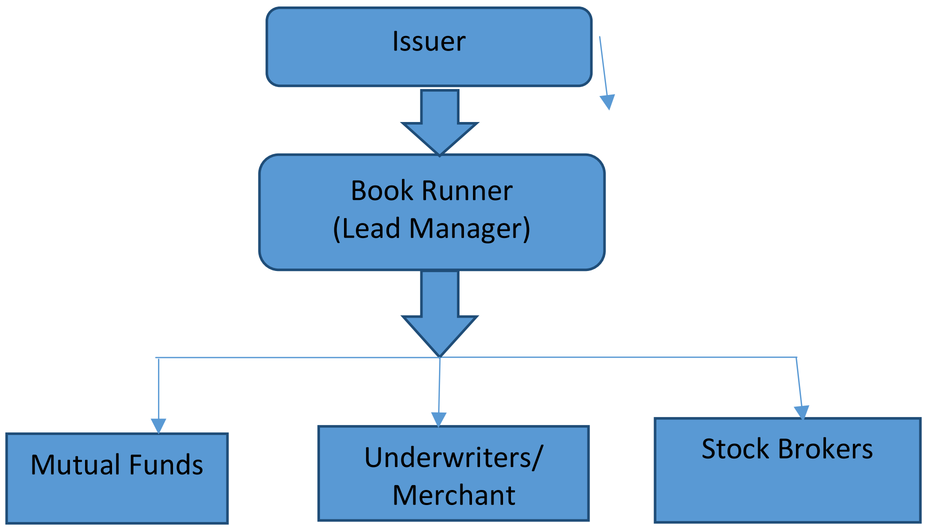
In case of 100 percent book building route adoption not more than 60 per cent of net offer to public can be allocated to qualified institutional buyers, not less than 15 percent of the net offer to the public can be allocated to no-institutional investors applying for more than 1000 shares and not less than 25 per cent of the net offer to public can be allocated to retail investors applying for up to 1, 000 shares.

In case of 75 per cent of net public offer is made through book building, not more than 60 percent of net offer can be allocated to qualified institutional buyers and not less than 15 percent of the net offer can be allocated to non-institutional investors. The balance 25 percent of the net offer to public, offered at a price determined through book building, are available to retail individual investors who have not received any allocation in the book built portion. The book built portion, either 100 percent or 75 per cent, the requirement of minimum of 25 per cent of the securities to be offered to the public shall be applicable.

7 PROCEDURE IN BOOK BUILDING PROCESS

1. Book Building is a process of price discovery mechanism for issue of new securities.
2. For book building the issuer company shall appoint an eligible merchant banker or bankers as book runner/s and their names shall be mentioned in the draft prospectus.
3. The lead merchant banker shall act as the lead book runner and the other eligible merchant bankers so appointed by the issuer shall be termed as co-book runners.
4. The primary responsibility for building the book is with the lead book runner.
5. In case of appointment of more than one lead merchant banker or book runners to the issue, the responsibilities of each of them should be allocated and stated clearly.
6. In book building the entire offer other than promoter's contribution, reservation for permanent employees of the issuer company and shareholders of the promoting companies should be fully underwritten by the syndicate members or book runners.
7. The syndicate members shall enter into an underwriting agreement with the book runners indicating the number of securities, which they would subscribe at the predetermined price.
8. The book runner/s shall in turn enter into an underwriting agreement with the issuer company. In the event of syndicate members, not fulfilling their underwriting obligations the book runner/s shall be responsible for bringing in the amount devolved.
9. The draft prospectus has to be filed by the lead merchant banker to the SEBI containing all the information as per the existing guidelines, except the information regarding the price at which the securities are offered.
10. SEBI within 21 days of the receipt of the draft prospectus may suggest modifications to it.
11. The lead merchant banker shall be responsible for incorporating the modifications and changes in the prospectus as suggested by the SEBI.

12. The copy of the draft prospectus filed with the SEBI may be circulated by the book runner to the institutional buyers who are eligible for firm allotment and to the intermediaries eligible to act as underwriters inviting offers for subscription to the securities.
13. However, the draft prospectus circulated to the institutional buyers and eligible underwriters shall contain the price band within which the securities are being offered for subscription.
14. Book building is used in IPO for efficient price discovery, wherein when the offer is open, bids are collected from investors at various prices, which are above or equal to the floor price.
15. Hence, the red herring prospectus does not contain a fixed price.
16. Instead, the red herring prospectus contains either the floor price of the securities offered through it or a price band along with the range within which bids can move.
17. The spread between the floor and the cap of the price band should not be more than 20 percent. In simple words, the cap should not be more than 120 percent of the floor price.
18. In book building process the issuer company can have an option for revision of the price band.
19. But such a revision in the price band shall be widely disseminated by informing the stock exchanges, by issuing press release and also indicating the change on the relevant website and the terminals of the syndicate members.
20. In case of the price band is revised, the bidding period shall be extended for a further period of 3 days subject to the total bidding period does not exceed 13 days.
21. The issuer company after receiving the final observations if any, on the offer document from the Board should make an advertisement in an English national daily with a wide circulation, one Hindi national newspaper and a regional language newspaper with wide circulation at the place where the registered office of the issuer company is situated.



Book Building Procedure

Steps In Book Building Procedure

1. SEBI as regulatory authorities does not play any role in fixing the price for issue of securities.
2. It is up to the company to decide on the price or the price band, in consultation with merchant bankers.
3. The basis of issue price is disclosed in the offer document.
4. The issuer is required to be disclosed in detail about the qualitative and quantitative factors justifying the price.
5. One day prior to the opening of the issue to the public, the book runner shall collect from the institutional buyers and the underwriters the application forms along with the application money to the extent of the securities proposed to be allotted to them.
6. The book runners shall have an option of demanding the underwriters to the net offer to the public to pay in advance all money required to be paid in respect of their underwriting commitment.
7. The number of bidding centres shall not be less than the number of mandatory collection centres specified in the guidelines of the SEBI.
8. The norms which are applicable for collection centres shall be applicable for the bidding centres also.
9. Only electronic bidding is permitted and bids are submitted through syndicate members.
10. An electronically linked transparent facility is used for bidding.
11. Individual as well as institutional investors shall place their bids only through the syndicate members shall be present at the

bidding centres so that the at least one electronically linked computer terminal at the bidding centres is available for the purpose of bidding.

12. Bidding demand is displayed graphically on the terminals at the end of every day.
13. The lead manager analyses the demand generated and determines the issue price in consultation with the issuer.
14. The retail investors have the option of bidding at cut-off.
15. During the fixed period of time for which the subscription is open, the book runner collects bids from investors at various prices, between the floor price and the cap price.
16. The process aims at tapping both wholesale and retail investors.
17. The final issue price is not determined until the end of the process when the book has closed.
18. There will be a standard bidding form to ensure uniformity and accuracy in bidding.
19. The bidding form shall contain information about the investor, the price and the number of securities that the investors wish to bid.
20. The investor can change or revise the quantity or price in the bid using the form for revising the bid that is available along with the application form.
21. However, the entire process of changing of revising the bids shall be completed within the date of closure of the issue.
22. The bids remain open for at least 5 days.
23. After the close of the book building period, the book runner evaluates the collected bids and the cut-off price is arrived at on the lines of Dutch auction.
24. If demand is high enough, the book can be oversubscribed.
25. In these cases the green shoe option is triggered.
26. The mandatory requirement of 90 percent subscription should not be considered with strictness, but the prospectus should disclose the amount of minimum subscription required and sources for meeting the shortfall.
27. In the case of book built issues, the basis of allotment is finalised by the book running lead managers within 2 weeks from the date of closure of the issue.
28. The investor is entitled to receive conformity allotment note in case the investor has been allotted shares within 15 days from the date of closure of a book built issue.

29. The registrar then ensures the demat credit or refund as applicable is completed within 15 days of the closure of the issue.
30. The issuer company may pay interest on the application money till the date of allotment or the deemed date of allotment provided the payment of interest is uniformly given to all the applicants.
31. On determination of the issue price within 2 days, the final prospectus containing all disclosures as per the SEBI guidelines including the price and the number of securities proposed to be issued shall be filed with the Registrar of Companies, thus completing the issue process.
32. The listing on the stock exchanges is done within 7 days from the finalisation of the issue.

Nominate Book Runner

Form Syndicate of Brokers, Arrangers, Underwriters, Financial Institutions etc.

Submit Draft Offer Document to SEBI without mentioning coupon Rate or Price

Circulate Offer Document Among the Syndicate Members

Ask for bids on Price and Quality of Securities

Aggregate and Forward all Offers to Book Runner

Rn the Book to maintain record of subscribers and their orders

Consult with Issuer and determine the issue price as a Weighted Average of the Offers Received

Firm up underwriting commitments

Allot Securities among Syndicate Members

Securities issued and listed

Trading commences on Exchanges

Advantages Of Book Building

Book building process has certain advantages to the company when compared to the fixed price method of issue of securities. Important advantages of book building process are of the following:

1. Book building process is more flexible than fixed price method of issue. In book building process the issuer company may be given the flexibility to revise the price band during the bidding period.
2. In book building process, book runners and the issuer company have the freedom to determine the issue size based on the demand in the market.
3. Public issue carries the risk of failure, if it does not receive a 90 percent minimum subscription. In book building, these risks can be avoided because the issuer can withdraw from the market, if the demand for the security does not exist.
4. Book building has made the primary issuance process comparatively faster by reducing the delay in issue process. In book building allotment for the placement portion can be made on the second day from the closure of the issue. The public offer portion of the offer could be launched simultaneously and listing on the stock exchanges can be done within 7 days from the finalisation of the issue.
5. Book building process is comparatively cost effective than fixed price method of issue.
6. Book building process eliminates refunds except in case of direct applications.

8 MAIN DIFFERENES BETWEEN NORMAL IPO AND BOOK BUILDING

Price at which securities will be allotted is not known in case of offer of shares through Book Building while in case of offer of shares through normal public issue, price is known in advance to investor. Under Book Building, investors bid for shares at the floor price or above and after the closure of the book building process the price is determined for allotment of shares.

In case of Book Building, the demand can be known everyday as the book is being built. But in case of the public issue the demand is known at the close of the issue.

9 ROLE OF MERCHANT BANKERS IN FIXING THE PRICE

Indian Primary Market ushered in an era of free pricing in 1992. SEBI does not play any role or fix any formula for price fixation. As per SEBI guidelines (1992) companies which are eligible to make public have the freedom to price their equity shares or any security convertible into equity at a later date. Pricing is done by companies themselves, in consultation with the lead merchant bankers. For fixing the price of a share the merchant bankers consider the following factors viz., earnings per share, book value, average market price for two or three years, future prospects of the company, market conditions etc. Premium on share has to be determined after taking into consideration the net asset value, profit-earning capacity of the company, market price etc. Justification of price including premium has to be stated in the prospectus.

In the case of public issue of equity shares, following types of companies have the freedom to price their issue:

1. A listed company whose equity shares are listed on a stock exchange, may freely price its equity shares and any security convertible into equity at a later date, offered through a public or rights issue.
2. An unlisted company eligible to make a public issue and desirous of getting its securities listed on a recognised stock exchange pursuant to a public issue, may freely price its equity shares or any securities convertible at a later date into equity shares.
3. An eligible infrastructure company shall be free to price its equity shares subject to compliance with the disclosure norms as specified periodically by SEBI.
4. The public and private sector banks can freely price their issue of equity shares or any securities convertible at a later date into equity shares subject to the approval of RBI.

10 TYPES OF PRICING

There are two types of pricing of issues:
a. **Fixed Price:** In this case the issuer is allowed to freely price the issue. Where the company and the lead merchant banker fix a price for its issue, it is called fixed price. The issuer company can mention a price band of 20 percent (cap in the price band and should not be more than 20 percent of the floor price) in the offer documents filed with the SEBI and actual price can be determined at a later date before filing of the offer document with the Registrar of Companies.

If the Board of Directors has been authorised to determine the offer price within a specified price band such price would be determined by a Resolution to be passed in the meeting by the Board of Directors. In the case of listed companies the Merchant Bankers should ensure that 48 hours-notice of meeting of the Board of Directors for passing a resolution for determination of price is given to the Designated Stock Exchange.

In case of a public issue by a listed company, issue price or price band may not be disclosed in the draft prospectus filed with the Board. In case of a rights issue, issue price or price band may not be disclosed in the draft letter of offer filed with the Board. The issue price may be determined at any time before fixation of the record date, in consultation with the Designated Stock Exchange. The final offer document should contain only one set of financial projections, if applicable.

b. Floor Price: Where the company and the lead merchant banker stipulate a floor price or a price band and leave it to market forces to determine the final price is called floor price. It is otherwise called the price discovery through book building process. This method provides an opportunity to the market to discover price for securities.

c. Differential Pricing: Any listed or unlisted company making a public issue of equity shares or any securities convertible at a later date into equity shares, may issue such securities to applicants in the firm allotment category at a price higher than the price at which securities are offered to the public A listed company making a composite issue of capital may issue securities at different prices in its public and rights issue.

11 FIXING OF FACE VALUE OF SHARES FOR PUBLIC ISSUE/RIGHTS ISSUE

An eligible company is free to make public or rights issue in any denomination determined by it in accordance with sub-Section 4 of Section 13 of the Companies Act 1956 and in compliance with the norms as specified by SEBI.

In case of Initial Public Offerings by unlisted company, if the issue price is Rs. 500 or more, the issuer company shall have the discretion to fix the face value at Rs. 10 per share, subject to the condition that the face value shall in no case be less than Rs. 1 per share. However, in case the issue price is less than Rs. 500 per share, the face value shall be Rs. 10 per share. However, a company is not allowed to issue shares in the denomination of decimal of a rupee.

The companies which have already issued shares in the denomination of Rs. 100 or Rs. 10 may change the standard denomination of the shares by splitting or consolidating the existing shares. The denomination of the existing shares shall not be altered to a denomination of decimal of a rupee. The company seeking to change the standard denomination may do so only after amending the Memorandum and Articles of Association, if desired.

Issue Of Shares At A Premium

Shares are generally issued by a company to the public at 1) face value or at 2) premium or at 3) discount. When shares are issued to the public, at a price higher than the face value, it is called issue of shares at a premium. The difference between the offer price and the face value is called the premium. Share premium is a capital profit for the company and the amount so earned has to be credited to a separate account called share premium account. There are no restrictions on issue of shares at a premium and the power to issue shares at a premium need not be taken in the Articles of Association. However, there are restrictions on the ways share premium can be utilised.

As per the SEBI guidelines, new companies can issue shares to the public at a premium only if the following conditions are satisfied:

1. The promoter company has a 3 year record of consistent profitable working.
2. The promoter takes up atleast 50 percent of the shares in the issue.
3. All parties applying for the issue should be offered the same instrument at the same terms, especially the premium.
4. The prospectus should provide justification for the proposed premium.

On the other hand, existing companies can make a premium issue without the above restrictions.

Issue Of Shares At A Discount

When shares are issued by a company to the public at a price lower than the face value it is called issue of shares at a discount. In order to issue shares at a discount, a company has to fulfil all the conditions laid down in Section 79 of the Indian Companies Act of 1956. The conditions are as follows:

1. The issue of shares at a discount must be authorised by a resolution passed by the company in a general meeting and sanctioned by the Company Law Board.
2. The shares to be issued at a discount must be of a class already issued.
3. The maximum rate of discount shall not exceed 10 per cent. However, a higher discount may be allowed by the Company Law Board under special circumstances.
4. At the time of issue of shares at a discount, the company must have been working for at least a year from the date it was entitled to commence business.

5. The shares to be issued at a discount must be issued within two months after the date on which the issue is sanctioned by Company Law Board.

After a company has issued shares at a discount, every subsequent prospectus for further issue of shares must contain particulars of the discount allowed on the issue of shares or of so much of that discount as has not been written off by the date of the issue of prospectus.

12 REDHERRING PROSPECTUS

A red-herring prospectus is a preliminary prospectus. It is given to prospective purchasers during the 20-day waiting period between the filing date of the registration statement and the effective date. The red-herring does not contain information such as the public offering price or the underwriter's spread.

According to Companies Act, 1956, "A prospectus which does not have complete particulars on the price of securities offered and the quantum of securities offered is known as red-herring prospectus." Such a prospectus is issued where a company offers its securities through the 'book-building mode'.

The purpose of issuing a red-herring prospectus is to acquaint potential investors with essential facts concerning the issue. A red-herring prospectus summarises many of the important details contained in the registration statement. It can never be used to solicit orders, only indications of interest. These indications of interest not binding commitments – they are not binding on the broker/dealer or the customer. A Registered Representative (RR) is not allowed to write comments or statements on a red-herring (preliminary) prospectus or mean it in anyway. Unless an exemption applies, it is unlawful for any person to use the mails or any other instrument of inter-state commerce to offer a security for sale unless a registration statement has become effective. Therefore, a security can be offered for sale only after a registration statement is effective.

According to sub-sections (2), (3) and (4) of Section 60B of the Companies Act, 1956, "A prospectus which does not have complete particulars on the price of securities offered and the quantum of securities offered is known as red-herring prospectus." Such a prospectus is issued where a company offers it securities through the 'book-building mode'.

To summarise, during the period between the filing date and effective date of the registration statement:

1. No sales of the security may take place.
2. Offers of the security mat take place, but a written offer may be made only through a preliminary prospectus or red-herring prospectus (tombstone advertising is permitted during the period).
3. Brokers may answer unsolicited requests for information by sending out a preliminary prospectus and accept unsolicited orders for the security.
4. Brokers cannot send out the company's research report or any report projecting the company's future sales and earnings.

Features Of Red-Herring Prospectus

The features of red-herring prospectus are as follows:

1. Filing: Red-herring prospectus shall be filed with RoC at least 3 days before the opening of the offer. A copy of this prospectus must also be filed with the SEBI.
2. Obligations: It carries the same obligations and liabilities as are applicable to an ordinary prospectus.
3. Contents: It must contain all the details as required in Schedule II of the Companies Act.
4. Signature: It must be signed by all the directors of the company or their constituted attorneys.

SUMMARY

- Capital market consists of primary and secondary market. Primary market is that part of the capital market that deals with the issuance of new securities. Primary market is otherwise called as New Issue Market (NIM). In the primary market the securities are purchased directly from the issuer. This is the market for new long-term or permanent capital. In other words, the money raised from the primary market provides long-term capital to the companies.
- There are different ways for offering new issues in the primary capital market. Primary issues made by Indian Companies can be classified as follows:

a. Public Issue

b. Rights Issue

c. Bonus Issue

d. Private Placement.

- Book building is a process of price discovery mechanism used by corporates issuing securities. It is a mechanism used to discover the price of their securities. Book building is a common practice in developed countries and has recently been making inroads into emerging market as well, including India.

- Price at which securities will be allotted is not known in case of offer of shares through Book Building while in case of offer of shares through normal public issue, price is known in advance to investor. Under Book Building, investors bid for shares at the floor price or above and after the closure of the book building process the price is determined for allotment of shares.
- Indian Primary Market ushered in an era of free pricing in 1992. SEBI does not play any role or fix any formula for price fixation. As per SEBI guidelines (1992) companies which are eligible to make public have the freedom to price their equity shares or any security convertible into equity at a later date. Pricing is done by companies themselves, in consultation with the lead merchant bankers. For fixing the price of a share the merchant bankers consider the following factors viz., earnings per share, book value, average market price for two or three years, future prospects of the company, market conditions etc. Premium on share has to be determined after taking into consideration the net asset value, profit-earning capacity of the company, market price etc. Justification of price including premium has to be stated in the prospectus.
- An eligible company is free to make public or rights issue in any denomination determined by it in accordance with sub-Section 4 of Section 13 of the Companies Act 1956 and in compliance with the norms as specified by SEBI.
- A red-herring prospectus is a preliminary prospectus. It is given to prospective purchasers during the 20-day waiting period between the filing date of the registration statement and the effective date. The red-herring does not contain information such as the public offering price or the underwriter's spread.

QUESTIONS

1. What is the meaning of private placement?
2. Define the term public issue.
3. What is Red herring Prospectus?
4. Define the terms Rights Issue.
5. State the advantages of book-building.
6. What is primary market? Explain the features of primary market.

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5

SECONDARY MARKET

Unit Structure

5.1 INTRODUCTION

All securities are first created in the primary market and then they enter into the secondary market. Thus securities generally have two stages of their life span. The first is the stage when the company issues them in the market and makes them available for the general public from its treasury at a predetermined offer price. This is known as the primary market offer or Initial Public Offer (IPO). In their second stage of life securities, the securities are traded further after being initially offered to public. Thus the Big Brokers and / or investment dealers frequently buy initial offer on the primary market and resell securities in secondary market. Secondary market is the base upon which primary market rests. Most of the trading is done in secondary market. This kind of trading deals with previously issued instruments and needs essentially an organised market. Examples can be New York Stock Exchange, NASDAQ, Bombay Stock Exchange (BSE), National Stock Exchange (NSE), bond market etc.

5.2 MEANING AND DEFINITION

Secondary Market, also known as the aftermarket, is the place where goods which are already used by someone are sold and/or bought. Thus we can define secondary market as "the financial market where previously issued securities and financial instruments such as stocks, bonds, futures and options are manoeuvred from one investor into another." Secondary market primarily deals with used products or an alternative use of an existing product or assets where the customer base is the second market. For example, rice is primarily known as food item so the food market is the first or primary market for rice. Broken rice is the by-product in rice mills and is used for producing liquid glucose. About 90% of liquid glucose produced in India is used in confectionary industry. Thus it can be said that confectionary industry is the secondary market for rice which is in the form of liquid glucose.

5.3 NEED FOR SECONDARY MARKET

Two basic needs of the investors can be proposed:

1. Need for buying and selling of existing securities

Investors who are able to gather some information about a particular security from the market or from some other sources tend to believe that they have superior information than other market players. They develop this misconception that the security is not correctly priced by the market.

If the information is good, this suggests that security is currently underpriced and investors who have access to such information will want to buy the security. On the other hand, if the information is bad, the security will be currently over priced and such investors will want to sell their securities in the market as soon as possible.

2. Need for liquidity

Investors who are motivated by the liquidity factor, transact in the secondary market in order to come out of the position of either excess liquidity or insufficient liquidity. Investors who are having surplus funds (e.g. due to ancestral property or some other reason) will buy securities, and investors who are having dearth of funds (e.g. desire to purchase land) will sell securities in the market.

5.4 ROLE OF SECONDARY MARKET

1. Facilitate liquidity

Secondary Market helps to create sufficient liquidity and marketability of outstanding debt and equity instruments. They help to connect investors desire for liquidity with the capital users' wish of using their capital for a longer period of time. For example in a traditional partnership, a partner cannot access the other partner's investment but only his or her investment in that partnership, even on emergency basis. Then if he or she may break the ownership of equity into parts and sells his or her respective proportion to another investor. This kind of trading is facilitated only by secondary market.

2. Helps in Capital Formation

Secondary Market contributes to economic growth by proper allocation of funds towards most efficient channel through process of disinvestment to reinvestment. Secondary markets of a country play catalytic role behind development and improvements in the Capital Markets. An active secondary market in fact promotes the growth of the primary market and helps in capital formation.

3. Acts as a "ready market"

For general investor, secondary market provides a ready market for carrying out his trading activities. An investor can sell stocks/shares which he might have purchased from primary market through Initial Public Offering process or he might have purchased them from another investor through secondary market. On the other hand, investors who are not able to purchase stocks/shares of a particular company through Initial Public Offering process in the primary market due to any reasons can purchase the same in secondary market. Thus we can say that secondary market helps investors to sell their holdings readily thereby ensuring liquidity.

4. Induces companies to improve their performance

Secondary Market induces those companies whose shares are listed in the stock exchange to improve their performance as the market price reflects company's performance and this price is very easily available to the investors. For the management of the company, secondary equity market serves as the monitoring and control conduit-by facilitating value-enhancing control activities; enabling implementation of incentive-based management contracts, and aggregating information (via price discovery) that guides management decisions.

5. Helps in instant valuation of securities

Secondary market provide for instant valuation of securities caused by changes in the internal environment such as company-wide or industry-wide factors. Valuation of securities makes it easy to measure cost of capital and rate of return of the economic entities at the micro economic level.

6. Protection of investors' interest

Secondary Market provides a safe platform to the investors for carrying out their trading activities. It ensures investors of fair dealing and protects their interest.

5.5 DISTINCTION BETWEEN PRIMARY MARKET AND SECONDARY MARKET

Both primary market and secondary market serve the Indian Financial System and helps the investors to invest their funds into profitable avenues. The proper functioning of both of them is very vital for the process of sound development and smooth functioning of Indian Capital Market. Both markets are complementary of each other but differ from each other on some major points. These are as follows:

	Primary Market	**Secondary Market**
Role	Primary market provides a platform where securities are to public for subscription for the purpose of raising capital.	It provides a platform to the investors to trade existing/pre-issued securities. Therefore, it is also known as the "aftermarket".
Players	Players of primary market are Merchant Bankers, R&T agents, Underwriters, Brokers and sub-brokers, depositories.	Players involved in secondary market are Stock Exchanges, Stock brokers, investors, FIIs
Instruments	Primary market deals in IPO (Equity and Preference shares) and NFO (Mutual Funds)	Secondary market instruments are mainly shares, debentures, mutual funds and bonds

Types of accounts required	In Primary Market an investor needs only Demat account.	Here demant account as well as trading account is also required.
Settlement	Here settlement means that shares are credited into investors Demat Account.	Here settlement takes place on T+1 for intra-day and on T+2 for delivery base.

5.6 PARTS OF THE SECONDARY MARKET

Secondary Market can be divided into three parts. These are:

1. Equity Market
2. Debt Market
3. Derivative Segment

1. Equity Market

Shares of a company which are also termed as equities make the person or organisation holding them as the shareholder of the company. Most of the investors prefer to invest in them because equities have the proven track record of outperforming other forms of the investments. The value of most of the equities tends to increase over a period of time. But this does not mean that all equities would be giving similar higher returns. Being high risk investments equities need to be studied carefully and patiently. As investors have bear higher risk in equities companies reward them back by paying dividend annually. Dividend is a percentage of the face value of a share that a company returns to the shareholders from its annual profits.

Equity as an Investment

In a laymen term equity can be defined as a stock or any security that represents ownership of a company. On company's financial statements such as balance sheet equity denotes those funds which are contributed by the owners plus the retained earnings (or losses), also known as the stakeholders' equity. It can be said that equity is a term whose meaning depends very much on context. In general, one can think of equity as ownership in any asset after all the debts that are related to that asset are paid off. For example a house will be counted as owners' equity only when all the loans taken for construction of house and purchase of land are paid off and the owner is free to sell the house for requirement of cash.

Equity is given preference over other forms of investments because they can outperform and they are supposed to deliver better returns over longer periods of time. But one needs to be careful if he/she is investing in equities for shorter period of time because equities tend to be very risky and due to their inclusion in portfolios makes portfolios highly volatile. And due to this very reason it is recommended time frame for equity investment is a sufficient long period of time (at least 3 years). Similarly, it is also advised that investors who are typically closer to their retirement age and who have lower risk appetite must include very negligible equity holdings in their portfolios.

Dutch East India Company was the first company to issue its share to general public in 1602. In India, it was Reliance that came out with the first ever IPO in January 1978. Equity markets world over were passing through a bearish phase in the late 80s and then the decade of 90s was followed by a largest ever bull market which lasted for about 10 years. This led to growth and development of equity market in the entire world. As a result of liberalisation in 1990s Indian Economy flourished and benefitted a lot. Series of financial sector reforms were introduced in which majority were capital market reforms. Controller of Capital Issues was completely abolished and free pricing of shares started. Hence development of Indian Equity Market matching to the standards of global equity markets took place.

Indian Equity Markets depend mainly on monsoons, global funds flowing into equities and the performance of various companies. Indian Equity Market is almost majorly dominated by the two oldest and biggest stock exchanges of the country. These are BSE and NSE. The benchmark indices of the two exchanges are Nifty for NSE and Sensex for BSE are closely followed.

Investing Principles

Investing in equities can be difficult proposition for retail investors. However, equity must form a part of every investor's portfolio. The proportion could vary, depending on the investor's age, monetary requirement, risk appetite etc. To cope up with volatility in equities it is important to have a disciplined and systematic approach to equity investment.

Set your own rules and more importantly, follow them religiously. Indeed the mantra for successful equity investment is a well thought-out disciplined investment strategy.

Here are some golden rules which are followed to sail through different market scenarios.

1. Be a long term investor

This is the first and most important rule of equity investment. Timing the market at low levels and exiting at higher levels is almost impossible. Thought often heard on the street, this strategy is difficult to implement, as it is nearly impossible to gauge when the market has peaked and when it has bottomed out. Investors should not indulge in the guessing game; it is more sensible to put money into the market with a long term commitment.

2. Invest time and efforts in doing homework

Investing in equities is not a onetime affair. A lot of time and effort, apart from money has to be spent in order to understand the industries, economic trends and so on. Further one should dedicate time in order to analyse companies, as it will help to avoid costly mistakes.

First hand information such as annual company reports, company announcements etc. should be read with priority. Revisiting financial fundamentals periodically is a good habit of a prudent investor. Basic concepts such as Price Earnings Ratio (P/E ratio), operating margin, earnings per share etc. should be very clear in mind. Further technicalities of investment should also be understood such as how the stock market operates, how to buy or sell, settlement procedures etc.

3. Pay the right price

It is very imperative to pay only the 'right' price, i.e the price an investor can comfortably pay. Stocks should not be bought because others are buying this will help in holding the stock for longer duration. Conversely, if one has decided when to sell, then if one feels that the market is overheated and prices have reached unrealistic levels then one should exit from the market.

4. Portfolio Diversification

Diversion is a very old and popular strategy, applied to reduce portfolio risk. To reduce risk, diversify within equities by investing across sectors. Investing in just one or two sectors is not advised because any negative development pertaining to those sectors will impact profitability of portfolio. A good blend of small, mid and large cap stocks must be present in portfolio. While large cap stocks could lend stability to portfolio, small and mid cap stocks will be giving an above average appreciation.

5. Do not buy on tips and rumours rather focus on fundamentals

Tips and rumours are an integral part of the stock market and these are engineered by group of traders. Therefore, a sharp rally based on rumours could fizzle out in short time. Therefore, investors should strictly stay away from rumours suggestions or tips received from brokers or friends or investor circles. Rather you would be better off investing based on industry and company fundamentals.

6. Buy Shares of the Company whose business you understand

In long term, the stock market rewards companies with strong fundamentals and good financial performance. Therefore, it is essential for an investor to invest in those companies whose industry dynamics and business models are well understood by him/her. This will help him/her to gauge whether a transformation in an industry is positive or negative, at an early stage itself and its likely impact on the company's fundamentals.

7. Don't sell in panic

Markets go through cycles of boom and bust and volatility is a way of life in equities. Do not sell your holdings in a hurry and panic just because your stocks have witnessed a sudden correction. Always focus on company fundamentals; if they are intact, there's nothing to worry about.

8. Do not borrow money to invest in equities

It is true that equities tend to outperform other investment avenues in the long run. However, there is no guarantee that you will make money on your stocks either in terms of dividends or capital gains, if your sale of shares is time-bound. Therefore, if you borrow funds to invest in equities, it might be difficult for you to repay the interest or principal on the loan, on time.

9. Invest regularly and build up your position gradually

Investment into equities must be on periodic basis. It is very similar to putting your money regularly in fixed interest bearing securities. One should buy small and regular lots. This will help in buying at reasonable price.

10. Monitor your portfolio

Investing in equity is not a onetime affair. Buying shares is perhaps the smallest part of the overall investment activity. It is important to periodically monitor and review your investment portfolio. It is always prudent to sell a stock if you feel that the fundamentals have deteriorated and the stock is overpriced in comparison to its fair values. Money has an opportunity cost and by selling an overvalued stock you can invest the same money somewhere else to get the benefit of better capital appreciation opportunities.

2. Debt Market

Debt Market is that part of secondary market where investors buy and sell debt securities which are mostly in the form of bonds. It is the market where fixed income securities are issued and traded. For a developing economy like India, debt markets are crucial source of capital funds. Indian Debt Market is almost third largest in the world and one of the largest in Asia. It includes government securities, public sector undertakings, other government bodies, financial institutions, banks and companies. Total size of the Indian Debt Market is in the range of $92 billion to $100billion i.e. approximately 30% of GDP.

Impact of Debt Market on Indian Economy

- Increased funds for implementation of government development plans. It is easy for government to raise funds at lower cost by issuing government securities.
- Conducive to implementation of a monetary policy.
- Lesser risk as compared to equity markets, thus equity markets encourages low risk instruments. This leads to inflow of funds into the economy.
- Higher liquidity and control over credit.
- There is enough opportunity for investors to diversify their investment portfolios.
- Better corporate governance.
- Improved transparency because of stringent disclosure norms and auditing norms.

Classification of the Indian Debt Market

Indian Debt Market can be broadly classified in two categories:

1. Government Securities Market
2. Bond Market

1. Government Securities Market

In G-sec market securities are issued by the Governments of the state and centre for the purpose of taking loans. However, securities issued by the state governments constitute only a very small portion of their fiscal deficits. In India it is mandatory for banks to maintain a certain percentage of their liabilities in Government securities and other specified liquid assets which creates a captive demand for Government securities. At present, the Statutory Liquidity Ration (SLR) for the banks is 25%. Similarly other types of financial institutions such as insurance companies, provident funds, non banking financial institutions etc., are required to fulfil certain statutory conditions.

2. Bond Market

Bond Market link issuers, i.e. governments, state owned institutions, local bodies and corporate having financing needs, with the investors having investible funds. In an efficient bond market requirements of both the issuers and investors are met effectively at a price (interest rates) determined competitively and price adjustment to some new information is seamless.

Bond Market consists of the following:

- Corporate Bonds
- Public Sector Unit Bonds
- Banks and Financial Institutions Bonds

Corporate Bonds and Debentures

Have maturities beyond 1 year and generally up to 10 years. Corporate also issue short term commercial paper with maturity ranging from 15 days to 1 year.

Public Sector Unit Bonds

PSU Bonds are generally treated as surrogates of sovereign paper, sometimes due to explicit guarantee of Government, and often due to comfort of public ownership. As compared to G-Secs, corporate bonds carry higher risks, which depend upon the corporation, the industry where the corporation is currently operating, the current market conditions and the rating of the corporation. However, these bonds also give higher returns as compared to G-Secs. Some of the PSU Bonds are tax-free; a status enjoyed which is not by even Government securities.

Banks and Financial Institutions Bonds

Most of the institutional bonds are in the form of promissory notes transferable by endorsement and delivery. They are negotiable certificates issued by the Financial Institutions such as the IDBI/ICICI/IFCI or by the commercial banks. These instruments have been issued both the regular income bonds and as discounted long term instruments (deep discount bonds).

Participants in Debt Market

Given the large size of trades, Debt Market is predominantly a wholesale market, with dominant institutional investor participation. The investors in debt market are mainly banks, financial institutions, mutual funds, provident funds, insurance companies and corporate.

In order to understand the participants and products dealt in debt market following table can be studied.

Issuer	**Instrument**	**Maturity**	**Major Investors**
Central Government	Dated Securities Treasury Bills	2-30 years 91/364 days	RBI, Banks, Insurance Companies, Provident Funds, PDs, Individuals.
State Government	Dated Securities	5-10 years	Banks, Insurance Companies, Provident Funds
PSUs	Bonds	5-10 years	Banks, Insurance Companies, Corporate, Provident Funds, Mutual Funds, Individuals
Corporate Debentures PDs	Bonds and Commercial Paper Commercial Paper	1-12 year 15 days to 1 year	Banks, Mutual Funds, Individual Banks, Corporate, Financial year Institutions, Mutual Funds, Individuals.

Banks	Bonds issued of tier II Capital Certificates of Deposits	Minimum 5 years 3 months to 1 year	Banks, Corporate

3. Derivative Segment

Financial markets are well known for their volatile nature and hence risk factor is an important factor for financial agents. To reduce this concept of derivatives comes into picture. Derivatives are product whose values are derived from one or more basic variables called bases. These bases can be underlying assets (for example forex, equity etc.) bases or reference rates. For example rice farmers may be willing to sell their harvest at a future date to eliminate risk of changes in the price by that date. The transaction in this case will be called derivative, while spot price of the wheat would be underlying assets. Derivatives were introduced in the Indian Stock Market to enable the investors to hedge their instruments against adverse volatile price movements. However, they are now commonly being used for taking speculative positions.

The need for Derivative Market

The derivative market performs a number of economic functions:

- They help in transforming risks from risk averse people to risk oriented people.
- They help in discovering the current as well as future prices.
- They catalyze entrepreneurial activity.
- They increase the volume traded in the markets because of participation of risk averse people in greater number.
- They increase savings and investments in the long-run.

The Derivative Market

Derivatives Market can broadly be classified in two categories, those that are traded on the exchange and those that are traded one to one or 'over the counter'. They are hence known as

- Exchange traded derivatives
- OTC Derivatives (Over The Counter)

Exchange traded derivatives

They are the most common and popular kind of derivatives traded normally on the exchanges.

OTC Equity Derivatives

They have long history in India in OTC Market. Options of various kinds were available (called Teji, Mandi and Fatak) in un-organised markets and were traded in Mumbai as early as 1900. However, SCRA banned all kind of option in 1956 and this can was lifted in 1995.

The Participants in Derivatives Market

Hedgers use futures or option markets to reduce or eliminate the risk associated with price of assets.

Speculators use futures and options contract to get extra leverage in betting on future movements in price of an asset. They can increase both the potential gains and potential losses by usage of derivatives in a speculative venture.

Arbitrageurs are in business to take advantage of a discrepancy between prices in two different markets. If, for example if they forecast that future price of an asset is getting out of line with the cash price, they will take offsetting positions in the two markets to lock in profit.

Types Of Derivatives

Forwards

A forward contract is customised contract between two entities, where settlement takes place on a specific date in future on today's pre-agreed price.

Futures

A future contract is an agreement between two parties to buy or sell an asset at a certain time in future at a certain price. They are special kind of forwards contracts in the sense that former are standardised exchange traded contracts.

Options

Options are of two types - calls and put option. Call option gives 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. On the other the put option gives 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 future date.

Warrants

Options generally have life of one year, the majority of options traded on options exchange having a maximum maturity of nine months. Longer dated options are called warrants and are generally traded over the counter.

LEAPS

Long term Equity Anticipation Securities are options having maturity of 3 years.

Baskets

Baskets options are options on portfolios of underlying asset. The underlying asset is usually a moving average or a basket of asset. Equity index options are form of basket options.

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. The two most commonly used swaps are:

- **Interest Rate Swaps:**

They involve swapping only interest related cash flows between the parties in the same currency.

- **Currency Swaps:**

They involve swapping of both the principal and interest between the parties, with cash flows in one direction being in a different currency than those in the opposite direction.

Swaptions

Swaptions are options to buy or sell a swap that will become operative at the expiry of the option. Thus, it can be said that Swaption, is an option on a forward swap. Rather than having calls and puts, the swaptions market has receiver swaptions and payer swaptions. A receiver swaption is an option to receive fixed and pay floating, on the other a payer swaptions is an option to pay fixed and receive floating.

5.7 INSTRUMENTS OF SECONDARY MARKET

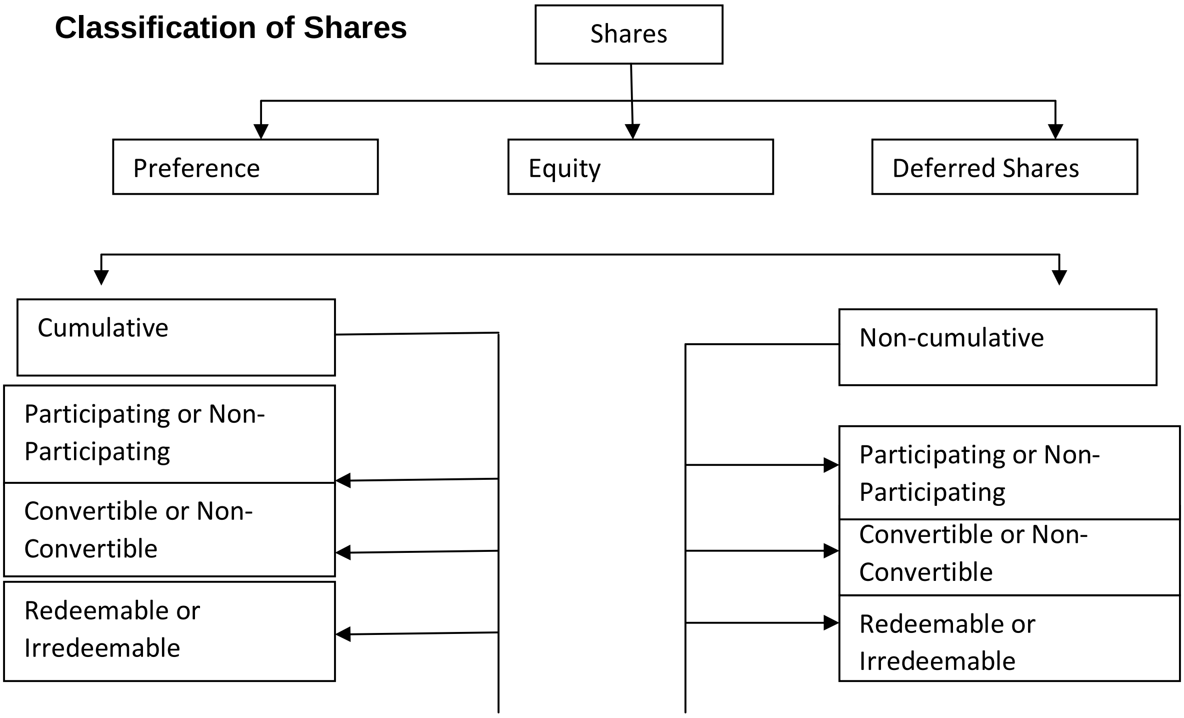
Following are the main instruments or products dealt in Secondary Market:

- Shares
- Debentures
- Bonds
- Mutual Funds

SHARES

"A share in the share capital of the company and includes stock except where a distinction between stock and share is expressed or implied." For example, if the capital of the company is 10, 000 and is divided into 1000 units of Rs. 10/- each then each unit of Rs. 10/- shall be called share of the company.

Classification of Shares



Preference Shares

Preference Shares are those which enjoy some preferential rights. These rights may be concerning:

- As to the payment of dividend at a fixed rate during the whole life of the company.
- As to the return of the capital at the time of winding up of the company.

But at the time of liquidation, preference shareholders rank below the claims of the company's creditors, bond holders/ debenture holders.

Voting rights of Preference Shareholders

Preference Shareholders do not enjoy normal voting rights as the equity shareholders do. However they are entitled to vote under the following two conditions:

- When any resolution directly rights is to be passed.
- When the dividend due (whether declared or not) on their preference shares or part thereof has remained unpaid.

Kinds of Preference Shares

Preference shares are broadly classified into two types:

1. Cumulative Preference Shares
2. Non-Cumulative Preference Shares.

Cumulative Preference Shares

In this kind of shares dividend accumulates if it remains unpaid if the company earns no and/or lean profits and when the company earns good profits all the arrears of preference dividend have to be paid out before paying dividend on equity shares. Preference shares shall always be cumulative unless any express provision is mentioned in the articles.

Non-Cumulative Preference Shares

Non-cumulative preference shares are those shares on which arrear of dividend do not accumulate. Therefore, if dividend is not paid on these shares in any year, the right to receive the dividend lapses and as such, the arrear of dividend is not paid out of the profits of the subsequent years.

Cumulative Preference Shares and Non-Cumulative Preference Shares fall under the following three categories:

1. Participating and Non Participating Preference Shares

The right of certain preference shareholders to participate in the profits after a specified fixed dividend contracted for is paid. Participation right is linked with quantum of dividend paid on the equity shares over and above a specified level. Thus, these kinds of shares entitle their holder to get a portion in surplus profits or surplus assets of the company at the time of liquidation or both, if the Articles of Association provides for it. On the other, Non-Participating Preference Shares do not enjoy such participating rights. Preference shares are always deemed to be non-participating unless otherwise mentioned.

2. Convertible and Non-Convertible Preference Shares

A type of preference shares where the dividend payable on the same accumulates if it is not paid. After a specified date these shares will be converted into equity capital of the company. Such shares are known as Cumulative Convertible Preference Shares.

Whereas when such shares are not converted into equity shares they are termed as Cumulative Non-Convertible Preference Shares.

3. Redeemable and Irredeemable Preference Shares

Redeemable preference shares are those shares which can be redeemed by the company on or after the certain date after giving the prescribed notice. These shares are redeemed in accordance with the terms and Sec. 80 of the Company's Act, 1956. Irredeemable preference shares are those shares, which cannot be redeemed by the company during its lifetime, in other words it can be said that these shares can only be redeemed by the company at the time of winding up. But according to the Sec. 80 (5A) of the Company's (Amendment) Act, 1988 on company can issue irredeemable preference shares.

Equity Shares

An equity share commonly known as ordinary share also represents the form of fractional ownership in which shareholder, as a fractional owner, undertakes the maximum entrepreneurial risk associated with a business venture. Their holders are the actual owners of the company and have voting rights. A company may issue such shares with deferential rights to voting, paying of dividend etc., directors of the company have the sole right of recommending dividends to such shares and as such they may not get any dividends in case the directors choose so.

These shares are also known as the "risk capital" because they get dividend on the balance of profit if any, left after payment of dividend on preference shares and also at the time of wingding up of the company, they are paid from the balance asset left after payment of other liabilities and preference share capital. Apart from this they can claim dividend only, if the company in its AGM declares the dividend. The rate of dividend on such shares is not predetermined, but it depends on the profits earned by the company.

Distinction between Preference Shares and Equity Shares

Basis of Difference	Preference Shares	Equity Shares
Rate of Dividend	These shares are entitled to a fixed rate of dividend.	The rate of dividend on equity shares depend upon the amount of profit available and funds requirement of the company for future expansion.
Preferential Rights	They enjoy some preferential rights over equity shares. Such as dividend on preference shares are paid before paying the same to equity shareholders. Preference shares also get preference at time of winding up of the company are paid back their capital before the payments to equity shareholders is made.	Equity shares do not enjoy such preferential rights with the regards to payment of dividend and capital the time winding up on the company. Their claims are the settled last, i.e. only after the company's creditors, bond holders are paid off.
Redemption	Redeemable preference shares may be redeemed by the company.	Equity shares cannot be redeemed except under a scheme involving reduction of capital or buy back of its own shares.
Voting Rights	Their voting rights are restricted.	An equity shareholder can vote on all matters that are concerned with the company.
Arrears of Dividend	If dividend is not paid on these shares in any year, the arrear of dividend may accumulate.	In case of equity shares, dividend do not accumulates.

Deferred Shares

They are also known as 'founder shares' as they are mostly held by the founder/promoter of the company. They are issued as other ordinary shares and they get fixed dividend just like preference shares. But they are last to receive both as regards dividend and payment of capital.

- Rights Issue/Rights Shares

The issue of new securities to existing shareholders at a ratio to those already held.

- Bonus Shares

Shares issued by the companies to their shareholders free of cost by capitalisation of accumulated reserves from the profits earned in the earlier years.

DEBENTURES

A debenture is a unit of loan amount. When a company intends to raise the loan amount from the public it issues debentures and the person holding debenture or debentures is called the debenture holder. A debenture holder is the creditor of the company. Debentures bear a fixed rate of interest on them and the same is paid on some pre specified date on half yearly basis. The bond amount is paid on a particular date on the redemption of the bond. Debentures are normally secured against the assets of the company in the favour of the debenture holder.

As per Section 2(12) of Companies Act 1956, "Debenture includes debenture stock, bond and any other securities of the company whether constituting a charge on the company's assets or not."

BONDS

Bond is a negotiable certificate evidencing indebtness. It is normally unsecured. A debt security is generally issued by a company, government agency or municipality.

MUTUAL FUNDS

Mutual Fund can be described as a common pool of money where many small and retail investors put in their money. This money is allocated towards some objective which is predefined. Thus it can be said that ownership of the fund is joint or mutual, as this belongs to all those investors who have contributed to it. Ownership of an investor is in same proportion as the contribution made by him bears toot the total pool (amount) of the fund created.

5.8 SUMMARY

- All securities are first created in the primary market and then they enter into the secondary market. Thus securities generally have two stages of their life span. The first is the stage when the company issues them in the market and makes them available for the general public from its treasury at a predetermined offer price.

- Secondary Market, also known as the aftermarket, is the place where goods which are already used by someone are sold and/or bought. Thus we can define secondary market as "the financial market where previously issued securities and financial instruments such as stocks, bonds, futures and options are manoeuvred from one investor into another."

- Secondary Market helps to create sufficient liquidity and marketability of outstanding debt and equity instruments.

- Secondary Market contributes to economic growth by proper allocation of funds towards most efficient channel through process of disinvestment to reinvestment.

- For general investor, secondary market provides a ready market for carrying out his trading activities.

- Secondary Market can be divided into three parts. These are: Equity Market, Debt Market and Derivative Segment.

- Debt Market is that part of secondary market where investors buy and sell debt securities which are mostly in the form of bonds. It is the market where fixed income securities are issued and traded.

- Indian Debt Market can be broadly classified in two categories: Government Securities Market and Bond Market.

- Derivatives Market can broadly be classified in two categories, those that are traded on the exchange and those that are traded one to one or 'over the counter'. They are hence known as Exchange traded derivatives and OTC Derivatives (Over The Counter).

- The instruments of Secondary Market are Shares, Debentures, Bonds and Mutual Funds.

5.9 QUESTIONS

Q1. Fill in the blanks with appropriate words:

a. --------------- is a percentage of the face value of a share that a company returns to the shareholders from its annual profits. (dividend, bond, debenture, equity share)

b. ------------------ an agreement between two parties to buy or sell an asset at a certain time in future at a certain price. (Futures, forwards, options, equities)

c. ---------------- option gives 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.

d. ---------------- swaption to receive fixed and pay floating.

e. ---------------- swaption is an option to pay fixed and receive floating.

Q2. Answer in One Sentence:

a. Define Secondary Market.
b. What is meant by Equity Market?
c. What is meant by Debt Market?
d. Define Derivative Market.
e. State the instruments of secondary market.

Q3. Answer briefly:

a. Explain the need for secondary market.
b. What is the role of secondary market.
c. Distinguish between primary market and secondary market.
d. Write short notes on:
    i. Equity Market
    ii. Debt Market
    iii. Derivative Market
e. Explain in detail the instruments of secondary Market.

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6

STOCK EXCHANGES

Unit Structure

6.1 INTRODUCTION

Over the last few years, there has been a rapid change in the Indian securities market, especially in the secondary market. Advanced technology and online-based transactions have modernized the stock exchanges. Stock exchanges were permitted to expand their trading to locations outside their jurisdiction through computer terminals. Trading is much more transparent and quicker than in the past.

Stock market refers to a market place where investors can buy and sell securities. Primary market deals with only new issue of shares, debentures and bonds, whereas secondary market provides a place for securities which have already been issued in an initial private or public offering. After the securities are issued in primary market, they are traded in the secondary market by the companies issuing securities, investors, brokers and the regulators. The stock exchanges along with a host of intermediaries provide the necessary platform for trading in secondary market and for clearing and settlement.

6.2 MEANIG OF STOCK EXCHANGES

The word ‘stock’ means a fraction of the capital of a company and the word ‘exchange’ means a place for buying and selling something. The market or place, where securities are exchanged or traded is called stock exchange or stock market.

A stock exchange thus provides a trading platform for the sale and purchase of securities. Stock exchange is a structured market place for the proper conduct of trading activities in shares, stocks and other securities issued by companies and government. Stock exchange provides marketability and price continuity for shares and helps a fair evaluation of securities in terms of their intrinsic worth.

Stock exchanges are formal organisations, approved and regulated by the regulatory authorities of a country. Stock exchanges deals in securities like shares, debentures or bonds issued by the companies or corporations in the private, as well as public sector and bonds issued by the central and state governments, municipal corporations etc.

In addition, the stock exchange sometimes buys and sells certificates representing commodities of trade. Stock exchanges also facilitate the issue and redemption of securities and other financial instruments.

Members are only permitted to trade those securities, which are generally entered in the official list of the exchange. The right to trade securities or make markets on an exchange floor is granted only to an individual or firm on becoming a member of the exchange.

An organised and recognised stock market ensures liquidity and marketability to securities, encourage investments in securities and support corporate growth.

6.3 DEFINITION OF STOCK EXCHANGE

The Securities Contracts (Regulations) Act, 1956 defines stock exchange “as an association, organisation or body of individuals, whether incorporated or not, established for the purpose of assisting, regulating and controlling the business of buying, selling and dealing in securities.”

According to the Oxford Dictionary of the business world, the stock market also known as the stock exchange is defined “as a place in which stock, shares and other securities are bought and sold, price being controlled by demand and supply.”

6.4 CHARACTERISTICS OF STOCK EXCHANGE

Following are the salient features of a stock exchange:

1. Stock Exchange is an organised market place where securities are purchased and sold.
2. Stock Exchange is a formal organisation which provides facilities to their members to transact only in securities.
3. By tradition stock exchange was a voluntary association of persons owned by its members and stockbrokers. Recently, stock exchanges got transformed from a mutually owned association to a shareholder owned company.
4. Recognition to a stock exchange is accorded by the Central Government.
5. Stock exchange does not conduct business for them.
6. The right to trade securities or make markets is strictly restricted to the members of the exchange.
7. The trading in a stock exchange is under the overall supervision of the regulatory authorities of the nation.
8. Each stock exchange formulates its own rules and regulations. Any member who acts against the rules of the exchange can be removed from its membership.
9. Trading is strictly regulated and rules and regulations are prescribed for various types of transactions.
10. Securities listed in the official list of the stock exchange alone are traded in an exchange.
11. The trading platforms of stock exchanges are now accessible through internet from anywhere in the country.
12. Both genuine investors and speculators can buy and sell shares in stock exchange.
13. Stock exchange provides information about the market price of the securities.
14. Members of the stock exchange generally elect a governing body which control and direct the activities of their members. However in a demutualised stock exchange, shareholders elect board of directors and they exercise direct and proper control over the activities of the exchange.

6.5 OBJECTIVES OF STOCK EXCHANGE

Main objectives of stock exchange are the following:

1. To create an efficient securities market in the country.
2. To regulate stock market practices and to protect the interest of investors.
3. To control illegitimate speculation, manipulation and other undesirable trade practices.

6.6 FUNCTIONS OF STOCK EXCHANGE

Stock Exchange is a vital organ in a modern society. Stock exchanges have a vital role to play in the economic development of the country in general and the growth of industrial sector in particular. Stock exchanges perform an important function of mobilising and channelizing resources which remain otherwise scattered. Apart from the above basic function it also assists in mobilising funds for government. Thus stock exchanges help orderly flow and distribution of savings between different types of investments. Stock exchanges perform multiple functions, which are given below:

1. Capital Formation and Economic Growth:

Stock exchanges help in mobilisation of surplus funds of individuals and business firms for investment in securities. The funds, which could have been consumed, or to be kept in idle deposits are mobilised and redirected to invest in securities, resulting in a stronger economic growth and higher productivity levels.

2. Ensure Continuous And Ready Market For Securities:

By regular dealings in securities, stock exchange ensures continuous and ready market for the securities. This enables it to attract people who have surplus money even for a short period of time.

3. Rational Allocation of Resources to the Various Sectors:

Stock exchange enables mobilisation of funds by allocation of the same rationally which would otherwise be invested in not so productive bank deposits and funds. Investment in various types of securities leads to rational allocation of resources, which promote divergent economic sectors such as agriculture, commerce and industry.

4. Provide Liquidity:

Stock exchange is a place for selling and buying of securities. The trading facility in stock exchange allows the small investors to quickly and easily sell off the securities thereby converting them into cash. This is an attractive feature of investing in securities over other less liquid investments like real estate.

5. Evaluation of Securities:

Stock exchange provides information about the demand and market price of various securities traded in the exchange. This information is published by the exchange in newspaper and other media. This helps investors to ascertain the current market prices of their holdings.

6. Acts as Barometer of the Economy:

Stock Exchange acts as a barometer of the business conditions in the country. At the stock exchange, share prices rise and fall depending, largely on market forces. Booms and depressions are reflected in the index of prices of various securities maintained by the stock exchange.

7. Better Control over Corporate Sector:

Every company indenting to list their securities has to fulfil certain conditions and rules framed by the stock exchange. Through these rules, stock exchange influence on the management and working of companies in public interest.

8. Ensure Fair Dealings and Safety:

Stock exchange ensures fair dealings and safety of investors' funds because trading in a stock exchange is under the overall supervision of the regulatory authorities of the nation and in accordance with the rules and regulations of the exchange.

9. Creating Investment Opportunities for Small Investors:

An investor can buy the number of shares as he/she can afford. Therefore stock exchanges provide the opportunity for small as well as large investors to own shares of the same companies.

10. Facilitate Takeovers and Acquisitions:

Takeovers, acquisitions or mergers are means of expansion of businesses for companies, which are made easier through the stock exchanges. Stock exchange facilitates takeovers by acquiring majority of shares in another company.

11. Assist in Primary Issue:

The efficient functioning of stock exchanges creates a conducive environment for an active and growing primary market for new issues.

12. Facilitate the Growth of Companies:

Stock market motivates companies to go public, or raise additional capital. It helps the companies with an opportunity to expand product line, increase distribution channels, increase market share and acquire other necessary business assets.

13. Assist Government to Raise Capital:

Stock exchange helps governments to raise capital finance for many public works such as development of water supply, housing estates etc. by selling bonds. The general public buy these bonds thereby giving loan to the government.

6.7 SUMMARY

- Stock market refers to a market place where investors can buy and sell securities. Primary market deals with only new issue of shares, debentures and bonds, whereas secondary market provides a place for securities which have already been issued in an initial private or public offering.

- The word ‘stock’ means a fraction of the capital of a company and the word ‘exchange’ means a place for buying and selling something. The market or place, where securities are exchanged or traded is called stock exchange or stock market.

Main objectives of stock exchange are the following:

a. To create an efficient securities market in the country.

b. To regulate stock market practices and to protect the interest of investors.

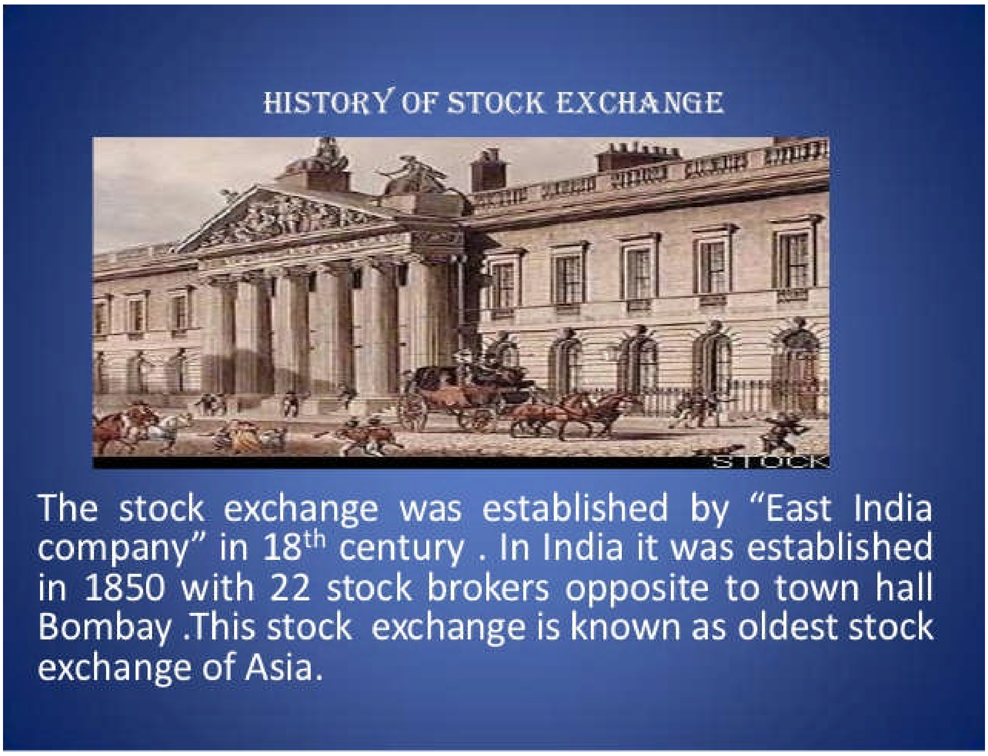
c. To control illegitimate speculation, manipulation and other undesirable trade practices.

- Stock Exchange is a vital organ in a modern society. Stock exchanges have a vital role to play in the economic development of the country in general and the growth of industrial sector in particular. Stock exchanges perform an important function of mobilising and channelizing resources which remain otherwise scattered.

6.8 QUESTIONS

1. What is meant by Stock Exchange?
2. Define Stock Exchange.
3. State the characteristics of Stock Exchange.
4. Describe various functions of Stock Exchange.

EVOLUTION AND GROWTH OF STOCK EXCHANGES



One of the oldest stock markets in Asia, the Indian Stock Markets have a 200 years old history.

- 18^{th} Century – East India Company was the dominant institution and by the end of the century, business in its loan securities gained full momentum.
- 1830's – Business on corporate stocks and shares in Bank and Cotton presses started in Bombay. Trading list by the end of 1839 got broader.
- July 9, 1875 – Native brokers formed the Native Share and Stock-Broker's Association in Mumbai, with membership fee of Re. 1.

- 1899 – Bombay Stock Exchange acquires own premises in Mumbai.
- 1921 – Clearing houses are established for settlement of trade as volumes increase.
- 1923 – K. R. P Shroff became the President of BSE.
- 1925 – Bombay Securities Contract Act (BSCCA) comes into force.
- December 1, 1939 – Stock Exchange building is acquired.
- 1943 – Forward trading banned till 1946. Only ready-to-delivery and hand-delivery contract permitted.
- 1956 – Securities Contract Registration Act, drafted on the lines of BSCCA, comes into force.
- 1957 – BSE becomes the first exchange in India to get permanent recognition.
- 1964 – Unit Trust of India (UTI) is born, gives fillip to capital markets.
- April, 1 1966 – K. R. P. Shroff retires and Shri Phiroze J. Jeejeebhoy becomes Chairman.
- June 29, 1969 – Morarji Desai bans forward trading.
- 1973 – Construction of P. J. Towers, named after late Phiroze Jamshedji Jeejeebhoy starts.
- 1974 – Foreign Exchange Resolution Act, 1973 ended MNC shareholdings cut to 40%.
- 1977 – Reliance goes public and the equity cult is born. The public issue of Reliance Textiles & Ind is oversubscribed 8 times.
- January 2, 1986 – BSE Sensex launched as the first stock market index with 1978-79 as the base year.
- November 1987 – SBI Mutual Fund launches Magnum regular income scheme.
- April 1988 – Securities and Exchange Board of India set up. S. A. Dave, SEBI's First Chairman.
- January 1992 – Securities and Exchange Board of India given statutory powers.
- May 1992 – Harshad Mehta securities scam breaks.

- May 27, 1992 – Reliance is the first Indian Company to make a GDR issue.
- May 30, 1992 – The Capital Issues Control Act, 1947 is replaced. Free pricing of public issue allowed.
- September 1992 – Foreign institutional investors are permitted to invest in Indian securities market.
- November 1992 – National Stock Exchange is born.
- November 1992 – Manmohan Singh, the then Finance Minister, inaugurates OTCEI – the Over the Counter Exchange of India.
- February 1993 – Infosys launches IPO at a premium of Rs. 95.
- April 1993 – Sensex climbs more than 2, 500 points.
- July 1993 – Kothari Pioneer (now merged with Franklin Templeton) registered as the first private sector mutual fund.
- October 30, 1993 – The First private sector mutual fund – Kothari Pioneer MF begins operations.
- 1993 – SEBI banks badla trading on BSE.
- June 1994 – NSE commences operations in wholesale debt market segment with 100 companies listed.
- November 1994 – Capital Market segment of NSE goes on stream. Trading is screen-based for the first time in India.
- March 1995 – BSE online trading system (BOLT) replace open outcry system.
- June 1995 – NSCCL, India's first clearing corporation is set up.
- October 1995 – National Stock Exchange overtakes the Bombay Stock Exchange as the largest stock exchange in terms of volumes of trading.
- April 1996 – NIFTY is born.
- November 1996 – The National Securities Depository is created.
- February 1997 – SEBI releases norms for takeovers and acquisitions.
- May 1997 – BSE introduces screen-trading.
- November 1998 – SEBI gives recognition to integrated stock exchanges founded by 16 regional stock exchanges.

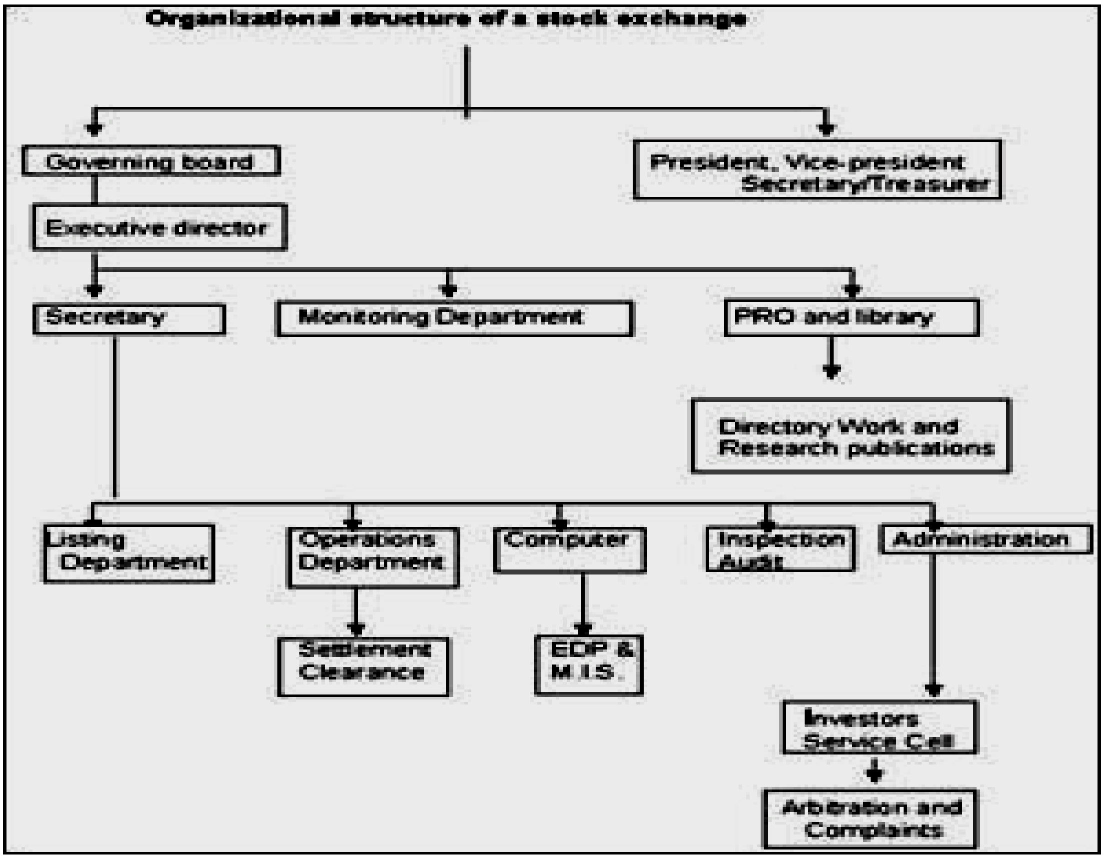
- February 1999 – Launch of automated lending and borrowing mechanism (ALBM), on NSE.
- March 11, 1999 – Infosys Technologies is the first company to list on NASDAQ through a public offering of American Depository Receipts.
- March 22, 1999 – Central Depository Services (India) promoted by BSE commence operations.
- September 1999 – ICICI is the first Indian Company to list NYSE.
- October 11, 1999 – For the first time in BSE's history, the Sensex closed above 5, 000 market at 5, 031.78.
- January 2000 – SE creates 'Z' category of Scrips, in addition to A, B1 and B2, comprising scrips that breached or failed to comply with the listing agreement.
- February 2000 – Internet trading commences on NSE. On February 21, NSE records peak market capitalization of Rs. 11, 94, 282 crore. On February 14, 2000 BSE Sensex hits an all-time high of 6, 150.
- April 10, 2000 – The Sensex is revamped to include Dr. Reddy's Lab, Reliance Petroleum, Satyam Computers and Zee Telefilms, replacing Indian Hotels, Tata Chemicals, Tata Power and IDBI.
- June 2000 – BSE and NSE introduce derivatives trading in the form of index futures.
- July 9, 2000 – BSE turns 125.
- October 19, 2000 – Wipro lists on NYSE.
- January 22, 2001 – Borrowing and Lending Securities Scheme (BLESS) launched on BSE to promote securities lending and borrowing activities.
- March 2001 – Ketan Parekh scam breaks. SEBI suspends all the broker-directors of the BSE in relation to the KP scam on March 13.
- May 2001 – BSE advises compulsory demat for B2 scrips.
- June 2001 – Index options start trading on NSE.
- July 2001 – A SEBI directive bans carry-forward, all major securities are moved to rolling settlement. Options of individual scrips start trading on NSE.

- November 9, 2001 – BSE and NSE launch futures in individual stocks.
- July 2, 2001 – The age old badla system is abolished and replaced by rolling settlement and option trading.
- August 2002 – Government announces Rs. 500 crore boil out package for UTI.
- February 2003 – SEBI directs exchanges to monitor the 'possibility of price manipulations.'
- September 2003 – BSE Sensex moves to "free float market capitalisation" from the earlier "full market capitalisation."
- January 2005 – Only ten of the original Sensex 30 survive. TCS and NTPC added to the list.
- August 19, 2005 – BSE transformed into a corporate entity BSE Ltd., with Rajanikant Patel as its CEO.
- September 2005 – The Sensex crossed the 8000 mark and closed at 8052.56 mark on 8-9-05, raising the investor's wealth to Rs. 22 lakh crore.
- April 20, 2006 – The Stock market breached the milestone with the benchmark Sensex surging past the 12, 000 point mark on 20-04-2006 for the first time in history.
- November 2006 – The stock market bounced back. Took merely 113 trading days to regain peak, crosses 13, 000 mart to close at 13, 130 mark.
- May 15, 2007 – The BSE index (Sensex) 14K mark again on May 16 and ended higher at 14, 127 points.
- July 6, 2007 – The BSE Index scaled to 15, 007.22.
- July 26, 2007 – Indian Stock Market achieved a historical land mark as the combined volume of business crossed Rs. 1 lakh crore (Rs. 1 trillion) (Rs. 1, 00186 crore) for the first time.
- August 29, 2007 – SEBI DE-RECOGNISES HYDERABAD EXCHANGE.
- August 29, 2007 – Market regulator SEBI has de-recognised Hyderabad Stock (HSE) as the course failed to dilute 51 per cent stake to non-brokers by August 28 as is mandated by law. The recognition granted to HSE stands withdrawn with effect from August 29, 2007. 1274 companies are listed with NSE.

- September 21, 2007 – The cumulative market capitalisation of all the 4,500-odd companies listed on the BSE, the world's biggest course in terms of listed firms, soared to a new peak of Rs. 50, 18, 265.06 crore on Friday 21-09-2007.

- October 2007 – SEBI banks.

- 2006-2007 – Investors complain against 1, 000 firms in just a year: Investors lodged 2, 415 complaints against over 1, 000 firms including mutual funds and NBFCs in the past one year (2006-2007). Around 90% of the companies against which investors had grievances were listed on the stock exchanges, according to official data. As many as 264 complaints were spread over 200 cities in the country. There were also some grievances coming from foreign countries.



ORGANISATIONAL STRUCTURE OF A STOCK EXCHANGE

- October 5, 2007 – NSE NIFTY MIDCAP 50 – Trading in futures and options commenced. The aim is to capture the surging movement and be a benchmark of the mid-cap segment.

QUESTIONS

1. Write explanatory notes on history of Stock Exchanges.
2. Discuss the organisation structure of Stock Exchange of India.

STOCK EXCHANGES IN INDIA

S. No	Name of the Exchange	Year of Establishment
1.	Bombay Stock Exchange, Mumbai	1875
2.	Ahmedabad Stock Exchange, Ahmedabad	1894
3.	Calcutta Stock Exchange, Kolkata	1908
4.	Madhya Pradesh Stock Exchange, Indore	1919
5.	Madras Stock Exchange, Chennai	1920
6.	Hyderabad Stock Exchange, Hyderabad	1941
7.	Delhi Stock Exchange, Delhi	1947
8.	Bangalore Stock Exchange, Bangalore	1963
1.	Cochin Stock Exchange, Cochin	1978
10.	Uttar Pradesh Stock Exchange. Kanpur	1982
11.	Pune Stock Exchange, Pune	1982
12.	Ludhiana Stock Exchange, Ludhiana	1983
13.	Guwahati Stock Exchange Ltd. Guwahati	1984
14.	Mangalore Stock Exchange, Mangalore*	1985
15.	Magadh Stock Exchange, Patna**	1986
16.	Jaipur Stock Exchange, Jaipur	1989
17.	Bhubaneshwar Stock Exchange, Bhubaneshwar	1989
18.	Saurashtra Kutch Stock Exchange, Rajkot	1989
19.	The Vadodara Stock Exchange, Baroda	1990
20.	Over The Counter Stock Exchange of India, Mumbai	1990
21.	Coimbatore Stock Exchange, Coimbatore	1991
22.	National Stock Exchange of India, Mumbai	1992

23.	Inter-Connected Stock Exchange of India Ltd., Mumbai	1999
24.	MCX Stock Exchange, Mumbai	2008
25.	United Stock Exchange of India, Mumbai	2010

* As per Securities Appellete Tribunal order dated October 4, 2006, the Managalore Stock Exchange is a de-recognised Stock Exchange under Section 4 (4) of SCRA.

** SEBI vide order dated September 3, 2007 refused to renew the recognition granted to Magadh Stock Exchange Ltd.

QUESTIONS

1. List the stock exchanges in India.

BOMBAY STOCK EXCHANGE

1 INTRODUCTION

The Stock Exchanges in India as elsewhere have a vital role to play in the development of the country. It helps the Government to raise internal resources for the implementation of various development programmes in the public sector. It performs an important function in mobilising and channelizing resources which remain otherwise unutilised. Stock Exchange is a vital organ in a developing economy like India.

Bombay Stock Exchange (BSE) is the oldest and the largest stock exchange in Asia. Bombay Stock Exchange traces its history to the 1980s, when a dozen stockbrokers gathered under a banyan tree in front of Mumbai's Town Hall. As the number of brokers kept increasing this location kept changed and finally they moved to Dalal Street in 1874.

These stock brokers then organised an informal association in 1875 known as 'The Native Share and Stock Brokers Association' Bombay. The Bombay Stock Exchange was recognised in May 1927 under the Bombay Securities Contracts Control Act of 1925.

BSE is the first stock exchange in the country to secure permanent recognition from the Government of India in 1956 under the Securities Contracts (Regulation) Act of 1956.

In 2002, the name “The Stock Exchange, Mumbai” was changed to ‘Bombay Stock Exchange.’ Subsequently on August 19, 2005, the turned into a corporate entity (Corporatisation and Demutualisation Scheme 2005) from an Association of Persons (AoP) and renamed as Bombay Stock Exchange Limited.

Bombay Stock Exchange is the largest of 25 exchanges in India. According to *The World Federation of Exchanges*, as on December 2011, BSE was the 14th largest stock exchange in the world and 6th largest in Asia with a market capitalisation of US$ 1 trillion. BSE is also world’s number one exchange in terms of number of listed companies. BSE has a nation-wide reach with a presence in 417 cities and towns. 5, 133 companies were listed with the stock exchange and over 9, 275 scrips were being traded as in April 2012.

BSE was migrated from the open outcry system to an online screen based order driven trading system in 1995. BSE is the first exchange in India and the second in the world to obtain an ISO 9001:2000 certifications. It was also the first exchange in the country and second in the world to receive Information Security Management System Standard BS 7792-2-2002 certification for its BSE On-Line Trading System (BOLT). It is undeniable from its history that majority of the corporates in India raised capital through utilising services of BSE. The BSE was the first exchange in India to list derivatives, such as futures, options etc. The BSE is also actively involved in the development of the retail debt market.

The Department of Investor Services of BSE redresses grievances of investors. BSE is the first exchange in the country to provide an amount of Rs. 1 million towards the investor protection fund and this amount is higher than that of any exchange in the country. BSE also launched a nationwide investor awareness programme ‘Safe Investing in the Stock Market’ under which 264 programmes were held in more than 200 cities.

2 BOARD OF DIRECTORS:

From an Association of Persons (AoP), BSE has become a corporatized and demutualised entity which is incorporated under the provisions of the Companies Act of 1956. The Exchange is managed professionally under the overall supervision of Board of Directors.

The Governing Board of BSE comprises 20 directors which exercises complete control and formulates policy issues. Its Board of Directors comprises of eminent professionals, representatives of trading members and of SEBI. Among these 20 Directors, 9 members are elected Directors of which one third retire every year by rotation.

Three members are nominees of Securities and Exchange Board of India, 6 are from public representatives and a Managing Director and Chief Operating Officer. The routine operations of BSE are managed by the Managing Director and are assisted by the professional management team.

3 MEMBERSHIP OF BSE

Individuals and corporate entities can apply for membership in BSE. Membership in BSE can be obtained in the following two ways:

1. Nomination by existing members or legal heirs in case of deceased member.
2. New membership.

Conditions for Eligibility for Becoming a Member:

The selection criteria for individual members and directors in case of corporate members are same.

1. Minimum age or 21 years.
2. Not been adjudged bankrupt or insolvent.
3. Not compounded with his creditors.
4. Not been convicted of an offence involving fraud or dishonesty.
5. Not engaged as principal or employee in any business other than of securities.
6. Not been at any time expelled or declared a defaulter by any other Stock Exchange.
7. Either matriculates or has the 10 plus 2 years qualification. Generally, preference is given to professionally qualified persons.
8. Minimum 2 years experience as a partner or authorised clerk or apprentice with a member or in other connected areas in capital market.
9. Minimum net worth requirement for individual members Rs. 30 lakh and for corporate members Rs. 50 lakh.

Monitoring Business of Members:

With the help of various markets monitoring reports BSE closely monitors the outstanding positions of the members on a daily basis.

These reports are scrutinised by officials of the Surveillance Department to ascertain the excessive purchase or sale position compared to normal level of business of each member. It also helps to examine the scrip-wise concentration of securities, quality and liquidity of scrips, margins already paid, capital deposited, pay-in position etc. of the members.

4 ON-LINE SURVEILLANCE SYSTEM

BSE's On-Line Surveillance System (BOSS) monitors on a real-time basis the price movements, volume positions and members' positions and real-time measurement of default risk, market reconstruction and generation of cross market alerts.

Capital for BSE Membership

The trading members of BSE are required to maintain three types of capital with the Exchange.

Base Minimum Capital

All trading members of BSE are required to keep Rs. 10 lakh as base capital with the Exchange, which is not available for adjustment towards margin obligations.

Trade Guarantee Fund

Trading members are also required to deposit with the Exchange a sum of Rs. 10 lakh towards his contribution to the Trade Guarantee Fund (TGF). Trading members are allowed to deposit cash, fixed deposit receipts, bank guarantee (i.e Cash and Cash Equivalent) towards their contribution to TGF. Trade Guarantee Fund will be available for adjustment towards margins.

Additional Capital

For availing higher trading limits, trading members can deposit additional capital in the form of cash and non-cash equivalents. Additional capital will be available for adjustment towards margins.

In addition to the above, a person becoming a member of BSE has to pay an admission fee of Rs. 2, 50, 000 brokers capital fund Rs. 2, 50, 000 and annual subscription amounting to Rs. 70, 000.

5 CLASSIFICATIONS OF SECURITIES

During the past three decades, the BSE had been facilitating the growth of the Indian corporate sector by providing it with an efficient and ready access to resources. The securities traded in BSE have been classified into various groups based on certain qualitative and quantitative parameters. Following are the classifications in the equity segment:

- 'A' Group or 'Specified' is a category in which there is a facility for carry forward (Badla) for a period not exceeding 90 days. It contains the shares of the companies which have fairly a good growth and track record in terms of dividend and capital appreciation. The scrips included in this group are on the basis of equity capital, market capitalisation, number of years of listing on the exchange, public share-holding, floating stock, trading volume etc.

- 'B1' Group is a subset of the other listed equity shares that enjoy a higher market capitalisation and liquidity than the rest. 'B2' Group of shares comprises those shares which are not covered by the above two categories.

- 'Z' Group was introduced by BSE in July 1999. 'Z' Group category comprises of shares of the companies which does not comply with the rules and regulations of the BSE. It includes companies which failed to comply with its listing requirements, failed to resolve investor complaints, not made the required arrangements with the depositories for dematerialisation of their securities etc.

- 'F' Group represents the fixed income securities (debt market) segment. Debentures and bonds issued by companies are listed under F Group (i.e fixed income securities). Trading in Government Securities by the retail investors is done under the 'G' Group. The 'T' Group represents scrips which are settled on a trade-to-trade basis as surveillance measure. The 'S' Group represents scrips forming part of the BSE-Indonext segment. The 'TS' Group consists of scrips in BSE-Indonext segment, which are settled on a trade-to-trade basis as a surveillance measure. BSE also provides a facility to the market participants for on-line trading of odd-lot securities in physical form in 'A', 'B', 'T', 'S', 'TS' and 'Z' groups and in rights renunciations in all groups of scrips in the equity segment.

6 COMPULSORY ROLLING SEGMENT

All transactions in all groups of securities in the equity segment and fixed income securities listed on BSE are settled on T+2 basis. Under rolling settlement, the trade done on a particular day are settled after a given number of business days. A+2 settlement cycle means that the final settlement of transactions done on T, i.e trade day by exchange of money and securities between the buyers and sellers respectively take place on second business day after the trade day (excluding Saturdays, Sundays, Bank and Exchange trading holidays). However, a transaction in securities of companies, which are in ‘Z’ Group, are settled only on a gross basis and the facility of netting of buy and sell transactions in such scrips is not available.

SUMMARY

- The Stock Exchanges in India as elsewhere have a vital role to play in the development of the country. It helps the Government to raise internal resources for the implementation of various development programmes in the public sector. It performs an important function in mobilising and channelizing resources which remain otherwise unutilised. Stock Exchange is a vital organ in a developing economy like India.
- Bombay Stock Exchange (BSE) is the oldest and the largest stock exchange in Asia. Bombay Stock Exchange traces its history to the 1980s, when a dozen stockbrokers gathered under a banyan tree in front of Mumbai’s Town Hall. As the number of brokers kept increasing this location kept changed and finally they moved to Dalal Street in 1874.
- From an Association of Persons (AoP), BSE has become a corporatized and demutualised entity which is incorporated under the provisions of the Companies Act of 1956. The Exchange is managed professionally under the overall supervision of Board of Directors.

Individuals and corporate entities can apply for membership in BSE. Membership in BSE can be obtained in the following two ways:

- Nomination by existing members or legal heirs in case of deceased member.
- New membership.
- BSE’s On-Line Surveillance System (BOSS) monitors on a real-time basis the price movements, volume positions and

members' positions and real-time measurement of default risk, market reconstruction and generation of cross market alerts.

- During the past three decades, the BSE had been facilitating the growth of the Indian corporate sector by providing it with an efficient and ready access to resources. The securities traded in BSE have been classified into various groups based on certain qualitative and quantitative parameters.

- All transactions in all groups of securities in the equity segment and fixed income securities listed on BSE are settled on T+2 basis. Under rolling settlement, the trade done on a particular day are settled after a given number of business days.

QUESTIONS

1. What is On-Line Surveillance System?
2. What is meant by Group 'A' shares?
3. What is screen based trading system?
4. Explain compulsory rolling settlement.
5. What are the eligibility criteria for trading membership in BSE?
6. Discuss the classification of securities in BSE.

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7

NATIONAL STOCK EXCHANGE OF INDIA

Unit Structure

7.1 INTRODUCTION

The 1991-92 securities scam revealed the inadequacies and inefficiencies in the Indian financial system. It was scam, which prompted a reform of the equity market. The 1990s will go down as the most important decade in the history of the capital market of India. Liberalisation and globalisation were the new terms coined and marketed during this decade. The Capital Issues (Control) Act of 1947 was repealed in May 1992. The decade was also characterised by a new industrial policy, emergence of SEBI as a regulator of capital market, advent of foreign institutional investors, euro-issues, free pricing, new trading practices new stock exchanges, entry of new players such as private sector mutual funds and private sector banks.

NSE was established to provide a fair, efficient and transparent securities market in India. The conventional stock exchanges in India are failed to prevent price rigging, insider trading, unfair trade practices, market manipulations and lack sophisticated infrastructural facilities at par with international standards. The settlement period in conventional stock exchanges was also very long. Hence, a Higher Power Study Group (Pherwani Committee) was appointed by the Government of India to recommend suitable measures for overcoming the defects of conventional stock exchanges.

NSE was the outcome of the recommendations of a Higher Power Study Group. The Higher Power Study Group recommended for the promotion of NSE by financial institutions to provide access to investors from all over the country on an equal footing. Based on the recommendations, NSE was promoted by leading public sector financial institutions, Indian commercial banks and insurance companies at the behest of the Government of India. NSE was incorporated in November 1992. It was registered as a limited company under the Companies Act of 1956 with an equity capital of Rs. 25 crore. NSE was given recognition as a stock exchange in April 1993 under Securities Contracts (Regulation) Act, 1956. The NSE is situated in Mumbai.

7.2 PROMOTERS OF NSE

The National Stock Exchange was promoted by the following financial institutions:

1. Industrial Development Bank of India (IDBI).
2. Industrial Credit and Investment Corporation of India (ICICI).
3. Industrial Finance Corporation of India (IFCI).
4. All Insurance Corporations.
5. Select Commercial Banks and other Financial Institutions.

7.3 OBJECTIVES OF NSE

NSE was set up with the following specific objectives:

1. To provide a nationwide trading facility for equities, derivatives, debt and hybrid instruments.
2. To ensure equal access to all investors all over the country through appropriate communication network.
3. To provide a fair, efficient and transparent securities market to investors using electronic trading system.
4. To reduce settlement period through book entry settlement system.
5. To ensure timely delivery of documents.
6. To protect members from default risk.
7. To meet the international benchmarks and standards.

Within a short span of operation, the above objectives have been attained and the exchange has played a leading role in transforming India capital markets to its present form. NSE has set up an infrastructure that serves as a role model for the security industry in terms of trading system, clearing and settlement practices and procedures.

The standards set by NSE in terms of market practices, products, technology and service standards have become industry benchmarks and are being emulated by other market participants. More than a mere market facilitator NSE is a force which guide the industry towards new horizons and greater opportunities.

NSE is the most advanced exchange with 1611 companies listed as on April 30, 2012.

The National Stock Exchange of India has stringent requirements and criteria for the companies listed on the Exchange. Minimum capital requirements, project appraisal, and company's track record are just some of the criteria. In addition, listed companies pay variable listing fees based on their corporate capital size.

7.4 MANAGEMENT OF NSE

NSE is one of the first demutualised stock exchanges in India. As a demutualised stock exchange, the ownership, management and trading rights of NSE are in the hands of three different sets of people. NSE is owned by a set of leading financial institutions and is managed by professionals, who do not directly or indirectly trade on the exchange. Only qualified traders can be involved in the securities trading.

NSE is different from other exchanges where membership automatically implies ownership of the exchange. However, the ownership and management of NSE have been totally delinked from the right of trading members. Since broker owned stock exchanges are also broker managed there is clear conflicts of interest. Demutualisation completely eliminates any conflict of interest helped NSE in aggressively pursuing policies and practices within a public interest framework.

The Board of Directors of NSE comprises of senior executives from promoter institutions, eminent professionals in the fields of law, economics, accountancy, finance, taxation, public representatives, nominees of SEBI and one full time Executive of the Exchange. Its Board of Directors does not have any representative of brokers. However, the Executive Committee, which is concerned with the management of the exchange, has four brokers nominated by the Board to reflect different types of interests in the market. NSE has benefitted from the experience and expertise of trading members in their advisory capacities. The exchange has also appointed different committees to advice in areas such as best market practices, settlement procedures and risk containment systems.

7.5 SCREEN BASED TRADING SYSTEM

The trading in stock exchanges in India used to take place through open outcry without use of information technology for immediate matching or recording of trades. This was time consuming and inefficient. NSE is the first stock exchange in the country to be set up as a national exchange having a nation-wide access and with fully automated screen based trading system. In order to ensure efficiency, liquidity and transparency, NSE introduced a nationwide, on-line, fully automated screen based trading system (SBTS). The main advantages of trading in NSE are that an investor can transact from any part of the country at uniform prices. The prices at which the buyer and seller are willing to transact will be displayed on the screen. When the prices match, the transaction will be completed.

7.6 MEMBERSHIP IN NSE

There is no entry or exit barriers to the membership in NSE. The members are admitted to the different segments of the Exchange subject to the provisions of the Securities Contracts (Regulation) Act of 1956, the Securities and Exchange Board of India Act of 1992, the Rules, circulars, notifications, guidelines etc., issued there under and the Bye laws, Rules and Regulations of the Exchange. The following persons are eligible to becoming trading members in NSE:

1. Individuals
2. Partnership firms registered under the Indian Partnership Act of 1932.
3. Institutions including subsidiaries of banks engaged in financial services.
4. Body corporates including companies as defined in the Companies Act of 1956.

Eligibiliy Criteria For Trading Membership

The types of securities trading in NSE are divided into three segments:

1. Wholesale Debt Market Segment.
2. Capital Market Segment.
3. Futures and Options (F&O) Market (Derivatives Market)

The NSE is one of the few exchanges in the world trading in all types of securities on a single platform. In June 1994, NSE commenced its operations in the Wholesale Debt Market (WDM), In November, the same year, the Capital Market (Equities) segment also commenced operations and the Derivatives segment in June 2000.

The minimum standards stipulated by NSE for membership are in excess of those laid down by the SEBI. The standards for admission of members laid down by the Exchange stress on factors such as corporate structure, capital adequacy, track record, education, experience etc. and reflect a conscious effort on the part of NSE to ensure quality broking services so as to build and sustain confidence among investors in the Exchange’s operations. NSE have been encouraging corporatisation of the broking industry. As a result, a number of brokers-proprietor firms and partnership firms have converted themselves into corporates.

7.7 CONDITIONS FOR MEMBERSHIP

No person shall be admitted as a trading member if:

1. He has been an adjudged bankrupt.
2. He has compounded with his creditors for less than full discharge of debts.
3. He has been convicted of an offence involving a fraud or dishonesty.
4. He is engaged as a principal or employee in any business other than that of securities, except as a broker or agent not involving any personal financial liability or for providing merchant banking, underwriting or corporate or investment advisory services, unless he undertakes to severe its connections with such business on admission, if admitted.
5. He has been at any time expelled or declared a defaulter by any other Stock Exchange or he has been debarred from trading in securities by any Regulatory Authorities like SEBI, RBI etc.

6. He has been previously refused admission to trading membership by NSE unless a period of one year has elapsed since the date of such rejection.

7. He incurs such disqualification under the provisions of the Securities Contract (Regulations) Act, 1956 or Rules made there under so as to disentitle him from seeking membership of a stock exchange.

Education And Experience

Where an applicant is a corporate, not less than two directors of the company (in case of a sole proprietorship, individual and in case of a partnership firm, two partners) should satisfy the following criteria.

They should be at least graduates and each of them should possess at least two years' experience in an activity related to broker, sub-broker, authorised agent or authorised clerk or authorised representative or remiser or apprentice to a member of a recognised stock exchange. Such experience will include working as a dealer jobber, market maker or in any other manner in the dealing in securities or clearing and settlement thereof, as portfolio manager or merchant bankers or as a researcher with any individual or organisation operating in the securities market. Minimum capital, net worth, deposits and fees payable by members in different market segment are given below.

Trading Membership In Wholesale Debt Market (WDM)

In wholesale debt market segment, applicants like companies and institutions are only eligible for membership. Individual and partnership firms are not eligible to apply for membership on wholesale debt market segment. Minimum net worth requirement for members in debt market segment shall be Rs. 2 crore. The deposits and fees payable by members of wholesale debt market segment are the following:

1. Minimum paid up capital Rs. 30 lakh.

2. Minimum net worth Rs. 2 Crore.

3. Interest free security deposit Rs. 1.50 crore.

4. Annual subscription Rs. 1 lakh.

Trading Membership In Capital Market And Futures And Options Market:

Individuals, partnership firms, institutions and corporations are eligible for membership in these segments and the deposits and fees payable by the members are the following:

1. Minimum paid up capital Rs. 30 lakh.
2. Minimum net worth Rs. 1 Crore.
3. Interest free security deposit Rs. 1.25 crore.
4. Annual subscription Rs. 1 lakh.
5. Collateral security deposit Rs. 2 Lakh.

Trading Membership In Capital Market, Futures And Options And Wolesale Debt Market:

Corporates and institutions are only eligible for membership in these three segments and the deposits and fees payable by the members are the following:

1. Minimum paid up capital Rs. 30 lakh.
2. Minimum net worth Rs. 2 Crore.
3. Interest free security deposit Rs. 2.75 crore.
4. Annual subscription Rs. 2 lakh.
5. Collateral security deposit Rs. 25 Lakh.

NSE is one of the first exchanges in the world to use a satellite communication technology for its trading. The trading system of NSE called National Exchange for Automated Trading (NEAT), is a state of-the-art client-server-based application. At the server end, all trading information is stored in memory database to ensure minimum response time and maximum system availability for its users. For all trades entered into NEAT system, there is a uniform response time which is less than one second. It is one of the very few exchanges in the world to adopt an anonymous order matching system.

The member punches in the NEAT system, the details of his order like the quantities and prices of securities on which he desires to transact. The transaction is executed as soon as it finds a matching sale or buys order from a counter party. All the orders are electronically matched on a price/time priority basis. This has resulted in reducing considerably the time spent, cost and risk of error as well as frauds thus ensuring improved operational efficiency. Further, the system allows a large number of participants, irrespective of their geographical locations, to trade with one another simultaneously, improving the depth and liquidity of the market. A single consolidated order book for each stock displays, on a real time basis, buy and sell orders originating from all over the country. Thus, NEAT system provides an Open Electronic Consolidated Limit Order Book (OECLOB), which ensures full anonymity by accepting orders, big or small, from members without revealing their identity. The NEAT system also provides equal access to all the investors.

NSE carries the trading platform to the PCs at the residence of investors through the internet. NSE also allows using of internet facility for buying and selling of securities through registered brokers. These brokers should obtain the permission of their respective stock exchanges. In February 2000, NSE become the first exchange in the country to provide web-based access to investors to trade directly in the exchange followed by BSE in March 2001. The orders originating from PCs of investors are routed through the internet to the trading terminals of the designated brokers with whom they have relations and then further to the exchange. After these orders are matched, the transaction is executed and the investors get the conformation of the same directly on their PCs.

7.8 CIRCUIT BREAKERS

NSE implemented index-based market-wide circuit breakers in compulsory rolling settlement with effect from July 02. 2001. In addition to the circuit breakers, price bands are also applicable on individual securities.

Index-based Circuit Breakers

The index-based market-wide circuit breaker system applies at 3 stages of the index movement, either way viz. at 10 percent, 15 and 20 percent. These circuit breakers when triggered bring about a coordinated trading halt in all equity and equity derivative markets nationwide. The market-wide circuit breakers are triggered by movement of either as BSE Sensex or the NSE S&P CNX Nifty, whichever is breached earlier.

- In case a 10 per cent movement of either of these indices, there would be a one-hour market halt if the movement takes place before 1.00 p.m. In case the movement takes place at or after 1.00 p.m. but before 2.30 p.m. there would be trading halt for ½ hour. In case movement takes place at or after 2.30 p.m. there will be no trading halt at the 10 per cent level and market shall continue trading.

- In case of a 15 per cent movement of either index, there shall be a two-hour halt if the movement takes place before 1.00 p.m. If the 15 per cent trigger is reached on or after 1.00 p.m., but before 2.00 p.m., there shall be a none-hour halt. If the 15 per cent trigger is reached on or after 2.00 p.m. the trading shall halt for reminder of the day.
- In case of a 20 per cent movement of the index, trading shall be halted for the remainder of the day.

7.9 PRICE BANDS

Daily price bands are applicable on securities as below:

1. Daily price bands of 2 per cent (either way) on securities as specified by the Exchange.
2. Daily price bands of 5 per cent (either way) on securities as specified by the Exchange.
3. Daily price bands of 10 per cent (either way) on securities as specified by the Exchange.
4. No price bands are applicable on scrips on which derivative products are available or scrips included in indices on which derivative products are available. In order to prevent members from entering orders at non-genuine prices in such securities, the Exchange has fixed operating range of 20 per cent for such securities.
5. Price bands of 20 per cent (either way) on all remaining scrips (including debentures, warrants, preference shares etc.)
6. For auction market the price bands of 20 per cent are applicable.

7.10 SUBSIDIARIES OF NSE

National Securities Clearing Corporation Ltd. (NSCCL)

The National Securities Clearing Corporation Ltd. (NSCCL) is a wholly owned subsidiary of National Stock Exchange of India. It was incorporated in August 1995 and commenced its clearing operations in April 1996. It was formed to build confidence in clearing and settlement of securities and to promote and maintain the short and consistent settlement cycles.

National Securities Clearing Corporation Ltd. (NSCCL) carries out the clearing and settlement of the trades executed in the Equities and Derivatives segments. It also operates Subsidiary General Ledger Account (SGL) for settlement of trades in government securities and undertakes settlement of transactions on other stock exchanges like the Over the Counter Exchange of India (OCTEI). The clearing corporation is responsible for post-trade activities such as the risk management and the clearing and settlement of trades executed on a stock exchange. Clearing and settlement of trades and risk management are its central functions.

7.11 OBJECTIVES OF SETTING NSCCL

NSCCL was set up with the following specific objectives:

1. To build confidence in clearing and settlement of securities.
2. To promote and maintain short, consistent and well defined settlement cycles without any derivatives.
3. To provide counter-party risk guarantee.
4. To operate a tight risk containment system.

National Securities Clearing Corporation Ltd. (NSCCL) determines the funds/securities obligations of the trading members and ensures that trading members meet their obligations. NSCCL becomes the legal counterpart to the net settlement obligations of every member. This principle is called "novation" and NSCCL is obligated to meet all settlement obligations, regardless of member defaults, without any discretion. NSCCL immediately cuts off trading and initiates recovery.

The NSCCL clears all trades, arranges for pay-in of funds/securities, receives funds/securities, processes for shortages in funds/securities, arranges for pay out of funds/securities to members, guarantees settlement, and collects and maintains margins/collateral/base capital/other funds. It follows a rigorous 'risk containment' framework involving collateral and intra-day monitoring. Due to setting up of the Clearing Corporation, the market has full confidence that settlements will take place on time and will be completed irrespective of possible default by isolated trading members.

NSE IT Ltd.

It is also a wholly owned subsidiary of NSE and is its IT arm. This arm of the NSE is uniquely positioned to provide products, services and solutions for the securities industry. NSE.IT primarily focuses on the area of trading, broker front-end and back-office, clearing and settlement, web-based, insurance etc. Along with this, it also provides consultancy and implementation services in Data Warehousing, Business Continuity Plans, Site Maintenance and Backups, Stratus Mainframe Facility management, Real Time Market Analysis & Financial News.

INDIA INDEX SERVICES AND PRODUCTS Ltd. (IISL)

It is a joint venture between NSE and CRISIL Ltd. to provide a variety of indices and index related services and products for the Indian Capital Market. It was set up in May 1998. IISL has a consulting and licensing agreement with the Standard and Poor's (S&P), which is the world's leading provider of investible equity indices, for co-branding equity indices.

NATIONAL SECURITIES DEPOSITORY Ltd. (NSDL)

NSE joined hands with IDBI and UTI to promote dematerialisation of securities. This step was taken to solve problems related to trading in physical securities. It commenced its operations in November 1996.

DotEx INTERNATIONAL LIMITED

DotEx was formed to provide a well-structured inter trading platform for the members to further offer on-line trading facilities to their customers. With this facility, the members can serve big customers with the use of automated risk management features and thus increase the volume of trade. The investors also get comprehensive, relevant and updated information through it.

OVER THE COUNTER EXCHANGE OF INDIA

OTCEI was set up in 199- as Section 25 Company under the Companies Act 1956 and is recognised as a Stock Exchange under Section 4 of Securities Contracts Regulation Act, 1956. It was set up to provide small and medium sized enterprises access to the capital markets and to investors a convenient mode of investments. It is a ring less electronic national exchange listing entirely new companies, which will not be listed on any other exchange.

Companies engaged in investment, leasing, finance, hire purchase, amusement parks etc. and the companies listed on any other stock exchange are not eligible for getting listed on OTCEI. Also, listing is granted only if the issue is fully subscribed to by the public and sponsor.

Promoters of the Exchange

OTCEI was promoted by a consortium of leading Financial Institutions of India, such as:

1. Unit Trust of India (UTI)
2. ICICI
3. Industrial Development Bank of India (IBRD)
4. SBI Capital Markets Limited
5. Industrial Finance Corporation of India (IFCI)
6. Life Insurance Corporation of India (LIC)
7. Canbank Financial Services Limited
8. General Insurance Corporation of India & its subsidiaries.

Members on the exchange are responsible for getting companies on the exchange through the mechanism of sponsorship. Dealers may perform the dual roles of broker and the market maker, and along with members, are responsible for trading of securities on the exchange. The Custodian/Settler is responsible for validation of trading documents, storage of trading documents, and share certificates as also clearing of daily transactions and giving each member/dealer his net monetary position with respect to the market as a whole. Registrars and the transfer agents are responsible for share transfers, allotment and keeping shareholders informed of all developments in the companies concerned.

SUMMARY

- The 1991-92 securities scam revealed the inadequacies and inefficiencies in the Indian financial system. It was scam, which prompted a reform of the equity market. The 1990s will go down as the most important decade in the history of the capital market of India.

The National Stock Exchange was promoted by the following financial institutions:

a. Industrial Development Bank of India (IDBI).

b. Industrial Credit and Investment Corporation of India (ICICI).

c. Industrial Finance Corporation of India (IFCI).

d. All Insurance Corporations.

e. Select Commercial Banks and other Financial Institutions.

- NSE is one of the first demutualised stock exchanges in India. As a demutualised stock exchange, the ownership, management and trading rights of NSE are in the hands of three different sets of people. NSE is owned by a set of leading financial institutions and is managed by professionals, who do not directly or indirectly trade on the exchange. Only qualified traders can be involved in the securities trading.

- The trading in stock exchanges in India used to take place through open outcry without use of information technology for immediate matching or recording of trades. This was time consuming and inefficient. NSE is the first stock exchange in the country to be set up as a national exchange having a nation-wide access and with fully automated screen based trading system. In order to ensure efficiency, liquidity and transparency, NSE introduced a nationwide, on-line, fully automated screen based trading system (SBTS).

There is no entry or exit barriers to the membership in NSE. The members are admitted to the different segments of the Exchange subject to the provisions of the Securities Contracts (Regulation) Act of 1956, the Securities and Exchange Board of India Act of 1992, the Rules, circulars, notifications, guidelines etc., issued there under and the Bye laws, Rules and Regulations of the Exchange. The following persons are eligible to becoming trading members in NSE:

a. Individuals

b. Partnership firms registered under the Indian Partnership Act of 1932.

c. Institutions including subsidiaries of banks engaged in financial services.

d. Body corporates including companies as defined in the Companies Act of 1956.

- NSE implemented index-based market-wide circuit breakers in compulsory rolling settlement with effect from July 02. 2001. In addition to the circuit breakers, price bands are also applicable on individual securities.

QUESTIONS

1. What is NSE?
2. What is on-line surveillance system?
3. State the objectives of NSE.
4. Discuss the rationale of NSE.
5. Who are promoters of NSE?
6. What are the trading segments in NSE?
7. What is meant by index-based circuit breaker?
8. Name the subsidiaries of NSE.
9. What are the objectives of National Securities Clearing Corporation Limited?
10. Write explanatory notes on Price Bands.

RECENT DEVELOPMENTS IN STOCK EXCHANGES

Reforms and developments

- Till recent past floor trading took place in all the stock exchanges in India. In this system the trade takes place through open outcry system during the official trading hours. Trading posts are assigned for different securities where buy and sell activities of securities took place.
- In 1994 NSE and OTCEI was set up with the screen based trading facility. After one year BSE introduced the screen based trading system. And after that more and more stock exchanges adopted screen based trading system.
- In 1992 foreign institutions investors have been allowed to invest in India.
- In 1993 private sector mutual funds have been allowed.
- In 2001 Derivatives in the form of futures and options are introduced for trading and hedging purpose.
- SEBI has made compulsory to all the intermediaries to register with it.
- At present trader can trade through laptops, palmtops and mobile phones also.
- The trading cycle has been shortened to T+2 from T+5 so that investor should not wait for sale proceeds of his investments.
- At present almost 99% of the scrips are dematerialized. Almost all the traders are in the demat form.

- Now balance sheet and prospectus of the company are available to the investors.
- At present NAV has to be published.
- Insider trading and unfair practices are strictly prohibited.

The Original OTCEI Mandate Yesterday

- India's first online, real time exchange.
- Unique market maker concept to provide liquidity and support.
- Transparency would attract the small investors.
- Commitment of large institutions will give a boost to OTCEI.
- Day-to-day affairs will be looked after by the Exchange Committee.

The Reality Today

- Connectivity problems.
- Trading software not up to the mark.
- Market making not understood as a concept.
- Low volumes and no depth.
- Lack of investor education.
- Orphan exchange: apathetic promoters of OTCEI.
- No provision for exchange of the committee members.
- Share transfers take up to six months.
- Too many dealers and too few companies.
- Low discounting of OTC listed companies. No speculation: OTC ideal exchange for forward trading.

POSSIBLE SOLUTION TOMORROW

- Switch over to VSAT.
- Make the software more-friendly.
- Let the promoters of OTCEI get active or
- Sell the Exchange to those who are willing to develop it.
- Sponsor track record gets included in new issue prospectus.
- Co-ordinated effort by all OTC players for investor education.
- Most active dealers and members represented on Exchange Committee.

- Product segmentation and development of the retail debt market.
- Penalise inactive members and dealers.
- Improve the performance of the registrars.
- Introduce forward trading in a regulated regime.

STOCK MARKET INDICES

INTRODUCTION

Stock Market is a place where the stocks of listed companies are traded. A stock index is a simple barometer reflecting the value of the underlying scrips in the market. Stock indices are used as reliable benchmarks to observe the vibrancy of the capital markets and to evaluate their performance. A good stock index captures the movement of the well diversified and highly liquid stocks. Financial indices are generally created to measure the movements of price of stocks, bonds, treasury bills and other types of financial instruments.

An index is a statistical average, which can be a simple or weighted average, of a few leading shares in the market. The average number so arrived at is called an index. A stock index consists of a set of stocks that are representative of either the whole market, or a specified sector, to measure the change in the overall behaviour of the markets or a sector over a period of time. The level of the index reflects the total market value of all the stocks in the index of a particular base period.

19th century mathematicians were the first to propose modern indices. The grandfather of all equity indices is the Dow Jones Industrial Average, which was first published in 1896. Since then indices have come a long way, not only in their sophistication but also in their variety. In India, till the decade of eighties, there was no scale to measure the ups and downs in the Indian Stock market. The Bombay Stock Exchange Ltd. (BSE) in 1986 came out with a stock index called ‘SENSEX’ that subsequently became the barometer of the Indian Stock Market. The launch of SENSEX in 1986 was later followed up in January 1989 by introduction of BSE National Index. Subsequently the national index was renamed as BSE-100. In 1996 the National Stock Exchange (NSE) developed their index called Nifty 50.

Indices are mainly of price index, quantity index and value index. Price index measures changes in prices of debt, government and equity securities. Price index is widely used in financial market than the quantity and value indices. Of these indices, equity indices are more important than indices of debt securities. Most of the indices are developed and computed by using the market capitalisation weighted method.

SIGNIFICANCE OF INDEX MOVEMENT

Stock Index generally indicate the overall performance of the market on a daily basis. It is the average of a large number of shares which shows the level of changes in stock prices with respect to time. It helps to measure the change in overall behaviour of the markets or sector over a period of time. For example if the share price index in June 2010 is 5000 and if the average share price in 1984-85 taken as 100, it means that on an average, share prices in the market have grown up by about 50 times since 1984-85. The year for which the average price is assumed to be 100 (in this case, 1984-85) is known as the base year.

Ups and downs of an index reflect the changing expectations of the stock market regarding future earnings of the corporate sector. When the index goes up, it is because the stock market thinks that the prospective earnings will be better than previously thought. When prospects of earnings in the future become pessimistic, the index drops. The ideal index gives us instant-to-instant readings about how the stock market perceives the future of a country's corporate sector. Every stock price moves up or down because of three possible reasons:

1. News about the company (e.g. a product launch, or the closure of a factory)
2. News about the industry.
3. News about the economy as a whole including political and sentimental factors.

USES OF STOCK INDEX

Following are the uses of stock market index:

1. It Acts as a Barometer: Stock index is a barometer which indicates the overall performance of the economy or a sector of the economy. The ups and downs in the stock index represent the volatility of the equity market. It acts as a signal to the government to the 'good or bad' factor prevailing in the economy.
2. It Acts as a Benchmark for Portfolio Performance: The most important use of an equity market index is to remain as a benchmark for a portfolio of stocks. All diversified portfolios,

belonging to either retail investors or mutual funds, use the common stock index as a yardstick for evaluation of their performance.

3. Index is an Underlying for Derivatives like Index Futures and Options: Indices are useful in modern financial application of derivatives. Indices serve as the underlying for futures, options and index funds etc.

4. Helps Companies in Raising Capital: An index is an indicator of the overall mood of the investors in the secondary market and it helps companies to determine the price of the new issue and the ideal time of making an IPO.

5. Helps in Studying the Market Behaviour: Stock index is used to monitor and measure market movements, either in real time or daily or even decades, helping us to understand economic conditions and prospects.

6. Helps in Comparison: It provides a historical comparison of returns on money invested in securities against other forms of investments. It is also helpful to the investors for comparison of performance of scrips in various sectors and companies.

7. Helps in Choosing Portfolio Investment: Another important use of an equity market index is to act as a benchmark for a portfolio of stocks. All diversified portfolios, belonging either to retail investors or mutual funds, use the common stock index as a yardstick for evaluation of their performance. An index is thus useful to the investors in choosing appropriate portfolio for investment.

8. Index can be used as a standard against which to compare the performance of an equity fund.

9. Index supports research, risk measurement and asset allocation.

DISADVANTAGES OF STOCK INDEX

A Stock Index reflects changing expectations of the market about the future of the corporate sector. Stock index has several uses but it is a double edged sword with some serious defects. Suppose an investor thinks that the stock of the company is going down and if this feeling prevails across the investors, then everyone would want to get out of the company's stock. This would automatically lead to the stock prices crashing. Any downturn in the market would be reinforced by the collective action of the investors to hedge against any losses and get out of the market. Even though an index is a popular guide to the investors, it is riddled with imperfections which can often confuse rather than help. For instance when the index rises, the market expects the future to be better than previously expected and drops when the expectations about future become pessimistic.

TYPES OF INDEX

Index can be classified into two types:

Broad Market Index: Broad Market Index is an index which consists of all the large, liquid stocks of the country and becomes the benchmark for the entire capital market of the country. Examples of this index are BSE-500 Index, S&P CNX 500.

Specialised Index: Specialised Index is an index which specialises an industry or a sector of the economy which serves as benchmark for that particular industry or sector. Examples of specialised or sectoral indices are BSE auto, BSE Metal, S&P CNX Energy Index etc.

DETERMINANTS OF STOCK INDEX

Following parameters should be taken into consideration while constructing a stock index:

1. The stocks selected for forming an index should be highly liquid. Illiquid stocks should be avoided for the construction of an index.
2. The number of scrips selected should have sizable proportion of the total market capitalisation of scrips. The index should include primarily the stock of companies that have significant market capitalisation with respect to the index such that any major change in the price of the stock is reflected in the index.
3. Each scrip should be properly weighted so that it influences the index n proportion to its respective market importance.
4. While selecting securities for forming an index, due representation should be given to each industry in the index sample and all major scrips should be included.
5. While selecting scrips, balanced representation should be given for all sectors.
6. Base year selected be normal and free from major fluctuation.
7. The size of the scrips selected for an index should be optimum. Number of scrips selected should be neither too small nor too large. More stocks lead to greater diversification but increasing the number of stocks beyond a point does very little in risk reduction.

DIFFERENT METHODOLOGIES FOR CALCULATION OF STOCK INDICES

Following are the different methods, which are adopted for the calculation of stock indices:

1. Price Capitalisation Methodology
2. Free-Float Market Capitalisation Methodology
3. Price-Weighted Index
4. Equal Weighted Index

Market Capitalisation Methodology: Market Capitalisation Method takes into account the entire equity for calculation of index and do not eliminate shares that are held by promoters and other companies which have a controlling interest. In this method weightage is calculated by multiplying the number of shares outstanding with the market price of the share. The shares with higher market capitalisation have higher weightage and will be most dominant in the index.

Free-Float Market Capitalisation Methodology: Free-Float methodology refers to an index construction methodology that takes into consideration only the free-float market capitalisation of a company for the purpose of index calculation and assigning weight to stocks in index. It takes into account only those shares that are freely available for trading in normal course. It excludes those shares that are held by promoters, strategic holding, government holding, lock-in shares etc. In other words, the market capitalisation of each company in a free-float index is reduced to the extent of its readily available shares in the market.

Price-Weighted Index: It is a stock index in which each stock influences the index in proportion to its price per share. The value of the index is calculated by adding the prices of each of the stocks in the index and dividing them by the total number of stocks. Stocks with a higher price will be given more weight and, therefore, will have a greater influence over the performance of the index. Dow Jones Industrial Average, one of the oldest indexes which were launched in 1896 is an example of one that is calculated on this methodology.

Equal Weighted Index: In this method the weights are equal and assigned irrespective of both market capitalisation and price. An equally weighted index makes no distinction between large and small companies, both of which are given equal weights. The good performance of large-cap stocks is negated one-for-one by poor performance of smaller-cap stocks in this index.

STOCK INDICES OF BOMBAY STOCK EXCHANGE

SENSEX: SENSEX (Sensitive Index) is the blue chip index of the BSE. Up to the eighties of the last century, there was no scale to measure the ups and downs in the Indian Stock Market. SENSEX, first compiled in 1986, was calculate on a 'Market Capitalisation Weighted' methodology of 30 component stocks representing large, well established and financially sound companies across key sectors. The BSE Sensex is generally regarded as the most popular and widely tracked index of the Indian Stock Market. SENSEX today is widely reported in both domestic and international markets through print as well as electronic media. The values of all BSE indices are updated on real time basis during market hours and displayed through the BOLT system, and BSE website. This is done automatically on the basis of prices at which trades in index constituents are executed. BSE also disseminates information on the Price Earning Ratio, the Price to Book Value Ratio and the Dividend Percentage on day-to-day basis of all its major indices.

SENSEX is not only scientifically designed but also based on globally accepted construction and review methodology. SENSEX consists of 30 largest, well-established and most vigorously traded stocks, representing various sectors of the BSE. SENSEX is thus a basket of 30 constituent stocks representing a sample of large and liquid companies. The set of companies which make up the index was changed only very few times during the past 25 years. These companies account for around one-fifth of the market capitalisation of the BSE.

The index includes 30 companies which figure in top 100 in terms of market capitalisation and are also among the leaders in their industry groups. Presently the following are the constituent companies: ACC, Infosys, Reliance, Infra, Jaiprakash Associate, HDFC Bank Ltd., Wipro Ltd., Tata Power, Hindalco Industries, L&T, Housing Development Finance Corporation, ITC Ltd., State Bank of India, CIPLA Ltd., Grasim Industries Ltd., Tata Motors, Sterlite Industries, NTPC Ltd., Tata Steel, Bharathi Airtel, BHEL, ONGC, TCS Ltd.

SENSEX Criteria for the Selection of Scrips: The general guidelines for selection of constituents in SENSEX are as follows:

1. Listing History

The company should have an acceptable record of accomplishment on the opinion of the Index Committee. The scrip should have a listing history of at least 3 months at BSE. Minimum requirement of 3 months is reduced to one month, if full market capitalisation of a newly listed company ranks among top 10 in the list of BSE universe. In case of a company, which is listed because of either merger or demerger or amalgamations, minimum listing history is not be required.

2. Trading Frequency

The scrip should have to be traded one which is on each and every trading day during the past three months.

3. Final Rank

The scrip should figure in the top 100 companies listed as per final ranking. The final rank is arrived at by assigning 75 per cent weightage to the rank on the basis of a three-month average full market capitalisation and 25 percent weightage to the liquidity rank based on three-month average daily turnover and three-month average impact cost.

4. Market Capitalisation Weightage

The weightage of each scrip in SENSEX based on three-month average free-float market capitalisation should be at least 0.5 percent of the Index.

5. Industry Representation

Scrip selection generally takes into account a balanced representation of the listed companies in the universe of BSE.

SENSEX CALCULATION METHODOLOGY

The base year of SENSEX was taken as 1978-79 and the base value is 100 index points. The SENSEX was initially calculated based on the “Full Market Capitalisation” methodology but was changed to the “Free-Float Market Capitalisation” methodology with effect from September 1, 2003. The free-float market Capitalisation-Weighted methodology is a widely followed index construction methodology on which majority of global equity benchmarks are based.

DOLLAR SERIES OF BSE INDICES

All BSE indices reflect the growth in market value of constituent stocks over its base period in rupee terms then a need was felt to design a yardstick by which these growth values are measured in dollar terms. Such an index would reflect, in one value, the changes in both the stock prices and the foreign exchange variation. This is facilitated by the introduction of a dollar-linked index emerged in the backdrop of Indian equity markets increasingly getting integrated with global capital markets and felt need to assess the market movements in terms of international benchmarks. This index is useful to overseas investors, as it helps them to measure their real return after providing for exchange rate fluctuations. Earlier BSE calculates dollar-linked version of SENSEX and BSE-200. Presently BSE calculated dollar-linked version of Dollex-30, Dollex-100 and Dollex-200 and displays them in BSE on-line trading terminals (BOLT) by taking into account real-time Rs/US$ Exchange rate.

BSE-100 Index: The BSE National Index was launched on January 3, 1989. It comprises 100 stocks listed at five of the major stock exchanges in India i.e at Mumbai, Kolkatta, Delhi, Ahemdabad and Chennai. The criterial for selection are market activity, due representation to various industry groups and representation of trading activity on major stock exchanges. The BSE National Index was renamed as BSE-100 Index from October 14, 1996 and since then it is calculated taking into consideration only the prices of stock listed at BSE. BSE also calculates a dollar-linked version of BSE-100 Index. The base period of BSE-100 is 1983-84 with a base value of 100.

BSE-200 Index: BSE-200 Index was constructed and launched on 27th May 1994. Equity shares of 200 selected companies from the specified and non-specified lists of BSE have been considered for inclusion in the sample for BSE-200. The selection of companies is primarily done on the basis of current market capitalisation of the listed scripts on the exchange. Besides market capitalisation, the market activity of the companies as reflected in the volumes of turnover and certain fundamental factors are considered for the final selection of the 20 companies. The base period for BSE-200 Index is 1989-90 with a base value of 100.

BSE-500 Index: BSE-500 Index consists of 500 scrips in its basket, which was launched on August 9, 1999. The changing patterns of the economy and that of the market are kept in mind while constructing this index. BSE-500 index represents nearly 93 percent of the total market capitalisation on BSE Ltd. This means BSE-500 Index closely represents the whole market. This index represents almost all the 20 major industries of the economy. The base period for BSE-500 index is 1st February 1999 with a base value of 100.

BSE Mid-Cap and BSE Small-Cap Index: BSE introduced BSE Mid-Cap and BSE Small-Cap Index to track the performance of the companies with relatively small market capitalisation that would exclusively represent the mid and small cap companies listed on the BSE. This index was constructed to capture the trend in the specific class of companies (with lower capitalisation). Scrips that are included in Z group are taken into account for this calculation. The number of companies in each of these indices periodically varies. The base period for BSE Mid-Cap and BSE Small-Cap Index is 2002-03 with base value of 1000 and it was launched on April 2005. Free-Float market capitalisation methodology is used for calculation of the index.

Sectoral Indices of BSE: BSE calculates various sectoral indices. All the indices are calculated and disseminated on BOLT which is BSEs trading terminal on a real time basis. Number of scrips in each of the sectoral indices at BSE is variable as they aim to represent minimum of 90 percent market capitalisation from the universe of BSE-500 index. Similar to other BSE indices, sectoral indices at BSE are also calculated and disseminated with in a frequency of 15 seconds. The base value of all sectoral indices is 1000. Some of the sectoral indices are given below:

BSE Fast Moving Consumer Goods (FMCG):

Index developed for fast moving consumer goods and products, which are non-durable and characterised by mass consumption. The index was introduced by the BSE on 9th August, 1999. The base period for the index is February 1, 1999 with a base index value of 1000.

BSE Capital Goods: It was introduced by BSE on August 9, 1999. The base period for the index is February 1, 1999 with a base value of 1000.

BSE Consumer Durables: It was introduced by BSE on August 9, 1999. The base period for the index is on February 1, 1999 with a base index value of 1000.

BSE Healthcare: BSE Healthcare index was developed to capture the performance of the companies engaged in the manufacture of healthcare products. It was introduced by BSE on August 9, 1999. The base period for the index is February 1, 1999 with a base index of 1000. These indices were initially calculated on free-float capitalisation method since August 16, 2005.

BSE Capital Goods, BSE Consumer Durables, BSE IT: BSE Capital Goods, BSE Consumer Goods, BSE IT are the various other sectoral indices introduced by BSE on 9th of August, 1999. The base period for these indices is February 1, 1999, with the base index value of 1000. These indices were initially calculated on full market capitalisation method, which is now changed to free-float capitalisation method since August 16, 2005.

BSE Tech Index comprises IT, Media and Telecommunication sector. It was introduced by the BSE on July 11, 2001. The base period for the indices is on April 2, 2001 and base index value is 1000. It is calculated on free-float methodology.

BSE BANKEX: BSE BANKEX was commenced on June 23, 2003. Base period for this index is January 1, 2002 with a base index value of 1000.

BSE Auto: BSE Auto was commenced on August 23, 2004. The base period for BSE Auto index is February 1999, with a base index value of 1000. It is calculated only on free-float methodology.

BSE Metal: BSE Metal index with free-float methodology for calculation was introduced on August 23, 2004. The base period for these indices is February 1, 1999 with a base index value of 1000.

BSE Oil and Gas: BSE Metal and BSE Oil and Gas were the indices introduced by the BSE on August 23, 2004. The base period for the indices is February 1, 1999 with a base index value of 1000. It is calculated on free-float methodology.

BSE Realty: BSE Realty Index was developed to synergise the emerging opportunities in the real estate sector. This sector thrusts on development of buildings, building townships and scaping land. There are plenty of opportunities in real estate sector which are backed by favourable tax regimes. BSE Realty was commenced by the BSE on July 9, 2007 and it was based on January 3, 2005. Prices.

BSE Power: BSE Power Index was developed to appraise the performance of the companies in the energy sector. BSE Power was commenced by the BSE on November 19, 2007 based on January 3, 2005 prices.

INDICES OF NATIONAL STOCK EXCHANGE OF INDIA

Nifty 50 is the blue chip index of the NSE of India Ltd. Besides Nifty 50, the various sectoral indices are also offered by the NSE of India. Nifty is owned and managed by India Index Services and Products Ltd. (IISL) which is a joint venture of NSE and CRISIL. IISL is India’s first specialised company focused upon the index as a core product. IISL is India’s first specialised company focused upon the index as a core product. IISL has a marketing and licensing agreement with Standard & Poor’s. Standard and Poor’s (S&P) is one of the World’s leading provider of equity indices.

S and P stands for US based ‘Standard and Poor’s Financial Information Services. The CNX stands for CRISIL NSE indices, the two companies that come together to form the index. CNX indices are useful for fund managers, corporates, brokers and all such enterprises connected with investments in the equity markets. These indices can be used for tracking the markets, understanding the performance of a company vis-à-vis the market, determining how an investors portfolio is performing as compared to the market, trading derivative products and most importantly for development of index based funds by mutual funds. The various indices of NSE are given below:

S & P CNX NIFTY: Standard and Poor's CRISIL NSE Index 50 or S & P CNX Nifty is the leading index of the NSE of India Ltd. S&P CNX Nifty 50 has nicknamed as Nifty 50 or simply Nifty. It consists of well-diversified 50 stocks accounting for 22 sectors of the economy. Nifty 50 has attained great popularity among the investors. The index is composed of top 50 most liquid stocks of largest companies in India. It is used for a variety of purposes such as benchmarking fund portfolios, index based derivatives and index fund. Thus, Nifty reflects the stock market behaviour and it is also used for the applications of index fund and index derivatives. It has now become one of the most popular and widely used stock market indicators of the country.

Nifty 50 was introduced on January 1996. The base period selected for Nifty 50 is November 1995 and the base value of the index has been set at 1000. It includes 50 of the approximately 935 companies listed on the NSE, captures approximately 60 percent of its equity market capitalisation and is a true reflection of the Indian Stock Market.

A. Nifty-Eligibility Criteria for the Selection of Scrips: All common shares listed on the NSE (which are of equity and not a fixed income nature) are eligible for inclusion in the S&P CNX Nifty Index. Convertible stocks, bonds, warrants, rights and preferred stock that provide a guaranteed fixed return are not eligible. Selection of stocks in nifty fifty is based on four criteria:

1. Liquidity (Impact Cost): Impact cost is the cost of executing a transaction in a security in proportion to the weight of its market capitalisation against the index market capitalisation, at any point in time. For inclusion in the index, the security should have traded at an average impact cost of 0.75 per cent or less during the last six months, for 90 percent of the observation.

2. Market Capitalisation: For being included in the S&P CNX Nifty 50, the companies should have an average market capitalisation of Rs. 500 crore or more during the last six months.

3. Floating Stock (Outstanding Shares): Companies eligible for inclusion in the S&P CNX Nifty should have at least 12 percent of its stocks available to investors (float). For this purpose, float shall mean stocks which are not held by the promoters and associated entities of such companies.

4. Others: The company must be domiciled in India and trade on the NSE.

B. **Additions:** The index is reviewed every quarter and a six-week notice is given to the market before making any changes to the index constituents. The complete list of eligible securities is compiled based on the market capitalisation criteria. After that, the liquidity (impact cost) and free float filter are applied to them, respectively, short listed companies form the replacement pool. The top stocks, in terms of size (market capitalisation), are then identified for inclusion in the index from the replacement pool.

C. **Deletions:** Stocks may be deleted due to mergers, acquisitions or spin offs. Otherwise, as noted above, every quarter a new eligible stock list is drawn up to review against the current constituents. If this new list warrants changes in the existing constituent list, then the smallest existing constituents are dropped in favour of the new additions.

S&P CNX Nifty Junior: CNX Nifty Junior consists of the most liquid stocks, but which are excluded from the Nifty 50. Nifty 50 and CNX Nifty Junior shows different stocks. CNX Nifty Junior was introduced in January 1997. The base period selected for CNX Nifty is November 1996 and the value of the index has been set as 1000.

S&P CNX 100: CNX 100 is a diversified 100 stock index accounting for 35 sectors of the economy. This index is a combination of Nifty 50 and CNX Nifty Junior. The CNX 100 has a base of January 2003 and a base value of 1000.

S&P CNX 500 Equity Index: The S&P CNX 500 is India's first broad-based benchmark of the Indian Capital Market used for comparing portfolio returns vis-à-vis market returns of companies share and stocks. Stocks are selected based on their market capitalisation, industry representation, trading interest and financial performance. The S&P CNX 500 Equity Index currently has 79 industry groups accounting for over 73 percent of total market capitalisation and over 98 percent of total turnover making it an ideal market benchmark. The CNX 100 index is based on the calendar year 1994 with a base value of 1000.

S&P Nifty Midcap 50: The primary objective of the Nifty Midcap 50 Index is to track the movement of the midcap segment of the market. The significance of Nifty Midcap 50 Index has of late increased mainly due to the increased attraction of investors for the medium capitalized segment of the stock market. The Nifty Midcap 50 Index has a base date of January 1, 2004 and a base value of 1000.

S&P CNX Midcap: The CNX MidCap 200 Index comprises 200 companies. The distribution of industries in the index represents the industry distribution in the Midcap Universe. The Index represents 71 percent of the total midcap market capitalisation and 72 percent of its trading value making it an optimal index for measuring the stock market performance of the Midcap segment. The CNX midcap index with a base date of January 2003 was introduced as a benchmark of the midcap segment of the market.

S&P CNX Defty: S&P CNX Defty is Nifty 50, measured in dollars. This index is very useful for overseas investors having an equity exposure in India. It helps them to calculate their real return on investment in dollar terms. The S&P CNX Defty Index has a base date of November 3, 1995 and a base value of 1000.

Sectoral Indices of NSE: NSE also calculates various sectoral indices. These indices cover 90 percent of the sectoral market capitalisation. Most of the sectoral indices are market capitalisation weighted index and the base value of all sectoral indices is 1000. Some of the sectoral indices of NSE are given below:

CNX MNC Index: CNX Multination Companies Index comprises 50 listed companies in which the foreign shareholding is over 50 percent or the management control is vested in the foreign company. The base period of the index is December 1994 and its base value is 1000.

CNX PSE Index: With a view to provide regulators, investors and market intermediaries with an appropriate benchmark that truly captures the performance of the stocks of Public Sector Enterprises, an index was introduced called CNX PSE Index. CNX PSE Index includes only those companies with 51 percent of their outstanding share capital held by the Central and State Governments directly or indirectly. The index comprises stocks of 20 Public Sector Enterprises. Market capitalisation weighted aggregate method is used for the calculation of the index. The base period is the month of December 1994 and its base value is 1000.

CNX IT Index: CNX IT Index reveals the real performance of the IT segment in the capital market. It is a benchmark for the investors and market intermediaries to know the performance of IT stocks. Companies in this index have more than 50 percent of their turnover from IT related activities like software development, hardware manufacturing, vending, support services and maintenance. This index is market capitalisation weighted index with its base period during December 1995.

CNX FMCG Index: CNX FMCG Index developed for fast moving consumer goods and products, which are non-durable, mass consumption products which are available off the shelf. CNX FMCG Index comprises of 15 stocks from the FMCG sector that are traded on the NSE. The base period is the month of December 1995, with a base value of 1000.

CNX Service Sector Index: CNX Service Sector Index was introduced with the objective of highlighting the performance of the companies belonging to the service sector. CNX Service Sector Index is a 30 stocks index and includes those companies belonging to the service sectors like computers, banks, telecommunication services, power, media courier, shipping etc. The base period is the month of May 1999, and its base value is 1000.

CNX Bank Nifty: In order to have a good benchmark for the Indian banking sector, Bank Nifty was developed. CNX Bank Nifty comprises the most liquid and large capitalised Indian banking stocks. It provides investors and market intermediaries with a benchmark which captures the capital market performance of Indian banks. This index is composed of 12 stocks from the banking sector, which are traded on the NSE. The index is a market capitalisation weighted index with based date of January 1, 2000 indexed to a base value of 1000.

S&P CNX Industry Indices: S&P CNX 500 equity index is desegregated in 72 industry sectors. S&P CNX Industry Index is developed very carefully to include stocks of industries in the entire universe of securities. The changes to the weightage of various sectors in the S&P CNX 500 would dynamically reflect the changes in the universe of securities.

CNX Energy Index: CNX Energy Index was developed to capture the performance of the companies in the energy sector. Energy sector include those companies belonging to petroleum, gas and power sectors. The index is a market capitalisation weighted index with base date of January 1, 2001 indexed to a base value of 1000.

CNX Pharma Index: CNX Pharma Index was developed to capture the performance of the companies in the pharma sector. The index is a market capitalisation weighted index with base date of January 1, 2001 indexed to a base value of 1000.

CNX Infrastructure Index: CNX Infrastructure Index has developed to capture the performance of the companies in the infrastructure sector. CNX Infrastructure Index comprises 25 stocks of various infrastructure companies namely Telecom, Power, Port, Air, Roads, Railways, Shipping and other Utility Service providers. The index is a market capitalisation weighted index with base date of January 1, 2004 and indexed to a base value of 1000.

CNX PSU BANK Index: CNX PSU Bank Index was developed to indicate the performance of the Indian banking industry especially public sector banks. This index is Free Float methodology based weighted index with base date on January 2004.

CNX Reality Index: CNX Reality Index is to indicate the performance of the stocks of Indian Realities company's viz. companies engaged in development of buildings, building townships and developing land. The index is a Free Float methodology based weighted index with base date of January 1, 2004, indexed to a base value of 1000.

QUESTIONS

1. Explain BSE Index.
2. Explain Nifty 50.
3. What are the different types of indices?
4. What is Dollex series of BSE indices?
5. Define stock index. What are the purposes of stock index?
6. Explain the different methodologies adopted for calculation of index.
7. Explain the significance of stock index.
8. Discuss the criteria for the selection of shares in Nifty 50.
9. How are stock market indices constructed?

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MODULE - III

8

INTRODUCTION OF MONEY MARKET

Unit Structure

8.1 MEANING OF MONEY MARKET

The money market is a market for short-term funds, which deals in financial assets whose period of maturity is up to one year. It should be noted that money market does not deal in cash or money as such but simply provides a market for credit instruments such as bills of exchange, promissory notes, commercial paper, treasury bills, etc. These financial instruments are close substitute of money. These instruments help the business units, other organisations and the Government to borrow the funds to meet their short-term requirement. Money market does not imply to any specific market place. Rather it refers to the whole networks of financial institutions dealing in short-term funds, which provides an outlet to lenders and a source of supply for such funds to borrowers. Most of the money market transactions are taken place on telephone, fax or Internet. The Indian money market consists of Reserve Bank of India, Commercial banks, Co-operative banks, and other specialized financial institutions. The Reserve Bank of India is the leader of the money market in India. Some Non-Banking Financial Companies (NBFCs) and financial institutions like LIC, GIC, UTI, etc. also operate in the Indian money market.

8.2 FEATURES OF THE MONEY MARKET

The following are the main features of a money market:-

1. It is a market only for short-term funds.
2. It deals with financial assets having a maturity period up to one year only.
3. It deals with only those assets which can be converted into cash readily without loss and with minimum transaction cost.
4. Transactions have to be conducted without the help of brokers.
5. It comprises of several sub-markets, each specializing in particular type of financing e.g., call money market, acceptance market, bill market etc.
6. The components of a money market are the central bank, commercial banks, non-banking financial companies, discount houses and acceptance houses. Commercial banks are playing a dominant role in this market.

8.3 MONEY MARKET INSTRUMENTS

Following are some of the important money market instruments or securities.

(a) **Call Money**: Call money is mainly used by the banks to meet their temporary requirement of cash. They borrow and lend money from each other normally on a daily basis. It is repayable on demand and its maturity period varies in between one day to a fortnight. The rate of interest paid on call money loan is known as call rate.

(b) **Treasury Bill**: A treasury bill is a promissory note issued by the RBI to meet the short-term requirement of funds. Treasury bills are highly liquid instruments that mean, at any time the holder of treasury bills can transfer of or get it discounted from RBI. These bills are normally issued at a price less than their face value; and redeemed at face value. So the difference between the issue price and the face value of the treasury bill represents the interest on the investment. These bills are secured instruments and are issued for a period of not exceeding 364 days. Banks, Financial institutions and corporations normally play major role in the Treasury bill market

(c) **Commercial Paper**: Commercial paper (CP) is a popular instrument for financing working capital requirements of companies. The CP is an unsecured instrument issued in the form of promissory note. This instrument was introduced in 1990 to enable the corporate borrowers to raise short-term funds. It can be issued for period ranging from 15 days to one year. Commercial papers are transferable by endorsement and delivery. The highly reputed companies (Blue Chip companies) are the major player of commercial paper market.

(d) **Certificate of Deposit:** Certificates Of Deposit (CDs) are short-term instruments issued by Commercial Banks and Special Financial Institutions (SFIs), which are freely transferable from one party to another. The maturity period of CDs ranges from 91 days to one year. These can be issued to individuals, co-operatives and companies.

e) **Trade Bill**: Normally the traders buy goods from the wholesalers or manufactures on credit. The sellers get payment after the end of the credit period. But if any seller does not want to wait or in immediate need of money he/she can draw a bill of exchange in favour of the buyer. When buyer accepts the bill it becomes a negotiable instrument and is termed as bill of exchange or trade bill. This trade bill can now be discounted with a bank before its maturity. On maturity the bank gets the payment from the drawee i.e., the buyer of goods. When trade bills are accepted by Commercial Banks it is known as Commercial Bills. So trade bill is an instrument, which enables the drawer of the bill to get funds for short period to meet the working capital needs.

Institutions of the Money Market:

The various financial institutions which deal in short term loans in the money market are its members. They comprise the following types of institutions:

1. Central Bank:

The central bank of the country is the pivot around which the entire money market revolves. It acts as the guardian of the money market and increases or decreases the supply of money and credit in the interest of stability of the economy. It does not itself enter into direct transactions. But controls the money market through variations in the bank rate and open market operations.

2. **Commercial Banks:**

Commercial banks also deal in short-term loans which they lend to business and trade. They discount bills of exchange and treasury bills, and lend against promissory notes and through advances and overdrafts.

3. Non-bank Financial Intermediaries:

Besides the commercial banks, there are non-bank financial intermediaries which lend short-term funds to borrowers in the money market. Such financial intermediaries are savings banks, investment houses, insurance companies, provident funds, and other financial corporations.

4. Discount Houses and Bill Brokers:

In developed money markets, private companies operate discount houses. The primary function of discount houses is to discount bills on behalf of other. They, in turn, form the commercial banks and acceptance houses. Along-with discount houses, there are bill brokers in the money market who act as intermediaries between borrowers and lenders by discounting bills of exchange at a nominal commission. In underdeveloped money markets, only bill brokers operate.

5. Acceptance Houses:

The institution of acceptance houses developed from the bankers who transferred their headquarters to the London Money Market in the 19th and the early 20 the century. They act as agents between exporters and importers and between lender and borrower traders. They accept bills drawn on merchants whose financial standing is not known in order to make the bills negotiable in the London Money Market. By accepting a trade bill they guarantee the payment of bill at maturity. However, their importance has declined because the commercial banks have undertaken the acceptance business.

Functions of a Money Market:

A money market performs a number of functions in an economy.

1. Provides Funds: It provides short-term funds to the public and private institutions needing such financing for their working capital requirements. It is done by discounting trade bills through commercial banks, discount houses, brokers and acceptance houses. Thus the money market helps the development of commerce, industry and trade within and outside the country.

2. Use of Surplus Funds: It provides an opportunity to banks and other institutions to use their surplus funds profitably for a short period. These institutions include not only commercial banks and other financial institutions but also large non-financial business corporations, states and local governments.

3. No Need to Borrow from Banks: The existence of a developed money market removes the necessity of borrowing by the commercial banks from the central bank. If the former find their reserves short of cash requirements they can call in some of their loans from the money market. The commercial banks prefer to recall their loans rather than borrow from the central banks at a higher rate of interests.

4. Helps Government: The money market helps the government in borrowing short-term funds at low interest rates on the basis of treasury bills. On the other hand, if the government were to issue paper money or borrow from the central bank. It would lead to inflationary pressures in the economy.

5. Helps in Monetary Policy: A well developed money market helps in the successful implementation of the monetary policies of the central bank. It is through the money market that the central banks are in a position to control the banking .system and thereby influence commerce and industry.

6. Helps in Financial Mobility: By facilitating the transfer for funds from one sector to another, the money market helps in financial mobility. Mobility in the flow of funds is essential for the development of commerce and industry in an economy.

7. Promotes Liquidity and Safety: One of the important functions of the money market is that it promotes liquidity and safety of financial assets. It thus encourages savings and investments.

8. Equilibrium between Demand and Supply of Funds: The money market brings equilibrium between the demand and supply of loan able funds. This it does by allocating saving into investment channels. In this way, it also helps in rational allocation of resources.

9. Economy in Use of Cash: As the money market deals in near-money assets and not money proper, it helps in economizing the use of cash. It thus provides a convenient and safe way of transferring funds from one place to another, thereby immensely helping commerce and industry.

QUESTIONS

A) Fill in the blanks.

1. The ___________of the country is the pivot around which the entire money market revolves.
2. The primary function of ___________ is to discount bills on behalf of other.
3. ___________ is a popular instrument for financing working capital requirements of companies.
4. ___________ is mainly used by the banks to meet their temporary requirement of cash.

B) Answer in one or two lines.

1. Acceptance Houses.
2. Trade bills
3. Money Market

C). Long Answers.

Q1. Give meaning of money market and explain its instruments in detail?

Q2. Explain features of money market.

Q3. Elaborate functions of money market in detail?

Q4.What are the institutions involved in money market, explain in detail?

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9

CALL MONEY MARKET

Unit Structure

9.1 INTRODUCTION TO CALL MONEY MARKET

Call money market means the market for extremely short period loans; say one day to fourteen days. These loans are repayable on demand at the option of either the lender or the borrower. When the money is lent for one day in this market it is known as "**Call Money**", and if it exceeds one day (but less than 15 days) it is referred to as "**Notice Money**". **Term Money** refers to Money lent for 15 days or more in the Inter Bank Market. These loans are given to brokers and dealers in stock exchange. Similarly, banks with 'surplus' lend to other banks with 'deficit funds' in the **call money market**. Thus, it provides an equilibrating mechanism for short term surpluses and deficits. Moreover, commercial banks can quickly borrow from the call market to meet their statutory liquidity requirements. They can also maximize their profits easily by investing their surplus funds in the call market during the period when call rates are high and volatile.

The call money market is a highly competitive and sensitive market. It registers very quickly the pressures of demand and supply for funds operating in the money market. Thus it acts as possibly the best available indicator of the liquidity position of the organized money market.

9.2 FEATURES OF INDIAN CALL MONEY MARKET

a) Nature of loan: In call money market, very short-term loan is arranged.

b) Time of repayment of loan: Generally the loan is to be repaid within 15days. So time of repayment of loan is very short.

c) Safety: Loan of call money market is repayable on demand. This kind of loan is considered as very safe by the bank. Discount houses are also participants of call money market and they can repay the loan on request.

d) Conversion into liquid cash: The loan is repayable on demand and at the option of either the lender or the borrower. So such loan can be easily and quickly converted into liquid cash. In fact, such loan is known as “Money at call and short notice.”

e) Object: The primary object of call money market is to meet up temporary cash deficiency of internal banks.

f) Nature of transactions: Daily surplus funds are transacted in this market. As a result, supply of short term fund in money market increases.

g) Investment: Call money market makes short term investment in share market, government securities, Treasury bill and other short term securities.

9.3 OPERATIONS IN CALL MARKET

Borrowers and lenders in a call market contact each other over telephone. Hence, it is basically over-the-telephone market. After negotiations over the phone, the borrowers and lenders arrive at a deal specifying the amount of loan and the rate of interest. After the deal is over, the lender issues FBL cheque in favor of the borrower. The borrower is turn issues call money borrowing receipt. When the loan is repaid with interest, the lender returns the lender the duly discharges receipt.

Instead of negotiating the deal directly, it can be routed through the Discount and Finance House of India (DFHI), the borrowers and lenders inform the DFHI about their fund requirement and availability at a specified rate of interest. Once the deal is confirmed, the Deal settlement advice is lender and receives RBI cheque for the money borrowed. The reverse is taking place in the case of landings by the DFHI. The duly discharged call deposit receipt is surrendered at the time of settlement. Call loans can be renewed on the back of the deposit receipt by the borrower.

Discount and Finance House of India (DFHI): The Working Group of Money Market, in its Report submitted in 1987, recommended, among other things, that a Finance House should be set up to deal in short-term money market instruments. As a follow-up on the recommendations of the Working Group, the Reserve Bank in India, in collaboration with the public sector banks and financial institutions, set up the Discount and Finance House of India Limited (DFHI) in April 1988. DFHI is the apex body in the Indian money market and its establishment is a major step towards developing a secondary market for money instruments. DFHI, which commenced its operations from April 25, 1988, deals in short-term money market instruments. As a matter of policy, the aim of the DFHI is to increase the volume of turnover rather than to become the repository of money market instruments. The initial paid up capital of DFHI is Rs.150 crores. Apart from this, it has lines of refinance from RBI and a line of credit from the consortium of public sector banks. As the apex agency in the Indian money market, the DFHI has been playing an important role ever since its inception. It has been promoting the active participation of the scheduled commercial banks and their subsidiaries, state and urban cooperative banks and all-Indian financial institutions in the money market. The objective is to ensure that short-term surplus and deficits of these institutions are equilibrated at market-related rates through inter-bank transactions and various money market instruments.

The main objective of DFHI is to facilitate the smoothening of the short term liquidity imbalances by developing an active money market and integrating the various segments of the money market.

At preset DFHI’s activities are restricted to:

1. Dealing in 91 days and 364 days Treasury Bills.
2. Re-discounting short term commercial bills.
3. Participating in the inert bank call money, notice money and term deposits.
4. Dealing in Commercial Paper and Certificate of deposits.
5. Government dated Securities.

Call loan market transactions

In India, call loans are given for the following purposes:

1. To commercial banks to meet large payments, large remittances to maintain liquidity with the RBI and so on.
2. To the stock brokers and speculators to deal in stock exchanges and bullion markets.

3. To the bill market for meeting matures bills.
4. To the Discount and Finance House of India and the Securities Trading Corporation of India to activate the call market.
5. To individuals of very high status for trade purposes to save interest on O.D or cash credit.

9.4 PARTICIPANTS OF INDIAN CALL MONEY MARKET

The participants in this market can be classified into categories viz.

1. Those permitted to act as both lenders and borrowers of call loans.
2. Those permitted to act only as lenders in the market.

The first category includes all commercial banks. Co-operative banks, DFHI and STCI. In the second category LIC, UTI, GIC, IDBI, NABARD, specified mutual funds etc., are included. They can only lend and they cannot borrow in the call market.

9.5 ADVANTAGES OF CALL MONEY

In India, commercial banks play a dominant role in the call loan market. They used to borrow and lend among themselves and such loans are called inter-bank loans. They are very popular in India. So many advantages are available to commercial banks. They are as follows:

- **High Liquidity**: Money lent in a call market can be called back at any time when needed. So, it is highly liquid. It enables commercial banks to meet large sudden payments and remittances by making a call on the market.

- **High Profitability**: Banks can earn high profits by lending their surplus funds to the call market when call rates are high volatile. It offers a profitable parking place for employing the surplus funds of banks temporarily.

- **Maintenance of SLR**: Call market enables commercial bank to minimum their statutory reserve requirements. Generally banks borrow on a large scale every reporting Friday to meet their SLR requirements. In absence of call market, banks have to maintain idle cash to meet their reserve requirements. It will tell upon their profitability.

- **Safe and Cheap**: Though call loans are not secured, they are safe since the participants have a strong financial standing. It is cheap in the sense brokers have been prohibited from operating in the call market. Hence, banks need not pay brokers on call money transitions.

- **Assistance To Central Bank Operations**: Call money market is the most sensitive part of any financial system. Changes in demand and supply of funds are quickly reflected in call money rates and give an indication to the central bank to adopt an appropriate monetary policy. Moreover, the existence of an efficient call market helps the central bank to carry out its open market operations effectively and successfully.

9.6 DRAWBACKS OF CALL MONEY

The call market in India suffers from the following drawbacks:

- **Uneven Development**: The call market in India is confined to only big industrial and commercial centers like Mumbai, Kolkata, Chennai, Delhi, Bangalore and Ahmadabad. Generally call markets are associated with stock exchanges. Hence the market is not evenly development.

- **Lack of Integration**: The call markets in different centers are not fully integrated. Besides, a large number of local call markets exist without an\y integration.

- **Volatility in Call Money Rates**: Another drawback is the volatile nature of the call money rates. Call rates vary to greater extant indifferent centers indifferent seasons on different days within a fortnight. The rates vary between 12% and 85%. One cannot believe 85% being charged on call loans.

9.7 CONCLUSION

The **call money market** as a significant component of the money market possesses a few special characteristics:-

1. Call money is an instrument for ultra-short period management of funds and is easily reversible.
2. It is primarily a “telephone” market and is therefore, administratively convenient to manage for both borrowers and lender.
3. Being an instrument of liability management, it provides incremental funds and adds to the size of balance sheet of banks.

9.8 QUESTIONS

Fill in the blanks

1) _____________ refers to Money lent for 15 days or more in the Inter Bank Market.
2) ______________ is also participants of call money market and they can repay the loan on request.
3) ________________ is the apex body in the Indian money market and its establishment is a major step towards developing a secondary market for money instruments.
4) The initial paid up capital of DFHI is Rs.____________.

Match the following.

Participants of Indian call money market	an instrument for ultra-short period management of funds
Call money	Banks can earn high profits by lending their surplus funds to the call market
Time of repayment of loan	Is a drawback
Volatility in Call Money Rates	UTI, GIC, IDBI, NABARD
High Profitability	within 15days

Long Answers:-

Q1. Define call money? Explain the Features of Indian call money market.

Q2. Give a brief note on Operations in Call Market?

Q3. Give Participants of Indian call money market.

Q4. Explain Advantages of call money in detail.

Q5.Give drawbacks of call money.

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10

COMMERCIAL BILL MARKET/ DISCOUNT MARKETS

Unit Structure

10.1 INTRODUCTION TO COMMERCIAL BILL MARKET

A commercial bill is one which arises out of a genuine trade transaction, i.e. credit transaction. As soon as goods are sold on credit, the seller draws a bill on the buyer for the amount due. The buyer accepts it immediately agreeing to pay amount mentioned therein after a certain specified date. Thus, a bill of exchange contains a written order from the creditor to the debtor, to pay a certain sum, to a certain person, after a creation period. A bill of exchange is a 'self-liquidating' paper and negotiable; it is drawn always for a short period ranging between 3 months and 6 months.

Definition of a bill

Section 5 of the negotiable Instruments Act defines a bill exchange a follows:

"an instrument in writing containing an unconditional order, signed by the maker, directing a certain person to pay a certain sum of money only to, or to the order of a certain person ort to the beater of the instrument".

10.2 TYPES OF COMMERCIAL BILL

Many types of bills are in circulation in a bill market. They can be broadly classified as follows:

1. Demand and Usance bills.
2. Clean bills and documentary bills.

3. Inland and foreign bills.
4. Export bills and import bills.
5. Indigenous bills.
6. Accommodation bills and supply bills.

1. Demand and Usance

Demand bills are others called sight bills. These bills are payable immediately as soon as they are presented to the drawee. No time of payment is specified and hence they are payable at sight. Usance bills are called time bills. These bills are payable immediately after the expiry of time period mentioned in the bills. The period varies according to the established trade custom or usage prevailing in the country.

2. Clean Bills and Documentary Bills

When bills have to be accompanied by documents of title to goods like Railways, receipt, Lorry receipt, Bill of Lading etc. the bills are called documentary bills. These bills can be further classified into D/A bills and D/P bills. In the case of D/A bills, the documents accompanying bills have to be delivered to the drawee immediately after acceptance. Generally D/A bills are drawn on parties who have a good financial standing. On the order hand, the documents have to be handed over to the drawee only against payment in the case of D/P bills. The documents will be retained by the banker. Till the payment o0f such bills. When bills are drawn without accompanying any documents they are called clean bills. In such a case, documents will be directly sent to the drawee.

3. Inland and Foreign Bills

Inland bills are those drawn upon a person resident in India and are payable in India. Foreign bills are drawn outside India and they may be payable either in India or outside India. They may be drawn upon a person resident in India also. Foreign boils have their origin outside India. They also include bills drawn on India made payable outside India.

4. Export and Foreign Bills

Export bills are those drawn by Indian exports on importers outside India and import bills are drawn on Indian importers in India by exports outside India.

5. Indigenous Bills

Indigenous bills are those drawn and accepted according to native custom or usage of trade. These bills are popular among indigenous bankers only. In India, they called ‘hundis’ the hundis are known by various names such as ‘Shah Jog’, ‘Nam Jog’, Jokhani’, Termainjog’. ‘Darshani’, ‘Dhanijog’, and so an.

6. Accommodation Bills and Supply Bills

If bills do not arise out of genuine trade transactions, they are called accommodation bills. They are known as 'kite bills' or 'wind bills'. Two parties draw bills on each other purely for the purpos4 of mutual financial accommodation. These bills are discounted with bankers and the proceeds are shared among themselves. On the due dates, they are paid. Supply bills are those neither drawn by suppliers or contractors on the government departments for the goods nor accompanied by documents of title to goods. So, they are not considered as negotiable instruments. These bills are useful only for the purpose of getting advances from commercial banks by creating a charge on these bills.

10.3 OPERATIONS IN COMMERCIAL BILL MARKET

From the operations point of view, the bill market can be classified into two viz.

- Discount Market
- Acceptance Market

Discount Market

Discount market refers to the market where short-term genuine trade bills are discounted by financial intermediaries like commercial banks. When credit sales are affected, the seller draws a bill on the buyer who accepts it promising to pay the specified sum at the specified period. The seller has to wait until the maturity of the bill for getting payment. But, the presence of a bill market enables him to get payment immediately. The seller can ensure payment immediately by discounting the bill with some financial intermediary by paying a small amount of money called 'Discount rate' on the date of maturity; the intermediary claims the amount of the bill from the person who has accept6ed the bill.

In some countries, there are some financial intermediaries who specialize in the field of discounting. For instance, in London Money Market there are specialize in the field discounting bills. Such institutions are conspicuously absent in India. Hence, commercial banks in India have to undertake the work of discounting. However, the DFHI has been established to activate this market.

Acceptance Market

The acceptance market refers to the market where short-term genuine trade bills are accepted by financial intermediaries. All trade bills cannot be discounted easily because the parties to the bills may not be financially sound. In case such bills are accepted by financial intermediaries like banks, the bills earn a good name and reputation and such bills can readily discounted anywhere. In

London, there are specialist firms called acceptance house which accept bills drawn by trades and import greater marketability to such bills. However, their importance has declined in recent times. In India, there are no acceptance houses. The commercial banks undertake the acceptance business to some extent.

10.4 ADVANTAGES OF COMMERCIAL BILLS:

Commercial bill market is an important source of short-term funds for trade and industry. It provides liquidity and activates the money market. In India, commercial banks lay a significant role in this market due to the following advantages:

- **Liquidity**: Bills are highly liquid assets. In times of necessity, bills can be converted into cash readily by means of rediscounting them with the central bank. Bills are self-liquidating in character since they have fixed tenure. Moreover, they are negotiable instruments and hence they can be transferred freely by a mere delivery or by endorsement and delivery.

- **Certainty of Payment**: Bills are drawn and accepted by business people. Generally, business people are used to keeping their words and the use of the bills imposes a strict financial discipline on them. Hence, bills would be honored on the due date.

- **Ideal Investment**: Bills are for periods not exceeding 6 months. They represent advances for a definite period. This enables financial institutions to invest their surplus funds profitably by selecting bills of different maturities. For instance, commercial banks can invest their funds on bills in such a way that the maturity of these bills may coincide with the maturity of their fixed deposits.

- **Simple Legal Remedy**: In case the bills are dishonored the legal remedy is simple. Such dishonored bills have to be simply noted and protested and the whole amount should be debited to the customer’s accounts.

- **High And Quick Yield**: The financial institutions earn a high quick yield. The discount is dedicated at the time of discounting itself whereas in the case of other loans and advances, interest is payable only when it is due. The discounts rate is also comparatively high.

- **Easy Central Bank Control**: The central bank can easily influence the money market by manipulating the bank rate or the rediscounting rate. Suitable monetary policy can be taken by adjusting the bank rate depending upon the monetary conditions prevailing in the market.

10.5 DRAWBACKS OF COMMERCIAL BILLS:

In spite of these merits, the bill market has not been well developed in India. The reasons for the slow growth are the following:

- **Absence of Bill Culture**: Business people in India prefer O.D and cash credit to bill financing therefore, banks usually accept bills for the conversion of cash credits and overdrafts of their customers. Hence bills are not popular.

- **Absence of Rediscounting among Banks**: There is no practice of re-discounting of bills between banks who need funds and those who have surplus funds. In order to enlarge the rediscounting facility, the RBI has permitted financial institutions like LIC, UTI, GIC and ICICI to rediscount genuine eligible trade bills of commercial banks. Even then, bill financial is not popular.

- **Stamp Duty**: Stamp duty discourages the use of bills. Moreover, stamp papers of required denomination are not available.

- **Absence of Secondary Market**: There is no active secondary market for bills. Rediscounting facility is available in important centers and that too it restricted to the apex level financial institutions. Hence, the size of the bill market has been curtailed to a large extant.

- **Difficulty in Ascertaining Genuine Trade Bills**: The financial institutions have to verify the bills so as to ascertain whether they are genuine trade bills and not accommodation bills. For this purpose, invoices have to be scrutinized carefully. It involves additional work.

- **Limited Foreign Trade**: In many developed countries, bill markets have been established mainly for financing foreign trade. Unfortunately, in India, foreign trade as a percentage to national income remains small and it is reflected in the bill market also.

- **Absence of Acceptance Services**: There is no discount house or acceptance house in India. Hence specialized services are not available in the field of discounting or acceptance.

- **Attitude of Banks**: Banks are shy rediscounting bills even the central bank. They have a tendency to hold the bills till maturity and hence it affects the velocity of circulation of bills. Again, banks prefer to purchase bills instead of discounting them.

10.6 CONCLUSION

The development of bill financing and bill culture would enable industry and commerce to borrow funds at a lower rate than under cash credit/overdraft arrangements. Bill culture can develop if government, public sector enterprises and large private sector undertakings accept it as a basis for financing business. Bill financing would enable banks to plan their cash management efficiently since the amount and the date of repayment are definite in case of bill. The bills also provide liquidity to the banks in the bill rediscounting market.

10.7 QUESTIONS

Fill in the blanks.

1. Banks prefer to ________ instead of discounting them.
2. Stamp duty __________ the use of bills.
3. Bills are drawn and accepted ____________ people.
4. Bills are __________ assets
5. Export bills are those drawn by Indian exports ___________ outside India

Write short notes.

1. Inland and foreign bills
2. Acceptance Market
3. Export/ Import Bills
4. Definition of commercial bill

Write Long Answers.

Q1. Explain commercial bill market in detail.
Q2. Explain types of bill markets?
Q3. Briefly explain the operations where bill market takes place.
Q4. Elaborate the advantages and disadvantages of bill market .

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11

TREASURY BILLS MARKET

Unit Structure

11.1 INTRODUCTION OF TREASURY BILLS MARKET

Treasury bill is a monetary policy instrument through which government raise funds for short period requirements and commercial banks invest their short period surpluses by buying these bills from government.

Three types of treasury bills are important:

1. 91 days Treasury bill;
2. 182 days Treasury bill; and
3. 364 days Treasury bills.

It may be noted that 91 day Treasury bill is a traditional instrument. During 1980's and 1990's the other two treasury bills were introduced. 182 days Treasury bill was introduced by auction for financing fiscal-deficit for the short period. Introduction of 364 day Treasury bills discontinued the use of 182 day Treasury bill.

11.2 TYPES OF TREASURY BILLS

Treasury bills are of two types:

- ad hoc and
- Regular.

The ad hoc treasury bills were used to support the borrowing program of the government. The ad hoc treasury bills are not marketable because they are not sold o the public or banks. In the past, the bulk of the Treasury bill issue was of ad hoc 91 day bills. The treasury bills sold to the public or banks are regular treasury bills. These are marketable.

All treasury bills are bought and sold at a discounted value. The amount of interest due on the bills is paid in the form of discount at the time of purchase. The discounted price is obviously lower than the face value.

In industrially developed countries, treasury bills are one of the important forms of holding short-term surplus funds by the financial institutions and firms because they are highly liquid and offer a risk-free reasonable rate of return. The government raises a large amount of funds through treasury bills. But in India, the RBI is the main holder of treasury bills. The financial institutions and firms are not active buyers in the Treasury bill market because of the low rate of discount on treasury bills. The RBI was made a captive buyer of ad hoc treasury bills. This has been responsible for the conversion of government debt into Reserve Money. As a result, money supply was growing more rapidly than the growth in money demand. The system of ad hoc treasury bills was discontinued from the year 1997-98.

11.3 BENEFITS OF INVESTMENT IN TREASURY BILLS

- No tax deducted at source
- Zero default risk being sovereign paper
- Highly liquid money market instrument
- Better returns especially in the short term
- Transparency
- Simplified settlement
- High degree of tradability and active secondary market facilitates meeting unplanned fund requirements.

11.4 PROCESS OF TREASURY BILL MARKET

- **FORM: -** The treasury bills are issued in the form of promissory note in physical form or by credit to Subsidiary General Ledger (SGL) account or Gilt account in dematerialized form.

- **MINIMUM AMOUNT OF BIDS: -** Bids for treasury bills are to be made for a minimum amount of Rs 25000/- only and in multiples thereof.

- **ELIGIBILITY: -** All entities registered in India like banks, financial institutions, Primary Dealers, firms, companies, corporate bodies, partnership firms, institutions, mutual funds, Foreign Institutional Investors, State Governments, Provident Funds, trusts, research organizations, Nepal Rashtra bank and even individuals are eligible to bid and purchase Treasury bills.

- **REPAYMENT: -** The treasury bills are repaid at par on the expiry of their tenure at the office of the Reserve Bank of India, Mumbai.

11.4.1 Treasury bill in Primary Market

- In the primary market, treasury bills are issued by auction technique.

Salient Features of the Auction Technique

- The auction of treasury bills is done only at Reserve Bank of India, Mumbai.
- Bids are received at Mumbai office during banking hours i.e. up to 2 pm on the date of auction.
- The bids are received in terms of price per Rs 100. For example, a bid for 91 day Treasury bill auction could be for Rs 97.50. Further, bids cannot be submitted with prices for more than two decimals.
- The auction committee of Reserve Bank of India decides the cut-off price and the results are announced on the same day.
- Bids above the cut-off price receive full allotment; bids at cut-off price may receive full or partial allotment and bids below the cut-off price are rejected.

Types of Auctions

There are two types of auction for treasury bills:

- **Multiple Price Based or French Auction:** Under this method, all bids equal to or above the cut-off price are accepted. However, the bidder has to obtain the treasury bills at the price quoted by him. This method is followed in the case of 364days treasury bills and is valid only for competitive bidders.

- **Uniform Price Based or Dutch auction:** Under this system, all the bids equal to or above the cut-off price are accepted at the cut- off level. However, unlike the Multiple Price based method, the bidder obtains the treasury bills at the cut-off price and not the price quoted by him. This method is applicable in the case of 91 days treasury bills only.

Classification of Bids

The bids submitted can be classified as competitive and non competitive bids.

Competitive Bids

Competitive bids can be submitted by any person or institutions like, banks, financial institutions, Primary Dealers, firms, companies, corporate bodies, institutions and trusts in India.

Non Competitive Bids

There is a provision to accept non- competitive bids in respect of all treasury bills auctions. State Governments, Provident Funds and Nepal Rashtra bank are allowed to submit non-competitive bids in the case of 91 days treasury bills. In the case of 364 days treasury bills however, only State Governments can participate as non-competitive bidders. The Reserve Bank of India participates as a non-competitive bidder in the auction. The unsubscribed portion of the competitive bids also devolves on the Reserve Bank of India. In the case of non-competitive bids, only the amount is indicated. They do not indicate any price. All the non-competitive bids are accepted at the weighted average price of the competitive bids.

To summarize,

The Reserve Bank of India conducts the auction of treasury bills of varying maturities as per the notified amount on pre announced auction dates.

- The auction for the notified amount is conducted on a competitive bid basis, which is submitted on a price basis.
- Non-competitive bids are also submitted and accepted, but the allotment is outside the notified amount and based only on quantity and not price.
- For consideration of competitive bidding, the bidding starts with the bid with lowest yield or highest price being awarded Treasury bills at their bid price.
- Successively higher yielding bids are accepted and are awarded Treasury bills at their bid price until the total amount accepted equals the notified amount.
- The highest yield accepted by the Reserve Bank of India is referred to the cut-off yield and the corresponding price is called the cut-off price.

11.6 TREASURY BILL IN SECONDARY MARKET

Participants

- The major participants in the secondary market are scheduled banks, financial Institutions, Primary dealers, mutual funds, insurance companies and corporate treasuries. Other entities like cooperative and regional rural banks, educational and religious trusts etc. have also begun investing their short term funds in treasury bills.

Advantages

- Market related yields
- Ideal matching for funds management particularly for short term tenors of less than 15 days.
- Transparency in operations as the transactions would be put through Reserve Bank of India's SGL or Client's Gilt account only
- Two way quotes offered by primary dealers for purchase and sale of treasury bills.
- Certainty in terms of availability, entry & exit

11.7 HOW TO PURCHASE TREASURY BILLS

Treasury bills can be purchased either from the primary market or the secondary market.

Primary Market

A bid will have to be made in the weekly auctions of Treasury bills as given earlier. The bid will have to be submitted to RBI, Mumbai. The bid can be submitted to RBI, Mumbai, or through the bank/Primary Dealer with whom he has a Constituent SGL account.

Secondary Market

A treasury bill can be purchased at any point of time from the secondary market, commensurate with the short term period for which funds are available.

11.8 DISCOUNT AND FINANCE HOUSE OF INDIA (DFHI)

The Working Group of Money Market, in its Report submitted in 1987, recommended, among other things, that a Finance House should be set up to deal in short-term money market instruments.
As a follow-up on the recommendations of the Working Group, the Reserve Bank in India, in collaboration with the public sector banks and financial institutions, set up the Discount and Finance House of India Limited (DFHI) in.

April 1988. DFHI is the apex body in the Indian money market and its establishment is a major step towards developing a secondary market for money instruments. DFHI, which commenced its operations from April 25, 1988, deals in short-term money market instruments.

As a matter of policy, the aim of the DFHI is to increase the volume of turnover rather than to become the repository of money market instruments. The initial paid up capital of DFHI is Rs. 150 crores.

Apart from this, it has lines of refinance from RBI and a line of credit from the consortium of public sector banks.

As the apex agency in the Indian money market, the DFHI has been playing an important role ever since its inception. It has been promoting the active participation of the scheduled commercial banks and their subsidiaries, state and urban cooperative banks and all-Indian financial institutions in the money market.

The objective is to ensure that short-term surplus and deficits of these institutions are equilibrated at market-related rates through inter-bank transactions and various money market instruments.

In 1990-91 the DFHI opened its branches at Delhi, Calcutta, Madras, Ahmadabad and Bangalore in order to decentralize its operations and provide money market facilities at the major money market centers in the country.

Discount and Finance House of India Ltd. (DFHI), a unique institution of its kind, was set up in April 1988. The share capital of DFHI is Rs 200 cores, which has been subscribed by Reserve Bank of India (10.5%), Public sector banks (62%) and Financial Institutions (26.6%). The discount has been established to deal in money market instruments in order to provide liquidity in the money market. Thus the task assigned to DFHI is to develop a secondary market in the existing money market instruments.

The establishment of a discount House was recommended by a Working Group on Money market. The main objective of DFHI is to facilitate the smoothening of the short term liquidity imbalances by developing an active money market and integrating the various segments of the money market. At preset DFHI’s activities are restricted to:

1. Dealing in 91 days and 364 days treasury bill
2. Re-discounting short term commercial bills.
3. Participating in the interbank call money, notice money and term deposits.
4. Dealing in commercial paper and certificates.
5. Government dated securities.

Treasury bills are issued by Reserve bank of India on behalf of the Government of India. Such bills are sold at fortnightly auctions. The Discount House regularly participates in such auctions. Moreover, it provides a ready market to other institutions/individuals to buy or sell the Treasury Bills. It purchases the same either as outright purchase or on repos basis. Repos mean the right to re-purchase the same bills again. For this purpose the DFHI quotes two way prices with fine spread. Such operations in Treasury Bills impart greater flexibility to banks in their funds management. Moreover, with the creation of a secondary market for treasury Bills, corporate bodies and other institutions could also invest their short term surplus funds in such bills.

Rediscounting of commercial bill: -

The Discount House aims at imparting liquidity to Commercial bills which have already been discounted by banks and financial institutions. It further re-discounts them and also enables banks and other institutions to re-discount from it such bills. For this purpose DFHI announces its bid and offers re-discount rates on a fortnightly basis.

11.9 ROLE OF DISCOUNT AND FINANCIAL HOUSE OF INDIA IN THE INDIAN MONEY MARKET

Discount House plays a very important role in money market. The money market can function well if there is adequate supply of money. Discount house helps the money market to function smoothly by providing the following services.

(a) External source of money supply: The central bank or the discount houses provide finance to the commercial banks and other financial institutes operating in the money supply in various forms.

(b) Helps in smooth function of the money market: Discount house helps in smooth functioning of the money market by removing the irregularities in the process of handover of money among the intermediaries. The Discount houses are experienced and experts in such job.

(c) Providing short-term loan: They provide loan for very short period, in other, in other words any business houses or government can take loan from discount house for urgent requirements. Such is paid at once i.e., on demand.

(d) Money supply to government or private enterprise: They not only provide loan to private enterprise but also supply money to state governments it needed by taking deposit of bills of exchange, treasury bills and other valid documents.

(e) Discounting and Re-discounting of bills: The RBI and the Discount house discount bills and it re-discount the bills which have already been discounted by the commercial banks and other financial intermediaries.

(f) Monetary Stability: Discount house provides monetary stability in the money market. Shortage of liquid fund affects the stability of money market severely. Whenever there is shortage of fund, discount house provide fund and brings liquidity in the money market.

(g) Indispensable: Money is required for any activity; since discount house provide money, they are indispensable for the development of the economy.

(h) Development of Financial market: The Discount houses work in both primary and secondary markets, as a result financial market is developed.

QUESTIONS

Fill in the blanks.

1. Discount houses work in both ____________ and secondary markets.
2. The discount houses provide finance to the ___________banks.
3. Treasury bills are issued by _____________ on behalf of the Government of India
4. High degree of ______ and ______________secondary market facilitates meeting unplanned fund requirements.

Write short notes on: -

1. Regular treasury bills
2. Treasury bills in secondary market
3. DFHI

Write long answers.

Q1. Give detailed meaning of Treasury bill with examples.

Q2. Explain the Role of Discount and Financial House of India in the Indian money market.

Q3.Explain the types of Treasury bill and benefits of treasury bills.

Q4. Explain the Treasury bills in primary market.

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MODULE - IV

12

FOREIGN EXCHANGE MARKET

(Nature, Organisation and Participants)

Unit Structure

12.0 LEARNING OUTCOMES

After completion of study of this unit, a learner will come to know

- Learner will come to know about forex market.
- Learner will comprehend the working of forex market.
- Learners will understand who the participants of the forex market are.
- Learners will understand different characteristics of forex market.

12.1 INTRODUCTION

The foreign exchange market is the largest and most liquid financial market in the world. Traders include large banks, currency speculators, corporations, governments, foreign currency remittance companies and other financial institutions.

Forex market is an organizational setting within which individuals, business, governments and banks buy and sell foreign currencies. It is a worldwide market which operates round the clock due to time zone that is, when it is morning in Hong Kong, it is evening in New York. Forex market is not a single physical place.

Foreign exchange market is a mechanism where various national currencies are purchased or sold like any other commodity. Demand for and supply of foreign exchange determines its price, that is, foreign exchange rate. When we say, Rs. 67 is the price of a dollar, it is the foreign exchange rate or the price of dollar expressed in terms of rupees. From a national point of view we may state the foreign exchange rate is a price of a rupee in dollar or cents. Accordingly we may say the value in terms of cents, but, for practical purpose it is expressed in terms of number of rupees for one dollar, i.e., Rs. 67 = $1 or Rs. 67.50 = $1.

Foreign exchange market can either be completely free or restricted. Restrictions vary from country to country. In India, full convertibility is allowed only on current account and not on capital account. Even under free exchange market or floating exchange rate, the Government intervenes whenever there is wide fluctuation in exchange rate. Such intervention is essential to avoid negative effects of unstable exchange rate.

Fluctuations in exchange rates are usually caused by actual monetary flows as well as by anticipation of changes in monetary flows caused by changes in gross domestic product (GDP) growth, inflation (purchasing power parity theory), interest rates (interest rate parity theory), budget and trade deficits or surpluses, large cross-border deals and other macroeconomic developments.

Supply and demand for any given currency, and thus its value, are not influenced by any single element, but rather by several in different proportions. These elements generally fall into three categories: economic factors, political conditions and market psychology.

12.2 FACT FILE ON INTERNATIONAL MARKETS

Average daily turnover is approximately USD 3 trillion with an additional USD 2 trillion turnover in foreign currency derivatives. Major component of this turnover is speculative.

This market is predominantly made up of day-traders which means that positions built up in currencies are mostly squared off during the day and there is very little carry forward of open speculative positions.

US Dollar is the most heavily traded currency. The most heavily used currency pairs are EUR/USD, GBP/USD (called CABLE) and USD/JPY.

London, New York and Tokyo are the biggest foreign exchange centres and Deutsche Bank (Germany) is the single largest trading entity in international foreign exchange markets.

Unlike a stock market, the foreign exchange market is divided into levels of access which means that all participants cannot operate in all segments of the market and are subject to different categories of exchange rates. At the wholesale level, generally called ‘The Interbank Market’, interbank rates are used between participants whereas, at the retail level the rates used are called ‘Merchant Rates’. Each localized market is governed by the domestic exchange control regulations which determine the different levels of access.

Generally, for a given currency pair, either currency can function as the base currency while the other acts as the variable or quoted currency. By convention the LHS currency is stronger than the RHS currency at the time of creation of the pair. However, when the euro was created, the European Central Bank mandated that EUR be the base currency in any pairing. Similarly, GBP has traditionally been base currency in all cases.

12.3 NATURE OF FOREIGN EXCHANGE MARKET

The forex market is an over-the-counter (OTC) market, which means that there is no central exchange and clearing house where orders are matched. With different levels of access, currencies are traded in different market makers:

The Inter-bank Market: Large commercial banks trade with each other through the Electronic Brokerage System (EBS). Banks will make their quotes available in this market only to those banks with which they trade. This market is not directly accessible to retail traders.

The Online Market Maker: Retail traders can access the FX market through online market makers that trade primarily out of the US and UK. These market makers typically have a relationship with several banks on EBS; the larger the trading volume of the market maker, the more relationship it likely has.

Market Hours: Forex is a market that trades actively as long as there are banks open in one of the major financial centres of the world. This is effectively from the beginning of Monday morning in Tokyo until the afternoon of Friday in New York. In terms of GMT, the trading week occurs from Sunday night until Friday night, or roughly 5 days, 24 hours per day.

12.4 CHARACTERISTICS OF THE INTERNATIONAL FOREX MARKET

The primary objective of the foreign exchange market is to facilitate international trade and investment, by allowing end-users to convert one currency into another. The conversion rates between currencies are called foreign exchange rates. The market also facilitates speculation, arbitrage and borrowing/lending of currencies for financing different transactions. Therefore this market connects exchange rates with interest rates. The modern foreign exchange market started with the introduction of the “Flexible Exchange Rate System” during the 1970s.

The main characteristics of this market are:

i. It is a decentralized, over-the-counter (OTC) market, engaged in negotiated transactions.

ii. In comparison to all other markets, it enjoys the highest trading volume which results in high liquidity.

iii. International foreign currency transactions do not involve transfers of currencies in physical cash form. All settlements, receipts and payments are conducted through demand deposit accounts with commercial banks and since only banks provide such accounts it follows that all transactions in this market get routed through the banking system.

iv. The actual settlement of transactions is done through a network of ‘NOSTRO’ and ‘VOSTRO’ accounts maintained by banks worldwide.

v. It is geographically dispersed across all countries which makes it a universal market. However in each country there is a domestic foreign exchange market governed by individual regulations.

vi. It operates 24 hours a day, except weekends, across all time zones.

vii. It operates on very fine (low) profit margins compared to other markets (Fixed income securities, commodities etc.)

viii. It provides for a ‘Barter’ of currencies. If person ‘A’ wants to sell USD to get INR, there must be a person ‘B’ wanting to sell INR for the USD at the same exchange rate. Therefore, as in the case of Barter there has to be a double coincidence of wants. The forex market thus functions as an international clearing mechanism or currency exchange bringing together participants wishing to exchange currencies at mutually agreed exchange rates.

ix. It has no physical existence and operates as an electronically connected network of end-users, banks, brokers and service providers.

x. The most modern communication systems are used thereby reducing transaction cost, eliminating interest loss factor and the problem of idle funds. Settlement systems worldwide have been synchronized so that participants are able to shift from one market to another and from one currency into another without settlement gaps.

12.5 ORGANISATION OF FOREIGN EXCHANGE MARKET

Participants in Foreign Exchange Market:

The main participants in the foreign exchange market are (i) retail clients (ii) commercial banks (iii) foreign exchange brokers and other authorised agents. The central banks too participate in this market as per its policy decisions. Let us briefly explain the main participants in the forex market.

Retail Clients: These comprise people, international investors, multinational corporation and others who need foreign exchange. Retail clients deal through commercial banks and authorised agents.

Commercial Banks: They carry out buying and selling orders from their retail clients and of their own account. They deal with other commercial banks and also through foreign exchange brokers.

Foreign Exchange Brokers: Each forex market centre has some authorised brokers. Brokers act as intermediaries between buyers and sellers, mainly the banks. Commercial banks prefer the brokers as banks could obtain the most favourable quotations from them.

Central Banks: Under the floating exchange rate the central bank of a country normally does not interfere in the exchange market. Since 1973 however most of the central banks frequently intervened to buy and sell their currencies in an attempt to influence the rate at which their currencies are traded.

The above groups are the sources from where demand and supply forces generate which in turn help determine the foreign exchange rate.
The forex market is broadly divided into (i) Retail and (ii) Wholesale market.

In the **retail market** travellers, tourists and people who are in need of foreign exchange for permitted small transactions, exchange one currency for another. The retail market is a secondary price maker.

The **wholesale market** is also called the interbank market. Commercial banks, business corporations and central banks are the main participants in this segment of the market. The size of transaction in the market is very large. The dealers here are highly professional and are the primary price makers. It is big players like multinational banks that exert a lot of influence in the market and are mainly responsible for determining the exchange rate.

Brokers act as middlemen between the price makers. They provide information to the banks about the prices at which there are buyers and sellers of a pair of currencies. Most of the banks except the major ones deal through brokers who purchase and sell on behalf of others. Brokers possess more information and better knowledge of market.

The **price takers** in the foreign market are those who buy the foreign exchange which they require and sell what they earn at the price determined by the primary price makers.

Indian Foreign Exchange Market is made up of three tiers. In the **first,** the dealings take place between Reserve Bank of India and Authorised Dealers (ADs) comprising mainly commercial banks. In the **second** tier the ADs deal with each other and in the **third** the ADs deal with their corporate customers. The retail market mainly caters to the tourists. In this segment there are money changers who deal in foreign currencies.

12.6 DEALING ROOM TRANSACTIONS

TREASURY OPERATIONS

The Treasury of a commercial bank or financial institution can be described as an independent profit centre within the organisation which deals specifically with optimising returns on surplus resources or arranging resources at the lowest cost. In a commercial bank the treasury operations are normally divided into four activities:

Call Money Operations involve management of short term financial resources so that the bank meets its obligations as per the Cash Reserve Ratio (CRR) stipulated by the RBI at a given time.

Securities Operations involve management of medium and long term financial resources and requirements, thereby ensuring compliance of the Statutory Liquidity Ratio (SLR) specified by RBI from time to time. Debt instrument values have an inverse relationship with nominal interest rates and it is the prime objective of this group to protect the bank from interest rate risk, on investments in debt securities.

Commodity Operations involve buying and selling of commodities for clients as well as an proprietary basis. Therefore this group operates as both a service delivery channel to customers and generating trading profits for the bank.

Foreign Currency Operations involve buying and selling of foreign currencies and providing all international trade related services to the banks customers. This group also undertakes speculative and arbitrage transactions on behalf of the bank. All such activities are collectively called Foreign Exchange Dealing Room Operations.

12.7 FOREIGN EXCHANGE DEALING ROOM OPERATIONS

It is a profit centre for the bank and functions as a centralised service branch to meet the needs of all other branches to buy/sell foreign currencies. It is manned by specially trained personnel called 'dealers or traders', who undertake all foreign currency treasury operations.

The primary function of the Dealing Room is to provide rates for various transactions being put through at branch level with customers. Therefore every foreign currency related transaction gets reported to the Dealing room. Rates provided by a bank to its customers are called 'Merchant Rates'. These rates can be subdivided as:

Card Rates - at the start of every trading day the market first establishes the vehicle currency quotation. The dealers then prepare cross rates for currencies normally used by their customers. Profit margins are loaded for different categories of transactions and tabulated under eight heads: TT Buying, Bills Buying, TC Buying, CN Buying, TT Selling, Bills Selling, TC Selling and CN Selling. These rates collectively called Card Rates are conveyed to all branches. All transactions undertaken at branches involving amounts less than USD 5000 or equivalent during the day are put through at the Card Rates. These rates generally remain constant for the given day. (TC = travellers cheque, CN = Currency banknote, TT = telegraphic transfer, Bills = Documentary transactions).

Ready Rates - when branches receive transactions involving amounts to excess of USD 5000 or equivalent, a transaction specific rate is provided by the Dealing Room in each case based on the ongoing market rate. Thus, while Card Rates are standardised, Ready Rates are customised. These rates are finer than Card Rates in terms of profit margins.

Transactions reported throughout the day are segregated currency - wise and separate dealers consolidate the exposure of the bank in each currency on an on-going basis. Depending on the view of the dealer the exposures are covered in the inter-bank market. The Dealing Room therefore represents the point of interface between the Retail and Wholesale components of the forex market.

Currency exposures are called 'positions.' A 'position' can therefore be described as an uncovered transaction in which the bank has assumed exchange rate risk by providing a committed rate to the opposite party. A dealer has to maintain two positions - funds position and currency position. The funds position reflects inflows and outflows of funds i.e. receivables and payables. A mismatch in funds position will expose the bank to interest rate risks in the form of overdraft interest in the Nostro a/c, loss of interest income on credit balances etc. Currency position deals with overbought and oversold positions, arrived after taking various merchant and/or inter-bank transactions. The overall net currency position exposes the dealer to exchange risks from market rate movements. Transactions undertaken in the inter-bank market to eliminate merchant exposures are called 'Cover Transactions'.

Customers of the bank require derivatives for hedging their currency risks. Forward Contracts and Swaps being OTC derivatives, they are provided by banks. Providing rates for such transactions and covering the same is also the function of the dealers.

An important feature of a dealer's job is to keep abreast of market developments, international events and news items which would have an impact on exchange rates. This helps them to take informed decisions regarding open positions to be maintained.

Dealers are required to comply with the Code of Conduct specified by RBI, and operational guidelines provided by the Foreign Exchange Dealers Association of India (FEDAI).

12.8 STRUCTURE

A standard structure of the dealing operations in a commercial bank involves three compartments:

Front Office: It is manned by dealers who represent the bank in all market operations at both retail and wholesale levels. They therefore function as the 'face' of the bank in the market. All dealing operations take place in this compartment.

Mid Office: This section deals with the risk management function. The parameters for evaluating and controlling risks are established by this section. Every transaction undertaken by a dealer is recorded in a 'Deal Slip' which provides all particulars of the transaction. Each deal slip is processed in this section to ensure adherence to all risk control limits specified by the management.

These control limits include:

- Limits on intra-day open position in each currency called 'Daylight limits'. (Exposure control).
- Limits on overnight open positions in each currency (lower than intra-day)called 'Overnight limits'. (Exposure Control)
- Limits on aggregate open position for all currencies. (Exposure control)
- Stop-loss limits. (For each currency) (Control over loss), A turnover limit on daily transaction volume for all currencies. (Control of overtrading)
- Deal Size limits. (Distribution of Risk)
- Country-wise exposure limits. (Control of Market Risk)
- Broker-wise business limits. (Control of Operational Risk)
- Counterparty limits. (Control of Credit Risk)
- Forward settlement date-wise limits. (Control of Settlement Risk)
- Currency-wise Individual Gap Limits (IGL's) - (Control of Maturity Risk / Interest Rate Risk)

- Currency-wise Aggregate Gap Limits (AGL's) - (Control of Maturity Risk / Interest Rate Risk)

The Mid Office therefore represents the Risk Management hub of all dealing operations. It provides a constant flow of market information to the dealers.

Back Office: Takes care of processing deals, maintaining mirror accounts (or nostro accounts reconciliation, recording of utilisation of forward contracts by customers, recovering overdue interest, preparing returns to be submitted to RBI, etc. It represents the administrative hub of all dealing operations.

12.9 DEALING ROOM TRANSACTIONS

All transactions in the dealing room can be classified as either:

- Merchant transactions entered into with customers of the bank and

- Interbank transactions undertaken with other banks or institutions.

Merchant Transactions: Customers of the bank continuously approach the bank for rates for various types of transactions. Either Card or Ready rates are applied depending on the volume of each transaction. Every deal is reported to the dealing room where it is recorded into the respective currency position. The impact of the deal on the funds position and forward gaps is also recorded separately. The evolving open currency position is offset through opposite transactions in the interbank market. These are called 'Cover Transactions'. All merchant deals are customised in nature.

Interbank Transactions: Such transactions are undertaken either to 'Cover' merchant transactions to lock the profit margins or represent proprietary trading or speculative transactions done in keeping with the view of the dealers regarding anticipated rate movements. All such transactions are conducted at interbank rates and are standardised in nature. Interbank deals are classified in terms of their settlement maturity i.e. Cash, Tom, Spot or Forward.

Irrespective of the nature of the transaction, they are each recorded in 'Deal Slips' providing full particulars and forwarded to the Mid-Office. This section processes each deal slip against all control parameters specified by the management. The deal slip then gets forwarded to the Back-Office.

In addition to verification of adherence to the control limits the mid-office also maintains a 'Rate Scan System'. Market rates are recorded at fixed intervals to cross check that deals have been done at reasonable rates and that there are no wide variations from the market rates at the corresponding deal timings.

Dealing Rooms in India are now required to maintain 'Voice Recording Systems.' Most deals are concluded verbally on 'Over-the-phone' (OTP) basis and are therefore subject to mis-understandings, mis-interpretations and disputes. Therefore all conversations in the dealing room between banks, bank and brokers with customers, branches and between dealing staff are recorded and stored for minimum six months. These records are kept to verify the stand taken by market participants in the case of disputes, litigations etc.

The back-office is the administrative section where the deal is actually processed. Each deal is recorded in term of maturity, confirmed with counterparties, settled through receipt/payment of respective currencies etc. All statistical and regulatory returns are compiled by this section.

12.10 DISTINCTION BETWEEN MERCHANT AND INTERBANK TRANSACTIONS

Sr. No.	Merchant Transactions	Interbank Transactions
1.	Represent transactions between the bank and its customers.	Represent transactions between the bank and other banks or institutions.
2.	Transactions are initiated by the customers. (end-users).	Transactions are initiated by the bank to cover merchant deals or acquire speculative positions.
3.	Customised deals.	Standardised deals.
4.	Do not involve brokers.	May or may not involve brokers.
5.	Conducted at merchant rates which are quoted to nearest 0.0025 paisa.	Conducted at interbank rates which are quoted to nearest 0.0005 paisa.

6.	Transactions classified as per rate types: TT, Bills, TC and CN.	Transactions classified in terms of settlements types: Cash, Tom, Spot and Forward.
7.	Represent the retail segment of the market and are governed by Exchange Control Regulation of RBI.	Represent the wholesale segment of the market and are subject to RBI rules and guidelines of the FEDAI.

12.11 SUMMARY

Foreign exchange market is not a physical place, but an organisational mechanism operating through satellite link SWIFT (Society for World Wide International Financial Transactions), headquarters in Brussels, Belgium - Europe.

This operates works round the clock. The forex market is an over-the-counter (OTC) market, which means that there is no central exchange and clearing house where orders are matched.

Currencies are traded in different market makers such as Inter Bank Market and Online Market Maker. Each market works at different hours.

The primary objective of the foreign exchange market is to facilitate international trade and investment, by allowing end-users to convert one currency into another. The conversion rates between currencies are called foreign exchange rates. The market also facilitates speculation, arbitrage and borrowing/lending of currencies for financing different transactions. Therefore this market connects exchange rates with interest rates. The modern foreign exchange market started with the introduction of the “Flexible Exchange Rate System” during the 1970s. The characteristics is discussed.

The main participants in the foreign exchange market are (i) retail clients (ii) commercial banks (iii) foreign exchange brokers and other authorised agents. The central banks too participate in this market as per its policy decisions.

Foreign exchange dealing room is a profit centre for the bank and functions as a centralised service branch to meet the needs of all other branches to buy/sell foreign currencies. It is manned by specially trained personnel called 'dealers or traders', who undertake all foreign currency treasury operations. The primary function of the Dealing Room is to provide rates for various transactions being put through at branch level with customers. Therefore every foreign currency related transaction gets reported to the Dealing room. Rates provided by a bank to its customers are called 'Merchant Rates'.

The structure of the foreign exchange dealing room is divided into front office, mid office and back office. There are two types of transactions in the dealing room and they are merchant transactions and interbank transactions. The difference between the two transactions is mentioned.

Check Your Progress

1. Fill in the blanks:

a. Foreign Exchange Market is an organisational mechanism operating through satellite link --------------------------. (SWIFT, SFIT, RIFD)

b. Foreign exchange market is ------------ market. (OTC, OTR, OTB)

c. During 1970's ------------ system was commonly used. (Managed Float System, Flexible Exchange Rate System, Fixed Exchange Rate system)

d. Main participants of foreign exchange market are: retail clients, commercial banks, foreign exchange brokers and --------------. (Authorised dealers, speculators, hedgers, arbitrageurs)

e. Rates provided by a bank to its customers are called '---------------------'. (Merchant rates, interbank rates, spot rates)

Q2. Answer the following:

a. What is foreign exchange market? State its characteristics.

b. Explain the following concepts:

i. Merchant rates

ii. Card rates

iii. Ready rates

iv. Merchant transactions

v. Inter bank transactions

Q3. Write short notes on the following:

i. Forex market

ii. Dealing room operations

iii. Dealing room transactions

iv. Treasury operations

Q4. Distinguish between Merchant transactions and inter-bank transactions.

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13

FOREIGN EXCHANGE TRANSACTION

Unit Structure

13.0 LEARNING OUTCOMES

After learning this chapter, a learner will be able to understand

- Meaning of FIAT currency
- NOSTRO, VOSTRO and LORO accounts
- The meaning of correspondent banks
- BOP statements
- Demand and Supply Factors in Exchange rate Determination

Foreign Exchange Market

The need for a foreign exchange market arises out of the fact that the power of domestic legal tender, circulating in the form of currency notes, to redeem commercial liabilities legally, is limited by national boundaries. Both the seller and the buyer want to receive and make payment in their respective domestic currencies. The task of fulfilling this requirement is handled by international commercial banks.

All countries have their own currencies like India - Indian Rupee, United States - US Dollars, United Kingdom - Sterling Pound etc. Any economic transaction that takes place between residents of two different countries involve exchange of some currency between those two residents. This may involve import/export of goods or services, investments or redemptions, borrowing/lending. or personal transfers such as family maintenance, tourism etc. In all these cases, the source of purchasing power is available in one currency whereas its utilisation after conversion is in another currency. When these transactions get executed through the intermediation of banks, one currency gets converted into another. This process is called 'Foreign Exchange.'

13.1 ELEMENTS OF A FOREIGN EXCHANGE TRANSACTION

Presuming 'X' wishes to buy pen for USDOLLAR 1 and is prepared to pay Rs. 45 for the same then, 'X' would expect to be relieved of his liability on payment of Rs. 45 whereas the foreign supplier would demand satisfaction through payment of USDOLLAR 1. Thus an intermediary would become necessary who would accept Rs. 45 from 'X' and pay USDOLLAR 1 to the foreign supplier. This role is always played by international commercial banks.

Now, 'X' would pay Rs. 45 to his bank which would then send a message to their overseas agent (called correspondent bank) to pay the supplier the corresponding amount in foreign currency from the account (called NOSTRO account) maintained with the agent.

Concepts of Foreign Exchange Transaction

FIAT currencies

FIAT currencies are paper currency notes issued by the Central Monetary Authority of the respective countries, incorporating a promise to redeem these notes at face value. The intrinsic value of these notes is always less than the face value. The notes derive their ability to discharge commercial liabilities up to the face value through the legally enforceable promise of the note issuing authority contained in the notes.

Foreign Currency

It can be defined as the legal tender applicable in a country outside the domestic area. Thus a foreign currency represents 'money' only in the country of issue. All other locations it should be viewed as a commodity having time value.

The Foreign Exchange Management Act, 1999, defines:
'Foreign Exchange means foreign currency and includes -
1. Deposits, credits and balances payable in any foreign currency;

2. Drafts, traveller's cheques, letters of credit or bills of exchange, expressed or drawn in Indian currency but payable in any foreign currency; and

3. Drafts, traveller's cheques, letters of credit or bills of exchange drawn by banks, institutions or persons outside India, but payable in Indian Currency."

The term 'foreign currency' and 'foreign exchange' are thus interchangeable, but, 'foreign currency' should be viewed as the commodity being bought or sold e.g. US dollar, pound sterling etc. whereas 'foreign exchange' should be viewed as the process of purchasing/selling currencies, that is, the mechanism by which one currency gets converted into another. Foreign currency would include NOSTRO balances and instruments.

NOSTRO accounts

Demand deposit accounts, denominated in foreign currencies maintained by domestic banks with banks overseas are called NOSTRO accounts. Nostro means 'our account with you'. For instance, if Bank of Maharashtra, Mumbai has a US Dollar account with Citibank, New York, then such an account would be called NOSTRO account.

VOSTRO accounts

Demand deposits accounts denominated in domestic currency maintained by overseas banks with domestic banks are called VOSTRO accounts. Vostro means 'your account with us'. For example, if Barclays Bank, London has an INR account with Punjab National Bank, Mumbai then such an account would be called VOSTRO account.

LORO accounts

The term LORO is used when the NOSTRO/VOSTRO account is referred to by a bank other than the account maintaining bank and the bank with which the account is maintained. In simpler words, it is used when referring to third party accounts. For example, if Bank of India, Mumbai has an account with Citibank, New York denominated in US Dollars then when Bank of Baroda has to refer to this account which corresponding with Citibank, it would be referred to as LORO account, meaning 'their account with you.'

NOTE: (a) The nationality of the banks at both ends is not material to this classification. If Deutsche Bank, Mumbai (GERMAN Bank) has a US Dollar denominated account with Barclays Bank New

York (British Bank), the account would still be classified as a NOSTRO account.

NOTE: (b) Every such account can be classified as both NOSTRO and VOSTRO depending on whether the reference is being made from domestic or foreign perspective. If SBI Mumbai has a US Dollar account with Citibank, New York, it is a NOSTRO account from Indian perspective but a VOSTRO account from US perspective.

The structure of the transaction shows that when the transaction is denominated in a foreign currency the exchange is effected by a bank located at a domestic centre whereas when the transaction is denominated in the domestic currency the exchange is effected by a bank located at a foreign centre. In effect, the entities at the two ends of the transaction purchase / sell the foreign currency whereas the actual exchange (the conversion) is undertaken by the intermediating banks.

Correspondent Banks

The foreign exchange market functions around the system of transfers and payments established between international commercial banks. This mechanism operates through NOSTRO and VOSTRO accounts being maintained by banks in different countries. The bank with whom such a NOSTRO or VOSTRO account relationship is established is called correspondent bank. This bank (in whose books the account is created) essentially acts as an agent of the bank in whose name the account stands (principal) and undertakes various functions is as follows:

1. Maintaining the foreign currency account and receiving and making payments on behalf of the counterparty (Principal) bank.
2. Providing temporary overdrafts as and when necessary.
3. Providing credit reports on companies located in the country of the correspondent bank.
4. Assisting the principal bank in all agency functions such as presentation of documents, advising of LC, confirmation of LC, reimbursing the negotiating bank etc.
5. Providing trade related data and product data to help the principal bank, provide information for business development to their customers.

All communications between correspondent banks are generally conducted through a unique code mechanism which overcomes security related problems. The concept of correspondent banking has developed because it is not always financially viable to establish representative offices or branches in various countries due to inadequate volume of business and high capital cost of multinational banking model.

Foreign Exchange

It can be defined as a transaction or mechanism which facilitates the exchange between one legal tender and another. It involves transfers through demand deposit accounts at both ends of an international transaction. The actual conversion takes place through the use of NOSTRO/VOSTRO accounts between international banks.

Foreign Exchange Market

The ability of FIAT currencies to discharge commercial liabilities is limited by national boundaries. This limitation gives rise to the need for a foreign exchange market facilitating exchange between currencies. The foreign exchange market can be defined as an electronically connected network of international banks, brokers and service providers:

The main characteristics of this market are:

1. This market does not involve any physical transfer of currencies in the form of cash.
2. This market does not have any physical structure (It is an OTP market).
3. This market helps to establish the rate of conversion between currencies. The conversion rates are called foreign exchange rates.
4. Receipts and payments in foreign currencies take place by way of transfers to and from demand deposit accounts at both ends of the transaction. This process is facilitated by international banks through NOSTRO/VOSTRO accounts maintained with correspondent banks.

Role of Banks in Foreign Exchange Transactions

Since only commercial banks provide demand deposit accounts which are essential for any foreign exchange transaction to be executed, every transaction involving foreign exchange therefore passes through the international banking sector. The actual conversion takes place through the NOSTRO and VOSTRO accounts maintained between banks. Effectively, banks are the best placed participants in the foreign exchange market to establish the demand - supply equilibrium between currencies. Thus, the activity of quoting foreign exchange rates is associated with international commercial banks.

The foreign exchange market includes end-users (individuals and corporate) commercial banks, brokers, Central Banks and service providers.

(Messaging service providers: SWIFT etc. Information service providers: Reuters, Telerate, Bloomberg etc.)

The foreign exchange market provides the environment for establishing the demand supply equilibrium between currencies based on which the rate of conversion is established. Thus the rate of exchange for a currency is known from the quotation in the foreign exchange market. The banks operating at a given financial centre, and dealing in foreign exchange, constitute/represent the foreign exchange market. The rates in the foreign exchange market are determined by the interaction of the forces of demand for and supply of the commodity dealt in, viz: foreign currencies. Foreign currencies cannot be created domestically. Therefore, every country strives to balance the inflows and outflows of foreign currencies. Therefore, the need arises for regulating or controlling foreign currency transactions. In India such measures are collectively called 'Exchange Control Regulations.' (ECR).

From the foregoing we can deduce that:

- Trade is the basis for international monetary flows.
- International trade contributes to economic growth.
- Trade transactions involve conversion between currencies.
- The ratio of conversion is called the Foreign Exchange Rate.
- The environment in which the exchange rate is established is called the Foreign Exchange Market. This rate is based on the demand supply factors affecting each currency pair.

13.2 BALANCE OF PAYMENTS AS DETRIMINANT OF DEMAND FOR AND SUPPLY OF CURRENCY

In the present context exchange rates in most major economies (exception: China) follow the Floating Exchange Rate System, which means that exchange rates are established through market demand - supply equilibrium. Demand - supply of currencies is based on currency flows into and out of the economy. The factors which contribute to such flows are:

- Export and Import of goods and services.
- Personal remittances.

- Investments and Redemptions.
- Borrowing and Lending.

All the above transactions pertaining to an economy over a given period are captured in the Balance of Payments Account (BOP) for the country.

BALANCE OF PAYMENTS

Definition

The BOP of a country is a systematic account, in the form of summarised record, of all economic transactions between residents of a country and non-residents over a given period. (normally the BOP covers a period of one year). The account is prepared using the double entry accounting system with both the debit and credit aspects of each transaction being recorded under different heads within the account which implies that the BOP account always balances. (i.e Debit and Credit summations are equal).

COMPONENTS OF BOP ACCOUNT

The BOP account has three components:

a) Current Account

b) Capital Account

c) Reverse Account

a) Current Account

The current account of the BOP is made up of three balances viz., Merchandise (Visibles) balance, Services (Invisibles) balance and Unilateral Transfers Balance. Effectively it reflects the net flow of goods, services and unilateral transfers (gifts, donations, legacies etc.) Balance on current account can thus be defined as the net value of the balances of visible trade, invisible trade and unilateral transfers.

Balance of Trade (BOT) is described as the difference between the value of merchandise (goods) exports and the value of merchandise imports. It can also be described as the 'Goods Balance' or the 'Balance of Merchandise Trade.' This balance reflects the country's capacity to provide material requirements of the population. An 'active' (positive) or 'passive' (negative) BOT by itself does not signify economic status. An analysis of the underlying elements of exports and imports is critical. The BOT represents the net trade in tangibles.

BOP on current account thus covers all receipts and payments arising out of trade and personal remittances. There is no reverse flow in current account transactions. This means that the Current Account represents all self-liquidating transactions which constitute 'ready' or immediate demand for and supply of currencies for an economy over a given period. It thus has a direct impact on the exchange rate of the domestic currency.

b) Capital Account

The Capital Account records all international transactions that involve creation of assets and liabilities in foreign currencies. These transactions involve a 'reverse flow' e.g. a loan taken in a foreign currency creates a ready inflow with a corresponding future liability/payable. On maturity of the loan, the (reverse)outflow would take place. The Capital Account thus records all 'receivables and payables' which would impact the demand - supply equilibrium in the future. The classification of a transaction as either current or capital therefore does not depend on the nature of the asset but on the nature of the transaction.

The net effect of the Current and Capital accounts taken together represents the status of the BOP. If the net effect is positive, that is, inflows are more than outflows, then the BOP is said to be 'Surplus', whereas, if the net effect is negative, that ism outflows are more than inflows, then the BOP is said to be 'Deficit'.

Surplus or Deficit in Balance of Payments Account;

Accommodating & Autonomous Capital Flows Concept

An autonomous transaction is a transaction undertaken in the normal course of business in response to the given environment of price levels, exchange rates, interest rates etc. It does not take into account the equilibrium aspect of the BOP. An accommodating transaction is a transaction undertaken with the specific intention of adjusting the imbalance arising out of other transactions. All foreign currency flows can thus be classified as 'autonomous' or 'accommodating'. Obviously the net effect of the accommodating and autonomous items must be zero, since all entries in the BOP account must get reflected under one of the two headings. (The BOP always). Whether the BOP is in surplus or deficit depends on the balance of the autonomous items. The BOP is said to be in surplus if autonomous receipts are greater than the autonomous payments and in deficit if vice versa. Autonomous transactions are viewed as 'above the line whereas accommodating transactions are viewed as 'below the line.'

Effectively all the elements of currency flows captured in the Balance of Payments get recorded in either the Current or Capital Accounts which together constitute the 'Autonomous Transactions'.

The monetary authority through the use of the Reserve Account makes the necessary adjustments for balancing the above transactions and these transactions therefore represents 'Accommodating Transactions.'

Distinction between Autonomous and Accommodating Transactions

Sr. No.	Autonomous Transactions	Accommodating Transactions
1.	These transactions are undertaken in the normal course of business without considering the equilibrium of the BOP.	These transactions are undertaken with the specific intention of balancing the BOP.
2.	These transactions effectively represent Current and Capital Account transactions.	These transactions effectively represent Reserve Account Transactions.
3.	These are classified as "Above the line' transactions.	These are classified as 'Below the Line' transactions.
4.	These transactions are normally undertaken by market participants other than the Central Bank.	These transactions are undertaken by the Central Bank.
5.	BOP is surplus if net balance of autonomous transactions is positive. BOP is deficit if net balance of autonomous transactions is negative.	Surplus BOP is an increase in reserves whereas a deficit BOP results is a decrease in reserves account.
6.	In the case of economies using the Fixed exchange rate system or the Managed Float System, the Central Bank participates in the domestic market through the Reserve Account transactions (accommodating transactions) which adjust the imbalance in the Autonomous transactions. Thus both types of transactions exist in such systems.	In the case of economies using the independent float system, the Central Bank does not participate in the market which implies that there is no change in Reserve Account. This means there are no Accommodating transactions and Autonomous transactions self-balance. Thus only Autonomous transactions exist in such a system.

The Official Settlement Concept

Another approach for indicating, a deficit or surplus in the BOP is to consider whether the net monetary transfer that has been made by the monetary authority is positive or negative. This means that the transfer to or from the Reserve Account represents the extent of accommodation being provided by the monetary authority for balancing the surplus / deficit in the autonomous transactions. Effectively, the monetary authority settles the disequilibrium in the BOP and hence such actions are called 'Official Settlements'.

If the net transfer by way of official settlements is negative i.e there is an outflow from Reserve Account then the BOP is said to be in deficit, and if there is an inflow then it is surplus. This means that the monetary authorities are the ultimate financers of any deficit in the balance of payments or the recipients of any surplus. The official settlements thus represent the accommodating items, whereas all others are autonomous.

The monetary authorities may finance a deficit by reducing their reserves of foreign currencies, by borrowing from multilateral institutions or by borrowing from foreign monetary authorities. The settlements approach has greater relevance under the Fixed Exchange Rate System than the Flexible Exchange Rate System since participation of the monetary authority in managing the demand - supply equilibrium is implied in pegged rates.

Current Account Monetary Model

This model is based on the Purchasing Power Parity theory and on the assumption that flexible exchange rates keep the balance of payment in continuous equilibrium. Consequently, it is implied that there are no changes in foreign exchange reserves. Nominal domestic money supply is determined by domestic credit creation which is controlled by domestic monetary authorities. The monetary authority is not bound by any compulsion to intervene in markets for protecting the exchange rate.

The philosophy of this model is that domestic residents, when faced with an imbalance between the desired amount of domestic money and the actual amount of domestic money created by the monetary authority will strive to correct it by creating a balance of payments deficit or surplus. If there is excess supply of domestic money it would be used to purchase both domestic goods as well as foreign goods and services. This will result in a higher domestic price level (inflation) and depreciation of the exchange rate. If there is excess demand for domestic currency then the exchange rate of the domestic currency will appreciate.

Capital Account Monetary Model

This Model was developed by economist Frankel in 1979. The Frankel model suggests (like the current account monetary model) that an increase in domestic money supply will, in the long-run depreciate the domestic money supply will, in the long-run depreciate the domestic currency while an increase in demand for the domestic currency will lead to its appreciation. The interest rate of a currency also has an impact on the appreciation or depreciation of the domestic currency. If interest rate increase due to tight monetary conditions i.e: greater demand for the domestic currency, then the currency would appreciate whereas if the interest rate increase is a consequence of higher inflation then the currency would depreciate.

Detailed Outline of the BoP Statement & Sub Accounts

Balance of Payments is a summary of all the transactions between the residents of one country and non-residents for a given period of time, usually one year. A BoP statement (revised) includes the following sub accounts, as shown in the table below:

Items	Credits	Debits	Net
A. Current Account			
1. Merchandise			
a. Private			
b. Official			
Non-Monetary gold account.			
2. Invisibles			
a. Transportation			
b. Travel			
c. Insurance			
d. Investment Income			
e. Government (not included elsewhere)			
f. Miscellaneous			
3. Transfer Payments (Unilateral Transfers)			
a. Private			
b. Official			
Total Current Account (1+2+3)			
B. Capital Account			
1. Private			
a. Short term			
b. Long term			
2. Banking			
a. Short term			
b. Long term			

3. Official a. Loans b. Amortisation c. Miscellaneous Total Capital Account (1+2+3) Errors and Omissions Account			
C. Reserves Account a. IMF Account b. SDR Account c. Reserve - Monetary gold account - Foreign currency account			

Note: This is not the official format of the BoP but a simplified version to facilitate understanding of the concepts discussed herein.

Benefits of BoP Analysis

1. It helps to identify areas of strength within the economy where the country enjoys a comparative advantage. This enables the government to channelise resources to optimise resource utilisation.

2. It helps to identify areas of weakness in the economy which require protection against foreign competition. This is achieved through qualitative and quantitative trade restrictions.

3. It helps the government to rationalise direct and indirect taxes. The purchasing power of the domestic currency (as reflected by the changes in the BoP) in relation to income levels, guides the government in this regard.

4. It identifies changes in consumption trends which guides the government in changing policies. Transaction-wise limits fixed under the Exchange Control Restrictions are governed by such studies.

5. It represents the basis on which the government makes changes in trade and investment policies, including sector-wise limits for Foreign Direct Investments, range of investment avenues available to Foreign Portfolio Investors etc.

13.3 ADJUSTMENT OF BOP IMBALANCES

If the domestic expenditure of the economy is more than the domestic output, then it results in balance of payment deficit. The difference represents excess of imports over exports. Therefore, the monetary authority takes measures to reduce the domestic expenditure to eliminate BOP deficit. The effort to reduce budget and fiscal deficit by the government represents its attempt to reduce expenditure. The different policies adopted for reducing/eliminating BOP deficit are:

1). Monetary Policies

2) Fiscal Policies

3) Trade Policies

4) Devaluation/Depreciation of exchange rate

Monetary Policies

The usual monetary policies adopted by the government in such a situation are:

The usual monetary policies adopted by the government in such a situation are:

a. Increase in the interest rates (Cost of money increases)

b. Increase in Cash Reserve Ratio or Statutory Liquidity Ration (reduces credit creation)

c. Issue government treasury bills, bonds and securities by way of open market operations (reduces money in circulation)

d. Increase margin requirements. (reduces borrowing capacity)

The ultimate effect of these policies is that the money with the public reduces and the market velocity reduces. When the money with the public reduces, the consumption expenditure also declines thus reducing the BOP deficit.

Fiscal Policies

Fiscal policies relate to the Government Budget. The income side of the budget comprises the direct and indirect taxes collected by the government. Increase in direct taxes i.e. income tax etc. reduces the disposable income of the population which reduces both consumption and savings. An increase in indirect taxes like customs duty, excise duty etc. increases the cost of acquiring goods and services reducing consumption. Historically changes in fiscal policies have been more effective in reducing expenditure/deficit.

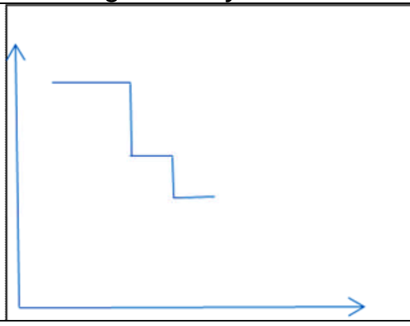
Trade Policies

If the major cause of BOP deficit is the adverse balance of trade, then trade policy changes are very effective. In such situations the government tends to promote exports and import substitution and to achieve this objective announces promotional policies providing subsidies and incentives to exporters such as concessional credit, reduced margins on borrowings, income tax benefits, reliefs in excise duties, customs duties and concessions in other inputs such as transportation, land, electricity, power and raw materials.

Devaluation / Depreciation of Exchange Rate:

Economies which operate on either a fixed exchange rate system or a Managed Float System use the exchange rate to achieve equilibrium in international trade. Devaluation is a conscious step taken by the monetary authority to reduce the exchange rate of the domestic currency whereas depreciation is a market led reduction in the currency value. Both result in increasing the cost of imports and make exports more profitable. The higher cost of foreign currencies reduces imports and boosts exports thereby reducing the trade deficit and achieving equilibrium.

Distinction between Devaluation and Depreciation

Sr. No.	Devaluation	Depreciation
1.	Represents reduction in the value of the currency through official action.	Represents reduction in the value of the currency through market action.
2.	It is a one time action.	It is a continuous process.
3.	It cannot be predicted.	It can be anticipated.
4.	Associated with fixed exchange rate system.	Associated with flexible exchange rate system.
5.		

13.4 DEMAND - SUPPLY FACTORS IN EXCHANGE RATE DETERMINATION

The foreign exchange rate is the relative price of one currency in terms of another. In the context of floating exchange rates, these prices should be determined by forces of supply and demand. The objective is to correctly incorporate all the factors that influence the demand for and the supply of currency. Foreign currencies represent commodities and as in the case of all such assets, the price at any time i.e the spot exchange rate, is influenced by anticipations regarding the future changes in the price and these expectations are in turn influenced by economic events, political developments, resource discoveries, technological developments etc. Demand for any given currency in the international markets arises from private end users i.e. individuals and corporate entities who undertake foreign currency transactions and central banks who hold a part of their reserves in the currency. Similarly, supply of the foreign currency arises out of non-residents wishing to buy domestic country goods and services, acquire domestic currency denominated assets, service liabilities and central bank interventions. Exchange rate is the equilibrium price that equates these factors.

The BoP theory of Exchange Rate determination is therefore the connecting link between demand supply of foreign exchange due to current account transactions, the corresponding asset / liability values represented by Capital account and Reserve Account transactions which help to balance the net surplus or deficit.

13.5 FACTORS AFFECTING FOREIGN EXCHANGE RATES

Foreign Exchange rates are influenced by several factors in the international market. All tangible factors that is, those which represent quantifiable commercial and personal transactions are captured in the BoP Account and the net disequilibrium in the BoP represents the single most important demand-supply element affecting an exchange rate. However, 90% of the volume in the foreign exchange market is made of speculative transactions, which are transactions without any underlying commercial base. These transactions are undertaken in anticipation of future changes in demand or supply. Factors which influence the trading decisions of speculators are called intangible factors since their impact cannot be quantified. These factors such as Economic indicators, political changes, Psychological elements etc. which also influence the exchange rate can be summarised as follows:

A. Gross Domestic Product (GDP)

GDP is the broadest measure of aggregate economic activity in a country and represents the total value of final goods and services produced in a country. GDP is the primary indicator of the strength of economic activity. So, the growth in the GDP positively influences the foreign exchange price of the currency. A fast growing economy will reflect strength in the exchange rate and vice versa.

B. Trade Balance

This represents the difference between imports and exports of tangible goods. The changes in exports and imports are recorded in the current account of the BoP and therefore have a ready/immediate effect on the demand - supply equation. This data is thus widely followed by the foreign exchange market. A positive BoT would result in an appreciation in the domestic currency which would make imports cheaper and exports costlier and vice versa.

C. Inflation

Inflation is the rate of change in the price level of a fixed basket of goods and services in an economy. In most countries the most widely followed measure of inflation is the Consumer Price Index (CPI) i.e rate of change in the price level of a fixed basket of goods and services purchased by consumers. Inflation reduces the purchasing power of the currency. This reduction in domestic purchasing power gets reflected internationally through depreciation in the exchange rate of the domestic currency.

D. Employment Levels

Employment levels in an economy reflect the development and stability in the economy. An expanding economy would result in greater investments which would result in more employment generation. This increases income within the economy resulting in higher consumption and savings. This again would mean more investments and the economy would continue in its growth trajectory. Higher employment data therefore reflects a growing economy and leads to appreciation in the domestic currency.

E. Interest Rate Differentials

Interest rate applicable to a currency has a dual impact on the currency valuation. If increase in the interest rate is a reflection of the strength of the economy then it would have a positive effect on the exchange rate. However if the interest rates increase due to expectations of higher inflation then it would have a negative effect on the value of the currency. In any exchange rate there are two currencies involved. Therefore, there are situations when interest rates of both currencies may rise simultaneously. In such situations the interest rate differential is relevant. Sometimes the interest rates of the two currencies could move in opposite directions thereby increasing the gap between the two. In such cases the effect on the exchange rate would be more pronounced.

F. Exchange Rate Policy

In many countries the exchange rate policy is decided by the Finance Ministry i.e by the government while monetary policy is decided by the central bank. However, the execution of the exchange rate policy is always managed by the Central Bank. The Central Bank of the country participates in the local foreign exchange market by way of intervention to stabilise the exchange rate or maintain it in a particular range. This also affects the exchange rate of the currency.

G. Political Factors

The forex market can be influenced by political events and changes. These events may be anticipated or unforeseen. Some of the common political developments are elections, public announcements by Central Bank or government officials, military takeovers, political instability etc. All such factors affect the exchange rate.

H. View of Speculators

More than 90% of the turnover in international foreign exchange markets represents speculative activity. The view or perception of the likely value of the currency of these participants in the market has a critical effect on the exchange rate.

These are some of the factors that affect the exchange rate but the objective of establishing a precise model for rate determination is a complex task because individual factors work together or in isolation in different proportions at different times.

At the centre of this complex environment are the forces of demand and supply that determine the prices of commodities in a free market. In the foreign exchange market, the commodity is the foreign currency. If at any given rate, the demand for a currency is greater than its supply, its price will rise. If supply exceeds demand, the price will fall.

The supply of a nation's currency is determined by that nation's monetary authority, which is usually its Central Bank. Government and Central Banks closely monitor economic activity to keep money supply at a level appropriate to achieve their economic goals. Too much money increases inflation, causing the value of the currency to decline and prices to rise, whereas too little money would slow economic growth and possibly cause unemployment.

The demand for and supply of a currency ultimately originates with the end users. The governments set monetary policy through their central banks to fulfill the needs of their residents. Banks equalise the supply and demand by trading with each other. The Central banks ultimately undertake the balancing act between the domestic economy and the external economy represented by the exchange rate and management of reserves.

SUMMARY

- The need for a foreign exchange market arises out of the fact that the power of domestic legal tender, circulating in the form of currency notes, to redeem commercial liabilities legally, is limited by national boundaries.
- NOSTRO and VOSTRO accounts are opened and maintained by the Correspondent Banks.
- Foreign Exchange deals with currency while forex rate represents the rate which is fixed.
- Since only commercial banks provide demand deposit accounts which are essential for any foreign exchange transaction to be executed, every transaction involving foreign exchange therefore passes through the international banking sector.
- The BOP of a country is a systematic account, in the form of summarised record, of all economic transactions between residents of a country and non-residents over a given period.
- An imbalance in BoP creates either surplus or deficit. These could be adjusted through monetary, fiscal, trade policies, devaluation and depreciation of exchange rate as well.
- GDP, Trade balance, inflation, employment levels, interest rate differentials, exchange rate policy political factors and view of speculators influence exchange rates.

QUESTIONS

Q1. Explain the following concepts

a. FIAT currency

b. Foreign Currency

c. Foreign Exchange

d. Foreign Exchange Market

e. Correspondent Bank

f. NOSTRO/VOSTRO/LORO accounts

g. Balance of Payments

Q2. Write short notes on the following

a. Balance of Payment as representative of Demand-Supply factors for foreign currencies.

b. Factors affecting demand for and supply of foreign currencies

c. Factors influencing foreign exchange rates

d. Benefits of BOP analysis.

Q3. Answer in detail

a. The Current Account of the BoP is the key to establishing foreign currency demand/supply equilibrium. Discuss.

b. Distinguish between Autonomous and Accommodating flows.

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14

FOREIGN EXCHANGE RATE

Unit Structure

14.0 LEARNING OUTCOMES

After reading this chapter, a learner will be able to understand:

- Direct, Indirect and Cross Rates
- The meaning of Vehicle currency
- How to calculate spread, spread percentage
- Meaning of arbitrage, speculation and trading
- How the rates are classified according to the settlement dates
- The meaning of Holgate's Principle.

14.1 EXCHANGE RATE QUOTATIONS

The foreign exchange market includes end-users (individuals and corporate) commercial banks, brokers, Central Banks and Service Providers such as:

- Interbank Messaging Service Providers: SWIFT etc.
- Information Service Providers: Reuters, Telerate, Bloomberg etc.

The foreign exchange market provides the environment for establishing the demand and supply equilibrium between currencies based on which the rate of conversion is established. These conversion rates are called 'Foreign Exchange Rates' or 'Exchange Rates'. Thus the rate of exchange for a currency is known from the quotation in the forex market. All foreign exchange transactions operate through the banking system and therefore, the banks operating at a financial centre, and dealing in foreign exchange, constitute/represent the foreign exchange market. The rates in the foreign exchange market are determined by the interaction of the forces of demand for and supply of the commodity dealt in, viz: foreign exchange.

SOME IMPORTATNT CURRENCIES REGULARLY QUOTED IN India

COUNTRY	CURRENCY	ABBREVIATION	SYMBOL
USA	US Dollar	USD	$
UK	Pound Sterling	GBP	£
Japan	Japanese Yen	JPY	¥
Euro-Area	Euro	EUR	€
Indian	Indian Rupee	INR	
Switzerland	Swiss Franc	CHF	SFr
Canada	Canadian Dollar	CAD	C$
Australia	Australian Dollar	AUD	A$
Singapore	Singaporean Dollar	SGD	S$
Sweden	Swedish Kroner	SEK	SKr
Germany	Deutsche Mark	DEM	Dm
France	French Franc	FRF	FFr

(Deutsche Marks and French Francs are not in use now).

Generally, the above abbreviations have been used for all numerical examples in this book.

14.2 FOREIGN EXCHANGE RATE CONVENTION

A foreign exchange rate is an equality which provides a relationship between two currencies. 1 USD = INR 56.0625 - 56.0650 is conventionally written as USD/INR 56.0625 - 56.0650. (USD = base currency and INR = variable currency). A rate therefore represents the value of the base currency expressed in terms of the variable currency.

Currencies are bought and sold against one another. Each currency pair therefore constitutes an individual product. ISO 4217 provides unique three-letter abbreviations (codes) for each currency which are internationally used. A rate expressed as EUR/USD is the price of the EURO expressed in US dollars, as in 1 euro = 1.2835 US dollars. The LHS (Left Hand Side) currency in the pair is the base currency, whereas the RHS (Right Hand Side) currency is the counter, quoted or variable currency. Representation of rates in this form is called as the ACI convention.

Note:

Exchange rates are represented under different conventions. Some patterns are as follows:

1 USD = INR 56.0625 - 56.0650

INR 56.0625 - 56.0650 per USD

INR 56.0625 - 56.0650 / USD

INR 56.0625 - 56.0650 = 1 USD

Students should rewrite the quotations as per desired convention. In this book the ISO 4217 abbreviations for currencies and the ACI conventions for exchange rates will be followed i.e Base currency / variable currency.

CLASSIFICATIN OF RATES: (DIRECT, INDIRECT AND CROSS RATES)

A foreign exchange rate which provides a relationship between fixed number of units of foreign currency against variable number of units of domestic currency is called a direct rate. {This format of expressing exchange rates is operative in India since August 1993}. In such rates the foreign currency acts as the base currency whereas the domestic currency acts as the variable currency.

A foreign exchange rate which provides a relationship between fixed number of units of domestic currency against variable number of units of foreign currency is called an Indirect rate {This form of expressing exchange rates prevailed in India prior to August 1993}. In such rates the domestic currency acts as the base currency whereas the foreign currency acts as the variable currency.

A foreign exchange rate which provides a relationship between two non-domestic currencies is called a cross currency rate. Eg.

Quotation	India	USA	Japan
USD/INR	Direct	Indirect	Cross-currency
INR/USD	Indirect	Direct	Cross-currency

Direct, Indirect and Cross Currency rates are therefore a function of location and the location of the quotation must always be indicated when classifying rates.

14.3 DISTINCTION BETWEEN DIRECT AND INDIRECT RATES

DIRECT RATES	INDIRECT RATES
1. Foreign exchange rates which represent a relationship between a fixed number of units of foreign currency against variable number of units of domestic currency are called Direct Rates.	Foreign exchange rates which represent a relationship between a fixed number of units of domestic currency against variable number of units of foreign currency are called Indirect Rates.
2. An example of a direct rate in India would be: 1 USD = INR 58.3825 - 58.3850	An example of an indirect rate in India would be: 100INR = USD 2.0605 - 2.0610
3. Direct rates were introduced in India effective from 2nd August, 1993.	Indirect rates were used in India from 1971 up to 2nd August, 1993.
4. When trading in foreign currency with the use of direct rates, the strategy used is 'Buy low - Sell High'.	4. When trading in foreign currency using indirect rates, the strategy used is 'Buy high - Sell low'.
5. Direct rates are generally expressed in India to the base of 1 unit of foreign currency except Japanese Yen whose relationship is expressed to the base of 100 units.	Indirect rates in India were expressed to the base of 100 INR.
6. In the US market, direct rates are called 'Rates on American Terms'.	In the US market, indirect rates are called 'Rates on European terms'.
7. An example of a quotation on American terms would be: 1GBP = USD 1.7675 - 1.7685	An example of a rate on European terms would be: 1USD = CHF 1..2950 - 1.2960
8. In the case of direct rates, the base currency is always a foreign currency while variable currency is always the domestic currency.	In the case of indirect rates, the base currency is always domestic currency while variable currency is always a foreign currency.

14.4 CHARACTERISTICS OF EXCHANGE RATES

1. Foreign exchange rates are quoted by banks on a two-way basis e.g. USD / INR 56.0675 - 56.0680.
2. The LHS rate in the quotation is called BID rate and represents the rate at which the bank would buy one unit of the base currency (USD).
3. The RHS rate in the quotation is called ASK or OFFER rate and represents the rate at which the bank would sell one unit of the base currency. (USD).
4. The difference between the Ask and Bid rates, in a given quotation is called the spread. Therefore spread is denoted as (ASK - BID). Since ASK > BID, the spread is always positive.
5. Foreign exchange rates are normally quoted up-to two or four decimal places. In India the general practice in the inter-bank market is to quote rates up to four decimal places.
6. Foreign exchange rates are always expressed to the base of 1, 10, 100 or 1000 units of base currency. In India, rates are expressed either to the base of 1 unit or 100 units of base currency.
7. Unless otherwise specified, an inter-bank quotation in India is usually valid for USD 1 million.
8. Percentage spread = Spread÷Mean Rate X 100 = ASK - BID÷ASK + BID/2 X 100 = ASK - BID÷ASK + BID X 200

FACTORS WHICH INFLUENCE SPREAD RATE

- Transaction cost (This includes brokerage, operating expenses and correspondent bank charges).
- Volatility in the market (Higher the volatility, wider will be the spread and vice versa etc.)
- Depth of the market (Depth of the market is associated with volume available for covering the transaction. Greater the depth, narrower will be the spread and vice versa).
- Exchange control regulations (The RBI does not specify any minimum or maximum spread for quotations in India

SIGNIFICANCE OF SPREAD TO END USERS

%age spread of cross rate = %age spread of vehicle currency quotation + %age spread of cross currency quotation.

Effectively this means that the fineness of a foreign exchange quotation decreases for the end user when the transaction is undertaken in any currency other than the vehicle currency. The spread therefore represents a level of safety for the person making the quotation whereas it represents cost to the person using the quotation.

Thus the spread represents the nominal difference between the 'ASK' and 'BID' rates of a quotation whereas the % age spread helps to compare the fineness of different quotations.

CALCULATION OF % SPREAD AND CROSS RATES

RULES:

1. When rates are provided in any form other than the ACI Convention, the given data may be reconstructed as per ACI Convention and a remark to that effect may be made in the solution.

2. When a quotation is to be derived with INR as base currency then it should always be calculated for 100 units of INR.

3. Mean Rate, Mid-Rate, Average Rate and Flat Rate all mean the same.

4. The terms 'PIPS' and 'POINTS' can be used interchangeably in the context of exchange rates. They represent the last decimal place of a conventionally expressed exchange rate. They represent the smallest increase or decrease in the rate. In the Indian foreign exchange market, rates are quoted to the fourth decimal point. Thus 1 'pip' would be 1% of the small currency unit = 1/100th of the small currency unit = 1/100 X 1/100 = 1/10000th of major currency unit. Therefore INR 46.3825 can be interpreted as 46 rupees, 39 paisa, 25 pips.

5. Therefore to convert pips / points to rate we divide by 10, 000 and to convert rate to pips / points we multiply by 10, 000.

6. As previously indicated, foreign exchange rates may be quoted to two or four decimal places. If the given data shows rates in a two decimal form the multiplication or division factor would be 100.

7. Identification of country in 'Direct' form is done by identifying the country of variable currency and identification of country in 'Indirect' form is done by indentifying the country of the base country.

8. A 'Basis Point' can be defined as last decimal place of a conventionally written interest rate. Since interest rates are quoted to two decimal places 1 Basis Point = 1/100 of 1% = 1/100 of the rate. If the interest rate changes from 2.25% to 2.50% then change = 25 Basis Points.

SOLVED EXAMPLES

1. USD / INR 53.8425 - 75
GBP / USD 1.5365 - 75
Calculate GBP/INR quotation.

Solution

$(GBP/INR)_B = (GBP/USD)_B$ X $(USD/INR)_B$
= 1.5365 X 53.8475
= 82.7290
$(GBP/INR)_A = (GBP/USD)_A$ X $(USD/INR)_A$
= 1.5375 X 53.8475
= 82.7905
QUOTATION: GBP / INR 82.7290 - 82.7905

2. Given: USD/SEK 6.4750 - 6.4850
Calculate % spread.

Solution

% Spread = ASK - BID÷ASK + BID X 200
= 6.4850 - 6.4750÷6.4850 + 6.4750 X 200
= 0.0100÷12.9600 X 200
= 00.1543%.

3. Given: GBP/USD Mid rate 1.5316
Spread = 0.0012
Calculate % spread.

Solution

% Spread = Spread ÷ Mean Rate X 100
= 0.0012 ÷ 1.5316 X 100
= 0.0783%
NOTE: Mean rate, Mid rate, Average Rate and Flat Rate all mean the same.

4. A bank in New York quotes: GBP/USD 1.5493-03
a. Is this an 'American' or 'European' quote.
b. Find Mean rate, spread and spread percentage.
c. Calculate the Inverse quote.

Solution

a. Given quote is an 'American' quote.

b. Mean Rate = ASK + BID ÷ 2 = 1.5503 + 1.5493 ÷ 2 = 1.5498.

Spread = ASK - BID = 1.5503 - 1.5493 = 0.0010

Spread Percentage = Spread ÷ Mean Rate X 100
= 0.0010 ÷ 1.5498 X 100
= 0.0645%

c. $(USD/GBP)_B$ = 1 ÷ 1.5503 = 0.6450

$(USD/GBP)_A$ = 1 ÷ 1.5493 = 0.6455

Therefore, inverse quote: USD/GBP 0.6450 - 0.6455.

14.5 ARBITRAGE, SPECULATION AND TRADING

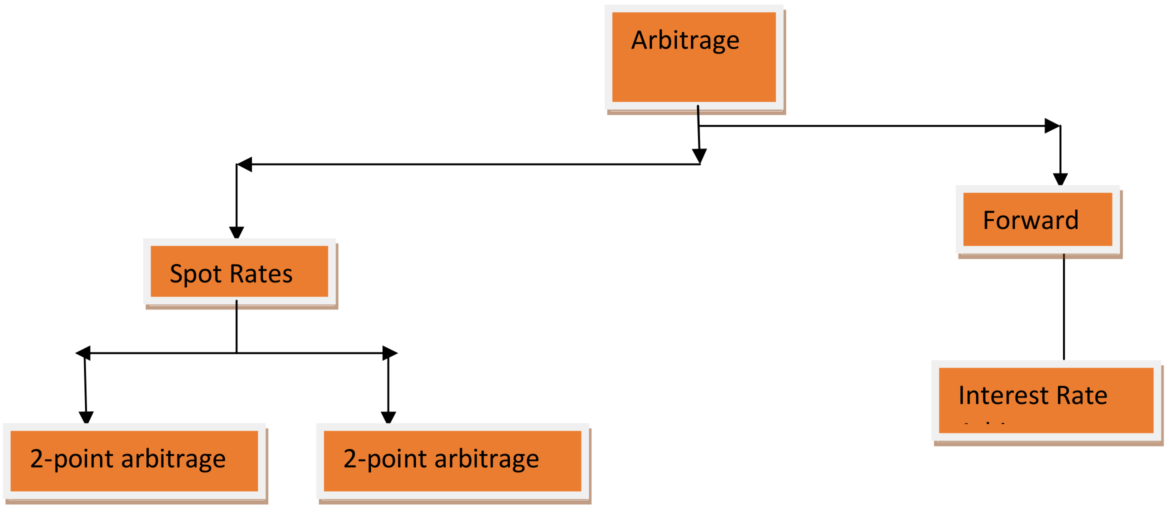
Arbitrage can be defined as an operation which involves simultaneous purchase and sale of equal quantity of asset or currency with the intention of deriving risk-free profit out of imperfect quotations in one or more markets.

An arbitrageur is an entity who identifies an opportunity for arbitrage and derives profit from it. Arbitrageurs are not market makers and therefore do not provide any quotations. They only utilize quotations made by others and profit from them.

Arbitrage operations help to equalize prices and remove imperfections. There are no arbitrage possibilities in a perfect market. The volume and profit of arbitrage transactions is market dependent. The arbitrageur does not use his/her assessment in this operation.

Factors which lead to arbitrage opportunities are:
1. Sudden imbalance in demand - supply equilibrium.
2. Time zone factors
3. Information arbitrage
4. Exchange control regulations.

The various types of arbitrage can be classified as follows:



- 2-point arbitrage is also called as Geographical Arbitrage and it involves 2 currencies.
- 3 - point arbitrage is also called as Triangular Arbitrage and it involves 3 currencies.

SPECULATION

Speculation can be defined as an operation which involves buying and selling of equal amounts of base currency, security or asset at two different times so as to derive profit from favourable rate movement in the interim period. Speculation involves a deliberate acceptance of risk since the anticipated rate movement may not materialise. Speculation may therefore result in either profit or loss depending on the accuracy of the speculators view or judgement. Entities who undertake such operations are called speculators. These entities normally operate contrary to market views and therefore help to provide liquidity in the market when critically needed.

While the volume of arbitrage operations depend on the opportunities provided by the market, the volume of speculative transactions depend on the resources of the speculators and the conviction of their view on rate movements. Speculation requires a high level of technical knowledge of the underlying asset.

TRADING

Trading can be defined as an operation involving buying and selling of currencies, securities, assets etc. through a process of continuously quoting two-way prices providing an instant entry - exit opportunity to all other participants in the market. Entities who undertake such operations are called traders or dealers. They are market makers since their presence ensures availability of entry - exit prices at all times during market hours. These entities help to make the market liquid and generally deliver the larger volumes of operations in the market. Traders are therefore both buyers and sellers at all times and act as 'buyer' for all sellers and as 'seller' for all buyers coming to the market. They provide continuity to the price discovery process.

14.6 CLASSIFICATION OF RATES IN TERMS OF SETTLEMENT

The function of quoting exchange rates is performed only by banks. However, they quote rates at two levels:

a. To their customers - such rates are called 'Merchant Rates' and involve an addition or subtraction of Exchange Margin which represents profit margin, transaction handling commission and overhead expenses. These rates are classified in terms of nature of transaction undertaken; and

b. To other banks - such rates are called 'Interbank Rates' and are used to settle interbank contracts. The various rates discussed so far represent interbank rates. These rates are classified in terms of their settlement maturities.

Interbank Foreign exchange transactions do not involve any pre/post payment of either currency. In all sale/purchase transactions the two currencies are always exchanged on the same calendar date but at two different times. The time difference is due to time - zone factors. This concept is called the Principle of Compensated Value.

Contract Date - The date on which the two counter parties to a foreign exchange contract agree to the currencies to be bought/sold, the rate of conversion, the amount and the settlement date is called the contract date. Represented as 'C'.

The settlement of any transaction takes place through transfers of deposits between the two contracting parties. The date on which the actual transfer/exchange of currencies takes place is called the settlement date or the value date. To effect the transfers, the correspondent banks in the countries of the two currencies involved must be open for business. The concerned countries are called settlement locations. The locations of the two principal banks involved in the trade are called dealing locations, which need not be the same as the settlement locations.

There are four different maturities possible in interbank contracts:

Contract Date	Settlement Date	Classification
C	C + O	Cash or value today
C	C + 1	Tom or value tomorrow
C	C + 2	Spot
C	C + 3 onwards	Forward

(C = Contract Date)

Cash Contracts

Foreign exchange contracts which provide for settlement on the contract date itself called 'cash' or 'value today' contracts and the rate applicable to them are called 'Cash' or 'Ready' rates. Such contracts are represented as C + O. The rates for such transactions are derived from the ongoing spot rates. It is not possible to deal on 'cash' basis in all currencies due to time zone limitations.

Tom Contracts

Foreign exchange contracts which provide for settlement on the first working day after the contract day are called Tom or Value tomorrow contracts and are represented as C + 1. The rates applicable to such contracts are called Tom rates. Rates for such transactions are derived from the ongoing spot rate. It is possible to deal on 'Tom' basis in all currencies.

Spot Contracts

A foreign exchange transaction which involves settlement of currencies on the second working day after the contract date is called a spot contract and the rate applicable to such contracts is called the spot rate. The Spot rate represents the standard conversion value between a given pair of currencies which is indicative of the relative strength and weakness of the respective currencies. Rates for all other settlement maturities are derived from the sport rate by adding or subtracting a factor called swap margin. The increase or decrease in the spot rate indicates the appreciation or depreciation in the base currency. Such contracts are represented as C + 2.

Forward Contracts

Foreign exchange transactions in which the counter parties agree to a settlement beyond the spot date are called 'Forward transactions' or 'forward contracts'. Rates applicable to such transactions are called 'Forward rates'. Forward rates are derived from the Spot Rates by adding or subtracting a factor called Forward Margin. Forward Margin represents the interest differential between the two currencies for the given maturity. Forwards margins are also referred to as SWAP POINTS or SWAP MARGINS.

Forward Margins

They can be classified as either PREMIUMS or DISCOUNTS. When the interest rate of the variable currency is more than the interest rate of the base currency, the forward margin is added to the spot rate to arrive at the forward rate. Such margins are called PREMIUMS on base currency. When the interest rate of the variable currency is less than the interest rate of the base currency, the forward margin is subtracted from the spot rate to arrive at the forward rate. Such margins are called DISCOUNTS on base currency.

The value of a currency is represented by the spot rate. The forward rate being higher or lower than the corresponding spot rate does not signify appreciation or depreciation of the currency. The difference between the forward and the spot rate signifies the compensation being exchanged between the two parties for the difference in the interest rates for the given forward period. Effectively it compensates the net opportunity cost in terms of interest rates.

When the buyer compensates the seller it results in premium that is the forward rate is greater than the spot rate whereas when the seller compensates the buyer it results in discount that is the forward rate is lesser than the spot rate. The premium / discount is thus always viewed in the context of the base currency.

HOLGATE'S PRINCIPLE

This principle states that -

1. Premium on base currency is always added whereas discount on base currency is always subtracted from the spot rate to arrive at the corresponding forward rate.

2. Premium on base currency implies discount on variable currency and discount on base currency implies premium on variable currency.

EXPLANATION

Consider a situation where Bank A and Bank B contract with each other that Bank A would buy USD 1 million from Bank B @ INR 64.6800. If the contract day is Wednesday 19th May 2015, then in the ordinary course the settlement would take place on the spot day i.e Friday 21st May 2015. Now, if the two banks agree to postpone the settlement to Monday 21 June 2015 i.e by one month, then Bank B will be able to deposit USD 1 million for one month and earn interest. However, they will be deprived of INR funds for one month and would on an opportunity basis lose the interest on INR funds. If INR interest rate is more than USD interest rate, Bank B suffers an opportunity loss equivalent to the difference in the interest rates of the two currencies for one month. Suppose this loss = X then Bank B would expect Bank A not only to pay the spot price but also compensate for the loss = X. The effective rate for the contract would thus be 64.6800 + X. Similarly, if INR interest rate is less than USD interest rate, then Bank A would expect to be compensated for opportunity loss. In that case the effective contract rate would be 64.6800 - X. The factor 'X' in the example represents forward margin. When the factor is added to the spot rate it is called 'Premium' whereas when the factor is subtracted from the spot rate it is called 'Discount'.

FORWARD RATES THEREFORE REPRESENT THE CONNECTING LINK BETWEEN EXCHANGE RATES AND INTEREST RATES.

SUMMARY

a. The foreign exchange market includes end-users (individuals and corporate) commercial banks, brokers, Central Banks and Service Providers such as:

- Interbank Messaging Service Providers: SWIFT etc.
- Information Service Providers: Reuters, Telerate, Bloomberg etc.

b. A foreign exchange rate is an equality which provides a relationship between two currencies. 1 USD = INR 56.0625 - 56.0650 is conventionally written as USD/INR 56.0625 - 56.0650. (USD = base currency and INR = variable currency). A rate therefore represents the value of the base currency expressed in terms of the variable currency.

c. A foreign exchange rate which provides a relationship between fixed number of units of foreign currency against variable number of units of domestic currency is called a direct rate

d. A foreign exchange rate which provides a relationship between fixed number of units of domestic currency against variable number of units of foreign currency is called an Indirect rate.

e. A foreign exchange rate which provides a relationship between two non-domestic currencies is called a cross currency rate.

f. Arbitrage can be defined as an operation which involves simultaneous purchase and sale of equal quantity of asset or currency with the intention of deriving risk-free profit out of imperfect quotations in one or more markets.

g. Speculation can be defined as an operation which involves buying and selling of equal amounts of base currency, security or asset at two different times so as to derive profit from favourable rate movement in the interim period.

h. Trading can be defined as an operation involving buying and selling of currencies, securities, assets etc. through a process of continuously quoting two-way prices providing an instant entry - exit opportunity to all other participants in the market. Entities who undertake such operations are called traders or dealers.

i. Interbank Foreign exchange transactions do not involve any pre/post payment of either currency. In all sale/purchase transactions the two currencies are always exchanged on the same calendar date but at two different times. The time difference is due to time - zone factors. This concept is called the Principle of Compensated Value.

j. Holgate's Principle states that:
1. Premium on base currency is always added whereas discount on base currency is always subtracted from the spot rate to arrive at the corresponding forward rate.

2. Premium on base currency implies discount on variable currency and discount on base currency implies premium on variable currency.

QUESTIONS

Q1. Explain the following concepts:
a. Foreign Exchange Rates
b. Direct Rates, Indirect Rates and cross rates.
c. Spread and % spread
d. Arbitrage, Speculation and trading
e. Settlement value / date
f. Holgate Principle

Q2. Write short notes on the following:

a. Foreign exchange market

b. Arbitrage, speculation and trading

Q3. Distinguish between the following:

a. Direct and indirect rates

b. Arbitrage and speculation

c. Speculation and trading

Q4. Answer in detail the following:

a. Define forward rates. Explain the concept of Premiums and Discounts in the context of Holgate's Principle.

b. The term 'Cash Contract' does not refer to currencies in physical cash form. Discuss.

c. A market is imperfect without the presence of market makers. Explain the importance of Foreign Exchange traders.

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15

CURRENCY CONVERTIBILITY

Unit Structure

15.1 INTRODUCTION

Floating of a currency is a pre-requisite to convertibility of a currency. While floating deals with the method used to establish the value of the currency, convertibility deals with the operational ease with which domestic currency is allowed to be converted into foreign currency. Convertibility therefore represents procedural simplification of foreign exchange transactions for persons dealing in a currency.

Although the INR was floated, which means market demand / supply factors would determine the exchange rate, the transactions constituting the demand / supply continued to be controlled by the RBI. Most transactions required licenses or permits from RBI. Effectively, the RBI controlled the elements forming the demand / supply for the foreign currencies. If the exchange rate determined by the market was to truly represent the economy, then it was essential to free the transactions constituting the demand and supply for foreign currencies.

Foreign Exchange transactions arising in an economy can be broadly classified as:

1. Export and Import of goods and services.
2. Personal remittances.
3. Investments and Redemptions.
4. Borrowing and Lending.

All the above transactions pertaining to an economy over a given period are captured in the Balance of Payments Account (BoP) for the country. All the above transactions get recorded in either the Current or the Capital Accounts in the BoP. The concept of convertibility is thus viewed at two levels: Current Account Convertibility and Capital Account Convertibility (CAC).

15.2 CURRENT ACCOUNT CONVERTIBILITY

In August 1994, the INR was made convertible on current account transactions. This means that all impediments such as licensing etc. were removed in so far as foreign exchange transactions involved purchase / sale of foreign currencies for permitted imports and exports of goods and services. Convertibility does not mean unlimited ability to convert domestic currency. Limits were placed on conversion allowed for several categories of activities. Ex., Currently, each resident individual is permitted to purchase foreign currencies only to the extent of USD 10000 per calendar year for international tourism described as Basic Travel Quota.

The Current Account of the Balance of Payments represents the cash / ready transactions which have an immediate impact on the demand - supply equilibrium. Making the INR convertible on Current Account thus implies that not only is the currency valued by the market but the factors contributing to the rate determination are also decontrolled thereby ensuring that the exchange rate truly represents the economic status of the currency.

15.3 CAPITAL ACCOUNT CONVERTIBILITY (CAC)

In 1997, a committee headed by Mr. S. S. Tarapore, the Deputy Governor of RBI, was constituted to recommend step-wise implementation of capital account convertibility (CAC). The recommendations of this committee could not be implemented because of international developments such as the South East Asian Crisis, currency failures in Brazil and Russia and events such as 11th September, 2001 in the USA.

While there is no formal definition of CAC the committee under the chairmanship of Mr. S. S. Tarapore defined CAC as the freedom to convert local financial assets into foreign financial assets and vice-a-versa at market determined rates of exchange. It is associated with changes of ownership in foreign / domestic financial assets and liabilities in the form of Receivables and Payables and involves the creation and liquidation of claims on or by, non-resident entities.

The critical preconditions specified by the committee in the 'road-map' for introducing CAC were:

- Fiscal consolidation.
- Control of inflation within targeted levels.
- Strengthening of the Financial System.
- Maintenance of domestic economic stability.
- Adequate foreign exchange reserves.
- Restrictions on inessential imports.
- Comfortable current account position.
- An appropriate industrial policy and a friendly investment climate.

The International developments between 1997 and 2001 showed that CAC is a double-edged sword. Outflow of capital from economies which had introduced CAC, created serious problems for their regulators as well as domestic market participants. India therefore took a conscious decision to modify their approach to CAC and gradually move towards 'Fuller Capital Account Convertibility'. This means that the INR would be made convertible on Capital Account in stages only to the desired extent.

A second committee to suggest a road map for achieving 'Fuller Capital Account Convertibility' was constituted. The recommendations of this committee received in 2006, will be implemented by the RBI in a phased manner so as to achieve the desired level of CAC by 2011-12.

In the interim period, the RBI has progressively allowed greater freedom in capital transactions. Some of these relaxations are:

a. Individual residents are permitted to invest up to USD 75, 000 in international securities.

b. Individual residents are permitted to establish non-interest bearing accounts in specified currencies with banks in India. (Resident Foreign Currency Accounts).

c. In a gradual manner, the RBI has allowed Indian Corporate entities to raise resources and invest overseas in higher quantities.

d. Branches of Indian Banks located in SEZ's (Special Economic Zones) are permitted to conduct banking operations, i.e., accept deposits and give loans, in non-resident currencies (Offshore banking) Bank branches undertaking such operations are accorded the status of Offshore Banking Units (OBU's).

15.4 PRO's AND CON's OF CURRENCY CONVERTIBILITY

PRO's

- It represents confidence of the country in maintaining a stable Balance of Payments position.
- It assures international investors about being able to exit their investments without any restrictions.
- It provides domestic entities with access to international financial markets and wider avenues for investments.
- It ensures that the forward market is in conformity with the Interest Parity Condition. Domestic participants are better placed to gain from arbitrage opportunities.
- It promotes Foreign Direct and Portfolio Investments which results in higher economic growth and employment generation.
- It provides greater depth to both the domestic foreign exchange market and the derivatives market. It eliminates unregulated markets such as the NDF (Non Deliverable Forward) Market.

CON's

- It makes the economy vulnerable to withdrawal of capital by both residents and non-residents.
- Exchange rate tends to be more volatile due to larger volumes of transactions.
- The economy becomes susceptible to international 'Hot Money' flows which have a disruptive effect on both the foreign exchange and capital markets.
- Greater integration with the global economy increases the influence of international events on the domestic economy. This was proved during the recent global recession of 2007-2009.
- Integration with the global economy results in domestic product prices getting aligned to International prices which increases

inflation risk. (Purchasing Power Parity effect is more pronounced).

- International capital has greater influence on domestic matters. The domestic economy becomes more dependent on foreign capital.

15.5 CURRENT STATUS OF EXCHANGE RATE MECHANISM IN INDIA

Currency Convertibility

The current status of the INR is that it is fully convertible on current account transactions and partially convertible on capital account transactions. The limitations in capital account transactions apply only to residents and not to non-residents which means that for non-resident entities the INR is for all practical purposes, fully convertible subject to quantitative sector-wise limits for investments.

Currency valuation

As regards the currency valuation process, the INR is fully floated effective from March 1993. However, the RBI has adopted the 'Managed Float Mechanism' to control the external value of the INR. This means that the vehicle currency quotation USD / INR is established through market demand / supply factors but the RBI intervenes periodically when market conditions warrant such interventions. The advantages of this approach are:

a. Volatility in the exchange rate is controlled.

b. Stability in the exchange rate assures international investors since it protects them against exchange rate risk.

c. Stability in the exchange rate enables domestic importers and exporters to factor possible rate changes in their trade transactions.

d. It helps to control speculation.

15.6 CO-RELATION BETWEEN CURRENCY CONVERTIBILITY AND EXCHANGE CONTROL

The FEMA clearly defines both current and capital transaction and broadly classifies current account transactions under four categories:

a. Freely permitted transactions.
b. Prohibited transactions.
c. Transactions requiring prior approval of the Central Government. and
d. Transactions requiring prior approval of the RBI which are in excess of the quantitative limits allowed under the act.

This classification shows that quantitative limits would continue to operate for permitted transactions. Exchange control in the current account context therefore means various limits imposed on the purchase / sale of foreign currency by residents and the purchase / sale of domestic currency by non-residents. Further, the FEMA also prohibits private transactions in, and possession of, foreign currency by residents. It also requires all foreign exchange transactions to be conducted through authorised persons.

Effectively, what exchange control does is to channelise all foreign currency transactions through identified entities and prioritise the use of scare foreign currency resources so that the country has adequate resources for critical imports. The benefits of exchange control are:

a. It protects scare foreign currency resources.
b. It helps to control the current account deficit in the BoP.
c. It consequently reduces the debt burden on the country.
d. It helps in making suitable policy changes.
e. It reduces the need for intervention and thereby helps in better reserve management.
f. It helps in proper economic planning.

As regards Capital Account transactions, the RBI regulations provide for general permissions / automatic routes for investments in India by non-residents, as well as investments and borrowings overseas by residents, etc. The control aspect covers sector-wise permissions and investment limits within sectors. Since the RBI is the recipient of all market data, it guides the government on policy changes pertaining to Foreign Direct Investment and Foreign Portfolio Investments.

The philosophy of FEMA in the context of this issue is that "all BOP Current account transactions are permitted unless specifically prohibited whereas all BOP Capital account transactions are prohibited unless specifically permitted."

SUMMARY

- Floating of a currency is a pre-requisite to convertibility of a currency. While floating deals with the method used to establish the value of the currency, convertibility deals with the operational ease with which domestic currency is allowed to be converted into foreign currency. Convertibility therefore represents procedural simplification of foreign exchange transactions for persons dealing in a currency.

- Foreign Exchange transactions arising in an economy can be broadly classified as:
    1. Export and Import of goods and services.
    2. Personal remittances.
    3. Investments and Redemptions.
    4. Borrowing and Lending.

- In August 1994, the INR was made convertible on current account transactions. This means that all impediments such as licensing etc. were removed in so far as foreign exchange transactions involved purchase / sale of foreign currencies for permitted imports and exports of goods and services.
- In 1997, a committee headed by Mr. S. S. Tarapore, the Deputy Governor of RBI, was constituted to recommend step-wise implementation of capital account convertibility (CAC).

The critical preconditions specified by the committee in the 'road-map' for introducing CAC were:

a. Fiscal consolidation.
b. Control of inflation within targeted levels.
c. Strengthening of the Financial System.
d. Maintenance of domestic economic stability.
e. Adequate foreign exchange reserves.
f. Restrictions on inessential imports.
g. Comfortable current account position.
h. An appropriate industrial policy and a friendly investment climate.

- The current status of the INR is that it is fully convertible on current account transactions and partially convertible on capital account transactions.

- As regards the currency valuation process, the INR is fully floated effective from March 1993. However, the RBI has adopted the 'Managed Float Mechanism' to control the external value of the INR.

- The FEMA clearly defines both current and capital transaction and broadly classifies current account transactions under four categories:

  a. Freely permitted transactions.
  b. Prohibited transactions.
  c. Transactions requiring prior approval of the Central Government. and
  d. Transactions requiring prior approval of the RBI which are in excess of the quantitative limits allowed under the act.

QUESTIONS

Q1. Write Short notes on the following:

1. Convertibility of a currency is a two-edged sword, why?
2. Discuss the issue of Convertibility of INR.
3. Describe in detail the step-wise progress towards Convertibility of INR.

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